

Methodology

*Legal Criteria for U.S.
Structured Finance Transactions*

SEPTEMBER 2009



Insight beyond the rating.

CONTACT INFORMATION

Claire J. Mezzanotte

Managing Director
U.S. ABS/RMBS
Tel. +1 212 806 3272
cmezzanotte@dbrs.com

Jerry van Koolbergen

Managing Director
U.S. Structured Credit
Tel. +1 212 806 3260
jvankoolbergen@dbrs.com

DBRS is a full-service credit rating agency established in 1976. Privately owned and operated without affiliation to any financial institution, DBRS is respected for its independent, third-party evaluations of corporate and government issues, spanning North America, Europe and Asia. DBRS's extensive coverage of securitizations and structured finance transactions solidifies our standing as a leading provider of comprehensive, in-depth credit analysis.

All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, Web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.

This methodology replaces and supersedes all related prior methodologies. This methodology may be replaced or amended from time to time and, therefore, DBRS recommends that readers consult www.dbrs.com for the latest version of its methodologies.



Legal Criteria for U.S. Structured Finance Transactions

TABLE OF CONTENTS

Introduction	4
Securitization Defined	4
Understanding Bankruptcy Risks	6
Special-Purpose Entities	11
Trust Indenture and Indenture Trustee	13
Credit Enhancement	16
Servicing and Collection Accounts	19
Asset-Specific Considerations	21
Conclusion	23



Introduction

Founded in Toronto in 1976, DBRS is a recognized international rating agency, providing timely and comprehensive rating opinions to the world's capital markets. Privately owned and independent, DBRS offers in-depth credit analysis of corporate, financial institution, structured finance and government issues in North America, Europe, Asia and Latin America. This publication provides greater transparency to the ratings process by outlining to market participants the principal legal criteria DBRS applies when rating a structured finance or structured credit transaction.

Structured finance is a dynamic and evolving form of debt financing. While each structured transaction is unique and new variations continue to emerge, there are a number of legal criteria common to all U.S. structured finance transactions. Financial considerations are the foundation of every credit rating, but the robustness of the legal structure is an essential part of the evaluation if the desired rating is to be assigned and retained for the duration of the transaction.

Securitization Defined

A securitization is a form of secured lending in which financial assets are pooled and used as collateral for a securities issuance in a transaction that minimizes risk through financial structuring. Securitization has many applications, although it is primarily used as a debt-financing tool for lenders or a funding tool for investors. In each case, the legal framework for securitization is similar, while the structures themselves can vary substantially.

The primary aim of securitization is the legal separation of a pool of assets (and their associated cash flows and contractual rights) from an asset seller (or Originator). This separation is achieved by transferring assets from the Originators to an entity that is created specifically for this purpose, a special-purpose entity (SPE). The SPE is designed to be independent of the liabilities and risks associated with the Originators and can therefore issue securities backed purely by the cash flows and credit strength of the assets sold to the SPE. The securities issued are often referred to as asset-backed securities (ABS).

The separation of the assets from the financial risk of the Originators is fundamental to a structured finance transaction. The assets must be transferred in a manner such that, in the event of the bankruptcy of an Originator, the assets would not be part of its bankruptcy estate or subject to an automatic stay under Title 11 of the U.S. Code (the Bankruptcy Code). The primary goal is to ensure that the assets are beyond the reach of an Originator's creditors. Bankruptcy remoteness is an essential concept in structured finance and is referred to throughout this publication. Attaining bankruptcy-remote status is dependent on the legal structure of the transaction, the transaction documentation, the relationship between an Originator and the SPE and the relevant laws of the applicable jurisdiction or jurisdictions. Consequently, these elements are a focus of DBRS's legal criteria for structured finance.

While bankruptcy remoteness is one essential factor in the DBRS legal criteria, it is not the only consideration. The DBRS legal criteria seeks to ensure that the structure of a transaction protects holders of ABS and sufficient resources are always available to allow the SPE to meet its obligations under the DBRS-rated ABS (the Rated Securities). DBRS's review of legal criteria addresses various other issues that may arise during the life of the transaction, such as the proper servicing of the assets and collection of the cash flows they generate. The legal structure is also reviewed to confirm that insolvency, legal status or existence of claims against any entity involved in the transaction do not threaten cash flow to rated security holders.



SECURITIZATION: A FINANCING TOOL FOR LENDERS

There are a number of options available to businesses¹ seeking funding to support their ongoing operations or expansions. These range from various forms of borrowings, such as bank loans and credit facilities, to issuing equity to investors. One common method of acquiring funding by way of borrowing is by issuing debt securities. A number of factors make debt issuance an attractive option. Unlike creditors under some bank loans or credit facilities, corporate bond holders maintain an unsecured claim on assets of the corporation. Loans and credit facilities can often be called on demand by the lender, while there are limited circumstances in which bond holders can demand payment in full before the scheduled maturity of their bonds. Unlike purchasers of equity, bond holders do not hold an ownership stake in the firm and, therefore, have no right to appoint directors or otherwise direct the management of the firm. Nor does the issuance of debt dilute the interest of equity holders. In addition, unlike dividends paid to equity holders, interest paid to bond holders is typically a tax-deductible expense of the corporation.

The decision to issue debt is often driven by the funding cost to the corporation. In simple terms, funding cost refers to the rate of interest that investors will demand in order to lend the corporation money through the purchase of its debt securities. An important factor in determining funding cost is the corporation's credit rating. Credit rating organizations such as DBRS analyze a company's financial information, management expertise, market position and a number of other factors to assign a credit rating. The credit rating reflects the credit rating organization's opinion as to the corporation's ability to pay interest and principal on their debt securities. The higher a firm's credit rating, the more likely it will pay its debt securities in accordance with their terms (in the opinion of the credit rating organization). Typically, the higher the likelihood of payment (as communicated through the credit rating) the lower interest rate demanded by investors for purchase of the corporation's debt securities, and hence, the lower the corporation's funding cost.

A number of factors make securitization an attractive option for companies seeking to raise debt financing: (1) the SPE insulates the assets and the related ABS from the operating risks, general liabilities and creditors, including a trustee in bankruptcy, of an Originator allowing the debt issued by the SPE to obtain a credit rating that is higher than the related Originator; (2) because of the credit rating of the ABS debt, the SPE can often access capital at a more attractive funding cost than can be obtained on the basis of an Originator's own credit if it were to issue debt directly; (3) by selling assets to an SPE, an Originator can move the assets off its balance sheet for accounting purposes, resulting in lower regulatory capital requirements for certain regulated entities; and (4) securitization allows Originators to diversify their funding sources.

SATISFYING DBRS LEGAL CRITERIA

DBRS reviews each transaction and the transaction documentation to determine if the DBRS legal criteria are satisfied. Satisfaction of the legal criteria outlined in this publication can be evidenced in a number of ways. Certificates of officers of the involved entities will attest to the existence of certain factual matters. Counsel for an Originator and SPE must provide opinions opining on the likelihood of certain legal outcomes. While certificates and opinions provide tangible items of support, some elements of DBRS legal criteria can only be satisfied by the structure of and safeguards built into the transaction. For this reason, DBRS examines the transaction and its documentation in its entirety in order to determine that the legal elements are appropriate for the desired rating.

While the fundamentals of securitization remain the same regardless of asset class, each asset class exhibits its own nuances and particular requirements. Consequently, this publication can not be read in isolation, but should be read in conjunction with, and as a complement to, the methodologies and criteria DBRS publishes on various structured finance asset classes.

¹ While sovereigns and their agencies also issue asset-backed securities, when discussing financing, this publication focuses on the issuance of ABS for corporate financing purposes.



Understanding Bankruptcy Risks

The avoidance of bankruptcy risk is a central purpose of any structured finance transaction. If the benefits of securitization are to be realized, the assets transferred to the SPE must be isolated from bankruptcy risk of any party to the transaction. In particular for financing transactions, the SPE must be isolated from bankruptcy risk of an Originator.

