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Legal considerations in structuring asset-backed securities in the US market

Michael S Gambro and Michael A McCormack
Cadwalader, Wickersham & Taft LLP

A successful asset-backed securities (ABS) transaction will partly depend on the treatment of the transaction under relevant laws. Although every ABS transaction gives rise to its own set of legal issues, sponsors should recognise that such transactions need to comply with applicable federal and state securities registration requirements (or find an exemption from such requirements), as well as finding an exemption from the registration requirements of the federal investment company laws. Sponsors also need to ensure that the issuer and its assets will be neither subject to any bankruptcy proceedings nor adversely affected by the bankruptcy of any other entity. For tax efficiency, transactions should be structured to avoid taxation of both the issuer and the investor. Other federal or state laws may also be relevant to ABS transactions in the US market.

Securities law issues

Securitisation transactions subject to US law must comply with the Securities Act 1933 (as amended). The Securities Act makes it illegal to offer or sell securities without proper registration or an exemption from registration. The issuer may satisfy the Securities Act requirements by filing a registration statement with the Securities and Exchange Commission (SEC). In general, a registration statement must be filed with the SEC before any ABS are offered to the public, and it must be declared effective before the sale of any publicly offered ABS. The SEC allows for the shelf registration of investment grade-rated ABS. This allows the issuer to offer ABS from time to time after the registration statement becomes effective without obtaining SEC approval of the offering document for the specific ABS transaction.

SEC regulations facilitate the use by foreign ABS issuers of shelf registration. ABS issued by a foreign issuer backed by foreign assets or affected by credit enhancement provided by a foreign entity may be offered pursuant to a registration statement on Form S-3, provided that any pertinent legal, regulatory, tax or other matters in such foreign jurisdiction that could materially affect payments on, the performance of or other matters relating to the pool of assets or the ABS are adequately disclosed. Form S-3 is the form of registration statement preferred by US issuers of ABS securities. It replaces the burdensome and expensive registration scheme previously applicable to foreign ABS issuers and puts them on a more equal footing with US issuers. Foreign ABS issuers are subject to the same ongoing reporting requirements as US issuers, except that they must also report any material impact on the ABS caused by foreign legal and regulatory developments during the reporting period.

Although changes to the US securities laws have liberalised the types of information and communication that may be used in a public offering of ABS, there may be cost, confidentiality, competitive or other reasons why an issuer may wish not to offer ABS publicly. In such circumstances, issuers may rely on an exemption for private offerings. A transaction does not involve a public offering if:

- the offer is made on a limited basis to selected persons and not pursuant to a general solicitation to the public or general advertising;
- the securities are sold only to persons who are either sophisticated in business matters or able to obtain assistance necessary to make informed investment decisions; and
- before making the decision to purchase the securities, the investors are either furnished with or given access to information of the type that would be obtained through the registration process.

The private offering exemption is limited to sales of securities by an issuer; any subsequent resale of securities must independently satisfy the registration exemption.

Rule 144A under the Securities Act is a frequently used exemption for resales of privately offered securities. Rule 144A provides the following advantages:

- it allows an underwritten offering of unregistered securities to eligible institutional investors;
- it facilitates the establishment of a liquid secondary market for unregistered restricted securities that otherwise would be unavailable for resale by the original holders unless they were to hold the securities for a specified holding period of at least one year; and
- it eliminates the need for issuers to utilise reasonable care to ensure that purchasers are not purchasing with a view to distributing the securities.

To qualify for a Rule 144A exemption, resales of restricted securities must be made to 'qualified institutional buyers'. These generally include institutional investors that own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the 'qualified institutional buyer'.

Securities sold outside the United States do not have to be registered with the SEC, provided that they meet the requirements of Regulation S under the Securities Act. Among other conditions, Regulation S requires that the offer and sale of securities be made in an offshore transaction. This means that either:

- the offer is not made to a person in the United States, and either at the time when the buy order is originated the buyer is outside the United States, or the seller and any person acting on its behalf reasonably believe that the buyer is outside the United States; or
- the transaction is executed in, on or through a physical trading floor of an established foreign securities exchange that is located outside the United States.

