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ESOTERIC ASSET-BACKED SECURITIES

Esoteric ABS are no longer so esoteric, as securitization of diverse revenue streams gains acceptance in the market and spreads across economic sectors. The author describes the origins and rise of esoteric ABS, and the drivers and challenges they present for issuers and investors. He then discusses, in detail, two recent securitizations — intellectual property receivables and cell phone purchase contracts — and closes with some notes on the outlook for esoteric ABS.

By Paul St. Lawrence *

In June 2015, institutional investors snapped up $400 million worth of securities backed by dirty laundry. These unusual securities depended on payments made by borrowers of laundromat equipment loans in a securitization sponsored by Alliance Laundry Systems. While this may sound odd to those not familiar with the market for esoteric asset-backed securities, this issuance was just the latest in a long line of securities that transform payment streams from a variety of businesses into securities that can be marketed on a broad basis to large, sophisticated investors. The strong collateral performance and high yields provided by securities backed by David Bowie royalties, Peanuts syndication payments, and Church's Chicken franchise fees (among others) have led to an esoteric ABS market that made up 21 percent of all U.S. asset-backed issuance in 2015 and accounted for about $40 billion in issuance through November of 2015, a 16% increase year over year.

Esoteric ABS were first developed during the structured finance boom of the 1990s, but steady sector performance through the 2008 financial crisis and since has driven increased investor interest.[1] The success of esoteric ABS issuances regularly draws new asset classes into the market, such as the first car repair franchise fee securitization offered in third quarter 2015, as operating companies involved in diverse economic sectors look to the securitization markets as a way to increase their access to capital.[2]

* *PAUL ST. LAWRENCE is a partner at Cleary Gottlieb Steen & Hamilton LLP. His e-mail address is pstlawrence@cgsh.com.*

[1] Ronald S. Borod, *Belling the Cat: Taming the Securitization Beast Without Killing It*, 31 Rev. Banking & Fin. L. 643, 651 (2012); Xilun Chen, *Franchise/Royalty Securitization Continues to Grow as Investors Are Attracted to Its Compelling Value*, STANDARD AND POOR'S NON-TRADITIONAL ASSET QUARTERLY TRENDS (Dec 19, 2014), http://ratings-newsletters.standardandpoors.com/content/CLONonTraditionalAssets.

[2] Kate Scanlan, *Continued Innovation Seen in Nontraditional Transactions as Investors Seek Higher Yield*, STANDARD AND POOR'S NON-TRADITIONAL ASSET QUARTERLY TRENDS (Jan. 13, 2015), http://ratings-newsletters.standardandpoors.com/content/CLONonTraditionalAssets; GUGGENHEIM INVESTMENTS, *Structured Credit Review 3Q 2015* 1 (Sep. 30, 2015), http://guggenheiminvestments.com/GuggenheimInvestments/media/pdf/Structured-Credit-Outlook.pdf.

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While these new issuers are attracted by the relatively lower cost of capital that securitization execution can bring, they also must wrestle with a number of challenges that come with building a structure that investors will find attractive. Similarly, as investors begin to explore taking exposure to this space, they too find a host of challenges come along with the opportunity for good relative value. Although the universe of underlying assets in the esoteric ABS market is diverse, these benefits and challenges for the issuer and investor are quite similar across the sector. This article expands on a recent panel discussion in which the author participated at ABS East 2015 to explore the drivers and challenges for investors and issuers interested in esoteric ABS, including by looking at several recent transactions.

ORIGINS AND RISE OF ESOTERIC ABS

The structured finance market grew rapidly through the 1990s with the creation and expansion of asset classes including credit card receivables, vehicle loans, home equity loans, subprime, and mortgages and home equity loans. As described in more detail below, issuers were attracted to this space because of the ability to arbitrage the relatively lower cost of capital they found when issuing bonds backed by specific financial assets with the higher implied yields on what was in most cases consumer debt.

