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# Securitization as an Integral Part of a Corporate Capital Structure

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## Introduction

Companies are increasingly incorporating securitizations and securitization-like financing arrangements as part of their capital structure. Utilizing these types of structured financing arrangements enables companies to diversify their lender base, increase their borrowing capacity, and even lower their financing costs. Securitization techniques may also be used to capture other benefits such as tailoring the financing to desired credit ratings, reducing lenders' regulatory capital charges or achieving particular treatments for tax or accounting purposes.

Asset-based lending in general, and securitization in particular, provides corporate borrowers with borrowing capacity against assets that, from a pure cash-flow-based lending perspective, may have limited to no borrowing value. Securitizations also have the potential for achieving a better regulatory treatment and a higher rating differential compared to the corporate credit rating, compared to more traditional secured financing arrangements. As such, operating companies should consider including securitization structures as part of their capital structure.

Cash-flow loans, even if secured, primarily look to a borrower's EBITDA and enterprise value. So long as the company retains sufficient enterprise value that the company is likely to restructure (and not liquidate) in case of any insolvency, cash-flow lenders primarily look to the protection afforded to secured lenders in a bankruptcy restructuring (i.e. Chapter 11 or equivalent insolvency proceedings). Provided that the collateral securing the cash-flow loan has sufficient value for the lenders to remain fully secured in case of insolvency proceedings, they will likely view any additional collateral as essentially a form for boot collateral: nice to have, but not particularly additive to the company's borrowing capacity. As such, cash-flow lenders will also generally have a greater tolerance, and even preference, for maintaining a security interest in core assets of the borrower that are not likely to be sold during a restructuring. In contrast, asset-based lenders primarily look to the cash-flow associated with particular assets and the liquidation value of such assets as providing the basis for the amount of financing that such lender will be willing to provide against such assets. A borrower may therefore be able to obtain significant additional borrowing capacity from various assets that cash-flow lenders do not give much value or where the asset-based financing does not have any particularly adverse impact on the borrower's EBITDA or, by extension, the borrowing capacity under cash-flow loans. A prudent mix of asset-based and cash-flow borrowing therefor has the potential for unlocking additional access to financing. By utilizing common securitization credit-enhancing techniques to decouple the rating of the asset-based financing from that of the operating company and restricted subsidiaries that would constitute the borrower group under a more traditional cash-flow loan, it is possible to achieve a ratings lift and other potential benefits that overall reduce the borrowing cost while expanding the universe of potential lenders. This decoupling is typically achieved by establishing a bankruptcy-remote special purpose entity (the "securitization SPE") that neither provides, nor relies on, credit support to or from its non-SPE affiliates.

The cash-flow from the securitization would flow back to the borrower-group through a combination of the up-front purchase price and cash-flow through the securitization SPE equity and, depending on the securitization structure, would typically retain its operating income treatment. As such, the operating income impact of selling receivables or income to a securitization entity is typically minimal, thereby allowing for continued financing under an EBITDA facility generally to the same level as if there was no such receivables securitization. Consequently, it is common for secured cash-flow financings, even when made to highly leveraged companies (i.e. "leveraged loans"), to allow for an unlimited or near-unlimited amount of such receivables securitizations.

The relationship between asset-based lenders and cash-flow lenders is more complex where the underlying asset is of a type that is central to the company's enterprise value or where the securitized asset consists of less liquid operating assets that makes it difficult to fully decouple the securitization financing from the operating company's credit. Securitization structures nevertheless may be able to unlock additional value, even for assets that a company is likely to view as important for its business and therefore likely to require during a reorganization. It is, for example, possible to construct a securitization of assets for which the related cash-flows are in the form of lease, rent, licensing fees or other payments from the related company and where a sale of such asset would require a significant amount of time or a significant discount. However, in those circumstances, the payment obligations (in the form of lease or licensing fees or otherwise) by the operating company that obtained financing through such securitization structure and the potential adverse impact on such company's operations and enterprise value that would result from the sale of core assets away from the company, are such that other creditors would want stronger guardrails around such financings. Cash-flow lenders typically include a number of covenants that are intended to protect them in case of securitizations or similar add-on financings of such assets. While it is usually possible to carefully structure a securitization of operating assets to comply with a typical high-yield or leveraged loan covenant package, such securitizations will have elements in common with some liability management transactions that, to put it mildly, are not always viewed favorably by cash-flow lenders. For example, there have been instances where lenders to distressed companies have objected to the use of "drop down" financings that move core assets away from the cash-flow lenders. However, while drop-down liability management transactions have many aspects in common with a securitization, there are also important differences between such transactions and an asset securitization structured outside a distressed scenario. This will be discussed in more detail below.

