Article Title: ARCHIVE | Criteria | Structured Finance | ABS: Overview Of Legal And Analytical Challenges In Rating U.K. Corporate Securitizations Data: (EDITOR'S NOTE: — This article, originally published on Jan. 18, 2007, is no longer current. It has been superseded by "European Corporate Securitizations," published on Feb. 12, 2016.) The term corporate securitization, also known as "whole business securitization," is a catch-all label applied to a broad range of structured transactions. Despite the bespoke nature of each transaction's structure, some key principles underlie our rating analysis of all corporate securitizations. Here we review some of these principles in the context of the recent legal and analytical challenges we have encountered when rating U.K. corporate securitizations. Essentially, these transactions use securitization-style financing structures and rely on a combination of restrictive covenants and credit and liquidity enhancements to fund often complex operating businesses at high levels of debt leverage. The notes are funded by a future cash flow generated by a business activity. These structures rely therefore on the continued operation of the business to service the debt, rather than the isolation of self-liquidating financial assets in an issuer SPE, as in the case of traditional securitizations. Each corporate securitization requires an analytical approach that takes into account the specifics of each transaction. Standard & Poor's Ratings Services consistently applies its general criteria but accounts for individual idiosyncrasies of the specific business, the type of structure proposed, and the relevant legal and regulatory regimes. One aim of these transactions is to provide access to cheaper funding through structured credit improvement of what would otherwise be a simple corporate secured loan. This structuring may not always be regarded as effecting full isolation of the cash-generating assets from the borrower's credit risk, which is the goal of traditional securitizations. However, a rating uplift over and above the rating on the simple corporate secured loan can be achieved even where full "de-linkage" from the borrower's credit risk cannot. The type of issuance seen last year confirms that the model of the typical corporate securitization continues to evolve, with an increasing diversity of structural solutions as the sector expands and builds on its stable track record. The corporate securitization sector is proving that it is still flexible enough to adapt to the fresh challenges of issuers' requirements. This article assumes a level of knowledge of corporate securitization techniques. It is not intended as a primer and provides cross references to articles that set out the rating approaches and themes developed here. Where the term borrower is used in this article, it is intended, where appropriate, also to refer to the other companies making up the securitization group, such as any operating company or property owning company. Key Recent Challenges In Rating U.K. Corporate Securitization The challenges that have recurred most frequently in rating U.K. corporate securitizations are the following: In transactions that are "rated through insolvency," getting appropriate legal and structural comfort that there would be a means of continued control for secured creditors of the securitized business through insolvency by the appointment of an administrative receiver (including ensuring that the key transaction documents remain in place); Investigating whether English issuer SPEs in the structure could be considered bankruptcy remote; Addressing payment characteristics both of the underlying loan and the rated notes (subordinated step-up coupons), which could threaten timely payment of interest; and Identifying and mitigating potential cash drains on business revenues arising from the operating group specifically with respect to pensions liabilities, group tax liabilities, and on the re-characterization of fixed charges into floating. Before exploring these challenges (and potential analytical solutions) it is useful to consider some key concepts that influence the rating approach to a corporate securitization. What Do "Delinkage" And "Rating Through Insolvency" Mean And What Are The Rating Implications In Corporate Securitizations? When we are asked to rate notes issued by way of a "corporate securitization," one of the key considerations is whether the rating to be assigned relies on the structure's ability to survive formal insolvency proceedings against the borrower. When we can conclude that interest and principal is likely to be paid notwithstanding a borrower insolvency, then it is said the rating can be "de-linked" from the borrower business score and that the debt has been rated "through insolvency." This concept is key because when it is possible to rate "through insolvency," the rating on the securitization notes is likely to be higher than the business score of the borrower. The transactions that have been able to be rated "through insolvency" are mainly concentrated in the U.K. where the insolvency regime makes it possible for the noteholders to gain substantial control over the assets in a borrower insolvency by enforcing a "floating charge" security and appointing an administrative receiver to administer the insolvent estate. By way of example, U.K. public house (pub) securitizations rely on a security package that is designed to enable the noteholder to indirectly take control of the securitized pubs and operate them through a replacement operator, notwithstanding