Structured finance growth up to the financial crisis of 2008 was largely driven by residential and commercial mortgage-backed securities, securitization of auto leases, credit card receivables, and other consumer debt. Although investors were becoming increasingly comfortable with investing in a wider variety of assets, including tax liens and intellectual property rights, securitization of more unusual asset classes continued to be bespoke and required substantial efforts by issuers and underwriters to develop structures and scrub the underlying assets in a way that satisfied investors' due diligence standards. Working with rating agencies to analyze new assets also added time and expense to the process.

On the other hand, the extra rigor imposed on esoteric ABS during this period was likely a key contributing factor to their relatively strong performance during the period when some of the most ubiquitous securitization transactions (most notably subprime mortgage-backed securities and ABS-backed collateralized debt obligations) were having the greatest difficulty. Esoteric ABS transactions, in contrast, came through the financial crisis with relatively strong records on performance and returns to its investors.[3] This has led to a steadily increased issuance volume since the crisis.[4]

DRIVERS OF ESOTERIC ABS FOR ISSUERS AND INVESTORS

It is generally understood that raising debt capital based on the performance of a discrete pool of financial assets that is not vulnerable to claims from other creditors of the assets' originator can result in a lower cost of capital, and by moving the financing off-balance sheet can provide the originator with increased flexibility for other capital raising efforts. This is achieved by legal structures that permit securitization investors to focus on the credit of the obligors on the assets, and not on the credit of the originator.

By transferring the cash-generating assets to an isolated bankruptcy-remote special purpose entity (SPE), the investment rating for the securities is typically rated higher than the originator's commercial credit rating and so commands a lower interest rate.[5] Ratings agencies and investors are primarily concerned with the creditworthiness of the transferred assets along with the value of any credit enhancements. This can lead to

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3 Chen, *supra* note 1; Borod, *supra* note 1, at 651.

4 Mark Adelson, *Report from Miami Beach 2012: Coverage of Selected Sessions of ABS East 2012* 20 (Oct. 28, 2012), http://www.markadelson.com/pubs/abs_east_2012_notes.pdf*;* Chen, *supra* note 1.

5 Ariel Glasner, *Making Something Out of "Nothing" the Trend Towards Securitizing Intellectual Property Assets and the Legal Obstacles That Remain*, 3 J. Legal Tech. Risk Mgmt. 27, 32 (2008).

substantially lower interest rates for ABS securities when compared to issuing high-yield corporate debt.[6]

Issuers may see further benefits where they are seeking funding for economic activity separate and apart from the creation of the financial assets themselves. For example, as discussed more fully below, cellular phone companies have recently been applying securitization technology to installment sales contracts for the purchase of cell phones. The creation of the installment sales contracts is incidental to the overall cellular communications business. Given the independent business purpose driving the creation of the financial assets, the resulting securities are viewed as being backed by stronger assets than those where the creation of the assets was the main business of the originator and thus subject to all of the same risks. This independent business purpose can further differentiate the risk of the assets from the risk of the operating company and lower costs.

Offering structured finance securities dependent on a discrete pool of assets is more versatile than a straight secured loan facility because it allows an issuer to access investors outside the banking sector. For example, insurance companies often buy the higher-rated notes and specialty investors often invest in the junior notes in esoteric ABS offerings. Increased investor interest in well-structured esoteric ABS securitization has brought new players into the market from a broad range of accounts.[7]

Investors are drawn to esoteric ABS offerings because of the higher yields available versus similarly rated traditional asset-backed securities or corporate debt issuances; the trade off of doing one's homework on unusual collateral or a creative structure. The esoteric ABS space offers relative value opportunities when compared to these sectors, as investors can find higher yields for only minimal increases in risk or illiquidity over other securities. In fact, despite low trading activity, esoteric ABS has performed well on the secondary market, often trading above par. In addition to attractive yields, investors are also drawn by high credit enhancement for these classes relative to the perceived credit risk.[8] Although "over-collateralization" — providing a receivable pool greater in principal amount than would be necessary to pay for the issued securities — is quite common, in esoteric ABS issuances the lack of a track record in the particular asset classes leave rating agencies and others requiring a greater cushion against losses.[9] Once again, a robust diligence effort can find additional value here. Finally, because ratings agencies cap the number of notches above the servicer rating the securitized debt can achieve, careful investors can gain a premium by identifying underrated offerings.

