

**Morgan Lewis**

# **AUTOMOTIVE FINANCE: FROM LENDING TO STRUCTURED FINANCE**

**November 14, 2018**

**Reed Auerbach  
Philip Russell**

# Morgan Lewis Automotive Hour Webinar Series

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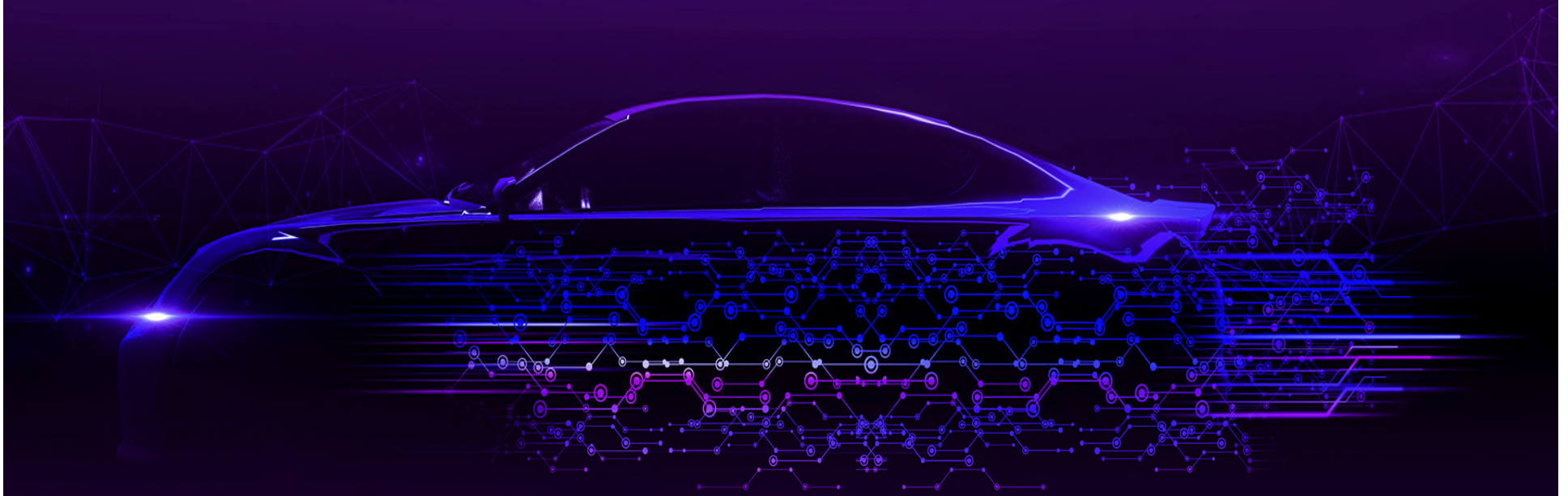
### **DECEMBER 12**

Automotive Advertising & Marketing: Challenges Promoting Innovation with Evolving Technologies

### **DATE TBD**

Labor and Employment from the Automotive Perspective

# INTRODUCTIONS



## Professional Profile



# Reed D. Auerbach

## Partner

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Reed Auerbach is the global leader of the structured transaction group at Morgan Lewis. Recognized in the 2018 edition of *Chambers USA* as a leading structured finance lawyer and “one of the goliaths of the business,” Reed represents a broad range of Fortune 100 companies, financial institutions, investment funds, and issuers in the development of innovative structured finance strategies and advises on the acquisition and disposition of financial assets and origination and servicing platforms. He advises underwriters and issuers in connection with both domestic and cross-border public and private offerings of asset-backed and mortgage-backed securities involving a wide variety of assets, collateralized loan obligations and related interim warehouse financings, asset-backed commercial paper conduits, whole loan purchases, repurchase agreements, derivative transactions, and residual financings.

Reed’s securitization experience includes student loans; prime and nonprime auto loans; auto leases; equipment; leases; servicing rights; unsecured consumer and commercial loans, including such loans originated on marketplace lending platforms; commercial real estate loans; middle-market loans; home equity loans; royalty streams and other intellectual property rights; dealer floor plan receivables; telecommunication receivables; litigation settlement fees; Australian mortgage loans; manufactured housing contracts; recreational vehicle loans; boat loans; reverse mortgages; credit card receivables; and insurance premium finance agreements.

Reed sits on the board of the Structured Finance Industry Group (SFIG) and the editorial board of *The Journal of Structured Finance*. He also co-authored the industry’s primary treatise, *Offerings of Asset-Backed Securities*, Wolters Kluwer Publishers.

# Reed D. Auerbach (cont.)

## **AWARDS AND AFFILIATIONS**

- Leading Lawyer, Capital Markets; Capital Markets: Derivatives; Capital Markets: Equity; Capital Markets: Structured Finance and Securitisation, *IFLR1000 Financial and Corporate* guide (2007–2018)
- Highly Regarded, *IFLR1000 United States* (2018)
- Band 1, Capital Markets: Securitization, Nationwide, *Chambers USA* (2014–2018)
- Ranked, Capital Markets: Securitization, Nationwide, *Chambers USA* (2003–2013)
- Band 1, Capital Markets: Securitization, USA, *Chambers Global* (2018)
- Ranked, Capital Markets: Securitization, USA, *Chambers Global* (2001–2017)
- Ranked, Securitization and Structured Finance, *Best Lawyers* (2007–2018)
- New York City Securitization and Structured Finance Lawyer of the Year, *Best Lawyers* (2014)
- Elite Leading Lawyer for Structured Finance, *The Legal 500 US* (2013–2017)
- Listed, *Super Lawyers*, New York Metro, Securities & Corporate Finance (2012, 2013)
- Harlan Fiske Stone Scholar, Columbia University School of Law
- Editor, *Journal of Transnational Law*, Columbia University School of Law
- Certificate with honors from the Parker School of International and Comparative Law

## **ADMISSIONS**

- England & Wales (Registered Foreign Lawyer) 2012
- New York 1986

## **EDUCATION**

- Columbia University School Of Law, 1985, Juris Doctor
- Columbia University School Of International And Public Affairs, 1982, Master Of Arts
- Franklin And Marshall College, 1980, Bachelor Of Arts, magna cum laude.

