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Can Whole Business Securitization *re-emerge*?

By Ronald S. Borod

It's certainly a challenge. The structure is hard to sell in a market that's currently shunning complexity and leverage. But if investors and issuers can overcome these hurdles, there's a future yet for this cost-effective financing tool.

Prior to the subprime meltdown, whole business securitization was on a modest upward trajectory in the United States. By providing favorable rates compared with more costly leveraged financing, it was becoming an attractive tool for refinancing private equity acquisitions of public companies like Dunkin' Brands. And the structure was also gaining popularity more generally as a way to reduce interest expense and to fund stock buy-backs, as in the IHOP, Sonic and Domino's Pizza transactions.

The rate differential was the result of ratings methodologies that facilitated multi-notch shadow rating uplifts above a company's debt ratings, and these in turn qualified the bonds for a triple-A wrap by a monoline insurer. In the Dunkin' deal, that allowed the firm to shave two-and-a-third percentage points off its annual interest payments, or $35 million.

The current credit market turmoil has made whole business securitization even more challenging than before while at the same time creating increased demand for its resurgence.

The leveraged buyout sector is already under substantial pressure. Major banks' exposure to LBO debt, much of it underwater, still runs at over $100 billion, leading to some to devise ways to reduce the pressure on their balance sheets, even if that means selling at a loss. Some even face the prospect of lawsuits from LBO firms over alleged unfunded commitments.

This pressure will only increase as leveraged loans closed several years ago hit their bullet maturities at a time when replacement credit, if available at all, will come at a much higher price and with much less favorable terms.

All this could create enough demand for whole business ABS to come to the rescue. Of course, demand alone does not a market make. A number of potentially conflicting factors will help determine when this funding tool returns to favor.

Chief among these: investors returning to asset-focused fundamentals. Income-generating assets and businesses have consistently been the centerpiece for esoteric asset securitizations generally and whole business securitizations in particular. The agencies have applied uniformly stringent stress cases and structural requirements when rating these transactions. As a result, ratings downgrades, defaults and rapid amortization events in this sector have been a rarity.

Is it time to come back out yet? Getty

If inattention to asset quality is perceived as the principal failure contributing to the current meltdown, it would be logical to expect the lights to come back on first in the esoteric sector before power is restored to the rest of the securitization grid.

Aligned with this factor is a general flight from complexity. Whole business securitizations, like other esoteric securitizations, are of course complex. But that is derived from the nature of the assets being securitized — not from the use of derivatives or multi-layered asset structures in the often impenetrable web of derivative products imbedded in CDO and SIV transactions. Unlike with CDOs of ABS, CDOs-squared, and other multi-layered securitizations, investors in a whole business securitization do not need to drill down several layers to identify the assets and the obligors on which cash flow depends.

Big challenge: the monoline meltdown

If the only take-away from the current crisis is that complexity is bad and simplicity is good, then the future of all forms of securitization except the most plain vanilla will be bleak indeed.

Just as there was a stigma attached to the SPE in the immediate aftermath of the Enron scandal, there is likely to be a stigma attached to complexity in the immediate wake of the current crisis. However, institutional investors are sophisticated enough to differentiate among different types of complexity, and any generic flight from organic complexity should be short-lived.

The meltdown of monoline insurers poses another big challenge. Whole business transactions relied heavily on monoline wraps, and the primary rating challenge has been to achieve the rating elevation to investment grade necessary to qualify for the guaranty policy. Most businesses for which ABS pricing is attractive — and particularly those which have been acquired in a leveraged buy-out — have junk ratings and are seeking significant debt service savings through refinancing their acquisition debt in the ABS market. For many, it is a stretch to reach investment grade on an unwrapped basis. If the monoline industry is not restored to its prior health, it will be difficult to issue large tranches of whole business deals with triple-A ratings, thus substantially reducing the investor base. If the senior tranches of whole business transactions are rated at the lower range of investment grade it will be difficult to meet the large funding requirements of these deals. If the monolines are not successful in recapitalizing themselves back to health, new third party enhancers or new structural enhancements will be needed.

The current credit market turmoil has made whole business securitization even more challenging than before while at the same time creating increased demand for its resurgence.

In addition, those investors who relied on bond insurance and did not analyze the complexity underneath the wrap will need to analyze the underlying complexity of the deal. This will add to the difficulties of filling out large order books.

Leverage also plays a major role in the attractiveness of whole business securitization. The ratios achieved by whole business transactions are not always transparent. Total rated debt in each of the Dunkin' Brands, Sonic and Domino's securitizations was just under seven times securitized cash flows, whereas the corresponding ratio for the first IHOP transaction was just above two times. Another key variable is leverage ratio triggers, which generally correlate to the leverage permitted at initial issuance. In the most recent publicly rated transaction, Local Insight Media Finance, which was wrapped by Ambac, the leverage ratio (partial amortization) trigger was set at eight-and-a-quarter times securitized cash flows for the first year, declining thereafter by 25 basis points each year. For new deals to achieve ratings between single- to triple-A on an unwrapped basis, the leverage on the higher-rated tranches will have to be reduced sufficiently to meet the stress tests and simulations for those rating levels. The challenge will be to achieve an all-in advance rate sufficient to meet the requirements of the sponsor while at the same time achieving the required rating and investor acceptance.

Another problem to be solved in the wake of the monoline crisis is the absence of the monoline insurer to make decisions on an expedited basis in the event of a default or a trigger event. The presence of a monoline insurer assured a timely and informed response during the transition between the sponsor-servicer regime and the regime of the back-up servicer; and also assured proper oversight of the activities of the servicer and the back-up servicer. The absence of a monoline insurer will require the creation of a new role within the securitization structure to perform this function. One possibility would be to include a designated bondholder representative or special servicer when the bonds are issued, empowered to act on behalf of the bondholders upon the occurrence of certain enumerated events.

The final possible by-product of the subprime meltdown is investors' and ratings agencies' heightened risk aversion and the resulting need to create deal structures that offer better protection. Because most whole business transactions involve the transfer of substantially all of the cash-generating assets from the sponsor to the SPV, there is increased risk that a bankruptcy judge would, in the case of a bankruptcy filing against the sponsor, be tempted to rule that the debtor company needs the assets previously transferred to the SPV in order to be successfully reorganized. This was the basis for the "core asset" doctrine enunciated in the Days Inn and LTV Steel cases, where the Bankruptcy Court came dangerously close to disregarding the true sale of the company's assets to the SPV and consolidating the SPV with the bankrupt estate. To obtain a significant ratings elevation above the rating of the sponsor company, it may be necessary to provide added comfort that this is unlikely to occur.

One method for doing so, which is already common practice in whole business securitizations, is to require that the proceeds of the whole business transaction be used to retire the secured debt facility of the company and to require the company to covenant that it will not incur additional long-term debt, thus removing the possibility of an involuntary filing by a secured lender and thus a challenge on the basis of the core asset doctrine. However, trade creditors and other general unsecured creditors can also pose a threat of an involuntary bankruptcy filing against the sponsor company. Therefore, other structural features may be necessary in certain circumstances to insulate the sponsor from the incurrence of trade claims and other liabilities which could trigger bankruptcy filings by or against the company. One structural feature to be considered is to ring-fence the operating company by creating a NewCo to perform the operating functions of the sponsor company post-securitization.

If these hurdles can be cleared, and whole business securitization deal flow can be restored, the applications of whole business technology are limited only by one's imagination — and by the restrictions imposed by a newly chastened market.

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After The Fall: Redemption For Whole Business Securitization?

BY RONALD S. BOROD (BROWN RUDNICK BERLACK ISRAELS LLP)

Repercussions of the subprime meltdown, which began in the summer of 2007, continue to immobilize the structured debt markets of the U.S., have begun to disrupt the U.S. tax-exempt bond market, the U.S. equity markets and other markets around the world, and are currently contributing to a U.S. economic recession. The multiple failures by the rating agencies, CDO managers, monolines and other structured finance participants, which led to a series of lapses in underwriting standards, rating agency methodologies and common sense, are not the focus of this article. Suffice it to say that these lapses led to a subversion of the basic principles on which the securitization market was built and turned the securitization paradigm—an asset-focused and supply-driven process—into a demand-driven process in which the quality of the assets became secondary to the need to fill up the MBS, CDO and SIV tranches to meet the seemingly insatiable investor appetite. The massive over-

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Tax and Other Considerations For Doing Business in China via the Cayman Islands

BY FRED M. GREGURAS, BARTON W.S. BASSETT AND JIANWEI ZHANG (FENWICK & WEST LLP)

Many companies doing business in China are using a structure that includes a company formed under the laws of the Cayman Islands (CI). Chinese technology and Internet companies (such as Actions Semiconductor, Baidu, CTrip, China Medical Technologies, China Sunergy, Focus Media, Longtop Financial Technologies, Noah Education Holdings, Shanda, Suntech Power, Tom Online, VanceInfo Technologies and Vision China Media) listed on U.S. stock exchanges are actually CI companies. The primary business reasons for an offshore structure are flexibility in an exit strategy, whether in connection with an initial public offering (IPO) or an acquisition; the possibility of reducing U.S. taxes; and reducing the impact of China's currency exchange restrictions.

In the simplest form, the structure is a CI company with a China subsidiary. Investments are made in the CI company and the subsidiary is the operating

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Can Whole Business Securitization Be Saved?
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leveraging which resulted is now being corrected by an equally massive de-leveraging, the extent of which cannot be predicted at this writing.

