JSF the Journal of STRUCTURED FINANCE

Winter 2016 | Volume 21 | Number 4 | www.iijsf.com

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IIJ Institutional Investor Journals

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Since 2005, there have been many so-called operating-asset or whole-business securitizations. This financing technique has been used to finance fast food franchising, music licensing, drug royalties, film libraries, cell towers, and technology licensing. In certain circumstances, this financing technique has proven to be a viable alternative to bank/bond deals, with fewer restrictive covenants and very attractive interest costs and maturity. Nevertheless, when comparing these types of transactions with bank/bond deals, the need for extensive legal structuring becomes apparent.

BACKGROUND

Whole-business or operating-asset securitizations are set up in a fundamentally different manner than leveraged finance. Bank/bond deals are predicated on companies using their balance sheet on a full recourse basis to secure financing. The lender in these transactions requires extensive covenants that regulate the conduct of borrower's business and use of its assets. Profits from the business are limited by dividend and investment restrictions.

In contrast, whole-business or operating-asset securitization is a strategy that seeks to isolate the operating assets from the credit risk of the parent entities so that the lender is relying primarily on the value of the assets in making the loan. Candidates for this type of finance hold valuable intellectual property or recurring contract revenue that can be exploited over a considerable period of time. Covenants in whole-business deals are generally focused on maintaining the value of assets so that debt service coverage is maintained. An affiliate of the parent company may be retained to manage the operating-asset securitization, but such an affiliate may generally run the business as it has done so before the securitization.

The manager and the parent are not subject to restrictions on how they can profit from the business, except in situations where the assets are not performing as expected. In the case of operating assets, the manager on behalf of the securitization entities is required to continue to expend effort to exploit the assets. As an example, in a securitization of fast food royalties, the securitization issuer through the manager is required to utilize the fast food chain's intellectual property in order to originate new franchises, thus generating revenue to service the securitization debt. The same may be said about patents and drug royalties or clothing licenses and their associated trademarks.

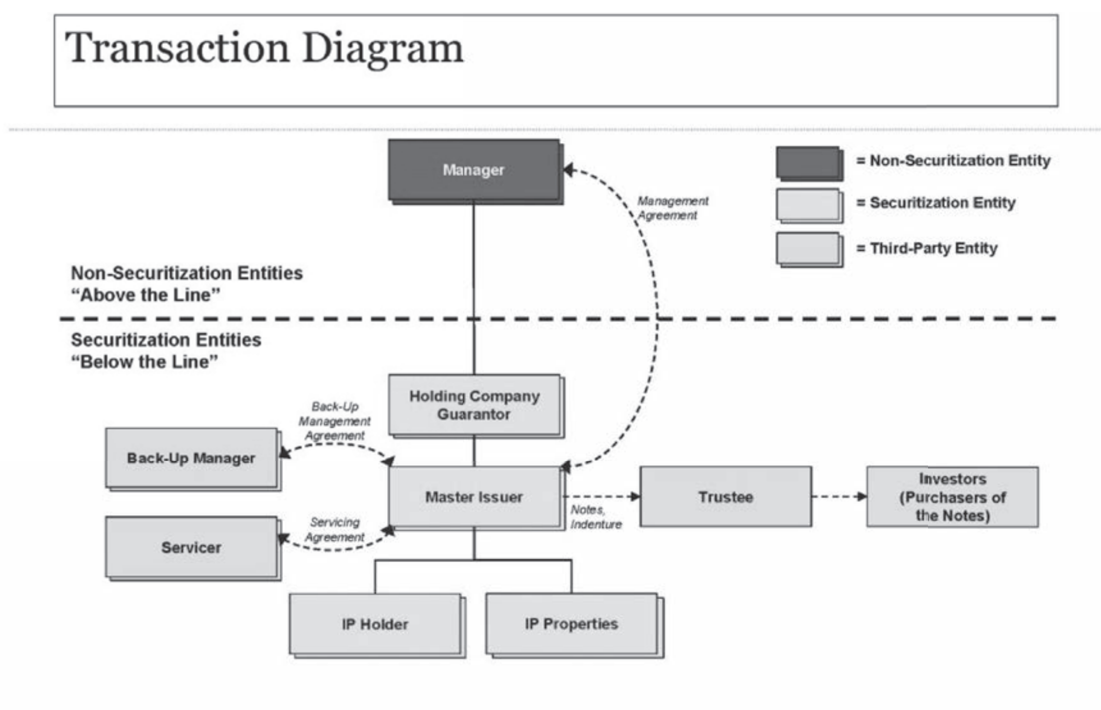
In traditional securitization, the contractual cash flows under credit cards, mortgages, or leases are conveyed into a special-purpose subsidiary of the parent in a "true sale" transaction. Stated more simply, the sale is supposed to be structured in such a way that if the parent becomes bankrupt, the assets and cash flow that have been securitized will not be included in the bankruptcy estate of the parent. Likewise, the special-purpose subsidiary is established with certain corporate requirements that ensure that it will not be "substantively consolidated" with the parent in the case of the latter's bankruptcy. It is not the intent of this article to describe the particular legal requirements required to establish a true sale or substantive nonconsolidation, except perhaps to note that these are also prerequisites for a successful operating-asset or whole-business securitization. Unfortunately, in the United States, unlike the United Kingdom, because of significant differences in bankruptcy law, a successful operating-asset or whole-business securitization requires extensive legal and rating-agency structuring.

