

Article Title: ARCHIVE | Legal Criteria: Structured Finance Criteria Introduced for English and Welsh Special-Purpose Entities Data: (Editor's note: These criteria have been superseded by the article titled "Amended Structured Finance Legal Criteria For English And Welsh SPEs," published on Dec. 16, 2005.) Standard & Poor's legal criteria for structured finance transactions are designed to ensure that either the entity owning the assets required to make payments on the rated securities is insolvency remote (that is, unlikely to be subject to voluntary or involuntary insolvency proceedings) or the transaction is properly accounted for as a dependent rating. In this regard, Standard & Poor's will evaluate the incentives of this type of entity, known as a special-purpose entity (SPE), or its equity holders, to resort to voluntary insolvency proceedings, and the incentives of creditors of the SPE to resort to involuntary insolvency proceedings. In cases where the SPE is not an "orphan" SPE (see below) the insolvency-remote analysis also examines whether third-party creditors of the SPE's parent would have an incentive to attempt to reach the assets of the SPE to satisfy the parent's obligations. Reflecting certain aspects of English law that differ from those of other jurisdictions, specific criteria for SPEs incorporated in England and Wales have been introduced by Standard & Poor's. In the main, these are identical to the general SPE criteria (see U.S. Legal Criteria in Structured Finance Transactions, April 2000, on [www.standardandpoors.com](http://www.standardandpoors.com). Under Resource Center, select Ratings Criteria, then Structured Finance). Nevertheless, they differ in a few places, particularly as to the location of various restrictions on activities, the type of security to be provided, and the absence, if certain conditions are met, of a requirement for independent directors. Fundamentally, the SPE criteria focus on matters of insolvency. Therefore, it is always crucial, when examining this issue, to focus on which insolvency regime (or regimes) would govern a putative bankruptcy of the SPE. Accordingly, the English SPE criteria may not be suitable for an SPE incorporated in England or Wales if the nature of its activities or the location of its assets suggests that an insolvency regime other than that set out in the U.K. Insolvency Act 1986 would apply to it or the majority of its assets. Characteristics of Insolvency Remoteness For companies incorporated in England and Wales, Standard & Poor's has compiled the following "English SPE criteria," which an entity should satisfy to be deemed an insolvency-remote SPE. An entity that satisfies these criteria is regarded by Standard & Poor's as being sufficiently protected against both voluntary and involuntary insolvency risks: Contractual restrictions on activities; Debt limitations; No reorganization or changes of ownership, etc.; Separateness covenants; and Fixed and floating security interests over assets. Each of these characteristics is important to the overall concept of insolvency remoteness. Regardless of the specific organizational structure of the SPE, these elements should, generally, be addressed in the transaction documents. Their rationale, briefly explained below, is followed by a full description of the English SPE criteria.

**Contractual Restriction on Activities** The fundamental SPE characteristic is that the entity be restricted as closely as possible to the bare activities necessary to effect the transaction. The purpose of this restriction is to reduce the SPE's risk of insolvency due to claims created by activities unrelated to the securitized assets and the issuance of the rated securities. To the extent that Standard & Poor's analysis relies upon the insolvency remoteness of an entity, it will generally require that the transaction documents incorporate explicit covenants that constrain the SPE to those activities needed to ensure the sufficiency of cash flow to pay the rated securities. In brief, 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 entity's resources, cash flows, and the ability to pay the entity's obligations in a full and timely manner. Although in its general SPE criteria, Standard & Poor's has indicated that the organizational documents are the preferred locus for this constraint, this is not the case for English SPEs. Standard & Poor's has always recognized that the severity of the doctrine of "ultra vires" in English law means that the incorporation of a restriction on activities in the SPE's memorandum of incorporation raises a risk that certain obligations of the SPE necessary for the proper functioning of the rated transaction could be struck down. On balance, Standard & Poor's is of the view that the traditional advantages of inserting such restrictions in the organizational documents of SPEs are outweighed, in the context of English incorporated companies, by the risks of the application of the doctrine of ultra vires. Accordingly, Standard & Poor's considers that the insertion of such restrictions in the appropriate transaction documents is the preferred course.

**Debt Limitations** An SPE should be restricted from incurring additional indebtedness except in cases where such indebtedness would not affect the rating