Notwithstanding the scale and duration of the subprime meltdown, and notwithstanding predictions that the CDO and SIV markets will be closed down for the foreseeable future, it is fair to ask (1) whether the esoteric sector of the securitization market—for which a close analysis of the underlying assets has always been the starting point and for which the rating agencies have applied more conservative assumptions in stressing anticipated cash flows—can return to favor in the eyes of the institutional investor community, and (2) if so, what changes can be expected in these transactions when they return to the market. This article will focus on one segment of this market, which was relatively new in the U.S. when the subprime meltdown occurred—whole business securitization.

Because many of the target companies were rich in trademarks and other intangibles, these assets were frequently used in the securitization.

History of Whole Business Securitization Before the Fall

Prior to the subprime meltdown, whole business securitization was on an upward trajectory in the United States. This was due to the convergence of three trends in the U.S. financial markets: *first*, some breakthroughs in rating methodologies that opened new pathways for issuing asset-backed debt rated multiple notches above the rating of the sponsoring company despite the dependency of the cash flows on the operating performance of the sponsor; *secondly*, the growing prominence of intellectual property and other intangible assets in the value chain of operating companies; and *thirdly*, the surge in merger and acquisition activities of private equity funds, with a significant portion of the liquidity provided by acquisition or bridge financings of the large banks. What emerged from the confluence of these three trends was a new template which was becoming the standard in M&A transactions: acquisitions were funded with a mix of equity and high-yield acquisition debt, followed by a refinancing into lower-yielding highly-rated debt through the issuance of ABS. Because many of the target companies were rich in trademarks and other intangibles, these assets were frequently used in the securitization; and because the performance of these assets was in many cases heavily dependent upon the operations of the target company, whole business securitization technology was used to achieve the desired rating uplift.

The most highly publicized exemplar of this new template was the 1.7 billion USD franchise and trademark royalty securitization—DB Master Finance, LLC—closed in 2006. This transaction securitized the revenues generated by trademark licenses, franchise agreements and real estate leases created by the Dunkin' Donuts, Baskin-Robbins and Togo's fast food franchises owned by Dunkin' Brands, Inc. ("DBI"). The securities issued by DB Master Finance, LLC achieved a shadow investment grade rating which enabled the issuer to obtain a monoline wrap on most of its bonds so that they were rated AAA/Aaa when sold to investors. The proceeds of the transaction were used in part to repay a 1.5 billion USD acquisition loan incurred only a few months before in a leveraged buyout of DBI by three private equity firms. The corporate debt of DBI at the time had a B- rating due to the substantial leverage (8.5 times) resulting from the LBO.

In granting the rating elevation to DB Master Finance, S&P and Moody's relied heavily upon the strength of the respective brands owned by DBI's three fast food franchises, their prior revenue history and the brands' strong market position, which together enabled the rating agencies to conclude that DBI would remain as a viable going concern. Furthermore, the agencies found that, were DBI to file for bankruptcy, it would be economically motivated to seek to reorganize under Chapter 11 rather than to liquidate. S&P's rating analysis concluded that in the event of a reorganization, DBI, acting as master servicer/manager, would most likely affirm the master servicing agreement under which it was obligated to continue managing the trademarks and the franchise agreements of the three restaurant chains, even though such an agreement could be rejected in bankruptcy as an executory contract. This reasoning was based on the view that affirmation of such contract would be beneficial to the bankruptcy estate of DBI by enabling it to continue to receive the servicing fees (in its role as servicer) and to manage the assets for future growth (in its role as residual equity

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holder). Finally, additional comfort was provided by the fact that a back-up servicer/manager (identified at the time the bonds were issued) could step in and provide the servicing functions needed to ensure the continuation of the cash flows in the event that a bankrupt DBI should choose to reject the master servicing agreement.

Other whole business securitizations involving food franchise systems (including deals by Arby's, Sonic, Domino's Pizza, IHOP and Applebee's) and using structures similar to the Dunkin' Brands securitization have also been closed. In addition to these food franchise transactions, there has been one whole business transaction in the advertising sector and another receiving an unpublished rating from Moody's involving an intra-company licensing of consumer goods trademarks. The former—Local Insight Media, L.P.—was a 547 million USD securitization of cash flows generated by two of Local Insight Media's subsidiaries, ACS media and CBD Media, which publish print directories and internet-based local search services in Alaska and the Cincinnati, Ohio metropolitan area. The latter – KCD IP – involved a whole business structure supported solely by cash flows internally generated through intra-company licenses of the Kenmore, Craftsman and DieHard brands of appliances, tools and batteries sold in Sears and Kmart stores. The 1.8 billion USD of bonds received a Moody's rating (unpublished) of Baa2.

Future of Whole Business Securitization

The market impact of the subprime crisis has itself created new pent-up demand for whole business securitization once the market stabilizes sufficiently for ABS transactions to re-enter the market. As a consequence of this crisis, a substantial portion of bridge loan commitments, which had been issued to finance acquisitions of operating companies by private equity firms, were required to be funded by the issuing banks alone, without the ability to fill out their syndicates with other bank participants. Moreover, the liberal terms which lenders were falling over themselves to offer prior to the meltdown—such as covenant-free or covenant-lite financings or pik-toggle features—have now joined the dinosaurs in the tar pits. Consequently, the banks and the private equity funds are in many instances joined in a lose-lose proposition: The lenders, having suffered multi-billion dollar writedowns as a consequence of their subprime exposures, are facing potential writedowns of their leverage finance book if they attempt to sell their positions, or are forced to classify their exposures as hold-to-maturity investments, which is often an equally unattractive option. The private equity firms were obligated under loan terms which in many cases do not offer the flexibility for growth of the acquired business or for funding of working capital or new acquisitions; and their acquisition debt may become subject to a lengthy lock-out if the lender ultimately succeeds in syndicating its exposure to other banks.

If the esoteric segment of the ABS market (including whole business securitization) should be the first to emerge from the current morass, there should be a strong demand from both the borrowers and lenders for whole business securitization to provide refinancing of these stranded acquisition loans.

If the esoteric segment of the ABS market (including whole business securitization)—with its focus on the underlying assets and conservative rating agency stress cases, and with historically strong performance results—should be the first to emerge from the current morass, there should be a strong demand from both the borrowers and lenders for whole business securitization to provide refinancing of these stranded acquisition loans.

The fact that the Local Insight Media Transaction was rated and closed in late 2007 offers a glimmer of hope that this sector will not suffer long-term consequences from the current crisis. In the short run, however, the crisis is expected to drive certain changes in the structure of whole business transactions. A few expected changes are listed below:

- *Fewer Wrapped Deals* – If the monolines, whose capital adequacy has been severely compromised by their subprime exposure, are unable to re-enter the market at the levels experienced prior to the meltdown, more unwrapped whole business transactions will be seen in the market.
- *Different Tranching* – With more unwrapped deals, it is expected that subordination levels will be changed to respond to new investor requirements. For example, unwrapped Baa/BBB tranches will be difficult to sell, because

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many regulated investors will be unwilling to buy securities which they will be forced to sell in the event of a one-notch downgrade. Also, it may be difficult to fill orders for variable rate tranches (typically used to fund working capital requirements and typically provided by the bank market). Underwriting firms currently active in the whole business sector are reportedly speaking with investors in an effort to re-map the securities distribution necessary to fund large whole business transactions.

Another entity should be identified to act as bondholder representative if the deal is not wrapped.

- *Need for Bondholder Representative* – One of the functions of a monoline in a whole business or any other securitization, in addition to providing the financial guarantee, is to make decisions on an expedited basis on behalf of the bondholders in the event of a default or a pre-default event. This is particularly important in the context of a whole business transaction, and therefore, another entity should be identified to perform this function if the deal is not wrapped. (One possibility is to have a designated Bondholder Representative which is empowered to act on behalf of the bondholders with respect to certain enumerated decisions, thereby avoiding the time-consuming and burdensome process of obtaining bondholder approval when actions are required on an expedited basis.)
- *Bankruptcy-Proofing of Sponsor Entity*—Because most whole business transactions involve the transfer of substantially all of the assets from the sponsor to the SPV, there is increased risk that a Bankruptcy Judge would in the case of the bankruptcy filing against the sponsor, be tempted to rule that the company needs the assets transferred to the SPV in order to be successfully reorganized. This was the basis for the "core asset" doctrine cited in the Days Inn and LTV Steel cases, where the Bankruptcy Court came dangerously close to disregarding the true sale of the company's assets to the SPV and consolidating the SPV with the bankrupt estate. To obtain a significant ratings elevation above the rating of the sponsor company, it will be necessary to provide comfort that this is unlikely to occur. One method for doing so is to require that the proceeds of the whole business transaction be used to retire the existing debt facility of the company and to require the company to covenant that it will not incur additional long–term debt, this removing the possibility of an involuntary filing and thus a challenge on the basis of the core asset doctrine. However, trade creditors can also pose a threat.

Therefore, other structures may be necessary to insulate the sponsor from the incurrence

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of trade claims and other liabilities which could trigger bankruptcy filings by or against the company.

