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The International Comparative Legal Guide to:

Securitisation 2019

12th Edition

A practical cross-border insight into securitisation work

Published by Global Legal Group, with contributions from:

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Published by
Global Legal Group Ltd.
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Fax: +44 20 7407 5255
Email: info@glgroup.co.uk
URL: www.glgroup.co.uk

GLG Cover Design
F&F Studio Design

GLG Cover Image Source
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Printed by
Ashford Colour Press Ltd
June 2019

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ISBN 978-1-912509-74-4
ISSN 1745-7661

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This publication is intended to give an indication of legal issues upon which you may need advice. Full legal advice should be taken from a qualified professional when dealing with specific situations.

PREFACE

On behalf of Latham & Watkins, I would like to thank Global Legal Group for their efforts in publishing the 12th edition of *The International Comparative Legal Guide to: Securitisation*.

Maintaining an accurate and up-to-date guide regarding relevant practices and legislation in a variety of jurisdictions is critical, and the 2019 edition of this *Guide* accomplishes that objective by providing global businesses, in-house counsel, and international legal practitioners with ready access to important information regarding the legislative frameworks for securitisation in 26 individual jurisdictions.

The invitation to participate in this publication was well received by the world's leading law firms, thereby validating the continued growth and interest in securitisation around the world. We thank the authors for so generously sharing their knowledge and expertise, and for making this publication so valuable a contribution to our profession. The *Guide*'s first 11 editions established it as one of the most comprehensive guides in the practice of securitisation. On behalf of Latham & Watkins, I am delighted to serve as the *Guide*'s contributing editor and hope that you find this edition both useful and enlightening.

Sanjev Warna-kula-suriya

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Securitization as an Integral Part of a Corporate Capital Structure

Shearman & Sterling LLP

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Corporate borrowers are increasingly using securitizations to optimize their debt structure. Securitization allows companies to use assets that are only given limited lending value in traditional corporate loans, to obtain financing in the investment grade asset-based lending market. As such, securitizations may diversify a company's lender group, reduce borrowing cost, and increase borrowing capacity. The non-recourse nature and the segregation of the assets that are subject to securitization also provide for a good interface with traditional corporate debt facilities, whether in the form of investment grade bonds or secured leveraged loans.

Securitizations can be used to finance a wide range of assets and receivables generated by such assets, including trade receivables, secured and unsecured loans, leases, royalty payments and other licensing fees. Securitizations can finance assets with a single payment stream or with a broadly diversified pool of receivables. The value proposition that securitizations may offer a corporate borrower will depend on a number of factors, including the types of assets available for securitizations, the rating of the company, its alternative borrowing availibility and costs and the quality of its receivables.

Companies with captive finance companies or significant embedded seller financing, may find that its pool of receivables is similar in scope and diversification to what would be a typical securitization by a financial lending institution. However, securitization of trade receivables and non-financial assets present several unique issues. This chapter summarizes some of the issues that a corporate borrower contemplating securitizations may want to consider. The first part of this chapter looks at the rights of set-off and recoupment that a company's customer may have and how such rights may affect the company's trade receivables. The second part of this chapter discusses the extent to which securitization of various assets will fit within the company's existing corporate debt structure. However, first, it is worth summarizing at a high level the salient features of typical securitization structures as well as typical bond and credit agreement covenants that may impact particular securitization transactions.

Summary of Securitization Features and Relevant Debt Covenants

a. Securitizations – a summary of key features

Securitization, at its core, involves isolating the asset to be securitized from the credit risk of the originator and other affiliates of the securitization issuer and obtaining financing secured and serviced by such assets. Typically, such asset isolation will be effected by transferring the relevant assets in a "true sale" to a "bankruptcy remote" special purpose entity ("SPE"). True sale is a legal and accounting concept intended to capture a transfer that will be respected in a potential bankruptcy of the transferor, such that the transferred assets would not be part of the transferor's estate if the transferor were to become subject to bankruptcy proceedings. That analysis hinges on whether the attributes of the transaction have more in common with a sale than a secured loan. Not surprisingly, the more attributes the relevant transfer has in common with a typical sale transaction, the more likely it is that a court will determine the transfer to be a true sale. Conversely, the more the transaction includes features that are more typical of a loan transaction, the greater the likelihood that the transaction would be characterized as a loan.

