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# Legal Risks in Structured Finance

## Analytical Considerations

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## I. Introduction

This document highlights the legal aspects Scope considers when analysing structured finance transactions and explains how they can influence the credit risk of a transaction. The concepts described in this document may also be relevant to the analysis of other debt instruments that rely on any of the elements described herein. These guidelines do not constitute a rigid or exhaustive set of requirements.


**Analyst**

**Burkhard Wiehler**
Director
Asset Based Finance Lawyer
+49 (0)30 27891-224
b.wiehler@scoperatings.com


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**Scope Ratings AG**

Lennéstraße 5
10785 Berlin
T: +49 (0)30 27891-0
F: +49 (0)30 27891-100
Service: +49 (0)30 27891-300

info@scoperatings.com
**www.scoperatings.com**

## 1. Scope´s Approach

When analysing the impact of legal aspects and their mitigants on credit risks, Scope takes into account the individual structure, the incentive mechanism and other aspects of each transaction. The credit view that emerges in the course of the analysis of the transaction depends not only on the associated credit risk but also on the applicability (or non-applicability) of the legal principles described below. Scope adjusts its analytical assumptions according to the applicability of these principles. For instance, legal aspects determine the mechanisms and features Scope can or cannot give credit to when analysing available sources of credit enhancement in a transaction.

Most of the concepts described herein were developed over time by the structured finance industry and have, to a large extent, resulted in legally robust structures. Scope recognises these concepts set by a seasoned industry. However, Scope is convinced that legal issues may be weighted differently with respect to the resulting risk and can be mitigated using alternative approaches.

## 2. General Legal Aspects

This document provides an overview of the general legal issues that Scope typically examines when assessing structured finance transactions. It cannot be comprehensive as such transactions vary in terms of the underlying assets, their structure or the jurisdictions involved.  The legal concepts likely to influence ratings are common to most structured finance transactions regardless of the applicable jurisdiction. They have therefore been crystallised in a set of principals relevant to any structured finance transaction. While this document does not consider specific jurisdictions, Scope assesses whether these principles are maintained by the jurisdictions applicable to the transactions. In the course of this assessment, Scope relies on internal legal expertise, transaction legal opinions and external legal advice, if necessary.

This document examines the legal aspects of a structured finance transaction, looking at the three key elements of any such transaction that could give rise to possible legal risks: first the asset of the transaction, second the issuer i.e. the Special Purpose Vehicle (SPV) issuing the rated debt, and third, the transaction parties and documents as outlined in Figure 1 on the right.