## Summary of Securitization Features and Character of the Receivables

### a. Securitizations – a summary of key features

Securitization, at its core, involves isolating the securitized asset from the originator and its affiliates and obtaining financing secured and serviced by such assets. Typically, such asset isolation will involve a "true sale" of such assets to a "bankruptcy remote" special purpose entity (i.e. the securitization 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 are no longer part of a transferor's property or bankruptcy estate. 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, the greater the likelihood that the transaction would be characterized as a transfer of collateral securing a loan. Some features, such as transferring the economic risks and rewards of ownership, are given greater weight than others in determining whether a purported sale will in fact be respected as such or instead be recharacterized as a loan.

Effectuating a true sale to a securitization SPE that is affiliated with the transferor would not be of much use in effectuating isolation of the assets, if the separate existence of the SPE could not be maintained in the face of a bankruptcy proceeding against its non-SPE affiliates. As such, it is also important to structure the SPE to minimize the risk of the SPE becoming substantively consolidated with such affiliates, as well as to minimize the risk of any voluntary or involuntary bankruptcy filing of the SPE.

The risk of the SPE becoming subject to an involuntary bankruptcy is typically reduced by limiting the SPE's activities to the securitization transaction and requiring transaction parties to waive or limit their right to bring a bankruptcy proceeding against the SPE. Contractual provisions that prevent the SPE from voluntarily filing for bankruptcy protection are not enforceable on public policy grounds. Therefore, the risk of a voluntary filing by the SPE is addressed more indirectly: in part, by limiting the activities of the SPE; in part, requiring the SPE's contract counterparties to agree that their claims against the SPE will be limited to its assets; and, in part, by requiring that any bankruptcy filing and certain other material actions require the affirmative vote of an independent manager whose fiduciary duty runs to the SPE itself and not its shareholders. Finally, to protect against a bankruptcy court applying the equitable "substantive consolidation" doctrine, the charter and transaction documents typically include a number of separateness covenants that are required to be observed at all times.

The "decoupling" of the securitization SPE from its affiliates, together with credit enhancements such as overcollateralization, collateral pool diversification, liquidity reserves and cash trap or amortization triggers, typically enables the securitization SPE to issue debt with a significantly better credit rating than the cash-flow loans of the SPE's affiliates. This can be very attractive to companies with a low investment grade or sub-investment grade rating. Even where the collateral is limited to a single asset for which the cash-flow to the securitization SPE comes from the affiliated borrower group and its restricted subsidiaries, it is possible to achieve a credit rating above that of the relevant payment obligors if the securitized asset is sufficiently important to the continued business of the payment obligors such that they are likely to continue to make lease, license or other relevant payments relating to such asset, even if they become subject to Chapter 11 bankruptcy.

Given the collateral isolation and the non-recourse nature of securitization debt, there is typically a lot of flexibility around where in the corporate organization structure the securitization SPE can be located. The securitization issuer can be a subsidiary of the borrower group or it can be a sister company that sits outside the borrower group. The SPE can be wholly owned or owned only in part by the borrower group or its affiliates and it can be structured as an unaffiliated entity altogether.

### b. Receivables arising under non-executory contracts

As noted above, there is a broad variety of cash-flows that can be securitized. Loans, leases and payment obligations for goods delivered and services rendered such that the only remaining obligation is the payment, are particularly well suited for securitizations. Such contracts are not executory, and therefore cannot be rejected in case of a bankruptcy affecting either party to the transaction giving rise to such receivable. Receivables arising from a company's ongoing business activities with its customers may also be securitized but will be subject to some increased risks of delay or failure to pay if the originating company fails to perform any future obligations to the 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.