on its existing indebtedness. An existing rating could be affected if holders of the additional indebtedness have an incentive to initiate insolvency proceedings in order to gain access to the SPE's cash flows and assets. Therefore, additional indebtedness that is either expressly subordinated to, or rated the same as, existing indebtedness should not, in principle, affect the rating of the existing indebtedness. Additional indebtedness includes any monetary obligation, or other obligation that may involve the payment of money, such as covenants by the SPE to remove liens, indemnify, etc. Standard & Poor's also generally requires nonpetition language in any agreement between the SPE and its creditors whereby the creditors agree not to petition for insolvency proceedings in relation to the SPE and not to join in any such proceedings. In some cases, a specific intercreditor agreement may also be appropriate. No Reorganization or Changes of Ownership This requirement attempts to ensure that, while the rated securities are outstanding, the insolvency-remote status of the SPE will not be undermined by the purchase by another company of the SPE's shares or any reorganization, dissolution, merger, amalgamation, reconstruction, liquidation, or asset sale. Standard & Poor's generally also requires that the SPE not amend its memorandum and articles without prior written notice to Standard & Poor's. Separateness Covenants Separateness covenants are designed to ensure that the SPE holds itself out to the world as an independent entity, on the theory that if the entity does not act as if it had an independent existence, a court may use the principle of "piercing the corporate veil" to bring the SPE and its assets into the insolvency proceeding of its parent or of an originator. The involvement of an overreaching parent or originator is a threat to the independent existence of the SPE. Piercing the corporate veil is the remedy exercised by a court when a controlling entity, such as the parent of an SPE, so disregards the separate identity of the SPE that their enterprises are seen as effectively commingled. The remedy can be sought by creditors (with claims against an insolvent company) who believe funds can be properly traced into 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 entity should observe certain separateness covenants, set forth in the following section (see "English SPE Criteria" below). In addition, Standard & Poor's may request legal opinions to the effect that the SPE would not be consolidated with an originator or with its parent (although such opinions would not normally be sought where the SPE's parent is itself an SPE or where the shares of the SPE are held on trust for charitable purposes). Security Interests Over Assets and Independent Directors Standard & Poor's general criteria relating to SPEs requires the appointment of an independent director to the board of the SPE. This reflects a concern that the directors of the SPE may seek to initiate insolvency or winding-up proceedings in respect of the company if, for example, the directors are also connected with the SPE's operating company parent. Under the U.K. Insolvency Act 1986, however, a creditor of a company that has a floating charge, which, together with any fixed charges, covers all or substantially all of the company's assets, has the right to appoint an administrative receiver to the company's assets and, effectively, obtain control of all those assets. In addition, creditors with the power to appoint an administrative receiver can block the appointment of an administrator to the insolvent company. Under the Insolvency Act, only a company in administration (i.e., to which an administrator has been appointed) can have the benefit of moratorium provisions in the payment of its debts. Accordingly, Standard & Poor's is of the view that, if the holders of the rated securities have the benefit of an appropriately structured floating charge, then there are no discernable incentives for the directors of the SPE to initiate insolvency proceedings. Furthermore, the initiation of such proceedings would not enable the SPE to suspend its payments under the rated securities or block or delay the access by the holders of the rated securities to the assets out of which it is anticipated those securities will be repaid. Recent changes to the U.K. insolvency regime introduced in the Insolvency Act 2000 and expected to be brought into force in June 2001 will introduce the possibility (under the scheme of "company voluntary arrangements") of a short moratorium of up to three months for "small companies" notwithstanding the existence of an appropriate floating charge. It is conceivable that certain SPEs will qualify as small companies. Standard & Poor's is comfortable, however, that the nature of the company voluntary arrangements is not such as to require a modification to Standard & Poor's views of the risks relating to SPEs. In the case of English SPEs, the shares of which are not owned on trust for charitable purposes (known as an orphan SPE), Standard & Poor's would also expect that those shares are

charged by the owning company for the benefit of the holders of the rated securities. In Standard & Poor's view, this would provide a further disincentive to an operating owner from seeking to interfere with the SPE, for example, by seeking to file for its insolvency. Accordingly, if an English SPE provides fixed and floating charges for the benefit of the holders of the rated notes such that they are empowered to require the appointment of an administrative receiver and the shares of the SPE are either held on trust for charitable purposes or charged for the benefit of the holders of the rated debt, then Standard & Poor's would not expect to see an independent director sit on the SPE's board. Generally, and irrespective of the issue of the independent director, Standard & Poor's wishes to see the SPE provide security over all of its assets for the benefit of the holders of the rated debt. In the context of an English SPE, such security should include a floating charge over all assets not charged under fixed security. In connection with this criterion, Standard & Poor's generally also requires a debt security interest opinion, which confirms that the holders of the rated securities have a first-ranking security interest in the assets secured by the fixed security. The opinion should also confirm the validity of the floating charge and its capacity, together with the fixed charges, to allow the appointment of an administrative receiver and the blocking of the appointment of an administrator. These elements help Standard & Poor's in reaching the analytic conclusion that an issuer is an SPE by reducing the incentives of the parent, the creditors of the parent, and any other creditors of the issuer, to initiate insolvency proceedings in respect of the issuer to gain access to its cash flows and assets. By reducing the incentive of the parties, the likelihood of an involuntary filing may be reduced. English SPE Criteria

Based on the principles discussed above, Standard & Poor's has developed criteria to help it assess whether an English incorporated company subject to the English insolvency regime is an SPE.

**Restrictions on Activities** The entity should not engage in any business or activity other than those necessary for, or incidental to, its role in the transaction.

**Debt Limitations** Except in the case of certain multi-use vehicles (see Appendix III of U.S. Legal Criteria in Structured Finance Transactions, April 2000), the entity should not incur any debt (other than indebtedness that secures the rated securities) unless (i) the additional debt is assigned the same rating by Standard & Poor's as the issue credit rating requested for the rated securities in a given transaction (at the time of issuance and at all times thereafter), or (ii) the additional debt is fully subordinated to the rated securities and, in either case, (a) is nonrecourse to the entity or any of its assets other than cash flow in excess of amounts necessary to pay holders of the rated securities, and (b) does not constitute a claim against the entity to the extent that funds are insufficient to pay such additional debt. Additional debt includes any monetary obligation or other obligation may involve the payment of money, such as covenants by the SPE to release security, indemnify, etc. Any agreement between the SPE and its creditors should include nonpetition language whereby the creditors agree not to initiate insolvency proceedings in respect of the SPE and not to join any such proceedings.

**Security** The entity should provide fixed and floating charges over all of its assets so that, among other rights, the holders of the rated debt are able to prevent the appointment of an administrator by the appointment of an administrative receiver.

**No Merger or Change of Ownership, Etc.** The entity 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** The entity should agree to abide by the following separateness covenants: To maintain books and records separate from any other person or entity; To maintain its accounts separate from those of 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 observe all corporate formalities; To use separate stationery, invoices, and checks; To hold itself out as a separate entity; and To correct any known misunderstanding regarding its separate identity.