Article Title: ARCHIVE | Legal Criteria: Legal Issues in German Asset-Backed Securitizations Data: (Editor's note: These criteria are no longer valid.) This paper seeks to identify certain key legal issues that arise in the context of German asset-backed transactions based on Standard & Poor's Ratings Services' experience in the German asset-backed market, and to set out the approach that Standard & Poor's has developed to attempt to ensure that transactions that it rates display the legal robustness appropriate to the rating assigned. This paper is primarily a practitioner's guide rather than an academic treatise. For this reason it does not seek to set out every legal issue that may be involved in an asset-backed transaction, nor does it purport to be a full legal analysis of the complex underlying legal principles that are discussed. Rather, it focuses on issues that, in Standard & Poor's experience, often arise in practice, and on the manner in which Standard & Poor's has adapted and applied its global criteria to these issues. Finally, this paper is not a complete list of all the issues that can be and are relevant to German structured finance transactions nor should it be considered to constitute legal advice. Market participants seeking a Standard & Poor's rating continue to be invited to familiarize themselves with all the published criteria that may be relevant to their transaction. Standard & Poor's ratings criteria can be found on Ratings Direct, Standard & Poor's on-line credit analysis system, at www.ratingsdirect.com, under Criteria. The published criteria are also available on Standard & Poor's Web site at www.standardandpoors.com. Under Resource Center, select Ratings Criteria, then Structured Finance. Initial Structuring Considerations The initial structuring considerations for all securitization transactions involving obligations that are to be rated focus on four key issues: (i) identification of the assets or risks to be transferred; (ii) determining the type and desired credit risk profile of the obligations to be issued; (iii) designing the mechanism of assignment/risk transfer; and (iv) determining the method or type of issuance of the proposed obligations. Assets/Risks to Be Transferred The German structured finance market has seen two distinct classes of originator emerge: banks and nonbank entities or corporates (referred to in this article as "nonbanks"). For the German nonbank sector, the main driver behind securitization has traditionally been lower-cost financing. For the German banking sector, although low-cost financing has been an important driver behind many securitizations, they have also used securitization as an important tool toward balance sheet and regulatory capital management. For the nonbank sector, the assets that have been securitized have generally been trade receivable-type assets (i.e., receivables generated through operating activities). For the German banks, because of the various rationales for securitizing, they have securitized a variety of assets including bank loans of various types including auto loans, residential mortgages, corporate loans, consumer loans, and bond portfolios. Credit Risk Profile In structuring transactions, the desired credit risk profile of the obligations to be issued is a function of the creditworthiness of the assets and the risks associated with them, the value of any credit enhancements, and the relationship of the various parties to those assets and risks. For example, in a transaction where the assets to be securitized have an implicit credit quality of 'A' but the desired rating on asset-backed notes to be issued is 'AAA', the asset-backed notes will require additional credit enhancement, external credit support, or subordination to achieve the desired rating. Designing the Mechanism of Assignment/Risk Transfer Save for the German Mortgage Bank Act ("Hypothekenbankgesetz") and the German Law on Covered Bonds and Similar Bonds of Public Law Credit Institutions ("Gesetz über die Pfandbriefe und verwandten Schuldverschreibungen öffentlich-rechtlicher Kreditanstalten") relating to covered bonds ("Pfandbriefe", "Kommunalschuldverschreibungen", or "Kommunalobligationen"), Germany does not have a specific legislative framework designed to facilitate securitization. Standard & Poor's does note however the recent legislation to improve the general framework for securitizations of bank receivables in Germany (see under the heading "Tax" for a summary). At the time of writing, German securitizations are structured on the basis of applying general provisions of German law. German securitizations can generally be divided into those that use an SPE and those that do not. SPE Structures For those transactions involving SPEs, as in other jurisdictions, German securitizations are sometimes based around the paradigm structure of an originator selling assets to an insolvency-remote SPE formed for the sole purpose of issuing debt and using the proceeds to finance the purchase price for the assets. With the development and use by the financial markets of derivative contracts documented on ISDA forms of contract (or the corresponding German standard forms), however, synthetic securitization structures have evolved where instead of a legal assignment of assets in return for a payment of a purchase price, the originator and the SPE synthetically replicate the sale transaction without a legal assignment of assets. In the past, for various reasons discussed below, synthetic structures have been far more commonly used in the German securitization market than in other European jurisdictions. Standard & Poor's notes that almost all SPEs used in German securitizations are incorporated outside of Germany. The most popular jurisdictions of incorporation for SPEs used in German securitizations traditionally include Jersey, Guernsey, The Netherlands, Luxembourg, and Ireland. All securitization transactions that use SPEs and are seeking a rating on their debt should satisfy Standard & Poor's insolvency remoteness criteria, a summary of which is in "SPE Criteria". Non-SPE Structures For those transactions not involving SPEs, Standard & Poor's notes the increased use by German banks of direct credit-linked note issuances under the umbrella of the banks pre-existing MTN program documents. Typically, the payment of principal and interest on these credit-linked notes are linked to the performance of a discrete pool of assets. The goal of such credit-linked note structures is usually to obtain regulatory capital relief for the bank involved from the risks that these discrete assets would normally impose upon the balance sheet of the bank. Standard & Poor's notes that some German banks occasionally choose to collateralize the credit-linked notes with a view to delinking the credit risk of the notes from credit/insolvency risk of the bank issuing the notes. Method/Type of Issuance of Rated Obligations As alluded to above, securitization structures usually involve the issuance of debt obligations for which a rating is sought. In the German securitization context this typically means asset-backed debt issued by a non-German SPE, backed by German assets, or for non-SPE structures, debt issued directly by, for example, a German bank, with the repayment of principal and servicing of interest being tied or credit-linked to the performance of a discrete pool of assets. Apart from these debt obligations, German mortgage and public sector banks issue and seek ratings for covered bonds, the structure and issuance of which is governed by a special framework under German law. SPE Criteria Characteristics of Insolvency Remoteness Standard & Poor's criteria specify that, for an asset-backed transaction to receive a rating from the highest categories, the SPE that owns the assets or issues the rated debt or both must comply with Standard & Poor's insolvency-remoteness criteria. Standard & Poor's regards an entity that satisfies these criteria as being sufficiently protected against both voluntary and involuntary insolvency risks. The criteria can be divided into the following: Restrictions on objects and powers; Debt limitations; Limited recourse and nonpetition language; Independent director; No reorganization or changes of ownership; Separateness covenants; and Security interests over assets. Each of the characteristics is important to the overall concept of insolvency remoteness. Regardless of the jurisdiction or specific organizational structure of the SPE, these elements should, generally, be addressed in the relevant organizational or transaction documents or both. These characteristics are set out in full in Standard & Poor's publication "Legal Criteria in Structured Finance Transactions", dated April 2002 (the "Structured Legal Criteria Book"), in the chapter entitled "Special-Purpose Entities" (the article is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. Select "Criteria", "Books", and then "Structured Finance". It is also available at Standard & Poor's website at www.standardandpoors.com, where it can be found under the heading "Credit Ratings Criteria"). For ease of reference each of the points is briefly explained below. Restriction on Objects and Powers The SPE should covenant to restrict its activities to those needed to ensure the sufficiency of cash flow to pay the obligations under the rated notes. The SPE should not engage in unrelated business activities unless the parties to a transaction are willing to allow the rating to reflect the effect of these activities on the SPE's resources, cash flows, and ability to pay the SPE's obligations in a full and timely manner. These restrictions may be set out either in the SPE's constitutional document or in a binding contract with the noteholders or their representative. Standard & Poor's notes that there is, with certain exceptions, no ultra vires doctrine in German law, so that German entities are generally able to enter into binding transactions with third parties even where such transactions are prohibited by their constitutional documents. Standard & Poor's does not, however, consider this an obstacle to the establishment of insolvency remoteness of German SPEs, provided that the internal restrictions on the SPE's management are sufficiently clear. Debt Limitations The SPE should be prohibited from incurring any additional indebtedness, except in cases where such indebtedness would not affect the rating on its existing borrowings. The one exception to this rule applies to SPEs that are structured to comply with Standard & Poor's "segregated issuer" criteria. For guidance on the criteria for issuance of additional debt from a securitization entity, see the chapter entitled "Legal Criteria Applicable to International Transactions — Segregation Criteria" in the Structured Legal Criteria Book. Limited Recourse and Nonpetition Language All debt and money payment obligations incurred by the SPE must be limited recourse to the cash available to the SPE in accordance with a preagreed order of payment priorities. All parties to the securitization that contract with the securitization entity must covenant not to file for the insolvency of the SPE nor take any legal action that would or would be likely to result in the insolvency of the SPE until at least 12 months from the repayment of the last maturing rated obligation. Independent Director Standard & Poor's will require that at least one of the directors of the SPE be independent from the participants in the transaction. Standard & Poor's expects the independent director, within the boundaries of his or her legal duties to the company, to review the operation of the SPE and to provide information to the note trustee if he or she becomes concerned about the governance of the SPE. No Reorganization or Changes of Ownership The SPE should not engage in any dissolution, liquidation, consolidation, or asset