Chapter 2

Defining the Source of Payment

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§ 2:1 Nature of the Obligors and the Originator

An essential element of securitization is that the receivables being sold consist of a payment stream as to which there is a reasonable predictability of payment. Collections on the receivables would be applied to pay principal and interest on the securities issued by the SPV.

Predictability of payment is affected by the nature and identity of both the obligors on the receivables and the originator, and also by the nature of the receivables themselves. With respect to the obligors, there are two risks: delay in payment (sometimes
§ 2:1.1 Slow-Pay and No-Pay Risks

The slow-pay risk is that the obligors on the receivables may delay in making their payments. A holder of securities issued by the SPV would be displeased to learn that its monthly or quarterly interest payment was not made because an obligor delayed its payment. For that reason, the number of obligors on the receivables should be large enough to maintain statistical assurance that even if a reasonably expected number of obligors delay in making their payments the securities issued by the SPV will be paid on time. Alternatively, receivables that are uncertain as to precise timing of collections may be able to be securitized if a loan commitment or similar facility (referred to as a “liquidity facility”) is provided to advance funds to the SPV to pay debt service if collections are temporarily delayed. Notwithstanding that security holders obtain comfort as to timing of collection, however, a liquidity facility does not necessarily protect the security holders in the case of larger-than-anticipated defaults.

The no-pay risk is that the obligors on the receivables may default in making their payments. That risk in turn depends on several factors. An obvious factor is the financial ability of the obligors to pay the receivables; an obligor might not pay because it is bankrupt or otherwise having financial problems. An obligor also may have a defense to payment. Therefore, the number of obligors on the receivables again must be large enough so that the risk of default can be statistically determined.

There are, however, certain factors that can impair the validity of a statistical analysis. It may be that a relatively small number of the obligors (counting, for that purpose, affiliated obligors as a single obligor, because default by any given obligor may signify financial trouble for its affiliates) account for a disproportionately large amount of payments under the receivables. Default by those obligors might impair the ability of the security holders to be repaid. That risk of high concentrations of payments in a relatively small number of obligors is called, naturally enough, the obligor-concentration risk.
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The default risk, therefore, can be managed by the SPV’s buying receivables having a statistically large number of obligors, and by analyzing the obligor concentrations. The financial ability of the obligors to pay, and the possibility that the obligors may be able to assert defenses to payment, also would be considered. The default risk then may be addressed by the originator’s adjusting the purchase and sale price of the receivables to take into account anticipated defaults.

There are various ways to compute the purchase and sale price of receivables. The most straightforward is to discount the outstanding balance of the receivables to be purchased, taking into account anticipated defaults and delays in collection. If the discount is too small, however, the SPV’s security holders could suffer a loss. But if the discount is too large, the originator would be underpricing its receivables. Sometimes the discount is intentionally small, but the SPV has a degree of additional recourse (a loss reserve) against the originator or against additional receivables. Other times the discount is intentionally large (sometimes referred to as overcollateralization), but the originator retains a right to certain excess collections if the actual defaults do not turn out to justify the large discount (payment of a "holdback"). These are merely examples. The method of pricing that is selected will depend on business and credit considerations that are beyond the scope of this book. It should be noted, however, that the more straightforward the method of pricing, and the more the SPV bears the risks and benefits of ownership, the more likely it is that the sale of receivables will be considered a true sale for bankruptcy purposes.

1. The standard defenses to payment are listed in U.C.C. § 3-305. They include infancy, duress, lack of legal capacity, illegality of the transaction, fraud, and discharge of the obligor in insolvency proceedings.
2. See the discussion in chapter 4.
§ 2:1.2 Structured Finance

Predictability of payment also can depend on the nature and identity of the originator. For example, a financially troubled originator is more likely to go bankrupt, thereby raising the question whether the transfer of its receivables is a sale for bankruptcy purposes. If a court holds the transfer not to be a sale for that purpose, the ability of the SPV to receive collections on the receivables will be delayed and may be seriously impaired.

