# CHAPTER 16A

# Structured Finance in Latin America

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## Chapter Contents



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## § 16A.01 Introduction

This chapter provides an overview of the securitization markets in Latin America. It is divided between discussions of two large groupings of deal types originating from Latin America: (a) those involving cross-border future flow structures, almost always executed with international investors, and (b) those involving local assets, often with local investors. However, given the likely readership of this volume, the discussion focuses on issues of concern to foreign participants in such securitizations.

The choice of the word "markets" in plural form is deliberate. In addition to the cross-border/local asset division noted above, another reason to refer to "markets" is the sheer diversity of Latin American local asset securitizations: different jurisdictions, economies, and currencies. Unlike the United States (with one currency) and Europe (with one dominant currency), and much commonality in asset structures and classes in both cases across component states, Latin America local market securitizations consist of a variety of sub-markets as a result of the foregoing differences. Likewise, developed markets have large volumes of "flow" products (especially those collateralized by pools of consumer assets such as residential mortgage loans, auto loans and leases, student loans and credit card receivables, as well as large business credit asset classes such as commercial mortgage loans, corporate loans and equipment leases), with the remaining minority of deals arising in highly diverse "esoteric" asset classes that change from year to year (e.g., whole business, natural resources, timeshare, health care receivables or intellectual property securitizations). In contrast, at least for foreign participants, Latin American securitizations can be said to consist entirely of esoteric securitizations, whether their recondite nature is due to comparative brevity of market history or modest issuance volumes, or non-existence of an asset type or structure outside one country or emerging markets more generally. Finally, it is worth noting the relative scale of the Latin American securitization market: Standard & Poor's estimates that issuance volume was about $13 billion in 2020 and will be $15 billion in 2021; in comparison, the corresponding annual figures for the United States are $452 billion and $520 billion, and for Europe €68 billion and €75 billion.[1]

On the other side of the challenges noted in the foregoing comparative perspective, market participants find working on these transactions enormously satisfying for several reasons, including: (1) the ability to do so many "firsts" by asset class or jurisdiction; (2) relatedly, the lack of specialization and ability to work across asset classes reminds those who worked in U.S. asset-backed securities in the early 1990s of that market's state prior to the asset class silos created by its success (each with its own high issuance volumes and increasingly standardized documentation); and (3) the positive economic effects of bringing alternative credit to developing markets, whether it be the extension of non-bank credit to consumers, lower cost funding to emerging markets banks and corporates, or access to medium-term dollar funding to issuers during crises when funding is not otherwise available, or is only available at much higher rates.

[1] Manzi, "Global Structured Finance 2021 Outlook: Market Resilience Could Bring Over $1 Trillion In New Issuance 4," S&P Global Ratings (Jan. 8, 2021), available at https://www.spglobal.com/_assets/documents/ratings/research/100048329.pdf (last visited July 15, 2021).

## § 16A.02 Future Flow Transactions with Cross-Border Assets

Asset classes within the general category of cross-border future flow securitizations are discussed individually below. However, as a general matter they share several attributes[1]: (1) the originator causes the asset to come into existence by normal operation of its business, or a key line of business; (2) as such, there is originator dependence on the asset coming into existence in order for the debt to be paid, as opposed to existing (whether revolving or fixed) pool ABS; therefore, although deal ratings are ultimately linked to the seller's ratings, the perceived likelihood of the seller continuing to generate the asset is usually viewed as higher than its likelihood of defaulting on senior unsecured debt; (3) the assets are payable from sources outside the emerging market (in this case, Latin American) country; therefore, although deal ratings are ultimately linked to the country's foreign currency ratings, by mitigating foreign currency transfer and convertibility risk, deal ratings typically exceed the "sovereign ceiling" that would apply to a direct foreign currency debt issuance by the same entity acting as seller; (4) related to the foregoing, such payments go to a trustee holding such funds in an offshore trustee controlled account, and applied first to pay for, or reserve against, next payable transaction expenses and debt service, with the remainder released to the seller on a daily basis; (5) although on a debt life basis the transaction may be undercollateralized compared to an existing asset ABS transaction due to its dependence on future flows, during any given collection period it should have robust debt service coverage ratios, with the ratios varying by asset class depending on how divertible such payments are perceived as being and how susceptible they are to event risk; (6) the substantial amount of assets in excess of such required debt service ratio returning to the seller through the structure during any particular collection period is viewed as helpful to (a) maintaining the seller's incentive to continuing to produce the asset and (b) lessening the sovereign's ability to interfere with the structure; and (7) the assets are sold to an offshore special purpose vehicle, or ("SPV") (typically in the Cayman Islands), pursuant to a bill of sale governed by the laws of the seller's jurisdiction, and local counsel opines as to the "true sale" nature of such transfer, although the remaining documents are typically governed by New York law.[2]

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[1] For an excellent analysis of this topic both in general and by asset type, see Wong-Bund, "Criteria Report: Future Flow Securitization Rating Criteria," Fitch Ratings (June 19, 2020).

[2] For a more extensive discussion of the rationales for some of these features and the contrast to existing asset ABS, see Arca, "How to Think About Bankruptcy Risk in Cross-Border Future Flow Transactions After the Avianca Case," 10(4) J. Structured Fin. 55 (Winter 2005).

Originally, these transactions were structured to achieve low investment grade ratings by allowing sponsors in below investment grade countries to "pierce the sovereign ceiling" by using the structural enhancements described above. Ratings on these transactions may be flat to the originator's own rating, in which case there is less reason to do them, or an uplift of as many six notches may be possible under the methodology of the leading rating agency in this product area, although to date the maximum uplift has apparently been five notches.[3] Such uplifts to investment grade status (BBB-/Baa3 or above) were especially significant in the early years of the market to allow emerging market originators to access, either singly or in combination: non-traditional fixed income investors in emerging market debt that due to investment guidelines or other restrictions needed to buy investment grade debt; monoline financial guaranty insurance companies that needed investment grade shadow ratings to achieve their capital charge model to in turn issue AAA/Aaa rated bond insurance; asset-backed commercial paper conduits that were restricted to buying debt either at levels that required such insurance or were structured to be able to buy uninsured but still investment grade debt, and/or to achieve large 144A issuance sizes that combined emerging market investors who had ratings flexibility with other public-style asset managers who needed higher ratings.

Over the years, while parts of the foregoing rationale still held in many cases, it is also true that: (1) comfort grew with the performance of these deals generally; investment in emerging market debt generally became more familiar; contagion effects from events in one emerging market country (as formerly pertained to, successively, the Mexican peso crisis of the mid-1990s, the Southeast Asia crisis of 1997, and the Russian default crisis of 1998) did not necessarily spread to other countries; (2) with the exception of one remaining AA-rated financial guarantor that occasionally insured these transactions, financial guaranty insurance ceased being a market force after the financial crisis of 2007-2008 that brought down the AAA-rated financial guarantors; and (3) investors also perceived creditors' rights advantages in these structures apart from the ratings arbitrage described above. As a result, a number of these transactions have been successfully executed with a noninvestment grade rating, including recent transactions from Jamaica, Nicaragua, and Ecuador.

As noted above, these transactions have regularly been executed in the 144A market, and occasionally purchased by asset-backed commercial paper conduits. However, in recent years, the two most common types of execution have been (a) marketed private placements or (b) club-style deals with a small predetermined group of investors

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[3] Wong-Bund, N. 1 *supra.*

including commercial banks, insurance companies, and national or multilateral international development finance institutions. For many years, the exclusive form of debt in these transactions was securities; in more recent years, new programs have typically allowed the SPV issuers to issue a series of *pari passu* debt, either in the form of loans (generally preferred by bank investors) or securities (generally preferred by insurance companies and other asset managers).

