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Thomas E. Plank

*University of Tennessee College of Law*

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# SECURITIZATION OF ABERRANT CONTRACT RECEIVABLES

THOMAS E. PLANK\*

## I. INTRODUCTION

Companies that are in the business of originating or acquiring rights to payment for moneys lent, property sold, or services provided—receivables—need funds to operate their businesses. These receivables can arise in two different situations. First, the receivables arise from loans of funds by the originator to the obligors, such as residential mortgage loans, commercial business loans, student loans, and other kinds of personal or business loans, which could include payday loans, title loans, and other “aberrant contract receivables.” In these cases, the originator needs funds to lend. Other receivables arise from the selling or leasing of goods or other property or from providing services on credit, such as automobile loans and leases, trade receivables, equipment loans and leases, and health care receivables. For these cases, the provider of the property or services needs funds (1) to repay funds borrowed to acquire the property sold or leased or to provide the services or (2) to acquire more property or to provide future services.

Originators can obtain funds from equity investors and typically must do so to begin business.<sup>1</sup> At some point, however, the higher cost of equity investment will cause originators to turn to other sources of financing. One traditional source of financing is a simple whole loan sale of batches of the receivables to another financial institution.<sup>2</sup>

\*Joel A. Katz Distinguished Professor of Law, University of Tennessee College of Law. A.B. 1968, Princeton University; J.D. 1974, University of Maryland. I have benefitted both professionally and financially serving as issuer’s counsel and bankruptcy counsel for securitization of mortgage loans and other consumer and business receivables, first as a partner with Kutak Rock LLP from 1987 to 1994, and then as a consultant for law firms on securitizations. The views expressed in this article are my personal views informed by my practice experience as well as my research and analysis of the issues and are not the views of any law firm for which I serve or have served as a consultant.

1. *See generally* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 5-11, 237-38, 248-50, 282-84, 306-10, 338-41 (2004) (describing the difference between equity and debt, the different types of debt, and the factors that a company will consider in deciding to issue equity or debt).

2. *See, e.g.*, NetBank, FSB v. Kipperman (In re Commercial Money Center, Inc.), 350 B.R. 465 (B.A.P. 9th Cir. 2006) (holding that a purported sale by Commercial Money Center, Inc.—which leased equipment to lessees with sub-prime credit, packaged groups of leases together, and assigned its contractual rights to future lease payments to financial entities, including NetBank, FSB—of a pool of future lease payments to NetBank pursuant to a sale and servicing agreement constituted a grant of a

Dealers that sell property in exchange for receivables will typically sell their receivables to financial companies that dictate the terms of the receivables. These financial companies are also referred to as originators, and this process is known as the indirect origination of receivables.<sup>3</sup> Another traditional source of financing is borrowing from another financial institution, typically by granting to the lender a security interest to secure the loan.<sup>4</sup> A more recent source of financing receivables is securitization and structured finance.

For mortgage loan receivables, securitization primarily<sup>5</sup> involves the sale of the mortgage loans to a trustee to be held in trust and the issuance of pass-through certificates that are then sold into the capital markets, often with a rating. The pass-through certificates evidence the beneficial interests in, but not the legal title to, the underlying mortgage loans, and the certificate holders are entitled to all of the cash flow from the mortgage loans. For non-mortgage loan receivables, securitization and structured finance primarily combine the two traditional forms of receivables financing: (1) traditional accounts receivables financing in which the lender takes a security interest in receivables and the borrower retains liability for default, and (2) factoring, in which the purchaser of receivables assumes the risk of loss from default by the obligors.<sup>6</sup> In a securitization or structured finance transaction, the owner of the receivables sells them to a separate legal person, typically a wholly owned subsidiary, that is intended to be a bankruptcy remote special purpose entity (an "SPE"). In a securitization, the SPE issues debt securities, often rated by a rating agency, and in a structured

security interest and not a true sale of the lease payments); *Bear v. Coben* (In re Golden Plan of Cal., Inc.), 829 F.2d 705 (9th Cir. 1986) (upholding sale of residential mortgage loans and interests in such loans to investors by Golden Plan of California, a mortgage loan broker).

3. See, e.g., STANDARD & POOR'S RATING SERVICES, ABS: GENERAL METHODOLOGY AND ASSUMPTIONS FOR RATING U.S. AUTO LOAN SECURITIZATIONS, ¶ 13 (Jan. 11, 2011, republished Jan. 5, 2012) [hereinafter, S&P AUTO LOAN CRITERIA] ("Most auto financings are indirect auto loans, which means that the auto dealer helped to secure financing for the buyer. Direct auto loans are those in which the consumer obtained the loan directly from a financial institution.")

4. See, e.g., *Funding Sys. Asset Mgmt. Corp. v. Chem. Bus. Credit Corp.* (In re Funding Sys. Asset Mgmt. Corp.), 111 B.R. 500 (Bankr. W.D. Pa. 1990) (addressing the extent to which a secured creditor had perfected its security interest in chattel paper in the form of equipment leases originated by a lease financing company).

5. Non-mortgage receivables, such as automobile loans, have been securitized by the issuance of pass-through certificates, and mortgage loan securitizations and structured finance transactions have used special purpose entity ("SPE") borrowers. Nevertheless, because of the differences between the two kinds of receivables, the vast majority of mortgage and non-mortgage loan securitizations have followed the pattern described in the text.

6. See Thomas E. Plank, *Sacred Cows and Workhorses: The Sale of Accounts and Chattel Paper Under the U.C.C. and the Effects of Violating a Fundamental Drafting Principle*, 26 CONN. L. REV. 397, 406-12 (1994) (describing the history of financing for accounts receivable before the enactment of Article 9 of the U.C.C.).

finance transaction, the SPE borrows from a lender. In both cases, the SPE borrower grants a security interest in the receivables to secure the debt securities or the loan, which is primarily payable from the receivables. Accordingly, from a structuring perspective, there is no significant difference between a securitization and a structured finance transaction.

Originators of receivables use securitization and structured finance debt transactions when they produce lower financing costs and greater benefits than sales or traditional lending. Although securitization and structured finance debt transactions are more complicated and entail greater structuring and operational costs, in many cases they result in lower overall financing costs and provide the originators with a greater return than whole loan sales or traditional lending.<sup>7</sup> These cost savings arise primarily from the reduced risks to the lenders and investors, which I will also call lenders, that hold debt obligations of the SPE borrower. The reduced risks result from the separation of the risk associated with the receivables, which the lenders in a debt securitization/structured finance transaction bear and which they can more easily assess, from all of the other risks facing an originator that is an operating company, which are more difficult and more costly to assess.

In the case of a sale of receivables, the originator transfers to the buyer all of the benefits and burdens of ownership. If the receivables produce any surplus over the purchase price, the buyer, not the seller, realizes the benefit of the surplus. In the case of a traditional secured loan, the originator as borrower retains the full benefits of ownership of the receivables, but the borrower must compensate the lender for two different risks that the lender faces. First, the lender as well as the owner takes the risk that the receivables themselves will not perform as well as expected and as well as necessary to repay the loan. This risk includes not only the risk of non-payment by the obligors, but also the risk of loss if the market value of the receivables declines to less than the amount owed on the loan.

