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Sense and Sensibility in Securitization: A Prudent Legal Structure and a Fanciful Critique

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INTRODUCTION

Since its inception in the 1970s until the end of 2007, the private securitization of mortgage loans and other consumer and business receivables had been one of the fastest growing forms of finance in the United States.[1] From a modest $12.5 billion at the end of 1984,[2] the

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[1] In the early 1970s, the Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Federal National Mortgage Association ("Fannie Mae"), government sponsored enterprises created by Congress, began issuing guaranteed securities backed by mortgage loans. *See* Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1384 (1991). This form of "public securitization" does not

amount of mortgage loans, consumer credit and trade receivables held by issuers of asset backed securities had grown to $3.740 trillion by the end of 2007,[3] an average annual growth rate of about 28%. Beginning in the latter part of 2007, the securitization of receivables declined substantially.[4] Nevertheless, despite the current financial market climate, for the reasons described below I believe that the securitization of receivables—especially mortgage loans—will remain a significant means of raising capital.[5]

Securitization had grown dramatically (and will rebound in the

require the structural features necessary for securitization by private entities described in this article and normally referred to as "securitization." The first private securitizations occurred in 1975. *See* Comm. on Bankr. & Corp. Reorg, N.Y. City Bar Ass'n, *Structured Financing Techniques*, 50 BUS. LAW. 527, 537-38 (1995).

2 *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1975-1984, at 71, tbl.L.126 ll. 5 & 10 (Sept. 18, 2008) [hereinafter FRB OUTSTANDINGS 1975-1984], *available at* http://www.federalreserve.gov/releases/z1/Current/annuals/a1975-1984.pdf. This figure excludes $8.8 billion of collateralized mortgage obligations backed by government agencies and government sponsored enterprises that were held by these issuers at the end of that year. *See id.* at l. 3. FRB OUTSTANDINGS 1975-1984 first reported assets in 1983, with $0.7 billion in trade credit receivables and $3 billion of collateralized mortgage obligations backed by government agencies and government sponsored enterprises. *See id.* at ll. 3 & 10.

3 *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 2005-2007, at 71, tbl.L.126 ll. 5, 9 & 10 (Sept. 18, 2008) [hereinafter FRB OUTSTANDINGS 2005-2007], *available at* http://www.federalreserve.gov/releases/z1/Current/annuals/a2005-2007.pdf. This figure excludes $769.2 billion of U.S. Treasury securities, collateralized mortgage obligations backed by government agencies and government sponsored enterprises, and other loans and advances. *See id.* at ll. 2-4.

4 For each of 2004, 2005, and 2006, the net balance of receivables held by issuers of asset backed securities, reflecting the acquisition of new receivables minus the sale, liquidation or prepayment of previously held receivables, had increased by $447 billion, $710 billion, and $808 billion; in the first three quarters of 2007, the net balance of receivables increased at an annual rate of $566 billion, $456 billion, and $58 billion; but in the last quarter of 2007 and the first two quarters of 2008, the net balance of receivables decreased at an annual rate of $257 billion, $292 billion, and $345 billion. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS SECOND QUARTER 2008, at 34, tbl.F.126 ll. 7, 11 & 12 (Sept. 18, 2008) *available at* http://www.federalreserve.gov/releases/z1/Current/z1.pdf. In addition, in 2007, the average monthly issuance of private mortgage backed securities was $56 billion, but in the last three months of 2007 the monthly average declined to $22.3 billion, and in 2008 the monthly average was only $5 billion. *See* SEC. INDUS. & FIN. MKTS. ASSOC., MORTGAGE- RELATED ISSUANCE, http://www.sifma.org/research/pdf/Mortgage_Related_Issuance.pdf (last visited Oct. 3, 2008).

5 There are many factors contributing to the current financial market crisis that will be analyzed for years to come. I will address some of the structural features of the controlling legal regimes that have contributed to the current market crisis in an upcoming article on the structural strengths and flaws of Fannie Mae and Freddie Mac as part of the South Carolina Law Review Symposium, "1.9 Kids and a Foreclosure: Subprime Mortgages, the Credit Crisis, and Restoring the American Dream" on October 24, 2008, and in an upcoming article, *The Mortgage Market, Securitization and The Bankruptcy Code: A Proposal For Reform*, which has been accepted for presentation at the Joint Program of the Section on Creditors' and Debtors' Rights and the Section on Real Estate Transactions, "Real Estate Transactions In Troubled Times," at the January 2009 annual meeting of the Association of American Law Schools.

future) for good reasons. Securitization lowers the costs of financing for businesses and consumers and also enables some originators to obtain financing to fund their originations that would otherwise not be available. As I discuss below and have explained elsewhere in greater detail,[6] securitization accomplishes these results because it avoids the costs that the Bankruptcy Code imposes—unwisely, in my view—on secured creditors. The consequences of these costs—a "Bankruptcy Tax"[7]—is especially apparent in the long term single family mortgage market, which has always formed a significant part of all securitized assets—more than 57% at the end of 2007.[8] It is no accident that of the $11.2 trillion dollars of single family mortgage loans outstanding as of the end of 2007, more than 93% were held either by entities that cannot be debtors under the Bankruptcy Code or by bankruptcy remote issuers of asset backed securities.[9] Because of the costs imposed on the secured creditors of entities eligible to be debtors under the Bankruptcy Code, those entities cannot feasibly engage in the long-term financing of mortgage loans.

The cost savings are significant. One study compared the cost of a $4 billion, AAA rated, automobile loan securitization sponsored by General Motors Acceptance Corporation in 1986 with the costs of GMAC's $18 billion AA+ rated corporate debt and found that the securitization produced financing cost savings of 1.3 percent per

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

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

[8] Asset back issuers held $2.163 trillion of single family mortgage loans at the end of 2007. FRB OUTSTANDINGS 2005-2007, at 71, tbl.L.126 l. 10. The other receivables consisted of $124 billion of multifamily residential mortgage loans, $656 billion of commercial loans, $682.2 billion of consumer credit receivables, and $111.4 billion of trade credit receivables. *See id.* ll. 7-10.

[9] *See* FRB OUTSTANDINGS 2005-2007, at 86, tbl.L.218 ll. 5-21. The entities listed in this report that are not subject to the Bankruptcy Code are state and local governments, the federal government, commercial banks, savings institutions, credit unions, life insurance companies, state and local government retirement funds, government sponsored enterprises, and agency- and GSE-backed mortgage pools. *See* 11 U.S.C. §§ 109(a), 101(41) (2006) (providing that only a "person" defined as a corporation, partnership or individual may be a debtor in bankruptcy); *id.* § 101(41) (excluding governmental units from the definition of "person" with exceptions not relevant here); *id.* § 109(b) (providing that a financial institution or insurance company may not be a "debtor" under the bankruptcy code); *id.* § 109(c) (providing that a municipality, but not the federal government or a State, may be a debtor under limited circumstances). Government sponsored enterprises are considered instrumentalities of the federal government for purposes of the bankruptcy code, and their liquidation or rehabilitation is the subject of a separate federal statute. *See* 12 U.S.C. § 4617 (2006), *amended by* Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 § 1145, 122 Stat. 2654, 2734 (2008). To the extent that state agencies and local governments may be a debtor under the Bankruptcy Code, they are nevertheless considered bankruptcy remote. *See* STANDARD & POOR'S, LEGAL CRITERIA FOR U.S. STRUCTURED FINANCE TRANSACTIONS 30 (5th ed. 2006), *available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/SF_USLegalCriteria_2006.pdf [hereinafter S&P 2006 LEGAL CRITERIA].

annum.[10] According to another study, the securitization of $1 trillion of mortgages in 1993 saved borrowers about $2 billion on a present value basis.[11]

As securitization has grown, so has criticism of securitization. A recent critique is Professor Kenneth Kettering's *Securitization and Its Discontents: The Dynamics of Financial Product Development*,[12] which questions the legal foundation of securitization as part of a larger analysis of the dynamics of financial innovation. This analysis introduces interesting and novel ideas that by themselves would have made his article a success. He suggests that financial products built upon an ambiguous legal foundation may, because of market acceptance, become too important in the market to be allowed to fail. This "shaky but too big to fail" dynamic therefore forecloses a judicial or regulatory determination that undermines the market's use of the financial product.[13] His application of this theory to the development of repurchase agreements is particularly compelling.[14]

Kettering applies this theory to securitization. He asserts—repeatedly[15]—securitization's shaky legal foundation. In particular, he argues that securitization is susceptible to avoidance as a type of fraud on creditors.[16] He then argues that the rating agencies have been willing to issue ratings for financial products built on a "shaky" legal foundation and have been willing to accept legal opinions central to securitizations—true sale opinions and non-consolidation opinions—that do not justify the legal certainty that the ratings imply.[17] Not opposed to securitization as a policy matter, he then proposes express legislation to validate but limit securitization.[18]

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10 *See* James A. Rosenthal & Juan M. Ocampo, *Analyzing the Economic Benefits of Securitized Credit*, 1988 J. APPLIED CORP. FIN. 32, 36-40.