Bankruptcy risks arise in a structured finance transaction: (1) upon the transfer of the assets from an Originator to the SPE, which is the focus of this section; (2) by the formation and conduct of the SPE, which is the focus of the next section; and (3) from the SPE's relationships with third parties such as trustees and financial institutions, which are addressed throughout this publication. Each of the following sections also highlight the relevant bankruptcy law as it typically relates to DBRS-rated transactions.

With certain exceptions, an Originator experiencing seriously deteriorating financial conditions may file a petition seeking protection under the Bankruptcy Code or, in some cases, creditors of an Originator may file a petition to have an Originator declared insolvent under the Bankruptcy Code. If a petition is filed, the bankruptcy court will appoint a trustee in bankruptcy to administer over the bankruptcy proceedings and organize the bankruptcy estate. The trustee in bankruptcy is also responsible for determining the assets owned by the Originator and maximizing the bankruptcy estate for the benefit of all creditors of a debtor. In order to permit the trustee in bankruptcy to carry out its duties, an automatic stay period follows the filing of a bankruptcy petition. The automatic stay prevents creditors from collecting from a debtor and the commencement (or continuation) of any action to seek payment or obtain property from the debtor, other than through the debtor's bankruptcy proceedings. The bankruptcy court will accept claims from secured creditors and unsecured creditors, and the trustee in bankruptcy will endeavor to allocate assets, first to secured parties with valid claims and then to unsecured creditors with valid claims. As a result, significant care must be taken to ensure that the holders of ABS are secured creditors only of the related SPE and that, if either an Originator or a parent of such Originator were to become a debtor under the Bankruptcy Code, neither the related pool of assets will be included in the debtor's bankruptcy estate nor will the holders of ABS be treated as creditors of the debtor.

TRUE SALE

One of the most important requirements of a securitization is the transfer of the assets from an Originator to the SPE. This transfer must be conducted in a manner sufficient to achieve the goal of removing the assets from the potential bankruptcy estate of an Originator. Typically, such removal requires a true sale from an Originator to the SPE. The transfer may be directly from an Originator to the SPE, which will issue the ABS (a one-step transaction), or there may be an intermediate transfer to another SPE before the assets are transferred to the SPE issuing the ABS (a two-step transaction). In the case of a one-step or a two-step transaction, each transfer must be on a true sale basis.

To ensure that a bankruptcy court would respect the transfer of assets as a true sale, the transfer must be a true sale in both form and substance. The form of the transaction should describe the transfer as a sale and not as a transfer in exchange for security, and the substance of the transaction should successfully transfer all legal and equitable interests held by an Originator to the SPE.

In determining whether a transfer of assets is on a true sale basis, some courts look to the form of the transaction to determine whether a transfer more resembles a sale than a pledge to secure a debt, often looking to the "intent" of the parties. Other courts have analyzed the substance of the transaction to determine whether the seller has transferred the benefits and burdens of ownership for a price that represents a fair market value of the transferred assets. Some of the factors the courts will consider include:

- Intent and Conduct of the Parties: How has the transaction been characterized by the parties in the



transaction documents? Does the language of the documentation express a clear intention that the transfer be treated as a true sale or, rather, as a pledge of security for a loan?

- Accounting and Tax Treatment: In their accounting records and tax filings, have the parties treated the transaction as a true sale?
- Servicing and Commingling: Will an Originator continue to service the assets and interact with obligors? If so, will collections from obligors be commingled with other funds of such Originator?
- Control of the Assets: Does an Originator retain control over the assets and the right to modify the contracts with obligors?
- Economic Benefits: Does an Originator retain an option to repurchase the assets? Is the purchase price fixed at the time of sale, or can it change because of events occurring after the sale or can such Originator demand payment of collections on the assets in excess of those originally considered in the purchase price?
- Risk of Loss: Which party bears the risk of loss on uncollectible assets?

The court will evaluate these factors and determine if the sale was valid or if recharacterization of the sale as a loan is appropriate. If the transfer can be characterized as a loan transaction, with the assets being transferred to provide security, an Originator will retain an interest. If an Originator were to retain an interest, upon its bankruptcy, that interest could form part of its bankruptcy estate per Section 541(a) of the Bankruptcy Code. As part of the bankruptcy estate, the assets could also be subject to the automatic stay provision of Section 362 of the Bankruptcy Code, thereby preventing collections on the assets and affecting cash flow to the holders of the Rated Securities. To provide some protection in the event of a recharacterization, the sale agreement will often include the grant of a back-up security interest to the SPE to allow the SPE to perfect its interest in the collateral. Without perfection, the assets held as collateral by the SPE could be included as part of an Originator's bankruptcy estate, and no longer be available as security for the ABS.

To gain comfort that the transfer of the assets from an Originator to the SPE would constitute a true sale, DBRS requests a legal opinion, usually referred to as a true sale opinion or a bankruptcy opinion. The opinion will review relevant statute and case law (in relation to the above points), provide a reasoned analysis of each of these considerations in light of the circumstance and context of the transaction, and opine on the likelihood of certain true sale matters. At a minimum, the opinion should state that upon the bankruptcy of an Originator (or other transferor), a court would determine that (1) the transfer of the assets would be characterized as a true sale for bankruptcy purposes (2) the assets would not form property of an Originator's estate per Section 541 of the Bankruptcy Code and (3) collections on the underlying assets would not be stayed per Section 362(a) of the Bankruptcy Code.

In instances where the transfer of the assets to the SPE is a two-step transaction, the opinion should address each respective transfer.

Springing True Sale

In certain circumstances, it may not be possible to obtain a true sale opinion that is effective as of the closing date of the transaction. True sale opinions usually rely on an assumption that the Rated Securities will be sold on the closing date to unaffiliated third parties that act at arm's length from an Originator. This assumption generally satisfies the requirement that an Originator does not retain an interest in the transferred assets. If a sufficient percentage of Rated Securities cannot be sold to third parties on the closing date due to market conditions, or as a result of the Originator retaining most or all of the securities for other reasons, a springing true sale opinion may be provided. A springing true sale opinion becomes effective only when a given percentage of Rated Securities have been sold to third parties.

DBRS considers on a case-by-case basis the efficacy of a springing true sale opinion.

True Sale – FDIC Originators

Certain financial institutions are not eligible to become debtors under the Bankruptcy Code. Instead, national banks, federal savings associations and certain state depository institutions that are insured under the Federal



Deposit Insurance Act are subject to the appointment of the Federal Deposit Insurance Corporation (FDIC), the primary federal bank regulator of an FDIC-insured bank, as a receiver or conservator. Institutions subject to the appointment of the FDIC as conservator or receiver are referred to as FDIC Originators.

The true sale opinion referred to above is intended to provide comfort that, in the event of an insolvency of an Originator, the transferred assets would not form a part of such Originator's conservatorship and would therefore be beyond the reach of any conservator appointed with respect to such Originator. In a structured finance transaction with an FDIC Originator, DBRS similarly requests comfort that, in the event of an insolvency of the FDIC Originator, the assets transferred to the SPE would not form a part of the FDIC Originator's conservatorship and would therefore be beyond the reach of the FDIC acting as receiver or conservator.

If the FDIC is appointed as a receiver or conservator of a depository institution, the FDIC succeeds to all rights, powers and assets of the depository institution. The factors for determining whether the assets were subject to a true sale is similar to those for a transfer of assets by a non-FDIC Originator that is a debtor under the Bankruptcy Code. Also similar to a non-FDIC Originator transaction, a true sale opinion is requested and should state that the FDIC will not reclaim, recover or recharacterize the assets transferred by an FDIC Originator comparable to the non-FDIC Originator true sale opinion described above.

