1 **Q. Reference: CA-NP-147, Attachment A: please provide a copy of the Standard and**
2 **Poor's publication, "Ring-fencing a subsidiary" at p. 7, footnote 8.**
3
4 A. Attachment A is a copy of the October 19, 1999 Standard and Poor's research publication
5 titled *"Ring Fencing a Subsidiary"*.

Standard & Poor's Research Publication
Ring Fencing a Subsidiary

Research:

Ring-Fencing a Subsidiary

Publication date: 19-Oct-1999

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The evolution of structured finance techniques, and their adaptation by corporate credit structures, has expanded the methods by which the credit quality of a subsidiary might be rated higher than the credit quality of the consolidated entity. These methods, colloquially referred to as "ring-fencing," are described here.

Standard & Poor's takes the general position that the rating of an otherwise financially healthy, wholly owned subsidiary is constrained by the rating of its weaker parent. The basis for this position is that a weak parent has both the ability and the incentive to siphon assets out of its financially healthy subsidiary and to burden it with liabilities during times of financial stress. The weak parent might also have an economic incentive to filing the subsidiary into bankruptcy--if the parent itself were forced into bankruptcy--regardless of the subsidiary's "stand-alone" strength. Experience suggests that insolvent corporations will often jointly file with their subsidiaries--even those subsidiaries not themselves experiencing financial difficulty.

Before arriving at the rating of any particular subsidiary, Standard & Poor's assesses the credit quality of the consolidated entity of which the subsidiary is a part. No rating, per se, is assigned to the consolidated entity; rather, the credit-quality assessment is a pro forma measure of the consolidated entity's general ability to meet its obligations. (See "Consolidated Ratings Methodology" sidebar.)

Issuers and their advisors typically offer two particular devices to justify a ratings separation between the parent/group and the subsidiary: the protective covenant and the nonconsolidation opinion. The problem with these devices is that by themselves they do not go far enough in effectively insulating or "ring-fencing" the subsidiary from its parent.

The protective covenant is designed to restrict the shifting of assets and liabilities between parent and subsidiary. The covenant accomplishes this either by outright prohibition of asset transfers and dividend declarations or by subjecting such transfers and declarations to stringent tests. The parent may also offer a so-called "nonpetition" covenant, by which it undertakes not to file the subsidiary into bankruptcy.

Covenants are generally given little weight in the analysis of whether a subsidiary might be rated higher than its parent. Courts will rarely compel an entity to comply with or perform the terms of a covenant. They prefer instead to limit remedies to provable monetary damages in the event of breach of covenant and consequential loss. If a company breaches its financial covenants and thereafter goes into bankruptcy, any proven resulting damages would have to be recovered from the company's bankruptcy estate, most likely at a relatively low priority. It is, moreover, difficult to draft covenants that will cover every conceivable eventuality. Standard & Poor's assumes that management will, in keeping with its responsibilities to shareholders, attempt to devise ways to defeat covenants that are burdensome.

"Nonpetition" covenants are also problematic in that they are unenforceable as a matter of public policy. Although it views nonpetition covenants as an indication (at least, at the time given) of the parent's disinclination to filing a subsidiary into bankruptcy, Standard & Poor's measures the likelihood of the performance of any covenant (such as the obligation to pay timely debt service) by the level of the covenantor's own rating level. Standard & Poor's views compliance with nonpetition covenants as being, ultimately, more a question of willingness than of ability.

The second device is the offer of a "nonconsolidation" opinion by the parent. Nonconsolidation opinions

are common in structured finance. The doctrine of substantive consolidation allows creditors of a bankrupt company to ignore the principles of the "corporate separateness" of parent and subsidiary if:

- The creditors can persuade the court that the parent was using the subsidiary to shelter the parent's assets; or
- The affairs of the parent and the subsidiary were so intertwined as to make the two entities essentially indistinguishable.

In appropriate circumstances, the court will "consolidate" the assets of the subsidiary with those of the bankrupt parent, thus allowing the parent's creditors access to the assets of the subsidiary. A nonconsolidation opinion addresses the degree of likelihood that a court will grant substantive consolidation based on the observance by parent and subsidiary of certain "separateness factors." Aside from the fact that they are fact-specific, limited in scope, and highly qualified, nonconsolidation opinions specifically do not address the likelihood of simultaneous bankruptcies of the parent and the subsidiary at the instigation of the parent. Even when a covenant package accompanies a nonconsolidation opinion, therefore, the potential still exists for a parent to act to the detriment of its subsidiary's creditors. Exceptions to the weak-parent/strong-subsidiary linkage have been made based on particular factual circumstances, such as transactions involving independent finance subsidiaries and regulated entities. Even in such instances, however, there typically remains some linkage. This linkage usually constrains the rating of an otherwise advantaged subsidiary to one full rating category (three "notches") above the credit quality of the consolidated entity. In cases where a regulated utility is the subsidiary, the three-notch, regulatory-based differential will not often be achieved, since it is only considered when the subsidiary is located in an actively regulated jurisdiction like Oregon, California, or Virginia. Similar examples of ratings that take serious regulatory oversight into account can be found in Australia and the United Kingdom.

