Legal status of special purpose vehicle company within cross-border securitization projects

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The author of the article has studied the distinctive features of the legal status of a special purpose vehicle company (SPV) as one of the principal participants of classic securitisation projects. In particular, it considers various approaches to choice of legal form for establishment of the SPV which is extremely significant for attaining the main objective of creation of the SPV – to insulate the holders of the asset-backed securities from the insolvency risk and any other risks related to the originator. It is established that creation of the SPV in the form of a public company is the most advantageous option in terms of asset-backed securities offering, but feasibility of this option for the SPV should be assessed with reference to the law of the place of incorporation. The article also highlights the main characteristic features of the SPV, such as its full independence from the originator for elimination the risk of piercing the corporate veil and the risk of re-characterization of the whole transaction; limited scope of legal capacity of the SPV suitable only for the intended purpose of the SPV within a securitisation project; insulation of the assets acquired by the SPV from the credit risk of the originator, when the originator does not bear the risk of insolvency of the SPV, and investors do not bear the risk of insolvency of the originator; absence of prior business history or commitments not related to the securitisation project. The author of the article also examines the issues of choice of jurisdiction for incorporation of the SPV and compliance with local regulatory requirements. Finally, the author considers the legal nature of the SPV and reaches a conclusion on its principal difference from other types of financial institutions, such as credit institutions, insurance companies, investment firms and collective investment undertakings.

Introduction

Securitisation is an innovative technique of raising finance in the international capital markets which rapidly evolved in the last few decades. It was invented to satisfy the needs of the financial institutions in additional capital, as well as in compliance with the capital adequacy and other regulatory requirements enabling a bank to transfer the assets from its balance sheet. By means of securitisation illiquid financial assets can be effectively transformed into a form more desirable for the investors, namely debt securities, whereby they can be further freely transferred to a multitude of investors. Generally speaking, securitisation is the process of pooling and repackaging loans into asset-backed securities, which are then sold to the investors, rearranging the cash flows and transferring the risks related to the real financial assets from the bank to the investors.

A special purpose vehicle company (SPV) which is typically created *ad hoc* for a particular securitisation project plays a pivotal role within such transactions. The bank (originator) shall sell receivables to this shell company, commonly incorporated in a tax haven, with no creditworthiness in itself. Once the project is completed, the SPV is liquidated. The key role of the SPV is to insulate the holders of the asset-backed securities from the insolvency risk and any other risks related to the originator. In order to attain this paramount goal, the SPV shall be incorporated and exist as an insolvency remote entity in every sense of the word.

During securitisation a special attention should be paid to the legal status of the SPV. Such company should normally be fully separated from the originating bank with no risk of lifting the corporate veil by courts and re-characterization of the sale of underlying receivables as a secured transaction which may ruin the whole transaction. Painstaking analysis of every legal aspect related to incorporation and operation of the SPV is indispensable when structuring the classic securitisation project. It should be admitted that legal issues pertaining to SPV have not been examined by legal scholars in complex, which gives the reasons for our present research of this problematic area.

The **purpose of this article** is to discuss various approaches to choice of legal form for establishment of the SPV and consider the most appropriate solution of this issue. Furthermore, we will examine the legal nature of the SPV by comparing it with similar legal entities and establish the distinctive features of such company caused by its specific role and function within securitisation projects.

Presentation of the main material

As observed in legal doctrine, the SPV has three major functions in securitisation: (1) it is a pass-through vehicle that allows the originator's assets to be securitized and sold to investors; (2) it provides protection against the SPV becoming insolvent for investors of the securitized assets; and (3) it protects the securitized assets from the originator's creditors[1].

[1] Pearce J.A., Lipin I.A. Special Purpose Vehicles in Bankruptcy Litigation. Hofsra Law Review. 2011. Vol. 40. Issue 1. P. 183–184.

In terms of a legal form the SPV may be established in the form of partnership, trust, corporation, fund, limited liability company, joint-stock company or in other legal form stipulated by the laws of the state of incorporation for such entities. In particular, in the United States an SPV generally takes the form of a limited liability corporation ("LLC"), a trust, or a limited liability partnership ("LLP"). In Europe an SPV can be organized as an LLC, a limited purpose corporation under domestic or offshore law with a charitable trust owner, while in Canada an SPV may take the form of a charitable trust[2]. In Luxembourg a securitisation company can be set up as a public limited liability company (*société anonyme*), a partnership limited by shares (*société en commandite par actions*), a private limited liability company (*société à responsabilité limitée*), a co-operative organised as a public limited company (*société cooperative organisée sous forme de société anonyme*)[3]. More commonly, the SPV is formed as a joint stock company, the shares of which are legally or beneficially held not by the originating bank, but by a neutral entity, wholly distinct from the bank, or held on trust for charitable purposes. Alternatively, it may also be incorporated as a limited liability company (in the civil law jurisdictions) or a trust (in English-based countries).

