

Structured Settlement Securitization: A Growing Opportunity

The downturn in the securitization industry has coincided with an increasing acceptance of structured settlement payments as an asset class for securitization. Since 1998, aggregate term issuance of structured settlement securitizations has surpassed \$2.4 billion,¹ and the sector continues to grow as more market players take greater notice of off-the-run assets. These transactions benefit from uncomplicated deal structures, stable assets, and a relatively easy underwriting process. With more than \$80 billion face value of structured settlements in existence, this sector of the securitization market has even more room to grow.

This *DechertOnPoint* will explain the basics of a structured settlement securitization and discuss recent developments that are having a broad impact on this market. These developments are recent California state court rulings involving petitions to approve the transfer of structured settlements from the original payees to securitization vehicles and a questionnaire to be used by Standard & Poor's ("S&P") to collect additional data in response to risks identified in California court cases.

Basics of a Structured Settlement Securitization

A "structured settlement" is either a payment agreement or an annuity designed to compensate a successful plaintiff in a tort action. Instead of receiving a lump sum payment, the plaintiff agrees to periodic payments over a

fixed time. In this case, the defendant in the case either signs the agreement to make such payments directly or purchases an annuity (usually from an insurance company) payable to the plaintiff, as payee. At any time after the settlement has been structured, the payee may agree to convert the structured settlement into a lump sum of cash by assigning his or her rights to receive the cash flows to a third party (usually a specialty finance company that focuses on this market). This third party usually purchases the payment streams outright at a discounted net present value in a transaction that is designed to preserve certain tax advantages for the insurance company paying the annuity. Once a sufficient number of such structured settlements have been amassed, the sponsor may seek to transfer them into a bankruptcy remote special-purpose vehicle ("SPV") for securitization.

In structuring a securitization, the specialty finance company or the sponsor will engage an underwriter to structure debt to be issued by the SPV. The underwriter will generally present the transaction for review by the rating agencies. This review will take in a wide range of information, including the composition of the pool of assets and individual characteristics of each asset, an assessment of the default risk of each asset in the pool, a review of the servicer's operating history, and analysis of the legal structure of the proposed securitization. Once the structure is approved and assigned a rating, the SPV will be able to issue rated debt to investors and use the proceeds to purchase the structured settlements from the sponsor.

¹ Standard & Poor's, Methodology and Assumptions for U.S. Structured Settlement Payment Securitizations, December 11, 2008.

Issues Impacting the Structured Settlement Industry: The *Henderson v. Sioteco* Case

At the heart of the structured settlement securitization industry is the process by which the finance companies acquire the structured settlements from the original payees. Using various forms of media and direct marketing, the finance companies contact the payees and arrange to purchase the structured settlements. Over the past decade, most states have passed legislation governing these transactions, the lynchpin of which is the requirement that the finance company obtain a court order approving the transfer of each structured settlement from the original payee. A recent court case in California, however, has cast some doubt on this process.

321 Henderson Receivable Origination, LLC (“Henderson”), a subsidiary of J.G. Wentworth, LLC, is a specialty finance company that has engaged in more than 2,000 judicially approved structured settlement payment transfers throughout California since 2002. In early 2008, Henderson filed a number of petitions to approve such transfers, as required by the California Structured Settlement Transfer Act² (“SSTA”). Surprisingly, the court denied each transfer, ruling that the transfers violated the anti-assignment provisions in the underlying contracts and settlement agreements. The court also ruled that the transfers were functionally loans and the effective rates of interest on each one violated California’s usury statute. By denying the legal sale treatment of the transfers, the court undermined the bankruptcy-remoteness of the SPV structure, thus rendering these assets incapable of being securitized.

Henderson appealed the lower court’s rulings and, in an opinion given on May 6, 2009, the California Court of Appeals for the Fifth District reversed the denial of all of the petitions. The Court of Appeals held that “public policy favors the legal conclusion that anti-assignment provisions do not bar court-approved transfers of structured settlement payments.”³ While there might be some situations in which the annuity payor could challenge a transfer, the anti-assignment provisions of the underlying agreements under question do not bar the transfers requested in the petitions. The court also held that “the transfer of structured settlement payment

rights under the SSTA is not a loan . . . but is a sale.”⁴ By validating the complete legal transfer of the assets, the court helped to assure the market that structured settlement securitizations involve complete sales of the settlements (so long as the facts and circumstances of each transfer meet the standards for true sale treatment).