Second, even if the receivables themselves perform well enough to repay the loan, there is a risk that the owner/borrower encounters financial difficulties for reasons not related to the receivables. These reasons could include poor performance on another batch of receivables securing a different loan; poor performance of other business operations, such as servicing, that give rise to creditors who are not paid; and the risk of tort liability for

7. See, e.g., Steven L. Schwarcz, *The 2011 Diane Sanger Memorial Lecture: Protecting Investors in Securitization Transactions; Does Dodd-frank Help, or Hurt?*, 72 LA. L. REV. 591, 591-92, n.1 (2012) [hereinafter, Schwarcz, *Securitization and Dodd-Frank*]; Steven L. Schwarcz, *The Roberta Mitchell Lecture: Structuring Responsibility in Securitization Transactions*, 40 CAP. U. L. REV. 803, 806-07 (2012); see also *infra* note 27 and accompanying text.

any kind of tort that the operating company could commit. If the owner/borrower gets into financial difficulties or creditors take actions to collect debts owed to them, an owner/borrower has an incentive to file a voluntary petition for relief under the Bankruptcy Code.<sup>8</sup> In addition, the borrower could become subject to an involuntary petition filed by unsecured creditors.<sup>9</sup>

As discussed in Part II below, the commencement of a bankruptcy case by or against the owner/borrower subjects the secured lender to additional costs—what have been referred to as a “bankruptcy tax”<sup>10</sup>—and to cover those costs, the lenders must charge a higher interest rate—an increase which I have elsewhere called a “bankruptcy premium.”<sup>11</sup> Securitizations and structured finance transactions avoid the bankruptcy tax that would otherwise be imposed on the secured lending transaction and the bankruptcy premium that lenders would have to charge to cover the bankruptcy tax arising out of the risk of bankruptcy for reasons not related to the receivables.

Securitizations and structured finance transactions do not avoid the bankruptcy tax altogether. To the extent that the receivables themselves do not perform, and the lender seeks to foreclose its security interest in the receivables held by the SPE borrower, the SPE borrower will have a reason to commence a bankruptcy case. Nevertheless, for traditional receivables, it is generally much easier to assess the credit quality of a pool of receivables and the risk of bankruptcy because of poor performance of the receivables than to assess the credit quality of an operating company.<sup>12</sup> Securitizations and structured finance transactions are cost-effective when the risk associ-

8. 11 U.S.C. §§ 101-1532 (2012).

9. 11 U.S.C. § 303 (2012) (providing for the commencement of an involuntary bankruptcy case).

10. See David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055, 1064 (1998).

11. See Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1660-71 (2004) [hereinafter Plank, *Security of Securitization*].

12. See, e.g., S&P AUTO LOAN CRITERIA, *supra* note 3, ¶¶ 6,15:

Standard & Poor’s methodology for rating and monitoring auto lease ABS securitizations consists of a review of collateral characteristics, static pool and portfolio performance, third-party forecasts of residual values, historical auction data, current used vehicle market values, and transaction structures. Based on this review, cash flow modeling parameters are established for the purpose of modeling the transaction’s payment structure and analyzing the pool’s ability to pay timely interest and ultimate principal under stress scenarios that are consistent with the assigned ratings. These criteria address the risks associated with the:

- Credit quality of securitized assets;
- Cash flow mechanics and payment structure;
- Operational and administrative risk;
- Counterparty risk; and
- Legal and regulatory risk.

See also app. tbls.2-4 (presenting historical data on auto loan performance since 1925).

ated with the receivables is less than all of the other risks of an operating company.

The isolation of risk that produces the cost savings by a securitization and structured finance transaction requires structural features absent from the traditional secured loan. As described in Part III below, the structural features necessary to achieve this isolation of risks consists of two elements. First, the originator, which is generally an operating company, must transfer the receivables to an SPE borrower in a way that removes the receivables from the potential bankruptcy estate of the originator seller—what is commonly referred to as a “true sale.” Second, the SPE borrower itself and the loan transaction to the SPE borrower must be structured to minimize the risk that the SPE borrower will become a debtor in bankruptcy for reasons not related to the receivables. Both the debt incurred by the SPE to acquire the receivables and the SPE borrower itself must be “bankruptcy remote.” The heart of these structural requirements is that the lender must look primarily to the receivables for repayment, and not to the originator or sponsor of the securitization or structured finance transaction.

Although securitization and structured finance have been used for a wide variety of receivables, it does not follow that a securitization or structured finance transaction is cost-effective or feasible for every type of receivable. The characteristics of each type of receivable and the different characteristics of the business model for financing receivables will dictate the cost-effectiveness or feasibility of a securitization or structure financed transaction for any particular receivable. As I discuss in Part IV below, the nature of aberrant contract receivables may present challenges to using securitization or structured finance as a form of financing. Determining the feasibility of securitization or structured finance for aberrant contract receivables requires detailed knowledge of these receivable. This article seeks only to identify the relevant issues for such a determination.

## II. THE BANKRUPTCY TAX ON SECURED CREDIT

As the most recent codification of a body of law that first appeared in the sixteenth century, the Bankruptcy Code addresses the problem that exists in any credit economy of the borrower that has insufficient liquid assets to repay his, her, or its creditors.<sup>13</sup> Under the Bankruptcy Code, a borrower can become a debtor in bankruptcy by filing a voluntary petition, which constitutes an “order for relief,” to liquidate its assets under Chapter

13. See generally Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487 (1996) (describing the development of bankruptcy law in England and the United States).

7, or to reorganize its affairs under Chapter 11.<sup>14</sup> In a Chapter 7 liquidation, an independent trustee is appointed to liquidate the assets,<sup>15</sup> and in a Chapter 11 reorganization, the debtor becomes the “debtor in possession,” which continues to operate the business of the debtor and which has the powers of a bankruptcy trustee.<sup>16</sup> Creditors can also initiate a bankruptcy case against the debtor by filing an involuntary petition, and the court will enter an order of relief unless the petition is controverted, in which case the court will enter an order for relief only if the debtor is not paying its debts as they become due.<sup>17</sup>

The commencement of a voluntary or involuntary bankruptcy case has the effect of accelerating all claims that creditors have against the debtor that arose before the commencement of the case.<sup>18</sup> In addition, the filing of a petition automatically stays actions by creditors to collect their debts, including the commencement or continuation of litigation and enforcement of liens against property of the estate.<sup>19</sup> Also, all unsecured and under-

14. See 11 U.S.C. § 101(13) (2012) (providing that “debtor” means a “person or municipality concerning which a case under this title has been commenced”); § 109 (providing what types of an entity may be a debtor under the different chapters of the Bankruptcy Code); 11 U.S.C. § 301(a) (2012) (providing that a “voluntary case under a chapter of this title is commenced by the filing with the bankruptcy court of a petition under such chapter by an entity that may be a debtor under such chapter”); § 301(b) (providing that the “commencement of a voluntary case under a chapter of this title constitutes an order for relief under such chapter”).

15. See 11 U.S.C. §§ 701-02 (2012) (providing for the appointment of an interim bankruptcy trustee and the election of the bankruptcy trustee); § 704 (providing for the duties of the trustee, including the liquidation of property of the estate); § 725 (requiring the trustee to dispose of property in which a third party has an interest, such as a lien); § 726 (providing for distribution of property of the estate, including distributions to creditors).