- *Future Candidates for Whole Business Securitization*—In addition to private equity funds which were forced by the meltdown to take down their bridge loans and prevented from refinancing them with securitized debt, other candidates for whole business transactions may include outsourcing companies and hotel companies. A survey of the major outsourcing vendors indicated estimated revenues for 2005 for the top 50 vendors aggregated in excess of 422 billion USD. Many of these companies have investment grade ratings and therefore may not need access to the securitization market. However, many others do not, and thus whole business securitization could be attractive. The most appropriate candidates would, of course, be outsourcing companies with strong competitive market positions and a diverse portfolio of customers with (optimally) strong credit profiles. Because outsourcing contracts are by their nature highly negotiated and terminable both for cause and under "termination for convenience" clauses, companies will also have to demonstrate through company-specific and industry-wide statistical data the sustainability of their cash flows over time. Moody's has recently issued a special report on hotel franchise fee securitizations (dated February 13, 2008) in which it predicts that there will be hotel franchise fee transactions entering the market soon, and that they will be rated in a manner similar to the food franchise system transactions. The one unique characteristic of hotel transactions is that securitizations are more likely to be based on royalty fees (representing the franchise or compensation for the use of the brand name, logos, good will and other franchise services) than on the basis of program fees (such as advertising fees, reservation fees and fees for system and technical support) because the former typically have lower volatility than the latter. In such case, the program fees would not be made available to the noteholders but would instead be deposited in a special account and used by the franchisor to cover marketing, advertising, reservation, system and other expenses. ❑

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After the fall: redemption for whole business securitisation?

Ronald S Borod, Madeleine ML Tan and Brian P Gallogly
Brown Rudnick Berlack Israels LLP

John Milton's epic poem *Paradise Lost* tells the story of the fall of man:

> *"Say first—for Heaven hides nothing from thy view,*
> *Nor the deep tract of Hell—say first what cause*
> *Moved our grand parents, in that happy state,*
> *Favour'd of Heaven so highly, to fall off*
> *From their Creator, and transgress his will*
> *For one restraint, lords of the World besides.*
> *Who first seduced them to that foul revolt?*
> *Th' infernal Serpent; he it was whose guile,*
> *Stirr'd up with envy and revenge, deceived*
> *The mother of mankind, what time his pride*
> *Had cast him out from Heaven with all his host*
> *Of rebel Angels, by whose aid aspiring*
> *To set himself in glory above his peers,*
> *He trusted to have equall'd the Most High..."*

(John Milton, *Paradise Lost*, Chapter1, Book I.)

Repercussions of the fall of the sub-prime market, which began in Summer 2007, continue to immobilise the US structured debt markets; have begun to disrupt the US tax-exempt bond market, the US equity markets and other markets around the world; and are contributing to a US economic recession. The multiple failures by the

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rating agencies, collateralised debt obligation (CDO) managers, monolines and other structured finance participants, which led to a series of lapses in underwriting standards, rating agency methodologies and common sense, are not the focus of this chapter. Suffice it to say that these lapses led to a subversion of the basic principles on which the securitisation market was built and turned the securitisation paradigm – an asset-focused and supply-driven process – into a demand-driven process in which the quality of the assets became secondary to the need to fill up the mortgage-backed securities, CDO and structured investment vehicle (SIV) tranches to meet seemingly insatiable investor appetites. The massive over-leveraging which resulted is now being corrected by an equally massive deleveraging, the extent of which cannot be predicted at the time of writing, and has caused liquidity crises at Bear Stearns in the United States and Northern Rock in the United Kingdom of sufficiently broad impact to warrant national government intervention.

Notwithstanding the scale and duration of the sub-prime meltdown and predictions that the CDO and SIV markets will be closed down for the foreseeable future, it is fair to ask:

- whether the esoteric sector of the securitisation market – for which close scrutiny of the underlying assets has always been the central focus and for which the rating agencies have applied conservative rating methodologies – will be the first to return to favour in the eyes of the institutional investor community;
- which market forces may hasten (or could delay) its return; and
- what changes can be expected in these transactions when they return to the market.

This chapter focuses on one segment of this market which was relatively new to the United States when the sub-prime meltdown occurred: whole business securitisation.

History of whole business securitisation: before the fall

Prior to the sub-prime meltdown, whole business securitisation was on an upward trajectory in the United States. This was due to the convergence of three trends in the US financial markets:

- some breakthroughs in rating methodologies that opened new pathways for issuing asset-backed debt-rated multiple notches above the rating of the sponsoring company despite the dependency of the cash flows on the operating performance of the sponsor;
- the growing prominence of intellectual property and other intangible assets in the value chain of operating companies; and
- the surge in merger and acquisition (M&A) activities of private equity funds, with a significant portion of the liquidity provided by acquisition or bridge financings of the large banks.

What emerged from the confluence of these three trends was a new template which was becoming the standard in M&A transactions: acquisitions were funded with a mix of equity and high-yield acquisition debt, followed by a refinancing into lower-yielding highly rated debt through the issuance of asset-backed securities (ABS). As many of the target companies were rich in trademarks and other intangibles, these assets were frequently used in the securitisation; as the performance of these assets was in many cases heavily dependent upon the operations of the target company, whole business securitisation technology was used to achieve the desired rating uplift.

The most highly publicised example of this new template was the $1.7 billion franchise and trademark royalty securitisation DB Master Finance, LLC, which was closed in 2006. This transaction securitised the revenues generated by trademark licences, franchise agreements and real estate leases created by the Dunkin' Donuts, Baskin-Robbins and Togo's fast-food franchises owned by Dunkin' Brands, Inc. The securities issued by DB Master

Finance, LLC achieved a shadow investment grade rating which enabled the issuer to obtain a monoline wrap on most of its bonds so that they were rated AAA/Aaa when sold to investors. The proceeds of the transaction were used in part to repay a $1.5 billion acquisition loan incurred only a few months before in a leveraged buy-out of Dunkin' Brands, Inc by three private equity firms. At the time the corporate debt of Dunkin' Brands, Inc had a B- rating due to the substantial leverage (8.5 times) resulting from the leveraged buy-out.

In granting the rating elevation to DB Master Finance, Standard & Poor's and Moody's relied heavily on the strength of the respective brands owned by Dunkin' Brands, Inc's three fast-food franchises, their prior revenue history and the brands' strong market position, which together enabled the rating agencies to conclude that Dunkin' Brands, Inc would remain as a viable going concern. Furthermore, the agencies found that were Dunkin' Brands, Inc to file for bankruptcy, it would be economically motivated to seek to reorganise under Chapter 11 rather than to liquidate. Standard & Poor's rating analysis concluded that in the event of a reorganisation, Dunkin' Brands, Inc, acting as manager of the franchise businesses under a master management agreement, would most likely affirm the master management agreement, even though such an agreement could be rejected in bankruptcy as an executory contract. This reasoning was based on the view that affirmation of such contract would be beneficial to the bankruptcy estate of Dunkin' Brands, Inc by enabling it to continue to receive the management fees (in its role as manager) and to manage the assets for future growth (in its role as residual equity holder). Finally, additional comfort was provided by the fact that a back-up manager (identified at the time the bonds were issued) could step in and provide the management functions needed to ensure the continuation of the cash flows in the event that a bankrupt Dunkin' Brands, Inc should choose to reject the master management agreement.

By analysing these factors, the agencies were able to rate the transaction through the bankruptcy of the operating company – that is, they were able to de-link the rating on the securitised debt from the sponsor's debt rating, despite the fact that there was a significant degree of dependency on the continued business operation of Dunkin' Brands, Inc. This resulted in a net annual debt service saving of approximately $35 million for the parent company.

Other whole business securitisations involving food franchise systems (including deals by Arby's, Sonic, Domino's Pizza, IHOP and Applebee's) and using structures similar to the Dunkin' Brands securitisation have also been closed. In addition to these food franchise transactions, there has been one reported whole business transaction in the advertising sector and another receiving an unpublished rating from Moody's involving an intra-company licensing of consumer goods trademarks. The former – Local Insight Media, LP – was a $547 million securitisation of cash flows generated by two of Local Insight Media's subsidiaries, ACS Media and CBD Media, which publish print directories and internet-based local search services in Alaska and the Cincinnati metropolitan area. The latter – KCD IP – involved a whole business structure supported solely by cash flows internally generated through intra-company licences of the Kenmore, Craftsman and DieHard brands of appliances, tools and batteries sold in Sears and K-mart stores. The $1.8 billion-worth of bonds received a Moody's rating (unpublished) of Baa2, several notches above the corporate debt rating of Sears.

Each of these transactions involved not only the cash flows of well-established brands, but also a strong business case for accessing the ABS market for liquidity. Businesses with ample liquidity and high credit ratings do not generally turn to the securitisation market without special strategic reasons. The ABS market provides attractive financing terms to companies with below or low investment grade ratings which are subject to capital constraints and in need of liquidity. However, for a capital-constrained company to access the ABS market using the whole business model, that company's business must be of sufficient quality and sustainability to allow rating agencies to rate cash flows

generated by the business after taking into account operating expenses which must be incurred in order to generate these revenues. In other words, whole business securitisation – unlike the securitisation of self-liquidating financial assets which are not dependent upon an operating company to generate cash flow – must allow gross revenues to be used for operating expenses at the top of the cash waterfall, before cash flow is available to service the debt. In short, whole business structures rely on earnings before interest, taxes, depreciation and amortisation (EBITDA) rather than gross revenues to pay debt service on the bonds. Consequently, for businesses to achieve favourable results under this model, the businesses themselves must be in a strong competitive position with a favourable long-term outlook. For companies meeting these criteria, whole business securitisation was – before the meltdown – rapidly becoming the vehicle of choice for replacing high-yield leveraged buy-out debt and thus a potentially important source of liquidity for the heated M&A market.