As an alternative to a traditional non-FDIC Originator true sale opinion, DBRS would also generally accept an opinion that states that the transaction would fall under the FDIC's Non-Repudiation Rule, Resolution and Receivership Rules, 12 C.F.R. §360.6 (2005). This regulation, entitled "The Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred in Connection with a Securitization or Participation," provides that the FDIC shall not, by exercise of its authority to disaffirm or repudiate contracts, reclaim, recover or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution in connection with a securitization or participation, provided that the transfer meets certain conditions. These conditions can be summarized as follows:

- The transaction falls under the definition of "securitization" or "participation" given in the regulation.
- The transfer meets all conditions for sale accounting treatment under generally accepted accounting principles, other than the "legal isolation" condition.
- The insured depository institution receives adequate consideration for the transfer of the assets at the time of the transfer.
- The transaction documentation reflects the intent of the parties to treat the transaction as a sale and not a secured borrowing.

The opinion, usually referred to as an FDIC Non-Repudiation Rule opinion, should state that the Non-Repudiation Rule applies to the transfer of the assets and that the FDIC would not reclaim, recover or recharacterize the transferred assets. This opinion is only appropriate where an Originator is an FDIC-insured bank.

Springing True Sale – FDIC Originator

Where a springing true sale, or FDIC Non-Repudiation Rule, opinion is given in the context of an FDIC Originator, DBRS typically seeks additional legal comfort from a security interest opinion. Such an opinion would typically state that, in the event the transfer of assets was determined by a court to be a loan and not a true sale, the FDIC would determine that the transfers and documentation had created a valid security interest in the assets for the benefit of the SPE and that the FDIC would not seek to set aside or avoid the security interest.

NON-CONSOLIDATION

As set forth previously, the purpose of using an SPE to issue ABS is to separate the risks associated with a pool of assets from any entity that previously owned the assets. The objective is to have the SPE and the assets be free from the liabilities and risks associated with an Originator, so that the cash flows and credit strength of the assets exclusively support the ABS.



Substantive consolidation is an equitable doctrine that allows a bankruptcy court, in applicable circumstances, to disregard the separate legal existence of two or more entities and treat them as one entity for bankruptcy purposes. In the event that a parent and subsidiary fail to respect the separateness of the entities in their operations, governance, administration or organizational formalities, a court may apply the doctrine of substantive consolidation under extraordinary circumstances. This allows the creditors of each entity to reach the assets of the entire consolidated estate. As this is an equitable power, it does not arise from the Bankruptcy Code or state law, but rather from the general equitable and discretionary powers of the bankruptcy court. In a structured finance transaction, safeguards must be in place and the transaction arranged to minimize the possibility of the SPE's assets being consolidated with those of an Originator in the event of such Originator's bankruptcy.

Although there is no clear test that bankruptcy courts apply in determining whether substantive consolidation is appropriate, case law has identified certain factors that will be considered. These factors include the following:

- **Common Ownership or Control:** If both entities share a common owner or are under common control, the likelihood of consolidation increases.
- **Common Directors (Where Both Entities Are Corporate):** An SPE that shares its board of directors with an Originator is more likely to be consolidated.
- **Accounting and Tax Treatment:** Are tax returns and accounting statements filed on a consolidated basis? If so, consolidation is more likely.
- **Existence of Inter-Corporate Loan Guarantees:** Each entity should stand on its own for purposes of obtaining credit.
- **Commingling of Assets and Business Functions:** Are each entity's assets kept separate, or are they so entwined as to make separation impossible or impractical?
- **Existence of Asset Transfers between the Entities without Observance of Corporate Formalities:** Failure to maintain corporate formalities will increase the probability of consolidation.
- **Prejudice to Creditors and Economic Benefits:** The court will consider the benefits to the debtor of consolidation and the prejudice that may arise to creditors.
- **Separateness in Form and Substance:** Do the entities maintain separate books, records and accounts; use separate stationery, invoices and checks; hold themselves out as separate entities; conduct business in their own respective names; pay liabilities out of their own respective funds; and maintain adequate capital in light of their respective contemplated businesses?

In addition to these elements, courts look to the reasonableness of consolidation in light of all of the circumstances. The benefits of consolidation are weighed against the material harm that may result for one or more creditors. While substantive consolidation is often referred to as an extraordinary remedy, case law demonstrates that it is available and that courts will order consolidation in appropriate circumstances.

To obtain comfort that, in the event of the bankruptcy of an Originator, the SPE and its assets would not be consolidated with such Originator, DBRS requests a legal opinion to this effect, often referred to as a non-consolidation opinion. The opinion is customarily a reasoned opinion, usually reviewing case law in relation to the above points and providing an analysis of each of these considerations in light of the circumstance and context of the transaction. The opinion should conclude that upon the bankruptcy of an Originator, a bankruptcy court would not substantively consolidate the assets and liabilities of the SPE with those of such Originator.

In practice, a true sale and non-consolidation opinion are often contained in the same legal opinion.

The doctrine of substantive consolidation should be distinguished from the doctrine of procedural consolidation, which relates only to the joint administration of related debtors pending in the same court. Procedural consolidation is a tool by which a bankruptcy court may allow separate, but related, entities to file a bankruptcy petition on a consolidated basis. One stay order can freeze the claims of creditors and



cash flows in all related entities comprising a group. Procedural consolidation differs from substantive consolidation in that it is initiated by the bankrupt entity(ies), as opposed to creditors, with individual creditors classified separately for voting purposes on the restructuring proposals of the bankrupt entity(ies).

Ordinarily, solvent entities should not be included in a filing, but an insolvent debtor may have strategic reasons to include them. The debtor may try to use cash from healthy entities to assist weak entities and may try to capture as many entities as possible in the filing. Alternatively, the creditors may have to prove that an entity purporting to be insolvent is really solvent, which can be quite difficult to accomplish.

Procedural consolidation is difficult to fight in the initial stages and can cause substantial problems and uncertainties for secured creditors. In addition, where an Originator acts as a servicer of the securitized assets or has a significant interest in deferred revenue in a transaction, an Originator may try to use reorganization proceedings to modify cash flows from the transaction to the detriment of the Rated Securities. Because of the wide discretionary powers available to the bankruptcy courts, this risk is difficult to mitigate. An attempted procedural consolidation by an Originator would require the SPE and representatives of the holders of the Rated Securities to become involved in the bankruptcy proceedings to ensure that the transaction is not rewritten to their detriment.

PREFERENCES

Section 547 of the Bankruptcy Code allows a debtor's trustee in bankruptcy to avoid any transfer to a creditor of an interest in property of the debtor that was made (1) when the debtor was insolvent, (2) 90 days before the filing of the bankruptcy petition or (3) up to one year before the filing of the petition if the creditor was an insider. The intention of this section is to protect creditors from a debtor who, sensing it is close to insolvency, makes payments with the intention of placing selected creditors in a preferential position to other creditors. Avoidance for preference enables the creditor to receive more than it would have in a bankruptcy or liquidation had the transfer not been made. Arm's length transactions made in the ordinary course of business will not be subject to avoidance for preference.

As support that the transfer of assets from an Originator to the SPE will not be avoided as preferential per Section 547 of the Bankruptcy Code, DBRS requests a certificate from an officer of an Originator to the effect that, as of the closing date of the transaction, such Originator was not insolvent, and the consummation of the transaction will not result in such Originator's insolvency.

NON-MONEYED ORIGINATORS

Debtors find themselves in a bankruptcy proceeding under the Bankruptcy Code by one of two routes. A debtor can voluntarily seek bankruptcy protection by making an assignment in bankruptcy, or it can be involuntarily petitioned into bankruptcy by its creditors. However, not all Originators are subject to an involuntary filing. The Bankruptcy Code contains several requirements for commencing an involuntary bankruptcy case against a debtor. The Bankruptcy Code states, "An involuntary case may be commenced only under chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation, that may be a debtor under the chapter under which such case is commenced."

