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## After the fall: redemption for whole business securitisation?

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John Milton's epic poem *Paradise Lost* tells the story of the fall of man:

*"Say first—for Heaven hides nothing from thy view,  
Nor the deep tract of Hell—say first what cause  
Moved our grand parents, in that happy state,  
Favour'd of Heaven so highly, to fall off  
From their Creator, and transgress his will  
For one restraint, lords of the World besides.  
Who first seduced them to that foul revolt?  
Th' infernal Serpent; he it was whose guile,  
Stirr'd up with envy and revenge, deceived  
The mother of mankind, what time his pride  
Had cast him out from Heaven with all his host  
Of rebel Angels, by whose aid aspiring  
To set himself in glory above his peers,  
He trusted to have equall'd the Most High..."*

(John Milton, *Paradise Lost*, Chapter 1, Book 1.)

Repercussions of the fall of the sub-prime market, which began in Summer 2007, continue to immobilise the US structured debt markets; have begun to disrupt the US tax-exempt bond market, the US equity markets and other markets around the world; and are contributing to a US economic recession. The multiple failures by the

rating agencies, collateralised debt obligation (CDO) managers, monolines and other structured finance participants, which led to a series of lapses in underwriting standards, rating agency methodologies and common sense, are not the focus of this chapter. Suffice it to say that these lapses led to a subversion of the basic principles on which the securitisation market was built and turned the securitisation paradigm – an asset-focused and supply-driven process – into a demand-driven process in which the quality of the assets became secondary to the need to fill up the mortgage-backed securities, CDO and structured investment vehicle (SIV) tranches to meet seemingly insatiable investor appetites. The massive over-leveraging which resulted is now being corrected by an equally massive deleveraging, the extent of which cannot be predicted at the time of writing, and has caused liquidity crises at Bear Stearns in the United States and Northern Rock in the United Kingdom of sufficiently broad impact to warrant national government intervention.

Notwithstanding the scale and duration of the sub-prime meltdown and predictions that the CDO and SIV markets will be closed down for the foreseeable future, it is fair to ask:

- whether the esoteric sector of the securitisation market – for which close scrutiny of the underlying assets has always been the central focus and for which the rating agencies have applied conservative rating methodologies – will be the first to return to favour in the eyes of the institutional investor community;
- which market forces may hasten (or could delay) its return; and
- what changes can be expected in these transactions when they return to the market.

This chapter focuses on one segment of this market which was relatively new to the United States when the sub-prime meltdown occurred: whole business securitisation.

### History of whole business securitisation: before the fall

Prior to the sub-prime meltdown, whole business securitisation was on an upward trajectory in the United States. This was due to the convergence of three trends in the US financial markets:

- some breakthroughs in rating methodologies that opened new pathways for issuing asset-backed debt-rated multiple notches above the rating of the sponsoring company despite the dependency of the cash flows on the operating performance of the sponsor;
- the growing prominence of intellectual property and other intangible assets in the value chain of operating companies; and
- the surge in merger and acquisition (M&A) activities of private equity funds, with a significant portion of the liquidity provided by acquisition or bridge financings of the large banks.

What emerged from the confluence of these three trends was a new template which was becoming the standard in M&A transactions: acquisitions were funded with a mix of equity and high-yield acquisition debt, followed by a refinancing into lower-yielding highly rated debt through the issuance of asset-backed securities (ABS). As many of the target companies were rich in trademarks and other intangibles, these assets were frequently used in the securitisation; as the performance of these assets was in many cases heavily dependent upon the operations of the target company, whole business securitisation technology was used to achieve the desired rating uplift.

The most highly publicised example of this new template was the \$1.7 billion franchise and trademark royalty securitisation DB Master Finance, LLC, which was closed in 2006. This transaction securitised the revenues generated by trademark licences, franchise agreements and real estate leases created by the Dunkin' Donuts, Baskin-Robbins and Togo's fast-food franchises owned by Dunkin' Brands, Inc. The securities issued by DB Master

Finance, LLC achieved a shadow investment grade rating which enabled the issuer to obtain a monoline wrap on most of its bonds so that they were rated AAA/Aaa when sold to investors. The proceeds of the transaction were used in part to repay a \$1.5 billion acquisition loan incurred only a few months before in a leveraged buy-out of Dunkin' Brands, Inc by three private equity firms. At the time the corporate debt of Dunkin' Brands, Inc had a B-rating due to the substantial leverage (8.5 times) resulting from the leveraged buy-out.

