KING & SPALDING

Client Alert

Providing Strategic Legal Guidance to the Global Financial Services Industry

FINANCIAL SERVICES

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For more information, contact:

Martin Y. Eid
+1 212 556 2102
meid@kslaw.com

Timothy Hoffmann
+1 312 764 6939
thoffmann@kslaw.com

Ryan D. McNaughton
+1 212 556 2244
rmcnaughton@kslaw.com

Terry D. Novetsky
+1 212 556 2328
tnovetsky@kslaw.com

Roger Schwartz
+1 212 556-2331
rschwartz@kslaw.com

Michael L. Urschel
+1 212 556 2285
murschel@kslaw.com

Matthew Warren
+1 312 764 6921
mwarren@kslaw.com

Kathryn M. Weiss
+1 212 556 2323
kweiss@kslaw.com

King & Spalding

New York
1185 Avenue of the Americas
New York, New York 10036-4003
Tel: +1 212 556 2100

Atlanta
1180 Peachtree Street, NE
Atlanta, Georgia 30309-3521
Tel: +1 404 572 4600

Chicago
110 N Wacker Drive
Chicago, IL 60606
Tel. +1 312 995 6333

Utilizing Structured Finance Techniques in Distressed Situations

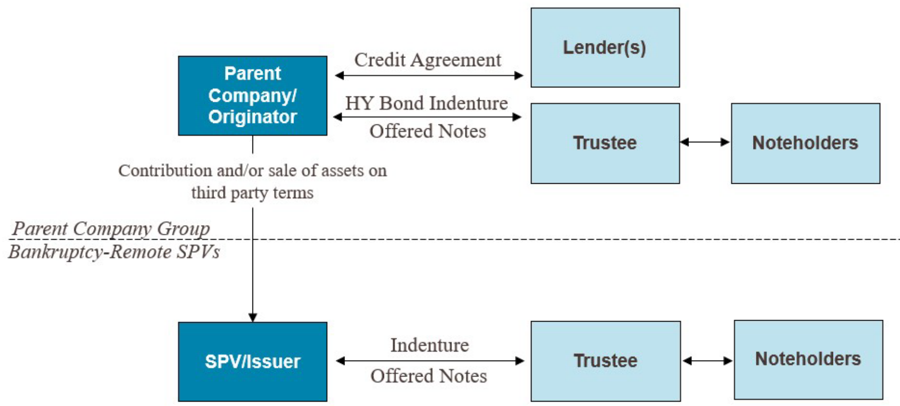
Securitization, and structured finance generally, is a critical capital-raising tool for many companies. Utilizing one or more bankruptcy-remote special purpose entities ("SPVs") to legally isolate the credit risk of quality, securitizable assets from the credit risk of the company itself can help raise capital at more favorable rates, on better terms, and from a broader investor base than may otherwise be available absent a securitization structure. In addition to legal isolation, structured finance generally employs credit enhancements and structural features that may provide additional opportunities to help finance a company facing a distressed situation.

This client alert illustrates how securitization techniques and mechanisms may provide an important addition to the toolkit for companies, as well as for credit providers considering their options with distressed credits.

SECURITIZATION OVERVIEW AND KEY SECURITIZATION PRINCIPLES

Isolating Credit Risk: Securitization Mechanics Generally and the Use of SPVs

In a securitization, an originator (or initial owner of certain assets), transfers assets (generally cash flow and/or revenue-generating assets) to a bankruptcy remote SPV that is a direct or indirect subsidiary of the originator/initial owner. That SPV then issues fixed income securities pursuant to which the holders thereof are paid from the cash generated by those same assets (which also secure the securities). Utilizing this structure decouples the credit risk of the originator from the SPV and allows investors to evaluate investment risk based principally on the securitized assets. Simply put, if an originator files for bankruptcy, the assets of the SPV conceptually should not be included as part of the originator's bankruptcy estate (further discussed in "Risks and Considerations" below), and, absent an SPV bankruptcy filing, the SPV's security holders should be free to exercise remedies against their collateral without the oversight of the bankruptcy court.