the insolvency of the original owner. This enables us to de-link the rating on the notes from the business score of the borrower, and thereby assign higher ratings in this type of structure than the corporate rating that could potentially be achieved by the borrower. There are some "corporate securitizations" where it is not possible to achieve a rating that is de-linked from the borrower's business score because a borrower insolvency would lead to an interruption of the cash flow coming from the operating business and therefore raise the risk of default on the notes. In this case, the notes cannot achieve a higher rating than the borrower's business score and the ratings assigned to the notes would, to a certain extent, be linked or capped by the business score of the borrower. This is most pertinent in businesses that rely entirely on state concessions that may be canceled upon insolvency and regulated utilities businesses where the relevant regulatory regime makes it unlikely that the noteholders could have access to the operating business following a formal insolvency of the utility. For example, in U.K. water corporate securitizations the lenders cannot take effective control of the assets—these transactions are therefore typically structured to minimize the probability of insolvency through a series of negative covenants and of early warning signals enabling corrective actions. Moreover, additional challenges may exist where nationally strategic or public assets are concerned, in particular infrastructure essential to the development of a country. Even when the legal analysis confirms the enforceability of the security, we are concerned about the role that the government would play in such circumstances and we may consider that the more likely outcome is that the noteholders would not gain access to these types of assets. Appointment Of Administrative Receiver And Consequences Of Such Appointment As mentioned above, in the U.K. it is possible under the insolvency regime for the secured creditor who holds a floating charge to enforce the security without necessarily accelerating the secured debt. Thereby, the secured creditor gains control over the business in a borrower insolvency through the appointment of an administrative receiver. The administrative receiver is able to appoint a back-up servicer/operator so as to allow the continued operation of the business and thereby permit continued payment of the rated debt. This provision under the U.K. insolvency regime that allows holders of floating charge security to appoint, in certain prescribed circumstances, such an officer and to gain control of the business has been key to the development of corporate securitizations in the U.K. The aim is to keep the transaction going by enforcing the security without necessarily accelerating the secured debt, both at the borrower level and at the issuer level. The appointment of the administrative receiver would—in addition to introducing a receiver acting primarily on behalf of the appointing secured creditors to the securitized business—enable any appointment of an administrator by other creditors to be blocked. The appointment of an administrator would normally be considered to cause difficulties for a transaction being rated through insolvency as it would involve a moratorium on the payment of amounts due and the enforcement of security. Where the continued payment of the notes relies on the ongoing operation of the business in a borrower insolvency, we therefore expect to receive comfort in transactions that: An administrative receiver can be appointed; Arrangements are in place that enable a reasonable conclusion to be drawn that an administrative receiver will be appointed; and In some cases, an insolvency practitioner would be prepared to take on such appointment. The second item is normally dealt with by documentary provisions (sometimes referred to as the "hardwiring" provisions) whereby the security trustee expressly agrees (i) to appoint an administrative receiver in respect of the borrower or, as the case may be, the issuer and (ii) to make such appointment in a timely manner so as to block any appointment of an administrator. This appointment is normally expressed to take effect no later than the final day the appointment must be made to prevent administration proceedings. Where an attempt has been made to appoint an administrator, this could be a period of no more than five business days. The comfort referred to in the third bullet point above may be required, for example, where, due to the specialist nature of the business, it is not clear that insolvency practitioners would in principle be prepared to be appointed as administrative receiver in reliance only on his indemnity out of the assets under his control. In some cases it may be appropriate to see the terms of an insolvency practitioner's appointment as an administrative receiver pre-agreed at the outset of the transaction (i.e., similar to the agreement for a substitute servicer). In some transactions the security trustee may require that there is a fund available to it for the initial financing of its costs and expenses associated with appointing an administrative receiver. Outside the U.K., if a direct equivalent to the U.K. administrative receivership is not available, the starting point should be to demonstrate the extent to which secured creditors could have control of the business in insolvency commensurate with the level of control afforded by administrative receivership. This level of protection has been regarded in our rating