16. See 11 U.S.C. § 1101(1) (2012) (providing that “debtor in possession” means the debtor unless an independent trustee is appointed); § 1107 (providing that the debtor in possession has substantially all of the powers of the trustee under Chapter 11); § 1108 (authorizing the trustee, which normally is the debtor in possession, to operate the debtor’s business).

17. See 11 U.S.C. § 303(a) (2012) (providing that an “involuntary case may be commenced only under chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation, that may be a debtor under the chapter under which such case is commenced”); § 303(b)-(c) (setting forth the requirements for an involuntary petition); § 303(h) (providing for the entry of the order for relief).

18. A creditor is an entity that has a claim that arose before the order of relief. 11 U.S.C. § 101(10) (2012). Proof of creditors’ claims may be filed by creditors or the debtor. 11 U.S.C. § 501 (2012). Claims are allowed unless a party in interest objects. § 502(a). If an objection is made, section 502(b) provides that the bankruptcy court “after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount” with certain exceptions not relevant to this discussion. § 502(b). The court must estimate certain contingent and unliquidated claims. § 502(c).

19. See 11 U.S.C. § 362(a) (2012). This subsection provides that the filing of a bankruptcy petition “operates as a stay, applicable to all entities,” of:

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;



secured creditors do not accrue interest on their claims after the commencement of the case.<sup>20</sup> These provisions impose costs on unsecured creditors. They are nevertheless necessary for the efficient liquidation of the debtor's assets for distribution to the debtor's unsecured creditors or reorganization of the debtor's affairs for the benefit of the unsecured creditors.

These provisions also apply to creditors that have a security interest in assets owned by the debtor.<sup>21</sup> In addition to the costs imposed by acceleration and the automatic stay, secured creditors are subject to other risks. These include: (1) the risk that a bankruptcy court would allow the bankruptcy trustee to substitute other collateral for the collateral that the secured creditor bargained for, so long as the court determines that the creditor is "adequately protected,"<sup>22</sup> and (2) the risk that the bankruptcy court would subordinate the secured creditor's claim to the security interest of a debtor-in-possession lender, again so long as the court determines that the creditor is "adequately protected."<sup>23</sup>

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor.

20. See 11 U.S.C. § 502(b)(2) (providing for a determination by the court of the amount of the claim allowed "except to the extent that . . . such claim is for unmatured interest"); *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 370-371 (1988) (holding that an undersecured creditor is not entitled to receive interest to compensate the creditor for the delay of foreclosure caused by the bankruptcy case). Note that oversecured creditors are allowed to accrue interest. See 11 U.S.C. § 506(b).

21. In my view, the Bankruptcy Code's treatment of secured creditors is less than ideal not only for the financing of receivables. See Thomas E. Plank, *The Creditor in Possession under the Bankruptcy Code: History, Text, and Policy*, 59 MD. L. REV. 253, 263-68, 336-49 (2000) (discussing the bankruptcy law history of the expanded jurisdiction over secured creditors and the policy reasons for limiting a creditor in possession of collateral obligation to return collateral).

22. See 11 U.S.C. § 361 (2012) (providing that adequate protection of an entity's interest may be provided by "an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property"); § 363(b)-(c), (f) (providing that the bankruptcy trustee may use, sell, or lease property of the estate or sell property in which the estate has an interest under certain conditions); § 363(e) (providing that, "on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest").

23. See 11 U.S.C. § 364(d)(1) (providing that the bankruptcy court may: "authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if (A) the trustee is unable to obtain such credit otherwise; and (B) there is adequate

Nevertheless, for certain types of assets and certain types of creditors, the immediate acceleration of claims and the automatic stay may be desirable. In the case of a debtor that operates tangible assets, like real estate and equipment, and finances those operations with loans secured by such assets, the acceleration of the secured claims and the imposition of the automatic stay may, in my view, be more efficient than allowing the secured creditors to enforce their security interests, which bankruptcy law had allowed until the 1930s. In the case of a liquidation, if the debtor has equity in the collateral, the bankruptcy trustee has a greater incentive and greater ability to maximize the value of the collateral than a secured creditor, which after all cannot realize any increase in that value above its secured claim. In the case of a feasible reorganization of, say, a trucking company or an airline, the reorganization cannot proceed if the secured creditors can foreclose on the trucks or airplanes that secure their debt. Hence, the increased costs imposed on these secured lenders by such acceleration and the automatic stay may be justified by a greater return for the secured creditors and unsecured creditors of the debtor.

The very existence of securitization, however, demonstrates that the increased costs from the acceleration of secured claims, the imposition of the automatic stay, and the other provisions of the Bankruptcy Code discussed above, impose costs for secured lenders to originators of receivables without significant benefit to the debtor or its other creditors.<sup>24</sup> For example, the costs imposed by the immediate acceleration of secured claims explains why it is not feasible for an operating finance company that would be subject to the Bankruptcy Code to finance the origination of long term mortgage loans by issuing debt secured by mortgage loans.<sup>25</sup> It is no accident that, since the enactment of the Bankruptcy Code effective in 1979, more than eighty-nine percent of all mortgage loans have been held by entities (1) that are not subject to the Bankruptcy Code or (2) that are bankruptcy remote issuers of asset-backed securities.<sup>26</sup>

protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.”).

24. See Thomas E. Plank, *Sense and Sensibility in Securitization: A Prudent Legal Structure and a Fanciful Critique*, 30 *CARDOZO L. REV.* 617, 629-32 (2008) (explaining why the Bankruptcy Code limitations on secured creditors with a security interest in receivables owned by an originator produce essentially no benefit to the other creditors of the originator).

25. See Thomas E. Plank, *Crisis in the Mortgage Finance Market: The Nature of the Mortgage Loan and Regulatory Reform*, 12 *TENN. J. BUS. LAW* 135, 137-45 (2011) (describing the development of mortgage finance, including public and private securitization, from 1945 to 2009, and explaining why the nature of mortgage loans requires protection from acceleration of debt secured by long-term mortgage loans).

26. See *id.* at 144-45, n.42.

For shorter-term receivables, the costs of acceleration are not as significant, but the automatic stay and the other provisions of the Bankruptcy Code affecting secured creditors remain significant. A study done in 1988 provides one example of the cost savings from the securitization of automobile loans.<sup>27</sup> This study compared the costs and benefits of \$4 billion in asset-backed securities (“ABS”) backed by automobile loans originated by General Motors Acceptance Corporation (“GMAC”) with the costs and benefits of GMAC’s publicly issued corporate debt. The costs, all expressed as an annual percentage of outstanding balance, are set forth below:<sup>28</sup>

<b>GMAC transaction and rating</b>	<b>Corp debt AA+</b>	<b>ABS AAA</b>
Principal amount	\$18 billion	\$4 billion
Interest rate	7.01%	6.91%
Fees	0.20%	0.26%
Loss reserve/credit enhancement	0.50%	0.52%
Net cost of capital	1.28%	0.00%
Total	8.99%	7.69%
Net difference	1.30%	

Although the slightly higher rating of the ABS—a AAA rating—produced a cost savings of 0.10 percentage points, or 10 basis points, over the corporate debt, which carried a AA+ rating, almost all of those savings were eaten up by the higher transaction costs—6 basis points—and loss reserves or credit enhancement—2 basis points.<sup>29</sup> The substantial cost savings derive from the costs of net capital—128 basis points—that GMAC had to maintain to achieve a AA+ rating on its corporate debt.<sup>30</sup> Further, by comparing rated corporate securities and rated asset-backed securities, this study eliminates any cost savings attributable to the greater liquidity and investor demand of securities over ordinary secured loans.

