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Tranching of debt as legal construction

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Tranching of debt as legal construction

– its building blocks and compatibility with the regulation of securitisation in the EU and the UK

Sara Göthlin

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– its building blocks and compatibility with the regulation of securitisation in the EU and the UK

Sara Göthlin[1]

Abstract

This paper addresses a core feature of the debt capital markets in general and securitisation transactions in particular; the creation of debt claims with different ranking and priority (also referred to as "**tranching**").

The primary purpose of the study is to develop an understanding of the contractual ranking of debt as an enforceable legal construction. It is suggested that a more coherent understanding of tranching could foster (i) greater compatibility of insolvency law with financial regulation; (ii) a reduction in unnecessary transaction costs through further standardisation; and (iii) a more level playing field between jurisdictions and different forms of debt finance.

I discuss tranching of debt in securitisations as one of many junctures between EU financial market regulation and the realm of local private law. At the same time, tranching highlights the elusive distinction between contracts that are valid and binding *inter partes*, and those that purport to affect third parties. These are vast topics, and even more daunting when taken together. The focus on securitisation and tranching therefore offers an opportunity to study fractions of these issues by virtue of the limited context.

The paper is organised as follows. After an introduction of the subject matter and theoretical foundations, it investigates the element of tranching by first looking at the term as it emerges in the Securitisation Regulation ((EU) 2017/2402). It then looks at how the ranking of a tranche of debt securities plays into the rules on capital adequacy in a securitisation context. The notions of tranching found in financial regulation do not however include the substantive rules that apply to the creation of an enforceable

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priority ladder between investors. That task is still left to domestic insolvency, contract, and property law.

Moving therefore beyond the definitions and usages of tranching in EU regulatory sources, the paper analyses how tranches of debt with different priority are created in actual transactions. Based on public transaction documents and domestic legal sources from three EU jurisdictions (France, Germany and the Netherlands) and the UK, it analyses the building blocks used to create enforceable contracts on the ranking of debt.

This is followed by concluding remarks, including a suggested common approach for evaluating the enforceability of an agreed payment waterfall across jurisdictions. By disentangling the elements of public STS transactions that are used to ensure enforceability of an agreed payment order, this study provides a starting point for finding paths in domestic law that allows legal certainty in relation to the ranking of notes.

1 Introduction

1.1 Background to subject matter and context

1.1.1 Introduction to securitisation

The term securitisation refers to a type of transaction, where a pool of financial assets that generate income is transferred from the originator to a new legal entity. That new entity issues different series – referred to as tranches –– of debt securities, the payment under which will depend on the performance of the original pool of assets. The issuer of new securities uses the proceeds from the issue to pay the originator for the transferred assets.[2]

The rationale for engaging in securitisation is different among originators and investors. Some of the reasons that are most commonly referred to in official sources shall be mentioned here. For an originator, such as a bank lender under multiple debt contracts, the transfer of receivables can be a means of transforming illiquid assets into liquidity.[3] The transaction may also entail transferring (most of) the risk that comes from holding those assets and the ensuing capital adequacy requirements. This frees up capital for taking on new business if the transfer of risk is successful. Further, it may fulfil the purpose of producing securities that are eligible as collateral for central bank liquidity operations.[4] For an investor in a securitisation position, the transaction is a way of allocating capital in exchange for a return on investment.[5] One may assume that where securitisations take place, there are commercial reasons to engage in this transaction type. Those reasons will continue to vary with time, innovation, and regulatory incentives.

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[2] Securitisation as a transaction form is described in similar ways across public documents; notably in the Securitisation Regulation ((EU) 2017/2402, as amended by Regulation (EU) 2021/557 (hereafter the "**Securitisation Regulation**"), Recital (1) and in the Capital Requirements Regulation (EU) 2013/575 as amended by Regulation (EU) 2019/876 (hereafter "**CRR**") Art. 4(1)(61). The Securitisation Regulation applies to securitisation the securities of which were issued on or after 1 January 2019. In the UK, a materially equivalent regulation as well as capital requirements apply from 1 January 2021, see 5.1.3 (*UK exit from the EU*) below.

[3] See e.g. European Parliament, Understanding Securitisation, October 2015 - PE 569.017 and the report EU CLO Credit Ratings – an Overview of Credit Rating Agencies Practices and Challenges (ESMA80-189-6982) 13 May 2020, p. 6 ff.

[4] On the ECB framework for collateral, see Bindseil et al. (2017). Also see Scopelliti (2016) p. 2.

[5] Wood, Project Finance (2019) pp. 123-125 provides an account of further objectives for engaging in securitisation.

Debt securities issued in a securitisation are typically divided into tranches with different risk profiles.[6] However, the *total* risk of potential losses deriving from an asset portfolio is (as a basic assumption) neither better nor worse because of the assets having been transferred to a new legal entity and subject to tranching.[7]

The EU, in its role as financial market regulator and moving alongside the Basel accords,[8] has expressed mainly two policy considerations in relation to securitisation as market phenomenon.

On the one hand, securitisation is *bad* because it partly caused the 2008 financial crisis. One frequent motive for research into this transaction type has been to understand the role of asset-backed and other structured finance transactions in that context.[9] If securitisations – or similar transactions where financial assets are bundled and re-packaged to investors (and then perhaps re-packaged and sold again) – are to be permitted, they must be made subject to rules and supervision preventing opaque or overly complex structures. Restrictions on the free use of securitisation as a transaction technique is therefore in line with the policy objective of financial stability.[10]

On the other hand, securitisation is *good* since it allows financial institutions to free up financing for new lending, increasing the potential flow of capital to the real economy. After the 2008 financial crisis, the securitisation market saw a significant slowdown.[11] The promotion and support of securitisation is therefore in line with the objectives of the Capital Markets Union and the general policy goal of stimulating economic growth.[12]

These two main policy goals may seem irreconcilable. The solution, as it has transpired at the time of this paper, has been for the EU to adopt the Securitisation Regulation and related changes to the capital adequacy framework, setting out certain ground rules for market participants.[13] At the same time, the Securitisation Regulation contains criteria for securitisations that are eligible to be labelled "STS" – simple, transparent and standardised. STS transactions will obtain a more favourable capital adequacy treatment, arguably

[6] Tranches are tailored to the risk appetite of different investors. See e.g. Commission Explanatory Memorandum COM(2015) 472 final p. 2.

[7] Douady et al. (2017) p. 395. This is however but a stylised assumption. See Gorton & Metrick (2013), p. 50, Bougheas (2014) and Martin & Parigi (2013). Further on the effects of securitisation on "total risk"; see Antoniades & Tarashev (2014) (discussing the "cliff effects" inherent in securitisation under Basel II rules), Marques-Ibanez (2016) (discussing the effect of monitoring incentives on the credit quality of securitised assets) and Deku et al. (2019) p. 6.

[8] An overview of Basel accords and related EU legislative acts can be accessed at: https://eba.europa.eu/regulation-and-policy/implementing-basel-iii-europe.

[9] Interesting contributions include Benmelech & Dlugosz (2009), Covitz et al. (2009), Albertazzi et al. (2011), Buchanan (2016), Keys et al. (2019), Dalhuisen (2019) pp. 298-302, and Wood, Project Finance (2019), p. 119. Also see the EU Larosière report: https://ec.europa.eu/economy_finance/publications/pages /publication14527_en .pdf. Further references are given in Linaritis (2020) p. 4.

[10] See e.g. Art. 8 (5) of the Securitisation Regulation and Recital (1) of Regulation (EU) 2017/2401.

[11] https://www.europarl.europa.eu/legislative-train/theme-economic-and-monetary-affairs-econ/file-framework-for-high-quality-securitisation/04-2020 (accessed on 19 May 2020). Wood, Regulation of International Finance (2019) p. 413.

[12] Indeed that is the policy goal put front and center in the EU Commission progress report for the Capital Markets Union; https://ec.europa.eu/finance/docs/policy/190315-cmu-factsheet_en.pdf, accessed on 8 May 2020. Also see Wymeersch (2019) p. 4 and Regulation (EU) 2021/557.

[13] See Recitals (2) – (4) of the Securitisation Regulation.

pushing more complex securitisations out of the market.[14] In short, the regulator can be seen to reach for reconciliation of the two policy goals through the promotion of securitisations, but only of those securitisations that are believed to be straightforward enough not to endanger financial stability.[15]

This paper has been finalised just as the transition period for the withdrawal by the United Kingdom from the European Union has come to an end. The substantive rules governing securitisation remain the same or very similar under the new UK regime. The paths for future harmonisation of insolvency and property law will however look very different from what could have been the case had the UK still been a part of the Union. This notwithstanding, English law and the market practice demonstrated by UK transactions remain a vital component for understanding securitisation.

In relation to capital adequacy regulation, the rules that are relevant for this paper have been onshored with minor changes, as further discussed in 5.1.3 (*UK exit from the EU*) below.[16] The matter of defining "tranching" and "seniority" within a capital adequacy context will therefore be relevant to the UK *mutatis mutandis*.

1.1.2 *On the function to be analysed*

The morsel of law to be investigated is determined by a function[17] implied in the term securitisation, being the creation of layers of debt with different priority. A more thorough description of securitisation as transaction type and the actors involved is provided in section 2.1 (*Mechanical description*) below.

The ranking of tranches of debt – "tranching" – is found in the very definition of securitisation in the Securitisation Regulation.[18] One of the key elements of the legal documentation of securitisation transactions is therefore an agreement on the order or "waterfall" of payments that the issuer of securities is contractually obliged to comply with.[19] Specifically, this paper deals with whether such payment order must be enforceable for the tranching function to fulfil its aims, and how enforceability can be achieved.

Enforceability in this context refers to an agreement or arrangement being upheld in relation to third parties, such as a receiver or administrator in bankruptcy or a bankruptcy estate, and the ability of an entitled party to seek enforcement of such an agreement or arrangement with a court or enforcement agency.[20]

Most lawyers will be familiar with the option for companies to issue equity in different classes, which come with varying entitlements to dividends and liquidation proceeds. In

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[14] Douady et al. (2017) p. 398. This development does not appear to have materialised at the time of this paper however. An impression is that margins are higher but non-STS notes are still accepted as ECB collateral (see footnote 4 above).

[15] Commission explanatory memorandum (COM(2015) 472 final) p. 3.

[16] See the Financial Holding Companies (Approval etc.) and Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) (EU Exit) Regulations 2020 and the Capital Requirements (Amendment) (EU Exit) Regulations 2019. See Wood, Project Finance (2019), p. 276 on the meaning of the term "onshoring."

[17] "Function" is understood, for purposes of this paper, as a means of achieving a desired commercial and/or financial result.

[18] Securitisation Regulation Art. 2 (6). Deku & Kara (2017) p. 14. Outside of the regulatory definition, the term "securitisation" may also be used to describe the issuance of debt securities without multiple classes of debt.

[19] Vries De Robbé (2008) pp. 51 and 67.

[20] As such term is used in e.g. the Securitisation Regulation, Arts. 20 (1) and 20 (8).

relation to equity capital, such ranking is hard-wired in the articles or by-laws of a company. When creating layers of debt however, transacting parties in many jurisdictions tend to run into the law on priority among creditors in insolvency.

On a general note, an agreed hierarchy of payments will be enforceable in all jurisdictions covered herein as a matter of contract *inter partes*.[21] Upon the bankruptcy of an investor holding a junior tranche, or the entity issuing the securities however, the tenability of an agreed order of payments will depend on whether the law explicitly stipulates enforceability of such agreements, or allows for sufficiently robust supporting measures. Some of the most important supporting measures, such as an undertaking by junior creditors not to act independently in relation to the issuer, are discussed in detail in section 5.1.1 (*Legal modules to be examined*) below.

An issuer of debt in a securitisation (referred to as an "**SSPE,**" a Securitisation Special Purpose Entity) is set up to be bankruptcy remote in the dual sense that (i) it or its assets may not be clawed back into an insolvency of the originator; and (ii) it is unlikely that it ever does enter into bankruptcy. An insolvency event cannot however be generally excluded. Indeed, a primary purpose of the heavy documentation in larger financing transactions is to prepare for a situation fraught by conflict; where there are not enough assets to pay all creditors in full.[22]

Should financial distress occur in a jurisdiction where enforceability of an agreed payment order is denied or uncertain, investors may end up with claims not only against the SSPE estate or assets, but contractual claims (or claims for damages) against other investors having received proceeds or otherwise caused delayed payments in breach of the securitisation documents. The holders of senior tranches would then have claims on the holders of junior tranches to hand over any funds received in violation of the contractual payment waterfall.[23]

This may seem like a minor issue, but it is in fact fundamental for any kind of layered debt finance. It highlights the distinction – one that is drawn up in both common and civil law jurisdictions – between agreements that are within the realm of the freedom of contract,

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[21] Faber et al. (2016) pp. 260 (France), 300-301 (Germany) and 364 (Netherlands). English law, Gullifer & Payne (2015) pp. 260-261 and Cranston et al. (2018) pp. 449-450.

[22] As demonstrated by the focus on enforcement in Art. 21 of the Securitisation Regulation. Also see Wood, International Insolvency (2019) p. 11. For a rating agency perspective, see Fitch Rating's rating criteria for CMBS transactions as of June 2020, at p. 2: "…not only the notes' issuer, but also the subsidiary borrowing entities are typically incorporated as bankruptcy-remote special-purpose vehicles (SPVs). Nevertheless, in most rating scenarios such borrower SPVs are assumed to become insolvent." Accessed at https://www.fitchratings.com/research/structured-finance/emea-cmbs-cre-loan-rating-criteria-12-06-2020. The concept of bankruptcy-remoteness in the structured finance context is analysed by Ramos Muñoz (2015). Muñoz (p. 243) distinguishes the two types of bankruptcy remoteness as vehicle shielding and 'enhanced' bankruptcy remoteness, which emphasises contracting out of bankruptcy proceedings.

[23] Even though transactions are not structured to rely on what is described in English law literature as "turnover subordination," a payment order that is not enforceable would typically give rise to claims by aggrieved parties on those that have received more than their *ex ante* bargain. See Wood, Project Finance (2019), p. 145. On English law in relation to contractual subordination, see Gullifer & Payne (2015) pp. 260-261 and Cranston et al. (2018) pp. 449-450.

and those that have entered the terrain of making arrangements that purport to affect third parties.[24] Parties cannot "contract out of insolvency distribution."[25]

From the perspective of a creditor, a claim in contract is simply not as good as an enforceable priority claim. It involves a credit risk on the counterparty that has received funds in contradiction with the agreed waterfall, rather than on the entity to which a loan was originally extended. Further, it involves a delay in payment even if full payment is eventually to be expected.

The situation is aggravated in case a junior creditor acts opportunistically or challenges the *ex ante* agreement because it makes commercial sense to do so. This is not a theoretical possibility but a commercial reality. Agreements on ranking, priority and senior creditors' control have been challenged in a number of cases.[26] Market dynamics, the commercial realities in the individual case, whether the junior creditor is itself insolvent, and the preferences of parties involved will determine whether this is a likely scenario. Hence legal uncertainty may translate into additional transaction costs and liquidity problems that can spread to other actors.

In short, rights that cannot be enforced in bankruptcy are not worth as much. This is why insolvency law is thought to heavily affect commercial decisions *ex ante*.[27]

Insolvency law often involves the balancing of legitimate interests. In a securitisation context, for example, parties will ensure that asset transfers into an SSPE are characterized as a "true sale." Such classification means that assets are not available for distribution among the creditors of an insolvent originator, such as its other financiers, its employees or suppliers. If a transfer is recharacterized as an unperfected security interest, assets could instead be withdrawn from investors in a securitisation position, such as pension funds or banks. Either solution may affect the legitimate interests of outside parties or the economy as a whole.

Tranching does not carry such distributive connotations. Enforceability of an agreed payment waterfall means that an agreement *ex ante* between consenting parties is upheld *ex post*. Lack of certainty, or even lack of enforceability, on the other hand is an incentive for junior creditors (or creditors of insolvent junior creditors) to challenge a payment order that they will typically have been compensated for by a higher return than more senior

[24] The notion that contracts, in order to be enforceable against third parties, must conform to certain predetermined requirements is discussed in, among others, Dalhuisen (2019) p. 76. From a U.S. perspective, Smith & Merrill (2000) p. 3. Also see Wessels et al. (2009) p. 16.

[25] Gullifer & Payne (2015) p. 261. Ramos Muñoz (2015).

[26] In MPM Silicones, LLC, 518 B.R. 740 (Bankr. S.D.N.Y. 2014), junior creditors made a side agreement to restructure with the debtor. In RadioShack Corp., 550 B.R. 700 (Bankr. D. Del. (No. 15-10197) (March 30, 2015), a junior creditor acted in breach of agreements that would have ensured control for senior creditors over assets sales from the debtor. From the UK; see Re SSSL Realisations [2004] EWHC 1760 (ch) and Re Maxwell Communications [1993] 1 WLR 1402. An important case for the securitisation market was Belmont Park Investments PTY Ltd v BNY Corporate Trustee Services Ltd [2011] UKSC 38, [2012] 1 All ER 505, [2012] 1 AC 383 (27 July 2011). The Belmont case is discussed in McCormick & Stears (2018) pp. 137-139. Also see Hayfin Opal Luxco 3 SARL v Windermere VII CMBS Plc [2016] EWHC 782 (Ch), where interest payment calculations for X notes were in issue, but which describes the typical features of CMBS transactions. Further, see Rawlings (2007). Gullifer & Payne (2015) p. 255 provide additional cases in relation to intercreditor agreements generally. One may also wish to consider the effects of legal uncertainty on originator risk retention through the holding of a first loss tranche in accordance with Art. 6 (3) (d) of the Securitisation Regulation.

[27] Pistor (2019) p. 137, Bebchuk (2002).

tranches.[28] Investors in securitisation notes would as a general rule have been able to obtain a return, adjust to the risk of losing their investment, and had the option of not entering into the trade.[29] In either case this does not immediately affect the distribution to third parties.[30]

1.2 Theoretical framework

1.2.1 Primarily this is about system coherence

This paper discusses a part of the law in four different legal systems from the perspective of their (vertical) compatibility with prudential regulation. That is, how does a certain domestic law applicable to the contractual ranking of debt fit with the EU regulation of securitisation and capital adequacy?

The study is undertaken against the backdrop of the policy considerations underpinning the EU capital markets union and its efforts within the field of securitisation; in particular to promote access to credit in the real economy, to level the playing field between jurisdictions and to promote financial stability.[31]

The analysis, for all its market and financial connotations, is therefore primarily a discussion of the *internal coherence of the body of law applicable to securitisations*. It does however build on the understanding that the law plays an important role for access to credit and economic wealth in a society. When it works as intended, the law is believed to affect financial development by reducing the cost of external financing. Inversely, financial aspects and real economy considerations influence the creation of law.[32]

1.2.2 Contextual Scope: Enforceability of tranching in securitisation transactions

The problem of enforceability in relation to agreed payment waterfalls involves several separate sub-functions or concepts of the relevant legal systems. The problem will be discussed in the context of securitisation only, even though the legal considerations identified will significantly overlap with ones found in other types of financing transactions.[33] The main focus of the paper is on “traditional” securitisation, with only limited considerations in relation to synthetic transactions.[34]

1.2.3 The x y z of norm-making as analytical tool

Securitisation has started out not as a legal term but as a constantly evolving, transnational transaction type with many variations. It is no wonder that the body of law applicable to matters such as the enforceability of a tranching arrangement emerges on multiple levels and from different types of norm-makers. While concepts of securitisation and tranching

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[28] Gullifer & Payne (2015) p. 262.

[29] On adjusting and non-adjusting creditors, see Gullifer & Payne (2015) pp. 80-81.

[30] Cooter & Ulen (2014) p. 7 ff on thinking about efficiency rather than distributions in analysing private law. Also see Schäfer & Ott (2004) p. 8 ff.

[31] On levelling the playing field in this context, see the Securitisation Regulation, Recitals (5), and (39) and CRR Recital (9). Also see Wymeersch (2019) p. 17 and Douady et al. (2017) p. 417.

[32] Schäfer & Ott (2004) pp. 100-101, Haselmann et al. (2010). Armour, Deakin, et al. (2009) p. 5.

[33] The contractual creation of layers of debt is by no means unique to securitisation. See e.g. Deku & Kara (2017) p. 14, Dalhuisen (2019) p. 100 and Göthlin (2023).

[34] For the regulatory definitions of traditional and synthetic securitisations, see Art. 2 items (9) and (10), respectively, of the Securitisation Regulation. Synthetic securitisation entails that “the transfer of risk is achieved by the use of credit derivatives or guarantees, and the exposures being securitised remain exposures of the originator.” Traditional securitisation will be discussed in further detail below.

have made it into the realm of positive law, they still carry broader meanings than the aspects caught by explicit legal provisions.

Kelly Chen provides an analytical tool for navigating complex legal landscapes. The tool is especially suited for matters where financial regulation, market practice and private law interact. Rather than relying on a traditional legal method, it situates the law within a metaphorical sphere. It is used here for the dual purpose of illustrating the legal landscape and giving context to the choice of materials for this paper.