In general, the legal form of the SPV should be best suited for public issue of asset-based securities in order to attract the widest range of investors. The SPV is formed as a public company, so as to be able to issue securities non-privately[4]. From this perspective, creation of the SPV in the form of a public company, with no restrictions on capital raising from unlimited range of investors, may be considered as the best alternative, subject to mandatory statutory requirements of the local jurisdiction. However, it should be borne in mind that a public company is in the focus of the most stringent corporate law regulations, especially in terms of disclosure of corporate information, formation of governing bodies, external audit of financial statements etc. In this context in Ukraine, for example, it is highly inadvisable to create an SPV in the form of a public joint-stock company, and other corporate forms (such as private joint stock company or limited liability company) should be considered.

The originating bank should not have any share capital in the issuer of the asset-backed securities or otherwise have a proprietary interest in or control over the issuer. The issuer's name should not include the name of the bank or contain any reference to it. The SPV should have separate financial statements, wholly distinct budget and documentation, no overlapping of positions of key management and personnel. The point is that the SPV should not be regarded as an affiliate or subsidiary of or a person somehow associated with the originator, which may be consolidated upon the originator's balance sheet. Otherwise, the holders of the asset-backed securities may be tempted to induce the court to pierce the corporate veil and recover the outstanding debt under these securities directly from the originator. Since the SPV is a separate and distinct legal entity, the originator bears no responsibility for its obligations. Ideally, the originating bank should have no excessive involvement in the SPV, in particular, in the form of a participating share in the capital of the SPV or representatives in its governing bodies. It should not provide additional guarantees (except for contractual warranties regarding quality of the underlying assets acquired by the SPV) or loans (except for a subordinated loan sometimes granted by the originator to keep the project afloat). It is submitted that "in order to ensure the perception of a 'true sale' by the regulatory authorities, the SPV must be "ring-fenced" from the originating bank or mortgage originator. That is, the SPV structure must be legally separated from the originating lender and its management"[5]. Also the bank should not provide any external services to the SPV, including underwriting services during securities offering. Overall, the SPV must observe all appropriate third-party formalities with the originator[6]. However, in practice the originator's involvement in continuing process of servicing the SPV's debt may appear in different forms. In particular, the originator may step in to protect investors in securities issued by the SPV if default levels on the underlying assets prove to be higher than expected[7]. Insolvency remoteness may be further enhanced by establishing a chain of multiple SPVs with receivables going successively through this circuit. It is alleged that "because this "true sale" quality is of utmost importance, originators often structure the transfer among multiple SPVs to ensure a bankruptcy court will not negate the sale later"[8].

The securitization process enables precise distribution and transfer of credit risk from banks to other investors[9]. In essence, the main incentive for creating of a separate SPV is to ensure a high level of insolvency remoteness: the originator does not bear the risk of insolvency of the SPV, and investors in the securities issued by the SPV do not bear the risk of insolvency of the originator. In practice, "various arrangements attempt to ensure that

[2] Ibid. P. 195–194.

[3] Zanev V., Barchman A. Structured finance and securitization in Luxembourg: overview. URL: https://uk.practicallaw.thomsonreuters.com/0-6242615?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1.

[4] Wood Ph. Project Finance, Securitizations, Subordinated Debt. London : Sweet & Maxwell, 2007. P. 120.

[5] Rajapakse P.J. An Analysis of the Concept of Mortgage-Backed Securities : An Economic and Legal Perspective. The Journal of Law and Financial Management. 2011. Vol. 10. Issue 1. P. 25.

[6] Dasgupta P., Vachha N. Multi-Jurisdictional Framework of International Securitization: Understanding the Various Facets of this Transnational Process. University of Miami Business Law Review. 2004. Vol. 13:91. P. 95.

[7] Albrecht T.W., Smith S.J. Corporate Loan Securitization: Selected Legal and Regulatory Issues. Duke Journal of Comparative & International Law. 1998. Vol. 8:411. P. 422.

[8] Hoffman S. The Uncertainty of "True Sale" Analysis in Originator Bankruptcy [unpublished]. 2012. P. 20. URL: http://works.bepress.com/stephen_hoffman/6/.

