Article Title: ARCHIVE | Legal Criteria: LEGAL CONSIDERATIONS IN RATING MANUFACTURED HOUSING SECURITIES Data: Structured financings are rated based primarily on the creditworthiness of isolated assets or asset pools, whether sold or pledged to secure debt, and without regard to the creditworthiness of the seller or borrower. The structured financing seeks to insulate transactions from entities (such as manufactured housing contracts sellers) that are either low rated or unrated and for whom Standard&Poor;'s is unable to quantify the likelihood of a potential bankruptcy or that are rated investment grade but wish a higher rating for the transaction. Standard&Poor;'s worst-case scenario assumes the bankruptcy of each transaction participant deemed not to be a bankruptcy-remote entity or that is rated lower than the transaction. Standard&Poor;'s resolves most legal concerns by analyzing the legal documents and, where appropriate, receiving opinions of counsel that address insolvency issues. Understanding the implications of Standard&Poor;'s assumptions and its criteria enables an issuer to anticipate and resolve most legal concerns early in the rating process. As a general matter, a pledge of collateral would not ensure that the creditor would have timely access to the collateral if the pledgor had become the subject of a proceeding under the U.S. Bankruptcy Code, 11 U.S.C. Although, as a matter of law, a creditor ultimately should be able to realize the benefits of pledged collateral, several provisions of the Bankruptcy Code may cause the creditor to experience delays in payment and in some cases receive less than the full value of its collateral. Under Section 362(a) of the Bankruptcy Code, the filing of a bankruptcy petition automatically stays all creditors from exercising their rights with respect to pledged collateral. The stay would affect creditors holding security interests in any collateral pledged by a borrower that has become a debtor under the Bankruptcy Code. Although a bankruptcy court could provide relief from the stay under certain circumstances, it is difficult to estimate the likelihood of such relief from the stay. Moreover, in most cases, it would be difficult to estimate the duration of the stay. Similarly, under certain circumstances, a bankruptcy court can permit a debtor to use pledged collateral to aid in the debtor's reorganization (Section 363) or to incur debt that has a lien on assets that is prior to the lien of existing creditors (Section 364). Under Section 542, a secured creditor in possession of its collateral may be required to return possession of such collateral to a bankrupt borrower. As a result, the existence of a strong asset pool to secure debt alone cannot determine the rating on such debt. The structure of the transaction must provide the means by which assets would be available to pay debt service in a timely manner notwithstanding the insolvency, receivership, or bankruptcy of the issuer, seller, or borrower. In rating asset-backed securities higher than the rating of the issuer, seller, or borrower, Standard & Poor's seeks to insulate the transaction from the consequences of the bankruptcy or insolvency of the issuer, seller or borrower. This determination is made either: On the basis that if the pool of assets is owned by an entity, that entity is bankruptcy remote (thus unlikely to be the subject of a bankruptcy or insolvency proceeding), or On the basis that the pool of assets supporting payments on the securities is no longer owned by the entity that may be the subject of a bankruptcy or insolvency (thus the pool of assets would not be affected by the delays or court valuations in the bankruptcy process). In addition, for each entity involved in the transaction that is not bankruptcy remote, Standard & Poor's evaluates all transfers of property and funds of the entity to ensure that these transfers would not be deemed preferential transfers under the Bankruptcy Code and, in some instances, that they would not be deemed fraudulent conveyances under applicable state and federal laws. BANKRUPTCY-REMOTE ENTITIES Standard & Poor's analysis relies on the fact that certain entities (generally owner trusts, limited partnerships, limited liability companies or corporations) are deemed bankruptcy remote. Standard & Poor's criteria seek to ensure that the entity is unlikely to become insolvent or be subject to the claims of creditors (who may file an involuntary petition against the entity). The following criteria would need to be met to ensure that such entity is a special-purpose corporation (SPC) and thus, bankruptcy remote. 1. The entity should be prohibited from engaging in a merger, consolidation, or asset transfer with an entity not rated as high as the securities or that does not meet Standard & Poor's single-purpose criteria. 2. The entity should be restricted from incurring additional debt, or the entity's organizational documents should prohibit additional debt, in each case other than debt rated by Standard & Poor's as high as the rating on the issue in question or debt that (a) is fully subordinated to the rated debt, (b) is nonrecourse to the issuer or any assets of the issuer other than cash flow in excess of amounts necessary to pay holders of the rated debt, and (c) does not constitute a claim against the issuer to the extent that funds are insufficient to pay such additional debt. 3. The entity should not engage in any other business or activity. 