Whole business securitisation after the fall

The market impact of the subprime crisis has paradoxically made it much more difficult for whole business securitisations to re-enter the market while at the same time creating increased demand for their resurgence. At the time of writing, the credit markets remain seized up, with virtually no bond trading or new issuance activity across all sectors including commercial mortgage-backed securities, ABS and leveraged finance. As a consequence, a substantial portion of bridge loan commitments, which had been issued to finance acquisitions of operating companies by private equity firms, have been funded by the committing banks alone, which were unable to fill out their syndicates with other bank participants. The possibility of refinancing these leveraged loans through whole business securitisation has been non-existent in the current credit market. Moreover, the liberal terms which lenders were falling over themselves to offer prior to the meltdown (eg, covenant-free or covenant-lite financings or PIK Toggle features) have now joined the dinosaurs in the tar pits. Consequently, in many instances the leveraged finance departments of the banks and the private equity firms are joined in an uneasy counterparty relationship. The lenders have for the most part suffered multibillion-dollar writedowns as a consequence of their sub-prime, CDO and structured investment vehicle exposures, and are facing potential writedowns of their out-of-the-money leveraged finance book if they attempt to sell their positions or are forced to classify their exposures as hold-to-maturity investments – often an equally unattractive option. In many cases, private equity firms are obligated under loan terms which do not offer the flexibility for growth of the acquired business or for funding of working capital or new acquisitions. Their acquisition debt may also become subject to a lock-out period if the lender ultimately succeeds in syndicating its exposure to other banks. Moreover, acquisition loans which were closed in the past three to five years and are approaching maturity will need to be refinanced in a credit market that is at worst non-existent and at best far less hospitable than when the loans were initially made.

Corporate bankruptcy filings have not trended upward with the increase in CDO, structured investment vehicle and sub-prime residential mortgaged-backed securities downgrades and defaults, except for certain companies in the residential lending sector, such as American Home Mortgage. This is not surprising, since there is not necessarily any direct correlation between the general corporate sector and the structured debt market. However, there are predictions that the corporate sector could be a lagging indicator of the credit market meltdown, and corporate bankruptcies could show a noticeable increase as credit facilities come up for renewals and refinancings or replacement facilities are unavailable or available only at extortionate rates. Within this phenomenon another cliff scenario could also lurk, as leveraged loans put in place several years ago to fund corporate acquisitions mature, thus creating increased demand for whole business ABS structures to provide the take-out financing.

Of course, demand alone does not a market make. A number of potentially conflicting factors will be influential in determining when the lights are switched back on in the whole business securitisation sector. Some of these factors are as follows.

Return to asset-focused fundamentals

Income-generating assets and businesses have consistently been the centrepiece for esoteric asset securitisations generally and whole business securitisations in particular. The rating agencies have applied uniformly stringent stress cases and structural requirements in rating these transactions. As a result, rating downgrades, defaults and rapid amortisation events in this sector have been a rarity, particularly when compared to the performance of CDOs, structured investment vehicles and subprime residential mortgage-backed securities over the past six years. Thus, if inattention to asset quality is perceived as the principal failure contributing to the current meltdown, it would be logical to expect the lights to come back on first in the esoteric sector before power is restored to the rest of the securitisation grid.

Flight from complexity

Many discussions of the credit market collapse have placed the blame upon the complexity that has invaded the capital markets over the past decade and the opaqueness that has resulted from it. A *New York Times* article of March 23 2008 referred to the villain as "the private trading of complex instruments that lurk in the financial shadows" ("What Created This Monster?", Schwartz and Creswell, *New York Times*, March 23 2008). Of course, these critiques are referring to the complex, and often impenetrable, web of derivative products imbedded in CDO and structured investment vehicle transactions, combined with structural complexity in the form of CDOs of ABS, CDOs-squared, and other multi-layered securitisations in which it would be necessary to drill down several layers to identify the assets and the obligors on which cash flow depends. Whole business securitisations, like other esoteric securitisations, are also complex, although their complexity is derived from the nature of the assets being securitised and not from the use of derivatives or multi-layered asset structures. If the only take-away from the current crisis is that 'complexity is bad and simplicity is good', the future of all forms of securitisation except the most 'plain vanilla' will be bleak indeed. Just as there was a stigma attached to the term 'special purpose entity' in the immediate aftermath of the Enron scandal, there is likely to be a stigma attached to 'complexity' in the immediate wake of the current crisis. However, institutional investors are sophisticated enough to differentiate among different types of complexity and any generic flight from complexity would be short-lived.

Investor education

Investors participating in unwrapped esoteric asset securitisations have generally been specialty investors willing to take the time to understand the transactions in which they are investing. These are typically not sound-bite or elevator-pitch investors. These investors should also be more aware than the general investment community of the strong performance history of esoteric securitisations. However, many investors in wrapped esoteric ABS relied heavily, if not exclusively, on the rating of the monolines providing the financial guarantees. It will be more difficult to fill the order books for whole business and other esoteric securitisations on the basis of traditional senior-subordinated tranching without the benefit of monoline insurance. However, it is incumbent upon the bond underwriting and distribution community to re-build their order books through investor road shows and one-one-one dialogues with the large buyers of esoteric ABS.

Monoline meltdown

The monoline insurers, with a few exceptions, have suffered life-threatening financial pressures as a result of their exposure to the subprime virus. Monolines have exposure through both financial guarantee insurance and credit default swaps written on senior tranches of

CDOs, structured investment vehicles and residential mortgage-backed securities which are backed by non-performing sub-prime portfolios. Those unable to be recapitalised will suffer – and have suffered – rating downgrades, and according to the International Swaps and Derivatives Association documents under which the credit default swaps were written, downgrades could constitute termination events. The result has been that the monoline surety market has virtually shut down and those deals that have been closed with monoline wraps have required credit default swaps to be written against the sureties, at extraordinarily wide pricing, thus further cutting into the vigorish of the transactions. The short-term consequence is the inability to obtain monoline wraps for whole business or any other ABS transactions. Since it is difficult to achieve ratings on many whole business deals higher than Baa/BBB without third-party credit support, this will mean that a large segment of the bonds in a whole business securitisation will be at this rating level. This will virtually eliminate many institutional investors which are required by regulation or by charter to limit their investments to investment grade securities, since a small downgrade in the rating would force them to sell. (It would also obviously eliminate investors which are restricted to AAA-rated securities.) This will pose serious obstacles to selling whole business securitisations of a substantial scale. However, it is not expected that the monolines will be permanently sidelined; and other forms of credit enhancement may be available from the re-insurance and residual value markets. Until the monoline industry is restored to health, creative solutions will be necessary to find alternatives to the monolines or to broaden the investor base for unwrapped ABS.

Filling the crisis management void

Another problem which will have to be solved in the wake of the monoline crisis is the absence of the monoline insurer to make decisions on an expedited basis in the event of a default or a trigger event. Although bond indentures authorise trustee and servicer actions in accordance with bondholder governance provisions, these provisions are often cumbersome and are not well suited for circumstances requiring fast decision-making. While the sponsoring company in a whole business or other esoteric asset securitisation normally fills this role under a master servicing or master management agreement, the rating agencies normally require a back-up servicer or manager to take over the functions of the sponsor upon the occurrence of certain triggering events (including but not limited to the sponsor's bankruptcy filing or failure to meet specified EBITDA levels and other financial tests). The presence of a monoline insurer in the capital structure assured a timely and informed response during the transition between the sponsor-servicer regime and the regime of the back-up servicer; and also assured proper oversight of the activities of the back-up servicer. The absence of a monoline insurer will impose more pressure on this process and may require the creation of a new role within the securitisation structure to perform this function. One possibility is to have a designated bondholder representative or special servicer identified upon the initial issuance of the bonds which is empowered to act on behalf of the bondholders with respect to certain enumerated events, thereby avoiding the time-consuming and burdensome process of obtaining bond holder approval and assuring timely action during the transition period between the tenures of the initial master servicer and the back-up servicer.

Increased concern with insolvency risk

Another possible by-product of the sub-prime meltdown is heightened concern of investors and rating agencies over other risk factors and increased efforts to create deal structures which provide better protection against these risks. As most whole business transactions involve the transfer of substantially all of the cash-generating assets from the sponsor to the special purpose vehicle, there is increased risk that a bankruptcy judge would, in the case of a bankruptcy filing against the sponsor, be tempted to rule that the debtor needs the assets previously transferred to the special purpose vehicle in order to be successfully reorganised. This was the basis

for the 'core asset' doctrine enunciated in the *Days Inn* and *LTV Steel Cases*, where the bankruptcy court came dangerously close to disregarding the true sale of the company's assets to the special purpose vehicle and consolidating the special purpose vehicle with the bankruptcy estate. To obtain a significant ratings elevation above the rating of the sponsor company, it may be necessary in some cases to provide added comfort that this is unlikely to occur. One method for doing so (which is current practice in whole business securitisations) is to require that the proceeds of the whole business transaction be used to retire the secured debt facility of the company and to require the company to covenant that it will not incur additional long-term debt, thus removing the possibility of an involuntary filing by a secured lender and a challenge on the basis of the core asset doctrine. However, trade creditors and other general unsecured creditors can also pose a threat of an involuntary bankruptcy filing against the sponsor company. Therefore, other structural features may be necessary to insulate the sponsor from the incurrence of trade claims and other liabilities which could trigger bankruptcy filings by or against the company. One structural feature to be considered is to ring-fence the operating company by creating a new company to perform the operating functions of the sponsor company post-securitisation.

