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THE SECURITY OF SECURITIZATION AND THE FUTURE OF SECURITY

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INTRODUCTION

Securitization is one of the most significant legal and business innovations of the last 30 years. Securitization transforms receivables—residential or commercial mortgage loans, automobile loans, credit card receivables, equipment leases and loans, student loans, trade receivables, and other receivables—into securities that can be sold in capital markets.[1] As of the end of 2002, there were more than 6 trillion dollars of outstanding securities issued in securitizations.[2] Securitization has been the fastest growing form of capital formation[3] because it gives originators of these receivables an additional way to

[1] *See generally* Jason H.P. Kravitt, *The Nature of Securitization, in* SECURITIZATION OF FINANCIAL ASSETS §§ 1.01-02, at 1-1 to 1-10 (Jason H.P. Kravitt ed., 2d ed. 1996 & Supp. 2002); 1 TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES §§ 1.01-02, at 1-7 (1991); STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (3d ed. 2002); Committee on Bankruptcy and Corporate Reorganization, Association of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW 527 (1995) [hereinafter Comm. on Bankruptcy, *Structured Financing Techniques*]; Robert D. Ellis, *Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights*, 24 J. CORP. L. 295, 299-310 (1999); Stephen I. Glover, *Structured Finance Goes Chapter 11: Asset Securitization by Reorganizing Companies*, 47 BUS. LAW 611, 613-14 (1992); Charles E. Harrell & Mark D. Folk, *Financing American Health Security: The Securitization of Healthcare Receivables*, 50 BUS. LAW 47 (1994); Charles E. Harrell et al., *Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques*, 52 BUS. LAW 885 (1997); Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994); Steven L. Schwarcz, *The Parts are Greater Than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies*, 1993 COLUM. BUS. L. REV. 139; Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369 (1991).

[2] For example, the total debt of issuers of asset-backed securities backed by non-mortgage business and consumer loans equaled $2.4 trillion as of the end of 2002. *See Domestic Financial Statistics*, FED. RESERVE BULL. A38, tbl. 1.59, *l*.47 (2003) [hereinafter 2003 *Domestic Financial Statistics*]. In addition, as of the end of 2002, about $8.5 trillion of single family and commercial mortgage loans had been originated and remained outstanding, of which about $4.2 trillion had been securitized. *Id.* at A33, *ll.* 1 & 53.

[3] For example, the total debt of issuers of asset-backed securities backed by non-mortgage business and consumer loans increased 237 percent from $713 billion as of the end of 1995 to $2.4 trillion as of the end of 2002. *See* 2003 *Domestic Financial Statistics, supra* note 2, at A38, tbl. 1.59, *l*.47; Board of Governors of the Federal Reserve System, *Domestic Financial Statistics*, 86 FED. RES. BULL. A40, tbl. 1.59, *l.* 47 (2000) [hereinafter *2000 Statistics*]. In contrast, outstanding corporate bonds of issuers in the non-financial sector increased 108 percent during the same period from $1.3 trillion dollars as of the end of 1995, about twice the outstanding debt of asset back issuers, $2.7 trillion dollars as of the end of 2002. *See* 2003 *Domestic Financial Statistics, supra* note 2, at A38, tbl. 1.59, *l*.8; 2000 *Statistics*, *supra*, at A40, tbl. 1.59, *l*.8.

raise capital to finance their operations or to extend credit to consumers. It also has lowered the costs to lenders[4] and to consumers.[5]

Notwithstanding this impressive record, some commentators have questioned the utility[6] of securitization, and a few have incorrectly described patently improper transactions, such as the fraudulent use by Enron of special purpose entities ("SPEs"), as "securitizations."[7] Others have questioned the legal foundations[8] of securitization. In my view these critics are wrong. I believe that securitization benefits society and rests on firm legal foundations.[9] The purpose of this article is to explain

4 In 1986, for example, General Motors Acceptance Corporation ("GMAC") securitized over $4 billion of automobile loans. A study found that this securitization saved GMAC an annual amount equal to 1.3% of the principal balance of these securities in comparison with GMAC's costs of raising money through traditional debt financing. *See* James A. Rosenthal & Juan M. Ocampo, *Analyzing the Economic Benefits of Securitized Credit*, 1988 J. APPLIED CORP. FIN. 32, 36-40. This annual rate of savings (on a principal balance that declined from the original $4 billion) translates roughly, over the life of the deal, into between $80 and $100 million in cost savings.

5 Several studies have shown that securitization has lowered mortgage rates. *See, e.g.*, Steven K. Todd, *The Effects of Securitization on Consumer Mortgage Costs*, REAL EST. ECON., Jan. 2001, at 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).

6 *See, e.g.*, Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 550-65 (2002) (arguing that securitization harms borrowers); Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101, 102 (1997) (suggesting that securitization is detrimental to the unsecured creditors of the originator); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 23-30 (1996) (suggesting that securitization can be a technique for judgment proofing); Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595 (1998) [hereinafter Lupica, *Asset Securitization*] (same); *see also* Lois R. Lupica, *Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic*, 9 AM. BANKR. INST. L. REV. 287, 312-15 (2001) (arguing that securitization has the potential to pose a greater risk to a debtor's unsecured creditors in bankruptcy than ordinary secured credit transactions and therefore questioning the wisdom of Revised Article 9's facilitation of securitization); Lois R. Lupica, *Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization*, 33 CONN. L. REV. 199, 200-02 (2000) (criticizing Revised Article 9's putative facilitation of securitizations).

7 *See, e.g.*, Robert B. Thompson, *Corporate Governance After Enron*, 40 HOUS. L. REV. 99, 114-15 (2003) (describing Enron's earnings manipulation as a "securitization policy"); DongJu Song, Note, *The Laws of Securities Lawyering after Sarbanes-Oxley*, 53 DUKE L.J. 257, 288 (2003) (suggesting erroneously that Enron, "presumably on the advice or at least consent of its lawyers, [obtained] off-balance sheet financing by placing its own stock, rather than hard assets, into a securitization vehicle"). It is true that Enron used special purpose entities for fraudulent purposes, but these transactions were not properly structured securitizations. *See generally* Steven L. Schwarz, *Enron, and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. CIN. L. REV. 1309 (2002).

8 *See, e.g.*, David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055 (1998) [hereinafter Carlson, *Rotten Foundations*]; Robert Stark, *Viewing the LTV Steel ABS Opinion in its Proper Context*, 27 J. CORP. LAW 211, 212 (2002) (asserting that "structured finance is not based on an entirely firm legal platform").

9 I have personally benefited from securitization, both intellectually and financially. Before becoming a full time law professor in 1994, I practiced law for nineteen years, the last seven of which were serving as issuer's, bankruptcy, and underwriter's counsel for the issuance of

why the legal foundations of securitization are very strong. In addition, because securitization generates cost savings to the parties without apparent detriment to others, and because it has created its own constituency in the business and legal world, the future of securitization is secure as a practical matter.[10] Further, the success of securitization reveals the inefficiency of the treatment of secured credit under the Bankruptcy Code.[11]

Part I of this article describes the mechanics and the direct benefits and costs of securitization. Although securitization entails costs that the sale of receivables in whole loan sales and the pledging of receivables as security for a loan do not, it generates cost savings that these other transactions do not. These costs savings, which can be significant, often will outweigh the additional costs of the transactions, which can be small in relation to the size of the transaction.

There are two significant sources of the cost savings. The first source is the conversion of reasonably liquid unrated receivables into highly liquid rated securities that can be sold in the capital markets. The second source is the avoidance of most of the costs imposed by the Bankruptcy Code on direct secured lending—described by David Carlson as a "bankruptcy tax" on secured credit.[12] Purchasers of debt securities from and lenders to SPEs do not have to charge a "bankruptcy premium" to pay this "bankruptcy tax" that secured lenders must charge in their loans to operating companies. I believe that the amount of the "bankruptcy premium" that SPEs can avoid paying is significant.

As Part II explains, securitization is legally secure because it is nothing more than a sophisticated combination of two well established American legal principles: 1) the sale of property interests from one legal person to another; and 2) the establishment of separate, artificial legal persons. These principles are used throughout the economy in many different ways. There is no reason to disregard either of these

mortgage-backed and asset-backed securities. Since 1994, I have served as a consultant for Kutak Rock LLP, of which I was a partner from 1986 through 1994, and since June 2001 I have been Of Counsel to McKee Nelson, LLP, in both cases providing advice on bankruptcy and security interest matters in securitizations. I have also served as an expert witness in two federal court cases involving securitizations, including serving as the expert witness for Abbey National Treasury Services PLC, on the true sale of trade receivables and the proper structuring of the LTV trade receivables securitization in *In re LTV Steel Co.*, No. 00-43866 (Bankr. N.D. Ohio 2000), which is discussed *infra* Part III.B.

[10] *See also* Thomas E. Plank, *Bankruptcy Professionals, Debtor Dominance, and the Future of Bankruptcy: A Review and a Rhapsody on a Theme*, 18 BANKR. DEV. J. 337, 356-57 (2002) (reviewing DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (2001), and describing the unsuccessful attack by pro-debtor interests on securitization and the unsuccessful efforts of the securitization industry to exempt securitizations from the Bankruptcy Code).

[11] 11 U.S.C. §§ 101-1330 (2000), *originally enacted by* the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978).

[12] *See* Carlson, *Rotten Foundations*, *supra* note 8, at 1064.

principles in the case of securitizations.

Part III describes several assaults on securitization: the argument that securitizations should be disregarded because they are disguised secured transactions; the desperate and unsuccessful attempt to collapse a properly structured securitization in the LTV Corporation bankruptcy; and David Carlson's rarified challenge to securitization. Part III explains why none of these attacks threaten the legal foundations of securitization.

After describing and refuting Professor Carlson's flight of fancy in Part III, I take my own flight of fancy in Part IV. In this part, I present my view of the limits of Congress's and courts' power under the Bankruptcy Clause, showing that under this view, securitization is secure. Under the Bankruptcy Clause, I believe that Congress may only modify the nonbankruptcy entitlements of an insolvent debtor and its creditors to the extent necessary to adjust the relationship among them. It may not modify the nonbankruptcy entitlements of non-debtors, and it may not alter the nonbankruptcy entitlements of debtors or creditors if the debtor is not insolvent in either a cash flow sense or a balance sheet sense. Accordingly, if a securitization meets the criteria of a true sale to a separate legal entity under nonbankruptcy law, bankruptcy courts may not disregard the structure.

Part V discusses the future of securitization. It describes the unsuccessful efforts of the securitization industry to obtain additional protection under the Bankruptcy Code. It also expresses my view of the relative insignificance of state statutes that attempt to give special protections to securitizations. Finally, it describes the tendency of some investors and originators to blur the lines of securitization to enable the investors to obtain additional protections from risk or to enable the originators to retain more benefits. This blurring of lines could cause a court to collapse a securitization. Such a collapse would not, however, threaten securitization as a legal device. The collapse of an improperly structured securitization will only strengthen those securitizations that are properly structured.

Part VI discusses the implications of securitization's secure future. The success of securitization in eliminating the bankruptcy premium that operating company borrowers must pay to their secured lenders raises questions about the wisdom of the current bankruptcy regime. In particular, it provides strong evidence that the Bankruptcy Code should respect more fully the nonbankruptcy entitlements of secured creditors. To this end, I propose two amendments to the Bankruptcy Code. First, the Bankruptcy Code should reverse the result in *United Savings Ass'n v. Timbers of Inwood Forest Associates*[13] and require that secured

[13] 484 U.S. 365, 382 (1988) (holding that the right of an undersecured creditor to adequate protection does not include interest payments to compensate the creditor for the delay of

creditors receive interest on the lesser of their claim or the value of their collateral until they obtain relief from the automatic stay. This should apply to all collateral and all secured lenders. Second, creditors who have a security interest in receivables should be allowed to liquidate the receivables without regard to the automatic stay. These two amendments would reduce the bankruptcy premium in direct secured lending. They would also eliminate the structural requirements in securitizations for avoiding the bankruptcy premium. This elimination would reduce the costs and the volume of securitizations.

I. DESCRIPTION OF SECURITIZATION

Except in the case of trade receivables, an originator of receivables is in the business of making loans.[14] To do so, it must raise money. Depending on the size of its operations, the volume of originations, and its financial strength, it can raise money in one or more ways. It can obtain money from equity investors through private investment or, if large enough, through the public securities markets. It also can borrow on a secured basis from a lender, using the receivables as collateral. This borrowing can be short term, under a "warehouse" lending facility, until the originator sells the receivables; in this case, the originator may be permitted to use the proceeds of these sales directly to originate more receivables, or it may be required to repay the warehouse lender and then borrow again to finance the origination of more receivables. The borrowing also can be on a long term basis, in which the originator retains the receivables, pledges them to secure a long term loan, and uses the proceeds of the loan to originate more receivables.[15] If the

foreclosure caused by the bankruptcy case).

[14] Originators of trade receivables are generally in the business of selling goods or services. When they sell their goods and services on account, they generate receivables that they can retain, sell, or pledge as security for a borrowing.

[15] Another method used for many years to finance the origination of single-family mortgage loans was the short term borrowing of savings and loan associations from depositors and the investment of those deposits in long term mortgage loans. This mismatch of assets and liabilities was amply demonstrated in the movie, IT'S A WONDERFUL LIFE (Liberty Films & RKO Radio Pictures 1946), when the building and loan association was facing a liquidity crisis by the demand of depositors to withdraw money from their savings accounts. Trying to persuade the depositors from refraining from withdrawing more than they really needed, George Bailey explained that the depositors' money was not in the back in a safe but had been invested in their neighbors' homes.

The regulatory regime for savings and loan associations required them to invest a large proportion of their assets in long term mortgage loans. This regulatory regime eventually lead to the insolvency of the entire savings and loan industry in 1979, as a result of high market interest rates that depressed the market value of their long term holdings, and the elimination of interest rate restrictions on rates that savings and loan associations could pay depositors in the 1982, and the subsequent collapse of the industry in the later 1980s. *See* Robert J. Laughlin, Note, *Causes of the Savings and Loan Debacle*, 59 FORDHAM L. REV. 301, 302-11 (1991); Kenneth E. Scott, originator has a sufficiently high credit rating,[16] it can issue debt securities in the capital markets.

Originators of receivables face risks that can be separated into two categories. One risk is that the receivables themselves will not generate sufficient principal and interest to repay to the originator the cost of lending money to the obligor. The other risk is that, for reasons unrelated to the quality and cash flow from the receivables, the originator suffers losses from its operations. If an originator borrows from a lender, whether a direct lender or the purchaser of debt securities, the lender shares these two risks. First, the lender bears the risk that the receivables themselves will not generate sufficient principal and interest to assure repayment of the debt. Second, the lender bears

Never Again: The S & L Bailout Bill, 45 BUS. LAW. 1883, 1885-93 (1990); Lawrence J. White, *The S&L Debacle*, 59 FORDHAM L. REV. 57, 61-65 (1991); *see also* Cottage Savings Ass'n v. Commis., 499 U.S. 554, 556-58 (1991). This case involved a transaction in which Cottage Savings Association exchanged approximately $6.5 million of single family mortgage participation interests, which had a market value of $4.5 million, for similar mortgage participation interests held by four other savings associations. The transaction was done pursuant to a regulatory directive of the former Federal Home Loan Bank Board that allowed such an exchange without requiring the associations to record a loss for regulatory accounting purposes. The exchange did, however, generate for Cottage Savings a $2.4 million loss for income tax purposes. The Court upheld the deductibility of the loss.

[16] There are four nationally recognized rating agencies in the United States: Standard & Poor's Ratings Services, a division of McGraw-Hill ("Standard and Poor's" or "S&P"); Moody's Investors Service, Inc.; Fitch, Inc.; and Dominion Bond Rating Service Limited. *See* Securities and Exchange Comm'r, Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, 68 Fed. Reg. 35,258 (June 12, 2003).

These rating agencies assign ratings to debt securities. 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) are generally considered "investment grade" securities. *See, e.g.*, The Role and Function of Credit Rating Agencies in the Operation of the Securities Markets, *available at* http://www.sec.gov/news/studies/credratingreport0103.pdf; Peter V. Darrow et al., *Rating Agency Requirements*, *in* 1 SECURITIZATION OF FINANCIAL ASSETS § 7.01 (Jason H.P. Kravitt ed., 2d ed. 2002-1 Supp.); Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 UNIV. ILL. L. REV. 1, 7-9.

S&P describes its ratings as follows:

> 'AAA' An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.
>
> 'AA' An obligation rated 'AA' differs from the highest rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.
>
> 'A' An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.
>
> 'BBB' An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.
>
> Obligations rated 'BB', 'B', 'CCC', 'CC', and 'C' are regarded as having significant speculative characteristics.

2001 STANDARD AND POOR'S, CORPORATE RATINGS CRITERIA 7-8.

the risk that, for reasons unrelated to the receivables, the originator can no longer repay its debt and must seek relief under the Bankruptcy Code. In the case of a secured loan to an originator, the lender must charge an interest rate that compensates it for both the risks related to the receivables and the operational risks of the originator.

The principal value of securitization flows from the separation of these two risks. In a securitization, the investors assume the risks associated with the receivables but they avoid the risks associated with the originator's operations. In other words, each securitization isolates the receivables from the risk of the bankruptcy of the originator. This disaggregation of risk results in lower overall financing costs for originators of receivables.

A. *Essential Features of Securitization*

Securitization transforms receivables into securities backed solely by the receivables. The investment return on the securities depends on the receivables themselves and does not depend upon the creditworthiness of the originator of the receivables or the issuer of the securities.[17] These securities, referred to as asset-backed securities, generally take two forms: pure pass-through certificates and debt securities. The sponsor of the asset-backed securities may be the originator of the receivables or another person in the business of acquiring receivables from originators and securitizing them.

In the case of pass-through certificates, the owner of the receivables transfers them to a trustee pursuant to a trust agreement[18] in exchange for certificates that represent a 100 percent beneficial ownership interest in the receivables. The owner then sells the certificates in the capital markets. The trustee has legal title to the receivables, receives the collections from the receivables and passes them through to the holders of the certificates in accordance with the operative document. For most purposes, the certificates are considered equity interests.[19]

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17 Some asset-backed securities have the benefit of third party credit enhancement, such as a letter of credit or a financial guarantee policy. However, in these cases, the credit enhancer will look only to the assets for reimbursement, and hence the structure is substantially the same.

18 Typically, this trust agreement is called a "pooling and servicing agreement."

19 Thus, for state law purposes they do not directly represent debt of any party. The plan asset regulations under the Employment Retirement Income Security Act ("ERISA") treat an investment in the certificates as an investment in the underlying receivables. *See* 29 C.F.R. § 2510.3-101(b) (2003) (defining equity interest as "any in an entity other than an instrument that is treated as indebtedness under applicable local law and which has no substantial equity features. . . . [Beneficial interests] in a trust are equity interests."). Because they are equity securities and not debt securities, the trust agreement and the trustee need not qualify under the Trust Indenture Act of 1939. *See* 15 U.S.C § 77ddd(a) (2000) (providing that the provisions of

In the typical case of debt securities, the owner transfers the receivables to a separate, special purpose, legal person, which can be a corporation, a limited partnership, a limited liability company or a business trust, that is designed to be "bankruptcy remote." This entity, known as a "special purpose entity" or "SPE," or a special purpose vehicle or "SPV," issues to the capital markets debt securities, backed by the receivables in the form of notes or bonds. A variation of debt securities are pass-through certificates that nominally represent beneficial interests in the underlying receivables but that have the cash flow characteristics of debt.[20]

The consideration for the sale of receivables will be the proceeds from the sale of the securities and other cash or property in an amount equal to the fair market value of the receivables. In the case of the sale of receivables by an originator to a newly-created SPE that is a subsidiary of the originator, the purchase price could include the stock in the new SPE.[21]

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the trust indenture act do not apply to "any security other than (A) a note, bond, debenture, or evidence of indebtedness, whether or not secured, or (B) a certificate of interest or participation in any such note, bond, debenture, or evidence of indebtedness, or (C) a temporary certificate for, or guarantee of, any such note, bond, debenture, evidence of indebtedness, or certificate").

[20] These consist of those classes of multi-class pass-through certificates that are entitled to priority in the case of losses on the underlying receivables. In this structure, the different classes of certificates will have different priorities of payment from the cash flow from the underlying receivables. In the simplest example, the certificates can be divided into two classes, Class *A* and Class *B*. The cash flow from receivables would be divided among the classes as follows: Cash flow, to the extent available, would go to pay interest on the Class *A* certificates first, then on the Class *B* certificates. Remaining cash flow would then be used to repay the principal of the Class *A* certificates until the principal balance was reduced to zero, and then, to the extent available, to pay the principal of the Class *B* certificates. If there are shortfalls in the cash flow because of payment defaults by obligors, the Class *B* certificates will be the first class to absorb those short falls and to suffer losses. From a bankruptcy perspective, the senior certificates—the Class *A* Certificates—may represent debt, even if they are not be debt for other purposes. In this case, the junior certificates—the Class *B* certificates—would represent the residual value of the receivables, and the holder of the subordinate certificates may be deemed to be the owner of the receivables underlying the certificates. Accordingly, if these subordinate certificates are not sold to a creditworthy third party, they must be sold to a bankruptcy remote SPE. Hence, from a bankruptcy structuring perspective, many multiple class pass-through certificates are essentially the same as pure debt securities.

Often there are multiple classes and sub-classes, and there are many ways in which the cash flow can be divided up. The cash flow structure of the certificates will be designed to meet the desires of investors to the extent possible.

[21] Other property could include a subordinated note from the SPE of sufficient credit quality to assure repayment of the note. *See, e.g.*, STANDARD AND POOR'S LEGAL CRITERIA FOR STRUCTURED FINANCE TRANSACTIONS 28-29 (3d ed. 2002), *available* at http://www.standardandpoors.com/spf/pdf/fixedincome/Legal2002.pdf [hereinafter S&P 2002 LEGAL CRITERIA] (noting that S&P will allow the use of subordinated notes as consideration for the purchase of the receivables if the subordinated note has a likelihood of repayment that is of investment grade quality and if the SPE has sufficient equity to assure that the risks and rewards of ownership have in fact been transferred to the SPE). Another possibility is a capital contribution of loans (or a portion of the value of the loans) by an originator to an SPE that is a wholly owned subsidiary. If the SPE is solvent, the originator's ownership interest in the SPE

In addition, by selling receivables to an SPE that is a subsidiary of the originator, the originator can retain, indirectly, the residual value in the underlying receivables that it originated. The SPE owns the receivables, which are now subject to a security interest to secure the debt securities that it issued, and it therefore retains the residual value in the receivables remaining after payment of the debt. This residual value, less the general expenses and liabilities of the SPE, is the value of the stock of or other ownership interest in the SPE owned by the originator as parent of the SPE. The parent of the SPE ultimately will receive most of this residual value in the form of dividends or distributions from its subsidiary.

Both pass-through certificates and debt securities are structured to insure that a bankruptcy of either the originator/seller of the receivables or the parent of the SPE will not adversely affect payments on the securities.[22] In the first step of the securitization, to isolate the securities from the bankruptcy risk of the seller, the seller must effect a "true sale" of the receivables to the pass-through trustee or the SPE.[23] Accordingly, to get the desired rating, the seller may retain little of the benefits and burdens of owning the receivables.[24] If the seller retains too much risk or benefit from the receivables and later becomes a debtor under the Bankruptcy Code, a bankruptcy court might include the receivables in the bankruptcy estate of the seller.[25]

For pure pass-through certificates, assuring a true sale to the pass-through trustee will be sufficient to isolate the securities from the bankruptcy risk of the seller or anyone else. For debt securities issued by an SPE, however, isolating the securities from risks not associated with the receivables requires additional protections. First, the organizational documents for the SPE must limit the activities of the

will increase by the amount of the capital contribution. *See* Butler Aviation Int'l, Inc. v. Whyte (*In re* Fairchild Aircraft Corp.), 6 F.3d 1119, 1129 (5th Cir. 1993) (holding that indirect benefits to a parent for making payments owed by a subsidiary was value within the meaning of the fraudulent conveyance provisions of the Bankruptcy Code); Rubin v. Mfrs. Tr. Co., 661 F.2d 979, 991-92 (2d Cir. 1981) (discussing the indirect economic benefit to a transferor as value).