## **PUBLICATIONS**

- Co-author *Offerings Of Asset-backed Securities* (Third Edition), Wolters Kluwer Publication (December 2015)
- Co-author, "Traps For The Unwary," *Institutional Investor's Global Private Equity And M&A Legal Guide* (September 2008)

## **SECTORS**

- Financial Services
- Transportation
- Automotive

## **SERVICES**

- Structured Transactions



# Professional Profile



## Philip W. Russell

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Philip W. Russell represents a diverse range of clients, including issuers, underwriters, lenders, borrowers, asset managers, buyers, sellers, and sponsors, in a variety of corporate and structured finance transactions. He regularly represents clients engaged in public and private offerings of debt and equity securities secured by auto loans and leases, marketplace and unsecured consumer loans, private and federally guaranteed student loans, mortgage loans, equipment, trade receivables, and other assets. Phil is admitted in New York only, and his practice is supervised by Illinois Bar members.

Philip also advises clients in the structuring of commercial paper conduits, warehouse credit facilities, whole loan and other asset purchases and sales, residual financings, restructurings, resecuritizations, tax-driven financings, and related mergers and acquisitions transactions.

#### **AWARDS AND AFFILIATIONS**

- Rising Star, *IFLR1000 United States* (2018)
- Listed, Rising Star, *IFLR1000 Financial and Corporate guide* (2017)
- Recommended, Finance - Structured finance, *The Legal 500 US* (2017)

#### **ADMISSIONS**

- New York

# Philip W. Russell (cont.)

## **EDUCATION**

- University of Pennsylvania Law School, Juris Doctor (2005)
- Colby College, Bachelor of Arts, cum laude (1999)

## **SECTORS**

- Transportation
- Automotive

## **SERVICES**

- Structured Transactions

# Agenda

- What is Securitization?
- Why securitize?
- Types of Automotive Securitizations
  - Basics of Retail Auto Loan Securitizations
  - Basics of Auto Lease Securitizations
  - Basics of Dealer Floorplan Securitizations
- Common issues facing all three structures
- Other issues to consider



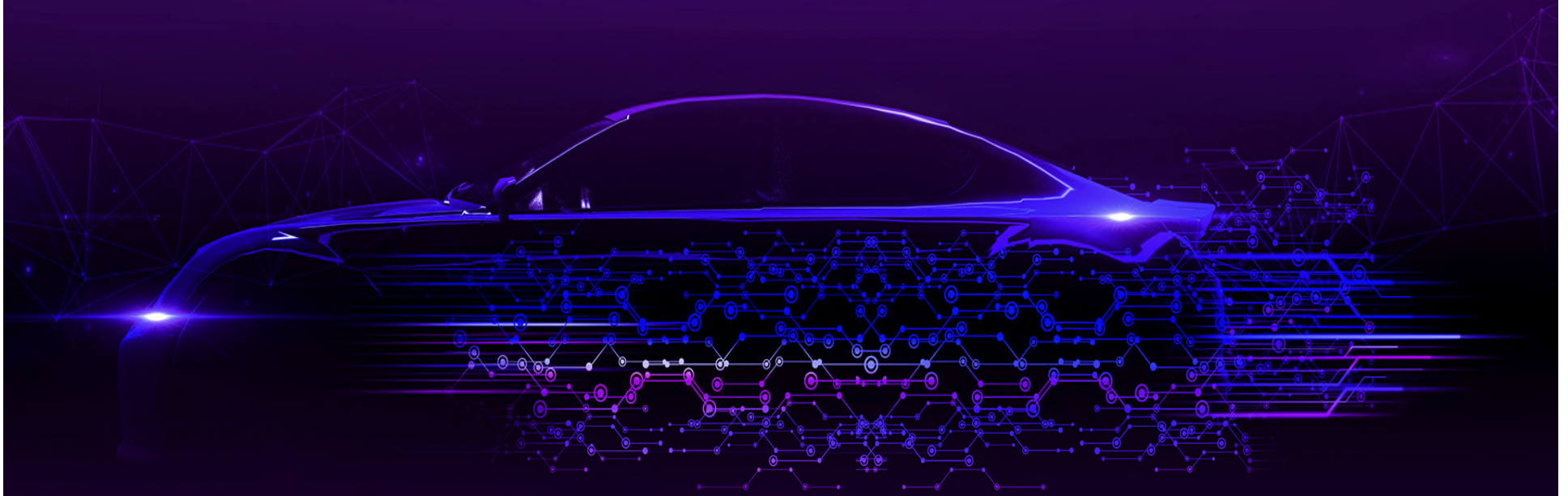
# WHAT IS SECURITIZATION?