### [1]—DPRs

Diversified payment rights ("DPRs") are the last in time of future flow asset classes to have been introduced into the Latin American securitization market (dating from 2000), but have also been the one such asset class securitized without interruption during the following twentyt-year period. To date, in the Latin American and Caribbean region, such transactions have been originated by banks in Brazil, Costa Rica, Ecuador, El Salvador, Guatemala, Jamaica, Mexico, Nicaragua, Panama, and Peru. The asset class first appeared in Turkey about a year earlier under the DPR name, or a bit earlier as a "trade payment rights" transaction. These transactions have also been executed in Kazakhstan and, in a secured loan format, in Russia.

DPR is a broad term intended to signify the right of a bank (currently via the SWIFT system, but also under replacement payments technology) to receive and retain funds associated with certain payment orders in its correspondent bank accounts abroad, in the case of Latin American banks, almost always in New York but occasionally in other U.S. or European cities. The definition of a DPR may vary somewhat from program to program, depending on which currencies, senders or beneficiaries are included, but in broad terms usually includes all dollar denominated payment orders associated with third-party beneficiaries of the sponsoring bank in its home country. Depending on the country and the bank's business profile, DPRs may arise from export finance payments, individual remittances, foreign direct investment or types of cross-border payments.

The correspondent bank accounts in the program are usually titled in the name of the sponsoring bank as servicer for the benefit of an SPV to which striking the DPRs have been sold (which holds equitable ownership of the account) and the indenture trustee to which the collections and the account have been pledged. They are under the control of the indenture trustee.

Before embarking on a DPR program, certain threshold legal questions need to be examined with local legal advisors in respect of the laws of the local jurisdiction, including whether (a) future assets can be sold and whether this type of asset is in principle assignable, (b) if so, the SPV has acquired ownership of the sold DPRs and such sale cannot be set aside by creditors of the selling bank (except in fraudulent conveyance-like circumstances), and all necessary actions will be taken to accomplish the sale, (c) the beneficiary has any claim against any specific funds sent to the local bank, or only an unsecured claim against the bank for failure to fulfill the payment obligation after receipt of the payment order from the sending bank (the latter conclusion being required to proceed with the program), (d) there are governmental approvals, other than those already obtained, to enter into the program and (e) there are any taxes to be deducted from collections or imposed on the SPV or investors.

The SPV pays for the DPRs in two ways: (a) as a cash purchase price on each issuance equal to the net proceeds the SPV receives from issuing debt, and (b) over time as a deferred purchase price from excess cash flows. Thus, over the life of the deal, the sponsoring bank will have received what it would have, had there been no securitization, save for interest and transaction fees and expenses. This is because the amount of principal used by the SPV in the waterfall to pay principal on its notes rather than paying the bank is equal to the equivalent amount the bank received as an initial payment at issuance. These deductions can be thought of as equal to the time value of money from the prepayment for the delivery of future assets in clause (a) above. However, as the advance payment of such amounts to the bank from a debt issuance is different than the schedule on which such cash would have been received subsequently, had there been no securitization, the bank needs to manage its liquidity to make payments to named beneficiaries if it wants to stay in the payments business.

### [2]—Credit Card Merchant Vouchers

Credit card merchant voucher receivables are one of the oldest future flow asset classes in emerging markets, dating from the early 1990s. In Latin American and the Caribbean, to date they have been executed in Brazil, Central America-wide, the Dominican Republic, Ecuador, Jamaica, Mexico, Panama and Peru. They have also been completed in other emerging markets including Egypt, Indonesia, South Africa, and Turkey. Some originators of these deals are banks that have also sponsored DPR programs, and the investor base for the two products has a heavy degree of overlap. It is important not to confuse credit card merchant voucher receivables deals with the major "credit card receivables ABS" asset class in the U.S. market as the latter involves (a) an existing, albeit revolving, asset structure (i.e., the deal is sized so that at any point in time the master trust issuer has more cash and receivables than debt) rather than a future flow structure, and (b) the securitization of receivables from designated consumer accounts; in contrast, the merchant voucher receivables deals relate to payments from the credit card companies themselves (Visa, Mastercard and/or American Express).

In order to visualize the difference, it is worth reviewing how payments on a credit card transaction work: An authorized issuing bank provides a credit card to a customer. If that bank issuer is outside the emerging market jurisdiction in question, then transactions involving that card when used in the emerging market jurisdiction are potentially eligible to be included in the securitization, whether the customer is resident abroad (which is usually the case) or locally. The customer then uses the card locally to purchase goods or services. The local establishment providing such goods or services charges the card and assigns the merchant voucher receivable created thereby to an authorized acquiror of such receivables (usually a local bank, but there are some non-bank authorized acquirors). In some cases, that acquiror may be the sole authorized acquiror in a country or region for a card company, but more commonly there is more than one such authorized acquiror. *That acquiror is the sponsor of the merchant voucher securitization, and what it is selling to an issuer SPV is its right to be paid by the card company in respect of the merchant voucher receivables.* As with most securitizations, the originator stays in the transaction as servicer. To complete the circle, the credit card company continues to make payments to an offshore bank account (typically, in New York) but that account is now under the control of the transaction's indenture trustee (or in programs with an option to issue debt in the form of loans, the program agent). The card company in turn seeks reimbursement from the card issuing bank, and the issuing bank charges the cardholder. *That issuing bank is the sponsor of a U.S. credit card receivables securitization, and what it is selling to an issuer SPV is its right to be paid by the cardholder in respect of receivables arising from its account.* The cardholder in turn pays that receivable and the circle is complete.

The merchant voucher securitization programs have a suite of documents similar to those for a DPR program. The main differences arise from the differences in collateral type: (a) DPR programs have account control agreements with all or a very high percentage of correspondent banks at which payments are received to allow the program agent to sweep required amounts to its account for the securitization, whereas merchant voucher securitization programs have notice and acknowledgment agreements with the participating credit card companies to send their payments to the program agent account and not elsewhere, in both cases until the program agent notifies the counterparty that the securitization arrangements are terminated because the program has ended and (b) the merchant voucher receivables are coming from one or at most three obligors, whereas DPRs may come from a large number of sending banks.

Some investors like the latter feature in merchant voucher receivables deals, as there are receivables coming from known sources, and the flows are less divertible than DPR flows because the only obligors have agreed to send funds to a designated account. As a result, coverage ratios are much lower on this product than they are on DPRs. On the other hand, merchant voucher deals are much more subject to "event risk" than DPRs, especially events involving business or leisure travel to the emerging markets jurisdiction, in particular events affecting travel more generally such as a terrorist attack or a pandemic. To date, all outstanding transactions have weathered these events without interruption in scheduled payments. Mitigating factors have included payments from local holders of foreign bank issued credit cards (by definition not dependent on foreign travel), prudent transaction sizing, and cash trapping triggers at levels above acceleration triggers.

### [3]—Remittances

There is perhaps no future flow asset class name that is more susceptible to multiple meanings, and therefore confusion, than that of "remittances." That is because in different times and contexts it has been used to refer to three different types of transactions.

In their original incarnation in the 1990s, remittance transactions referred to future flow securitizations in which Latin American banks sold their rights to be paid on U.S. checks and money orders received at their home country offices to the issuer SPV. In those transactions, such originating banks made payments to the beneficiaries in the home country, and then endorsed the checks to the issuer SPV for deposit at one designated account in the United States at which payments would be received from the issuing institutions of those instruments. Such transactions disappeared with the advent of electronic banking, whereby money transmitters or banks made electronic payments to Latin American banks and fewer senders of payments sent local beneficiaries paper checks or money orders. They were also subject to concerns about diversion risk (whether from the seller's contractual compliance or a sovereign-induced diversion order), as their premise was that all those paper assets would be sent by the originating bank to one U.S. clearing bank that had entered into the appropriate control arrangements regarding the SPV's money. One vestige of these transactions survives in some DPR programs, not in checks or money orders received in the bank's home country, but in including such instruments received at U.S. branches or agencies or a U.S. affiliated remittance company of the sponsoring bank; in those cases, such flows are included in the DPR deals, typically with separate coverage tests for such paper assets.

