MOODY'S
INVESTORS SERVICE

CROSS-SECTOR RATING METHODOLOGY

Bankruptcy Remoteness Criteria for Special Purpose Entities in Global Structured Finance Transactions

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Introduction

If a special purpose entity (SPE) is bankruptcy remote, the likelihood of 1) a bankruptcy filing[1] by or against it; or 2) substantive consolidation (that is, the pooling of the SPE's assets and liabilities with those of a bankrupt affiliate) is so low that it has no rating impact.

We determine whether an SPE is bankruptcy remote by reference to a number of criteria, which we divide into separate sets of protective features relating to the type of bankruptcy filing (i.e., involuntary or voluntary) and the risk of substantive consolidation.

If we determine that an SPE is not bankruptcy remote, we assess whether the potential bankruptcy risk has a rating impact. We evaluate the impact on a case-by-case basis according to both the likelihood of bankruptcy and the possible negative consequences for noteholders.

Potential Consequences of an SPE Bankruptcy

The bankruptcy of an SPE can have various negative consequences for noteholders, depending on the applicable bankruptcy laws and how the transaction is structured and its documents drafted.

In most jurisdictions, the opening of bankruptcy proceedings suspends the making of payments to creditors and limits the ability of creditors to take enforcement action, including the enforcement of security, against the bankrupt entity. As a result, the bankruptcy of an SPE is likely to impede the timely payment of notes.

In some jurisdictions, bankruptcy laws allow for the modification of the terms of a bankrupt entity's debt obligations (e.g., by extending the maturity date, lowering the interest rate or reducing the principal amount owed). Any such modifications in respect of an SPE's obligations may result in a loss to noteholders.

THIS RATING METHODOLOGY WAS UPDATED ON AUGUST 27, 2019. WE HAVE MADE MINOR EDITORIAL CLARIFICATIONS AND FORMATTING CHANGES.

[1] In this report, the terms "bankruptcy filing" and "bankruptcy" mean the successful opening of bankruptcy proceedings or any analogous proceedings (including pre-bankruptcy proceedings) in any jurisdiction.

SPEs generally enter into support contracts, such as swaps, servicing agreements and liquidity facilities. A bankruptcy filing by or against the SPE usually triggers an event of default under these contracts, allowing support providers to terminate their obligations. The termination of an SPE's support contracts can materially affect its ability to make full and timely payments to noteholders.

Noteholders may also suffer a loss if the relevant bankruptcy laws 1) provide for the termination of support contracts (either automatically or at the option of a bankruptcy official); 2) invalidate key structural features (such as subordination and security arrangements); or 3) allow for the liquidation of the SPE's assets without requiring noteholders' consent.

In addition, the opening of bankruptcy proceedings against an SPE is typically an event of default under the conditions of the notes. A note event of default generally permits the trustee - either at its discretion or at the direction of senior noteholders - to serve a note enforcement notice. The potential consequences of note enforcement include:

» *Fire sale of assets:* Following the service of an enforcement notice, the SPE's assets may be sold, possibly resulting in noteholders bearing market value losses.[2]

» *Switch to post-enforcement priority of payments:* Upon enforcement, the allocation of cash flows usually changes so that no interest or principal payments are made to junior or mezzanine noteholders until all higher priority notes are paid in full. Enforcement may also change the way that principal cash flows are allocated among sub-classes of a single class of notes.

Bankruptcy Remoteness Criteria

A bankruptcy filing may be either involuntary or voluntary. An involuntary filing is made by a third party such as a creditor, and a voluntary filing is made by the debtor itself. We divide our bankruptcy remoteness criteria into separate sets of protective features relating to each type of bankruptcy filing and the risk of substantive consolidation.[3]

Protective features relating to involuntary bankruptcy filing against an SPE

We generally assume that an SPE will not be subject to an involuntary bankruptcy filing by an external creditor[4] if criteria a) to f) below are satisfied.

a) *Its activities are suitably restricted*

An SPE's permitted activities may be restricted by (i) its organisational documents; (ii) negative covenants in the transaction documents; or (iii) by law. Key restrictions include:

» no activities (including incurring debts) other than those contemplated in the transaction documents

» no merger with another entity

» no ownership or occupation of real property

» no subsidiaries

» no employees

b) *It is independently owned and managed*

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[2] Since, in general, senior noteholders can control the enforcement process and are unlikely to cause a loss to themselves, the risk of market value losses is most relevant for subordinated noteholders.