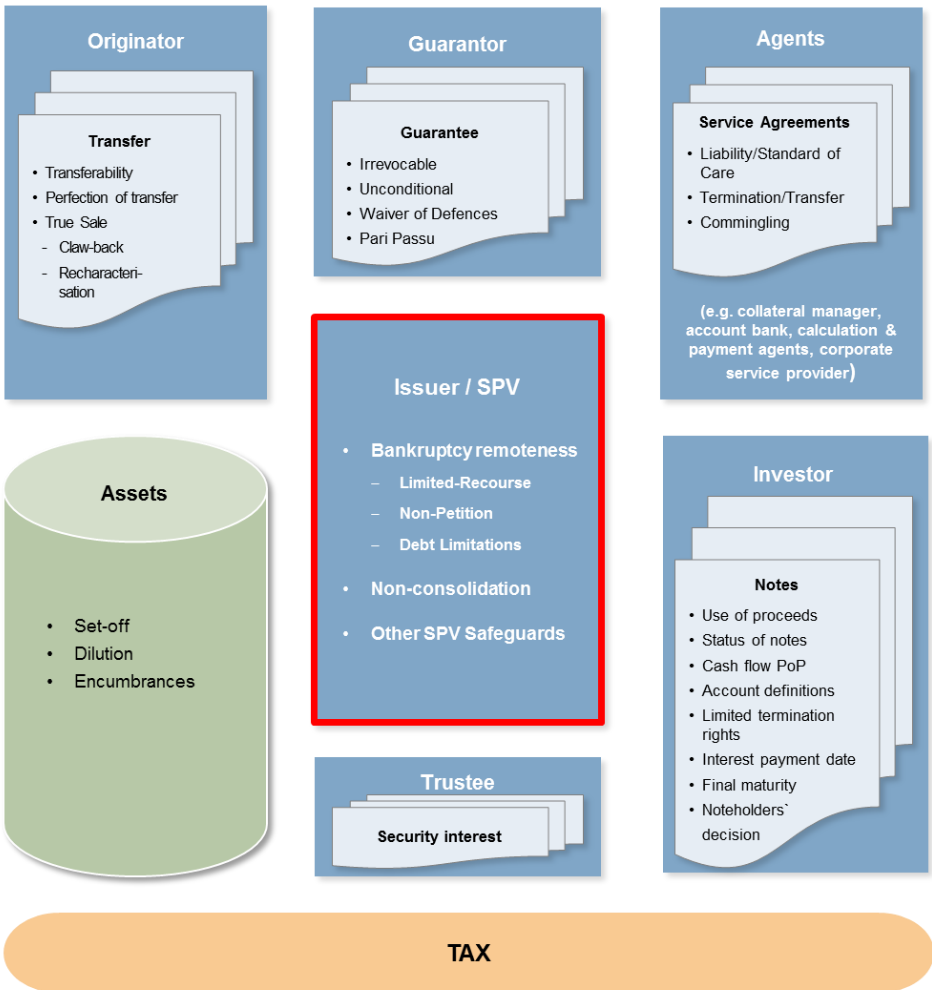


**Figure 1.**
Key elements of structured finance transactions

## II. Assets

The quality of the underlying assets and the SPV's legal recourse to the proceeds from them are key elements of any asset-based finance transaction. The financial crisis highlighted the need for credit analysis to focus on the assets of a transaction. It demonstrated not only the legal deficiencies of certain structures but, more importantly, the fact that a key weakness of distressed structures was attributable to the non-performance of the underlying assets.

### 1. Enforceable Assets

In order to ensure that the asset produces the cash flows necessary to cover the SPV´s liabilities, Scope assesses whether the payment obligations owed to the SPV are valid and enforceable in the amount required for this purpose.

The existence and enforceability of the claims and obligations stemming from the assets may be challenged by applicable laws. These laws may prohibit certain transactions (e.g. usury, fraudulent dealings, collusion); grant some counterparties extraordinary termination rights (consumer protection); or stipulate formal prerequisites (e.g. filings, notarisation). Scope takes into account the validity and enforceability of obligations, typically confirmed by a legal opinion. Any factual elements necessary for the obligations to be considered existing and enforceable would be explicitly represented by the originator or the collateral manager where the transaction provides for the purchase or substitution of assets at a later stage. Especially where the asset base of the SPV consists of a pool of assets, Scope may limit its assessment to considering whether one of the transaction parties (i.e. the originator or the collateral manager) is contractually obliged and capable of checking the existence and enforceability of the assets.

Even if the payment obligations were originated in a valid and enforceable fashion, the creditor may not be able to fully benefit from them. In particular, any rights of the obligor to refuse full payment due to statutory defences or contractual changes to the payment obligations have to be taken into consideration. In this context, set-off, dilution and encumbrances may have a negative impact on the ratings of some structured finance transactions.

#### a) Set-Off

Set-off may be invoked by a debtor where he holds a monetary cross-claim against the creditor. In this case, the debtor may be entitled to be absolved from honouring the creditor's claim to the extent of the cross-claim. Depending on the jurisdiction, the set-off right may be a statutory defence or contractually agreed. If it is a statutory defence, it may be waived by contract. Set-off can be of particular concern in consumer credit or SME loan securitisation transactions if the originator of the securitised loans holds deposits of the consumer or SME debtors in his accounts.

Due to the above-described mechanism, set-off exercised by a debtor in relation to the asset may substantially reduce or completely cancel out the enforceable claim, i.e. the proceeds of the SPV. Where such cross-claims exist or are likely to come into existence, Scope examines whether the documents relating to the asset contain waivers of set-off and whether these are valid under the relevant jurisdiction. In case such waivers have not been agreed upon or are not recognised by the applicable jurisdiction, Scope assesses whether any features have been implemented in the structure to mitigate the negative impact of set-off. Otherwise, Scope evaluates whether the credit risk of the originator must be factored into the rating. If the mitigation is not effected by means of a mechanism such as an appropriately sized reserve or similar features, but instead takes the form of indemnities or substitution rights granted by the originator, Scope considers whether those indemnities or substitution rights affect the True Sale of the asset (see below).

Set-off may also create challenges for the structure if invoked by transaction parties other than the debtors of the claims generated by the asset, for example the account bank. In this case, Scope examines how set-off is treated in the transaction documents mentioned below and how it affects the structure.