Although securitization and structured finance transactions avoid the costs that the Bankruptcy Code imposes on secured creditors to operating companies, structuring the transactions to avoid such costs also entails additional costs. Part III describes the additional transactional requirements

27. See James A. Rosenthal & Juan M. Ocampo, *Analyzing the Economic Benefits of Securitized Credit*, J. APPLIED CORP. FIN. 32, 36 (Fall 1988).

28. *Id.* at 36-40.

29. *Id.* at 40-41.

30. *Id.*

to achieve bankruptcy remoteness. The question then remains whether aberrant contract receivables can satisfy the legal and credit-dependent requirements for structured finance and securitization transactions.

### III. SECURITIZATION AND STRUCTURED FINANCE REQUIREMENTS

As discussed above, securitization and structured finance debt transactions achieve bankruptcy remoteness by effecting a legal true sale of the receivables to a separate, bankruptcy remote legal entity, the SPE that issues debt secured by the receivables. To ensure a structure that will likely be respected by a bankruptcy court, the transaction documents will impose significant limitations on the seller of the receivables, the SPE, and the lender. Specifically, unlike a typical corporate financing in which a parent of a borrower will also guarantee the debt of the subsidiary borrower, the lenders must look primarily to the receivables for repayment and not to the credit of the originator of the receivables. This limitation requires two different conditions: (1) reliable and predictable cash flow from the receivables, and (2) legal restrictions on the originator, the SPE, and the lenders.

#### *A. The Nature of the Receivables*

The value of any receivable depends on the willingness and ability of the obligor to pay the amounts that the obligor agrees to pay. Accordingly, determining the value of any receivable requires an examination of both the obligor's financial condition and the specific characteristics of the receivables that affect the likelihood of timely payment of the receivable. For many different types of receivables, originators and lenders have developed criteria for predicting the likelihood of timely payment of principal and interest. Originators and lenders have also developed analyses to predict, over a pool of receivables, the percentage of receivables that will default and the amount that will likely be realized on defaulted receivables.<sup>31</sup> The larger the number of receivables of similar types, the easier the determination of expected losses and the methods of covering those losses, including covering losses on defaulted receivables from the interest paid on performing receivables. For this reason, there is a large and functioning market for

31. See, e.g., Schwarcz, *Securitization and Dodd-Frank*, *supra* note 7, at 591-92; see also STANDARD & POOR'S CORP., STRUCTURED FINANCE CRITERIA 25-26 (1988) (providing a general description of Standard & Poor's methodology in assessing the credit quality of a pool of receivables owed by unrated entities and remarking that its "'asset loss' model . . . is based on the belief that only pools of assets that can withstand potential adverse circumstances merit high quality credit ratings").

automobile loan securities backed by prime receivables and also by sub-prime receivables that meet certain minimum criteria.<sup>32</sup>

The analysis does not depend solely on the credit rating of the obligor. Other characteristics of the receivables will affect cumulative net losses. For example, cumulative net losses for obligors with identical credit ratings were lower for auto loans secured by new cars compared to those secured by used cars, and for auto loans with a term of sixty months compared to those with a term of seventy-two months.<sup>33</sup> In addition, other factors may affect a determination of the quality of a pool of automobile loans, such as origination and underwriting standards and credit/risk scoring tools; servicing and collection policies; accounting policies; and dealer relationships and monitoring tools.<sup>34</sup> Every lender must analyze all of these factors for each type of receivable in structuring a securitization or structured finance debt transaction secured by those receivables.

### B. Legal Restrictions

As noted above, to achieve bankruptcy remoteness for the receivables, there must be (1) a true sale to (2) a bankruptcy remote SPE. To achieve these goals, the originator/seller, the SPE, and the lender must agree to limitations that do not arise in direct secured lending transactions.

#### 1. True Sale

*Intent.* First, to achieve a true sale, the documents effecting the sale and the actions of the parties must express the intent that there be an absolute assignment of the receivables to the SPE borrower.<sup>35</sup> This requirement does not constrain the parties, but it does require careful attention. Originators look to securitization as a form of financing and as business people, may not be particularly interested in the legal terminology. They need to be educated about the fact that the first transfer is a sale.

*Fair Market Value Purchase Price.* The second requirement for a true sale is the receipt of fair market value by the seller for the receivables.<sup>36</sup>

32. See, e.g., S&P AUTO LOAN CRITERIA, *supra* note 3, ¶¶ 6, 15.

33. *Id.* at ¶ 29, tbl.2.

34. *Id.*

35. See generally Thomas E. Plank, *The Key to Securitization: Isolating the Assets to Be Securitized from the Risk of An Insolvency Proceeding*, in OFFERINGS OF ASSET-BACKED SECURITIES § 8.03[B][1] (John Arnholz & Edward E. Gainor eds., 2d ed., 2013) (providing a detailed analysis of the elements of a true sale) [hereinafter Plank, *Isolating Assets*].

36. See generally Robert D. Aicher & William J. Fellerhoff, *Characterization of a Transfer of Receivables as a Sale or a Secured Loan upon Bankruptcy of the Transferor*, 65 AM. BANKR. L.J. 181, 207, 209-11 (1991); Plank, *Isolating Assets*, *supra* note 35, § 8.03[B][2]; Plank, *Security of Securitization*, *supra* note 11, at 1663.

This requirement is not difficult to achieve. For example, assume a transfer of a \$100 receivable to a newly formed subsidiary SPE that will borrow \$75 from a lender. The seller will sell the receivable and receive \$75 cash and the equity interest in the SPE, which is worth approximately \$25.<sup>37</sup> The consideration for subsequent sales may consist of cash from subsequent borrowings and the principal collected on the receivables already owned by the SPE, borrowings by the SPE from the seller under a subordinated note, or the increase in the value of the SPE. For example, if the SPE owns receivables with a value of \$1,000 previously transferred to it by the seller and has borrowed \$750 from a lender, the seller has an equity interest in the SPE worth \$250. The SPE could purchase another \$100 in receivables, borrowing \$75 from the lender and paying the other \$25 in the form of collections from the existing receivables, borrowing \$25 from the seller under a subordinated note, or simply recording an increase in the seller's equity interest of \$25.

*Transfer of Benefits and Burdens of Ownership.* The legal requirement that most constrains the seller, the SPE, and the lender is the rule that substantially all of the burdens and benefits of ownership of the receivables must be transferred from the seller to the SPE.<sup>38</sup> The SPE buyer and the lender to the SPE must bear most of the risk of loss from credit default. A small amount of credit recourse to the seller for default by obligors is permitted, limited either to ten percent of the receivables sold or the expected loss on the receivables.<sup>39</sup> This limited recourse is not a major source of repayment, and in fact, it is intended primarily to create an incentive for the seller to sell good quality receivables to the SPE.