analysis as a minimum protection benchmark for the securitization creditors. However, where the business concerned is straight-forward in nature in that it involves minimal business risks and legal title to the business assets has been transferred to a limited-purpose entity (such as those used in CMBS), other structural approaches to justify de-linkage may be possible. The likely impact of an insolvency proceeding in the relevant jurisdiction(s) would need, however, to be assessed on a case by case basis and a range of structuring and legal issues would need to be taken into account. Do The Key Transaction Documents And Credit Enhancement Remain In Place In Administrative Receivership? In our rating analysis of corporate securitizations we consider the effect of an insolvency on the credit enhancements, such as the liquidity facility and the swap agreement. Given that the purpose of the structure is generally to survive an insolvency of the borrower, we would expect the liquidity and swap arrangements to continue beyond an appointment of an administrative receiver to the borrower or the issuer so as to ensure continued timely payment of interest and to cover other interruptions of cash flow during the administrative receivership. We expect therefore that events of default and drawstop events in the liquidity facility and swap documents to be limited to: The issuer's failure to pay; Acceleration of the notes; and Illegality of the transaction documents or of the issuer to perform its obligations under the documents. We would not expect such events to include insolvency of the borrower or the issuer nor insolvency proceedings when an administrative receiver is in place. Investigating Whether The English Issuer SPEs Are Bankruptcy Remote The bankruptcy remoteness of the issuer SPE needs to be taken into account within the context of the amended criteria published for English SPEs. These criteria include our request that a bankruptcy remote English SPE has and maintains an independent director. This concept has been reiterated in the article "Independent Directors' Role Clarified For English SPEs" (detailed below). In the context of corporate securitization, the case for independent directors is reinforced where the issuer SPE is owned by a non-SPE operating parent, especially where the directors of the parent are also the directors of the issuer SPE. From Jan. 1, 2007, borrowers, arrangers, and their legal advisers should expect to provide independent directors to all English companies intended to comply with the SPE criteria. The inclusion of an independent director on the boards of the borrower and the issuer is seen as a further important protective element in supporting the conclusion that there are disincentives for the directors to put this entity into insolvency. One of the other important reforms introduced in 2003 was the ability to appoint an administrator without the need for court proceedings. This could heighten the risk that an English company could be voluntarily filed into insolvency by its directors. Rather than solely rely on the security trustee to block within a tight timetable an administration requested by the directors of the borrower or issuer, the more prudent approach is to minimize the likelihood of voluntary filing by appointing an independent director at the outset. However, even an independent director may have concerns regarding personal liability or wrongful trading and so, although important, we do not rely on the appointment of an independent director alone. In fact, a range of issues could be relevant in considering the motivation of directors (and ultimately shareholders) to put an entity into voluntary insolvency, and we consider these along with the mitigants on a case-by-case basis. IFRS And Change to U.K. Accounting We note that various changes in the accounting regimes for issuers, listed companies, and limited-purpose entities are at varying stages of implementation. There is an increased risk that new accounting under IFRS and revisions to U.K. GAAP that is based on fair value could, among other things, create a mismatch for derivatives (interest hedging) between the assets and liabilities in the balance-sheet of the issuer SPE. In particular, derivatives typically require accounting at fair value, but the corresponding hedged risk—for example debt that is swapped from floating rate to fixed—is generally accounted for at amortized cost. Accordingly, the net assets of the company may vary from time to time as changes in derivative values increase or decrease (resulting from interest rates, currency exchange, or other fluctuations). This accounting treatment has no impact on the company's future cash flow nor on its ability to carry on as a going concern. Therefore, the potential technical balance-sheet insolvency does not necessarily reflect an actual insolvency of the issuer and its directors should be able to provide solvency certificates at the closing of the transaction. In this context we request that opinions (from both originators'/issuer's counsel and arrangers'/lead arranger's counsel) analyze the potential technical insolvency risk, when relevant, the issuer's solvency certificate signed by the directors, the relevant board minutes, and the accounting advice as to the proposed treatment of the issuer in the issuer's account. This enables us to conclude that a technical balance-sheet insolvency of this type should not be an insolvency within the meaning of Section 123(2) of the Insolvency Act 1986. Subordinated Step-Up Coupons: The New Criteria There exist a