22 This article focuses on originators who can be debtors under the Bankruptcy Code. Banks, savings associations, and insurance companies are also originators of these receivables but are not eligible to be debtors under the Bankruptcy Code. *See* 11 U.S.C. § 109(b)(2) (2000). Most of the concerns raised by a bankruptcy of a Bankruptcy Code eligible originator will apply to these non-code originators, but some will not. *See infra* notes 388-94 and accompanying text (describing the different treatment of secured creditors in the case of the insolvency of financial institutions).

23 In addition, if the seller has acquired the receivables from the originator or other prior owner, that transfer also must be structured as a true sale.

24 *See infra* notes 75-78 and accompanying text (discussing the general requirements for a true sale).

25 *See, e.g.*, Fireman's Fund Ins. Co. v. Grover (*In re* Woodson Co.), 813 F.2d 266, 269 (9th Cir. 1987) (holding that the purported sale of participation interests in underlying loans was a disguised grant of a security interest because the sellers retained all of the risk of loss on the underlying loans).

SPE to acquiring the receivables and issuing securities backed by or secured by the receivables.[26] With these limitations, including limitations on issuing additional debt, the SPE should not become a debtor under the Bankruptcy Code for any reason other than defaults relating solely to the receivables. Because there should be no other activities or other significant debt, the SPE will not have creditors other than the holders of the asset-backed securities. Accordingly, there will be no other creditors who could file an involuntary petition against the SPE under the Bankruptcy Code[27] or who could initiate collection activity that would cause the SPE to file a voluntary petition. Of course, every one understands—or should understand—that if the receivables held by the SPE perform poorly and the holders of the asset-backed securities are not paid, the holders could initiate collection activity that would cause the SPE to file for bankruptcy.[28]

Second, the SPE is structured to prevent opportunistic behavior by its parent if the parent were to become a debtor in bankruptcy. The governing body for the SPE will include or consist of one person who is independent of the parent. For an SPE that is a corporation,[29] this independent person will be an independent director.[30] For an SPE that is not a corporation, the independent person will often be an SPE, such as a bankruptcy remote corporation with an independent director, serving as the general partner in a limited partnership[31] or a member in a limited liability company.[32] In the case of a limited liability company,

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26 *See, e.g.*, S&P 2002 LEGAL CRITERIA, *supra* note 21, at 19.

27 *See* 11 U.S.C § 303(a)-(b) (2000) (authorizing a specified number of creditors to file a petition under the Bankruptcy Code against a person that can be a debtor other than a non-profit corporation or a farmer); *In re* Kingston Square Assoc., 214 B.R 713, 724, 733-35 (Bankr. S.D.N.Y. 1997) (upholding the filing of an involuntary petition against several insolvent, defaulting SPEs by creditors solicited by the principal of the SPEs), which is further discussed *infra* notes 100-107 and accompanying text.

28 Under the Bankruptcy Code, an entity eligible to be a debtor cannot effectively preclude itself from filing a petition or being the subject of an involuntary petition. *See* Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 303-15 (1997) (describing and questioning the conventional wisdom of unenforceability of bankruptcy waivers). Accordingly, the risk of bankruptcy cannot be eliminated, and SPEs are known as bankruptcy remote entities, not bankruptcy proof entities.

29 *See* S&P 2002 LEGAL CRITERIA, *supra* note 21, at 22.

30 *See id.* at 21,161. An independent director is defined as a

> duly appointed member of the board of directors of the relevant entity who shall not have been, at the time of such appointment or at any time in the preceding five years, (a) a direct or indirect legal or beneficial owner (beyond a nominal amount) in such entity or any of its affiliates, (b) a creditor, supplier, employee, officer, director, family member, manager, or contractor of such entity or any of its affiliates, or (c) a person who controls (whether directly, indirectly, or otherwise) such entity or its affiliates or any creditor, supplier, employee, officer, director, manager, or contractor of such entity or its affiliates.

Id. at 161.

31 *See id.* at 8, 20, 22.

32 *See id.* at 20, 100.

the independent person can be an independent manager whose function is similar to that of the independent director of a corporate SPE.[33] In addition, the organizational documents of the SPE will require the assent of the independent person to authorize or consent to the filing of a bankruptcy petition.[34] This requirement for the independent person's assent is designed to prevent the filing of a voluntary bankruptcy petition (or the acquiescence in an involuntary petition) at the behest of the parent for any reason other than the failure of the receivables to pay as expected.[35] This provision is primarily designed to prevent the parent of the SPE from putting a solvent SPE into bankruptcy to capture excess value in the receivables.[36]

Third, the SPE must be structured and operated so that, if the parent of the SPE were to become a debtor under the Bankruptcy Code, a bankruptcy court would not disregard the separateness of the SPE under the doctrine of substantive consolidation and consolidate the assets and liabilities of the SPE with the assets and liabilities of the parent/debtor.[37] The organizational documents will contain covenants designed to ensure that the SPE operates as an entity independent of its parent.[38] The presence of the independent director or other person is also a helpful element in preventing substantive consolidation.

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33 *See id.* at 100.

34 *See id.* at 22, 100.

35 *See id.* at 20.

36 *See infra* notes 348-50 and accompanying text, which describes an attempt by the owners of a solvent SPE to cause the SPE to file for bankruptcy to accelerate the debt of the SPE, which otherwise was not subject to prepayment. By prepaying the debt at par, that is, one hundred percent of the face amount, the owners could have sold the underlying collateral at a premium, that is, at a price greater than par, and recaptured the excess value in the collateral that otherwise would have gone to the debt holders.

37 *See infra* notes 109-11 and accompanying text (discussing substantive consolidation).

38 S&P requires the following separateness covenants on the part of the SPE: Maintain its books, records, and accounts separate from any other person or entity; not commingle assets with those of any other entity; conduct its own business in its own name; maintain separate financial statements; pay its own liabilities out of its own funds; observe all corporate, partnership, or LLC formalities and other formalities required by the organic documents; maintain an arm's-length relationship with its affiliates; pay the salaries of its own employees and maintain a sufficient number of employees in light of its contemplated business operations [although it is not necessary to have employees, if contractors will conduct the business of entity]; not guarantee or become obligated for the debts of any other entity or hold out its credit as being available to satisfy the obligations of others; not to acquire obligations or securities of its partners, members, or shareholders; allocate fairly and reasonably any overhead for shared office space; use separate stationery, invoices, and checks; not pledge its assets for the benefit of any other entity or make any loans or advances to any entity; hold itself out as a separate entity; correct any known misunderstanding regarding its separate identity; and maintain adequate capital in light of its contemplated business operations. S&P 2002 LEGAL CRITERIA, *supra* note 21, at 21-22.

B. *Net Benefits of Securitization*

The prime motivation for isolating the asset-backed securities from the credit risk of the originator (or subsequent seller) of the receivables and of the parent of an SPE is to enable the securities to receive an investment grade rating from a rating agency.[39] Properly structured, asset-backed securities can receive a rating from a rating agency regardless of the creditworthiness of the originator of the receivables. Many originators cannot obtain any rating on their debt securities. For other originators, the asset-backed securities would receive a higher rating than the originators' own debt securities.[40] Indeed, even large, credit-worthy originators of receivables use securitizations to maintain favorable debt-equity ratios and to lower costs.[41]

With a pool of receivables of sufficient size, the risk associated with the receivables can be more easily quantified than the risks associated with an operating company. From studies of historical defaults on receivables, ratings agencies have developed methodologies by which they can predict, with reasonable certainty, the likelihood and severity of loss on any pool of receivables. The rating agencies can assign ratings to securities backed by the pool of receivables by determining the amount of coverage for the predicted loss commensurate with the rating. This loss coverage—or credit enhancement—may take many forms.[42]

[39] *See supra* note 16 (discussing the different rating agencies and the different ratings).

[40] *See generally* Jason H.P. Kravitt & Jeffrey Seifman, *Identifying Legal, Accounting & Related Issues, in* SECURITIZATION OF FINANCIAL ASSETS §§ 3.02, at 3-4 through 3-11 (Jason H.P. Kravitt ed., 2d ed. 1996 & Supp. 2002) [hereinafter Kravitt & Seifman, *Legal Issuers*]; Comm. on Bankruptcy, *Structured Financing Techniques*, *supra* note 1, at 530-31.

[41] *See supra* note 4 (discussing cost saving to GMAC from a $4 billion securitization of automobile loans).

[42] For example, if securities backed by a pool of receivables need loss coverage or credit enhancement equal to seven percent of the original principal balance of the receivables to achieve the desired rating, this loss coverage could be in the form of additional collateral: An issuance of $100 million of debt securities backed by a pool of $107 million receivables; an issuance of $100 million of securities backed by a pool of $100 million receivables and a reserve fund or a letter of credit or pool insurance policy from a highly rated issuer (in which case, the rating of the issuer must equal the rating on the securities) in the amount of $7 million; or an issuance of a class of senior pass-through certificates in the amount of $100 million to be sold to investors and a class of subordinate pass-through certificates in the amount of $7 million either sold to investors or retained by an SPE. *See supra* note 20 (describing senior and subordinate pass-through certificates). Reserve funds are not the most economical form of credit enhancement for mortgage loans because the moneys in the reserve fund would earn a much lower return than the mortgages themselves. However, for asset-backed securities with a much shorter term, such as securities backed by four and five-year automobile loans, a reserve fund is a common form of creditor enhancement. In addition, in some transactions, the reserve fund will be financed not by a lump sum deposit but by diverting to the reserve fund the excess spread between interest rate on

Securitization provides several benefits to originators that reduce the cost of capital. Securitization transforms somewhat liquid unrated receivables into highly liquid rated securities that can be sold in the capital markets. As a result, a larger universe of investors can purchase securities backed by receivables than would buy the underlying receivables or would lend money to the originator or purchase the securities of the originator. The more buyers for the originator's receivables in the form of these securities, the higher the price for the receivables that the originator can obtain or the lower the interest rate the originator can charge on the receivables to begin with.[43] The pressures of a competitive market will lead the originator to lower the interest rate that the ultimate borrower—the obligor on the receivable—must pay.[44]

Securitizing receivables entails greater transaction costs than selling the receivables in whole loan transactions or pledging them as security for a loan. The two principal costs of securitization are the costs associated with issuing rated securities and the costs of structuring a separate SPE.[45] The costs associated with issuing asset-backed securities are similar to the costs of issuing rated securities by any issuer, such as rating agency fees, attorneys' fees, and registration fees in the case of public offerings.

The costs of structuring a separate SPE, however, are peculiar to securitization. The originator must establish a separate legal person and must operate that SPE separately. This requires additional legal expenses to ensure the proper creation of the SPE. The SPE also will incur additional administrative and overhead expenses over the life of the securities. In addition, the SPE must pay the fees and expenses of

the securities and the interest rate on the underlying receivables. As another alternative, the securities themselves could receive credit enhancement, like a financial guaranty policy, from a third party, whose debt securities have a rating equal to that of the asset-backed securities. The insurer would then structure the securities with a sufficient loss coverage. Frequently, there is a combination of any of the foregoing.

[43] Securitization allows originators and purchasers to avoid a mismatch of assets and liabilities. FRANKEL, *supra* note 1, § 3.02, at 69-72; Kravitt & Seifman, *Legal Issuers* § 3.02, at 3-10 to 3-11. Indeed the necessity to ameliorate a gross mismatch in assets and liabilities in the home mortgage industry was the initial impetus for the development of mortgage backed securities in the 1970s and 1980s. *See* Shenker & Colletta, *supra* note 1, at 1384-93.

[44] *See supra* note 5 (discussing a study showing that securitization of mortgage loans save mortgagors two billion dollars in 1993).

[45] The cost of credit enhancement for the securities, however, is not a cost peculiar to securitization. The risk of loss on receivables is inherent in the receivables and is accounted for in the interest charged. Many forms of credit enhancement simply transform a diffuse risk of loss spread throughout all receivables and accounted for in the interest rate on the receivables into a more compact form. Much of the risk of loss will be removed from the securities—how much depends on the rating that the securities receive—and transferred to the form of credit enhancement, such as the reserve fund, the excess interest, or the over-collateralization. *See supra* note 42 (describing different forms of credit enhancement). In effect, securitization distills the risk of loss premium out of the interest rate on the receivables.

the independent director or other independent person.[46] These costs, however, are not significant.[47]

The originator or the SPE also must pay legal fees to obtain opinions peculiar to the structural features of securitizations. Specifically, these are (1) a "true sale" opinion to the effect that, after the transfer of the receivables from the originator to the SPE or the pass-through trustee, the receivables would not be included in the bankruptcy estate of the originator if the originator were to become a debtor under the Code,[48] and (2) in the case of debt securities issued by an SPE, a "non-consolidation" opinion to the effect that the assets and liabilities of the SPE would not be consolidated with the assets and liabilities of the parent of the SPE if the parent were to become a debtor under the Bankruptcy Code.[49]

When the direct benefits of securitization outweigh the direct costs, a rational originator will securitize its receivables. When the direct costs outweigh the benefits, the rational originator will use some other method to raise money for its business.

The net benefits of securitization derive from two distinct sources. One source is the net benefits of issuing securities in highly efficient capital markets, rather than borrowing from banks or other direct lender. The second, and unique, source of the cost savings of securitization is the structural feature of securitization that limits the credit risk of the securities solely to that of the receivables and isolates the securities from the bankruptcy risk of the originator of the receivables and other third parties. Securitization accomplishes this isolation by a transfer of receivables in a true sale to a bankruptcy remote SPE. This isolation of risk enables the holders of the securities to avoid the bankruptcy costs that would be borne by lenders who make secured loans to the originator.

C. *The Bankruptcy Premium*

Isolating the receivables from the bankruptcy risk of the originator and seller of the receivables and the parent of the SPE is essential to securitization. The holders of pass-through certificates must truly be the beneficial owners of the receivables, and the holders of debt securities must be secured creditors only of the SPE. If either the seller of the

[46] *See supra* notes 29-36 and accompanying text.

[47] For pure pass-through certificates, there is no separate SPE, but a pure pass-through securitization often offers less flexibility that has the effect of reducing slightly the attractiveness of the certificates to investors.

[48] *See* S&P 2002 LEGAL CRITERIA, *supra* note 21, at 7, 9; Schwarcz, *supra* note 1, at 135-36.

[49] *See* S&P 2002 LEGAL CRITERIA, *supra* note 21, at 8-9; Schwarcz, *supra* note 1, at 135-36.

receivables or the parent of the SPE were to become a debtor under the Bankruptcy Code, the receivables must not be included in the bankruptcy estate of such debtor and the holders of the securities may not be treated as a secured creditor of the debtor. Although the rights of secured creditors are respected to a large extent in bankruptcy, the filing of a bankruptcy petition nevertheless adversely affects a creditor who has a security interest in the debtor's receivables.

The most significant adverse effect is the automatic stay that arises upon the filing of the bankruptcy petition. The automatic stay prevents creditors, including secured creditors, from taking any action to collect their claims and therefore prevents the payment of the proceeds of the receivables to a secured creditor.[50] In addition, the bankruptcy trustee (including the debtor in possession) could require the return of the receivables in the possession of a creditor or third party.[51] The trustee could possibly use the collections from the receivables[52] or give another lender a superior interest in the receivables.[53]

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[50] *See* 11 U.S.C. § 362(a)(6) (2000) (providing that a bankruptcy petition operates as a stay of "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title"). If a borrower becomes a debtor under the Bankruptcy Code, the debtor will cease paying its debts. Secured creditors will not be able to exercise their nonbankruptcy remedies, specifically foreclosing on its collateral pledge to secure the debt.

Many courts and commentators believe that a secured creditor is stayed by § 362(a)(3), which stays acts against property of the estate. *See id.* § 362(a)(3) (providing that a bankruptcy petition operates as a stay of "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"). As I have explained elsewhere, the exercise by a secured creditor of its rights against collateral pledged by a debtor is not exercising control over property of the estate, which consists only of the debtor's rights in the collateral, although for tangible property items in the possession of the debtor, it may be the obtaining of possession of property from the estate. *See* Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 EMORY L. REV. 1193, 1259-62, 1264-67 (1998) [hereinafter Plank, *Bankruptcy Estate*].

[51] *See infra* notes 187-97 and accompanying text (discussing 11 U.S.C. § 542(a), *as interpreted by* United States v. Whiting Pools, Inc., 462 U.S. 198, 211 (1983)).

[52] 11 U.S.C. § 363 states:

> (b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.
>
> . . .
>
> (c)(1) If the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.
>
> (2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless—
>
> (A) each entity that has an interest in such cash collateral consents; or
>
> (B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

Although the security holders would be entitled to "adequate protection," that adequate protection may not necessarily equal the protection that they had originally bargained for. *See id.*

[53] *See id.* § 364(d)(1) (providing that the "court, after notice and a hearing, may authorize the

Further, the secured creditor would be entitled to the promised interest only to the extent that it remained oversecured.[54] If the secured creditor were undersecured, it would not be entitled to interest.[55] An undersecured creditor would not be able to obtain relief from the automatic stay if the receivables were deemed necessary for reorganization.[56] These provisions of the Bankruptcy Code essentially allow for the transfer to the debtor in bankruptcy of some of the value to which the secured creditor would be entitled outside of bankruptcy. The secured creditor also must incur costs to participate in the bankruptcy case to protect its interest. All of these potential adverse effects impose additional costs on secured creditors for the benefit of unsecured creditors and debtors. The secured creditors must recoup this cost by including a bankruptcy premium in the interest that they charge to their borrowers.

Recent developments in bankruptcy discussed in this Symposium[57] and elsewhere[58] suggest that some secured creditors have learned how to use the bankruptcy process to obtain a larger portion of their claims. This effect may reduce the size of the bankruptcy premium. These developments, however, merely ameliorate and do not eliminate the structural features imbedded in the Bankruptcy Code that require the bankruptcy premium that direct secured lenders must charge.

II. THE LEGAL FOUNDATIONS OF SECURITIZATION

The true sale of receivables from the originator or seller to a separate legal entity, either a pass-through trustee in the case of pure

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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 [certain conditions are met]." Again, the security holder would be entitled to "adequate protection." *Id.*

54 *See id.* § 506(a).

55 *See id.* § 502(b)(2) (providing that, if an objection to a creditor's claim is made, the court, after notice and a hearing, shall allow the claim except to the extent that "such claim is for unmatured interest"); United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 381 (1988) (holding that the right of an undersecured creditor to adequate protection does not include interest payments to compensate the creditor for the delay of the bankruptcy case).

56 *See* 11 U.S.C. § 362(d):

> On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—
>
> . . .
>
> (2) with respect to a stay of an act against property under subsection (a) of this section, if (A) the debtor does not have an equity in such property; and (B) such property is not necessary to an effective reorganization.

57 Douglas G. Baird, *Secured Lending and Its Uncertain Future*, 25 CARDOZO L. REV. 1789 (2004).

58 *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675, 682-85 (2003) (noting the increased creditor control in Chapter 11 cases).

pass-through certificates or the SPE in the case of debt securities, is the essential feature of securitization. Such a sale ensures that the receivables would not be included in the seller's bankruptcy estate if the seller were to become a debtor under the Bankruptcy Code. In the case of a transfer of receivables to an SPE, the separateness of the SPE also keeps the receivables out of the bankruptcy estate of the SPE's parent. Hence, securitization relies on two long standing, well recognized legal concepts: the sale of property, and the separateness of legal entities.

A. *The Sale of Property*

An owner of a property interest may transfer all of that property interest to another person.[59] Under non-bankruptcy law, such a transfer is recognized as a sale of the property interest.[60] Bankruptcy law does not directly recognize a "true sale" as such. Instead, bankruptcy law recognizes the nature of a transfer of a property interest through the definition of property of the estate. Section 541(a)(1) provides that the commencement of a case creates an estate, and the estate consists of "all legal or equitable interests of the debtor in property as of the commencement of the case."[61] For this reason, the common reference

[59] Normally, the owner may not transfer a greater interest that she has, but there are exceptions. For example, if O has transferred a property interest, P, to Buyer-1, but that transfer is not perfected, as between O and Buyer-1, Buyer-1 would be considered the owner of P. Nevertheless, in the case of real estate or the sale of accounts or chattel paper, O retains the power to transfer P to Buyer-2, and Buyer-2's ownership interest would eliminate Buyer-1's ownership interest. *See, e.g.*, WILLIAM B. STOEBUCK & DALE A. WHITMAN, LAW OF PROPERTY § 11.9, at 871-72 (3d ed. 2000) (describing how the recording system may give priority to a later transferee if the first transferee fails to record the instrument of transfer); U.C.C. § 9-318(b) (2001) (providing that, as against creditors and purchasers for value, while the interest of a buyer of an account or chattel paper is unperfected, "the debtor [seller] is deemed to have rights and title to the account or chattel paper identical to those the debtor sold"); *id.* § 9-322(a)(2) (providing that a "perfected security interest [including an ownership interest in accounts and chattel paper] . . . has priority over a conflicting unperfected security interest"). Similarly, if a thief steals a negotiable instrument payable to bearer from A and sells it to B, B may acquire the instrument free of A's ownership even though the thief had no ownership interest in the instrument. *See id.* § 3-306 (providing that a holder in due course takes free of claims to the instrument). Finally, if an owner of goods entrusts a merchant with the goods, the merchant can transfer to a buyer all of the owner's interests in the goods, even though the merchant does not have that interest. *See id.* § 2-403(2) (providing that the entrusting of goods to a merchant-dealer gives the merchant the power to transfer all the rights that the entrustor has).

[60] *See, e.g.*, U.C.C. § 2-106(1) (stating that a "'sale' consists in the passing of title from the seller to the buyer for a price"); *id.* § 2-401(1)(2) (providing that title to goods cannot pass until they are identified to the contract for sale but that title may pass in any manner agreed and that absent agreement otherwise title passes when the seller completes its obligation to delivering the goods to the buyer); *see also infra* note 76 and accompanying text (discussing the elements of a sale of receivables).

[61] 11 U.S.C. § 541 (2000) provides:

> (a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by

in securitization to "true sale opinions"[62] is somewhat inaccurate. The opinions typically do not opine that there has been a true sale; they typically opine that receivables transferred would not be included in the bankruptcy estate of the transferor.[63] In any event, whatever is absolutely transferred by an originator can no longer be part of the property of the estate.[64]

Of course, the owner need not transfer all of the property interest that she has. If she owns a property item, for example, she can transfer a leasehold interest to a lessee and retain a reversion.[65] If the lessor becomes a debtor under the Bankruptcy Code, her reversion would become property of the estate. Similarly, an owner of a property item can grant a security interest to a secured creditor. She retains legal title, the right to redeem the security interest, the right to any surplus value upon sale of the property item, and typically, depending on the nature of the property item, the right to possess and use the property item.[66]

whomever held:

> (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

Id. This is the principal definition for property of the estate, and the only one relevant for true sale purposes. The other enumerated items refer to community property, *id.* § 541(a)(2), and to property added to the estate after the commencement of the case, *id.* § 541(a)(3)-(7).

62 *See supra* note 48 and accompanying text (describing the requirement for true sale opinions in securitizations).

63 The nomenclature of "true sale opinions" sometimes causes difficulties for sellers of receivables. Financial Accounting Standard No. 140, which establishes the guidelines for when a transfer of receivables can be considered a "sale" for accounting purposes sufficient to trigger the recognition of gain or loss by the transferor, includes the requirement that the receivables be legally isolated from the transferor if the transferor were in bankruptcy. Financial Accounting Standards Board, Statement of Financial Accounting Standard no. 140 ¶¶ 9(a), 27-28 at 9, 21 (Sept. 2000) [hereinafter FAS 140]. The American Institute of Certified Public Accountants prepared an example of language in an opinion that would satisfy this requirement stating that "the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale (or a true sale) of the Financial Assets and the proceeds thereof transferred to the Purchaser and not a loan." American Institute of Certified Public Accountants, Profession Standards Auditing Interpretation Section 9336 ¶ 1.13 (2002) (emphasis in original). The difficulty with this approach is that a bankruptcy court must decide whether the transferred receivables have been excluded from the estate but is not required to rule on whether there has been a sale and may not in fact make such a ruling. In addition, the suggested language contains a technical error in stating that the transfer would not be "a loan." A transfer of assets cannot be a loan; the language should have used language to the effect that the transfer "would not be a transfer as security for a loan."