Effectuating a true sale to an SPE that is affiliated with the transferor would not be of much use in effectuating isolation of the assets, if the SPE itself would be likely to file for bankruptcy protection or be consolidated with the transferor as part of the transferor's bankruptcy proceedings. It is therefore typical to include various features in the SPE's charter and the relevant transaction's documents to limit the likelihood that the SPE itself will seek voluntary bankruptcy protection or that the transaction creditors of the SPE would seek to involuntarily put the SPE into bankruptcy. In addition, in order to avoid the SPE from becoming part of its affiliates' bankruptcy proceedings through the equitable substantive consolidation doctrine, the SPE will also be subject to a number of separateness provisions intended to limit activities of the SPE and to ensure that its separate legal existence is respected by its affiliates and its creditors. The formulation of the substantive consolidation analysis used by the courts varies somewhat between the U.S. circuits. Generally, each formulation reflects the concept that the separateness of the SPE should be respected where it has been treated as a separate entity by its affiliates and the reasonable expectations of the investors in the SPE and the investors in its affiliates, is that the assets of the SPE are not available to support the credit of the SPE's affiliates.

Securitization structures are typically able to issue debt with credit ratings significantly higher than that of its sponsor. In part, because of the credit isolation, and in part because of other available credit enhancements. Such credit enhancements may include some or all of the following:

(a) bankruptcy remoteness;

(b) tranching of debt;

(c) overcollateralization reflecting the amount of collateral in excess of the relevant debt obligation (i.e. the SPE's equity in

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case of the SPE's lowest tranche of debt, and the sum of the equity and each subordinated tranche of debt in the case of any senior debt tranches);

(d) excess spread, reflecting any excess in the amount of periodic payments over the amounts required to service the relevant debt;

(e) diversification of payment risk by virtue of pool of collateral; and

(f) amortization triggers that trap cash and accelerate the pay down.

b. Typical corporate debt covenants

Corporate lenders generally look to the corporate group's earnings and enterprise value for its credit analysis. As such, much of the focus on corporate credit covenants is to make sure that the earnings generated by the various subsidiaries of the borrower will be available to the lenders, with the exception of a relatively small portion of the subsidiaries that have been designated "unrestricted subsidiaries".

For an investment grade company, the covenant package is typically relatively light, but it will still usually include one or more restrictions that may impact securitizations. For example, the covenants may include a negative pledge that restricts the company and its subsidiaries from granting liens on more than a permitted portion of the consolidated group's assets before all the investment grade debt has to be secured *pari passu*. There would also typically be a financial covenant of some sort that would limit the overall debt that would be permitted to be incurred by the consolidated corporate group. These types of covenants would, absent a specific carve out, capture the company's subsidiaries, including a securitization SPE, unless such SPE is structured as an off-balance sheet entity.

For companies that are below investment grade, a leveraged loan covenant package would typically include (a) a grant of security in most assets of the company and its restricted subsidiaries (with carve outs for certain security grants that have adverse tax consequences or for which perfection of the security interest is deemed to be disproportionately burdensome), (b) a guarantee of the company's indebtedness by restricted subsidiaries (with carve outs for guarantors that would cause adverse tax consequences), and (c) a requirement that new domestic subsidiaries that are not designated as unrestricted subsidiaries join in the security interest and guarantees granted in favor of the company's debt. In addition, leveraged loans typically contain a number of negative covenants, many of which will impact securitizations absent a specific carve out. These include restrictions on (a) liens, (b) indebtedness, (c) investments, (d) asset-dispositions, (e) affiliate transactions, (f) restricted payments and (g) financial covenants. Similar to investment grade credits, unless the SPE were to be structured to not be a subsidiary of the company or structured as an unrestricted subsidiary, the various covenants would apply to the securitization SPE.