sale (other than as provided in the relevant transaction documents), or amendment of its memorandum or articles so long as the rated securities are outstanding, without prior written notice to Standard & Poor's. Separateness Covenants Separateness covenants are designed to ensure that the SPE holds itself out in the world as an independent entity, on the theory that if the entity does not act as though it has an independent existence a court may use the principles of "piercing the corporate veil" or "alter ego" or "substantive consolidation" to bring the SPE and its assets in to the parent's insolvency proceedings. The involvement of an overarching parent could otherwise be a threat to the independent existence of the SPE. An important element of Standard & Poor's insolvency remote analysis is the existence of legal comfort that the SPE's assets would not be treated as part of the insolvency estate of its parent or an originator. In this regard, the SPE should agree to abide by the separateness covenants set out in the Structured Legal Criteria Book. In addition, Standard & Poor's may request legal opinions to the effect that the SPE would not be consolidated with either of its parent or originator. These legal opinions, if requested, will need to be delivered in respect of the jurisdictions in which the parent or originator are situated, because it is the insolvency law applicable to them and not the SPE that is relevant to the question of consolidation. German insolvency law does not contemplate the substantive consolidation of assets and liabilities of an insolvent debtor with those of its parent or another affiliate. Under general principles of German corporate law, however, a parent can incur liability for the debts of its subsidiary under "piercing the corporate veil" principles. The requirements under German case law for these principles to apply are substantially similar to those applicable in other jurisdictions. The situations in which "piercing the corporate veil" may occur include cases in which there is a commingling of assets, material "undercapitalization", lack of separateness, willful acting with prejudice to the company or its third-party creditors, or (under more recent German case law) other acts of a controling shareholder that put the continued life of the company in jeopardy. In unusual circumstances, the application of these principles can also result in liability of a subsidiary for the debts of its parent, which from a rating perspective is obviously the more relevant risk where nonorphan SPEs are used. In transactions involving nonorphan SPEs with German parents, Standard & Poor's expects a German nonconsolidation opinion, which also provides comfort that, on the face of the transaction documents, there is nothing that causes counsel to believe that "piercing the corporate veil" principles may create a risk. Equivalent legal opinions from counsel in other jurisdictions should also be delivered where the insolvency or corporate laws or both of those jurisdictions might become applicable. Security Interests Over Assets A requirement of insolvency remoteness is that the SPE grants a security interest over all its assets for the benefit of the noteholders. The purpose of this general security interest is primarily to diminish the incentives for any potential third-party creditor to seek to initiate insolvency proceedings against the SPE. To the extent that there are no free-floating and available assets for such a creditor to seize or share in, the likelihood of such an action may be reduced. Accordingly Standard & Poor's will expect to see a valid and enforceable security package covering all assets of a non-negligible value that the SPE owns in favor of a trustee for the benefit of the noteholders. In this regard Standard & Poor's will expect that legal opinions will be delivered confirming (i) that the security interests purported to be created by the documents create legal, valid, binding, and enforceable security interests that are fully perfected, and (ii) that in the event of an insolvency of the SPE, the security interests would not be capable of being set aside or successfully challenged by any creditors or insolvency administrator of the SPE. Typically in German true sale transactions, Standard & Poor's notes that German law-governed security interests are given by non-German SPEs over their German assets. In this scenario, Standard & Poor's would expect to see (i) a German legal opinion confirming the creation and perfection of security and its efficacy through insolvency as a matter of German law, and (ii) a legal opinion from the jurisdiction of the SPE confirming that the German security interests created by the SPE will be recognized and upheld by the courts in the jurisdiction of the SPE, even through insolvency of the SPE. Security Interests In the context of structured finance transactions, one will typically see security being given over assets by one party in favor of another. The security rights given underpin contractual obligations of the security provider in the event of default under those contractual obligations or the insolvency of the security provider. From Standard & Poor's perspective, the analysis of the security arrangements in any structured finance transaction is dependent on the level of reliance the arranger is seeking to place on these arrangements. The support security arrangements provide to a transaction can range from supporting the insolvency remoteness of an SPE to providing access to collateral that is meant to provide credit support for a transaction. Indeed, it is a significant feature of the German market that the rating of many (usually synthetic) transactions relies on the efficacy of a security interest rather than a "true sale" of assets. Most German structured finance transactions use one or both of the following forms of security: (i) "pledge" ("Pfandrecht"), (ii) a "transfer/assignment for security purposes" ("Sicherungsübereignung/Sicherungsabtretung"). Pledge A pledge is a security device recognized under sections 1204 et seq. of the German Civil Code ("Bürgerliches Gesetzbuch"). It is considered an accessory security right, in that it is accessory to the obligation that it secures. Accordingly, a pledge will terminate upon full satisfaction of the obligations secured by it. A pledge may only be validly granted to the creditor of the claim secured by the pledge. In the case of a pledge over tangibles such as physical assets, perfection of the pledge is effected by delivery of possession over the pledged asset to the pledgee (or its agent). In case of a pledge over intangibles, such as claims or receivables, notice must be given to the debtors under those claims to perfect the pledge. Where notification of a pledge of claims/receivables is impracticable or undesirable, parties usually consider as an alternative the use of the security device "transfer/assignment for security purposes". Although pledges of tangibles result in possession of the asset's being transferred from the pledgor to the pledgee, a pledge does not effect a transfer of title in the asset to the pledgee. Transfer/Assignment for Security Purposes A transfer for security purposes or security assignment is a security device that is based upon the transfer of title provisions in the German Civil Code. A security transfer/assignment is considered a nonaccessory security right, in that the extinguishment of the secured debt does not necessarily result in the termination of the security right. Unlike a pledge, a security transfer/assignment may be made to a person other than the creditor of the secured obligation. In addition, a security transfer/assignment, again unlike a pledge, does not require either notice or delivery for the security interest to become effective. A security transfer/assignment results in a full transfer to the secured party of the title in the collateral that is subject to the security transfer/assignment with the grantor of the security holding a right to the return of the collateral upon full satisfaction of the secured obligations. Insolvency Issues As part of the rating analysis of a structured finance transaction, arrangers and their counsel will need to explain and provide opinion comfort as to the effect of insolvency of the debtor on the security interests provided. Standard & Poor's will expect the insolvency discussion to include comfort (i) on the rights held by secured creditors over security collateral in relation to the insolvency administrator; (ii) on the ability of secured parties to directly enforce their security rights; (iii) on the ability of secured parties to enforce their security interests without deduction for costs and expenses of the insolvency estate from the proceeds of the collateral; and (iv) on the ability of the secured parties to enforce their security rights on a timely basis. The analysis of the latter point is dependent on a number of factors, including (i) the type of security interest, (ii) how the collateral subject to the security interest is held and (iii) who has possession or control over the collateral. What follows is a summary discussion of the various security insolvency issues as understood by Standard & Poor's from the opinions delivered by German counsel in rated transactions. For the purposes of the discussion that follows, the analysis will focus on issues relating to movables and accounts receivable. Secured Creditors —

Insolvency Rights German insolvency law creates a distinction how the different rights of contractual counterparties of the insolvent debtor (including secured creditors) are to be viewed in the insolvency of the debtor. Specifically, the German Insolvency Code ("Insolvenzordnung") divides creditors into two categories: those to which a "Right of Separation" ("Aussonderung") applies and those to which a "Right to Separate Satisfaction" ("Absonderung") applies. Right of Separation (Aussonderung) A "Right of Separation" will apply to those assets that no longer belong to the debtor (i.e., where legal and beneficial ownership have been transferred) and, accordingly, the creditors entitled to separation are not "insolvency creditors" in the normal sense, but rather they have a right to demand from the insolvency administrator a removal of the assets concerned from the insolvency estate. For example, this would apply to the purchaser in a properly structured true sale transaction in respect of the assets sold. However, secured creditors, including those that have obtained a security interest in the form of a security transfer/assignment (i.e., on the basis of a transfer of legal, but not beneficial, title), generally have no right of separation, but merely a right to separate satisfaction. A creditor entitled to separation would not share in any costs or expenses of the insolvency proceedings. This is important because of the "haircut" provision discussed in the following. Right to Separate Satisfaction (Absonderung) A "Right to Separate Satisfaction" will generally apply to those assets in respect of which a creditor has a security interest. In this case, the assets subject to such security interest do form part of the insolvency estate of the debtor, save that the secured creditors have a preferential right in respect of the assets and the proceeds thereof over the rights of unsecured creditors of the debtor (or, where applicable, any lower-ranking secured creditors). The right exists only to up the amount of the secured claim; any surplus belongs to the insolvency estate. Examples of security rights under which a secured creditor will have a right to separate satisfaction are a pledge (by which neither legal nor beneficial ownership is transferred) and a transfer/assignment for security purposes (by which legal but not beneficial ownership is transferred). Direct Enforcement of Security Interest in Insolvency Section 