64 *See* Plank, *Bankruptcy Estate*, *supra* note 50, at 1204-07.

65 *See* STOEBUCK & WHITMAN, *supra* note 59, § 3.3, at 83-85, § 6.1, at 243-45, § 6.12, at 256-57 (describing the specific interests of a lessee and lessor in real estate); *see also* U.C.C. § 2A-103(1)(j)-(m), (p)-(q) (1995) (defining the specific interests of a lessee and lessor in goods).

66 *See* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW §§ 4.1-29, at 129-206 (4th ed. 2001) (describing the mortgagor's equity interest in real estate); *see also* U.C.C. §§ 9-608(a)(4), 9-611, 9-615(d) (2001) (in the case of personal property, requiring the secured party to account to and pay to a debtor any surplus from collections on receivables or proceeds from a foreclosure sale and to give the debtor notice of the foreclosure sale). Although Article 9 defines a security interest to include a buyer's interest in receivables, the provisions giving the debtor the right to surplus or notice before a sale do not apply to a buyer and seller of receivables.

These retained interests would also become part of property of the transferor's estate. If the transferor of these lesser interests—a leasehold interest or a security interest—becomes a debtor in bankruptcy, the inclusion of the transferor's interest in the property of the estate may have an adverse effect on the transferee. As discussed above, this adverse effect creates additional costs for a secured creditor.[67]

Since time immemorial, parties to transactions have attempted to disguise the true nature of the transaction when one or both of the parties want to avoid limitations imposed by law on that type of transaction. In exchange for a loan, for example, an owner of real estate may deliver an absolute deed to the creditor as security for the loan, retaining an option to "repurchase" the real estate at a fixed price on some future date. By taking such a deed, the creditor hopes to avoid limitations on its ability to liquidate the collateral pledged to secure a loan.[68] A borrower and a lender may characterize a pledge of receivables to the lender as a "sale" to avoid limits on the amount of interest that can be charged on a loan[69] or to enable the lender to avoid the jurisdiction of the bankruptcy court.[70] The lender in such a disguised pledge transaction may simply want to avoid the obligations of a true secured party to comply with foreclosure requirements of Article 9 of the UCC[71] or to remit to the "seller" the surplus collections from receivables over the amounts advanced to the seller.[72] These

See id. § 9-601(g) & cmt. 9, § 9-608(b), 9-615(e).

67 *See supra* notes 50-56 and accompanying text.

68 NELSON & WHITMAN, *supra* note 66, §§ 3.4-11, at 46-60.

69 *See* West Pico Furniture Co. v. Pac. Fin. Loans, 469 P.2d 665 (Cal. 1970); Milana v. Credit Discount Co., 163 P.2d 869 (Cal. 1945); People v. Serv. Inst., 421 N.Y.S.2d 325 (Sup. Ct. 1979); Annotation, *Usury As Predicable Upon Transaction in Form a Sale or Exchange of Commercial Paper or Other Choses in Action*, 165 A.L.R. 626 (1946).

70 *See, e.g.*, Fireman's Fund Ins. Cos. v. Grover (*In re* The Woodson Co.), 813 F.2d 266, 269 (9th Cir. 1987) (holding that the purported sale of participation interests in underlying loans was a disguised grant of a security interest because the sellers retained all of the risk of loss on the underlying loans); *In re* Carolina Util. Supply Co., 118 B.R. 412 (Bankr. D.S.C. 1990); Malone v. Celeron Oil & Gas Co. (*In re* Currie), 57 B.R. 224 (Bankr. M.D. La. 1986) (assignment by a mortgagor to a mortgagee payments from a mineral lease as additional security for a mortgage loan); Rechnitzer v. Boyd (*In re* Exec. Growth Inv., Inc.), 40 B.R. 417 (Bankr. C.D. Cal. 1984); Sarf v. Leff (*In re* Candy Lane Corp.), 38 B.R. 571 (Bankr. S.D.N.Y. 1984) (assignment of a portion of an expected condemnation award as part of a loan transaction); Castle Rock Enter. v. S.O.A.W. Indus. Bank (*In re* S.O.A.W. Indust. Bank), 32 B.R. 279 (Bankr. W.D. Tex. 1983); *In re* Evergreen Valley Resort, 23 B.R. 659 (Bankr. D. Me. 1982); 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 (1991).

71 *See* U.C.C. § 9-607(c) (requiring a secured party to proceed in a commercially reasonable manner to collect receivables); *id.* § 610(b) (requiring every disposition of collateral repossessed by a secured party to be commercially reasonable); *id.* §§ 9-611 to -613 (requiring notification to debtor before disposition of collateral).

72 *Se*e id. § 9-608 (requiring a secured party to account to and pay to the debtor any surplus from collections); *id.* § 9-615(b) (requiring a secured party to account to and pay to the debtor any

obligations generally do not apply to a true buyer of receivables.[73] Similarly, an owner of a personal property item may disguise an installment sale of the item to the purchaser as a "lease" in which the seller retains only a nominal residual interest and title to secure the payment of the purchase price in the form of rent, again, to obtain these impermissible benefits.[74] Courts will look through these disguised transactions and apply the legal rules appropriate for the true nature of the transaction.

Securitizations, like other transactions involving the sale of property, are not immune from these limitations. Securitization requires that the transfer of receivables by an owner to a pass-through trustee or an SPE be a true sale of the receivables. The elements of a true sale are relatively straightforward. First, the terms of the transaction should describe it as a sale and not a transfer for security. In other words, the form of the transfer must be a sale.[75] Form alone, however, is not enough. The substance of the transaction also must constitute a sale. Hence, the transferor should transfer most of the benefits and burdens of ownership.[76] In the case of the transfer of receivables, this requires that the buyer receive most of the risk of loss from default by the obligors and most of the opportunity for gain or loss in the market value of the receivables.[77] Finally, the seller must receive fair market value for the transfer of benefits and burdens of ownership and for retention of any of those risks.[78]

In practice, the sale of receivables in a securitization is stronger

surplus from the disposition of collateral repossessed by a secured party).

[73] Except in the case of U.C.C. § 9-607(c), which requires a secured party to proceed in a commercially reasonable manner to collect receivables if it is entitled to recourse against the seller, none of the duties imposed on secured parties by Part VI of the U.C.C., discussed *supra* in notes 71 and 72, apply to a buyer of receivables. *See id.* § 9-601(g).

[74] *See generally* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 21-3, at 718-33 (4th ed. 1995).

[75] *See* S&P 2002 LEGAL CRITERIA, *supra* note 21, at 93 (app. I) (noting the importance of the language of the parties to express the intent of the parties); Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON L. REV. 287, 333-34 (1991) [hereinafter Plank, *True Sale*]; Comm. on Bankruptcy, *Structured Financing Techniques*, *supra* note 1, at 547

[76] S&P 2002 LEGAL CRITERIA, *supra* note 21, at 93-94 (app. I) (describing various elements of the burden and benefits of receivables that should be transferred); Plank, *True Sale*, *supra* note 75, at 328-29, 334-39; Comm. on Bankruptcy, *Structured Financing Techniques*, *supra* note 1, at 542-47.

[77] The market value of receivables will change, even without taking into consideration obligor default, as a result of changes in interest rates for comparable receivables and other market factors that affect value, such as factors that affect prepayment of the receivables. These could also include changes in the law that make the receivables more or less desirable for the owner. *See, e.g.*, S&P 2002 LEGAL CRITERIA, *supra* note 21, at 94 (app. I) (noting that "[r]ecourse to the seller for risks of changes in law or regulations are viewed as inconsistent with a sale treatment").

[78] *See, e.g.*, *id.* at 93-94 (noting that the seller should not receive substantially less than fair market value and that the consideration should not depend on the future performance of the receivables); Plank, *True Sale*, *supra* note75, at 328-29, 334-39.

than most sales of property. Because the stakes are high—the issuance of securities carrying an investment grade rating—the investors must receive a true sale opinion.[79] Therefore, the law firm rendering the opinion would require that the sale be structured so that there is an extremely high degree of certainty that any court *would*[80] conclude that the receivables sold were not part of the seller's bankruptcy estate. Opinions that say that "it is more likely than not" or that a court "should" uphold the sale are not acceptable. For most other sales of property items, neither true sale opinions nor questions about whether a bankruptcy court would disregard a sale arise, even in those cases where the seller retains some of the future risk relating to the property item, such as liability associated with the future performance of the property *item*.[81]

Indeed, courts have upheld the sale of property items when the seller retains some of the risk or the some of the benefits of ownership. For example, many courts have upheld a sale of receivables even though the seller retains 100 percent recourse, that is, liability if the underlying obligor does not pay.[82] I have argued that there could be a true sale under such circumstances, if properly structured.[83] Yet, in securitizations, the seller generally may not retain recourse greater than historical loss[84] or, in the case of long-term mortgage loans, 10 percent

[79] *See supra* note 48 and accompanying text.

[80] *See* S&P 2002 LEGAL CRITERIA, *supra* note 21, at 95.

[81] Sellers of goods often make promises concerning future performance. *See* U.C.C. § 2-313(a)(1) (defining an express warranty as any "affirmation of fact or promise" made by seller that relates to the goods and that is the basis of the bargain). Holders who negotiate negotiable instruments to subsequent holders by indorsement retain liability if the maker or drawer does not pay the instrument unless they expressly disclaim liability. *See id.* § 3-415(a), (b). Practically every person who has cashed a check drawn by another at a bank or other establishment, which normally requires the person's indorsement, retains liability if the check is not paid. Nevertheless, one does not see claims that there had not been a true sale of the check to the bank.

[82] *See, e.g.*, Nichols v. Fearson, 32 U.S. (7 Pet.) 103 (1833); Gen. Motors Acceptance Corp. v. Mid-West Chevrolet, 66 F.2d 1 (10th Cir. 1933); Goldstein v. Madison Nat'l Bank, 89 B.R. 274 (D.D.C. 1988); Inv. Thrift v. AMA Corp., 63 Cal. Rptr. 157 (Ct. App. 1967); Indian Lake Estates, Inc. v. Special Inv., Inc., 154 So.2d 883 (Fla. Dist. Ct. App. 1963); Starker v. Heckart, 267 P.2d 219 (Or. 1954); Coast Fin. Corp. v. Ira F. Powers Furniture Co., 209 P. 614 (Or. 1922); Lake Hiawassee Dev. Co. v. Pioneer Bank, 535 S.W.2d 323 (Tenn. 1976); A.B. Lewis Co. v. Nat'l Inv. Corp., 421 S.W.2d 723 (Tex. Civ. App. 1967); Val Zimmermann Corp. v. Leffingwell, 318 N.W.2d 781 (Wis. 1982); *cf.* Refinance Corp. v. N. Lumber Sales, Inc., 329 P.2d 109 (Cal. Dist. Ct. App. 1958) (involving twenty percent recourse in the form of a reserve fund financed from sale proceeds plus one hundred percent recourse for loans without the buyer's prior approval).

[83] *See generally* Plank, *True Sale, supra* note 75. The securitization industry has not, understandably, adopted my argument that there could be a true sale even if the seller retained one hundred percent recourse for credit default. *See* S&P 2002 LEGAL CRITERIA, *supra* note 21, at 28 (noting that S&P will not rely on a true sale opinion for a transaction if the seller retains a significant subordinate interest in the receivables or guarantees losses higher than historic loss because "Standard & Poor's believes that, although these transactions may actually be true sales, they have a higher likelihood of being recharacterized as secured loan transactions").

[84] *See* S&P 2002 LEGAL CRITERIA, *supra* note 21, at 93-94; *see also supra* note 83.

of the principal balance sold.[85] In addition, numerous courts have held that a sale of assets constitutes a true sale notwithstanding a seller's option to repurchase such assets, when there were no other significant facts, such as inadequate consideration, suggesting that the parties intended the transfer to be for security rather than to be an absolute transfer.[86] In securitizations, however, options by sellers to repurchase are generally limited.[87]

[85] This limit, even if larger than historical loss, appeared in the 1980s in mortgage loan securitizations by savings associations when they were regulated by the former Federal Home Loan Bank Board, which had a regulation defining a sale "without recourse" as a sale with recourse for losses of less than ten percent, a rule that is still in effect for purposes other than capital requirements under its successor, the Office of Thrift Supervision. *See* 12 C.F.R. § 561.55(b) (2003) (defining "recourse," for general regulatory purposes, as credit liability for saving associations exceeding ten percent). Although S&P's published criteria has consistently limited permitted credit recourse to historical loss, *see supra* note 84 and accompanying text, S&P has long accepted true sale opinions in mortgage securitizations with recourse in excess of historical loss but less than ten percent. I believe there is a good reason for allowing recourse of up to ten percent in a mortgage sale. Even with a guarantee of the buyer's principal against loss from default by the mortgagor of up to ten percent, the buyer is still taking a risk of greater than ten percent in loss of value in the case of a change in market rates for comparable mortgages. An increase of two percentage points in mortgage interest rates will cause the market value of a long term mortgage loan to decline by more than ten percent. *See* Plank, *True Sale, supra* note 75 at 298-301 (proving examples of the effect on the market value of a mortgage with a twenty-eight year maturity of a change in comparable market interest rates of two percentage points).

[86] *See, e.g.*, Robert Mickam Trust v. United States, 860 F. Supp. 1200 (E.D. Mich. 1994) (holding that a vendor of real property retained no interest in property to which a federal lien could attach after sale of property, though the deed was delivered into escrow under an agreement allowing repurchase by vendor upon satisfaction of conditions contained in agreement); *In re* San Francisco Indust. Park, Inc., 307 F. Supp. 271 (N.D. Cal. 1969) (holding that transactions styled in terms of sale and leaseback and carried as the same by the parties on their books was in fact, as well as in form, a sale and leaseback, and not a mortgage); Costello v. F & M Enter. (*In re* F & M Enter.), 34 B.R. 211 (Bankr. M.D. Fla. 1983) (holding that a deed with repurchase option was an absolute conveyance and not security for a loan); Henslee v. Ratliff, 989 S.W.2d 161 (Ct. App. Ark 1999) (upholding a trial court finding that, for purposes of determining right to proceeds of tort recovery action, a deed conveying 200 acres of timber land subject to separate repurchase option transferred ownership to transferees); Dillree v. Devoe, 724 P.2d 171 (Mont. 1986) (upholding a finding of fact that a transfer of goods was a sale and not a secured transaction notwithstanding seller's option to repurchase); Cizek v. Cizek, 266 N.W.2d 68 (Neb. 1978) (holding that a seller was not entitled to have a deed conveying farm with option to repurchase declared a mortgage); Redman Indus. v. Couch, 613 S.W.2d 787 (Tex. Civ. App. 1981) (affirming a summary judgment that a transfer was a sale and not a secured loan where seller held an option to repurchase the asset); *see also* Resthaven Mem. Cemetery, Inc. v. Comm'r, 43 B.T.A. 683 (U.S. Bd. of Tax App. 1941) (holding that transfer of assets constituted a sale notwithstanding seller's option to repurchase assets).

[87] Options to repurchase at the then fair market value are not problematic, because this kind of an option does not enable the seller to retain the benefit of an increase in the market value of the receivable. These usually only appear when there are some special circumstances that require the seller to retain the option. However, options to repurchase receivables at par, that is, at the then face amount—which may or may not be fair market value at the time of the exercise of the option—are allowed in only limited circumstances. One example is the "clean up call." If the seller is the servicer, the seller—but only in its role as servicer—may repurchase the receivables when the then principal balance of the pool of receivables that has been securitized has been reduced to ten percent of the original balance. The justification for this clean up call is that, when the balance of the receivables becomes so small, the aggregate servicing fee (which is a

Whatever the standards for a true sale, so long as there is a true sale of receivables to a separate legal person, the receivables should not be included in a bankruptcy estate of the seller. There is no principled basis for treating a true sale of receivables in a securitization in a manner different from a true sale of receivables or other property items in any other context. To be sure, the analysis of whether there is a true sale may differ in its particulars because different types of property items manifest different benefits and burdens of ownership.[88] Nevertheless, if there is a true sale of receivables in a securitization, the sale should be respected. Further, it should not matter that the sale is to an affiliate of the seller.[89]

B. *Separateness of the Special Purpose Entity*

The innovation in securitization is the use of a bankruptcy remote SPE to separate the risk associated with a particular pool of receivables from all the other risks associated with an owner of the receivables that is an operating company. When the risks associated with the pool of receivables are lower than the risks associated with the operating company, the overall costs of issuing debt securities by an SPE are lower than the cost of issuing debt securities by the operating

percentage of the declining principal balance of the receivables, usually between one-quarter of one percent and three percent per annum, depending on the type of receivable) earned by the servicer becomes overwhelmed by fixed costs of satisfying the requirements for servicing for a pool of rated securities. FAS, 140, *supra* note 63, ¶¶ 9(c), at 5, 30-31, 50-54 & 153 (defining a clean up call). Another example is the option of the servicer to repurchase a defaulted receivable at par. Typically, a servicer would exercise this option if it thought that it could obtain greater proceeds if the receivable were not subject to the limitations that the securitization documents put on the servicer.

88 For example, if I buy a tire, and the seller promises for an extra fee to repair or replace the tire for any reason, no one would challenge the true sale of the tire because I have possession, control, and use of the tire. Yet, the seller retains all of the risks associated with the tire except the risk of theft. This risk, in the case of the sale of receivables, would be comparable to retaining both one hundred percent credit recourse and one hundred percent responsibility for yield maintenance for a receivable. In this regard, courts treat transfers of receivables more unfavorably, and I believe they do so because they are less familiar with receivables as property. *See* Plank, *True Sale*, *supra* note 75, at 298.

89 *See, e.g.*, *In re* W.T. Mayfield Sons Trucking Co., 225 B.R. 818, 827 (N.D. Ga. 1998) ; *In re* Guyana Dev. Corp. 168 B.R. 892, 905 (S.D. Tex. 1994) (same); *see also* Rimco Acquisition Co. v. Johnson, 68 F. Supp. 2d 793, 797 (E.D. Mich. 1999) (holding that the automatic stay does not stay actions against a non-debtor subsidiary when its parent is in bankruptcy); *In re* Wheeling-Pittsburgh Steel Corp., 59 B.R. 129, 134 (Bankr. W.D. Pa.1986) (holding that the mine that debtor had transferred to wholly owned corporation before filing chapter 11 petition, did not become property of debtor's estate at commencement of bankruptcy case and therefore debtor had no responsibility for maintenance expenses of mine); Texaco-Ohio Gas, Inc. v. Mecom, 28 S.W.3d 129, 144 (Tex. Ct. App. 2000) (holding that the automatic stay does not extend to separate legal entities).

company.[90] Establishing separate legal entities to allocate risk, however, is not new.

Corporations have long been treated as separate legal persons. By statute, a corporation generally has perpetual existence, and it can sue and can be sued, can deal with property, make contracts, incur obligations, conduct business, carry on operations, own equity interests in other legal entities, lend money, purchase insurance, and do other acts that a natural person can do.[91] More recently, state statutes have given limited partnerships, limited liability companies, and statutory trusts broad powers as separate legal entities[92] and declared them to be

[90] *See supra* note 4 (discussing a transaction in which GMAC saved money by securitizing four billion dollars of automobile loans). In this case, when GMAC securitized these loans, its traditional debt securities had an AA rating. The securities backed solely by the loans received a AAA rating. The cost saving for GMAC, however, resulted not from the difference in interest rates. The difference in the interest rates from a AAA security and a AA security were small, and after factoring in the increased costs of the asset-backed securities, amount only to two-hundreths of one percent, or two "basis points," annually. Instead, the primary form of savings derived from avoiding the cost to GMAC of maintaining the amount of equity required for GMAC to achieve a AA rating on its own debt securities. *See* Rosenthal & Ocampo, *supra* note 4, at 32.

[91] *See, e.g.*, DEL. CODE ANN. tit. 8, § 122 (2003):

> Every corporation created under this chapter shall have power to:
>
> (1) Have perpetual succession by its corporate name . . . ;
>
> (2) Sue and be sued in all courts and participate, as a party or otherwise, in any judicial, administrative, arbitrative or other proceeding, in its corporate name;
>
> . . .
>
> (4) Purchase, receive, take by grant, gift, devise, bequest or otherwise, lease, or otherwise acquire, own, hold, improve, employ, use and otherwise deal in and with real or personal property, or any interest therein, wherever situated, and to sell, convey, lease, exchange, transfer or otherwise dispose of, or mortgage or pledge, all or any of its property and assets, or any interest therein, wherever situated;
>
> . . .
>
> (8) Conduct its business, carry on its operations and have offices and exercise its powers within or without this State;
>
> . . .
>
> (10) Be an incorporator, promoter or manager of other corporations of any type or kind;
>
> (11) Participate with others in any corporation, partnership, limited partnership, joint venture or other association of any kind . . . ;
>
> . . .
>
> (13) Make contracts, including contracts of guaranty and suretyship, incur liabilities, borrow money at such rates of interest as the corporation may determine, issue its notes, bonds and other obligations, and secure any of its obligations by mortgage, pledge or other encumbrance of all or any of its property . . .;
>
> (14) Lend money for its corporate purposes, invest and reinvest its funds, and take, hold and deal with real and personal property as security for the payment of funds so loaned or invested.

Id.

[92] UNIF. LTD. LIAB. CO. ACT §§ 112 (1996), 6A U.L.A. 560, 576-77 (2003) (stating that a "limited liability company may be organized under this [Act] for any lawful purpose," and that unless "its articles of organization provide otherwise, a limited liability company has the same powers as an individual to do all things necessary or convenient to carry on its business or affairs," including the power to: "(1) sue and be sued, and defend in its name; (2) . . . acquire, own, hold, improve, use, and otherwise deal with real or personal property, or any legal or

separate legal entities.[93]

During the last part of the twentieth century, a substantial body of scholarship eschewed the "entity" model of corporations in favor of a "contractarian model" and has argued that corporations represent a nexus of contracts among their many constituents, such as shareholders, directors, officers, employees, and others.[94] This model may be helpful in analyzing the interaction among and the role of these different constituents. Nevertheless, this view of the firm does not eliminate the fact that, for purposes of transactions with others, the corporation and other artificial legal entities are separate legal entities.[95] To put it another way, to analyze the sale of a property interest from a seller to a corporation, even if only a "nexus of contracts," still requires the simple property analysis of whether the seller has transferred a substantial part of the benefits and burdens of ownership to the corporation.[96]

Whatever the scholarly view of the nature of the corporation, legislatures and courts have for over a century recognized the separateness of the corporation from its shareholders, affiliates, and other constituent bodies. Such separateness allows for the allocation and diversification of risks and the development of specialization. Hence, General Motors Corporation can establish a separate subsidiary corporation, General Motors Acceptance Corporation ("GMAC"), to specialize in the business of financing automobile dealers and purchasers of their product.[97] Lenders to and investors in GMAC

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equitable interest in property, wherever located; (3) sell . . . and otherwise encumber . . . its property; (4) . . . acquire, own, hold, vote, use, sell, grant a security interest in, or otherwise dispose of and deal in and with, shares or other interests in or obligations of any other entity; (5) make contracts and guarantees, incur liabilities, borrow money . . . and . . . secure any of its obligations . . .; lend money and invest . . ."); 104(c) (2001), 6A U.L.A. 9, 18 (stating that a "limited partnership has a perpetual duration"); 105 (providing that a limited partnership "has the powers to do all things necessary or convenient to carry on its activities, including the power to sue, be sued, and defend in its own name"); DEL. CODE ANN. tit. 12, § 3805(c) (2003) (providing that a beneficial owner's beneficial interest in the statutory trust is personal property and that, except as otherwise provided in the governing instrument, "a beneficial owner has no interest in specific statutory trust property").

93 *See, e.g.*, UNIF. LTD. LIAB. CO. ACT § 201 (1996), 6A U.L.A. 560, 578 (2003) (stating that a "limited liability company is a legal entity distinct from its members"); UNIF. LTD. P'SHIP ACT § 104(c) (2001), 6A U.L.A. 9, 18 (2003) (stating that a "limited partnership is an entity distinct from its partners"); DEL. CODE ANN. tit. 12, § 3801(a) (Supp. 2003) (declaring a Delaware statutory trust to be "a separate legal entity").

