Structured finance SPVs and choice of jurisdiction

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Practice note: overview | **Maintained** | International

An overview of the use of, and choice of jurisdiction for, special purpose vehicles in structured finance transactions.

Scope of this note
What is an SPV?
Ensuring the SPV is insolvency remote
Ensuring the SPV is treated separately from the originator
Typical deals using SPVs in the structured finance market
Choice of SPV jurisdiction
SPVs in specific jurisdictions

Scope of this note

This note gives an overview of the use of (and the issues to consider when establishing) *special purpose vehicles (SPV)* in structured finance transactions, including in the Cayman Islands, Ireland, Luxembourg, Jersey, the Netherlands and the UK.

What is an SPV?

The type of SPV used for structured finance transactions depends on the jurisdiction in which it is established.

In many jurisdictions the SPV is a corporate entity with a small amount of equity capital, the shares of which are typically held by a charitable trust. This is why the SPV is often referred to as an 'orphan' vehicle. In jurisdictions, such as those where the trust concept is not recognised, there may be legislation governing structured finance transactions and the SPV may be set up according to its provisions. Jurisdictions, such as the United Kingdom or European Union have legislative *securitisation* regimes (and other domestic legislation, such as Irish "section 110 companies" and the newly introduced legislation in Luxembourg for securitisation structures) which allow UK and certain European incorporated SPVs to be used for specified transaction types provided that the structured finance transaction falls within the relevant legislative framework.

If a transaction is unable to accommodate a required legal form for an SPV in the jurisdiction of the originator, or there are certain advantages to establishing it elsewhere, the SPV is likely to be established in an offshore jurisdiction. Tax neutrality is often important in choosing where to establish the SPV. SPVs are often established in low-tax or tax neutral jurisdictions, such as the Cayman Islands, Ireland and Jersey.

The SPV in a structured finance transaction is established so that it:

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- Is not treated as a subsidiary of the originator.
- Is not affected by the insolvency of the originator.
- Is "off balance sheet", which means it does not need to have its balance sheet consolidated with the originator's balance sheet (although this may depend on the accountancy practices and various other rules in the jurisdiction of the originator).
- Is tax neutral so it does not add an additional layer of taxation to the structure.
- Acts to hold assets/credit so as to isolate the credit risk.

Ensuring the SPV is insolvency remote

It is important that the SPV is, as far as legally possible, insolvency remote (that is, the SPV is set up and operates so that it is highly unlikely that it will become subject to insolvency proceedings). What is necessary to achieve the insolvency remoteness of the SPV depends on the jurisdiction in which it is established and may include:

- Ensuring the SPV is operated on a solvent basis.
- Appointing directors (or a director) independent of the originator whose vote is required to pass a board resolution relating to the SPV's insolvency.
- Placing restrictions on the SPV that prevent it from incurring liabilities outside those contemplated by the transaction.
- Having "limited recourse" clauses in all significant transaction documents to restrict the reach of a claimant counterparty by limiting the assets to which it has recourse to those that the SPV actually holds and over which the counterparty has security. This means that the obligations of the SPV will not exceed the value of its assets, whatever that may prove to be.
- Having "non-petition" clauses in all significant transaction documents, which means that the transaction parties are unable to proceed against the SPV and its directors and prohibits the commencement of insolvency proceedings against the SPV.

Ensuring the SPV is treated separately from the originator

In some jurisdictions, the courts can treat the assets of an affiliate closely associated with a parent entity as if the assets are all held by the same entity. Consequently, the affiliate's assets can be made available to meet the obligations of the parent if it becomes insolvent. This is commonly known as lifting (or piercing) the corporate veil (or substantive consolidation in the US). The extent to which courts can do this and methods necessary to avoid such consolidation will depend partially on the law of the relevant jurisdiction.

Typical deals using SPVs in the structured finance market

Structured finance is a technique employed for a variety of purposes, including the restructuring of debt, capital raising, the transfer of assets and to manage risk. While the dominant form of structured finance is a securitisation transaction, whereby typically illiquid debt assets or receivables are pooled and then the revenues are sold to investors in the form of securities,

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companies may also employ the same techniques for project financing and repackagings. SPVs are the issuing vehicle for a broad range of structured finance products with investors worldwide buying instruments issued by such entities.

A key component of structured finance, whatever the form, is the use of SPVs. In a typical financing, a sponsor (the company holding the assets that need financing) transfers a pool of assets to one or more SPVs that hold the assets and issue fixed-income securities to investors. Payment on the securities depends primarily on the cash flows generated by the pooled assets. A servicer administers the pool by collecting payments on the underlying assets when due and ensuring that funds are available so that investors are paid in a timely manner. In most cases, an independent trustee, monitors an SPV's fulfilment of its obligations as issuer.