#### b) Dilution

Dilution affects a transaction´s cash flow because in a trade receivables securitisation, for example, it results in the trade receivable´s debtor being able to pay less for the underlying contract than the face amount for which it was sold. Dilution is not a legal term but may occur for a number of reasons based on different legal concepts. It may stem from contractual arrangements such as rebates (fast pay or volume rebates), discounts, credit notes, etc. or statutory withholding rights such as price reductions due to defects in the deliverable goods or the services rendered.

Since a dilution reduces the cash flow generated by the asset, Scope assesses this risk in light of the documents governing the asset, appropriate representations of the obligor, other contractual safeguards in the transaction documents and legal opinions, if necessary. Where the risk of dilution cannot be excluded but is adequately quantified, Scope´s assessment may rely on appropriate mitigants, for example dilution reserves.

### c) Encumbrances

Other impediments to enjoying the benefits of a given asset are any encumbrances of the rights to it, i.e. if any of these rights have been pledged, charged or are subject to a security interest for the benefit of a third party. This third party may be entitled to enforce its rights to the asset if the preconditions to such enforcement have been fulfilled. Where such encumbrances have to be made public, for example recorded in a register as is the case for German mortgages, Scope will assess if these public records have been checked by the transaction counsel. In case such publication requirements do not exist, Scope may rely on appropriate representations.

## 2. Legal Benefit

In order for the structure and hence the rating to be able to rely on the cash flows generated by the asset, it is essential that the issuer, i.e. the SPV, be entitled to fully benefit from this asset. In structured finance cash flow transactions this benefit will be made available by the transfer of these assets to the issuer from a third party, which in most cases is identical with the originator of the assets.

This transfer of property does not apply to synthetic transactions. For synthetic risk transfers, the legal analysis will focus on the valid, legally binding and enforceable nature of the payment obligations of the party transferring the risks to the SPV in order to determine whether the issuer benefits from the cash-flows generated by the synthetic exposure to the asset.

In any cash securitisation, Scope takes a two-step approach to its analysis of this asset transfer: First, Scope looks at the actual transfer and second at the True Sale requirement. As an exception to this approach the True Sale requirement may not be relevant in certain jurisdictions in which the transaction can be structured with an SPV relying on secured loans.

### a) Transfer

The actual transfer of the asset has to be legally valid, binding and enforceable by the SPV in order for it to benefit from the cash-flows generated by the asset. Two issues, in particular, may be problematic: the transferability of the asset and the perfection of transfer.

#### aa) Transferability

The transferability of an asset may be restricted by law or by contract. In the case of bank loans, for instance, the underlying loan documentation sometimes limits transferability in terms of minimum transfer amounts, number of transfers and qualifying transferees. The latter limitation, in particular, poses a challenge to a valid transfer to the SPV in case only financial institutions qualify as transferees under the loan contract. In this regard Scope typically relies on the relevant representations of the originator as well as on a legal opinion. For this reason the legal opinion usually covers the transfer (agreement), which is generally contained in the asset sale and purchase contract. However, in transactions where the SPV purchases assets over the lifetime of the transaction and not just at closing, the transaction must ensure that no transfer restrictions will apply to future asset purchases. In managed or revolving structures, Scope will look for corresponding undertakings in the agreements with the agents selecting the assets. For instance, the collateral manager of an actively managed transaction may only purchase assets after verifying transfer restrictions, and Scope would typically assess whether the manager demonstrates sufficient abilities and skills to comply with his obligation.

#### bb) Perfection of Transfer

Formal requirements have to be met in order to perfect a transfer of asset. To the extent that the legal opinion does not address this particular issue, Scope gains reassurance from relevant documentary proof (e.g. registry excerpts, capital account statements, etc.). Certain transactions, such as trade receivables securitisations, may be structured in such a way that the originator does not have to notify the debtor of the asset at the time of transfer. This is typically the case where the seller does not want his debtor to know that he has sold and transferred his commitment. Depending on the jurisdiction, notification is not necessarily a precondition for a valid transfer. However, in most legal systems the debtor may be entitled to discharge his obligations directly against the originator and exercise his right of set-off against him as long as he has not been informed about the transfer (see set-off above). This does not pose a threat to receiving the cash-flows as long as the seller is solvent. Therefore, such risks have to be eliminated before the seller becomes insolvent by providing for notification mechanisms ideally based on triggers linked to the financial performance of the seller. In this context it may not be sufficient to oblige the seller to notify the debtors concerned. Beyond that, it should be ensured that in the event of a defaulting originator, the SPV is able to eliminate this risk itself. This may be achieved by providing for corresponding powers of attorney or other forms of prepared notices enabling the SPV to make these notifications on behalf of the defaulting seller. The transaction lawyers typically opine on the effectiveness of such post-insolvency notifications and Scope would consider the operational issues relating to this procedure.