§ 2:1.2 Right to Sell the Receivables

The discussion so far has assumed that the originator has the right to sell its receivables. Sometimes, however, that right is restricted either by the contract(s) between the originator and the obligors on the receivables, or by one or more separate contracts between the originator and third parties. I discuss each in turn.

Contracts between the originator and obligors that purport to restrict the originator’s right to sell the receivables—such restrictions often being referred to as “anti-assignment clauses”—are not uncommon. However, they are frowned upon by commercial law. Current Article 9 of the Uniform Commercial Code (U.C.C.), nullifies anti-assignment clauses that prohibit “assignment of an account or . . . creation of a security interest in a general intangible for money due or to become due.” The rationale given is that the nullification of anti-assignment clauses “is widely recognized in the cases and . . . corresponds to existing business practices.” An implicit rationale, however, might be that the obligor on the account or general intangible is

3. For example, franchise agreements commonly restrict the right of either party to assign the agreement or any right therein. See discussion of franchise fees in chapter 2, infra, at section 2:2, “Nature of the Receivables.”


not prejudiced by its assignment,\(^6\) whereas enforcing the anti-assignment clause would impair the free alienability of property rights.\(^7\)

Article 9 of the U.C.C. recently has been revised, and the revision (among other things) goes even further to nullify anti-assignment clauses.\(^8\)

**NOTE:** As necessary to avoid confusion, references in this book to “revised” Article 9 mean the 2000 Revision, and references to “current” Article 9 mean Article 9 prior to such revision. As this third edition goes to press, all fifty states of the United States have enacted revised Article 9 into law. In certain states, however, the effectiveness of revised Article 9 is deferred to future dates beyond July 1, 2001. Furthermore, there are complex transition rules. Readers therefore should check their applicable state laws to determine whether the “current” or “revised” version of Article 9 applies at any given time.

First, the revision eliminates any argument that a transfer of receivables in violation of an invalidated anti-assignment clause nonetheless constitutes a breach as between the obligor and the originator.\(^9\) Second, the revision treats anti-assignment clauses

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6. Current U.C.C. § 9-318 protects the obligor from being prejudiced by the assignment.
7. A receivable represents the originator’s right to payment; and property, after all, is merely a bundle of rights.
8. For a general discussion of the impact of this revision on securitization, see Steven L. Schwarcz, *The Impact on Securitization of Revised UCC Article 9*, 74 CHI.-KENT L. REV. 947 [1999]. Although this revision is widely referred to as the “2000 Revision,” it has a delayed effective date of July 1, 2001. This was intended to permit as many states as possible to enact it into law prior to its actual effectiveness.
9. See revised U.C.C. §§ 9-406(d)(2), 9-408(a)(2) (providing that a transfer in violation of an anti-assignment clause does not constitute a default).
in payment intangibles and promissory notes differently depending on whether the transfer in question is a sale or merely a transfer for security. Anti-assignment clauses would be ineffective in both cases from preventing perfection of the transfer of the right to payment, but they would be upheld to prevent an originator from selling its underlying business relationship. Thus, if the originator is a bank which has made a loan to a borrower, the bank could sell a participation in that loan—a loan participation being a payment intangible—to an SPV or other third party and could perfect that sale notwithstanding an anti-assignment clause in the underlying loan agreement; but the bank could not alter the underlying debtor-creditor relationship with its borrower. The buyer of the loan participation therefore would have no direct collection rights against the borrower.

The originator’s right to sell its receivables also may be restricted by one or more separate contracts between the originator and third parties. Typically this takes the form of a so-called negative pledge covenant made by the originator in favor of a third party (typically, a creditor) in which the originator agrees not to grant a security interest in or otherwise encumber its assets. Current Article 9 is somewhat ambiguous as to the en-