# What is Securitization?

- Securitization involves the legal isolation of a pool of financial assets resulting from the sale of such assets to an SPV and the issuance and sale of securities by such SPV backed primarily by the cashflows from those financial assets
  - No credit recourse to transferor
- Key to securitization is the legal isolation of the transferred assets from the bankruptcy risk of transferor
  - True sale
  - Non-consolidation

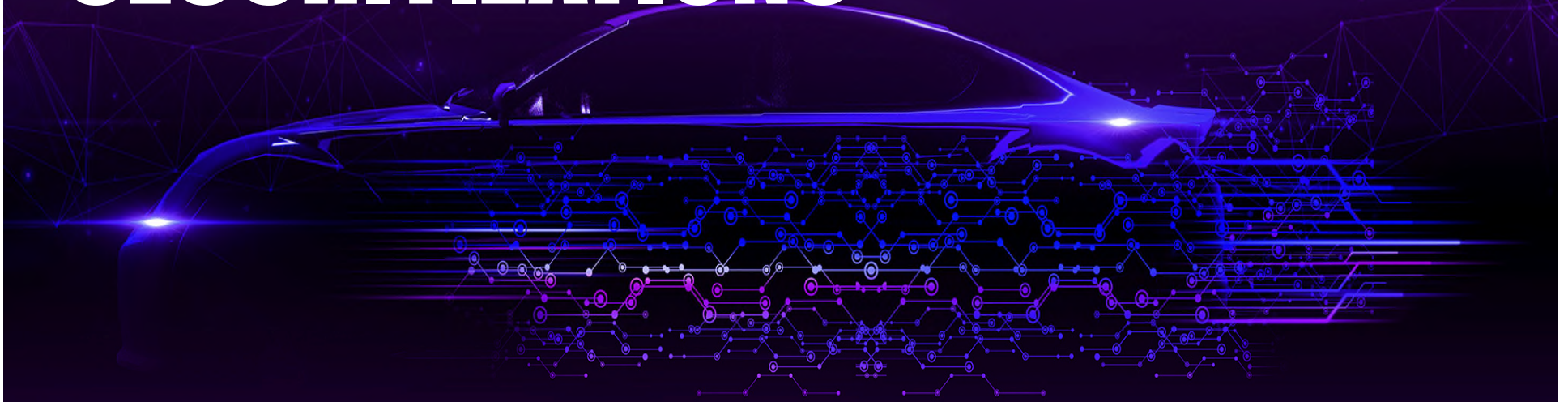
# WHY SECURITIZE?



# Why securitize?

- Cheaper cost of funds
  - ABS may have higher credit rating than corporate debt
- Balance sheet management
  - Matches assets and liabilities
- Different investor base
- Demonstrates to equity investors and rating agencies liquidity of balance sheet

# TYPES OF AUTOMOTIVE SECURITIZATIONS

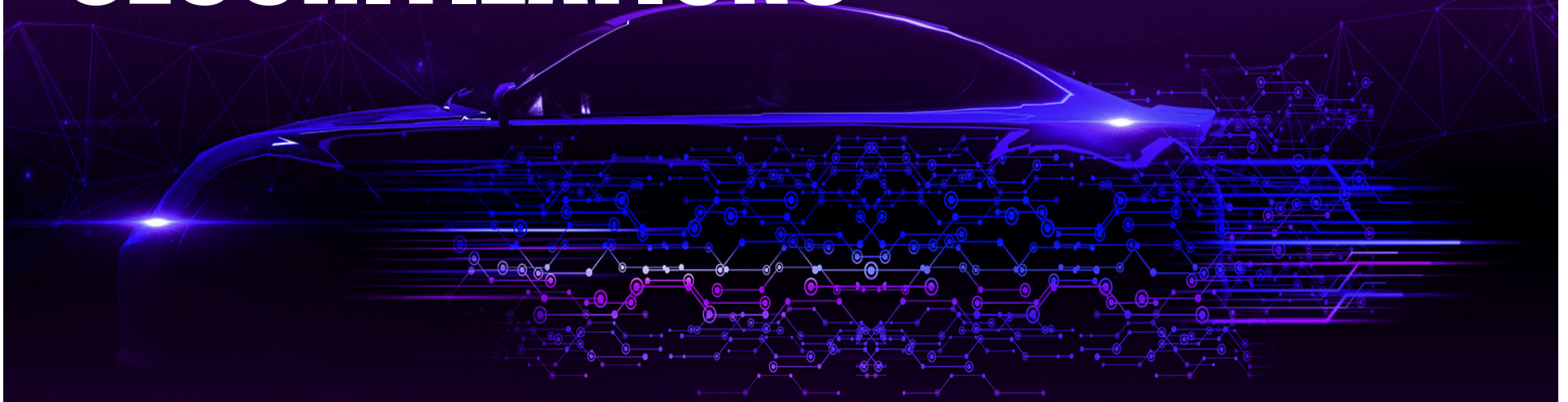


# Types of Automotive Securitizations

- Auto Loan Securitizations
- Auto Lease Securitizations
- Dealer Floorplan Securitizations