### b) True Sale

True Sale is a subcategory of the analysis of a valid transfer, which Scope analyses in a separate step due to its importance to the structure. In structured finance the term ´True Sale` stems from the early days of US securitisation transactions and describes one particular characteristic of the transfer: its indefeasibility in an insolvency of the seller (normally the originator) of the assets. Only if this is ensured will the SPV have the benefit of an isolated asset that cannot be questioned by any creditor of the seller or its insolvency administrator (or equivalent). The effectiveness of a True Sale can be called into question depending on the jurisdiction governing the transfer and the applicable insolvency regime. The two major challenges to a True Sale, which have been the subject of numerous court cases and academic discussions, are Claw-back and Re-characterisation.

#### aa) Claw-back

Most jurisdictions provide for claw-back mechanisms to protect the creditors of an insolvent entity that has transferred assets or has otherwise diminished the value of its asset base, not only during but also prior to insolvency. In such cases, the transfer may be rescinded so that the transferred asset is “clawed-back” by the insolvency administrator into the insolvency estate of the insolvent transferor for the benefit of its creditors. Such claw-backs can occur in the event of fraudulent transactions but also where a transfer detrimental to the obligor´s creditors falls within a certain observation period prior to insolvency. In its analysis, Scope takes into account the nature of the transaction and the financial situation of the transferor. Since in most cases, Scope is not in a position to assess whether the transaction was effected at arms-length, Scope typically relies on corresponding representations from the parties. Regarding the financial situation of the transferor, Scope will consider its credit risk. A strong True Sale opinion will typically cover amongst other insolvency searches, checking applicable registers for filings of insolvency proceedings in respect to the transferor. Since not all stages of a company staggering towards insolvency are subject to publicly available filings Scope looks for standard representations regarding the seller´s solvency.

#### bb) Re-characterisation

The second major challenge to a True Sale is the re-characterisation the transfer of the asset into a security over the asset. Should the seller become insolvent, the SPV would not be the legal owner of the asset, but would have a monetary claim secured by the asset against the seller. This jeopardises the timely payment of cash flows due to the delay caused by the enforcement of the security interest. When assessing the legal nature of the asset transfer and determining whether it might be re-characterised as a secured claim, the courts may take into account the conduct of the transferor and the transferee, how the assets are controlled and serviced, the ownership of the economic benefit or the distribution of loss associated with the asset. This is problematic where the originator covers certain risks related to the assets.

A legal opinion confirming the perfection of the True Sale (True Sale opinion) would be necessary due to the diversity of the above mentioned aspects, which can taint a True Sale, and the dissimilarities in its recognition by different jurisdictions. The scope of the legal opinion may be reduced where the relevant jurisdiction provides for securitisation laws or insolvency regimes that facilitate or establish a True Sale by law.

## III. The issuer / the SPV

The issuing SPV constitutes one of the defining features of any structured finance transaction. It serves as the mechanism de-linking the underlying asset from the credit risk of the originator and hence enables the structure to rely solely on the credit stemming from the asset. The issuer has to fulfil a number of restrictive criteria in order to ensure that the payment deriving from the asset is neither interrupted nor negatively affected in any way. These criteria can be grouped into the main goals to be achieved by the SPV: bankruptcy remoteness and non-consolidation. Whereas the first should prevent the SPV from entering into insolvency proceedings, the second should prevent the assets of the SPV from being affected by the insolvency of its parent or other related company.

Bankruptcy remoteness and non-consolidation are targeted by using different types of corporate entities as SPVs, which will vary according to the jurisdiction under which they are set up. In order to facilitate structured finance transactions, some jurisdictions have issued specific securitisation laws providing for the incorporation of bankruptcy and consolidation remote SPVs. A corporate entity not benefitting from this kind of statutory backup could nevertheless be set up in such a way that the necessary requirements are met. Structured finance transactions often rely on Orphan SPVs and/or on jurisdictions that provide appropriate securitisation laws to ensure bankruptcy remoteness and non-consolidation.