A second meaning attached to "remittance" transactions is to treat them as synonymous with DPR transactions (or vice versa) because in some countries a large percentage of the DPR flows relate to individual remittances. However, as the "diversified" component of the DPR definition implies, such securitizations are not limited to remittance-related collateral but include other types of payments, especially those arising from exports. It is better not to use the terms synonymously to avoid confusion. As described above, they also arise under different types of payment arrangements.

The third meaning of "remittance" transactions is to refer to a few recent transactions in Mexico and Central America that securitize payments made by U.S.-based money transmission companies under "services" agreements whereby a local institution (which not be a bank) makes payments on its behalf to local beneficiaries. The money transmitters receive notices of the local institution's sale of its payments to the SPV and are instructed to pay a designated U.S. account, and preferably affirmatively agree to do so. These transactions thus resemble credit card merchant voucher deals in that their payments come pursuant to agreements from designated, known obligors (although typically the sold flows are described as those from *any* such obligors, present or future). They also resemble DPR deals, as the subject matter of the payments (individual remittances) overlaps with those of DPR deals and involves the same economic dynamics whereby such flows tend to increase if economic conditions are better in the United States for ex-patriates or relatives than for family members in the developing country.

### [4]—Airline Ticket Receivables

Future flow securitizations backed by payments from credit card companies and airline clearing payment systems have been an occasional feature of the future flow securitization market from its early days in the 1990s to the present. In Latin America, airlines based in Brazil, Central America, Chile, Colombia, and Mexico have executed such transactions.

However, their potential significance to the future flow product market has been out of proportion to the frequency of their issuances due to two U.S. bankruptcy proceedings involving the Colombian airline Avianca and two of its ticket receivables transactions. Airlines have been a focus of this concern for three reasons: (1) in contrast to most other types of future flow originators, they have broad international footprints of inherently mobile properties, and many international counterparties and international contracts that lend themselves to resolution in a primary proceeding in a U.S. bankruptcy court rather than their local courts; (2) they are not exempt debtors under the U.S. Bankruptcy Code; and (3) as an industry, airlines are frequent, in some cases individual serial, filers for relief for judicially supervised restructuring proceedings in various countries including the United States.

Before turning to the specifics of the two Avianca cases, it is worthwhile to examine the general U.S. Bankruptcy Code regime as it applies to originators who may (or may not) be foreign debtors in a U.S. bankruptcy. The first question is whether they are eligible debtors. Unless an exemption applies, any foreign person with a place of business or property in the United States may be an eligible debtor.[4] No threshold of property in the United States is specified in the statute but as a jurisdictional matter minimal property or even New York law governed contracts have been held to be sufficient.[5] However, at least two categories of originators in future flow securitizations are not eligible debtors. Foreign governmental units, such as the originators in the oil royalties transactions discussed below, are not eligible debtors.[6] Likewise, foreign banks maintaining a branch or agency in the United States where certain licensed core banking functions are carried out are not eligible to be debtors under the U.S. Bankruptcy Code. Specifically, the U.S. Bankruptcy Code provides that a "foreign bank" that has a branch or agency in the United States may not be a debtor under the U.S. Bankruptcy Code.[7] In the absence of an applicable entity exclusion such as these, the originator with a place of business or property in the United States is an eligible debtor in the same manner as an ordinary foreign corporation, which could be in a U.S. Chapter 7 case (liquidation), a Chapter 11 case (reorganization) or a Chapter 15 case (assistance with a foreign bankruptcy or restructuring proceeding).

However, federal bankruptcy courts are courts of equity and have discretion on grounds of public policy or comity to decide whether to accept jurisdiction over cases involving foreign debtors having insignificant assets or operations in the United States. Thus, a second question in considering the risk of a U.S. bankruptcy proceeding, even for originators who are jurisdictionally eligible debtors under the statute, is whether the U.S. court will accept such jurisdiction. Should the debtor become subject to a U.S. Chapter 7 or 11 case (whether such case is commenced voluntarily or by reason of an involuntary petition filed by requisite creditors), the continuation of such case could be contested in the U.S. court. The U.S. Bankruptcy Code invests discretion in the court to dismiss a Chapter 7 or 11 case or to abstain (i.e., decline) to administer a case. Such determination is made based on,

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[4] 11 U.S.C. § 109(a).

[5] 8 *Collier on Bankruptcy*, ¶ 1517.01 (16th ed. 2019); see also, 2 *Collier on Bankruptcy*, ¶ 109.02 (16th ed. 2019) ("[C]ourts have been willing to entertain title 11 cases brought by or against foreign persons in the United States where the debtor's nexus to the United States was as tenuous as ownership of stock, a clearing account, or bank account.").

[6] 11 U.S.C. § 109(d); *id.* § 101(41).

[7] *Id.* § 109(b)(3)(B); *id.* § 109(d).

among other things, the interests of the creditors and the debtor and if applicable, whether a U.S. Chapter 15 case is also then pending in aid of a foreign proceeding. The determination could take into account, among other things, the nature of the debtor and its importance to the foreign country, the location of most of its assets and business, and/or considerations of comity with a foreign proceeding. Such considerations are likely to be especially significant in deciding whether to exercise the "abstention doctrine" over a foreign bank in a U.S. bankruptcy proceeding, but have also been applied to other types of entities as well.[8]

A third consideration, which may affect both the potential debtor's ability to file voluntarily or the court's willingness to accept an involuntary filing, in the case of foreign regulated entities is whether local legislation in its country restricts it from filing such a case, especially voluntarily commencing a winding up of its business (which would include a foreign proceeding such as in a U.S. Chapter 7 case). For example, in at least one jurisdiction where this matter has been considered in regard to a bank, to the extent that any third party brings insolvency proceedings in another jurisdiction but enforcement action would need to be taken in that country the foreign representative would need to be recognized in that country and the foreign representative would likely need or be asked to seek the consent of the regulator to do so. In that case, the view of local counsel was that the regulator would be very reluctant to give that consent given the likely implications for the financial sector in the country and would instead take some kind of action itself to appoint a temporary manager or to initiate a proceeding locally. Likewise, in the case of any voluntary attempt by a regulated entity such as a bank to file in the United States for protection under its bankruptcy law in light of such entity's

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[8] See, e.g.:

*Third Circuit:* In re Northshore Mainland Services, Inc., 537 B.R. 192, 206, (Bankr. D. Del. 2015) ("I perceive no reason—and have not been presented with any evidence—that the parties expected that any 'main' insolvency proceeding would take place in the United States. In business transactions, particularly now in today's global economy, the parties, as one goal, seek certainty. Expectations of various factors—including the expectations surrounding the question of *where* ultimately disputes will be resolved—are important, should be respected, and not disrupted unless a greater good is to be accomplished.").

*Fifth Circuit:* In re Yukos Oil Co., 321 B.R. 396, 399 (Bankr. S.D. Tex. 2005) ("This is a very large case. On the assets identified in the schedules and other pleadings filed in the instant case, it is the largest bankruptcy case ever filed in the United States. However, the debtor is not a United States company, but a Russian company, and its assets are massive relative to the Russian economy, and, since they are primarily oil and gas in the ground, are literally a part of the Russian land. While there is precedent for maintenance of a bankruptcy case in the United States by corporations domiciled outside the United States, none of those precedents cover a corporation which is a central part of the economy of the nation in which the corporation was created.").

likely systemic importance to the country and its financial system, it is possible that the regulator would take steps to ensure that the main proceedings occur in that country instead. In addition, parties need to consider whether the involuntary commencement of a Chapter 7 or Chapter 11 case against a debtor in the United States subsequent to the commencement of a local insolvency or reorganization proceeding would violate any local stay of remedies.