For transactions in which an Originator is not a moneyed, business or commercial corporation (e.g., some student loan transactions), DBRS does not request a true sale opinion. Instead, DBRS requests an opinion of counsel to the effect that such Originator would not be deemed a moneyed, business or commercial corporation susceptible to an involuntary bankruptcy petition under the Bankruptcy Code.



Special-Purpose Entities

The special-purpose entity is a vital element in a structured finance transaction. It is the innovation that allows the credit risk of an Originator to be separated from that of the assets. An SPE purchases the assets from an Originator(s), and it is an SPE that issues the Rated Securities. Given their pivotal role, SPEs must be structured carefully to isolate the assets from the bankruptcy risks of any Originator. To make an SPE bankruptcy remote, it must be created with limitations that eliminate the risk that the SPE might file for bankruptcy and the risk that it may be consolidated with a parent that filed for bankruptcy. These limitations include restrictions against holding other assets and engaging in other activities that could attract liability or additional risk.

FORMS OF SPEs

There are a number of legal structures available for utilization as an SPE. These include grantor and owner trusts, financial asset securitization investment trusts (FASITs), real estate mortgage investment conduits (REMICs), limited liability partnerships (LLPs) and limited liability corporations (LLCs). Transaction parties will select the structure that best suits their needs and the objectives of the transaction. In many instances, the choice of structure will be driven by the desire to obtain pass-through treatment that does not result in tax liability at the SPE level.

Regardless of the structure chosen, bankruptcy remoteness is a prerequisite of any SPE and a characteristic that must be present in order for DBRS to rate a transaction. An SPE is considered bankruptcy remote not only when it is bankruptcy remote from an Originator(s), as considered previously, but also when it and the assets it holds cannot be affected by the bankruptcy of any party to the transaction or claims of the creditors of any party to the transaction, and when the possibility of its own bankruptcy is properly limited.

NECESSARY CHARACTERISTICS OF AN SPE

In order to obtain comfort that the SPE is a bankruptcy remote entity, DBRS requests that SPEs display certain characteristics. These characteristics generally fall into two categories:

- (1) Those intended to ensure that the SPE does not engage in any activities, or make any changes in its organizational structure, that could (a) produce creditors other than the owners of the Rated Securities and certain related parties or (b) put the assets or the credit rating of the Rated Securities at risk.
- (2) Those intended to ensure that the SPE maintains an identity independent from that of an Originator.

ACTIVITIES AND CHANGES THAT COULD PUT ASSETS AT RISK

Structured finance transactions can obtain a better credit rating than a financing on an Originator's own credit partly because the SPE issuing the securities has no existing creditors. In order to avoid the SPE having multiple creditors, the SPE should be prohibited from engaging in any activities that are likely to produce creditors other than the investors in the Rated Securities and certain related parties. In addition, the circumstances and legal relationships involved in the transaction can be specifically tailored in the transaction documentation to ensure that these relationships and circumstances do not change while the Rated Securities remain outstanding.

LIMITED POWERS

The SPE's organizing documents, be they a declaration of trust, a limited partnership agreement or articles of incorporation, set forth the powers and capacities of the SPE and set limits on the SPE's activities. The organizing documents should limit the SPE to those activities that are necessary to carry out the transaction. Curtailing the SPE's powers must be done carefully to ensure it maintains the power needed to enforce its rights and perform its obligations under the securitization documents.



DEBT LIMITATION

The SPE's ability to issue additional ABS must be subject to prior written notice in order to enable DBRS to evaluate whether such issuance would affect the current outstanding Rated Securities. Additional credit enhancement or other mitigating measures that protect the interests of security holders in these situations may be warranted. The SPE should be prohibited from guaranteeing any other entity's obligations or pledging the assets to secure any other entity's debts since such pledges or guarantees could result in claims against the assets and compromise the independent existence of the SPE. This risk would be particularly acute in cases where the SPE guarantees debt of an Originator.

NO MERGER OR REORGANIZATION

The trust indenture, pooling agreement or related financial instrument governing the Rated Securities should contain restrictions on the ability of the SPE to merge or otherwise join with another entity because the Rated Securities may be affected by the credit of the merged SPE. DBRS requests prior notice of changes to the SPE's organizing documents while Rated Securities are outstanding.

TAX NEUTRALITY

The principal tax concern in any securitization transaction is the avoidance of any entity-level tax on the securitization vehicle. Any tax liability incurred by the issuer could erode assets that are available for meeting the obligations of the Rated Securities. A tax liability can potentially arise from a tax on the income of the SPE and/or a tax on the transfer of the assets. As discussed above, DBRS expects that the form of SPE used results in no tax liability being incurred at the SPE level. DBRS generally requests a tax opinion to this effect in circumstances where DBRS is concerned that tax liability may be transferred to the SPE along with the assets or otherwise be imposed on the SPE.

IDENTITY INDEPENDENT FROM THAT OF AN ORIGINATOR

As set forth previously, the structure and operations of the SPE must ensure that a court would respect its legal separateness and not "substantively consolidate" the SPE with its parent or affiliate. Although case law has identified various factors to be applied in determining separateness, a well-recognized set of principles has developed for maintaining separateness of two affiliated entities, and DBRS maintains the criteria listed below.

Independent Director/Members

An Originator should not be in a position to control the activities of the SPE. This is especially so with respect to any decision by the SPE to make a voluntary filing under the Bankruptcy Code. There may be an incentive for an Originator experiencing financial difficulty to have an SPE it controls make a bankruptcy filing in order to gain access to the SPE's assets.

In order to protect against this possibility, DBRS requests that the board of directors of a corporate SPE contain at least one independent director or the membership of a LLC contain at least one independent member. The vote of the independent director or member will be required in order for the SPE to make a bankruptcy filing or in order for the SPE to amend its organizing documents. In casting its vote, the independent director or member will be required by the organizing documents to vote in the best interests of the SPE and its security holders.

The definition of "independent director" (or "independent member") found in the SPE's organizing documents must ensure that the individual appointed is not an employee of or otherwise affiliated with an Originator. Persons who had been employed by or associated with an Originator within a given number of previous years (usually 2-5 years) are also ineligible.

Maintain Existence

The SPE's organic documents must contain provisions that the SPE cannot be terminated while Rated Securities remain outstanding. The vote of the independent director should also be required to dissolve



the SPE.

Separateness Covenants

To ensure the separate identity of the SPE, the formation documents should contain a number of separateness covenants that restrict the SPE from engaging in certain activities while requiring it to engage in others. For example, the SPE must:

- Maintain its accounts, books and financial statements separately from any other entity.
- Maintain its own office space, letterhead and stationery.
- Pay its own expenses and liabilities out of its own funds.
- Observe all formalities of its organizing documents.
- Conduct business in its own name and maintain an arm's-length relationship with Originators.
- Maintain adequate capital to meet its operational needs.
- Refrain from acquiring any interest in any Originator.

Minimal Unsecured Assets

The SPE should acquire no assets other than those transferred which should be limited to those assets necessary to carry out its functions under the transaction documents. This restriction prevents the SPE from having multiple creditors and makes it less attractive to creditors of an Originator or other parties to the transaction. The trust indenture, pooling agreement or related financial instrument should provide that all assets related to a pool of collateral are pledged to secure the Rated Securities. This ensures that all claims are secured claims governed by the priorities of the related financial document and no benefit exists for any person to advance unsecured claims.

Non-Petition Clauses

The transaction may necessitate the SPE entering into agreements with a number of third parties, including credit enhancers, liquidity lenders and swap counterparties. To the extent that such agreements create obligations, the third party becomes a creditor of the SPE. DBRS therefore requests that third-party agreements contain non-petition clauses whereby the third party agrees not to petition the SPE into bankruptcy.

Trust Indenture and Indenture Trustee

A trust indenture is the transaction document that governs the issuance of debt and contains many of the covenants which provide rights and protections for security holders. The trust indenture creates security over the assets of the SPE, defines certain restrictions on the SPE's operations and financing activities, assigns the relative priority ranking of the Rated Securities in the payment of obligations, and enumerates the rights and remedies that are available to security holders and specified creditors under the trust indenture.