Requiring the securitization SPE to guarantee the company's indebtedness and grant a security interest in its assets other than for the benefit of creditors under the securitization transaction would not be consistent with the securitization structure. If the securitization SPE were to be organized as an off-balance sheet entity or designated as an unrestricted subsidiary, the covenants would not apply to the SPE itself. However, the company would still have to make sure that any sale of assets to the SPE would constitute a permitted asset-disposition by the company, that any investment by the company in the SPE would be permitted under the investment restrictions and that the dealings with the securitization SPE would fit within the affiliate transaction requirements to the extent the SPE is still deemed to be an affiliate of the company.

It is at this point fairly routine, however, for corporate debt documents to include a concept of "permitted receivables financings" that allows the company to enter into non-recourse financing with respect to its receivables, including in the form of securitizations, by means of carving out such transactions, and the related securitization SPEs from the covenant restrictions outlined above. As such, the definition of permitted receivables financing (or similar terms) will typically allow for non-recourse securitizations of receivables (including trade, lease and loan receivables) as well as residual interests in securitization SPEs and related assets through on-balance sheet SPEs that are not required to fit within the narrow "unrestricted subsidiary" basket. There will also commonly be a corollary definition of "standard securitizations undertakings" which covers typical representations, warranties, covenants, and repurchase and indemnification obligations of the company in its role as a seller and servicer to the relevant securitization. These definitions will often be constructed using additional definitions as building blocks, and those additional definitions may further restrict the amount or types of receivables that can be securitized or they may further restrict the business of the securitization SPE.

Character of the Securitized Receivables

a. Receivables arising under non-executory contracts

As noted above, many different sources of cash flows are suitable for securitizations. Loans, leases and payment obligations for goods and services that have been delivered under contracts where the only remaining obligation is the payment, are particularly well suited for securitizations. Such contracts are not executory, and therefore cannot be rejected in bankruptcy of either party. Receivables arising from a company's business activities with its customers incur some risks if the company were to fail to perform any future obligations to a customer. Such failures could result in the customer (i.e. "account debtor") using such future breach as a counterclaim to reduce its payment obligations with respect to the assigned receivables. To the extent such subsequent company obligations arise under separate contracts from the contract that gave rise to the purchased receivable, the SPE and its lenders may protect themselves by giving notice of the assignment to the relevant account debtor. Such notice cuts off any defense or claim of the account debtor against the assignor which accrues after the account debtor receives a notification of the assignment authenticated by the assignor or the assignee, except for "any defense or claim in recoupment arising from the transaction that gave rise to the contract". See, New York UCC 9-404(a).

b. Receivables arising under executory contracts

Any contract with performance obligations remaining by both parties at the time that one party becomes subject to bankruptcy proceedings will likely be deemed to be an "executory contract." If a party to an executory becomes subject to bankruptcy proceedings it will have the right to reject such contract and cease further performance. See, Bankruptcy Code Section 365 (providing that subject to court approval and certain limitations, a debtor in bankruptcy can assume or reject any executory contract or unexpired lease). See, e.g. *Matter of C & S Grain Co.*, 47 F.3d 233, 237 (7th Cir. 1995) ("For the purposes of the Bankruptcy Code, an executory contract is one in which the obligations of each party

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remain substantially unperformed."); In *re Spectrum Information Technologies, Inc.*, 190 B.R. 741, 747 (Bankr. E.D.N.Y. 1996) ("contracts where one party has completed performance are excluded from the ambit of section 365"). Any risk that a bankruptcy by the company could result in a reduction in the payment obligations by the account debtor on the receivables sold to the securitization SPE is, naturally, inconsistent with the construct of insulating the SPE and its assets from the bankruptcy risk of the company. The types of contracts that could be viewed as executory on the basis that there are future performance obligations remaining by both parties, include master purchase or supply agreements that are intended to form a single integrated agreement. Intellectual property licenses are another example of executory contracts. The same is likely true for contracts that involve ongoing services.