In considering the potential differences between a proceeding involving an airline, at one extreme of the factual and equitable factors discussed above, and one involving banks, at the other, it is worthwhile to review the one bankruptcy proceeding of a foreign bank with a future flow securitization program of which one of the authors is aware. That case involved JSC Alliance Bank of Kazakhstan. In that case, the bank's local plan of reorganization excluded its DPR securitization from its bankruptcy estate, describing it as a sale to a Cayman special purpose company. The Kazakh restructuring proceeding was subsequently recognized as a foreign main proceeding by bankruptcy courts in England and the United States, and the plan of reorganization was given effect in those jurisdictions.[9] Therefore, this most importantly allowed correspondent banks to continue having amounts in their Alliance Bank-related accounts swept to the indenture trustee in the manner contemplated by the transaction documents without any stay. As a result, DPR investors were ultimately paid in full, while creditors of the bankruptcy estate were generally subject to a substantially discounted settlement amount.

With the foregoing caveats that not all foreign originators may be eligible debtors, and that there may be practical and equitable considerations on whether the issues discussed below are ever decided in a U.S. bankruptcy court, it is worth examining the structure of how the typical future flow securitization is structured today, regardless of asset class, and the potential U.S. bankruptcy risks attendant thereto. The transfer of the financial assets by the originator to the SPV is structured as a sale under local law, preferably under a separate bill of sale, although the remaining transaction documents are governed by New York law. Local counsel opines that the bill of sale effects a sale to the SPV of the financial assets under local law, meaning that the SPV is the owner of the assets and that neither its creditors nor local bankruptcy administrators may set aside the sale. In turn, New York counsel opines that a New York court, including a U.S. bankruptcy court (or other federal court) sitting in New York, should give effect to the contractual choice of local law in the bill of sale.[10]

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[9] In re JSC Alliance Bank, No. 10-10761 (Bankr. S.D.N.Y. March 10, 2010); Re JSC Alliance Bank [Dec. 18, 2009] EWHC (Ch) 21895 (Eng.).

[10] N.Y. U.C.C. § 1-301 (2014); U.C.C. § 1-301 (2001) (the "reasonable relationship" test for foreign choice of law, assuming the transaction is within the scope of the

Such opinions are, however, subject to qualifications, and are not guarantees as to the ultimate outcome. If a bankruptcy or other insolvency proceeding is commenced in the United States with regard to the originator, then the originator, or its creditors, trustee or administrator, might persuade the bankruptcy court (or other authority) to (a) characterize the transfer of the financial assets as part of a loan rather than a true sale and (b) thereby conclude that the originator continues to own the financial assets. In reaching this decision, the court or other authority might disregard the parties' contractual choice of foreign law under the bill of sale and apply the law of another jurisdiction, although in our view that result would be contrary to a correct application of relevant choice of law statutory and case law principles. If a U.S. bankruptcy court were to characterize the transfer under the bill of sale as a financing, the SPV (and, indirectly, its noteholders) would only benefit from a security interest in the financial assets that arose prior to the commencement of the originator's bankruptcy, meaning that the applicable court or other authority may treat the SPV as an unsecured creditor of the originator with respect to any claims exceeding the value of such pre-petition financial assets. In addition, that court or other authority could continue to treat this collateral as property of the originator, in which case payments to secured creditors based on such financial assets could be delayed, collateral substituted or other remedies imposed that could adversely affect the amount and timing of payments on the offered notes.[11]

A second risk on a bankruptcy or insolvency proceeding of the originator in the United States is that the originator, or its creditors, trustee or administrator may assert that the arrangements under the transaction documents should be characterized as a contract with unfulfilled obligations on both sides. If a court or other applicable authority accepts this assertion, then the transaction documents may be subject to rejection as executory contracts. The argument in favor of treating the arrangements as executory is that the originator has various unperformed obligations (causing the assets to come into existence, servicing obligations), as does the SPV (mainly, making on-going purchase price payments via excess collections to the originator), and the argument against such treatment is that the sale at closing via the bill of sale is severable from the other contractual obligations.

The two Avianca cases concerned both these issues. The first one was filed in 2003 and after pleadings were filed on either side of these issues, was eventually confidentially settled.[12]

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Uniform Commercial Code); see also, *Restatement (Second) of Conflict of Laws* § 6(2) (1988).

[11] For a fuller discussion of the reasons for choosing foreign law to govern the sale, and differences between U.S. ABS sale structures and those in foreign future flow deals, see Arca, N. 2 *supra*.

[12] For a complete discussion of the first *Avianca* case, see Arca, N. 2 *supra*.

More recently, a proceeding based on another Avianca ticket securitization, *In re Avianca Holdings S.A.*, was filed in the Bankruptcy Court for the Southern District of New York, on June 23, 2020.[13] In the filings of that case, the debtors (hereafter, "Avianca") challenged a future flow ticket receivables securitization on both of the grounds described above: (1) that the transaction was not a true sale, notwithstanding the contractual provisions to such effect under Colombian law, but rather a disguised secured financing and therefore that the security interest would not attach to receivables generated after such filing date; and (2) that the receivables purchase agreement and a related servicing agreement between Avianca and the SPV issuer relating to the transaction constituted executory contracts.[14] On September 4, 2020, the court found for Avianca in part, by holding that such agreements (but not six other transaction related agreements) were executory contracts.[15] As a result, it permitted Avianca to reject future obligations under both of such contracts, effective from the June 23, 2020, filing date of the petition for such rejection. The receivables are payable under credit card processing agreements with American Express and Credomatic entities in respect of the use of American Express, Visa and MasterCard credit cards to purchase tickets and related services in the United States. The court held that future obligations under the rejected sale and servicing agreements included obligations under replacement agreements with such credit card processors once the existing credit card processing agreements had been rejected (although those existing agreements had not yet been rejected as of the date of the ruling).[16] It also held that rejection of future obligations did not mean rescission of the contracts as a whole or therefore of performance thereunder prior to the petition date.[17] Pursuant to a stipulation from the debtors, the court stated that it did not need to reach the true sale characterization and related issues summarized in point (1) above if it found for Avianca on the executory contract issue.[18]

On September 18, 2020, the SPV filed a notice of appeal to the United States District Court for the Southern District of New York in regard to such ruling, but the SPV's filing states that it does not appeal the opinion and (or including) its findings and determinations that: under Colombian law, the transaction agreements cannot be treated as a single contract for purposes of rejection under the U.S. Bankruptcy

[13] Notice of Motion for Entry of Order Authorizing Rejection of Certain Executory Contracts, ECF Doc. # 306, In re Avianca Holdings S.A., No. 20-11133 (MG), 618 B.R. 684 (Bankr. S.D.N.Y. June 23, 2020); Comp., ECF Doc. # 307, *id.*

[14] *Id.*

[15] In re Avianca Holdings S.A., 618 B.R. 684, 698-704 (Bankr. S.D.N.Y. 2020).

[16] *Id.*, 618 B.R. at 704-709.

[17] *Id.*, 618 B.R. at 709.

[18] *Id.*, 618 B.R. at 689 n.3.

Code; six of the eight agreements are not executory contracts that the debtors may reject; Avianca sold to the SPV its right to receive payment of any sales identified by specific Credomatic or American Express merchant numbers and any replacement or additional merchant codes; rejection of the sale and servicing agreements does not terminate the SPV's right to receive payment of any sales processed by Credomatic and American Express under the existing transactions with such entities; rejection does not rescind or unwind the sale and servicing agreements; and that rejection does not allow the debtors to take back the contract rights to specified sales processed by American Express and Credomatic entities that the debtors sold in 2017.[19] As of this writing, the case is apparently subject to mediation between the parties.[20]

As noted above, the degree of U.S. bankruptcy risk parties are willing to take may vary depending on the type of originator involved. For those who wish to minimize potential executory contract risk, one structural solution may be to have two successive special purpose entity owners of the financial assets. The first would be a subsidiary of the originator, and it could receive the financial assets by way of capital contribution. Therefore, such subsidiary would have no contractual obligations to the originator of any type, especially further purchase price payments. Of course, like any subsidiary, it could (separately from the securitization transaction) send sums to its parent by dividend or other distribution, or loan, but as it would have no contractual obligation to do so, its interactions with the parent should not form its part of any bilateral contract with unfulfilled obligations. Such a structure, where desired and not collapsed by a court, should mitigate the risk that the first transfer agreement is executory.