[3] Specific transactions may benefit from alternative protections against bankruptcy and therefore achieve bankruptcy remoteness notwithstanding the absence of certain of the protective features listed in this report. We assess the effectiveness of alternative protections on a case-by-case basis.

[4] That is, a creditor who is not a party to, or otherwise contemplated in, the transaction documents.

If the shareholders and management of an SPE are each sufficiently independent of the transaction parties and have no material economic interest in the SPE's activities, they should have no incentive to violate the restrictions listed in a).[5]

However, the absence of independent shareholders and management will not materially affect the likelihood of involuntary bankruptcy if 1) the restrictions in a) are either irrevocably embedded in the SPE's organisational documents or prescribed in the laws of the relevant jurisdiction, and are effective against third parties;[6] or 2) the shareholders and/or management, while not being independent, are very unlikely to have an incentive to cause a particular SPE to engage in restricted activities.[7]

c) *There is no realistic prospect that it will incur secondary liabilities*

If an SPE belongs to a corporate group, we generally request legal opinions on whether it can be made liable for any obligations of other group companies. We address the related, but different, risk of substantive consolidation separately below.

d) *Its activities will not result in any tax liabilities*

We are able to discount the possibility of an involuntary bankruptcy filing by tax authorities if, for example, we receive satisfactory legal opinions to the effect that the SPE's activities contemplated in the transaction documents will not result in it incurring any tax liabilities.

e) *It has no outstanding liabilities from previous activities*

If an SPE has a history of commercial activity and is being "recycled" for the purpose of issuing rated notes, it may have outstanding liabilities towards non-transaction creditors. We look for both legal and factual confirmation that a recycled SPE has no pre-existing creditors.

f) *It has all the necessary licences and authorisations*

If an SPE does not have the requisite licences and authorisations, it may be wound up or incur financial penalties. We generally expect this to be addressed in legal opinions.

The absence of one or more of the protective features listed above in a) to f) does not necessarily prevent us from disregarding the prospect of an involuntary bankruptcy filing by a particular creditor if it is sufficiently likely the SPE will pay that creditor in full and on time or will settle its claim. For example, we may assume that a tax liability will not result in a bankruptcy filing by tax authorities if we determine with sufficient certainty that the SPE will have available funds to pay the relevant tax in full and on time in accordance with the waterfall of payments.[8]

We generally assume that an SPE will not be subject to an involuntary bankruptcy filing by transaction creditors if either criterion g) or criteria h) below is satisfied.

g) *Transaction creditors agree*[9] *to contractual terms that legally prevent them from successfully filing against the SPE*

[5] See bankruptcy remoteness criterion i) for when we deem the shareholders and management of an SPE to be sufficiently independent. In certain circumstances, the SPE may also achieve the requisite independence even where it is not independently owned (see bankruptcy remoteness criterion j), to be applied *mutatis mutandis* in relation to engaging in restricted activities).

[6] As is the case for many US SPEs, which are often members of the originator's corporate family.

[7] For example, if 1) securitisation is an important funding tool for an originator and 2) substantially all the SPE's assets are subject to security in favour of securitisation creditors, the originator will have a disincentive to misuse its SPE, and any advantage it may gain from using the SPE to issue other debt is likely to be limited.

[8] However, the prospect of any liability for an SPE can affect the amount of funds available to pay noteholders and may therefore have a negative rating impact, even if there is no material prospect of a bankruptcy filing against the SPE.

[9] Or will agree (e.g., where the issuer has covenanted not to contract with additional transaction creditors unless they agree to limited recourse and non-petition).

Transaction documents commonly contain non-petition covenants, by which transaction creditors agree not to file a bankruptcy petition against the SPE, and limited recourse provisions, which limit creditors' recourse against the SPE to the amounts available to make payment to them in accordance with the waterfall of payments.[10]

For a particular transaction, we may determine (on the basis of a suitable legal opinion or otherwise) that the applicable non-petition covenants or limited recourse provisions are effective to substantially exclude the possibility of a successful bankruptcy filing.[11] On the other hand, if there is material uncertainty as to whether a bankruptcy filing is legally possible,[12] this criterion g) is not satisfied.

