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ASSET-BACKED COMMERCIAL PAPER CONDUITS

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I. INTRODUCTION

This paper offers an introduction to Asset-Backed Commercial Paper (ABCP) securitization as a case study of a particular, and widely used, type of securitization in which large and small banks frequently participate. Securitization of any kind is a financing technique through which financial assets are converted into publicly or privately issued securities with which the owners of those assets raise money in the capital markets. The structural keys to securitization are to isolate the assets and the related securities from the bankruptcy risk of the assets' owner and to protect investors from the credit risks associated with the underlying assets. What follows will describe how these basic principles of securitization are put into practice in ABCP programs.

Asset securitization through commercial paper conduits began in the early 1980s in order to securitize credit card receivables. The concept expanded through the rest of the decade with conduit programs introduced by several money center banks, including 1st Chicago, Continental Bank and Security Pacific. This expansion has continued in the 1990s and includes many conduits sponsored by European and Japanese banks as well as several regional banks in the United States. As of the end of 1996, roughly 160 ABCP programs had approximately $150 billion in asset-backed commercial paper outstanding.[1] In addition to the growth in size, the market for ABCP has experienced diversification in the types of assets securitized. Conduit programs now issue commercial paper backed by a variety of asset classes, including trade receivables, automobile and consumer loans, corporate loans, and leases. The industry is also exploring additional asset types to securitize. Examples include 12b-1 fees (management fees for mutual funds), tax liens and utility fees.

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1. STANDARD AND POOR'S, STRUCTURED FINANCE GUIDE (1996).

Although not in commercial paper conduit form, the singer and songwriter David Bowie recently raised $55 million from asset-backed notes secured by future royalties on his songs.

The purpose of asset securitization through issuance of commercial paper is to provide a flexible and economic source of funding for financial institutions and companies that create or acquire financial assets. ABCP, like term asset-backed securities, often offer a lower cost of funds to an issuer than conventional bank loans or from the sale of whole portfolios of assets. By converting credit cards receivables or trade receivables, for example, into broadly traded commercial paper, the owner of those assets gains access to a larger source of capital in the form of the institutional investors that participate in the commercial paper market. In addition, the credit enhancement and liquidity provided to ABCP (as discussed below under Credit Enhancement and Liquidity) enable issuers to obtain funds from short-term capital markets at lower interest rates than from other sources. Commercial paper also offers flexibility to issuers with respect to the amount, timing and duration of borrowings. Within an existing conduit program, ABCP generally can be issued on short notice, in large or small amounts and with maturities of from 30 to 90 days. Some institutions and companies use ABCP to warehouse mortgage loans, auto loans or leases, using ABCP to fund the origination or acquisition of these assets until they have created a pool large enough to sell or securitize in a term structure (that is, a securitization in which fixed-term securities are issued have medium to long maturities). Finally, an important aspect of asset securitization is to remove assets from the owner's balance sheet. An ABCP conduit can be structured to permit the transfer of assets from the owner to the conduit entity to be treated as a sale for accounting purposes.

II. STRUCTURE

ABCP conduits generally fall into one of two structures: single-seller and multi-seller. As the terms suggest, some conduits are designed to securitize the assets of a single entity, while others are a vehicle through which a number of asset owners securitize into the commercial paper market. The majority of all ABCP outstanding is issued by multi-seller conduits. As a generalization, single-seller conduits are typically used by companies or banks to securitize their own balance sheet, e.g., a portfolio of credit cards or auto loans, whereas large banks employ multi-seller programs to securitize the assets of various of their customers, as in the case of trade receivables. The following discussion will focus on a multi-seller conduit structure (see Diagram 1), with commentary on a few significant differences of single-seller structures.