10. Perfection refers to the protection of a transferee’s interest in transferred assets from creditors of the transferor and from the transferor’s trustee in bankruptcy. See full discussion in chapter 3.
11. Revised U.C.C. §§ 9-406(d), 9-408(a), (b).
12. Revised U.C.C. § 9-408(d) effectively provides that, in the case of sales of payment intangibles or promissory notes and in the case of any transfer of a health-care-insurance receivable, anti-assignment clauses are ineffective to thwart perfection of the sale or other transfer but may be effective for all other purposes.
13. See text accompanying note 4, supra.
14. Sometimes, the originator agrees not to grant a security interest in its assets without equally and ratably securing the creditor, in which case the negative pledge covenant is commonly referred to as an “equal and ratable clause.”
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forceability of a negative pledge covenant.\textsuperscript{15} Revised Article 9 offers clarity by providing that while negative pledge covenants cannot restrict alienability, a transfer of receivables in breach of a negative pledge covenant nonetheless constitutes a default by the originator.\textsuperscript{16} That default could entitle the SPV to exercise remedies against the originator, and might also allow the SPV to sue the transferee, if it knew or should have known of the breached covenant, for tortious interference with contract.

§ 2:2 Nature of the Receivables

Finally, predictability of payment may depend on the nature of the receivables themselves. For example, if the receivables constitute obligations owing for goods sold or services rendered (standard trade receivables), there are few defenses to payment. Perhaps some of the goods sold may turn out to be defective, or some of the obligors may turn out to be minors. In general a buyer of the receivables can anticipate the delinquency and default risks based on past collection patterns.

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\textsuperscript{15} Current U.C.C. § 9-311 provides that “[t]he debtor’s rights in collateral may be voluntarily or involuntarily transferred . . . notwithstanding a provision in the security agreement prohibiting any transfer or making the transfer constitute a default.” It is uncertain whether this means that negative pledge covenants are unenforceable, or merely that negative pledge covenants cannot restrict the transfer but the transfer nonetheless constitutes a breach of the covenant.

\textsuperscript{16} Revised U.C.C. § 9-401(b) provides that:

\begin{quote}
[a]n agreement between the debtor and secured party which prohibits a transfer of the debtor’s rights in collateral or makes the transfer a default does not prevent the transfer from taking effect.
\end{quote}

Reporters’ Comment 3 explains that if, in violation of a negative pledge covenant, the debtor purports to grant a security interest in the same collateral to another secured party[,] subsection (b) validates the creation of the subsequent [prohibited] security interest. . . . However, . . . subsection (b) does not provide that the [negative pledge covenant] itself is ‘ineffective.’ Consequently, the debtor’s breach may create a default.
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That type of predictability may not be obtained if the receivables represent payment for future performance obligations of the originator. An example is franchise fees. These are amounts payable from obligors, called franchisees, to a franchisor (the originator) in return for the license to run a business using a special trade name or trademark and selling designated products or services.\textsuperscript{17}

Franchise fees may not be payment obligations at all, but merely expectations of payment. The fees may be calculated, for example, by a percentage (or other formula) of the franchisee’s monthly or other periodic revenues or profits. If there are no revenues or profits, no franchise fee is payable. Also, if the franchisor (originator) fails to perform the contractually agreed upon franchise services, the franchisee may have a legal defense against payment of franchise fees.

In addition, in the case of a bankruptcy of the originator, the originator (or its trustee in bankruptcy) may have the right, under section 365 of the Bankruptcy Code, to reject, or terminate, the franchise agreement as an executory contract. An executory contract is any contract on which substantial performance remains due on both sides such that breach by one party of its performance obligations would excuse the other side’s obligation to perform.\textsuperscript{18} A franchise agreement would appear to be

\textsuperscript{17} See, e.g., BLACK’S LAW DICTIONARY 592 [5th ed. 1979] [definition of franchise]. It is typical for franchise agreements, and indeed many other types of long-term contracts, to contain prohibitions on assignment. That should not, however, prohibit the assignment of the right to payments made thereunder. Even if the contract purports to prohibit the assignment of rights thereunder, such a prohibition may be ineffective as a matter of law. See the discussion of anti-assignment clauses at section 2:1.2, supra.

