Article Title: ARCHIVE | Legal Criteria: Criteria for Trust Issuers in U.S. Structured Finance Transactions Data: (EDITOR'S NOTE: —This criteria article is no longer current. It has been superseded by the article titled, "Legal Criteria For U.S. Structured Finance Transactions: Special-Purpose Entities," published Oct. 1, 2006.) The trust vehicle is often chosen by securitization parties to issue their transaction's rated ABS. In the U.S., trusts are generally created under a state's common (or "judge-made") law, its statutory law, or a combination of both. The choice of any issuing vehicle, whether a corporation, limited liability company (LLC), partnership, trust, or some foreign version thereof, involves various bankruptcy, tax, and accounting considerations. In rated securitizations, however, the common factor to all these issuers is their bankruptcy remoteness, that is, the requirement that the issuer be unlikely to be drawn into insolvency as a result of its, or a related entity's, activities. As a general matter, therefore, Standard & Poor's Ratings Services' bankruptcy-remote criteria apply to trusts to the same extent as other types of issuers. The first part of this article sets forth those criteria in the trust context. The second part of the article contains a list of FAQs and answers about the various types of trusts encountered by Standard & Poor's in many types of structured finance transactions. Trusts as Special-Purpose Entities A fundamental principle underlying Standard & Poor's securitization analysis is the bankruptcy-remote characterization of the special-purpose entity (SPE) issuing the rated obligations and holding the pool of assets generating the cash flow needed to service the rated obligations. Standard & Poor's believes that the bankruptcy remoteness of the issuer makes it less likely that the transaction's cash flow will be interrupted or compromised. For this reason, Standard & Poor's bankruptcy-remote criteria were developed to reduce the potential for the issuer's bankruptcy. In the case of trusts, the issue of whether a trust is inherently bankruptcy remote (based on the theory that it is not a "person" eligible for bankruptcy protection) is not settled. Under Section 109 of the U.S. Bankruptcy Code, only a "person" (which includes corporations, LLCs, partnerships, and "business trusts") may file for protection under the liquidation or reorganization provisions of the Code. What is a business trust for bankruptcy purposes? The Code gives little guidance as to the meaning of the term. Case law suggests that whether a trust qualifies as a business trust hinges on whether the trust is carrying out a for-profit business. Rather than determining whether the activities of a particular trust constitute a for-profit business, Standard & Poor's takes the position that trusts used in structured financings could be viewed as eligible for bankruptcy protection under the Code, and therefore should be designed to achieve the goals reflected in the bankruptcy-remote criteria for other types of SPEs. Standard & Poor's believes that, in practice, most trusts in rated transactions are structured to be bankruptcy remote. This article is intended to summarize, and provide guidance on, the principles of bankruptcy remoteness for trusts. Restrictions on Objects and Powers As with other type of SPEs, the activities of an SPE trust should be limited to holding transaction assets, issuing the rated obligations, and engaging in activities reasonably related to the foregoing. In the case of both statutory and common law trusts, the limitation on the trust's activities should be explicit in the trust instrument. Limitations on Indebtedness Standard & Poor's structured finance ratings are based in part on the value of the quantifiable cash flow from the assets held by the issuer relative to the size of the liabilities serviced by such cash flow. It is an established principle that to the extent the issuer may incur additional liabilities without a commensurate increase in assets, the rating may be affected unless such liabilities are: Fully subordinated to the rated debt; or Rated as high as the rating on already outstanding issues; and In either case, nonrecourse to the issuer or any assets of the issuer other than cash flow in excess of amounts necessary to pay holders of the rated debt. Such additional liabilities, moreover, should not constitute a claim against the issuer to the extent they are unpaid. These principles apply equally to an SPE trust. Master trusts (see FAQs) are consistent with these criteria because Standard & Poor's views the asset allocation provisions contained in the pooling and servicing agreement by which the master trust is created and administered as constituting a subordination agreement under the Code. Prohibitions on Merger and Consolidation Unlike common law trusts, statutory trusts are generally permitted to merge and consolidate with other entities. The SPE requirement against such merger or consolidation is designed to prevent the bankruptcy-remote status of the SPE from being undermined by any dissolution, liquidation, consolidation, merger, or asset sale while the rated debt is outstanding. This requirement, as well as restrictions on termination or dissolution until all the rated debt is paid, should appear in organizational documents for statutory trusts. Additionally, the trust should be restricted from amending such documents without a rating affirmation of any outstanding debt. Separateness Covenants Whether an entity is bankruptcy remote depends in part on whether it holds itself out to the world as independent from its parent. With respect to trusts, "separateness" risk may exist in cases where one of the parties to the transaction retains (directly or through a wholly owned subsidiary) an ownership interest in the trust through