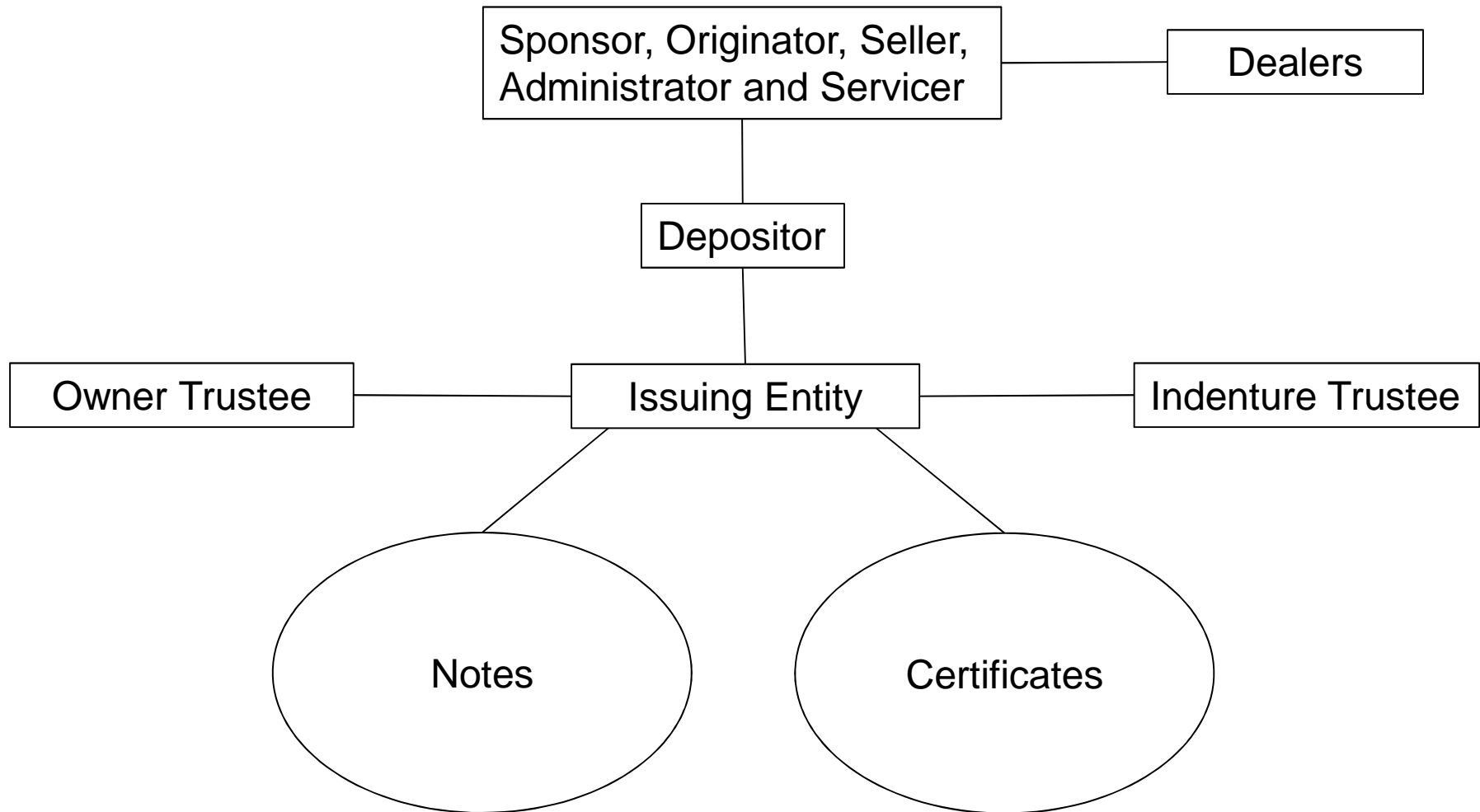


# **BASICS OF RETAIL AUTO LOAN SECURITIZATIONS**





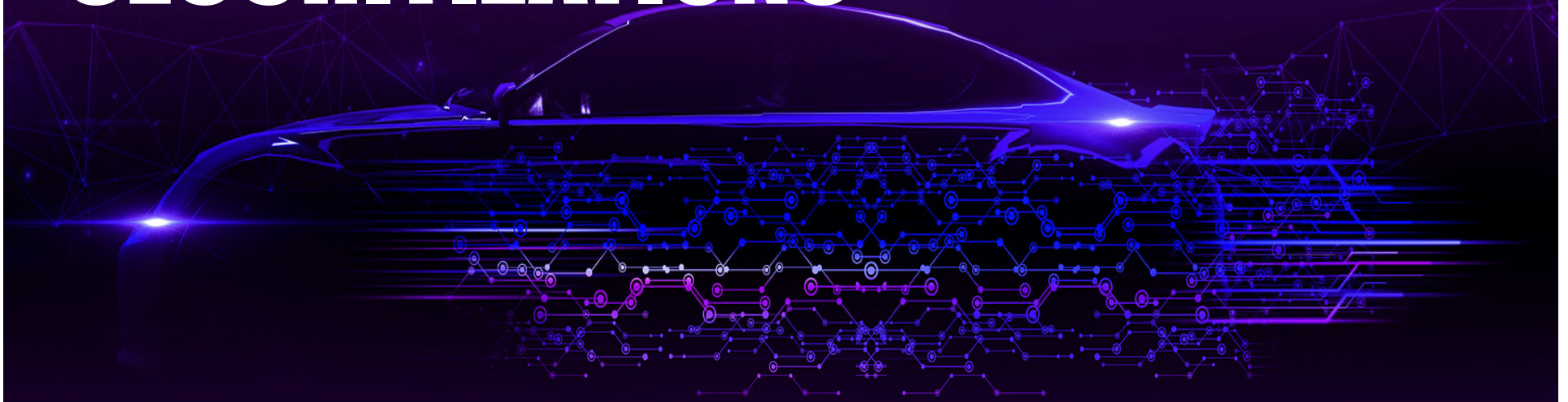
# Basics of Retail Auto Loan Securitizations