A typical structure for a multi-seller trade receivables conduit is as follows: A bank (the Sponsor) establishes an unaffiliated special purpose corporate or partnership entity (the Vehicle) to acquire the accounts receivable of several of the bank's customers and to issue commercial paper backed by those trade receivables. The Vehicle is usually an "orphan subsidiary" which is owned by an entity unaffiliated with the Sponsor. Through a management agreement with the Vehicle, however, the Sponsor effectively directs the activities of the Vehicle. In a management agreement, the Vehicle appoints the Sponsor as managing agent of the Vehicle with power of attorney to take actions on the Vehicle's behalf in return for a fee. The Vehicle purchases receivables indirectly from each of several participating bank customers (each, a Seller). The transfer of receivables from a Seller to the conduit occurs in a two-step transfer, whereby the Seller first transfers the assets on an ongoing basis to a special purpose entity (an SPE), and the SPE then transfers the assets to the Vehicle. The transfer from each Seller to its SPE is governed by a receivables purchase agreement (a Receivables Purchase Agreement), and the transfer from SPE to the conduit is embodied in a sale and servicing agreement (each, a Sale and Servicing Agreement). The purpose of the two-step transfer is to distance the assets purchased by the Vehicle from a bankruptcy of the Seller. As discussed under "Legal Issues" below, an SPE (usually a corporation, sometimes a limited liability company) is created with provisions in its governing documents that limit the likelihood of its being placed in bankruptcy and of being consolidated with the bankruptcy estate of its parent, the Seller.

Each Seller sells its accounts receivable to the Vehicles on an ongoing basis for so long as that Seller commits to participate in the conduit program. The Seller also agrees to service (primarily collecting payments) the accounts receivable for the benefit of the Vehicle and commercial paper investors. The Vehicle pays for the accounts receivable with the proceeds of the issuance of commercial paper. The Vehicle typically purchases accounts receivable from the Sellers in the form of a certificated participation interest (each, a PC) which represents a fractional beneficial ownership interest in all accounts receivable sold into a conduit. PCs are created by a Seller pursuant to a Sale and Servicing Agreement (or similar agreement). The Seller normally retains an interest in that portion of the transferred receivables not required to support the PC.

Commercial paper is issued by the Vehicle pursuant to a depositary agreement (the Depositary Agreement) in discreet "tranches," each having its own interest rate and maturity as directed by the applicable Seller. Maturing tranches of commercial paper are repaid by the Vehicle, in the first instance, by new issuances of commercial paper. If the Vehicle cannot issue a sufficient amount of new commercial paper to repay the maturing commercial paper on a given day, it may apply collections on the receivables, and to the extent such collections are insufficient, the Vehicle will draw a liquidity facility provided by a bank or group of banks for that purpose.

III. CREDIT ENHANCEMENT AND LIQUIDITY

A. *Risks*

A fundamental element in the design of ABCP programs is to protect investors in the commercial paper from credit risk and liquidity risk associated with the assets being securitized. Credit risk is the possibility that the obligor on an asset, for example a credit card holder, automobile owner or an account debtor on a Seller's trade receivables, will default on its obligation to pay the Seller. Liquidity risk is the danger that collections on an asset will be delayed and therefore not available when needed to pay maturing commercial paper secured by that asset. In a bankruptcy of the Seller, the Vehicle should ultimately receive collections on the assets because the Vehicle has a first priority perfected security interest in the assets pursuant to the Sale and Servicing Agreement. However, a bankruptcy proceeding with respect to the Seller would likely delay the payment of such collections to the Vehicle and so to the commercial paper holders.

Two other risks associated with ABCP securitization are dilution and preference risk. Dilution arises when the amount payable under a receivable is reduced in ordinary course of the a Seller's business. Examples include rebates, offsets or credits that result from disputes between a Seller and obligor, marketing programs or claims related to faulty goods. The reduction of the amount payable under a receivable may be permitted under the terms of the applicable loan agreement or account but the result to an ABCP conduit is insufficient funds to pay maturing commercial paper. Dilution is ordinarily covered by a covenant of the Seller in a Sale and Servicing Agreement to reimburse the Vehicle for the amount of any dilutions. In the event of a Seller's insolvency, however, this reimbursement obligation would not be fulfilled.

Preference risk is another problem stemming from Seller bankruptcy. Payments made by a Seller to the Vehicle with respect to dilutions or to cure breaches of representations and warranties with respect to the receivables may be recovered by a bankruptcy trustee if they were made within the applicable "preference" period prior to the onset of the Seller's bankruptcy.

Credit risk, and to some extent dilution and preference risk, are protected against by several mechanisms, both at the level of the Seller as well as at the conduit level. A basic measure to protect against losses on a conduit's assets is the concept of "eligible receivables." A conduit Vehicle will only purchase receivables that meet defined criteria. Eligibility criteria attempt to exclude from a conduit receivables that are likely not to pay in full. Important eligibility criteria include requirements that a receivable: (i) is not defaulted at the time it is acquired by the Vehicle; (ii) is not delinquent more than a certain number of days (usually 120); (iii) is denominated in U.S. dollars; and (iv) as to which the Seller has good title, free and clear of all liens. If, after receivables are transferred to the Vehicle, it is determined that a receivable is not an eligible receivable, the Seller must repurchase the receivable from the Vehicle. The Seller also makes a number of other representations and warranties to the Vehicle in the Sale and Servicing Agreement as to the characteristics of the receivables. A breach of any of those representations and warranties will usually require a repurchase of the related receivable by the Seller.