4. The entity should have at least one independent director on the board of directors. The consent of the independent director should be required in order to institute insolvency proceedings. 5. The parties to the transaction documents should covenant that so long as the rated securities are outstanding, they will not file any involuntary bankruptcy proceeding against the entity. According to Standard & Poor's criteria, the entity should also agree to abide by certain "Separateness Covenants" whereby the entity covenants: To maintain books and records separate from any other person or entity; Not to commingle assets with those of any other entity; To conduct its own business in its own name; To maintain separate financial statements; To pay its own liabilities out of its own funds; To observe all corporate formalities; To maintain an arm's-length relationship with its affiliates; To pay the salaries of its own employees; Not to guarantee or become obligated for the debts of any other entity or hold out its credit as being available to satisfy the obligations of others; To allocate fairly and reasonably any overhead for shared office space; To use separate stationery, invoices, and checks; Not to pledge its assets for the benefit of any other entity; and To hold itself out as a separate entity. If the bankruptcy-remote entity is wholly owned by a parent that is not bankruptcy remote, Standard & Poor's will request an opinion of counsel to the effect that, in an insolvency of the parent, the bankruptcy-remote entity would not be substantively consolidated with the parent under applicable insolvency laws (for example, bankruptcy laws for Bankruptcy Code entities, applicable insurance laws for insurance companies, and applicable banking law for banks). Standard & Poor's continues to monitor developments in banking and insurance law and evaluates the need for nonconsolidation opinions on a case-by-case basis. In addition, the following limits should apply to limited partnerships: The other assets of the general partner(s) and all successor general partners should not be commingled with any assets of the limited partnership. Standard & Poor's requires that at least one general partner be a special-purpose, bankruptcy-remote entity. If a partner has a controlling interest in the partnership (50% or more), Standard & Poor's needs to receive acceptable nonconsolidation opinion with respect to the partner and partnership. In the absence of such an opinion, no partner should own at any time 50% or any greater percentage interest in the profits and losses of the limited partnership (either as a general or a limited-partnership interest). Upon dissolution of the partnership, or other events of default, the trustee should have the independent ability to retain the collateral and continue to pay scheduled debt service or to liquidate the collateral in the event the proceeds would be insufficient to repay all amounts due securityholders. For limited liability companies (LLCs), in addition to the criteria set forth above, Standard & Poor's requires that: The LLC conduct its business at arm's length with, and maintain its existence separate from, its members. Standard & Poor's also requires an opinion of counsel to the effect that, under applicable insolvency laws, in an insolvency of a member, the LLC would not be consolidated with such member. The LLC must have at least one outside member that is an SPC and the vote of all members must be required for filing a voluntary bankruptcy petition. The articles of organization should provide that, in the event of a dissolution, the LLC will not liquidate collateral without the consent of the holders of rated obligations and that such holders may continue to exercise all rights with respect to the collateral under the security agreement. Standard & Poor's must receive an opinion of counsel to the effect that the LLC will not be taxed as an association taxable as a corporation. These criteria should be incorporated in the entity's certificate of incorporation, partnership agreement, or articles of organization and, as appropriate, in the other transaction documents. TRANSFERS, OWNERSHIP, SECURITY INTEREST The second level of Standard & Poor's bankruptcy analysis involves the evaluation of the nature of each party's property rights and whether third parties (that may be unrated or that are not bankruptcy remote) have retained rights that may impair the timely payment of debt service on the securities. Standard & Poor's will look at all asset transfers and analyze whether the transfer is a sale or a pledge of collateral. In general, Standard & Poor's criteria requires that transfers from entities that are not bankruptcy-remote be true sales. Standard & Poor's will require opinions of counsel to the effect that, in an insolvency of the transferor the transfer would be viewed as a true sale of the property by the transferor (for Bankruptcy Code issuers that is, the property