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ESOTERIC ABS: PUSHING THE ENVELOPE

Sponsors and underwriters repeatedly push the envelope to introduce new asset classes into the market, some of which join the lower-yield world of commoditized ABS while others disappear. After a prologue describing the general features of the esoteric ABS market, the author discusses in detail cell phone contract securitizations by Verizon; wireless spectrum securitization by Sprint; solar power securitizations by several companies; and Property Assessed Clean Energy programs under state and municipal laws. He closes with discussions of marketplace lending and whole business securitizations.

By Ronald S. Borod *

PROLOGUE

Most discussions of esoteric asset-backed securities¹ begin with a definition. Esoteric ABS, however, cannot be given a tidy definition but rather is identifiable by the presence — or the absence — of certain characteristics. One characteristic that is normally absent from esoteric ABS is collateral that has been “commoditized” in large and repetitive securitizations that attract AAA or AA ratings and are issued at tight spreads to the applicable benchmark rate due to the familiarity and relative safety of the collateral. (However, as we will see later in this article, some esoteric ABS are also sometimes issued at tight spreads, even when new to the market.) The

volume of assets supporting esoteric ABS is also generally smaller and the data regarding the performance of the assets is generally less available or robust, and thus the ratings tend to be in the A/BBB categories. Also, some of the structural features and documents are bespoke and thus the investors must take more time to review the transactions; and the deal sizes tend to be smaller, and thus less liquid. Consequently, the securities are priced at wider spreads, at least during the earlier stages of the asset class’s life cycle. (However, there are also exceptions to this rule, as illustrated below.)

Two other features common to esoteric ABS are structural innovation and heightened rating agency scrutiny: As each new asset class makes its debut in the capital markets, new deal features are required to address risks and credit deficiencies associated with the assets, and the transactions are subjected to vigorous analysis and stress testing by the rating agencies. Another feature of esoteric ABS is a lengthy gestation

¹ Most esoteric ABS are sold pursuant to the exemption from registration under SEC Rule 144A and are therefore not registered with the SEC. Thus, the transactions discussed in this article are generally not available for detailed review by those not actually participating in these transactions.

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period: the period between deal commencement and closing and funding is generally quite long for the initial issuance, whereas the time to market for each subsequent issuance becomes progressively shorter. Although this varies with the asset class, some assets achieve such familiarity in the market through repetitive issuances that they lose their novelty and their spreads tighten to the point that they cease to be attractive to relative value buyers. In short, they have then for all practical purposes joined the ranks of the non-esoteric ABS.

Because of the continuing search for relative value by investors, and the continuing search by issuers and underwriters for new scalable assets that lend themselves to the advantageous pricing of the ABS market, new asset classes periodically emerge to replace other asset classes that have graduated from the esoteric to the non-esoteric or have simply disappeared from the market. Sponsors and underwriters repeatedly push the envelope to introduce new assets into the market, and in some but not all cases what is a new asset class one day will later, after several repeat issuances, join the ranks of the lower-yield world of commoditized ABS. In other cases a new type of asset-backed security is introduced with great fanfare, only to be followed by no or few repeat issuances because the circumstances for issuance prove to be *sui generis*. Thus, there is a double-Sisyphian quality to the life cycle of esoteric ABS: With some assets classes, a successful launch of a new esoteric ABS is followed by the process of repeat issuance, acceptance, and commoditization. With other asset classes, a promising debut trails off into either oblivion or a short tail of repeat issuances, either due to lack of asset supply, or dwindling sponsor or investor interest. This repetitive cycle is the principal driver of innovation in the securitization market.

Because esoteric ABS transactions during the early stages of their life cycles tend to be bespoke and involve assets unfamiliar to the ABS market, rating agency and investor scrutiny are quite rigorous, when compared to that given to more traditional ABS. As a result of this heightened scrutiny, the historical performance record of esoteric ABS has been better than other market sectors. During the height of the 2008 recession and its

aftermath, when the markets seized up and defaults were cascading in the mortgage-backed securities and commercial mortgage-backed securities sectors as well as in consumer ABS transactions, the primary issue afflicting esoteric ABS during this period was illiquidity due to market disruption and the downgrades of the monolines that had wrapped the senior classes of many of the larger esoteric issuances. The collateral backing the esoteric transactions performed within acceptable ranges even during this heightened period of stress; and once the market itself recovered, the bonds were among the first to return to their pre-recession levels. Reports of assembly-line documentation and issuance, irresponsible underwriting, and compromised rating agency methodologies that were so prevalent in the subprime mortgage market were not applicable to esoteric ABS. This high level of performance was rewarded by the market: despite the early mutterings in the wake of the financial collapse that only “plain vanilla” securities would be accepted by the market in the future, asset-backed securities falling into the esoteric category were among the first to return to the market and were well-received by investors looking for a combination of safety and yield.

In addition to the heightened diligence associated with the issuance of esoteric ABS, another factor has driven the steady performance of this asset class: what went so tragically wrong in the securitization market leading up to the financial collapse was that securitization technology became corrupted by the overriding desire to create arbitrage. The subprime MBS market between 2003 and 2008 was at its core an arbitrage delivery vehicle, in which subprime mortgages could be bought cheaply and subprime MBS could be sold at a substantially higher price, using the rating agencies as the transformative agent and the competitive pressure among the agencies to subvert the ratings process. The assets themselves were secondary, and, in the case of synthetic CDOs, quite literally non-existent. The major driver of esoteric ABS, on the other hand, has since its inception and to the present time been to enable operating companies, portfolio investors, or individuals with pre-existing exposure to the assets to either sell or leverage those assets at favorable yields. In short, esoteric ABS has remained throughout its history as an

asset-centric issuer-driven funding medium for pre-existing assets as opposed to a system for fueling an originate-to-distribute arbitrage model.

Of course, esoteric ABS is vulnerable, like any other sector, to external economic and political forces. As Moody's Investors Service stated in a recent commentary on the esoteric ABS market, "the continued, albeit slow, growth of the U.S. economy will positively affect sectors including rail car lease, fleet lease, and mobile phone financing securitizations in the coming year... [and] [m]odest global economic growth will support the performance of aircraft securitization and, to a lesser extent, restaurant whole business deals, while anemic global trade growth will be negative for container lease ABS."² Container and similar ABS are likely to be buffeted by protectionist trade policies. Moreover, history has shown that esoteric ABS transactions are not immune to fraud and mismanagement at the sponsor level. However, as long as the esoteric market stays true to its mission of providing low-cost financing to legitimate businesses and asset aggregators, it will hopefully avoid the corrupting influence that created systemic risk for the mortgage market and the global banking system almost a decade ago.

A CLOSER LOOK AT RECENT ESOTERIC ABS TRANSACTIONS

Cell Phone Securitization

Verizon Communications launched in 2016 two securitizations backed by contract payments made by Verizon customers on their mobile phone devices. The first transaction, Verizon Owner Trust 2016-1, involved the issuance of \$1.169 billion of notes consisting of three series: Class A in the principal sum of \$1 billion (rated AAA (sf) by S&P and Fitch), Class B in the principal sum of \$84,520,000 (rated AA (sf) by S&P and Fitch), and Class C in the principal sum of \$84,510,000 (rated A (sf) by S&P and Fitch).