Investor interest in esoteric ABS is also driven by a relative contraction of opportunity in other structured products post-crisis, such as the shrinking of the private label residential mortgage-backed security ("RMBS") market. Investors seeking to reinvest proceeds have had few securitized options outside of auto receivables and other traditional assets. Investors are also attracted to the longer time horizons available with esoteric ABS.

Investors also can gain a premium from being one of the initial investors in a new esoteric class, as follow-on issuances typically price at tighter spreads as the market becomes more familiar with them.

CHALLENGES OF ESOTERIC ABS FOR ISSUERS AND INVESTORS

Esoteric ABS are inherently more complex transactions than traditional securitizations. Unusual assets often require unique structures to ensure predictable cash flows. If the originator of the assets (or one of its affiliates) retains any of the economic exposure to and/or continues to service the underlying assets, as is often the case for esoteric ABS, true sale typically requires the transfer of those assets through multiple entities to ensure the assets are sufficiently isolated and dealt with at an arm's length by the originator. This is not necessarily unique to esoteric transactions — for example, securities backed by auto lease receivables require the creation of a bankruptcy-remote titling entity existing only to hold title, and a securitization trust with beneficial interest in the portfolio of leases to issue securities based on the cash flows from that portfolio. In more well-developed asset

[6] Chen, *supra* note 1 (noting that securitization offerings 100 – 300 base points or more per annum savings versus high-yield corporate debt).

[7] Chen, *supra* note 1 (noting that the 2014 Miramax refinancing, a whole-business esoteric ABS offering, was four times over-subscribed across a wide range of investors).

[8] Paul St. Lawrence & David Kucera, *ABS East 2015 Presentation* 7 (Sep. 2015) (on file with author).

[9] Steven L. Schwarcz, The Alchemy of Asset Securitization, 1 Stan. J.L. Bus. & Fin. 133, 141 (1994).

classes, however, investors can take comfort that what appears to be a very complex legal structure has been used as the preferred execution approach on billions of dollars worth of issuance before their investments. With esoteric ABS, even if the asset class is borrowing an existing legal structure from another type of deal (e.g., while complex, the titling trust structure is the preferred structure for several more unusual asset classes, including marine lease and lottery receivables) there is less of a track record in that particular asset class on which investors can depend.

Another complication for originators and issuers comes from changes to their own operational structures that are required to accommodate an ABS offering. The creation of the necessary servicing systems, reporting systems, and additional legal entities can be costly and time consuming. Companies must also be mindful that the transactions it engages in as part of the securitization do not unintentionally breach financial covenants in existing debt documentation. In addition to greater costs and time to market, issuers also face the risk of divulging proprietary data that relate to their origination practices or consumer credit evaluations.

As mentioned above, esoteric ABS issuances generally require a greater degree of credit enhancement than more mainstream ABS products. This of course has an impact on the value to the issuer of this capital source, and structuring that credit enhancement in the most efficient way possible is key. Where assets underlying esoteric ABS are closely related to the business of the issuer, such as whole-business or intellectual property securitizations, credit enhancement are required to achieve higher ratings and lower cost of capital when compared to what the issuers can obtain in the capital markets. Credit enhancement can be provided external to the transaction by letters of credit, surety bonds, subordinated loans from other parties, or guarantees, provided that such contractual support does not undermine the legal isolation of the assets from the originator. Internal enhancement can use over-collateralization, equity contributions to the SPE or other isolated entities, or subordinated bonds to protect senior bond tranches from losses on underlying assets. As discussed, substantial enhancement is often necessary, given the difficulty of accurately evaluating credit and non-credit risks for novel asset classes, including in some cases potential future legislation that can directly affect the asset (e.g., tax liens or solar leases).

