

WHOLE BUSINESS SECURITIZATION: SECURED LENDING REPACKAGED?

A COMMENT ON HILL

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Professor Claire Hill's article on whole business securitization provides a succinct account of the interesting device of whole business securitization. It is one of the very few investigations into the economics of such devices and the exportability of the concept to emerging markets.

Whole business securitization lies somewhere between the categories of asset-backed securities and corporate finance but is arguably closer to the latter than to the former. Whole business securitization utilizes several features typical of asset-backed securities, including the use of credit enhancements and the stratification of investors. However, some of the key distinctive features of asset-backed finance are: legal transfer and isolation of assets; independence of investor service to the continued performance of the originator; off-balance sheet funding, etc. All these features are absent in whole business securitization. Furthermore, because whole business securitization encompasses all of the cash flows of an operating business, it is more of a collateralization and bankruptcy-proofing device than it is an asset-backed securitization. However, since what matters to investors is the ultimate credit quality of an investment, these hybrid finance transactions have had an appeal and, if the trends in the past couple of years are an indication, this appeal is increasing.

The legal basis for whole business securitization is the power of a backup servicer, apprehending bankruptcy of the originator, to take over the assets of the originator and have them administered for the interest of the investors. One source of this power is a provision of U.K. insolvency law, which allows holders of floating charges on sub-

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stantially the entire property of a borrower to appoint an administrative receiver, who effectively will be able to restrain the jurisdiction of the bankruptcy court over such assets.¹ Similar insolvency laws exist in other countries such as Malaysia,² Hong Kong,³ etc. Even under the Indian company law, debenture holders are entitled to exercise a power conferred under the instrument of debentures and appoint a receiver to take over the charged property.⁴ In the U.K., the proposed Enterprise Bill was presented before Parliament on March 26, 2002. This bill seeks to recast the insolvency regime and, in particular, scrap the administrative receivership.⁵ However, there are exceptions, inter alia, for capital market transactions. From the way that capital market transactions have been defined⁶ it seems that securitization transactions will continue to use administrative receiverships even after the insolvency law reform.⁷ Administrative receivership is not the only way used by whole business securitization to gain control over the assets of the originator. In various cases, pledge⁸ and uncompleted sale of assets⁹ have also been used.

1. The U.K. Insolvency Act of 1986 defines an administrative receiver as “a receiver or manager of the whole (or substantially the whole) of a company’s property appointed by or on behalf of the holders of any debentures of the company secured by a charge which, as created, was a floating charge, or by such a charge and one or more other securities.” Insolvency Act, 1986, c. 45, § 29(2) (Eng.). The powers of an administrative receiver are laid out in Schedule 1 to the Act, which includes the power to take possession of the property secured by the charge. *Id.* sch. 1.

2. See Rabindra Nathan, *Insolvency Law Reforms: Report on Malaysia*, ASIAN DEVELOPMENT BANK § C (Regional Assistance Project NO:5795-REG), at http://www.insolvencyasia.com/insolvency_law_regimes/malaysia/index.html (last visited Apr. 9, 2002).

3. See Charles D. Booth, *Insolvency Law Reforms: Report on Hong Kong, China*, ASIAN DEVELOPMENT BANK § C (Regional Assistance Project NO:5795-REG), at http://www.insolvencyasia.com/insolvency_law_regimes/hongkong/index.html (last visited Apr. 12, 2002); see also Companies Ordinance §§ 300A, 300B (H.K.), available at <http://www.justice.gov.hk/index.htm> (last visited Apr. 21, 2002) (discussing provisions relating to the appointment of a receiver in an insolvency proceeding).

4. Companies Act, 1956, § 424 (India).

5. See Enterprise Bill, 2002, cl. 241 (Proposed bill introduced in the House of Commons, Mar. 26, 2002) (Eng.) [hereinafter Enterprise Bill], available at <http://www.publications.parliament.uk/pa/cm200102/cmbills/115/2002115.htm> (last visited Apr. 10, 2002) (proposing Section 72A to amend the Insolvency Act by providing that a holder of a floating charge may not appoint an administrative receiver).

6. Enterprise Bill, sch. 18 (proposing Schedule 2A to the Insolvency Act, providing the exceptions to the prohibition on the appointment of an administrative receiver).