One of the advantages that securitization structures can provide in a distressed situation is simplicity. Distressed scenarios often involve complex debt structures (i.e., several overlapping or conflicting instruments with negotiated intercreditor arrangements) and are dominated by funds and other investment vehicles that specialize in distressed investment. Rather than having to focus on and solve all the challenges of a distressed enterprise in a wholistic sense, however, a securitization structure allows investors to assess credit risk primarily based upon the securitized assets and the cash flow generated from such assets and to consider more strategic and surgical financing options. Utilizing a securitization structure and simplifying what otherwise may be a complex financing environment for a distressed company may allow the company to unlock value by expanding the universe of potential financing sources and ultimately obtaining financing that is more economically advantageous than would be achievable solely utilizing traditional debt structures. The securitization structure may also be more readily available and achievable than other options in a distressed situation since a structured product solution may not necessarily require the consent of other creditors or agreement around the parameters of a global balance sheet restructuring. In particular, in recent years, top-tier credit agreements and high-yield bond indentures typically contain pre-negotiated securitization carveouts. These "permitted securitization financing" provisions could leave the door open for securitization as permitted debt within the parent facility, while allowing certain collateral to be effectively transferred into one or more SPVs to serve as securitization collateral. Depending on the type of distress, however, such carveouts may be of limited use, and may depend on available restricted payment, asset sale and investment capacity under the parent-level credit facilities.

Contingency Planning: Back-up Managers and Servicers

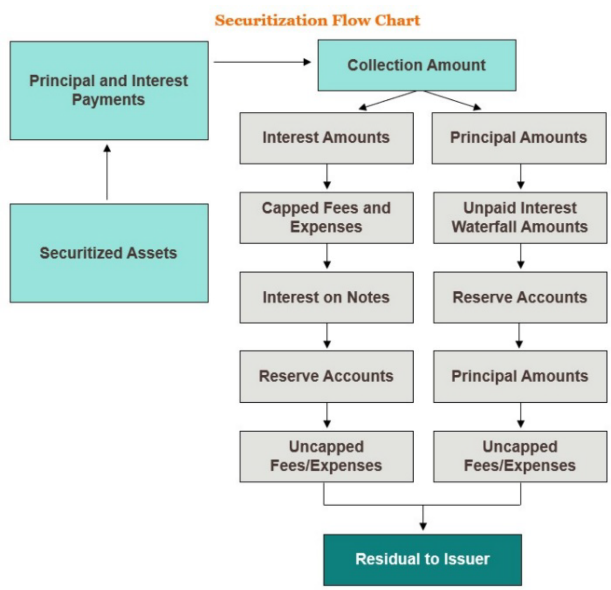
Another common feature of securitizations is the use of "back-up" servicers. In securitizations, a bankruptcy remote SPV does not have employees and instead utilizes a servicer via a servicing agreement to service and collect cash flows on the securitized assets. The servicer is often the originator, its affiliate or parent who performs certain duties in exchange for a negotiated fee. These duties include monitoring the assets, collecting payments, maintaining transaction documents, and preparing required reports to support interest payments and other expenses. Because the servicer is usually the originator (or affiliated with same), most securitizations require a third-party back-up servicer who steps into the responsibilities of the servicer upon occurrence of certain negotiated triggers. Such triggers could include financial covenants, failure to pay in full/refinance by certain dates and other manager termination events. A detailed transition plan (or at the least a mechanism for the creation of one) is typically negotiated in advance of the closing of any issuance, which documents how and when a back-up servicer ascends into the servicer role.

In the context of a “whole business” securitization (WBS), the “back-up” concept evolved to also include a back-up manager. In a WBS, substantially all of a businesses’ revenue-generating assets are contributed/sold to an SPV. Since the SPV does not have employees, it enters into a management agreement with the originator (or an affiliate of same) to continue to run the business in a manner acceptable to the investors. Upon the occurrence of negotiated triggers tied to, among other things, the performance of the underlying business, the back-up manager can ascend to the management role or otherwise effectuates a manager transition. Once ascended, the back-up manager (like the back-up servicer) operates pursuant to a transition plan.