173(1) of the Insolvency Code states that an insolvency creditor's right to directly enforce or foreclose upon collateral will not be affected by insolvency proceedings unless the insolvency administrator is entitled to such enforcement under the Insolvency Code. Under section 166 of the Insolvency Code, an insolvency administrator may only foreclose upon (i) moveable tangible assets (including, generally, securities) if the insolvency administrator is in possession of that asset or (ii) claims/receivables that have been assigned for security purposes (as opposed to a pledge). If an insolvency creditor is entitled to foreclose upon the collateral directly, this right is qualified by the discretion of the competent insolvency court to set a deadline on foreclosure by the creditor upon application by the insolvency administrator. Deduction or "Haircut" on Enforcement by Insolvency Administrator In the event that an insolvency administrator is entitled under section 166 of the Insolvency Code to foreclose on collateral that is subject to a security arrangement, the insolvency administrator is obliged to enforce the collateral on behalf of the secured creditor and transfer the proceeds from such enforcement to the secured creditor. Sections 170 and 171 of the Insolvency Code, however, permit the insolvency administrator to deduct from the proceeds of enforcement as fees payable to the insolvency estate the costs for the identification and assessment of the asset in question and its realization. Specifically, the Insolvency Code provides that the insolvency administrator may deduct from the enforcement proceeds 4% for the identification and assessment of the asset and an additional 5% (generally) for enforcement costs, plus any applicable VAT (the "haircut provisions"). The application of the haircut provisions to collateral posted under security arrangements may be problematic to the rating analysis where the cash flow model is assuming and dependent upon 100% of collateral proceeds' being available to service the rated obligations. Timely Enforcement of Security Interests In the context of a structured finance transaction, Standard & Poor's credit ratings speak not only to the issue of ultimate repayment of principal and interest on the rated obligations, but also to the issue of timely payment of interest or principal or both in accordance with the terms and conditions of the rated obligations. Whether timely enforcement of security interests is relevant to the rating analysis for a particular transaction depends on the role that the security interests and their related collateral are playing in the structure presented to Standard & Poor's for analysis, and on the existence of any structured or financial liquidity enhancement to bridge the gap when no enforcement takes place. For example, in a transaction involving an SPE where the SPE grants security over its assets in favor of a note trustee, the security interests and their efficacy through insolvency go toward supporting the disincentive to filing argument and the analysis that the SPE is an insolvency-remote entity (see "SPE Criteria" for a more detailed discussion of insolvency remoteness). The timeliness of enforcement of those security interests by the note trustee is, therefore, not all that significant to the rating analysis. This situation is to be contrasted with a structure where collateral is being posted by a third party in favor of an SPE, or by a non-SPE issuer in favor of the noteholders, to support the rating on the notes issued. In these circumstances, timely access to the collateral under the security arrangements, including in the insolvency of the security provider, is important, as it will determine whether there will be sufficient funds available to meet the relevant payment obligations in accordance with the terms and conditions of the notes on a timely basis. Applying the general security discussion above, a transfer for security purposes or pledge of moveable tangible assets where possession is not delivered to the secured creditor, or a security assignment of claims/receivables, would be problematic where timing is at issue because, although the right to separate satisfaction would be preserved, there is a practical timing issue involved in the insolvency administrator's realizing the collateral on behalf of the secured creditor. In addition, the haircut provisions of the Insolvency Code would also apply to the proceeds realized, creating a credit stress. A scenario where moveable tangible assets (generally including securities) are delivered as collateral into the possession of a SPE under a pledge or a transfer for security purposes is favorable from a timing perspective, because the SPE would be entitled to enforce upon the collateral without application of the haircut provisions of the Insolvency Code. Even in the absence of any discussion about the legal right of the secured party to "immediate" enforcement, however, Standard & Poor's considers that such enforcement would still be likely to involve some practical delay and, depending on the circumstances, some form of liquidity may be required to cover this delay. Table 1 gives a summary of various security interests and how they fare when measured against issues of post-insolvency enforcement and haircut provisions. Table 1 Insolvency Administrator Security Enforcement Rights and Recovery of Costs SCENARIOS INSOLVENCY ADMINISTRATOR ENFORCEMENT RIGHT DEDUCTION FROM ENFORCEMENT PROCEEDS Moveable tangible assets (generally including securities) in possession of insolvency administrator Y Y Moveable tangible assets (generally including securities) not in possession of insolvency administrator N N Claims/receivables assigned for security purposes Y Y Claims/receivables pledged N N German Banking Act — Moratorium In the context of German banks' providing security, an additional issue that requires consideration when looking at the question of timely enforcement of security interests is the effect of an imposition of a moratorium under section 46a of the German Banking Act ("Kreditwesengesetz"). Under section 46a of the Banking Act, the German Federal Financial Supervisory Authority ("Bundesanstalt für Finanzdienstleistungsaufsicht" or "BAFin") may impose a moratorium on payments to be made by a bank. German counsel in their opinions generally explain that a moratorium under section 46a of the German Banking Act may be construed to result in a deferral of the due date of all payment obligations of the relevant bank. In this regard counsel refer to the views of some legal authors that a secured creditor would not be able to exercise the security right because the moratorium would mean that no obligation of the bank is due, and that general principles of German law require a secured obligation to be due and payable to entitle the secured creditor to enforce its security. Counsel have, however, generally provided comfort that, notwithstanding these views, a section 46a moratorium would not prevent a secured creditor from enforcing its collateral where possession of the collateral has been transferred to the secured party, or where the restriction on enforcement would not result in a liquidity benefit for the relevant bank, on the basis that (i) section 46a of the German Banking Act does not expressly exclude the enforcement of collateral for an obligation that is subject to moratorium, (ii) as a matter of contract law parties may provide that an obligation that is not yet due may be performed out of the proceeds of a specific asset, and (iii) from a pragmatic perspective no purpose is otherwise served by the BAFin's restricting the enforcement of collateral during a moratorium, when the preserved collateral will in any event ultimately be used to satisfy the claims of the secured creditor. Standard & Poor's has been satisfied that this analysis generally provides grounds for discounting a risk of delay in the enforcement of bank-provided security due to a section 46a moratorium. Security Interests — Conclusion Regardless of which security device is employed in any particular structure, originators and their counsel are expected to provide Standard & Poor's with an explanation of how the security arrangements are structured to support the rated obligations commensurate with the rating requested. Where relevant to the rating analysis, Standard & Poor's will expect to receive robust legal opinion comfort through insolvency about the efficacy of such security arrangements, including opinion comfort on each of the matters discussed above. Transfers of Assets/True Sale For structures involving a sale and transfer/assignment of assets (i.e., receivables) Standard & Poor's looks to the transaction participants to provide comfort on how assets can be transferred/assigned under German law so that a bankruptcy/insolvency or corporate reorganization of the transferor would not adversely affect the timely payment of principal and interest on the rated securities. As a legal matter, a transfer can be thought of as fulfilling three specific goals, depending on whether it is valid and enforceable: As a contractual matter, against a solvent transferor and resulting in the transferee having priority against third-party creditors while the transferor is solvent; Against the regulator (if any), debtor in possession, or an insolvency administrator of the transferor, an insolvency or reorganization proceeding, and against other creditors of an insolvent transferor; or Against the account debtors, enabling the transferee to enforce the assets directly without relying on the transferor (e.g., the ability to instruct the account debtor to make future payments to the transferee, or the ability to foreclose on a mortgage or repossess an automobile upon default). As a general matter, a true sale of an asset is a transfer that meets all three goals. An unperfected transfer may meet only the first two goals above, but may not be recognized in an action against the account debtor. An unperfected transfer also may be more likely to be challenged in an insolvency or corporate reorganization proceeding. A promise to transfer assets in the future is only enforceable against the transferor and so would meet only the first goal. Although the word "transfer" is often used without regard for its breadth, being able to define the breadth of transfer required for securitization and accomplishing the necessary formalities can lead to successful transactions. German True Sale Some countries have enacted securitization statutes that clearly delineate the conditions and formalities under which the transfer must take place for the transfer to be a true sale. At the time of writing, no such special legal framework exists in Germany. There is no explicit legal authority in Germany for what constitutes a true sale in a structured finance transaction and, accordingly, true sale transactions are structured under the existing general legal framework provided by German law. The prevailing German view is to apply the principles that have been established by the German courts for distinguishing true or genuine factoring ("echtes Factoring") from untrue or nongenuine factoring ("unechtes Factoring") to the question of true sale of receivables. True factoring means that the sale of receivables is without recourse to the seller, whereas untrue factoring is more akin to a collection arrangement in that the assignee will have recourse to the assignor with respect to any shortfall in collections. In discussing this issue, German counsel point toward a decision of the German Federal Supreme Court in Civil Matters ("Bundesgerichtshof"), which decided that the transfer of the credit risks relating to the assigned receivables is an important factor for determining whether the assignment is to be considered a true factoring. German counsel also point out that, for an assignment to qualify