Regulation S also requires that no 'directed selling efforts' (ie, any activity that conditions the market in the United States for such securities) may be made in the United States by the issuer, a distributor, any of their respective affiliates or any person acting on their behalf. Such activity includes placing an advertisement in a publication with a general circulation in the United States that refers to the offering of securities being made in reliance upon Regulation S, except for tombstone advertisements that meet certain requirements. In general, legitimate selling activities carried on in the United States in connection with registered or exempt offerings do not constitute directed selling efforts with respect to Regulation S offers and sales.

ABS issuers and underwriters must also comply with state securities laws. While most state securities laws registration requirements have been pre-empted with regard to certain mortgage-backed securities by federal legislation, other ABS offerings will have to be registered under, or sold in reliance on exemptions from, these state securities laws. However, all state securities laws contain exemptions for sales to institutional investors, and there are also exemptions for private offerings to individuals based on the federal exemption described above.

Investment Company Act

The costs imposed by the registration and other requirements of the Investment Company Act of 1940 are prohibitive for most ABS transactions. Thus, it is essential that the sponsor structures the ABS transaction to fit within one of the following registration exemptions under the Investment Company Act.

Rule 3a-7

Rule 3a-7 permits securities to be sold to either investors in a public offering, provided that the securities are rated in one of the four highest rating categories, or institutional investors that meet certain minimum income or assets tests. This exemption is useful for securities that will be marketed, at least in part, to the general public. The issuer must comply with the following additional limitations:

- the assets must consist of only those types that convert into cash within a finite time period;
- the pool of assets must be fixed at the outset of the securitisation and cannot be actively managed during the term of the securitisation to take advantage of market value changes; and
- the securities cannot be redeemable.

Section 3(c)(1)

Section 3(c)(1) of the Investment Company Act provides an exemption where the beneficial owners of all outstanding securities of the issuer number no more than 100 at any given time. Under certain circumstances, persons or entities will be deemed as holding the issuer's securities even though these persons or entities do not themselves directly hold any of these securities.

Section 3(c)(7)

Section 3(c)(7) of the Investment Company Act applies if the issuer will not make a public offering of the securities and the securities are owned solely by certain qualified purchasers that meet certain minimum income or asset tests.

In general, issuers of mortgage-backed securities may also rely on the exemption under Section 3(c)(5)(C) of the Investment Company Act, which applies where the assets primarily consist of mortgage loans or other real estate interests.

Bankruptcy considerations

The rating of the ABS should be based solely on the credit quality of the assets, free from the effects of actions by the sponsor outside the scope of the ABS transaction or by the credit quality of any other entity. The sponsor must ensure that the issuer itself will not become a debtor in bankruptcy and that the issuer and its assets will be 'bankruptcy remote', meaning they will not be adversely affected by the bankruptcy of any other entity.

To structure a bankruptcy-remote issuer, the following steps must be taken:

- The sponsor must prohibit the issuer from engaging in activities other than those related to owning and managing the assets that are the subject of the securitisation. In general, the issuer cannot incur debt or obligations other than the ABS.
- To ensure that the issuer and its assets will not be affected by the bankruptcy of the transferor, the transfer of the assets to the issuer must be structured as a true sale, not as a loan by the issuer to the transferor. If the transfer is considered to be a loan, a court may deem the assets to be owned by the transferor, leaving the issuer with nothing more than a security interest in the assets. In a bankruptcy context this could adversely affect the ability of investors to get paid on a timely basis or to realise on the assets being securitised.
- The transaction should be documented as a sale, indicating an intention to treat it as a sale for accounting purpose. This may be achieved by creating a legal structure and characteristics of the transaction consistent with the rights that one would expect to pass to a transferee in a sale, ensuring the economic substance of the transaction is a sale and that the risks and rewards of owning the assets have passed to the issuer. The issuer must be structured to minimise the risk of being included in the bankruptcy of either the transferor of the assets or an affiliate of the issuer pursuant to the doctrine of substantive consolidation. Substantive consolidation is an equitable doctrine which provides that, in order to prevent a perceived injustice, the separate legal status of two or more entities may be disregarded so that the assets and liabilities of these entities may be consolidated and dealt with as if the assets were held, and the liabilities were incurred, by a single entity.
- The possibility that an issuer will be consolidated with a bankrupt transferor or affiliate may be avoided by prohibiting the issuer from engaging in any activity that would suggest that the issuer is merely the alter ego or instrument of the bankrupt transferor or affiliate. Courts view the following as indications where consolidation may be proper: common officers or directors; office location at the same address; sharing of operational expenses; majority control or ownership of the issuer by the bankrupt entity; and assumption of the issuer's obligations by the bankrupt entity.