Legal norms are derived from sources that are national or international in nature, produced by states or markets, and that are somewhere on the scale between hard law and soft law. The model, referred to as the x y z of norm-making, emphasises the constant interplay between processes and that the determination of legal sources and their provenance is not a binary exercise. It conceptualises and hones a way of thinking about legal research in the financial market space expressed by a wide range of authors.[35]

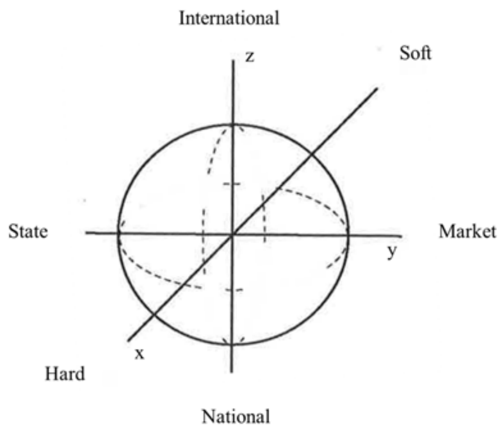

Figure 1: The x y z of norm-making

Drawing on this model to position the matters discussed in this paper, the body of law applicable to tranching in a securitisation context can be pinned down as follows.

On the *x axis*, hard law exists in the form of EU regulation and national insolvency, contract and property rules. The contents of EU hard law however depend to an extent on soft law, such as guidelines from the European Banking Authority (EBA) and national supervisors. Further, it builds on market practice and models produced by market actors.[36] The *lex financeria* produces norms for structuring transactions and determines to an extent the application and precise contents of hard law.[37] This dynamic may also be observed on the y axis concerning the interplay between state and market.

The term *lex financeria* is not firmly established, but it is taken here to capture the following. Market participants may not be overly concerned that an agreed payment waterfall is not a recognised enforceable concept in all, or perhaps even most, jurisdictions.

[35] Chen (2018) p. 292. Cafaggi (2011) p. 118.

[36] An example of market norms that feed into the law in this area is: https://www.icmagroup.org/assets/documents/Regulatory/AMIC/Guide-to-investor-due-diligence-when-investing-in-securitisation-190219.pdf (accessed on 8 June 2020).

[37] Jordan (2014) p. 147, and Chen (2018) pp. 299 and 305 (with further references). For a similar discussion but using the wider and more established term "*lex mercatoria,*" see Dalhuisen (2019) p. 200 (among others) and Goode (2007). Also see p. 24 item (26) of Commission explanatory memorandum COM(2015) 472 final.

Judging by the risk disclosure in public transactions, tranching is not a contested area in jurisdictions where SSPEs are incorporated. The order of payment is agreed between the initial transaction parties, according to an established transactional pattern. The parties then task their deal teams with propping up the structure so that the domestic law lives up to the assumptions about enforceability that underpin and enable the rating of a transaction and, where relevant, also the application of capital adequacy regulation.

The criteria expressed in rating agency models and capital market regulations in turn refer to legal opinions, issued by the same lawyers that have structured a transaction, to verify the correct application.[38] As demonstrated by a review of all public STS transactions[39] as of 31 October 2020, a handful of law firms appear as regular issuers of legal opinions.[40] They act as external certifiers of sort, at the same time as structuring the transactions upon which they opine. Hence, a market practice or consensus among lawyers about the correct interpretation of law, becomes enshrined in hard law.

Frankel observes that the less clear the hard law is, the stronger the impact of transaction documents and the pattern of behaviour of market actors.[41] Rather than using the term *lex financeria*, Frankel refers to a *lex juris* which forms the law governing cross-border securitisation, first created by decentralised 'markets,' and then absorbed by centralised 'lawmaking bodies.'[42]

It should be clear then, that the body of law applicable to securitisation is impossible to grasp without some knowledge of market practice. Legal research in this area therefore becomes partly a traditional scrutiny of legal sources, partly a fact-finding exercise that includes a review of transactions as well as the relevant policies of rating institutes and financial institutions.

Turning to the *y axis*, this concerns the interplay between market and state as producers of norms. In relation to tranching, market actors can be said to have co-developed capital regulation on securitisation through formal consultation and other interaction with the legislative process. The applicable domestic rules have however been issued under a varying degree of market influence. States may have enacted the current rules on priority in bankruptcy with little consideration to enabling structured finance transactions. Or, they may have had more room even in the realm of insolvency for judge-made law to interact with market participants in reflecting economic developments.[43]

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[38] See 3.5 (*How lawyers determine the seniority of a tranche*) below regarding the role of legal opinions in EU capital adequacy regulation.

[39] The STS concept will be explained in 2.2.2 (*STS Certification*) below.

[40] The register of STS transactions in the EU can, at the time of this paper, be accessed at: Securitisation (europa.eu). The five international law firms most frequently cited as transaction counsel were involved in 62 per cent of all public STS transactions during the period 1 January 2019 – 31 October 2020. For example, local firms Nauta Dutilh and Loyens & Loeff dominate the reported STS transactions for the Netherlands. However, one should not read too much into this rather limited material. The register which applies for UK transactions instead of the ESMA register as of 1 January 2021 can be found here: https://data.fca.org.uk/#/sts/stssecuritisations (accessed on 26 January 2021). The review undertaken for this paper comprised all public transactions listed in the ESMA register as of 31 October 2020; hence the UK transactions there reviewed have since been removed and re-listed under the FCA regime. See 5.1.3 (*UK exit from the EU*) below in relation to the exit by the UK from the EU.

[41] Frankel (2002) p. 486. Commented on by Wymeersch (2002).

[42] Frankel (2002) p. 475.

[43] As manifested in e.g. Re Maxwell Communications Corporation plc [1993] 1 WLR 1402 by English courts or in the case HR-2010-00568-A (on the standing of an agent for noteholders) by the Norwegian Supreme Court.

On the *z axis*, we may observe the national / international dichotomy. This also provides an illustration of tranching as a juncture between on the one hand capital regulation, which becomes binding through EU legislation but traces its origin to global bodies, and on the other, insolvency, contract and property law which has only been subject to patchwork harmonisation.[44]

Finally, to anchor the legal topics at hand in their context, this paper will contain a number of references to economic or financial matters. This has been limited to two situations.

The first situation is where financial or commercial circumstances are referred to in a legal text, such as a court precedent or an EU regulation. In such cases, the circumstances are treated as having been brought into the legal realm and are used to refer to reasons or aims intrinsic to the law.

The second situation is where, in my opinion, the discussion would otherwise become too abstract. References are made in such cases to economic or "law and finance" scholarship to invite the reader to trace and discover the nuances in relation to the relevant financial assumptions or objectives. For example, in order to understand what is means that some debt securities are designed to be "senior" for capital adequacy purposes, one must be familiar with the general assumption that an investment that is less risky requires less regulatory capital, and that this is generally held to be a good thing for the investor. At the same time, one should be aware that the effects of regulatory capital are a topic of scholarly debate.[45] The materials referenced in these situations have been selected based on their immediate relevance to the topic, with a preference for more recent publications that contain reiterations of previous research.

1.2.4 Rationale for and scope of comparative study

As seen from the above, the legal conditions for tranching cannot be understood by a review of financial regulation and market practice alone. The law surrounding contractual payment waterfalls also highlights differences between jurisdictions that are subject to the same capital regulations and part of a global market for capital. Differences lie not only in their norm-making processes, but also in the resulting legal facts.[46] Key differences are (i) to what extent the parties to a transaction may rely on the enforceability of a contractual payment order; and (ii) the complexity and cost of obtaining an acceptable level of legal certainty. A comparative review may reveal merits and drawbacks of certain solutions and legislative strategies, as well as paving the way for further enquiry and efforts towards considering alternatives for greater standardisation.[47] Section 4 (*Tranching and enforceability in the EU context*) contains a discussion on the level of substantive harmonisation sought in, or required as a consequence of, the regulation of securitisation as a transaction type. Tax law considerations fall outside of the scope of this paper.

The jurisdictions covered in this paper are France, Germany, the Netherlands and the UK. They have been selected on the basis of the following circumstances:

[44] Wymeersch (2019) pp. 5-6 refers to the tension and divergence arising as a consequence of national underlying law interaction with financial regulation. A seminal paper in this strand of thought is Teubner (2001).
[45] See 3.1 (*The purposes and basic structure of capital adequacy rules in the EU*) below.
[46] Pistor (2019) (in her highly political analysis) refers to bankruptcy law as "(t)he big stumbling block for seamless global markets based on domestic law," p. 144.
[47] Securitisation Regulation Recital (38) on the harmonisation intentions of the securitisation framework.

(i) They are some of the jurisdictions where securitisation SSPEs for public STS transactions are most frequently incorporated (be it for tax or other reasons);[48]

(ii) They represent both civil law and common law jurisdictions, as well as the German and Roman legal families within the realm of civil law jurisdictions;[49] and

(iii) They represent different legislative strategies (whether or not deliberate) in how and to what extent the enforceability of a payment waterfall can be ensured.

We cannot know in advance in which categories of the law or in which local legal sources the relevant rules on tranching of debt are found. Hence, the vantage point for investigation is the function as it appears in the definition of tranching in the Securitisation Regulation.[50]

1.2.5 *On efficiency*

A common starting point for any evaluation of law in the commercial realm is to attempt to measure its allocative efficiency under generally accepted economic theories. The scope of inquiry here is however, as mentioned above, primarily dictated by an effort to understand the internal coherence of the law applicable to securitisation. It is confined to the effects of the law on legal certainty (and indirectly on transaction costs) and its compatibility with financial regulation.

Still, two aspects of efficiency as a normative preference are assumed. *First*, the pricing as well as the regulatory capital calculation in relation to a certain tranche of securities should reflect as closely as possible the risk of default and loss given default applicable to that tranche.[51] If the commercial and regulatory treatment is not aligned with actual risk, either credit becomes too expensive (i.e. issuers of lower risk tranches are made to pay too much for credit), or it becomes too cheap (i.e. an issuer of riskier tranches can borrow at terms that are more favourable than what is warranted by the lenders' risk). On the regulatory capital side, the corresponding effects would be that an exposure may be over- or undercapitalised (too much or too little capital is required). For the economy as a whole,

[48] Out of 163 public transactions in the ESMA STS register per 31 October 2020, these four jurisdictions represented 122 when it came to jurisdiction of the assets (which is the only jurisdiction listing that the transaction receives in the STS documentation). Looking at the jurisdiction of the SSPE, the four jurisdictions covered here represented 102 out of 163 transactions. The difference between the 122 for jurisdiction of assets and 102 for jurisdiction of issuer is mainly explained by German and British structures opting for Luxembourg and Dutch SSPEs. The choice of jurisdiction for SSPEs is commented on in Wood, Project Finance (2019) p. 126.

[49] Wood, Principles of International Insolvency (2019) pp. 66-67. See Siems (2014) pp. 72-93 for a critical discussion of the mapping of legal systems.

[50] On functionality as a basic principle of comparative legal research, see Zweigert & Kötz (1995) pp. 34-35. For a critical discussion of this perspective, see Siems (2014) pp. 26-28.

[51] In credit risk terms, this is expressed as PD (Probability of Default) and LGD (Loss Given Default). See e.g. EBA Guidelines on STS Criteria for non-ABCP Securitisations (EBA/GL/2018/09) p. 18. Further see EBA Guidelines on PD Estimation, LGD Estimation and Treatment of Defaulted Exposures (EBA/GL/2017/16) p. 79, on changes to the legal framework and recovery process as part of LGD calculation. The legal risk of non-enforceable contracts belongs in the context of expected recovery and is not immediately related to a debtor's probability of default. The matching ambition expressed here is perhaps mostly relevant on a societal level; individual institutions may adapt to (and benefit from) a certain divergence between a capital adequacy categorisation and the more flexible interest rates charged to borrowers.

this dynamic translates into either a lack of access to credit for companies in the real economy on reasonable terms or conversely, a risk of over-indebtedness.[52]

Secondly, it is assumed that transaction costs can be an impediment to efficient markets.[53] At a certain point, the costs of carrying out a transaction become prohibitively high. The legislator (in whatever capacity) therefore must balance the interest of creating fertile ground for economic exchanges against other objectives such as investor protection or the prevention of money laundering. The interest of investor protection has given rise to, among other things, requirements on issuers of listed securities to publish a prospectus and to continuously disclose financial information. Those requirements inhibit access to the bond markets for smaller issuers.[54] In the interest of public safety, banks are required to carry out time consuming "know your customer" checks and employ additional compliance staff, which at least in theory steals resources from being put to better use.

In relation to the enforceability of tranching however, there is no such apparent balancing of interests. It is an area of the law where EU regulation uses a common concept to define transactions, but that concept depends on disparate insolvency, contract and property law on the local level. Therefore, transaction costs might not be tolerated to the same extent as a necessary evil; in the context of tranching, they may just be unnecessary.[55]

1.2.6 How the term "legal uncertainty" is used

Legal uncertainty is considered for purposes of this paper both as a component of legal risk and a driver of transaction costs. Legal risk in this context is understood as part of a wider range of risks that are created or exacerbated in the financial system rather than stemming from the real economy.[56]

Specifically, we are concerned here with the risk that because of legal doubts or barriers, market actors make errors in calculating capital requirements, or are unable to enforce on their contracts. The enforceability – or lack thereof – in relation to financing documents is a risk that is widely discussed and managed. In order to counter uncertainty, parties may need to undertake additional – sometimes costly – legal measures to live up to regulatory or commercial expectations.

The semantic opposite of legal uncertainty is legal certainty, often also referred to in terms of legal foreseeability or predictability.[57] The EU principle of legal certainty encompasses an important element of the rule of law, which entails both legitimate expectations and non-retroactivity of the law. As such, legal certainty does not fit easily with the problem of enforceability of payment waterfalls. Legal doubts in relation to tranching is rather a "known unknown" – a lack of clarity that is often referred to in legal documents. Legal

[52] Schäfer & Ott (2004) p. 434.

[53] On transaction costs in relation to financing transactions, see Douady et al., p. 417. Also see Wessels et al. (2009) p. 16 and Cafaggi (2011) p. 111.

[54] The latest EU prospectus regulation ((EU) 2017/1129) as amended (hereafter the "**Prospectus Regulation**") strives to lower the formal requirements for smaller issuers in order to increase their access to the capital markets, see e.g. Recital (12) of the regulation preamble and the most recent amendment to the Prospectus Regulation as part of the covid-19 recovery package, Regulation (EU) 2021/337.

[55] In relation to future reforms however it may be adequate to speak of a balance between legal certainty and flexibility; see Chen (2018) p. 321.

[56] On legal risk, see Dalhuisen (2019) pp. 60, 65 and McCormick & Stears (2018) p. 31. Legal risk is often also viewed as a component of operational risk (see CRR Art. 4 (1) (52).

[57] On legal certainty as a fundamental principle of EU law, see Mathis (2014) p. 308 (with case law references).

certainty however also has an economic dimension which is the main interest of this paper. Clarity on the enforceability of contracts is one of the cornerstones of a well-functioning credit market.[58]

2 What is securitisation and how is it regulated?

2.1 Mechanical description

Securitisation is the creation of new financial instruments based on the expected income from other assets. The first part of this operation is for an originator to transfer income generating assets to a separate legal entity, set up especially for this purpose.[59] The securitised assets can take many forms, such as credit card debts, home mortgages or customer receivables.

The term "originator" refers to the entity that holds the assets prior to securitisation. For example, if a bank extends a mortgage to a debtor and then transfers the rights to payment under such mortgage, the bank is the originator. The special purpose entity is referred to as the "SSPE" as this is the term used in the Securitisation Regulation.

The next step is for the SSPE to issue new negotiable debt securities to investors. Payment of interest and principal under the new securities is tied to the performance of the underlying pool of assets. The new issuance of debt may or may not be intended for trading and/or subject to the publication of a prospectus.[60]

In short, securitisation as a transaction type rests on the use of an SSPE that is separate from the credit risk of the originator, and that produces new securities of different credit quality. The SSPE should be bankruptcy remote in the dual sense that (i) the asset pool cannot be implicated in the insolvency of the originator; and (ii) it is set up so that bankruptcy of the SSPE itself is highly unlikely.

Below is a simplified picture for illustration purposes.

[58] In the securitisation context, see ECB Opinion CON/2019/42 p. 6. Gullifer & Payne (2015) p. 348. McCormick & Stears (2018) p. 43. Also see Hughes (2017). Hughes positions legal uncertainty in relation to true sale in securitisations as a driver of transaction costs. Ayotte & Stav (2010) test the effects of a court ruling that created legal uncertainty on the interest rate on credit to companies. The effect was estimated to between 26 and 29 basis points in the months following the court decision. Douady et al., p. 417, state that a unified insolvency law on the EU level would "…grant investors a certain degree of predictability of the level of loss given default. The US rule provides investors with the certainty that their level of loss will depend almost entirely on the borrower's distress level and their seniority ranking."

[59] The description of a process in sequential "steps" is for explanatory purposes; the different actions are interdependent.

[60] See Prospectus Regulation, Art. (3).

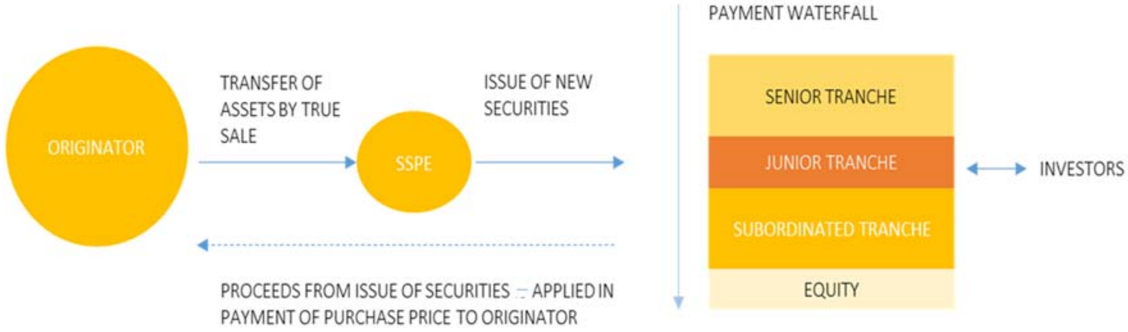

Figure 2: Simplified securitisation structure

In addition to the core actors – originator, SSPE and investors – a securitisation transaction will involve other roles to support the proper functioning of a structure. Someone will be servicer of the original assets (often the originator), another entity will be appointed to manage the SSPE. There will often be a security agent or trustee on behalf of the noteholders. Others still may manage bank accounts. The "sponsor" of a securitisation is typically affiliated with (or the same as) the originator, being the driving force behind the transaction.

2.2 How securitisation is regulated in the EU

2.2.1 The EU Framework for High Quality Securitisation

Under the umbrella of the Capital Markets Union project, the EU has produced a comprehensive package for the regulation of securitisation.[61] Its centrepiece is the Securitisation Regulation, which entered into force on 1 January 2019.[62] The regulation was accompanied by amendments to the CRR and the Capital Requirements Directive (2013/36/EU) as amended by directive (EU) 2019/878 (hereafter "**CRD**").[63]

Under the Securitisation Regulation, requirements on risk retention, transparency and due diligence have been amended and their scope and related sanctions have been expanded. The increase in formal requirements have been the subject of discussion in the market. Partly, this has been due to a lack of clarity in the absence of final regulatory technical standards and guidelines. But questions have also been raised as to the scope of the rules, due to the broad definition of securitisations in the Securitisation Regulation.[64] It defines

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[61] https://www.europarl.europa.eu/legislative-train/theme-economic-and-monetary-affairs-econ/file-framework-for-high-quality-securitisation/04-2020 (accessed on 19 May 2020). Securitisations under US jurisdiction are regulated by the Dodd-Frank Act 2010 ss 941-946. The developments are closely tied to the Basel III framework, see https://www.bis.org/bcbs/publ/d491.htm.

[62] It replaced previously applicable rules on securitisation in the CRR, the Solvency II Regulation ((EU) 2015/35) and the AIFM Directive (2011/61/EU).

[63] CRR amendments in relation to securitisation were enacted through Regulation (EU) 2017/2401. All references to the CRR and the CRD in this paper are references to such acts including amendments up to and including Regulation (EU) 2019/876 (CRR2), Regulation (EU) 2021/558 (covid-19 recovery package) and Directive (EU) 2019/878 (CRD5).

[64]Public Q&A records of interest can be accessed at: https://eba.europa.eu/single-rule-book-qa/-/qna/view/ publicId /2018_3806 and https://eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2018_4323 (accessed on 8 June 2020).

securitisation as "a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics:

(a) payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures;
(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;
(c) the transaction or scheme does not create exposures which possess all of the characteristics listed in Article 147(8) of Regulation (EU) No 575/2013."[65]

A "tranche" is defined in the Securitisation Regulation as follows:

"'tranche' means a contractually established segment of the credit risk associated with an exposure or a pool of exposures, where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in another segment, without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments."[66]

Prior to 2019, securitisation in the EU was subject to fragmented regulation in capital requirements and domestic laws. The "Framework for High Quality Securitisation" therefore represents a harmonisation effort on the level of financial regulation at the same time as being a measure for promoting other policy goals.