Obtaining a credit rating is also a more labor-intensive undertaking than for established asset classes. For assets like collateralized loan obligations ("CLOs"), credit card ABS, and other mainstream products, leading rating agencies such as Fitch Ratings, Moody's, and Standard & Poor's have published criteria that issuers and arrangers can utilize in structuring their offering. These rating agencies, however, typically will not publish criteria for an ABS product until they have sufficient experience with an asset class. By definition, this does not usually exist for esoteric ABS. Instead, the issuers must work closely with the analysts at the rating agency of choice and provide them with historical information on the performance of assets of the type they want to securitize so that the agencies can undertake an analysis of those similar assets and consider the issuer and/or arranger's proposals for how to structure the issuance to achieve the desired rating. This can take months and carries with it a fair amount of uncertainty.

Esoteric ABS present challenges for investors as well. Analysis of the investment value is more difficult, as the novelty of the assets makes future performance unknown or difficult to determine. Investors in ABS typically examine the historical losses and volatility of the underlying assets – but a smaller sample size necessarily makes this analysis more uncertain. While the isolation of the assets from the issuer will help insulate the performance of the ABS from the credit of the originators, in structures where those assets continue to be serviced by the originator or one if its affiliates, the performance of the ABS will necessarily depend in part on that servicer's operations and overall effectiveness. Servicing transition mechanics are also often uncertain, as servicing of unusual assets can be difficult or impossible to replicate by anyone other than the originator or its affiliates. There can also be reputational risk, particularly in revolving structures where their duration depends on the ability of the originator to continue to generate assets for the ABS issuer. For example, in a whole-business securitization in the restaurant sector, a food borne illness outbreak at a food chain could undermine the franchise's value, affecting cash flows, the generation of future receivables, and overall asset performance.[10] Operating risks are often dealt with through increased credit support, higher or dynamic cash reserves that can be adjusted based on certain triggers, or changing payment structures to pay senior bonds in full before paying down junior capital.

[10] Investors are seemingly not always deterred by these operational risks given the recent popularity of whole-business securities, including recent offerings of securities underwritten by the proceeds from Sonic drive-in restaurants, Adams Outdoor Advertising, and Church's Chicken, among others.

SECURITIZATION OF INTELLECTUAL PROPERTY RECEIVABLES

Intellectual property (IP) receivables were one of the first esoteric asset classes, beginning with a music royalty securitization in 1997 backed by future cash flows from David Bowie's catalogue.[11] This initial esoteric ABS IP deal was a $55 million offering with a 10-year duration and a 7.9 percent coupon. The offering was followed closely by a $30 million IP securitization for Motown songwriting royalties, and today IP securitization has included film royalties, book publishing rights, technology patents, and other trademarked properties.[12] Owners of valuable IP rights have been drawn to esoteric ABS as a means of removing barriers to entry for investments in IP, diversifying sources of available capital, and raising funds while maintaining ownership rights.

There are unique challenges in structuring IP offerings, even beyond the challenges inherent in esoteric ABS. A significant one is the dependence on the originator or another interested party to defend IP rights from infringement or suspension of the patent, either of which can upset the underlying asset cash flows. An unusual financing of IP royalties recently had to address just this issue.[13] The issuer sought to securitize steady cash flows from a portfolio of IP licensing agreements. The issuer sought immediate access to the future cash flows from the licensing contracts in a way that would raise capital off-balance sheet and at a lower rate than their corporate borrowing rate. The issuer also needed to maintain control over the underlying contracts to ensure enforcement of the licensing arrangements and ensure that the income streams remained viable.

The issuer's continued control made true sale and full isolation of the assets difficult. First, the contracts were assigned in whole to a first SPE, wholly owned by the issuer. This first SPE was bankruptcy-remote, but entirely controlled by the issuer. In order to still provide for true sale, a second bankruptcy-remote SPE was created that purchased the payment streams from the contracts from the first SPE, and then pledged those payment streams to the investors to secure its repayment obligations on the debt that it issued. This structure achieved a lower cost, off-balance sheet borrowing, while separating control of the contracts from ownership of the payment stream.

