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Asset-Based Lending and Structured Finance: Isolation of Assets, Bankruptcy-Remote Structures, Waterfall Technology

What Traditional Lenders Should Know About the Application of Structured Finance Techniques to Asset-Based Lending

THURSDAY, SEPTEMBER 1, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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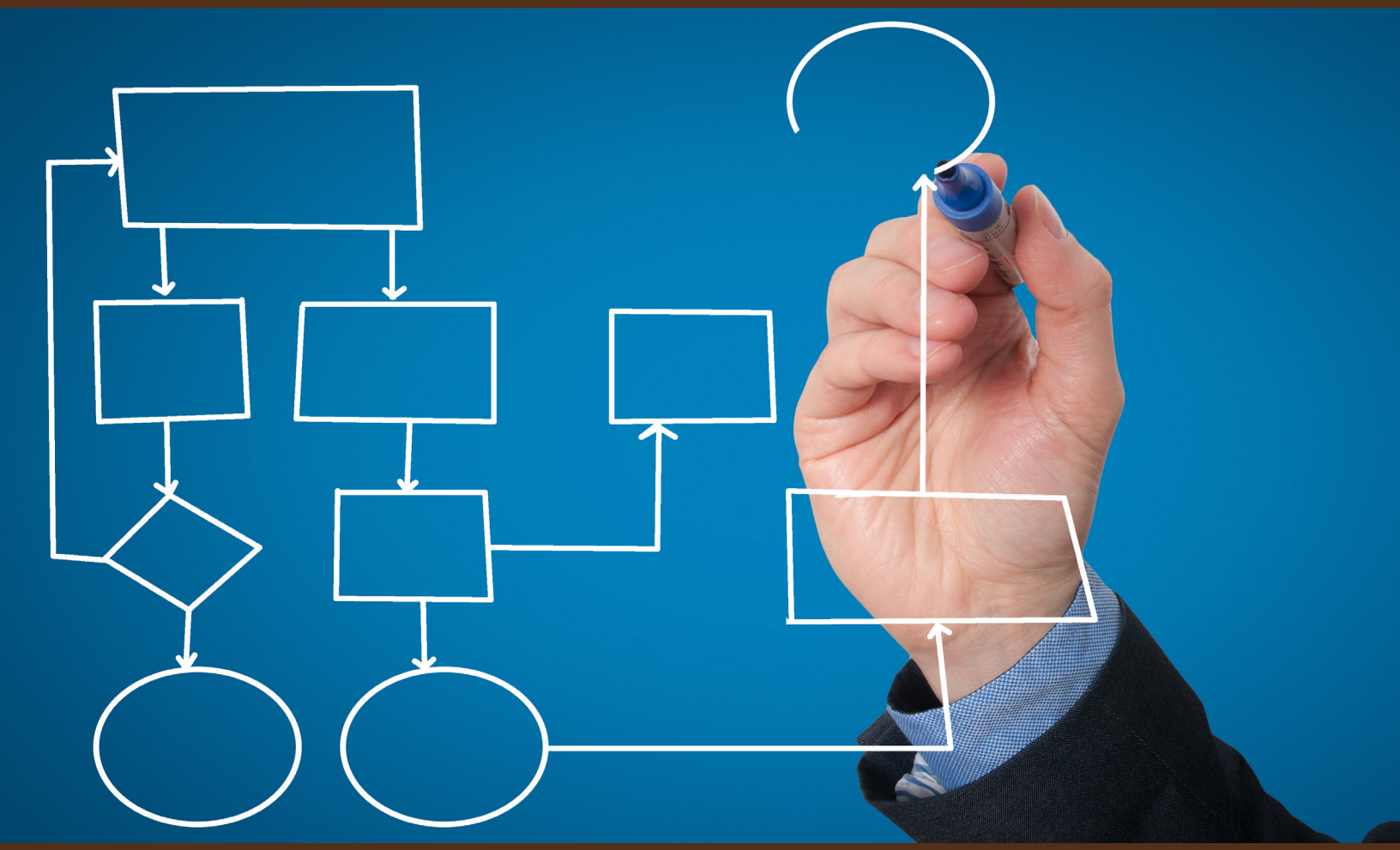

The Application of Structured Finance Techniques to Traditional and Asset-Based Lending Transactions

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The Application of Structured Finance Techniques to Traditional and Asset-Based Lending Transactions

Structured finance transactions seek to identify high-value assets (often financial assets) and legally isolate those assets for financing at more favorable rates and terms than may otherwise be available to originators or other owners of those assets. In a structured financing, such an originator or owner will transfer certain identified assets to a bankruptcy remote, special purpose entity (often colloquially called an "*SPV*") in a "true sale/contribution" transaction. In addition, the parties will seek to further enhance the credit quality of the transaction compared with "regular-way" financings through various structural techniques, and various types of credit enhancement, including overcollateralization, cash reserves, and/or third-party advances or credit support.

Many structured finance transactions will include tranching of the indebtedness issued by the SPVs to meet certain risk/return levels desired by particular investors. Structured finance facilities typically contain formal cash management and collection requirements and distribution mechanics, known as "waterfalls" or "priorities of payments".

Asset-based lenders may consider utilizing structured finance techniques in their own transactions to more effectively limit credit risk by isolating the underlying portfolio of assets to be financed. In this manner, lenders may be able to make more credit available to their borrowers while providing better pricing to the borrower on more competitive terms, and borrowers can more effectively manage their balance sheets and businesses.

This memorandum explains a selection of structured finance techniques that may be applied by traditional and asset-based lenders to achieve these results. In determining whether to apply any of these techniques as part of its lending platform, an asset-based lender will need to also consider the comparative advantages relative to the additional time and cost required for implementation.

* * *

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Isolation of Borrower Assets

Traditional and Asset-Based Lending

Asset-based lending facilities link credit availability to the credit quality of the underlying portfolio of assets, relying on a security interest in defined pools or classes of assets. These facilities value those secured assets and then apply eligibility criteria, borrowing base calculations and other techniques that seek to value the quality of the portfolio of assets to be financed in the event of sale or liquidation of such assets.