Some of the benefits of using an SPV are that the SPV can be used to ring-fence certain assets in an insolvency remote vehicle thereby enabling a borrower to obtain better financing terms. SPVs are also useful to hold assets that can be challenging to secure. Once such assets are held by the SPV, security can be granted over the shares in the SPV, which enables easier access to the secured lending market.

SPVs can be created as nearly any legal entity. The most common forms of SPVs are companies, limited partnerships (LPs), limited liability companies (LLCs), or trusts. In almost all cases, the SPVs are passive entities that generally only hold assets and receive cash flow from those assets. They, therefore, conduct no business and have no need for employees or management structures.

The types of structured finance transactions include:

- **Securitisations**

  For an overview of securitisation, including details of the structure, parties and documents in a typical transaction, see *Practice note, Securitisation, overview*.

- **Credit linked transactions such as collateralised loan obligations (CLOs) and credit linked notes (CLNs)**

  For an overview of *CLOs*, including details of the structure, parties and key legal issues involved in executing a typical cash flow CLO transaction, see *Practice note, Collateralised loan obligations (CLOs): overview*.

  For information on *CLNs*, see *Practice note, Debt securities: types of securities: Credit-linked notes*.

- **Repackaging**

  For an introduction to *repackaging* (repack) transactions, including an explanation of their legal structure and economic rationale, a description of the principal parties and an overview of the key documents that are typically involved in executing a repack transaction, see *Practice note, Repacks: understanding repacking note transactions*.

- **Catastrophe bonds**

  A debt instrument structured to provide that interest and/or principal payments will be delayed or lost in the event of a loss due to a specified catastrophe, such as a hurricane or earthquake (see *Practice note, Reinsurance: an overview: Insurance-linked securities*).

- **Trade financing and receivables financing**

  Trade finance represents the financial instruments and products that are used by companies to facilitate international trade and commerce. Trade finance makes it possible and easier for importers and exporters to transact business through trade. Trade finance is an umbrella term meaning it covers many financial products that banks and companies utilise to make trade transactions feasible.

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For information and resources on various types of structured trade finance transactions, see *Practice note, A guide to key resources: trade finance: Structured trade finance transactions*.

Receivables finance is a term that describes several different techniques a business can use to raise funds against the amounts owed to it by its customers in outstanding invoices, also known as its trade receivables or accounts receivable.

For an overview of trade receivables securitisation, see *Practice note, Trade receivables securitisation*.

- **Asset financing**

  Asset financing (such as, real estate, aircraft and ship financing) refers to the use of a company's balance sheet assets, including short-term investments, inventory and accounts receivable, to borrow money or get a loan. The company borrowing the funds must provide the lender with a security interest in the assets.

  For an introduction to the types of structures used in asset financing and some of the key issues relevant to those structures, see *Practice note, Asset finance: overview*.

- **Islamic finance**

  Islamic finance is banking, lending, and saving practices that comply with Islamic law.

  For an introduction to the basic principles of Islamic law (or Sharia) that affect finance transactions, see *Practice note, Islamic finance: UK law overview*.

Choice of SPV jurisdiction

There are a number of jurisdictions that are used to incorporate or register SPVs for structured finance transactions. The choice of jurisdiction for the SPV for a particular transaction type is generally driven by existing market practice, the skill set of service providers in a jurisdiction, investor location and the location of underlying assets (as well as more technical reasons for certain products).

SPVs for the securitisation of UK and European located assets are typically incorporated in the UK, or a European Union jurisdiction, often Ireland, the Netherlands or Luxembourg. The issuance of UK covered bonds tends to involve the use of a UK SPV. CLOs tend to use either Cayman Islands, Irish or Jersey SPVs. Repacking SPVs are typically located in the Cayman Islands, Ireland or Jersey.

SPVs used for catastrophe bond transactions tend to be established in the Cayman Islands while Islamic finance structures typically use Jersey, UK and Cayman Islands SPVs.

SPVs in specific jurisdictions

We are in the process of publishing a series of articles in which we look at each major structured finance SPV jurisdiction (being the Cayman Islands, Ireland, Luxembourg, Jersey, the Netherlands and the UK) and review the reasons each one is used for the type of structured finance product typically seen there. See Articles:

- *SPVs in structured finance transactions: Cayman Islands*.
- SPVs in structured finance transactions: Ireland. [*awaiting publication*]

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- SPVs in structured finance transactions: Luxembourg. [*awaiting publication*]
- SPVs in structured finance transactions: Jersey. [*awaiting publication*]
- SPVs in structured finance transactions: the Netherlands. [*awaiting publication*]
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