Generally, the uniform commercial code distinguishes between set-off rights stemming from different contracts and set-off rights arising under the same contract (also referred to as recoupment). An assignee, including a securitization vehicle, can generally prevent an account debtor from being able to set off unrelated claims it has against the seller of such payment rights to the securitization SPE, simply by giving such debtor notice of the assignment. However, such notice will not suffice to prevent the relevant debtor from asserting claims under the same contract. Preventing such claims requires the debtor to waive such defenses to payment. In circumstances where the relevant originator or servicer of the receivables has sufficient credit quality and sufficiently well-established operations that allow the risk of set-off and recoupment to be carried by such originator without much impact to the rating of either the securitization entity or the relevant originator or servicer, it may not be necessary to go through the extra steps of decoupling such risks. From a true sale perspective, it is permissible (and typical) to have recourse against the servicer or originator for any *bona fide* set-off or recoupment claims that an account debtor raises as defenses to its payment obligation on any receivable sold in a securitization, so long as such recourse does not relate to the account debtor's financial inability to pay. The recourse provided for set-off and recoupment claims, as well as for any indemnity or repurchase obligations relating to any breach of representations, warranties or covenants of any seller of assets to a securitization SPE or of any service provider to the SPE, are often referred to as "typical securitization undertakings" (or words of similar import in leveraged loan facilities) and are generally permitted in conjunction with any permitted securitization transactions.

### c. Receivables arising under executory contracts

Any contract where both parties have performance obligations remaining at the time that one party becomes subject to bankruptcy proceedings are likely to be an "executory contract" that can be rejected in bankruptcy; 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), *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 remain substantially unperformed.); and *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"). Examples of executory contracts include intellectual property licenses and ongoing service contracts. A rejection of a contract in bankruptcy is the same as a breach by the bankrupt party of its obligations thereunder and will give the counterparty a right of recoupment that may permit such counterparty not to make further payments under its contract, unless such right has been waived, even when the related receivables have been sold to a securitization SPE. Any risk that a bankruptcy by the company could result in a material reduction in the payment obligations under the receivables sold by the company is, naturally, inconsistent with the securitization principle of decoupling the SPE's credit from the company's credit.

If a securitization includes receivables under executory contracts, the question then becomes how best to insulate the SPE from the Company's rejection risk. As noted above, 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 assignment or any invoicing by the SPE. Such agreement could also be entered into between the company and the customer, for the benefit of any assignee of the payment rights, including the securitization SPE. The uniform commercial code expressly provides that such waiver of rights under commercial contracts are enforceable so long as the assignee took assignment for value, in good faith and without knowledge of any existing counterclaims. See UCC 9-403 (b). The only exceptions to enforcing such waiver 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 such recoupment rights against an assignee of the payment claim. However, the customer will typically continue to be able to make a claim against the provider of goods and services, even if it waives its right to dispute any payment obligations. In that respect, the waiver puts the assignee of the receivable in the same position as if the assignee had made a loan directly to the account debtor for the purpose of the account debtor to pay for the goods and services at the time of the contract. The account debtor would in either case be expected to repay its loan regardless of whether the account debtor was satisfied with the goods delivered or services rendered.

In many circumstances, it will not be practicable, however, 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 if the company fails to do so.

### d. Transfer of assets beyond receivables and related contracts

Some executory contracts provide counterparties with additional protections against a rejection in bankruptcy, in particular intellectual property licenses and real-property leases. Section 365(n) of the bankruptcy code provides the licensee 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. Leases of real property where the debtor is the lessor also are afforded similar bankruptcy protection to where the bankrupt entity is the lessor, allowing the lessee to retain its rights under the lease for the remainder of the lease term pursuant to Section 365(h), even if the lessor rejects such lease in bankruptcy.

It is therefore possible to protect any related license or lease payment streams by ensuring that the securitization SPE becomes the lessee *vis-à-vis* the company that owns such property, with rights to sub-lease or sub-license such real or intellectual property, as applicable, to the relevant third-party obligors. Should the licensor or lessor file for bankruptcy, the SPE will, naturally, elect to continue such lease and license transactions.