Even when non-petition covenants or limited recourse provisions are not effective, of themselves, to substantially exclude the possibility of bankruptcy, they can reduce the incentive for a transaction creditor to file, and therefore contribute to satisfying criterion h) below.

h) There is no material likelihood that transaction creditors will choose to file against the SPE

We generally assume that a transaction creditor will not choose to file for bankruptcy unless the SPE defaults, or is likely to default, on its obligations to that creditor.

Even if a transaction creditor experiences a payment default, so long as it does not have a good incentive to file for bankruptcy, we generally assume it will not file if 1) there is a material prospect that the filing will be unsuccessful;[13] or 2) it may suffer a negative consequence, such as liability for breaching a non-petition covenant.

A transaction creditor will have a good incentive to file if, for example 1) the relevant bankruptcy laws suggest it could successfully challenge its contractual subordination; or 2) it stands to benefit from a bankruptcy-triggered event of default under the notes or a support agreement.

Protective features relating to voluntary bankruptcy filing by an SPE

We generally assume that an SPE will not be subject to a voluntary bankruptcy filing, if at least one of the criteria from i) to l) below is satisfied.

i) It is independently owned and managed

If the shareholders and management of an SPE are each sufficiently independent of the transaction parties and have no material economic interest in the SPE's activities, they should have no incentive to bring about the SPE's bankruptcy. Where this is not the case, the shareholders or management may benefit from the SPE's bankruptcy.[14]

By way of example, we deem the ownership of an SPE to be sufficiently independent if a corporate trustee who is not connected to any of the transaction parties holds all the shares in the SPE pursuant to a charitable trust.

In relation to the management of an SPE, we generally deem this criterion i) to be satisfied if A) either 1) at least one of the directors is provided by a nationally recognised corporate services provider and is not connected to any of the transaction parties; or 2) the SPE has at least two

10 As a variant on this, creditors sometimes agree that their claims shall be extinguished upon full distribution of the SPE's assets in accordance with the waterfall.

11 For example, in some jurisdictions, suitable limited recourse provisions may ensure that an SPE cannot become technically insolvent.

12 As is commonly the case in relation to non-petition provisions (on the basis that it is contrary to public policy for a creditor's statutory right to file for bankruptcy to be fettered by contract).

13 For example, due to limited recourse or non-petition.

14 As an example, General Growth Properties, Inc. (GGP) procured the voluntary bankruptcy filings of its subsidiary SPEs in order to, *inter alia*, benefit from the continuation of a cash pooling system that operated to its financial advantage.

professional directors that are not connected to any of the transaction parties; and B) if there are any non-independent directors, the organisational documents provide (and are effective in ensuring that) the agreement of at least two independent directors[15] is required as a pre-condition for voluntary bankruptcy.[16]

j) It is not independently owned, but a voluntary bankruptcy filing requires the affirmative vote of at least one independent director, who is provided by a nationally recognised corporate services provider and owes no duty to the SPE's shareholders

Independent directors[17] can be an effective protection against voluntary bankruptcy even in circumstances where the ownership of the SPE is not sufficiently independent, but only if the organisational documents irrevocably provide (in a binding and effective manner) that 1) there must at all times be at least one independent director who is provided by a nationally recognised corporate services provider; 2) the dismissal of any independent director requires good cause; 3) the independent directors' agreement is required as a pre-condition for voluntary bankruptcy; and 4) the independent directors owe no duty to consider the interests of the SPE's shareholders when voting on whether to file for voluntary bankruptcy.[18]

k) The shareholders and/or management are very unlikely to have an incentive to cause the SPE to file for bankruptcy

Even if the shareholders and/or management are not independent, they will not necessarily have a material incentive to cause the SPE to file for bankruptcy. We assess this on a case-by-case basis by reference to the facts of each transaction and the applicable bankruptcy laws.[19]

As an overriding caveat, if an SPE's directors may be required or incentivised to file by reason of the applicable bankruptcy law,[20] satisfaction of one or more of criteria i) to k) above may not, of itself, enable us to assume an SPE will not be subject to a voluntary bankruptcy filing.

l) There is no material possibility that it will ever be in sufficient financial distress to file for voluntary bankruptcy

We may determine that a particular SPE will never be in sufficient financial distress to file for voluntary bankruptcy. We assess this by reference to the applicable bankruptcy laws. For example, where bankruptcy is subject to a clear and objective balance-sheet insolvency test, suitable limited recourse provisions in an SPE's transaction documents or a high ratio of asset value to liabilities may be sufficient to substantially exclude the possibility of voluntary bankruptcy. In some jurisdictions, the relevant test is not so objective, making it more difficult to conclude that it will never be satisfied.[21]

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15 Or at least one independent director that is (or is provided by) a nationally recognised corporate services provider.