Credit determinations by asset-based lenders are based primarily on a valuation of the assets to be financed rather than the overall cash flow or credit history of the borrower. While the underlying portfolios of secured assets vary widely in asset-based transactions (and lenders often takes liens beyond their core collateral), the core assets considered in a borrowing base typically are comprised of accounts receivable and inventory in a dynamic pool, or real property, machinery or equipment in a static pool. The borrowing base is calculated by applying a percentage against all borrowing base assets that meet certain defined eligibility criteria. When an asset-based lending facility is secured by an "all assets" lien, it is common for portions of that lien to be shared with other lenders in a "crossing liens" scenario—*i.e.*, the asset-based lender will possess a first-priority lien on the "borrowing base" assets, but only possess a second-priority lien on the remaining assets of the borrower.

Eligibility criteria typically take the form of asset-related representations and warranties that are tailored to the specific type of asset(s) to be included in the borrowing base, which criteria are tested on the date of inclusion in the borrowing base and periodically thereafter. Eligibility criteria typically include representations that (i) the borrower maintains good and marketable title, (ii) the assets are not subject to any other lien or encumbrance of the borrower (other than certain permitted liens), (iii) the assets were originated in compliance with applicable law and are enforceable in accordance with applicable law subject to customary qualifications, and (iv) the assets are payable in accordance with their terms without setoff. Eligibility criteria often include specific legal, regulatory, accounting, business and tax considerations applicable to holding and perfecting a security interest in that specific asset type. If the eligibility criteria for any borrowing base assets are determined not to have been met as of any date of determination resulting in a borrowing base deficiency, the borrower will be required to replace the ineligible asset with one or more eligible assets, reduce the amounts outstanding under the asset-based loan or take other remedial action. In any event, the ineligible assets will no longer be included in the borrowing base calculation.

The borrowing base calculation in an asset-based lending facility typically applies a specific percentage of the principal balance or market value of the specified assets to be financed (often referred to as an "advance rate" or "borrowing base percentage"), with sub-limits, concentrations and adjustments to reflect the specific asset type(s) and other terms individually negotiated for the specific transaction, as illustrated by the following example:

"**Borrowing Base**" means, as of any date of determination, the sum of:

(a) 90% of the amount of Eligible Inventory, *plus*

(b) 85% of the amount of Eligible Accounts Receivable, *minus*

(c) the aggregate amount of Reserves, if any, established by the Lender.

Lenders often seek the flexibility to impose "reserves" against loan availability to address specific risks and liabilities and to achieve further credit enhancement. These particular reserves are in addition to required cash reserves for scheduled payments of interest, expenses and other amounts that come due monthly or quarterly.

In addition, because an asset-based lender typically maintains full recourse to the borrower and its assets, the transaction documents will contain representations, warranties and covenants regarding the general business of the borrower and the other loan parties. In addition, asset-based loan documents often include financial covenants, necessitating periodic reporting by the borrower and monitoring of financial compliance and performance.

A primary feature distinguishing asset-based facilities from structured finance transactions is that the underlying assets are not transferred or contributed to an SPV, and remain at the originating entity. This simpler structure has the advantage of providing full recourse to the borrower and its assets as well as avoiding the time and cost involved in creating an SPV and documenting the asset transfers.

Because of the status of the lender as a direct general creditor borrower, a credit analysis in an asset-based lending structure must consider not only the quality and performance of the underlying collateral portfolio but also the general creditworthiness and actual and contingent liabilities of the borrower. The failure to isolate the underlying portfolio may be reflected in the availability and pricing of credit to the borrower—*i.e.*, lenders must consider the credit as a company-wide credit risk, even given their discrete and identifiable pool of collateral.

Structured Finance Facilities

Structured finance is distinguished from asset-based lending by the contribution or sale of portfolio assets into an SPV that is a direct or indirect subsidiary of the originator or owner.[1] While the assets may comprise a static portfolio, most structured finance transactions involve continuing contributions to the SPV of a dynamic portfolio of liquidating or other cash-flow producing assets.

The SPV may take the form of a corporation, limited liability company, statutory trust, common law trust or another type of legal entity, all selected based on the borrower's regulatory, accounting, tax, business and other objectives. The governing documents of the SPV and the transaction documents set forth specific bankruptcy remote and special purpose provisions of the SPV. These bankruptcy remote provisions are intended to ensure that the SPV remains separate and is not substantively consolidated with its parent company in an insolvency proceeding of the parent company or any of its affiliates. Accordingly, the special purpose provisions significantly limit the activities of the SPV to those exclusively related to owning and holding the underlying portfolio of assets and performing its duties under the related transaction documents.

Set forth below is a representative sample of the activities permitted to be engaged in by an SPV to maintain its bankruptcy remote, special purpose nature:

- *the maintenance of separate books and records;*
- *the maintenance of separate bank accounts;*
- *the conduct of business in its own name;*
- *the payment of liabilities and expenses out of its own funds;*
- *holding itself out to be a separate entity from the parent company or any of its other affiliates;*
- *conducting business with the parent company or any of its other affiliates on an arm's-length basis; and*
- *correcting any known misunderstandings about its separate identity.*

[1] This Memorandum does not discuss trade securitization transactions that utilize a "single-tier" sale structure.