As a part of its response to the covid-19 pandemic, the EU produced certain amendments to the Securitisation Regulation and related capital adequacy regulations.[67] Securitisation has in this context been described as key for the recovery of the financial markets. Two aspects of the 2021 amendments relate to synthetic securitisations and to non-performing exposures ("**NPEs**").[68] Synthetic securitisations will, under the amended rules, be eligible for classification as STS (see 2.2.2 (*STS certification*) below), which is expected to facilitate such transactions.

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[65] Securitisation Regulation Art. 2 (1). The carve-out in (c) refers to specialised lending. The definition stems from the provisions on securitisation in previous versions of the CRD. A different definition of "securitisation" is found in the AIFM Directive (Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers) (as amended), which refers to Art. 1(2) of the now repealed Regulation (EC) No 24/2009 of the European Central Bank of 19 December 2008 concerning statistics on the assets and liabilities of financial vehicle corporations engaged in securitisation transactions. The definition referred to in the AIFM Directive does not incorporate tranching as a necessary element.

[66] Securitisation Regulation Art. 2 (6).

[67] See (i) in relation to the Securitisation Regulation, Regulation (EU) 2021/557 amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 pandemic (hereafter the "**SR Amendment**"); and (ii) in relation to the CRR, Regulation (EU) 2021/558 amending Regulation (EU) 575/2013 as regards adjustments to the securitisation framework to support the economic recovery in response to the COVID-19 crisis.

[68] In the Commission explanatory memorandum, it is clearly stated that "By transforming loans into tradable securities, securitisation could free up bank capital for further lending and allow a broader range of investors to fund the economic recovery. The current framework does not reach its full potential in two respects, which are very important for fostering economic recovery: the framework does not cater for on-balance-sheet synthetic securitisation and it is not entirely fit for purpose for the securitisation of non-performing exposures (NPEs)." Non-performing exposures are currently defined in Art. 47 (a) 3rd Paragraph and Art. 178 of CRR. Although the term "Non-performing loans or "NPL" is also frequently used in this context, this paper will refer only to NPEs for simplicity.

Given the financial distress brought upon borrowers in the real economy due to the Covid-19 pandemic, the regulators have also seen fit to promote the secondary market for distressed assets.[69] The tranching element of securitisation arguably carries particular weight in relation to NPE securitisations. In order to produce securities with a risk level that may be acceptable for mainstream investors, the characterisation of a tranche as "senior" in this context should not be open to challenges.[70]

The contractual relations governing a securitisation transaction, as well as the rights to property and rules on insolvency, are however still governed by domestic law in the jurisdictions elected by the parties or designated by application of the *lex rei sitae* or *lex concursus*.[71]

2.2.2 *STS certification*

The Securitisation Regulation introduced criteria for simple, transparent and standardised (STS) securitisations. The STS concept highlights the balancing of policy goals discussed in 1.1.1 (*Introduction to securitisation*) above – securitisations should be promoted, but only if they are not so complex as to endanger financial stability.[72] All STS transactions shall be recorded in a register, kept by ESMA or, in relation to the UK, the FCA.[73]

The STS label may be assigned to a transaction in order for investors to obtain a more favourable capital treatment.[74] It also entails, subject to certain additional requirements, that the securities issued qualify as "2B assets" for credit institutions' liquidity requirement purposes.[75] From a liquidity perspective, the element of standardisation in the STS framework stands out as particularly important.

An STS designation is the responsibility of the transaction parties, but the label can be produced by independent agencies as well. Currently, there are two verification bodies that are authorised under Art. 28 of the Securitisation Regulation.[76] Similar to external credit rating agencies, an STS verification body will gather information on the transaction and engage with the issuer in exchange for a fee.

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[69] For an account of such measures undertaken in a Greek and Italian context, see Linaritis (2020).

[70] See in a Greek and Italian context, Linaritis (2020) pp. 26-27.

[71] See Juutilainen (2018) p. 12 and Cranston et al. (2018) p. 555 for recent discussions on the *lex rei sitae* principle. On *lex concursus*, see Regulation (EU) 2015/848 of 20 May 2015 on insolvency proceedings (recast) Arts. 3(1), 7(1) and 7(2)(i). Where an entity has its COMI (Centre of Main Interest) in a member state other than where it has its registered office, this may be demonstrated and the courts of the COMI jurisdiction may be competent to open insolvency proceedings. See Court of Justice of the European Union in C-341/04 (Eurofood IFSC Ltd) ECLI:EU:C:2006:281 and C-1/04 (Staubitz-Schreiber) ECLI:EU:C:2006:39, and the English case ARM Asset Backed Securities S.A. [2013] EWHC 3351 (Ch) (9 October 2013). Also see Wood, Principles of International Insolvency (2019) p. 736. Steps towards harmonisation of approaches for the law governing assignment of or security over receivables and netting on insolvency have been taken through the Financial Collateral Directive (2002/47/EC) and the EU Settlement Finality Directive (1998/26/ EC).

[72] Securitisation Regulation Recital (5). The concept of STS traces back to post financial crisis initiatives to revive the securitisation market.

[73] See Arts. 18 (b) and 27.5 of the Securitisation Regulation and of the UK Securitisation Regulation.

[74] Art. 243 CRR, which sets out certain additional requirements to be met in order for a transaction to qualify for more favourable capital treatment.

[75] See Commission Delegated Regulation (EU) 2018/1620 of 13 July 2018 amending Delegated Regulation (EU) 2015/61 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for credit institutions, Recital (4), Art. 8 (1).

[76] Prime Collateralised Securities (PCS) UK Limited (with its French branch Prime Collateralised Securities (PCS) EU SAS) and STS Verification International GmbH.

An STS verification does not however entail statements about the credit quality of a product. It will only account for how the transaction at hand meets the STS criteria set out in the Securitisation Regulation. The relation between the ranking of tranches and the STS label will be further discussed below in 3.3.5 (*References to payment priority in the criteria for STS transactions*).

2.3 Typical features

Below is a description of transactional traits that typically come with the concept of securitisation.

2.3.1 Isolation of assets from credit risk of originator (true sale)

In contrast to borrowing directly against security over assets, securitisation involves separating the revenue streams from underlying assets from the credit risk of the originator. The isolation of assets from the credit risk of the originator is one of the reasons securitisations make sense from a commercial perspective. In a true sale (as opposed to a synthetic) securitisation, the transfer of assets from the originator to the SSPE must fulfil certain criteria, meaning that under the applicable law, the assets cannot be drawn back into an insolvency of the originator. Like tranching, ”true sale” is a term created by rating agencies and lawyers. Unlike an agreed payment order however, true sale is subject to explicit requirements for an explicit verification of its enforceability. [77]

This highlights a key difference between securitisation and its capital markets neighbour “covered bonds.” A covered bond investor will hold a preferential claim in relation to a designated pool of assets *but also* a claim on the originator financial institution.[78]

2.3.2 Bankruptcy remote SSPE

A feature which is closely related to the true sale requirement is the concept of a bankruptcy remote SSPE. The SSPE must be set up so as to not be implicated in an insolvency of the originator and to preferably not ever become subject to formal insolvency proceedings itself. Measures taken to ensure, as far as possible, that the SSPE is neither consolidated with the originator, nor likely to file for bankruptcy on its own, will vary depending on its jurisdiction of incorporation and market practice. The SSPE will often be an “orphan” controlled by a trust or foundation. Another common feature is to limit the activities that the SSPE may undertake according to its by-laws or articles of incorporation.[79]

2.3.3 Credit structure – tranching

The debt securities issued by an SSPE will be tailored to suit the purposes of the transaction. This is achieved by issuance of more than one series of notes, and by procuring for the ranking of the different series of notes issued by the same SSPE. Under the transaction documents, a payment waterfall will be agreed that determines the order in which each series of notes is entitled to payment of interest and principal. Depending on the jurisdiction of the SSPE and the desired characteristics of the notes, the ranking of tranches can be ensured by the corporate documents of the SSPE, contractual provisions, security arrangements, guarantees, insurance, or any combination thereof. The

[77] Securitisation Regulation, Recitals (22) and (23), Arts. 20 (1) and 24 (1).

[78] The “dual recourse” feature is captured in the covered bonds framework, see Directive (EU) 2019/2162, Chapter 1, Art. 4.

[79] Ramos Muñoz (2015) p. 243 ff.

enforceability of the agreed payment order in a securitisation context is the main topic of this paper. The modules that are used to create tranching are discussed in detail in section 5.1.1 (*Legal modules to be examined*) and following below.

2.3.4 *Rating*

As part of the structuring of a securitisation transaction, tranches above the most subordinated layers are often rated. The sponsor will be in dialogue with the rating agency, providing additional information where needed. A transaction will not be submitted for rating without a strategy and having engaged with the rating process in advance.[80]

An external rating is a label assigned to financial instruments (or issuers) to signal the credit risk associated with investing in the rated product. Credit rating agencies, such as Standard & Poor's, Moody's or Fitch Ratings, are regulated in the EU since 2009.[81]

Rating is a way of communicating with the market. The issuer of securities will pay a rating agency to undertake a deeper due diligence instead of leaving that exercise to each individual investor. Although investors should not trust external ratings blindly, they are an important tool for supporting commercial decisions.[82] This applies throughout the financial markets and not only in structured finance.

At the same time as being a tool for market communication, rating is a way of categorising exposures for investors that are subject to capital adequacy rules. When issued by an authorised credit rating agency, an external rating may be used in order to assign a risk-weight to securitisation positions under certain conditions. The link between the credit rating of a product of securitisation and the legal concept of tranching is further discussed under 3.4 (*How rating agencies designate a tranche as senior*) below.

3 Regulatory capital in the context of securitisation

3.1 The purposes and basic structure of capital adequacy rules in the EU

The basic idea behind capital adequacy rules is to ensure, by binding rules, supervision, and disclosure, that financial institutions are capitalized in a way that makes them resilient. As expressed by the EU Commission, "*The goal of these rules is to strengthen the resilience of the EU banking sector so that it can better absorb economic shocks, while ensuring that banks continue to finance economic activity and growth.*"[83] The rules are designed to limit contagion in the financial system in case of individual failures, and to

[80] Deku & Kara (2017) p. 15. EU CLO Credit Ratings – an Overview of Credit Rating Agencies Practices and Challenges (ESMA80-189-6982) 13 May 2020, p. 6 ff.
[81] Regulation (EC) No 1060/2009 (as amended) (the "**CRA Regulation**"). The regulation text does not hold back on its critique against rating agencies and their role in the 2008 financial crisis; see e.g. Recitals (9) and (10). Credit rating agencies must now be authorised (Art. 18) and a list of all authorised agencies is found at https://www.esma.europa.eu/supervision/credit-rating-agencies/risk (accessed on 19 May 2020). For a summary of the applicable legal framework, see Wood, Regulation of International Finance (2019) pp. 593-599.
[82] Under the CRA Regulation, Art. 5 (a), entities within the scope of the regulation "shall not solely or mechanistically rely on credit ratings..."
[83] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/prudential-requirements_en (accessed on 28 June 2020).

reduce the financial sector's dependence on government bail-out in future economic downturns.[84]

Requirements that institutions have sufficient coverage for credit risk have existed in one form or another since the first implementation of rules produced by the Basel Committee in 1988.[85] Risk weights are assigned to the exposures of an institution, intended to reflect the risk of default and the expected loss on default. The calculation of risk-weighted exposures then determines how much loss-absorbing capital must be held to correspond to the risk. An institution must hold a certain percentage of its amount of risk-weighted assets in equity or deeply subordinated debt instruments.[86]

The original Basel logic of capital buffers determined by a risk classification of exposures has been complemented in the most recent decade, first by adding the elements of market and operational risks. Following the 2008 financial crisis, rules have been added to address liquidity, leverage, resolution reserves and other additional layers of capital protection that apply to systemically important institutions. The most recent full Basel accord agreed in 2010 is referred to as Basel III.[87] Prior to being fully implemented though, Basel III has been subject to significant renegotiation. The most recently agreed framework, to be implemented by 2027, is therefore referred to by some as "Basel IV."[88] The norms produced by the Basel Committee are not binding, but become hard law as and to the extent implemented by national lawmakers (including the EU).

Since holding capital costs money, the riskier an asset is, the more expensive it is for an institution to hold that asset or exposure on its balance sheet.[89] For example, if a bank lends money to a retail company on an unsecured basis, this will entail a higher cost of capital to be (theoretically) set aside by the bank than if they would have lent to a blue-chip institution against full security.[90]

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[84] As such aims are expressed in CRD, Recital (34), and CRR, Recital (7) and (14). Further see Wymeersch (2019) p. 2 and Wood, Regulation of International Finance (2019) p. 603. The framework for Bank Recovery and Resolution (Directive 2014/59/EU as amended by Directive (EU) 2019/879 (BRRD2)) is a tool for specifically preventing the distress of one institution from spreading to others. The effectiveness of such instruments can of course be, and has been, discussed. See e.g. Ringe & Patel (2019) and Avgouleas & Goodhart (2019).

[85] A history of Basel accords and a summary of their main contents are provided at https://www.bis.org /bcbs/ history.htm (accessed on 28 June 2020).

[86] Art. 92 of the CRR sets out the basic own funds requirement of 8% of risk-weighted assets, which was the ratio introduced with Basel I.

[87] See https://www.bis.org/bcbs/basel3.htm, accessed on 28 June 2020.

[88] See e.g. Neisen & Roth (2018). Significant changes include reversing developments to an extent in relation to the use of internal models and a more favourable treatment of covered bonds. See Wood, Regulation of International Finance (2019) p. 611 for a summary table of changes between the current framework and the updated CRR and CRD. The regulatory framework applicable to insurance undertakings is centred around "Solvency II" (Directive 2009/138/EC).

[89] This notion rests on the assumption that all investors require a return on investment, and investors in equity or otherwise loss-absorbing capital require a greater return. See Jagannathan et al. (2017) p. 260. It has proven difficult however to figure out the cost and effects on the wider economy of holding regulatory capital. See e.g. Plosser & Santos (2018) and Basel Committee (2019). Also see Gorton & Metrick (2013), p. 39, emphasising the difficulty in producing solid evidence of to what extent regulatory capital is expensive for institutions. It is not within the scope of this paper to investigate the complex questions of capitalisation of financial institutions.

[90] See CRR Arts. 122-126. Also see Wood, Regulation of International Finance (2019) p. 605.

3.2 Capital adequacy rules in relation to securitisations

In the context of securitisation, capital adequacy rules are important for two main reasons.

First, the cost of capital can be reduced for a lender (originator) if a portfolio of loans (and hence credit exposures to the debtors in that portfolio) is transferred from that lender to a separate legal entity.[91]

Secondly, the actors investing in securities sold through a securitisation are often regulated entities, such as insurance undertakings or banks. By purchasing the bonds, they acquire a securitisation exposure which is subject to capital adequacy requirements.

In theory, a securitisation should neither lower nor increase the total risk. The credit risk in a portfolio of claims does not change merely because the assets are transferred to a new entity and re-packaged.[92]

So, we proceed on the assumption that an investor who would purchase a vertical slice of all tranches of the notes in a securitisation would become exposed to the same average default risk as if it had stepped directly into the shoes of the originator. What produces a different risk is the investment into a particular tranche. An investment in the most junior tranche entails that such tranche will absorb all losses in the total portfolio up to a certain amount. Conversely, the exposure of the most senior tranche which has ideally been insulated from losses by the subordinate tranches carries a lower risk of default. Therefore, the regulatory capital requirements will be significantly lower for senior tranches than for those ranking behind them in the contractual payment waterfall. Wood explains that "the noteholders are tranched or tiered with different priority levels so that the rules can fix different risk weights according to the tier."[93]

This marks our arrival at a core question: If seniority determines the risk-weighted exposure for notes issued in a securitisation, how can we know the seniority of a tranche? This question warrants a closer look at the rules that refer to the ranking or payment priority of tranches in the CRR.

First however, it may be helpful to distinguish between the terms "senior" and "secured." To be secured is typically understood to mean that one has an enforceable priority to payments out of certain assets of a debtor. Seniority on the other hand is a relational concept. For example, bonds that are marketed as "senior" might very well enjoy priority in relation to a subordinated shareholder loan, but at the same time there may be a secured creditor which has better priority to the assets of the debtor. To provide security for one tranche but lower-ranking or no security to the rest is one of the legal tools for creating seniority.

Secondly, why is the answer to the question "how can we know the seniority of a tranche" not simply that it follows from the terms and conditions of the relevant debt securities? It is true that the notes issued in a securitisation will specify the ranking of tranches.[94]

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[91] See Wood, Project Finance (2019) p. 167 for one of the reservations against this general assumption.

[92] This is reflected from a regulatory perspective in the "look through" provisions of CRR Art. 267. While the perspective of the legislator may be that regulatory arbitrage should not be available to apply risk weights that lead to lower capital charges in total, market participants may be concerned that risk weights instead have become higher than what is justified based on the underlying assets.

[93] Wood, Regulation of International Finance (2019) p. 659.

[94] Wood, Regulation of International Finance (2019) p. 659: "The tranching is achieved by provisions that the noteholders are paid according to a ladder of priorities or "waterfall," especially on default."

However, as discussed in 1.1.2 (*The function to be analysed*) above, we are in search of the robustness of such agreement in financial distress. The question is not if a payment priority has been agreed – but rather if that agreement, from the point of view of capital adequacy regulation, must be enforceable, and if so, how enforceability is achieved.

3.3 How does financial regulation refer to the ranking of a tranche?

3.3.1 Introduction

First, the regulatory definitions of "securitisation" and "tranche" as submitted in 2.2.1 (*The EU Framework for High Quality Securitisation*) above may provide some clues as to the legislator's expectations on enforceable payment structures. The Securitisation Regulation's definition of a tranche as a "contractually established segment," signals that an agreement that works *inter partes* is all that the legislator has had in mind. Given the centrality of bankruptcy remoteness of SSPEs in securitisations, this would not be a surprising approach. At the same time however, the definition of securitisation states that "the subordination of tranches *determines* the distribution of losses" (my emphasis).

The basic rules for the capital treatment of securitisation positions in the EU are then found in the CRR, which is based on the Basel III accord.[95] In the UK, the CRR and CRD have been brought into UK domestic legislation by the European Union (Withdrawal) Act 2018. Statutory instruments have also been adopted to adapt the rules for functioning as UK legislative acts.[96] Because of the substantive similarities that remain between the CRR and CRD as defined here, and the corresponding onshored acts, the UK provisions will not be addressed separately.

The determination of a risk-weighted exposure is a granular (and mathematical) exercise. It is made by each institution individually. Institutions can use different approaches for calculations, in the following order. First, an internal ratings-based approach (SEC-IRBA) should be applied. The SEC-IRBA is expected to be used primarily by originators, since outside investors may lack the necessary data for the underlying assets in a securitisation.[97] Secondly, if SEC-IRBA cannot be used, institutions should apply a standardised approach (SEC-SA). Last in the hierarchy is the external ratings based approach (SEC-ERBA).[98]

The calculation of risk weighted exposures uses the credit quality mapping from external ratings as an input, where available. Given the importance of rating for securitisation transactions, most tranches will have been assigned an external rating.[99]

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[95] A summary and links to the consultations leading up to the Securitisation Regulation and related CRR and CRD amendments can be accessed at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/securitisation_en (accessed on 11 May 2020). Also see Regulation 2017/2401 Recital (3).
[96] See further in 5.1.3 (*UK exit from the EU*) below.
[97] Neisen & Roth (2018) p. 180.
[98] Art. 254 of CRR sets out the hierarchy of approaches. Explained in Recital (4) of the amending Regulation EU/2017/2401. What looks like a preference for SEC-SA over SEC-ERBA deviates from the Basel III framework (Art. 68 of the "*Basel III Document Revisions to the securitisation framework*"). Also see European Parliament, Briefing: Legislation in Progress. Securitisation and Capital Requirements: https://www.europarl.europa.eu/RegData/etudes/BRIE/2017/608778/EPRS_BRI(2017)608778_EN.pdf (accessed on 3 June 2020) p. 3.
[99] Wood, Regulation of International Finance (2019) p. 625 and Wood, Project Finance (2019) pp. 171 and 183.

3.3.2 *Definition of senior, mezzanine and first-loss positions in the CRR*

A "senior securitisation position" is defined in Art. 242 (6) of CRR as being backed or secured by a first claim on the total pool of assets.[100] In bankruptcy law terms, this implies that no one else can begin to receive distributions out of the assets of a bankrupt debtor (subject to statutory carve-outs) before the senior creditor is satisfied in full. This definition is used to establish which tranches can enjoy an advantageous risk-weight floor of 10 % for senior securitisation positions in STS transactions (compared to 15% for non-STS securitisations, that in principle apply the same concepts of priority).[101]

The concept of seniority is also defined in Art. 13 (2) (b) of Commission Delegated Regulation (EU) 2015/61 regarding liquidity coverage requirements. The definition reads (my emphasis):

"For these purposes, a tranche shall be deemed to be the most senior where after the delivery of an enforcement notice and where applicable an acceleration notice, *the tranche is not subordinated* to other tranches of the same securitisation transaction or scheme *in respect of receiving principal and interest payments*, without taking into account amounts due under interest rate or currency derivative contracts, fees or other similar payments in accordance with Article 261 of Regulation (EU) No 575/2013."

This does not add to an understanding of the concept of seniority, except to the extent that it illustrates that the term is related to having a first claim on both principal and interest.