In granting the rating elevation to DB Master Finance, Standard & Poor's and Moody's relied heavily on the strength of the respective brands owned by Dunkin' Brands, Inc's three fast-food franchises, their prior revenue history and the brands' strong market position, which together enabled the rating agencies to conclude that Dunkin' Brands, Inc would remain as a viable going concern. Furthermore, the agencies found that were Dunkin' Brands, Inc to file for bankruptcy, it would be economically motivated to seek to reorganise under Chapter 11 rather than to liquidate. Standard & Poor's rating analysis concluded that in the event of a reorganisation, Dunkin' Brands, Inc, acting as manager of the franchise businesses under a master management agreement, would most likely affirm the master management agreement, even though such an agreement could be rejected in bankruptcy as an executory contract. This reasoning was based on the view that affirmation of such contract would be beneficial to the bankruptcy estate of Dunkin' Brands, Inc by enabling it to continue to receive the management fees (in its role as manager) and to manage the assets for future growth (in its role as residual equity holder). Finally, additional comfort was provided by the fact that a back-up manager (identified at the time the bonds were issued) could step in and provide the management functions needed to ensure the continuation of the cash flows in the event that a bankrupt Dunkin' Brands, Inc should choose to reject the master management agreement.

By analysing these factors, the agencies were able to rate the transaction through the bankruptcy of the operating company – that is, they were able to de-link

the rating on the securitised debt from the sponsor's debt rating, despite the fact that there was a significant degree of dependency on the continued business operation of Dunkin' Brands, Inc. This resulted in a net annual debt service saving of approximately \$35 million for the parent company.

Other whole business securitisations involving food franchise systems (including deals by Arby's, Sonic, Domino's Pizza, IHOP and Applebee's) and using structures similar to the Dunkin' Brands securitisation have also been closed. In addition to these food franchise transactions, there has been one reported whole business transaction in the advertising sector and another receiving an unpublished rating from Moody's involving an intra-company licensing of consumer goods trademarks. The former – Local Insight Media, LP – was a \$547 million securitisation of cash flows generated by two of Local Insight Media's subsidiaries, ACS Media and CBD Media, which publish print directories and internet-based local search services in Alaska and the Cincinnati metropolitan area. The latter – KCD IP – involved a whole business structure supported solely by cash flows internally generated through intra-company licences of the Kenmore, Craftsman and DieHard brands of appliances, tools and batteries sold in Sears and K-mart stores. The \$1.8 billion-worth of bonds received a Moody's rating (unpublished) of Baa2, several notches above the corporate debt rating of Sears.

Each of these transactions involved not only the cash flows of well-established brands, but also a strong business case for accessing the ABS market for liquidity. Businesses with ample liquidity and high credit ratings do not generally turn to the securitisation market without special strategic reasons. The ABS market provides attractive financing terms to companies with below or low investment grade ratings which are subject to capital constraints and in need of liquidity. However, for a capital-constrained company to access the ABS market using the whole business model, that company's business must be of sufficient quality and sustainability to allow rating agencies to rate cash flows

generated by the business after taking into account operating expenses which must be incurred in order to generate these revenues. In other words, whole business securitisation – unlike the securitisation of self-liquidating financial assets which are not dependent upon an operating company to generate cash flow – must allow gross revenues to be used for operating expenses at the top of the cash waterfall, before cash flow is available to service the debt. In short, whole business structures rely on earnings before interest, taxes, depreciation and amortisation (EBITDA) rather than gross revenues to pay debt service on the bonds. Consequently, for businesses to achieve favourable results under this model, the businesses themselves must be in a strong competitive position with a favourable long-term outlook. For companies meeting these criteria, whole business securitisation was – before the meltdown – rapidly becoming the vehicle of choice for replacing high-yield leveraged buy-out debt and thus a potentially important source of liquidity for the heated M&A market.