7. *Id.*

8. In the 2000 “Marne et Champagne” deal, a French equivalent of pledge was used to put the champagne bottles under the physical custody of the trustees. See Elena Folkerts-Landau, *Commentary: Principles for Analyzing Structured Finance/Corporate Hybrid Transactions*, STANDARD AND POOR’S, July 2, 2001, at <http://www.standardandpoors.com/emarketing/structuredfinance/copy070201hybrid.html> (last visited Apr. 11, 2002) (describing Marne et

Professor Hill's article attempts to explain the inherent economics of whole business securitization, which, as she admits, is complicated. Off-balance sheet funding and the consequential regulatory arbitrage is not applicable to these hybrid deals. However, the author finds explanation in primarily two distinctive features: bankruptcy proofing,¹⁰ and the capital market window provided to an otherwise bilateral transaction.¹¹

The most important advantage of whole business securitizations is the fixed and floating charge of the security trustee that acts as a shield for investors. This protection results from the pro-creditor stance of U.K. insolvency laws, which is due to be scrapped for secured borrowings in general, but is proposed to be retained for capital market transactions, including securitization. The other oft-cited advantage of whole business securitizations is that, in the event of bankruptcy the originator, as the business operator, may be replaced by a receiver who would take over the assets of the defaulting corporation and manage the business to pay off the investors. The rating agencies expect that these features will "minimise the risk of bankruptcy, preserve the value of the assets, organise external financial or operating assistance in case of underperformance, and trigger a change of control in case of prolonged under-performance or insolvency."¹²

While traditional asset-backed securitizations have passed several tests of bankruptcy, the resilience of whole business securitizations in distress is yet to be tested. Professor Hill's analysis of the economics of whole business deals will make eminent sense if the recently completed deals utilizing whole business securitization continue to perform satisfactorily in difficult economic conditions.

Champagne, "which involved cash flows generated from the liquidation or turnover of inventories," as an example of a hybrid business operation that is very suitable for hybrid securitization transaction).

9. In the "Rosy Blue" deal, a certain stock of diamonds was sold to the special purpose vehicle (SPV), but not delivered. Whenever the diamonds are actually sold to outsider buyers, the SPV would make the sale and route the sale proceeds in accordance with the "waterfall." See generally Helene M. Heberlein & Polly Kolatas, *Rosy Blue Carat S.A.*, FITCH STRUCTURED FINANCE, July 10, 2001 (providing a pre-sale rating report).

10. "But what seems likelier as a source of benefit is the ex-ante intercreditor agreement among the investors, with its careful planning for the firm's bankruptcy." Claire Hill, *Whole Business Securitization in Emerging Markets*, 12 DUKE J. COMP. & INT'L L. 521, 529 (2002).

11. "The other generic benefit is that securitization investors are capital markets investors, providing cheaper sources of financing than banks." *Id.* at 528.

12. Benedict Pfister, *Special Report: Whole Business Securitizations: A Unique Opportunity for UK Assets*, MOODY'S INVESTORS SERVICE, Oct. 19, 2000, at 3.

Another advantage, not discussed by the author, is that whole business securitization allows a firm to leverage itself based on its future revenues or assets that are not on-balance sheet, as opposed to traditional financing approach, which only looks at assets on the balance sheet. This results in both a higher leverage as well as funding for a longer period.¹³

In her investigation of the applicability of the whole business model to emerging markets, the author looks at the Malaysian wafer plant's \$250 million funding raised in June 2001.¹⁴ However, there are no examples of similar securitizations in Asia or, for that matter, much securitization activity outside of Japan. Ratings agencies and law firms specializing in structured finance have been discussing the increased interest of Asian corporations in using the device.¹⁵ The author suggests that governments use credit or credit enhancements to encourage the use of whole business transactions, as has been done in Malaysia. The experience with state guarantees has not widely varied among Asian environments and, therefore, structural enhancements (i.e., subordination, credit derivatives, or such other features which do not carry a political risk) are likely to be preferred by investors.¹⁶

13. In private discussions, a JP Morgan London executive confirmed that a number of corporate borrowers are tempted by the leveraging feature more than other factors.

14. Hill, *supra* note 10, at 526.

15. See Mark Adelson, *Report from Arizona: Coverage of Selected Sessions of the February 2002 Securitization Conferences*, NOMURA FIXED INCOME RESEARCH, Feb. 27, 2002 (reporting the deliberations at the ABS Summit organized by Frank Fabozzi/IMN Feb. 6–9, 2002, and suggesting that the participants saw potential in operating revenues securitization, even in the U.S. market). “Notwithstanding the challenges and the pitfalls, operating asset securitizations are the next frontier for structured finance.” *Id.* at 12.

16. There are examples where guarantees have not been honored by a state for purely political reasons. For example, Enron entered into a power purchase agreement with a State Electricity Board in India guaranteed by the State Government of Maharashtra and counter-guaranteed by the Union Government. Francine R. Frankel, et al. eds., *Politics of Infrastructure Reforms: The Power Sector*, 1 DOING BUSINESS IN INDIA 1, 10–11 (1998), available at <http://www.sas.upenn.edu/casi/reports/DBI-S98.PDF> (last visited Apr. 11, 2002). Both guarantees were breached due to political motivations.