THE INDENTURE TRUSTEE

Under the trust indenture the SPE appoints an indenture trustee to act as agent for the security holders and other specified creditors. In addition to being empowered to enforce their rights, the indenture trustee serves an administrative function, collecting any funds due the security holders, registering interests of holders of the ABS and distributing those funds each in accordance with the terms of the trust indenture. This function may also be delegated to an issuing and paying agent.

DBRS criteria for indenture trustees are summarized below:

- The Indenture trustee holds a short-term rating of R-1 (low) and long-term rating of BBB (high). This rating criterion is applied consistently to any other financial services agent, such as a calculation agent or paying agency.



- The indenture trustee should be independent and act at arm's length from the SPE.
- The indenture trustee must be legally entitled to act as an indenture trustee in each relevant jurisdiction.
- The indenture trustee must contain provisions to replace the indenture trustee and stipulate that the indenture trustee cannot resign until a replacement has assumed its responsibilities. Prior written notice shall be given to DBRS regarding replacing the indenture trustee.
- There must be no commingling of funds held in trust for the security holders with personal funds of the indenture trustee. Designated trust accounts must be maintained and controlled by the indenture trustee for the benefit of the holders of the ABS in accordance with Article 9 of the Uniform Commercial Code (UCC).

SECURITY INTEREST AND SECURITY INTEREST OPINION

The SPE must grant a security interest in all assets pledged under the trust indenture to the indenture trustee for the benefit of the security holders and specified creditors. DBRS requests an opinion that the security interest has been validly created and that, based on a certificate provided by an officer of the servicer and the actions described in the opinion, all necessary steps have been taken to perfect the indenture trustee's security interest in the assets. Typically, the SPE is not permitted to grant any security interests in assets it holds, except pursuant to the trust indenture.

COVENANTS

Covenants in the trust indenture are promises by parties to the trust indenture, in this case the SPE, to perform or not to perform certain acts to protect the interests of the security holders. Covenants typically restrain the issuance of new debt, restrict the amount of prior ranking indebtedness that may be issued and govern asset acquisitions, asset dispositions, mergers and consolidations. In the event that the SPE fails to perform a covenant, the indenture trustee should be authorized to perform the covenant on its behalf if capable of doing so.

The following covenants can be considered boiler-plate covenants as they are common to almost all trust indentures seen in structured finance. While DBRS reviews the trust indenture for the inclusion of these covenants, the following should be seen as an illustrative not an exhaustive list. The necessity, or lack thereof, of any particular covenant is determined on a case-by-case basis.

Positive Covenants

The SPE undertakes to do the following:

- Pay interest and principal on the Rated Securities when due and punctually pay all secured creditors and transaction parties in the manner provided for in the transaction documents.
- Maintain and protect the collateral, the trust property and assets.
- Do all things necessary to maintain the existence of the SPE under the laws of all applicable jurisdictions.
- Comply with all relevant laws and regulations.
- Pay all applicable taxes and fees levied by governments.
- Take all actions necessary to establish and maintain the rights of secured parties under the trust indenture in connection with the granting of security interest; for example, executing and delivering future financing statements.
- Pay the reasonable fees and expenses of the indenture trustee.
- Appoint successors for terminated or resigned third parties, including servicers and credit enhancement providers, in a timely manner.
- Deliver information to the indenture trustee and rating agencies.
- Deliver audited financial statements to rating agencies in a timely manner following the end of each fiscal year.
- Notify the indenture trustee and rating agencies of any change of name or address of the indenture trustee or the SPE.
- Take all steps necessary to register and renew any financing statements or other instruments that are required to preserve and protect the security interest of the indenture trustee.
- Promptly notify the indenture trustee of any agreement that would give rise to a secured creditor.



- Ensure no timing mismatch of asset and liability maturities.

Negative Covenants

The SPE is not to undertake any of the following:

- Sell or dispose of the assets other than for fair market value.
- Engage in any activity other than those contemplated by the trust indenture and the transaction documents.
- Permit the assets to be impaired or permit the validity or effectiveness of security created by the trust indenture to be impaired or amended.
- Create encumbrances on the trust property.
- Take any steps to release any security or guarantee with respect to the assets.
- Amend program agreements or grant any waiver if such amendment or waiver could reasonably be expected to be prejudicial to creditors.
- Consent to the resignation of certain service providers to the SPE, prior to the appointment of a replacement as set forth under the terms of the transaction documents.
- Enter into any secured lending agreement, acquire an asset-backed security, enter into any credit-default transaction or increase the size of any such transaction unless all consents have been provided by required parties in addition to providing DBRS with prior written notice of any such action.

PAYMENT PRIORITIES

A typical trust indenture includes an article that outlines the priority of payments for creditors and transaction parties, and grants rights to the security holders to enforce their security. These provisions are referred to as the payment priority section, or the waterfall.

The priority in which security holders will be paid is an essential consideration in the credit rating process. Amounts payable to service providers to the SPE that rank senior in priority to payment to Rated Securities must be a pre-determined amount or capped. Any fees or indemnities to servicers, trustees or other service providers granted by the SPE that exceed such pre-determined or capped amount must rank below payment of principal on the Rated Securities. In the case of revolving debt that is issued under the trust indenture and the related asset-backed commercial paper (ABCP), any payments senior in priority to holders of Rated Securities must be subject to excess funds language. Excess funds language is designed to ensure that sufficient funds are available to pay security holders after the payment of prior ranking obligations.

EVENTS OF DEFAULT

The trust indenture outlines events of default. An event of default allows the enforcement of the security interest granted under the trust indenture and any other remedies available to the secured parties under the transaction documents. Enforcement of the security interest is not automatic upon the occurrence of the event, and are subject to cure periods set forth in the trust indenture during which the event can be cured and thus deemed not to have happened. DBRS maintains standards with respect to cure periods. An event of default as a result of a non-payment to security holders should be cured within 3 to 5 business days. The indenture may also provide for an event of default if the security interest granted to the indenture trustee is impaired and not cured within 10 to 20 days. Generally, other events should be cured within 30 to 60 business days.

The SPE has the ability to waive events of default in certain circumstances. If 662/3 of security holders approve of the waiver by way of extraordinary resolution, DBRS requests notice of the waiver. In instances where the event of default is determined to be non-material to the SPE's ability to meet its obligations to security holders, as evidenced by a legal opinion to this effect, DBRS requests notice of the waiver and to be an addressee of the related legal opinion.

ENFORCEABILITY BY HOLDERS OF THE RATED SECURITIES

The trust indenture must give security holders the right to enforce the terms and covenants of the trust



indenture. This right is vested in the indenture trustee for the benefit of the security holders and authorize the indenture trustee to bring an action on behalf of security holders.

While DBRS insists that the indenture trustee (on behalf of the security holders) have a right of enforcement, it must be recognized that in practice this right is difficult to exercise. Enforcement of the trust indenture usually requires approval by a certain percentage of security holders, with a super majority of 662/3 of security holders typically the minimum approval percentage being required. This can present a significant obstacle if a prompt action is necessary. Courts seek confirmation that the indenture trustee has complied with the procedural steps outlined in the trust indenture for the enforcement of remedies. Once an action is commenced, the subsequent litigation is often characterized by significant time delays, high costs and an uncertain outcome.

INDEMNITIES

The trust indenture contains provisions whereby the SPE indemnifies the indenture trustee for liability arising out of actions taken in connection with its responsibilities under the trust indenture and other transaction documents. Such indemnification is subject to the proviso that the liability must arise from actions that were taken by the indenture trustee in good faith. Liability arising from willful misconduct or bad faith is specifically exempted. The indemnification is paid solely from the trust property and survives the termination of the trust indenture or the early resignation or removal of the indenture trustee. A similar indemnity could also be granted to other transaction parties such as a financial services agent. In all cases, indemnities that are uncapped should be junior to the priority or payment to interest and principal on the Rated Securities.