Also, if the market value of the receivables changes because of changes in market interest rates, the SPE borrower and the lender must bear that risk.<sup>40</sup> Generally, the seller may not guarantee that the borrower or the

37. Steven O. Weise has pointed out to me that, because the holder of the equity interest in the SPE will be subordinate to other creditors of the SPE, the value of the equity would be slightly less than \$25 if the value of the receivable held by the SPE remains \$100. Of course, the SPE is not designed to have significant creditors but it may have a small amount of debt arising out of liability to service providers, such as lawyers and accountants. On the other hand, in my experience, the value of the equity in the SPE—because of the lower costs of securitization—will often be more than the difference between the market value of the receivable held by the originator for sale as a whole loan and the amount of the SPE's debt. In other words, the value of the equity could be worth \$26 or \$27 dollars.

38. See generally Plank, *Isolating Assets*, *supra* note 35, § 8.03[B][2]; Plank, *Security of Securitization*, *supra* note 11, at 1675; Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO MASON L. REV. 287, 333-34 (1991).

39. Plank, *Isolating Assets*, *supra* note 35, § 8.03[B][2]. Another exception is full recourse to the seller for early payment default, that is, when the obligor fails to make a payment during the first month or three months after the sale. See *id.* § 8.03[B][3].

40. For example, a five-year \$10,000 automobile loan payable monthly and bearing interest at 6% annually would have a present value of \$9,534.63, a 4.65% decline, if rates on comparable loans sud-

lender will receive a particular yield on the receivables or otherwise protect the SPE or the lender from a decrease in the market value of the receivables.<sup>41</sup> On the other hand, the seller is generally prohibited from being able to repurchase the receivables at par to capture any increase in the market value of the receivables.<sup>42</sup>

One other characteristic of receivables is that they must be serviced.<sup>43</sup> The advantage of receivables is that they turn into cash almost by themselves. I say “almost” because someone has to collect and process the payments on the receivables, account for the payments, and, when obligors become delinquent, attempt to collect from the obligors. This burden, similar to the burden of maintaining a car to keep it running, should be shifted to the buyer of the receivables. The seller is often retained as the agent for the buyer to service the loans because the seller has the familiarity with the obligors, and servicing is a good business that generates an income stream. Retention of the servicing is not inconsistent with a true sale so long as the buyer can replace the servicer for poor performance, the servicer has no liability for the performance of the receivables other than liability for its failure to service the loans properly, and the servicer earns a reasonable fee that adequately compensates it for its services.

## 2. Bankruptcy Remote SPE

The purpose of a bankruptcy remote SPE is to protect the lender from three different types of risks of bankruptcy: (1) the risk that the SPE will engage in activities other than owning the receivables and borrowing money from the lender, and therefore become a debtor in bankruptcy as a result of those activities, that is, for reasons not related to the receivables them-

denly increase to 8%, and a present value of \$10,497.53, a 4.98% increase, if such rates suddenly fall to 10%. The longer the term of the receivable, such as a fixed rate 30-year mortgage loan, the greater the change in market value, even taking into account prepayments. For example, a 2% swing in interest rates on a 30-year mortgage loan could, depending on the assumed rate of prepayments, generate a decline in the present value of more than 10% or an increase of up to 6%. See Thomas E. Plank, *Regulation and Reform of the Mortgage Market and the Nature of Mortgage Loans: Lessons from Fannie Mae and Freddie Mac*, 60 S.C. L. REV. 779, 790, tbl.4 (2009) (describing the range of the decline or increase in present value depending on the prepayment rates).

41. One exception is the requirement that if a seller has sold a receivable at a premium, say, 102% of the principal balance, and it pays off within a short period of time after the sale, say between three and six months (depending on the receivable), the seller may be required to refund to the buyer the premium that it received, that is, the 2%. See, e.g., FANNIE MAE, SELLING GUIDE: FANNIE MAE SINGLE FAMILY 992 (Apr. 9, 2013), available at <http://www.fanniemae.com/content/guide/sel040913.pdf> (discussing premium pricing recapture for mortgage loans that pay off within 120 days of the date of sale to Fannie Mae).

42. See generally Plank, *Isolating Assets*, *supra* note 35, § 8.03[B][2][c] (also discussing permissible types of repurchase options).

43. Plank, *Isolating Assets*, *supra* note 35, § 8.03[B][2].

selves (“Non-Asset Risk”); (2) the risk that a parent of the SPE will cause the SPE to file for bankruptcy to obtain some benefit for the parent (“Parent Opportunism Risk”); and (3) the risk that, if the parent of the SPE were to become a debtor in bankruptcy, a bankruptcy court will consolidate the assets and liabilities of the SPE with those of the parent under the doctrine of substantive consolidation (“Substantive Consolidation Risk”).<sup>44</sup> To protect from these risks, the charter documents establishing the SPE and the other transaction documents will contain provisions that constrain the seller or parent of the SPE, the SPE itself, and the lender. These constraints create costs.<sup>45</sup>

To address the Non Asset Risk, the SPE charter will limit its activities to owning the receivables and borrowing from the lender.<sup>46</sup> The major constraint here is that these limitations may prevent a legitimate expansion of the SPE’s activities. For example, if the SPE can only own automobile loans, then it may not be able to securitize automobile leases. This is a relatively minor risk or cost.

To address the Parent Opportunism Risk, the SPE charter will require the SPE to engage a director, in the case of a corporation, or an independent manager, in the case of a limited liability company, or some other person that is independent of the parent.<sup>47</sup> The SPE charter will require the consent of the independent person to authorize the filing of a bankruptcy petition and certain other major actions, such as dissolution. Directors and managers appointed by the parent of the SPE who are officers, directors, or employees of the parent would be expected to follow the directions of the parent even if those directions were not necessarily in the best interest of the SPE, such as filing a bankruptcy petition when the SPE is solvent and paying its debts as they come due. An independent director or manager, however, is expected to consider the interests of the SPE, and to the extent legally possible, its creditors. Hence, if the SPE does not need to be a debtor in bankruptcy because it is not in default or otherwise insolvent in a cash flow or balance sheet sense, it is expected that the independent director or manager would not vote to authorize a bankruptcy filing simply because the filing may benefit the parent. This limitation does constrain the seller or parent of the SPE, and it also entails some cost.

44. See generally Plank, *Security of Securitization*, *supra* note 11, at 1664-66.

45. See Plank, *Isolating Assets*, *supra* note 35, § 8.04 (providing a detailed discussion of the requirements to satisfy these risks).

46. *Id.* § 8.04[A][2].

47. *Id.* § 8.04[A][1].



Finally, to address Substantive Consolidation Risk, the SPE charter will contain a set of separateness covenants that require the SPE to operate separately from the parent, to observe all legal formalities, and to segregate its assets, books, records, and bank accounts from those of the parent.<sup>48</sup> Accordingly, even though the activities of the SPE are limited to owning and pledging assets, the SPE must incur the costs of a real separate legal entity. Further, the lender must primarily rely on the credit of the SPE and its assets.<sup>49</sup> It cannot obtain a general guarantee from the parent, as is common in many ordinary corporate financings. At most, it may obtain only a very limited guarantee, generally not to exceed ten percent of the SPE's debt or the amount of recourse allowed for a seller of the receivables if the seller is the parent.