The Basel III framework defines seniority somewhat differently. It states that "a securitisation exposure (tranche) is considered to be a senior exposure (tranche) if it is *effectively* backed or secured by a first claim on the entire amount of the assets in the underlying securitised pool."[102] The word "effectively" could indicate that the structure must indeed be legally enforceable.

A "mezzanine securitisation position" is defined in CRR Art. 242 (18) only as being in the middle of the senior and first loss positions and based on the risk-weights it has received. A "first-loss" position is defined in the Securitisation Regulation (Art. 2 (18)) as "the most subordinated tranche in a securitisation that is the first tranche to bear losses incurred on the securitized exposures and thereby provides protection to the second loss and, where relevant, higher ranking tranches."

The definition of a position as "senior" or "mezzanine" does not include a requirement regarding how much debt must rank behind it to protect against losses; this element of tranche "thickness" is instead inserted in the risk-weight calculations through the reference to an attachment point and a detachment point for losses. The maturity of tranches is also an important separate input to risk-weight calculations.

The word "senior" is used in numerous other instances throughout the CRR, however without reference to a defined term.

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[100] The definition reads: "'senior securitisation position' means a position backed or secured by a first claim on the whole of the underlying exposures, disregarding for these purposes amounts due under interest rate or currency derivative contracts, fees or other similar payments, and irrespective of any difference in maturity with one or more other senior tranches with which that position shares losses on a pro-rata basis."

[101] Art. 243 of CRR.

[102] My emphasis. Art. 40.18 of the consolidated Basel III framework, accessed on 22 May 2020.

3.3.3 *Attachment and detachment points*

In the formulae for capital adequacy calculations, the ranking of a tranche translates into its "attachment point" and "detachment point." The attachment point is where a tranche begins to suffer losses. It can also be described as the fraction of losses in the underlying pool to which it is not exposed. The detachment point corresponds to the amount of losses in the underlying assets that wipes out the tranche completely.[103]

A senior tranche may for example represent 40 euro out of a total 100 that were raised[104] in a transaction. Since the other tranches shall carry the losses first, losses in the underlying portfolio need to exceed 60 euro in order for the senior tranche to be affected. In this example, the attachment point for such senior tranche would be 0,6.

The rules on attachment and detachment points do not explicitly refer to the legal arrangements that are used to create them.

3.3.4 *Credit risk mitigation*

After the calculation of a risk-weighted exposure, an institution may modify the calculations to take account of the benefits of collateral or other "credit risk mitigation." In order to qualify, such mitigation techniques must fulfil the requirements under CRR Art. 194. The language used in this context differs from the references to seniority, as it includes that institutions should obtain an "independent, written and reasoned legal opinion" confirming the effectiveness and enforceability of collateral arrangements in relevant jurisdictions.

3.3.5 *References to payment priority in the criteria for STS transactions*

As discussed under 2.2.2 (*STS Certification*) above, it is possible under the Securitisation Regulation to label transactions as "simple, transparent, standardised." The fact that a securitisation is classified as STS entails a more beneficial capital treatment than it would have otherwise enjoyed.[105]

The criteria that must be fulfilled for STS are set out in Chapter 4 of the Securitisation Regulation. They are divided between those that apply to ABCP securitisations (asset backed commercial paper; signifying shorter term securities), ABCP Programmes and non-ABCP. For the sake of simplicity, and because there are no substantial differences for purposes of this paper, references are only made to the non-ABCP provisions.

The certification body that reviews a transaction and issues a statement as to its STS compliance will complete a checklist, commenting on the fulfilment of STS criteria. The form of checklist has been provided in a delegated regulation, specifying the contents to be filled out in relation to each criterion.[106] The form also references the relevant sections

[103] Art. 256 of CRR. In literature, see Antoniades & Tarashev (2014), Deku & Kara (2017) p. 15 and Wood, Regulation of International Finance (2019) p. 656.

[104] Or more accurately, "the outstanding balance of all the underlying exposures"; see CRR Art. 256 (1). Where appropriate, terms have been simplified.

[105] Art. 243 of CRR.

[106] The "checklist" discussed here is found in Annex I to the Commission Delegated Regulation (C219/8008) supplementing Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down regulatory technical standards specifying the information to be provided in accordance with the STS notifications requirements. This act derives from Art. 27.7 in the Securitisation Regulation. For examples of how the forms are filled out by STS verification bodies, these can be accessed either via the ESMA register of STS transactions

of the information to be provided in a prospectus.[107] It therefore makes sense to read the STS criteria in the Securitisation Regulation together with the checklist and, where relevant, EBA guidelines.[108]

The credit structure and priority of payments between tranches are caught by Art. 21 of the Securitisation Regulation as a matter of "standardisation." According to Art. 21, there can be no cash trapped in the SSPE after delivery of an acceleration or enforcement notice, subject to limited exceptions. Payments from the SSPE are to be made in order of seniority. For transactions that do not stipulate a sequential payment order according to seniority prior to a default, that order needs to change upon certain trigger events.[109]

Further, under the heading of "transparency" in Art. 22 (3), originators or sponsors are required to make available to investors a "liability cash flow model which precisely represents the contractual relationship between the underlying exposures and the payments flowing between the originator, sponsor, investors, other third parties and the SSPE."

More recently, the SR Amendment refers to the STS criteria for on-balance sheet (i.e. synthetic) securitisations where "Losses shall be allocated to the holders of a securitisation position in the order of seniority of the tranches, starting with the most junior tranche." And further, "Sequential amortisation shall be applied to all tranches to determine the outstanding amount of the tranches at each payment date, starting from the most senior tranche."[110]

In an interesting passage, the rules for synthetic securitisations and credit protection specify that (my emphasis): "In the case of funded credit protection, upon termination of the credit protection agreement, collateral shall be returned to investors in order of the seniority of the tranches *subject to the provisions of the relevant insolvency law*, as applicable to the originator." This indicates a recognition of the fact that distribution may not be carried out according to the transaction documents in case of an encounter with national insolvency law.

In relation to Art. 21 (4), EBA guidelines emphasise that investors should not have to consider "complex structures of the payment priority that are difficult to model," nor be exposed to "complex changes in such structures throughout the life of the transaction." It should be "ensured that junior noteholders do not have inappropriate payment preference over senior noteholders that are due and payable." Further, it refers to the objective of the criterion in Art. 21 (4), being to "prevent investors from being subjected to unexpected

(https://www.esma.europa.eu/policy-activities/securitisation/simple-transparent-and-standardised-sts-securitisation) or the websites of the verification bodies.

[107] In relation to the priority of payments for securitisation transactions, that information is specified in Annex 19 of Commission Delegated Regulation (EU) 2019/980, items 3.4.7 and 3.4.8.

[108] See EBA/GL/2018/09, items 55-60.

[109] So called "flip clauses," which alter the ranking of claims upon certain insolvency related triggers, have been subject to doubts as to their enforceability following cases in the wake of the 2008 financial crisis. See *Lehman Bros. Holdings Inc. v. BNY Corp. Tr. Servs. Ltd.*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010)*; Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd.*, 452 B.R. 31 (Bankr. S.D.N.Y. 2011). Many transactions still refer to legal uncertainty in relation to an *ex post* alteration of payment priorities. See however *In re Lehman Bros. Holdings Inc.*, 2020 WL 4590247 (2d Cir. Aug. 11, 2020), where it was held that, even assuming flip clauses should be treated as *ipso facto* clauses, they were still enforceable under the safe harbour for swap agreements in Section 560 of the U.S. Bankruptcy Code.

[110] SR Amendment Art. 26 (c) (5).

repayment profiles and to provide appropriate legal comfort regarding their enforceability."[111]

The STS checklist in relation to Art. 21 (4) asks for "confirmation" that, notably, "principal receipts from the underlying exposures are passed to the investors …as determined by the seniority of the securitisation position." The way that the STS verification bodies have completed this item, is typically by reference to how the transaction is described in the prospectus (if any) and other transaction documents. Legal opinions are also referred to as a means of verification.[112] Prospectuses, in turn, will discuss potential legal risks inherent in the structures and sometimes mention that a legal opinion (in general, not tied to payment priorities in particular) from external counsel has been obtained. The same approach is taken in relation to Art. 21 (9), which in itself refers to information in the transaction documents.

In sum, the STS criteria emphasise that the seniority structure in STS transactions should be straightforward enough to model and rely on. The EBA Guidelines indicate that the payment priority should be legally enforceable. Where confirmation is given by the transaction parties or an STS verification body however, a reference to underlying documentation seems to be accepted at face value. There is no obvious conclusion to be drawn from the legislative texts and guidelines on STS as to whether the payment order must meet relevant requirement as a matter of statutory law or contract.

3.4 How rating agencies designate a tranche as senior

External ratings are crucial in their capacity as a tool for pricing and for communication with the market.[113] They also feed into capital adequacy calculations for investors that are regulated entities.[114] The seniority of a security is a crucial factor in the financial modelling supporting its rating.[115] It is therefore interesting to understand from a legal (as opposed to merely financial) perspective how the ranking of a tranche is corroborated by rating agencies.

Regulation (EC) 1060/2009 contains high-level provisions regarding the methodology to be used by authorised rating agencies. It states that "(c)redit ratings should be well-founded and solidly substantiated, in order to avoid rating compromises."[116] The regulation further allows reliance on reputable third parties for certain inputs.[117]

A major part of the rating process in relation to securitisation is of course about the credit risk on the underlying assets. To understand how seniority is established however, it is the part of the rating process that focuses on structural features that is of interest.

Interestingly, according to Wood, rating agencies will assume that the parties to a transaction will comply with their covenants.[118] At the same time, however, they will

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[111] EBA/GL/2018/09, item 56 and 55, respectively.

[112] See e.g. https://www.sts-verification-international.com/sts-verification#c78 (accessed on 9 June 2020).

[113] See e.g. Armour et al. (2016) p. 128.

[114] Dalhuisen (2019) p. 937. For discussion by one major rating agency, see https://www.moodysanalytics.com/-/media/whitepaper/2019/whitepaper-basel3-calculation-of-tranche-maturity-for-sec-erba.pdf. Accessed on 3 June 2020.

[115] Altman & Kalotay (2014) p. 116. Qi & Zhao (2013).

[116] Regulation (EC) 1060/2009, Recital (24).

[117] Regulation (EC) 1060/2009, Recital (35).

[118] Wood, Project Finance (2019) pp. 138 and 184.

collect extensive legal opinions covering the enforceability of transaction documents to underpin their ratings.[119] An important component to be reviewed in a legal opinion is the payment waterfall that creates the tranching of debt securities.[120] Judging from the language in rating agency criteria, such analysis will focus more on the existence and tenability of supporting measures (or modules, as discussed in 5.1.1 (*Legal modules to be examined*)) than on the priority of payments as a separate enforceable feature.[121]

From this perspective, the enforceability of a tranching arrangement comes down to the right combination of contractual building blocks, as affirmed by the opinions of external lawyers.

3.5 How lawyers determine the seniority of a tranche

As discussed above, credit rating agencies will use legal opinions, together with their own assessment and assumptions, to support the rating of a tranche. Transacting parties and STS verification bodies will also rely to an extent on external opinions. The burden of proof for showing that a transaction structure will hold up, so as to justify its treatment under capital adequacy rules, thus flows back to the law firms that helped draft the transaction documents. This is the case even though, in contrast to the elements of true sale and credit risk mitigation eligibility, no explicit reference to legal opinions is made in the regulatory text.

Legal opinions will not go into detail on calculation inputs such as the attachment or detachment points of tranches. They will speak to the legality, validity and enforceability of the agreements and other documents entered into in order to create the intended tranching.[122]

In this setting, the *lex financeria* may be clearly observed as supplementing or even specifying the hard law contained in the Securitisation Regulation and the CRR, by filling the gaps on what constitutes seniority.[123] In a sophisticated market such as this, structured finance lawyers will devise which modules from the relevant jurisdiction(s) that are appropriate, will combine those modules in the transaction documents, and will then issue a legal opinion stating (more or less) that it all works.

Legal opinions are similar to legal memoranda or other written advice. They are bespoke products of individual law firms, backed by professional indemnity insurance. Opinions may typically not be relied upon by others than the addressees in a particular transaction. As an exception, there are industry opinions commissioned for a type of transaction and

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[119] See Fitch Ratings: https://www.fitchratings.com/research/structured-finance/global-structured-finance-rating-criteria-02-05-2019 (accessed on 3 June 2020) (hereafter "**Fitch Rating Criteria**") pp. 3-4. Moody's Cross-Sector Rating Methodology: Bankruptcy Remoteness Criteria for Special Purpose Entities in Global Structured Finance Transactions (October 7, 2014) p. 4. Standard & Poor's Structured Finance Ratings – European Legal Criteria 2005 Part II, p. 43. Wood, Project Finance (2019) p. 156 briefly discusses legal opinions in securitisations.

[120] Vries De Robbé (2008) p. 51. Fitch Rating Criteria p. 18. DBRS Morningstar structured finance rating criteria (accessed in latest draft on 15 February 2021 at https://www.dbrsmorningstar.com/research/366797/legal-criteria-for-european-structured-finance-transactions-request-for-comment) (hereafter "**DBRS Rating Criteria**") p. 37.

[121] Fitch Rating Criteria pp. 19-20.

[122] Vries De Robbé (2008) pp. 92-93.

[123] See under 1.2.3 (*The x y z of norm-making as analytical tool*) above for a brief discussion of the term *lex financeria*, with further references.

which are capable of being accessed by multiple bodies (but will still only be accessible for members of the relevant industry organization).[124]

As a consequence, legal opinions are not public documents.[125] Their property of "trade secret" is sanctioned under the STS criteria, where transaction documents generally must be made available to investors, *except* legal opinions.[126] At the same time, the regulation emphasises transparency and access to information in order to promote a safe and efficient market.[127]

The limits to publicity for legal opinions are, in my view, based on legitimate commercial, intellectual property and liability considerations for law firms. However, one may discern a legal certainty deficit when the contents of a legal opinion come to determine the application of law and at the same time are not publicly available.

The way forward, I believe, is not to continue to ultimately rely on legal opinions that are kept in the desk drawers of rating agencies and arrangers. Nor is it to force law firms into a new role through the general disclosure of their reasoning. Rather, it is to move the discourse towards a legal concept of tranching that can be accessed and understood by market participants as well as regulators and domestic courts.

3.6 Summary: How do different regulations address the legal tenability of tranching?

As seen above, the CRR makes only flat references to the ranking of a securitisation position. The rules do not say, for example, that a senior first claim to all underlying assets must be legally recognised in the issuer's jurisdiction of incorporation. Nor that any such assurances about the legal tenability of an agreed payment order are required in relation to the attachment and detachment points. This differs from the language used in relation to the elements of true sale of assets or collateral. A reading of guidelines and Q&A related to the relevant CRR provisions does not add anything conclusive in this respect.

The Securitisation Regulation contains definitions of securitisation and tranching that are not clear on whether an agreed payment priority needs to be enforceable against third parties. It does however express that where a transaction is a "securitisation" for regulatory purposes, that entails that *contractually established* segments of debt *determine* the order in which losses are absorbed.

Further, the Securitisation Regulation sets out requirements concerning the ranking of debt in relation to the STS criteria. These requirements seemingly concern the contents of the transaction documents, and not the legal robustness of the concept. Outside of the STS requirements, due diligence and disclosure requirements in the Securitisation Regulation explicitly refer to information on, but not the enforceability of, payment priorities and other structural features of a transaction.[128]

[124] Such as the ISDA country opinions, see https://www.isda.org/opinions-overview (latest accessed 8 June 2020).
[125] In contrast, the (U.S.) SEC requires certain legal opinions to be published under securities law. See Roe (2017).
[126] Securitisation Regulation Art. 7 (1) (b) (i).
[127] See e.g. Securitisation Regulation, Recital (12).
[128] Arts. 5 (3)(b) and 7 (1) (b) of the Securitisation Regulation.

In addition, there are instances in CRD addressing legal risk. Such provisions however speak only generally of ensuring that "the economic substance of a transaction is fully reflected in the risk assessment and management decisions."[129]

Perhaps due to the divergence between domestic jurisdictions and insolvency regimes, no clear lines appear to have been drawn for regulatory purposes between agreements that are enforceable *inter partes* and those that are enforceable against third parties. Against this background, the following sections will discuss the question of tranching and seniority from the perspective of EU legal principles and interpretation.

4 Tranching and enforceability in the EU law context

4.1 Introduction

Terms such as "tranching" and "senior" are fundamental for the application of the regulatory framework for securitisation. At the same time, as established above, the definitions of such terms do not reveal much about their private law contents, the level of legal certainty required as to their private law construction, or if a harmonised understanding of such concepts across Member States has been intended. Most of the rules discussed here have come in the form of regulations and are hence immediately applicable in all Member States. This begs the question: How deep into domestic legal systems does the tranching concept of the Securitisation Regulation reach? Would it be considered by a court to float atop or to override an application of national insolvency law refusing to give effect to a contractual payment waterfall?[130]

4.2 Implications of the principles of conform interpretation, primacy and pre-emption

When analysing the effects of EU law on national insolvency law and the parameter of national courts, the first question to consider is the nature of the relevant EU regulatory provisions. As discussed above in 3.6 (*Summary: How do different regulations address the legal tenability of tranching?*), a plain reading of the relevant provisions of the CRR and Securitisation Regulation do not give away whether the rules require that an issuer, regardless of jurisdiction, should be able to issue debt in tranches, or if they simply apply to the extent possible. Arguments for both main alternatives are discussed in 4.3 (*The concept of tranching and EU principles for interpretation*) below.

[129] CRD Arts. 80 and 82, including a reference to the management of "residual risk" which occurs as a consequence of e.g., a lack of enforceability.

[130] That is, the CJEU by referral under Art. 267 of the Treaty on the Functioning of the European Union ("**TFEU**") or by a national court applying national law that falls within the scope of EU law. Given that the UK is no longer a member of the EU, this reasoning does not apply directly to UK circumstances.

The Court of Justice of the European Union (the "**CJEU**") has consistently held that national authorities are under an obligation to interpret national law in a way that conforms with the wording and purpose of relevant EU acts.[131] In cases where national law already harbours the possibility of enforceability of tranching, and the regulations are understood to require it, the principle of conform interpretation should therefore reinforce an argument in that direction. The application of national law in a way that furthers the effects of EU law on the same topic is required notwithstanding the legislative history and previous body of court precedents in a Member State.[132] If such application is possible, there would not necessarily be any conflict between EU and national law.

Depending on the jurisdiction, there may however be no viable route for a national authority to interpret rules in a way that would disapply or complement statutory law in favour of giving effect to the tranching feature of securitisations. Following the conceptual framework suggested by Arena, a lack of enforceability of payment waterfalls in Member States' laws would best be understood as a possible *obstacle pre-emption*.[133] An inability of domestic legal systems to accommodate contractually agreed payment priorities in securitisation can be seen to stand in the way of attainment of the objectives of the relevant EU law. If it is accepted that the EU rules entail that a payment waterfall must be enforceable, the two sets of norms relate to the same set of facts.

A normative conflict may hence be identified between, on the one hand, EU norms tying certain regulatory consequences to the concept of "seniority" and the "tranching of debt" and on the other, mandatory law in a member state stipulating that contractually agreed payment waterfalls cannot (or cannot without significant structuring costs) be given effect upon an insolvent liquidation of the issuer. If an obstacle pre-emption is established, it must be determined whether a conflict can nevertheless be permitted to persist due to an applicable exemption. In the absence of any relevant exemptions, the principle of EU primacy indicates that EU law must prevail.[134]

Both the question of whether a conflict exists and whether there would be grounds for justifying a national deviation hinge on an interpretation of the relevant regulations. Ultimately therefore, this analysis relies on an interpretation of the EU legal acts themselves that goes further than a textual exercise.

4.3 The concept of tranching and EU principles for interpretation

4.3.1 Introductory remarks – context and objectives

As a starting point, terms in EU law that make no express reference to the law of Member States for the determination of their meaning and scope must normally be given an autonomous and uniform interpretation throughout the Union. Such interpretation shall have regard to the *context* and *objectives* of the relevant legislation.[135] Further, EU legal

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[131] See Case C-14/83 (Von Colson) ECLI:EU:C:1984:153, Paragraph 26, and C-306/12 (Spedition Welter) ECLI:EU:C:2013:359, Paragraph 29. Also see Arena (2018) p. 316 and in relation to directives, Art. 288 of the TFEU.

[132] Cases C-371/02 (Björnekulla) ECLI:EU:C:2004:275, Paragraph 13 and C-106/89 (Marleasing) ECLI:EU:C:1990:39, Paragraph 8. C-456/98 (Centrosteel) EU:C:2000:402, Paragraph 17.

[133] Arena (2018) p. 327. Art 2(2) of the TFEU stipulates that Member States can only exercise competence within an area to the extent that the Union has not, or has ceased to, exercise its competence in the same area.

[134] Arena (2018) p. 315.