There would thereafter be a sale to a second SPV, which would be—as SPVs typically are in future flow securitizations—an offshore "orphan" SPV (referring to its being owned by a charitable trust and with completely independent directors). The use of offshore SPVs as the final owners of the collateral is viewed as desirable to mitigate foreign sovereign interference risk with the transaction, as that way not only are assets held outside the country, but the named owner is as well and is not under the control of the originator. The orphan SPV would have to make contractual deferred purchase price payments that could be subject to the same executory contract claim as asserted in the two Avianca cases. However, since those payments

[19] Notice of Appeal, ECF Doc. # 959, In re Avianca Holdings S.A., No. 20-11133 (MG) (Bankr. S.D.N.Y. Sept. 18, 2020); Notice of Appeal, ECF Doc. # 960, *id.*

[20] Order Directing Avianca S.A., Official Committee of Unsecured Creditors, USAVflow Limited, USAVflow Secured Lenders and Citibank, N.A. to Mediation and Staying Certain Matters, ECF Doc. # 1125, In re Avianca Holdings S.A., No. 20-11133 (MG) (Bankr. S.D.N.Y. Oct. 28, 2020).

would be between two bankruptcy-remote special purpose entities with no creditors (other than the securitization noteholders in the case of the issuer SPV), those two entities should not be included in the originator's bankruptcy estate in a properly argued and decided substantive consolidation case.

The second executory contract risk, at least for those transactions with receivables arising under specified contracts, is that those customer contracts are rejected. It may be helpful for future flow sales to refer to the sold assets as including all receivables—i.e., as an asset class—arising under such types of contracts without being limited to any named contracts or their replacements.

### [5]—Export Receivables

Export receivables financings have been a familiar product in the broader finance markets before, during and after their period of highest usage in the future flow securitization markets. In the bank loan markets, both local and cross-border, export receivables have always been attractive collateral against which to lend to leading companies in Latin American countries. Likewise, in the capital markets, secured export notes ("SENs") have been utilized, and they resemble future flow securitizations, although without the increased sovereign interference mitigation and creditors' rights enhancements afforded by the "true sale" structures in future flow securitizations. Like the bank loan product, SENs are full recourse to the company producing the exports, secured by certain export receivables.

Future flow securitizations backed by export receivables began in the early 1990s and had their peak during the years from the mid-1990s to the mid-2000s. They have been done from a wide variety of countries in Latin America and the Caribbean, especially Brazil, Mexico and Argentina, for products ranging from pure commodities (oil, minerals), processed commodities (steel, aluminum), agricultural products (pulp and paper, soybeans, coffee, sugar and orange juice) and manufactured products (auto parts, tequila, and textiles). They were popular when the ratings advantages over straight debt issuances from within a country offered advantages in tenor, offering size and/or pricing over competing forms of capital. However, by the mid-2000s, ratings uplifts (especially, in the case of Brazil to Mexico, to investment grade), a global commodities boom (fueled in part by increased demand from China), and a lessening sense of contagion from one emerging market's problems to another's made conventional forms of international debt and—in the case of the largest such companies—equity cheap and lessened the need for such deals. Moreover, while most of such deals had always been executed in the private placement market, a number of the largest ones involving pure commodities appeared in the 144A market with the benefit of financial guarantee insurance afforded by the leading monoline insurers of the day. When those insurers ceased their participation in new deals following their severe downgrades due to losses from U.S. subprime residential mortgage portfolios (or products based on exposure to such portfolios) in the financial crisis of 2007-2008, the insurance that facilitated those largest deals with cross-over investors likewise disappeared. However, there has recently been renewed interest in these structures in light of the reversal of the favorable ratings and macroeconomic conditions noted above.

Unlike transactions backed by bank originated financial assets described above, export receivables securitizations never reached any significant degree of market-standard documentation packages. However, especially in Brazil, they often involved the sale of the product to an offshore marketing company (as part of the company's pre-existing business, for tax reasons), followed by the sale of the receivables to an offshore SPV created for the securitization. Typically, a high percentage of customers had to be notified of the sale and directed where to send payments to an account controlled by an indenture trustee. Analogously to the way correspondent bank arrangements must be monitored on an on-going basis in DPR deals, this arrangement is not only set at closing but monitored on a periodic basis so that any customer singly accounting for a certain percentage of payments is included, as are customers that in the aggregate account for a certain percentage of the pool (typically over 70%). The foregoing was especially important because few such deals had long-term contracts—with payment already earned by prior performance or on a take or pay basis—on which such deals were sized. Although most had steady long-term customers with natural mutual dependencies, they nonetheless typically relied on spot market sales. As a result, only receivables from customers who have received such notices should be counted in debt service coverage ratio tests triggering early amortization events, cash trapping events or permitted future issuances. Ideally, customers would also acknowledge being bound by such instructions, in part to lessen fraud or mistake risk as to whether the notices had been sent, in part to evidence their intent to cooperate, in part to overcome anti-assignment clauses in relevant contracts, or where required to make such instructions binding under relevant laws governing the contractual relationship. Whether such acknowledgments were always required depended on the concentration risk of particular customers, applicable law, and/or the presence of trade payment insurance or letters of credit as back-ups for non-payment. When such transactions are revived in the future, it is to be hoped that they will incorporate many of the documentation innovations introduced into the future flow securitization market in deals with bank originators.

## § 16A.03 Transactions with Local Assets

### [1]—Overview of Existing Asset ABS in Latin America

Structured finance comprised of securitizations of local assets has expanded considerably both by asset type and countries involved over the decades in Latin America. As is the case in the rest of the world, legal and economic technology first developed in the United States for mortgage-backed securities ("MBS") and ABS was "exported" to Latin America beginning in the 1990s. The one exception to this U.S. inspiration of the development of local asset structured finance has been the introduction of covered bonds into Latin America, such as issuances by Global Bank of Panama and legislation in Brazil. These dual-recourse securities, supported both by the payment obligation of an originating financial institution and a "cover pool" of mortgages in a SPV, draw their inspiration from long-standing market practice in Europe (particularly Germany), the United Kingdom and Canada. However, covered bonds have not to date been a significant asset class in Latin America or the United States.[1]

Instead, structured finance offerings backed by local assets has consisted of securitizations of existing assets in the major economies of Argentina (credit card receivables, payroll deductible loans and residential mortgage-backed securities ("RMBS")); Brazil (commercial assets such as agribusiness loans, secured corporate loans, equipment leases, commercial mortgage-backed securities ("CMBS") and consumer assets such as auto loans, personal loans, student loans, payroll deductible loans, pension payments and credit card receivables, as well as future flow transactions backed by sanitation, water, electricity, transmission line and other infrastructure asset revenues); and Colombia (RMBS, CMBS and payroll deductible loans). There have also been existing asset transactions in smaller economies such as El Salvador (RMBS and corporate future flow transactions), Panama (RMBS, CMBS) and Chile (RMBS).[2] Given the likely international readership for this volume, we consider separately below at greater

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[1] See Meirelles, Arca and Carvalho, "New Product, Familiar Challenges," Int'l Fin. L. Rev. 40, 40-41 (March 2015).

[2] See generally: Manzi, "Global Structured Finance 2021 Outlook: Market Resilience Could Bring Over $1 Trillion In New Issuance 4," S&P Global Ratings (Jan. 8, 2021), available at https://www.spglobal.com/_assets/documents/ratings/research/100048329.pdf (last visited July 15, 2021); Moreno *et al.*, "Fitch Ratings 2021 Outlook: Latin America Structured Finance," Fitch Ratings (Dec. 9, 2020); Coballasi, "COVID-19 Update: Latin America Structured Finance Collateral Performance," S&P Global Ratings (Aug. 6, 2020); Fitch Ratings, "Non-Rating Action Commentary: Coverage Levels Protect Brazilian Future Flows from Initial Coronavirus-Related Shocks" (May 5, 2020); Fitch Ratings, "Non-Rating Action Commentary: Coronavirus Impact & Containment Measures Pressure LatAm Domestic ABS" (March 23, 2020).

length transactions executed in Mexico, transactions backed by oil royalties, and operating asset securitizations.