DELEGATION OF AUTHORITY

The indenture trustee can, under certain conditions, delegate responsibility for some of its obligations under the trust indenture to a third party. Delegations considered to be in the ordinary course of business do not need to be reviewed by DBRS. DBRS requests prior written notice regarding delegations outside of the normal course of business. While delegation may be permitted, the indenture trustee will remain responsible for its obligations under the trust indenture.

AMENDMENTS TO THE TRUST INDENTURE

Since the trust indenture controls many of the structured elements of a securitization, DBRS expects satisfaction that any amendments to the trust indenture will not have a negative impact on security holders. To obtain this comfort, DBRS requests that any amendment to the trust indenture or any other material transaction document be subject to the same notice provisions applicable to a waiver of an event of default.

RATING AGENCY CONDITION OR NOTICE

Rating Agency Condition may be a defined term in transaction documents that requires that DBRS confirm in writing that no negative rating action will result from a certain action or that prior written notice be delivered to DBRS. Actions subject to the Rating Agency Condition involve a material change in some element of the transaction. DBRS prefers to receive prior written notice of any material changes to transaction documents or parties to evaluate the impact of the change on our outstanding ratings.

Credit Enhancement

A vital structural element of each transaction is the level of credit enhancement or credit protection provided to holders of Rated Securities. The provision of credit enhancement is one of the primary elements of a securitization that allows the credit rating of the Rated Securities to exceed that of an Originator. Enhancement can take several forms, each with distinct advantages and disadvantages. Of



significant and, in some cases, overriding importance is the composition of such enhancement. Forms of credit enhancement used in DBRS-rated structured finance transactions include, but are not limited to, overcollateralization, excess spread, the holding of cash and securities as reserve funds, letters of credit, insurance policies, swap agreements and, in some cases, guarantees.

This publication addresses the forms of credit enhancement that are most often seen in a structured finance context. Some of these raise legal issues, while others are generally less legally sensitive. While this publication does not attempt to address all possible forms of credit enhancement, the following sections describe credit enhancement techniques and the associated legal concerns.

OVERCOLLATERALIZATION

Overcollateralization is the most common form of credit enhancement provided in structured finance transactions. Overcollateralization refers to the practice of issuing Rated Securities in a dollar amount lower than the fair market value of the assets transferred to and held by the SPE. This helps to ensure that if the assets are liquidated due to an event of default or early payout of the Rated Securities, or some of the assets do not perform as expected or decline in value, sufficient assets will still be available to cover the SPE's obligations.

EXCESS SPREAD

After overcollateralization, excess spread is the next most common form of credit enhancement used in structured finance. Excess spread refers to the difference in the yield generated by the assets and the funding cost of the Rated Securities. Put more simply, this is the amount by which interest collected on the assets surpasses interest paid on the Rated Securities. Excess spread provides the credit enhancement necessary to allow the SPE to pay interest and principal on the ABS as well as expenses incurred under the transaction documents. Examples of such expenses include trustee and professional fees.

RESERVE FUNDS

Reserve funds are typically cash or highly liquid securities with little default risk held in reserve accounts controlled by the indenture trustee for the purposes of Article 9 of the UCC. To be eligible, such securities must hold a high credit rating, typically at least an R-1 (middle) short-term rating or a AA (low) long-term rating. U.S. Treasury bills are often used for this purpose. Reserve accounts are held at an eligible institution. Eligible institutions are typically banks and trust companies that hold a rating of at least an R-1 (low) short-term rating and a BBB (high) long-term rating. If the rating of an institution at which reserve funds are held falls below the threshold rating during the life of the transaction, the reserve account must be relocated.

DBRS looks for legal assurances on two points arising from reserve funds: (1) the cash or securities deposited in the reserve fund account must not be vulnerable to fraudulent conveyance or preferential treatment claims and (2) if the reserve fund account is not held in the name of the SPE or indenture trustee, the SPE or indenture trustee have to take a perfected first-priority security interest in the account for the purposes of Article 9 of the UCC. If the SPE is not the owner of the account, legal opinions may be requested to establish the SPE's ability to access the funds despite the owner's bankruptcy.

LETTERS OF CREDIT

A letter of credit is an agreement between a provider, usually a bank, and a beneficiary, in this context the SPE. Under the terms of the contract, in defined circumstances, the provider will forward funds directly to the beneficiary in satisfaction of obligations of a third party. Letters of credit can be attractive as a type of credit enhancement because they can form contractual obligations between the beneficiary and the provider, independent of the conduct or status of the third party. The credit strength of a letter of credit is the credit strength of the provider, often a highly rated bank. DBRS criterion for the provider is a long-term rating of AA (low) and a short-term rating of R-1 (middle).



Although letters of credit are not common in a structured finance context, they are sometimes employed as a form of credit enhancement. In these situations, DBRS legal review ensures that the provider's obligation to pay is enforceable by the indenture trustee on behalf of the security holders.

SWAP AGREEMENTS

Swap agreements, or swaps, are often part of a structured finance transaction. Swaps are used to tailor the SPE's cash flows to better match those of the Rated Securities. For instance, the Rated Securities may offer a fixed-coupon payment, while the consumer loans that comprise the assets are floating-rate loans. Often the SPE can be exposed to the risk of diminishing revenue flows if interest rates fall. To mitigate this risk, the SPE enters into an interest rate swap arrangement whereby it pays a floating rate to a counterparty in return for fixed-rate payments. The SPE then uses the payments it has received under the swap agreement to pay the interest on the Rated Securities. Swaps may also be used to hedge currency and basis risk or to introduce a hedge of credit risk as an asset through credit default swaps.

A swap agreement introduces swap counterparty risk into the transaction. DBRS rating criteria for a swap counterparty includes a long-term rating of A (high) or short-term rating of R-1 (middle). If the counterparty is downgraded and fails to maintain a rating of A (high) or R-1 (middle), within 30 business days the swap counterparty is expected to either:

- Post additional acceptable collateral covering one payment period in advance, to be rebalanced each payment period (for a total return swap, the amount to be posted must be subject to the satisfaction of DBRS); This option is only available if there is a second downgrade trigger.
- Provide a guarantee acceptable to DBRS from a guarantor rated A (high) or R-1 (middle).
- Assign its obligations under the swap to a counterparty that holds a rating of A (high) or R-1 (middle).

If the swap documentation contains a second ratings threshold, and the counterparty is subsequently downgraded and fails to maintain a rating of BBB (high) or R-2 (high), one of the following actions must be taken within 30 days (unless otherwise indicated below):

- The swap terminates at par within ten days.
- Assignment of the downgraded counterparty's obligations to another counterparty that holds a rating of A (high) or R-1 (middle).
- Post additional acceptable collateral covering all future payment obligations of the downgraded counterparty under the swap.

DBRS maintains a schedule of acceptable collateral for posting and the valuation percentages that is applied. Collateral must be held in a bankruptcy-remote account in the name of the SPE at an eligible institution.

GUARANTEES

In traditional corporate debt financing, parent corporations often provide guarantees to support debt offered by their subsidiaries. An absolute, irrevocable and unconditional payment guarantee results in a legal obligation of the guarantor parent to pay interest and principal on its subsidiary's outstanding securities. This allows DBRS to flow through the rating of the parent to securities issued by the subsidiary.

While a central function of structured finance is to remove the assets from the credit risk of an Originator parent, there are situations in which guarantees are relevant to structured finance. Guarantees are most frequently seen when an Originator is a subsidiary of a foreign parent. The foreign parent often guarantees the performance of the subsidiary's contractual obligations to the SPE as servicer with respect to indemnity obligations. In a similar manner, if a swap counterparty or liquidity provider is a subsidiary of a foreign company, a guarantee may be appropriate. Factors that impact this determination include the size of the subsidiary's obligation to the SPE, the credit rating of the subsidiary and the rating of its parent entity.