For other assets that do not have such express bankruptcy protections available, it may be necessary for the securitization sponsor to transfer actual ownership of the relevant assets required to service the financed cash-flows to the SPE upfront. The more revenue-generating assets and related rights are transferred to the SPE, the greater the SPE's ability to continue to generate revenue and service its debt, effectively operating as a separate business line, even if the transferor or servicer becomes subject to bankruptcy proceedings.

In some cases, such as whole business securitizations, the principal revenue-generating assets of the business will reside in the securitization structure, thereby making it difficult for the remaining business to obtain other financing outside the securitization. Nevertheless, a company may decide that a securitization financing would still be preferable compared to other corporate financing alternatives. Placing the operating assets into an SPE structure in principle allows for another operating company to step in and service the assets, essentially allowing for an efficient transfer or sale of the business operations inside the SPE (with the accompanying debt) to such successor servicer. The more easily a third party could step in and take over the servicing of the assets (or otherwise be incentivized to pay down the financing at the SPE level in order to take out the assets), the greater the extent to which the credit of the SPE can be decoupled from the credit of the parent company that established the operating business securitization. However, even where the ability to fully decouple is limited, a whole business securitization structure will often permit a sub investment grade corporate group to achieve a ratings step-up to a low investment grade rating, which significantly increases the investor base and reduces the cost of funds. As such, whole business securitization is used in a significant number of restaurant franchises such as Sonic, Domino's, Wendy's and Taco Bell, as well as fitness clubs such as Planet Fitness and automotive services such as Driven Brands, all with a rating typically in the BBB (sf) range.

It is worth noting some of the criticism levied against corporate securitizations by some rating agencies, which primarily centers around overstating the benefits of some highly leveraged corporate securitizations. For example, Fitch Ratings commentary published in December 2019 titled "U.S. Whole Business Securitization Benefits Overstated", criticized some whole business securitizations that had achieved an investment grade rating (in the "BBB" range) despite leverage multiples of 7× to 8× of EBITDA (which otherwise would qualify for a rating significantly below investment grade). Fitch Ratings noted several factors that raised its concerns; the first being whether the securitization related to "the vast majority of [the sponsors'] assets and liabilities" in contrast to "traditional securitizations that are designed to isolate only a part of the assets from the fortunes of the company itself", and others being industry considerations that were not of a type that could be mitigated by use of a special purpose entity, triggers or covenants alone, such as low barriers to entry, exposure to technological advances and changes and consumer preferences and lastly what Fitch viewed as an overstatement of the difference between the control lenders had over replacing management over the securitized operating assets compared to the influence lenders and shareholders had in a more traditional financing structure.

While there may be debate around the amount of credit enhancements that a securitization structure of all of a Company's assets should be able to achieve as compared to a traditional cash-flow-based financing, there seems to be far less controversy and much greater acceptance of the credit enhancement that a securitization can and should achieve where only a portion of an operating company's assets are separated out in a securitization structure. Of course, the credit rating of the SPE itself depends on typical credit factors such as overall leverage, liquidation value of the assets, value of the assets when operated by the SPE, ability for an alternative operator to step in and operate the SPE without a material adverse impact on the cash-flows or value of the assets, barriers to entry, etc. In SPEs where the brand name and intangible rights tied to a particular operator are crucial to the SPE's value, especially when operating in a business with low barriers to entry, the ability to decouple the SPE's credit from the operator's credit may be limited. Conversely, a whole business SPE structure in which valuable operating assets are transferred to the SPE and where such assets are of a type and in a line of business where a multitude of different operators could step in and provide the required servicing of the assets to ensure that the cash-flow to the SPE continues, then there is a greater ability to decouple the credit of the SPE from the credit of the sponsor-company. Examples of the latter include oil and gas royalty securitizations from proved developed and producing oil and gas reserves, and securitization of telecommunication tower lease payments.