[135] See cases C-316/05 (Nokia Corp. v Joacim Wärdell) ECLI:EU:C:2006:789, Paragraph 21, C-467/08 (Padawan) ECLI:EU:C:2010:620, Paragraph 32 and C-516/17 (Spiegel Online) ECLI:EU:C:2019:625, Paragraph 62.

provisions shall be interpreted so as to give effect to the purposes of the relevant legislation.[136] Of particular interest here, the principle of effectiveness has a corrective function where it is used to examine whether national law is acceptable from the point of view of the protection of EU rights.[137]

Starting with the *context*, the competence to legislate is derived, in the Securitisation Regulation as well as the CRR, from Art. 114 of the Treaty on the Functioning of the European Union (the "**TFEU**"). Given the legislative foundations, it is reasonable to interpret the scope of the provisions on tranching and seniority in light of the free movement of capital as laid down in Art. 63 of the TFEU. The view that insolvency law falls within the scope of EU competence derived from the freedom of movement of capital is demonstrated *inter alia* by the 2019 directive on preventive restructurings.[138]

The relevant *objectives* are, in the Securitisation Regulation "laying down a general framework for securitisation and creating a specific framework for STS securitisation," further stating that "a level playing field in the internal market for all institutional investors and entities involved in securitisation should be ensured."[139] Further, the Securitisation Regulation "promotes the harmonisation of a number of key elements in the securitisation market." Importantly, the harmonisation of the "key elements" is "without prejudice to further complementary market-led harmonisation of processes and practices…" Market participants are encouraged to continue standardising processes and documentation.[140]

The prudential requirements of the CRR are "meant to ensure the financial stability of the operators on those markets as well as a high level of protection of investors and depositors." The regulation "aims at contributing in a determined manner to the smooth functioning of the internal market."[141]

4.3.2 *Arguments supporting the view that a harmonised understanding of tranching and enforceability is required by existing regulation*

The ranking of tranches determines the right to a certain regulatory treatment. Conversely, getting it wrong may give rise to administrative sanctions.[142] The provisions of the CRR and the Securitisation Regulation hence could be said to "operate in such a way that reliance thereon by individuals may not be frustrated by domestic provisions or

[136] On the effectiveness principle or effet utile, see e.g. cases C-45/79 (Comet) ECLI:EU:C:1976:191, C-469/17 (Funke Medien) ECLI:EU:C:2019:623 and C-399/11 (Melloni) ECLI:EU:C:2013:107, Paragraph 59.

[137] Hartkamp (2011) pp. 142-143.

[138] Directive (EU) 2019/1023 Recital (1) states that "The objective of this Directive is to contribute to the proper functioning of the internal market and remove obstacles to the exercise of fundamental freedoms, such as the free movement of capital and freedom of establishment, which result from differences between national laws and procedures concerning preventive restructuring, insolvency, discharge of debt, and disqualifications." The CJEU has held that Directive 88/361/EEC and the nomenclature set out in Annex I of the Directive can be used to define what is understood by the "capital movement," see e.g. C- 112/05 (Volkswagen) ECLI:EU:C:2007:623, Paragraph 18 and Ringe (2010) p. 381. Also see Joined Cases 286/82 and 26/83 (Luisi and Carbone v Ministero del Tesoro) ECLI:EU:C:1984:35, Paragraph 28, C-308/86 (Lambert) ECLI:EU:C:1988:405, Paragraph 16, and C-222/97 (Trummer and Mayer) ECLI:EU:C:1999:143, Paragraphs 26-28. Valiante (2016) p. 27 ff. describes several alternative legal bases for harmonisation of substantive insolvency law. For further developments, see EPRS Briefing (March 2023): Harmonising certain aspects of insolvency law in the EU (PE 745.671).

[139] Securitisation Regulation, Recital (46). Also see COM(2020) 282 final, Recital (23).

[140] Securitisation Regulation, Recital (38).

[141] CRR, Recital (7).

[142] See Section IV of CRD.

practices."[143] This perspective underscores the need for a uniform understanding of whether a contractual payment waterfall entails enforceability in relation to third parties.

Concretely, it would present market actors with considerable legal uncertainty if on the one hand, a securitisation position is treated as senior for investors' capital adequacy purposes, while at the same time the contractual features creating such seniority would be disregarded in case of an issuer's insolvency. The divergence both in the certainty of tranching enforceability and the cost of taking the necessary legal measures to achieve it runs contrary to the objectives of the relevant regulations discussed above. It is also at odds with the overarching aim of the free movement of capital. Recalling the possible carve-outs under Art. 65 of the TFEU, where Member States are allowed to limit the freedom of movement for capital, none of them are readily applicable here.

In light of the above arguments, it seems likely that national authorities would have trouble refusing to give effect to a contractually valid payment waterfall, even where a conform interpretation or "gap-filling" without conflict would be out of reach. Would they decide that the contractually established segments of debt in a securitisation will not *determine* (as the legal definitions stipulate) the distribution of losses in a transaction, but that such distribution will instead be determined by an application of national insolvency law? Or (although at odds with common sense) if national law on priority rather than the "contractually agreed segments" dictates the order of loss absorption in a transaction, does that mean that the transaction cannot be a "securitisation" under the Securitisation Regulation?

*4.3.3 Arguments supporting the view that a harmonised understanding of tranching and enforceability is **not** required by existing regulation*

Even though the financial regulations under scrutiny here have implications for the private law structure of transactions, they cannot unreservedly be interpreted so as to stipulate matters of national contract or insolvency law.[144] The regulations are stated (under the principle of proportionality) to not go beyond what is necessary in order to achieve their objectives.

Further, the persistence of diverging insolvency regimes is demonstrated by the final report of the Capital Markets Union High Level Forum. There, harmonisation of rules concerning creditor priority and the ranking of claims is on the list of pressing matters to be dealt with in future legislation.[145]

In a tax law context, it is noted that the mere disparity between national regimes is not enough to constitute a restriction on the free movement of capital.[146]

A narrow interpretation, where the reach of the relevant regulations is found to be limited to the explicit scope and the regulatory treatment of certain transactions, may also be

[143] See e.g. C-93/71 (Leonesio) ECLI:EU:C:1972:39, Paragraph 22. C-167/73 (Commission v France) ECLI:EU:C:1974:35, Paragraph 41. EU law takes supremacy even if the norm is not specific enough to have direct effect in the sense that it produces rights for individuals. Craig & De Búrca (2020) p. 310

[144] Mucciarelli (2021) pp. 16-17. Dalhuisen (2019) p. 1039.

[145] https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf., access 25 August 2020, p. 114. Also see the Report from the Commission to the Council and the European Parliament, Accelerating the capital markets union: addressing national barriers to capital flows, (COM)2017 147 final, pp. 9-10 and Valiante (2016) p. 20 on harmonisation of the ranking of creditors.

[146] Ringe (2010) p. 406. TFEU Art. 65(1)(a) however contains an explicit exemption for tax law.

supported by a look at the drafting in comparable fields. In the framework for covered bonds, the relevant EU acts have explicitly required changes to domestic insolvency laws to ensure alignment.[147] The same is true for the priority ladder applicable in bank resolution.[148] Under the 2019 directive on preventive restructuring, substantive harmonization is explicitly prescribed.[149] The absence of such techniques and explicit purposes in the securitisation framework indicates that the reach is limited.

A further reference for interpretation is offered by studying the Greek and Italian special legislation relating to securitisation of non-performing loans. In that context, "senior" has become a legally defined term in order for it to operate within the framework of state guarantee schemes.[150]

4.3.4 *A harmonised understanding should be sought whether or not it follows from current EU regulations*

Let us assume that the last arguments in favour of a narrow interpretation are accepted. A conflict is not seen to exist between the regulation of securitisation and national laws were they to refuse (or make exceedingly difficult) enforceability of a contractually agreed payment order on insolvency. Even in this case, given the current momentum for further substantive harmonisation, initiatives to extend the scope cannot be excluded. National authorities are also arguably already under an obligation to accommodate an interpretation in furtherance of the regulatory framework where domestic law harbours such possibility.

A "harmonised understanding" as discussed is this paper should not be interpreted as not allowing the national legal systems to be different in respect of the ways in which enforceability is achieved. National legal systems should arguably however not be different in whether or not certainty on enforceability is possible; and the ways of obtaining enforceability should not for some jurisdictions be so costly as to deter from transactions that would otherwise have been economically desirable.

If indeed domestic courts are (or in the near future will be) expected to give effect to the tranching of debt as it appears in the securitisation framework, they would not do so from scratch. There will not be a legal vacuum, but a body of domestic insolvency and contract law where this concept needs to fit in. The remainder of this paper aims to contribute to such legal operation.

[147] See the new Covered Bonds Directive (2019/2163 (EU)) which is currently under implementation. Recital (2) thereunder remarks that "While those additional requirements increase the level of harmonisation of covered bonds within the Union, they serve the specific purpose of establishing the conditions to be satisfied in order for covered bond investors to receive such preferential treatment, and are not applicable outside the framework of Regulation (EU) No 575/2013."

[148] Directive 2014/59/EU as amended by Directive (EU) 2019/879 (BRRD2) and its Recitals (4), (5) and (10). Also see Directive 2017/2399, Recitals (7) and (12).

[149] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, Recital (1).

[150] See ECB Opinion CON/2019/42 and Linaritis (2020) pp. 26-27.

5 The legal construction of tranching – comparative review

5.1 Introduction

5.1.1 Legal modules to be examined

As discussed, tranching of debt does not represent an established legal concept outside of being defined in the Securitisation Regulation. An arrangement to divide debt issued by a single legal entity into different tranches should match on the one hand a desired regulatory treatment and on the other, the commercial agreement of the transacting parties. The desired result, to produce tranches of debt with different seniority, is achieved by combining different established legal tools or building blocks that I refer to as *modules.*[151]

By looking at such modules, this section aims to provide a starting point for thinking about what could be a transnational private law understanding of "tranching" or "seniority." Arguably, as discussed above, the recognition of an enforceable payment waterfall might already be required by the expectations on market participants implicit in the Securitisation Regulation.

Let us therefore consider what is already taking place in the market, and if "seniority" or "tranche" as regulatory concepts could be made clearer in terms of their private law contents. If domestic courts would be required to give effect to contractually agreed segments of debt, are there private law explanations that could be understood across jurisdictions?

It was noted above, in relation to the distinction between contracts that are valid between the parties and those that are also enforceable in bankruptcy, that parties "cannot contract out of insolvency distribution." The principles of *lex concursus* and *lex rei sitae* point to the law of incorporation of the issuer to determine some of the core elements underpinning the enforceability of tranching.[152] In securitisation, parties can however be seen to contract *away from* the domestic insolvency distribution. Where domestic law would not uphold a contractual payment waterfall in the bankruptcy of an issuer, either no SSPEs are incorporated in that jurisdiction; or legal modules are combined to replace the law with private enforcement mechanisms.[153] The key term that runs through all of these modules is "bankruptcy remoteness"; meaning in this context that the payment waterfall (and other elements of a transaction) should not be tested. At the same time, the enforceability of a payment waterfall is part of what *makes* a transaction bankruptcy remote, since a seniority structure that is open to challenges also entails an incentive for subordinated creditors to take legal action.[154]

The most noteworthy modules that are deployed to create an enforceable payment waterfall are:

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[151] See Pistor (2019) p. 3 on the term "module" as a way of explaining legal tools that can be combined to produce legal concepts and ultimately a desired economic result.
[152] See footnote 71 above. On *pari passu* distribution in bankruptcy generally, see Gullifer & Payne (2015) p. 256.
[153] Grimaldi & Barrière (2011) p. 1087 discuss that where parties (in the context of trust and *fiducie*) "are unable to find an appropriate tool within their national legal system, they will more often try to find it elsewhere."
[154] Moody's Cross-Sector Rating Methodology: Bankruptcy Remoteness Criteria for Special Purpose Entities in Global Structured Finance Transactions (October 7, 2014) p. 4. See e.g. the case of Bank of New York v Montana Board of Investments [2008] EWCH 1594 (Ch): [2009] 1 All E.R. (Comm) 1081: [2008] 7 WLUK 299 (Ch D).

(a) *overriding law*; being law (whether judge made or statutory) that explicitly allows tranching of debt and directs the courts to respect such tranching arrangements;[155]

(b) *trustee and agency functions* that allow security to be held on behalf of noteholders and that enable control over cashflows for distribution according to an agreed payment order;

(c) *limited recourse,* meaning in the base case that investors agree to neither claim payment from assets of the issuer beyond their collateral, nor beyond what is available after satisfaction of more senior tranches; and

(d) *non-petition undertakings* by investors, seeking to restrict individual noteholder action, protect an issuer from bankruptcy, and prohibiting claims against an issuer in contradiction with the agreed payment order.

This review aims to discern to what extent each of these modules are considered effective in the covered jurisdictions.[156] When identifying these contractual features, the aim has been to disentangle elements that work directly in relation to the ranking of tranches. The measure of providing security is not separately analysed beyond the sections on trustee and agency.[157] Another example of "modules" not covered here is the restriction of SSPE business operations, even though that measure seeks to limit the existence of non-contracting creditors.

Further, the management of legal risk as discussed here does not serve to protect noteholders from defaults in the underlying portfolio. Rather, the features included to reinforce a payment waterfall and bankruptcy remoteness of an SSPE should provide that nothing *except* an actual deterioration in the underlying assets can cause payment defaults, and that in case of such deterioration, it will strike noteholders in the agreed order of loss absorption.

That being said, the terms and conditions of real transactions contain all of these and other elements that are mutually reinforcing. It should also be stressed again, that the insolvency related legal risks in focus in transaction documents as well as in the legal discourse are predominantly those that pertain to the relationship between originator and SSPE. Tranching, in the private law sense, is however about the relationship between the SSPE and the noteholders, and the noteholders among themselves.

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[155] The term "overriding" is used by Hughes (2017) p. 876, to describe (from a US perspective) laws in certain states that have been enacted to promote securitisation and ensure enforceability of the transaction terms regardless of the underlying property and insolvency law.

[156] It is worth mentioning again that these modules are not the only legal tools used to structure a securitisation transaction, nor does enforceability of the tranching element represent the only interesting legal aspect. Other salient features of securitisation are discussed in section 2.3 (*Typical features*) above.

[157] Enforceable security interests are, in many cases, instrumental in upholding the priority of payments. However, the topic merits a discussion of its own, not least because security and assignment of receivables and of financial collateral are the subject of substantive harmonisation efforts (see footnote 71). Taking security and organising it in an intended order of seniority fulfils partly different, and partly overlapping functions as compared to an agreement on ranking of claims. One important distinction being that security typically is a way of obtaining priority over, and (ideally) smooth realisation of, *specific assets* of the debtor.

5.1.2 *Outline of the comparative review*

First, each of the modules referred to in items (a) – (d) above will be introduced in relation to the jurisdictions covered. *Secondly*, a comparison will be outlined as a simplified distress scenario, seeking to exemplify specific problems that each of the modules is designed to address. The purpose of using the distress scenario is to make visible where and why transaction costs or potential timing issues may become prohibitive or serve as a competitive disadvantage. Transactions are structured to not only guard against an ultimate unenforceability of obligations, but against timing (and hence liquidity) disruptions.

5.1.3 *UK exit from the EU*

31 December 2020 marked the end of the transition period in respect of the withdrawal by the United Kingdom from the European Union. As of that date, the Securitisation Regulation was transposed into the UK Securitisation Regulation by the European Union (Withdrawal) Act 2018. Minor changes have been made to adapt the regulation to applying in the UK as a domestic legal instrument.[158] At the same time, a national register has been launched to provide for the registration of transactions qualifying as STS for UK purposes.[159]

Importantly, the EU has not provided for an exception or grandfathering provision allowing investors to continue to treat UK transactions that have previously qualified as STS in the ESMA register, as EU STS transactions for capital adequacy purposes.[160] Art. 18 of the Securitisation Regulation reads: "The originator, sponsor and SSPE involved in a securitisation considered STS shall be established in the Union." The corresponding article in the UK Securitisation Regulation however contains a two-year grace period within which transactions registered as STS with ESMA will be treated as such for UK purposes. As mentioned above, the CRR and CRD have been brought into UK domestic legislation by the European Union (Withdrawal) Act 2018.

The UK Securitisation Regulation is equivalent to the Securitisation Regulation in all material respect for the purposes of this paper. However, recent amendments introduced in the Securitisation Regulation after 31 December 2020 have not made it into the UK equivalent. Certain provisions, for example in respect of non-performing loans, are therefore currently different in the two instruments in addition to there now being two separate STS regimes.[161]

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[158] See the Securitisation (Amendment) (EU Exit) Regulations 2019 No 660.

[159] The UK register which applies for UK transactions instead of the ESMA register can be found here: https://data.fca.org.uk/#/sts/stssecuritisations (accessed on 26 January 2021). The review undertaken for this paper comprised all public transactions listed in the ESMA register as of 31 October 2020; hence the UK transactions there reviewed have been removed and listed under the FCA regime.

[160] The ESAs issued a statement on 7 December 2020, clarifying that UK STS transactions would be removed from the ESMA register at the end of the transition period, and that the preferential capital treatment would "come to an end" on 31 December 2020.

[161] See 2.2.1 (*The EU Framework for High Quality Securitisation*) above in relation to the recently adopted amendments to the Securitisation Regulation.

5.2 Legal modules and their relevance in covered jurisdictions

5.2.1 Overriding law

5.2.1.1 General background

As discussed, both civil and common law jurisdictions harbour a conceptual divide between matters governed by the laws on contract and matters of insolvency law. The mandatory nature of insolvency law means that agreements that purport to determine what will happen in relation to insolvency will be, as a starting point, problematic. That is, in the absence of legal support for upholding such agreements. The classification of a problem as either contractual or related to either public law or mandatory insolvency law also has a bearing on whether parties may choose the law to be applied to their arrangements in case of a conflict.[162] This section will address how each of the jurisdictions covered deals with that "stumbling block" that insolvency law can be said to represent for the free contracting on payment priorities.[163]

5.2.1.2 English law

Under English law, court precedents provide a high level of comfort in relation to the enforceability of agreed payment waterfalls. Rather than relying on special legislation, one finds support in court-settled principles of general application. As seen in *Belmont* and other recent cases, English law not only recognises that parties may agree on the priority of payments among themselves in the insolvency of a common debtor, but also on the alteration of such payment priorities on the insolvency of a creditor.[164] The limits to freedom of contract in this area are drawn where parties would infringe the *pari passu* or *anti-deprivation* principles under English law.[165] Recent changes to the restructuring frameworks under English law introduced provisions barring *ipso facto* clauses, but such provisions do not apply to financial services (as that and certain other exempt services are defined) and so for example a "flip clause" altering the payment priority for a swap counterparty on insolvency would still be upheld under the new regime.[166]

Any uncertainties as to the enforceability of tranching expressed in transaction documents tend to raise matters of international insolvency law in this context, rather than any real concerns should an English SSPE become insolvent. A risk factor that has become more or less standard reads:

[162] Rome I Regulation (EC) 593/2008, Art. 3 (1) and (3) and Insolvency Regulation (EU) 2015/848, Art. 7 (1). Also see the case C-308/17 (Leo Kuhn v. Hellenic Republic) ECLI:EU:C:2018:911, in relation to jurisdiction under Art. 7 (1)(a) of the Brussels Regulation (EU) No 1215/2012. A matter concerning the rights of a bondholder in relation to the restructuring of Greek sovereign debt was not held to fall within the realm of civil and commercial matters, determining the framework for resolving a dispute. Also see cases C- 649/16 (Valach) ECLI:EU:C:2017:986 and C-641/16 (Tünkers) EU:C:2017:847, paragraph 28, on the demarcation between insolvency law matters and matters that fall within the scope of the Brussels Regulation.

[163] Pistor (2019) p. 144.

[164] Belmont Park Investments Pty Limited v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc. [2011] UKSC 38.

[165] Gullifer & Payne (2015) pp. 260-261 and Wood, Project Finance (2019) p. 145. Cranston et al. (2018) pp. 449-450. The anti-deprivation principle, referred to in British Eagle International Airlines Ltd v. Compagnie National Air France, [1975] 2 All ER 390, enables invalidation of a transaction the effect of which is to deprive a company's creditors of property that would otherwise have been realised for their benefit. Further on this and the *pari passu* principle, see especially the arguments in Re Maxwell Communications Corporation plc [1993] 1 WLR 1402.

[166] The Corporate Insolvency and Governance Act 2020, Schedule 12 Part I.

"There is uncertainty as to the validity and/or enforceability of a provision which (based on contractual and/or trust principles) subordinates certain payment rights of a creditor to the payment rights of other creditors of its counterparty upon the occurrence of insolvency proceedings relating to that creditor. In particular, recent cases have focused on provisions involving the subordination of a hedging counterparty's payment rights in respect of certain termination payments upon the occurrence of insolvency proceedings or other default on the part of such counterparty (so-called "flip clauses")./…/."[167]

This reservation is relevant where – as is often the case – swap counterparties are affected by New York law. It therefore tends to be included in securitisation risk factors regardless of SSPE jurisdiction.

5.2.1.3 French law

Another way of addressing the conceptual divide between mandatory insolvency law and freedom of contract is to create product-specific institutions that do not fall within the scope of the main insolvency and restructuring laws. This has been the chosen path for some of the European civil law jurisdictions, exemplified here by France.[168]

Parties opting for a French securitisation structure may choose a form of entity which is designed to embody the tranching element of securitisation in its constituting documents. The entities are called *fonds communs de titrisation* ("**FCT**") or (the less common) limited liability companies for securitisation purposes ("**SDT**"). The notes issued by such entities only exist in the assigned tranches.[169]

The fact that there is a particular type of entity available for issuance of tranches of debt would perhaps not necessarily mean that there are no insolvency related uncertainties. In France, however, the law provides that an FCT is not a legal person and the insolvency laws are disapplied.[170] It is hence truly bankruptcy remote.[171]

5.2.1.4 German law

In Germany, the law does not provide a particular legal framework for securitisation like the French and others in the Napoleonic jurisdictions.[172] Nor is there a body of court precedents supporting that an *ex ante* bargain regarding payment priorities would be upheld in bankruptcy.