Like securitizations elsewhere in the world, participants in such transactions backed by local assets must consider universally applicable securitization issues, including: underwriting standards; servicing policies and systems; length of underwriting and servicing history; legal issues that are particular to the specific asset and obligor type; perfection of ownership or security interests in the assets; and legal isolation of the assets and the special purpose vehicle issuer in the event of an originator/servicer insolvency. Most of these transactions are now offered to local investor bases, but given the anticipated international audience for this volume, we also separately consider below special considerations applicable to foreign investors.

### [2]—Mexico

#### [a]—Typical Vehicle and Structure

Trusts (*fideicomisos*) are the most widely used securitization vehicle (i.e., the SPV) in Mexico to segregate collateral/assets from debtors.

Trusts are agreements by which a settlor (*fideicomitente*) transfers ownership of one or more assets to a trustee (*fiduciario*) for determined and lawful purposes that the trustee must fulfill. Thus, a trust does not have legal personality, but is identified by the trust capacity pursuant to which the trustee holds the assets. Similar to so-called "common law" trusts in the United States (in contrast to statutory business trusts in the United States), the trust is formed by contract between the settlor and the trustee rather than by statutory formation like a corporation. In a typical securitization, the seller will be the settlor, the bondholders or lenders will be the beneficiaries, and a licensed bank will be the trustee. The trust issues debt and with the proceeds of such debt purchases assets from the seller.

One of the main reasons to use trusts to segregate collateral is that the transfer of ownership of the assets is, generally, not a taxable event to the extent that the settlor maintains the right to reacquire the assets at the expiration of the trust. Also, for tax purposes, the trust is transparent when the passive income represents at least 90% of its total income earned in the given tax year.

It is also possible (but not common) to use vehicles formed abroad (*i.e.*, foreign SPVs) as securitization vehicles. However, the transfer of the assets/receivables to a foreign SPV (whether a trust or an entity) will be deemed a taxable transaction in Mexico.

### [b]—Transfer of Receivables and True Sale Considerations

Mexican law recognizes three main types of transactions to transfer title to receivables: (i) assignment agreements; (ii) endorsement; and (iii) factoring agreements.

Endorsement is the least common transfer method because it can only be used when receivables are documented as negotiable instruments and requires physical delivery of the original negotiable instrument with specific endorsement language inserted in the negotiable instrument or adhered to the negotiable instrument.

Both assignment agreements and factoring agreements are statutorily regulated but the law is more detailed with respect to factoring agreements and that may give more comfort to all stakeholders. The law expressly provides that any rights held by a creditor may be transferred through a factoring agreement, without the consent of the obligor thereunder, unless the nature of the obligor's obligation is such that it cannot be transferred or the documents by which the rights are evidenced expressly restrict the ability to transfer such receivable through a factoring transaction. The law only requires that the receivable is documented in an invoice, counter receipt, bill, negotiable instrument, electronic communication or any other document evidencing the existence of such receivable.

The legal consequences arising out of each type of transaction are different. For instance, when transferring a negotiable instrument through endorsement, the default rule is that the transferor is liable for the obligor's payment failure whereas in an assignment agreement, the default rule is that the transferor is only liable for the existence and validity of the receivable but will not be held liable for the obligor's payment failure. However, all of the foregoing transactions—assignment agreement, endorsement and factoring agreements—share a common feature: they are recognized by statute and/or judicial precedents as transactions that transfer ownership/title to the receivable. In particular, there is a binding judicial precedent recognizing the effectiveness of the transfer of title to a receivable by the mere execution of the assignment agreement.[3]

There are two main underlying transactions in an assignment of rights: a purchase or a donation. In the context of a sale/transfer

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[3] See Assignment of Rights (Registro 164151). Notice to Debtor is Not a Requirement for its Effectiveness, Tribunales Colegiados de Circuito, Semanario Judicial de la Federación y su Gaceta, Novena Época, Tomo XXXII, Agosto de 2010, Tesis III.20.C J/23, página 1945 (Mexico); see also, "Endorsement & Assignment Agreement: The Difference Between Both Legal Transfer Methods" (Registro 192652), Tribunales Colegiados de Circuito, Semanario Judicial de la Federación y su Gaceta, Novena Época, Tomo X, Diciembre de 1999, Tesis VI.3o.C.63 C, página 698 (Mexico).

transaction to a trust, the underlying transaction is always a purchase because there is always a price paid in exchange for the receivables. Therefore, the rules applicable to purchase agreements shall be considered.

The rules governing purchase agreements provide that a sale is perfected and binding once agreement has been reached with respect to the purchased asset and its price, even if there is still no physical delivery of the purchased asset and the price has not been paid. This means that in a purchase agreement, transfer of title is completed upon execution of the purchase agreement that identifies the purchased asset and the price (or the formula to calculate the price).

Through any of these transactions, the assets transferred by the seller to the purchaser cease to be part of the seller's estate and become property of the purchaser.

In the case of trusts as SPVs, the trustee becomes the owner of the assets contributed to the trust, but the trustee needs to register these assets in separate accounting books and these assets are not consolidated with the assets of the trustee if the trustee is subject to insolvency proceedings. When a trust purchases a receivable, either through an assignment agreement, endorsement or factoring agreement, in principle the trustee becomes the legal owner of such receivable, but the asset cannot be used for purposes different from those contemplated in the trust.

On September 2, 2016, a decision of the federal collegiate circuit court was published in the Mexican Judiciary Newspaper[4] that did not recognize the transfer of assets to a trust and the ownership of such assets by the trustee in a context of an insolvency proceeding. We continued to see securitizations using trusts as vehicles even after the decision because it was a non-binding decision and it was issued in the context of a project finance structure in which the trust did not pay consideration in exchange for the assets. This factual difference and the "non-binding" nature of the precedent gave enough comfort for the market to continue using trusts.

More recently, on May 30, 2018, a new non-binding judicial precedent was issued reinforcing traditional considerations regarding the independence of trusts' estate, stating that one of the main effects of

[4] See Trusts or Assignment of Rights: In the Event of Insolvency, Future Income Derived from a Private Executory Contract, for Purposes of Securing or Paying an Obligation, Shall Not Continue in Force Since the Administration & Application of Future Assets Shall Be Regulated by Public Policy Rules that Apply to the Assignor or Settlor (Registro 2012476), Tribunales Colegiados de Circuito (Aislada), Semanario Judicial de la Federación y su Gaceta, Décima Época, Tomo IV, Libro 34, Septiembre de 2016, Tesis I.3o.C.230 C (10a), página 2736 (Mexico).

forming a trust is to create a separate estate that has total independence and autonomy from the Settlor's/borrower's estate.[5]

### [c]—Effectiveness and Formalities

There are several rules to determine when the transfer of a receivable and/or right is effective vis-à-vis the obligor thereunder. Effectiveness vis-à-vis the obligor is only relevant to compel the obligor to pay amounts owed under the receivable to the purchaser instead of the seller but is not relevant to determine the validity of the transfer.

The requirements to compel the obligor to pay directly to the purchaser vary depending on the nature of the transfer transaction. If the transfer is made through an assignment agreement, the obligor needs to be notified of the transfer in the presence of two witnesses. If the transfer is made through endorsement, mere presentation of the original negotiable instrument with the endorsement inserted therein or adhered thereto is sufficient. If the transfer is made through a factoring agreement, the law requires notification of the obligor by one of the following means: (a) delivering the document by which the receivable is evidenced with a transfer legend and acknowledgment of receipt; (b) notice through certified mail with acknowledgment of receipt; (c) notice attested by a notary public or commercial notary public; or (d) electronic notice.

Failure to make the transfer effective vis-à-vis the obligor implies that the obligor will be discharged of its payment obligation by paying amounts owed under the receivable to the transferor/seller, but the transfer itself is not invalidated.