It is also possible to construct solid securitization structures where the primary source of income to the securitization entity consists of lease or royalty payments from the sponsor company (or its affiliates). It is common and straightforward to build interest reserve features that permit the securitization SPE to service its debt during an interim period that allows it to enter into a replacement lease or effectuate an orderly liquidation sale. For example, in aircraft securitizations using enhanced equipment trust certificates, the lenders benefit from liquidity facilities that can be drawn when the lessee files for bankruptcy and rejects the lease. The mere ability to effectuate such sale may create sufficient incentives for the current operator, even if in bankruptcy, to assume its lease payments in order to secure its rights to continue to operate such assets. As noted above, this would expectedly often be the case where the relevant asset is important to the continued operations of the bankrupt lessee and such likely assumption is itself credit enhancing. This is, amongst others, illustrated in the securitization of spectrum by Sprint Communications, Inc., where Moody's awarded the notes a Baa2 (sf) rating at a time when the Sprint corporate family rating was B2. As part of its ratings rationale, Moody's noted the significant franchise value of Sprint, its substantial customer base and its nationwide network structure as important contributing factors, and that, in the case of an insolvency, Sprint would be likely to realize more value as a going concern and therefore to file for bankruptcy under Chapter 11, rather than liquidation under Chapter 7. Because the securitized spectrum portfolio was important to Sprint's business operations, Sprint would be strongly incentivized to assume the lease to avoid any disruptions in its operations resulting from any Chapter 11 filing. In turn, this would avoid disruption in the payments on the securitized notes. The securitized notes also benefited from a liquidity reserve and significant excess value of the collateral, but because of the illiquid nature of the spectrum and the low number of comparable spectrum license sales and the value of the spectrum, Moody's assigned secondary value to this credit enhancement in the spectrum notes.

## Lender Concerns and Debt Covenants

### a. Typical cash-flow debt covenants impacting securitization financings

A cash-flow loan covenant package will generally focus on ensuring that a sufficient portion of the earnings generated by the borrower group and its restricted subsidiaries will be available to service the lenders under the cash-flow facility and other permitted senior or *pari passu* debt.

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 from granting liens on more than a permitted portion of the consolidated group's assets before all the investment grade debt must be secured *pari passu* by the relevant assets. There would also typically be a covenant limiting the overall debt that may be incurred by the consolidated corporate group. These types of covenants will, absent a specific carve-out, generally apply to the company and its subsidiaries, including securitization SPEs, unless such securitization SPEs are structured to not fall within the definition of "subsidiaries" to which such covenants apply.

If the borrower group is below investment grade, there will typically be additional covenants that come into play. Leveraged loan facilities generally require that all existing and future subsidiaries, other than "unrestricted subsidiaries" and "excluded subsidiaries" become part of the borrower group as guarantors and grantors of a security interest in their assets. In addition, leveraged loans contain a multitude of negative covenants that restrict the activities of the borrower group, and that would also impact the borrower group's dealings with a Securitization SPE.

Consequently, careful structuring will often be required to enable the Securitization SPE and any asset transfers and ongoing dealings between the borrower group and the Securitization SPE to allow a securitization to operate with a borrower group's general corporate financing facility. As part of the process of ensuring technical compliance with the relevant covenant package, it is important also to assess how the relevant securitization transactions would be viewed by lenders under the corporate facility. If the securitized assets are receivables, it is likely that the corporate lenders would not have much of an issue. As noted above, it is fairly common for leveraged loan facilities to permit securitizations of customer receivables. For borrowers that are in the business of providing financing to their customers, whether as part of their main business or by virtue of providing seller financing to their customers, it is also fairly typical for corporate financing facilities to allow for a broad ability to securitize loans and leases made by the borrower group. Utilizing existing exceptions to a negative covenant package that are expressly designed to allow for securitization-type financing facilities is of course not controversial and it is also usually not difficult to insert typical securitization exceptions into a facility where the borrower group can demonstrate a need or desire to enter into such transactions. However, securitization of asset types that are not as commonly securitized may require navigating generally applicable covenant restrictions in a corporate facility without the benefit of a specific exemption. The covenants are often sufficiently flexible to allow for other forms of financings, including securitizations. However, there are numerous examples of lenders that are unpleasantly surprised when borrowers find creative ways to transfer significant assets away from the lenders under corporate facilities in order to use such assets to support additional borrowing.