94 *See generally* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 1.5, at 26-38 (2002).

95 *See id.* § 1.2, at 7 (stating that, as "a legal matter, the corporation is an entity wholly separate from the people who own it and work for it" and that for most purposes it has "an identity wholly apart from its constituents").

96 *See, e.g.*, *id.* § 1.5, at 28 (noting that, under the contractarian model of the firm, owning a few shares of stock in a corporation does not entitle the stockholder "to trespass on [the corporation's] property—[the stockholder does] not own the land or even have any ownership-like right to enter its land")

97 *See* General Motors Acceptance Corporation, Annual Report, Form 10-K, at 1 (2002)

therefore do not assume the risks associated with the manufacture of automobiles.[98]

Some might argue that SPEs should be treated differently on the grounds that the use of an SPE in a securitization allows secured creditors to avoid the jurisdiction of bankruptcy law. This is not correct. The SPE, as a separate legal entity, retains the risks associated with the receivables. The SPE is not bankruptcy proof; it is merely bankruptcy remote. An SPE is structured to eliminate the risk of bankruptcy for reasons not related to the receivables. An SPE retains the risk of bankruptcy if the receivables perform poorly and the SPE defaults on its debt. If the receivables do not perform as expected, and the creditors seek to enforce their security interest against the SPE, the SPE has a reason to file for bankruptcy. At least one insolvent SPE has filed for bankruptcy for this reason.[99]

For this reason, *Kingston Square Associates*[100] is no threat to securitization. In this case, eleven SPEs that owned real estate properties and that had defaulted on their loans faced foreclosure by the secured lenders. To stall the foreclosures, the individual who was the controlling principal of the SPEs solicited creditors to file an involuntary bankruptcy petition against the SPEs.[101] The lenders challenged the involuntary petitions as a bad faith avoidance of the requirement that the SPEs obtain the consent of the independent director of the SPEs for a voluntary or involuntary filing.[102] The controlling principal of the SPEs had not sought the consent of the independent director because he viewed the independent director as an agent of the lenders and did not expect that such consent would be given.[103]

Although finding that the principal had orchestrated the filings, the court rejected the lenders' claim that soliciting the involuntary petition evidenced bad faith. For this reason, and because of the failure of the principal to seek the approval of the independent director, the court declined to rule on the motion of the debtors and the petitioning creditors to invalidate the requirement for the approval of the independent director for a bankruptcy petition. Some commentators

(noting that GMAC has been a wholly owned subsidiary of General Motors Corporation ("GMC") since 1919).

98 See id. at 29 (disclosing approximately $180 billion in debt).

99 *See* Comm. on Bankruptcy, *Structured Financing Techniques*, *supra* note 1, at 565-67; Harold L. Kaplan & Stephanie Wickouski, Column, Intensive Care, *Health Care Financing And Securitization After National Century*, AM. BANKR. INST. J., May 2003, at 28.

100 214 B.R 713 (Bankr. S.D.N.Y. 1997)

101 Some of the SPEs were corporations, in which an independent director was a member of the board of directors. Others were limited partnerships in which the general partner was an SPE corporation, again with an independent director was a member of the board of directors. *See id.* at 716-17.

102 *See id.* at 715, 723 .

103 *See id.* at 720 n.11, 736.

have interpreted the court's decision as raising "questions concerning the viability of corporate governance mechanisms in bankruptcy remote vehicles."[104] I do not believe that either the case or the court's language has any such effect. True, the court seemed not to understand the nature of the provisions requiring the consent of the independent director for a bankruptcy filing. The court repeatedly called them "bankruptcy proof" provisions in all but one instance.[105] These are not "bankruptcy proof" provisions, just bankruptcy remote provisions. Indeed, the independent director in the case testified that these provisions were designed to prevent the principal of the debtors from bringing the SPEs into the principal's personal bankruptcy.[106] More importantly, as discussed above, when an SPE is insolvent and the secured creditor commences foreclosure proceedings against the SPE's assets, one would expect that an independent director would vote in favor of a bankruptcy petition.[107]

At a broader level, the legal device of a separate corporation or other artificial legal person, like all legal devices, can be abused. The law, however, recognizes a remedy. State law allows creditors of a corporation to "pierce the corporate veil" and impose liability for the creditors' claims on the shareholders of the corporation under certain circumstances. Courts will do so if the shareholder has failed to respect the separateness of the corporation, that is, has failed to comply with corporate formalities and to keep the operations, assets, and records of the corporation separate, and at the same has engaged in inequitable conduct, such as using the corporation to perpetuate fraud on creditors.[108]

A bankruptcy court will also substantively consolidate two affiliated entities under similar circumstances. For example, the Court of Appeals for the Second Circuit in *Augie/Restivo Baking Co.*[109]

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[104] *See* Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, *New Developments in Structured Finance*, 56 BUS. LAW. 95, 162 (2000).

[105] *See Kingston Square*, 214 B.R. at 716 (stating that the requirement for independent director consent to a bankruptcy filing is "commonly referred to as a 'bankruptcy remote' or 'bankruptcy proof' provision"); *id*. at 721, 722, 729, 737 (using only the term "bankruptcy proof"); *id.* at 724 (noting that the involuntary petitions were filed "to circumvent what effectively were prohibitions on the filing of voluntary petitions"); *id.* at 736 (stating that the "Movants [lenders] may feel bruised because the Respondents outmaneuvered what the Movants thought was an iron-clad provision in the corporate by-laws preventing a bankruptcy filing, but this does not mean that, without more, the petitions must be dismissed"). It may be that either of the parties used this term "bankruptcy proof" and the court simply accepted this use.

[106] *See id.* at 722.

[107] Another distinguishing feature of this case is the failure of the board of directors to hold regular meetings and comply with corporate formalities, including the inattention of the independent director to the affairs of the debtors, and the close ties of the independent director to the lenders. *See id.* at 730, 735-36.

[108] FRANKLIN A. GEVURTZ, CORPORATION LAW §1.5, at 69-108 (2000) (analyzing and criticizing the law on piercing the corporate veil).

[109] 860 F.2d 515 (2d Cir. 1988).

identified two critical factors for consolidation: "(i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit . . . [or] (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."[110] Some courts have used a more liberal approach and have substantively consolidated affiliates if there has been a failure to respect the separateness of the affiliates, and the creditor or party opposing the consolidation has failed to demonstrate that it did not rely solely on the separate credit of one affiliate.[111] As discussed above, securitizations contain features to reduce or eliminate the risk of substantive consolidation or veil piercing. Unless the SPE meets the tests applicable to corporations or other legal entities for disregarding their separateness, the separate legal existence of the SPE should continue to be respected by federal courts.

III. ASSAULTS ON SECURITIZATION

A. *The Undifferentiated "Form over Substance" Argument*

As noted above, courts have long disregarded the express form of a single transaction when the substance of the transaction did not match the form. In these cases, they have given effect to the substance of the transaction. Calling a transaction a sale does not make it a sale if the transfer in substance is a grant of a security interest to secure repayment of a debt. Thus, a "seller" may transfer a property interest to a "buyer"

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110 *See id.* at 518.

111 *See, e.g.*, Eastgroup Prop. v. S. Motel Assoc., Ltd., 935 F.2d 245, 249 (11th Cir. 1991); *In re* Vecco Constr. Indus., 4 B.R. 407, 408-09 (Bankr. E.D. Va. 1980). In *Eastgroup*, the court upheld a bankruptcy court's order consolidating a debtor corporation that operated a motel and that had many debts and few assets with an affiliated debtor partnership that owned the motel property and had greater assets and fewer debts. The court held that a proponent of substantive consolidation must show that (1) there is a substantial identity between the entities to be consolidated and (2) consolidation is necessary to avoid some harm or realize some benefit. Upon a proponent making a prima facie case for consolidation, the burden shifts to the objecting creditor to show that (i) it has relied on the separate credit of one of the entities to be consolidated and (ii) it will be prejudiced by substantive consolidation. *See Eastgroup*, 935 F.2d at 249. The court cited the following facts: (1) ownership was common; (2) both entities used the same employees and the same physical facilities and employees were paid by only one entity, although they performed services for both; (3) funds were transferred from one entity to the other; (4) one entity paid unsecured debts of the other; (5) substantial defaults in performance of inter-company agreements had no effect on the continuing relationships; (6) confusion existed regarding the question of which entity owns which assets [based on testimony of one witness]; and (7) absent consolidation, majority of creditors [mostly of the operating partnership] will receive only a small portion of their claims, while the equity interest holders [of the partnership] may receive substantial distribution. *See id.* at 250. Finally, the court held that, even though creditors of the less insolvent partnership would be prejudiced by consolidation, those creditors had failed to show that they had relied solely on the separate credit of the partnership. *See id.* at 251-52.

in exchange for the "purchase price" but retain all of the benefits and burdens of ownership. For example, the seller may guarantee the buyer against future losses and retain all of the residual proceeds in excess of the purchase price. In this case, the courts will recharacterize this "sale" as a pledge, and properly so.

Relying on this analogy, some bankruptcy scholars have suggested to me that securitizations should be disregarded because, in their view, a securitization is only a disguised security interest.[112] They argue that the two separate transactions in a securitization—sale of receivables to an SPE and a grant of a security interest in the receivables by the SPE as security for the debt securities—is in substance a grant of a security interest in the receivables by the seller in favor of the securities holders.[113] They note that the seller can retain the economic benefits from the receivables by selling them to a wholly owned SPE subsidiary. For example, assume that originator O sells to a SPE receivables worth $100, and the SPE issues debt securities in the amount of $80. The SPE retains an equity interest in the receivables, and O retains stock in the SPE worth, roughly, $20.[114] Hence, the argument is that the two steps in the securitization—sale by O to SPE and pledge by SPE to investors—should be recharacterized as a simple grant of a security interest by O to the investors.

This simple argument, however, is flawed. First, it only applies for those originators who establish their own wholly owned SPEs. Although this structure is used in many securitizations, many other securitizations involve a sale by an originator to an unaffiliated SPE. The "form over substance" argument does not apply to these securitizations. Hence, successful deployment of the argument would not stop securitizations. It would merely eliminate some of them, and reduce the choices available to originators to obtain money to conduct their businesses.

Also, other securitizations involve a sale to an SPE that is an affiliate of the seller, such as a sister corporation, that is not a direct or indirect subsidiary. In these cases, an affiliate of the SPE—say, the parent of both the originator and the SPE—retains the indirect residual benefit. The "form over substance" argument does not directly apply to

112 *See also* Lupica, *supra* note 6, at 641 (suggesting that bankruptcy judges could use their discretion to find that "securitization transactions are nothing more than extravagant and embellished security interests designed to circumvent the bankruptcy process").

113 *See* Letter from Kenneth J. Kettering, Associate Professor, New York Law School, et al. to Senator Patrick Leahy and Congressman F. James Sensenbrenner (February 5, 2002) [hereinafter Kettering Letter], *available at* http://www.abiworld.org/resources/research/nylawschoolletter.html.

114 In reality, because the financing costs for the SPE are lower as a result of the lower interest rate on the debt securities—taking into account the lack of a bankruptcy premium that O would have to pay—the receivables owned by the SPE, even after taking into account the additional costs of the SPE, will be worth more than they were when owned by O.

these securitizations. To make the argument fit to these securitizations, one would have to collapse two affiliated legal entities into one.

Second, the "form over substance" argument fails to take into account the real economic difference between a direct security interest and the two-step sale and pledge in securitizations. In a direct pledge by an owner of receivables to secure debt obligations of the originator, the creditors of the owner have a claim on all of the owner's assets.[115] If the receivables themselves underperform, and prove to be insufficient to repay the creditors, the creditors will be able to share at least as unsecured creditors in the owner's assets if the owner files for bankruptcy. In the case of a securitization, however, the investors only have a claim on the assets of the SPE, and not the assets of the seller. If the seller becomes a debtor in bankruptcy, the investors will not have claims against the seller.

Third, securitizations are not "disguised" transactions. In the traditional case in which a court will disregard the form of a transaction to give effect to its substance, the parties attempted to disguise the true nature of their transaction to avoid legal rules that they deemed undesirable. Securitizations, however, are transparent. There must be an open, clear true sale in both form and the substance to an SPE.[116] The SPE must be, in both form and substance, a separate legal person.[117] Securitizations are openly and specifically designed to avoid the risks of the bankruptcy of the seller of the receivables and the bankruptcy premium paid on direct secured debt.

Although some may decry this risk avoidance, there is nothing insidious about using existing legal technologies to reduce risk—including bankruptcy risk—in an open manner. There is no basis in the law for disregarding two open and legitimate legal transactions—a true sale of property, and the establishment of a separate legal entity—simply because the combined result might, in some respects, resemble a single step transaction that has different legal consequences. In this regard, a securitization is no different that an individual conducting

[115] The creditors would not have a claim against all of the assets of the owner if the debt were "non-recourse." Non-recourse lending is common in loans secured by real estate. *See, e.g.*, Alan Wayte, *Selected Issues in the Negotiation of Real Estate Financing Documents*, REAL ESTATE FINANCING DOCUMENTATION: COPING WITH NEW REALITIES 57, 59, 73-76 (2003). To my knowledge, it is not used in receivables financing.

[116] The sale must be perfected, and for sales of accounts and chattel paper, perfection requires notice through the filing of a financing statement. *See* U.C.C. § 9-310(a) (2001). Sales of payment intangibles and instruments are perfected upon attachment, and therefore no public notice is given. *See id.* § 9-309(3) & (4). Nevertheless, for all securitizations, to ensure a true sale, the seller must mark its books and records to reflect the sale, the documentation for the sale must use unequivocal language of sale, and the seller must give up control of the receivables except to the extent it retains the rights to service them.

[117] To ensure the separateness of the SPE, the SPE must comply with separateness covenants that ensure that the SPE operates separately from its parent and that it is identified as being a separate legal person. *See supra* note 38 (describing the separateness covenants).

business through a corporation instead of operating as a sole proprietor, or having General Motors Corporation operate an automobile financing business through a separate corporation.

B. *The LTV Bankruptcy*

The bankruptcy of LTV Corporation ("LTV") presented a direct assault on securitization that caused some initial discomfort to the securitization industry but that ultimately proved unsuccessful. In my opinion, the LTV case presents no threat to the firm legal foundations of securitization.

On December 29, 2000, LTV and 48 of its operating subsidiaries, which produced and sold steel products, filed chapter 11 petitions under the Bankruptcy Code.[118] On the same day, LTV sought to repudiate a trade receivables securitization and another transaction that was called an "inventory securitization" that LTV had established in 1994 and 1998. The proffered grounds for repudiating both securitizations were that these transactions were merely disguised secured transactions by the debtors.[119]

Shortly after emerging from a prior bankruptcy in 1993, LTV and several of its subsidiaries securitized the trade receivables generated from the sale of their steel products.[120] LTV created an SPE, LTV Sales Finance Company (the "Receivables SPE"), to purchase the receivables, and LTV and several affiliates entered into a revolving sale agreement providing for the continuous sale of their receivables to the Receivables SPE.[121] The Receivables SPE simultaneously entered into a revolving credit agreement providing for the issuance to investors of notes secured

[118] *See In re* LTV Steel Co., 274 B.R. 278, 280 (Bankr. N.D. Ohio 2001); Voluntary Petition, *In re* LTV Steel Co., 00-43866 (Bankr. N.D. Ohio) (doc. no. 1 filed Dec. 29, 2000); Motion of Debtors and Debtors in Possession for an Order Directing Joint Administration of Related Chapter 11 Cases, at 12-14, *In re* LTV Steel Co., (doc. no. 2 filed Dec. 29, 2000). The docket for the LTV case and the pleadings is accessable through the LTV Corporation web site at http://www.ltvsteel.com (last visited Dec. 27, 2003), which has a link to the "Bankruptcy Docket."

[119] *See In re* LTV Steel Co., 274 B.R. at 280; Emergency Motion for (1) Order Granting Interim Authority to Use Cash Collateral and (2) Scheduling and Establishing Deadlines Relating to a Final Hearing; Memorandum and Points and Authorities at 1-4, *In re* LTV Steel Co. (doc. no. 28 filed Dec. 29, 2000) [hereinafter LTV Emergency Motion].

[120] *See In re* LTV Steel Co., 274 B.R. at 280.

[121] *See* Receivables Purchase and Sale Agreement, dated as of October 12, 1994, among the LTV Corporation, the Sellers Named Herein, LTV Steel Company, Inc., as the Servicer and LTV Sales Finance Company, as the Purchaser, attached as Exhibits H and I to LTV's Emergency Motion, *supra* note 119, at 387-485 [hereinafter LTV Receivables Purchase Agreement]. References to pages for any exhibit to the LTV Debtors Emergency Motion reflects continuous pagination for all of the exhibits to the Emergency Motion.

by the receivables[122] that obtained a rating of AAA from Standard and Poor's,[123] the highest rating for debt securities.[124]

Four years later, two of LTV's subsidiaries established what they called an "inventory securitization." These subsidiaries sold their unfinished inventory to a newly created SPE, LTV Steel Products, LLC (the "Inventory SPE").[125] The Inventory SPE issued debt securities and granted a security interest in the inventory to secure repayment of the debt securities.[126] The Inventory SPE entered into a Servicing Agreement with LTV Steel Company by which LTV Steel Company processed and sold the inventory on behalf of the Inventory SPE.[127]

As discussed below, the inventory securitization played a significant role in the litigation. The inventory securitization was not a typical securitization, although it appears to have been a properly structured consignment.[128] Unlike a securitization of receivables, in which the receivables generate the cash used to repay the securities,[129] this inventory securitization was an attempt to "securitize" operations. Standard and Poor's calls these transactions "hybrid transactions" because they use the securitization structure but the cash flow from the transactions depend heavily upon the activities of an operating company. Accordingly, the rating on the securities depends not on the

122 *See* Revolving Credit Agreement Dated as of October 12, 1994, among LTV Sales Finance Company the Financial Institutions Parties Hereto as Banks, the Issuing Banks, and the Facility Agent and Collateral Agent, attached as Exhibit G to LTV's Emergency Motion, *supra* note 119.

123 *See In re* LTV Steel Co., 274 B.R. at 286.

124 *See supra* note 16 (describing the rating agencies and the ratings).

125 *See* Contribution and Sale Agreement of February 26, 1998, among the LTV Steel Products, LLC, as Purchaser, LTV Steel Company, Inc., as Servicer, LTV Steel Company, Inc., and Georgia Tubing Co., as Initial Sellers, attached as Exhibit A to LTV's Emergency Motion, *supra* note 119.

126 *See* Trust Agreement of February 26, 1998, between LTV Steel Products, LLC and Chase Manhattan Bank, as Collateral Agent, attached as Exhibit C to LTV's Emergency Motion, *supra* note 119. Note Purchase and Letter of Credit Agreement dated as of Feb. 26, 1998 among LTV Steel Products, LLC, certain Note Purchasers, Chase Securities Inc., as Placement Agent, and Chase Manhattan Bank, as Administrative Agent and Collateral Agent, attached as Exhibit D to LTV's Emergency Motion, *supra* note 119 [hereinafter LTV Inventory Note Purchase Agreement].

127 *See* Inventory Processing and Servicing Agreement, dated as of February 26, 1998, among LTV Steel Products, LLC, LTV Steel Company, Inc., as Processor and Servicer, and Chase Manhattan Bank, as Collateral Agent, attached as Exhibit B to LTV's Emergency Motion, *supra* note 119.

128 There was a sale of inventory to the Inventory SPE and a delivery of possession of the inventory to a servicer for processing and sale and retention of title to the inventory by the Inventory SPE. *See, e.g.*, U.C.C. § 9-109(a)(4) & cmt. 6 (2001); U.C.C. § 2-326 (1972) (both discussing consignments).

129 The ownership of receivables requires the servicing of the receivables, that is, the collecting, processing, and accounting for payments by obligors, and pursuing defaulting obligors, and the quality of the servicing will affect the value of the receivables. Nevertheless, the primary value in the receivables is the obligation of the multitude of obligors on the receivables, most of whom voluntarily repay their obligations.

quality of the assets but on the quality of the processor.[130] For this reason, the securities issued by the Inventory SPE obtained a rating of BBB from Fitch Rating Services, Inc.,[131] the lowest of the investment grade ratings[132] and substantially lower than the AAA rating on the securities backed by the trade receivables purchased from LTV.

In 2000, LTV sought relief under the Bankruptcy Code.[133] Unable to obtain a commitment for debtor in possession financing before filing,[134] LTV immediately sought to repudiate the trade receivables securitization and the inventory securitization, recapture the receivables and inventory, and use the cash proceeds of the receivables and the inventory to fund its reorganization efforts.[135] The bases for this emergency motion were the assertions that the securitizations were only "disguised financing transactions" and that the court's failure to allow the use of the cash collateral from the trade receivables and the inventory would "elevate form over substance at a tremendous and tragic cost, including the loss of more than 17,500 jobs and severe economic consequences for the unsecured creditors, shareholders and other parties in interest."[136]

On that very same day, the court entered an interim order permitting the temporary use of the receivables and inventory and setting a hearing on the allegations raised by LTV.[137] The interim order noted the dispute between LTV and the secured lenders to the Receivables SPE and the Inventory SPE (the "SPE Lenders") about whether the transactions between the LTV debtors and the SPEs were true sales or disguised financings.[138] It permitted LTV to use, and it

[130] *See* S&P 2002 LEGAL CRITERIA, *supra* note 21, at 57 (describing these transactions as "hybrid transactions" because they combine techniques of securitization and traditional corporate finance and noting that, in these transactions, "securitization techniques generally cannot effect complete isolation of the credit risk of the operating assets").

[131] *See* LTV Inventory Note Purchase Agreement, *supra* note 126, at 24, 145.

[132] *See supra* note 16 (describing the rating agencies and the ratings).

[133] LTV's summary of the events that lead to the filing appears in the Disclosure Statement, Pursuant to section 1125 of the Bankruptcy Code with Respect to the First Amended Joint Plan of Liquidation for VP Holdings et al., at 15-1. *In re* LTV Steel Co. (doc. no. 6828 filed Nov. 6, 2003) [hereinafter VP Disclosure Statement] (copy on file with the Law Review and the author).

[134] A debtor usually does not have a realistic chance of reorganization if it does not obtain a commitment for debtor in possession financing before filing. *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 784-85 (2002); Marcia L. Goldstein et al., *Current Issues in Debtor in Possession Financing*, at 147, 149 (PLI Comm. L. & Practice Course, Handook Series No. 853 (2003)); David A. Skeel, Jr., *Creditors' Ball: the "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 919, 925 (2003).

[135] LTV's Emergency Motion, *supra* note 119; *see also* VP Holdings Disclosure Statement, *supra* note 133, at 19, 21.

[136] LTV's Emergency Motion, *supra* note 119, at 4.

[137] *See In re* LTV Steel Co., 274 B.R. at 281; Interim Order (1) Authorizing Debtors to Obtain Post-Petition Financing or Use Cash Collateral Pursuant to 11 U.S.C. §§ 105, 361, 363, 364(c)(1), 364(c)(2), 364(c)(3), and 507(b) and (2) Granting Adequate Protection to Pre-Petition Parties, *In re* LTV Steel Co., at 1-5 (doc. no. 41 filed Dec. 29, 2000) [hereinafter Interim Order].