\textsuperscript{18} See H.R. REP. NO. 595, 95th Cong., 1st Sess. 347 [1977]; see also In re Streets & Beard Farm P’ship, 882 F.2d 233 [7th Cir. 1989]; In re Grayson-Robinson Stores, Inc., 321 F.2d 500 [2d Cir. 1963]; 2 WILLIAM MILLER COLLIER, COLLIER ON BANKRUPTCY §§ 365-01, -02, -05, -06, -08 [15th ed. 1989].
that type of contract. Accordingly, an originator that becomes
the subject of a bankruptcy case may be able to terminate the
contract if it has business reasons to do so.20 A possible solution
to the executory contract risk would be to assign the franchise
agreements, if assignment is permitted, to the SPV. To be effec-
tive, that might also require assignment of the relevant trade
names and trademarks. In addition, one must address perform-
ance of the obligations of the SPV as franchisor.21 These is-
issues are beyond the scope of this book.

The rejection of an executory contract by an originator in
bankruptcy would subject the originator to a claim for damages
for breach of contract. That damage claim, however, has no pri-
ority and ranks at parity with the originator’s general unsecured
claims. Presumably the claim would be worth less (perhaps far
less) than 100 cents on the dollar.22

N.E. 766 (N.Y. 1919); Isquith v. N.Y. State Thruway Auth., 215
N.Y.S.2d 393, 397 (Ct. Cl. 1961) (thruway toll ticket as executory
contract); Gerry v. Johnston, 378 P.2d 198 (Idaho 1919). Many con-
tracts have been held to be executory even when the performance
obligation has not been obvious. For example, a lease has been held
to be an executory contract because of the lessor’s obligation not
to interfere with the lessee’s right of quiet enjoyment. See, e.g., In re
1982).

20. For example, the franchisor may be unable to provide the products
or perform the training or other services, if any, required under the
franchise contract, or the originator may wish to terminate the
existing franchise and enter into a new franchise contract (not sub-
ject to the structured financing) with the same franchisee.

21. As demonstrated by the Days Inn franchise fee securitization trans-
action [see the discussion at section 2:2.1, infra], payment streams
that are dependent upon the ongoing unique skills of, or services
provided by, the originator may be more difficult to securitize.

22. See 11 U.S.C. § 365(g) [hereinafter, title 11 sections are cited as the
Bankruptcy Code].
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There is a further question that could arise in bankruptcy. Bankruptcy Code section 552(a) provides, in part, that property acquired by a company after the commencement of a bankruptcy case is not subject to a lien resulting from a prebankruptcy security agreement. Section 552(b) provides that proceeds of prebankruptcy property may be exempt from that restriction. Where the SPV pays for a future payment stream, such as lease rentals, would the SPV be entitled to rentals paid after the originator goes bankrupt? At least one court has said yes, holding that the net amount of payments received after bankruptcy under a prebankruptcy coal supply contract were proceeds subject to a prebankruptcy lien, even where the bankrupt company would have to continue to supply the coal in order to be paid.23 Because section 552(b) on its face allows a court to weigh the equities of each case, there is no assurance that a similar result will obtain in each case. In practice, however, courts generally have permitted claims of secured creditors against post petition proceeds of prepetition collateral except to the extent of costs and expenses incurred by the debtor post petition in generating such proceeds.24

The foregoing analysis of risks was illustrated by reference to a payment stream represented by a franchise contract. The same legal conclusions would obtain, however, for other types of future payment streams—such as leases and licenses—where a contract breach by the originator could raise a defense to pay-
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ment by the obligors or where the contract is an executory contract.25

§ 2:2.1 The Days Inn Example

The 1991 voluntary bankruptcy filing by a major motel franchisor and its affiliates [which included an SPV formed to securitize its future franchise fees] illustrates both the structural strengths and possible weaknesses of securitizations of future receivables. Days Inn of America, Inc. [DIA] and certain of its affiliates each filed a voluntary petition under Chapter 11 of the Bankruptcy Code.26 Days Inn Receivables Funding Corp. [DIRF], one of those affiliates, was a “bankruptcy-remote” SPV27 previously created to acquire from DIA [through a subsidiary of DIA] franchise agreements and franchise fees payable thereunder, as well as the Days Inn trademarks and trade names, the computer reservation systems, and certain other related property [the “Days Inn System”]. DIRF then issued notes secured by a security interest in the Days Inn System.