Set forth below is a representative sample of the activities prohibited from being engaged in by an SPV (other than as contemplated in the transaction documents) in order to maintain its bankruptcy remote, special purpose nature:

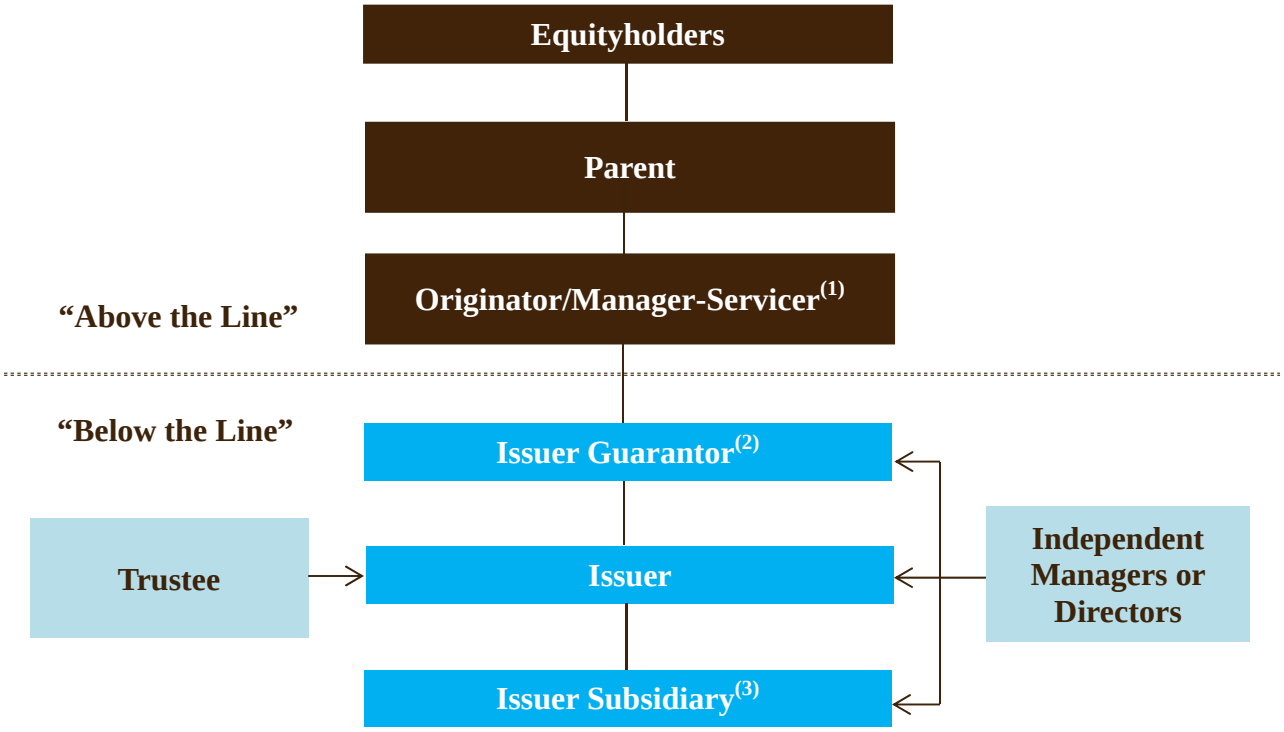
- *engaging in any business not expressly contemplated under the loan documents;*
- *dissolution, liquidation or merger or sale of all or substantially all of its assets;*
- *engagement in business activities other than owning, financing and collecting/selling portfolio assets;*
- *formation of additional subsidiaries;*
- *making loans;*
- *purchase, guaranty or holding of any indebtedness other than indebtedness under the loan documents;*
- *commingling of assets with other entities;*
- *pledging of assets for the benefit of other entities;*
- *holding out credit as available to satisfy the obligations of other entities; and*
- *identifying as a division of another entity.*

In certain transactions, particularly including rated transactions, one or more independent managers or directors whose vote is required in favor of any "material action" under the organizational documents will be required. A "material action" under the organizational documents would principally focus on the filing, consent or support of any insolvency-related proceeding relating to the SPV. If the independent managers or directors, as would be expected, do not support such a filing, a bankruptcy court would be expected to enforce the terms of the corporate documentation and dismiss the bankruptcy case for lack of authority.

Many independent managers or directors are engaged from a third-party service provider and are paid a nominal fee for their services. Typically, SPVs do not have employees and are managed under a management or servicing agreement with the originator or an affiliate of the originator or its parent entity, in consideration of a servicing fee, as further described below. In certain circumstances, the role of servicer may also be performed by a third party in consideration of a market-based fee.

The next page illustrates a sample structure showing an SPV in relationship to the parent/originator and its other affiliates:

Sample Structured Finance Structure



(1) The Parent or another "above the line" affiliate can also act as the Servicer.
(2) If applicable.
(3) If applicable.

Companies sometime raise the possibility of converting an existing entity with securitizable assets into an SPV as cost-saving measure. Except with respect to certain asset classes when this conversion is contemplated from inception (and extreme care is taken to not incur incidental liabilities), this approach is highly disfavored unless it can be demonstrated that the existing legal entity does not have outstanding or contingent liabilities and other criteria are met.

Sale and Contribution of Assets

Following the creation of an SPV, the assets of the originating entity are transferred by sale or contribution to the SPV pursuant to a sale and contribution agreement. This agreement is structured in a manner such that contributions or sales thereunder will be legally recognized in an insolvency-related proceeding of the originator or parent entity as "true sales" or "true contributions" —*i.e.*, such that the transferred assets are recognized as the property of the SPV and no longer constitute property of the estate of the originator under the U.S. Bankruptcy Code. One key aspect of "true sale" analysis is that the assets must be sold without recourse for fair value on terms that would reflect an arm's-length transaction between two unaffiliated parties. So long as the SPV is solvent and the contribution is reflected in the capital account of the SPV, contribution agreements should satisfy a "true contribution" analysis.

As part of a structured finance transaction, generally the SPV will apply the net proceeds from the financing provided by a third party towards the purchase price under the purchase and sale agreement. Contributions can be more flexible, as the transfer can be effected without consideration of the financing. Often, a combination is used in which the value of the assets is greater than the funds available to the SPV to purchase the assets

pursuant to the financing or otherwise; a portion of the assets can be treated as a contribution.