[138] *See In re* LTV Steel Co., 274 B.R. at 281; Interim Order, *supra* note 137, at 2-5.

ordered the SPE Lenders to turn over to LTV, the cash proceeds of the inventory and receivables as working capital for LTV.[139] Nevertheless, the interim order recognized that the bankruptcy court might determine these transactions to be true sales and therefore granted the SPE Lenders administrative expense priority and adequate protection in the form of senior liens on the inventory and receivables and weekly interest payments to the SPE Lenders at pre-petition non-default rates.[140]

The investor in the trade receivables securitization moved for modification of the interim order on several grounds.[141] The receivables investor argued that (1) it did not receive adequate notice of the December 29, 2000 hearing and was thus denied due process of law; (2) there was no basis for the court to determine that the receivables sold by the LTV debtors were property of the debtors' estate; and (3) that the receivables investor's interests were not adequately protected.[142] The debtors countered that the receivables investor received notice of the December 29 hearing, had failed to state adequate grounds to modify the interim order, and had received adequate protection of its interests in the receivables.[143] On February 5, 2001, the court agreed with the debtors and rejected the motion of the receivables investor.[144]

The parties then prepared for a full hearing on the debtors' allegations. This preparation included deposition of officers and representatives of the debtors, the production of documents by the debtors, the filing of briefs by the receivables investor, the filing of an expert report prepared by me concluding that the trade receivables securitization had been properly structured in accordance with industry standards,[145] the filing of amici briefs on behalf of the securitization

[139] *See In re* LTV Steel Co., 274 B.R. at 281; Interim Order, *supra* note 137, ¶ 3, at 5.

[140] *See In re* LTV Steel Co., 274 B.R. at 281; Interim Order, *supra* note 137, ¶¶ 5-10, at 5-7.

[141] *See* Emergency Motion by Abbey National Treasury Services PLC for Modification of Interim Order Entered on Dec. 29, 2000 and Objection to such Order, *In re* LTV Steel Co. (doc. no. 98 filed Jan. 9, 2001); *see also* Memorandum of Points and Authorities in Support of (1) Emergency Motion by Abbey National Treasury Services PLC for Modification of Interim Order Entered on December 29, 2000 and (2) the Objection to such Order, *In re* LTV Steel Co. (doc. no. 180 filed Jan. 9, 2001) [hereinafter Abbey Modification Memorandum]; Memorandum of Points and Authorities (A) in Further Support of Objection by Abbey Nat'l Treasury Serv. PLC to the Interim Order Entered on December 29, 2000, (B) in Opposition to Debtor's Emergency Motion for (1) Order Granting Interim Authority to Use Cash Collateral . . ., *In re* LTV Steel Co. (doc. no. 180 filed Jan. 17, 2001) [hereinafter Abbey Supplemental Memorandum].

[142] *See In re* LTV Steel Co., 274 B.R. at 282; *see also* Abbey Modification Memorandum, *supra* note 141, *passim*; Abbey Supplemental Memorandum, *supra* note 141, *passim*.

[143] *See In re* LTV Steel Co., 274 B.R. at 282.

[144] *See id.* at 287.

[145] *See* Notice of Abbey National Treasury Services PLC of Filing Its Supplemental Memorandum in Opposition to Debtors' Emergency Motion for Final Order Granting Authority to Use Cash Collateral Under Seal, *In re*: LTV Steel Co., (doc. no. 524 filed Feb. 20, 2001); Expert Witness Report of Thomas E. Plank Filed Under Seal, *In re*: LTV Steel Co. (doc. no. 584 filed Mar. 2, 2001).

industry, and other filings on behalf of the inventory investor.[146] As the date for the hearing on the debtors' allegations neared, the debtors, the receivables investor, and the inventory investor entered into a settlement agreement. Under the settlement, the SPE Lenders, among others, agreed to provide debtor in possession financing, the debtor/sellers repurchased the receivables and inventory sold to the two SPEs, and the debtors conceded that the sale of the receivables and inventory had been true sales.[147] On March 20, 2001, the court entered an order approving the terms of the settlement. The court specifically found that the sale of the receivables and the inventory to the two SPEs had been true sales.[148]

The LTV case illustrates the solid legal foundations of securitization. Initially, some viewed the case as a potential problem for securitization, referring specifically to language in the court's published opinion in *In re LTV Steel Company*[149] denying the receivables investor's motion for modification of the interim order. In rejecting the argument that the court lacked jurisdiction over the receivables sold by the debtors to an SPE that was not a debtor, the court remarked:

> Furthermore, there seems to be an element of sophistry to suggest that Debtor does not retain at least an *equitable* interest in the property that is subject to the interim order. Debtor's business requires it to purchase, melt, mold and cast various metal products. To suggest that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept. Accordingly, the Court concludes that *Debtor has at least some equitable interest in the inventory and receivables, and that this interest is property of the Debtor's estate*. This equitable interest is sufficient to support the entry of the interim cash collateral order.[150]

This bare statement that the debtor has some equitable interest in property that purportedly had been sold caused a minor stir in the

[146] Motion for Leave to File a Memorandum on Behalf of Amici Curiae in Opposition to the Debtors' Emergency Motion for an Order Granting Interim and Final Authority to Use Cash Collateral, *In re*: LTV Steel Co., (doc. no. 500 filed Feb. 20, 2001) [hereinafter Motion of Securitization Amici]; Memorandum of Securitization Amici Curiae In Opposition to Debtors' Emergency Motion for (1) Order Granting Interim and Final Authority to Use Cash Collateral, *In re* LTV Steel Co. (doc. no. 502 filed Feb. 20, 2001) [hereinafter Memorandum of Securitization Amici]; Brief of The New York Clearing House Association L.L.C. as Amicus Curiae In Opposition to Debtors' Emergency Motion for (1) Order Granting Interim Authority to Use Cash Collateral, *In re* LTV Steel Co. (doc. no. 507 filed Feb. 20, 2001) [hereinafter Brief of New York Clearing House Association].

[147] Final Order Authorizing Debtors Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364(c)(1), 364(c)(2), and 364(c)(3) to (A) Obtain Post-Petition Financing and (B) Repurchase Certain Inventory, Accounts Receivable and Adequate Protection Claims, ¶¶ 5 at 7-8, 11, at 11, *In re* LTV Steel Co. (doc. no. 734 filed on Mar. 20, 2001), *available at* 2001 WL 1822360 at *4, *6 (Mar. 20, 2001).

[148] *Id.*

[149] 274 B.R. at 280.

[150] *Id.* at 285 (emphasis added).

market[151] and has also given hope to those who criticize securitizations. Nevertheless, this statement does not support an argument that a sale by an originator to an SPE and a secured borrowing by the SPE in a securitization should be recharacterized as a direct secured transaction by an originator.

First, the procedural posture of the court's decision renders this statement irrelevant to a true sale analysis. On the first day of the case, the court had entered the interim order exerting control over the receivables and inventory that the debtor/sellers claimed they still owned. The agent for the receivables investor was present at the hearing. This agent had reached agreement with the debtors regarding the interim order, had negotiated some of the terms of the interim order, and, although not consenting to the order because of the lack of the consent of the receivables investor, did not object to the entry of the order.[152] The receivables investor then sought modification of this interim order. Hence the court did not decide that the seller had an interest in the receivables and inventory sold. It merely decided that there were insufficient grounds to modify the interim order.

Second, the court's statement is a conclusory declaration devoid of analysis. The court did not identify or describe what the debtor's equitable interest consisted of. To be sure, LTV Steel Products, one of the debtors, did have possession of the steel inventory because it was the "servicer" processing the inventory on behalf of the Inventory SPE. This possessory interest is an interest in property, and such a possessory interest has long been a sufficient basis for the bankruptcy court's jurisdiction. In the case of the receivables, LTV Steel Products also was the servicer that collected the payments of the trade receivables. In this regard, it had some control over the receivables, but, as discussed below,[153] this control does not amount to an "equitable interest" in the receivables. Accordingly, it would be difficult to build a strong legal assault on securitization on the basis of the court's conclusory statement.

There is a more plausible explanation of the court's statement. The debtor had made an allegation that the debtor/sellers had not sold the receivables. This allegation, no matter how unsubstantiated, was

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151 *See, e.g.*, *ABS Finds It's By No Means Immune to Market Rumble*, INV. DEALERS' DIG., Mar. 26, 2001; *LTV Decision Shakes Securitization Industry*, BANKR. CT. DEC., Mar. 27, 2001, at 1; *Section 912: "Good Law,"* 37 BANKR. CT. DEC. 1 (Mar. 27, 2001); *Section 912: "Potentially Evil,"* 37 BANKR. CT. DEC. 4 (Mar. 27, 2001); Barbara M. Goodstein, *How Secure Are Your Securitizations? LTV Case Raises Important Issues for Creditors*, BANKR. STRATEGIST, April 2001, at 1; Alexandra Dill & Letitia Hanson, *True Sale Assailed: Implications of In re LTV Steel for Structured Finance* (Special Report, Moody's Investors Service 2001).

152 *See In re* LTV Steel Co., 274 B.R. at 281.

153 *See infra* Part III.C.2.b (explaining why a servicer who collects receivables has no property interest in the receivables and only a possessory interest in collections in its possession in trust for the benefit of the owner of the receivables).

sufficient to confer jurisdiction on the bankruptcy court to adjudicate the allegation.[154] The most that can be made out of the court's decision is that an allegation of a property interest confers on the court sufficient jurisdiction to enter an interim order regarding the property interest until final resolution after a full trial.

The third factor that neutralizes any threat from the LTV case to securization is the presence of the "inventory securitization." The "inventory securitization," which is not a true securitization,[155] provided the fuel for the initial allegation by the LTV debtors that the securitization of trade receivables was a disguised secured transaction. Specifically, the debtors' initial cash collateral emergency motion used the features of the "inventory securitization" to paint the sale of both the inventory and the receivables to the SPEs and the granting of security interests in the SPEs to the inventory and receivables investors as sham transactions.

For example, the debtor alleged that the purchase price of the inventory was not fair market value because it was based on a formula that it did not equal the fair market value when sold to third parties.[156] In light of the depression in steel prices as the result of substantial increases in supply from foreign sellers, this allegation is plausible on its face.

The debtors then appended to this allegation the following statement: "The pricing of accounts [sold] . . . are similarly arbitrary and unrelated to the fair market value of the Receivables."[157] This statement is false. Although the formula for the pricing of the receivables appears to be daunting for those not familiar with the pricing of trade receivables, the basic concept is relatively simple. Buyers and sellers of trade receivables, which do not bear interest, determine the fair market value of trade receivables by subtracting two components from the amount due on the receivable: (1) a discount to reflect the time value of money, and (2) a discount to reflect the risk of non-payment by the obligor.

[154] *See infra* note 222 (quoting 28 U.S.C. § 157 (2000) (specifying the bankruptcy court's jurisdiction over property of the estate)); *see also* Cambridge Co. v. Cotton (*In re* Trafficwatch), 138 B.R. 841, 842 (1992) (finding that the bankruptcy court had jurisdiction to determine its own jurisdiction) (citing United States v. United Mine Workers of Am., 330 U.S. 258, 291-92 (1947)); Inv. Materials Corp. v. First Interstate Bank of Nev., 1999 U.S. App. LEXIS 16297, at *4-*5 (9th Cir., July 15, 1999) (finding that the bankruptcy court's core jurisdiction was invoked because it had to determine to whom the disputed assets belonged, the debtor or the non-debtor). Of course, if the debtor had no interest in the receivables transferred by the debtor, the receivables would not be part of the bankruptcy estate and the court would not have jurisdiction over those receivables, but the court would not know if it had jurisdiction until it decided the legal question being presented. This is not a new problem.

[155] *See supra* note 130 and accompanying text (explaining the difference between a hybrid transaction and a true securitization).

[156] *See* LTV's Emergency Motion, *supra* note 119, at 7.

[157] *See id.*

Because trade receivables, like the receivables in LTV, do not bear interest, the discount to reflect the time value of money will reflect both the amount of time during which the receivables are expected to remain outstanding and the interest rate—the yield—that the buyer expects to earn. For example, assume that a buyer is thinking of buying a receivable in the amount of $100 nominally payable in 60 days. If the buyer wants a yield of 12 percent per annum on its investment and expects (based on historical experience) that the obligor will pay in two months, the buyer will determine that the present value of the receivable on the date of purchase equals $100 less approximately $2 if there is no default.[158] If the obligor pays faster, say in 30 days, the buyer will be better off, since it will have received a higher annual yield of approximately 24 percent.[159] If the obligor pays more slowly, say in 90 days, then the buyer will have received a lower yield on its investment than it expected, approximately eight percent.[160] Accordingly, the purchase price and the fair market value of a trade receivable will incorporate an estimate of the uncertain maturity date and the current interest rate environment.

In addition, in any receivable there is a risk that the obligor will not pay. The buyer will estimate this risk and subtract the present value of this risk from the amount it is willing to pay for the receivable. For example, if the buyer expects that there is a one percent chance that the obligor will not pay, the buyer would also subtract approximately $1 from the face amount. Based on these determinations, this buyer would pay approximately $97 for the receivable.

In the case of the sale of receivables to the Receivables SPE in LTV, as in the case of the continuous sale of other trade receivables,[161]

[158] The discount is not exactly two dollars because it is a discount from the future value. The discount is the amount of interest at a specified rate that would be earned on the present value of the receivable at the discount rate to produce the future value. The formula for the future value is $FV = (1+i)^n * PV$, and the formula for the present value is $PV = FV/(1+i)^n$, where, in each case, PV is the present value, i is the periodic rate of interest, n is the number of periods, and FV is the future value. *See* C. STEVEN BRADFORD & GARY ADNA AMES, BASIC ACCOUNTING PRINCIPLES FOR LAWYERS 113 (1997). Hence, if the periodic interest rate is one percent per month, and the total periods are two months, the present value of the sum of $100 payable in two months at an annual discount rate of twelve percent equals $\$100/(1.01)^2$, which equals $100/1.0201, or $98.03.

[159] The yield is determined by the following formula: $i = (FV/PV)^{1/n} - 1$. Hence, the monthly yield is $(100/98.03) - 1$, which equals $1.0201 - 1$, which equals 0.0201, or 2.01% a month, which is an annual yield of 24.12%, more than twice the yield that the buyer expected.

[160] Again, using the formula: $i = (FV/PV)^{1/n} - 1$, the monthly yield is $(100/98.03)^{1/3} - 1$, which equals $1.006654 - 1$, which equals 0.006654, or 0.6654% a month, which is an annual yield of 7.99%, about one third less yield than the buyer expected.

[161] For example, in the Jefferson Smurfit Finance Company receivables securitization in Mar. 1995, described in *Standard and Poor's Structured Finance Ratings, Asset Backed Securities, Trade Receivables Criteria* 61-62 (undated), the transfers of the eligible receivables were "structured to be true sales in which the purchase price is discounted by a loss and carrying cost component. The discount applied is designed to reflect a current expected loss number and a real interest and carrying cost for the financing to ensure that each sale is a true sale." *Id.* at 66.

the formula set the price for the purchase of each batch of receivables based on historical factors. This formula was not arbitrary because it was based on the factors that the financial industry uses to price financial assets of this type. For each batch of receivables purchased during a monthly period, the purchase price reflected the expected discount rate and losses, as well as the other costs of and a profit for the Receivables SPE, determined by using the historical data for receivables previously purchased.[162] This formula produced a purchase price that reflected the fair market value of the receivables. Although the LTV debtors may have been able to argue that the formula was complicated, they could not, like they did in the case of the sale of inventory, point to elements in the formula that appeared on its face to be arbitrary and unrelated to fair market value. The LTV debtors simply used the pricing formula for the inventory to mislead the court about the nature of the pricing formula for the receivables.

The debtors made other allegations to challenge the true sale by the debtor/sellers of the inventory. These included allegations that:

> (1) The debtor/sellers of the inventory did not receive the purchase price in cash.[163]
>
> (2) LTV Steel Company's servicing fees were paid not in cash but in the form of subordinated notes of the Inventory SPE that were not payable until after the inventory investors had received repayment of moneys lent to the Inventory SPE.[164]

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[162] The LTV Receivables Purchase Agreement provided that the Purchase Price for the Receivables equals the Original Balance of the Receivables times the Purchase Price Percentage. *See* LTV Receivables Purchase Agreement, *supra* note 121, at 476. The Purchase Price Percentage, which applies to purchases that occur on or after each Settlement Date—the twentieth day of each calendar month (or the next following business day, if the twentieth is not a business day), *see id.* at 480, is one hundred percent minus the sum of (i) the Loss Discount Ratio and (ii) the Purchase Discount Rate Reserve Ratio. *See id.* at 476. The first deduction, the Loss Discount Ratio, represents the ratio of (a) losses on the Receivables realized during the three calendar months preceding the Settlement Date to (b) the total collections received during the same preceding three months. *See id.* at 469- 470.

The second deduction is the Purchase Discount Rate Reserve Ratio. This ratio reflects the expected term of the Receivables, the cost of funds, the cost of operations (all based on information that precedes the calculation of the Purchase Price Percentage), and a profit amount. *See id.* at 475-76 (defining the "Purchase Discount Rate Reserve Ratio"). The expected term of the Receivables is determined by calculating the "Turnover Days," that is, the average number of days from the creation of the Receivable to the payment of the Receivable, for Receivables previously sold. *See id.* at 482. The expected cost of funds and cost of operations are those costs of the Purchaser for the calendar month preceding the Settlement Date. *See id.* at 454 (defining the "Discount Rate"); *id.* at 452 (defining "Cost of Funds Rate"); *id.* at 449 (defining "Carrying Cost Percentage"). The profit discount provides a cushion to protect the Purchaser from the risks that the historical losses on the Receivables, historical turnover, historical interest rates, and historical cost of operations used in calculating the Purchase Price will increase. On the other hand, to the extent that these historical losses, turnover, interest rates, and costs of operations used in calculating the Purchase Price decrease, the Purchaser will make a greater profit.

[163] *See* LTV's Emergency Motion, *supra* note 119, at 7.

[164] *See id.* at 7, 14-15.

> (3) To satisfy the requirement that the Inventory SPE maintain at least $10 million in equity, $300 million in subordinated debt held by its parent, LTV Steel Company, was converted to capital contributions (perhaps necessitated by the inability of the Inventory SPE to sell steel products for an amount equal to or greater than the price at which it purchased the inventory plus the servicing fees of the inventory processor).[165]

Based on these allegations, the performance and warranty obligations of the related debtor/sellers of both the inventory and receivables,[166] and the use of subordinated notes by the Inventory SPE, the debtors misleadingly stated: "The net effect is that the economic risk associated with the sale of inventory and *collection of accounts* remains with the Debtors, notwithstanding their purported 'sale' of the inventory and *accounts*."[167] Whatever force these allegations may have had to challenge the true sale of the inventory, this characterization of the transfer of the receivables was absolutely false.

The debtor/sellers continued in this vein by stating that the debtor/sellers maintained dominion and control over the inventory and accounts.[168] To support this statement, the debtor/sellers alleged that LTV Steel Company, one of the debtor/sellers and the inventory servicer, performed all of the business functions of the inventory debtor/sellers. These included "inventory processing (i.e., manufacture) of raw materials into saleable products; storage and safekeeping of the inventory; transportation; and marketing and sale of the products."[169] The debtors, however, did not claim that the servicer of the receivables retained control over the receivables in a manner inconsistent with a sale of the receivables.

The alleged use of subordinated notes by the Inventory SPE, the alleged conversion of $300 million of subordinated notes into capital contributions to the Inventory SPE, and the possession, control, and processing of the inventory by one of the debtor/sellers, as a matter of appearances, creates questions about the nature of the transfer of the inventory. Whether these allegations, if true, would be sufficient to establish that there was no true sale of the inventory requires a detailed analysis of the substance of the transaction. This analysis would have to take into account all the other factors used in determining whether there had been a true sale, such as whether, on balance, the risks and rewards of ownership had been transferred to the Inventory SPE or had been

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165 *See id*. at 8, 15.

166 *See id*. at 8-9, 14, 16. The warranty and performance obligations of the debtor/sellers of receivables to the Receivables SPE are completely consistent with a true sale of the receivables and provide no basis for challenging the receivables securitization. *See infra* note 160.

167 *See* LTV's Emergency Motion, *supra* note 119, at 9 (emphasis added).

168 *See id*.

169 *See id*. at 9-10.

retained by the sellers. None of these allegations, however, were relevant to the transfer of the receivables.[170] The debtor/sellers misleadingly attempted to tar the sale of the receivables with those aspects of the transfer of the inventory that appeared to be inconsistent with the sale of the inventory.[171]

For the most part, the debtor/sellers' argument seemed to be limited to a simple argument that the initial transfer to the SPEs—the first step—was not a true sale but a disguised grant of a security interest to secure repayment of a debt.[172] The debtor/sellers, however, broadened their attack in a way that suggests that the entire

[170] The LTV debtors alleged that the debtor/sellers' obligations to indemnify the Inventory SPE and the Receivables SPE for the debtor/sellers' failure to perform their obligations or for breach of warranties regarding the inventory or receivables sold indicated that the transfers were not true sales of the inventory or the receivables. *See* LTV's Emergency Motion, *supra* note 119, at 8, 9, 14, 16. These allegations are completely without foundation in the case of the sale of the receivables. Because the receivables sold to an SPE are the source of payment for the securities issued by an SPE, investors and rating agencies generally require the seller of the receivables to make detailed warranties about the receivables. If such warranties are incorrect, the seller generally agrees to repurchase any receivables that do not conform to the warranties or otherwise to indemnify the SPE/purchaser for losses arising from a breach of warranties. The seller also often agrees to indemnify the SPE/purchaser for any actions or failures to act for which the seller is responsible that cause damages to the SPE/purchaser. In the case of trade receivables, indemnification obligations normally cover pricing disputes with customers/obligors, the sale of defective goods to customers/obligors, the return by customers/obligors of products sold, any discounts or adjustments from the stated balance of the receivable that the seller might grant to the customers/obligors, other acts that give rise to a defense or claim in recoupment by the obligor of the receivable that the obligor could set off against the amount due on the receivable, and other activities of the seller that might cause liability to the SPE/purchaser. These actions might cause a reduction in the principal balance of the receivable—generally known as dilution—for reasons other than the inability or failure of the obligor to pay the receivable. It is appropriate for sellers to retain this dilution risk because the risk arises out of actions by the seller. In the LTV case, each seller made these normal warranties about itself and the receivables. *See* LTV Receivables Purchase Agreement, *supra* note 121, § 3.01, at 401-05; *id.* at 456-57, 497 (defining "Eligible Receivable" and "Noncomplying Receivable"). The representations and warranties do not include any representations or obligations guaranteeing the ability of the obligors to pay the receivables or the yield to the purchaser. Because they relate to the nature of the receivables at the time of the sale or to the actions that the sellers took with respect to the receivables, they are not inconsistent with a true sale of the receivables. *See* S&P 2002 LEGAL CRITERIA, *supra* note 21, at 93-94; Plank, *True Sale*, *supra* note 75, at 306.

[171] *See* LTV Emergency Motion, *supra* note 119, at 10.

[172] In this regard, the debtor/sellers also made additional allegations that LTV Steel, as the owner of the two SPEs, failed to treat the SPEs as separate entities. *See id.* at 11. The debtor/sellers, however, did not provide any evidence to support these allegations, and the evidence produced during discovery showed that the SPEs were indeed operated as separate entities. The debtor/sellers also argued that the filing of a financing statement by the debtor/sellers in favor of the Inventory. SPE indicated an intent to treat the transfer of the inventory as a grant of a security interest for security and not as a true sale. *See id.* at 12. This argument is silly. The filing was no doubt a precautionary filing to protect the Inventory SPE against a court's re-characterization of the transfer as a grant of a security interest and not as the intended sale. Further, to the extent that the inventory servicer's retention of possession could be considered a consignment by the Inventory SPE, such a filing would be necessary to protect the Inventory SPE's ownership interest from claims of creditors. *See, e.g.*, U.C.C. § 9-109(a)(4) & cmt. 6 (2001); *id.* § 2-326 (1972) (both discussing consignments).

securitization structure should be collapsed. They specifically pointed to the fact that LTV Steel was the 100 percent owner of the Inventory SPE and the Receivable SPE.[173] They argued that all of the excess economic benefit generated from the accounts and inventory flowed to the debtor/sellers, and that the debtor/sellers, not the two SPEs, were "ultimately entitled to any surplus" from the sale of inventory and collection of accounts.[174] They accordingly argued that the securitizations should be treated as a loan, and not a sale of the inventory and accounts.