#### IV. SECURITIZATION AND STRUCTURED FINANCE FOR ABERRANT CONTRACT RECEIVABLES

The material in this Symposium presents a disturbing picture of some aberrant contracts, especially the ones that bear very high interest rates. On the other hand, people should have the freedom to enter into contracts of their choosing or, as is often the case, to accept or reject the contract terms that are available. Laws and regulations that help the market function better are desirable, but very often laws and regulations are a form of rent seeking that protects special interests, whether those special interests are business interests or bureaucratic and political interests. This article does not address the utility of these aberrant contracts. This article does suggest some issues and constraints on whether the rights to payments under these aberrant contracts—aberrant contract receivables—can be securitized. The utility of the securitization of aberrant contract receivables is different from the utility of the aberrant contracts themselves and the former should, in my view, be left to the decisions of the parties, which are commercial actors.

One of the key requirements for financing receivables through a securitization or structured finance transaction is the reliability and predictability of the cash flow from the receivables.<sup>50</sup> Some of the contracts considered to be aberrant contracts in this Symposium may produce cash flows of sufficient reliability and predictability for a securitization or structured finance transaction and others may not.

48. *Id.* § 8.04[B][1].

49. *Id.* § 8.04[B][2].

50. *See supra* Part III.A.

In assessing the feasibility of financing aberrant contract receivables through a securitization or structured finance transaction, it is important to consider that, even for traditional receivables securitization and structured finance transactions are not the primary source for financing. For example, according to statistics published by the Federal Reserve Board, from the end of 1995 to the end of 2009, consumer credit grew from \$1.2 trillion to \$2.4 trillion.<sup>51</sup> Of this amount, the balance held by United States depository institutions, other than credit unions, grew from about \$542 million to \$906 million, with the percentage dropping from forty-six percent of the total at the end of 1995 to thirty-four percent at the end of 2002; it then increased slightly to thirty-eight percent and thirty-seven percent, respectively, at the end of 2008 and 2009.<sup>52</sup>

The balance held by issuers of asset backed securities (“ABS Issuers”) grew from \$213 million at the end of 1995 to \$625 million at the end of 2007 and then declined to \$575 million at the end of 2009; the percentage increased from eighteen percent of the total at the end of 1995 to a high of thirty-two percent at the end of 2002, and then declined to twenty-three percent at the end of 2009.<sup>53</sup> During this time, the consumer receivables held by finance companies grew from \$152 million at the end of 1995 to \$572 million at the end of 2007, and then declined to \$471 million at the end of 2009; the percentages ranged between twelve percent and twenty-two percent during this period.<sup>54</sup> These figures somewhat understate the amount of consumer finance receivables held by ABS Issuers because the Federal Reserve Board statistics for ABS Issuers only include those assets that are not consolidated on the books of their originators.<sup>55</sup> Some finance

51. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS AND INTEGRATED MACROECONOMIC ACCOUNTS; HISTORICAL ANNUAL TABLES 2005-2012 98, tbl.222, 1.2 (2013) [hereinafter FRB FINANCIAL ACCOUNTS 2005-2012]; BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL ACCOUNTS OF THE UNITED STATES: FLOW OF FUNDS, BALANCE SHEETS AND INTEGRATED MACROECONOMIC ACCOUNTS; HISTORICAL ANNUAL TABLES 1995-2004 98, tbl.222, 1.2 (June 3, 2013) [hereinafter FRB FINANCIAL ACCOUNTS 1995-2004].

52. See FRB FINANCIAL ACCOUNTS 2005-2012, *supra* note 51, at 98, tbl.222, 1.6; FRB FINANCIAL ACCOUNTS 1995-2004, *supra* note 51, at 98, tbl.222, 1.6. The percentage held by credit unions ranged between ten and eleven percent during this time. See FRB FINANCIAL ACCOUNTS 2005-2012, *supra* note 51, at 98, tbl.222, 1.7; FRB FINANCIAL ACCOUNTS 1995-2004, *supra* note 51, at 98, tbl.222, 1.7.

53. See FRB FINANCIAL ACCOUNTS 2005-2012, *supra* note 51, at 98, tbl.222, 1.9; FRB FINANCIAL ACCOUNTS 1995-2004, *supra* note 51, at 98, tbl.222, 1.8.

54. See FRB FINANCIAL ACCOUNTS 2005-2012, *supra* note 51, at 98, tbl.222, 1.10; FRB FINANCIAL ACCOUNTS 1995-2004, *supra* note 51, at 98, tbl.222, 1.9.

55. See FEDERAL RESERVE STATISTICAL RELEASE, G19 CONSUMER CREDIT MONTHLY SERIES, at n.8 (May 2013).

companies did not treat the sale of receivables to their wholly owned SPEs as a “sale” for accounting purposes.<sup>56</sup>

Banks and finance companies use securitization and structured finance transactions as just one source and not the primary source of financing for traditional receivables. The choice to use securitization and structured finance transactions for these receivables depends on the relative costs and benefits of securitization and structured finance transactions versus the costs and benefits of other sources. If securitization or structured finance transactions for a particular type of receivables entail greater costs, those costs may overwhelm the savings achieved by avoiding the bankruptcy tax on direct secured lending to originators.

The nature of aberrant contract receivables and the restrictions demanded by the bankruptcy remote structure could prevent any meaningful use of securitization or structured finance for most types of aberrant contracts. Securitization and structured finance transactions work for traditional receivables because lenders can assess the credit quality of the receivable-receivables largely independent of the activities of an operating company. An automobile loan turns into cash almost by itself. An item of inventory, such as a car on a dealer’s lot or an item of equipment like a truck owned by a trucking company, does not turn into cash by itself. It produces cash only because of the activities of an operating company, that is, a dealer that sells cars or a trucking company that uses trucks to transport goods.

To be sure, receivables must be serviced, and the value of a pool of receivables does depend to a certain extent on the quality of the servicing.

56. Under the accounting standards in effect during the period from 1995 through 2009, including the Financial Accounting Standards Board (“FASB”), FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 140: ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES (2000), available at <http://www.fasb.org/pdf/fas140.pdf>, an originator that sold receivables to a wholly-owned subsidiary could obtain a sale for accounting purposes, that is, recognized a gain or loss on the transfer. In June 2009, the FASB issued two statements, effective for reporting periods that ended after November 30, 2009, which essentially required consolidation of the receivables owned by an SPE and the debt of the SPE with the assets and liabilities of an originator or affiliate that owned the SPE. See FIN. ACCOUNTING STANDARDS BD. OF THE FIN. ACCOUNTING FOUND., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 166: ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS AN AMENDMENT OF FASB STATEMENT NO. 140 (2009); FIN. ACCOUNTING STANDARDS BD. OF THE FIN. ACCOUNTING FOUND., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 167: AMENDMENTS TO FASB INTERPRETATION NO. 46(R) (2009).