For example, as part of the restructuring of Claire's 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 an unrestricted 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 and asset-disposition to effectuate a debt swap whereby unsecured company debt was exchanged for new structurally senior debt backed by the intellectual property rights. This time, some lenders challenged the transaction, arguing that the transfer violated the credit agreement. Because a majority of lenders subsequently consented to the transaction, and because the credit agreement, with some exceptions, could be amended with majority lender consent, the real question became whether the transfer of the intellectual property rights constituted transfer of "all or substantially all" of the collateral, which would only be permitted with unanimous lender consent. See Decision & Order, *Eaton Vance Management v. Wilmington Savings Fund Society*, No. 654397/2017 (N.Y. Sup. April 25, 2018). During 2020, a number of other companies engaged in J.Crew-type transactions, including Travelport, Cirque de Soleil and Revlon.

The Loan Syndication and Trading Association ("LSTA") recently published a market advisory, "Liability Management Transaction: Drafting Fixes" (March 29, 2021) discussing, amongst others, "drop-down financings" of the type used in J.Crew. The LSTA advisory noted that "[i]n the recent past, lenders have been caught unaware by certain liability management transactions ("LMTs") that have taken place and been permitted under credit agreements. In a drop-down financing, a borrower identifies assets that may be readily separated from the rest of the business (such as a separate business line or discrete intellectual property) and transfers these assets to either an unrestricted subsidiary or a non-guarantor (excluded) restricted subsidiary ("NewCo"). Upon such transfer the lien on these assets securing the borrower's obligations to existing creditors is automatically released and such (newly) unencumbered assets are available to secure newly incurred indebtedness of NewCo provided by new creditors."

Drop-down financings have long been a feature in connection with high-yield bonds and as leveraged loans and high-yield bonds converge, it is not surprising that these types of transactions also start to affect leveraged loans. The covenants that are typically implicated in these transactions are: (i) covenants enabling the designation or formation of subsidiaries that are not subject to the collateral and guarantee requirements (typically the definition of "unrestricted subsidiary" and provisions relating to excluded subsidiaries and designation of unrestricted subsidiaries); (ii) covenants restricting transfer of assets (typically investments covenants, asset sale covenants, collateral release provisions, in particular limitations on sale of "all or substantially all" of the collateral and "J.Crew blocker" provisions, and sale-leaseback covenants); (iii) debt covenants (which would not apply to any subsidiary that is not a restricted subsidiary, but could apply to lease and license payment obligations of the borrower group and its restricted subsidiaries); and (iv) *pro rata* sharing provisions and limitations on debt prepayments or repurchases, if the transaction also involves a "roll-up" of existing debt.

From a borrower group's perspective, it is of course important to maintain flexibility over its business, including operations and capital structure, particularly as it is generally impractical to obtain consent from each lender in a broadly syndicated debt facility. From a lender's perspective, the principal concern with liability management transactions typically centers on transactions that result in priming of collateral positions or repayments or refinancing opportunities that are not shared *pro rata*. Sales of operating assets at an arm's-length price with at least 75% of the consideration consisting of cash (which is typically the requirement of the general permitted asset disposition exception) and where the cash proceeds are either reinvested by the borrower group or used to repay lenders *pro rata* are far less concerning. Much has been written about J.Crew-type transactions and these transactions have given rise to a covenant "fix" in the form of a "J.Crew blocker provision" that prohibits (i) transfers of material intellectual property to unrestricted subsidiaries, and (ii) designating as "unrestricted" any subsidiaries that hold material intellectual property. The LSTA's market advisory includes a version of the J.Crew blocker provision as it relates to disposition of "material assets" to unrestricted subsidiaries, but notes that the scope of material assets is often limited to material intellectual property.