Both a back-up servicer and manager could provide comfort to investors who might be otherwise skittish of a distressed company and its historic financial performance. Effectively, the “back-up” mechanic provides a failsafe to (i) stabilize business operations and (ii) protect asset values, all for the benefit of the lenders to the SPV. By coupling the underlying investment with a negotiated contingency plan, the originator may significantly limit investor risk and cause an attendant increase in the pool of potential investors. It is important to note that while both of the concepts above were developed for rated, investment-grade securitizations, they could also be of use to private credit or special situations investors looking to invest in a securitizable concept of a distressed brand either pre- or post-distress.

Providing Certainty: Use of Waterfall, Reserve Accounts and Advances

Distressed investors seek greater certainty in modeling and evaluating investments, which, in a securitization, is typically documented in a discrete set of operative provisions, for example the “waterfall”/priority-of-payments, reserve accounts and any protective advance or equity cure features. Typically, securitizations utilize a formalized allocation of funds—the “waterfall” or “priority-of-payments”—negotiated at the outset of the transaction and set to run periodically (in contrast to a traditional non-securitization financing where a waterfall might only go effective upon an exercise of remedies/default). This structure ensures that scheduled fees, expenses, reserves, interest and principal are paid in a prescribed order from the closing of the transaction onward.



With respect to reserve accounts, certain funds are escrowed to cover future amounts, such as interest payments and fees/expenses. Such reserves can be funded by a portion of an issuance’s proceeds, cash generated by the securitized asset, or a combination of the foregoing. Moreover, payment of such reserves (and creation of same), is normally mandated by the applicable waterfall.

Similarly, the use of protective advances (which may be voluntary or mandatory, depending on the concept) further creates certainty that various amounts due and owing will be paid. Specifically, the responsibilities of a third-party servicer, back-up servicer and trustee could include the provision of advances (to the extent funds are not otherwise available under the applicable waterfall) to provide additional liquidity to the structure. Such advances provide further certainty to a potential investor, ensuring that adequate reserves are available to pay crucial amounts and/or to make opportunistic advances to preserve the value of the collateral at a key moment. Among other things, in securitizations such advances might include debt service advances to cover interest payments (if on a given payment date, the amount due exceeds the amount available in the applicable account) or a collateral protection advance if the servicer or other advance provider determines that an advance is necessary to prevent immediate value destruction. The trustee may also be required to make debt service advances in certain limited circumstances (i.e., if third-party servicer fails to make such an advance). Advancing determinations are typically subject to a recoverability analysis but given that advances are often reimbursed at a high level of priority in the waterfall, funding an “advance” by a third-party credit provider may also provide a way for inject additional liquidity at a time of need.

The foregoing features, when applied to a distressed situation, individually and taken together, provide down-side protection to an investor, which, in turn, might make the use of structured products an attractive alternative for private credit and special situations lenders assessing and navigating distressed investments and opportunities.

Additional Securitization Features: Credit Enhancements and Investor Access to Information

Securitizations often employ various other credit enhancements that, taken together, decrease the overall cost of borrowing and investors’ risk. Such enhancements include, without limitation, (i) overcollateralization of the applicable issuance, (ii) the subordination of certain classes or tranches of notes, (iii) retention of a residual interest by the originator (subordinated in payment to other amounts), (iv) excess interest based on the yield of the underlying assets over the priced bond coupon and (v) insurance coverage and other third-party coverage for losses. In a distressed situation, such enhancements could have a similar impact on the overall credit worthiness and marketability of the issuance.

