Article Title: ARCHIVE | Criteria | Corporates | General: Defeasance Of Corporate Bonds May Be Gaining Popularity Data: (EDITOR'S NOTE: — This article is no longer current. It has been superseded by "Methodology And Assumptions: Assigning Ratings To Bonds In The U.S. Based On Escrowed Collateral," published May 31, 2012. This criteria article was originally published on July 25, 2006. We are republishing this article following our periodic review, completed on Nov. 18, 2010.) True legal defeasance has been the province of U.S. municipal bonds--including industrial development bonds once used to finance some corporate projects. A variation on the theme--so-called "economic defeasance"--applies to corporate bonds as well. Over the years, there has been a trickle of such transactions; lately, however, there seems to be somewhat greater interest in defeasing straight corporate bonds. This technique may become more popular as the result of changed interest rate levels and spreads, excess corporate cash, and increased M&A; activity. Standard & Poor's Ratings Services has specific criteria and rating policies for both legal and economic defeasances. Legal Defeasances Are Clear Cut In a legal defeasance, the bond indenture provides for setting up an irrevocable trust that holds high quality assets (normally, U.S. Treasury bonds) sufficient to service the original obligation. The cash flow from the assets matches the payments due on the original bond: interest paid is used for original interest amounts and maturing assets pay off the original bonds' scheduled maturity. This arrangement satisfies the issuer's obligations completely. Accordingly, the trust assets are severed entirely from the issuer. Were the issuer subsequently to file for bankruptcy protection, the trust assets would not be part of the issuer's estate--and there would be no stay on payments from the trust to bondholders. These provisions have been found in municipal bonds--and, very rarely, in ordinary corporate bonds. As far as rating the defeased bond is concerned, as long as the defeasance is properly consummated, all credit risk associated with the issuer is replaced with the credit risk attached to the assets in the trust. If those assets are treasury bonds (as they almost always are), our credit rating on the bond should be 'AAA'. Indeed, if we can verify--through legal opinions--that the defeasance was done properly, the bond's rating would be upgraded to 'AAA'. However, in practice, such opinions often are not available. This creates an informational limbo surrounding the bonds. In all likelihood, they have been correctly defeased, and deserve to be rated 'AAA'; however, there is no way for us to ascertain this. Given the lack of information upon which we can base a rating, when this situation arises, we discontinue our rating of the bond. The bond's rating status is therefore is Not Rated (NR). Given the complete satisfaction of the issuer's obligations by virtue of such defeasances, the extant bond plays no role whatsoever in the ongoing rating analysis of the issuer's finances. Economic Defeasances Have Their Benefits Whether provided for in the indenture or not, the issuer can always set up a trust to service a particular debt issue--as described above. This arrangement is often called an economic defeasance--although, technically, it is not a true defeasance. (Purists would object to referring to the arrangement as defeasance altogether.) There is no legal satisfaction of the original debt; rather, that debt has been transformed into secured debt. Indeed, it would be very well secured, given the excellent collateral in the trust. The trust assets may still be legally entwined with the company, so that payment would be stayed in the event of a corporate bankruptcy, leading to a default. But the bond's recovery prospects are superior. The rating of a bond defeased in this fashion takes into account such enhanced recovery attributes, as with other secured debt. Even if the default risk is not differentiated from that of the issuer, bondholders have better prospects for being made whole in the course of any bankruptcy. Given the quality of the collateral in a defeasance trust, leading to our confidence in presumed full recovery, the defeased bond's rating would be three notches (a full rating category) above the corporate rating. (Under our current criteria, these three notches above the corporate rating represent the maximum enhancement attributable to recovery aspects of a bond.) In notching up, we do not require full legal opinions--as opposed to the documentation requirements for assigning our 'AAA' rating in the case of legal defeasances. Apart from the higher standard associated with 'AAA' generally, we have greater concern over the many technicalities that are involved in legally defeasing a debt issue. The corporate credit rating also benefits from arranging a defeasance. Whatever accounting may apply, we would net the trust assets and the bond amounts in our financial analysis and ratio calculations. This adjustment reflects the analytical perspective that this debt will be serviced from the trust, rather than corporate cash flow. This treatment is analogous to our netting adjustment for other instances where a company possesses excess cash/liquid assets. The key is that the cash be viewed as a permanent corporate feature, which can be evidenced by long-term practice, tax arbitrage positions, or other company-specific situations. An irrevocable defeasance trust amply meets this criterion.