SECURITIZATION OF CELL PHONE INSTALLMENT CONTRACTS

Another recent transaction involved a securitization of cash flows from a pool of cell phone installment contracts.[14] The issuer sought funding for these new receivables in a way that did not conflict with its overall corporate goal of reducing the debt on its balance sheet. This project had the added complication of existing in a rapidly changing market for the underlying consumer good. Therefore, a relatively simple structure was sought to ensure maximum flexibility.

Like most securitizations of consumer goods, an affiliate of the originators would be engaged to continue to service the installment contracts. In order to maintain operational efficiency, the amounts due from customers on the installment contracts would be billed together with other services provided by the originators or its affiliates to the customers. This led to a period of co-mingling of cash flows that was slightly longer than initially sought by the debt investors, and thus needed to be managed through unique contractual provisions.

Finally, the receivables contracts were generated by multiple originators and each of those originators were also seeking to minimize the tax impact of the transfer of the receivables through the structure. Thus they sought to structure the transfers as tax-free by tracing gains and losses on the individual receivables back to the original originator, even while, for both legal and accounting purposes, one or both of the transfers were viewed as true sales.

A two-step securitization process was developed to achieve these goals. First the receivables contracts attributable to an originator would be transferred to an originator owned and controlled SPE in exchange for equity. This created legal separation of the receivables from the originators, but also permitted the originators to

[11] Borod, *supra* note 1, at 122-23 (noting that cash flows can be as complex as the structure; music royalties can include performance and broadcast royalties from use in public, often fixed by a larger entity such as Broadcast Music, Inc. (BMI), payments from the printed sale of music, sale of the music in recorded form, and synchronization use, which includes usage of the song in commercials or movies).

[12] Ross Snell, *New "Bowie" Bonds Bank on Royalties from Motown Trio,* Wall. St. J., Apr. 29, 1998, at C24.

[13] Cleary Gottlieb represented the issuer in this transaction.

[14] Cleary Gottlieb also represented the issuer in this transaction.

continue to trace the gains and losses on its particular pool of assets through its equity ownership.[15] Since each originator had its own SPE to which it transferred its assets, the SPEs then had to cross-collateralize all of its sister SPEs in order to maintain the efficiencies and loss protection of one large pool of assets. The second step consisted of the SPE's selling the receivables contracts to a group of investors under one receivables purchase agreement in order to implement the cross-collateralization. Because the SPEs would, for accounting purposes, continue to be consolidated on the books of the originators, the second step transfer from the SPEs to the investors needed to also be a true sale for accounting purposes. Those investors, however, required the SPEs to retain some economic exposure to provide credit enhancement. The required credit enhancement was achieved through a partially deferred purchase price structured in a way that was compatible for off-balance sheet treatment of the transaction as a whole.

OUTLOOK FOR ESOTERIC ABS

Analysts expect to see continued growth in esoteric ABS in the coming years. This growth will be seen across existing assets — including whole-business, franchise fees, solar power leases, and equipment leases such as airline leases — as well as new and as yet untested assets, such as the cell phone receivables contracts discussed above. Some variables that could affect the size and growth of this market include ever-talked-about reform of the government-sponsored enterprises that now dominate the mortgage-backed securities market and thus crowd out a vibrant private label market. A return of private label RMBS in any size could be a competitor for investors that otherwise might turn to esoteric ABS. From a regulatory perspective, if and when the Securities and Exchange Commission adopts rules applying Regulation AB to private securitizations, esoteric ABS transactions may become more costly and cumbersome to complete. In addition, the effective date of the application of U.S. credit risk retention rules to securitizations of assets other than residential mortgages occurs in December 2016. The requirements of each of these regimes are beyond the scope of this article but compliance is expected to be manageable for most ABS securitizations. Therefore, the main drivers in the growth of esoteric ABS will most likely be the performance of esoteric ABS already in the market, and the emergence of alternative opportunities for investors. ■

[15] In some cases, there was an additional step of transferring assets from a subsidiary of the originator up to the parent originator before making the contribution down to the SPE.