Below is a representative sample of typical corporate representations, warranties and covenants made by the originator as of the date of the contribution and/or sale:

- *due organization and good standing;*
- *due qualification;*
- *due authorization;*
- *no conflicts;*
- *no consents other than those obtained;*
- *enforceability;*
- *no threatened or actual proceedings; and*
- *solvency.*

Typical ongoing representations, warranties and covenants made by the parent/originator include:

- *continued existence in good standing;*
- *compliance with its charter documents and applicable law;*
- *UCC filings;*
- *compliance with certain corporate formalities in order to maintain the separateness of the originator and parent entity from the SPV; and*
- *non-petition under relevant insolvency laws.*

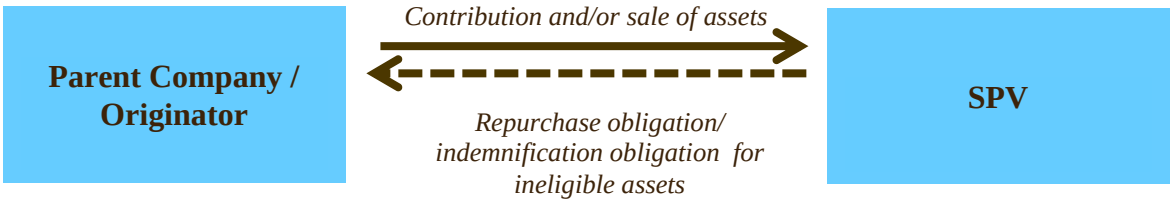
Representative representations, warranties and covenants made by the parent/originator relating to the transferred assets as of the date of the contribution and/or sale typically include:

- *good and marketable title to the assets;*
- *no liens other than permitted liens;*
- *none of the assets have otherwise been sold, assigned or pledged;*
- *each of the assets (i) is the obligation of the transferor, (ii) is enforceable by the transferor, (iii) has been properly executed, (iv) is assignable and (v) complies with applicable law;*
- *no existing liabilities exist with respect to any of the assets that would affect payment thereon; and*
- *the parent intends to effect an absolute transfer and conveyance.*

The parent/originator typically agrees to indemnify the SPV for any losses incurred as a result of a breach of its representations, warranties and covenants and would also be obligated to either indemnify or buy back (or substitute and replace) any assets contributed and sold by the originator determined to not have satisfied the asset-related representations and warranties as of the transfer. This indemnity and repurchase obligation, when structured properly, should not impair the "true sale" and "true contribution" of assets, so long as the originator is not effectively indemnifying or buying back the assets for credit-related events. Subject to certain limitations, the originator may elect to substitute or replace assets.

A contribution and/or sale of assets by the originator should generally be protected by a precautionary security interest granted by the originator in the event that the transaction is challenged as a financing rather than a contribution or sale. Securitization documents will carefully note that such an interest is *merely precautionary* in nature, and the parties intend the transfer of assets to be an absolute transfer/conveyance.

Set forth below is a structural diagram depicting the transfer of assets by a parent company to an SPV and the corresponding repurchase obligation of the parent company for assets determined to have breached the asset-related representations and warranties as of the date of transfer:



Legal Opinions

Investors in structured finance transactions typically require opinions from a nationally recognized law firm regarding true sale or true contribution (or combination thereof) of the transfer transaction as well as the substantive non-consolidation of the SPV with the originator, in the manner described below. These opinions are fact-intensive, reasoned opinions that recognize that the applicable law is subject to change. One value of requesting such opinions is that the firm delivering the opinion will demand that the borrower and parent create "good facts" in the organizational documents and related transaction documents on which the firm will rely in preparing the opinion, and which will help ensure continued compliance with SPV requirements.

Non-Consolidation Opinion

Under a non-consolidation opinion, a law firm will opine that in a properly presented and decided case under U.S. federal bankruptcy law, the U.S. bankruptcy court would not substantively consolidate the assets and liabilities of the SPV with those of the originator. The opinion is a reasoned analysis based on facts and assumptions set forth in the opinion that would be considered by a court in considering consolidation as an option.

True Contribution and/or Sale Opinion

Under a true sale/true contribution opinion, a law firm will opine that, in a properly presented and decided case under U.S. federal bankruptcy law, the U.S. bankruptcy court would conclude that the transfer of the assets to the SPV pursuant to the contribution and sale agreement constitutes a true contribution or sale and absolute transfer of the assets by the parent company to the SPV, as opposed to a secured loan, and therefore (1) the assets would not be property of the originator's bankruptcy estate under Section 541(a)(1) of the U.S. Bankruptcy Code and (2) Section 362(a) of the U.S. Bankruptcy Code would not operate to stay payments of the proceeds of the assets under the documentation by virtue of the bankruptcy of the originator. As with the non-consolidation opinion, this is a reasoned analysis based on facts and assumptions set forth in the opinion and specifically will consider the distinction between a true sale/contribution and a secured financing.

Other Legal Opinions

In addition to the securitization opinions described above, the borrower's counsel will also deliver typical corporate, UCC, tax and other opinions that may be tailored to the specific nature or specific regulatory concerns of the transaction.

Many of these opinions will be similar to those given in a traditional lending transaction, with additional opinions that relate to structured finance regulatory and investment company matters (such as SEC Rules 17g-5 and 15Ga-2 and the "Volcker Rule"). Opinions of in-house counsel to the parent/originator are often accepted with respect to the corporate-related matters that would require additional due diligence by outside counsel, such as no conflict with material agreements and no litigation or regulatory action.

The delivery of the bankruptcy law-related opinions and such other opinions is customarily a condition to the issuance of rating letters by rating agencies, as described below, but is almost always required by lenders even in the absence of a rating by one or more rating agencies.