11 *See, e.g.*, Steven K. Todd, *The Effects of Securitization on Consumer Mortgage Costs*, 2001 REAL EST. ECON. 29, 50 (finding that in 1993 securitization of mortgage loans saved consumers more than $2 billion in mortgage origination fees, but criticizing the methodology of other studies all finding a lowering of interest rates).

12 Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553 (2008). Carlson, *supra* note 7, is the only other article that in my view attempts a systematic critique of the legal foundations of securitization. I address Carlson's critique in another article. *See* Plank, *supra* note 6, at 1698-1722. Most critics of securitization allege that securitization harms the unsecured creditors of the originators or causes other undesirable results, such as causing or contributing to predatory lending and subprime lending that harms the borrowers. *See* Kettering, *supra*, at 1559-61 & nn.24, 27, & 28.

13 Kettering, *supra* note 12, at 1633-40.

14 *Id.* at 1640-52.

15 In his article he describes securitization with such words as "shaky," "shakiness," "dubious," "uncertain," "wobble," and "persistent disquiet" more than 30 times. *See* Kettering, *supra* note 12 *passim*.

16 *Id.* at 1585-1622.

17 *Id.* at 1671-87.

18 *Id.* at 1722-27.

Kettering's application of his "shaky but too big to fail" theory to securitization fails. He does not directly attack the analytical foundations of securitization—the true sale of assets to a separate legal entity—except by innuendo.[19] His fraud theory can most generously be described as fantastic. Because the legal foundation of securitization is strong, rating agencies cannot be credited with creating a financial product that survives only because it is "too big to fail." Whatever errors and omissions the rating agencies may have committed in rating securitizations, treating securitization as a legally solid financial product is not one of them.

I. SECURITIZATION AND AVOIDANCE OF THE BANKRUPTCY TAX ON SECURED CREDIT

Securitization entails a sale of receivables originated by an originator to a separate legal entity. In one type of securitization, described by Kettering as the prototypical securitization,[20] the separate legal entity is a bankruptcy remote, "special purpose entity" or "SPE." The SPE's activities are limited to owning the receivables, borrowing money through debt securities or a loan, granting a security interest in the receivables, using the proceeds of the debt to pay the purchase price of the receivables, using collections from the receivables to pay the secured debt and to provide a return to the owner of the SPE (which is often the originator and seller of the receivables), and performing additional activities related to owning the receivables, such as contracting for the servicing of the receivables. I will focus on his analysis of the prototypical securitization, but there is another type of securitization that predominates for mortgage loans—a securitization in which the buyer is not an SPE but is a trustee that holds title to the receivables for the benefit of certificate holders—that puts an intolerable strain on Kettering's theory, as I discuss in part VII below.

Securitization requires a sale of the receivables to separate risk. An originator of receivables that owns a pool of receivables bears two kinds of risks as an operating company: (1) the risks associated with the specific pool of receivables, such as the risk of non-payment and the risk of loss if the market value of the receivables declines, and (2) all the other risks of an operating company. A creditor that takes a security interest in a pool of receivables owned by the originator bears both of these risks. Even if the pool of receivables performs well, financial difficulties for reasons not associated with the pool of receivables could

[19] *See infra* text accompanying notes 73-79 and Part VI; *see also* Kettering, *supra* note 12, at 1561-62.

[20] *See* Kettering, *supra* note 12, at 1561-62, 1564-66.

cause an originator to become a debtor in bankruptcy. If so, the secured creditor will suffer several adverse effects, including the following:

1) the immediate acceleration of the secured debt, which becomes payable at the face or par amount, regardless of the market value of the secured debt;[21]
2) the immediate cessation of payments on the secured debt, notwithstanding its acceleration, and the automatic stay of any creditor collection action, including an action to foreclose the creditor's security interest;[22]
3) the nonaccrual of interest for undersecured[23] claims and the accrual (but not payment) of interest only to the extent that the secured creditor is oversecured;[24] and
4) the ability of the bankruptcy trustee—including the originator as debtor-in-possession—to use the cash proceeds from the receivables if it can provide adequate protection of the secured creditor's interests.[25]

These consequences impose a Bankruptcy Tax on secured creditors. To recoup these costs, secured creditors must charge a higher interest rate—what I have called a "bankruptcy premium."[26] Securitization minimizes (but does not eliminate) the Bankruptcy Tax and hence reduces the bankruptcy premium by separating the risks associated with the receivables from the risks associated with the operating company by combining two long established legal devices: (1) the sale of the receivables to a buyer (2) that is a separate legal entity. The sale removes the receivables from the potential bankruptcy estate of the originator,[27] and therefore the securitization investors do not assume the risks associated with the operating company.[28] An SPE

[21] *See* 11 U.S.C. § 502(b) (2006).

[22] *See* 11 U.S.C. § 362(a)(1), (6) (2006). The automatic stay prevents creditor actions to obtain payment, and other sections of the bankruptcy code prohibit payment of most claims until resolution of the bankruptcy case. *See id.*; *id.* § 726 (distribution under chapter 7); *id.* § 1123 (distribution under chapter 11); *id.* § 549 (avoidance of unauthorized post petition transfers).

[23] *See* United Sav. Ass'n. of Texas v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 382 (1988) (holding that an undersecured creditor is not entitled to interest payments under the guise of "adequate protection" to compensate the creditor for the delays in foreclosing caused by the automatic stay). This treatment of undersecured creditors mirrors that of unsecured creditors, which generally do not receive postpetition interest on their claims. *See* 11 U.S.C. § 502(b) (2006).

[24] *See* 11 U.S.C. § 506(b) (2006).

[25] *See* 11 U.S.C. § 363(a), (c)(2), (e) (2006). The cash proceeds of the receivables would be "cash collateral." *Id.* § 363(a).

[26] *See* Plank, *supra* note 6, at 1658, 1669-71.

[27] *See* 11 U.S.C. § 541(a)(1) (2006) (providing that the commencement of a bankruptcy case creates an estate that is "comprised of . . . all legal or equitable interests of the debtor in property as of the commencement of the case").

[28] However, there is the risk that the operating company will be unable to compensate the SPE for any breaches of representations and warranties on the receivables sold if it becomes insolvent.

(or a certificate trustee) that buys the receivables and the secured creditors that lend to an SPE (or the buyers of pass-through certificates payable from the receivables), however, assume the risks associated with the receivables. If the receivables do not perform and the secured creditors begin an enforcement action, the SPE could file a bankruptcy petition. In such a case, the creditors would become subject to the Bankruptcy Tax.

As I have explained elsewhere in greater detail,[29] from the very beginning, securitization has been founded on sound legal doctrine using the two well established legal devices of sale to a separate legal entity. In a properly structured securitization, these two legal devices have substance. The sale must be a true sale, in which the seller receives cash or other property equal to the fair market value of the receivables sold and transfers to the buyer/SPE direct control over the receivables and the burdens and benefits of ownership. The SPE buyer must be a truly separate legal entity with a separate governance structure that is sufficiently capitalized to pay its own expenses, that keeps separate books and records, that accounts for its assets, income, and expenses separately, and that complies with the requisite formalities for its type of legal entity. These requirements cost money and constrain originators.

Kettering does not attack this legal structure directly, although he does so obliquely, as I describe in part VI below. He instead develops a fanciful fraud theory.

II. KETTERING'S SHAKY ARGUMENT THAT SECURITIZATION IS A FRAUD ON CREDITORS

Kettering argues that the legal foundation of securitization is shaky or dubious because securitization's avoidance of the Bankruptcy Tax is a species of fraud on the originator's creditors. He asserts that Congress imposed the Bankruptcy Tax on secured creditors to force them to contribute to the debtor's bankruptcy estate and therefore to the unsecured creditors of the debtor. Because securitization avoids a specific Congressional bankruptcy policy, his argument goes, bankruptcy courts should disregard the legal forms on which securitization rests.[30] For example, he notes that bankruptcy courts have generally prohibited the direct waiver by a debtor of the benefits of

[29] *See* Plank, *supra* note 6, at 1659, 1671-83.

[30] Kettering, *supra* note 12, at 1567-80; *see also id.* at 1575 (stating that "[i]t is evident that securitization conflicts with the policy of the Bankruptcy Code as it currently stands"). Frequently, a statement that a proposition is "clear" or "evident" signals that the proposition is not "clear" or "evident."

bankruptcy. He then equates securitization as a form of waiver from bankruptcy that should be equally disregarded.[31]

Relying on a creative reading of older, forgotten cases, he argues that an originator's sale of receivables to an SPE to avoid the Bankruptcy Tax on secured credit hinders or delays the originator's creditors.[32] In addition, he argues that the originator's use of an SPE to avoid the Bankruptcy Tax is the type of inequitable conduct that permits a more robust application of the doctrine of substantive consolidation to consolidate the assets and liabilities of the originator and the SPE and therefore subject the transferred receivables and the SPE's secured creditors to the Bankruptcy Tax.[33]

His fraud theory suffers from two defects. First, the case law that he cites does not support his application of fraudulent transfer law to securitization. Second, he fails to demonstrate that avoiding the Bankruptcy Tax is the type of debtor misbehavior that fraudulent transfer law or substantive consolidation law is intended to police or even that it is sufficiently repugnant to the Bankruptcy Code to justify abolishing the structure judicially.