On the other hand, effectiveness vis-à-vis third parties is accomplished by means of registration with the Sole Registry of Liens Over Movable Assets (*Registro Único de Garantías Mobiliarias*). This rule applies to both assignment agreements and factoring agreements. Endorsement does not require any registration.

Achieving effectiveness against third parties is important so that all third parties other than the obligor of the receivable must accept that the receivable is no longer owned by the seller and is now owned by the purchaser. The third parties here are mainly the creditors of the seller who cannot seize the asset transferred by the seller once the transaction is effective against them.

[5] See Collateral Trusts: Their Effects in Case of Debtor's Insolvency (Registro 2017494), Tribunales Colegiados de Circuito (Aislada), Semanario Judicial de la Federación y su Gaceta, Décima Época, Agosto de 2018, Tesis: I.8o.C.57 C (10a) (Mex); see also, Collateral Trusts: They Are Not Security Interests (Registro 2017493), Tribunales Colegiados de Circuito (Aislada), Semanario Judicial de la Federación y su Gaceta, Décima Época, Agosto de 2018, Tesis: I.8o.C.58 C (10a) (Mexico).

### [d]—Bankruptcy Remoteness

As a general rule, transferring an asset to a trust or a securitization vehicle will subtract it from the reach of the seller's other creditors.

However, there are certain cases in which a transfer may be set aside. For instance, the Mexican Bankruptcy Law (*Ley de Concursos Mercantiles*) allows creditors to set aside fraudulent conveyances in the context of an insolvency proceeding. Any action consummated by the debtor prior to the date of an insolvency judgment will be deemed fraudulent when such entity is knowingly defrauding its creditors, and the third-party participating in any such action had actual knowledge of such fraudulent intent.

Moreover, any action consummated by the insolvent entity during the claw-back period (270 days but may be extended to three years before the insolvency judgment in certain cases) will be deemed fraudulent when, inter alia, the debtor receives no consideration, or the consideration received or paid by the entity, or the terms and conditions of the transaction, are below market. Therefore, if an asset is deemed transferred at a price that is below market, a Mexican insolvency court may set aside the transfer of such asset/receivable.

There is no law or precedent defining what would constitute "below-market terms and conditions" in the context of a private securitization program. Private securitizations/factoring programs in Mexico typically include the payment of a purchase price that is equal to the net present value of the receivables. However, in most cases: (i) the seller receives upfront less than the net present value in order to allow for the creation of payment reserves; and (ii) the deferred portion of the net present value is paid partially once the reserves are funded and partially at the termination of the program subordinated to the payment to the investors and transaction expenses.

### [e]—Servicing/Management of the Receivables

As a general practice, administration and servicing agreements are executed between the parties. In most cases, the originator acts as servicer and collection agent. It is also very common for lenders to require an independent third party to act as back-up servicer or even as master servicer to review the reports submitted by the servicer–in particular, eligibility-requirement certifications–to oversee the actions of the servicer and to step in as servicer in the event of default or system failure.

In addition, the servicer commonly acts as the depository of all resources, amounts or original documentation, contracts and promissory notes. Lenders often require this to make such person directly liable for any destruction, deterioration, extraction or any other negligent or willful misconduct affecting the assets/documentation under its custody.

In general terms, the servicer is required to observe and fulfill the obligations provided under such contract and in case of default, the servicer can be automatically removed.

### [f]—Public vs. Private Securitizations

Securitizations in Mexico may be done through private or public/registered offerings. Public offerings may reach more investors, especially institutional investors that have regulatory restrictions to invest in unregistered securities such as the Mexican pension funds.

Registered offerings require an authorization from the Mexican Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*), listing the security in a licensed stock exchange and depositing the certificate representing the bonds (*certificados bursátiles*) with the central depository institution. The originator needs to file a prospectus detailing the characteristics of the offering, risk factors, distribution plan, description of the transaction structure and financial information, along with rating from a licensed rating agency, legal and tax opinions and other documents to secure the registration and authorization for the public offering.

Private securitizations may be done through public offerings exemptions contemplated in the Mexican Securities Exchange Law (*Ley del Mercado de Valores*) and do not require regulatory authorizations.

### [g]—Withholding Tax

Whenever the lender or the bondholder is a foreign entity or a natural person, withholding taxes over the interest payable by the securitization vehicle may apply. Withholding rates vary depend on the double taxation treaty executed by Mexico. Payments other than interest identified as interest in the securitization documents may qualify as interest for tax purposes, depending on the economic terms of such payments and the definition of interest provided in the applicable double taxation treaty.

Withholding rates vary from 4.9% to 40%, depending on the nature of the recipient and its country of residence for tax purposes.

### [h]—Local Assets Securitized in Mexico

In addition to the future flow transaction based on receivables paid by obligors outside of Mexico, discussed elsewhere in this chapter, securitizations by Mexican originators have been backed by payments from automobile, bus and truck loan loans and leases; commercial mortgage loans; construction loans; consumer loans; payroll deductible loans; equipment leases; and residential mortgage loans. More recently, we have also seen securitizations of digital loans by fintech companies.

### [3]—Considerations for Foreign Investors

In addition to the issues of the type noted above that have to be considered in securitizations in any jurisdiction, securitizations from emerging market countries offered to investors outside their respective local markets have to be considered in light of several additional types of issues.[6]

#### [a]—Currency Risk

Some foreign investors will invest in securitizations denominated in local currencies because they want, or at least are willing to accept, exposure to the local currency in which the offered securities are denominated. They may do so by taking local securities directly or by the foreign clearing system ~~being~~ participating as a Clearstream participant. Where the local clearing system is not a Clearstream participant, they may do so via a corresponding global note in Clearstream (which accepts settlement in a large number of currencies), or by taking a corresponding global note in DTC settled in dollars (the dollar entitlement to which is pegged to the spot exchange rate on each settlement date). As in the corporate bond market, such global notes can be referred to as GDNs (Global Depositary Notes) or ADNs (American Depositary Notes). They are simple pass-throughs of payments on the local security held by a trustee, which is also the paying agent on the global note.

For other investors who wish to be paid in their home currency (U.S. dollars typically), there are several potential options in evaluating transactions backed by local assets: (i) transactions from dollarized jurisdictions; (ii) transactions backed by dollar-denominated assets from non-dollarized jurisdictions; (iii) cross-currency swaps; and (iv) overcollateralization. Each of these options are discussed below.

##### *[i]—Transactions from Dollarized Jurisdictions*

In this case, there is no asset (currency of the collateral)/liability (currency of the issued securities) currency mismatch, at least on the surface. As of this writing in 2021, several countries in Latin America are dollarized as an inflation mitigant, also variously because of historic ties to United States (Panama), significant inflows of dollar

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[6] See also, Arca, "International Securitisations of Local Assets from Emerging Market Countries," Global Securitisation Rev. 2006/2007 (July 24, 2006) (on file with author).

remittances (El Salvador) or oil export payments, a commodity priced in dollars (Ecuador). In each case, investors need to evaluate the likelihood that these or other dollarized countries will stay on the dollar for the expected life of the transaction. That is not always a given. In the 1990s, Argentina had a 1:1 dollar-peso peg but broke it when it found that such linkage limited its fiscal flexibility. The ability of borrowers on mortgage loans in RMBS transactions to pay in depreciated pesos led to losses on such RMBS. In retrospect, such breakage was pure sovereign risk and perhaps foreseeable given that Argentina's political and economic history did not suggest that such linkage would be sustainable, and its economy was not otherwise naturally dollar-dependent.

*[ii]—Transactions Backed by Dollar-Denominated Assets from Non-Dollarized Jurisdictions*

In this case, investors have to consider whether obligors (whether consumer or commercial) can pay in dollars on an asset in the collateral pool if such obligors' own incomes are denominated primarily in local or other currencies. If not, and the obligor has to take the depreciation risk of its local currency, then the investor is being collateralized by a dollar denominated asset as if, for economic purposes, each obligor had written it a cross-currency swap for each payment date. On the other hand, some assets (whether denominated nominally in local currency or dollars) are dependent on prices set in dollars in global markets. That is the case with the Brazilian oil transaction discussed in Section 16A.03[4] below, where the global price of oil serves as a natural hedge on the value of locally denominated (*reais*) payments on oil royalties, as the royalties are calculated as a percentage of oil sales, which in turn are dependent on the international dollar price of oil.