[167] See for a recent example the 2021 transaction "E-Carat 12 PLC": https://pcsmarket.org/pcs-transaction/503 (accessed 14 June 2021), p. 73 at 6.12.
[168] Others with similar regimes include Luxembourg, Belgium, Spain, Portugal and Italy.
[169] Under Arts. L. 214-166-1 to L. 214-175, L. 214-180 to L. 214-186, L. 231-7 and Arts. R. 214-217 to R. 214-235 of the French Monetary and Financial Code. The first form of securitisation special vehicle was created in France in 1988 under Law No. 88-1201 dated 23 December 1988 (the Securitisation Law).
[170] Art. L.214-175 III. of the French Monetary and Financial Code reads: "Le livre VI du code de commerce n'est pas applicable aux organismes de financement." Livre VI (Book VI) of the commercial code comprises bankruptcy liquidation as well as preventive restructuring procedures such as the "sauvegarde" and moratoria.
[171] Insolvency or restructuring can however take place in other entities than the issuer, indirectly affecting the transaction. An FCT is set up by a fund manager (*société de gestion*) and fund custodian (*dépositaire*), each of which may be the subject of insolvency or restructuring (but then they would be replaced). See *Cour d'appel de Paris*, fifth section, 25 Feb. 2010, *Coeur Défense*, RG number 09/22756; Decision of the *Cour de cassation* dated 8 March 2011.
[172] The term "Napoleonic" is used as explained in the works of Philip R. Wood, e.g. in Wood, Comparative Law (2019) p. 12.

Where SSPEs are incorporated in Germany, they tend to be limited liability companies in the form of UGs (*Unternehmergesellschaft (haftungsbeschränkt*)). A recognised way of establishing orphan SSPEs under German law is to take advantage of the services and platform of the company TSI GmbH.[173]

Securitisation with a German SSPE has long been disadvantageous from a tax perspective, except where the securitised assets are originated by banks.[174] In a review of public STS transactions between 1 January 2019 and 31 October 2020, only five of the 27 transactions listed as "German" in the ESMA register had German incorporated SSPEs.

Securitisation vehicles are caught by the insolvency laws of general application found in the Insolvenzordnung 1999 (InsO).[175] In an insolvency of the issuer, funds would be distributed according to the statutory order of priority. This would entail equal ranking among unsecured creditors, and the need to rely on the contractual provisions, such as an obligation to turn over funds received in contradiction with the agreed waterfall.[176] German law hence clearly demonstrates the need for supporting legal techniques in order to ensure enforceability of agreed payment priorities.

5.2.1.5 Dutch law

Dutch law does not provide a legal framework or forms of legal entities particularly aimed at securitisation. An SSPE incorporated under Dutch law tends to be a limited liability company (*besloten vennootschap met beperkte aansprakelijkheid*), governed by Title 2:5 of the Dutch Civil Code (*Burgerlijk Wetboek)*. The shares of such company are often, as in other jurisdictions, held by a foundation and managed by independent servicers in order to protect the independence of the SSPE in relation to the originator.

Unlike the other jurisdictions reviewed here however, Dutch law contains statutory support for the subordination of tranches. Section 3:277(2) of the Dutch Civil Code reads (in translation): "The creditor and debtor may arrange by agreement that the debt-claim of the creditor in its relation towards the debt-claims of certain or all other creditors is ranked lower than it would be according to law."[177]

The agreement on subordination under this provision must be made between the debtor and the creditor and not between the creditors concerned only, and must not be subject to amendments without the consent of all creditors.[178] This would be in line with the documentation practice for securitisations, where an agreed payment waterfall may not be altered by agreement between the SSPE and only certain of the creditors. An agreed payment waterfall would hence be enforceable under Dutch law on this basis. Parties will want to ensure bankruptcy remoteness for other important reasons (such as timing and

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[173] True Sale International GmbH (TSI). See the International Comparative Legal Guide to Securitisation 2019, 12th ed (hereafter "**ICGL**") p. 160 for current views on market practice.

[174] Graziadei et al. (2005) p. 513. ICGL, p. 160.

[175] Insolvenzordnung v. 5.10.1994, (BGBl. I p. 2866) (hereafter "**InsO**").

[176] See InsO § 39, Faber et al. (2016) pp. 300-301, and Wood, International Insolvency (2019) p. 279. This is a view likely to be found in the Nordic legal family as well, although there is no clear precedent or legislative authority. See Göthlin (2023).

[177] A similar wording was proposed by the Nordic-Baltic Recommendations on Insolvency Law (2016) VIII:6. Also see UNCITRAL Legislative Guide on Insolvency Law, Part I and II (2004) p. 268 (59).

[178] Dutch Securitisation, General overview of a typical Dutch true sale securitisation May 2015, p. 16, accessed on 26 November 2020 (www.dutchsecuritisation.nl) (hereafter "**Dutch Securitisation Overview**").

effects on other agreements). However, no additional legal tools are believed to be strictly necessary to ensure that the seniority structure would be upheld *ex post*.

5.2.2 Trustee and Agency

5.2.2.1 General background

The matter of trustee or agency functions in the context of tranching is essentially about two things.

First, it is about the practicalities of issuing debt to multiple investors, especially where the debt is to benefit from security over assets of the issuer. As in all secured capital market transactions, the assets subject to security must be "held" by someone.[179] A third party should also be in control of enforcement and distribution of enforcement proceeds in accordance with the agreed payment waterfalls.

The major assets typically held as security on behalf of noteholders are rights under the receivables subject to securitisation and money on bank accounts. The SSPE would also grant security over its rights under the transaction documents, derivatives, and other potential sources of value protection. If the original receivables are secured by e.g. home mortgages, the original security should attach to the receivables when transferred. It is possible, in all four jurisdictions covered, to grant and obtain enforceable security interests over such assets. Security may in principle be granted over future receivables so long as there is a specified means of identifying such assets. Further, while notice to debtors is required in order to obtain a security interests that is free from the risk of being affected by set-off or discharges with the originator, notice can be (and is) omitted in transactions since it is not required for a perfected security interest to be created.[180]

Secondly, the flow of funds in a securitisation transaction should be under the control of an independent entity, especially after a default or an insolvency related event. The control of cash flow from this perspective is a proxy for protecting and separating funds on behalf of each class of creditors, for application in accordance with an agreed payment waterfall. Prior to a default, the management of cash flow in a transaction is supported by a number of different agents, as illustrated in Figure 3 (*Transaction structure including agency roles in recent STS transaction*) below. In distress situations, control over cash flows should vest with a trustee (or equivalent) acting on behalf of noteholders.

The flip side of the trustee function as it pertains to management of defaults is the non-petition clauses discussed below. Under trust or agency arrangements, noteholders waive some of the rights that would otherwise accompany the holding of a claim against the SSPE. Under non-petition clauses in the note terms and conditions and the trust deed (or equivalent), noteholders undertake not to take individual action against the issuer.

Some general legal requirements should be met in order for the third-party function to work, whether it be fulfilled by a trustee or one or more agents with equivalent capacity:

(i) First, the third party must be able to hold security on behalf of a shifting collective of creditors.

[179] In traditional lending, an agency function may be fulfilled by one of the lending institutions as well as an external entity. In case one of the lenders in a syndicate for example acts as both lender and security agent on behalf of all secured parties, contractual safeguards are provided to protect other lenders from conflicts of interest. See Cranston et al. (2018) p. 252. On legal aspects of trustees in note issuances generally, see Rawlings (2007).

[180] Wood, Project Finance (2019) pp. 137-138.

(ii) Secondly, the third party must be able to represent the noteholders in legal proceedings and enforcement, to deal with turning security assets into funds for repayment. Its mandate should not, in order to protect the legal certainty of the arrangement, be open to challenges, competing actions and/or withdrawal by opportunistic investors. Ideally, from the point of view of upholding agreed payment priorities, noteholders must not be able to take individual action directly against the issuer.

(iii) Finally, the third-party construction must be reliable in terms of proprietary bankruptcy risk and conflicts of interest. The entity should be able to hold assets separately on behalf of clients, so that they are protected from creditors in its own bankruptcy.

In case all of the above conditions are fulfilled, the method of having a third, independent party manage security and legal proceedings, and control the distribution of payments, effectively limits the need for recognition of an agreed payment waterfall as such in the issuer's jurisdiction. Instead of looking at "tranching" as a concept that requires recognition from the point of view of insolvency law, it would be sufficient to review the integrity of the third-party arrangements.

A review of public STS transactions to date allows the conclusion that a professional trustee entity is always used to hold security and take enforcement action, except where there is overriding securitisation law such as the French. Trusts are used regardless of their being recognised in the SSPE jurisdiction. However, in such cases a caveat may be included in the documentation should a court reframe the arrangement according to domestic law.[181]

The preference for using trust constructions over agents for the three key functions listed above, might be explained by a fundamental difference between the two concepts. An agency contract will typically, in many jurisdictions, be interpreted so as to cease on the insolvency of either the principal or the agent. As such, a mandate construed as agency is vulnerable to insolvency proceedings in relation to both the issuer (insofar as an agent draws its authority from the appointment by the issuer) and individual creditors.[182]

[181] For example, the terms of a German Prospectus contain a clause headed "Declaration of Trust (*Treuhand*); Reinterpretation as Agency Agreement." From a *de lege ferenda* perspective, Grimaldi & Barrière (2011) do not see any real objections to why a function like the one fulfilled by the trust institute in common law countries should not be made available in all EU jurisdictions.

[182] Gullifer & Payne (2015) provide a basic understanding of agency under English law, p. 371: "…a person who acts on behalf of another person so that the former can affect the latter's legal relations with third parties." The French "security agent" discussed in 5.2.2.3 below is an example of an institution that is equivalent to an English law trust in relation to the tasks described. So is the recently introduced Finnish "ombud" under the law (574/2017) on noteholder agents. The "agent" as the term is used here on the other hand reflects the contract law institution in its most basic form, as understood in the European model law projects, see von Bar et al.: DCFR, Chapter IV Part D on Mandate Contracts. Also see Gullifer & Payne (2015) p. 380 and Wright (2014) p. 327 on the distinctions between agency and trustee arrangements in debt issuance generally. Also see Linaritis (2020) p. 21.

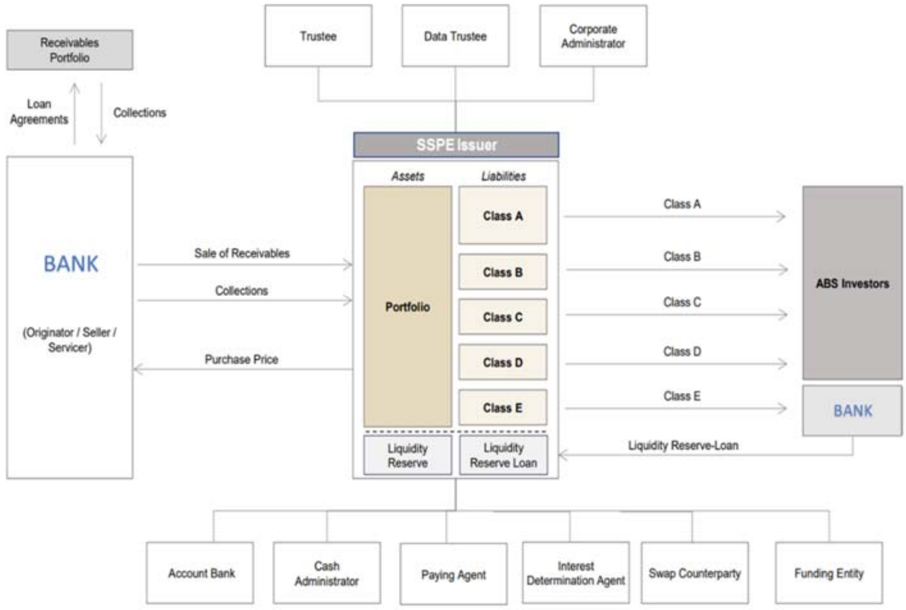

Figure 3: Transaction structure including agency roles in recent STS transaction

The above figure points out the contractual links between parties. The cash flow however will typically move along different paths. The agency functions illustrated above are organised so as to avoid the accumulation of funds in any accounts that may be drawn into an insolvency of the originator or the issuer. Therefore, income due to the issuer is swiftly to be removed from (or never touch) accounts that are set up in the name of the issuer or the originator unless such accounts are properly segregated and/or made subject to security in favour of noteholders.[183]

A factor in assessing the enforceability of agency or trustee arrangements is that in note issuances, the legal relations may be complicated by the mechanics of holding of dematerialised securities. One therefore needs to take into account how investors become bound by the terms of the bonds issued in securitisation in each relevant jurisdiction, and how the legal positions of the parties involved are affected by intermediate holdings.[184]

Further, it is not sufficient that the governing law of an agreement or deed appointing the agent or constituting the trust provides legal certainty; the law where any insolvency proceedings may take place must not override the necessary features of the relevant third

[183] In jurisdictions such as France, overriding law will provide for proper bankruptcy remoteness of cash in the structure. On the management of cash flows in securitisation generally, see Wood, Project Finance (2019) p. 143.

[184] Gullifer & Payne (2015) pp. 387-389 and Wood, Project Finance (2019) p. 216. Also see UNIDROIT Convention on Substantive Rules regarding Intermediated Securities 2009 (the Geneva Securities Convention) and Hague Convention on the Law Applicable to Certain Rights in respect of Securities Held with an Intermediary 2006. See C-375/13 (Harald Kolassa v. Barclays Bank plc) ECLI:EU:C:2015:37, in relation to jurisdiction. Further, see Secure Capital SA v. Credit Suisse AG [2015] ECWH 388 (and Court of Appeal [2017] EWCA Civ 1486) where it was held under English law that an investor in immobilised bearer bonds did not have standing to sue the issuer of notes for breach of the note terms and conditions.

party's mandate. The conditions outlined above will therefore be considered in relation to the four jurisdictions here under review.

5.2.2.2 English law

It has often been said that English law is especially well suited among European legal systems as the governing law for commercial transactions. One of the aspects pointed to in this context is the availability of the trust.[185]

The main benefit of the trust in this context is that it provides a well-established method for obtaining certainty in respect of the legal requirements referred to under (i)-(iii) in 5.2.2.1 (*General background*) above. Looking at transactions where English law is not only chosen as governing law of the notes, but also the law applicable to property rights and insolvency, the agency/trust requirements listed above do provide comfort to transacting parties. In addition to the availability of the trust institute, English law also enables parties to issue irrevocable powers of attorney that would likely not be revoked upon a winding-up or insolvency of an issuer.[186]

Seen from another angle, the superior reliability of a trustee in financing is one of the features of English law that can get lost in translation when transaction documents that have been developed mainly in common law systems are used as a starting point for other jurisdictions. Transactions tend to be based on the documentary standards developed under the influence of common law, regardless of the issuer jurisdiction. Further, the *lingua franca* of finance is English, which means that concepts in all other jurisdictions somehow need to relate semantically to the English law terms.[187]

In addition to the security trustee function discussed in the context of tranching enforceability, in common law jurisdictions, a form of trustee may also hold the assets subject to securitisation in lieu of another form of SSPE. This may be appropriate where for example an asset pool consists of short-term, constantly variable receivables that are suitable for a floating allocation of beneficial interests between the investor and the originator. In fact, the French FCT (and similar entities) can be compared to the trust as a collective investment vehicle.[188]

5.2.2.3 French law

Trusts are not generally recognised under French law, and France has not ratified the Hague Convention on the Law Applicable to Trusts and on their Recognition (the "**Hague Trust Convention**").[189] Notably though, the French Supreme Court has recognised the concept of a trust when constituted under New York Law.[190] In addition, a similar concept

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[185] Conditions for constituting a trust, see Gullifer & Payne (2015) pp. 362-371 and the "three certainties" as set out by Lord Langdale MR in Knight v. Knight (1840) 3 Beav. 148. On turnover trusts, of particular interest in relation to layers of debt, see Wood, Project Finance (2019) pp. 247-248.

[186] Section 4 of the Powers of Attorney Act 1971 (the **PoAA**). Also see Sowman v. David Samuel Trust Ltd [1978] 1 WLR 22. It does not seem entirely clear whether a court would extend the rule in the PoAA to administration. Powers to act for enforcement of security rights may also be subject to court or administrator consent, see Paragraph 43 and 44 Schedule B1 to the Insolvency Act 1986 and Re Atlantic Computer Systems plc [1992] Ch 505 (CA).

[187] See 1.2.3 (*The x y z of norm-making as analytical tool*) above re the *lex financeria* which is based to a large extent on the practices of lawyers trained in common law jurisdictions.

[188] Wood, Project Finance (2019) pp. 126-127.

[189] For signatories and status, see the convention website (accessed on 26 November 2020): HCCH | #30 - Status table.

[190] *Belvédère case:* Cass. com., 13 sept. 2011, n° 10-25.533, 10-25.731, 10-25.908, 840: JurisData n° 2011-018623.

as the trust was introduced into the French Civil Code in 2007. The *fiducie* allows a party to isolate assets into a special-purpose fund which is managed by a fiduciary for the benefit of the constituent or a third-party beneficiary.[191] This however did not solve the problem of holding security and enforcing on behalf of multiple creditors. Parties still made use of the "parallel debt" concept, and uncertainty lingered as to the ability of security trustees or agents to enforce on behalf of noteholders.

Therefore, in response to market needs, a law on security agents was introduced in 2017 in sections 2488-6 et seq. of the French Civil Code.[192] A security agent governed by said provisions of the Civil Code would fulfil the requirements discussed above in relation to a trust, being the ability to hold security on behalf of a shifting group of noteholders, to enforce on behalf of noteholders, and to hold assets separately (through the *patrimoine affecté*) from a future insolvent estate of the agent.

Although the agency function has been significantly improved under French law, it would typically not be used in securitisation since the overriding law discussed above makes such arrangements redundant. Security is rarely granted in French structures since the assets of an FCT are not to become the subject of insolvency proceedings. The payment priorities of tranches are further protected by the constitutional documents of the FCT, and so these transactions do not require the support otherwise provided by a trustee or a French law security agent. As for the control of cash flows, Arts. L. 2014-173 and D.214-228 of the French Monetary and Financial Code provide for dedicated bank accounts for collections under the securitised receivables.

5.2.2.4 German law

German law does not provide for trusts and Germany has not acceded to the Hague Trust Convention.[193] The recognition in Germany of trusts constituted under laws of other jurisdictions is therefore uncertain. No particular legislation has been enacted to establish a security agent or trustee-like function that can be certain to fulfil the requirements discussed in (i)- (iii) above.

A contractual institute similar to the trust, *Treuhand* can be and is utilised in German transactions. The documents speak of "security trustee (*Treuhand*)", both using the common law term and implying that it should be interpreted as the German concept.[194] The trustee will hold an independent claim (expressed in a similar way as the Dutch parallel debt described below) against the issuer corresponding to the claim held by the secured parties.

However, the use of the proprietary German institution is limited by the fact that only the original assets are immune from competing creditor claims, not additions or substitutions.[195] Segregation from other assets of the trustee is accomplished by

[191] See *Loi n° 2007-211 du 19 février 2007 instituant la fiducie*, JORF n°44 du 21 février 2007 page 3052, texte n° 3.
[192] As introduced through the *Ordonnance n° 3027748 du 4 mai 2017 relative à l'agent des sûretés* JORF n°0106 du 5 mai 2017, texte n° 91.
[193] For signatories and status re the Hague Trust Convention, see the convention website (accessed on 26 November 2020): HCCH | #30 - Status table.
[194] Grimaldi & Barrière (2011) p. 1090.
[195] Wood, International Insolvency (2019) p. 274.

contractual arrangements and not protected as would be the case had there been a true trust equivalent.

The documentation of German securitisations conveys the view that there are no authoritative statements to the effect that the commonly used security trustee arrangements would not be enforceable under German law. There are however statements from courts and legal literature in support of the recognition of *Treuhand* in the case of insolvency of the trustee. Should an agency function be used instead of the trust, or a trust be re-characterised by a court as a kind of agency agreement, such arrangements are subject to termination upon an insolvency of the issuer.[196]

In addition to the contractual provisions of notes, the mandatory German Act on Issues of Debt Securities dated 31 July 2009 (*Gesetz über Schuldverschreibungen aus Gesamtemissionen*) applies to the representation of noteholders.

In sum, for German SSPE structures, the agency or trustee function is not, stand alone, a reliable tool for achieving enforceability of an agreed payment waterfall. In relation to holding of security on behalf of noteholders, the "independent claim" construction used under German law is believed to work but has not been tested in court. In respect of the second criterion – being able to exclusively represent noteholders in enforcement or court proceedings – the lack of a recognised trust concept means that the structure is vulnerable to the (albeit unlikely) insolvency of the issuer. Lastly, the third criterion is met by way of contract and not protected by the legal institution of trust itself.