[9] Zuckerman A.M. Securitization Reform : A Coasean Cost Analysis. Harvard Business Law Review. 2011. Vol. 1. P. 306.

the SPE will be "bankruptcy remote", i.e., that the SPE will not itself become subject to a bankruptcy proceeding and that, if the originator enters bankruptcy, the SPE and the originator will not be substantively consolidated and treated as a single entity"[10]. However, complete insolvency remoteness can hardly be achieved. It is submitted that "in a traditional securitization structure, the SPV will not have any credit risk exposure to the originator, unless the originator's own independent debt rating at least matches the debt rating of the most senior tranche of debt issued by the SPV"[11].

Due to insulation of the assets acquired by the SPV from the credit risk of the originator the SPV may obtain a much higher credit rating, as compared to the originator issuing the same securities secured by the same assets. Such economic effect becomes possible entirely due to "non-contamination" of the underlying assets by the originator's inherent business risks. It is for this reason that securitization can enable companies to access capital markets directly, in most cases at lower cost than the cost of issuing direct debt (such as bonds or commercial paper)[12].

It is submitted that the special purpose company is better suited to achieve insolvency remoteness in terms of creating a definite divide between the originator and the SPV[13]. In order to remove the risk of insolvency of the SPV to the maximum extent possible, the SPV should not incur excessive liabilities and should not undertake such obligations which are not explicitly related to the securitisation project. Being a newly-established entity, the SPV has no prior business history or commitments occurred before commencement of a securitisation project. Furthermore, the constitutional documents of the SPV may envisage restrictions on the commercial dealings in which this company can be engaged with third persons. Business activities of the SPV are specifically narrowed to those transactions which are effected within the securitisation project, namely purchase of the receivables, issue of securities and performance of obligations under this issue due to investors. It is reasonably argued that "although it is important to keep the SPV and its receivables out of the originator's bankruptcy estate, it is also necessary to implement a structure that prevents the SPV from voluntarily filing its own bankruptcy petition"[14]. It is evident that the SPV needs procedural protections against bankruptcy to maintain the desirability of its securities[15].

Generally speaking, "SPVs are institutional intermediaries. They issue their own obligations to investors, and invest the money they receive from investors in the obligations of others"[16]. Upon acquisition of the underlying receivables, "the SPV issuer finances the acquisition of the pooled assets by issuing tradable interest-bearing asset-backed securities which are sold to institutional investors via global capital markets"[17]. The securities issued by the SPV are structured as limited recourse securities. It means that in case of default of the SPV under the asset-backed securities recourse of the holders of securities is limited to the receivables encumbered for the benefit of these holders and held on trust by the security trustee. If these assets are not enough to satisfy their claims, the investors may not resort to other assets of the SPV (if any) or originator. This condition should be precisely established in the terms and conditions of the issue which shall unequivocally state that when the underlying assets are completely exhausted for the purpose of repayment to the investors, the obligations of the SPV under the securities issue owed to the holders of securities and the security trustee shall be fully discharged.

Terms and conditions of the issue may also contain a "no-action clause" disabling the investors to file a petition for bankruptcy proceedings against the SPV even in case of an outstanding debt owed by the SPV under the securities issue. However, such a clause may prove to be unenforceable in a range of jurisdictions as depriving the investor of its right to sue (in particular, such risk exists in Ukraine, since under Art. 4 (1) of the *Code of Commercial Procedure of Ukraine* dated 6 November 1991, nobody may be deprived of its right for consideration of its case before commercial court having jurisdiction to consider it[18], and Ukrainian courts tend to construe this rule in a rather conservative way).

Choice of a jurisdiction for incorporation of the SPV is predominantly determined by tax considerations and cost of incorporation. Taxation of the profit to be generated by the SPV shall be of major concern when forming the SPV. It is usually domiciled in a tax haven jurisdiction, such as the Cayman Islands, Gibraltar, the British Virgin Islands, Bermuda, Guernsey and Jersey, as well as low tax jurisdictions such as Ireland, the Netherlands and Luxembourg (common home jurisdictions for the SPVs involved in the European securitisation projects). It is observed that "establishing the SPV in a tax haven jurisdiction is desirable. This will both minimize withholding tax on any interest payments made by the SPV and avoid mainstream tax

[10] Harris S.L., Mooney Ch.W., Jr. When Is a Dog's Tail Not a Leg? : A Property-Based Methodology for Distinguishing Sales of Receivables from Security Interests That Secure an Obligation. University of Cincinnati Law Review. 2014. Vol. 82. P. 1033.