The second transaction, Verizon Owner Trust 2016-2, closed in November 2016 and was in the total principal sum of \$1.4 billion, consisting of \$1,200,000 Class A Notes, rated AAA/AAA (sf) by S&P and Fitch, \$100 million Class B Notes, rated AA/AA (sf) by S&P and Fitch, and \$100 million Class C Notes, rated A/A (sf) by S&P and Fitch. The Class A Notes in the 2016-2 transaction were priced at 35 BPs over the swap rate, to yield 1.69 percent, which was 20 BPs tighter than the

pricing on the comparable notes in the 2016-1 transaction.

The collateral for these securities generally consisted of a revolving pool of wireless device payment plan agreement receivables. The bond structure included a revolving period of up to two years, initial overcollateralization (excluding the yield supplement overcollateralization (YSOC) amount intended to protect against below-targeted yields on the pool) of 17.7 percent of the adjusted pool balance, and a requirement that the overcollateralization be increased to 21.70 percent if the pool quality declines beyond certain thresholds. The YSOC amount was calculated at 7.5 percent of the initial adjusted pool balance and recalculated monthly using a discount rate of 8 percent to create overcollateralization plus excess spread. The transaction also featured a non-amortizing reserve account equal to one percent of the initial adjusted pool balance during the revolving period, which increases to five percent of the current adjusted pool balance when the pool enters amortization.

The specific collateral for the Verizon deals was a revolving pool of Device Payment Plan Agreements for wireless devices originated by Verizon Wireless and other affiliates of Verizon Communications. Under the DPPAs, which are replacing the previous payment plans used by Verizon and other mobile device carriers, the customer pays for the total retail price for the device over a 24-month period. The DPPAs bear a zero percent annual percentage rate, require that the customer maintain service with Verizon, apply payments first to the service fee and then to the deferred payments for the mobile device, provide to the customer the right to pre-pay without penalty, and require the customer to retain the risk of loss. Verizon itself agreed to guarantee the payment obligations of the originator, the marketing agent, and the servicer, but did not guarantee any payments on the notes. During the revolving period, the issuer is subject to collateral composition tests to assure a properly balanced portfolio.

The primary drivers behind the Verizon cell phone securitizations were: (1) the transaction provided AAA-rated low-cost financing to Verizon (Verizon's long-term corporate debt rating is BBB+/Baa1) for funding the upfront mobile device costs, which the customers were obligated to repay only over a two-year term without interest; (2) at least one rating agency (Moody's) warned that the proliferation of equipment installment plans for mobile phone carrier companies could mean that the four major U.S. carriers could be left holding the exposure to \$55 billion in outstanding consumer loans, and this was perceived as a credit negative; (3) Verizon

² Moody's Global Credit Research, 13 December 2016.

itself was facing a working capital deficit that could be as high as \$25 billion; (4) the transactions enabled Verizon to avoid increasing its unsecured debt balance on its balance sheet and to substitute short-term secured ABS debt, similar to the captive auto finance companies of the major U.S. auto manufacturers; and (5) Verizon was able to achieve over 6x leverage without adversely affecting its own corporate debt rating.

Positives from a rating perspective were that: (1) Verizon has a large and loyal customer base; (2) Verizon customers are generally creditworthy (average FICO score of 708); and (3) wireless service in today's culture is considered a necessity and will be among the top payment priorities for the cell phone user's monthly outlays. The potential downside risk from a ratings perspective was that, unlike a plain vanilla consumer loan securitization, the customer payment behavior under the DPPAs is dependent upon the service that they receive under the Verizon network. If the network suffers from bad maintenance or is dissolved or divested, payment defaults could increase. Additionally, even though the customer assumes all risk of proper network performance and handset performance, equipment problems could also disrupt cash flow. (Although the manufacturer's warranty takes first risk under most handset equipment arrangements, if there were a major and widespread defect, such as that experienced by the Samsung Galaxy Note 7, and if the manufacturer does not respond satisfactorily to the issue, payments under the DPPAs can suffer.)

Of particular interest in the Verizon cell phone securitizations is the rating methodology applied. As stated previously, the transaction is not a pure consumer loan transaction because the reliability of payments is directly correlated to the reliability of the wireless network service provided by Verizon. Thus, the performance of the pool is dependent in part on the performance of the sponsor company and, in that respect, the transaction bears some resemblance to a whole business securitization involving a franchise system (discussed *infra*). Therefore, the rating analysis must consider both an analysis of the telecom company sponsor and its wireless network, and an analysis of the assets. The corporate-level analysis must take into account the essentiality of the network and how the wireless network would weather a bankruptcy filing by the carrier, applying an AAA-level stress scenario. On the customer side, as important as FICO scores might be in normal consumer asset securitizations, customer loyalty in the form of the average tenure of consumer contracts with their wireless provider is even a more important data point.

Interesting questions for the future of cell phone securitization include: (1) will other carrier companies be able to achieve a comparable ratings uplift, or will they be capped at lower ratings and thus will the pricing on the bonds be unattractive when compared to alternate funding sources? and (2) will the network performance of the various carriers be differentiated, measured by data and voice performance, thus resulting in different levels of customer loyalty and thus different evaluations of network sustainability through bankruptcy, or will they be considered roughly equivalent? Some commentators have predicted that a securitization of mobile phone payments could quickly grow to be the third-largest consumer finance market, lagging only behind car loans and credit cards. But the realization of this prediction will depend upon the ratings that can be achieved by other carriers. It could also be argued that cell phone securitization has already moved, in the course of the two Verizon transactions, from the esoteric ABS market to the commoditized ABS market, considering the AAA ratings and the very tight spreads on the Verizon transactions.³ Another unanswered question about cell phone securitization is whether the new business model of Verizon and other carriers — of financing the actual equipment purchases by their customers — will have any impact on the handset manufacturers themselves. Some predict that since the customers are actually buying the devices under the DPPAs and a two-year payment plan, they may decide to hold on to their devices for a longer period of time, thus reducing sales of new devices by the manufacturers. Another phenomenon that is starting to be observed is that handset manufacturers themselves will begin offering their own finance plans in competition with the carriers.

Wireless Spectrum Securitization

In October 2016, Sprint Communications Inc. (SCI) sponsored a \$3.5 billion asset-backed securities transaction backed by lease payments under a synthetic "hell-or-high-water" lease which, in turn, backed a portion of Sprint's electromagnetic spectrum licenses granted by the U.S. government for specific frequency ranges. The licenses serving as indirect collateral consisted of 2.5 GHz and 1.9 GHz spectrum licenses, valued at \$14.6 billion to \$18.1 billion. These licenses were contributed by Sprint to three separate bankruptcy-remote special purpose vehicles ("License Holding

³ As further evidence of this, as of this writing, a new \$1.3 billion Verizon cell phone securitization is being priced — Verizon Owner Trust 2017-1 — and the senior \$1.1 billion notes were priced at a spread of 30 BPs over the benchmark rate (5 BPs tighter than the 2016-2 transaction), to yield 2.076%.