ABCP programs also guard against credit and related losses on receivables by issuing commercial paper in an amount somewhat less than the face amount of receivables transferred to the conduit. The purchase price paid by the Vehicle for receivables is also, therefore, proportionally less than the amount of receivables purchased. The effect of this discounted advancing against receivables is to create overcollateralization in the conduit. That is, the Vehicle will own a greater face amount of receivables than it issues commercial paper. Collections on this excess amount of receivables is available to pay maturing commercial paper to the extent other receivables are not collectible in full. The amount of discount is calculated to reflect the probability of losses on the receivables. Generally, the discount is tied to the level of historical losses on the receivables of a particular Seller. The purchase price paid by a Vehicle to different Sellers in a single conduit will vary, therefore, depending on the past performance of each Seller's receivables. The purchase price is often reset periodically to reflect losses experienced during a moving window of time, extending a specified number of months prior to the date on which the purchase price is reset.

B. Credit Enhancement

The most important form of protection against credit related losses is the credit enhancement facility. Credit enhancement facilities most frequently take the form of a letter of credit provided by a bank or syndicate of banks which may include the Sponsor. Credit enhancement may also be provided by cash-collateralized guarantees from the Sponsor or by financial guarantee insurance policies issued by monoline insurance companies. Early ABCP conduits sometimes offered credit enhancement against 100% of the amount of commercial paper issued; however, it is much more common recently to find partial credit enhancement in the range of 10% to 15% of the maximum amount of commercial paper issuable by a conduit program. The rating agencies establish the amount of credit enhancement required for a given conduit based on models of the expected timing and severity of losses on the receivables. Their analyses take into account the various credit risks of the receivables of each Seller and the strength of each Seller's origination and servicing operations. Credit enhancement facilities are contracted for by an ABCP Vehicle for the benefit of all commercial paper holders, and can therefore be used to cover losses on receivables of any Seller in the program.

C. Liquidity Facility

ABCP conduits typically obtain a liquidity facility to offset liquidity risks. As with credit enhancement, a liquidity facility is provided by a bank or group of banks of which the Sponsor may be a member. The size of liquidity support is most often equal to 100% of the maximum amount of commercial paper issuable by the conduit. Commonly, the size of the liquidity facility is equal to the difference between the maximum program size and the amount of the credit enhancement facility. A credit enhancement facility may also be available for liquidity draws by the Vehicle after the liquidity facility has been exhausted. The managing agent for a conduit Vehicle, usually the Sponsor or one of its affiliates, will draw on the liquidity facility to repay maturing commercial paper on any day on which it is not possible to issue new commercial paper in an amount that, when combined with collections on hand with the Depositary, is sufficient to pay such maturing commercial paper. The provider of the liquidity provider is repaid collections on the receivables as they become available.

In multi-seller conduits, the liquidity facility may be at either the Seller level or the program level. In the latter case, a single facility provides liquidity support to the entire transaction, regardless of which Seller's receivables have been slow to pay. In other ABCP conduits, each Seller has the benefit of a dedicated liquidity facility sized to cover the full amount of commercial paper issuable with respect to such Seller's receivables.

IV. LEGAL ISSUES

The primary set of legal issues involved in ABCP securitization revolve around bankruptcy. As indicated at the outset, a fundamental goal of any securitization is to isolate the assets being securitized from a potential bankruptcy of the owner of those assets. Investors in ABCP rely on, and the ratings assigned to ABCP depend upon, the premise that repayment of ABCP will be determined by the performance of the underlying assets and not on the financial performance or business condition of the securitizer of those assets.[2] Consequently, ABCP transactions are structured in a manner that permits counsel to opine, so far as is possible, that the securitized assets will not be involved in a bankruptcy of the Seller or the SPE.