as true factoring, a transfer of the economic chances associated with the assigned receivables may also be required. In legal opinions discussing true sale, German counsel point to issues to be considered in determining whether a transaction should be viewed as resulting in a true sale, including the following: The amount and variability of purchase discounts provided by the originator to the purchaser and the ratio borne between the credit enhancements provided by the originator to the purchaser and the historic default ratio of the assets being assigned; The provision by the originator to the purchaser of buyback options or guarantees for defaulted assets; The payment by the purchaser to the originator of unexpected economic surplus; Adjustments in the purchase price for assets depending on the realized amount of defaults; and The amount and payment of servicing fees being dependent on the realized amount of defaults. Although not necessarily determinative for the legal characterization of any transfer of assets, Standard & Poor's notes the issuance by the German Institute of Accountants (IDW) of a guideline dated Oct. 31, 2002 regarding the accounting treatment of asset-backed securities transactions (the "IDW Guideline"). The IDW Guideline provides that a sale for accounting purposes will only be achieved if the seller of receivables assigns the legal title to the receivables to the buyer and if the buyer assumes the entire credit risk with respect to the receivables. The IDW Guideline addresses the issues of credit enhancements and discounts and states that for the transfer to be recognized as a true sale from an accounting perspective the sum of all credit enhancements and discounts should be measured against and should not exceed the market discount rate in factoring transactions and, depending on the structure should also not exceed the historic default ratio. As noted above, the absence of any explicit legal authority in Germany for what constitutes a true sale means that the structuring of true sale transactions presents challenges to the parties involved in such transactions to ensure that true sale treatment of the transaction, both from a legal and accounting perspective, is achieved. Although there are German term true sale transactions that have been and continue to be structured, Standard & Poor's has noted the German securitization market's past preference for structuring synthetic transactions, where the economic risks of a true sale transaction can be replicated without the need for a legal assignment of assets. Sale Recharacterization Risk The importance of structuring a transfer as a true sale is underscored by the recharacterization risk that would otherwise manifest itself in the context of a securitization of claims/receivables. If a purported true sale transaction is not structured to effect a true sale of the assets, in the event of an insolvency of a seller, the transaction will be recharacterized as a secured loan arrangement, with the purchaser viewed as having lent the purchase price to the seller of the assets in return for a promise to repay the funds secured by a security assignment of the "sold" claims/receivables. As discussed in "Security Interests", section 166 of the German Insolvency Code provides that in an insolvency of the seller, its insolvency administrator would be entitled to enforce upon the claims/receivables that have been assigned for security purposes. Apart from the question of timeliness that such a collection would introduce into a securitization, the proceeds of the realization would be subject to the haircut provisions of the German Insolvency Code, putting at risk the purchaser's ability to make full payment on the rated obligations. The inability to mitigate this risk effectively would have a negative impact on the ratings to be assigned to any asset-backed notes supported by these receivables. Restrictions on Assignment In any transaction involving the transfer of assets, part of the analysis that needs to be performed by the parties is whether there are any restrictions on assignment of those assets. As a matter of general contract law, German law recognizes that a creditor cannot validly assign a claim if the creditor and the debtor of the claim have contractually restricted the assignment. In true sale transactions, Standard & Poor's expects the arrangers and their counsel to provide an analysis of the underlying claims being assigned and whether there are any restrictions on assignment. As part of this analysis, Standard & Poor's expects that counsel will provide a confirmation that they have reviewed a sample form of the contract(s) that are representative of the pool of claims being assigned and confirm whether the forms of contract provide for any restriction on assignment. The review of the sample form of contract should be supported by a representation by the originator that the claims being transferred are all documented on the sample form(s) of contract reviewed by its counsel. To the extent counsel identify a contractual restriction on the assignment of the claims, those claims may need to be excluded from the pool of assets being transferred. Standard & Poor's understands that section 354a of the German Commercial Code ("Handelsgesetzbuch") provides that, notwithstanding any contractual restriction on assignment, a claim may be validly assigned if the claim arises by way of a commercial transaction ("Handelsgeschäft") and the parties to the contract under which the claim arises are merchants ("Kaufleute"). Reliance on section 354a is however problematic from a rating prospective in that the relevant account debtors are able to discharge their debt by making payment to the assignor (whether or not notice of the assignment has been given to them), thereby continuing to expose the assignee to the credit risk of the assignor. Accordingly, all other things being equal, Standard & Poor's does not consider that reliance on section 354a will enable transactions to reach the highest rating categories and/or be rated without reference to the rating of the seller. Transfers of Assets — Conclusion For structured finance transactions that rely on a true sale arrangement, Standard & Poor's will expect legal counsel to provide robust legal opinions on the efficacy of these arrangements and confirm that the sale of such assets could not otherwise be successfully recharacterized, challenged, or set aside, including in the insolvency of the seller, by any creditor or insolvency administrator of the seller. Table 2 compares true sale, pledge, and security assignment. Table 2 True Sale, Pledge, and Security Assignment Compared TRUE SALE PLEDGE SECURITY TRANSFER Perfection required? N Y N Transfer of title? Y (legal and beneficial) N Y (legal, but not beneficial) Accessory right? N/A Y N Right of separation on insolvency (Aussonderung)? Y N N Right to separate satisfaction on insolvency (Absonderung)? N Y Y N/A—Not applicable Contingent Transfer Structures that rely on trigger events to perfect the sale of assets or to perfect security interests at a future date often are called contingent transfer or contingent perfection structures. The term "contingent" may imply more comfort than the legal analysis reveals — perfection of collateral or the transfer may not be possible in the future. Prospective issuers contend that transactions that rely solely on the occurrence of certain postclosing events (the trigger events) to transfer (or perfect the transfer of) assets at a future time should be rated under traditional structured finance methodology. Thus, they argue that debt of an 'A-' obligor that agrees to transfer a pool of assets when the obligor is downgraded below 'BBB' should be rated 'AAA' because the assets have an implicit 'AAA' credit quality. They argue that Standard & Poor's should look only to the implicit credit quality of the future assets, which is at 'AAA' level, and not to the issuer credit rating on the transferor, which is rated 'A-'. At first, the argument seems appealing. If a highly rated transferor agrees that at some time in the future it will deliver assets (or perfect the delivery of assets), then an investor should be better off than if he had relied solely on a promise of the transferor to pay principal and interest. The trigger event would be some specified event, including a default by or downgrade of the transferor. On closer examination, however, a promise to deliver assets in the future is only worth as much as the creditworthiness of the transferor. At the time the transaction is closed, the investor has no additional security or assurances that a trigger event will actually occur or will occur early enough so that the transfer or perfection can take place. If the transferor becomes insolvent before the trigger event occurs, there may be no assets. As a general matter, Standard & Poor's believes that the trigger-event mechanism only serves to increase the incentive of the transferor, receiver, liquidator, regulatory supervisor, or other creditors to exercise rights before the trigger event and frustrate the transfer of assets. If this happens, the rated noteholder would be an unsecured creditor of the transferor. Thus, Standard & Poor's has decided that, based on a review of the structures presented to Standard & Poor's to date, transactions using contingent transfer or contingent perfection mechanisms should not be rated higher than the transferor's issuer credit rating. Preference Risk and Avoidance of Transfer Almost all jurisdictions contain rules whereby transfers that would otherwise have been valid can be set aside in the insolvency of the transferor. These rules usually require that, at the time the transfer took place, the transferor was already insolvent or became insolvent as a result of the transfer. Using the example of an SPE that has purchased assets from an originator, in case of a successful preference claim, the insolvency administrator would get the assets that were sold and transferred returned to the estate of the insolvent originator. The SPE would then be entitled to receive back the purchase price. However, the obligation to return the purchase price would merely be another unsecured payment obligation of the originator and would become part of the claims in the general insolvency. From a ratings perspective, this money would be a total credit loss. To the extent that there are transfers in a transaction (whether by way of true sale or the posting of collateral under security arrangements) that underpin the rating analysis, Standard & Poor's will wish to see a legal opinion from counsel in the jurisdiction of incorporation of the transferor (and, where applicable, from counsel in other jurisdictions where insolvency proceedings might be opened in respect of the transferor) that sets out exactly the circumstances in which the transfer could be voided or set aside. Such opinion should (i) set out why such circumstances are not relevant to the transaction at hand and/or (ii) to the extent such circumstances are relevant, provide comfort on why the transfers could not be set aside. German Law Preference Rules Under German law, any assignment or transfer of rights or assets or any payments can be challenged, inter alia: Outside of insolvency proceedings, by any creditor of the transferor that has obtained an enforceable judgment or other enforceable instrument against the transferor in respect of an outstanding debt if (i) the transfer was effected with the intention known to the transferee of prejudicing other creditors of the transferor and the transfer was made in the 10 years before the challenge, or (ii) the transfer was without consideration and was made in the four years before it was challenged; or Upon the opening of insolvency proceedings of the transferor by an insolvency administrator under sections 129 to 147 of the German Insolvency