Entities”) which were in turn wholly owned by three separate bankruptcy-remote special purpose entities (collectively, the “Issuers”). The three separate Issuers entered into a master lease agreement with SCI, under which SCI agreed to make specified lease payments. The lease obligations of SCI were in turn guaranteed by Sprint Corporation and all of SCI’s other subsidiaries. The Issuers pledged their rights under the master lease, as well as their equity in the License Holding Entities plus certain cash accounts, to secure the notes issued by the Issuers. Thus, the entire structure of the transaction was built upon the basis of a synthetic lease arrangement structured within the corporate family of SCI.

The securitization notes were, as stated above, in the aggregate principal sum of \$3.5 billion, although the transaction documents authorized total issuance up to a maximum program amount of \$7.0 billion. Since the total program available under the Sprint documents permitted \$7 billion of note issuance, both agencies that rated the securities — Moody’s and Fitch — applied their stress cases on the assumption that the additional \$3.5 billion of notes was already outstanding. The notes were issued by the three Issuers, Sprint Spectrum Co. LLC, Sprint Spectrum Co. II LLC, and Sprint Spectrum Co. III LLC, Series 2016-1. The three series of notes issued by the three Issuers were all assigned ratings of Baa2 (sf) by Moody’s and BBB (sf) by Fitch.

The most interesting feature of the Sprint transaction is the methodology used to achieve a rating elevation on the notes above Sprint’s corporate family rating of B3. On its face, the notes are secured by lease obligations of SCI as the master lessee, and therefore, under traditional credit lease analysis, the rating on the notes would be tied to the corporate rating of the lessee. Moreover, the notes did not receive the additional benefit of a direct pledge of the spectrum licenses, since direct pledges are prohibited under federal law. The security of the noteholders is limited to proceeds derived from the licenses and the leases, and the pledge of equity in the License Holding Entities.

Despite these limitations, Fitch and Moody’s were each able to assign investment-grade ratings to the notes on the basis of their analysis of the following key factors: (1) the low probability that SCI would, in the event of a bankruptcy filing, liquidate under Chapter 7; (2) the essentiality of the spectrum portfolio to SCI; and (3) the value of the spectrum portfolio held by the License Holding Entities, estimated at \$16.4 billion (and thus even if SCI elected Chapter 7 and liquidated that portfolio, the proceeds would be sufficient to pay off the note balances, even at 50 percent stress assumptions). The rating agencies were influenced by the additional

facts that more value would likely be realized in a Chapter 11 proceeding than in a Chapter 7, the FCC would more likely want to maintain SCI as an operating entity, and in the context of a Chapter 11 proceeding, SCI would have a strong economic motivation to affirm the spectrum leases because of the importance of the spectrum portfolio to its overall business operations. The spectrums involved in the securitization constitute 14 percent of Sprint’s total spectrum holdings, representing 77 percent of Sprint’s 2.5 GHz-enabled sites and 33 percent of Sprint’s 1.9 GHz-enabled sites. If Sprint lost these licenses, the result would be reduced data speeds and increased network congestion, which would jeopardize its substantial customer base. The agencies were also influenced by the fact that the subsidiary guarantors of the lease obligations would have joint and several obligations ranking *pari passu* with SCI’s revolving credit facility. Finally, the agencies were influenced by the fact that SCI is a large company with significant franchise value, a substantial customer base, and an extensive nationwide infrastructure.

Thus, while not identical, the rating methodology used to achieve the elevation above a corporate credit rating of the master lessee (parent) was similar to that used in achieving rating elevations in whole business securitizations, where the franchise company has a below-investment-grade rating and the whole business securitization notes achieve a substantial rating uplift, notwithstanding the dependency of the franchise fee payments on the performance of the franchise company. (See Whole Business Securitization, *infra*.) A major difference between the spectrum transaction and WBS transactions is that the obligors under a WBS transaction are normally the franchisees, whereas the obligor in the Sprint deal was Sprint itself.

Questions remaining in the wake of the Sprint transaction are whether the securitization of wireless spectrum could be a new esoteric ABS class, or whether the circumstances surrounding the issuance were unique to Sprint. For companies more highly rated than Sprint, it is doubtful that this structure would have any utility, since it would not achieve any balance sheet improvements and would, to the contrary, impose a new layer of lease liability on top of the other outstanding liabilities of the sponsor. Moreover, the multiple guarantees and the other structural elements present in the Sprint transaction would be appealing only if they achieved a material rating uplift over the corporate rating of the sponsor. The higher the sponsor rating, the less the rating uplift would be. Finally, the federal spectrum licenses are considered the “crown jewels” of the telecom carrier industry, and they would not be used to

raise debt capital unless the benefits substantially outweighed the risks.

Solar Securitization

After a slow issuance volume year in 2016 (with only two reported rated solar ABS transactions aggregating approximately \$140 million in principal, plus a \$227 million non-rated cash equity monetization by SolarCity), 2017 is off to a more auspicious start, with two solar transactions hitting the market at approximately the same time in the first month and aggregating a greater principal amount than all of the 2016 transactions. Reviewing 2016 first, SolarCity LMC Series V, LLC (Series 2016-1) was a securitization of residential leases and power purchase agreements of the sponsor, utilizing a master lease structure in a variant on the inverted lease tax equity structure. The advance rate on this transaction (ratio of total bond size to aggregate solar discounted asset balance (computed as the net present value of the future expected cash flows on the leases and PPAs, discounted at the expected bond rate)) was approximately 75.2 percent, and the senior class of \$52.15 million received a BBB (sf) S&P rating and a BBB+ (sf) rating from Kroll. The subordinated class, in the sum of \$5.3 million, received a BB (sf) rating from S&P and a BB+ (sf) rating from Kroll. The weighted average yield on the two tranches was approximately 5.45 percent.

The second 2016 transaction — Spruce ABS Trust 2016-E1 — was sponsored by Spruce Financial. The collateral consisted of a pool of unsecured energy efficiency loans (77.2 percent) and solar loans (22.8 percent). The senior notes, in the principal sum of \$73.49 million, received a Kroll A (sf) rating and the \$10.29 million of subordinated notes received a Kroll rating of BBB (sf). The advance rate achieved on the Spruce transaction was 79.5 percent. The Class A bonds were priced to yield 4.32 percent and the Class B bonds were priced to yield 6.9 percent.

Turning to the 2017 solar ABS issued to date, in January 2017 SolarCity issued \$145 million of new notes in three separate classes. The notes were secured by a portfolio of SolarCity's MyPower loans, similar to the collateral used in the SolarCity FTE Series 1, LLC (Series 2015-A) issued in late 2015. The advance rate achieved on this transaction was 75.7 percent. The senior class was assigned an A (sf) rating by Kroll and the junior class was assigned a BBB (sf) Kroll rating. The Class A notes were priced to yield 4.974 percent, the Class B, 6.094 percent, and the Class C, 7.5 percent.

The second solar bonds issued so far in 2017 were the \$138.95 million issuance sponsored by Solar Mosaic,

Inc., called Mosaic Solar Loans 2017-1. These bonds received an A (sp) rating from Kroll, and achieved an advance rate of 79.47 percent. The Mosaic transaction was backed by a portfolio of mostly prime quality residential consumer solar loans and the solar systems securing them. The loan sizes range from \$10,000 to \$100,000, and the manner in which the loans are originated creates a hybrid between solar ABS and marketplace lending ABS, inasmuch as the assets securitized were solely loans originated on an electronic lending platform, but the loans were made to finance the installation of solar equipment on residential rooftops.