The first step in making assets "remote" from a Seller bankruptcy is to interpose a bankruptcy-resistant entity—the SPE—between the Seller and the Vehicle.[3] As noted above, the transfer of assets in a typical conduit moves in two steps: from Seller to SPE and from SPE to the conduit. The SPE is set up in a manner to make it resistant to (i) being placed in bankruptcy and (ii) being drawn into a bankruptcy of its parent, the Seller. The first goal is addressed by limiting the corporate purposes of the SPE to activities related to securitization, typically to acquiring and disposing of receivables, loans or other financial assets. In addition, an SPE's articles of incorporation restrict its power to incur debt. Usually an SPE cannot incur any debt unless it is nominal in amount, incidental to securitization and fully subordinate to the SPE's obligations in a securitization. These

2. It is, of course, important that the Seller of assets into a securitization conduct efficient servicing operations. But servicers can usually be replaced, and a servicer's failure should not impair the credit quality of the assets. Also, ratings of ABCP programs rely heavily on the obligation of credit enhancement and liquidity providers to cover losses and liquidity shortfalls.

3. This requirement has traditionally applied only to non-investment grade Sellers. The introduction of FASB 125, however, has prompted investment grade Sellers as well to adopt a two-tier structure.

provisions are intended to minimize the possibility that the SPE will create liabilities that could make it the subject of an involuntary bankruptcy by creditors. Further, an SPE's articles will usually require that at least one member of the board of directors be independent of the Seller or its affiliates and that such independent director(s) consent be required for any voluntary bankruptcy filing by the SPE. In this way, the possibility that a voluntary filing by the SPE might be forced by the parent Seller is reduced.

In order to keep an SPE free of its parent's bankruptcy, an SPE must operate in a way that observes corporate formalities, distinct from the Seller. Such formalities include maintaining separate offices, maintaining its own books and records, taking corporate action by appropriate meetings and board resolutions and keeping the SPE's finances separate from those of its parent.

Legal analysis of the risk that an SPE would be drawn into its parent's bankruptcy is provided in a non-consolidation opinion of counsel to the Seller. A non-consolidation opinion is a highly reasoned opinion, generally reaching the conclusion that a bankruptcy court would not disregard the corporate separateness of the Seller and its subsidiary SPE and order the assets of the SPE consolidated with those of its bankrupt parent. This opinion can be difficult to render, especially in the context of a securitization in which, despite the formal separateness of Seller and SPE, the SPE is wholly owned by the Seller and has no real existence apart from the parent's securitization activities. Much depends on the particular facts of the relationship between the Seller and the SPE. Counsel must evaluate this relationship closely and advise the Seller how to structure the SPE and its relationship to the Seller. These opinions will be reviewed closely by counsel to the rating agencies and must include certain generally accepted lines of analysis.

A non-consolidation opinion reviews a number of factors which case law shows courts tend to consider in deciding whether to order the substantive consolidation of two entities. One set of factors concerns the effect of such a consolidation on the creditors of each entity. Relevant issues include whether (i) creditors of one entity dealt with the two companies as a single economic unit;[4] (ii) the two entities are so entangled that the expense of separating them would prevent creditors from recovering on their claims;[5] and (iii) assets

4. *See* Soviero v. Franklin Nat'l Bank of Long Island, 328 F.2d 446, 448 (2d Cir. 1964); Stone v. Eacho, 128 F.2d 16 (4th Cir. 1942).

5. *See In re* Augie/Restivo Baking Co., 860 F.2d 515 (2d Cir. 1988); Chemical Bank

were transferred between the two companies without fair consideration or with the intent to hinder or defraud creditors.[6] The other main issue is the nature of the relationship between the two entities to be consolidated. This analysis inquires whether one entity serves as a more "instrumentality" or "alter ego" of the other and, further, whether one entity has used the other as a "cloak of fraud" or has otherwise created an abuse of creditors.[7] In determining the question of instrumentality, courts have viewed the following factors, among others, as suggesting instrumentality: one corporation is the wholly owned subsidiary of the other; the two entities have directors and officers in common; the parent finances the subsidiary; the subsidiary has grossly inadequate capital; the subsidiary has substantially no business except with the parent or no assets other than those transferred to it by its parent; the directors or officers of the subsidiary do not act independently from the parent entity; and the two companies do not observe the legal forms of two distinct corporations.[8]

Applying this analysis to the structure of an ABCP conduit, it is difficult to conclude with certainty that a court would not consolidate a Seller and its SPE. A court has many factors to weigh and has broad discretion in using its equitable powers. Perhaps most importantly, there are virtually no cases directly analogous to a securitization. Further, the relationship of a Seller and its financing SPE often run afoul of some of the indicia of "mere instrumentality." For example, it is common for an SPE to share officers or directors with the parent Seller and for the SPE to effectively take direction from the Seller, which has set up the SPE specifically to serve the Seller's purpose of participating in a conduit securitization. Such an SPE has little real business of its own apart from its dealings with its parent.