Code, which provide that legal acts made before the opening of insolvency proceedings that disadvantage insolvency creditors may be avoided if certain prerequisites are met. In analyzing the applicability of sections 129 to 147 of the German Insolvency Code to securitization transactions, German counsel in their opinions usually draw attention to the provisions of sections 130 to 133 of the German Insolvency Code as being relevant. Section 130 of the German Insolvency Code provides that any legal act that granted a creditor security or satisfaction will be voidable if (i) it was taken within the last three months before the filing of an application for the opening of insolvency proceedings, provided that the debtor was insolvent at the time when the act was taken and the creditor was aware of the debtor's insolvency, or (ii) it was taken after the filing for the opening of insolvency proceedings with respect to the debtor, provided the creditor was aware of either the debtor's insolvency or the filing for the opening of insolvency proceedings. Section 132 of the German Insolvency Code provides for a similar test in relation to legal transactions resulting in immediate adverse effects on other creditors of the debtor. An exception to these rules applies in the case of a transaction for which contemporaneous consideration of equal value is given ("Bargeschäft", section 142 of the German Insolvency Code). Section 131 of the German Insolvency Code provides that a legal act that granted a creditor security or satisfaction to which such creditor was not entitled — or not entitled in such a way or at such time — will be voidable if (i) it was taken during the last month before the filing of an application for the opening of insolvency proceedings or after such filing, (ii) it was taken during the second or third month before the filing of an application and the debtor was insolvent at the time of the act, or (iii) it was taken during the second or third month before the filing of an application and the creditor was aware that the transaction was detrimental to other creditors of the debtor. Section 133 of the German Insolvency Code provides that the insolvency administrator may also avoid any legal acts taken by the debtor with the intention — as known to the relevant other party — to prejudice the debtor's other creditors if the act was taken in the 10 years before the filing of an application for the opening of insolvency proceedings or after such filing or — subject to a two-year preference period — any agreement entered into by the debtor with a related person by which the debtor's other creditors were directly adversely affected. Under section 134 of the German Insolvency Code, additional grounds for avoidance may exist in a transaction that was entered into without consideration. The preference risks described in section 130 to 133 of the German Insolvency Code and above (subject to the final exception set out in the paragraph following) can from a ratings perspective typically be addressed by the delivery of a separate solvency certificate by the transferor to the transferee at the time of each transfer. Standard & Poor's does not consider, though, that a mere representation by the originator about its solvency that is embedded in the transaction documents will provide sufficiently robust evidence. The delivery of a solvency certificate, signed by a senior officer of the originator, should among other things confirm that (i) the transferor is solvent at the time of the transfer, and (ii) the transaction was not undertaken to prejudice the transferor's other creditors. Clearly, such certificates are not legally binding upon a court and a court could choose to ignore them in determining whether the SPE was or ought to have been aware of the insolvency of the originator. Nevertheless, in the absence of genuine fraud, such certificates should provide favorable evidence to strengthen the SPE's plea of ignorance. This is important since, under section 130, the transferee's knowledge of insolvency is a key component of the test. The solvency certificate should contain such other representations and warranties as transaction counsel deem necessary for counsel to provide a favorable opinion on the mitigation of any preference risk. In cases where the originator has an investment-grade rating on the closing date of the transaction, reliance will be placed on the rating on the originator as a strong indication of its solvency and no certificate will be required. In cases where the originator has an investment-grade rating on the closing date of the transaction but where further sales of receivables are expected (e.g., by way of substitution of maturing assets), the transaction documentation will need to provide that, should the originator ever lose its investment-grade rating, it will then comply with the requirements for a non-investment-grade originator (e.g., the provision of solvency certificates). For transactions that may revolve frequently, delivery of solvency certificates may be required at defined intervals (i.e., typically every three months). The preference risk described in section 131 would not usually occur in a traditional securitization transaction since no anticipatory satisfaction of debt or granting of security to which the SPE was not entitled should take place. Clearly, though, should Standard & Poor's be invited to rate a transaction that exceptionally featured such elements, a thorough analysis of the relevant preference risk would need to be conducted. On this basis, the preference risk described in section 133 is designed much more clearly to prevent a debtor's fraud on its creditors or other exceptional circumstances that do typically not exist in a traditional securitization transaction. Standard & Poor's is, therefore, comfortable, based on legal advice that it has received, that this section is very unlikely to be invoked by an insolvency court unless it can be demonstrated that assets were sold at a gross undervalue or that other exceptional circumstances exist. Unless, therefore, the sale price of the assets is subject to a very substantial discount to their face value or their fair market value (or other exceptional circumstances obtained), Standard & Poor's does not see the risk of a section 133 preference as meaningful, even in the context of highly rated deals. Commingling Credit Loss or Liquidity Stress The problem of commingling will occur whenever cash belonging to the issuer is mixed with cash belonging to a third party or goes into an account in the name of a third party in such a way that, in the insolvency of that third party, such cash is lost or frozen. The cash would become "lost" if, after the insolvency of the third party, the issuer's claim to the money were treated at law as an unsecured debt of the insolvent entity. Under Standard & Poor's criteria, such an unsecured debt claim would be treated as a total credit loss for the issuer. On the other hand, such cash would become "frozen" if, after the insolvency of the third party, the issuer retained a proprietary claim over the money so that the money did not form part of the insolvent entity's insolvency estate. The cash could also be "frozen" if the account was the subject of a valid security interest in favor of the issuer. In both cases where cash is "frozen", although the issuer's rights to obtain the money would have a solid grounding in law, Standard & Poor's would seek to determine how long it would take for the issuer to assert these rights as against the insolvency administrator and competing creditors of the insolvent holder of the cash. Standard & Poor's would like to stress that such determination is pragmatic rather than formalistic. In other words, Standard & Poor's recognizes that even if the law provides the issuer with an immediately enforceable right of access, the complexities inherent in the insolvency of a large institution are likely to result in a delay in the issuer's being able to assert its rights. After such delay, however, the issuer would be able to access the relevant cash, so such cases would be treated not as total credit losses but as liquidity strains on the transaction. Accordingly, the transaction will need to demonstrate features that will enable the issuer to meet in full and on a timely basis its current obligations under the rated notes, notwithstanding the delay in cash flows caused by the third party's insolvency. Commingled cash may also be lost in the insolvency of the accountholder where the account bank is allowed to assert a setoff. In other words, it may be lost where the accountholder owes money to the account bank flowing from other, probably unrelated, obligations and is allowed under the terms of the account or under general principles of German law to set off the amounts owed to it by the accountholder against funds standing to the credit of the account, including funds belonging to the issuer. Although not the only situations in which commingling can arise, the most common type of commingling seen in German true sale transactions (particularly non-bank-originated transactions) arises from the situation in which the account debtors continue to make their payments under the sold receivables into accounts in the name of the originator. Similar commingling risks seen in German bank-originated transactions arise from the situation in which the banks post collateral to support or enhance the rated obligations. Account Bank Insolvency What happens to money held with a bank when the bank becomes insolvent is not, strictly speaking, a commingling issue. Nevertheless, there is sometimes a degree of confusion between this issue and the issue of commingling in the strict sense. This is particularly the case when the originator is a financial institution and is also the account bank for the transaction. It therefore seems appropriate to deal with the point here. As a matter of German law, when a person deposits cash with a bank, that person's rights over the bank account constitute a debt. Any amounts standing to the credit of a bank account reflect a debt owed by the bank to the accountholder, usually payable on demand. Since banks are not in the habit of granting security to their accountholders, the debt owed by the bank is a normal unsecured debt and will be treated accordingly in the insolvency of the bank. Therefore, consistent with Standard & Poor's approach to unsecured debt of an insolvent company, all cash held with a bank that is not rated appropriately highly to support the rating on the notes (see "Rating Triggers") will be treated as lost to the issuer. This analysis holds true even when the bank is also the originator. This is because, once deposited with the originator bank, the collections are merged with the bank's general funds and used by the bank in the normal course of its business. To avoid problems with the potential insolvency of the account bank, transactions should be structured in one of two ways: (i) to move the funds into an account maintained with a suitably rated bank, or (ii) to invest the funds in suitably rated eligible investments, which in turn must be chosen so as to ensure that proper security may be given over them, so protecting the issuer's interests in the event of insolvency of the bank holding the investments.