The 2016 and 2017 solar ABS transactions are four in a series of 10 rated securitizations backed by solar loans, power purchase agreements, or leases, aggregating \$1.170 billion in principal volume since the first SolarCity securitization was closed in November 2013. (This number excludes the SolarCity \$227 million equity monetization which was closed with a single insurance company purchaser in an unrated transaction in 2016, and also excludes the Property Assessed Clean Energy (PACE) bond-backed notes (which contained a mixture of solar and other energy efficiency financings) which are discussed in the following section.)

The advance rates under these 10 solar bonds perhaps tell the most revealing story of the increasing level of acceptance of solar ABS by rating agencies and investors: The advance rate of the original 2013 SolarCity bonds was 62 percent as compared to the high of 79.5 percent on the Spruce and Mosaic transactions and 75.7 percent on the 2017 SolarCity transaction.

Despite these increasing advance rates, solar developers continue to face headwinds in the form of limited performance and production data (6-7 years of data vs. 20-year legal term for most solar bonds). To overcome the limited years of data available, rating agencies are forced either to find proxies for solar performance data (e.g., in the form of consumer loans or home equity loans), to apply more severe stress assumptions, or to impose limits on ratings assigned to solar ABS. (S&P, for example, has to date refused to assign ratings above BBB+ due to the limited available data.) Solar ABS issuance volume is further hampered by the fact that, despite the dramatic growth in installed solar power in the U.S. over the past two years (installed MW capacity increased to 14,626 in 2016, an increase of almost 95 percent over installed capacity in 2015),⁴ solar energy has still achieved only a less than two percent market penetration of the total energy supply in the U.S.,

⁴ Source: Solar Energy Industry Association, SEIA Weekly Array, February 15, 2017.

and the solar development market is highly fragmented. This means that only a few solar developers are able to aggregate the critical mass necessary to make ABS issuances cost effective and to issue bonds in a sufficient principal amount to create interest for investors.

An added impediment to issuance volume in the solar sector is that typical solar development financing consists of a combination of sponsor/cash equity, debt, and tax equity. Tax equity, whereby investors with sufficient tax exposure to utilize efficiently the investment tax credit and accelerated depreciation benefits generated by solar projects invest in one of three structures to utilize the tax benefits, generally accounts for between 40 and 50 percent of the total capital structure of a typical solar PV portfolio. Sponsor/cash equity is generally responsible for between 20 and 30 percent of the capital stack, and debt sometimes provides the balance, although many portfolios are unleveraged.

The majority of tax equity investors utilize the so-called “partnership flip” structure, whereby the tax equity investor invests in the same partnership that owns the solar assets and in which the sponsor equity invests.⁵ Where tax equity is already in place before an attempted securitization occurs, it is difficult and sometimes impossible to obtain the consent of tax equity investors to the transfer of the solar assets into an SPV and the issuance of debt secured by those assets, which are the typical features of a securitization structure. The resistance is due to the fact that a foreclosure on the solar assets within five years of their placed-in-service date will result in the recapture of all or part of the ITC. For this reason, the solar securitizations completed to date have, where a partnership flip structure was already in place, utilized a “back leverage” structure, in which the notes are secured by the sponsor’s interest in the managing member of the tax equity partnership (and cash distributable with respect to such interests) and not by the solar assets themselves, which remain unencumbered inside the tax equity partnership. This structure was used in SolarCity LMC Series IV, LLC (Series 2015-1) and in SolarCity LMS (Series III) LLC (Series 2014-2). (The first two SolarCity transactions

were financed under the DOE grant program and therefore did not have to deal with the issues of tax equity, and the SolarCity FTE Series 1, LLC (Series 2015-A) and SolarCity FTE Series 2, LLC (Series 2017-A), securitized SolarCity’s loans under its MyPower loan program, and therefore tax equity was not involved.)

The Sunrun Callisto — Issuer 2015-1 LLC (Series 2015-1) — transaction used a different tax equity structure, the inverted lease or “pass-through” lease structure, whereby the tax equity investor invested in a separate master lessee entity and the sponsor equity invested in the master lessor entity, which owned the actual solar assets. The tax equity investor received the benefit of the investment tax credit as the result of an election by the lessor to pass the tax credit through to the lessee under a provision of the Internal Revenue Code permitting such an election. Thus, the pledge and assignment of the solar assets did not create the same risk to tax equity as in a partnership flip structure.

In addition to the friction over pledging the ITC-generating assets to secure the securitized debt, another issue that hampers securitization where tax equity investors are in place is that the sponsor is normally required to provide indemnities for breaches of certain representations and warranties, and one of the major risks covered by these indemnities is that the tax basis used in computing the ITC is challenged successfully by the IRS. Because cash sweeps⁶ are the remedy for such breach, the enforcement of such a remedy could have an adverse impact on the available cash flow for debt service on the bonds. This has also posed a significant issue in obtaining a rating on securitized solar debt. One approach used in one SolarCity transaction (SolarCity LMC Series IV, LLC (Series 2015-1)), was the use of tax loss insurance to cover a sufficient portion of the indemnity risk to satisfy the rating agency and investors in the event that the ITC was reduced through such a challenge. These policies, which are frequently used in non-securitized tax equity transactions, generally cover the first 35 percent of the ITC amount, since this is generally considered to be the “soft cost” component of the ITC basis calculation, and thus the portion most at risk. Another method used to address the indemnity risk is to have the parent corporation assume the risk and have the tax equity investor agree to look first to the parent before seeking any indemnification payment from the issuer. These and other issues have been identified by the Solar Energy Industry Association as major

⁵ In a “partnership flip” structure, the tax equity investor is allocated 95- 99% of the Investment Tax Credit (30% of the fair value of the solar assets in the year placed in service) and taxable income and losses of the partnership for the first five years and the solar developer-sponsor is allocated the remaining 5-1%; at the end of the five-year period (or in some cases the later of five years and the receipt by the tax equity investor of a minimum stated IRR on its investment) the allocations “flip” to the inverse, with the developer-sponsor being allocated 95-99% and the tax equity allocated the remaining 5-1%.

⁶ A cash sweep refers to a provision giving the tax equity investor a right to additional cash distributions to offset the after-tax effect of the loss or reduction of the ITC or other tax benefits.

friction points in preventing the growth of the solar ABS market, and a subgroup of SEIA, the Solar Energy Finance Advisory Council, which focuses on solar finance issues, has appointed a subcommittee to identify and address these friction points.