# Basics of Retail Auto Loan Securitizations

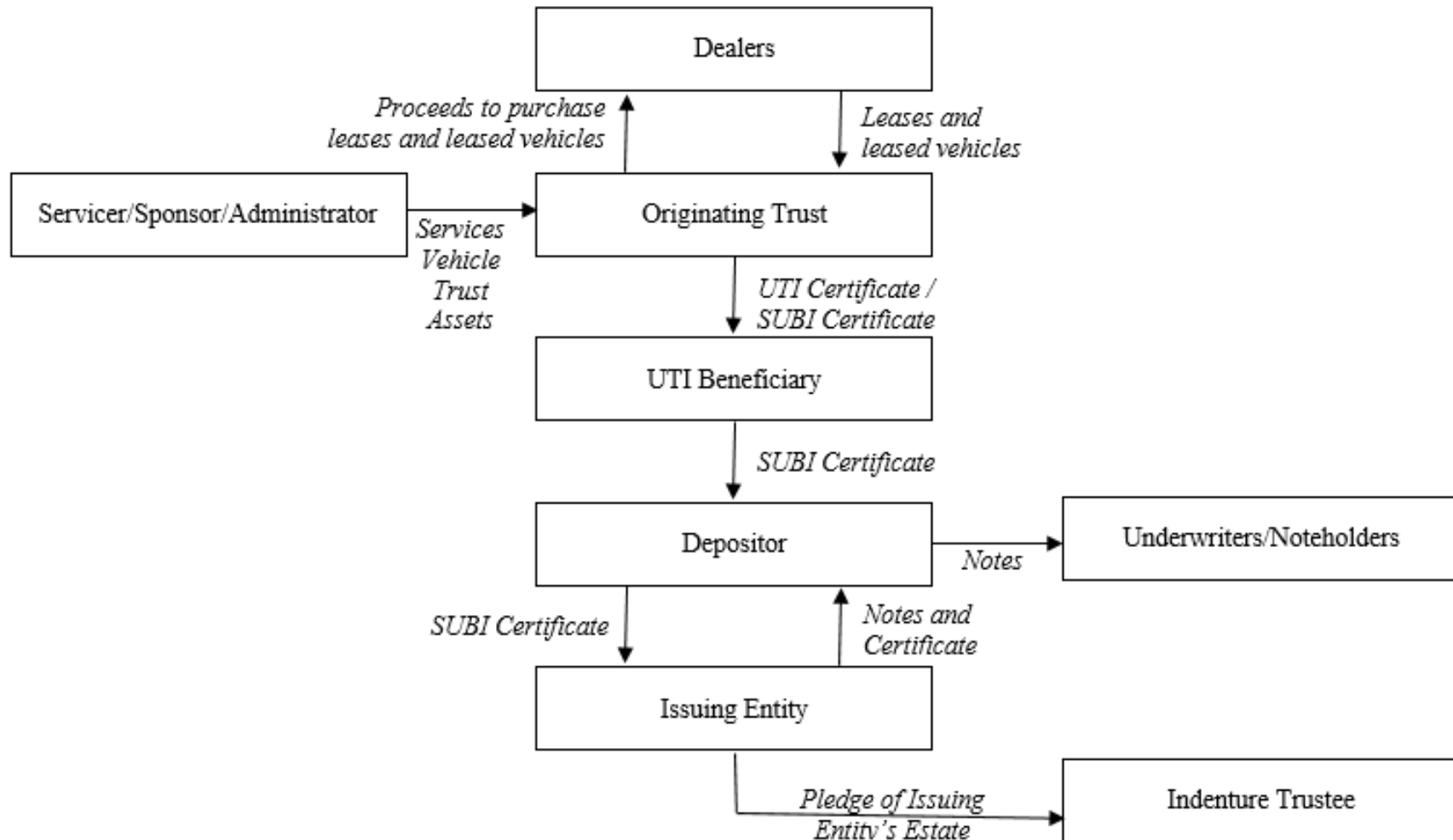
- Typically loans originated through automobile dealers and sold to the auto finance companies – so called “indirect loans”
- Transaction generally takes the form of retail installment sale contracts which are chattel paper under Article 9 of the UCC
- Automatic perfection of sale of chattel paper
- Chattel paper contains both a promise to pay and a grant of a security interest – in this case in the financed vehicle
- Car is titled in the name of the borrower but has notated the name of the finance company as lienholder on certificate of title
- Typically do not change lienholder when securitizing auto loans but servicer is generally lienholder
- If there is a geographic concentration above certain limits specified by the rating agencies, a so-called state titling opinion will be required
- Chattel paper remains in possession of seller/servicer
  - Fraud risk
- Electronic chattel paper – if seller does not transfer control to issuing entity then inventory financing party with lien on after acquired property of dealer would trump competing lien on chattel paper