16 Further, provided that the ownership of an SPE is sufficiently independent, criterion i) may be satisfied even if the management is not independent. We assess this on a case-by-case basis and, in particular, in consideration of whether shareholder agreement is necessary to commence voluntary bankruptcy proceedings in the relevant jurisdiction.

17 In this report "director" includes any equivalent position, such as a manager in an LLC.

18 In the GGP case, the US bankruptcy court held that the SPEs' managers had a duty to consider the interests of GGP and, therefore, did not act inappropriately in filing for bankruptcy. However, the Delaware Limited Liability Company Act provides that an LLC agreement can validly limit managers' fiduciary duties. Therefore, it is possible for the independent managers of a Delaware LLC to be substantially relieved of any duty to consider the interest of the SPE's shareholders when voting on voluntary bankruptcy.

19 For example, contractual undertakings by shareholders or directors not to initiate bankruptcy proceedings (and to incur direct liability to noteholders if they do) can, if enforceable, diminish or neutralise any commercial incentive they may otherwise have to seek bankruptcy, provided that any successor directors and shareholders will be required to give the same covenants.

20 For example, in the UK, directors commit a criminal offence if they continue to trade at a time when it has become inevitable that the company will be wound up by its creditors (although satisfaction of our criteria relating to involuntary filing ought to ensure that it never becomes inevitable that an SPE will be wound up by its creditors).

21 For example, the threshold for bankruptcy filing in the US is low. A debtor need not be insolvent, but must only show "financial distress." Indeed, the bankruptcy court judge in the GGP case said, "the Bankruptcy Code does not require *any particular degree* of financial distress" to file.

Protective features relating to substantive consolidation

We generally assume that an SPE's assets and liabilities will not be pooled with those of a bankrupt affiliate, if either criterion m) or n) below is satisfied.

m) *It is located in a jurisdiction that does not apply substantive consolidation*

Many legal systems, including those of most countries in Europe and Asia, do not allow for the possibility of substantive consolidation.[22]

n) *It is established and operated in a manner that substantially excludes the risk of consolidation*

In jurisdictions that have a doctrine of substantive consolidation, such as the US, the risk of consolidation is generally mitigated if 1) the parties dealing with the SPE and the relevant affiliate do not rely on them being treated as one legal entity and 2) the assets and liabilities of the SPE are kept separate from those of its affiliate. SPEs are usually established and operated so that the risk of consolidation is minimised (e.g., by the inclusion of separateness covenants in their organisational documents). If, in addition, effective security is granted over substantially all the SPE's assets (thereby reducing the incentive of the parent's creditors to seek substantive consolidation), we are able to assume the SPE will not be consolidated.

Assessing Rating Impact when an SPE Does Not Achieve Bankruptcy Remoteness

If we determine that an SPE is not bankruptcy remote, we assess whether the risk of bankruptcy has a rating impact. We evaluate the impact on a case-by-case basis according to both the likelihood of bankruptcy[23] and the possible negative consequences to noteholders.[24]

If, for a particular SPE, we determine that bankruptcy can have no negative consequences for noteholders, the rating of the notes will not be sensitive to whether bankruptcy remoteness is achieved. Where the incremental expected loss associated with bankruptcy can be quantified with sufficient certainty, we may incorporate it in our modelling analysis. However, if we cannot easily quantify the expected loss to noteholders (e.g., where there is a material risk of substantive consolidation) or there is a likelihood of substantial payment delays resulting from bankruptcy, we may cap the note rating or even decline to rate the notes.

[22] Some jurisdictions have analogous doctrines in their bankruptcy laws, such as piercing the corporate veil, but they generally apply in very narrow circumstances and are not relevant to SPEs in typical structured finance transactions.

[23] By way of example, the likelihood of an SPE incurring a secondary liability for the obligations of its parent will depend on the parent's credit quality.

[24] In each case, relative to the rating of the notes.

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