Before describing the particular structures employed in operating-asset or whole-business securitization, it is perhaps worthwhile for me to explain the terminology "whole-business securitization" and "operating-asset securitization." In general, operating assets, such as fast food, clothing, film, or drug royalties, have been securitized in the context of the disposition of a sponsor's whole business or of the whole business of a division of that sponsor's business. In these transactions, which now number several dozen, all or substantially all of a parent's assets (in the form of the royalties described previously) have been conveyed into a securitization vehicle and a financing has been completed that is secured by the securitization vehicle's assets. Notwithstanding the foregoing, it is possible for a parent to convey a portion of its operating assets into a securitization vehicle and complete the transaction. In fact, in some of the drug royalty transactions completed to date, only a portion of a parent's drug royalties have been conveyed into the securitization vehicle, albeit requiring extensive cross-licensing arrangements, given the dependence of the royalties on the parent's trademarks.

LEGAL AND ECONOMIC STRUCTURE

Many different structuring strategies have been employed in the context of operating-asset securitizations. A simplified schematic of a relevant structure is illustrated in the Exhibit. Central to each structure is

EXHIBIT



the concept of a special-purpose entity to which the operating assets are deposited. Generally, this entity may be a trust, corporation, or a limited liability company. Probably the most efficient tax vehicles are either trusts or limited liability companies. There are significant legal advantages to organizing a trust or a limited liability company in Delaware, including statutes in that state that are generally quite friendly to securitization structures. In all of the extant structures, the parent or original owner of the assets either directly or indirectly deposits the assets into the special-purpose entity, usually in the form of a capital contribution or a sale. The special-purpose entity is generally wholly owned by the parent. Because of the high degree of bankruptcy sensitivity to these structures, as more fully described later in this article, many of the transactions to date have employed a layered set of special-purpose entities so that the parent is not the direct owner of the special-purpose entity that issues the debt (the issuer) but is rather an indirect owner of such entity. The theory behind multilayered special-purpose entities is an attempt to distance the operating assets that collateralize the securitization debt as far from the parent as possible.