5.2.2.5 Dutch law

Dutch law does not have the concept of trust. Unlike Germany and France however, the Netherlands is signatory to the Hague Trust Convention.[197] A trust validly created under another jurisdiction will therefore (subject to certain conditions) be recognised by a Dutch court. In Dutch SSPE securitisations, a foundation (*stichting*) will typically be used and referred to as security trustee for the noteholders, even though it is not a "trust" as understood in common law jurisdictions or under the Hague Trust Convention.[198] The foundation will be independently managed and its business dealings restricted.

The first issue to consider for Dutch trustee arrangements is not whether a trust can be validly created (as there is no such concept under Dutch law), but rather whether under Dutch law security can validly be granted to a person who is not the creditor under the secured claim. In order to allow security to be held by a security trustee or agent for the noteholders, the market therefore uses a concept known as "parallel debt." A claim is created in favour of the trustee, giving it its own, separate, independent claim on identical terms as the noteholders.[199] This has not been tried in court, but transactions reviewed express confidence that such arrangements would be upheld. Hence, the third-party function of holding security on behalf of noteholders can be fulfilled, albeit accompanied by a grain of uncertainty. Further, since it has its own claims due to the parallel debt arrangements, the trustee may act in its own name against the issuer to recover the debt

[196] InsO § 115 et seq. provides that powers of attorney and mandates will terminate upon insolvency by operation of law.
[197] For signatories and status, see the convention website (accessed on 26 November 2020): HCCH | #30 - Status table.
[198] Dutch Securitisation Overview p. 20.
[199] Dutch Securitisation Overview pp. 18-19.

and enforce security. (See however below in relation to non-petition undertakings by noteholders.)

The third requirement discussed above to make a trustee or agency function ideal, is that such external party should be able to keep funds separate on behalf of noteholders. This requirement does not appear to be fulfilled in Dutch securitisations. In reviewed STS transactions, it is stated that the security trustee will not be able to hold funds received from the security assets segregated in the case of the trustee's own insolvency.

In sum, Dutch law contains a particular complication since it does not with any certainty recognise that security may be held by a third party on behalf of the noteholders, nor is a trustee holding security based on a parallel debt basis able to segregate funds for the benefit of noteholders. This is however mitigated by the fact that each transaction typically will have a separate security trustee, which is not allowed to engage in any activities outside that role.

5.2.3 Limited recourse obligations of the SSPE issuer

5.2.3.1 General background

The term "limited recourse" in a securitisation context refers to contractual provisions to the effect that repayment cannot be sought by a noteholder beyond what derives from certain specified assets of the SSPE, nor beyond what remains after more senior claims have been satisfied.[200] It is not necessarily tied to collateral.

Where all known creditors have validly agreed not to claim against the SSPE in excess of what is available to them from the SSPE assets and in accordance with the payment waterfall, it is highly unlikely that the SSPE could ever be deemed insolvent.[201] The limited recourse can be seen as a natural element of securitisation, where the risk transferred from originator to SSPE and then on to investors should ideally not change because of the transaction. It is closely related both to the true sale principles and to the non-petition clauses, where noteholders agree not to take individual legal action against a debtor or its estate.

The legal technique is akin to how, in certain common law jurisdictions, home mortgages may be granted on the basis that they may be enforced on default without recourse for the lender to other assets of the obligor.[202] Limited or no recourse is also used in project finance and factoring, typically to describe that creditors are not able to turn to shareholders of a project SPV, or sellers of receivables, respectively. Depending on the

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[200] Limited recourse is explained as general principle by Wood, Project Finance (2019) p. 145.

[201] See Fitch Rating Criteria, p. 18: "Fitch expects transaction creditors to agree to limited recourse and non-petition covenants. In circumstances where a structure may not include limited recourse and/or non-petition covenants, or where there are restrictions on these covenants, Fitch will expect information as to the reasons for this (together with any structural mitigants)." Also see Wood, Project Finance (2019) p. 145, who stresses the importance of limited recourse provisions for the enforceability of tranching: "Instead of turnover subordinations, these securitisations provide that the proceeds of the receivables are paid in a sequential order from senior to junior notes in accordance with the waterfall clause described below." /…/ This arrangement avoids all the complications of turnover subordinations which would be inconvenient in the case of scattered noteholders and pose legal problems in many jurisdictions."

[202] For further explanation, see Ghent & Kudlyak (2011). A similar distinction is sometimes made by differentiating between "personal" or "unpersonal" claims, where the latter would entail no recourse to the debtor beyond what a certain asset covers, see for example § 38 of the German InsO.

drafting, limited recourse clauses may position a claim as conditional upon certain circumstances materialising (all claims more senior than mine have been fully discharged) or not materialising (absent a shortfall higher up on the payment priority ladder, my claim is at 100 per cent).

The support provided by the concept of limited recourse depends to an extent on the framework for classification of claims as contingent or conditional. One would consider the effects for tax and regulatory (and perhaps credit insurance) purposes of treating part of a debt as being written off or waived, as opposed to conditional or defaulted and unpaid.[203] Draftsmen should also be careful to not include provisions in note terms and conditions that could be seen as conflicting with the limited recourse language, such as statements that the obligations are "absolute and unconditional."[204]

Above all however, such support hinges on insolvency law related to claims in bankruptcy and the nature of the insolvency test in a particular jurisdiction.

5.2.3.2 English law

In the English law context, the limited recourse does not explicitly target the function of upholding the agreed payment waterfall, but refers to payments being made from the assets in accordance with certain security documents. It therefore stands out as a measure primarily designed to ensure, together with the non-petition clause, that the SSPE cannot become insolvent due to any noteholder claims. A limited recourse clause may be drafted as follows:

"Notwithstanding any other provision in the [Transaction Documents], all obligations of the Issuer to the Noteholders are limited in recourse to property, assets and undertaking of the Issuer the subject of any security created under and pursuant to the Deed of Charge."

It then goes on to state that if there are insufficient amounts available from the charged assets, then "the Noteholders shall have no further claim against the Issuer /…/ and any further payment right shall be extinguished." The terms "write-off," "extinguish" or "cease," appear to be used interchangeably to capture what happens to claims that exceed what a noteholder is entitled to pursuant to the limited recourse provisions. There is also a notion that claims under the notes, due to this clause, are conditional. In certain programmes, the notes are described as constituting "direct, secured, and (subject to the limited recourse provisions in [xx]), unconditional obligations of the Issuer."

Even though different tranches of debt may be subject to limited recourse, to the extent there are more issuances within a single SSPE, there is still the risk that an SSPE can become insolvent and will have to unwind all obligations at the same time.[205] There is also

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[203] DBRS Rating Criteria p. 11.

[204] In the U.S. case Bank of New York v. First Millennium, Inc., et al. (607 F.3d 905 (2d Cir. 2010), noteholders were found to have full recourse to funds because of conflicting language in the transaction documents. In one instance, certain obligations were said to be limited recourse (with payment only to the extent of the collateral) whereas elsewhere the same obligations were expressed to be "absolute and unconditional." The later case In re Taberna Preferred Funding IV Ltd (2018 WL 5880918 (Bankr. S.D.N.Y. Nov. 8, 2018)) however provided comfort, since in that case nonrecourse provisions were upheld, and creditors petitioning for insolvency of an issuer were therefore found to lack standing.

[205] Wood, Project Finance (2019) p. 129. An important benefit of an SSPE in a jurisdiction such as Luxembourg which allows segregation of obligations of a single SSPE into "compartements" is that it insulates against this kind of risk (and with that, the need for elaborate non-recourse language).

case law to suggest that although limited recourse provisions are binding on a creditor, they do not stop a petition for insolvency proceedings.[206] The limited recourse provisions (as well as the non-petition undertakings discussed below) are seen under English law as a matter of defining the contractual rights and obligations of parties, and hence would be subject to the choice of law governing the terms and conditions of the relevant notes. Limited recourse can therefore be said to work under English law, but it is not stand-alone a guarantee against timing or practical problems.

5.2.3.3 French law

Under Art. L. 214-175 III of the French Monetary and Financial Code, the Issuer is only liable for its debts to the extent of its assets and in accordance with the ranking of creditors as provided by law, or, pursuant to Art. L. 214-169 II of the French Monetary and Financial Code, in accordance with the issuer's funds allocation rules (*règles d'affectation*). Even if an investor would act against the issuer, it is hence bound by the agreed priority of payments. Limited recourse provisions may also be effective under French law outside of the securitisation laws, provided e.g. that the creditors have freely agreed thereto.[207]

5.2.3.4 German law

In transactions with German SSPEs, obligations are clearly stated to be limited recourse. Most prospectuses do not contain risk factors addressing any risk that a junior noteholder would not be bound by the limited recourse as expressed in the transaction documents.

One variety provides for any amounts in excess of what a creditor may claim under the limited recourse, to be subordinated under § 39, 2nd paragraph, InsO instead of ceasing to be payable.

However, insolvency or over-indebtedness (which is another ground for bankruptcy under German law, see below under 5.2.4.4) cannot be excluded on the basis of limited recourse language only.

Market participants are also aware that expressing an obligation as "conditional" may give rise to tax implications if not carefully considered.[208]

5.2.3.5 Dutch law

Section 3:276 of the Dutch Civil Code states that a creditor has recourse to all assets of an obligor, unless otherwise provided by law or contract. Limited recourse provisions are therefore as a starting point enforceable under Dutch law. In Dutch programmes, the limited recourse feature is seen to be integrated in the language on payment priorities. But it is also, separately, drafted in line with the standard in English programmes referred to in 5.2.3.2 (*English law*) above.

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[206] ARM Asset Backed Securities S.A. [2013] EWHC 3351 (Ch) (9 October 2013) and BNY Corporate Trustee Services Ltd and others v Eurosail-UK 2007-3BL PLC and others [2013] UKSC 28 (9 May 2013).
[207] ICLG p. 141.
[208] ICLG p. 159. In the German programmes reviewed, obligations are expressed as unconditional whereas in English law documentation, the obligations to noteholders are "…subject to the limited recourse provisions in [clause], unconditional."

5.2.4 *Non-petition undertakings (no direct actions by noteholders)*

5.2.4.1 *General background*

In case a securitisation structure begins to show signs of distress, noteholders will face incentives to act. In any organisation, responsible professionals will look to protect their stakeholders and to shield themselves and their businesses from liability. A noteholder or its creditors (if the noteholder is subject to insolvency proceedings) cannot be expected to consider any interests beyond individual maximum recovery. The non-petition clause deals with these incentives by barring (where legally possible) or deterring from individual creditor action that may create delays and even place a structure – and notably control of its cashflows – in the hands of public administrators or receivers. Like the limited recourse clause, it is also there to reinforce the bankruptcy remoteness of the issuer and to ensure that the transaction documents operate as originally intended.[209]

It is a well-known objective of having bankruptcy law at all, to prevent a race of creditors to the detriment of an orderly liquidation if not survival of troubled businesses.[210] It is also a feature of the bond market at large, that individual noteholder action should be avoided for practical reasons.[211] The positive side of non-petition is the handing over of authority to act to an agent or trustee, as discussed in 5.2.2 (*Trustee and Agency*) above.

As with limited recourse provisions, non-petition clauses have become fairly standard, without regard to the governing law of the notes or the jurisdiction of the issuer. The following is a commonly found language:

"No Noteholder may proceed directly against the Issuer unless the Note Trustee, having become bound to do so, fails to do so within a reasonable period of time and such failure is continuing.

"No Noteholder shall be entitled to take any steps or proceedings to procure the winding up, administration or liquidation of the Issuer."

In one of the programmes reviewed, the non-petition language also included an undertaking specifically not *"to take any steps which would result in any of the Priorities of Payments not being observed."* The clause in its standard wording is open to interpretation to a certain degree, as it preserves the right for noteholders to take individual action should the trustee fail to do so within a "reasonable period of time."

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[209] DBRS Rating Criteria, p. 11.

[210] Wood, Principles of International Insolvency (2019) p. 17. Gullifer & Payne (2015) p. 381.

[211] For an American market perspective on collective action clauses, see Bratton & Levitin, (2017). Also see Carletti et al. (2020). Also see "The design and effectiveness of collective action clauses", report prepared by the Legal Department of the IMF, 6th June, 2002 (available at www.imf.org). The Report of the G-10 Working Group on Contractual Clauses, 26th September 2002 (available at www.bis.org) p. 2 states in the context of sovereign debt that "The Working Group believes that there should be a bondholder representative in place for the life of the bond in order to act as an interlocutor with the sovereign during this time. Such a representative could be of benefit to both debtors and creditors, /…/. In common law jurisdictions (e.g., England and New York), this role might be performed within a trust structure (as opposed to the more common fiscal agency structure currently used), while the laws of civil law jurisdictions (e.g., Germany and Japan) recognise structures other than trust structures which are able to provide similar benefits. The use of such trust or other structures would automatically provide bondholders with a means of facilitating communication with the sovereign debtor and vice versa. Use of such structures would also confer the right of legal enforcement of the bonds on a single entity (as described below) and provide for the pro rata distribution of any recovery proceeds."

From a legal perspective, the idea of non-petition clauses is particularly complex. It appears uncontroversial that creditors should be able to waive parts of the rights that would normally come with the holding of a claim. The reality of a market practice to the effect that holders of traded debt securities will be bound by collective proceedings in relation to the issuer is demonstrated by Art.18 of the Transparency Directive.[212] The fact that investors will be bound by majority decisions, and that there is a practical need for a common representative acting on the instructions of the majority, is well understood in the European markets. This has not however produced legal certainty in relation to the effects of non-petition undertakings by individual investors.

An explanation for the remaining uncertainty is that the right to take legal action represents a fundamental right.[213] As such, it does not fall within the realm of freedom of contract. Further, the idea of mandatory insolvency law would be deflated if parties could contract out of their right to petition regardless of the circumstances.

In the *Lithgow* case, an arrangement similar to that of a bond trustee structure was tried in relation to the access to justice requirements of Art. 6 of the ECHR by the European Court of Human Rights. The case concerned rights to compensation for nationalisation of assets that had taken place under the UK Aircraft and Shipbuilding Industries Act 1977. Under said Act, the individual claimants would be represented in compensation negotiations by a common representative. Such exclusive right of a common representative to act in legal proceedings on behalf of individual creditors was found to serve a legitimate aim and to be proportionate. Without such arrangement, a process for compensation (as was the case in Lithgow) would be “unworkable.”[214] In other cases involving shareholder interests in a commercial undertaking, the absence of an opportunity for an individual or entity to bring legal actions has however been found to violate Art. 6.[215]

Neither the Lithgow case referred above nor the cases where a violation was established are immediately comparable to the case of non-petition and noteholder representation. Let us turn therefore to the principles laid down by the European Court of Human Rights in *Ashingdane*, which predates the ruling in Lithgow.[216] Having established that the right of access to legal remedies in Art. 6 is not absolute, the court in Ashingdane specified that

212 Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

213 As expressed in Art. 6 of the European Convention on Human Rights, which includes “civil” rights and obligations. Also see Art. 47 of the EU Charter of Fundamental Rights. In von Bar et al.: DCFR, the demarcation between mandatory rules on security and the freedom of contract is not clear but at least would allow creditors to waive their otherwise mandatory rights in out of court-proceedings. See von Bar et al.: DCFR p. 4691 (IX. –7:102: Mandatory rules) and p. 4692 with comments to Clause IX. –7:103 which provides that: “*While it is always possible for the secured creditor to seek judicial enforcement, i.e. an enforcement of the security right through the courts or other competent authorities, paragraph (1) implies that the parties may agree on the exclusion of extra-judicial enforcement.”*

214 Lithgow and Others v. The United Kingdom, 9006/80; 9262/81; 9263/81; 9265/81; 9266/81; 9313/81; 9405/81, Council of Europe: European Court of Human Rights, 24 June 1986. See especially § 28 2nd Paragraph and § 197. Also see Harris et al. (2014) p. 402 and the opinion of the Avocat General in C-308/17 (Leo Kuhn v Hellenic Republic) ECLI:EU:C:2018:911.

215 See Arma v. France - 23241/04 Judgment 8.3.2007 and Suda v. the Czech Republic - 1643/06 Judgment 28.10.2010.

216 Ashingdane v. United Kingdom - 8225/78 Judgment 28.05.1985.

restrictions can be permitted so long as they pursue a legitimate aim, are proportionate and are not so wide-ranging as to destroy the very essence of the right.

In an "essence of the right test" following Ashingdane, the precise arrangements and remaining protections for investors under national law that permits non-petition clauses would likely be considered. The two components of non-petition language that are often seen, being that (i) only the trustee or agent may take enforcement action, and (ii) *no one* must institute bankruptcy proceedings against the issuer (until a certain time has passed after discharge) may therefore need to be analysed separately. The fact that many aspects of Article 6 rights may be waived may also be taken into account.[217] It remains however to be settled if parties may waive their right to bring legal action well before any grounds for dispute having surfaced.[218]

Aside from touching on public policy and the right to a fair trial, the non-petition clause cannot be dealt with without making a technical distinction. What it is ideally designed to achieve (from the *ex ante* perspective of all transacting parties) is that a petition for winding-up or other legal action against the SSPE by an investor should be disallowed. Failing this, it should be dismissed or rejected after a trial on the merits.

It cannot be fully developed here how to think about the balance between the interests of public and insolvency law on the one hand, and the practicalities of issuing debt to multiple investors on the other. However, the following sections will provide a commentary on how non-petition clauses can be understood in the context of the four jurisdictions reviewed, from the perspective of ensuring enforceability of payment waterfalls.

5.2.4.2 *English law*

In an English law context, there are no blanket rules ascertaining the enforceability of non-petition or - as commonly referred to - "no-action" clauses. As noted in the practitioners' guide ICLG, a party may have statutory or constitutional rights to take legal action and to invoke insolvency law which may not be contractually disapplied.[219] That being said, there is robust support for the position that individual noteholder action would be possible to bar based on the language used in STS securitisations.

Wood comments that "There is no objection to these no-action clauses so far as English law is concerned."[220] Objections that were (unsuccessfully) raised in the case Re Colt Telecom included that the creditors of a company could find themselves in a situation where, because of a broadly applied no-action undertaking, *no one* would be in a position to take legal action against a defaulting debtor.[221] This would not likely be a concern in a situation where creditors have bargained to hand over the rights to take legal action to a trustee, and the trustee is liable to act in accordance with a pre-determined procedure.

[217] Se e.g. Suda v. the Czech Republic - 1643/06 Judgment 28.10.2010.
[218] Guide on Article 6 of the Convention – Right to a fair trial (civil limb). Updated per 31 December 2020. Council of Europe/European Court of Human Rights, 2021, p. 33.
[219] ICLG p. 116.
[220] Wood, Project Finance (2019) p. 155.
[221] Re Colt Telecom [2000] EWHC 2503. Gullifer & Payne (2015) pp. 381 and 402-403. Even the result that no one could sue for damages was however accepted as it was the "precise consequence of the express terms…" in Secure Capital SA v. Credit Suisse AG [2015] ECWH 388 (and Court of Appeal [2017] EWCA Civ 1486). This case related to the law applicable to, and right to sue, an issuer of immobilised bearer securities.

5.2.4.3 *French law*

If an FCT or SDT is used under French law to issue securities, the enforceability of a non-petition undertaking should not be of great concern in relation to the legal integrity of a credit structure. Even if an investor in a junior tranche would technically be able to sue, a challenge of its position in a payment waterfall would lack substance due to the overriding law. Nevertheless, it is noted that under French law, a court would not be likely to uphold a non-petition undertaking.[222]

French securitisation programmes generally note in the terms and conditions: "Non-Petition. Pursuant to Art. L.214-175 III of the French Monetary and Financial Code, provisions of Book IV of the French Commercial Code (which govern insolvency proceedings in France) are not applicable to the Issuer." Presumably, this is for information purposes only and not intended to create any restrictions on investors that do not already follow from the nature of the securitisation laws.

5.2.4.4 *German law*

The market view in Germany is that a non-petition undertaking by a noteholder should be considered valid by a court. Any reservations target the case where an issuer would be deemed to act with wilful misconduct or gross negligence. Some programmes however have chosen to include in the prospectus risk factors that there is no specific judicial or statutory authority supporting such view.[223]

Further, under German law, there is a compulsory duty of directors to petition for insolvency if the liabilities of the company exceed its assets (*Überschuldung*) or the company is insolvent due to an inability to pay its debts as they fall due (*Zahlungsunfähigkeit*). As in most other jurisdictions, insolvency is a matter of fact and not of contract.[224]

5.2.4.5 *Dutch law*

Under Dutch law, a non-petition clause will not with any certainty prevent a claim from being lodged with a court and tried on its merits.[225] In Dutch securitisation programmes, one will find provisions (in addition to the standard non-petition) to the effect that neither individual noteholders nor the security trustee may institute bankruptcy related proceedings against the issuer until one year after discharge of the notes.

One Dutch programme specifically highlights that the non-petition is complemented by limited recourse provisions to ensure bankruptcy remoteness. Even if a petition for bankruptcy would be heard, and insolvency is a matter of fact rather than of contract, the limited recourse nature of obligations is thought to ensure that the issuer cannot be found to have ceased to pay its debts as they fall due.[226]

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[222] ICLG p. 144.