In reaching the conclusion that a court, after a consideration of the relationship between Seller and SPE and the relevant case law, would hold that an SPE should not be consolidated with the bankruptcy estate of its parent, counsel rely heavily on (i) the observance

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New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966); Matter of Lewellyn, 26 B.R. 246, 251 (1982).

6. *See* Sampsell v. Imperial Paper Corp., 313 U.S. 215, 220 (1941); Maule Indus. v. Gerstel, 232 F.2d 294, 297 (5th Cir. 1956).

7. *See* Baker v. Raymond Int'l, Inc., 656 F.2d 173, 180 (5th Cir. 1981); *see also* Henry W. Ballantine, *Separate Entity of Parent and Subsidiary Corporations*, 14 CAL. L. REV. 12, 17-20 (1925).

8. *See* Anaconda Building Materials Co. v. Newland, 336 F.2d 625, 627 (9th Cir. 1964); *see also* Fisser v. Int'l Bank, 282 F.2d 231, 238 (2d Cir. 1960); Maule Indus. v. Gerstel, 232 F.2d 294, 297 (5th Cir. 1956); Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940).

of corporate formalities by the SPE, (ii) structuring of the transactions between Seller and SPE (primarily the sale and purchase of assets) such that creditors of the Seller are not deceived as to the relationship between the two entities or defrauded by the transfer of assets and (iii) the fact that consolidation is an unusual step in bankruptcy cases, requiring a strong showing that failure to consolidate would constitute an abuse of creditors.

As a further bankruptcy safeguard, the rating agencies may require that Seller's counsel opine that the transfer of assets by the Seller to the SPE should or would be viewed as a sale and not be recharacterized by a bankruptcy court as a borrowing by the Seller from the SPE secured by a pledge of the Seller's assets. Specifically, a "true sale" opinion attempts to conclude that, subject to certain qualifications, a bankruptcy court should or would: (i) find that the assets conveyed by the Seller to the SPE are not part of the bankruptcy estate of the Seller under Section 541 of the Bankruptcy Code; (ii) find that the transfer of the assets would not be subject to the stay of Section 362 of the Bankruptcy Code; and (iii) not compel the turnover of the assets to the Seller pursuant to Section 542 of the Bankruptcy Code.

The factors analyzed in such an opinion include: (a) the business objectives and intent of the parties, (b) the extent to which the Seller retains any interest in the assets, such as the right to repurchase the assets, (c) the level of recourse to the Seller for losses on the assets, (d) the degree of control over the assets retained by the Seller, (e) whether reasonably equivalent value was given by the SPE for the assets, and (f) the extent and the nature of the parties' disclosure of the transaction to third parties as a sale.[9] In applying the factors to the Seller-SPE transfer, a favorable true sale analysis relies on some or all of the following: (i) the Receivables Purchase Agreement expresses the intent of the parties that the transfer of assets be a sale, (ii) the Seller retains only a limited right to repurchase assets and has limited recourse on the assets; the Receivables Purchase Agreement and the Sale and Servicing Agreement typically provide that the Seller repurchase assets only in the instance of a breach of representation and warranty regarding the assets, and not because of credit losses, and (iii) the Seller has little discretionary control over the assets once they have been transferred into a securitization. The