In all of the structures, the role of the issuer is key to the functioning of the transaction. Because these deals involve the transfer of an ongoing business instead of passive assets, such as mortgages and credit cards, the role of the issuer is crucial. In all the structures, the issuer issues the debt and holds the operating assets. However, the issuer also retains liabilities and must therefore employ a competent servicer or manager to perform these tasks lest the assets associated with the liabilities become worthless. For example, in a franchise royalty securitization, the issuer or a subsidiary of the issuer becomes the franchisor under the franchise contracts that are deposited into the issuer. As franchisor, the issuer has certain obligations to the franchisees that, if breached, would have the effect of reducing or eliminating the franchise royalty flow. Most of the franchisor's obligations are simply to license the trademark to the franchisee so that the franchisee can operate the system under the brand. However, even this simple obligation requires maintenance and protection of the trademark. A potentially more complex situation is one in which the assets involve mobile office units. An issuer that holds these units will need to be able to re-lease the units when current leases expire. If the issuer is unable to do so, the stream of income necessary to pay the securitization debt will not be available. Again, the crucial element is that the issuer has retained a competent servicer or manager to operate the assets and protect the issuer against liabilities.

Over the last 10 years, many fast food franchisors have been able to securitize the value of not only the franchises in their system but also the company-owned stores. The inclusion of company-owned stores in a securitization has required the transfer of both real estate and operations to new special-purpose entities. As is the case of cell tower securitizations, in restaurant securitizations, the special-purpose entities must be managed by a competent manager, usually the parent or one of its affiliates, with a third-party back-up manager in the event the operating company does not perform its duties or becomes bankrupt.

In virtually all of the relevant transactions to date, the issuer has retained the parent or one of its affiliates as the servicer or manager of the assets after they have been deposited into the issuer. This follows the pattern of traditional securitization transactions in which the originator of the assets generally acts as the servicer on behalf of the issuer. In operating-asset or whole-business transactions, however, the financial health and capability of manager is magnified. Rather than just collecting checks on behalf of the issuer or occasionally exercising remedies against a consumer borrower, the manager in the operating-asset context is actually fulfilling contractual obligations on behalf of the issuer, which if breached will be catastrophic to the securitization transaction.

For this reason, many operating-asset securitizations have levels of triggers designed to result in an orderly transition to a back-up or successor servicer if the original manager fails in its duties or is otherwise financially impaired. Triggers are generally based on debt-service coverage. For example, if debt-service coverage falls below 1.2 to 1, the manager may be required to meet with a consultant and follow the consultant's advice. If the debt-service coverage deteriorates even further, let's say below 1.1 to 1, the securitization trustee generally will have discretion to replace the original manager.

Other precautions that have found their way into these transactions include a requirement that the original manager issue a special class of stock that is held by a subsidiary of the securitization trustee or the bond insurer, where applicable, which entitles the holder of such stock to vote as to whether the manager can file a

Chapter 11 petition or otherwise seek to avoid its obligations. In some transactions, the scope of business of the original manager has been restricted to the managing of the issuer's assets and not other unrelated activities.

Finally, many of the transactions have featured limitations on the amount and type of debt that the original manager can incur after the securitization transaction has occurred. All of these precautions are considered desirable to ensure that the original manager will not fail in its obligations or, in cases where it does, that the transition to a new servicer will be seamless and will not unduly expose the issuer and the securitization holders. For a parent doing a whole company securitization, these restrictions may not be unduly burdensome because, after the securitization transaction is completed, the parent has effectively become a holding company whose only role may be to act as original manager and holder of the equity interest in the securitization.

In some whole-business securitizations, it has been proposed that the manager be split off from the sponsor in a new bankruptcy-remote structure based on the theory that this effectively separates the parent's bankruptcy risk from the servicing of the securitization transaction. To accomplish this variation of the whole-business structure, the parent has to spin off employees, real estate, and operating infrastructure to a newly formed subsidiary. For many parents, this has been a difficult process, given the web of recordkeeping requirements, health and pension plans, and other general logistical problems. As a result, this solution has not been used on a widespread basis.