However, outside the context of distressed liability management, in transactions that do not involve some of the more aggressive forms of debt priming and roll-up tactics, it stands to reason that a corporate group should be able to rebalance its capital structure between cash-flow loans to the borrower group and asset-backed securitizations entered into by securitization SPEs, without too many objections from existing cash-flow lenders. This is particularly true because outside a distressed scenario, any additional financing structure, including a securitization, would typically not involve some of the more aggressive moves that have been used in conjunction with distressed drop-down financings, such as selective repayment lenders that are willing to participate in a debt exchange or provide additional financing and extensive use of non-cash consideration in connection with an asset transfer. Securitization transactions typically require sale of assets to the securitization SPE in a transaction that is treated as a "true sale" and require any dealings between a securitization SPE and its affiliates to be conducted on an arms'-length basis. This means that the transfer of assets to be securitized to a securitization SPE would readily satisfy the "arm's-length" transaction requirement for "affiliate transactions", that is a typical covenant requirement of corporate facilities, as well as the general asset disposition exception that is also a typical feature of corporate facilities and allows for dispositions of assets at fair value, with at least 75% of the consideration paid in cash. In a sale of assets to a securitization SPE, the 25% non-cash portion of the consideration would typically consist of an ownership interest in the SPE and would be considered an investment by the borrower group. While corporate financing facilities generally restrict the borrower group's investment activities, the investment covenant typically found in corporate facilities includes an allowance for investments in the non-cash position received in connection with a permitted asset disposition. However, sometimes it may be necessary to make further structuring adjustments to accommodate applicable investment restrictions.

By separating the securitized assets into an unrestricted subsidiary or other entity outside the borrower group, it is likely that any earnings of the SPE would not count directly as EBITDA of the borrower group and its subsidiaries. However, distributions made from the SPE to the borrower group would typically be included as income of the borrower group when such distribution is made, and any hit to the borrower group's EBITDA that would result from a securitization structure, as compared to a financing by the borrower group directly, could therefore be limited to the amount necessary to make interest payments under the securitization facility, at least for so long as any amortization or cash trap provisions under the securitization facility have not been triggered.

Where the transaction involves ongoing payment obligations to the SPE from the borrower group, it will also be necessary to ensure that such payments are permitted under the corporate facility covenants, which may require careful review of the indebtedness definition and debt restrictions and may also require examination of whether the arrangement constitutes a prohibited sale-leaseback transaction. See, e.g. *U.S. Bank N.A. v. Windstream Services, LLC*, No. 17-cv-7857 (S.D.N.Y. 2017) (finding that although the transaction was structured as a sale by one entity and a leaseback by a second entity that would fall outside the strict read of the sale and leaseback definition, it was nevertheless in substance a prohibited sale leaseback). However, if the borrower group has capacity under the corporate facility to incur additional lease obligations (as a combination of a permitted lien and debt or as a combination of a permitted asset sale and debt), it is also fairly typical for lenders to also extend such flexibility to a sale-leaseback arrangement.

Ultimately, it is of course necessary to not only examine whether an asset can be transferred into a securitization structure as a technical matter but also whether such asset is suitable for separate financing. Not surprisingly, the more attractive an asset is to alternative buyers outside the corporate group and the more readily such assets can be transferred, the easier it will be to obtain a higher advance rate and higher credit rating for any financing of such asset. Intellectual property rights and inventory as well as all forms of payment rights are all attractive assets, as is any other asset that can be readily monetized. Conversely, the rating and advance rate in respect of an asset that has only a limited market, whether because of its size or nature, may be more limited. It may be possible to construct operating business securitization structures that can compensate for limited buyers by providing for alternative operators of an asset. Furthermore, as new technology for registering and tracking ownership rights becomes more available, it will become easier to sell various forms and combinations of rights in various assets.

## Conclusion

Securitization techniques can be used to obtain separate financing against assets of a corporate group that are given only limited lending value in a typical cash-flow-based corporate financing facility. Such separate securitization financing can be structured to have a much higher credit rating than the rating of the corporate borrower group, and can also be further tailored to achieve certain tax and accounting goals. The greater and more diversified the asset pool, the easier it may be to unlock such benefits. However, even securitizations of operating assets with a single payment obligor under a related contract may achieve such goals, even where the payment obligor is the sponsor of such securitization. While litigation around liability management transactions may give the impression of an uneasy relationship between secured lenders in a leveraged loan structure and secured lenders to an unrestricted subsidiary, the relationship is likely to be much more harmonious where securitization transactions are established outside a distressed scenario and a company that optimizes its capital structure and diversifies its lender pool is likely to enhance its enterprise value, which benefits all lenders to the relevant corporate group.

**Bjorn Bjerke** 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.

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