number of difficulties posed in rating notes when there is a distinction between rated and unrated portions of interest. In particular, tax concerns for English issuers could present unique challenges to arrangers in the context of unrated step-up coupons. This is elaborated upon in the articles "Technical Challenges In European CMBS Structures" and "CMBS And Corporate Securitizations—The Use Of Unrated Fees In English Issuer SPE Structures." To date, most structures involving an English issuer have not been able to adopt a true pass-through mechanism for tax reasons. In certain corporate securitizations— Globe Pub Issuer PLC, Mitchells & Butlers Finance PLC, and Telereal Securitisation PLC—the solution adopted was to characterize what was formerly an unrated step-up payment of interest as a fee payment instead. Therefore, the ratings do not address payments of these fees, while at the same time preserving the transparency of the rating analysis for noteholders. Identifying And Mitigating Potential Cash Drains Cash used to service the debt could potentially be drained out of the securitization structure by certain liabilities. We focus here on identifying and mitigating tax, pensions, and various other liabilities. Tax issues Understanding the tax implications in a corporate securitization is an important part of the rating process. Failure by the transaction parties to correctly assess the tax liabilities, which can be substantial, could result in an underestimation of borrower cash flows, and even in some cases increase the likelihood of borrower and, indeed, issuer default. We expect the information regarding the tax analysis (generally in the form of tax opinions) to consider all tax issues that the structure raises and to confirm, for example: That the issuer and borrower are not liable for corporate tax (or, if so liable, that the tax position is either neutral or quantified and factored into the cash flows). In many cases the borrower is liable for corporate tax and this is usually modeled in the cash flow; That VAT is not applicable to cash flows owed to or by the issuer in the transaction (or, if so applicable, that the timing of recovery and the amount of any irrecoverable VAT has been quantified and modeled accordingly); That withholding taxes are not applicable to cash flows flowing through to the issuer (or, if so applicable, that the amount of potential withholding tax liability is quantified); That withholding taxes are not applicable to payments by the issuer, the borrower etc. under swaps and other derivative instruments (or, if so applicable, that the amount of potential withholding is quantified and any risk of "clawback" analyzed); That stamp duties are not payable in respect of the documents and stamp duty land tax (SDLT) is not payable in respect of any property transfers (or if so payable, the amount has been quantified); That where the issuer is a non-U.K. resident, that it would not be deemed to be taxable additionally in the jurisdiction of the loan level obligors or the assets solely by virtue of entering into the corporate securitization; and That either there are no other taxes applicable, or that these taxes have been identified and quantified. On the issue of corporate tax, if the issuing vehicle in a U.K. corporate securitization is a "securitization company", it is likely to fall within the new regime implemented by "The Taxation Of Securitisation Companies Regulations 2006." This should ensure that the taxable profit of the issuer SPE will be the cash profit (rather than accounting profits), which will be the retained amount as provided for—and actually retained—in the documents. However, we understand that presently the borrowing vehicles in corporate securitizations will likely not fall within this regime and a number of tax results may flow from this. For the time being such a company will be taxed on the basis of old U.K. GAAP under Section 83 of the Finance Act 2005 but it is likely that Section 83 will be repealed and in such a scenario, unless a solution is found, these companies may face the prospect of unfunded tax liabilities (because the taxable profit will be linked to the accounting profit, whether IFRS or U.K. GAAP, which includes the application of FRS 26). It remains to be seen how these additional tax liabilities resulting from accounting changes will be captured in the cash flow model. Most typically, the tax issues that can pose difficulties for corporate securitizations are potential secondary tax liabilities or group tax arrangements; tax on the transfer of property SDLT, tax on chargeable gains and reduction of the available capital allowances pool. In the case of tax on chargeable gains, the property owner may be a new limited-purpose entity that has recently acquired the property—in which case there may be no deferred capital gains tax (CGT) liability. Alternatively, if there were a deferred CGT liability, we would, on a case-by-case basis, seek comfort that the debt amount, plus the tax on the capital gain, would be less than the market value of the property. If taxes become payable upon a change in the corporate structure of the borrower and the parent companies belonging to the same group, we would require appropriate de-grouping covenants to ensure that additional taxes, otherwise frozen within the structure, should not become payable. Sale of subsidiaries or part of the group that may have a material effect on the ability of the borrower to service the loan on a timely basis is expected to be subject to trustee consent and rating affirmation. Pensions