III. KETTERING'S CASES

In the cases on which Kettering relies, the Supreme Court held that certain transfers by the transferor to defeat some express bankruptcy or creditor protection policy were fraudulent because they "hindered or delayed" creditors. He gives some attention to *Benedict v. Ratner*[34] and *Dean v. Davis*,[35] but relies most heavily on *Shapiro v. Wilgus*.[36]

These cases, and *Wilgus* in particular, do not undermine securitization. In *Wilgus*, Robinson, conducting his business as an individual, became insolvent in a cash flow sense, although he believed that he was solvent in a balance sheet sense.[37] Unable to pay his debts as they were coming due but hoping to preserve his business as a going concern, he developed a reorganization plan that all but two creditors accepted. Because bankruptcy law did not then include reorganization provisions, and state law did not permit the appointment of a receiver

[31] *Id.* at 1561, 1576-80.

[32] *Id.* at 1562, 1585-1622.

[33] *Id.* at 1562, 1622-31.

[34] 268 U.S. 353 (1925); *see* Kettering, *supra* note 12, at 1593-96 (discussing *Benedict*).

[35] 242 U.S. 438 (1917); *see* Kettering, *supra* note 12, at 1596-98 (discussing *Dean*).

[36] 287 U.S. 348 (1932); *see* Kettering, *supra* note 12, at 1601-08, 1620-22 (discussing *Wilgus*).

[37] *Wilgus*, 287 U.S. at 352-53 (noting that Robinson "was unable to pay his debts as they matured, but he believed that he would be able to pay them in full if his creditors were lenient" and that he could realize a $100,000 potential surplus).

for an individual, he sought to employ a federal equity receivership to prevent the dissenting creditors from dismantling his business. Robinson created a Delaware corporation, transferred all of his assets to the corporation in exchange for stock and the assumption of all of his debts, and three days later sued the corporation in federal court for the appointment of a receiver. With the consent of his corporation as defendant, the court ordered the appointment of a receiver and enjoined all attachments and executions unless permitted by the court.

The obstreperous creditor obtained a state court judgment against Robinson and sought to enforce the judgment against the chattels in possession of the receiver on the grounds that the transfer to the corporation and the appointment of the receiver was a scheme to hinder and delay creditors. Reversing the lower courts, the Supreme Court agreed with the creditor and held that the "conveyance and the receivership are fraudulent in law as against nonassenting creditors."[38] A significant factor in the Court's analysis was Robinson's resort to a federal equity receivership proceeding founded solely on diversity jurisdiction to frustrate the public policy of the state, which did not allow the appointment of receivers for individuals conducting business.

In Kettering's view, *Wilgus*'s application of fraudulent transfer law to avoid transfers that hinder or delay creditors, what Kettering calls the "primordial rule" of fraudulent transfer law, renders securitization legally shaky: "[T]he principle of *Wilgus* alone would amply justify application of the primordial rule [i.e., avoidance of transfers that hinder or delay creditors] to avoid the bankruptcy-gaming transfer of securitized assets from the Originator to the SPE in the prototypical securitization transaction."[39]

This argument suffers from several defects. At the most general level, the indeterminacy of a rule disapproving transfers that could be seen as hindering or delaying creditors makes the rule useless. Many well accepted transfers of property could be seen as hindering or delaying creditors. Every time an operating company grants a security interest in an asset or sells an asset, that asset is no longer potentially available for the satisfaction of unsecured creditors' claims. Every time an operating company uses liquid assets, such as cash, to invest in less liquid assets or to pay employees, the use of those assets may hinder or delay creditors. Outside of bankruptcy, paying one creditor before another may hinder and delay other creditors. Yet none of these activities would be avoidable simply because they hindered or delayed creditors.

The precise issue is whether a transfer of receivables by an originator to an SPE to avoid the Bankruptcy Tax that would be directly

38 *Id.* at 353.
39 Kettering, *supra* note 12, at 1620.

imposed on the originator's secured creditors and therefore indirectly on the originator, is the type of transfer that hinders, delays, or defrauds creditors to a sufficient degree to justify abrogating the transfer. Does a transfer of receivables that enables the originator to obtain financing for its originations at lower cost but that also deprives the originator of the ability as a debtor-in-possession to use the cash proceeds of the receivables in a future bankruptcy case hinder or delay creditors? Nothing in *Wilgus* (or in *Benedict*, *Dean* or the other cases cited by Kettering) supports an affirmative answer.

In *Wilgus*, the detriment to the creditor was significant. Robinson's maneuvers would have prevented the creditor from using his existing remedies to be paid in full and would have required that he accept less than full payment. In contrast, as I discuss below, any harm to the creditors because the originator as a debtor-in-possession may be prevented from using the cash proceeds is fanciful.

Moreover, even if one could extrapolate a more general rule for avoiding transfers that hinder or delay creditors from *Wilgus*, at its very best, Kettering's reading of *Wilgus* could only apply to a securitization sponsored by an originator that was insolvent in some sense and that transferred receivables to an SPE to ensure that, as a soon as it became a debtor-in-possession, it could not use the collections from the receivables to finance its reorganization efforts. Even in this situation, however, would we want to apply Kettering's "primordial nonhindrance rule"? Securitizations by originators that are insolvent or approaching insolvency are very rare,[40] but application of Kettering's rule would prevent these originators from using securitization if they otherwise could. These originators would have to cease operations or use more costly financing options, which would worsen their business prospects. This application of *Wilgus* would counter the consistent bankruptcy policy of not discouraging creditors and other persons from doing business with entities that may be in financial difficulty and thereby unnecessarily push those entities into bankruptcy.

Further, an expansive reading of *Wilgus* would not affect the standard securitization, which almost always involves an originator in good financial condition. This conclusion becomes apparent if we were to change the facts in *Wilgus* and imagine how the Court would rule. Assume that Robinson in *Wilgus* is fully solvent in both senses in operating his business. Looking into the future, he ruminates on how to

[40] The biggest concern with a securitization by an insolvent originator is the potential inability of the originator to repurchase receivables for which there is breach of warranty by the originator on the nature of the receivables. Also, there is a risk that a bankruptcy trustee could attempt to avoid the sale of the receivables as a constructively fraudulent transfer by alleging that the sale price received by the originator was less than "reasonably equivalent value." *See* 11 U.S.C. § 548(a)(1)(B) (2006). Although the practical risk is low, whether the sale price is "reasonably equivalent value" is generally not an issue that can be covered by a legal opinion.

preserve his business if it were to encounter financial difficulties. Advised that a receiver cannot be appointed for his business operated by him as an individual, he forms a corporation, transfers all of his assets to the corporation, and continues to operate his business through the corporation. In addition, assume that the only purpose of this transfer is to prevent a single future creditor from thwarting a potential reorganization plan. Even a fanciful use of the Supreme Court's analysis in *Wilgus* does not support any argument that this transfer of assets hinders or delays creditors in a way that could or should be characterized as fraudulent.[41]

Kettering also argues that a robust application of *Sampsell v. Imperial Paper & Color Corp.*,[42] the progenitor of the current substantive consolidation doctrine, renders securitization legally unsound. There are two difficulties with this argument. First, after *Sampsell*, substantive consolidation law has taken enough of a shape to permit structuring to avoid substantive consolidation. The current structures of securitizations conform to the guidance that can be gleaned from current substantive consolidation law. Accordingly, Kettering's expansive view of *Sampsell* would require a repudiation of a large body of case law.