[11] Albrecht T.W., Smith S.J. Op. cit. P. 417–418.

[12] Schwarcz S.L. Securitization, Structured Finance, and Covered Bonds. The Journal of Corporation Law. 2013. Vol. 39. P. 132.

[13] Locke N. Aspects of Traditional Securitisation in South African Law. Thesis submitted for the degree of Doctor of Laws. University of South Africa. 2008. P. 38.

[14] Cohn M.J. Asset Securitization: How Remote Is Bankruptcy Remote? Hofstra Law Review. 1998. Vol. 26. Issue 4. P. 932.

[15] Ibid. P. 933.

[16] Frankel T. Securitization: The Conflict Between Personal and Market Law (Contract and Property). Annual Review of Banking Law. 1999. Vol. 18. P. 214.

[17] Dinca S.E. Covered Bonds vs. Assets Securitization. Theoretical and Applied Economics. 2014. Vol. XXI. No. 11. P. 77.

[18] Господарський процесуальний кодекс України від 6 листопада 1991 р. №1798-XII. Відомості Верховної Ради України. 1992. № 6. Ст. 56.

on the net income of the SPV – assuming it is an entity subject to such tax"[19].

Furthermore, local regulatory requirements should be taken into consideration when choosing the appropriate jurisdiction for incorporation of the SPV. In particular, national legislations may provide for obtaining a valid license of a financial institution for a company buying loan receivables. It is reasonably emphasized that "if the SPV is subject to regulation or licensing requirements, compliance with these requirements may increase its funding costs to an extent that renders it economically unsustainable"[20].

There are different doctrinal approaches towards determination of legal nature of the SPV within securitization projects. It may be regarded as a credit institution (based on similarity of the activities of a bank and of the SPV)[21] or an insurance undertaking ("just make the periodical payments be the premium, and the amount drawn be the compensation, and the securitization SPV could go as an insurance company"[22]), or as an investment firm and collective investment undertaking[23]. However, in our opinion, an SPV cannot be qualified as a credit institution due to its limited functional role in securitization projects, *ad hoc* creation and distinctive features of legal status described above. Rendering banking services is not the function of the SPV for which it is established, and gaining profit out of banking transactions does not belong to a very narrow scope of objects of such entity. Even acquisition of receivables cannot be characterized as a financial service rendered by the SPV, just in common with a factoring company. We have even fewer grounds for consideration of the SPV as an insurance undertaking or an investment company – provision of insurance services obviously falls outside the scope of its activities, and investment transactions sporadically performed by the SPV in order to preserve the value of assets available for future repayments for investors under securities will not suffice for qualification of the SPV as a collective investment scheme. Rather, the SPV should be considered as a specific *ad hoc* legal entity with a limited legal capacity and very restricted scope of activities specifically tailored for the needs of a particular securitization project. Any similarities of SPV and its operations with various types of financial institutions (banks, factoring companies, investment companies, insurance companies, collective investment schemes etc.) should be recognized as purely coincidental, having no implications for determination of the legal status of the SPV.

Conclusion

1. Legal form chosen for the establishment of the SPV should be best suited for public issue of asset-based securities in order to attract the widest range of investors. Creation of the SPV in the form of a public company, with no restrictions on capital raising from unlimited range of investors, may be considered as the best alternative, subject to mandatory statutory requirements of the local jurisdiction.

2. Distinctive features of the SPV are caused predominantly by the principal objective of availability of the SPV within a securitisation project – to ensure a high level of insolvency remoteness. The most important feature is complete segregation of the originating bank and the SPV – the bank should have no (at least excessive) further involvement in the SPV and should not be affiliate with it.

3. From the standpoint of its legal nature, the SPV cannot be qualified as a credit institution or other financial company due to its limited functional role in securitization projects, *ad hoc* creation and distinctive features of legal status. The SPV should be considered as a specific *ad hoc* legal entity, separate and fully independent from the originator, with a limited legal capacity and very restricted scope of activities specifically tailored for the needs of a particular securitization project and aimed at acquiring the underlying receivables from the originator and issuing the asset-backed securities.

[19] Dasgupta P., Vachha N. Op. cit. P. 117.
[20] Albrecht T.W., Smith S.J. Op. cit. P. 451.
[21] Ramos-Muñoz D. Living on the Edge: Securitization Supervision and Characterization Problems. European Company Law. 2009. № 5. P. 221.
[22] Ramos-Muñoz D. Op. cit. P. 222.
[23] Ramos-Muñoz D. Op. cit. P. 222.