### 1. Bankruptcy Remoteness

SPVs are set up as bankruptcy-remote vehicles so that the risk of insolvency proceedings being initiated against the SPV is reduced to the greatest possible extent. The importance of this feature must be considered in light of the effect an insolvency proceeding would have on the transaction. First and foremost, it affects the payment of interest and principal from the SPV to its investors, as such payments may be disallowed in an insolvency scenario in order to protect other creditors. Second, a default resulting from such a shortfall may give the investors the opportunity to enforce the security interest over the asset granted to them. That could, in turn, result in potential fire sales. Last but not least, insolvency will most likely trigger the termination of the services and other contracts the SPV has entered into and which are vital for the operation of the transaction.

The different structural elements resulting in bankruptcy remoteness can be separated into restrictions that have been contractually agreed by the transaction parties and those that limit the number of potential claimants against the SPV. These elements apply cumulatively to the structure.

#### a) Contractual restrictions

The essential contractual arrangements include limited recourse and non-petition clauses, which generally form part of any transaction document creating potential obligations for the SPV. Their purpose is to prevent the transaction parties from initiating bankruptcy proceedings against the SPV. The SPV typically grants pledges over all its assets to a trustee, for the benefit of the investor, thus reducing other creditors' incentive to file for bankruptcy. Legal opinions will typically confirm that these contractual arrangements are valid, legally binding and enforceable.

**aa) Limited recourse**

All creditors of the SPV (including the investor) agree to limit their recourse against the assets of the SPV. The limited recourse will typically be subject to the cash available under the waterfall of payments, complemented by a corresponding limitation of the termination rights so that if the cash flow does not cover the obligations towards the SPV´s creditors after application of the waterfall, it will not constitute an event of default.

**bb) Non-petition**

All creditors of an SPV (including the investor) typically agree not to file, initiate or join in any insolvency proceedings against the SPV. Given the uncertainty in some jurisdictions as to the validity of such clauses, the non-petition clause is sometimes limited to a certain time period.

**cc) Asset pledges**

Pledging the SPV's assets to a security trustee for the benefit of the investor provides the latter with recourse to the assets should this prove necessary to protect his investment. More importantly, it is crucial in the context of bankruptcy remoteness to dissuade other creditors from filing for bankruptcy. Ultimately, the investors will have priority over the proceeds from the enforcement into the assets and no significant assets to be liquidated for the benefit of other creditors should remain in the estate of the insolvent SPV.

### b) Debt limitation

The SPV must comply with the conditions listed below to ensure it does not incur obligations other than those subject to the provisions in the transaction documents. This not only limits the risk of the SPV becoming insolvent due to a mismatch of incoming and outflowing cash flows; it also ensures that the waterfall is not affected by any debt that was not initially anticipated in the structure and, finally, that no third parties are able to file for bankruptcy of the SPV. These conditions are commonly made subject to representations of the SPV which typically include amongst others the following:

- No existing debt: the SPV has no legacy obligations towards third parties in case it has not been set up explicitly for the rated transaction.
- Limitation of debt: the SPV is prohibited from incurring any debt other than that created in the transaction documents and by applicable law, including taxes. If it envisages incurring further debt, this may be capped in order to be quantifiable for the purpose of the credit risk analysis.
- Limited business purpose and powers: the SPV´s constitutional documents provide for a business object and powers that are strictly limited to the issuance of the debt and the dealings necessary to set up the transaction structure.
- No employees: the SPV is prevented from entering into commitments in connection with employment contracts including pension liabilities.
- No subsidiaries: the SPV is prohibited from creating any subsidiaries that in turn could incur obligations for which the SPV might ultimately be liable.

## 2. Non-Consolidation

Scope views consolidation risk as the threat that the SPV and/or its assets could be consolidated with (the estate of) another legal entity. This consolidation could ensue from corporate reorganisations or insolvency proceedings relating to the parent company.

### a) No corporate reorganisation

In order to prevent a corporate reorganisation from affecting the SPV or its assets, negative covenants may prevent the SPV from entering into any mergers, consolidations or other forms of corporate reorganisations. These negative covenants normally extend to ruling out dissolution, liquidation or sale of assets, although such negative covenants do not strictly address consolidation risk per se.