# **BASICS OF RETAIL AUTO LEASE SECURITIZATIONS**



# Basics of Auto Lease Securitizations

## Summary of Auto Lease Transactions



# Basics of Auto Lease Securitizations

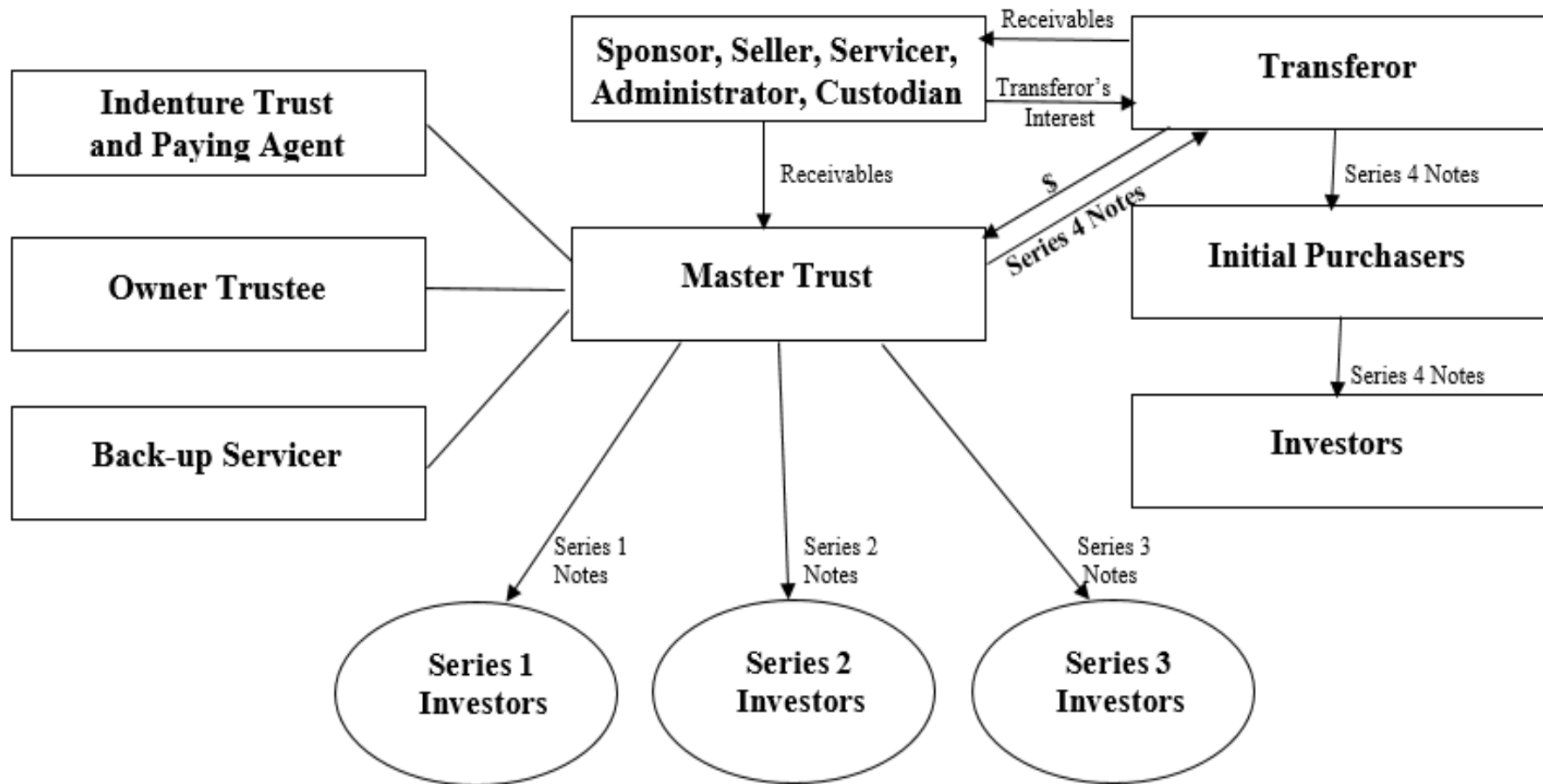
- Differs from retail auto loans in that the asset being securitized are both the leases and the residual value in the vehicles
- To mitigate bankruptcy risk, a so-called titling trust is established to originate the lease
- Titling trust is named as owner on the certificate of title for the vehicle
- As a consumer lease originator, titling trust may be required to be licensed under state law
- Titling trust issues both a UTI and one or more SUBIs
- SUBI represents an undivided beneficial ownership interest in a pool of leases and related vehicles
- Asset which gets securitized is the SUBI as opposed to the actual leases and vehicles
- Some deals have titling trust issue exchange notes instead to mitigate risk of ERISA or tax liens on titling trust assets trumping claims of the holder of a SUBI
- Complex Investment Company Act analysis required for the titling trust and issuing entity

# **BASICS OF DEALER FLOORPLAN SECURITIZATIONS**



# Basics of Dealer Floorplan Securitizations

## TRANSACTION PARTIES FLOORPLAN RECEIVABLES

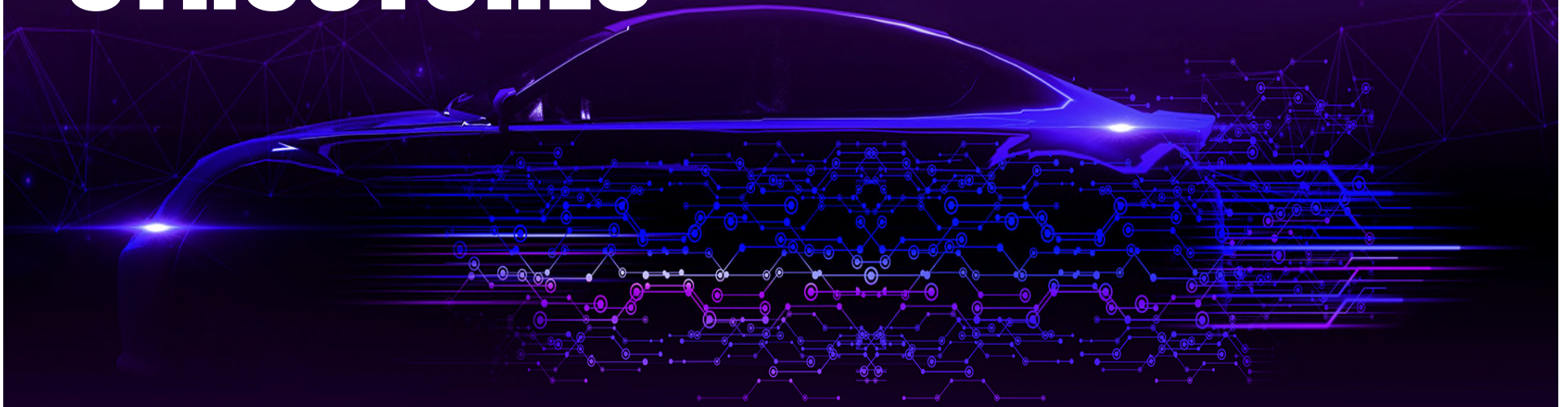




# Basics of Dealer Floorplan Securitizations

- Assets being securitized are loans made by an auto finance company to dealers secured by the automobile inventory on the dealers' lots
- Loans revolve – when cars are purchased loan is repaid with proceeds and when new cars are added to the dealer's lot a new borrowing occurs
- Securitization structure accommodates the revolving nature of the assets by providing for a revolving period during which the master trust purchases new loans to be added to the securitized pool with the principal collections received on other loans
- During the revolving period no principal is paid on the ABS
- Revolving period ends at earlier of a date certain and the occurrence of certain specified events
- May issue multiple series which share in all of the assets of the master trust where some series are in the revolving period while other series are in amortization
- Concerns about dealer concentration