[223] For market views, see ICGL, p. 161 and sample prospectuses: www.sts-verificationinternational.com/fileadmin/svi/Transaktionen/Red_Black_Auto_Germany_6/20191119_ Red_BlackAutoGermany6_Final_Prospectus.pdf, p. 101 and www.ise.ie/debt_documents/1_ 41548 _SD_23112 009_15814.pdf, p. 17.

[224] Wood, Project Finance (2019) p. 155. ICGL p. 161. For further developments and the prospects of a harmonised duty of directors and managers to petition for insolvency proceedings, see Proposal for a Directive of the Parliament and of the Council harmonising certain aspects of insolvency law, COM(2022) 702 Final, Title V.

[225] Dutch Securitisation Overview, p. 6.

[226] Section 1 Dutch Bankruptcy Act (*Faillissementswet*).

5.2.5 *Summary of country reviews*

Three distinct legislative approaches to securitisation emerge in the study of European jurisdictions. In the first group, represented here by France, the legislator has taken measures directly aiming at facilitating securitisation as a transaction type. In such jurisdictions, the enforceability of a payment order based on the tranching of securities is not an issue of contestation. SSPEs are bankruptcy remote in the sense that they are not legal persons subject to formal insolvency proceedings. The other modules may form part of the transaction documents, but are not required or even effective in order to ensure the tenability of an agreed ranking of debt securities. The French model will therefore not be discussed further in the context of identifying viable paths to private law enforceability.

In the second category, represented here by England and Wales, no such particular legislation has been enacted. This does not mean that the payment order set out in relation to a certain credit structure cannot be relied upon. Rather, it entails that one must rely on indirect support from the other modules, that may or may not do the trick. Under English law, court precedents provide comfort that *ex ante* bargains will be upheld in the absence of violating principles of English law, such as the anti-deprivation principle in relation to bankruptcy. Compared with the Napoleonic special legislation, the precedent based system appears more flexible in that it allows to a greater extent market-led developments and innovation.[227]

In the third category, we find countries like the Netherlands and Germany. Under German law, the enforceability of an agreed payment order is a key legal issue. Subordination of tranches is neither directly supported by the bankruptcy law, nor are there any court precedents or other statutes to provide comfort on their own. This notwithstanding, structural enhancements (even in addition to the modules examined here) and the limitation of activities of the SSPE provide comfort so to enable issuances to be rated and hence commercially viable. There are also court precedents that are generally held in the market to support the non-petition and limited recourse features.

The Netherlands have no special securitisation laws, but the general rules on priority of creditors explicitly allow contracts for granular ranking of debt to be enforceable against the party accepting the subordinated nature of its claims. Statutory law further provides support for upholding the concept of limited recourse.

5.2.6 *The modules in distress*

Let us assume that a securitisation transaction is under stress because of changes in the real economy that will have caused a rise in payment defaults in the asset pool. Assuming further that the issuer SSPE is bankruptcy remote in the sense that the financial situation of the originator does not affect it, and that a perfected security interest over all assets of the issuer has been provided in favour of noteholders. There are structural enhancements in place to still ensure payments of interest to all noteholders. However, calculations show that upon a forced sale of the assets, the SSPE would not have sufficient funds to pay all noteholders their interest and principal in full.

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[227] Wood, Project Finance (2019) p. 139, points to this difference in approaches and notes that the jurisdictions having adopted special legislation “tend to be restrictive so as to not erode existing policies, and to keep the chink of light as narrow as possible.”

In this scenario, senior noteholders may prefer one strategy and subordinated classes may have come to a different preferred route for potential enforcement, timing and course of action. Hence there is a conflict of interest between classes of noteholders.[228]

At this point, the legal tools described above will come into play in the following ways (as simplified for illustration purposes).

(i) Upon review of the transaction documents, noteholders should obtain legal certainty that their agreement on payment priorities will be upheld in an enforcement scenario, regardless of the route. This criterion is met by overriding laws particular to securitisation in France, by the comfort of case law in the UK, and by the statutory support for ranking of creditors in the Netherlands.

Since the UK case law is based on the consideration of individual circumstances and that principles of *anti-deprivation* and *pari passu* are not violated, there might however be room for challenges in case a transaction contained significant flaws in violation of those principles. Further, a minor concern remains in relation to "flip clauses" that alter the priority of payments because of an insolvency related event.

In Germany, noteholders cannot ultimately rely on agreed payment priorities being upheld within judicial enforcement, and hence for that situation it holds even more significance to steer clear of formal proceedings. This is achieved with the support of other modules, three of which are discussed below.

(ii) In evaluating its options, an individual noteholder should readily find that communications with and actions against the issuer are exclusively in the hands of a common representative. Noteholders should be able to rely on a third-party representative (on the instructions of noteholders as such procedure is agreed) to enforce security and distribute proceeds in accordance with a pre-determined procedure.

In France, this function is made less relevant thanks to the solidity offered by special legislation. In the UK, the trustee serves as an example upon which other jurisdictions have modelled their third-party functions. In both the Netherlands and Germany, market participants have reconstructed the requirements for effective noteholder representation using the contractual tools available. Save for instances of fraud or other exceptional circumstances, the method of channelling assets and enforcement authority through a common representative will make sure that agreed payment priorities are upheld within all extra-judicial courses of action. It will also aid in preventing any judicial proceedings (such as a petition for bankruptcy), to the extent that the fourth module examined – the non-petition – is reliable.

The role of the trustee as an "enforcement intermediary" is a powerful example of the *lex financeria* gaining territory at the expense of statutory insolvency regimes. Transacting parties have in a way pre-empted the need for substantive harmonisation of insolvency law by creating their own market-based enforcement regimes.

[228] See Bank of New York v Montana Board of Investments [2008] EWCH 1594 (Ch): [2009] 1 All E.R. (Comm) 1081: [2008] 7 WLUK 299 (Ch D).

This does not mean that the trustee or its contractual equivalents are perfect. Among other things, a balance must be achieved between the trustee's rights, its duties, and obligations to act independently of noteholder instructions.

(iii) In this scenario, it is clear that the assets of an issuer SSPE will not be sufficient to repay all noteholders. Certain noteholders claim – perhaps as part of negotiation - that they will circumvent the agreed decision-making process and petition a court in the jurisdiction of the issuer for restructuring or winding-up. When evaluating this possibility, the first module that comes into play is the limited recourse nature of the issuer's obligations. In all of the reviewed jurisdictions, it is generally believed that contractual provisions limiting the issuer's obligations to whatever it can afford will be valid and binding. The caveat here is that in most jurisdictions, insolvency is a matter of fact and depends on a statutory test.

The second important module is therefore the non-petition undertaking of noteholders. Even if a claim from a noteholder bringing action would be lodged with a court and subject to trial on the merits, the near certainty that such a claim would ultimately be rejected would deter from action. This is especially the case considering potential consequences for breach of contract that would await noteholders "breaking ranks." An undertaking not to bring legal action except in a manner and at such time as prescribed by the note terms appear to be accepted as valid and binding in all jurisdictions reviewed, at least in the context of securitisation.

The protection obtained by these contractual provisions should however not be understood as a carte blanche for any variations. There is a balance to be struck between on the one hand the practical need for effective noteholder representation and legal certainty, and on the other the fundamental right to seek judicial remedies and enforcement. Notably, the non-petition module might not work without the third-party representation module discussed above and some level of "noteholder democracy." A situation where *no one* could take legal action would be likely to tip the scales against upholding such clauses.

In relation to the limited recourse provisions, there is also a line to be drawn since parties must not purport to agree among themselves that an entity can never become insolvent (even if that is the practical consequence).

In sum, what can the above distress perspective inform us about the private law contents of the regulatory term "tranching"? A tentative development of the concept and suggested criteria for evaluation may start to take form along the lines discussed in the final sections below.

6 Conclusions: The case for a common understanding

6.1 Compatibility with financial regulation

In order to reconcile private law with the regulatory use of terms such as "tranching" and "seniority", and against the background of approaches discussed in 4 (*Tranching and enforceability in the EU law context*) above, one of the following alternatives for interpretation should be employed.

The *first option* is that the legal foundations for the enforceable ranking of tranches are required to always be solid, regardless of the jurisdiction of the SSPE and the law governing the transaction documents.

In other words, the provisions on "seniority" in capital regulation and/or the references to payment priorities in the Securitisation Regulation entail that the underlying contractual provisions must be enforceable. Financial regulation, as discussed above, is ultimately there to protect against inefficient loss allocation and contagion effects in times of financial distress. The private law arrangements underpinning regulatory measures, such as maintaining a capital buffer, would therefore need to hold in distress. Considering the legal strategies described, enforceability does also seem to be possible to achieve in ways that do not trigger public policy concerns.

This interpretation would, I believe, require domestic legal communities to identify a path to enforceability of an agreed payment waterfall if tested. Certain assessment criteria to consider in that case are discussed in 6.2 (*Suggested assessment criteria*) below.

Alternatively, it is it not required for the treatment of an exposure as "senior" or "mezzanine" that the structures are legally enforceable. As long as the ranking of tranches is clearly stated in the transaction documents, it is solid enough to support a certain regulatory treatment.

This second alternative would mean that enforceability of tranching from a regulatory perspective is a kind of "best efforts" feature; where parties to a transaction are able to ensure it and rating agencies are convinced it works, the transaction will be commercially viable. With this interpretation, there is an incentive to ensure enforceability, but it is neither a direct requirement for a certain application of the capital adequacy rules nor for fulfilment of the STS criteria.

If this interpretation is the more likely one, it would entail that the capital adequacy framework is insensitive to the legal nuances of tranching arrangements. As a consequence, financial regulation would not reward the fact that an issuer is incorporated in a jurisdiction where legislation has been enacted, or structuring efforts have been made, to ensure enforceability. This does not mean that such efforts are meaningless; only that they could be omitted had it not been for the rating requirements. It would further add to the already crucial roles fulfilled by credit rating agencies and specialised law professionals.

With this second option, a common understanding of the private law construction of tranching may be seen primarily as a means for furthering standardisation and transparency. It would also increase the level of legal certainty for transacting parties. [229]

Under both alternatives, the current state of affairs is unsatisfactory in light of the aim of promoting securitisation as a financing tool that can be equally accessed regardless of the domicile of the issuer. So where do we go from here?

Cafaggi (2011) discusses two main routes for private regulation – in our case, the market practice in relation to creating tranches of debt – to spread and produce legal effects on third parties other than those who have opted into an agreement.[230] First, the privately produced standard becomes binding (and in our case, enforceable) through judicial interpretation. Secondly, legislation provides *ex post* endorsement or incorporation. In either of those cases, it is suggested that the four modules discussed above of what makes a payment waterfall legally certain can form a point of departure.

6.2 Suggested assessment criteria

Based on the comparative summary above, the following approach is suggested for evaluating the most efficient, least invasive paths to legal certainty on payment priorities. The aim is to pave the way for an understanding across jurisdictions, that certain standard elements of securitisation transactions are what constitute the private law contents of the regulatory terms "senior" and "tranche".

First, doubts as regards the enforceability of agreed payment priorities is not a reason in itself to seek transaction-specific laws such as the French. Although special legislation promotes securitisation as a transaction type, it does not necessarily promote innovation and development of new financial products. Innovation in the design of loans and bonds has proven to be crucial in facing the challenges posed by for example the Covid-19 pandemic or NPEs, or in overcoming the funding gap in sustainable finance.

Further, debt layering as a technique is not unique to securitisation. This means that if the legal room for creating seniority based on agreement is uncertain in general, special legislation for securitisations leaves the rest of the finance universe with a lingering uncertainty. A guiding principle for finding the best approach to tranching enforceability should therefore entail that certain standard legal strategies may extend to also benefit legal certainty for *other transaction types* involving debt layering.

Secondly, based on the above and a review of STS transactions, the documentation of securitisations is similar regardless of the underlying law. Due to the transnational nature of financial markets, draftsmen are influenced by documentation from other legal environments. In a "tick the box" exercise, each participant in a transaction may require features that they are used to seeing. Hence, documentation builds up. It rarely scales back. This begs the question, if time is not ripe to take steps towards further simplification, transparency and standardisation that is manifested by documentation that is easier to access for non-incumbents.

Therefore, a second guiding principle in searching for the best common understanding of tranching enforceability should be the *promotion of brevity*. In fact, brevity is a reason

[229] See Cafaggi (2011) p. 92. Cafaggi claims that "general and sector specific principles are needed to guide domestic Courts in assessing validity and conformity of private regulation with EU law."
[230] Cafaggi (2011) pp. 96-97.

in itself for trying to avoid the use of too many different modules – and the invention of new ones - to pin up enforceability and bankruptcy remoteness.

Thirdly, the standardisation already achieved to an extent by market participants (such as rating agencies) should encourage strategies that reinforce, rather than deviate from, the common understanding that has already emerged.[231]

Fourthly, any solution should, in order to be effective, be aligned with certain principles of insolvency law that exist if most, if not all, EU jurisdictions (and the UK) albeit varying in their precise content. As Mucciarelli (2021) observes however, it is most difficult to pin down what those principles are.[232] He suggests (with reservations) that a common denominator between Member States seems to be the duty to treat creditors equally and respect pre-insolvency entitlement and creditor ranking. In relation to securitisation, a reasonable consequence of this common denominator would be that *ex ante* agreements on ranking should be upheld in insolvency, absent any infringement or deprivation of the rights of third parties.

The key to disarming objections deriving from domestic insolvency laws lies, I believe, in that the ranking of tranches in securitisation does not purport to rank potential non-adjusting creditors any worse than they would have been absent an agreed payment waterfall.[233]

This means that under scrutiny, an agreement for the ranking of tranches *must not interfere with the ranking on insolvency of parties outside of the agreement*. Supported by this demarcation, limited recourse clauses may also be determined to be matters of contract, rather than mandatory insolvency law.[234]

Fifthly, and tying into the fourth criterion above, it should be stressed that the ranking of tranches does *not affect the right of employees*, since that is an area outside of the legislative mandate upon which the securitisation and capital adequacy frameworks are based.[235] The ranking of employees' claims on insolvency, broadly understood, is tied to a host of ancillary (and widely diverging) legislation, such as guarantee schemes, social insurance, co-decision rights and pensions.[236]

Sixthly, any solution should be *in line with the aim of investor protection* as such comes across in, notably, the Prospectus Regulation. This aim reinforces striving for brevity and legal certainty that should be available in all jurisdictions subject to the same financial regulation. It is especially relevant considering cases where securitisation notes end up in the hands of small investors or savers.[237]

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[231] Cafaggi (2011) p. 111 discusses in relation to standardised contract practices generally that "gap-filling" should look for the "regulatory" purpose and interpret contracts in light of industry practices. A representation of such transnational understanding of legal terms, see Moody's Cross-Sector Rating Methodology: Bankruptcy Remoteness Criteria for Special Purpose Entities in Global Structured Finance Transactions (October 7, 2014) p. 4.

[232] Mucciarelli (2021) p. 18.

[233] See under 1.1.2 (*On the function to be analysed*) above and Gullifer & Payne (2015) pp. 80-81.

[234] See footnote 162 above regarding this distinction.

[235] See Art. 114 (2) TFEU. Also see Mucciarelli (2021) p. 16.

[236] See Insolvency Regulation (EU) 2015/848, Recital (22).

[237] If for example such assets are part of the underlying in structured deposits, see EBA Report on Cost and Past Performance of Structured Deposits, 10 January 2019: https://www.eba.europa.eu/eba-publishes-report-on-cost-and-performance-of-structured-deposits. Savers and employees are also indirectly investors in structured finance instruments through institutional investors such as insurance undertakings and pension funds.

Finally, as has been stated in the beginning of this paper, what is sought is ultimately an increased compatibility between financial regulation on the one hand, and the private law underpinning it on the other. Any solution must therefore be evaluated in light of how it would *fit in* with the CRR and Securitisation Regulation. In the next section, we shall therefore return briefly to the language in the relevant regulations.

6.3 Development of definitions to allow compatibility

In the Securitisation Regulation, "tranche" means (my emphasis) "a *contractually established segment* of the credit risk associated with an exposure or a pool of exposures, where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in another segment, without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments."[238]

Further, the definition of "securitisation" entails (my emphasis) that "the subordination of tranches *determines the distribution of losses* /…/."

It is suggested therefore that the phrase "*contractually established*…" in this context be taken to mean that the priority of payments agreed upon in the note documentation made available to investors must not be altered by operation of mandatory insolvency law in the relevant SSPE jurisdiction. This would be compatible with the definition of securitisation which states that the subordination of tranches *determines* the distribution of losses.

Further, the definition of a "senior securitisation position" in Art. 242 (6) of CRR as being "backed or secured by a first claim on the total pool of assets", could perhaps be understood to mean that the position is "backed" by a first claim by virtue of an enforceable agreement on the ranking of tranches; which may (but does not need to) be complemented by a first ranking security interest in SSPE assets. This understanding has the benefit of protecting the seniority treatment of a claim even if the security granted should be flawed or open to claims from lower ranking secured tranches.

The purpose of elaborating on these core definitions is to provide a starting point for discussion. And, together with the suggested assessment criteria above and the inventory of modules, ultimately to think about an interpretation that allows national laws to be compatible with EU regulation without the need for further regulatory intervention.

6.4 Final remarks and suggestions for further research

In a review of securitisation structures, an account of plane crashes given in Malcolm Gladwell's "Outliers" comes to mind. A securitisation structure, like an airplane, will not fail unless several things go wrong at the same time. Unlike an airplane however, securitisation is a paper product that comes into being by combining legal tools. That means that in order to make it more secure or efficient, no real-life engineering or testing would need to take place. It appears, in a technical analysis of the law and practice in four European jurisdictions, as though time and costs could be saved both in the construction and in the maintenance phase. In addition, an informed discussion about the legal underpinnings of transactions has the potential of increasing legal certainty and ensuring compatibility with financial regulation.

[238] Securitisation Regulation Art. 2 (6).

The statutory support or strong court precedents represented by Dutch and English law, respectively, enable market actors to rely on an agreed payment waterfall. Limited recourse and non-petition undertakings are included to strengthen the bankruptcy remoteness of the issuer further, and to compensate where explicit support for the subordination of tranches is lacking.

The contractual features of limited recourse and non-petition should, in most instances, be possible to hold up if evaluated in light of their effects according to established market practice. One of the benefits of such legal tools is that, as opposed to taking security or arranging for a third-party entity to carry out a number of administrative tasks, these provisions cost very little.

As discussed however, a non-petition clause would most likely be evaluated in light of trustee or agency arrangements, providing for some degree of noteholder representation rather than a complete lack of enforcement rights. Therefore, the viability of non-petition clauses is tied to the rules on noteholder representation.

For practical reasons, some kind of collective decision-making and noteholder representation will always be necessary. Therefore, even though the third-party component is costly to put in place, little additional costs appear to be required in order to increase legal certainty through allowing the effective segregation of assets in entities acting as professional noteholder agents.

This has been a technical study based on the *prima facie* contents of law, literature, guidelines and market practice. It would of course be possible to take this discussion further and to ask whether it is still justified to entertain different rules on creditor priorities at all within the EU.[239] This broader question is especially relevant in light of how market participants find ways to all but disapply mandatory insolvency or procedural law.[240] The starting point for this paper has however been that diverse insolvency laws will persist, but that there is room for development within the existing framework.

In relation to STS transactions, priority of payment is categorised as a matter of "standardisation".[241] This paper has sought to further such standardisation by disentangling what constitutes the priority of payments in securitisation, and how enforceability of such arrangements may be ascertained.

Arguably, the recognition of agreed payment priorities might already be required, given the expectations on market participants implicit in the Securitisation Regulation. There, *contractually agreed* segments of debt are supposed to *determine* the distribution of losses. The seniority of tranches then forms the basis for a certain capital adequacy treatment of positions.

The mere recognition of the modules identified here as the private law means of creating tranches of debt might go a long way to improve compatibility with financial regulation. Mainly this is the case for countries that have not adopted special securitisation laws. In a wider sense however, it would be interesting to evaluate whether the tools for creating

[239] See Eidenmüller (2017), who suggests, as an alternative to further top-down substantive harmonisation, to develop an opt-in insolvency system. Also see Valiante (2016) p. 27.

[240] On the use of agents or trustees as "enforcement intermediaries," see Frankel (2002) p. 487. Goode (2007) pp. 74-75. Also see Dalhuisen (2019), regarding the "privatisation of recourse," p. 100.

[241] Securitisation Regulation, Recital (38). Market participants are encouraged to continue standardising processes and documentation.

enforceable payment priorities among contracting parties ought to be available for other transaction types as well.

In order to promote access to securitisation as a transaction type across jurisdictions, and to produce a more level playing field, future research is needed. In particular, it would be interesting to (i) evaluate enforceability of tranching as discussed here across further EU Member States, in order to identify whether there are any material obstacles to a common approach (using the suggested criteria set out in 6.2 above); and (ii) expand the analysis to enable a common understanding of *other* elements that are used to ensure bankruptcy remoteness of SSPEs, such as limits to the conduct of business of the SSPE and the directors' duty not to file for insolvency or winding-up. Such research would also be beneficial to inform the balancing of interests, in light of the current direction towards further harmonisation in the field of substantive insolvency law.

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