#### Whole business securitisation after the fall

The market impact of the sub-prime crisis has paradoxically made it much more difficult for whole business securitisations to re-enter the market while at the same time creating increased demand for their resurgence. At the time of writing, the credit markets remain seized up, with virtually no bond trading or new issuance activity across all sectors including commercial mortgage-backed securities, ABS and leveraged finance. As a consequence, a substantial portion of bridge loan commitments, which had been issued to finance acquisitions of operating companies by private equity firms, have been funded by the committing banks alone, which were unable to fill out their syndicates with other bank participants. The possibility of refinancing these leveraged loans through whole business securitisation has been non-existent in the current credit market. Moreover, the liberal terms which lenders were falling over themselves to offer prior to the meltdown (eg, covenant-free or covenant-lite financings

or PIK Toggle features) have now joined the dinosaurs in the tar pits. Consequently, in many instances the leveraged finance departments of the banks and the private equity firms are joined in an uneasy counterparty relationship. The lenders have for the most part suffered multibillion-dollar writedowns as a consequence of their sub-prime, CDO and structured investment vehicle exposures, and are facing potential writedowns of their out-of-the-money leveraged finance book if they attempt to sell their positions or are forced to classify their exposures as hold-to-maturity investments – often an equally unattractive option. In many cases, private equity firms are obligated under loan terms which do not offer the flexibility for growth of the acquired business or for funding of working capital or new acquisitions. Their acquisition debt may also become subject to a lock-out period if the lender ultimately succeeds in syndicating its exposure to other banks. Moreover, acquisition loans which were closed in the past three to five years and are approaching maturity will need to be refinanced in a credit market that is at worst non-existent and at best far less hospitable than when the loans were initially made.

Corporate bankruptcy filings have not trended upward with the increase in CDO, structured investment vehicle and sub-prime residential mortgaged-backed securities downgrades and defaults, except for certain companies in the residential lending sector, such as American Home Mortgage. This is not surprising, since there is not necessarily any direct correlation between the general corporate sector and the structured debt market. However, there are predictions that the corporate sector could be a lagging indicator of the credit market meltdown, and corporate bankruptcies could show a noticeable increase as credit facilities come up for renewals and refinancings or replacement facilities are unavailable or available only at extortionate rates. Within this phenomenon another cliff scenario could also lurk, as leveraged loans put in place several years ago to fund corporate acquisitions mature, thus creating increased demand for whole business ABS structures to provide the take-out financing.

Of course, demand alone does not a market make. A number of potentially conflicting factors will be influential in determining when the lights are switched back on in the whole business securitisation sector. Some of these factors are as follows.

#### **Return to asset-focused fundamentals**

Income-generating assets and businesses have consistently been the centrepiece for esoteric asset securitisations generally and whole business securitisations in particular. The rating agencies have applied uniformly stringent stress cases and structural requirements in rating these transactions. As a result, rating downgrades, defaults and rapid amortisation events in this sector have been a rarity, particularly when compared to the performance of CDOs, structured investment vehicles and sub-prime residential mortgage-backed securities over the past six years. Thus, if inattention to asset quality is perceived as the principal failure contributing to the current meltdown, it would be logical to expect the lights to come back on first in the esoteric sector before power is restored to the rest of the securitisation grid.