A few interesting features of some of the more recent solar ABS transactions are worth mentioning: Of particular note regarding the Spruce transaction, issued in the summer of 2016, is that over 77 percent of the collateral consisted of unsecured energy efficiency loans. Moreover, these loans were not issued pursuant to a PACE regime, whereby the loans are secured by a tax assessment on the property. Notwithstanding this composition of the collateral, the Spruce transaction received an A (sf) rating on the senior notes from Kroll and the overall advance rate was the highest to date of all solar ABS transactions — 79.5 percent. Part of the explanation for this is that the borrowers in the pool had an average FICO score of 749, with the largest distribution of loans (34.1 percent) in the 760-799 range. Kroll considered this to be consistent with a prime collateral pool. Moreover, based on the historical performance of the portfolio since 1999, Kroll computed the weighted average base case cumulative gross loss range at 6.57 percent to 7.57 percent, with a mid-point of approximately 7.07 percent. Moreover, the transaction had a feature which caused the overcollateralization amount (14.5 percent initially) to build to a targeted amount of 19 percent at the end of each collection period; and the Class B Notes provided additional credit enhancement to the extent of 10.5 percent of the adjusted pool balance. In addition, the Spruce transaction required a reserve account equal to one percent of the adjusted pool balance, which was a non-declining reserve account; and the weighted annual excess spread was calculated at 1.73 percent based on an adjusted pool APR of 8.02 percent less 1.64 percent servicing fees and an assumed weighted average bond coupon of 4.66 percent. The transaction also required a YSOC amount based on a minimum yield of 5.75 percent, to provide a further buffer in the event that portfolio loans produce lower yields than projected.

In the Mosaic transaction, credit enhancement on the collateral consisted of overcollateralization, a YSOC amount, and a reserve account. The total loan collateral in the transaction consisted of \$177.9 million of residential solar loans, having a weighted average original balance of \$27,947, a loan term of 17.05 years, and an interest rate of 4.34 percent. The average customer in the pool was a homeowner with a weighted average FICO score of 746 and 89 percent of the customers paid their loans through recurring ACH deposits. Mosaic provides no operation and

maintenance coverage and therefore if the system for any of their customers is not operational, the borrower may either contact the original installer or work with Mosaic to find an alternative installer. Additional structural features included: (1) a YSOC amount calculated on each distribution date equal to the positive excess (if any) of the present value of all future scheduled payments on the solar loans discounted at their stated interest rate, and the present value of all future scheduled payments on the solar loans discounted at the specified discount rate of 4.75 percent; (2) a reserve account equal to one percent of the initial pool balance, non-declining; and (3) a lockout period during which all excess cash flow is applied to pay down the notes until the target overcollateralization (“Target OC”) is reached. The Target OC amount is equal to the greater of 24.5 percent of current adjusted pool balance and two percent of the initial adjusted pool balance. If the Target OC is reached prior to month 30, 75 percent of the excess cash flow is still required to pay down the notes, and if the Target OC is not met by month 30, no cash will be released until the Target OC amount is met. There is a second lockout period that begins upon the earlier of the first monthly payment date that is 120 months after the closing date and the first monthly payment date on which the pool balance is equal to 10 percent of the initial pool balance. During this second lockout period, all excess cash flow will be used to pay down the notes, as in the first lockout period.

The investment tax credit is not utilized by the sponsor when solar loans (as opposed to solar leases or power purchase agreements) are involved, since in those transactions the customer — and not the developer-installer — owns the solar assets and is thus entitled to the ITC. As a result, the friction of tax equity was not present in the Mosaic transaction, nor was it present in the Spruce or SolarCity transactions involving their loan products. However, it is interesting to note how these loan programs monetize the ITC that is available to their borrowers. The SolarCity MyPower loans provide for an amortization schedule that follows the tax benefit of the ITC received by the borrower. The Mosaic loan product, known as “PowerSwitch,” re-amortizes to a higher monthly payment if the borrower does not make a pre-payment tied to the ITC which the borrower is scheduled to receive on the solar equipment. Thus, if less than a 30 percent pre-payment is received, there is an increase of the monthly principal payment, and if more than a 30 percent ITC-related payment is received, the loan re-amortizes to a lower monthly payment. As a result, even when the solar developer does not qualify for the ITC because a loan structure rather than a lease or PPA structure is used, the developer generally negotiates accelerated cash flow (or amortization, in the

case of Mosaic) under its loan payment schedule to correspond to the ITC benefit received by the borrower.

The loan vs. lease/PPA dichotomy in the solar ABS sector has given rise to a debate as to which provides the better protection for the ABS noteholder. On the one hand, the loan structure, in which the solar developer is entitled to collect loan payments — regardless of the power generated or the cost of competing utility rates — is appealing and makes the loan product appear to generate a more predictable cash flow. On the other hand, in connection with some loan products the lender still contracts to provide operation and maintenance services, and this could give rise to claims of offsets or refusal to pay where those services are not provided to the satisfaction of the borrower. Moreover, even in the Mosaic model, where the lender does not take responsibility for any O&M, there is still a risk that if the homeowner, left to his or her own devices, fails to properly maintain the solar equipment, and the result is a reduction in the efficiency of the solar assets, this could still give rise to the borrower's refusal to pay the full payments due under the loan. Therefore, it could be argued that having the developer take responsibility for O&M and therefore the responsibility for assuring that the solar assets perform properly could be an advantageous feature when compared to a pure loan structure. At least one rating agency also imposes a stricter stress case where there is not an O&M provider under contract with an investment-grade rating. It should also be pointed out that a pure loan structure falls more directly into the consumer loan regulatory regimes of the federal government and the states, whereas a lease or PPA structure falls more at the periphery of consumer lending regulation. Therefore, in a solar loan program it is essential that the loan documentation be in strict compliance with all of the truth-in-lending and other consumer protection requirements of federal and state law.

PACE Bond Securitization

PACE programs have been adopted by approximately 32 states and over 2000 municipalities. Although the details of PACE programs vary from state to state and municipality to municipality, their common feature is that advances are made to residential and commercial property owners for the purpose of installing solar or energy efficiency retrofits, and the property owner's obligation to repay the advance is evidenced by an assessment that is enforceable by the governmental unit and that has equal lien priority with real estate taxes and other special assessments and are generally senior to all non-tax liens, including mortgages. The governmental entities periodically bundle these assessments into bonds

to capitalize the program and these bonds are in turn aggregated by various PACE administrators or sponsors. The PACE assessments are generally payable on a semi-annual or annual basis at the same time that the property owner's ad valorem real estate taxes are paid, and the proceeds are temporarily comingled by the governmental entity until disbursed to pay debt service on the bonds. The PACE assessments constitute liens against the entire property and not just the specific improvements installed with the PACE proceeds; and the assessment continues to attach to the property irrespective of any intervening transfers of title, until fully paid. The amount of a PACE assessment is normally small relative to the total property value and, unlike a mortgage lien, a default under the assessment generally does not entitle the assessment holder to accelerate the entire assessment. Instead, only the amounts currently due and the amounts in arrears would be due at foreclosure, thus rendering any attempts to cure a PACE assessment default by a mortgagee that is primed by the assessment less onerous.

Although residential PACE assessments, as stated above, prime a pre-recorded mortgage, the Federal Housing Finance Association — as conservator of Fannie Mae and Freddie Mac — has objected to the PACE assessment program as providing unacceptable risks to Fannie Mae and Freddie Mac mortgages. As a consequence, a residential homeowner subject to a PACE assessment will, under the current policy of the FHFA, be required to refinance the PACE assessment in order to obtain a conforming mortgage from either of those GSEs. During the summer of 2016, the Federal Housing Administration announced that it would permit residential PACE assessments to prime residential FHA-insured mortgages, but this did not alter the position of the FHFA with respect to Fannie Mae and Freddie Mac mortgages.