Second, the facts and holding in *Sampsell* do not support Kettering's argument. In *Sampsell*, an insolvent individual who owed one creditor a sum of money transferred assets to a corporation on credit. After the individual filed a bankruptcy petition and was adjudicated a bankrupt under the Bankruptcy Act of 1898, the referee found that the initial transfer of the assets to the corporation was a

[41] Kettering's reliance on *Dean v. Davis*, 242 U.S. 438 (1917), and *Benedict v. Ratner*, 268 U.S. 353 (1925), is similarly misplaced. In *Dean*, the bankrupt, Jones, was insolvent when he transferred his assets to Davis as security for a debt. Although Jones received reasonably equivalent value for the transfer, he used the value received to pay one of his unsecured creditors. The net effect of the transfer was to deprive Jones' other creditors of property from which they could be paid. *Dean*, 242 U.S. at 442-46. In *Benedict*, the "fraud" consisted of attempting to create in a transferee a property interest in accounts when the transferor maintained almost complete control and dominion over the accounts. *Benedict*, 268 U.S. at 360, 362. Today, this type of a property interest is well understood and accepted. *See, e.g.*, U.C.C. § 9-205 (2003) (providing that a "security interest is not invalid or fraudulent against creditors solely because (1) the debtor has the right or ability to (A) use, commingle, or dispose of all or part of the collateral, including returned or repossessed goods; (B) collect, compromise, enforce, or otherwise deal with collateral; . . . or (D) use, commingle, or dispose of proceeds; or (2) the secured party fails to require the debtor to account for proceeds or replace collateral"); *id.* § 8-106 (providing that a purchaser has "control" over a security or a security entitlement even if the registered owner or the entitlement holder retains the right to deal with the security or security entitlement); *id.* §§ 8-106, 9-104 (providing that a secured party has "control" over a deposit account even if the owner has the right to dispose of funds in the deposit account). The Court was applying an outmoded view of personal property law. *See Benedict*, 268 U.S. at 362 (stating without explanation that "reservation of dominion inconsistent with the effective disposition of title must render the transaction void").

[42] 313 U.S. 215 (1941); *see* Kettering, *supra* note 12, at 1622-31 (discussing *Sampsell*).

fraudulent transfer whose purpose was to remove the assets from the claims of the individual's creditors. Accordingly, the referee ordered the substantive consolidation of the assets and liabilities of the corporation with the individual. No appeal was taken to that order.

Later, an unsecured creditor of the corporation filed a claim and sought priority over other creditors. The Court held that the creditor of the corporation, who had some knowledge of the fraudulent character of the corporation, had not carried its "burden of showing by clear and convincing evidence that [the application of the rule of equality of distribution] to his case so as to deny him priority would work an injustice."[43] As in *Wilgus*, the individual in *Sampsell* transferred property while insolvent to prevent his creditors from using their state law remedies to obtain payment of their debts. Both the fact of insolvency and the nature of the harm to creditors in *Sampsell* deprive *Sampsell* of any force to justify abrogating securitization because securitization seeks to avoid the Bankruptcy Tax on secured credit.

IV. THE COSTS AND BENEFITS OF THE BANKRUPTCY TAX

Aside from the case law, Kettering argues that the avoidance of the Bankruptcy Tax justifies the abrogation of securitization.[44] This essentially policy argument suffers from several defects. First, contrary to Kettering's characterization of the Bankruptcy Tax as a deliberate Congressional policy, it is more likely an unintended consequence. Not until *Timbers*[45] in 1988 did the Supreme Court determine that an undersecured creditor was not entitled to compensation for the delay in foreclosing its security interest. Further, though correctly decided as a matter of statutory interpretation, *Timbers* embodies a policy that is economically inefficient and socially harmful. A person should not be allowed to use someone else's property without paying for that use. A debtor in bankruptcy, however, may continue to use property subject to a security interest without paying for it when the value of the collateral is less than the amount of the secured debt. Congress most likely never contemplated this result.[46] How many unsuccessful and wasteful

43 *Id.* at 217-19.

44 Kettering, *supra* note 12, at 1567-80.

45 United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., 484 U.S. 365 (1988) (holding that an undersecured creditor is not entitled to interest payments under the guise of "adequate protection" to compensate the creditor for the delays in foreclosing caused by the automatic stay).

46 The Court in *Timbers* did not cite any direct legislative history to support its conclusion. *Id.*; *see also* David Gray Carlson, *Postpetiton Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577, 601-21 (1989) (criticizing the Court's statutory analysis in *Timbers*). Professor Carlson's analysis demonstrates that Congress had no congressional intent on this point.

attempts to reorganize would have been avoided if debtors and their debtor-in-possession lenders had to compensate secured creditors for not foreclosing on their collateral?

In addition, the Bankruptcy Tax as applied to receivables simply reflects poor regulatory design, a failure to craft rules that are appropriate for the specific property interests involved. The automatic stay of creditor collection actions makes sense for a debtor that is a manufacturing company or a trucking company that is seeking to reorganize. A trucking company, for example, cannot reorganize if the secured creditor can foreclosure on the trucks. Therefore, the trucking company should be allowed to continue to operate its trucks, so long as the secured creditor receives adequate protection of its property interest.

This rationale for the automatic stay does not apply, however, to the reorganization of an originator of receivables. The continued ownership of receivables is not essential to the business of an originator of receivables. Applying the automatic stay to a secured creditor with a security interest in receivables is not necessary to implement a reorganization. In this light, securitization does not thwart a purposeful Congressional policy. It is a private law means of curing a defect in the statutory scheme. This is not a new approach. Recall the development of field warehousing at the beginning of the twentieth century to enable borrowers to create and lenders to receive valid security interests perfected by possession before the days of notice filing.[47]

Second, Kettering's argument relies substantially on an empirical question: Does the Bankruptcy Tax in fact benefit the unsecured creditors of a debtor?[48] Further, to what extent do the costs to the secured creditor (and to society as a whole through the addition of the bankruptcy premium) outweigh the putative benefits to the unsecured creditors or the bankruptcy estate? A quick look suggests that, although the Bankruptcy Tax imposes significant costs on secured creditors (and therefore on their other borrowers), it provides no or little benefit to the unsecured creditors of the originator. Hence, we turn to the point that Professor Schwarcz made and Kettering questions as a matter of policy:[49] By avoiding the Bankruptcy Tax on secured credit and obtaining financing at lower costs, securitization benefits the unsecured

[47] *See, e.g.*, GRANT GILMORE, 1 SECURITY INTERESTS IN PERSONAL PROPERTY ch. 6 (1965).

[48] Or, does it in fact benefit the management of the debtor and the bankruptcy professionals who can prolong a questionable reorganization at the expense of the unsecured creditors?

[49] Kettering, *supra* note 12, at 1576; *see* Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1573-74 (2004). Kettering states that this policy argument is not consistent "with the positive law of the Bankruptcy Code." Kettering, *supra* note 12, at 1576. But this statement is erroneous. Securitization is consistent with the positive law of bankruptcy, that is, Section 541(a)(1) of the Bankruptcy Code, which defines the property of the estate. *See supra* note 27 and accompanying text. Kettering must rely on unfounded empirical judgments and a fantastic reading of fraudulent transfer law to abrogate the structure based on positive law.

creditors of the originator and society as a whole.

Preliminarily, Kettering masks the empirical nature of this question by assuming that the avoidance of the Bankruptcy Tax on secured credit deprives unsecured creditors of *rights*.[50] This assumption is baseless. The avoidance of the Bankruptcy Tax by excluding the receivables from the bankruptcy estate of the originator under Section 541(a)(1) of the Bankruptcy Code does not deprive the unsecured creditors of rights. If a securitization were collapsed, the unsecured creditors would have no rights to the Bankruptcy Tax.

The more critical question is whether abrogating the securitization provides any benefits to the unsecured creditors. The answer is essentially "no." At most, the primary benefit that the bankruptcy estate of an originator would receive if the transferred receivables were included in the bankruptcy estate is a short-term borrowing of some of the collections on the receivables that the bankruptcy estate must repay. Collections on receivables constitute "cash collateral" under the Bankruptcy Code, and the bankruptcy trustee may use cash collateral only with court approval so long as the secured creditor's security interest in the cash collateral is adequately protected.[51]

A simple example will illuminate any benefit or cost from the use of collections. Assume that an originator sells to an SPE $100 million of receivables bearing interest at 6% per annum and amortizing over a five year period. The SPE issues to investors $90 million of debt bearing interest at 4.5% secured by a security interest in the receivables. The servicing fee is 0.50%. The SPE, which is owned by the originator, has an initial equity cushion of $10 million. The SPE will distribute to the originator the net cash flow after payment of the servicing fee and the debt service on the secured debt, which the originator will use (along with other fees that it can charge in originating receivables) to pay its operating expenses and pay a return to the investors in the originator.[52] Now assume that the day after this securitization, the originator becomes a debtor-in-bankruptcy, the receivables are included in the bankruptcy estate of the originator, and the SPE's creditors remain secured creditors of the originator with a security interest in the receivables.

If, as assumed above, the balance of the receivables exceeds the secured claim, the equity cushion could provide adequate protection for the use of the collections on the receivables as cash collateral. In this

50 *See, e.g.*, Kettering, *supra* note 12, at 1682 (stating that "because the [securitization] structure has no purpose or significant effect other than to avoid the Bankruptcy Tax, it is avoidable under fraudulent transfer law as an impermissible attempt to 'hinder' the rights of the Originator's unsecured creditors").

51 *See* 11 U.S.C. § 363(a), (c)(2), (e) (2006).