# COMMON ISSUES FACING ALL THREE STRUCTURES



# Common issues facing all three structures

- Bankruptcy Remoteness
- Tax treatment of Notes
- ERISA Plan Eligibility
- 40 Act/Volcker Rule
- Risk Retention
- Rated v Unrated Deals
- Public v Private (Pros/Cons)

# Common issues facing all three structures:

## **Bankruptcy Remoteness: True Sale**

- Key feature of securitization versus other financings
- Requires “true sale” of assets from transferor to SPV
- “True sale” means that in the event of the bankruptcy of transferor, the assets transferred to SPV would not be part of the bankruptcy estate of transferor
  - If not a true sale, cashflows on assets and assets themselves subject to automatic stay
- Main factors in determining true sale
  - Credit recourse to transferor
  - Transferor retains benefits and/or burden of assets

# Common issues facing all three structures:

## **Bankruptcy Remoteness: Non-Consolidation**

- For ratings of ABS not to be dependent on rating of transferor must have legal corporate separateness
- Concept typically applies to parent/subsidiary
- Key factors to avoid substantive consolidation include no interlocking boards, separate bank accounts, separate books and records, and only arms'-length transactions
- If corporate formalities ignored and transferor files for bankruptcy, bankruptcy court could substantively consolidate the assets and liabilities of SPV with the transferor

# Common issues facing all three structures:

## **Tax Considerations:** SPV must not be taxable

- Want to maximize amount of cashflow from assets available to be distributed to security holders
- To do this, SPV must not be taxable as a corporation – a pass-through entity
- Can take the tax form of a grantor trust, a partnership, or a disregarded entity for tax
- Revolving structures put pressure on tax analysis

# Common issues facing all three structures:

## **Tax Considerations:** Debt for tax

- Securities issued could take the form of debt or equity
- Debt for tax has benefits
  - No withholding tax
  - May be purchased by non U.S. persons
  - If selling equity, must be either restricted to U.S. persons or assets must be held by SPV through a grantor trust



# Common issues facing all three structures:

## **ERISA Eligibility**

- ERISA plans among the largest purchasers of ABS
- To be eligible for purchase by ERISA plans, ABS must either be debt for tax or meet certain criteria which makes the security eligible for purchase by ERISA plans by virtue of the so-called “Underwriters’ Exemption”

# Common issues facing all three structures:

## **Investment Company Act:** Investment Company

- SPV must not be required to register as an investment company
  - Registration very burdensome and costly
- If SPV is an investment company and does not register, all of its contracts are void
- Most common exemptions include Rule 3a-7 and Section 3(c)5(C) as well as Section 3(c)(1) and Section 3(c)(7)
- Particular challenges for auto lease securitizations

# Common issues facing all three structures:

## **Investment Company Act: Volcker Rule**

- Post-crisis Congress passed the so-called Volcker Rule
- Prohibits banking entities from certain proprietary trading or acquiring or retaining an ownership interest in a “covered fund”
- Securitized asset pools can resemble covered funds under the rule
- Preferred strategy to avoid characterization of securitization vehicle as a covered fund
  - Entity that relies on Section 3(c)(1) or Section 3(c)(7) as an exemption from registration under Investment Company Act is a covered fund
  - If rely on Rule 3a-7 or Section 3(c)5(C) then not a covered fund
- If cannot structure the transaction as 3a-7 or 3(c)(5)(C) eligible, may be able to rely on loan exemption
  - No other assets permitted but loans
  - No securities (but SUBIs permitted under certain circumstances)

# Common issues facing all three structures:

## **Risk Retention:** U.S. Risk Retention

- Adopted as part of Dodd Frank Act
- Financial crisis attributed to originate to securitize model
- Cure was to have securitizers have “skin in the game”
- Applies to public and private offerings
- Regulation RR requires 5% risk retention in one of three forms
  - Eligible vertical interest
  - Eligible horizontal interest
  - “L-shaped”

(continued)

# Common issues facing all three structures:

## **Risk Retention:** U.S. Risk Retention (Continued)

- Retained interest must be held by “Sponsor” or MOA
- No hedging of retained interest
- May finance on “full recourse” basis only
- Specified holding period for Auto ABS latest of
  - Pool amortizes to 33%
  - Notes amortize to 33%
  - Two years after closing date
- No risk retention required for “Qualified Auto Loan”
  - Very few loans qualify because of minimum downpayment requirement (10%) and DTI of 36%

# Common issues facing all three structures:

## **Risk Retention:** E.U. Risk Retention

- Differs from U.S. risk retention in several respects
  - Types of risk retention
  - Who may hold risk retention
  - E.U. rules permit risk retention to be held synthetically
  - E.U. rules apply for life of deal
  - Similar restrictions on hedging and financings
- To do a U.S. and E.U. compliant transaction may add inefficiencies to execution

# Common issues facing all three structures:

## **Rated vs Unrated Deals**

- Rated deals tend to be more liquid and easier to price than unrated deals.
- While rating agencies were under acute scrutiny when hundreds of deals were downgraded during the financial crisis, nonetheless, investors take comfort in the rating
- The higher the rating, the lower the cost of funds
- For rated deals, Rule 17g-5 requires issuer to post to special website any information transmitted to hired rating agency for rating purposes
  - Information is accessible to other rating agencies
  - Applies to public and private deals

(continued)