For commercial PACE assessments, because of the larger loan balances involved and the risks of commercial mortgagees successfully contesting the validity of a PACE assessment purporting to prime its mortgage lien, commercial PACE administrators generally follow the practice of obtaining some form of acknowledgment or consent from the mortgagee.

Because PACE assessments constitute liens on the real property, the credit quality of the property owners receiving the PACE advances usually does not play a major part in the underwriting process. The primary metric employed in PACE underwriting standards is the ratio of the PACE assessment to the total property value and to the principal balance of the outstanding mortgage. Because of the priority of PACE assessments, PACE bond securitizations have been well-received by the

rating agencies and by investors. The leading residential PACE originator is Renovate America, which has sponsored securitizations between 2014 and the present aggregating over \$1.6 billion in total issuance. Additional residential PACE securitizations have been sponsored by YGreene Energy Fund and Renew Financial. Securitizations sponsored by these three sponsors in the aggregate total over \$2 billion. While commercial PACE activity has also shown a steady growth trajectory since its inception in 2009, there have been, as of this writing, no commercial PACE-only securitizations, although one or more commercial PACE transactions have been predicted for 2017.

There has been some criticism of the PACE underwriting process based on the fact that the leading originators rely on contractors who receive the contracting work and commissions for originating PACE assessments, thus creating the potential for compromised underwriting standards. Additionally, some concern has been expressed over the quality of disclosure given to residential homeowners of the risks and disadvantages of a PACE assessment, including the disclosure that they may be forced to refinance their PACE loan in the event that they desire to refinance their mortgage with Fannie Mae or Freddie Mac. However, the PACE industry has been proactive in addressing these concerns; and California, which is the most active state for PACE assessments, recently enacted the PACE Preservation and Consumer Protection Act, which introduced additional safeguards, including full financial disclosure prior to signing of documents, full disclosure that the owner may be required by a mortgagee to fully repay the assessment before refinancing or selling the property, plus a three-day right of rescission. Additionally, the U.S. Department of Energy published a best practices for residential PACE programs in November 2016.

Because PACE bonds are backed by assessments on the property, whereas solar projects derive their primary credit support from the obligors under the PPAs, leases or notes, and are not secured by the real estate, a comparison between PACE bonds and solar ABS is instructive. Since collections under PACE assessments are commingled with other tax revenue collections, the credit quality of the municipalities is generally required to be considered in order to avoid extra stressing for bankruptcy risk. Kroll, for example, requires that municipalities responsible for collecting over 10% of PACE revenues in a single securitization either have investment-grade ratings or submit to additional lockbox arrangements. Residential PACE ABS also face the possibility of FHFA challenge to the priority of the assessment lien, and this also has required some special

stressing in the rating methodology applied to PACE bonds. Solar ABS generally relies on the average FICO scores of residential borrowers, lessees, or obligors under power purchase agreements, whereas, as stated previously, the primary metric in a PACE securitization is the lien-to-value ratio. The priority of the PACE assessment lien is, however, the primary driver of the credit analysis in a PACE securitization, and because of the lien priority and the relatively low lien-to-value ratio inherent in most PACE securitization portfolios, the advance rate on PACE ABS issued to date has been in the range of 97 to 99 percent, as compared to the 62 to 80 percent range applicable to solar ABS.

Some additional structural features of PACE ABS are worth noting. For example, in the November 2016 HERO Funding 2016-IV Class A Notes, sponsored by Renovate America, the Notes received an AA (sf) rating from Kroll. The transaction size was \$283,634,000, consisting of Class A1 Notes and Class A2 Notes, which were *pari passu*. The maximum initial lien-to-value for PACE assessments was approximately 14.92 percent. The transaction contained excess spread representing the difference between the rate on the PACE bond portfolio and the rate on the securitization notes, with the bond portfolio having a weighted average coupon of 7.99 percent, and the ABS note rate approximating 4 to 4.5 percent. HERO 2016-IV also contained overcollateralization of three percent and a liquidity reserve required in the amount of one percent of the aggregate bond principal amount, to be funded on the first semi-annual payment date, and an additional one percent to be funded on the second semi-annual payment date. An additional feature of the HERO 2016-IV transaction was that Renovate America agreed to make advances to the issuer, in the event that an underlying PACE assessment does not conform to certain agreed-upon transaction guidelines, equal to the outstanding principal balance of the non-conforming PACE assessments, plus interest to the next payment date. This feature was added to the HERO transactions in 2015 and is intended to be a proxy for the repurchase obligation present in most asset-backed securitizations to remedy a breach of representations and warranties with respect to the collateral.

Because of the concentration of many PACE administrators in only a few states, geographical concentration has been common in PACE securitizations. For example, in the HERO 2016-IV transaction, Los Angeles, San Diego, Riverside, and San Bernardino counties, all in California, accounted for approximately 66.5 percent of the principal balance of the bonds. This represented greater diversification than

in prior HERO offerings, with the HERO 2014-I transaction collateralized by assessments located in only one county (Riverside).

Marketplace Lending

The marketplace lending sector of the securitization market, also known as FinTech, has been growing steadily during 2016, despite adverse headlines coming from two of the largest and oldest online lenders, The Lending Club and CAN Capital. The sector is divided among three sub-categories — (1) unsecured consumer loans, (2) student loans, and (3) small-to-medium enterprise (SME) loans. The unsecured consumer category has generated the largest volume, followed by the student loan category, and then the SME loan category.

The loans for these companies are generated primarily by online lending platforms, and to avoid usury and licensing issues the loans are often originated by industrial banks in states having favorable state bank regulatory frameworks for these institutions. Under these origination platforms, the industrial bank generally originates the loan, often using software and due diligence protocols established by the online lending firm, and thereupon sells, by way of participations, interests in the loans (sometimes 100 percent interests) to the online lending firm.

The underwriting standards for these loans are either the key strength or the key vulnerability to the asset class; and increasing scrutiny is being paid to the quality of the underwriting protocols and the resulting performance of the loan portfolios. The lenders usually negotiate revolving credit or warehouse facilities to fund the ramp-up of their portfolios, and upon reaching a certain critical level of loan volume, the lenders then sponsor term securitizations and use the proceeds to create more capacity for their aggregation funding facilities.

Total issuance volume for marketplace lending securitization for 2016 is estimated at \$7.8 billion, as compared to \$4.9 billion for 2015, representing a 59 percent increase.⁷ In addition to the increased volume, average deal size also grew from \$252 million in 2016, versus \$35 million in 2013.

Because high-yield loans are at the core of marketplace lending, the ability to rely on the usury law applicable for the state in which the lender is located is

important. This ability is traceable to the “valid when made” doctrine, which states that if the interest rate on a bank loan is not deemed usurious based on state law in the originating state, and the loan is sold to a new owner domiciled in a different state and the new owner takes collection action on the loan in a different state from the state where the loan was originated, the loan remains valid and enforceable even if it would be usurious under the laws of the state where the new owner or where the borrower is domiciled. In reliance on this doctrine, the lenders that originate loans for the marketplace lending sector are generally domiciled in states with high usury rate limitations.