Future candidates for whole business securitisation

Assuming a restoration of whole business securitisation in the near future, some concluding thoughts on likely candidates for this type of financing are in order. In addition to private equity firms which were forced by the meltdown to take down their bridge loans and prevented from refinancing them with securitised debt, other candidates for whole business transactions may include outsourcing companies and hotel companies. A recent survey of the major outsourcing vendors for 2006 indicated estimated revenues for 2005 for the top 50 vendors aggregated in excess of $422 billion. Many of these companies have high investment grade ratings and therefore may not need access to the securitisation market. However, many others do not and thus whole business securitisation could be attractive. The most appropriate candidates would be outsourcing companies with strong competitive market positions and a diverse portfolio of customers having (optimally) strong credit profiles. As outsourcing contracts are by their nature highly negotiated and terminable both for cause and under 'termination for convenience' clauses, companies will also have to demonstrate through company-specific and industry-wide statistical data the sustainability of their cash flows over time.

Moody's recently issued a special report on hotel franchise fees securitisations (dated February 13 2008) which predicted that there will be hotel franchise fee transactions soon and that they will be rated in a manner similar to the food franchise system transactions. The one unique characteristic of hotel transactions is that securitisations are more likely to be based on royalty fees (representing the franchise or compensation for the use of the brand name, logos, goodwill and other franchise services) than on the basis of programme fees (eg, advertising fees, reservation fees and fees for system and technical support) because the former typically have lower volatility than the latter. In such case, the programme fees would not be made available to the noteholders, but would instead be deposited in a special account and used by the franchisor to cover marketing, advertising, reservation, system and other expenses.

If hotel management firms and outsourcing businesses are likely candidates for whole business securitisation, there are numerous other industry sectors which should also find this type of financing beneficial. These include businesses deriving revenues from patented technology and other intellectual assets requiring hands-on management, technology upgrades or ongoing infringement monitoring and assertion activities; vehicle parking systems; entertainment venues; distributors of power and water; and healthcare delivery systems. The applications of whole business technology are limited only by one's imagination – and the restrictions imposed by a jaded marketplace.

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Exploring the perimeters of whole business securitisation

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The Dunkin Brands (DB) Master Finance LLC $1.7 billion franchise and trademark royalty securitisation generated considerable buzz in 2006 for its size – exceeded only by the $1.8 billion KCD IP trademark royalty securitisation rated and closed privately in 2006 – and the rating elevation of six notches above the corporate sponsor's B-rating that it achieved. Equally significant are the possibilities created by the whole business rating methodology on which the rating elevation was based. To examine these possibilities, it is useful to consider the new door partially opened by the DB transaction and explore some of the places this may lead.

A brief look backwards

Ordinary securitisation isolates self-liquidating financial assets from the bankruptcy risk of the originator and then uses them to collateralise obligations of the special purpose vehicle (SPV); whole business securitisation involves assets that are not self-liquidating but that must instead be actively managed in order to generate continuing cash flow. Whole business securitisation originated in the United Kingdom and other jurisdictions with insolvency laws that assure absolute priority to holders of fixed and floating charges over all or substantially all of a borrower's assets in favour of a secured creditor. Under such insolvency laws, secured creditors with a security interest in substantially all of a bankrupt company's assets generally have the unfettered right to appoint an administrative receiver to run the company for the benefit of the secured creditors. Due to the control that these laws give secured creditors, securitisations can be structured involving not simply isolated financial assets of a company that have been

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transferred to a bankruptcy-remote SPV, but instead all or virtually all of the operating assets of a company that, by definition, remain in the ownership and under the control of the company. Thus, under the UK bankruptcy system, it is possible to leave the assets generating the cash flow within the operating company and protect the bondholders from insolvency risks through iron-clad control arrangements that will be honoured post-insolvency. Whole business securitisation transactions taking advantage of this feature began to be closed in the late 1990s involving various types of business (including securitisations of pub revenues, Madame Tussauds and Formula 1 racing). Figure 1 sets out a typical deal structure for a UK whole business securitisation.

Unlike UK insolvency laws, the US bankruptcy system was not initially viewed as a hospitable (or even a possible) venue for whole business transactions because of the power of the US bankruptcy courts to override the primacy of the secured creditor's position through automatic stays, substitution of collateral, cram-downs and other equitable remedies that benefit junior classes of debt as well as equity. Thus, attempting to limit control to senior debt holders subsequent to the filing of a bankruptcy petition would have been a futile gesture under the US Bankruptcy Code. However, the creativity of the US capital markets, as well as some recent breakthroughs in rating agency methodologies, have made whole business securitisation an increasingly robust phenomenon in the United States, although it uses significantly different structures from those in the United Kingdom.

Core asset doctrine

The core asset doctrine has also influenced the early development of US whole business securitisation. It was first applied in a securitisation context in the 1991 *Days Inn* bankruptcy case. Although the $155 million securitisation of the trademark and franchise assets of motel franchisor Days Inn was performing adequately, its sponsor was not. When Days Inn declared bankruptcy, the debtor caused the SPV that had issued the securities backed by the trademark and franchise assets to file a petition in bankruptcy and prevailed upon the bankruptcy court to issue a preliminary ruling that it would substantively consolidate the assets of the SPV with the assets of the bankrupt parent. This ruling was based on a core assets analysis, under which the trademark and franchise agreements were considered core assets of the bankrupt debtor and thus necessary for its successful reorganisation in bankruptcy. Although this ruling was subsequently withdrawn, the core asset analysis has left a genetic imprint on securitisation-rating methodology.

The Guess? Royalty Finance LLC transaction, which closed several years after the *Days Inn Case*, adopted a structural feature that elegantly addressed the core asset problem posed by *Days Inn*. The corporate sponsor, Guess? Inc, transferred all its material trademarks, licence agreements and related receivables to a bankruptcy-remote SPV, IP Holder LP, in a transfer qualifying as a true sale for bankruptcy purposes. IP Holder in turn contributed to Guess? Royalty Finance LLC, another bankruptcy-remote SPV, all receivables generated by the licence agreements contributed to IP Holder, but not the trademarks. IP Holder also provided a guaranty of the principal of the notes upon their legal final maturity, secured by a first-perfected security interest in the related trademark and licence agreements.

By IP Holder assigning to the issuer SPV only the receivables generated by the licence agreements and pledging the licence agreements and trademarks themselves only to secure the maturity guaranty, the transaction avoided the core asset issue raised by the *Days Inn* transaction. This was accomplished because the holders of the rated securities were given no right to the trademarks and licences assigned by the parent company to IP Holder and, in fact, the trademarks assigned to IP Holder were re-licensed back to the parent company to permit the continuation of its core licensing activities. The sole collateral for the notes was the cash receivables payable under the licensing agreements transferred to IP Holder. However, the noteholders were given the benefit of the trademarks and licences in the form of collateral supporting IP Holder's maturity guaranty. This did not pose a core

asset issue because the maturity guaranty would, by definition, not be subject to the claims of the noteholders until the final legal maturity of the notes. In rating the transaction, Standard & Poor's reasoned that the presence of the core asset issue at the time of legal final maturity implied no incremental risk to the transaction since this risk was already factored into the credit analysis on which the rating of the legal final maturity was based.

Evolution of US whole business securitisation

Whole business securitisation in the United States has been forced to navigate the narrow channel between the Scylla of leaving securitised assets inside the operating company and thus subjecting them to the disruptions of a bankruptcy of the operating company, and the Charybdis of transferring assets central to the operating business to a separate bankruptcy-remote SPV and thus risking them being consolidated with the bankruptcy estate under the core asset doctrine. For a decade after the nearly fatal use of the core asset doctrine in *Days Inn*, those wishing to securitise operating assets were faced with the grim choice between leaving the assets in the operating entity and therefore subject to bankruptcy risk, or transferring the assets out of the operating entity and risking the application of the core asset doctrine. Moreover, where the latter course is chosen, an operating structure is still required in order to generate the cash flow on which the securitisation is based. In either case, overhead and other expenses will be incurred in the course of operating those assets and the cash-flow waterfall will require the application of the gross revenues to pay these expenses before funds are available for debt service. Thus, in order to obtain a rating of the whole business structure, it is necessary to satisfy the rating agencies as to the reliability and predictability of the earnings before interest, taxes, depreciation and amortisation. This creates a far more complex and layered rating analysis than stressing the cash flows of a credit card or residential mortgage portfolio.

Whole business securitisation, like any other securitisation, occurs only when there is a convergence between business requirements and securitisation technology. Businesses with ample liquidity or high credit ratings generally do not need to turn to the securitisation market. Thus, the earliest participants in whole business securitisation were companies with capital constraints resulting from a need for liquidity and low credit ratings (and consequently high-yield bank lines). However, coupled with the business need for securitisation, there must be a business model or a pool of assets within the business which is of sufficient quality and sustainability to clear the rating agency hurdles described above. Not surprisingly, the earliest users of whole business technology were companies combining a franchise model with a strong retail brand. Early examples included the Arby's transaction in November 2000, backed by the franchise fees and trademark royalties of Arby's fast-food restaurant chain. This was followed by the securitisation backed by franchise fee revenues and trademark royalties of The Athlete's Foot Group and the Guess? transaction.