Guarantees are also appropriate where a custodian, issuer trustee, indenture trustee or other service



provider to the SPE does not hold the appropriate DBRS rating.

In circumstances where a guarantee is sought, DBRS requests an opinion from the guarantor's counsel stating that the guarantee is an absolute, irrevocable and unconditional obligation of the guarantor, enforceable by the SPE against the guarantor. Comfort letters, keepwell agreements, indemnities and other forms of support that have questionable enforceability and value, are not considered acceptable by DBRS in a structured finance transaction.

Servicing and Collection Accounts

While the structure of the transaction and the quality of the assets are key factors in assigning ratings, it is collections on the securitized assets, the underlying loans and receivables, etc., that repay the Rated Securities. SPEs typically do not have employees or internal collection capabilities and without the ability to collect payments from the obligors, the SPE will have difficulty meeting its obligations. A servicer is therefore retained by the SPE to serve as a point of contact with the obligors, to collect payments due on the assets and to pass these funds on to the trust collection account for distribution by the indenture trustee to the security holders and other specified creditors under the priority of payments. The care taken to structure the transaction and ensure that the SPE is bankruptcy remote would be nullified if the cash flow from Obligor to SPE to security holder were interrupted.

ORIGINATOR AS SERVICER

Often, an Originator is also the servicer of the portfolio of securitized assets. There are economic and practical considerations that make an Originator well placed to participate in the transaction in this role. Using an alternative servicer imposes costs on the transaction for services that an Originator has historically performed itself. Utilizing an Originator as the servicer brings administrative efficiencies and seamless service for an Originator's customers. Furthermore, rather than pay a separate fee that could attract additional taxes, the consideration for the servicer can be built into the overall consideration for the sale of the assets. If a third-party servicer were to be used, the expenses of the SPE would be higher, necessitating either additional overcollateralization or excess spread be available to pay principal and interest on the Rated Securities. Since an Originator is commonly the servicer, this publication assumes that an Originator acts as the servicer for a securitization. However, the possibility always exists that the servicer will default in the performance of its duties, or otherwise have financial difficulties, and need to be replaced. Accordingly, each structure must have sufficient cash flows available to retain a third-party servicer and continue to meet its obligations under the Rated Securities.

REPLACEMENT SERVICER

The servicing agreement is the contract between the SPE and the entity, often the Originator, that handles the collections, payment processing and administrative functions associated with managing the assets and referred to as the servicer. The servicing function is so integral to any structured finance transaction that the servicing agreement must contain provisions allowing the SPE to appoint a replacement servicer if the original is unable or unwilling to perform its duties under the contract, or if the servicer defaults in certain of its material obligations. Termination events are incorporated into the servicing agreement providing for the right to replace the servicer.² Any replacement servicer must be acceptable to DBRS. Termination events must be proactive with early warning triggers that allow the servicing contract to be terminated before the servicer enters bankruptcy. Upon the filing of a bankruptcy petition by the servicer, the rights of the servicer under the servicing agreement become part of its bankruptcy estate. If the servicing agreement produces a net burden to the servicer, the bankruptcy trustee could reject the servicing agreement

² The servicing agreement may contain provisions to waive servicer termination events. If so, any waiver of a servicer termination event must be subject to the same requirements as those applicable to a waiver of an event of default under the trust indenture.



and the SPE would then need to engage another servicer. However, contracts cannot be terminated solely for the reason that a party to the contract has entered a bankruptcy proceeding, provided that the servicer continues to perform its obligations under the servicing agreement. Companies that enter into bankruptcy proceedings may also seek to have the court use its broad discretionary powers to prevent the SPE from terminating them as servicer, particularly where servicing revenues represent significant income for the servicer. Servicer termination events should include, subject to certain notice provisions or appropriate cure periods: (1) failure by the servicer to make a required payment or remittance, (2) a material breach of representation or warranty given by the servicer in the servicing agreement, (3) any failure to observe or perform a material term or covenant of the servicing agreement, (4) standard bankruptcy and insolvency triggers, and (5) in some cases, financial tests and triggers.

Replacement of the servicer typically imposes additional costs on a transaction related to the transfer of files and information, and to the providing of necessary notices and related costs associated with the replacement servicer's assumption of responsibilities. Provisions for these expenses must be made – based on prevailing market rates – and built into the transaction documentation and anticipated cash flows to ensure that a changeover to a new servicer does not adversely affect the interests of security holders.

BACKUP SERVICER

In instances where an Originator/Servicer is a non-investment grade company – and no other mechanisms are in place to mitigate the increased risk of a non-investment-grade servicer, a backup servicer may be appointed when the transaction closes. For certain asset classes, suitable replacement servicers can be obtained on short notice, with little or no disruption in the servicing function. The servicing agreement must include provisions that records, software and other critical resources of an Originator/Servicer will be transferred to a backup servicer and that any software licenses necessary for such transfers are obtained. The appointment of a standby servicer helps ease any transition problems associated with a new servicer, since servicing expectations, file management and access issues can be addressed in advance. Appointing a standby servicer at the beginning of the transaction is considered advantageous because the servicing fee can be predetermined, thus eliminating the risk that market rates could be higher than expected if the original servicer must be replaced.

COLLECTION ACCOUNTS

Funds collected by the servicer for the SPE generally must be placed in segregated collection accounts that are opened in the name of the SPE at an Eligible Institution (DBRS long-term rating of BBB (high) and short-term rating of R-1 (low)) and over which the indenture trustee has sole control for the purposes of Article 9 of the UCC. DBRS considers exceptions to its criteria where it is determined to be acceptable to leave certain accounts in the name of the servicer, provided that the indenture trustee is granted a perfected first-priority security interest in the account. DBRS may also request a blocked account agreement be entered into with the bank holding the account, or in the case of an investment account, an account control agreement between the SPE and a securities intermediary.

COMMINGLING

Commingling refers to a practice of allowing the funds collected by the servicer from obligors for the SPE to remain in its regular corporate accounts commingled with the servicer's own funds. It is often onerous from an administrative viewpoint for servicers to immediately separate collections of securitized assets from those of other assets. However, if cash flow from securitized assets is commingled with the servicer's other funds, it may become impossible to separate the entitlements of the SPE from that of other creditors in instances where fewer funds are available than necessary to satisfy all claims. If the SPE cannot establish ownership over its funds, it may be forced to share those funds with other creditors.

It is DBRS's general policy for companies rated investment grade to allow the commingling of funds. DBRS maintains concerns regarding companies that are below investment grade or not subject to the U.S. Bankruptcy Code, and limits the maximum allowable commingling period that may be permitted, typically two days, depending on the company's capability to remit the funds collected. Non-investment-



grade companies and banks are typically not permitted to commingle cash flows for more than a short period of time and, in some cases, may be requested to have obligors remit directly to segregated collection accounts. Funds collected by non-investment-grade servicers are deposited directly into the collection accounts or placed in sweep accounts held by the servicer. Ideally, sweep accounts are swept on a daily basis with the funds being transferred to trust collection accounts. If an investment-grade company were to be downgraded to non-investment grade while Rated Securities remained outstanding, DBRS would request that the servicer follow the commingling criteria for non-investment-grade companies outlined above.

There are two primary concerns associated with commingling. The first is the possibility funds collected on behalf of the SPE, and which are thereafter commingled with other funds of the Originator, may no longer be identifiable as being collected on behalf of the SPE, so that there would be little likelihood of establishing any priority to those amounts in the event of the bankruptcy of the Originator. In addition, the automatic stay resulting from a bankruptcy of the Originator may result in a prolonged period before funds are forwarded to the SPE or that such cash may be used to satisfy other creditors, making it wholly or partially unrecoverable by the security holders. Although terminating the servicer and changing remittance obligations could be delayed or frustrated in a restructuring proceeding, generally the shorter the permitted commingling period, the lower the exposure to a servicer bankruptcy.