A recent decision by the U.S. Court of Appeals for the Second Circuit, *Madden v. Midland Funding, LLC*,⁸ has raised some concerns about the universal application of the “valid when made” doctrine. In *Madden*, the plaintiff, a resident of New York state, had a credit card account with Bank of America, which was transferred for servicing to FIA Card Services and subsequently transferred to Midland Funding. Midland attempted to collect the account, which bore interest at 27 percent, against the plaintiff, although the interest rate is capped at 25 percent on consumer loans under New York law. The Second Circuit on appeal ruled that Midland was not entitled to rely on the “valid when made” doctrine as an absolute defense against assertion of usury laws of the state of residence of the debtor, and remanded the case to the U.S. District Court for the Southern District of New York for the resolution of remaining state law questions. The U.S. Supreme Court declined to review the Second Circuit decision. Subsequently, in response to the defendants’ motion for summary judgment and plaintiff’s motion for class certification, the District Court found that the plaintiff could not assert violations of the New York civil usury statute as a defense, but could assert violations of New York’s criminal usury statute as a defense. The court also held that the plaintiff did not have a valid affirmative claim that the debt was void and uncollectible on the grounds of usury. However, the court did hold that the violation of criminal usury law could be used as a basis for making a claim against the defendants under the New York Fair Debt Collection Practices Act and another provision of New York General Business Law, which permit the recovery of statutory damages as well as actual damages. Thus, while the court held that the loan remained valid, the attempt to collect the interest rate on the loan could give rise to statutory and actual damages under New York law.⁹

⁷ PeerIQ’s Marketplace Lending Securitization Tracker Q 2016, January 25, 2017.

⁸ 786 F. 3d 246 (2nd Cir. 2015).

⁹ 2017 WL 758518, 11-CV-8149 (CS), (S.D.N.Y. Feb. 27, 2017).

The *Madden* decision leaves many unanswered questions. The purpose of this article is not to plumb the depths of usury laws in the context of marketplace lending, but the marketplace lending sector continues to monitor the progress of the *Madden* case as it proceeds through the courts. By its terms, the *Madden* case is limited to consumer lending and to loans that are sold outright to non-bank assignees, as distinguished from loans which are originated by banks, which in turn offer participations to non-bank platforms in a partner-bank model. Moreover, state usury laws are generally more liberal as they pertain to loans to commercial enterprises.

Not all marketplace lenders use bank lending platforms for their origination activities, and some which do not need to rely on the “valid when made” doctrine originate from their own online platforms. Because of the high severity of the risk posed by the *Madden* case in the event that courts ultimately deem loans originated through the partner-funding bank model as invalid, some marketplace lenders are considering applying for their own national bank charters, which would offer the ability to export rates across state lines and avoid the need for individual state-by-state licensing or origination through partner banks. The Office of the Comptroller of the Currency announced in November 2016 that it would grant national bank charters to qualifying FinTech firms, and it subsequently announced in March of this year that its policy for chartering FinTech firms would not be a ticket to “light-touch” supervision but would instead subject firms to full capital and liquidity standards, as well as laws on fair lending, discrimination, and debt collection.

In a sector profile recently published by Moody’s Investors Service on marketplace lending securitizations, Moody’s observed that unsecured consumer installment loans will generally “rank relatively low in borrowers’ payment priority hierarchy because of the lack of ongoing benefits from staying current on the loans — in contrast with credit cards or auto loans [or cell phone contract payments], which have more ongoing utility.”¹⁰ The report goes on to say that marketplace loans in the consumer loan category “may rank even lower than other unsecured consumer loans due to the transactional nature of working with lenders that don’t have local offices and/or because borrowers often will lack relationships with lenders across multiple products that could increase their willingness to repay the debt.”

Another risk cited by Moody’s is that small business loans “offer relatively higher rate loans than available

through banks or government programs, in turn for faster and easier origination processes,” and these higher-borrowing costs could lead to adverse selection in which borrowers with less financial flexibility are more likely to use the loans. The Moody’s report also points out that because marketplace lenders typically rely on proprietary algorithms and data-mining technology, as well as third-party tools and services to prevent fraud, this technology has not been proven to be efficacious in all situations and therefore there can be higher than expected default rates.

Despite these risks, marketplace lending securitizations have obtained strong investment-grade ratings. The senior tranches of marketplace loan securitizations have been assigned ratings of A or BBB. Kroll Bond Rating Agency and DBRS have been the most active in rating these securities. These ratings are achieved through various credit enhancement features, including the following: (1) weighted average yield requirements to assure excess cash flow from the pool; (2) overcollateralization through the issuance of subordinated lower-rated tranches; (3) cash reserve accounts tied to aggregate outstanding principal balance of the notes; and (4) triggers resulting from deficiencies in weighted average yields, weighted average excess spreads, and average delinquency rates on loans. Some marketplace lending securitizations are issued in the form of static loan pools, whereas others are issued as revolving pool securitizations. In a recent revolving pool marketplace loan securitization, there was a limited (36-month) revolving period, during which no principal amortization would occur, and there was a targeted receivables balance which, if not attained, is required to be supplemented in the form of an excess funding cash account.

Whole Business Securitization

Whole business securitization first appeared in the United States in the early 2000s, with relatively small securitizations of franchise fees and trademark royalties of the Arby’s fast-food restaurant chain, the Athlete Foot Group of athletic shoe stores, and the Guess? trademark portfolio. The first marquee whole business securitization in the U.S. was the Dunkin’ Brands-sponsored \$1.7 billion franchise and trademark royalty securitization, which was closed in 2006. It is beyond the scope of this article to analyze the particular bankruptcy issues that needed to be resolved in order for whole business securitization to become a large

¹⁰ *A Guide to Marketplace Lending Securitizations*, Moody’s Investors Service, February 13, 2017.

component of the esoteric ABS sector.¹¹ The secret sauce of whole business securitization is its ability to create rating uplifts several notches above the long-term debt rating of the sponsor company, despite the fact that the revenues generated by the franchise or other operating business are dependent upon the management of the sponsor. A second challenge was the fact that the revenues available for debt service payments are revenues after paying operating expenses, which take a priority because they are necessary to operate the business; i.e., most whole business securitizations rely on EBITDA-based cash flow rather than gross revenues of self-liquidating financial assets, which normally support more typical esoteric ABS or non-esoteric transactions.

Based on the strength and market position of the sponsor company and stress scenarios that assume a bankruptcy filing by the sponsor, rating agencies have succeeded in assigning ratings to whole business transactions that are elevated several notches above the rating of the operating company. Companies most frequently taking advantage of whole business securitization technology are large food franchise systems, which have a preponderance of franchisee-operated (as opposed to company-operated) stores, whose brands are well-established with a long operating history, and which are attracted to the relatively low funding costs of WBS as compared to regular-way bank debt.

The year 2016 was a relatively slow year for WBS transactions, with two food franchise securitizations — Sonic \$575 million transaction and Taco Bell \$2.1 billion transaction — both pricing in April 2016, and with a \$505 million Driven Brands deal pricing the following month. Since most WBS transactions generally refinance the entire capital structure of the sponsor company, including off-shore assets, once a transaction is closed there are no follow-on issuances by the sponsor until conditions are ripe for another refinancing. This partly explains the sometimes sporadic schedule of WBS issuance. Because many of the food franchise systems that are large enough to sponsor WBS transactions have stores in multiple jurisdictions, they often include both on-shore and off-shore assets in their collateral. One recent exception is Taco Bell, which limited its securitization to its U.S. assets. While it is unclear why this was done in that instance, companies with multi-jurisdictional assets that contemplate a WBS transaction would be well-advised to address their multi-

jurisdictional tax structuring concurrently with their WBS financing, to assure the optimization of both and to avoid putting into place tax structures that limit their options for their WBS structures, and vice versa.

