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# The Advantages of “Direct Debt” Securitization Structures

*By Jim Cotins and Matt Lyons\**

*In this article, the authors discuss “direct debt” securitizations, the advantages of these securitizations compared to traditional securitizations, the tax considerations, and the asset classes for which these securitizations are appropriate.*

## WHAT IS A “DIRECT DEBT” SECURITIZATION?

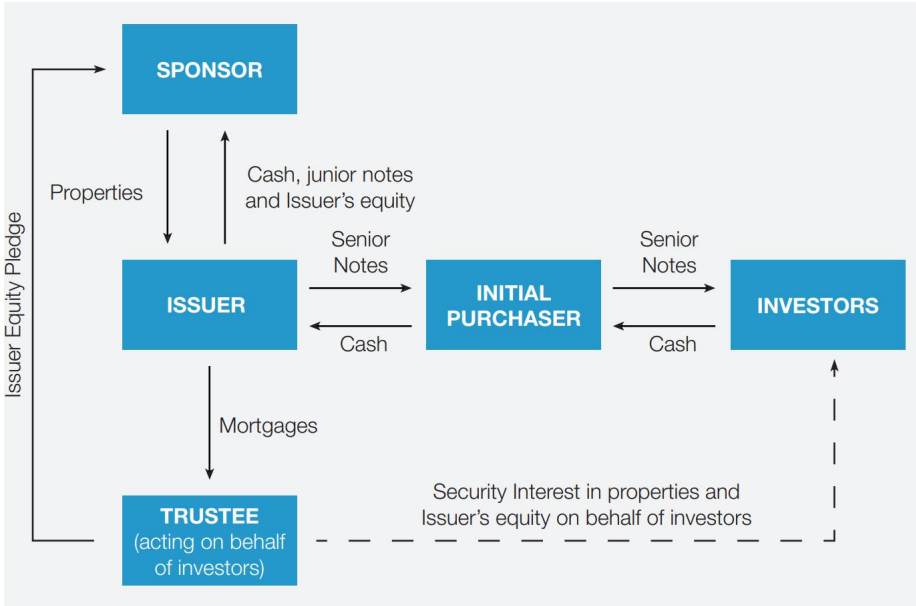
In a typical securitization, loans or other financial assets are pooled together and securities backed by those assets are created and sold to investors. Upon the creation of each loan, proper steps must be taken in order for the lender (and hence the securitization trust) to have a security interest in the collateral securing the loan. For example, if the collateral securing the loan is real property, the lender must obtain and record a mortgage in order to have a first priority perfected security interest in such property.

In a direct debt securitization, the properties are owned by the securitization issuer, not by individual borrowers to whom loans are made. The issuer issues notes secured directly by the properties, and the senior notes are sold to investors (typically through an initial purchaser).

Some portion of the junior-most notes are generally retained by the sponsor or its affiliates in order to satisfy the leverage requirements of the investors as well as to comply with risk retention regulations (if applicable). Mortgages are granted by the securitization issuer with respect to each property for the benefit of the securitization trustee. The right to receive lease payments on the properties are also pledged to the trustee as security for the notes, and the parent company of the issuer (generally the sponsor or an affiliate) may also grant a pledge of the issuer’s equity interests.

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**WHAT ARE THE BENEFITS OF A “DIRECT DEBT” SECURITIZATION COMPARED TO A TRADITIONAL SECURITIZATION?**

**Simplified Issuance of Additional Debt and Refinancing**

Direct debt securitizations are typically structured to permit the issuance of additional series of notes in the future. These “master trust” structures allow the securitization sponsor to transfer additional properties to the issuer and sell additional notes to investors without setting up an entirely new securitization transaction. Additional notes may even be issued without a corresponding addition of collateral if the existing properties have appreciated in value.

The process for issuing a new series of notes requires fewer documents, and therefore can be accomplished in significantly less time and for significantly lower cost, than entering into a new securitization. The issuance of an additional series of notes requires confirmation from the rating agencies that the issuance will not result in the downgrade or withdrawal of the ratings on the current notes, but does not typically require consent from investors in the current notes.