52 The originator needs an equity investment to fund the difference between the balance of the receivables and the $90 million secured debt.

case, the bankruptcy trustee could use collections in one of two ways. It could simply take the principal and interest payments on the receivables (net of the servicing fee) and pay operating expenses. It could do so, however, only to the extent that the remaining balance of the receivables exceeds the secured claim. Because the secured claim will accrue interest, the principal balance of the receivables will decline, and the equity cushion will be charged with the collections so used, the trustee's use of collections to pay operating expenses would quickly consume the equity cushion—in a matter of months.[53] Once the equity cushion is gone, the trustee may no longer use the collections. Also, once the equity cushion disappears, the secured creditors will no longer accrue interest. In this case the use of the cash collateral would give the trustee a short term loan for operating expenses that must be repaid later, ahead of unsecured creditors, while depriving the secured creditors of the interest that would accrue after the exhaustion of the equity cushion.[54] The bankruptcy estate gains little but the secured creditors lose a great deal more.

Alternatively, the trustee could use the collections to originate more receivables, and the new receivables could serve as the adequate protection. The trustee could sell these receivables and originate more receivables. In either event, however, the bankruptcy estate gets essentially no more benefit than it would have gotten from the residual interest in the original securitization.[55] Further, the volume of originations could not exceed the monthly collections, and the spread between the interest payable on the secured debt and the interest

53 Under this scenario, the bankruptcy estate will retain collections net of the servicing fee of approximately $1,900,000 a month, which would include not only interest on the receivables but monthly payments of principal. The trustee may use this sum by allocating the available equity as adequate protection. Hence, the equity cushion would be reduced by this amount from $10 million to $8,108,390. However, interest on the secured debt in the first month would be $337,500 and the principal balance of the pool would have declined by $1,432,800. This causes the equity cushion to decline by another $1,770,300. Hence, in the first month, the equity cushion will decline to $6,338,090, the secured claim will be $92,229,110 (accrued interest plus the collections used), and the security for the secured debt will be $98,566,720. At the end of two more months, the trustee will have been able to use about $5,676,630 of collections, but the use of this amount of the equity cushion to provide adequate protection, the interest accrual on the secured debt, and the decline in the principal balance of the pool of receivables will cause the equity cushion to disappear.

54 As a result, one year after the filing, the secured creditors will have lost about $3.2 million in interest, and after two years, they will have lost $7.5 million in interest.

55 This use of collateral does provide one relatively small benefit. Under the securitization, the principal balance of the secured debt would decline as the balance of the receivables declined. Because the interest is calculated on the then outstanding balance, the spread between the interest collected on the receivables and the interest paid on the debt in absolute terms would also decline. If the secured debt is subject to the automatic stay and the principal payments on the receivables are used to originate more receivables, the principal balance of both the secured debt and the receivables would remain the same or, taking into account the accrual of interest, would grow at the same rate, and the amount of interest spread would remain the same or increase slightly.

collected on the receivables would need to be sufficient to pay the expenses of the originator in originating receivables. In any event, whatever combination of courses of action that the trustee could have taken in using the collections from the securitized receivables, its use does not appear to have a great effect on the unsecured creditors, and a concomitant inability of the bankruptcy trustee to use cash collateral as the result of a securitization would seem to have a very small effect, if any, on the unsecured creditors.[56] Kettering seems to recognize this fact toward the end of his article.[57]

V. KETTERING'S "SHAKY BUT TOO BIG TO FAIL" THEORY AND SECURITIZATION

Kettering's article presents an intriguing and interesting idea: that judges and regulators will uphold financial products built on "shaky" legal foundations when the economic consequences of ruling against the financial product become so significant that the financial product becomes "too big to fail."[58] He presents a cogent analysis of why repurchase agreements and standby letters of credit fall under this category.[59] However, his big idea—that securitization is a shaky financial product that is too big to fail—fails.

First, in the case of repurchase agreements, it has long been understood (and is immediately obvious to any knowledgeable commercial finance lawyer) that the legal basis for treating a repurchase agreement as a sale is shaky. Under the terms of a repurchase agreement, the seller "sells" an asset with a promise to repurchase the asset at a fixed future date for a fixed future price. The justification for treating a repurchase agreement as a sale is the use of the term "sale" in the agreement and the transfer of control over the asset to the buyer. As Kettering correctly notes, however, a repurchase agreement is economically and contractually a secured lending transaction in which the "sold" asset secures repayment of a fixed repurchase price. Although the buyer has legal title to and actual control over the asset (and may even resell the asset), the seller retains by contract (but not as a property interest) the economic benefits and burdens of ownership.

[56] Kettering does not address another significant part of the Bankruptcy Tax—the risk of acceleration. The uncertainty of acceleration is a cost for secured creditors. For the bankruptcy estate of an originator, acceleration may provide a benefit only if the market value of the secured debt is greater than the par amount of the debt and any prepayment premium; if the market value of the secured debt is less than the par amount of the debt and any prepayment premium, acceleration is a cost to the bankruptcy estate. *See infra* note 104 and accompanying text.

[57] Kettering, *supra* note 12, at 1718-19.

[58] *Id.* at 1633-40.

[59] *Id.* at 1640-52, 1661-71.

Kettering posits that courts uphold the characterization of a repurchase agreement as a sale not because of a legal analysis of the transaction but because the economic consequences preclude an adverse ruling. That is, repurchase agreements as wobbly sales became too big to fail.

In the case of repurchase agreements, this analysis is plausible. It is not the only explanation, however. Although courts have for a long time recharacterized transactions called sales that operate substantially as secured transactions, courts may legitimately allow sophisticated parties in the finance world to determine the legal consequences of their transactions by the use of words in the agreement and the form of the transaction, whatever its substance.[60] Indeed, courts sometimes do require parties to abide by the words in their documents even when those words are not consistent with the substance of the transaction.[61]

Kettering's "shaky but too big to fail" analysis does not apply to securitizations, however. Kettering argues that securitizations are shaky transactions that became "too big to fail" because the rating agencies were willing to give high ratings to securitizations despite their allegedly shaky legal foundations.[62] In addition to his fraud theory, he relies on a faulty characterization of the true sale and non-consolidation opinions that accompany securitization as "reasoned" opinions of supposedly great length that allegedly "communicate substantial uncertainty about the outcome."[63] He charges the rating agencies with failing to discount their ratings of securitizations by the asserted legal uncertainty expressed in the opinions.

As a preliminary matter, his reliance on the alleged mushiness of true sale and non-consolidation opinions is logically irrelevant. Kettering's "shaky but too big to fail" thesis applies only to a legal structure that is, well, shaky. Regardless of the nature of the legal opinions accepted by the rating agencies, if the legal foundations of securitization are sound, then the rating agencies did not rate a shaky financial product that became too big to fail; they merely rated a big and useful financial product. As noted above, securitization rests on the combination of two well known legal doctrines, the true sale of assets to a truly separate legal entity. Although there has been significant academic skepticism of the legal basis for treating a repurchase

60 *See, e.g.*, Cohen v. Army Moral Support Fund (*In re* Bevill, Bresler & Schulman Asset Mgmt. Corp.), 67 B.R. 557, 597-598 (D.N.J. 1986) (upholding the characterization of a repurchase agreements as a "sale" of securities by the parties even though the repurchase agreement contained many secured loan characteristics).

61 *See*, *e.g.*, *In re* Treasure Island Land Trust, 2 B.R. 332 (Bankr. M.D. Fla. 1980) (upholding the express language in a trust agreement that the trust, which had filed a bankruptcy petition, was not a business trust and therefore was not eligible to be a debtor under the Bankruptcy Code notwithstanding a significant factual basis for characterizing the trust as a business trust).

62 *See* Kettering, *supra* note 12, at 1681-87; *see also id.* at 1687-1701.

63 *See id.* at 1683.

agreement as a "sale,"[64] even the most serious attempts to question the legal foundations of securitization do not challenge the two solid legal tools underlying securitization.[65] These fanciful attempts do not compare to the well founded concerns about the legal treatment of a repurchase agreement as a sale. Indeed, in my experience, the lawyers who draft the allegedly uncertain true sale opinions for securitizations will not issue opinions that a repurchase agreement is a sale.[66]

In addition, I disagree with Kettering's assertion that the "reasoned" nature of true sale and non-consolidation opinions communicates uncertainty about the legal foundations of securitization.[67] In some contexts, reasoned opinions provide an analysis of applicable law to support an attorney's best judgment on an uncertain issue of law.[68] True sale opinions and non-consolidation opinions, however, do not fall in this category. True sale and non-consolidation opinions address the basic legal foundations of securitizations, and the opinion language is quite conclusive. The opinions generally state that, under the facts set forth in the opinion and in a properly presented and argued proceeding, a bankruptcy court "would" hold that the transferred receivables would not be included in the bankruptcy estate of the seller or "would" hold that the transfer of the receivables was a sale and not a pledge to secure a debt [or both][69] and "would" hold that the assets and liabilities of the SPE would not be substantively consolidated with its parent.[70]

64 *Id.* at 1644-45 & n.299.