Rating Triggers It is also important to note that under the Standard & Poor's rating methodology, an entity will be assumed to be liable to insolvency only if that current rating on the entity is below the rating on the notes (or if the entity is unrated). Accordingly, the transaction will not be required to display features designed to mitigate the effects of commingling if the issuer's cash is commingled only with cash belonging to corporations rated as highly as the notes. This is equally true for the account bank. In the absence of such features, however, market participants must also be aware that the rating on the party with whose cash the transaction's cash flows are commingled or the bank with which money is deposited will become a dependant rating for the transaction. Other things being equal, the downgrade of this entity or the placement of the ratings on it on CreditWatch with negative implications would normally lead to the transaction's notes' being downgraded or similarly placed on CreditWatch with negative implications. Nevertheless, many originators and banks, although highly rated, may not have a long-term unsecured rating high enough for the rating sought on the notes. To mitigate this problem, Standard & Poor's will rely on a short-term rating on an entity with whose cash the issuer's cash is to be commingled or on the account bank. This short-term rating will need to correspond to the long-term rating on the notes, in accordance with Standard & Poor's rating correspondence table. However, this short-term rating contemplates only a one-year horizon. Accordingly, the transaction documents must provide that, if the entity is downgraded so that the short-term rating on it no longer corresponds to the long-term rating on the notes, appropriate measures will be taken within 30 days to bring all commingling to an end or, in the case of an account bank, find an alternative and suitably rated account bank. This is known as a "rating trigger". In certain cases, reliance may be placed on an entity whose rating does not meet the above criteria, where Standard & Poor's is satisfied, after consultation with the finance or corporate analysts who follow the relevant entity, that circumstances exist that make the use of the correspondence table less appropriate. Setoff General Setoff risk is the risk that monetary obligations owed by party A to party B may be set off by party A against obligations owed by party B that for some reason party B has not paid. In the context of a structured finance transaction where parties are modeling expected cash flows on a gross level, the exercise of setoff rights would decrease the actual cash flows received by the structure and this may threaten the structure's ability to make full and timely payment on the rated obligations. Setoff risk can materialize in a transaction in a number of ways but is seen most often in relation to debtor setoff and account bank setoff. Debtor Setoff In all asset-backed transactions, it is a concern that, upon the insolvency of the originator, the receivables sold to the SPE may be decreased by the amounts that the underlying debtors set off against other obligations due to them by the seller. The classical case of debtor setoff would occur when a bank sold, for example, a pool of car loans, some of which had been made to the bank's own customers. Upon the insolvency of the bank it is likely that some, if not all, of these customers would have money owed to them by the bank — namely the amounts standing to the credit of their current accounts. Depending on the jurisdiction, these bank customers may be entitled to deduct from the amounts due under the sold car loans the amounts standing to the credit of their accounts with the seller at the time of the latter's insolvency. This would reduce the amount that the issuer was entitled to collect on the securitized receivables and could, depending on the size of the reduction, cause a loss to the noteholders. This form of setoff may be recognized at law and results in a legal diminution of the debt. In addition to this "legal" setoff, there is also the risk of a "practical" setoff. This would occur when a debtor is faced with the loss of money due to it by the now insolvent seller. Having neither consented nor in some cases been notified of the sale of his or her receivable, the debtor may simply refuse to pay on the grounds that, irrespective of the legal position, the actions of the seller were iniquitous. In the case of a "practical" setoff, though, the right of the issuer to recover the sold receivable from the underlying debtor is not legally impaired. The issuer can expect delays, however, in recovering the amounts due to it. For this reason, Standard & Poor's will treat "legal" setoff as a credit loss to the transaction while "practical" setoff will be treated as liquidity stress. In determining the nature of the risk of the setoff and its potential impact, it is necessary to understand the law of the relevant jurisdiction but also the business of the originator. There will be cases where the existence of mutual rights as between the underlying debtors and the originator are extremely unlikely, for example, where the originator is a special-purpose lender that does not have a deposit-taking business. In other cases, the existence of "no setoff" provisions in the contract between the debtors and the originator may be dispositive, as a matter of law, in removing the rights of setoff. Under section 387 of the German Civil Code, if two persons have claims of the same kind (e.g., claims for the payment of money) against each other, each person may set off its claim against the claim of the other person as soon as its claim becomes due. The setoff is effected by declaring it vis-à-vis the other person. In certain situations, the setoff right is subject to statutory restrictions, e.g., claims against which a valid defense exists may not be set off, and setoff is not permissible against claims arising out of tort if committed intentionally. Generally, setoff rights can be validly excluded by contractual agreement. However, if the relevant clause constitutes a standard business term, the clause may be invalid according to the rules on standard business terms ("Allgemeine Geschäftsbedingungen") as contained in sections 305 et seq. of the German Civil Code (see "Standard Business Terms"). Exercise of Setoff Rights Against Assignees In addition to the general rules on setoff described in the preceding, in structured finance transactions involving an assignment of assets, it is important to understand the degree to which the debtors of the underlying obligations that have been assigned may exercise rights of setoff against assignees. Section 404 of the German Civil Code provides that an account debtor may invoke against an assignee all defenses to payment of a claim that the account debtor possessed at the time of the assignment of the claim. Section 406 of the German Civil Code provides that an account debtor may set off against an assignee a claim that the account debtor has against the assignor except where either (i) the account debtor was aware of the assignment of debt at the time at which it acquired the claim against the assignor or (ii) the claim of the account debtor did not become due until after the debtor became aware of the assignment to the assignee and the claim of the account debtor matured after the claim was assigned to the assignee. Under section 407 of the German Civil Code the assignee has to give credit to payments made by the account debtor to the assignor until such time as the account debtor has been notified of the assignment. Account Bank Setoff Another setoff concern arises when cash is held by an account bank in a transaction in the name of a party other than an SPE. Commingled cash may also be lost in the insolvency of the accountholder where the account bank is allowed to assert a setoff. In other words, it may be lost where the accountholder owes money to the account bank flowing from other, probably unrelated, obligations, and the bank is allowed under the terms of the account or under general principles of law, to set off the amounts owed to it by the accountholder against funds standing to the credit of the account — including funds belonging to the SPE. Most bank account standard terms explicitly allow the account bank to set off obligations of the accountholder against amounts standing to the credit of the bank account. For Standard & Poor's to give credit to cash collections standing in an account in the name of a party other than an SPE, legal opinions will need to be provided to the effect that the bank will not be entitled as a legal matter to effect a setoff. In addition, Standard & Poor's requires that the bank contractually waive its rights of setoff over the account, even in circumstances where the rights may not exist, and that the bank is notified in writing of the interests of the SPE over cash in the account. This will give Standard & Poor's comfort that the bank will not raise a setoff claim in the insolvency of the accountholder, arguing that it was not aware of the real economic ownership of the account funds. Setoff — Conclusion Standard & Poor's will expect the arranger and its transaction counsel to provide an explanation of the setoff risks that exist in any particular transaction that may affect the ability of the structure to make timely payments of interest and principal on the rated obligations and provide comfort that these risks are successfully mitigated. In the absence of successful mitigation, Standard & Poor's would conduct the analysis of the cashflow available to the noteholders net of any setoff amounts. Standard Business Terms Sections 305 to 310 of the German Civil Code provide that terms of a contract may be set aside by a court as invalid if they constitute standard business terms. Section 305 provides that standard business terms are defined as one or more contractual terms preformulated for a multitude of contracts that one party to the contract, the "user" of such terms, imposes upon the other party as part of the contract. Section 305 further provides that contractual terms do not constitute standard business terms to the extent they have been individually negotiated between the parties. The standard business terms rules are designed to protect the user's counterparty, not the user. According to existing German case law, financial instruments are not exempt from the standard business terms rules. Standard & Poor's notes past practice of certain German counsel to attempt to qualify their entire opinions by the statement that they cannot rule out that terms of the transaction documents may be considered standard business terms under the provisions of sections 305 et seq. of the German Civil Code, and that this could affect the legality, validity, and enforceability of any of the provisions of the transaction documents. Standard & Poor's does not consider that it is useful or indeed appropriate for counsel to make such a bold qualification without also expressing a view as to the applicability of the standard business terms rules to the transaction documents in question. This is particularly the case in the context of structured finance transactions where the efficacy of certain structural elements such as the true sale, security arrangements, the priority of payment provisions, restrictions on setoff rights, limited recourse or the terms and conditions of the notes themselves, are critical to the successful operation of the transaction and underpin the rating analysis. Legal counsel typically have been involved in the drafting and the negotiation of the various transaction documents, and they are well acquainted with the terms of them. Accordingly, Standard & Poor's expects that should counsel believe it necessary to qualify their transaction legal opinion by reference to the standard business terms rules, counsel will also provide a robust view why it is that they believe the specific transaction in question would not be challenged or set aside under these provisions. To the extent they are not so able to conclude with respect to any particular provision, then counsel should set out which provisions they are concerned about so that parties concerned, including Standard & Poor's, can determine whether the efficacy of such provisions is material to their analysis. The failure by transaction counsel to provide such comfort