In addition to the foregoing, securitizations often provide ample opportunity for investors to both diligence the investment prior to purchase and periodic reporting. Such reporting might often go beyond what is required by the Securities and Exchange Commission and, as such, provides a useful mechanism for the evaluation, and monitoring, of an investment—it is a fundamental principle of securitization that information be made available as to the performance of the underlying assets. Specific information on the assets may be more useful than financial statements or balance sheet information in identifying ways to initiate liquidation or refinance. Notably, in many securitization transactions, prior to the closing of a transaction, the originator’s management will be asked various diligence related questions which can be targeted to any then-present circumstances (both micro and macro issues). Furthermore, esoteric asset securitizations are often modeled on a base case and worst-case scenario for the projected cash flow generated by the securitized assets. In a distressed scenario, such models will be of particular value to investors in understanding asset performance (especially as pre-distress historic periods might not offer much insight into the current financial situation) and providing critical information necessary for private credit and special situations lenders to assess the risks of a potential investment (or additional investment) in the distressed company through a structured product.

RISKS AND CONSIDERATIONS

As discussed above, modern securitizations are built around bankruptcy remoteness and dependent upon a transfer of assets from an originator (directly or indirectly) to an SPV in order to separate the credit risk of the originator from the value of the underlying asset. In distressed situations, amendments to existing debt documents, court approval (if a process has already formally entered restructuring) and/or other accommodations from existing creditors may be necessary to effectuate a transfer of assets. In addition, if such a transfer/sale is avoided or unwound, then the assets of the SPV may otherwise be available for the benefit of the originator’s creditors and the entire structure, and its attendant benefits, falls apart. As such, any securitization must be evaluated with respect to the potential risk of (i) recharacterization, (ii) fraudulent transfer and (iii) substantive consolidation.

Recharacterization refers to the risk that a bankruptcy court will find that a transfer and/or sale of assets to an SPV was actually a secured financing, in which case the assets never actually left the ownership of the originator and remain available to satisfy the debts of the originator’s creditors. To protect against this risk, the sale or contribution by the originator to the SPV must be structured such that the transfer will be legally recognized as a 'true sale' or 'true contribution', as applicable, by a bankruptcy court—in other words, ensuring that the assets are ultimately considered property of the SPV. A “true sale” analysis hinges upon whether the sale was for fair value on arm’s-length terms and if the assets were sold without recourse to the transferor. A “true contribution” analysis requires that the SPV be solvent at the time of transfer and the contribution be reflected in the SPV’s capital account. Typically, as part of a securitization transaction, a law firm representing the originator will issue a “true sale” and/or “true contribution” opinion (as well as a potential substantive consolidation opinion), which are fact-intensive, reasoned opinions.

Both state laws and the Bankruptcy Code also address the fraudulent transfer of assets. In a fraudulent conveyance scenario, ownership of the SPV’s assets may revert to the originator. Fraudulent transfers exist in two varieties: (i) actual—made with the intent to hinder, delay or defraud creditors; and (ii) constructive—made while the debtor was insolvent and not in exchange for reasonably equivalent value. The risk of a constructive fraudulent transfer is omnipresent in structuring a securitization of a distressed originator, because the structure itself requires the originator’s transfer of its assets to the SPV. As such, parties should ensure the originator receives fair consideration on account of such transfer. The Bankruptcy Code has a two-year statutes of limitation on fraudulent transfer actions, but that time period may be significantly longer in certain circumstances. Under state laws, statutes of limitations for fraudulent conveyance fluctuate, but many states have a four-year statute of limitation (for example, New York and Delaware). Moreover, bankruptcy courts have permitted fraudulent conveyance actions to proceed on a look-back period as long as ten or more years based upon the statute of limitation available to the IRS.

Finally, parties should evaluate the risk of substantive consolidation. Substantive consolidation is a judicial remedy whereby a court consolidates an SPV’s assets with those of the debtor – making the SPV’s assets available to all other creditors of the originator. A substantive consolidation analysis focuses on whether the SPV adhered to corporate separateness and how creditors dealt with the SPV as compared to the originator.

CONCLUSION

Many of the key advantages offered by traditional securitization techniques could create significant value in a distressed scenario – providing additional mechanisms for distressed companies to procure critical financing from investors and creating potential flexibility for private credit and special situations lenders assessing and navigating existing and potential distressed investments and opportunities.