Another unique aspect of the issuer's role in these transactions is the need to control intellectual property that forms the basis for the value of the issuer's assets. As described previously, many of the major securitizations in this area entail the monetization of intellectual property. So, for example, transactions with respect to receivables on drug licenses, clothing licenses, or franchise agreements have also involved absolute access to the underlying intellectual property. In each of these transactions, the receivables and the underlying intellectual property have been conveyed in a true sale to the issuer or a sister entity that is also bankruptcy-remote from the original sponsor. If, for example, only the receivables were conveyed to the special-purpose entity without the intellectual property, the parent would have to license the intellectual property to the issuer.

In the case in which the parent went bankrupt, it could accept or reject the license to the issuer. If the license were rejected, the issuer would be unable to service existing franchise agreements or clothing licenses or issue new ones. The damage to cash flow would be devastating. As a result, whether copyrights, trademarks, or patents, in all cases, the intellectual property has followed the receivables into the issuer or a special-purpose affiliate of the issuer. Many of the transactions have housed the intellectual property (IP) in a subsidiary or sister entity of the issuer, known as the IP holder. The advantage of the IP holder structure is that it further insulates the IP from the bankruptcy risk of the parent.

In cases where the intellectual property has not been housed in the issuer, the issuer has entered into a long-term license with the IP holder, thus enabling the issuer to access the intellectual property for the full term of the securitization and for some period beyond in the event the securitization were not to pay off on a timely basis. Where a license arrangement is employed between the issuer and the IP holder, great pains are taken to make sure that this license is fully enforceable and will survive an attack by the sponsor's creditors in a bankruptcy. If the IP holder's bankruptcy remoteness from the parent is not respected in a parent's bankruptcy, the same consequences of rejection of a license (as described in the previous paragraph) might occur.

One technique that has been employed in licenses between the issuer and IP holder has been to grant the issuer a security interest in the intellectual property against which it could foreclose if the IP holder were consolidated with the parent and the parent rejected the license. This security interest would give the issuer and its securitization creditors assurances of control over the intellectual property in the unlikely event of the parent's consolidation of the IP holder. In certain of the transactions, the intellectual property has resided along with the primary securitization assets in the issuer. In such a scenario, no license is necessary, but the intellectual property is arguably more exposed to the parent's bankruptcy.

As should be apparent at this point, companies that are highly dependent on intellectual property, such as fast food chains or clothing outfits that have engaged in these transactions, have put virtually all of their most crucial assets into the securitization vehicle, whether that vehicle is the issuer or its IP holder affiliate. As described earlier, the role of the parent after the transaction occurs is primarily as a holding company receiving the residual cash flow from the securitization, with the manager acting on behalf of the issuer in most instances. Some parents, such as food franchisors or clothing manufacturers, have multiple operations internationally and domestically. As a result, if all of the intellectual property of the parent is conveyed into the issuer or IP holder, there are instances where such entities must license some of the uses of the intellectual property back to the parent so that the parent can operate its other lines of business. A good example of this might be a sponsor that is a food franchisor, which has conveyed its franchise operations into the securitization vehicle along with all of the relevant intellectual property. If the food franchisor later decides it wants to license the food product to the supermarkets, it will need to enter into a license with the IP holder or issuer to be able to offer that product. Likewise, if a food franchisor is part of a larger corporation, its parent may want to pledge its stock to secure a borrowing at the parent company level. Moreover, the parent may be able to enter into a license with the IP holder if it wants to start a business related to the parent's securitized business, subject in all instances to noncompetition covenants with the securitization lenders. In some multinational transactions, the IP holder has licensed IP to foreign subsidiaries of the parent that are not part of the securitization transaction. This has facilitated the use of whole-business securitization for a number of multinational corporations.

LEGAL ISSUES

All securitizations, but particularly whole-company or operating-asset securitizations, raise many legal issues that must be resolved satisfactorily for the transactions to occur. As in other forms of securitizations, a variety of constituencies must be satisfied that there is acceptable legal resolution. Generally, the lawyers for the parent and the underwriters must satisfy the prospective buyers and the rating agencies that the structure of the transaction will not raise unacceptable legal barriers. This process occurs through disclosure in the offering memorandum and the preparation of relevant legal opinions, primarily by counsel to the sponsor.