The current year is expected to see more activity in WBS than 2016, with new companies expected to enter the securitization market for the first time. Two new WBS entries so far in 2017 are the TGIF Funding (Series 2017-1) transaction, representing the debut issuance into the WBS market by the TGI Friday's restaurant chain, and the FOCUS Brands LLC/Carvel Funding LLC/McAlister's Funding LLC transaction, representing the first securitization of the Auntie Anne's, Carvel, Cinnabon, McAlister's Deli, Moe's Southwest Grill, and Schlotzsky's franchise operations.

The TGIF transaction was issued in two tranches, Class A-1 Notes and Class A-2 Notes. The Class A-1 Notes are variable funding notes, in the sum of \$50 million, which were rated BBB- (sf) by S&P and BBB (sf) by Kroll. (WBS transactions usually consist of variable funding notes as a companion to the term notes, to assure a source of liquidity if revenues or expenses do not track estimates.) The Class A-2 Notes were term notes in the principal sum of \$375 million and were rated BBB- (sf) by S&P and BBB (sf) by Kroll. The collateral for the transaction consisted of existing and future franchise agreements, existing and future company-operated restaurant royalties, license agreements, intellectual property, and related revenues. The proceeds of the transaction were used to refinance the company's existing debt while also providing a dividend to shareholders. The total TGIF restaurant system included approximately 903 locations and the transaction was backed by royalties from 849 locations and 54 company-operated restaurants. Only slightly over 50 percent of the restaurant locations are located within the United States, while the remainder are outside the U.S., across over 50 countries.

The Class A-2 Notes had a weighted average life of 6.7 and were priced at a spread of 411 basis points over the comparable risk-free rate, with a coupon of 6.202 percent and a yield of 6.250 percent. The long-term corporate rating of TGI Friday's was B+ from S&P and B2 from Moody's. Thus, the rating on the whole business securitization notes was elevated four notches above the corporate rating of S&P. In its pre-sale report, S&P commented that its preliminary BBB- (sf) rating was lower than many other corporate securitizations they have rated, to take into account the relative credit weaknesses of the sponsor, including lower store count, higher franchisee concentration, and higher foreign currency exposure. Key structural features supporting the rating uplift over the corporate debt rating were as

¹¹ See Borod, Sroka and Apstein, *The Second Coming of Whole Business Securitization*, World Trademark Review, June/July 2015, pp. 34-39.

follows: (1) cash trapping event (50 percent of cash flow is trapped if the debt-service-coverage-ratio (“DSCR”) is less than 1.75x but equal to or greater than 1.50x). If DSCR is less than 1.50x, then 100 percent of excess cash flows are trapped; (2) rapid amortization event (triggered if DSCR is less than 1.20x); (3) cash flow sweeping event (if senior leverage ratio is greater than 8.5x, then 50 percent of all excess cash flows will be used to amortize principal); (4) manager termination (if on any payment date the interest-only DSCR is less than 1.2x, then the Manager (TGI Friday’s) may be terminated with the consent of the controlling class of notes); and (5) event of default DSCR trigger (if on any payment date the interest-only DSCR is less than 1.10x, an event of default will have occurred, triggering acceleration of all outstanding notes.)

S&P also provided in its pre-sale report a comparison of the TGIF transaction to other WBS transactions that it had recently rated, and, while the average unit volume of the TGIF stores was higher than the comparables, the number of stores included in the franchise was substantially smaller than the comparables. Another enhancing feature of the TGIF transaction was that Midland Loan Services agreed to act as servicer and as such will act as the “control party” and is required to make interest and collateral protection advances to the extent they are deemed recoverable. In addition, FTI Consulting, Inc. was designated as the back-up manager, to take the place of the sponsor company in the event of the company’s bankruptcy or inability to perform its functions under the management agreement.

The FOCUS Brands deal involved \$200 million of Class A-1 Notes (issued as variable funding notes) and \$800 million of Class A-2 Notes (issued as term notes), divided into A-2-I Notes and A-2-II Notes. All Notes were rated BBB+ (sf) by Kroll and BBB(sf) by S&P. The deal has structural features similar to the TGIF transaction, except that the cash flow sweeping event is triggered when the DSCR is less than 2.00x and the sweep occurs only with respect to the Class A-2-II Notes. The Class A-2 Notes also have scheduled amortization at only 1% per annum of the initial principal balance until April 2021 in the case of the A-2-I Notes and April 2027 in the case of the A-2-II Notes, at which times the Notes convert to a payment mode whereby all available cash flow is applied to reduce the Notes. There is no amortization if specified leverage ratios are no greater than 5.00x. Another structural difference is that the FOCUS Brands transaction has a Master Issuer (FOCUS Brands Funding LLC) and two Co-Issuers (Carvel Funding LLC and McAlister’s Funding LLC), plus guaranties from each of the parent HoldCo’s of these issuers.

CONCLUSION

As this article is being written, the Trump administration and the new Republican-controlled Congress have set their sights on rolling back the financial regulatory reforms embodied in the Dodd-Frank Act¹² and the rules promulgated thereunder. It is beyond the scope of this article to analyze the various ways in which the new rules under Dodd-Frank have affected the esoteric ABS market. It is worth noting, however, that the greatest impact of the new rules on the esoteric sector are the risk retention rules,¹³ which generally require sponsors of securitizations to retain “skin-in-the-game” in the securitized assets in the form of a retained interest equal to at least 5% of the credit exposure. Most, although not all, of the esoteric ABS transactions described above require retained exposure to the securitized assets of at least 5%, if not substantially more, in order to obtain the desired investment-grade rating and often in order to receive a tax opinion that the notes that are issued will be classified as debt for U.S. income tax purposes. What the risk retention rules added were formal requirements to assure that the retained risk is properly sized and structured to meet the 5% test; but even without these rules sponsors of the cell phone, wireless spectrum, solar, marketplace loan, and whole business¹⁴ securitizations discussed above will usually hold a significant residual exposure in any event (the one exception being PACE transactions, which have to date received investment-grade ratings at advance rates of 97 to 99%).

It is impossible to predict which of the Dodd-Frank rules will be affected by the current attempt to de-regulate the financial markets. However, it is the responsibility of the participants in the esoteric ABS sector to chart their future course by the abiding principles discussed in the Prologue to this article, regardless of the regulatory framework in which they operate; and if they follow that course, then the future of the esoteric ABS market should be bright. ■

¹² Pub.L. 111–203, H.R. 4173.

¹³ Section 15G of the Securities Exchange Act of 1934, as added by section 941(b) of the Dodd-Frank Act.

¹⁴ Whole business securitizations generally are not required to comply with the risk retention rules because the transactions generally do not fall within the definition of an “asset-backed security” covered by the rules, since they are not securities collateralized by a self-liquidating financial asset. However, the sponsor operating companies are, because of the nature and purpose of the transactions, generally required to retain an interest in the securitization far in excess of 5%.

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