The evolution of structured finance techniques, and their adaptation by corporate credit structures, has expanded the methods by which the credit quality of a subsidiary might be rated higher than the credit quality of the consolidated entity. Of course, corporate affiliation can never be totally ignored, even where the parent has adopted a number of these structuring techniques. When business dependencies exist between subsidiary and parent, such techniques may not be respected by the courts. These methods, colloquially referred to as "ring-fencing," are cropping up in a variety of financing situations, including:

- Acquisition financing (the incurring of debt by a newly formed entity for the purpose of acquiring an existing entity);
- Monetizing a subsidiary's dividend distributions (the formation by a low-rated parent of an intermediary subsidiary, interposed between the parent and its operating subsidiaries, for the purpose of borrowing funds, the debt service on such loans being derived from dividend streams received from the operating subsidiaries); and
- Corporate spinoffs (the formation by a single, low-rated parent of a new subsidiary, which then incurs debt for the purpose of acquiring a relatively profitable line of business, or assets, from the parent).

Exceptions to the Rule

Depending on the "stand-alone" strength of the subsidiary, a package of enhancements (including structural features, covenants, and a pledge of collateral) may be effective to raise the rating of the subsidiary a full rating category over the credit quality of the consolidated entity. (See "A Ratings Enhancement Package" sidebar.) If the subsidiary has multiple owners, one or more of which is capable of defending the subsidiary from the acts of a financially stressed or insolvent parent, an even wider rating differential may be merited. The basis for the rating differential is that the package may be viewed as reducing the means--as well as the incentive--of the parent to shift assets from and liabilities to the subsidiary, or to file it into bankruptcy. (The operational nature of the subsidiary's business distinguishes this approach from true securitizations in which differentials of three or more ratings categories can be achieved. Securitizations of statistically predictable pools of accounts receivable are, in the view of Standard & Poor's, fundamentally different from the business and financial issues characteristic of operating entities.)

Structure.

As noted above, parent/subsidiary linkage is prompted, in part, by two concerns:

- That a healthy subsidiary's assets may be consolidated with those of its insolvent parent; and
- That the parent will have the ability to cause the subsidiary to file itself into bankruptcy, despite the fact that the subsidiary is not itself experiencing financial difficulty. Ensuring that the subsidiary is a limited-purpose operating entity, somewhat similar to the "special purpose entity" (SPE) found in a securitization, may mitigate this bankruptcy risk.

While the SPE is, strictly speaking, a creature of securitization, its operating asset analogues are found in the limited-purpose operating entities employed in industrial-based or project-financed transactions. In the context of a "ring-fenced" transaction, Standard & Poor's expects that such limited-purpose entity will:

- Be "single-purpose";
- Incur no additional debt (beyond that sized into the rating and necessary for routine business purposes, such as trade debt and ordinary working-capital facilities to prestated levels);
- Not merge or consolidate with a lower-rated entity;
- Not dissolve; and
- Have an "independent director."

In the context of a "ring-fenced" transaction, the operative feature is the independent director.

Absent any stipulation to the contrary, a company's directors have a fiduciary duty to its shareholders. The fiduciary duties of the subsidiary's directors are understood to include the execution of the parent's instructions, including an order to file the subsidiary into bankruptcy voluntarily. (A financially healthy subsidiary should not properly be involuntarily filed by the parent, since the subsidiary would be able to pay its debts as they become due.)

To ensure that this duty is fulfilled properly, the charter documents of the SPE require the affirmative vote of the independent director, an individual with no tie or relationship to the parent, as a prerequisite to the SPE's voluntarily filing itself into bankruptcy. The charter documents of the SPE require the independent director to take into account the interests of the creditors of the subsidiary (including the holders of the rated debt), in addition to the interests of the shareholding parent, when deciding to file. The creditors of the subsidiary would almost certainly be prejudiced by such a filing.