S&P’s Post-*Henderson* Questionnaire

In response to the *Henderson* decision, S&P has released a new questionnaire to be used with each new structured settlement securitization issuance. The questionnaire contains 24 questions covering all aspects of the originator’s business, but focusing primarily on the process (and historical results) of successfully transferring the payment annuities from the original payees to the securitization vehicle. S&P will use the information gathered from this lengthy questionnaire to assess certain legal and operational risks highlighted by the *Henderson* case. These questions break down into five categories, which are each summarized below.

First, the questionnaire seeks more information concerning the originator’s corporate and compliance policies. Each originator is asked to provide copies of, and full background details on, its originations policy and quality assurance policies as well as a description of the originator’s process for compliance with each relevant state’s insurance code. The questions are attuned to discovering that these procedures are up-to-date and that the originator has procedures in place to keep them current. In addition, the questionnaire directs the originator to submit a list of references—parties that can confirm the origination and underwriting processes outlined by the originator.

Second, S&P’s questionnaire asks a series of questions focused on payee compliance—ensuring that each payee that transfers payment rights to the securitization vehicle has had sufficient notice of, and opportunity to exercise, their rights. The underlying theme of this series of questions is mitigating against the headline risk inherent in this asset class. The originator is directed to explain, in detail, its diligence process used to determine whether the transfer is in the best interest of the original payee. The originator must identify the statutory requirement to provide legal advice to such

² Cal. Ins. Code § 10136 et seq. (West 2009).

³ *Id.* at 1076, 93 Cal. Rptr. 3d 331.

⁴ *Id.* at 1077, 93 Cal. Rptr. 3d 333.

payees (and what steps the originator takes in the absence of any such statutory mandate) and what processes the originator has in place to make sure all payees receive notice of their right to receive legal advice. The questionnaire also gathers data regarding how referrals to outside counsel are handled and what contacts, if any, exist between the originator (and its affiliates) and such outside counsel. Finally, the questionnaire seeks to discover how the originator communicates with outside counsel with regard to individual transfers and how disputes over outside counsel's advice to the payee are resolved.

Third, S&P's questionnaire asks a series of questions related to the process of obtaining court orders approving the transfers of structured settlements, specifically focused on information about denials of prior petitions for transfers. The originator must detail its process (in each separate jurisdiction) for complying with local requirements for submitting petitions to approve transfers. Further, the originator is asked to present a breakdown of the percentages of all petitions denied (against total submitted) for all jurisdictions (jointly) and California (separately, including a quantification of all petitions approved and denied in the past year), and Fresno, Kern, and Riverside Counties of California (prior 12 month's activity only) as well as a statement detailing any states where the originator has suffered denials in excess of their national average. Finally, the questionnaire requests a summary of the reasons that courts have given for denying petitions to approve transfers and an indication of which reasons are the most recurrent.

Fourth, the questionnaire requests the originator supply detailed information on risks inherent in the underlying annuity contracts. Specifically, the questionnaire asks if the annuity contracts have anti-assignment clauses (regardless of whether such clauses are enforceable in any given jurisdiction), and whether and how particular transactions can be cancelled at the request of the beneficiary of any annuity. Further, the questionnaire requests disclosure concerning whether any of the annuity contracts in the proposed pool can be renegotiated. If any can, the originator is requested to supply a description of the renegotiation process as well as a description of when such renegotiations are possible and will be accepted by the originator.

Finally, S&P's questionnaire requests each originator provide extensive details about specific risks in the court approval process beyond the historical denial rates discussed above. First, it asks for a list of all counties and states that have presented legal challenges

similar to Fresno County, California, and California (as a whole). The questionnaire also asks the originator to present a list of other states that have statutes, including language for voiding annuity transfers. The originator must quantify and describe its history of having any court-approved transfers voided after the fact. The originator must provide a summary of all current litigation (including status, timing, and expected resolution). Finally, the originator is asked what lessons the originator has learned from the *Henderson* case and how it has adjusted its business practices following the decision.

Summary

Structured settlements continue to mature as an asset class for securitization. While the lower court's ruling in the *Henderson* case provided a surprising challenge to the legal underpinnings of structured settlement securitizations, the appeals court ruling has helped to calm the roiled waters. Further, market participants are adapting to the legal and procedural risks identified by the *Henderson* case. S&P, in particular, has developed a diligence process that will allow it to more effectively identify and address these risks in future securitizations. With the market responding and adapting so quickly to these unique challenges, structured settlements should remain an active and attractive asset class for securitization.

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