The second and potentially more important consideration is the ongoing cash flow arrangement of the transaction. While commingled cash may be subject to review once a bankruptcy proceeding has been initiated, safeguards should be in place to ensure that further cash flows are not included in the bankruptcy estate. A court-ordered stay could mean that cash flow arrangements and other servicing functions cannot be changed after the servicer enters bankruptcy protection. It is therefore necessary to take a proactive approach in drafting the transaction documentation.

INDENTURE TRUSTEE'S SECURITY INTEREST IN COLLECTION ACCOUNTS

The security interest opinion mentioned in the Trust Indenture and Indenture Trustee section should address the indenture trustee's security interest in all of the SPE's assets, including the collection accounts.

Asset-Specific Considerations

All asset-backed transactions share certain common characteristics and are addressed in the preceding sections of this publication. There are, however, a number of concerns unique to individual types of transactions. The nature of the underlying assets is a key consideration that results in different treatment and legal requirements for each transaction.

REVOLVING VERSUS FIXED ASSET POOLS

Structured finance transactions may involve fixed or revolving asset pool structures. With a fixed asset pool, no new assets are added to the asset pool over the life of the transaction.³ The loans, mortgages, receivables, etc., that are initially securitized are the assets that are relied upon to pay interest throughout the term of the transaction and ultimately pay the principal upon maturity (and all other costs associated with the transaction). The static nature of a fixed pool of assets allows DBRS to evaluate the underlying credit risk and anticipated historical loss rates with a high degree of certainty.

Revolving asset pool transactions involve a number of considerations not relevant to fixed asset pool structures. The assets that eventually pay the principal upon maturity are not the same as those that were

³ Subject to the exception that assets that do not meet eligibility criteria (discussed on page 22) may need to be replaced.



initially securitized. Therefore, an evaluation of the assets at the beginning of the transaction remains essential but is not sufficient. The initial evaluation assumes the portfolio is traded in accordance with the portfolio criteria defined in the legal documents governing the transaction and must be accompanied by measures that ensure the assets entering the asset pool after the closing date are of similar credit quality.

DBRS examines an Originator's underwriting criteria, with emphasis on underwriting standards, legal safeguards (including standard-form legal agreements and procedures for security registrations, lien searches, etc.) and collection policies. These standards and policies must be documented and formalized. Assets that enter the asset pool, both at the time of closing and after, must be originated in a manner consistent with the underwriting criteria and collection policies. DBRS must be notified of any material changes in these policies and procedures and then determine if such changes pose additional risk to the Rated Securities before any non-conforming assets can be permitted in the pool.

For both fixed and revolving asset pool structures, DBRS reviews the performance of the pool on a quarterly, semi-annual or annual basis (as considered appropriate by DBRS).

The ongoing viability of an Originator is also crucial. The deterioration of an Originator's business may reduce its ability to replace initially collateralized assets as they are repurchased or substituted (described below). When the financial health of an Originator deteriorates, it may be more inclined to relax or fail to maintain underwriting standards in an attempt to generate or maintain business volume. Trigger events are therefore built into the structure to protect investors. Triggers may be tied to loss levels, delinquency levels, prepayment rates, an Originator's credit rating, bankruptcy or insolvency events, payment or other obligation defaults and the level of the remaining credit enhancement.

ELIGIBILITY CRITERIA

Ensuring that assets meet strict eligibility criteria is one structural mechanism used to maintain consistent asset quality and to ensure the overall pool performs as expected. Typical eligibility criteria include the following:

- Assets are freely assignable with or without notice to or consent of the obligor.
- Assets should not be in arrears or default.
- Obligors should not have defaulted or been delinquent on previous obligations to an Originator.
- Assets should not have been extended or restructured in any significant manner.
- Obligor concentration level (the value of the obligations owed by an obligor in relation to the total value of the pool) should not exceed certain specified limits.
- Assets have been originated according to the Originator's written credit and collection policies.
- The Originator holds valid legal title to the assets.
- No liens or encumbrances exist against the assets (other than certain permitted encumbrances).
- The assets are not subject to any dispute, counterclaim or repurchase obligation.
- The assets are not subject to set-off, unless the set-off risk is otherwise addressed.
- No tax liabilities arise due to the transfer of the assets from an Originator to the SPE.

If it is determined that a transferred asset did not meet the eligibility criteria when it was transferred to the SPE, an Originator may be obligated to either repurchase such asset at face value or substitute an eligible asset of equivalent value. This obligation of an Originator must be part of the asset purchase agreement or sale agreement between an Originator and the SPE.

It is sometimes argued that the ability of the SPE to require an Originator to purchase an ineligible asset is detrimental to a true sale analysis, since it is suggestive of recourse back to an Originator or the retention by an Originator of an interest in the performance of the asset. However, provisions requiring the Originator to repurchase or substitute a transferred asset was in breach of a representation or warranty or that is otherwise an ineligible asset, do not transfer credit risk back to the Originator, but instead ensures that all parties receive to what they are entitled.



Conclusion

This publication has been provided as a guide to understanding the typical legal criteria used by DBRS to rate U.S. structured finance transactions and not as a uniform template applicable in all circumstances. DBRS reviews market, legislative and case law developments on an ongoing basis to ensure that its policies and criteria remain relevant. Debt issuers and their agents are encouraged to contact DBRS to discuss the legal aspects of any structured transaction. DBRS makes no claim as to the comprehensiveness of this publication.

Copyright © 2009, DBRS Limited, DBRS, Inc. and DBRS Ratings Limited (collectively, DBRS). All rights reserved. The information upon which DBRS ratings and reports are based is obtained by DBRS from sources DBRS believes to be accurate and reliable. DBRS does not audit the information it receives in connection with the rating process, and it does not and cannot independently verify that information in every instance. The extent of any factual investigation or independent verification depends on facts and circumstances. DBRS ratings, reports and any other information provided by DBRS are provided "as is" and without representation or warranty of any kind. DBRS hereby disclaims any representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, fitness for any particular purpose or non-infringement of any of such information. In no event shall DBRS or its directors, officers, employees, independent contractors, agents and representatives (collectively, DBRS Representatives) be liable (1) for any inaccuracy, delay, loss of data, interruption in service, error or omission or for any damages resulting therefrom, or (2) for any direct, indirect, incidental, special, compensatory or consequential damages arising from any use of ratings and rating reports or arising from any error (negligent or otherwise) or other circumstance or contingency within or outside the control of DBRS or any DBRS Representative, in connection with or related to obtaining, collecting, compiling, analyzing, interpreting, communicating, publishing or delivering any such information. Ratings and other opinions issued by DBRS are, and must be construed solely as, statements of opinion and not statements of fact as to credit worthiness or recommendations to purchase, sell or hold any securities. A report providing a DBRS rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. DBRS receives compensation for its rating activities from issuers, insurers, guarantors and/or underwriters of debt securities for assigning ratings and from subscribers to its website. DBRS is not responsible for the content or operation of third party websites accessed through hypertext or other computer links and DBRS shall have no liability to any person or entity for the use of such third party websites. This publication may not be reproduced, retransmitted or distributed in any form without the prior written consent of DBRS. ALL DBRS RATINGS ARE SUBJECT TO DISCLAIMERS AND CERTAIN LIMITATIONS. PLEASE READ THESE DISCLAIMERS AND LIMITATIONS AT <http://www.dbrs.com/about/disclaimer>. ADDITIONAL INFORMATION REGARDING DBRS RATINGS, INCLUDING DEFINITIONS, POLICIES AND METHODOLOGIES, ARE AVAILABLE ON <http://www.dbrs.com>.



Insight beyond the rating.

www.dbrs.com

DBRS, Inc.
140 Broadway
35th Floor
New York, NY 10005
TEL +1 212 806 3277