The question then becomes how best to insulate the SPE from the risks of the company in case of receivables arising under executory contracts where the company continues to have performance obligations to the account debtor. One way to address the issue would be to have the account debtor agreeing to waive its right to assert any counterclaims or right to set-off and recoupment for the assigned receivables. Such waiver could either be entered into directly with the SPE, for example at the time of invoicing the receivable sold to the SPE. Alternatively, such waiver could be entered into directly between the company and the customer. An agreement between two commercial parties for the account debtor not to assert any claims against the assignee is enforceable under the uniform commercial code so long as the assignee took assignment for value, in good faith and without knowledge of any existing counterclaims. See, UCC 9-403 (b) (providing that for contracts, other than consumer contracts, "an agreement between an account debtor and an assignor not to assert against an assignee any claim or defense that the account debtor may have against the assignor is enforceable by an assignee" subject to such assignee taking assignment for value, in good faith and without notice of a claim of a property or possessory right to the property assigned and without notice of a defense or claim in recoupment existing at the time of assignment). The only exceptions to such enforceability are defenses based on (i) infancy of the obligor to the extent that it is a defense to a simple contract, (ii) duress, lack of legal capacity or illegality of the transaction under other law, (iii) fraud in the inducement or (iv) discharge of the obligor in insolvency proceedings. Notably, rejection by the account creditor or account debtor of a contract in bankruptcy does not amount to discharge of such contract nor does any breach by the account creditor constitute one of the remaining defenses that can be asserted after assignment.

One might ask why an account debtor would be willing to waive its defenses to payment. However, the account debtor is not giving up its rights to assert a counterclaim against the obligor under the contract. The account debtor is only giving up its right to use such counterclaim as a basis for reducing its payment obligations to the receivables assignee and the account debtor is still free to make counterclaims against the company itself. Making the receivables more financeable will strengthen the financial position of the company which, in turn, often also benefits the account debtor as a customer of the company. The company may also be willing to concede to longer payment terms for the account debtor in return for the account debtor consenting to such waiver. From a customer's standpoint, the credit risk would be similar to a scenario where it would obtain a separate loan and use the proceeds to pay the company upfront for the relevant goods and services. In fact, certain equipment leases benefit from statutory "hell or high water" language that requires the customer to pay regardless of any counterclaim, once the customer has accepted delivery of the goods. See, New York UCC § 2A-407, which provides that upon the lessee's acceptance of the relevant leased goods, the lease is effective and enforceable between the parties and by or against third parties including assignees of the parties and such payment obligation is not subject to cancellation, termination, modification, repudiation, excuse or substitution without the consent of the party to whom the promise runs. Commercial parties to lease agreements may also agree to treat any lease that does not satisfy the statutory requirements for a "finance lease" to be treated as if it is a "finance lease" within the meaning of Article 2A.

c. Transfer of assets beyond receivables and related contracts

In many circumstances it will not be practicable to obtain a waiver of recoupment rights from the customer. Under those circumstances, it may be necessary to ensure that additional assets or rights have been transferred to the securitization SPE in order to give the SPE the ability to continue to perform under the executory contract. Some assets are well suited for transfer to the securitization SPE to ensure that the relevant receivables contracts can continue to be serviced even in the event of a bankruptcy of the company.

Intellectual property licensing rights are deemed to be executory contracts. However, where the relevant receivable constitutes licensing or royalty payments for intellectual property rights in the form of trade secrets, patents, patent applications, or copyrighted works, there is an additional layer of protection available to the licensee in case the licensor becomes subject to bankruptcy proceedings. Section 365(n) of the Bankruptcy Code provides the licensee under a rejected license, with a right to either elect to treat such contract as terminated (to the extent the licensee otherwise had a contractual right to do so) or to retain its rights under its license of such intellectual property as such rights existed immediately before the commencement of the bankruptcy case.

If the customer were to reject the contract, it would of course not be helpful in protecting the SPE's payment rights. However, the fact that a licensee has a right to continue its current license allows for a construct whereby the company could provide the securitization SPE with a license that, in turn, can be sublicensed to the account debtor, such that while the account debtor is part of the securitization, its license rights flow from the securitization SPE. The securitization SPE can then elect to continue its license for the purpose of servicing its sublicensing obligations, even if the company otherwise rejects such agreement.

Similarly, assets that are either passive in nature similar to intellectual property rights, and assets that require limited servicing, such that a backup service could perform the relevant obligations on behalf of the issuer, are also well suited for the SPE to protect is payment rights.