As illustrated earlier, probably the most significant legal challenges accompanying whole-business securitizations or securitizations of operating assets are bankruptcy related. As an initial premise, all of the structures attempt to isolate the issuer and its affiliates (including the IP holder) from the risk of the parent's bankruptcy. This requires that the transfer of the assets from the parent to the issuer (directly or indirectly through a series of special-purpose entities) be a true sale or absolute assignment such that the assets would not be part of the parent's estate in the event of its bankruptcy. In order to meet this test, the transfer between the parent and the issuer must be without recourse to the parent (except for reasonable representations and warranties as to the quality of the assets) and must not permit the parent to continue to benefit from changes in the value of the assets that have been transferred to the issuer. The second key element of bankruptcy-remoteness is that the parent and the issuer must operate as separate businesses so that creditors of the parent do not have a claim against the issuer's assets and, most importantly, so that in a bankruptcy of the parent, the issuer is not substantively consolidated with the parent. In the legal documents executed by the parent and the issuer at the closing, each party is obligated to maintain a series of covenants to ensure that its businesses are operated separately. Legal counsel to the parent typically renders two legal opinions to cover both the true sale and substantive nonconsolidation issues. These opinions are always premised on the assumption that the parent and the issuer will observe the required legal covenants in the documents.

Because of the operating nature of the issuer and its affiliates after the completion of the securitization, these transactions have been alleged to have a heightened risk of substantive consolidation. In particular, in 1989, Days Inn of America securitized its franchise royalty fees through a special-purpose entity that held its trademarks, licensing agreements, and rights to receive franchise fees. When Days Inn later became bankrupt, its creditors attacked the securitization subsidiary, arguing that its assets were central to the business of Days Inn and therefore should be consolidated with Days Inn. Ultimately, the so-called "core assets" argument was not adjudicated because the relevant creditors' claims were settled. In fact, many of the standard bankruptcy-remote covenants required in securitization transactions today either were not present in the Days Inn documents or the relevant parties did not actually comply with them. However, some of the rating agencies have considered Days Inn to be a cautionary experience that requires some mitigation in operating-asset or whole-business securitizations. In particular, lenders and the rating agencies have wanted to know that, after the securitization occurs, the parent will continue to exist as a solvent and viable company and that the parent has received adequate consideration for the transaction through a combination of proceeds and residual interest in the issuer.

In addition to the Days Inn example, *In re LTV Steel Company, Inc.* has been cited as a case that could present troubling applications to a whole-business or operating company securitization. The case involved a traditional securitization of accounts receivable and inventory by LTV to special-purpose subsidiaries. In a memorandum opinion in the case, the court said "Debtor has at least some equitable interest in the inventory and the receivables and … this interest is property of the Debtor's estate."[1] The court "was particularly concerned that the workers at the company would be in jeopardy if the assets held in the securitization were not available to the company. Ultimately, the two securitizations were repaid in the bankruptcy proceedings and the court's decision did not go any further. However, at least one rating agency has suggested that this decision may give it pause if the parent has numerous employees, while the key assets of the company have been transferred to a special-purpose entity in order to effect a securitization.[2] The rating agency in question will evaluate the liquidity position of the parent, particularly in situations where the parent continues to employ large numbers of workers. Once again, the key point appears to be that the parent is solvent and viable after the operating-asset or whole-business securitization occurs.