65 As I have explained elsewhere, Carlson's admittedly "rarified" argument in *The Rotten Foundations of Securitization* relies on an unwarranted extension of the Supreme Court's poor analysis in *United States v. Whiting Pools* and some minor quirks in the law. *See* Plank, *supra* note 6, at 1659, 1698-1722. Kettering strains to characterize a true sale of receivables to a separate SPE to avoid the Bankruptcy Tax on direct secured lending as a species of fraud or inequitable conduct.

66 *See* Fin. Accounting Standards Bd., *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions*, FASB Staff Position No. FAS 140-3, at ¶4A (Feb. 20, 2008) (noting that when a transferor sells assets to a transferee and the transferee finances the purchase through a repurchase agreement with the seller—a common occurrence—the structure generally precludes the issuance of a true sale opinion for the seller).

67 Kettering, *supra* note 12, at 1679-87.

68 *See, e.g.*, Comm. on Legal Opinions, Am. Bar Ass'n, *Guidelines for the Preparation of Closing Opinions*, 57 BUS. LAW. 875, 879 (2002) (stating that lawyers giving closing opinions "may include their legal analysis in an opinion when they believe it involves a difficult or uncertain question of professional judgment and have decided that the conclusions expressed should not be stated without setting forth the underlying reasoning," and that such opinions are commonly referred to as "explained" or "reasoned" opinions).

69 *See, e.g.*, S&P 2006 LEGAL CRITERIA, *supra* note 9, at 15; Emergency Motion for (1) Order Granting Interim Authority to Use Cash Collateral and (2) Scheduling and Establishing Deadlines Relating to a Final Hearing, at 486, 494, *In re* LTV Steel Co., No. 00-43866 (Bankr. N.D. Ohio) (doc. no. 28, filed Dec. 29, 2000) [hereinafter Davis Polk Opinion] (Opinion Letter of Davis Polk & Wardwell dated October 12, 1994), *available at* http://ltv.williamslea.net/pdf/docket/28.pdf.

70 *See, e.g.*, S&P 2006 LEGAL CRITERIA, *supra* note 9, at 17; Jennifer P. Story et al., *Use of SPEs in CMBS*, Com. Mortgage Special Rep. (Fitch Ratings, Inc.), at 3 (Apr. 26, 2001), *reprinted*

These conclusions are no less certain than the typical enforceability opinion, which Kettering praises as a "comparatively crisp opinion."[71] The typical enforceability or remedies opinion contains significant qualifications that could also be interpreted as conveying "uncertainty" about outcome. These include qualifications that the opinion is subject to (i) the effect of bankruptcy, insolvency, reorganization, receivership, moratorium and other similar laws affecting the rights and remedies of creditors generally; and (ii) the effect of general principles of equity. The latter qualification includes the availability of specific performance, injunctive relief or other equitable remedies, which are subject to the discretion of a court; the availability of equitable defenses, such as waiver, laches and estoppel, and defenses based upon unconscionability; and requirements of good faith, fair dealing, and reasonableness in, and the impracticability or impossibility of, the performance and enforcement of a contract.[72]

There are several good reasons for providing reasoned true sale and non-consolidation opinions. These opinions generally follow a similar structure. They contain a description of the transaction; the assumptions about the significant facts relevant to the opinion; a discussion—which may be short or lengthy—summarizing or analyzing the relevant case law; an opinion paragraph; and qualifications. Although some firms, including some leading firms, draft very long opinions—20 to 50 pages for each—many other leading firms use shorter forms, ranging from two and a half to ten pages each. Sometimes the two opinions are combined. The true sale opinions and non-consolidation opinions that I have drafted generally run about seven and half pages to nine pages each.[73] Longer opinions devote more ink to a discussion of the existing case law, sometimes elaborating on the application of the cases to the facts of the particular transaction.

These true sale and non-consolidation opinions address a narrow and specialized area of law, for which there is no generally applicable statutory safe harbor.[74] The legal principles on which the opinions rest

in ALI-ABA Course of Study: Commercial Securitization for Real Estate Lawyers, SL095 ALI-ABA, at 447 (Apr. 27-28, 2006); Davis Polk Opinion, *supra* note 69, at 11.

[71] Kettering, *supra* note 12, at 1683.

[72] *See, e.g.*, Comm. on Legal Opinions, Am. Bar Ass'n, *Third-party Legal Opinion Report, Including the Legal Opinion Accord, of the Section of Business Law, American Bar Association*, 47 BUS. LAW. 167, 202-06 (1991).

[73] From 1987 to 1994, I served as both issuer's counsel for securitizations and as bankruptcy counsel in connection with my and others' securitizations as a partner in Kutak Rock LLC. From 1994-2001, I served as bankruptcy counsel for securitizations as a consultant for Kutak Rock and since June 2001 as Of Counsel to McKee Nelson LLP. I have drafted and reviewed many hundreds of true sale and non-consolidation opinions for just about every type of receivable.

[74] Even where there is a clear statute, a reasoned or explained opinion is useful. For example, the form of opinions that a particular transaction qualifies as a "repurchase agreement" or a "securities contract," which may be accelerated upon the bankruptcy of one of the counterparties and which are not subject to the automatic stay, will summarize the applicable statutory

are derived from the many cases that have either upheld sales of receivables, that recharacterized them as disguised secured transactions or that have ordered or eschewed the substantive consolidation of affiliated entities. In these cases, the courts apply a variety of legal considerations to a variety of specific factual situations. From these cases, the bankruptcy structuring lawyer distills the basic factual and legal elements that the securitization transaction must contain to ensure that a court would reach the correct conclusion for that transaction. For this reason, the reasoned opinion presents a detailed description of those factual elements of the transaction that are relevant for true sale or non-consolidation analysis and summarizes, in various degrees of detail, the case law that applies to these facts. The preparation and issuance of these opinions ensures that the securitization has been structured properly. They also inform the opinion recipient of the details of the legal elements that lead to the conclusion and provide solid evidence that the transaction has been structured properly.[75] They are most definitely not, in the words of one anonymous practitioner described by Kettering as summarizing the content of true sale opinions, "meaningless" opinions that "[say] nothing."[76]

Further, the opinions are legal judgments. They are not—and cannot be—a guarantee of what any bankruptcy court will in fact do in the future. The explanation and the qualifications exist to account for—and to warn the recipient of—the rare but real time when a judge goes off the track of existing case law.[77] Courts sometimes are oblivious to even well-settled case law or simply make an egregious error in legal reasoning and issue opinions that can only be described as nutty. *Octagon Gas Systems, Inc. v. Rimmer* (In re *Meridian Reserve, Inc.*)[78]

provisions instead of simply stating the factual assumptions and giving a conclusion. As a drafter of these opinions, I believe that the explanation is helpful for the opinion recipient and for the transactional lawyers that structure these transactions.

75 Reasoned opinions also support efficient law firm practice by concentrating in one or two documents a check list of the elements necessary for these transactions.

76 *Kettering*, *supra* note 12, at 1685 & n.434 (quoting Jonathan C. Lipson, *Price, Path & Pride: Third-Party Closing Opinion Practice Among U.S. Lawyers (A Preliminary Investigation)*, 3 BERKELEY BUS. L.J. 59, 94 (2005) (quoting an attorney interviewed on June 10, 2005, publicly identified as "Attorney K-1")).

77 *See, e.g.*, Steven G. Horowitz, Opinion Letter Regarding Authority to File Bankruptcy for LLC (Feb. 28, 2007), *reprinted in* ALI-ABA Course of Study Materials: Commercial Securitization For Real Estate Lawyers, SM100 ALI-ABA at 441, 451 (May 2007) ("The opinion expressed herein is not a guaranty as to what any particular federal bankruptcy court would actually hold, but a reasoned opinion as to the decision a federal bankruptcy court would reach if the issues are properly presented to it and the federal bankruptcy court followed existing precedent as to legal and equitable principles applicable in bankruptcy cases.").

78 995 F.2d 948 (10th Cir. 1993) (absurdly holding that a debtor that had sold an account still retained an interest in the account because Article 9 defined a sale of an account as a secured transaction); s*ee* Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 EMORY L.J. 1193, 1281, 1285 (1998) (criticizing *Octagon Gas*); Thomas E. Plank, *Sacred Cows and Workhorses: The Sale of Accounts and Chattel Paper Under the U.C.C. and the Effects of*

fits this category. The reported decision in the *LTV Steel Co.* case,[79] reaffirming a consensual interim cash collateral order, was not a nutty decision, although a final decision collapsing the trade receivables would have been.

Kettering's discussion fails to mention the very conservative nature of both securitization structures and the opinions that are delivered. One example of this conservatism (notwithstanding the use of a reasoned opinion) is the different treatment of credit recourse and warranty liability. Credit recourse is liability of the seller to the buyer if the obligor on the receivable were to default. Warranty liability is the seller's obligation to repurchase receivables or indemnify the buyer if the seller breached a warranty about the nature of receivables that it sold. Numerous cases have upheld the true sale of receivables notwithstanding 100% credit recourse to the seller. I wrote a law review article in the early 1990s arguing that there can be a true sale of receivables even with 100% credit recourse.[80] Nevertheless, law firms representing originators will not issue a reasoned true sale opinion for a securitization with 100% credit recourse, and neither the firms representing the underwriters of the rated securities nor the rating agencies will accept that securitization structure (with or without a reasoned true sale opinion).