For this reason, it is unclear whether LTV's attack was based on the argument that the sales to the SPEs were simply disguised pledges or the broader argument that the court should disregard the securitizations on the grounds of economic substance over form. In any event, the peculiar facts surrounding the inventory securitization enabled the LTV debtor/sellers to throw sufficient dust in the eyes of the bankruptcy judge to impede a clear understanding of the trade receivables securitization. The bankruptcy court faced a very real prospect that LTV's liquidity crisis might well cause the imminent loss of jobs by 17,500 workers. Given these peculiar facts, and the acquiescence of the agent for both the receivables investor and the inventory investor, it is not surprising that the court entered the initial interim order. Nor is it surprising that the court rejected the receivables investor's attempt to modify the interim order pending a full hearing on the question of whether there had been a true sale of the inventory or the receivables.

Without the peculiar facts pertaining to the inventory securitization, I believe that the debtors would have had a much more difficult task—if not an impossible task—in convincing the court to enter an interim order allowing the debtor/sellers to recapture the proceeds of receivables that they had sold. Moreover, as the expert witness for the receivables investor who analyzed the documents and facts developed in discovery, I believe that the receivables securitization was properly structured, that there was no legal or factual basis for recharacterizing the sale of the receivables to the Receivable SPE as a pledge to secure a loan, and that there were no grounds for substantively consolidating the Receivable SPE with its parent, LTV Steel Company, one of the sellers. In addition, as pointed out by the industry groups who filed amici briefs, LTV's attempt to repudiate a properly structured securitization to save 17,500 jobs would have had the effect of destroying an industry that provided trillions of dollars of lower cost financing to many borrowers, including LTV and other steel

[173] *See* LTV's Emergency Motion, *supra* note 119, at 10.
[174] *See id.* at 16.

companies.[175] Therefore, it is my firm conviction that, had the matter gone to a full hearing, the court would have, however reluctantly, ruled that there had been a true sale of the receivables.[176] In any event, the unusual circumstances of this case, the ramifications of a final repudiation of the receivables securitization, and the parties' agreement and the court's final determination that the transfers of the inventory or the receivables were true sales eliminate *In re LTV Steel Co.* as a legal threat to securitization.

C. *David Carlson's Assault on Securitization*

1. A Rhapsody on *Whiting Pools* and the Sale-Lien Distinction

In 1998, David Carlson wrote an article, blandly entitled *The Rotten Foundations of Securitization*,[177] arguing that, under the language of the Bankruptcy Code and its policy favoring reorganization, "securitization's right to exist may be sharply questioned."[178] Professor Carlson admits that his analysis may be perceived as "rarified."[179] His analysis also can be seen as a rhapsody[180] on the Supreme Court's decision in *United States v. Whiting Pools*.[181] I of course disagree with his conclusion and with the analysis that Professor Carlson presents in *Rotten Foundations*. In particular, I think his reliance on *Whiting Pools* dooms his argument.

I have made a mini-career criticizing *Whiting Pools*.[182] The Court

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175 Motion of Securitization Amici, *supra* note 146, at 1-2 (identifying as the "Securitization Amici" several steel companies who sell asset-backed securities to fund their operations, issuers of asset-backed securities, trade associations, investors, and underwriters); Memorandum of Securitization Amici, *supra* note 146, at 17-18, 20 (stating that accepting "LTV's extreme legal arguments and disregarding the structure of the LTV transactions could cause a seismic disruption in the capital markets" and LTV's motion "is an attack on a major funding technique that benefits manufacturers, consumers, investors, and creditors alike"); Brief of The New York Clearing House Association, *supra* note 146, at 4 (noting that LTV's motion would sacrifice the form of financing that successfully aided its earlier rehabilitation and adversely affect thousands of companies with millions of employees as well as millions of investors).

176 I did not perform a legal and factual analysis of the inventory securitization. Some of the allegations of the debtors raise issues about the nature of the transfer of the inventory to the Inventory SPE and its separateness. Nevertheless, given the debtors' failure to produce any evidence to support their allegations about the nature of the sale of the receivables, I am skeptical that the debtors could ultimately convince the court to recharacterize the sale of the inventory.

177 *See* Carlson, *Rotten Foundations*, *supra* note 8.

178 *See id.* at 1065.

179 *See id.* at 1060.

180 *See, e.g.*, THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 1650 (2d ed. 1987) (defining "rhapsody" as "an ecstatic expression of feeling or enthusiasm").

181 United States v. Whiting Pools, Inc., 462 U.S. 198 (1983).

182 *See, e.g.*, Thomas E. Plank, *The Creditor in Possession Under the Bankruptcy Code: History, Text, and Policy*, 59 MD. L. REV. 253, 255-58, 301-05, 310-11, 339-44 (2000)

used poor legal reasoning and relied on extremely dubious legislative history while ignoring direct legislative history that would have demanded the opposite conclusion. Despite its weaknesses, and the Court's later repudiation of its analysis of the definition of property of the estate in *Citizens Bank of Maryland v. Strumpf*,[183] *Whiting Pools* is still with us. Nevertheless, as poor an example of judicial craftsmanship as it is, one can justify the result in *Whiting Pools* in a way that rescues the Court from embarrassment. In any event, *Whiting Pools* offers no threat to securitization.

Whiting Pools, Inc., had failed to pay approximately $92,000 in federal taxes withheld from employees. To obtain payment, the Internal Revenue Service seized all of Whiting Pools' personal property pursuant to the Federal Tax Lien Act[184] to collect the unpaid taxes.[185] Whiting Pools then filed a chapter 11 petition in bankruptcy and as debtor in possession sought an order under § 542(a) of the Bankruptcy Code directing the IRS to return the seized goods to the debtor in possession to enable it to reorganize.[186] The Supreme Court held that § 542(a) authorized a bankruptcy court to direct a creditor—here, the IRS—in rightful possession of tangible property items pending a foreclosure sale to return the seized items to the bankruptcy trustee, here Whiting Pools as debtor in possession.[187]

Section 542(a) in essence requires that any person in possession or control of property of the estate return that property of the estate to the bankruptcy trustee.[188] The purpose of § 542(a) was to codify the judge-made law of turnover under the Bankruptcy Act of 1898.[189] Property of the estate means "all legal or equitable interests of the debtor in

[hereinafter Plank, *Creditor in Possession*] (criticizing the Court's failure to follow the statutory language of the Bankruptcy Code, its use of weak legislative history and its ignorance of direct, contrary legislative history and its too general policy analysis); Plank, *Bankruptcy Estate*, *supra* note 50, at 1196-97, 1234-63 (critiquing the Court's analysis in *Whiting Pools* and its effect on the interpretation of property of the estate under § 541(a)(1) and explaining why it should no longer be considered good law).

183 516 U.S. 16 (1995).

184 26 U.S.C. §§ 6321-34 (1976).

185 *See Whiting Pools*, 462 U.S. at 200-01.

186 *See id.*

187 *Id.* at 209.

188 *See* 11 U.S.C. § 542(a) (2000), which requires an entity "in possession, custody, or control . . . of property that the trustee may use, sell, or lease under [§] 363" to deliver that property to the trustee. Pursuant to the relevant subsections of § 363, the trustee "may use, sell, or lease property of the estate." *See supra* note 52 (quoting § 363(b)(c)). Section 363(f) also authorizes a trustee under certain circumstances to sell property items in which the estate and another entity have an interest, *see infra* note 239 (quoting § 363(f)), but this subsection did not apply in *Whiting Pools* because the debtor in possession did not want possession to sell the goods. *See Whiting Pools*, 462 U.S. at 203-04; *see also* Plank, *Creditor in Possession*, *supra* note 182, at 320-23 (describing how § 542(a) and § 363(f) authorizes a turnover order for certain items in possession of a creditor for purpose of allowing the trustee to liquidating the items).

189 *See* Plank, *Creditor in Possession*, *supra* note 182, at 264-65, 302-03.

property,"[190] not the property item in which the debtor has an interest. In *Whiting Pools*, the debtor's interest in the goods seized by the IRS consisted of its "equity interest", that is, its legal title (subject to loss of title upon foreclosure),[191] its right to redeem the security interest by paying the secured debt,[192] its right to notice before any foreclosure sale,[193] and its right to any surplus from the foreclosure sale of the goods.[194] The IRS did not have possession, custody or control over these rights. Whiting Pools' interests, however, emphatically did not include the right to possess or use the goods. Accordingly, under the language of §§ 542(a), 363(b), (c), and 542(a)(1), the IRS was not required to return the goods.

Nevertheless, the Court held that Congress intended § 542(a) to require a creditor in rightful possession of repossessed goods to return them to the trustee and to rely on its right to adequate protection. It relied in part on the legislative history:[195] the appearance of § 542(a) in the major redraft of the bill that eventually became the Bankruptcy Code after four witnesses testified that the prior draft of the bankruptcy bill did not have a provision requiring the avoidance of what one witness termed a "preferential possession."[196] Unfortunately, the Court missed direct legislative history that, as enacted, § 542(a) required the return of property acquired by the estate *after* the filing of the bankruptcy petition that was in the possession or control of third person:

> Section 542(a) of the House amendment modifies similar provisions contained in the House bill and the Senate amendment treating with turnover of property to the estate. The section makes clear that any entity, other than a custodian, is required to deliver property of the estate to the trustee or debtor in possession whenever such property is *acquired by the entity during the case*, if the trustee or debtor in possession may use, sell, or lease the property under section 363 . . . .[197]

[190] *See supra* note 61 (quoting § 541(a)).

[191] *See Whiting Pools*, 462 U.S. at 209-11; *see also infra* note 217 and accompanying text (describing *Whiting Pools*' analysis of the IRS's interests and a creditor).

[192] *See* I.R.C. § 6342(b) (1976) (authorizing an owner to redeem the IRS's lien on the goods by paying the amount of taxes due).

[193] *See id.* § 6335(b).

[194] *See id.* § 6342(b).

[195] *See Whiting Pools*, 462 U.S. at 207-08 & n. 16.

[196] *See Hearings on H.R. 31 & H.R. 32 Before the Subcomm. on Civil & Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong. 439 (pt. 1) (1975-76) (prepared statement of Patrick A. Murphy that in a reorganization case "the legislation should expressly deal with the question of when and under what standards displacement of the secured creditor [in possession] or its agent should be permitted" and suggesting the concept of "preferential possession" as a further refinement, that is, distinguishing between a pledgee and a creditor repossessing after default); *id.* at 489-92 (testimony of Patrick Murphy to the same effect; also stating that a creditor need not return property in a liquidation).

[197] *See* 124 CONG. REC. H11089 (Sept. 28, 1978) (statement of Don Edwards, Upon Introducing the House Amendment to the Senate Amendment to H.R. 8200), *reprinted in* 1978

In any event, the Court reasoned that Congress intended to encourage reorganization of debtors, and that, to do so, Congress had displaced creditors' state law remedies of foreclosure with the requirement of adequate protection of the secured creditor or lien creditor.[198]

I believe that the Court's analysis is wrong. It ignores the language of the statute in favor of vague policy considerations, and its use of legislative history is pitiful. There is, however, a basis for justifying the Court's conclusion: the simple exercise of the Court's power to make federal common law.[199]

The Supreme Court has stated in *Butner v. United States*[200] and *Raleigh v. Illinois Department of Revenue*[201] that, in the absence of an important federal interest, federal courts in bankruptcy should respect the state law entitlements of creditors. Accordingly, the Court held in *Butner* that a bankruptcy court should apply the relevant state law on when a mortgagee obtained a property interest in rents from the mortgaged property and not create a federal rule of equity.[202] It more recently held in *Raleigh* that a bankruptcy court should apply the state law allocating burden of proof of a creditor's claim and not apply a federal rule reversing that burden of proof.[203] Nevertheless, these statements and holdings contain an important caveat: If necessary to vindicate an important federal interest, bankruptcy courts may create a federal rule that overrides the state law rights of creditors when the Bankruptcy Code is silent. Indeed, courts have done so under the Bankruptcy Code and the Bankruptcy Act of 1898.[204]

In *Whiting Pools*, the Court was faced with an issue for which

U.S.C.C.A.N. 6436, 6455 (emphasis added); *see also* 124 CONG. REC. S17406 (Oct. 6, 1978) (statement of Dennis DeConcini, Upon Introducing the Senate Amendment to the House Amendment to H.R. 8200), *reprinted in* 1978 U.S.C.C.A.N. 6505, 6525 (same).

198 *See Whiting Pools*, 462 U.S. at 203-04, 207.

199 *See also* Charles J. Tabb, *The Bankruptcy Reform Act in the Supreme Court*, 49 U. PITT. L. REV. 477, 507-14 (1988) (suggesting that the Court should have acknowledged that the statute did not accomplish Congress's intent to provide for the return of repossessed property items and should have declared that the Bankruptcy Code provided for that turnover).

200 440 U.S. 48, 55 (1979).

201 530 U.S. 15, 20 (2000).

202 *Butner*, 440 U.S. at 55.

203 *Raleigh*, 530 U.S. at 20.

204 For example, the power of the trustee to reject or assume executory contracts, *see* 11 U.S.C. § 365 (2000), first added to the Bankruptcy Act of 1898 in 1938, *see* Act of June 22, 1938, ch. 575, § 1, 52 Stat. 840, 880-81 (amending Bankruptcy Act of 1898, ch. 541, § 70(b), 30 Stat. 544, 565-66) (codified as amended at 11 U.S.C. § 110(b) (1976)), originated with decisions of federal bankruptcy courts. *See* Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection*,*"* 59 U. COLO. L. REV. 845, 856-62 (1988). Similarly, the power of the bankruptcy trustee to abandon burdensome or inconsequential property of the estate, *see* 11 U.S.C. § 554 (2000), first codified with the enactment of the Bankruptcy Code, originated in judicial decisions under the Bankruptcy Act. *See* Midlantic Nat'l Bank v. N.J. Dep't of Envtl. Prot., 474 U.S. 494, 500-01 (1986) (describing the history of the abandonment power).

there was no direct answer. As I have explained elsewhere, the Bankruptcy Code does expressly provide for turnover by creditors in possession of property items owned by the debtor in three circumstances: redemption, sale under § 363(f), and turnover pursuant to a confirmed reorganization plan.[205] For a debtor who has no equity in property items that are necessary for reorganization, the first two are not practical for a reorganizing debtor in possession.[206] Turnover pursuant to a plan would entail a delay until confirmation. Such delay may not be helpful for a debtor trying to stay in business while it prepares a plan, solicits approval, and obtains confirmation. Meanwhile, the automatic stay against acts to collect a debt—not the stay against acts to control property of the estate—prevents the creditor in possession from foreclosing.[207] Faced with this standoff, the Court could have legitimately determined to create a federal bankruptcy common law rule requiring the creditor to return the property items before redemption, sale, or confirmation of the plan when possession was necessary for reorganization.

Accordingly, one can view *Whiting Pools* either as the creation of a federal bankruptcy common law rule or as a poor interpretation of §§ 542(a) and 541(a)(1) of the Bankruptcy Code. Under the latter interpretation, *Whiting Pools* can be read as extending the definition of property of the estate: when a debtor retains an equity of redemption in a property item, the entire property item—or at least the creditor's right to possession—is part of property of the estate. This latter interpretation flies in the face of a statutory scheme that defines property of the estate quite specifically as the debtor's interest in property[208] and—with few exceptions—uses that definition consistently throughout the Bankruptcy Code.[209] Unfortunately, many courts have followed this cartoon version of property of the estate.[210] Even so, the

[205] *See* Plank, *Creditor in Possession*, *supra* note 182, at 261, 319-26.

[206] In the case of redemption, the debtor must pay the full amount of the debt, which by definition exceeds the value of the collateral. In the case of turnover for liquidation, the collateral must be sold for an amount that exceeds the creditor's claim. *See id.* at 319-23.

[207] *See supra* note 50 (quoting the provisions of the automatic stay, 11 U.S.C. § 362(a)(3) & (6) (2000)); Plank, *Bankruptcy Estate*, *supra* note 50, at 1263-66 (describing why a foreclosure action by a creditor is an act to collect a claim, is not a act to control property of the estate, but may be an act to obtain possession of property from the estate).

[208] *See supra* note 61 (quoting § 541(a)).

[209] *See generally* Plank, *Bankruptcy Estate*, *supra* note 50, at 1216-34 (describing the drafting history of the provisions of the Bankruptcy Code defining and using property of the estate and the consistent use of the definition of property of the estate and of property in the Bankruptcy Code).

[210] *See, e.g.*, Knaus v. Concordia Lumber Co. (*In re* Knaus), 889 F.2d 773, 775 (8th Cir. 1989) (citing *Whiting Pools* for the erroneous proposition that "property seized but not yet sold before the filing of the bankruptcy petition is property of the estate"); Plank, *Bankruptcy Estate*, *supra* note 50, at 1267-80 (analyzing cases citing *Whiting Pools* for the proposition that the property of the estate consists of the property item in which a creditor has an interest instead of the analyzing the debtor's interest in the property item, as required by § 541(a)(1)).

important feature of *Whiting Pools* under either interpretation is that the case is limited to a property interest of a debtor in relation to a property interest of a secured creditor of the debtor.

In his analysis of *Whiting Pools*, Professor Carlson does not rely on the cartoon version of property. Instead, he relies on the fact that the debtor's equity was valueless: "*Whiting Pool*, then, grounds bankruptcy jurisdiction on valueless, or mere hypothetical, property interests."[211] From this proposition, Professor Carlson makes a further leap: "If a bankruptcy trustee can fathom any legal connection between the debtor and a thing, the thing may be expropriated for the benefit of the unsecured creditors."[212] The flaw in this statement is that *Whiting Pools* cannot be read for such a broad proposition. At most, *Whiting Pools* stands for this proposition: "If a bankruptcy trustee can fathom any *equity interest by a debtor in* a thing *in which a creditor has a security interest*, the thing may be expropriated *from the creditor* for the benefit of the unsecured creditors."[213] Under any interpretation, *Whiting Pools* only alters the nonbankruptcy law entitlements of creditors against a debtor who retains well-recognized property interests in property items—the debtor's equity interest—even if they are valueless. This limitation is consistent with the whole history of the law that has sought to protect debtors even when their equity interest is "valueless."[214]

Whiting Pools expressly limits its expansion of the bankruptcy trustee's power to the creditor's interest: "We conclude that the reorganization estate includes property of the debtor that has been seized by a creditor prior to the filing of a petition for reorganization."[215] The Court emphasizes this limitation in its analysis of why its holding applied to the IRS: "We see no reason why a different result should obtain when the IRS is the creditor."[216] The Court continues: "Of course, if a tax levy or seizure transfers to the IRS ownership of the property seized, § 542(a) may not apply."[217] One might argue that the Court deliberately used the word "may" to leave room for Professor's Carlson's extension of *Whiting Pools* beyond the

211 *See* Carlson, *Rotten Foundations*, supra note 8, at 1078.

212 *See id.*

213 *See id.* with my modifications italicized.

214 *See, e.g.*, U.C.C. §§ 9-620, 9-621, 9-620 & accompanying comments. (imposing significant restrictions on when and how a secured creditor may use strict foreclosure, that is, may accept the debtor's interest in the collateral in satisfaction of the secured debt); NELSON & WHITMAN, *supra* note 66, §§ 7.9-7.10, at 554-58 (noting that in most states, strict foreclosure of a mortgagor's interest is not permitted, and that it is only used in a few states or under limited circumstances).

215 *Whiting Pools*, 462 U.S. at 209. Note that the Court uses the phrase "property of the debtor" to mean the colloquial meaning of "property," that is, the property item, and not the property interest.

216 *Id.*

217 *Id.*

debtor-creditor relationship,[218] but *Whiting Pools* itself does not extend beyond the debtor-creditor relationship. After correctly analyzing why the IRS was a creditor, the Court restated its holding: "Until [a foreclosure] sale takes place, the property remains the debtor's and thus is subject to the turnover requirement of § 542(a)."[219]

Professor Carlson also asserts that, under the language of the Bankruptcy Code, if a debtor retains any interest in a thing, then a bankruptcy court has jurisdiction over that thing.[220] To a certain extent, this is correct. Any interest in a property item that the debtor has at the commencement of a case becomes property of the estate under § 541(a)(1).[221] The bankruptcy court has jurisdiction over property of the estate and therefore has jurisdiction to decide matters involving the property of the estate.[222]

This extensive jurisdiction, however, does *not* bring into the bankruptcy estate property interests that have been sold to third parties. There is nothing in the Bankruptcy Code that subjects these excluded property interests to the automatic stay of acts to control property of the estate,[223] the trustee's power to use[224] or require turnover[225] of property

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218 In my view, the most plausible reason for the use of the term "may" is simply to avoid appearing to decide any issues not before the Court.

219 *Id*. at 211.

220 *See* Carlson, *Rotten Foundations*, *supra* note 8, at 1060-61, 1065.

221 *See supra* note 61 (quoting § 541(a)).

222 *See* 28 U.S.C. § 157(b)(1) (2000) ("Bankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments, subject to review under section 158 of this title.")
See also id. § 157(b)(2):

> Core proceedings include, but are not limited to—
>
> (A) matters concerning the administration of the estate;
> (B) allowance or disallowance of . . . exemptions from property of the estate . . .;
> . . .
> (E) orders to turn over property of the estate;
> . . .
> (G) motions to terminate, annul, or modify the automatic stay;
> . . .
> (K) determinations of the validity, extent, or priority of liens;
> . . .
> (M) orders approving the use or lease of property, including the use of cash collateral;
> (N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate; and
> (O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims.

Id.

223 *See supra* note 50 and accompanying text (discussing the automatic stay).

224 *See supra* note 52 and accompanying text (discussing the trustee's power to use property of the estate).

225 *See supra* note 188 (quoting the turnover provision, § 542(a)).

of the estate, or the other limitations of the Bankruptcy Code that affect secured creditors.[226] Although Professor Carlson argues that it is an error to assume "that the sale-lien distinction is also the test for bankruptcy jurisdiction,"[227] the sale-lien distinction retains its vitality under both the Bankruptcy Code and *Whiting Pools*. The sale-lien distinction determines the different treatment of *x*, an originator that is an operating company that must pay to its secured creditors a bankruptcy premium to compensate them for the risk of its bankruptcy, and *y*, a third party non-creditor that owns receivables, including but not limited to an SPE, that will not have to pay to its secured creditors a bankruptcy premium to compensate them for the risk of the bankruptcy of the prior owner of the receivables.

2. Insufficiency of a Seller's Retained Powers

Further, even if the sale-lien dichotomy did not matter, the powers retained by a seller in a securitization proffered by Professor Carlson are not sufficient to undermine the legal foundations of securitization. Professor Carlson posits three types of powers retained by a seller in a securitization that would permit recapturing receivables sold by the seller who later becomes a debtor under the Bankruptcy Code:

> (1) The power of a seller of chattel paper who retains possession of the chattel paper to resell the chattel paper to a third party who takes possession for value.[228] Under § 9-330(b), a subsequent purchaser of chattel paper for value who obtains possession of the chattel paper takes priority over a "secured party," which includes a buyer of the chattel paper,[229] which perfects its interest by filing a financing statement.[230] This analysis now would extend to sellers of promissory notes by virtue of the revision of Article 9 of the UCC.[231]

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226 *See supra* note 53 and accompanying text (discussing the power of the trustee to obtain a superpriority security interest); *supra* note 55 (discussing the inability of the undersecured creditor to receive interest on the value of its collateral or to get prompt relief from the automatic stay).

227 *See* Carlson, *Rotten Foundations*, supra note 8, at 1082.

228 *See id*. at 1061, 1088-91.

229 *See* U.C.C. § 1-201(35) (2001) (defining a "security interest" to include a buyer's interest in chattel paper).

230 *See id.* § 9-330(b). At the time of Professor Carlson's article, the only kind of chattel paper was what is now defined as "tangible chattel paper." *Compare id.* § 9-102(a)(9) (2001) (defining tangible chattel paper as chattel paper inscribed on a "tangible medium"), *with id.* § 9-105 (1972) (requiring that chattel paper be a "writing or writings"). Professor Carlson's analysis would not apply to a purchaser of electronic chattel paper who obtains "control," *see id.* § 9-105, of the electronic chattel paper and who therefore may take priority over a buyer of the electronic chattel paper who does not have control. *See id.* § 9-330(b).