Generally, parents of operating-asset or whole-business securitizations will have some outstanding debt even after the securitization occurs. It is crucial that the sponsor receives "fair consideration" for its sale of the assets to the special-purpose entities and that the sponsor is not left with "unreasonably small capital" after the transaction occurs so as to result in a "fraudulent conveyance" or "voidable preference." If a fraudulent conveyance occurs, other creditors of the parent may attack the transaction and seek to have it undone. Unlike true sale or substantive nonconsolidation, fraudulent conveyance or voidable preference are not issues that can be addressed through legal opinions because they are fundamentally economic issues. The transaction has to be fair to the parent; for example, the parent, either through the proceeds received and/or the residual interest it retains, has to receive reasonable consideration for its assets. Because of the significance of this issue, at least one rating agency has said it will carefully consider the post-securitization debt position of the sponsor, its contingent liabilities, its use of securitization proceeds, its post-securitization capitalization, and most significantly, the adequacy of the consideration received by the sponsor. Although an appraisal of the transaction is generally not necessary, both the parent and the underwriters must feel comfortable that the transaction is not proceeding at the expense of the parent's creditors that remain outstanding after the transaction has occurred.

Another significant legal concern in operating or whole asset company securitizations revolves around the liabilities to which the issuer or its affiliates are exposed by virtue of their ownership of operating assets. In the simple franchisor-sponsor situation, although the franchisor's duties are performed by the sponsor as servicer, the issuer-franchisor is still primarily liable to the franchisees. Some of this risk may involve breach of contract claims, tort liability, indemnifications claims, infringement claims, food quality claims, tax liability, and failure to observe government regulations. These concerns have been heightened by the appearance of securitizations of company-owned stores in the restaurant securitization arena. Moreover, a recent National Labor Relations Board (NLRB) decision relating to joint employer liability raises the risk that a pure franchisor may be liable for actions of a franchisee.[3] To the extent the issuer can insure against these elements of risk, its legal exposure diminishes. However, some of the aforementioned risks cannot be easily insured. Generally, the rating agencies will evaluate the extent and likelihood of these risks in rating the transactions.

These transactions also raise corporate-governance issues. To the extent that a securitization constitutes a sale of all or substantially all of a parent's assets, shareholder approval may be required or parent debt covenants may be implicated. In a private company situation, the shareholder vote may not be significant, but for public companies, this could be important. Generally, under Section 271 of the Delaware Code, the sale of all or substantially all of a company's assets to a newly formed subsidiary of the company would require a shareholder vote of the selling company. In addition, while remote, the sale of all or substantially all of a company's assets to a newly formed subsidiary could result in successor liability—that is, the successor entity is liable for the debt of the selling company. This risk, like fraudulent conveyance, is mitigated if the parent remains solvent and reasonably well capitalized after the securitization transaction occurs.

Most of the whole-business securitizations have not resulted in a taxable event to the parent because the parent has received a 100% residual interest in the issuer. In addition, the issuer's securitization has been treated as debt for tax purposes with a look-through to the sponsor. In some transactions, the nature of the assets in relation to the repayment of the debt has resulted in some phantom income to the holders of the debt. The tax effects of these transactions are generally determined through a case-by-case analysis.

NEW DIRECTIONS

Whole-business and operating-asset securitization is a well-established form of finance. Some of the structures described in this article will undoubtedly change as new and different assets are securitized using this technology. As these conditions suggest, the frontier for these deals is wide open. Restaurant royalties, drug royalties, clothing licenses, and music royalties most likely are just the beginning; there are many analogous asset classes, particularly in the patent, trademark, and copyright world.

ENDNOTES

[1]*In re LTV Steel Company, Inc.,* United States Bankruptcy Court, Northern District of Ohio, Memorandum Opinion dated February 5, 2001.

[2]See S. Marcy, "Moody's Approach to Operating Securitizations," Moody's Investors Service Special Report on Structured Finance, February 8, 2002.

[3]Browning-Ferris Industries of California, Inc., d/b/a BFI Newby Island Recycling, and FPR-II, L.L.C., d/b/a Leadpoint Business Services, and Sanitary Truck Drivers and Helpers Local 350, International Brotherhood of Teamsters, Petitioner. Case 32-RC-109684 362 NLRB No. 186 (August 27, 2015).