Cash Management

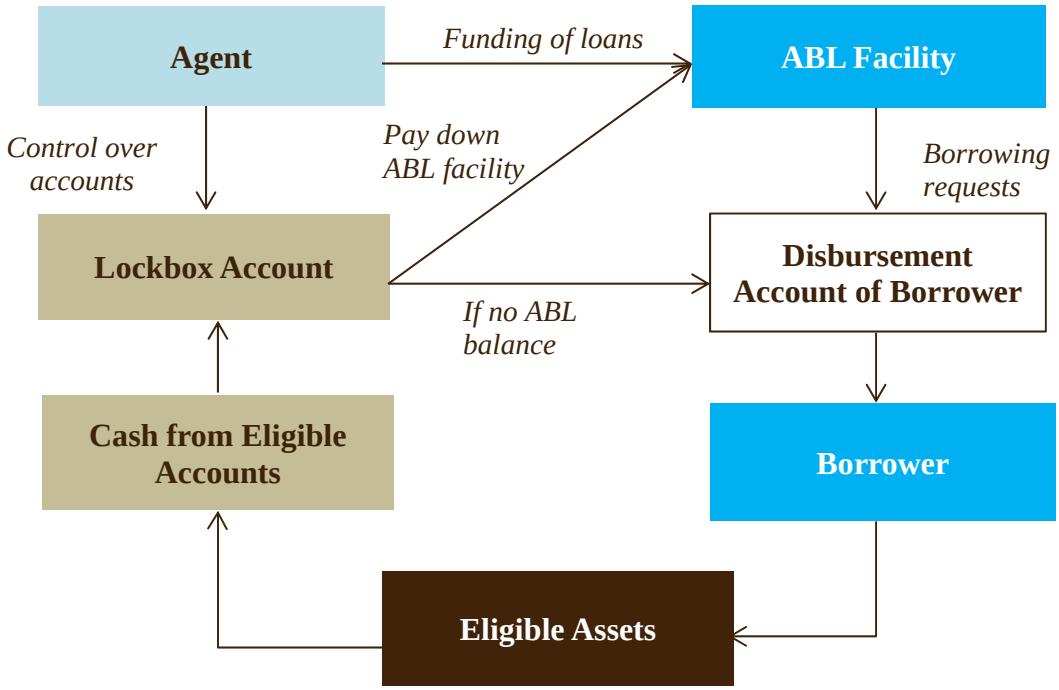
Full Cash Dominion in Asset-Based Lending

In addition to periodic monitoring of the borrower assets, asset-based lending facilities often mitigate exposure to corporate credit risk through control of the borrower's receivables-based cash flow. In cash dominion transactions, borrowers direct all account debtors to make payments to a lender account or lender-controlled lockbox account. In "strict" facilities, a lender will notify account debtors directly of the direction and collateral assignment, which provides additional credit protection as well as statutory protections under the UCC. In certain transactions, the lender or lender agent will actively monitor and approve distributions of daily collections. Under this arrangement, if the borrower requires funding in excess of collection amounts released, the borrower will be required to request an additional advance and, in practice, a borrower may be required to borrow almost daily—something many borrowers may not wish to do. While lenders benefit from their loans being reduced daily from substantially all proceeds of collections, this type of monitoring arrangement requires significant effort and a dedicated workforce.

When credit reasons do not demand close collections monitoring, many (if not most) asset-based loans will institute "full cash dominion" of cash collections only following a default. Following the occurrence of a default and in the absence of any negotiated restructuring terms, these funds will be available to repay all outstanding amounts under the loan, with the residual amount payable to the borrower only after the agent and lender(s) have been paid in full.

Set forth below is a chart depicting a typical cash management system applied by asset-based lenders as described above:

ABL Facility Cash Management System



While the simplified nature of the cash management system set forth above provides control to the agent and lenders over collections, the limited ability to modify the cash management system to satisfy the needs of an individual transaction (including, in particular, in connection with the exercise of remedies) may make this approach less attractive to both lenders and borrowers.

Structured Finance Cash Management

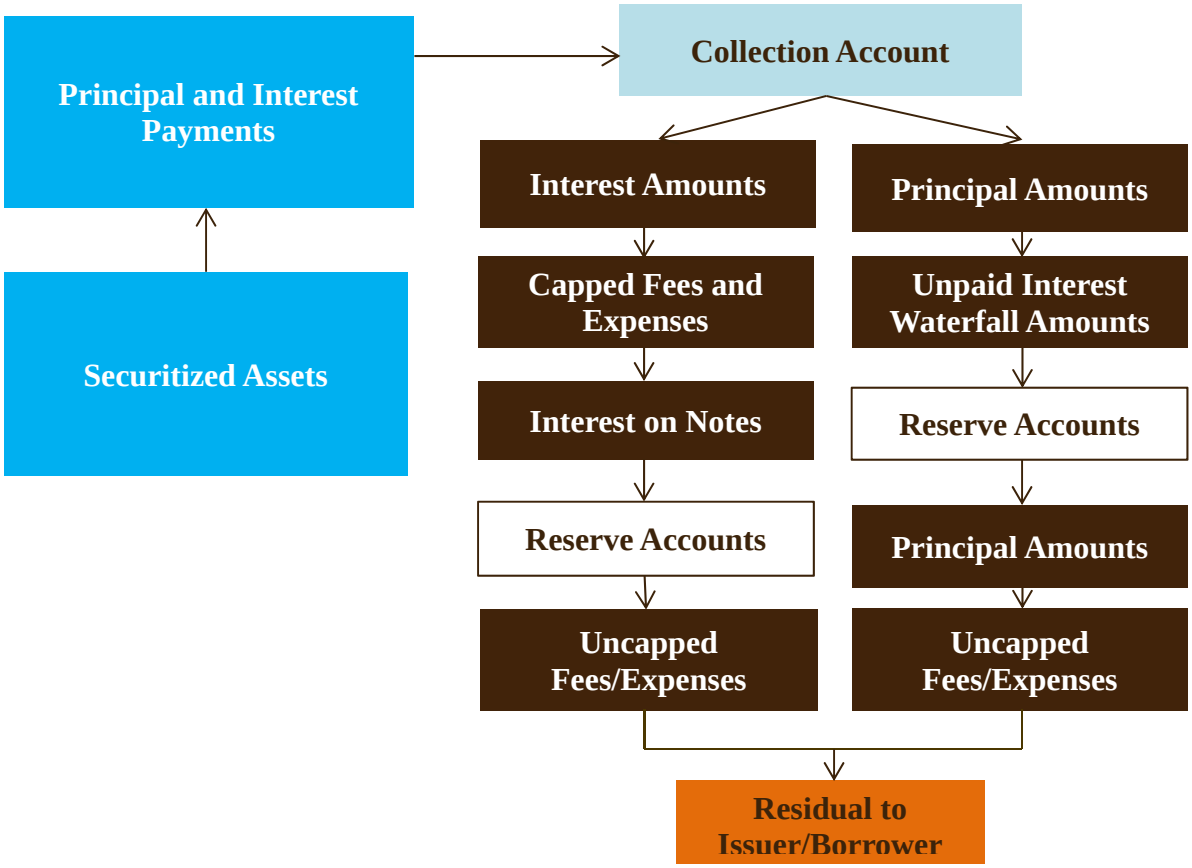
Structured finance transactions do not utilize asset-based lending's active (and labor intensive) daily cash flow monitoring model. Instead, a structured finance transaction typically implements a formalized allocation of funds known as a "waterfall" or the "priority of payments" established at the outset of the transaction and set to run on a periodic basis (usually monthly)—*i.e.* not only after an exercise of remedies.