its holding of an equity interest. Such retention could lead to a consolidation of the trust's assets with those of the certificateholder. In cases where trust equity interests are held by unrelated third parties, the risk of consolidation may be reduced. The so-called separateness covenants aim to provide that the affairs of the SPE are kept independent of its parent and affiliates. In addition, Standard & Poor's generally requests a legal opinion confirming that, in the event of bankruptcy of the equity certificateholder, neither the SPE nor its assets would be substantively consolidated with such entity (a nonconsolidation opinion). However, separateness covenants and a nonconsolidation opinion for a trust SPE would not be necessary if: The trust equity is so dispersed that no single equityholder can maintain a controlling position (which is true of many trusts in rated securitizations); or The trust's controlling equityholder is an SPE. Nonpetition Language It is customary for the transaction documents in a securitization to contain an agreement by creditors not to involuntarily file the SPE into bankruptcy until one year and one day after the last payment to the debtholders has occurred. Such a "nonpetition" covenant should also be included in the transaction documents when a trust is the issuer. Security Interest Over Assets Like any other SPE issuer, a trust should create and perfect a security interest in the trust assets in favor of its debt obligation holders. The creation and perfection of the security interest acts as a disincentive to a bankruptcy filing of the trust by potential creditors seeking access to trust assets. Nevertheless, a security interest is not applicable in circumstances where the trust is issuing only equity or equity-like obligations, such as certificates representing undivided ownership interests in the trust assets. Independent Consent to File for Bankruptcy The requirement that an independent entity (such as an independent director) consent to an SPE's filing of a voluntary bankruptcy petition generates more inquiries in the trust context than any other aspect of the SPE criteria. As a general matter, Standard & Poor's assumes that financial institutions acting as trustees in rated securitizations would not file the trust into bankruptcy absent the consent of 100% of the trust beneficiaries. In transactions where the trust equity is concentrated in a single holder, the trust documents should contain provisions restricting the ability of the equityholder to file the trust into bankruptcy or terminate the trust. FAQs on Trusts What Is a Common Law Trust? A common law trust is one whose creation and existence is governed by the common law of a state, that is, the principles of case law (judge-made law), rather than by statute. Until recently, trusts used for commercial (including securitization) purposes in the 50 states were common law trusts. Another characteristic of a common law trust is that trust property is owned directly by the trustee, rather than through a trust entity legally separate from the trustee. This contrasts with the statutory trust where the trust entity itself, rather than the trustee, owns the property. What Is a Statutory Trust? In a statutory trust jurisdiction, trust law is determined primarily by statute rather than by case law. The primary example of a statutory trust jurisdiction, particularly for structured financings, is Delaware. In 1988, Delaware implemented (and has since frequently amended) a statutory trust system. Since Sept. 1, 2002, this body of legislation has been termed the Delaware Statutory Trust Act. Aside from codifying certain existing common law trust principles, the policy behind the act was to review and improve existing trust law, remove certain anachronisms, and implement features that permitted more adaptability of the trust to commercial arrangements without necessarily losing the types of protection found in more traditional types of trusts. Connecticut also has adopted statutory trust provisions. What Is an Owner Trust? An owner trust is a trust in which the sponsor owns all of the trust equity in the form of certificates that can be subsequently transferred. As with other asset-backed debt issuers, the owner trust's debt obligations are secured by a pledge of the trust assets. The owner trust uses the trust's net income to pay principal and interest on the debt and to make distributions of the excess to the equity. Owner trusts typically have only a single or at most two classes of equity interest, but often issue debt in multiple classes with different levels of subordination and rights to payments. Titling trusts, discussed below, are owner trusts that do not issue debt. What Is a Grantor Trust? The term grantor trust is a characterization under the Internal Revenue Code. A trust that is characterized as a grantor trust is treated as a pass-through entity (like a partnership) that is not required to pay tax on its net income. As with a partnership, the trust equityholders are required to pay tax on their net income from the trust. In a grantor trust, there can be no significant power under the trust agreement to vary the composition of the trust's assets (other than to dispose of assets) or otherwise to reinvest payments received. A grantor trust must have, with limited exceptions, only a single class of ownership interests. The exceptions to the single-class-of-ownership requirement allow for the issuance of stripped certificates (the separation of the rights to principal and interest), and senior and subordinated certificates. What Is an Indenture Trust? The issuer of debt (a corporation, partnership, LLC, or trust) may elect to secure the borrowing by a pledge of collateral. The borrowing and pledge are often evidenced by a document called a trust indenture or bond indenture. In a