#### **Flight from complexity**

Many discussions of the credit market collapse have placed the blame upon the complexity that has invaded the capital markets over the past decade and the opaqueness that has resulted from it. A *New York Times* article of March 23 2008 referred to the villain as "the private trading of complex instruments that lurk in the financial shadows" ("What Created This Monster?", Schwartz and Creswell, *New York Times*, March 23 2008). Of course, these critiques are referring to the complex, and often impenetrable, web of derivative products imbedded in CDO and structured investment vehicle transactions, combined with structural complexity in the form of CDOs of ABS, CDOs-squared, and other multi-layered securitisations in which it would be necessary to drill down several layers to identify the assets and the obligors on which cash flow depends. Whole business securitisations, like other

esoteric securitisations, are also complex, although their complexity is derived from the nature of the assets being securitised and not from the use of derivatives or multi-layered asset structures. If the only take-away from the current crisis is that 'complexity is bad and simplicity is good', the future of all forms of securitisation except the most 'plain vanilla' will be bleak indeed. Just as there was a stigma attached to the term 'special purpose entity' in the immediate aftermath of the Enron scandal, there is likely to be a stigma attached to 'complexity' in the immediate wake of the current crisis. However, institutional investors are sophisticated enough to differentiate among different types of complexity and any generic flight from complexity would be short-lived.

#### **Investor education**

Investors participating in unwrapped esoteric asset securitisations have generally been specialty investors willing to take the time to understand the transactions in which they are investing. These are typically not sound-bite or elevator-pitch investors. These investors should also be more aware than the general investment community of the strong performance history of esoteric securitisations. However, many investors in wrapped esoteric ABS relied heavily, if not exclusively, on the rating of the monolines providing the financial guarantees. It will be more difficult to fill the order books for whole business and other esoteric securitisations on the basis of traditional senior-subordinated tranching without the benefit of monoline insurance. However, it is incumbent upon the bond underwriting and distribution community to re-build their order books through investor road shows and one-one-one dialogues with the large buyers of esoteric ABS.

#### **Monoline meltdown**

The monoline insurers, with a few exceptions, have suffered life-threatening financial pressures as a result of their exposure to the subprime virus. Monolines have exposure through both financial guarantee insurance and credit default swaps written on senior tranches of

CDOs, structured investment vehicles and residential mortgage-backed securities which are backed by non-performing sub-prime portfolios. Those unable to be recapitalised will suffer – and have suffered – rating downgrades, and according to the International Swaps and Derivatives Association documents under which the credit default swaps were written, downgrades could constitute termination events. The result has been that the monoline surety market has virtually shut down and those deals that have been closed with monoline wraps have required credit default swaps to be written against the sureties, at extraordinarily wide pricing, thus further cutting into the vigorish of the transactions. The short-term consequence is the inability to obtain monoline wraps for whole business or any other ABS transactions. Since it is difficult to achieve ratings on many whole business deals higher than Baa/BBB without third-party credit support, this will mean that a large segment of the bonds in a whole business securitisation will be at this rating level. This will virtually eliminate many institutional investors which are required by regulation or by charter to limit their investments to investment grade securities, since a small downgrade in the rating would force them to sell. (It would also obviously eliminate investors which are restricted to AAA-rated securities.) This will pose serious obstacles to selling whole business securitisations of a substantial scale. However, it is not expected that the monolines will be permanently sidelined; and other forms of credit enhancement may be available from the re-insurance and residual value markets. Until the monoline industry is restored to health, creative solutions will be necessary to find alternatives to the monolines or to broaden the investor base for unwrapped ABS.

#### **Filling the crisis management void**

Another problem which will have to be solved in the wake of the monoline crisis is the absence of the monoline insurer to make decisions on an expedited basis in the event of a default or a trigger event. Although bond indentures authorise trustee and servicer actions in accordance with bondholder governance

provisions, these provisions are often cumbersome and are not well suited for circumstances requiring fast decision-making. While the sponsoring company in a whole business or other esoteric asset securitisation normally fills this role under a master servicing or master management agreement, the rating agencies normally require a back-up servicer or manager to take over the functions of the sponsor upon the occurrence of certain triggering events (including but not limited to the sponsor's bankruptcy filing or failure to meet specified EBITDA levels and other financial tests). The presence of a monoline insurer in the capital structure assured a timely and informed response during the transition between the sponsor-servicer regime and the regime of the back-up servicer; and also assured proper oversight of the activities of the back-up servicer. The absence of a monoline insurer will impose more pressure on this process and may require the creation of a new role within the securitisation structure to perform this function. One possibility is to have a designated bondholder representative or special servicer identified upon the initial issuance of the bonds which is empowered to act on behalf of the bondholders with respect to certain enumerated events, thereby avoiding the time-consuming and burdensome process of obtaining bond holder approval and assuring timely action during the transition period between the tenures of the initial master servicer and the back-up servicer.