Tax considerations

The primary tax concern with regard to ABS transactions is the avoidance of taxation of income from the assets twice - once to the investor and once to the issuer. To avoid income taxation at the issuer level, the sponsor must establish a tax-free entity. The choice of entity will partly depend on whether the sponsor wishes to finance the pool of assets through the issuance of debt or instruments representing beneficial ownership of the underlying assets.

Debt

Sponsors can create debt structures by using one of the following five forms of entity.

Special purpose corporations

A special purpose corporation may be created as a subsidiary of the sponsor, in which case tax at the special purpose corporation level is avoided through consolidation for tax purposes with the sponsor. Other structures, particularly asset-backed commercial paper, use standalone corporations nominally owned by an unaffiliated accommodation party to help achieve off-balance sheet financing. These standalone corporations are usually thinly capitalised and are generally designed to have zero taxable income through their fee structures.

Owner trusts

The issuer may utilise an owner trust, which is often a Delaware statutory trust. It is often unclear whether an owner trust should be treated as a grantor trust or a partnership for tax purposes. Typically, the more activity the trust permits in the way of substituting collateral or reinvesting reserve funds, the more likely a court is to find that a partnership exists if there is more than one owner. An unincorporated entity can check the box to be treated as a partnership, and an unincorporated entity that is not a grantor trust and has only one owner is disregarded (ie, combined with the owner) for federal income tax purposes.

Limited liability companies

Limited liability companies may be formed under statutory authority in nearly all states. Under the check the box regulations they will be either automatically treated as partnerships (with two or more owners) or disregarded.

Partnerships and publicly traded partnerships

Structuring the issuer as a partnership will avoid taxation at the issuer level. However, partnerships and owner trusts or limited liability companies treated as partnerships for tax purposes must avoid being classified as a 'publicly traded partnership', which is taxable as a corporation. Interests in a publicly traded partnership are either traded on an established securities market or are readily tradable on a secondary market. However, an issuer will not be a publicly traded partnership if its interests are not offered to the public and fewer than 100 beneficial owners exist at any given time, or if 90 per cent or more of its gross income is qualifying passive income, including interest that is not derived from the conduct of a financial business (which could exclude securitisations involving fixed pools of assets.)

Non-US entities

Organising an entity in a non-US jurisdiction that does not impose income tax (eg, the Cayman Islands) allows an issuer to avoid federal income tax. Non-US entities may not be engaged in business in the United States, which is generally accomplished by imposing restrictions on the issuer's activities and investments that allow the issuer to qualify for the exception under federal tax law for being a mere trader in stock or securities.

Grantor trust or fixed investment trust

An alternative to the debt structures discussed above is for the issuer to be formed as a grantor trust or fixed investment trust. To obtain such classification, the trust cannot have multiple classes of ownership, other than interests that qualify as fixed-coupon strips or senior and subordinated interests that pay principal on a daily basis unless a default occurs. Each owner in the trust would have an undivided beneficial interest in all the trust's assets; these undivided beneficial interests are central to the idea of avoiding tax at the issuer level and the trust cannot have the power to vary the investment of the trust's owners in order to profit from changes in the market.

Real estate mortgage investment conduits

Sponsors of multi-class mortgage-backed securities typically structure the issuer as a real estate mortgage investment conduit, as this is generally the only US tax vehicle that can be used for a multi-class, sequential pay, mortgage-loan securitisation. In general, treatment as a real estate mortgage investment conduit permits the issuer to avoid federal income taxation. Any form of entity (eg, partnerships, trusts and corporations) may elect to be treated as a real estate mortgage investment conduit provided that it satisfies the specific requirements necessary for real estate mortgage investment conduit status.