The DB Master Finance transaction traces its lineage directly to these earlier examples of whole business securitisation. Key features of the DB transaction include the following:

- All of the trademarks and franchises, as well as the royalty payments and leases generated by the Dunkin' Donuts, Baskin-Robbins and Togo's fast-food franchises, owned by Dunkin' Brands Inc, the parent company, were transferred to SPVs and were used to secure the full debt service payments of the issuer (ie, the maturity guaranty feature of Guess? was not present).
- The securitisation was used to repay a $1.5 billion acquisition debt incurred in a leveraged buy-out of Dunkin' Brands Inc several months earlier by a consortium of three private equity firms.
- The two senior DB debt tranches achieved a shadow investment grade rating (enabling the issuer to obtain a monoline wrap) although the securitisation transaction occurred only a few months after the leveraged buy-out was completed when Dunkin' Brands Inc had a B-

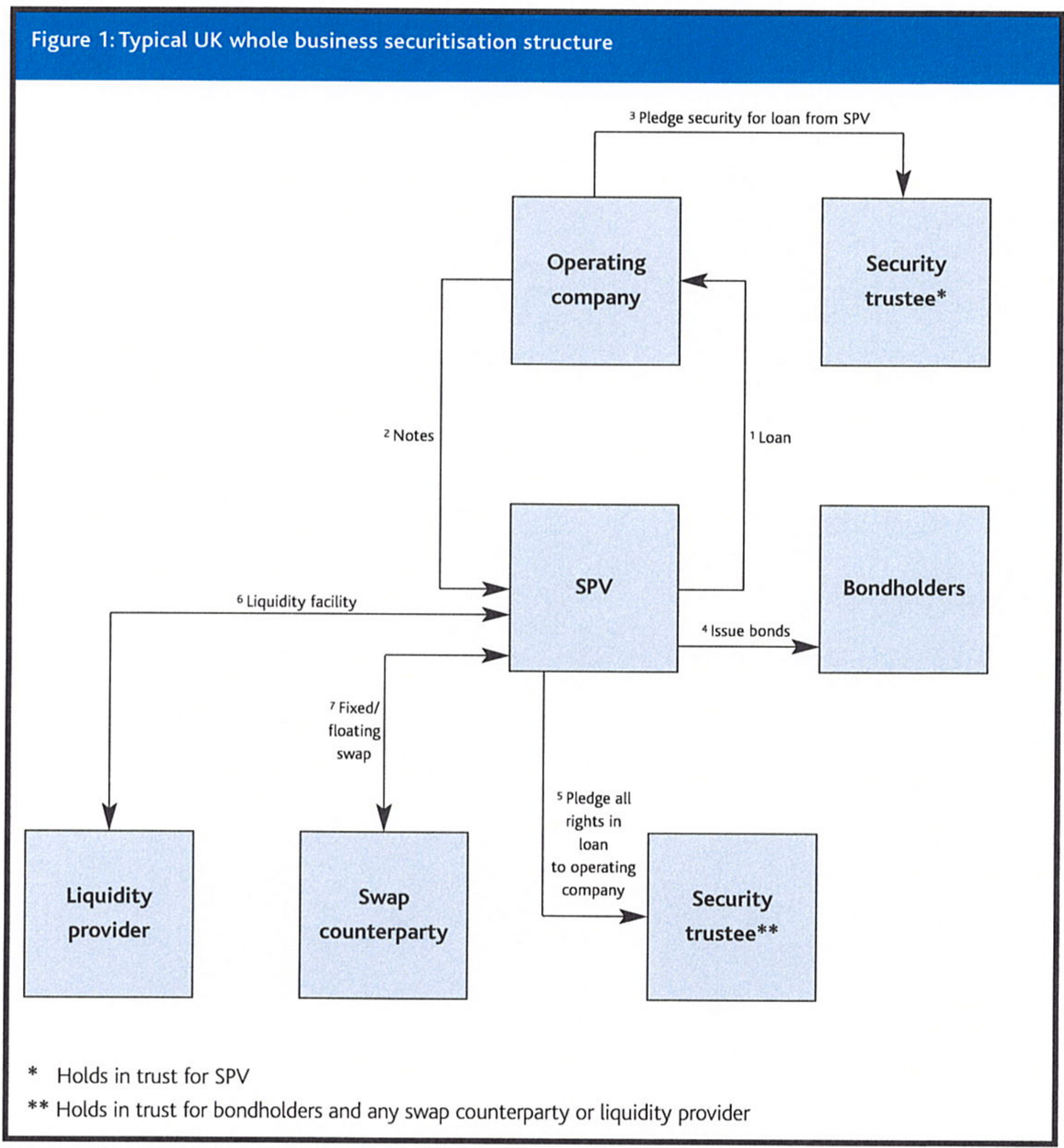


Figure 1: Typical UK whole business securitisation structure

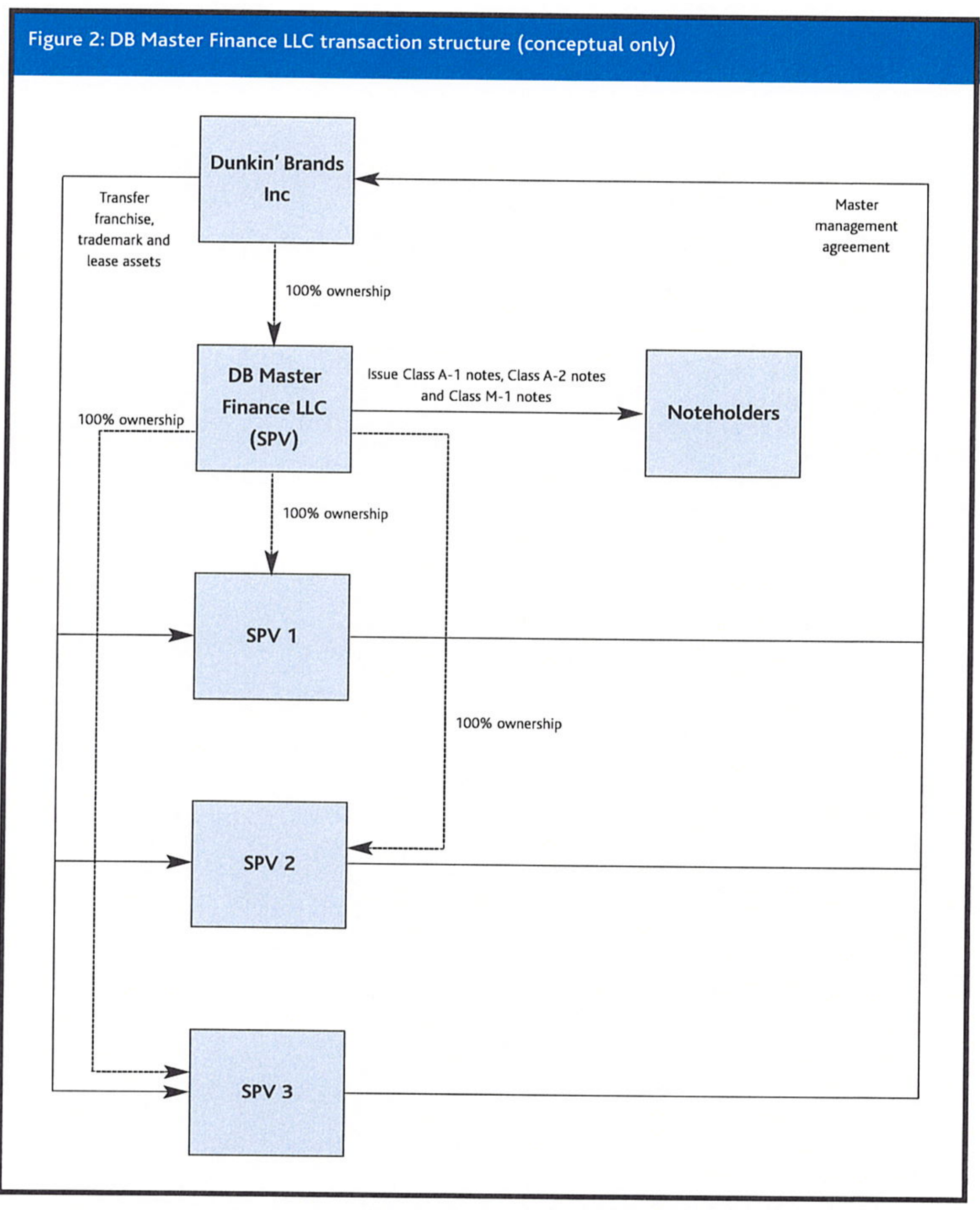
* Holds in trust for SPV

** Holds in trust for bondholders and any swap counterparty or liquidity provider

rating due to the substantial leverage (8.5 times) resulting from the leveraged buy-out.