25. The nature of the receivable also can affect predictability of payment when the receivables are prepayable. If, for example, the receivables consisted of mortgage loans, and interest rates declined, the obligors might prepay the loans. Although the collections then should be sufficient to prepay the principal amount of the debt securities issued by the SPV, the holders of those securities may have bargained to have their securities outstanding for a longer period of time at a fixed interest rate. The problems associated with prepayments are beyond the scope of this book.


27. DIA caused DIRF to file for voluntary bankruptcy despite DIA’s admission in the filing that DIRF was solvent at the time and was intended to be “bankruptcy-remote.” See infra chapter 3 for a more detailed analysis of bankruptcy-remote SPVs.
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After the Chapter 11 filings, these debtors sought to sell the Days Inn System to a third party pursuant to section 363(b) of the Bankruptcy Code. In their request for bankruptcy court approval of the sale, the debtors stated how the sale proceeds would be allocated among the various creditors. Because the DIRF secured noteholders would not be paid in full under the proposed allocation and, as a result of the proposed sale of the Days Inn System, their security interest therein would be adversely affected, the secured noteholders had a right under section 363(e) of the Bankruptcy Code to request the bankruptcy court to restrict the sale as necessary to provide “adequate protection of such interest.” Rather than so objecting, however, the secured noteholders agreed to settle their claims against DIRF for payment of slightly less than full value despite such claims’ being oversecured. The secured noteholders apparently were willing to settle at a discount because they were concerned that the bankruptcy (as well as the inevitable delay and cost that

28. Bankruptcy Code § 363(b)(1) provides that “[t]he trustee, after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate.” Absent a formal plan of reorganization under Chapter 11, courts have allowed a sale of substantially all of a debtor’s assets under § 363 when there is a “sound business justification” therefor. See, e.g., In re Lionel Corp., 722 F.2d 1063, 1070–71 (2d Cir. 1983); In re Ionosphere Clubs, Inc., 100 B.R. 670, 675 (Bankr. S.D.N.Y. 1989).

29. Bankruptcy Code § 363(e) provides that “[n]otwithstanding any other provision of [§ 363], on request of an entity that has an interest in property . . . sold . . . or proposed to be . . . sold . . . by the trustee, the court, with or without a hearing, shall prohibit or condition such . . . sale . . . as is necessary to provide adequate protection of such interest.”
any litigation would entails, even if successful) could have a detrimental effect on the value of the Days Inn System.\footnote{30} Pursuant to the settlement agreement, however, the debtors effectively acknowledged the validity of the structure of the securitization.\footnote{31} The assignment of the Days Inn System to DIRF was never challenged, and there was no attempt to “substantively consolidate” the assets of DIRF with those of the other debtors.\footnote{32}

In short, the Days Inn bankruptcy illustrated both strengths and weaknesses in the structure. There were, in essence, two weaknesses. First, DIRF’s single independent director voted to put the SPV into bankruptcy. As discussed in chapter 3, in light of new case law defining a director’s fiduciary obligations to creditors in the vicinity of insolvency, an independent director of an SPV today should be less likely to vote for bankruptcy. Sec-

\begin{itemize}
  \item \footnote{30} Response of LaSalle Nat’l Bank as Successor Indenture Trustee to the Motion of Certain Debtors pursuant to Bankruptcy Code Section 363, DIA Bankr. Filing (Dec. 16, 1992) (hereinafter Noteholder Response). Pursuant to the settlement, the secured noteholders received an amount equal to the sum of (1) 95% of the outstanding principal of their secured notes, (2) accrued interest at the contractual predefault interest rate from the date of the last interest payment until closing of the settlement (including pre- and post-petition interest), and (3) in accordance with § 506(b) of the Bankruptcy Code, the reasonable expenses of the indenture trustee, the various committees representing the secured noteholders, their financial advisers, and their counsel.
  \item \footnote{31} Id. at 6 n.3. The settlement agreement provided that the debtors and the Original Committee of Unsecured Creditors acknowledged [1] the validity, priority, and effect for all purposes of the secured noteholders’ security interest in the Days Inn System, [2] that the secured noteholders were oversecured, and [3] that all payments previously made on or in respect of the secured notes and a related loan and security agreement “were properly made in the ordinary course of business and cannot be avoided under applicable law,” and shall not be challenged by the other parties to the settlement “as being preferential, or for any other reason.”
  \item \footnote{32} For a discussion of the substantive consolidation risk, see chapter 3, \textit{infra}, at section 3:4.
\end{itemize}
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ond, because of the length of time needed to repay the secured noteholders from collection of future franchise fees, the originator’s bankruptcy raised a practical concern regarding valuation of the receivables sufficient to induce the secured noteholders to settle at a small discount for an immediate payment. The possibility of linkage of the value of the receivables (including the ability to service and collect the receivables) to the health of the originator is an issue that should be carefully analyzed in every structured finance transaction.