A waterfall set forth in the loan agreement or indenture may include features that permit flexibility for the needs of the specific transaction, such as one or more of the following:

- *senior payments for third-party servicers and agents, which results in reduced risk and reduced charges for such services;*
- *priority for the payment of scheduled interest payments, which enhances rating agency analysis and treatment;*
- *tranching provisions governing priority of interest and principal payments, which effectuate critical intercreditor arrangements and eliminate the necessity for separate intercreditor agreements;*
- *fee caps in the form of limitations on fees and expenses that can be paid at a senior level in the waterfall prior to payment of interest, principal and other amounts;*
- *cash trap reserve accounts to provide credit support and reserves for payment of the debt following the occurrence of trigger events; and*
- *"rapid amortization" provisions that apply excess cash flow to amortize the principal due to the noteholders on an accelerated basis.*

The following page shows a chart depicting the cash management system applied in a representative structured finance transaction as described above:

Securitization Cash Flow (Example Showing Financial Assets)



In structuring such a transaction, the parties should consider whether the SPV could possibly be subject to potential liabilities that are not paid under the waterfall (such as those to regulatory agencies, judgment creditors and the like). This risk is mitigated by prohibiting the SPV from conducting ordinary course business activities, such as engaging employees or entering into agreements that could give rise to such liabilities.

Certain recent "cutting edge" transactions have pushed the boundaries of traditional securitization, and, in doing so, have required reserves or other features to mitigate the risk of contingencies to address unanticipated liabilities. In particular, "whole business" securitizations and securitization transactions that transfer core operating assets to the SPV raise the risk of unanticipated liabilities. Careful transaction structuring to quantify these liabilities in a meaningful manner is undertaken on a fact- and transaction-specific basis. Insurance and indemnities by the servicer or other "above the line" entities are commonly utilized risk-mitigation devices.

Cash Management

Structured finance transactions typically require one or more specified accounts into which the servicer will be required to deposit payments on the assets. Such payments are often required to be deposited directly into one or more lockbox accounts and related collection/concentration accounts. Certain transactions will allow the originator to continue to manage collections and require the transfer of funds within a specified time of receipt. Often, collections in multiple collection accounts are then transferred into (or "swept") and subsequently distributed out of a single concentrated account—

i.e. the "waterfall" or "priority of payments" will operate from pooled collections in a single account.

Given their non-recourse nature, structured finance transactions may include reserve accounts, such as interest reserve accounts, expense reserve accounts, cash trap accounts, either funded at closing or subject to build-up amounts funded out of the waterfall up to a target amount. An interest reserve account provides essential transaction stability through the additional assurance of the timely payment of scheduled interest in the event of an unanticipated and temporary disruption in cash flow. Expense reserve accounts ensure payment of essential expenses, and specifically address any timing issue arising as a result of gaps due to the periodic payment mechanics of the waterfall. A cash trap account will permit reallocation of funds to prepayment of the securitized debt or other required amounts upon the occurrence of specified trigger events.

Cash management is typically established and maintained pursuant to an account control agreement or indenture or other similar agreement with one or more financial institutions that already have a working relationship with the originator. These documents establish the responsibilities of the trustee or agent in managing deposits and withdrawals from the accounts. In certain transactions, the accounts may be established and maintained in the name of the trustee or agent instead of the issuer.

Tranching of Indebtedness

While structured finance facilities often contain multiple debt tranches, the seniority rights are effectuated in the waterfall under the indenture and not under intercreditor agreements as are common in "regular-way" facilities. As a result, a single lender party (often the collateral agent or trustee) takes a single security interest in the pledged assets of the SPV on behalf of all lenders and other secured parties. This tranching of indebtedness may make credit more readily available to borrowers or issuers on better terms from a risk-arbitrage perspective. Multiple tranches can be sized under the waterfall with a great latitude of terms to meet the risk/return criteria desired by individual lenders. Waterfall provisions allow for much greater flexibility and creativity in the form of time tranching, multiple maturities, differing priorities of principal and interest, and other features. Creating these types of complex intercreditor arrangements under asset-based facilities would require complex drafting of crossing-lien and intercreditor mechanics and significant lender negotiation.

Set forth below is an example of how the indebtedness issued by an issuer may be structured to achieve differing return relative to risk for particular lenders:

Sample Tranching of Indebtedness

Class of Notes	Principal Amount	Interest Rate	Credit Rating	Maturity
Class A Notes	$ 250,000,000	LIBOR + XX%	AAA/Aaa	July 1, 20XX
Class B Notes	$ 150,000,000	LIBOR + XX%	AA/Aa2	July 1, 20XX
Class C Notes	$ 100,000,000	LIBOR + XX%	A/A2	July 1, 20XX
Class D Notes	$ 50,000,000	LIBOR + XX%	BBB/Baa2	July 1, 20XX

Advances

A structured finance transaction may require a creditworthy third party, such as a third-party servicer or the trustee, to make advances to pay amounts due to the extent funds are not otherwise available under the waterfall, in a manner approximating the role of a "swingline" lender in an asset-based facility.