Among the more interesting features of the DB transaction is how it dealt with the core asset issue. Rather than addressing the core asset issue through the maturity guaranty structure of the Guess? transaction, the DB transaction avoided a core asset analysis by using the securitisation proceeds to pay off all existing third-party debt at the parent-company level. Although the collateral for the securitisation was held by three separate bankruptcy-remote SPVs and the notes were issued by another bankruptcy-remote SPV (the 'master issuer'), the generation of revenue from all these assets was materially dependent on the operational function being performed by Dunkin' Brands Inc under a master

Figure 2: DB Master Finance LLC transaction structure (conceptual only)



management agreement. Moreover, the agreement between Dunkin' Brands Inc and the master issuer would be characterised as an executory contract in the event of the bankruptcy filing of Dunkin' Brands Inc, with the result that Dunkin' Brands Inc would have the option of rejecting such agreement.

The rating analysis of Standard & Poor's relied heavily upon the strength (based on prior revenue

history) of the respective brands owned by the lower-tier SPVs and concluded that, based on this history and the brands' strong market position, Dunkin' Brands Inc would remain as a viable going concern and, were it to file for bankruptcy, it would be economically motivated to seek to reorganise under Chapter 11 of the Bankruptcy Code rather than liquidating. Moreover, the rating analysis concluded that in the event of a reorganisation, Dunkin' Brands Inc would be most likely to affirm and not reject the master servicing agreement since such affirmation would be beneficial to the bankruptcy estate of Dunkin' Brands Inc by enabling it to continue to receive the servicing fees and manage the assets for future growth. In addition, a back-up manager could be readily identified to step in and provide the servicing functions needed to ensure the continuation of the cash flows in the event of such a rejection.

By analysing these factors, the agency was able to rate the transaction through the bankruptcy of the operating company; it could de-link the rating on the securitisation from the sponsor's debt rating, despite the fact that there was a significant degree of rating dependency between the securitised debt and the sponsor, by concluding that the cash flows from the securitised assets were not critically dependent on Dunkin' Brands Inc not becoming a debtor in a bankruptcy case. Although not prominent in the rating agency's pre-sale report, it is significant that the agency became comfortable with the core asset issue - despite the fact that all the parent's assets were transferred to SPVs and used to collateralise the rated debt - because the proceeds of the securitisation were used to pay off the third-party debt that existed at the time of the closing. Thus, there was no secured debt in existence at the operating company level after the securitised debt was issued. A conceptual diagram of the DB deal structure is included as Figure 2.

Another franchise/trademark securitisation similar to the DB transaction in structure and use of proceeds was closed a few months later - an approximately $800 million asset-backed securities issue sponsored by fast-food chain Sonic. The securitised debt, rated by Moody's and Standard & Poor's, was collateralised by royalty payments to be collected by Sonic for licensing its brand name to its more than 3,000 food outlets (including both those owned by franchisees and those which are company operated). The bonds were issued with a fixed rate and a variable-rate tranche, although at the time of writing the variable-rate tranche is to be issued at a later date. The fixed-rate tranche achieved an investment grade shadow rating and was wrapped by Ambac. The company's own long-term unsecured debt rating was Ba3/BB-, and thus the securitised debt achieved a three-notch elevation above the sponsoring company's debt rating. The business need being satisfied by the transaction was to use the proceeds to pay off company debt incurred to fund ongoing repurchases of its common stock.

A brief look forwards

In rating the DB and Sonic transactions, Standard & Poor's applied its new US corporate securitisation rating criteria. Standard & Poor's had previously refused to give rating elevations more than three notches above the sponsor's rating where the performance of the securitised assets was dependent on the performance of the sponsor. In contrast, Moody's has no automatic rating elevation ceiling, but instead applies its rating criteria on a case-by-case basis. Under the Standard & Poor's corporate securitisation criteria, it is possible to achieve ratings that are de-linked from the rating of the sponsor company without a rating elevation ceiling provided that the requisite factors are present in the transaction. In the DB transaction a rating elevation of six notches was achieved, and in the Sonic transaction a rating elevation of at least three notches was achieved.

It does not take an overly fertile imagination to imagine situations (both IP-backed deals as well as other future-flow deals) where this organic approach to whole business securitisation can be applied to achieve investment grade ratings where the operating company is well below investment grade but its cash-generating assets are of investment-grade quality. The possibilities will, however, most likely be limited to situations where the following factors are present:

- Recapitalisation of corporate debt structure - it is clear that one of the key facts that facilitated the rating elevations achieved in the DB and Sonic transactions was the use of securitisation proceeds to pay off third-party debt - acquisition debt in the case of DB and shareholder redemption debt in the case of Sonic. With the increased activity of the private equity and hedge fund sector in large-scale business acquisitions, which is expected to continue through 2007, it is a fairly safe prediction that whole business securitisation will be used with increasing frequency as a means of refinancing more costly acquisition debt.
- Compelling business case - in order to obtain the most favourable results through whole business securitisation, the business being securitised must have a dominant market position. This is necessary in order to support the conclusion that the sponsor company has the necessary incentives to file for Chapter 11 rather than Chapter 7 measures in the event of financial stress and to affirm the master servicing/management agreement with the SPV issuer under such circumstances. Without a robust and sustainable business model with acceptable barriers to entry by competitive companies, it will be more difficult for the rating agencies to reach this conclusion, and therefore it will be more difficult for them to rate through the sponsor's bankruptcy risk. A compelling business case will also be necessary in order to convince the rating agencies to accept a workable level of earnings before interest, taxes, depreciation and amortisation projections for purposes of sizing the transaction.
- Strong back-up servicer - it is also obvious from the whole business transactions that have been rated that a strong back-up servicer remains highly important as a backstop to the bankruptcy analysis. This means that any company wishing to use the whole business securitisation model must be able to find a competent back-up servicer to sign on for those responsibilities. This may create issues in highly competitive and sparsely populated sectors where there is a strong incentive to protect trade secrets, client lists and proprietary products and processes.
- Reliable contractual cash flows - each of the whole business transactions discussed above is based on cash flows arising from leases, trademark licences and franchise fees. These provide a basis on which to project forward and stress company cash flows. In the absence of strong contractual cash flows, the process of modelling out a potential transaction will be much more difficult.

The whole business structures discussed above leave numerous unanswered questions that must be addressed as new applications of these models are presented to the rating agencies and to the market. Some of these questions are as follows.

Can whole business technology be used in partial business securitisations?

This question illustrates the tension implicit in the whole business securitisation rating methodology. On the one hand, a strong and compelling business model is a key factor in rating through the risk of the sponsor's bankruptcy. On the other hand, if only a portion of a company's cash-flowing assets is being securitised, this weakens the incentive on the part of the company to affirm the servicing contract in the event of its bankruptcy, while at the same time reducing core-asset risk (depending on the essentiality of the securitised assets to the sponsor's operations). Thus, the Scylla and the Charybdis will continue to be obstacles to be avoided in the future.

Can a whole business securitisation be achieved effectively without paying off all pre-existing third-party debt of the sponsor?

This question leads on from the first question. If only a portion of a company's assets are being securitised, and therefore the core asset issue is mitigated, why would it be necessary to retire third-party debt with proceeds?

Where is the golden mean between partial business securitisation and debt retention?

This poses the issue of how to strike an optimum balance between what portion of the business to securitise and how much of the pre-existing debt can remain outstanding. Obviously, the more core the securitised assets are, the more sensitive the credit analysis will be to the amount of third-party debt left outstanding.

Will post-closing covenants be imposed in whole business securitisations?

This poses the question of whether, assuming that the repayment of pre-existing debt is necessary in order to avoid the core asset issue, financial covenants should be imposed on the sponsor to prevent it from incurring new debt after the securitisation is closed. One of the principal reasons why securitisation is attractive to issuers is the lack of financial covenants, and it remains to be seen whether this aspect of whole business securitisation methodology will take companies down the slippery slope towards financial covenants.

Will the core asset issue be laid to rest?

There has been some discussion that the core asset issue emanating from Days Inn is a red herring that should be eliminated from the rating analysis of securitisation transactions. Whether and to what extent this issue ceases to be a factor in future transactions remains to be seen.

Will whole business securitisation evolve into the new financial driver of the leveraged buy-out market?

Just as junk bonds made leveraged buy-outs possible in the 1980s, will whole business securitisation become the leverage of choice for leveraged buy-outs in the 2000s? Or will the relatively high bar for a whole business transaction to achieve a rating de-linked from the operating company limit the use of this technology to 'best of class' businesses?

What new types of transaction may be made possible by whole business technology?

To date, the growth of whole business securitisation has been concentrated in the trademark and franchise sectors. This is understandable given the presence in this sector of the elements necessary to support whole business transactions – that is:

- capital constraints;
- provable cash flows;
- well-known or dominant brands;
- dependence on the operating company to generate cash flow; and
- the availability of back-up servicers.

However, these factors are not exclusive to the franchise and trademark sectors; there are many operating companies with below-investment grade debt ratings and 'best of class' intellectual property that have the requisite need and financial characteristics to support whole business securitisation. These transactions may take the form of single company-sponsored IP securitisations or joint company-sponsored IP securitisations.