The more revenue-generating assets and related rights are transferred to the SPE to continue to service the underlying contracts in case of a bankruptcy involving the company, the more the SPE will act as a separate business line of the company. In some cases, such as whole business securitization, the principal revenue generating assets of the business will reside in the securitization structure, thereby making it difficult for the company to obtain financing outside the securitization. Nevertheless, a company may decide that securitizations would still be preferable compared to other corporate financing that may not be available where the core revenue-generating pieces of the business have been insulated from the manager.

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There is a fine line between securitizations of receivables that require transfers of additional assets to service the relevant receivables, and the transfer of an asset to a securitization SPE in order to then create a leasing or licensing fee or other payment stream that can be used to finance a securitization. A company with significant capital assets may want to free up cash by entering into a sale and leaseback transaction with a securitization SPE or a third party. Similarly, a company could sell intellectual property rights to an SPE or a third party, and then license back such intellectual property. A transfer to a securitization SPE, as compared to a third-party lessor would allow the company's license and lease payments to be used to service the SPE's debt obligations with the excess spread flowing back to the company through the equity in the SPE. At first it may seem counterintuitive that an SPE whose principal cash flow comes from lease or license payments of a single company can be given a higher credit rating than that of the relevant payment obligor. After all, the company would either pay or it would not, and with the company as the sole payment obligor, one would expect this binary outcome to be reflected in the credit risk of the securitization. However, if the underlying asset can be readily leased to other customers, then the credit is tied more to the asset itself rather than the current lease and license payments from the company. Similarly, if the asset is critical to the company's operation, the likelihood of the company rejecting the lease contract in bankruptcy is low.

While such structured receivable transactions may be attractive to the company and the structured facility lenders, it is also important to assess how such transactions would be viewed by lenders under the corporate debt documents. There are numerous examples of lenders that are unpleasantly surprised when borrowers find ways to transfer significant assets to unrestricted subsidiaries and then use such assets to support additional borrowing. Depending on how such transfers are structured, they may result in protest from the lenders under the corporate loan documents.

For example, as part of the restructuring of Claire Stores, Inc. in 2016, Claire's engaged in a set of transactions that involved the transfer of its intellectual property from a restricted subsidiary to a newly formed unrestricted subsidiary. Claire's then entered into a debt exchange whereby new notes were issued by the newly formed unrestricted subsidiary and, as part of the restructuring, Claire's agreed to pay annual licensing fees for the intellectual property previously owned by it. No litigation arose out of this transaction at the time, but following Claire's subsequent bankruptcy in 2018, a second-lien lender protested this overall arrangement on a variety of grounds, including that it amounted to transfer of core intellectual property rights to a restricted subsidiary and away from the corporate borrower group without the transferor receiving reasonably equivalent value for such assets. The second lien lenders ultimately settled their claims with Claire's prior to confirmation of Claire's chapter 11 restructuring plan.

J. Crew similarly transferred a significant portion of its trademarks to a newly formed unrestricted subsidiary by using a combination of investment baskets to effectuate a debt swap. This time some lenders challenged the transaction, but J. Crew's motion to dismiss was upheld on the basis that the minority group of lenders protesting the transaction did not have standing to challenge, given that the transaction did not require unanimous consent and a majority of the lenders subsequently consented to the intellectual property transfer. See, Decision & Order, *Eaton Vance Management v. Wilmington Savings Fund Society*, No. 654397/2017 (N.Y. Sup. April 25, 2018). Nevertheless, as a result of the J. Crew type transactions, covenant restrictions that limit transfers of intellectual property have become a more frequent feature in leveraged loans and high-yield debt covenants. However, what is equally notable is that the covenant restrictions around the assets that cannot be transferred to restricted subsidiaries have been relatively narrow and surgical, which preserves the borrower's ability to effectuate transfers of other assets that then can be dealt with by the company outside the restrictions of its existing debt.