For example, the third-party servicer in a securitization may be required to make (i) a debt service advance when the interest due on a given payment date is greater than the amounts available for such purpose on deposit in the relevant securitization accounts or (ii) a collateral protection advance if the servicer determines that such an advance is necessary to prevent an immediate loss in value of the secured parties in one or more of the securitized assets. The trustee may also be required to make debt service advances in certain limited circumstances, in particular if the third-party servicer fails to make such an advance. These advances are repaid on a senior priority level in the waterfall. The trustee and third-party servicer generally are not required to make advances if it is determined that the advances would be "nonrecoverable", that is, the advancing party did not reasonably believe that it would be reimbursed in accordance with the waterfall for advances made.

Other Parties to the Structure

The Trustee and Administrator

A trustee or administrator in a structured finance transaction is responsible for holding and maintaining a valid, perfected first-priority security interest in the securitized assets, monitoring the reports received from the servicer regarding the administration of the borrower, and oversees the disbursements due to the investors under the transaction documents. Additionally, the trustee or administrator provides limited monitoring of compliance by the deal parties under the transaction documents and notifies investors in any event of receipt of any notice of noncompliance or default.

The Servicer

Being a limited purpose entity whose duties are strictly limited to corporate governance matters and with no employees, the SPV must contract with a third party to provide essential servicing of its assets and performance of its obligations under the loan agreement or indenture. The servicer assumes responsibility for day-to-day management of the SPV and servicing the SPV's assets pursuant to a servicing or management agreement.

Typically, the servicer is the originator, parent entity or any other "above the line" affiliate of the SPV. The servicer will manage and service the assets of the SPV either directly or through additional third parties acting as "sub-managers" or "sub-servicers." The servicer will typically be entitled to a servicing fee and entitled to reimbursement for costs and expenses, as expressly provided under the waterfall. These fees are often bifurcated into a "senior servicing fee" payable at a senior priority level and a "subordinate servicing fee" payable at a subordinate priority level. Upon certain events (including, *e.g.*, a servicer default), the servicer may be removed and replaced by a replacement third party entity to provide servicing of the collateral portfolio.

Typical servicer duties in a structured finance transaction include (i) monitoring the assets (including the addition or removal of assets), (ii) collecting and servicing payments on the assets, (iii) maintaining compliance by the SPV with the transaction documents and applicable law, (iv) preparing certificates and other communications required under the transaction documents on behalf of the SPV, (v) preparing monthly and quarterly reports required under the transaction documents and running calculations required under the reports, (vi) making collateral advances (if applicable) and (vii) making debt service advances (if applicable).

The Back-Up Servicer

Because the servicer and originator are usually affiliated entities, most structured finance transactions require a third-party back-up servicer. The back-up servicer should be an entity experienced in providing (or coordinating the provision of) the services required of the servicer. The back-up servicer's duties customarily include monitoring compliance by the servicer with its duties under the relevant transaction documents. Upon the occurrence of certain trigger events, the back-up servicer will develop a plan to transition the servicing to itself or another successor servicer. The back-up servicer's duties can vary significantly based on a transaction's requirements, and generally are described as "cold," "warm" or "hot" back-up servicing based on the complexity of the duties required to be performed from the closing date and prior to any default.

A representative sample of "cold," "warm" and "hot" back-up management services is as follows:

"Cold" Back-Up Management

- *general and continuous monitoring and reporting services, which may include reviewing reports generated by the manager and examining the manager's performance under the transaction documents*

"Warm" Back-Up Management

- *certain actions that the back-up servicer takes upon the occurrence of specified financial trigger events, which may include performing a financial analysis of the securitization entities to determine the cause of the trigger event, generating revised financial projections, identifying business plan alternatives and developing a transition plan*

"Hot" Back-Up Management

- *duties that the back-up servicer assumes upon the termination of the manager, which may include implementing the transition plan, assisting the trustee and servicer in seeking out a successor manager, and assuming management over the securitization entities*

Rating Agencies

Investors often require the indebtedness issued by the SPV in a structured finance transaction to be rated by one or more rating agencies. Ratings permit a broader range of investors (as some investors require ratings on their investments for regulatory reasons or their own internal policies). Such ratings typically require compliance with standardized tests, documentation and other conditions imposed by the rating agencies in addition to periodic reporting to the rating agencies. An asset-based lender would need to compare the relevant advantages to the additional time and cost associated with obtaining one or more ratings for a facility in the same manner as for an asset-based lending facility.

Reporting

Structured finance transactions typically provide a more formalized reporting rubric than asset-based lending transactions. A monthly or quarterly noteholder report will typically detail the application of funds under the waterfall and test compliance with various triggers and financial covenants, and certify whether or not defaults or events of default or other events have occurred. Reporting will be focused on the performance of the collateral and will not rise to the level of the more detailed reporting required of public companies under federal, state and local securities laws. Reporting in certain asset classes will not include general financial performance reporting for the borrower or the parent.

A back-up servicer may be required to monitor compliance by the servicer with its reporting obligations, even prior to a servicer default.

In addition, reporting in structured finance includes independent accountants' reports on an annual basis that include a review of a representative sample of the reports prepared by the servicer over the past year, annual security interest opinions and other periodic reporting.

Whole Business Securitization

Whole business securitization applies the structured finance techniques described above to securitize an entire business. In a whole business securitization, substantially all of the revenue-generating assets of an entire business are directly or indirectly contributed and/or sold to SPVs. The business is contributed to multiple SPVs in order to contribute different aspects of the business to different entities to achieve certain legal and regulatory objectives. One or more of the SPVs typically issue the securitized indebtedness for sale to investors with the remaining SPVs jointly and severally guaranteeing or co-issuing the debt.