As is the case in true securitizations, the SPE is most effective when paired with a nonconsolidation opinion. The combination of the SPE structure and the nonconsolidation opinion may provide some comfort that the parent and its potentially more highly rated subsidiary are adequately distanced from each other, thus justifying the existence of a rating differential between the credit quality of the subsidiary and the credit quality of the consolidated entity. Nevertheless, structural separation alone may simply elevate form over substance when the subsidiary has significant operating and business dependencies on the parent (and vice versa). Consequently, the advantages of structural separation may be lost if such dependencies exist.

An additional structural protection is the use by the subsidiary of a "lockbox" mechanism, whereby accounts receivable owed to the subsidiary are deposited by its customers directly into a bank account controlled by, and in the name of, the security trustee or collateral agent for the rated debt. The trustee or agent then allocates the cash according to a distribution mechanism designed to:

- Pay the costs of the subsidiary's operations;
- Settle administrative expenses; and
- Pay debt service while segregating cash from the direction and control of, and potential interference by, the lower-rated parent.

Covenants.

Together with structural (or regulatory) and collateral provisions, a tightly drafted covenant package is important in preserving the financial well-being and autonomy of the subsidiary. These covenants may include (but are not limited to):

- Dividend tests;
- Negative pledges;
- Nonpetition covenants;
- Prohibitions against creating new entities; and
- Restrictions on asset transfer and intercompany advances.

In structures where the subsidiary has affiliates, covenants prohibiting any intercorporate dealings whatsoever (even when subject to "arm's-length" tests) may be desirable because of the potential for abuse.

Collateral.

If the debt is fully secured by a pledge of all or substantially all of the assets of the subsidiary, the parent, in principle, has less freedom to deal with the assets of the subsidiary and, therefore, a reduced incentive to file the subsidiary into bankruptcy. The security usually takes the form of a subsidiary's general pledge of its assets to the collateral agent or security trustee, and a parent's pledge of its ownership interest, e.g., membership (LLC), partnership, (LP) or share (corporation interest) in the subsidiary as security for payment.

In support of the pledge, Standard & Poor's will request that the parent and the subsidiary provide evidence of the pledge, including, for example, in the case of real property, title insurance showing the interest of the collateral agent or security trustee and a legal opinion (addressed to Standard & Poor's) stating that the collateral agent or security trustee has a first perfected security interest in all other collateral in which a security interest can be perfected, either by possession or filing, or at common law. If the subsidiary is unwilling or unable to pledge its assets, reduced credit may be given for the parent's pledge of its ownership interest in the subsidiary.

Regulatory Supervision.

Transactions involving electric, water, natural gas, and telephone utilities may be subject to regulatory supervision. In the context of the weak-parent/strong-subsidiary linkage, the utility usually represents the strong subsidiary. Regulatory approval, influence, or mandate may well have a positive effect on credit quality. The effect of regulation is felt minimally when the subsidiary must secure regulatory approval to sell debt or dividend cash to the parent. Depending on particular circumstances, the rating differential created by such regulatory environment may be compounded by a package of structure, covenants, and collateral.

Multiple Ownership.

In circumstances where the subsidiary is controlled by at least two parents, or is the subject of a joint venture, the insolvency or financial difficulty of a particular venturer is less likely to have consequences for the credit quality of the subsidiary. The measure of control that a particular parent can exercise is usually related to the size of its ownership interest and the extent of its legal rights in the subsidiary. For this reason, the percentage of ownership is significant, but the identity and nature of any other owner is equally important in assessing its capabilities for effectively blocking an attempt by a co-owner to file the subsidiary. In general, where two or more parents are motivated and able to prevent each other from harming the credit quality of the subsidiary, the rating of the credit quality of the subsidiary may be higher than that of any parent's, if justified on a "stand-alone" basis. Moreover, the subsidiary may depend more heavily on one particular parent, in which case the subsidiary's rating may be affected by the dependency.

Conclusion

In the United States, there are a number of more or less traditional ways in which the credit quality of a subsidiary might be rated higher than the credit quality of its parent entity. In common-law jurisdictions such as the United Kingdom and Australia, there may be greater potential for differentiation. In all cases, the "package" of distancing mechanisms that serves as the basis for the rating differentiation should be an extensive one. Nevertheless, ratings benefits accruing to the subsidiary through the

methods described above may come at a price: To the extent that the credit-quality rating of the subsidiary is elevated above the credit quality of the consolidated entity, the rating of the consolidated entity may be reduced. Finally, it cannot be overemphasized that the differentials achieved by true securitization will seldom be possible in a corporate transaction because of "single-asset" or enterprise risk, regardless of the structural and other features incorporated into the transaction.

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