If there were widespread securitizations with 100% credit recourse, like the repurchase agreements that Kettering analyzes, in which there is significant ambiguity about the ultimate legal structure because the case law and legal argument support both sides of the issue, these types of securitizations would be good candidates for Kettering's "shaky but too big to fail" argument. In that case, such securitizations could be rated under Kettering's theory only if the rating agencies determined that courts would find that such a structure were too important in the marketplace to be recharacterized as direct secured lending. But, unlike the widespread use of legally ambiguous repurchase agreements, these legally ambiguous securitizations do not exist.[81]

Violating a Fundamental Drafting Principle, 26 CONN. L. REV. 397, 453-61 (1994) (more extensive criticism); Thomas E. Plank, *When a Sale of Accounts Is Not a Sale: A Critique of* Octagon Gas, 48 CONSUMER FIN. L.Q. REP. 45-53 (1994) (same).

79 *In re* LTV Steel Co., 274 B.R. 278 (Bankr. N.D. Ohio 2001).

80 *See* Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON L. REV. 287 (1991).

81 A seller may retain a limited amount of direct credit recourse, generally not to exceed expected loss on the receivables. *See, e.g.*, S&P 2006 LEGAL CRITERIA, *supra* note 9, at 159; Thomas E. Plank, *The Key to Securitization: Isolating the Assets to Be Securitized from the Risk of An Insolvency Proceeding*, § 7.03[B][2][a], in OFFERINGS OF ASSET BACKED SECURITIES (John Arnholz & Edward E. Gainor eds., 2005 & Supp. 2007) (describing the rationale for limited direct credit recourse and the allowance, in the case of whole loan sales of mortgage loans, of credit recourse of up to 10%) [hereinafter *Key to Securitization*]. Sellers may also retain a residual interest in the SPE that bears the credit losses (and that also benefits from better than expected performance).

In contrast, there is unanimous agreement that warranty liability is consistent with a true sale. Yet, in 2002, the federal district court in *Lifewise Master Funding v. Telebank* held that in a securitization, a sale of receivables with warranty recourse but with no credit recourse was a sale "with recourse."[82] This decision was contrary to well established case law holding that the phrases "with recourse" or "without recourse" referred only to credit recourse and that warranty liability—which arises even by implication in the sale of receivables if not expressly created—is not "recourse." This decision falls in the category of "nutty." If you doubt this point, I invite you to read the appellate briefs in the case. One cites case law, treatises, restatements of the law, state statutes, and federal regulations on the meaning of these words.[83] The other—well, you decide.[84] Fortunately, this erroneous ruling was reversed on appeal.[85]

Lifewise involved a question of whether there had been a breach by a lender of a funding agreement with an SPE. Nevertheless, the reasoning of the trial court in *Lifewise* could have caused a recharacterization of the sale of the receivables as a disguised pledge. Such a recharacterization would occur notwithstanding a true sale opinion on what a court "would" hold. That courts sometime make significant errors fully justifies the use of reasoned true sale and non-consolidation opinions both as a matter of professional integrity and a means of limiting potential professional liability for an erroneous ruling.

Given the conservative nature of securitization structures, the actual legal risk in a properly structured securitization is extremely low, regardless of the extent of the legal discussion, qualifications, or disclaimers in a true sale or non-consolidation opinion. Fortunately, nutty decisions are rare. Rating agencies are fully justified in relying on these opinions, and there is no need for a discount on their ratings to reflect the risk of legal failure.

The fate of securitizations in originators' bankruptcies confirms the soundness of the legal structure. In almost all of the bankruptcies of originators from the early 1990s to this day, bankruptcy trustees have not challenged the securitizations.[86] Indeed, in some cases, the only

[82] *See* Lifewise Master Funding v. Telebank, 374 F.3d 917, 921-22, 925 (10th Cir. 2004).

[83] Appellant's Opening Brief at 35-44, *Lifewise*, 374 F.3d 917 (No. 03-4086), 2003 WL 23945675. I briefed and argued this issue.

[84] Brief for Appellee E'Trade Bank at 43-53, *Lifewise*, 374 F.3d. 917 (No. 03-4086), 2003 WL 23945674 (the strongest argument being the "plain meaning" of the word "recourse").

[85] *See Lifewise*, 374 F.3d at 925-26.

[86] *See, e.g.*, Alexander C. Dill & Lettitia Accarrino, *Moody's Investors Service Special Report, Bullet Proof Structures Revisited: Bankruptcies and a Market Hangover Test Securitizations' Mettle*, *reprinted in Trends in Securitization: Research and Rating Agency Perspectives*, 843 PRAC. L. INST. COMMERCIAL L. & PRAC. COURSE 437, 449-56, 458-65 (Dec. 5-6 2002); *Key to Securitization*, *supra* note 81, § 7.07[B] (describing the bankruptcy cases of Conseco Finance Corporation in 2002, ContiFinancial Corporation in 2000, and HomeGold

valuable assets that an originator might have are the residual interests in its SPEs. Because of the cost savings of securitization, the residual interests in an SPE are more valuable than a direct ownership interest in the receivables encumbered by a direct security interest.

One might counter that the costs of litigating the securitization structure—or maybe a presumed conflict of interest[87]—are the only reason for the lack of a challenge to the structure. But, originators have not shied away from engaging in costly litigation when they thought there was a good economic reason for doing so. Two cases come to mind: *In Re WE Financial, Inc.*[88] in 1991, and *In re LTV Steel Co.*[89] in 2000.

Kettering attributes the ultimate vindication of the inventory and trade receivables securitization in *LTV Steel* as the product of the "shaky but too big to fail" phenomenon.[90] Amici briefs educated the bankruptcy judge on the consequences of *LTV Steel*'s attempt to undo a properly structured securitization. These facts are legally irrelevant. But in a litigation context, they are no more irrelevant than the debtor's cry that a failure to undo the two securitizations would cost the jobs of 17,000 workers.[91] As I have explained elsewhere,[92] the real reason for the ultimate vindication of the securitization of the trade receivables in *LTV Steel* was the fact that the *LTV Steel* sellers had truly sold their

Financial, Inc. in 2003).

[87] Kettering also posits as a substantial impediment to litigation systemic conflicts of interest among elite law firms that represent the debtors in possession in "large Chapter 11 cases (which are the only bankruptcy cases that are likely to involve debtor that have done securitization transactions)" and also counsel to originators and underwriters in securitizations. Kettering, *supra* note 12, at 1672-73. Here, Kettering reveals a lack of familiarity with securitization. Although I have not done an empirical study of the issue, my own experience belies this statement. Many securitizations have been done for large and small companies by law firms that would not be the counsel in the future bankruptcy of the originator.

[88] No. 92-01861-TUC-LO (Bankr. D. Ariz. 1992)**;** *see Key to Securitization, supra* note 81, § 7.06[B] (discussing the case). In this case the owners of a solvent SPE caused the SPE to file a bankruptcy petition to accelerate high yielding securities that had a market value above their outstanding principal balance, sell the high value collateral securing the securities, pay the secured debt at par, and pocket an $11 million difference. After significant litigation, the owners settled the case by reinstating the securities. *Id.*; *see also* Plank, *supra* note 6, at 1728-29; Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487, 553-54 (1996) (describing the case).

[89] *In re* LTV Steel Co., No. 00-43866 (Bankr. N.D. Ohio Dec. 29, 2000); *see also In re LTV Steel Co.*, 274 B.R. 278 (Bankr. N.D. Ohio 2001). As I have explained elsewhere, the debtor in *LTV Steel* engaged in a costly and unsuccessful litigation challenging the trade receivables securitization because it could not find a debtor-in-possession financier and needed the cash proceeds from the receivables and the inventory to fund its reorganization attempt. *See* Plank, *supra* note 6, at 1687-88.

[90] Kettering, *supra* note 12, at 1635 & n.270.

[91] As an expert witness for the receivables investor, I of course prefer to view the vindication of the trade receivables securitization as the direct result of my expert report presenting a detailed analysis of how LTV's trade receivables securitization complied with the standards in the industry for a true sale of the receivables. But I do so facetiously.