trust indenture, a bank or other fiduciary will hold an interest in property as security for payment on behalf of the borrower without taking actual legal title to such property. As such, the term trust indenture is something of a misnomer (for this reason, some practitioners prefer to use the term collateral agent or security trustee instead of bond trustee or indenture trustee). Because there is no transfer of title but merely a grant of an interest in the pledged collateral, the arrangement is actually a security device, not an actual trust. What Is a Master Trust? A master trust is a revolving financing arrangement in which the trust (typically a common law trust) acquires, from time to time, assets from a transferor or depositor. Based on the value of these assets, the trust periodically issues various series of certificates representing undivided beneficial ownership interests in all of the trust assets. In practice, an undivided beneficial interest represents the right to receive income from the trust after payment of costs and expenses, or the right to receive a pro rata share of liquidations proceeds from the trust after payment of its liabilities. Generally, the cash flow from trust assets is allocated among all certificateholders through a master pooling and servicing agreement, as amended by series supplements establishing the terms of each certificate series. Master trusts provide flexibility for the sponsor in that the different series (as well as different classes within series) may have different payment priorities. What Is a Titling Trust? The titling trust (also known as an origination trust) is typically a statutory trust used in securitizations of pools of automobile leases. Titling trusts hold automobile titles and leases. Titling trusts do not issue debt, but rather two types of certificates of beneficial interest: an undivided trust interest (UTI) representing an ownership interest in the titles and leases held by the trust that are not specifically allocated for a securitization, and a special unit of beneficial interest (SUBI) representing an ownership interest in a defined pool of automobiles and leases and the related cash flows. Typically, the UTI is issued to the transaction sponsor and the SUBIs are issued to an SPE affiliated with the sponsor for purposes of securitization. This SPE then issues debt secured by a pledge of its SUBIs. By using a titling trust, the sponsor can minimize the administrative formalities and costs that otherwise would be created by title transfer and pledge of the vehicles for the benefit of the noteholders. What Is an Equipment Trust? The term equipment trust usually refers to an owner trust used in the leveraged lease of a capital asset (such as aircraft). Most equipment trusts are structured as statutory trusts. By contrast, an equipment pass-through trust is a pooling arrangement for obligations issued by one or more equipment trusts. An equipment pass-through trust may be established under either common law or statutory trust principles. For tax purposes, an equipment pass-through trust is normally treated as a grantor trust. What Are Cayman Island and Bermuda Trusts? In these "money-center" jurisdictions, trusts are most often encountered in securitizations as holders, for the benefit of a local charity, of the shares of a locally domiciled corporation that issues the rated obligations. The independence of the issuer from any corporate parent (in particular, the depositor of the assets) is the reason why these issuers are known as orphan subsidiaries. The tax benefit for the parent of setting up an entity in one of these offshore money centers would be lost if the U.S.-incorporated parent were to directly own the entity. A local trust, therefore, operates much like a voting trust (see below), whereby the shares of the issuer are held in trust. The trustee votes on matters in accordance with the provisions of the trust deed. The economic benefits of ownership are usually minimal, either because the corporation's assets liquidate on their own or because the economic benefits (usually in the form of the residual interest in the corporation's assets) are allocated to another shareholder. What Are Jersey Trusts? Jersey is another offshore money-center jurisdiction. Jersey law provides for a variety of different types of trusts, including discretionary trusts and purpose trusts. The charitable purpose trust is the most frequently used type of Jersey trust in rated transactions, and as with other offshore jurisdictions, a charitable purpose trust governed by Jersey law is typically used to hold the shares of a Jersey-domiciled issuer. As is the case with Bermuda and Cayman Island trusts, English common law influences the interpretation of Jersey trusts. The doctrine of substantive consolidation is not implemented, although other related theories ("alter ego" and "piercing-the-veil") may be applied in unusual cases. Similar to other offshore trust centers, a favorable tax environment applies in Jersey. What Is a Voting Trust? A voting trust is an arrangement whereby a fiduciary is granted, through the issuance of voting stock in its name, voting rights with respect to defined actions proposed to be taken by the stock issuer. The voting trust is constituted by a deed of trust between a corporation and the fiduciary serving as trustee. The trust deed defines and limits the powers of the fiduciary to vote the shares in a specified fashion. The arrangement is used in situations where the corporation wishes to achieve a degree of bankruptcy remoteness and the appointment of an independent director may be problematic. Voting trusts are not very common in securitizations or structured financings in the U.S., although they have other applications. They are akin to powers of attorney and are also known as golden share arrangements.