may lead Standard & Poor's to conclude that the legality, validity, and enforceability of the key provisions of the transaction documents are in question and may result in Standard & Poor's being unable to assign its highest levels of rating to a transaction. Tax In securitization transactions, Standard & Poor's will generally need to be satisfied either that there are no taxes payable by the issuing SPE (and, if relevant, any intermediary SPE) or that any such taxes have been calculated and that the liability is accounted for and can come out of the available cash flow while still leaving sufficient amounts to meet principal and interest on the rated notes. In addition to these considerations of general application, multijurisdictional transactions create certain additional concerns that need to be met. Without attempting to be exhaustive, what follows is a summary discussion of Standard & Poor's understanding of those tax issues that most often arise in the context of German securitization transactions. Withholding Tax Whenever cash flows across a jurisdictional border, there is a heightened risk that the tax authorities in the jurisdiction from which the cash left will require part of that amount to be remitted to it in the form of withholding tax. This is certainly the case of proceeds of receivables where the debtor in one country is effectively paying an SPE in another country, as is most often the case in German securitizations involving German debtors whose debts have been assigned to non-German SPEs. This may also occur in respect of payments under swap and other derivative agreements entered into by the SPE for hedging purposes, any form of external credit enhancement such as a letter of credit and collateral posted under security arrangements or otherwise purchased directed by an SPE. Accordingly, Standard & Poor's would expect to see a legal opinion from counsel qualified in the jurisdiction of the payer confirming that no withholding tax will be imposed on the payment. Alternatively, if a withholding tax does fall to be paid, the amount will need to be deducted from the cash flows in calculating the amounts available to the SPE in calculating the cash available to it to meet its obligations under the rated securities. Also, in respect of withholding tax on swaps, derivatives, and external credit enhancement, it is acceptable to Standard & Poor's for such opinions to be issued by internal counsel to the relevant counterparty. Under German tax law, there is generally no withholding tax when interest is paid by a German debtor to a non-German SPE. The same is true for payments under swap and other derivative agreements. Exceptions apply only where a German debtor makes a payment on an equity or hybrid instrument, such as a silent partnership interest, participating loan, jouissance right ("Genussrecht") or convertible bond, or where a bank or financial services institution pays interest in Germany over the counter upon presentation of coupons or other securities in certificated form. These exceptions are usually not relevant for asset-backed securitizations. This also applies to the German domestic withholding tax ("Zinsabschlagsteuer") on interest payments made by, or through, German banks (including German branches of foreign banks). This tax is only withheld on payments made to German resident accountholders (or to accounts of the German permanent establishment of a foreign enterprise). The tax is creditable as a prepayment against the final income tax liability of the recipient of the interest income (or, if in excess of such liability, refundable).

Permanent Establishment and Branch or Agency Many SPEs in international transactions are incorporated in zero-tax or low-tax jurisdictions. They will often, though, own pools of assets located in high-tax jurisdictions. In addition, if the assets default recoveries will need to be pursued in the local courts, so these transactions always carry a risk that the tax jurisdiction in which the assets are located will seek to maintain that the SPE, although located elsewhere, has a local "permanent establishment" or a "branch or agency". This in turn would result in the SPE becoming taxable in that high tax jurisdiction. Almost invariably, the issue of whether a foreign corporation, such as the SPE, is to be deemed as taxable in a particular country is to be determined by applying a combination of legal and practical tests. Therefore, Standard & Poor's does not expect that multijurisdictional transactions will have the benefit of legal opinions stating that, as a legal matter, the SPE will not be held taxable in any particular jurisdiction. Nevertheless, in certain circumstances, Standard & Poor's will require a tax opinion setting out the legal criteria that would result in the SPE's becoming taxable in that jurisdiction and setting out the reasons under the transaction documents this risk is removed or mitigated. To the extent that the risk is not removed or mitigated then the impact of the tax effect will need to be sized and the amount will need to be deducted from the cash flows in calculating the amounts available to the SPE in calculating the cash available to it to meet its obligations under the rated securities. As discussed under the heading "Initial Structuring Considerations" almost all SPEs used in German securitizations are incorporated outside of Germany, predominantly in low- or zero-tax jurisdictions. These non-German SPEs, however, own pools of assets located in Germany where taxes are imposed on corporate activity. The question then becomes whether the non-German SPE through its activities whether (i) by way of holding German assets, (ii) by way of servicing German assets by a servicer based in Germany, (iii) by way of contracting with German counterparties under other contractual arrangements, or (iv) by a combination of the foregoing, becomes taxable in Germany because of a permanent establishment ("Betriebsstätte") or a primary place of management ("Geschäftsleitungsbetriebsstätte") - collectively referred to as a "taxable presence" - or through a permanent representative ("ständiger Vertreter"). In addition, a non-German SPE can become taxable in Germany if it holds assets that are secured by German real estate or vessels registered in Germany. Currently, neither German tax law nor the German tax administration provides definitive guidelines as to how a taxable presence or a permanent representative may be triggered by a securitization transaction involving a non-German SPE. Accordingly and where relevant, Standard & Poor's should be provided with an analysis of what the impact to the structure would be in the event the German tax authorities were to view the SPE as having liability to German tax either through a taxable presence or permanent representative. German counsel in their opinions confirm that in this event, the SPE would be subject to German corporate tax ("Körperschaftsteuer") of 26.5% (2003) plus a solidarity surcharge ("Solidaritätszuschlag") of 5.5% (2003), and additionally, in the case of a taxable presence, German trade tax ("Gewerbesteuer"), where applicable, which is discussed in detail under the heading "Trade Tax". German counsel generally confirm that the calculation of the taxable profit for the purpose of German corporate tax (excluding any impact of German trade tax) is based on the difference between gross income and deductible expenses. Standard & Poor's expects German counsel to confirm in their opinion discussion of potential German tax liability of the SPE whether the projected expenses of the SPE would constitute deductible expenses for the purposes of calculating taxable profit. Assuming positive comfort is given, as most securitizations are not structured to capture any material taxable profit (i.e., all cash flow from the assets is generally paid out to the various counterparties during the relevant periods) Standard & Poor's would generally take the view that the SPE would be tax neutral. A corporate tax-neutral SPE is one that is subject to taxation but is not expected to have any taxable income because it is projected that its revenue will be offset by an equal amount of deductions or exemptions. For example, if the SPE is projected to have income of €5 million in any year, but offsets this income with deductible expenses of €5 million, the German taxable profit of the SPE for that year would be zero. Accordingly, the German tax liability of the SPE (again excluding any impact of German trade tax calculations) would be zero. Correspondingly, if counsel cannot provide comfort that all expenses of the SPE would be viewed as deductible expenses for the purpose of calculating taxable income, the resulting tax liability may need to be sized and reserved for in the projected cash flows for the transaction. Trade Tax To date, one of the main drivers behind the use of non-German SPEs in securitization transactions has been the liability of German organized entities to German trade tax. Trade tax is calculated separately from the corporate tax but uses the taxable income amount as a starting point. The basis for trade tax is calculated by taking the taxable income under the corporation tax rules and adding to it 50% of the interest (plus fees and expenses, if these are "interest-alike", i.e., if they constitute remuneration for the forbearance of the use of capital) paid by the entity during the relevant period in respect of long-term debt ("Dauerschulden") the entity has outstanding. This aggregate figure is then multiplied by the relevant trade tax percentage to arrive at the trade tax liability. As trade tax is applied at a municipal rather than state or federal level, the applicable trade tax percentage, which varies from municipality to municipality, will depend on which municipality the entity has its taxable presence in. If a German SPE were used in a securitization, the transaction would need to cater for the leakage of cash flows to the tax authorities for the payment of the trade tax liability. In January 2001, Standard & Poor's first commented on reports emanating from the German financial markets that the tax authorities of a number of German states were seeking to establish the principle that foreign corporate vehicles used in securitization transactions involving German assets serviced by German-based services should be treated as "onshore" and, therefore, liable for German tax. These reports appeared to contradict the general market understanding that such structures were not at risk of taxation in Germany. In terms of impact from the perspective of German corporate tax, apart from the administrative burden of filing German tax returns, the non-German SPEs, should they be viewed as having a German taxable presence, were not expected to have any additional tax liability due to their being structured as tax neutral. Nonetheless, of course, as discussed, the corporate tax neutrality of any structure could not eliminate the trade tax liability due to the nature of its calculation. However, on June 6 and July 11, 2003, respectively, the German Small Businesses Support Act ("Kleinunternehmerförderungsgesetz") was passed by the German "Bundestag" and "Bundesrat". This law contains a reform for the trade tax treatment of securitization SPEs to facilitate securitization transactions in Germany with retroactive effect as from Jan. 1, 2003. The effect of this law is intended to eliminate the liability to German trade tax for German SPEs, or non-German SPEs deemed to have a taxable presence in Germany, in relation to 50% of the interest, fees, and expenses paid by the SPE in respect its long-term debt. In particular, the law states that the provisions are intended to provide relief to securitization SPEs that (i) purchase loans, acceptance credits, bills of exchange, or guarantees from banks or offer credit protection to such banks in