I did not set forth any of the balances for 2010 or later. Because of this change in the accounting rules, most of the consumer receivables held by ABS Issuers are held on the books of their originating banks or finance companies, and the Federal Reserve Board does not include those in the assets of ABS Issuers. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., G19 CONSUMER CREDIT MONTHLY SERIES, at n.9 (May 2013). Accordingly, the Federal Reserve Board statistics for the years after 2010 provide little meaningful information. For example, the balance of consumer receivables held by ABS Issuers declined from \$573 million, or 23.69%, as of the end of 2009, to \$50 million, or 1.99%, as of the end of 2010. See FRB FINANCIAL ACCOUNTS 2005-2012, *supra* note 51, at 98, tbl.222, 1.8.

This portion of the value of the receivables, however, is small in comparison to the value of the pool. If a servicer is servicing a pool poorly, the servicer can be replaced. Most securitization and structured finance transactions, in my experience, absent poor performance of the receivables, have sufficient credit cushion to survive a poor servicer that must be replaced.

If the value of the pool of receivables, however, depends too much on the ongoing actions of the originator or servicer, a securitization or structured finance transaction may not be feasible. A few simple examples will illustrate the point.<sup>57</sup>

First, assume that an originator originates and holds a pool of good quality receivables that amortize monthly over a five-year period and bear interest at 6%. The interest rate is intended to cover expected defaults and the cost of servicing. Assume an annual default rate of 0.25% with no recoveries and a servicing fee of 1%. The remainder of the interest earned—net interest of 4.75% in this example—is intended to cover the originator's cost of funds, its operational costs of originating receivables, and profit. The assumed default rate would generate cumulative net losses of 0.67% of the original principal balance of the pool, and the total servicing fee paid would also equal 2.67% of the original principal balance of the pool and 2.31% of the total principal and net interest collected, that is, interest net of defaults.<sup>58</sup>

The servicing burden inherent in the receivables is very small relative to the principal to be paid and the interest to be earned. If the originator transfers the receivables to a wholly owned SPE that borrows from a lender, the lender can easily assess the credit quality of the receivables and the predictability and reliability of the cash flow from the receivables. In this case, the lender is relying almost exclusively—greater than 97%—on the willingness and the ability of the obligor on the receivables to pay, and the costs of and losses arising from replacing the originator, as a servicer, will also be relatively small. The SPE borrower will obtain the net benefit of a lower interest rate, against slightly higher costs, from the bankruptcy remote structure, and as the owner of the SPE borrower, the originator will also receive that benefit.

Second, assume a pool of receivables of lower quality that amortize monthly over a five-year period and bear interest at an annual rate of 24%. Also assume an annual default rate of 3% with no recoveries and a servic-

57. I developed the following two examples by constructing cash flows in an Excel document. The cash flows are available from the author and the Chicago-Kent Law Review.

58. Some of these numbers would be slightly smaller on a present value basis, that is, discounting the future values to the value as of the date of the origination of the pool.

ing fee of 3%. The net interest would be 18%, which is necessary to cover the higher cost of funds and higher operational costs for an originator of these types of receivables.<sup>59</sup> This default rate would generate cumulative net losses of 9.08% of the original pool balance, and the total servicing fee paid would also equal 9.08% of the original principal balance of the pool and 5.55% of the total principal and net interest collected, that is, interest less defaults. Although higher, the servicing burden inherent in the receivables is still less than 10% of the original principal balance of the pool to be paid and about 5.9% of total principal paid and net interest to be earned. In this case, the lender is still relying primarily—greater than 90%—on the willingness and the ability of the obligor on the receivables to pay.

Now assume a contract of \$1,000 on which the originator induces the obligor to pay 300% interest over a one-year period and then at the end of the year the originator writes off the principal amount as a complete loss. This looks like an aberrant contract. Out of 300% interest collected (\$3,000), 100% (\$1,000) covers the total loss of principal. Assume that the originator obtains funds from equity investors and must pay a 25% annual return out of the remaining 200% (\$2,000). That still leaves 175% (\$1,750) for the costs of servicing this particular loan and the other operating costs. The much higher costs for servicing and other operations, if they are legitimate, indicates that a lender willing to finance this type of receivable would necessarily need to rely more on the ability of the originator to service the loan—including inducing the obligor to make the high interest payments—than on the willingness and ability of the obligor to pay.

Reliance on an operating company does not make a bankruptcy remote structure irrelevant. A bankruptcy remote structure for operating companies will reduce some risks because of the separation of one set of operational risks from another set of operational risks. For example, single asset real estate financings often use a bankruptcy remote, special purpose financing structure.<sup>60</sup> The entity that owns the real estate and borrows under a real estate loan will be an SPE, whose charter contains separateness covenants and may require an independent director or manager. Law firms often provide an opinion that the SPE borrower would not be substantively consolidated with its direct and indirect parents, which may own many

59. On the basis of my experience, a plausible breakdown of the costs would be about seven percent for interest costs, eight percent for operating expenses other than servicing, and about three percent for profit. These higher operating costs reflect a smaller pool balance as well as the nature of the receivables.

60. See generally STANDARD & POOR'S RATING SERVICES, U.S. CMBS LEGAL AND STRUCTURED FINANCE CRITERIA (2003).

other entities that own real estate projects.<sup>61</sup> Lenders to a single asset real estate SPE need only assess the operating risks of that SPE and not the operating risks of other real estate projects owned by affiliates of the SPE. Nevertheless, the lender is lending against an entity that owns and operates a business and not against a large pool of receivables that will turn into cash with little effort by an operating company.

There are two examples of transactions that illustrate the limits of a bankruptcy remote structure: (1) attempts to securitize servicing fees and (2) so-called hybrid transactions. Servicing of receivables under a servicing agreement generates servicing fees. The right to receive the servicing fees is itself a receivable, an “account” under Article 9 of the U.C.C., which can be assigned.<sup>62</sup> Accordingly, the right to receive servicing fees can be sold to an SPE that could borrow money from a lender.<sup>63</sup> Servicing fee receivables fit neatly into the legal structure for a securitization or a structured finance transaction.

Nevertheless, the nature of servicing fee receivables precludes widespread use of servicing fee receivables in structured finance and securitization transactions. Servicing fees are earned by the performance of the servicer. If the servicer fails to perform under the servicing agreement, and either the servicing agreement is terminated or the servicer is terminated as servicer, the fees could end. Further, if the servicer that sells the servicing fees to the SPE becomes a debtor in bankruptcy, the bankruptcy trustee may reject the servicer’s obligation to service, which would terminate the right to receive the servicing fees.<sup>64</sup> The bankruptcy trustee would reject the servicing agreement if the costs of servicing exceeded the servicing fee earned. Accordingly, a lender that would lend funds against servicing fee receivables as collateral necessarily must rely extensively on the continued performance of an operating company.

There are ways to mitigate the risks inherent in servicing fee receivables. To the extent that the servicing fees exceed the cost of servicing, the servicer could sell the right to receive excess servicing to an SPE. For example, if the servicer is earning a servicing fee of 35 basis points, but the cost of servicing is 20 basis points, the servicer could sell the right to re-

61. *Id.* at 95, 105-09.