The initial contribution and sale of the business to the SPVs can be time- and cost-intensive, though recent innovations have made this process much more efficient. The originator that contributes the business continues to hold direct and indirect ownership interests in the securitization entities. The originator receives the residual on the return on the business after payment of amounts due on the debt issued by the securitization entities and all other amounts due and payable in accordance with

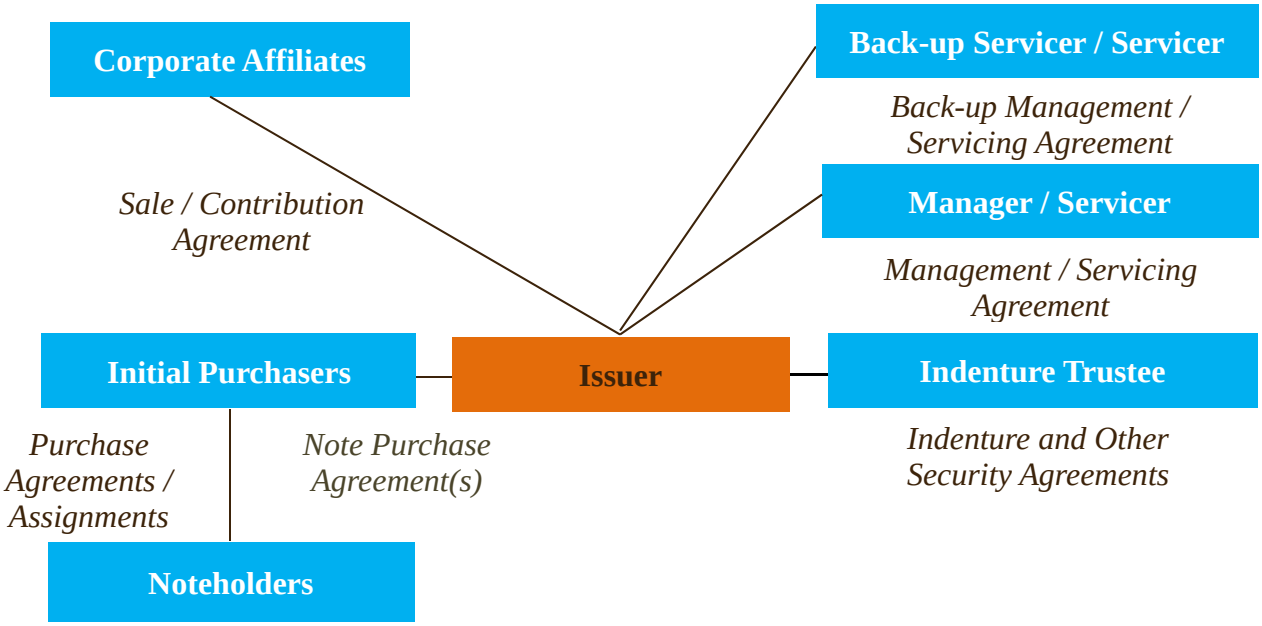
the waterfall for the whole business securitization. Whole business securitizations initially took the form of the securitization of franchised restaurant businesses. More recently, similar structures have been applied to securitize a broader range of businesses with modifications to the structure to reflect the nature of the business being securitized. There is the potential to adopt whole business or "operating asset" securitizations for many other asset types.

A whole business securitization will typically provide for the issuance of multiple series of securitized notes pursuant to a base indenture and a series supplement for each series. This structure permits issuance of additional series of notes in a shorter time frame and at less cost following the initial issuance of notes, permitting the parties to the transaction to respond more promptly to favorable conditions for the issuance of additional series of notes, including in order to permit the optional prepayment of earlier series of notes. Whole business securitizations have adopted many concepts from traditional leveraged finance facilities in structuring the notes issued by the SPVs, including revolvers, swingline facilities, letter of credit facilities, equity cure provisions, "par call" baskets and other provisions.

The cash management system for a whole business securitization is more complex than for other securitizations, because an entire business is being securitized. The proceeds of the various revenue-generating assets of the business will typically be deposited within a short time frame to one or more separate securitization accounts. The manager for the securitization will be permitted to withdraw amounts on deposit in these accounts to pay specified costs and expenses of the business as they come due outside of the waterfall. The remaining amounts on deposit in these accounts, less certain amounts to continue to pay costs and expenses in running the business, will be withdrawn and "swept" as frequently as weekly for deposit to a single master account for application in accordance with the waterfall for the whole business securitization. The waterfall for a whole business securitization is typically far more complex than it is for other types of securitizations, reflecting the more complex nature of the transaction, with more parties involved and the additional operating flexibility and liquidity required on account of securitizing an entire operating business and need to replicate facilities available in leveraged finance transactions, including letter of credit and revolving facilities.

A whole business securitization will typically have a manager that is an affiliated "above the line" entity with a third party acting as servicer that monitors the performance by the manager of its duties and acts as a control party on behalf of the noteholders, making certain decisions on behalf of the noteholders under the transaction documents. A separate back-up manager monitors the performance by the manager of its duties and is prepared to replace the manager at the direction of the control party or noteholders following the occurrence and continuation of a manager termination event. Set forth on the next page is an organizational chart showing the typical structure:

Whole Business Securitization



Conclusion

The application of structured finance techniques to traditional and asset-based lending permits lenders to more effectively tie credit availability to the credit quality of the underlying portfolio of the assets of the borrower. Structured finance is constantly expanding to include new asset classes involving increasingly creative structures over time, such as whole business securitizations, executory contract monetizations and other operating asset securitizations. The key factor in all these transactions is the flexibility that can be applied in tailoring these techniques to the core structural elements of securitized products.

This memorandum serves as an introduction to the application of these techniques to traditional and asset-based lending, and does not address specific issues this will inevitably arise in any specific transaction or regarding particular types of borrowers or asset pools. As structured finance techniques continue to be applied to more varied asset types over time, new legal, regulatory, accounting, tax and business issues also must be addressed by both lenders and borrowers.

Importantly, even absent a full securitization product, traditional and asset-based lenders may consider implementing certain elements of structured finance techniques into their facilities. By way of example, a real property lender might segregate collateral properties into an SPV, or specialty lenders may use waterfall techniques to finance particular pools of assets on a "senior/subordinated" basis, avoiding complicated intercreditor mechanics.

A lender need not necessarily implement a full-featured securitization to benefit from a number of the individual techniques described in this memorandum, but should consider each element as part of their toolbox of credit enhancement techniques for particular asset and lending types.