231 When Professor Carlson published his article, Article 9 of the U.C.C. governed the sale of chattel paper but not the sale of promissory notes. Revised Article 9 now governs the sale of

(2) The power of a seller who continues to act as the servicer and who therefore collects the proceeds of the receivables.[232]

(3) The future power of a bankruptcy trustee to avoid a sale of accounts and chattel paper that has been perfected by filing a financing statement if the buyer fails to file a continuation statement at the five year intervals.[233]

These are thin "interests" indeed. I do not think them sufficient interests to cause the receivables to be included in the property of the estate of their seller. Further, if retention of these powers were sufficient to defeat a sale in a securitization, they would also be sufficient to defeat every sale of receivables.

a. Seller's Power to Sell Tangible Receivables in Its Possession

The first of Professor Carlson's retained "interests"—the power of a seller in possession of tangible chattel paper or promissory notes to resell to a second purchaser who takes possession—runs afoul of § 541(d) of the Bankruptcy Code. This section provides that in the case of property items held in trust by the debtor, property of the estate does not include the beneficial interest held by the non-debtor beneficiary.[234] When a seller retains possession of these tangible receivables, it does so in trust for the buyer,[235] and if the seller were to sell the tangible receivables, it would hold the proceeds in trust for the buyer. If a seller who retains possession of the receivables becomes a debtor in bankruptcy, the bankruptcy trustee would succeed to the seller's right to

promissory notes, *see id.* § 9-109(a)(3), defines a "security interest" to include a buyer's interest in the promissory note, *see id.* § 1-201(a)(35), and provides that a sale of a promissory note is perfected upon attachment of the security interest, *see id.* § 9-309(4). A purchaser for value who takes possession of a promissory may have priority over a prior buyer whose interest is perfected other than by possession. *See id.* § 9-330(d). If that purchaser in possession is a buyer, that priority eliminates the first buyer's ownership interest.

232 *See* Carlson, *Rotten Foundations*, *supra* note 8, at 1061, 1091-96.

233 *See id.* at 1061-62, 1096-1099; *see also* U.C.C. § 9-515(a) (providing that, with some exceptions, a filed financing statement is effective for a period of five years after the date of filing); *id.* § 9-515(c) (providing that, at the end of the specified period, the effectiveness of a filed financing statement lapses unless before the lapse a continuation statement is filed); *id.* § 9-515(e) (providing that the timely filing of successive continuation statements continues the effectiveness of the initial financing statement continues for additional five-year periods).

234 *See* 11 U.S.C § 541(d) (2000):

> Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

235 The documents will explicitly so state.

possession, but the trustee has no power to sell the receivables. It can sell property of the estate after notice and a hearing[236] or, if it authorized to do business, in the ordinary course of business,[237] but the property of the estate is only the right to possession under the sale documents.[238] The trustee also can sell property items in which the estate and a third person has an interest under certain conditions, but none of these conditions would permit sale of the tangible receivables.[239] Of course, the trustee could in fact sell the receivables and apply the proceeds without regard to the rights of the owner of the receivables or proceeds, but such actions would be ultra vires. Under the Bankruptcy Code, with the exception of § 363(f) and a few other sections not relevant to this discussion,[240] the trustee has no power to use or to sell property interests that are not part of the property of the estate.

Professor Carlson recognizes this argument.[241] He answers by stating that the relevant provision of § 541 of Bankruptcy Code cannot be read literally because then a debtor in possession that was a retailer could not sell inventory in the ordinary course of business free of the security interest. His larger point is that, in his view, the Bankruptcy Code is contradictory and requires the good will of bankruptcy judges to make it coherent.[242]

I disagree. I think the Bankruptcy Code is by and large coherent,

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236 *See supra* note 52 (quoting 11 U.S.C. § 363(b)(1) (2000) (providing that the "trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate")).

237 *See supra* note 52 (quoting § 363(c)(1) (providing that if the business of the debtor is authorized to be operated, "the trustee may sell or lease of property of the estate in the ordinary course of business without notice or a hearing")).

238 *See supra* note 61 (quoting § 541(a)(1) (providing that property of the estate consists of the "interests of the debtor in property").

239 *See* 11 U.S.C. § 363(f) (2000):

> (f) The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if—
>
> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
>
> (2) such entity consents;
>
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
>
> (4) such interest is in bona fide dispute; or
>
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Id.

240 *See id.* § 363(g) (authorizing the trustee to sell property free and clear of any vested or contingent right in the nature of dower or curtesy); *id.* 363(h) (stating that notwithstanding the limitations in § 363(f); *supra* note 239, authorizing the trustee to sell both the estate's interest and the interest of any co-owner in property in which the debtor had an undivided interest as a tenant in common, joint tenant, or tenant by the entirety, if certain conditions were met).

241 *See* Carlson, *Rotten Foundations*, *supra* note 8, at 1089. However, Professor Carlson starts with § 541(b) of the Bankruptcy Code and not § 541(d).

242 *See id.* at 1091.

at least in its treatment of property interests.[243] For example, in the case of a retailer-debtor in possession who must sell inventory free of a secured party's security interest to stay in business and reorganize, the Bankruptcy Code expressly allows the debtor in possession to do so.[244] I discuss other examples in the next section below. Hence, there is no need to disregard either § 541(a)(1), as *Whiting Pools* did, or §§ 541(b) or (d), as Professor Carlson suggests must be done, to make the other provisions of the Bankruptcy Code work together well.

b. Seller/Servicer's Power to Collect Receivables

Professor Carlson's second retained power also does not defeat a true sale, whether in a securitization or as a whole loan sale. Professor Carlson argues that a seller/servicer who collects receivables has a property interest in the receivables that brings the receivables into the bankruptcy estate.[245] In making that argument, he must go through several steps. I believe that there are flaws in each step that prove to be fatal to his argument.

First, he correctly notes that §§ 363(b) and (c) authorize the trustee to use only property of the estate, and property of the estate consists of the debtor's interest in collateral subject to the security interest, not the collateral itself.[246] He also states, "Such an argument overturns the fondest beliefs of the debtors' bar and twenty years of everyday experience."[247] This statement is true only because people in every day experience, including bankruptcy practitioners and bankruptcy judges, confuse the popular concept of property as the "thing"—usually, the "debtor's thing"—with the legal concept of property, as "the interest in the thing."[248] The Bankruptcy Code has explicitly adopted the legal concept of property in its definition of property of the estate as "the interest of the debtor in property."[249] Under the express definition of

243 *See generally* Plank, *Bankruptcy Estate*, *supra* note 50 at 1213-16, 1219-34, 1259-67 (showing that the use of the definition of the property of the estate as the "interests of the debtor in property" was deliberate and, with only a few exceptions, consistent and coherent).

244 *See supra* note 239 (quoting 11 U.S.C. § 363(f)(1) (2000), which provides that trustee may sell property free and clear of any interest in such property of an entity other than the estate, if applicable nonbankruptcy law permits sale of such property free and clear of such interest). Under U.C.C. § 9-307, a buyer in ordinary course takes free of a security interest created by a seller in favor of secured party in inventory. This provision satisfies the requirements of 11 U.S.C. § 363(f)(1).

245 *See* Carlson, *Rotten Foundations*, *supra* note 8, at 1091-96.

246 *See id.* at 1068-69

247 *See id.*

248 *See generally* Plank, *Bankruptcy Estate, supra* note 50, at 1193-95, 1200-13.

249 *See supra* note 61 (quoting the definition of § 541(a)(1)); Plank, *Bankruptcy Estate*, *supra* note 50, at 1216-34 (analyzing the drafting history and language of § 541 to demonstrate the conscious choice of Congress to define property of the estate through the legal concept of

property of the estate, a trustee may only use "the interest of the debtor" in a property item,[250] not the property item itself.[251]

Professor Carlson then points out that § 363 distinguishes "cash collateral" from all other collateral, which he terms illiquid collateral.[252] He correctly notes that "cash collateral" means cash and the like "in which the estate and an entity other than the estate have an interest."[253] He then incorrectly asserts "Section 363(a) expressly states that the trustee may use the whole of the collateral—the secured party's portion and the debtor's portion."[254] This statement is incorrect. Although § 363(a) does define cash collateral as the thing in which the debtor and another has an interest, § 363(a) does not authorize anyone to use cash collateral. Similarly, § 363(b) and (c)(1) authorize the trustee to use "property of the estate." Property of the estate is not the "cash collateral;" it is the "interest of the debtor in the cash collateral." Sections 363(b) and (c) do not authorize the trustee to use "cash collateral."

The definition of the term "cash collateral" serves a limited, and

property).

250 Actually, the use of the term "property" should be interpreted to mean "property interest." Hence, if a debtor owns a car subject to no other interest, her property interest is an unencumbered ownership interest. If she has granted a security interest to a secured creditor, she has an equity interest in this totality of a property interest, and the lender has a security interest in this totality of a property interest. In real estate law, this totality is called a "fee simple absolute." STOEBUCK & WHITMAN, *supra* note 59, § 2.2, at 28.

251 Some take the view that the term "property of the estate" in § 363(b)-(c) must have a broader meaning of "property interest in which the debtor has an ownership interest." *See* DOUGLAS G. BAIRD ET AL., CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 383 (3d rev. ed. 2001), in which the authors state: "'Property of the estate' is here a reference to property in which the estate has an interest—i.e., any property in the possession or control of the trustee or debtor—even though in other contexts (*see, e.g.*, §541(a) . . .) the term refers only to the debtor's or estate's interest in property." The author's justify this *Dewsnup*-ian mode of interpretation. *See* Dewsnup v. Timm, 502 U.S. 410 (1992) (erroneously giving "secured claim" a different meaning in 11 U.S.C. § 506(d) (2000) than from its definition in § 506(a) as follows: "Were this not the case, despite authorization to use 'property of the estate' under § 363, the debtor could not use property subject to a perfected lien, say the debtor's bulldozer as the bulldozer embodies both the debtor's interest and that of the secured creditor. Such absurdity is avoided by a less than precise parsing of the provision." *See id.* at 383-84. As discussed in the text, such improper manipulation of precisely defined terms is not necessary to enable to the trustee to use the debtor's interest in the property.

252 *See* Carlson, *Rotten Foundations*, *supra* note 8, at 1066-67, 1072.

253 11 U.S.C. § 363(a):

> In this section, "cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

Id.

254 *See* Carlson, *Rotten Foundations*, *supra* note 8, at 1072-73.

limiting, purpose. Aside from the definition, the term "cash collateral" appears in the Bankruptcy Code in only two places. Section 363(c)(2) limits the trustee's power to use property of the estate—including the debtor's interest in cash collateral. This section states that the "trustee may not use, sell, or lease cash collateral under paragraph (1)" unless each entity that has an interest in the cash collateral consents or the court authorizes such use, sale, or lease.[255] Section 363(c)(4) requires the trustee to segregate and account for cash collateral in the trustee's possession, custody, or control.[256] These provisions protect the interests of an entity other than the debtor in the cash collateral; they do not authorize the use of "cash collateral."

The limiting purpose of the term "cash collateral" becomes more obvious when we consider its precise definition. Unlike the definition of "cash proceeds" in Article 9 of the UCC, which simply defines "cash proceeds" as cash equivalents,[257] "cash collateral" means cash and its equivalents only if another party has an interest. If the debtor owns cash and its equivalents, but no other entity has an interest, it is not "cash collateral." The debtor's interest in this cash and its equivalents is property of the estate.

The operation of § 363(b) and (c) and the differences between liquid and illiquid collateral also explain the specific purpose of the definition. If a company owned a truck subject to a security interest, and became a debtor under the Bankruptcy Code, the trustee could use, sell or lease the debtor's interest in the truck out of the ordinary course of business only with court approval under § 363(b) but in the ordinary course of business without court approval under § 363(c)(1).[258] The estate's interest in the truck consists of the debtor's equity interest, that is, title to the truck and the debtor's right to possess and use the truck.[259] The filing of the bankruptcy petition and the ensuing non-payment of the secured loan would be a default that, outside of bankruptcy, would allow the secured creditor to repossess the truck and stop the debtor's use of the truck. In bankruptcy, the automatic stay prevents the secured creditor from interfering with the trustee's right to use the debtor's equity interest in the truck, that is, the right to use the truck. If the trustee's use of the debtor's equity interest in the truck adversely affects

255 *See supra* note 52 (quoting 11 U.S.C. § 363(c)(1)-(2)).

256 *See* 11 U.S.C. § 363(c)(4) (stating that, "[e]xcept as provided in paragraph (2) of this subsection, the trustee shall segregate and account for any cash collateral in the trustee's possession, custody, or control").

257 *See* U.C.C. § 9-102(a)(9) (defining "Cash proceeds" as "proceeds that are money, checks, deposit accounts, or the like").

258 *See supra* note 52 (quoting §§ 363(b)(1) & (c)(1)).

259 It may be awkward to refer to the trustee using the debtor's equity interest, that is, its right to use the truck, and it may be easier to think in terms of the trustee using the truck, but tolerating a little awkwardness is preferable to the mischief that arises from giving a defined term a meaning different from its definition.

the secured creditor, however, the secured creditor may seek adequate protection of its interest.[260] Because the trustee's ordinary use of the estate's interest in the truck would not normally destroy the secured creditor's interest in the truck (and other types of illiquid property), putting the burden on the secured creditor to seek adequate protection seems appropriate.

Cash and its equivalent are different. If the debtor had cash or its equivalent that was not encumbered, upon filing of the petition, the trustee could use that complete ownership interest in the cash in the ordinary course of business. However, if the cash or its equivalent is subject to a security interest, that is, if it is "cash collateral," the trustee could quickly dispose of that cash free of the security interest.[261] The purpose of the definition of "cash collateral" and the restriction on use of "cash collateral" is simply to reverse the burden from the secured creditor to the trustee. If the trustee wants to use the debtor's interests in the cash collateral, the trustee must seek permission from either the secured party or the court.

Section 363(c)(2) prohibits use of the "cash collateral" and not use of "the estate's interest in the cash collateral." The latter phrase is more accurate. The incorrect use of the term "cash collateral" is an instance of inconsistency in the Bankruptcy Code. Professor Carlson's basic point is that the Bankruptcy Code is inconsistent, and therefore property interests depend on the goodwill of bankruptcy judges to maintain coherence.[262] I believe Professor Carlson pushes this point too far. As discussed above, the Bankruptcy Code in a few instances fails to distinguish the interest in the thing and the thing, and in these cases bankruptcy judges must resolve the inconsistency. In an overwhelming number of places, however, the Bankruptcy Code is consistent.[263] Slight imperfections—the existence of an inconsistency in a few sections—do not destroy the general coherence of the Bankruptcy Code. In particular, this particular inconsistency in § 363(c)(2) does not negate the preceding analysis. A prohibition on the use of "cash collateral" in § 363(c)(2) is not an authorization to use "cash collateral" under § 363(c)(1). Under § 363(c)(1), the trustee may only use property of the estate, that is, the debtor's interest in the cash collateral.

260 *See* 11 U.S.C. § 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").

261 *See, e.g.*, U.C.C. §§ 9-330(d) & 331 (providing when a good faith purchaser who takes possession of a negotiable instrument takes free of a security interest); *id.* § 332 (providing that a transferee of money or of funds from a deposit account takes the money or funds free of a security interest unless the transferee acts in collusion with the debtor in violating the rights of the secured party).

262 *See supra* note 242 and accompanying text.

263 *See supra* note 243 and accompanying text.

When a company owns receivables subject to a security interest and becomes a debtor in bankruptcy, the bankruptcy trustee may use the debtor's equity interest in the receivables, including the proceeds of the receivables. The proceeds will most likely be cash collateral.[264] If a company does not own receivables but has a contractual right to service the receivables and it becomes a debtor in bankruptcy, the servicer's right to service the receivables become part of the property of the estate, and the trustee may assume or reject the servicing contract.[265] The servicer, however, has no property interest in the receivables. At best, it might have possession of tangible receivables, and it will typically have possession for a short time of collections on the receivables. This possession, however, is held for the benefit of the owner of the receivables. The Bankruptcy Code expressly recognizes this relationship between the servicer and the owner in § 541(d). This section states that, when a person who has legal title to but not a beneficial interest in a property item, including "a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest," only the legal title and not the beneficial interest becomes part of property of the estate.[266] The definition of "cash collateral" does not expand the servicer/debtor's interest in the collections—the "cash collateral"—or the trustee's right to use the debtor's interest in the collections or the receivables.

In this regard, receivables are similar to the truck discussed above. If an owner of a truck contracts with another person to drive the truck—be it a company or an individual—the driver has the right under the contract to drive the truck and also a possessory interest in the truck consistent with such use. If the driver becomes a debtor in bankruptcy, the trustee may use those rights. The right of the trustee to exercise the debtor's rights, however, does not cause either the truck or the owner's rights in the truck to become property of the estate.

Unlike the trustee for the contract driver of the truck, however, under § 363(c)(2), the trustee for a servicer/debtor may not even use the servicer's possessory interest in collections of the receivables—the cash collateral—unless the owner of the receivables consents or the owner receives adequate protection of its ownership interest. Further, even with adequate protection, the trustee's use of the possessory interest in the collections must be consistent with its obligations under the

264 *See supra* note 253 (defining cash collateral). Because cash collateral includes promissory notes, receivables in the form of promissory notes, such as single family mortgage loans, would also be cash collateral.

265 *See* 11 U.S.C § 365(a) (authorizing the bankruptcy trustee to assume or reject an executory contract).

266 *See supra* note 234 (quoting 11 U.S.C. § 541(d)).

servicing agreement. If the trustee assumes the debtor's obligations under the servicing agreement, the trustee may continue to collect the proceeds of the receivables, to pass them on to the owner, and to receive the servicing fees. If the trustee rejects the servicing agreement, it must relinquish all of its power to service the receivables and to possess the collections.

The definition of "cash collateral" provides the owner of the receivables greater protection of its interest in the collections than the protection that the owner of the truck receives. The definition, however, does not bring into property of the estate receivables owned by someone other than the debtor or collections on those receivables, simply because a debtor is a servicer. This is true regardless of whether the servicer were a prior owner of the receivables or a servicer who never had an interest in the receiveables. Indeed, if Professor's Carlson's second argument were valid, all servicing arrangements would be undermined, not just those servicing arrangements of sellers who retain servicing rights.

Professor Carlson tries another line of attack. He asserts that the power to collect the receivables is "clearly" a property interest in the receivables themselves.[267] Professor Carlson's use of the word "clearly" clearly indicates that this proposition is not so clear. Further, his only support for this proposition, *In re Modern Settings, Inc.*,[268] is weak.[269] *In re Modern Settings, Inc.* considered the question of whether the trustee for a debtor could settle a claim for negligence.[270] A corporation, whose principals were also the principals of the debtor, objected to the settlement, claiming that the debtor had assigned the claim to it before the filing of the bankruptcy petition. Although no notice of the assignment had been given to the obligor, the court assumed for purposes of the case that there had been an effective assignment—a matter disputed by the trustee. The court also acknowledged that, under New York law, notification was not necessary for an effective assignment.

Nevertheless, the court stated that, "where no notice of the

267 *See* Carlson, *Rotten Foundations*, *supra* note 8, at 1096.

268 74 B.R. 358 (Bankr. E.D.N.Y. 1987).

269 In addition, relying on *Modern Settings*, another court stated in dicta that "the notification [to the obligor] would have taken the account receivable out of the estate." *See* Dewhirst v. Citibank (Arizona) (*In re* Contractor's Equip. Supply Co.), 861 F.2d 241, 245 n.8 (9th Cir. 1988). This is dicta because *Dewhirst* involved an assignment as security for a debt.

270 *See Modern Settings,* 74 B.R. at 359. The debtor sustained a $5,364,674 burglary loss. The debtor's insurers paid to the debtor $3.875 million and in the name of the insured debtor sued A.D.T. Company, Inc., for alleged gross negligence in maintaining the debtor's alarm system. A.D.T. made an offer of settlement in an amount of more than $1 million. *Id.* at 359. The court stated that this settlement "if consummated, will be divided between the insurers who paid a portion of the loss, and the debtor (or the debtor's assignee) in proportion to the amount of net loss sustained by each." *See id.*

assignment is given to the obligor, the assignor retains an interest in the assigned claim sufficient to enable it to accept payment thereon and to discharge the claim, although by so doing it may incur liability to the assignee."[271] The court thus held that this power was an interest in property that became property of the estate upon the filing of the petition under § 541(a)(1).[272] The court concluded that the bankruptcy trustee had the sole right to collect the payment of the settlement of the negligence claim and that the release discharged the claim.[273] Further, the court in *Modern Settings* stated in dicta that the assignee was stayed from giving notification of the assignment after the bankruptcy petition was filed.[274]

I do not think *Modern Settings* is good law for several reasons. First, the court assumes the conclusion. The court did not cite any authority for the proposition that the "power" to discharge a claim is property or an interest in property.[275] In asserting that "the assignor retains an interest in the assigned claim sufficient to enable it to accept payment," it cited *Associates Discount Corp. v. Commander*.[276] This case merely repeats the rule that an assignor can discharge a receivable until the obligor receives notification. It does not characterize what the assignor's power is or refer to this power as an interest or a right in property. Indeed, the case notes that the exercise of such a power is "wrongful."[277] Even if the Bankruptcy Code authorized the trustee to exercise such power by compromising a claim, does it sanction the wrongful use of such power?

Second, I do not think that such a power is an "interest in property" that could become property of the estate. An assignor's power to discharge the obligor's obligation does not have any of the attributes of property. The power cannot be transferred by the assignor because the assignor cannot divest himself of this power. The power has no value and is not otherwise recognized under state law as a property interest. The sole purpose of the rule giving the assignor the power to discharge the obligor is to protect the obligor from double payment. This rule makes good sense. Between two innocent people, who should bear the risk of bad behavior by the assignor? The answer is the assignee should bear the risk. The assignee can prevent the bad behavior by notifying

271 *See id.* at 360.

272 *See id.* at 360-61.

273 In addition, the court of appeals in *In re Contractors Equipment Supply Co.*, 861 F.2d 241, 245 n.8 (9th Cir. 1988) stated in dicta that, in the case of a true assignment, notification would take an account receivable out of the estate.

274 *Modern Settings*, 74 B.R. at 361.

275 *See also* Greey v. Dockendorff, 231 U.S. 513, 516 (1913) (upholding the assignment of accounts for security against a trustee in bankruptcy and requiring the trustee to remit the proceeds of the assigned accounts to the assignee).

276 244 N.Y.S.2d 103 (1963).

277 *See Assocs. Discount Corp.*, 244 N.Y.S.2d at 105.

the obligor. The obligor should not bear the risk because the obligor has no ability to protect itself.

Third, unlike the assignment of the negligence claim in *Modern Settings*, the assignment of receivables in securitizations is generally[278] governed by Article 9 of the UCC. Article 9 expressly grants an assignor limited power to modify the obligations of the obligor. Specifically, section 9-405 provides that, until notification of the obligor, the assignor can modify a contract "in good faith."[279] The assignor has no other "power." Instead, section 9-404(a) merely provides that the rights to a receivable are subject to any defense or claim in recoupment arising from the transaction that gave rise to the receivable.[280] A defense under this section includes the defense of payment by the obligor. Even if one views section 9-404(a) as codifying the common law,[281] it directly expresses the basic purpose for the rule: to allocate the risk of bad behavior by the assignor to the assignee, not the obligor. In sum, the power of an assignor to accept a payment of a

[278] The claim in *Modern Settings*, which was a claim for damages for negligence in maintaining a burlar alarm system, *Modern Settings*, 74 B.R. at 359, would probably qualify as a "commercial tort claim" under Article 9 of the U.C.C. §§ 9-102(a)(13) (defining "commercial tort claim" as "a claim arising in tort with respect to which (A) the claimant is an organization; or (B) the claimant is an individual and the claim (i) arose in the course of the claimant's business or profession; and (ii) does not include damages arising out of personal injury to or the death of an individual"); 9-102(a)(2) (providing that "account" does not include . . . (ii) commercial tort claims"); 9-102(a)(42) (providing that the term "general intangible," which includes a payment intangible, "means any personal property, including things in action, other than . . . commercial tort claims").