liabilities and The Pension Act The legislative changes introduced by The Pension Act 2004 may also have a bearing on the analysis of the cash flow and disposal proceeds on which the issuer relies to fund the rated debt. The reason is that the U.K. pension regulator now has the ability to require parties "connected with" or "associated with" an employer running a defined benefit pension scheme (DBS), to contribute to shortfalls in that scheme. The issuer or borrower could, as a result, be called upon to meet potential pension liabilities of the borrower or a company in the borrower group. If the issuer, the borrower, or any other company in the securitization group could be called upon to meet potential pension liabilities we may request confirmation that the pension fund is sufficiently resourced. In the event that there is shortfall in the applicable pension fund we need to understand if there is sufficient cash and value in the transaction to meet a potential contribution notice and what impact such a notice would have on the cash flow available to service the rated notes. In the event that there is not sufficient cash, we would expect additional pension contributions to be paid to fund the DBS deficit. However, we would normally consider the main support to be the transaction's credit enhancement—such as a liquidity facility and cash reserves—and the equity in the transaction. We would expect further credit enhancement when the covenants provided are not considered sufficiently robust. The legislation introduced a clearance mechanism that allows confirmation to be sought from the pensions regulator in advance of a transaction that it would not issue either a financial support direction or a contribution notice in the future. If such a clearance is being relied upon to ensure that there is no funding risk, we may request information regarding the application for clearance and the result of the application. Additional liabilities from potential re-characterization of fixed charges Under U.K. insolvency law a receiver (including an administrative receiver), liquidator, or administrator of a company is now required to make a "prescribed part" of the company's "net property" available for the satisfaction of unsecured debts in priority to the claims of the holder of a floating charge. This prescribed part should not exceed £600,000. This applies whether a charge has been created as a "floating" charge or whether a charge has been created as a "floating" charge or whether a charge has been created as "fixed" charge but re-characterized as "floating" charge In a corporate securitization that includes ownership of assets by multiple companies, realizations on enforcement may be further reduced in respect of each company by up to £600,000. If we consider it likely that this amount would be payable upon enforcement of the security, we generally assess, within the context of each transaction, whether the amount could be considered de minimis within the credit analysis or if an ad hoc reserve should be expected. We generally size the cash flow to reflect all such claims and amounts that may rank ahead of the noteholder's security in an insolvency—this means that we size the cash flow so as to reflect each applicable reduction of up to £600,000 per company. We account for the re-characterization risk unless the legal analysis can confirm unequivocally that there is no such risk attendant on all the fixed charges. When the relevant section of the Companies Act 2006 comes in to force, the costs and expenses of the liquidation (in each case, where such assets are subject to a floating charge) will be required to be paid in priority to liabilities secured by the floating charge. Any corporation tax on income or chargeable gains payable in respect of the disposal of floating charge assets are costs of the realization of those assets and thus would be payable in priority to the debt secured by the floating charge. This could include, for instance, a deferred capital gains tax liability of the sort discussed under "Tax issues" above. It remains to be seen precisely how this amount will be sized for. We encourage readers who are structuring or considering structuring a corporate securitization to contact us as early as possible in the process to discuss any of the points raised above. Related Articles “European

Corporate Securitization Outlook 2007—Restructuring And Acquisition Finance To Drive Issuance" (published on Jan. 15, 2007). "A New Tax Regime For Securitization SPEs In The U.K." (published on Dec. 20, 2006). "CMBS And Corporate Securitizations—The Use Of Unrated Fees In English Issuer SPE Structures" (published on Dec. 11, 2006). "Independent Directors' Role Clarified For English SPEs" (published on Dec. 6, 2006). "Rating Approach To European Corporate Market Value Securitizations" (published Nov. 23, 2006). "Technical Challenges In European CMBS Structures" (published Feb. 16, 2006). "Amended Structured Finance Legal Criteria For English And Welsh SPEs" (published on Dec. 16, 2005). "European Legal Criteria for Structured Finance Transactions" (published on March 23, 2005). "Guide To U.K. Tax Implications For CMBS Transactions" (published on Sept. 15, 2005). "Legal Brief: U.K. Pension Regulatory Net Tightens For U.K. Securitizations" (published on Aug. 23, 2005). All criteria and related articles are available on RatingsDirect, the real-time Web-based source for our credit ratings, research, and risk analysis, at www.ratingsdirect.com. The criteria can also be found on our Web site at www.standardandpoors.com.