### b) No statutory consolidation

In certain jurisdictions the insolvency proceedings may provide for the assets of the SPV to be consolidated with the insolvency estate of the parent company. This risk is sometimes addressed by using orphan SPVs or by choosing a jurisdiction that does not allow for such consolidations. If consolidation is a threat in the applicable jurisdiction, it may, however, be mitigated by using structural elements. In this case the transaction may typically include elaborate separateness covenants and independent management provisions, etc. ensuring that the SPV will be treated by the applicable insolvency regime as a separate entity, which will not be consolidated with an insolvent parent company.

## 3. Other SPV Safeguards

While SCOPE's legal analysis focuses on bankruptcy remoteness and non-consolidation, there are further contractual safeguards that are either indispensable or at least beneficial to the overall robustness of any structured finance transaction. These include amongst others representations regarding the fulfilment of appropriate regulatory requirements, the existence of an independent management and a restriction on changes to the constitutional documents of the SPV.

### a) Necessary licences and authorisations

The SPV must have all licences and authorisations necessary to ensure that it can conduct its business in full compliance with all legal obligations and regulations. Any lack thereof could endanger the validity of the asset transfer, void other transaction documents or prompt fines from the supervisory authorities resulting in additional liabilities. The SPV documents will therefore contain adequate representations and the legal opinions may not be qualified in this regard.

### b) Independent management

The SPV is generally managed by a board that is independent from the SPV´s parent or other transaction parties. This not only prevents the board from being wrongly incentivised in its management of the SPV, but also limits the risk of a dependent manager filing for voluntary insolvency to benefit certain transaction parties or the SPV´s parent company. Depending on the capacities of the individual board members, having one independent director may suffice as long as, according to the constitutional documents, that director is able to ensure that decisions taken by the board of the SPV are not influenced by any parties to the transaction having interests contrary to the investors.

### c) No change to constitutional documents

Scope is aware that the above-mentioned necessary restrictions applying to the SPV could be subject to changes by its owners, which are generally entitled by law to amend the constitutional documents at their discretion. Scope expects this risk to be eliminated by appropriate covenants prohibiting any changes without notification to the various transaction parties and appropriate consents including, in certain cases, the approval of the investors.

## IV. Transaction Documents

Any structured finance transaction involves a number of transaction parties that are necessary for the performance of the structure. Scope would usually investigate the general documentary issues pertaining to all transaction documents and those that are relevant only to specific agreements depending on the role of the respective transaction party.

### 1. General Documentary Considerations

This paper has touched on certain provisions that Scope looks for in the transaction documents, such as specific standard representations and covenants. In addition, the legal assessment will include the following aspects of the contractual arrangement: First, Scope will consider whether the transaction documents contain all services or other actions necessary for the performance of the structure. Second, Scope verifies whether anything in these contracts negatively affects the required cash flow. Third, Scope typically checks that the agreements with the transaction parties create valid, legally binding and enforceable obligations of the transaction parties vis-à-vis the SPV. In order to confirm this, Scope requests that the legal opinion which is normally provided to the issuer covers all of the transaction documents, i.e. all contractual arrangements entered into in relation to the rated transaction.

### 2. Transaction Parties

In addition to the above general legal issues, certain legal aspects are specific to the agreements with particular transaction parties, for example the investors, agents, provider of credit enhancement.

### a) Investors

The transaction document between the issuing SPV and the investor will usually consist of a subscription agreement including the actual rated debt instrument (e.g. note). A market standard note (or its terms & conditions) contains, amongst others, the following provisions:

- Use of proceeds
- Standard representations, warranties and covenants (as partly discussed above)
- Status of the notes
- Cash-flow priority of payments
- Account definitions and allocations of moneys
- Limitation of termination rights for the SPV
- Interest payment date (possibly subject to deferrals)
- Final legal maturity (not subject to deferral)
- Decision by the noteholders, reserved to holders of rated notes with an appropriate quorum

### b) Agents

Many transaction parties provide services necessary for the performance of a structure, e.g. calculation agents, paying agents, corporate service providers and asset or investment managers. Scope considers whether the respective transaction documents demonstrate an appropriate level of commitment by these agents and whether they can be replaced with an entity providing equivalent services in terms of scope and quality depending on the importance of the particular agent for the performance of the transaction. In this regard Scope will focus, amongst others, on the following elements of these contracts:

#### aa) Liability / Standard of care

Especially in the contractual arrangements with agents performing a crucial role for a transaction, such as a collateral manager, the performance of the transaction heavily depends on the quality of the services rendered by these agents. Therefore Scope verifies whether these agreements contain liability provisions as well as the standard of care that is appropriate for such services. If the agent is entitled to subcontract his services, Scope will determine whether the agent is responsible only for the proper selection of the subcontractor, or also for the subcontractor's performance.