On the other hand, *Days Inn* also illustrated some of the strengths of structured financing. The secured noteholders were repaid promptly with only a slight discount. Also, as mentioned, no attempts were made to substantively consolidate DIRF, or to invalidate the assignment of the Days Inn System as a fraudulent conveyance. There is little doubt that had DIRF

33. Despite the fact that the Days Inn System was assigned to DIRF, the unique skills of the DIA personnel were perceived by existing and potential franchisees as being critical to the value of their Days Inn franchises. Additionally, the publicity from the bankruptcy was perceived by franchisees as being detrimental to business, and the time required by DIA personnel to attend to matters related to the bankruptcy distracted them from providing the services required under the franchise agreements. Existing and potential franchisees were reluctant to renew or enter into franchise contracts, and some existing franchisees claimed that the bankruptcy was a defense to their payment of franchise fees. See, e.g., Noteholder Response 7 ("there may exist some danger that absent a speedy sale of the [Days Inn System] to a financially sound purchaser relations with franchisees might deteriorate, and the [Days Inn System] might lose the ability to retain present franchisees and attract new franchisees. In such circumstances, the value of the [Days Inn System] might substantially diminish, and it might be difficult to attract a purchaser for the Days Inn System, or to effect a successful reorganization"). Despite legally separating DIA from the Days Inn System, as a practical matter these factors linked the collateral value of the Days Inn System to DIA, including DIA’s ability to perform under the franchise contracts.

34. See chapter 3, *infra*, at section 3:4 and chapter 4 at section 4:7, respectively, for discussions of substantive consolidation and fraudulent conveyance law.

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itself been able to avoid bankruptcy, or (even if DIRF were in bankruptcy) had the receivables been short-term assets, the secured noteholders may well have ended up with full payment of their claims.35

§ 2:3 Credit Enhancement

Sometimes the risk of predictability of payment is addressed by third-party credit enhancement.36 That can take various forms, such as a guaranty or surety bond, a bank letter of credit, an irrevocable credit line, or (indirectly) the purchase by a third party of a tranche of subordinated securities from the SPV.37 The

[A]bsent the Settlement Agreement, any challenge to the extent of the DIRF noteholders’ secured claims would likely entail burdensome, protracted and highly complex litigation with respect to the appropriate valuation of the DIRF noteholders’ collateral. Such litigation would unquestionably have a negative impact on the proposed sale of the [Days Inn System], and result in a lower purchase price—all to the detriment of creditors and the Debtors’ estates.


37. The purchase by a third party of a tranche of subordinated securities (sometimes referred to as a “senior/subordinate” structure) actually is different from the other forms of third-party credit enhancement mentioned above. The creditworthiness of the buyer of the subordinated securities in unimportant. See text accompanying notes 40–41, infra. In cases where the originator, as opposed to a true third party, retains the subordinated securities, there often is not a true senior/subordinate structure but merely recourse to the originator by another name.
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goal is that a creditworthy party ensures payment of all or a portion of the securities issued by the SPV. A rating agency that rates the SPV’s securities would want the third party to be at least as creditworthy as the rating on the securities. The third party providing the credit support would want to be comfortable, as a business matter, with the ability to be repaid from the SPV. If the third party has a claim for repayment that is enforceable against the originator or its general assets (as opposed, for example, to a subrogation claim limited to the receivables sold), the transaction may appear to provide a form of indirect recourse against the originator, which may impair true sale characterization.