In the latter model, one company with valuable intellectual property with strong commercialisation potential transfers its intellectual assets to an SPV, and a second company with financial and other resources key to the future development, marketing and licensing of the intellectual property contributes those resources to the SPV. As the SPV will be comparable in many ways to a start-up company, it will need substantial capital. Using whole business securitisation to raise this capital may be an attractive alternative to an infusion of capital by either of the two joint venture companies and will also avoid issues of financial control which would otherwise be present where one of the companies funds the operation. Finally, in many cases it is likely that the intellectual assets will not be fully commercialised at the time of contribution to the SPV, and therefore securitisation will be used as a back-leveraging strategy once sufficient cash flows are generated.

A second type of business model for which whole business securitisation may be appropriate is the outsourcing industry. A recent survey of major outsourcing vendors for 2006 indicated estimated revenues for 2005 for the top 50 vendors aggregated in excess of $422 billion. Many of these companies have investment grade ratings and therefore may not need access to the securitisation market. However, many others do not, and thus whole business securitisation could be attractive. The most appropriate candidates would, of course, be outsourcing companies with strong competitive market positions and a diverse portfolio of customers with (optimally) strong credit profiles. As outsourcing contracts are by their nature highly negotiated and terminable both for cause and under termination for convenience clauses, companies will also have to demonstrate the sustainability of cash flows over time through company-specific and industry-wide statistical data.

Can whole business technology be used to create corporate value and liquidity through intra-company licensing arrangements?

The KCD IP transaction was a private transaction that received an unpublished rating from Moody's, and thus little detail is publicly available. However, based on the information that is available, it appears that KCD involved a whole business structure supported solely by cash flows internally generated through intra-company trademark licensing agreements involving the Kenmore (appliances), Craftsman (tools) and DieHard (batteries) brands sold in Sears and Kmart stores. The $1.8 billion of bonds received a Moody's rating of Baa2. Although the strategy behind this transaction is no more accessible than the details of the securitisation, it is interesting to note that a structure utilising the licensing of trademarks and patents among commonly owned or affiliated companies could - with the assistance of whole business securitisation - create new reservoirs of potential liquidity in the form of structured, rated and unsold bonds that can be released into the capital markets at opportune times to fund acquisitions or other corporate business objectives.

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Whole Business Securitization After the Sub-Prime Meltdown: What Next?

BY RONALD S. BOROD
(BROWN RUDNICK BERLACK ISRAELS LLP)

Prior to the sub-prime meltdown this summer, whole business securitization was on an upward trajectory in the United States. This was due to the convergence of three trends in the U.S. financial markets: first, some breakthroughs in rating methodologies that opened new pathways for issuing asset-backed debt rated multiple notches above the rating of the sponsoring company despite the dependency of the cash flows on the operating performance of the sponsor; secondly, the growing prominence of intellectual property and other intangible assets in the value chain of operating companies; and thirdly, the surge in merger and acquisition activities of private equity funds, with a significant portion of the liquidity provided by acquisition or bridge financings of the large banks. What emerged from the confluence of these three trends was a new template which was becoming the standard in M&A transactions.

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Danger and Opportunity:
The Effect of the Credit Squeeze on Hedge Funds and Structured Investment Vehicles (SIVs)

BY STEPHEN PHILLIPS AND DAN HAMILTON (WHITE & CASE LLP)

Few of us would have predicted that difficulties in the US sub prime mortgage market would cause such a significant reverberation around the financial markets. Loss of investor confidence seems to have caused a lack of liquidity. Institutions are wary of lending to each other as it is not clear who is holding the most "toxic" US sub-prime mortgage investments. Participants in credit markets, particularly those exposed to any form of asset backed securities, have been most affected. Whilst the credit squeeze has thrown up a large number of issues, this article focuses on some of the legal issues facing hedge funds and structured investment vehicles (SIVs). As is perhaps inevitable behind the gloomy headlines, the credit squeeze presents opportunities for distressed debt investors.

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Under this template, acquisitions were funded with a mix of equity and high-yield acquisition debt, followed by a refinancing into lower-yielding highly-rated debt through the issuance of ABS. Because many of the target companies were rich in IP and other intangibles, these assets were frequently used in the securitization; and because the performance of these assets was in many cases heavily dependent upon the operations of the target company, whole business securitization technology was used to achieve the desired rating elevation.

Because the performance of these assets was heavily dependent upon he operations of the target company, whole business securitization technology was used to achieve the desired rating elevation.

U.S.-based private equity firms invested over 421 billion USD worldwide in acquisitions in 2006, and raised 156 billion USD in new money during the same year. Institutional forward loan commitments by late July of 2007 were estimated at approximately 250 billion USD, much of this attributed to LBO activity, and other estimates of unfunded bridge commitments by mid-summer were at almost twice this amount.

The most highly publicized exemplar of this new template was the $1.7 billion franchise and trademark royalty securitization—DB Master Finance, LLC—closed in 2006. This transaction securitized the revenues generated by trademark licenses, franchise agreements and real estate leases created by the Dunkin' Donuts, Baskin-Robbins and Togo's fast food franchises owned by Dunkin' Brands, Inc. ("DBI"). The securities issued by DB Master Finance, LLC achieved a shadow investment grade rating which enabled the issuer to obtain a monoline wrap on most of its bonds so that they were rated AAA/Aaa when sold to investors. The proceeds of the transaction were used in part to repay a 1.5 billion USD acquisition loan incurred only a few months before in a leveraged buyout of DBI by three private equity firms. The corporate debt of DBI at the time had a B- rating due to the substantial leverage (8.5 times) resulting from the LBO.

In granting the rating elevation to DB Master Finance, S&P and Moody's relied heavily upon the strength of the respective brands owned by DBI's three fast food franchises, their prior revenue history and the brands' strong market position, which together enabled the

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rating agencies to conclude that DBI would remain as a viable going concern. Furthermore, the agencies found that, were DBI to file for bankruptcy, it would be economically motivated to seek to reorganize under Chapter 11 rather than to liquidate. S&P's rating analysis concluded that in the event of a reorganization, DBI, acting as servicer, would most likely affirm the master servicing agreement under which it was obligated to continue managing the trademarks and the franchise agreements of the three restaurant chains, even though such an agreement could be rejected in bankruptcy as an executory contract. This reasoning was based on the view that affirmation of such contract would be beneficial to the bankruptcy estate of DBI by enabling it to continue to receive the servicing fees (in its role as servicer) and to manage the assets for future growth (in its role as residual equity holder). Finally, additional comfort was provided by the fact that a back-up manager could be readily identified to step in and provide the servicing functions needed to ensure the continuation of the cash flows in the event that, contrary to the foregoing analysis, a bankrupt DBI chose to reject the master servicing agreement.

By analyzing these factors, the agencies were able to rate the transaction "through" the bankruptcy of the operating company; that is, they were able to de-link the rating on the securitized debt from the sponsor's debt rating, despite the fact that there was a significant degree of dependency on the continued business operation of DBI.

Other franchise and trademark securitizations (including deals by Arby's, The Athlete's Foot, Sonic and IHOP) similar to the Dunkin' Brands securitization have also been closed using similar structures and achieving similar rating elevations. Each of these transactions had not only the cash flows of a well-established national franchise system to securitize, but also a strong business case for accessing the ABS market for liquidity. Businesses with ample liquidity and high credit ratings generally do not turn to the securitization market, absent special strategic reasons. The ABS market provides attractive financing terms, however, to companies subject to capital constraints and in need of liquidity. However, for a capital-constrained company to access the ABS market using the whole business model, that company's business must be

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of sufficient quality and sustainability to allow rating agencies to rate cash flows generated by the business *after* taking into account operating expenses which must be incurred in order to generate these revenues. In other words, whole business securitization—unlike the securitization of self-liquidating financial assets which are not dependant upon an operating company to generate cash flow—relies upon EBITDA rather than gross revenues to pay debt service on the bonds. Consequently, for businesses to achieve favorable results under this model, the businesses themselves must be in a strong competitive position with a long-term favorable outlook. For companies meeting these criteria, whole business securitization was rapidly becoming the vehicle of choice for taking out high-yield LBO debt and thus a potentially important source of liquidity for the heated M&A market.

But "That Was Then...This is Now." At this writing, the contagion of the sub-prime mortgage meltdown has spread to most corners of the capital markets, including structured debt and acquisition and bridge loans. The sudden loss of liquidity and the precipitously widening spreads on even highly-rated asset-backed securities have, at least temporarily, wreaked havoc with the acquisition financing template described previously. The liquidity crunch has forced private equity firms to take down their bridge loans to fund their acquisitions. Bridge lenders are struggling to fill out their syndicates and in many cases are left to fund the bridge alone. Covenant-free or covenant-lite financings are meeting increased resistance from lenders; and this, combined with increased spread requirements, has left many financial institutions with substantial underwater positions on their bridges. Meanwhile (again at this writing), new issuance volume in the ABS market (whether conventional ABS or whole business ABS) is in a state of suspended animation, while investors wait for pricing levels to settle and are licking their wounds over losses in their portfolio due to massive rating downgrades.

It would be foolish to speculate how this will all shake out. However, a few things are reasonably clear:

- Investment opportunities will be created for those with liquidity as SIVs and other asset aggregators are forced to unwind their positions.
- Unless ABS spreads return to their pre-meltdown levels, larger equity or quasi-equity tranches, with equity-type yields, will be necessary to liquefy the collateral pools and achieve off-book treatment for the portfolio owners.
- Assuming that the ABS market recovers more quickly than the institutional whole loan market, the demand for the use of whole business securitization to take out or reduce acquisition or bridge debt will be greater than ever. ❑

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