If we look at the covenants in corporate debt documents relating to asset dispositions, a company will generally have a broad ability to sell the relevant assets so long as the assets are sold at fair market value, for a consideration consisting of at least 75% cash, coupled with covenants that dictate how the proceeds are to be used. So long as the covenant restrictions are satisfied, the company's corporate lenders should be indifferent as to whether such permitted asset is sold to a third party, or to a securitization entity that is structured as an unrestricted subsidiary. Naturally, the leaseback or intellectual fee obligation does impose some additional payment burdens on the company similar to what the company may have been subject to had it incurred additional debt. Consequently, such sale and leaseback transactions are, from time to time, prohibited by the relevant corporate debt documents. See, e.g. *U.S. Bank N.A. v. Windstream Services, LLC*, No. 17-cv-7857 (S.D.N.Y. 2017) (finding that although structured as a sale by one entity and a leaseback by a second entity that would fall outside the strict reading of the sale and leaseback definition, the transaction was nevertheless in substance a prohibited sale leaseback). However, where a borrower wishes to preserve capacity to enter into sale and leaseback transactions, this is often addressed either as a combination of a lien and debt or as a combination of an asset sale and debt. In either case, if the company has capacity to incur the additional lease obligations, it is typical for lenders to give the borrower that flexibility.

Conclusion

Corporate lenders principally look to enterprise value and EBITDA to determine the borrowing capacity of the company, whereas asset-backed lenders will typically look to the value of the relevant asset in terms of its ability to generate a cash stream. By separating out a payment stream or other asset into a securitization SPE or an unrestricted subsidiary that is otherwise set up as a securitization SPE, it is possible to tailor each portion of the existing corporate financing and the securitization financing to maximize the overall lending value. This does not in all circumstances mean that the company effectively receives a "free" basket of additional financing through the securitization. The sale of the assets to the securitization transaction may reduce EBITDA or otherwise trigger covenants that require the proceeds from such sale to be used to repay the existing debt. However, where such existing debt consists of expensive subordination debt, and the replacement financing is primarily investment grade, the overall credit of the company should be improved, all else being equal, and such improvement coupled with the ability to access additional sources of funding should enhance the company's enterprise value.

Securitization techniques are powerful in their ability to isolate and extract lending value from assets that can continue to service debt, even in the case of the company's bankruptcy should that occur. However, their downside is that the expense of establishing a securitization program can be significant. They also do not work well with other financing facilities if the securitized asset is so core to the enterprise value of the business that the existing lenders would not be willing to lend absent a security interest over such asset. For other assets, however, securitizations are likely to

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interface well with traditional debt and where the securitization relates to trade receivables or other continuously generating assets, any sunk costs in establishing a securitization program would rapidly amortize over a few issuances. Similarly, where securitization techniques can be used to extract lending value from a stranded asset in a situation where the company is otherwise precluded from entering the loan market, securitizations may prove invaluable. Even if a company is not currently in a position to engage in securitization transactions, it can take easy steps to permit such transactions in the future by ensuring that its indentures and credit agreements contain appropriate carve outs for a variety of securitization transactions.

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Bjorn is a partner in the Finance practice and resident in the New York office. He focuses his practice on representing lenders, borrowers, managers and investors in a broad range of complex financing arrangements across a wide spectrum of asset classes including securitizations and other structured financings, various shared collateral and second lien structures, repo facilities, commodity, equity, credit and fund linked derivatives, subscription lines and a variety of funding arrangements tailored to existing purchase commitments such as energy management agreements and airline frequent flyer miles programs. In addition, he has extensive experience representing investors, creditors and managers in complex restructurings, work-outs and acquisitions of distressed and non-performing assets. He is involved in all aspects of deal structuring, negotiation and documentation.

With lawyers in New York, London, Washington, D.C. and Frankfurt, Shearman & Sterling's Structured Finance & Securitization Group assists clients in developing, structuring and executing a broad range of financings including securitizations, structured products, asset-based lending, tailored leasing and royalty arrangements and other sophisticated financing techniques. We have in-depth experience in all aspects of the public and private offering and distribution of structured finance securities. Highly regarded by major corporations and financial institutions, we represent the entire range of global market participants, including issuers, underwriters, investors, trustees, servicers, credit-enhancement providers, lenders, rating agencies and conduits.

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