62. *See* U.C.C. § 9-102(a)(2) (2010) (defining an “account” as “a right to payment of a monetary obligation, whether or not earned by performance . . . (ii) for services rendered or to be rendered”).

63. *See* U.C.C. § 9-109(a) (providing that Article 9 of the U.C.C. applies to “(1) a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract; [and] (3) a sale of accounts, chattel paper, payment intangibles, or promissory notes”).

64. *See* 11 U.S.C. § 365(a) (2012) (A bankruptcy trustee “may assume or reject any executory contract or unexpired lease of the debtor.”).

ceive 10 basis points to an SPE that could obtain a loan secured by the excess servicing fee. In this case, the reliability of the cash flow from the excess servicing is enhanced because the lender to the SPE can rely on the servicer's continued incentive to service the underlying loans well. Accordingly, in my experience, although it has been difficult to structure an absolute assignment of all the servicing fee receivables, assignments of excess servicing are common.

Another example of a transaction that illustrates the limits of a bankruptcy remote structure is what Standard & Poor's Rating Services calls a "hybrid" transaction that combines elements of both securitization and corporate finance.<sup>65</sup> In a hybrid transaction, an SPE holds assets other than traditional receivables that are serviced or managed by a parent servicer in a way that generates funds to repay debt borrowed by the SPE.<sup>66</sup> As Standard & Poor's notes, however:

[T]he legal techniques used in a securitization generally cannot alone achieve complete isolation of the credit risk of the operating assets. The legal structure may not remove some uncertain cash flow characteristics of the securitized assets. Thus, Standard & Poor's criteria for hybrid transactions recognize that, while the integrity of a particular transaction's legal structure should be established and maintained, the structure itself is unlikely to insulate completely the transaction from the more active types of operational or servicing risk.<sup>67</sup>

The 2000 LTV Steel Company bankruptcy case provides a useful contrast between a typical securitization of receivables and a hybrid transaction. Although LTV Steel had emerged from bankruptcy in 1993, it was able to sponsor a trade receivables securitization in 1994. In this transaction, LTV Steel entered into a revolving sale agreement to sell accounts, representing the obligation of buyers of steel products to pay for those products within a specified time period, to an SPE. The SPE entered into a revolving credit agreement providing for the issuance of debt secured by the receivables. The debt obtained a rating of "AAA" from Standard & Poor's Rating Services, the highest rating available.<sup>68</sup>

Four years later, LTV Steel also sponsored an "inventory securitization." In this transaction, LTV Steel entered into a revolving sale agreement to sell unfinished steel products, its inventory, to a separate SPE. This inventory SPE entered into a revolving credit agreement providing for the

65. See generally STANDARD & POOR'S RATING SERVICES, LEGAL CRITERIA FOR U.S. STRUCTURED FINANCE TRANSACTIONS 145 (2006).

66. *Id.*

67. *Id.*

68. *In re LTV Steel Co.*, 274 B.R. 278, 280 (Bankr. N.D. Ohio 2001). For an extended discussion of the LTV Steel transaction, see Plank, *Security of Securitization*, *supra* note 11, at 1686-98.

issuance of debt secured by the inventory. LTV Steel was hired as the servicer to process the inventory and sell finished steel products on behalf of the inventory SPE.

The debt issued by the inventory SPE obtained a rating of only “BBB” from Fitch Rating Services, which is the lowest rating that is considered an “investment grade” rating. Although the BBB rating for the inventory securitization was presumably higher than LTV’s corporate rating, which must therefore have been below investment grade, it was substantially lower than the AAA rating of the trade receivables securitization.<sup>69</sup> Hence, a securitization structure provided some benefit for the inventory securitization. Nevertheless, because the lenders in the inventory securitization were still relying to a substantial degree on LTV’s manufacturing and selling operations, the benefit to the structure was significantly less than the benefits of the trade receivables securitization. This much lower benefit shows the limitations of a securitization or structured finance transaction for assets other than receivables that generate cash flow substantially by themselves.<sup>70</sup>

Structured finance and securitization transactions involving traditional receivables offer substantial financing savings because of (a) the nature of the receivables and (b) the bankruptcy remote requirements. In these transactions, a pool of traditional receivables will produce reasonably predictable and reliable cash flows from many obligors, most of who are able and willing to pay the amounts they owe. Often the credit quality of the pool is greater than the credit quality of the originator. The risk of default is spread among many obligors and, given a sufficiently large number of obligors, can be predicted. The bankruptcy remote requirements separate the risks associated with the receivables from all of the other risks associated with the originator of the receivables. A lender to an SPE holding these receivables relies almost entirely on the pool of receivables and not on any one particular operating company.

69. Around the time of this case, the four highest rating categories (AAA, AA, A, and BBB for Standard & Poor’s and Fitch, and Aaa, Aa, A, and Baa for Moody’s, for example) were generally considered “investment grade” securities. See Plank, *Security of Securitization*, *supra* note 11, at 1661, n.16. The classification system has not changed. See, e.g., STANDARD & POOR’S, GUIDE TO CREDIT RATING ESSENTIALS 10-11 (2011) (describing “investment grade” ratings as AAA, AA, A, BBB [including BBB-] and “speculative grade” ratings as BB, B, CCC, CC, C, and D).

70. In addition, when steel prices fell in 1999 and 2000, LTV filed for bankruptcy in December 2000 and unsuccessfully attacked both the inventory securitization and the trade receivables securitization to fund its reorganization. The very existence of the inventory securitization and the degree of reliance on the operational capacity of the servicer formed the basis for the ultimately unsuccessful attack on the trade receivables securitization. See Plank, *Security of Securitization*, *supra* note 11, at 1686-98.



If, however, an SPE holds assets, whether receivables or other types, that produce cash flow primarily because of the activities of a single person or a few persons, such as an originator and a servicer, the bankruptcy remote structure provides less practical benefit. Accordingly, if the cash flow from aberrant contract receivables depends too much on the ability of the originator to generate such cash flow and not enough on the ability and willingness of a sufficiently large pool of obligors to pay, financing such aberrant contract receivables through a securitization or structured finance transaction may not be possible or at least not cost effective.

Moreover, if a lender that makes a loan to an SPE secured by a pool of receivables owned by the SPE cannot rely primarily on the ability and willingness of the obligors on the receivables to pay, that lender would seek assurance of repayment from the originator or servicer in the form of credit recourse on the receivables or other guarantees of payment of the SPE's debt. However, to the extent that the originator or servicer provided such assurance beyond the limited assurance permitted for a bankruptcy remote structure, the transaction would cease to be bankruptcy remote. The benefits that a structured finance or securitization transaction offers by avoiding most of the bankruptcy tax on secured credit extended to the originator would be lost.

On the other hand, receivables that may be considered aberrant contract receivables but that produce reasonably predictable and reliable cash flows from obligors willing and able to make the required payments without too much reliance on the operations of the originator of those receivables may be financeable through a cost-effective structured finance or securitization transaction.

## V. CONCLUSION

The feasibility of financing any particular pool of aberrant contract receivables through a structured finance or securitization transaction depends on an extensive analysis of each type of contract, each type of obligor, the nature of the cash flows, and the extent to which those cash flows depend on a single operating entity. The other articles in this Symposium will provide insight to such feasibility.