would not be viewed as property of the estate of the transferor under Section 541 of the Bankruptcy Code or be subject to the automatic stay under Section 362(a)). Standard & Poor's also may require an opinion to the effect that the assets transferred and the related debt service payments to the securityholders would not be recoverable as a preference under Section 547(b) of the Bankruptcy Code or be deemed a fraudulent conveyance under state and federal laws. For bankruptcy-remote entities, Standard & Poor's examines the documents to ensure that the trustee has a first priority perfected security interest on the pledged property. Standard & Poor's requires proper steps be taken to perfect the security interest under applicable law. In general, filing UCC-1 financing statements will be sufficient to perfect the sale or the grant of a security interest in manufactured housing contracts. Standard & Poor's also requires an opinion of counsel to the effect that the trustee has a first priority perfected security interest in the manufactured housing contracts, the underlying manufactured home, and other property pledged to secure the rated issue. With respect to any reserve funds or other credit support established under the documents, Standard & Poor's will examine the transfers of funds deposited in such accounts. To the extent that monies other than bond proceeds are used for such funds, Standard & Poor's may require one or more of the opinions set forth above. To the extent that a transaction relies on funds invested under an investment agreement with a rated entity, or a guarantee, LOC, insurance policy, or liquidity facility from a rated institution, Standard & Poor's may require an opinion that the investment agreement, guarantee, LOC, insurance policy, or liquidity facility is the legal, valid, and binding obligation of such institution, enforceable against it in accordance with its terms. To the extent the institution is a U.S. branch or division of a foreign institution on foreign enforceability, opinion would be required also addressing among other matters the enforceability of the obligation against the foreign institution. Standard & Poor's also will review the investment agreement, guarantee, LOC, or insurance policy to ensure that there are no circumstances that would relieve the institution from its obligation to pay. Given that transaction structures are varied, it is difficult to generalize criteria. Clearly, the insolvency concerns, simple in theory, prove to be elaborate in practice. SELECTED SPECIFIC CRITERIA In manufactured housing transactions, criteria that have legal implications can generally be classified into two categories: criteria relating to the nature of the collateral and the servicing functions specific to the collateral, and criteria relating to the structure of the transaction (that is, bankruptcy-remote entities, credit support, and transaction-specific structure). Criteria Related To Collateral The collateral backing the securities is composed of the manufactured housing contracts, which are generally classified as chattel paper under the Uniform Commercial Code (UCC), and related property, such as insurance policies and monies on deposit in certain accounts maintained for the benefit of the securityholders. The contracts show the debt and the grant of a security interest in the underlying manufactured homes (and in certain cases, a lien on the real estate on which the home will be permanently affixed). The sale of, or grant of a security interest in, chattel paper can be perfected as against the originator or seller by the filing of UCC financing statements or by possession of the chattel paper. The originator, acting as servicer for the issuer and the trustee, generally retains possession of the contracts as custodian, to perform the necessary servicing functions. To serve notice to other creditors of the originator that the contracts were sold, the contracts are stamped to reflect their assignment to the SPC and then to the trustee for the securityholders. UCC-1 financing statements are filed to perfect the assignment of the contracts and to give notice to third parties of the trustee's rights in the contracts. The manufactured homes securing the contracts may be located in a number of states. Under the laws of most states, manufactured homes that have not been affixed to the land constitute personal property, perfection of a security interest in which may be obtained by filing a UCC financing statement. In some states, manufactured homes are covered by certificates of title laws. In these states, perfection of a security interest requires notation of the lien on the certificate of title of the manufactured home. The originator/seller represents in the transaction documents that it has obtained a first priority perfected security interest in the manufactured homes underlying the contracts and Standard & Poor's receives an opinion to that effect. Because of the cost and administrative inconvenience involved, there is generally no amendment of the certificates of title of the manufactured homes to reflect the lien of the trustee, even though such an amendment is required in some states to render the assignment of