#### bb) Termination / Transfer

Scope may give credit to the quality and experience of key agents such as a collateral manager on condition that their contract runs until the maturity of the rated debt. This should typically be underpinned by a reasonable limitation of termination rights for these agents. Reasonable events entitling an agent to early termination are default and insolvency of the SPV, change of law and change of business of the agent. The transaction document may typically stipulate a strong replacement mechanism, which either provides for the replacement of the parting agent with an adequate successor or makes the replacement subject to investors' approval. Scope considers whether this replacement mechanism stipulates an obligation of the parting service provider to continue delivering his service until the replacement has taken over.

#### cc) Commingling risk

Commingling may occur if an agent collects cash belonging to the issuer, i.e. the SPV. In this case, initially the cash is not held by the account bank in the account of the SPV, but first collected by the agent on its own accounts. This is common practice in certain consumer credit or trade receivable securitisations where the loan originator and seller collects the payments to be made under the securitised assets for the SPV.

Commingling risk occurs when funds placed in the account of an entity are or could be commingled with funds from third parties. Should the cash collection servicer become insolvent, the risk is that the funds belonging to the SPV cannot be separated or not quickly enough to ensure the timely payment under the notes. Depending on the jurisdiction, the claim of the SPV against the collection servicer for payment of the collected amounts may be treated as an unsecured claim against the insolvency estate of the servicer. The credit risk stemming from commingling may be mitigated by creating a security interest over the account or by declaring a trust in respect to the funds held in the same. Scope also assesses the potential liquidity issues that may stem from the delays caused by enforcing these commingling mitigants in an insolvency scenario of the servicer. Short cash sweeps from the servicer to the issuer's own account, or bank guarantees reduce both the credit and liquidity risk of commingling.

### c) Provider of credit enhancement

Credit enhancement can stem either from third parties or from structural elements contained in the transaction documents. In order to give credit to credit enhancement, Scope will consider whether the agreements with the providers of credit enhancement or the structural elements are covered by a legal opinion.

#### aa) Third-party enhancement / Guarantees

Third-party credit and structural enhancement take various forms: guarantees, letters of credit, swap contracts, liquidity facilities, etc. This document focusses on guarantees as they constitute a key form of third-party credit enhancement. Guarantors provide credit enhancement to the structure by way of credit substitution. Scope will consider whether the credit risk of the guaranteed transaction party can be replaced by the credit risk of the guarantor. Credit substitution may be contemplated if the guarantee features the following characteristics:

- Irrevocable: Guarantee can not be revoked in relation to obligations entered into prior to the termination of the guarantee.
- Unconditional: The claim of the guarantee is not conditional upon the beneficiary of the guarantee having pursued his rights vis-à-vis the principal debtor or the completion of other prerequisites.

- Waiver of Defences: The guarantor forgoes the defences that the principal debtor may have against the fulfilment of the guaranteed obligation.
- Pari Passu: The guarantee ranks at least pari-passu with the other senior unsecured obligations of the guarantor.
- Beneficiaries: The guarantee is for the benefit of the SPV or the noteholders and enforceable by the same.
- Amendment/Termination: Any amendment or termination of the guarantee is typically subject to the consent of the beneficiary. The guarantee will generally provide for an obligation to notify the rating agencies of any amendments. The notification obligation will encompass any change of guarantor (e.g. by way of merger, corporate restructurings, etc.).

**bb) Structural elements**

Structural credit enhancement elements are common in structured finance transactions and include the following:

- Subordination: The claims of a junior investor are subordinated to those of a senior investor as the junior investor is paid only after satisfaction of the senior investor´s claim; thus subordinated investors absorb the first losses.
- Overcollateralisation: The value of the underlying assets exceeds the obligations under the issued notes.
- Reserve Funds: The typically junior investor or sponsor pays an amount that is not invested in the assets but is retained as a reserve to cover costs, first losses or to provide liquidity support. It may be replenished by extra cash available after the application of the cash-flow waterfall.
- Excess Interest: Any excess interest generated by the asset not paid out to the investor may be captured and used to make repayments, cover periodic losses, or be retained as a reserve to cover future payment obligations of the SPV.