respect of such assets and (ii) are funded directly or indirectly by debt securities. These provisions are not intended to apply to transactions other than as summarized above and, accordingly, the uncertainty remains on the issue of trade tax liability on funding expenses for SPEs that facilitate securitization in Germany other than through banks. Apart from the comfort provided by the new law to certain types of German securitizations and the applicability of tax rulings issued by the German tax authorities to the question of potential trade tax liability Standard & Poor's does not currently expect that counsel can provide robust opinions on this issue in the context of German securitizations. Accordingly, Standard & Poor's expects for all German securitizations, save for the aforementioned exceptions, that arrangers, counsel, and their auditors will provide an estimate of the potential German trade tax liability arising from funding expenses for each securitization transaction where a Standard & Poor's rating is being requested. Standard & Poor's will take the figure provided and assume that such trade tax liability amounts will not be available to repay any obligations of the securitization transaction and determine whether there is a negative impact on the rating analysis. Mitigation of this impact may result in the requirement for the provision of additional credit enhancement in order to ensure that payment of trade tax would not cause the SPE to become unable to meet in full its obligations on the rated notes. Standard & Poor's intends to continue to monitor developments on this issue and modify its criteria approach as appropriate. VAT As with the other potential tax liabilities, Standard & Poor's will expect counsel to provide comfort whether German VAT may apply to any of the cash flows or payments being made to or from German counterparties. If there may be a German VAT liability (e.g., on servicing payments made for the servicing of assets in Germany in the context of true sale transactions, or payments made to German resident collateral managers in the context of CDOs), it will be a requirement that the necessary steps are taken to mitigate this liability or otherwise demonstrate why VAT liability would not affect the ability of the SPE to meet in full its obligations on the rated notes. Secondary Tax Liability In some transactions it is held to be necessary or useful for the SPE to be a subsidiary of another company (usually the transferor) rather than for it to be an orphan SPE. Care must be taken, however, that, by having a shareholding link with an operating company the SPE does not, under the relevant tax legislation, become liable on a secondary basis for the taxes payable by that operating company. This would occur under some principle of "tax grouping". To the extent that, in the relevant jurisdiction, the SPE may become liable for another party's taxes, it will be a requirement of the transaction that the necessary steps to eliminate this liability are taken or that the liability is quantified and that payment of such taxes would not cause the SPE to become unable to meet in full its obligations on the rated notes. Legal Opinions General For each German securitization transaction that it rates, Standard & Poor's will expect to see appropriate legal opinions dealing with all issues of law raised by the structure that are relevant to the rating. Although many legal issues have already been discussed, it is not possible to set out a complete list of all the items that need to be addressed in legal opinions since each transaction will have its own issues. To maximize the likelihood of a smooth rating process, Standard & Poor's urges legal counsel to the transaction to produce drafts of the legal opinions as early as possible, and to discuss any matters that they expect may be problematic with the analyst assigned to the transaction or a member of the Standard & Poor's legal department. Legal Opinion Issues Without limiting the discussion in this paper, Standard & Poor's does expect that, unless the transaction exhibits some extremely unusual features, the following items will always need to be dealt with in the legal opinion: For true sale transactions, a true sale has been effected that will be recognized in the insolvency of the transferor and not be subject to any successful challenge or recharacterization as a secured loan by any creditor or insolvency administrator of the transferor, and comfort that the assets are not subject to any restrictions on assignment; For the purposes of supporting the SPE's insolvency remoteness, all non-negligible assets of the SPE that are contemplated in the transaction documents are subject to effective security (creation and perfection) that will be recognized by the German courts, including in the event of German insolvency proceedings of the SPE and not be subject to any successful challenge by any creditor or insolvency administrator of the SPE; Where collateral is posted as security to support full and timely payment on rated debt, confirmation regarding: (i) the nature of the security interest; (ii) the effective creation and perfection of the security interest and its recognition by the German courts, including in the insolvency of the security provider, and that such security interest would not be subject to any successful challenge by any creditor or insolvency administrator of the security provider; (iii) whether in insolvency the security entitles the beneficiary thereof to directly enforce upon the collateral; (iv) whether in insolvency the direct enforcement right over collateral can be exercised on a timely basis; (v) whether the haircut provisions of the German Insolvency Code apply to the enforcement proceeds; (vi) where a prior-ranking security right (prior in ranking to the security trustee's claim for the noteholders) is granted over collateral to a party other than for the benefit of rated noteholders, whether this security right prevents the exercise of the security right by the security trustee on behalf of the noteholders, including in the insolvency of the first-ranking security holder; and (vii) the impact of any moratorium imposed under the German Banking Act on the exercise of collateral security; The limited recourse provisions set out in the documents will be recognized by the German courts as legal, valid, binding, and enforceable; The nonpetition provisions set out in the documents will be recognized by the German courts as legal, valid, binding, and enforceable; The subordination/priority of payment clauses (the "waterfall provisions") set out in the documents would be recognized as legal, valid, binding, and enforceable, including in the event of German insolvency proceedings of the SPE, and not be subject to any successful challenge by any creditor or insolvency administrator of the SPE; If any document with German signatories is governed by a law other than the law of Germany, the choice of that law would be upheld by the German courts; There are no consents, licenses, or similar requirements required in respect of the transaction, including, where relevant, no requirements to obtain a license under the German Act on Legal Advice ("Rechtsberatungsgesetz"); Where, in respect of transaction documents expressed to be governed by a law other than the law of Germany, an opinion is given subject to the nonexistence of any violation of local public policy or internationally mandatory principles of local law, counsel should confirm that, on the face of the documents reviewed, nothing has come to his attention which would cause them to believe that any such violation may exist; If any document with German signatories provides for their submission to a foreign jurisdiction, the submission to jurisdiction would be upheld by the German courts, and that judgments rendered by the foreign court would be enforced in Germany; If any funds belonging to the issuer are left in an account in the name of a third party when Standard & Poor's analysis is not treating these as a total credit loss, that those funds will not form part of the insolvency estate of the accountholder, but are and will remain the property of the SPE or be subject to a valid enforceable security right in favor of the SPE; An analysis of the setoff risks that exist in any transaction and how they are being mitigated; For SPE transactions, confirmation on questions of German tax that: (i) the SPE would, if found liable to German corporate tax, be viewed as corporate tax neutral and/or if not that the amount of potential German corporate tax liability is quantified, and (ii) the SPE would not be liable for German trade tax due to either the provisions of German law or the applicability of any specific tax ruling and/or that the amount of potential liability to German trade tax is quantified; Comfort regarding the nonapplicability of German VAT to cash flows in the transaction and/or the amount of the potential German VAT liability is quantified; Comfort regarding the nonapplicability of German withholding taxes to cash flows in the transaction and/or the amount of the potential German withholding tax liability is quantified; and Comfort regarding the nonapplicability of the standard business terms rules to the terms of the transaction documents, or discussion of the possible impact of such rules on the validity and enforceability of the transaction documents (including in particular the true sale of assets and the grant of effective security interests). In addition, for German securitizations where the documents are governed by a law other than German law and/or a non-German SPE is used and/or counterparties to the transaction are located outside of Germany, Standard & Poor's would expect to see legal opinion(s) from counsel in the relevant jurisdiction(s) opining on all pertinent aspects of their local law in relation to all the matters discussed in this paper. Further, when the SPE owns property, such as bank accounts, in a jurisdiction other than Germany, Standard & Poor's would expect to see a legal opinion from the jurisdiction in which the asset is situated to ensure that the security package granted by the SPE will be effective in respect of such asset. As a general matter, highly rated transactions require that clear and unambiguous opinions be expressed on key elements of the structure. Legal counsel to the transactions must be of the firm opinion that the transaction maintains the requisite legal integrity. For this reason, expressions such as the following are not consistent with the highest rating categories: "The courts should …" (rather than "will" or "would"); "Although opinions on the matter differ, the majority view seems to be …"; "It is generally held that …"; "It appears more likely, on balance, that …"; "There are good arguments that …"; "In the absence of judicial precedent, no opinion can be averred on …"; or "On balance, it is probably correct that …". Similarly, the use by counsel of a general insolvency or bankruptcy qualification to qualify legal opinions given on key structural issues detracts from the legal integrity of the structure and are not consistent with high levels of ratings. In such an event, Standard & Poor's will view the opinions being given as not supporting the efficacy of the key structural elements of the transaction through insolvency. These requirements are not exhaustive but are set out to provide guidance and are subject to change. Legal counsel to transactions are invited to contact any member of the Standard & Poor's legal department to seek clarification of any of these points or any other matter that they find problematic. In writing this guide, Standard & Poor's would like to thank Cleary Gottlieb Steen & Hamilton, Frankfurt am Main, for its assistance and advice, although the content of this paper remains, of course, the responsibility of Standard & Poor's.