the originator's security interest in the manufactured home to the trustee directly enforceable against third-party creditors of the borrower under the contract. Standard & Poor's generally has received comfort from the notice function served by both certificate of title laws and UCC filings. Regarding the borrower, the originator will be noted as lienholder in the manufactured home. The borrower will thus be unable to sell the home free and clear of the lien. The originator, as servicer, will be able to enforce the lien of the contract and foreclose on or repossess the manufactured home. The SPC files UCC-1s to perfect the sale of the manufactured housing contracts from the originator and the further transfer to the trust. Thus, regarding third-party creditors of the originator, the UCC-1 filings give notice that the assets are being held by the originator solely as servicer for the SPC or the trustee. Stamping the contracts reduces the risk that the originator will mistakenly assign the contract to a subsequent purchaser. In addition, a segregated collection account also ensures that payments made by the borrowers are not commingled with other servicer funds. To the extent the servicer retains an interest in the manufactured homes (arguably because the certificate of title is not amended), Standard & Poor's is comfortable that retention of bare legal interest in the manufactured homes would not render the contracts property of the estate of the originator. Therefore, in an insolvency of the originator, the contracts would not be subject to the automatic stay. If there are significant concentrations of manufactured homes in a particular state, Standard & Poor's may require an opinion of counsel to the effect that amendment of the certificate of title would not be required to perfect the sale of the originator's interest in the homes to the SPC and the subsequent grant of a security interest to the trustee. Another risk attaching to the nature of the collateral underlying the contracts is that of manufactured homes becoming permanently affixed to the real estate. Courts in many states have held that manufactured homes, in such circumstances, may become subject to real estate title and recording laws, in which case perfection would require recordation in the real estate records. Failure to record may result in the trustee losing its first priority position against a third party who may have filed a mortgage under the applicable real estate laws. The originator generally includes a clause in the manufactured housing contracts prohibiting the borrower from attaching the manufactured home to the site permanently. To the extent permanent attachment is allowed and for the newer "land and home" contracts, the originator requires, and records in the real estate records, a first mortgage or deed of trust representing a first lien on the real estate on which the manufactured home will be permanently affixed. The mortgage is then assigned to the SPC together with the manufactured housing contract and then to the trustee as security for the rated securities. Because of the significant costs involved, these subsequent assignments are not recorded in the real estate records. A similar analysis to that undertaken for certificate of title laws gives Standard & Poor's comfort that third-party creditors of the borrower have notice of the lien through the initial recordation in the real estate records of the originator's interest in the manufactured home. Standard & Poor's is also comfortable that, subsequent to the assignment to the SPC (perfected through the filing of a UCC-1) the mortgage will generally follow the note, and bare legal interest in the mortgage held by the originator will not affect timely receipt of principal and interest on the securities. On a case-by-case basis, Standard & Poor's may request recordation of the assignment of mortgage (or an opinion of counsel that recordation is not required to perfect the assignment of mortgage), depending on the amount of land and home contracts in the pool, their geographic distribution, the principal amount of the contracts, and Standard & Poor's comfort with the servicer and servicing procedures. Collections on collateral. Most structured finance transactions do not explicitly look at the rating (or implied rating) of the servicer as long as the servicer does not commingle funds and remits such funds with reasonable promptness to the trustee. Standard & Poor's evaluates, however, whether in the event of the insolvency of the servicer, there would be sufficient funds to pay the rated obligations in a timely manner. The filing of the bankruptcy petition would place a stay on all amounts held in a servicer account. Since these amounts would no longer be available, the transactions would have to cover the commingling risk through credit support. The documents should be very specific with respect to the circumstances under which commingling is allowed. Criteria Related To Transaction Structures In manufactured housing transactions, the rated securities are generally certificates of a trust, for which an election to qualify as a real estate mortgage investment conduit (REMIC) for tax purposes may be made. In the