#### **Increased concern with insolvency risk**

Another possible by-product of the sub-prime meltdown is heightened concern of investors and rating agencies over other risk factors and increased efforts to create deal structures which provide better protection against these risks. As most whole business transactions involve the transfer of substantially all of the cash-generating assets from the sponsor to the special purpose vehicle, there is increased risk that a bankruptcy judge would, in the case of a bankruptcy filing against the sponsor, be tempted to rule that the debtor needs the assets previously transferred to the special purpose vehicle in order to be successfully reorganised. This was the basis

for the 'core asset' doctrine enunciated in the *Days Inn* and *LTV Steel Cases*, where the bankruptcy court came dangerously close to disregarding the true sale of the company's assets to the special purpose vehicle and consolidating the special purpose vehicle with the bankruptcy estate. To obtain a significant ratings elevation above the rating of the sponsor company, it may be necessary in some cases to provide added comfort that this is unlikely to occur. One method for doing so (which is current practice in whole business securitisations) is to require that the proceeds of the whole business transaction be used to retire the secured debt facility of the company and to require the company to covenant that it will not incur additional long-term debt, thus removing the possibility of an involuntary filing by a secured lender and a challenge on the basis of the core asset doctrine. However, trade creditors and other general unsecured creditors can also pose a threat of an involuntary bankruptcy filing against the sponsor company. Therefore, other structural features may be necessary to insulate the sponsor from the incurrence of trade claims and other liabilities which could trigger bankruptcy filings by or against the company. One structural feature to be considered is to ring-fence the operating company by creating a new company to perform the operating functions of the sponsor company post-securitisation.

#### **Future candidates for whole business securitisation**

Assuming a restoration of whole business securitisation in the near future, some concluding thoughts on likely candidates for this type of financing are in order. In addition to private equity firms which were forced by the meltdown to take down their bridge loans and prevented from refinancing them with securitised debt, other candidates for whole business transactions may include outsourcing companies and hotel companies. A recent survey of the major outsourcing vendors for 2006 indicated estimated revenues for 2005 for the top 50 vendors aggregated in excess of \$422 billion. Many of these companies have high investment grade ratings and therefore may not need access to the securitisation

market. However, many others do not and thus whole business securitisation could be attractive. The most appropriate candidates would be outsourcing companies with strong competitive market positions and a diverse portfolio of customers having (optimally) strong credit profiles. As outsourcing contracts are by their nature highly negotiated and terminable both for cause and under 'termination for convenience' clauses, companies will also have to demonstrate through company-specific and industry-wide statistical data the sustainability of their cash flows over time.

Moody's recently issued a special report on hotel franchise fees securitisations (dated February 13 2008) which predicted that there will be hotel franchise fee transactions soon and that they will be rated in a manner similar to the food franchise system transactions. The one unique characteristic of hotel transactions is that securitisations are more likely to be based on royalty fees (representing the franchise or compensation for the use of the brand name, logos, goodwill and other franchise services) than on the basis of programme fees (eg, advertising fees, reservation fees and fees for system and technical support) because the former typically have lower volatility than the latter. In such case, the programme fees would not be made available to the noteholders, but would instead be deposited in a special account and used by the franchisor to cover marketing, advertising, reservation, system and other expenses.

If hotel management firms and outsourcing businesses are likely candidates for whole business securitisation, there are numerous other industry sectors which should also find this type of financing beneficial. These include businesses deriving revenues from patented technology and other intellectual assets requiring hands-on management, technology upgrades or ongoing infringement monitoring and assertion activities; vehicle parking systems; entertainment venues; distributors of power and water; and healthcare delivery systems. The applications of whole business technology are limited only by one's imagination – and the restrictions imposed by a jaded marketplace.