When the securities issued by the SPV are sold in a public offering, it is not uncommon to see a third party, typically rated AAA by Standard & Poor’s Corp. and Aaa by Moody’s Investors Service, Inc. (or the equivalent by other nationally recognized rating agencies, such as Fitch, Inc.), take at least a portion of the risk of nonpayment. For example, the third party may issue a surety bond or other financial guaranty in support of the securities issued by the SPV, causing such securities to be rated AAA/Aaa. That often would occur where the receivables are novel or do not have a well-established record of payment. The financial guaranty, although costly, provides the assurance needed to sell the SPV’s securities in the public markets at investment-grade prices. Entities that are well known for providing those financial guarantees include Financial Security Assurance Inc. (FSA), MBIA Inc., Ambac Assurance Corporation (Ambac), and Financial Guaranty Insurance Co. (FGIC).

As many institutions have experienced downgradings in the ratings on their long-term debt securities, new ways have been found to achieve credit enhancement that is not dependent on such ratings. For example, a bank may be prepared to issue a letter of credit to back an SPV’s securities, but its long-term credit rating may be insufficient to justify the desired rating on the securities. In the so-called cash collateral account approach,

38. See chapter 4, infra.
the bank,39 instead of issuing the letter of credit, would fund a subordinated loan to the SPV. The SPV then would pledge the loan proceeds as collateral for its securities.

Because a cash collateral account is fully funded, it would be costlier than a letter of credit. On the other hand, investors may prefer the comfort provided by a cash collateral account as opposed to a letter of credit issued by a bank, which may be downgraded during the life of the transaction. Further, funding a cash collateral account is a method by which many banks can support a higher rating on an SPV’s securities than would be obtainable through letters of credit issued by such banks. If the savings to the SPV in issuing higher-rated securities offsets the extra cost of a cash collateral account, a cash collateral account may well be an attractive alternative.

However, a more widespread way of providing credit enhancement independent of ratings is the so-called senior/subordinate structure.

§ 2:4 Senior/Subordinate Structures

In these structures, sophisticated investors provide the equivalent of “credit enhancement” to the SPV by purchasing subordinated securities. The originator thereby allocates certain repayment risks to these investors, who are in the business of assessing and accepting such risks and who consequently are willing to accept a higher level of risk than the average investor. Because the proceeds of the SPV’s subordinated securities are

39. A cash collateral account is particularly useful when funded by a bank or other entity [such as, perhaps, an insurance company] that is not subject to federal bankruptcy law. See Bankruptcy Code § 109. If the cash collateral account were funded by an entity that later went bankrupt, arguments could be made that the loan might be voidable as a fraudulent conveyance or that the pledged loan proceeds constituted property of the bankrupt entity.
used to purchase receivables and thereby further overcollateralize the SPV’s senior securities, the subordinated securities supplement the means by which the senior securities are paid.40

The interest rate on these subordinated securities would be higher than the interest rate on the nonsubordinated (or senior) securities to compensate for the greater risk. Nonetheless, this combination of senior and subordinated securities will still be of benefit to the originator if, as is usually the case, the resulting blended interest rate on the combined securities is lower than the rate that would have been applicable if only one class of securities had been issued.

The senior/subordinate structure thereby can be used to expand the universe of parties available to provide credit enhancement. As discussed, an entity providing external credit enhancement in the form of a guarantee or its equivalent is usually required to have a credit rating at least equal to that of the securities being guaranteed. But investors in subordinated securities have no rating requirement; the credit enhancement comes from their cash investment in the SPV’s subordinated securities.

It should be cautioned, however, that in cases where the originator, as opposed to a true third party, retains the subordinated securities, there often is not a true senior/subordinate structure but merely recourse to the originator by another name. This might impair the true sale characterization.41

40. That is, the cash the SPV receives by selling the subordinated securities enables the SPV to buy additional receivables from the originator. Because collections on the SPV’s receivables, including these additional receivables, would be applied (in accordance with the terms of the subordination) to pay the SPV’s senior securities before the subordinated securities are paid, the issuance of the subordinated securities will have the effect of overcollateralizing the senior securities.

41. See chapter 4, infra.