[92] *See* Plank, *supra* note 6, at 1686-98.

receivables to a separate, non-consolidatable SPE, and there was no basis for concluding otherwise.[93]

VI. KETTERING'S INDIRECT ATTACK ON SECURITIZATION

Although Kettering does not directly attack the true sale of receivables to a separate legal entity as the legal foundations of securitization, he implies that there are other reasons for questioning that legal foundation.[94] First, initially describing *LTV Steel* as the only case in which a challenge to the doctrinal foundations of securitization resulted in a contested adjudication, he inaccurately asserts that the court ruled against the product.[95] Later, his claims about the *LTV Steel* case are more circumspect and more accurate.[96] In fact, the initial challenge to the trade receivables securitization would not have been possible without the presence of the inventory securitization.[97] Further, the challenge to the trade receivables securitization resulted in an order finding that there had been a true sale of the receivables to the receivables' SPE.[98]

Second, he states that a securitization is "economically identical to a nonrecourse loan by the Originator secured by the same assets that are used to support the financing under the securitization structure."[99] This

[93] In the case of the inventory "securitization," there were some problematic elements in the transaction. Nevertheless, there was also a substantial basis for vindicating the legal structure of the inventory securitization.

[94] He states in several places that securitization relies on "mere formal devices" or "formal devices," without any discussion of and with apparent disregard for the substance behind the forms. *See* Kettering, *supra* note 12, at 1585, 1662. He also offers as evidence of securitization's legal shakiness the efforts of securitization participants to pass legislation favorable to securitization. *Id.* at 1558. These efforts do not necessarily reflect a lack of confidence in the legal foundation of securitization, despite whatever statements lobbyists may have uttered to achieve passage of the legislation. The most significant reason for these efforts is to reduce the costs of structuring securitizations and the limitations that those requirements place on both originators and investors. Also, the state securitization statutes enable financial institutions to accomplish a sale for accounting treatment when they do not receive a true sale opinion. *See Key to Securitization*, *supra* note 81, §§ 7.03[C][2], [3] & 7.06[B].

[95] Kettering, *supra* note 12, at 1558. He also incorrectly states that the court's interim order was "based on the premise that the purported transfer from Originator to SPE did not remove the securitized assets from the Originator's estate." *Id.* at 1582. The interim order was based on the debtor's allegations and was negotiated with the agent for the inventory and receivables investor, which did not object to the entry of the order, and it specifically recognized that there was a dispute about the nature of the transfer. *In re* LTV Steel Co., 274 B.R. 278, 281 (Bankr. N.D. Ohio 2001).

[96] Kettering, *supra* note 12, at 1672, 1717-18 (noting that the court's ruling in the *LTV Steel* case was a "mere" denial of a motion to modify an interim order).

[97] *See* Plank, *supra* note 6, at 1692-96.

[98] *See id.* at 1690 & nn.145-46.

[99] Kettering, *supra* note 12, at 1561, 1570-71. Kettering dismisses the risk of non-payment to the SPE's creditors on the grounds that they are insulated from such risk by the high ratings.

statement, even if it were true, is irrelevant. Whatever theoretical economic similarity there is between a securitization and direct non-recourse secured lending,[100] Kettering posits a similarity between a real transaction in the market—securitization—and an imaginary structure—direct non-recourse secured lending—that does not exist to any substantial degree for receivables.[101] If a lender lends directly to the originator, there is generally no reason for the lender to do so on a non-recourse basis. Indeed, in my experience, when lenders choose to make a direct secured loan instead of investing through a securitization, they do so because they would rather have recourse to the originator than rely solely on the receivables.

Finally, even if direct non-recourse secured lending existed, any economic equivalence is irrelevant. Many types of transactions have similar economic effects but different legal consequences. The sole proprietor that incorporates and runs his or her business in the exact same way, except for the need to respect the corporate formalities, is but one example. Another is the large real estate developer that owns and operates real estate projects through separate legal entities instead of one legal entity.

VII. THE LIMITED SCOPE OF KETTERING'S CRITIQUE

Many securitizations follow the prototypical securitization structure that Kettering describes, but many do not, especially in mortgage securitization where a different type of securitization structure predominates. In this form of securitization, the originator sells receivables to a trustee that holds legal title to the receivables in trust for the benefit of the investors that hold pass-through certificates representing a beneficial interest in the receivables.[102] The certificate

Aside from the fact that some highly rated securities have failed to pay, securitizations typically involve the issuance to investors of lower rated securities that bear higher interest rates and higher risks. The risk of default on these "mezzanine" securities is much greater.

[100] Although substantially similar, there are important differences. In a securitization, the creditors of the SPE may not even participate in the originator's bankruptcy case. In a non-recourse direct secured lending, the primary secured creditors may not have a claim against the originator for any deficiency, but they would participate in and have a voice in the originator's bankruptcy case. Further, in an origination, the originator has no direct control over the receivables, while in a direct secured lending, the originator retains a great deal of control. For example, the originator may sell the receivables subject to the lien for any price that it deems appropriate. The originator may control the SPE that owns the receivables, but that indirect control does not put the originator in a comparable position, because the SPE must deal with the receivables is a way that is in the best interests of the SPE and not of the originator.

[101] This is an empirical question, of course, and I have not done a study. In my experience, however, non-recourse secured lending exists only for commercial loans secured by mortgages on real estate.

[102] *See* Plank, *supra* note 6, at 1662, 1664.

holders receive the cash flow from the receivables as specified in a pooling or servicing agreement or trust agreement.

Because these pass-through certificates are typically divided into different tranches with different priorities of payment, the more senior certificates could be viewed as debt from a bankruptcy perspective and the most junior certificates in right of payment could be seen as the equity in the assets. If the originator were to retain these residual interests, they often must be transferred to an SPE owned by the originator to ensure a true sale of the receivables. This transaction resembles Kettering's prototypical securitization. Many securitizations, however, do not follow that form because the residual interests are sold to third parties.

If an originator sells receivables to a trustee in a true sale, and third parties acquire all of the beneficial interests in receivables, neither the transfer of the receivables to the trustee nor the transfer of the certificates to third parties who never owned the receivables could be challenged as a fraud on the originator's creditors under Kettering's theory. Hence, even if a court were to adopt Kettering's fraud analysis, it would only apply to securitizations in which the originator retains ownership of an SPE and would not apply to securitizations in which investors are willing to acquire the residual interests. This limitation may reduce the volume of securitizations, but would not eliminate them.

Further, even for securitizations that use an SPE, the sale of the ownership interests in the SPE to a third party would also obviate Kettering's fraud theory. Hence, the effect of Kettering's fraud theory would be not to stop securitization but to prevent an originator from retaining the residual interest in its receivables through ownership of an SPE. Is there any reason for this result? In my view, this possible result simply demonstrates the fantasy of Kettering's theory.

CONCLUSION

Kettering's idea that a legally ambiguous financial product could become too big to fail is a novel and interesting idea. When he applies his theory to securitization, however, he abandons prudence and engages in romantic fantasy. Nevertheless, unlike many critics, Kettering is not hostile to securitization as a policy matter, and he proposes amending the Bankruptcy Code to eliminate the Bankruptcy Tax on loans secured by receivables. I do not think such legislation necessary to make securitization secure, but if it were properly crafted, it could reduce costs for businesses that originate receivables and the consumers and businesses that are the obligors of receivables. Congress took a partial step in that direction in 2005 when it expanded the exemption from the automatic stay and the abrogation of ipso facto clauses for repurchase agreements and securities contracts for mortgage loans.[103] Expanding these exemptions would be a good thing. These provisions do not go far enough, however, because they do not solve the problem of the acceleration of debt upon a bankruptcy filing. The immediate acceleration of the debt of a debtor in bankruptcy is a significant part of the Bankruptcy Tax on long term secured debt secured by, and payable only from, long term receivables.[104] This is a particularly acute problem for longer term receivables such as mortgage loans and student loans. Any properly structured reform of the Bankruptcy Code must solve the problem of the acceleration of long term debt.[105]

Editor's Note: Professor Kettering's reply to this article will appear in a forthcoming issue of the journal.

103 *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 §§ 907(d)(1), (g)(2), (i), 119 Stat. 23, 176, 178 (2005), *as further amended by* Pub. L. No. 109-390 § 5(a)(2)(A), 120 Stat. 2692, 2696 (2006) (codified as amended at 11 U.S.C. §§ 362(b)(6), (b)(7), 555, 559 (2006)). *See generally* Thomas E. Plank, *Toward a More Efficient Bankruptcy Law: Mortgage Financing Under the 2005 Bankruptcy Amendments*, 31 SO. ILL. U. L.J. 641 (2007).

104 The acceleration of long term debt adversely affects investors in two ways. First, if the value of the debt and the underlying receivables were to increase because of a decline in market interest rates, the acceleration of the debt would require the payment of the debt at par and deprive the investors of the benefit of this increase in market value. *See id.* at 650, 665-66. On the other hand, if the value of the underlying receivables declined to less than par, the investors would be required to receive only the value of the underlying receivables and would not have the option of retaining the debt and waiting for a potential recovery of the par value of the receivables.

105 This issue is discussed in my upcoming article, *The Mortgage Market, Securitization and The Bankruptcy Code: A Proposal For Reform*, which has been accepted for presentation at the Joint Program of the Section on Creditors' and Debtors' Rights and the Section on Real Estate Transactions, "Real Estate Transactions In Troubled Times," at the January 2009 annual meeting of the Association of American Law Schools.