# Common issues facing all three structures:

## **Rated vs Unrated Deals** (Continued)

- Rule 17g-10 requires provider to provide certificate on ABS Due Diligence 15E to any rating agency that requests it and to party responsible for posting 17g-5 website
- Rule 15Ga-2 requires an issuer or underwriter of rated ABS to furnish to the SEC the findings and conclusions of third party due diligence report at least five business days before pricing



# Common issues facing all three structures:

## Public Offering vs Private Placement

- Public deals generally price tighter than private deals due to increased liquidity
- Public offerings are more expensive due to registration process, SEC filing fees, and ongoing reporting requirements
- Regulation AB governs disclosure requirements for public deals
- Auto ABS public offerings are always done on shelf registration statement on Form SF-3
- To qualify for Form SF-3, Depositor must file a CEO Certification and the transaction documents must provide for
  - Asset Representations Reviewer
  - Repurchase Request and Dispute Resolution
  - Investor Communications

(continued)

# Common issues facing all three structures:

## **Public Offering vs Private Placement** (Continued)

- Public auto loan and auto lease deals also require asset-level data to be filed with the preliminary prospectus
- In public offerings, Rule 193 requires disclosure of findings and conclusions of third party diligence reports in the preliminary prospectus
- In public offerings, a preliminary prospectus must be filed three business days prior to pricing
- Any material changes to the preliminary prospectus must be filed 48 hours before pricing
- Preliminary prospectus must be delivered to investors 48 hours before confirmation of sale

(continued)

# Common issues facing all three structures:

## **Public Offering vs Private Placement (Continued)**

- Ongoing public reporting requirements:
  - Form 10-D – required to be filed monthly 15 days following distribution date
  - Form 8-K – required to be filed within 4 business days of a reportable event
  - Form 10-K – required to be filed annually within 90 days of end of fiscal year
  - Failure to timely file these reports may result in loss of shelf eligibility

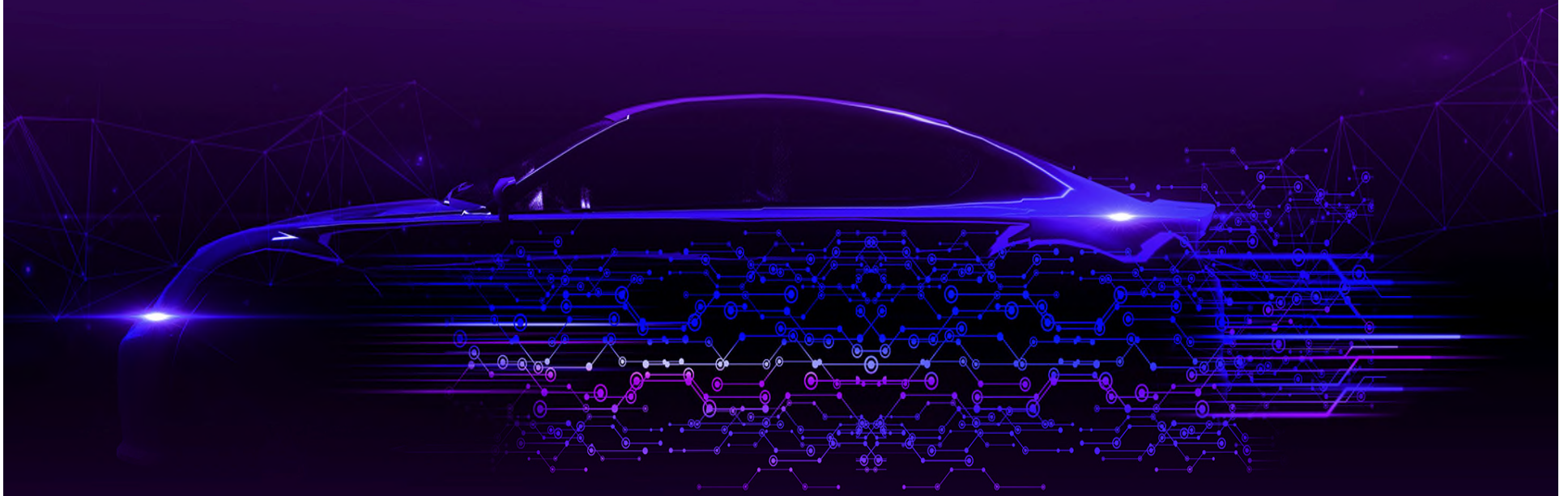
# OTHER ISSUES TO CONSIDER



# Other issues to consider

- Licensing
- 15Ga-1 repurchase requests
- Servicemembers Civil Relief Act
- Military Lending Act

# QUESTIONS?



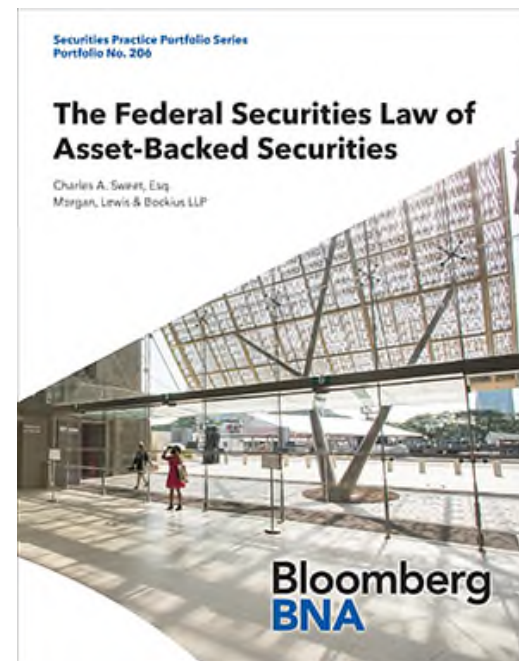
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*The Federal Securities  
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