case where such election is not made, the trust may be a grantor trust or owner trust. The trust fund is composed of the manufactured housing contracts, security interests in the manufactured homes securing such contracts (including a mortgage, if applicable), rights under certain insurance policies with respect to the manufactured homes, and amounts on deposit in certain accounts held by the trust. Standard & Poor's legal analysis will examine the effects of the insolvency of the originator on the transaction and require proper insulation of the assets from the originator's insolvency, as well as legal opinions addressing the nature of the various transfers of the assets and the consequences for the SPC of the originator's insolvency. In the typical transaction, the originator establishes a wholly owned SPC and sells the manufactured housing contracts to the SPC. The SPC serves as the depositor to the trust and sells (or pledges) the collateral to the trust. The SPC uses the proceeds of the securities to purchase the manufactured housing contracts and related rights from the originator. In some transactions, the originator does not use an intermediate SPC but rather sells the contracts directly to the trust in a true sale. In these transactions, if the originator is a Bankruptcy Code entity, Standard & Poor's has to be comfortable with the true sale nature of the transfer. Standard & Poor's will not rely on true sale opinions if the originator takes back a subordinated interest that is not rated investment grade. If the originator is a bank, Standard & Poor's has relied on advice from the FDIC that the FDIC, as receiver or conservator of a bank, will not stay or otherwise avoid securitized transactions supported by a first priority perfected security interest over the assets of the bank. Senior/subordinated transactions. A senior/subordinated transaction is characterized by the subordination of a portion of the contract pool held by the trust to serve as credit support for the senior certificates. More complex transactions involve multiple levels of subordination and may also be structured to contain reserve funds and/or insurance policies to provide credit support for certain enhanced classes of subordinated certificates. The SPC usually sells the senior certificates and the enhanced subordinated certificates to the public through an underwriter and retains (or sells through a private placement offering) the unenhanced subordinated certificates. When subordinated certificates are retained by the SPC issuer, the following opinions are required: (i) A "true sale opinion with respect to the transfer of the contracts from the originator to the SPC. If the transferor is subject to the bankruptcy code, the "true sale" opinion should state that the contracts will not be property of the transferor's estate under Section 541 of the Bankruptcy Code or be subject to the automatic stay under Section 362 (a) in the event of the bankruptcy of the transferor. If the originator is a bank, Standard & Poor's will require a first priority perfected security interest opinion. Because of uncertainties inherent in bank insolvency, proceedings depending on the structure of the transaction, in a given case Standard & Poor's may require additional opinions or assurances. (ii) A "nonconsolidation" opinion stating that the SPC would not be consolidated with the originator/parent in the event of the bankruptcy of the parent. (iii) An opinion that the transfer of the contracts by the SPC to the trust either constitutes a "true sale" or the grant of a first priority perfected security interest in the assets in favor of the trustee. When subordinated certificates are transferred to the parent (either in partial payment for the contracts or otherwise), the validity of the "true sale" opinion in (i) above can be undermined. As the parent could arguably be said to have not fully divested itself of all rights to the collateral (one of the legal tests of ownership), a court could possibly view the holding of the subordinated certificate as a "financing" by the parent (secured by a lien on the contracts) rather than a true sale of the contracts. In many cases, the transaction can be restructured in a manner acceptable to Standard & Poor's or the transaction can be analyzed under a "blended rating" approach. In some situations, Standard & Poor's has allowed the parent of the SPC to hold subordinated certificates if they represent only a small portion of the contract pool or if the subordinated certificate is a "strip" or noneconomic residual. In many cases, an affiliate (either a wholly owned subsidiary or a sister company of the parent) may be the purchaser of the subordinated certificates. Such affiliate may or may not be an SPC. If the affiliate is a newly created SPC subsidiary of the parent, created solely for the purpose of purchasing the subordinated certificates, there is an increased concern that the SPC is really the parent. Standard & Poor's will request the opinions mentioned in (i), (ii) and (iii) above, and an additional opinion that the affiliated SPC holding the subordinated certificate would not be consolidated with the parent in the event of the latter's bankruptcy.