## V. Taxation

Scope takes into account any liabilities originating from taxes that could affect the cash flows and hence the rating promise. Potential tax liabilities are of major concern not only because they are senior obligations by law in most jurisdictions, but also because any non-payment of taxes could result in regulatory actions affecting the SPV or the structure. The significance of tax liabilities is reflected by the fact that they usually rank senior to all of the SPV’s other payment obligations in the cash flow priority of payments.

### 1. Sources of Tax Liabilities

Tax liabilities arise for various reasons and take different forms. Scope groups these taxes according to the item they are related to.

- Taxes on the assets: Taxes may be levied in relation to the assets as withholding taxes on the payments to be made from such asset to the SPV; as VAT on the transfer of an underlying asset; or as stamp duties for the perfection of the asset transfer.
- Taxes on the SPV: Taxes may also be charged in relation to the SPV itself, i.e. the earnings of the SPV could be taxable unless the SPV is tax neutral or tax transparent. If neither is the case, taxation would not affect the structure if only the profit is subject to taxation, i.e. the earnings after deducting the cash needed to service the rated debt plus senior ranking obligations.
- Taxes on transaction parties´ payments: If the structure relies on payments of third parties, in particular providers of credit enhancement, these could be subject to taxation as well.

### 2. Tax Analysis

In most cases Scope assesses tax liabilities by requesting and relying on tax opinions. In the case of cross-border transactions, in particular, complexity could stem from tax re-characterisation or secondary tax liabilities. Tax re-characterisation is of relevance where a certain jurisdiction other than that in which the SPV is resident applies its tax regime to the SPV. This could, for instance, be the jurisdiction in which a company providing all essential services to the SPV is domiciled. Secondary tax liabilities are of relevance where the jurisdiction of a parent of the SPV would claim unpaid tax liabilities of the parent from its affiliate. Possible mitigants such as double taxation treaties governing potential cross-border taxation help to reduce taxes, but not their complexity.

However, Scope may not need to rely on external tax assessments to demonstrate that no tax obligations exist as long the relevant transaction documents contain valid, legally binding and enforceable gross-up clauses in favour of the SPV; or if the generated cash flow suffices to settle all tax claims.

Scope´s ratings do not address the potential taxes borne by an investor on his investment in the rated instrument.

## VI. Legal Opinions

In its legal review Scope will rely on external legal opinions.

The legal opinions typically confirm:

- that all transaction documents constitute valid, legally binding and enforceable obligations of the parties;
- the effectiveness of the True Sale;
- the effectiveness of SPV bankruptcy remoteness elements;
- the taxation of the underlying assets, transaction documents and the SPV.

These legal opinions may contain only the limited assumptions and qualifications that are standard for this kind of transactions. In case any of these cast doubt on the opinion, Scope will discuss the implications with the transaction counsel and the arranger of the transaction in order to assess the issues raised and better understand their implications for the robustness of the structure.

## VII. Final Remarks

Scope requests readers of these considerations on legal risks in structured finance transactions to keep the following points in mind:

### 1. Change of Law

Changes in the applicable law are one of the challenges to a legal analysis of structured finance transactions. In addition, their interpretation (e.g. in jurisprudence or administrative guidance) significantly affects the robustness of the legal elements of structured finance transactions leading to constant adjustments to the market standard documentation. Since this is an ongoing process, these legal considerations only reflect the situation at the time of their publication. This document will only be updated if these changes have a material impact on the legal considerations laid down herein.

### 2. Miscellaneous

This compendium does not constitute legal advice, nor does it represent a promise by Scope that a certain rating will be achieved if all legal aspects described herein are covered by any structure presented for a rating.

Although Scope forms its own view on the legal robustness of structured finance transactions, it acknowledges that the structures and legal elements of these transactions are driven by market participants and their legal counsels. Scope invites these parties, in particular, to contribute to the development of these legal considerations by sharing their views with Scope.

Last but not least, these legal considerations complement and should be read in conjunction with Scope´s Structured Finance Methodology as the latter may be updated from time to time.

## VIII. Disclaimer



**Scope Ratings AG**

Lennéstraße 5
10785 Berlin
T: +49 (0)30 27891-0
F: +49 (0)30 27891-100
Service: +49 (0)30 27891-300
info@scoperatings.com
**www.scoperatings.com**