Typically the existing notes and the new series of notes are equally secured by all the collateral contributed to the securitization (i.e., both the existing collateral and any additional collateral contributed at the time of issuance of the



new series). This cross collateralization and the accompanying diversification in the overall collateral pool may create more reliable cash flow, which may permit higher levels of leverage when the new series of notes are issued.

The ability to issue new series of notes can also simplify the refinancing of a series of notes that is reaching maturity.

New notes can be issued and the proceeds from the sale of those notes used to retire the maturing notes without the need to set up a new securitization transaction.

### **Real Estate Cost Savings**

A significant element of the costs associated with traditional securitizations comes from the cost of creating mortgages and the related title company fees and mortgage recording taxes. The use of a master trust direct debt structure may significantly lessen these costs for a securitization sponsor, since a new series of notes can, in many cases, be issued without transferring the existing properties or creating new mortgages.

As a result, the costs of creating new mortgages, mortgage recording taxes and title company fees relating to the existing properties should be significantly reduced (although such fees will need to be paid in full with respect to any additional properties added to the collateral pool at the time of the new issuance). In addition, it should not be necessary upon the issuance of a new series of notes to engage the services of a due diligence provider with respect to the current pool of properties.

### **U.S. Risk Retention Rules May Not Apply**

A security is only subject to the U.S. risk retention regime if it constitutes an “Asset-Backed Security” as defined in Section 3(a)(79) of the Securities Exchange Act of 1934 (as amended). An “asset-backed security” is defined in relevant part as “a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset” (emphasis added). Loans are clearly self-liquidating financial assets and therefore traditional loan securitizations are generally subject to the U.S. risk retention regulations.

However, since in a direct debt securitization the securities issued are collateralized by properties (which are likely not self-liquidating financial assets), the securities may not be treated as asset-backed securities and hence may not be subject to risk retention. The determination of whether the risk retention rules are applicable to a direct debt transaction hinges primarily on an analysis of whether the transaction’s cash flow are primarily attributable to

payments on the leases (since the leases are likely self-liquidating financial assets) as opposed to the properties themselves.

## **TAX CONSIDERATIONS**

For tax purposes, the notes rated investment grade or above will generally receive the benefit of a “will be” debt opinion and will not contain transfer restrictions with respect to pension plans subject to ERISA or non-U.S. investors. Notes rated “BB” will typically receive a “should be” debt opinion and will contain transfer restrictions that prevent their transfer to pension plans subject to ERISA and non-U.S. investors. Any notes that are rated below “BB” or that are unrated (in a deal that otherwise has rated notes) would not receive the benefit of any tax opinion, but this would not typically be problematic since such notes would likely be retained by the sponsor or an affiliate to comply with leverage and, if applicable, risk retention requirements.

In order to avoid creating an entity that is subject to U.S. net income taxation under the Internal Revenue Code’s “taxable mortgage pool” rules, a mortgage securitization issuer that is relying on “debt for tax” treatment (rather than REMIC treatment) is formed in an offshore jurisdiction (such as the Cayman Islands) if more than one tranche of notes is to be issued. However, since the assets of a direct debt issuer are properties, and not mortgages or debt instruments, the taxable mortgage pool rules are not applicable. This enables the issuer to be formed onshore, thereby eliminating the additional cost and complications of having an offshore issuer. Further, an offshore issuer would be highly undesirable for direct debt structures due to the tax treatment of such an issuer.

## **WHAT ASSET CLASSES ARE “DIRECT DEBT” SECURITIZATIONS APPROPRIATE FOR?**

Direct debt structures have been used for many years for rated securitizations of net lease properties. Net lease properties are typically small, standalone commercial properties (such as chain restaurants, convenience stores, pharmacies and gas stations), which are leased to a single tenant and require the tenant to pay the all insurance, maintenance and property tax costs associated with the property.

The structure would also be a good fit for single borrower securitizations (including both single asset / single borrower transactions and single family rental securitizations). In those transactions, an “accommodation loan” is generally made by the lead placement agent simultaneously with the closing of the securitization solely to facilitate the use of a traditional loan securitization.

ADVANTAGES OF “DIRECT DEBT” SECURITIZATION STRUCTURES

Using a direct debt structure would eliminate the need for such accommodation loan and potentially introduce the additional benefits described above.