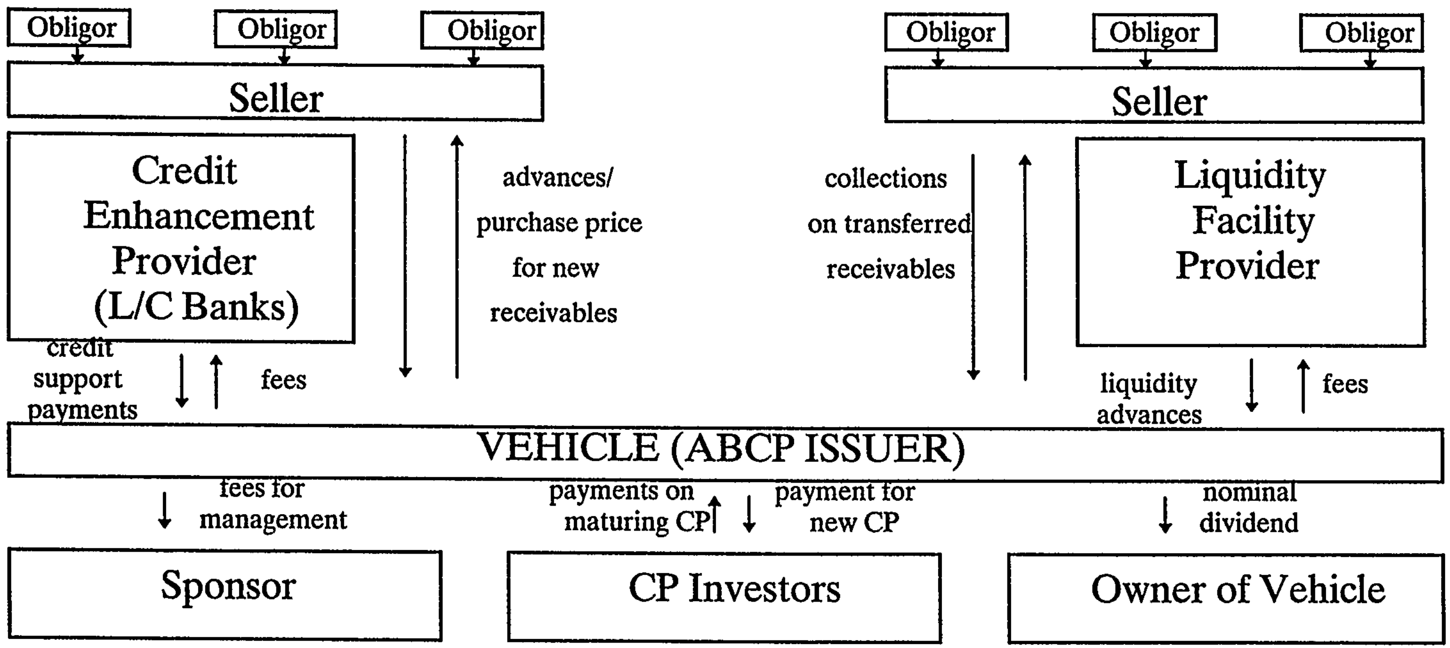
9. *See* Major's Furniture Mart, Inc. v. Castle Credit Corp., Inc., 602 F.2d 538 (3d Cir. 1979); *In re* Joseph Kanner Hat Co., Inc., 482 F.2d 937 (2d Cir. 1973); *In re* O.P.M. Leasing Services, Inc., 30 B.R. 642 (Bankr. S.D.N.Y. 1983); Fox v. Peck Iron & Metal Co., Inc., 25 B.R. 674 (Bankr. S.D. Cal. 1982).

agreements provide that the Seller relinquishes its rights to control the assets other than to perform customary servicing activities, primarily making collections on the receivables. Discretion on the part of the Seller is minimized because these duties are constrained by the terms of the Sale and Servicing Agreement. Also, the Seller performs these functions not for its own account but as an agent of the conduit Vehicle for the benefit of the commercial paper holders.

As with the requirement that the Seller's SPE be bankruptcy remote, the rating agencies encourage protections against the conduit Vehicle being drawn into a bankruptcy of any other entity, particularly the Sponsor, or becoming the subject of its own bankruptcy proceeding. The latter risk is addressed by incorporating in the Vehicle's governing documents limitations on activities and indebtedness and provision for independent directors like those used in the articles of an SPE. The former issue is most often approached by arranging for third party ownership of the Vehicle. Although the Sponsor often directs the creation of an ABCP conduit and acts as its managing agent, it will not own the SPE. A Sponsor can contract with one of a number of companies in the securitization industry providing services as the owner of "orphan" subsidiaries.

Finally, as a backstop to the opinions supporting a sale characterization of transfers of securitized assets by their Sellers and the corporate separateness of Sellers and their SPEs, counsel must generally provide opinions (i) that an SPE has a first priority perfected security interest in the assets transferred to it by the related Seller and, in many cases, (ii) that the conduit Vehicle has a first priority perfected security interest in the assets transferred to it by the SPEs.

DIAGRAM 1*



* Adapted from Moody's Investors Service Structured Finance Research & Commentary, April 1993