*[iii]—Cross-Currency Swaps*

The potential asset-liability mismatch can be shifted to a suitably rated financial intermediary that is the issuer's counterparty in a cross-currency swap. The utility of such solution depends, at the time of execution, on the availability of such swaps for the currency in question and if it is available, whether its tenor is long enough to cover the expected tenor of the deal, and its price.

*[iv]—Overcollateralization*

Few emerging markets deals with local assets have taken this approach because it is difficult to size sufficient overcollateralization to cover potential depreciation risk. Such risk can easily exceed losses due to credit risk.

### [b]—Withholding Tax

Many countries in Latin America impose withholding taxes on payments made to foreign investors. To the extent there is no solution to their applicability, they are typically absorbed by foreign investors in deals marketed as local deals. Deals marketed primarily to a foreign investor base are usually subject to a gross-up from the waterfall of application of collateral payments. In some countries there is an exemption for payments made to banks, so a structure may incorporate a loan to a foreign bank with a corresponding participation to an issuing offshore SPV. In Mexico, a lower withholding rate applies to "public" deals and discussion needs to be had with local counsel on the criteria for such public designation, which may turn on whether the transaction is deemed an offer to the public in a foreign jurisdiction and other potentially relevant indicia of a public offering, such as a foreign listing. In other cases, a sale of assets to a foreign issuer SPV can be a solution if the overall transaction is not viewed as a debt offering by the originator for tax purposes. Each potential solution is not only jurisdiction-specific, but comfort levels of participants may change over time depending on current views of tax authorities and/or local tax advisors.

### [c]—Local Risks

By investing in transactions backed by foreign assets, investors are taking the risks of the jurisdiction in which they originate, which are likely to be different from their home jurisdiction. After all, there is a reason such countries are deemed emerging market countries. They often have greater susceptibility to event risk and weaker institutions than more developed countries, especially for a product highly dependent on legal structure, like a securitization. These risks include (i) economic, social and political risks; (ii) legal risks such as timing to execute on collateral pledges (which may be much longer than the timing in other types of jurisdictions), transparency, ability to rely on legal precedent, and stability of current legal regimes; and (iii) a limited back-up servicing industry if a servicer needs to be replaced.

## [4]—Oil Royalties

Oil royalties transactions in Latin America have consisted of payments owed, directly or indirectly, by oil companies to provinces or states for the right to extract oil. They have been of two types: In Argentina, such transactions were executed in the 1990s (and revived in more recent years); and in Brazil, the State of Rio de Janeiro sponsored a program securitizing its royalties from offshore oil production beginning in 2014 and most recently in 2018. There has also been discussion of additional states following this model. Of the two, the

Brazilian precedent is more relevant for this volume, as it involves a securitization structure using an SPV issuer (the Rio Finance Trust). The Argentine examples are straight debt issuances of the provinces secured by their oil royalties. The Rio Oil Finance Trust program is one of the largest ever emerging market securitization programs, involving total initial issuance amounts of over $4 billion, primarily in dollars for international markets, but also including a reais tranche for local investors.[7]

The Rio Oil Finance Trust program is structured as a future flow program with certain structural similarities to the future flow transactions discussed above in this chapter:

- There is a true sale from the originator to a SPV of an entire asset class (the state's share of royalties initially paid to the federal government after allocation to other governments and statutorily dedicated purposes);
- The transaction has only limited recourse events to the sponsor (the State of Rio de Janeiro) and the seller (Rio Previdência, the state's pension fund, that, prior to the securitization, owned all the royalties), primarily for adverse change in law risk and any legal shortcomings in the structure; and
- The SPV issuer may issue future senior or subordinated series subject to satisfaction (or existing investor waiver) of certain debt service coverage ratios and rating agency confirmations as to ratings of existing series.

However, it also differs from such future flow programs in significant respects:

- There is no dependence on the originator to produce the product giving rise to the product—the respective owners of the royalties both pre- and post-securitization are essentially passive recipients of an entitlement to certain payment streams;
- There is no attempt to achieve a rating higher than the federal government's foreign currency rating, as: the transaction involves local payments in local currency with conversion to dollars as required to meet the transaction's dollar needs; the royalties entitlement is a creature entirely of the federal legal system; and the largest payor of the royalties is the partially government-owned oil company Petrobras, although the structure does achieve a rating higher than that of the local state; and

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[7] See Rio Oil Finance Trust, Luxembourg Stock Exchange, https://www.bourse.lu/issuer/RioOilFinTrust/71659 (last visited July 15, 2021).

- The issuer is a Delaware business trust. While this is an extremely common form of SPV issuer (both as to entity type and jurisdiction of formation) in U.S. ABS issuances, it is typically not used in other forms of future flow securitizations that seek to minimize their U.S. contacts for U.S. Bankruptcy Code purposes. However, in this case, there was no need for an issuer in an "offshore" financial center,as neither the State of Rio de Janeiro nor Rio Previdência should be viewed as eligible debtors in either a Brazilian or a U.S. bankruptcy proceeding due to their governmental status.

The Rio Oil Finance Trust program includes a number of innovative features including the following:

- The ability to issue in multiple foreign currencies, while mitigating the risk to existing series in different series by requiring such future series (and have counted against their debt service coverage ratios) the amount available to pay a foreign currency beyond an exchange factor specified at the outset or swap breakage payments at a pari passu level, with the remainder of such entitlements to other currency series only paid at a subordinated level. While to date such mechanism has not had to be employed as all series have been issued in dollars or *reais* (and the oil royalties payments paid in *reais* are converted into dollars to the extent needed for dollar payments at a spot rate on any date of determination, while the international price of oil is dollar-determined), nonetheless it exists to be used if required.
- The ability to allocate collateral in the master trust both (a) for internationally issued notes issued by such trust and (b) to a separate local issuer for local securities issuances, a mechanism that was employed in its first set of issuances in 2014.

As such, the Rio Oil Finance Trust program provides a template that can be used by other Latin American governments seeking to securitize future payment streams.

### [5]—Operating and Infrastructure Assets

In Latin America, project bonds and operating asset securitizations have been used for infrastructure assets such as infrastructure (airports, toll roads, subway lines, water treatment, both traditional and renewable power projects), and operating assets such as drill ships and heavy equipment.[8]

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[8] For a more in-depth discussion of the history and issues with project bonds in Latin America, see Arca, "The Future of Project Bonds in Latin America," 3 Harv. Bus. L. Rev. Online 187 (2013).

Project bonds and securitizations are sometimes not thought of as related members of the structured finance family, in part because they can sit in diverse groups at banks, law firms, asset managers and rating agencies, in part because project finance has its roots in loan-financed "greenfield" (construction risk) transactions while securitization has its roots in the big public ABS and MBS asset classes backed by homogenous consumer assets. However, from these different starting points they have similarities where the lines between the two can be blurred and techniques used in the two can be similar, and sometimes imported from one to the other. The similarities, particularly for the majority of project bonds that are for "brownfield" (operating stage) assets, can include: capital markets execution; non-recourse or limited recourse to sponsors; structured finance features such as waterfalls, reserve accounts and other credit or liquidity enhancement, and ratings; the ability to replace operators/servicers through step-in rights and/or successor servicer provisions; and ring-fenced SPV issuers. Such features often resemble financing and structuring techniques and disclosure issues found in traditional securitization asset classes such as CMBS, aircraft structured finance and securitization, and future flow securitizations.

As such, practitioners need to be less focused on the taxonomy of how the transaction is classified, than in thinking about a matrix of risks and mitigants, and asking how similar risks are mitigated in other transactions—regardless of what they are called, and whether they are familiar to the practitioner—and whether such solutions are relevant and feasible in the transaction at issue.