

Article Title: ARCHIVE | Legal Criteria: U.S. Legal Criteria for "Recycled" Special-Purpose Entities  
Data: (EDITOR'S NOTE: —This criteria article was superseded by "U.S. Structured Finance Asset Isolation And Special-Purpose Entity Criteria," May 15, 2019.)

1. The following are the traditional characteristics of a bankruptcy remote SPE: Restrictions on objects, powers, and purposes; Limitations on ability to incur indebtedness; Restrictions or prohibitions on merger, consolidation, dissolution, liquidation, winding up, asset sale, transfers of equity interests, and amendments to the organizational documents relating to "separateness"; Incorporation of separateness covenants restricting dealings with parents or affiliates; "Non-petition" language (i.e., a covenant not to file the SPE into involuntary bankruptcy); Security interests over assets; and An independent director (or functional equivalent) whose consent is required for the filing of a voluntary bankruptcy petition.
2. The function of these characteristics is to minimize the likelihood that the SPE will file itself into (voluntary) bankruptcy, or will be filed by third parties into (involuntary) bankruptcy. Thus, in analyzing the ability of the SPE to make its debt service payments, the bankruptcy of the SPE need not be taken into account. Rationale for the Newly Created SPE
3. The advantage of a newly created vehicle for each new transaction is that investors have the assurance that it has no prior history of dealings or disguised liabilities that could affect cash flow. If the vehicle is created just prior to its use in the securitization, it is unlikely that there would be claims that might have to be satisfied at some later date. If the SPE is not newly created for the securitization, an unrated, pre-existing liability of the entity may result in a lawsuit against it which might have to be satisfied out of its assets, and which could give the plaintiff the incentive to put the entity into an involuntary bankruptcy.
4. S&P; Global Ratings recognizes that an SPE may, if appropriately structured, serve as the issuer for more than one transaction. (See "Structured Finance: Asset Isolation And Special-Purpose Entity Methodology," published March 29, 2017.)
5. Another exception is the subject of this article. In some instances, S&P; Global Ratings may view an entity that "transforms" from an existing operating entity as an SPE. The "Recycled" SPE
6. As discussed above, the concern with using an existing entity for a new asset-backed transaction is that the entity may have previously incurred material liabilities that could ultimately trigger an involuntary bankruptcy filing.
7. In transactions where, it may be onerous to transfer the asset(s) to a newly formed SPE, the transaction sponsor may, in addition to adopting the SPE criteria (including provision of a substantive nonconsolidation opinion), consider removing or mitigating potential liabilities from the existing entity. (See "Structured Finance: Asset Isolation And Special-Purpose Entity Methodology," published March 29, 2017.) The now-recycled entity may potentially be treated more advantageously than a non-SPE for rating purposes, though it is likely that some rating penalty may attach to the transaction, particularly at the higher rating levels, unless all risks (regardless of whether known as of the closing date) are specifically mitigated by a creditworthy source. Depending on the rating sought (and in addition to other documents or information that might be required for the rating), such a "recycling" would generally involve: A certification by an officer of the company, An audit, Proof of compliance with environmental standards, and Applicable legal comfort.
8. The officer's certificate should be delivered by an executive officer competent to address each of the matters therein. The certificate should state that the entity:
  9. 1. Is and always has been duly formed, validly existing, and in good standing in the state of its incorporation and in all other jurisdictions where it is qualified to do business;
  10. 2. Has no judgments or liens of any nature against it except for tax liens not yet due;
  11. 3. Is in compliance with all laws, regulations, and orders applicable to it and has received all permits necessary for it to operate;
  12. 4. Is not aware of any pending or threatened litigation;
  13. 5. Is not involved in any dispute with any taxing authority;
  14. 6. Has paid all taxes;
  15. 7. [For real estate transactions] Has never owned any property other than the property that is the subject of the current transaction and has never engaged in any business except the ownership and operation of such property;
  16. 8. Is not now, nor has ever been, party to any lawsuit, arbitration, summons, or legal proceeding (if it has been a party, the entity should supply evidence of liability insurance acceptable to Standard & Poor's);
  17. 9. Has provided Standard & Poor's with complete financial statements that reflect a fair and accurate view of the entity's financial condition;
  18. 10. Has passed a Phase One environmental audit for all of its properties;
  19. 11. Has (with respect to the nonconsolidation opinion referred to below) materially complied with the separateness covenants referred to in such opinion since its formation (or any material noncompliance is properly addressed and analyzed in the nonconsolidation opinion); and
  20. 12. Has no material

contingent or actual obligations not related to the mortgaged property. 21. The audit aspect of the recycling involves the provision to Standard & Poor's of an accounting audit of the entity. The audit should confirm the substance of the representations and warranties in the Officer's Certificate dealing with the entity's financial statements. The legal comfort involves providing Standard & Poor's the following: An acceptable legal opinion confirming the relevant representations and warranties (typically 1 to 5 above) set forth in the Officer's Certificate, and An acceptable nonconsolidation opinion containing no assumptions with respect to the entity's prior conduct unless (a) the transaction documentation contains representations to the effect that, since its inception, the entity has never violated Standard & Poor's SPE criteria, and (b) the opinion provider states that it has undertaken appropriate investigations as to prior conduct (including, without limitation, review of lien searches, loan documents from prior loans, and certificates) in support of such assumptions. 22. If the entity holds real property, Standard & Poor's may request a copy of the Phase One environmental audit referred to in the Officer's Certificate. 23. Ideally, the result of the recycling is a clean bill of "liability" health for the entity. On occasion, however, issuers or sponsors of the existing entity have not been able to give clean certifications. In such instances, the relevant liabilities have been mitigated by acceptable credit enhancement. 24. While a newly created SPE is, of course, the ideal, Standard & Poor's recognizes that circumstances occasionally conspire to make this impracticable. In such cases, Standard & Poor's will consider the effect that recycling may have on the desired rating. The resulting recycled SPE, by being held to analogous criteria as a newly created SPE, may consequently support a higher rating than might otherwise be possible. Revisions And Updates This article was originally published on Sept. 19, 2002. Changes introduced after original publication: Following our periodic review completed on June 14, 2016, we updated the contact information and removed certain commentary. Following our periodic review completed on June 8, 2017, we updated the contact information and certain criteria references. Following our periodic review completed on June 4, 2018, we republished this article without any changes. Related Criteria And Research Related Criteria Structured Finance: Asset Isolation And Special-Purpose Entity Methodology, March 29, 2017