[279] *See* U.C.C. § 9-405 (2001):

> (a) A modification of or substitution for an assigned contract is effective against an assignee if made in good faith. . . . This subsection is subject to subsections (b) through (d).
>
> (b) Subsection (a) applies to the extent that: (1) the right to payment or a part thereof under an assigned contract has not been fully earned by performance; or (2) the right to payment or a part thereof has been fully earned by performance and the account debtor has not received notification of the assignment under [§] 9-406(a).
>
> (c) This section is subject to law other than this article which establishes a different rule for an account debtor who is an individual and who incurred the obligation primarily for personal, family, or household purposes.
>
> (d) This section does not apply to an assignment of a health-care-insurance receivable.

Id.

[280] *See id.* § 9-404(a):

> (a) Unless an account debtor has made an enforceable agreement not to assert defenses or claims, and subject to subsections (b) through (e), the rights of an assignee are subject to:
>
> > (1) all terms of the agreement between the account debtor and assignor and any defense or claim in recoupment arising from the transaction that gave rise to the contract; and
> >
> > (2) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives a notification of the assignment authenticated by the assignor or the assignee.

Id.

[281] Section 9-404(a) appears to reflect the common law. *See* RESTATEMENT (SECOND) OF CONTRACTS § 338(1) (2002).

receivable in trust for the assignee is not a separate "interest in property" in its own right, giving the assignor a property interest in the payment that becomes part of the property of the estate of the assignor. At best, the assignor who actually has received a payment has mere possession or control of the proceeds, but the assignee owns those proceeds.[282]

Nor is the power of an assignor to accept a payment of a receivable in trust for the assignee an interest in the receivable sufficient to bring the entire receivable into the bankruptcy estate of the assignor. The Supreme Court's decision in *Citizens Bank of Maryland v. Strumpf*[283] precludes an argument to the contrary. In this case, the Court rejected the argument that a bank's administrative hold on a checking account violated the automatic stay against an act to exercise control over property of the depositor's bankruptcy estate. The Court noted that a bank account consisted of "nothing more or less than a promise to pay, from the bank to the depositor . . . and [the bank's] temporary refusal to pay was neither a taking of possession of [the debtor's] property nor an exercising of control over it, but merely a refusal to perform its promise."[284] In other words, the interest of the debtor in a bank account—the property of the estate—is not an interest *in* some separate property item, but only the rights that the debtor had under his contract with the bank that established the account. In the case of the collection of a receivable by a seller/servicer, the seller/servicer may have the right to collect a payment on a receivable and this contract right is a property interest. But this contract right does not give the seller/servicer an interest in the receivable itself.

c. Lapsed Perfection and Trustee's Avoidance Power

Finally, Professor Carlson argues that the future, theoretical, contingent power of a bankruptcy trustee to avoid a sale of accounts and chattel paper that becomes unperfected if the buyer fails to file a continuation statement is an interest in property that subjects the entire account or chattel paper to "bankruptcy jurisdiction."[285] Assuming that Professor Carlson is equating "bankruptcy jurisdiction" with "inclusion in property of the estate," I disagree that this power is a sufficient interest in property to make an account or chattel paper part of the

[282] *See* U.C.C. § 9-315(a)(2) (providing that a security interest, which includes a buyer's interest in receivables, *see id.* § 1-201(b)(35), "attaches to any identifiable proceeds of collateral," which includes receivables that have been sold, *see id.* § 9-102(a)(35)).

[283] 516 U.S. 16 (1995).

[284] *Id.* at 21.

[285] *See* Carlson, *Rotten Foundations*, *supra* note 8, at 1061-62, 1096-1107; *see also supra* note 233 (describing the provisions of the UCC requiring the filing of continuation statements).

property of the estate.

A buyer of an account must file a financing statement to perfect its ownership interest,[286] and a buyer of chattel paper must either file a financing statement or take possession of the chattel paper to perfect its ownership interest.[287] Financing statements are generally effective for five years.[288] To retain its perfected status, the buyer whose ownership interest is perfected by filing must file a continuation statement every five years.[289] If the buyer fails to maintain perfection by filing the necessary continuation statements, the buyer's interest in the account or chattel paper would become subordinate to a person who becomes a lien creditor while the buyer's interest in the account or chattel paper is unperfected.[290] If the seller becomes a debtor under the Bankruptcy Code while the buyer's interest is unperfected, the bankruptcy trustee can avoid the sale under its power as a hypothetical lien creditor under § 544(a).[291] If so, the trustee can bring the buyer's interest in the account into the property of the seller's bankruptcy estate.[292]

No one disputes that if a buyer had failed to maintain perfection by filing a continuation statement and the buyer's interest becomes unperfected because of lapse of the financing statement, and the seller then files for bankruptcy, the seller's bankruptcy trustee can recapture the accounts (and chattel paper, to the extent perfection is only by filing) that the seller sold. Professor Carlson, however, posits a more rarified situation: a seller of accounts or chattel paper becomes a debtor in bankruptcy while the buyer's interest is perfected by filing. At that point, the bankruptcy trustee has the potential, future right to avoid the sale if, during the case, the end of the five-year period perfection draws near and the buyer fails to file a continuation statement before the end of the five-year period, which the buyer could file under the Bankruptcy

286 *See* U.C.C. § 9-310(a) (providing that, except as otherwise provided in Article 9, a financing statement must be filed to perfect all security interests, which includes a buyer's interest in accounts, *see id.* § 1-201(b)(35)).

287 *See id.* §§ 9-312(a) (providing that a security interest in chattel paper may be perfected by filing); 9-313(a) (providing that a secured party may perfect a security interest in tangible chattel paper by taking possession of the collateral, including chattel paper that has been sold); *see also id*. § 9-102(a)(12)(B) (defining collateral to include chattel paper that has been sold).

288 *See supra* note 233 (describing the provisions of U.C.C. § 9-515(a)).

289 *See id.* (describing the provisions of U.C.C. § 9-515(c)(e)).

290 *See* U.C.C. § 9-317(a)(2) (providing that a security interest is subordinate to the rights of a person that becomes a lien creditor before the security interest is perfected).

291 *See* 11 U.S.C § 544(a)(1) (providing that the trustee has, as of the commencement of the case, the rights and powers of, or may avoid any transfer of property of the debtor that is voidable by, a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains at that time a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists).

292 *See id.* §§ 550(a)(1) (providing that to the extent that a transfer is avoided under § 544 the trustee may recover the property transferred, or, if the court so orders, the value of such property, from the initial transferee); 541(a)(3) (providing that property of the estate includes any interest in property that the trustee recovers under § 550).

Code.[293]

Although these conditions seem remote, they could arise.[294] Nevertheless, unlike the contingent future interest, such as remainders and executory interests that Professor Carlson refers to for analogy,[295] this potential power is not an interest of the debtor in property. Therefore, it can not become property of the estate. The trustee's avoidance power under § 544(a) is not an interest of the debtor in property at the time of the commencement of the case. It arises by operation of the Bankruptcy Code.[296] To the extent that the trustee's avoidance power arises under state law by virtue of being a "lien creditor" with an interest superior to an unperfected secured party, including a buyer of receivables,[297] this is not an interest of the debtor in property. It is only an interest of a lien creditor of the debtor.

A buyer who fails to maintain continuous perfection in its receivables by filing is vulnerable not only to a lien creditor and a bankruptcy trustee. Such a buyer is also vulnerable to a second purchaser. A second buyer who buys the same receivables from the seller and who perfects its security interest will achieve priority over the first buyer if the first buyer's interest becomes unperfected.[298] UCC Article 9, revised in 2001, bolsters this priority rule by stating that the seller of accounts and chattel paper has the express power to resell any accounts or chattel paper previously sold if the prior sale is not

[293] *See id.* §§ 362(b)(3) (providing that the automatic stay does not stay "any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee's rights and powers are subject to such perfection under section 546(b)"); 546(b)(1)(B) (providing that the rights and powers of a trustee are subject to "any generally applicable law that . . . provides for the maintenance or continuation of perfection of an interest in property to be effective against an entity that acquires rights in such property before the date on which action is taken to effect such maintenance or continuation").

[294] Securitizations are often structured to require a law firm to deliver either annually or every five years an opinion describing what steps the secured party needs to take to maintain perfection of a security interest or advising the secured party that no further steps are necessary for the next year or five-year period. I have drafted and consulted on these opinions. Occasionally, I have seen security interests become unperfected because of a failure to file a continuation statement. So far, I have not experienced a lapsed financing statement that was a problem for a securitization because a search has shown no intervening lien creditors or security interests. But, somewhere out there a lapsed financing statement could result in the subordination of a buyer of receivables.

[295] *See* Carlson, *Rotten Foundations*, *supra* note 8, at 1061 (referring to contingent future interests and the Rule Against Perpetuities).

[296] *See supra* note 291 (describing § 544(a)(1), which creates the trustee's power as a hypothetical lien creditor).

[297] *See also* U.C.C. § 9-102(a)(51)(C) (2001) (defining a "lien creditor," which takes priority over an unperfected security interest, *see* U.C.C. § 9-317(a)(2), to include a bankruptcy trustee as of the filing of the petition).

[298] *See id.* §§ 9-322(a)(2) (providing that a perfected security interest has priority over a conflicting unperfected security interest); 9-515(c) (providing that, if a security interest "becomes unperfected upon lapse, it is deemed never to have been perfected as against a purchaser of the collateral for value").

perfected.[299]

This power of a seller to resell accounts and chattel paper that had been previously sold is a power of some kind. It too is not, however, an "interest in property." It has none of the attributes of a property interest. Most importantly, it is not transferable. It exists solely by virtue of a statutory requirement, which I have criticized before,[300] that an owner of accounts (and an owner of chattel paper not in possession) must file continuation statements. The seller can never divest itself of this power.[301] It is like my power to breath or to vote; I could attempt to sell either of those two powers, but I could not effectively vest them in my transferee. In addition, the seller's contingent, future power to resell the accounts or chattel paper is not a power that is relied upon or recognized in the marketplace as a property interest.[302] If such a power is not an interest of the debtor in property, it cannot become property of the estate that the trustee can use or sell.[303] The most that the trustee in bankruptcy for a seller/debtor can do is avoid the sale of the accounts or chattel paper if the contingency arises during the case.

3. Limited Effect of Professor Carlson's Retained Powers

Even if Professor Carlson's retained powers were sufficient to defeat a sale of receivables, they are of limited consequence for securitizations. They do not undermine the legal foundations of securitization in general. At best they would prevent only certain kinds

[299] *See id.* § 9-318(b) (stating, "For purposes of determining the rights of creditors of, and purchasers for value of an account or chattel paper from, a debtor that has sold an account or chattel paper, while the buyer's security interest is unperfected, the debtor is deemed to have rights and title to the account or chattel paper identical to those the debtor sold."); *see also* James J. White, *Chuck and Steve's Pecadillo*, 25 CARDOZO L. REV. 1743 (2004).

[300] *See* Thomas E. Plank, *Sacred Cows and Workhorses: The Sale of Accounts and Chattel Paper Under Article 9 of the U.C.C. and the Effects of Violating a Fundamental Drafting Principle*, 26 CONN. L. REV. 397, 487-88 (1994) [hereinafter Plank, *Sale of Accounts*] (criticizing the lapse of financing statements and the requirement for the filing of continuation statement in the case of sale of accounts and chattel paper).

[301] Presumably, the seller could attempt to assign the power. However, after such an assignment, if the contingency arose—the first buyer failed to file a continuation statement—the seller could still sell the accounts or chattel paper to a second buyer notwithstanding the assignment.

[302] Accordingly, it does not even have the status of a governmental benefit, that has been treated like a property interest for purposes of the due process clause of the United States Constitution. *See* Goldberg v. Kelly, 397 U.S. 254, 261-62 & n. 8 (1970) (holding that termination of welfare benefits without a hearing violated the due process clause of the Fourteenth Amendment on the grounds that welfare benefits as statutory entitles were "important rights" and also noting that it "may be realistic today to regard welfare entitlements as more like 'property' than a 'gratuity,' that at least have value to the recipient but otherwise do not meet the attribute of a property interest, such as transferability").

[303] *See supra* note 52 (quoting 11 U.S.C. § 363(c)(1)-(2) (2000), which authorizes the trustee to use, sell, or lease property of the estate).

of securitization.

First, the buyer can eliminate the seller's power to transfer chattel paper or promissory notes either by taking possession—often done in securitization transactions, especially in the case of sellers who do not have a high credit rating—or by having the chattel paper or promissory note marked to indicate the buyer's interest.[304] The buyer can eliminate the seller's powers as servicer to collect the receivable by requiring a different servicer and giving notice to the obligor that it should direct payments to the new servicer. This may not be such a hardship. Although the seller is also the servicer in many transactions, in many others the servicer is either a separate affiliate or an unaffiliated third party.[305] Preventing sellers from acting as servicers to obviate Professor Carlson's arguments seems to be unnecessary restrictions. These restrictions would serve only to limit the choices available to the parties without providing any concomitant benefit for society. But if necessary to eliminate Professor Carlson's arguments, these limitations could be implemented.

The future power of a trustee to avoid a sale of accounts[306] or the power of the seller to resell the sold accounts if the buyer does not file a continuation statement at the required five-year intervals would only adversely affect the sales of accounts that have a maturity date that approaches five years. Securitization of trade receivables and health care receivables, which have short term maturities, would avoid this problem. One answer—consistent with Professor Carlson's article—is the truly fantastic position that the mere possibility that a sixty-day receivable could still be outstanding in the years following the sale[307] gives the bankruptcy trustee the present power to recapture the short term receivables as property of the estate. If so, then under Professor's

304 One requirement for priority for a subsequent purchaser of chattel paper or a promissory note under UCC 9-330(b)(d) (2001) is that the purchaser take possession of the chattel paper or promissory note "without knowledge that the purchase violates the rights of the [prior] secured party." *See id.* § 9-330(b)-(d). However, UCC § 9-330(f) provides: "For purposes of subsections (b) and (d), if chattel paper or an instrument indicates that it has been assigned to an identified secured party other than the purchaser, a purchaser of the chattel paper or instrument has knowledge that the purchase violates the rights of the secured party."

305 Many securitizations involve an unaffiliated master servicer who subcontracts with the seller or its affiliated servicer. If necessary, the master servicer could be prohibited from subcontracting with the seller.

306 Buyers of chattel paper could avoid this fantastic future power of the bankruptcy trustee altogether by taking possession of the chattel paper and therefore perfecting its "security interest." *See* U.C.C. § 9-313(a) (2001) (providing that a "secured party" may perfect a "security interest" in tangible chattel paper by taking possession).

307 I say "years following the sale" because presumably the securitization would include a continuous sale of short term receivables for a period of years perfected by the filing of a financing statement at the beginning of the transaction, as in the case of the trade receivables securitization in *In re LTV Steel Co.*, 274 B.R. 278 (N.D. Ohio 2001). *See* LTV Receivables Purchase Agreement, *supra* note 121, § 2.01, at 391, and related defined terms at 450, 468, 476, 481 (providing for a five-year commitment to purchase receivables).

Carlson's theory, there could be no securitization of accounts.

There remain two simple solutions to save the securitization of accounts from Professor's Carlson's theory. First, revising Article 9 to eliminate the filing requirement to perfect a sale of accounts[308] would eliminate the trustee's and seller's putative retained power. Sales of accounts would then resemble sales of payment intangibles or promissory notes, which are automatically perfected upon attachment.[309] The second solution is eliminating the need to file continuation statements for sales of accounts or chattel paper.[310] If a court were to accept Professor Carlson's argument, I expect that state legislatures would move quickly to adopt either of these solutions. Recall the immediate reaction when the United States Court of Appeals ruled in *Octagon Gas Systems, Inc. v. Rimmer (In re Meridian Reserve, Inc.)*[311] that an account that had been sold still remained part of the seller's property and therefore became part of the seller's bankruptcy estate because Article 9 defines a security interest to include a buyer's interest in accounts.[312] Oklahoma, whose law was the applicable state law, quickly amended Article 9 to reverse the effect of *Octagon Gas*.[313] The Permanent Editorial Board of the Uniform Commercial Code issued a commentary repudiating *Octagon Gas*.[314] Finally, revised Article 9 repudiated *Octagon Gas*.[315]

In sum, I believe that the lien-sale distinction that Professor Carlson seeks to dismantle remains valid in bankruptcy. Under § 541, property of the estate is only the interest of the debtor in a property thing, not the thing itself. Property interests sold by a seller do not become part of property of the seller's bankruptcy estate if the seller becomes a debtor. The legal foundations of securitization—well established principles of state law and the language of the Bankruptcy

[308] I actually think this would be a good thing. *See* Plank, *Sale of Accounts*, *supra* note 300, at 475-82.

[309] *See* U.C.C. § 9-309(3)(4) (2001) (providing that a sale of a payment intangible and a sale of a promissory note are perfected when they attach).

[310] *See* Plank, *Sale of Accounts*, *supra* note 300, at 488 (proposing such elimination).

[311] 995 F.2d 948 (10th Cir. 1993).

[312] *Id*. at 957 (holding "that because, under Article 9, a sale of accounts is treated as *if it creates a security interest* in the accounts, accounts sold by a debtor prior to filing for bankruptcy remain property of the debtor's estate" (emphasis added) (citations omitted)).

[313] Oklahoma amended its version of the former UCC section 9-102, which provides that former Article 9 of the U.C.C. applied to the sale of accounts and chattel paper, to add a new subsection (4) that stated: "This article does not prevent the transfer of ownership of accounts or chattel paper. The determination of whether a particular transfer of accounts or chattel paper constitutes a sale or a transfer for security purposes is not governed by this article." *See* 1996 Okla. Sess. Laws, Ch. 56, § 21.

[314] *See* PERMANENT EDITORIAL BOARD FOR THE U.C.C., A.L.I., COMMENTARY NO. 14 (Section 9-102(1)(b) (1994)).

[315] *See* U.C.C. § 9-318(a) (2001) (providing that a "debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold.")

Code—are very secure. If courts respect the language of the Bankruptcy Code, as they are bound to do, securitization is safe. Further, even if there were a few squeaky boards[316] in the legal structure supporting securitization, those boards can be avoided. If one of those boards[317] were in fact rotten, it can be replaced. Even if Professor Carlson's arguments were to prevail, they would not establish that the *foundations* of securitization are rotten.

IV. CONSTITUTIONAL FOUNDATIONS OF SECURITIZATION

Having criticized Professor Carlson's rarified attack on securitization, I now present my own rarified argument on the constitutional foundations of securitization. The argument is rarified because very few courts or scholars have addressed the limits on Congress's power under the Bankruptcy Clause.[318] If the foundations of securitization rested only on an interpretation of Congress's constitutional authority, its foundations would indeed be shaky. However, the mundane basis for the secure foundations of securitization described in Part II above is consistent with my view of the limits of Congress's Bankruptcy Power.

In my view, Congress's power to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States"[319] is limited to adjusting the relationship between a debtor that is insolvent in some broad sense[320] and that debtor's creditors. Accordingly, neither Congress nor the federal courts may alter the nonbankruptcy rights of other entities who have a relationship with the debtor but who are not creditors (which I call "Third Parties"), with one exception described below.

These limits on the "subject of Bankruptcies" follow logically from the meaning of the term "bankruptcies" when the Constitution was adopted and inductively from the various legislative responses to bankruptcies before the adoption of the Constitution. First, in the latter half of the eighteenth century, the meaning of the word "bankruptcy" used in the Bankruptcy Clause was synonymous with the meaning of "insolvency." Both "bankruptcy" and "insolvency" meant the condition

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316 I am referring to Professor Carlson's first two retained powers, *see supra* notes 228-32 and accompanying text.

317 I am referring to the trustee's power to avoid a sale that becomes unperfected and the seller's power to effect second, perfected sale of the same accounts if the first sale becomes unperfected.

318 *See* U.S. CONST. art. I, § 8, cl. 4 (empowering Congress to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States").

319 *See id*.

320 *See infra* note 342 and accompanying text (defining "insolvency" broadly).

of being unable to pay one's debts, as defined in contemporary dictionaries, and these terms were used interchangeably in a variety of legislative acts and other documents.[321] Accordingly, the textual meaning of the "subject of Bankruptcies" is the "subject of debtors who are unable to pay their debts."

Second, the English and American legislatures of the seventeenth and eighteenth centuries addressed the problem of debtors' inability to pay their debts through a variety of laws that only attempted to adjust the relationship between an insolvent debtor and his or her creditors. These laws consisted of the English Bankrupt Acts,[322] the English Insolvency Acts, generally titled "An Act for the Relief of Insolvent Debtors,"[323] and the great variety of laws enacted in the American colonies and early states.[324] Although these laws differed in their specifics, they all had common features and limitations. For the most part, these laws established a collective proceeding for the debtor and all the creditors in which commissioners, justices of the peace, assignees, or in some cases judges gathered and liquidated substantially all of the debtor's property and distributed the proceeds pro rata to the creditors.[325] In a few instances, these laws forced all creditors to accept an arrangement negotiated between the debtor and a majority of the creditors.[326] None of these laws attempted to do more than alter the relationship between the debtor and the creditors. No legislation regulated or created the debtor-creditor relationship, or the property rights or contract rights underlying that relationship.

321 *See* Thomas E. Plank, *Bankruptcy and Federalism*, 71 FORDHAM L. REV. 1063, 1077-78 (2002) [hereinafter Plank, *Bankruptcy and Federalism*].

322 These Acts consisted of the 1570 Statute of 13 Elizabeth, 13 Eliz., c. 7 (1570) (Eng.), the 1604 Statute of 1 James, 1 Jam., c. 15 (1604) (Eng.), the 1623 Statute of 21 James, 21 Jam., c. 19 (1623) (Eng.) and the 1732 Statute of 5 George II, 5 Geo. 2, c. 30 (1732) (Eng.). The 1732 Statute of 5 George II revised and expanded, without significant change, several earlier Bankrupt Acts that had expired, primarily the 1705 Statute of Anne, 4 Ann., c. 17 (1705) (Eng.), which itself modernized the bankruptcy system. The 1732 Statute of 5 George II, originally scheduled to expire in 1735, was renewed periodically (with a few minor amendments) and then became permanent in 1797 by 37 Geo. 3, c. 124 (1797) (Eng.); *see also* Plank, *Bankruptcy and Federalism, supra* note 321, at 1079-82 (summarizing the provisions of these acts).

323 *See, e.g.*, 2 & 3 Ann., c. 16 (1703) (Eng.) ("An Act for the Discharge out of Prison such Insolvent Debtors" who will serve in the army or navy); 6 Geo., c. 22 (1719) (Eng.) (act for "Relief of insolvent Debtors"); 11 Geo., c. 21 (1724) (Eng.) (same); 2 Geo. 2, c. 20 (1729) (Eng.) (act for "Relief of Insolvent Debtors"); 21 Geo. 2, c. 31 (1748) (Eng.) (same); 28 Geo. 2, c. 13 (1755) (Eng.) (same); 9 Geo. 3, c. 26 (1769) (Eng.) (same); 12 Geo. 3, c. 23 (1772) (Eng.) (same); 14 Geo. 3, c. 77 (1774) (Eng.) (same); 16 Geo. 3, c. 38 (1776) (Eng.) (same); 18 Geo. 3, c. 52 (1778) (Eng.) (same); 21 Geo. 3, c. 63 (1781) (Eng.) ("An Act for the Discharge of certain Insolvent Debtors"); *see also* Plank, *Bankruptcy and Federalism, supra* note 321, at 1082-83 (summarizing the provisions of these acts).

324 *See also* Plank, *Bankruptcy and Federalism*, *supra* note 321, at 1085-87.

325 *See id.* at 1078-89; *see also* Thomas E. Plank, *Why Bankruptcy Judges Need Not and Should Not be Article III Judges*, 72 AM. BANKR. L.J. 567, 576-90, 596-606 (1998) [hereinafter Plank, *Bankruptcy Judges*].

326 *See* Plank, *Bankruptcy and Federalism*, *supra* note 321, at 1087.

The language of the Bankruptcy Clause and these English and American bankruptcy and insolvency acts suggests to me four principles for determining Congress's ability to adjust the relationship between an insolvent debtor and the debtor's creditors. These are: (i) the Debtor-Creditor Adjustment Principle, (ii) the Non-Expropriation Principle, (iii) the Non-Interference Principle, and (iv) the Debtor-Insolvency Principle. Under these principles, the foundations of securitization are secure. To the extent that these principles constrain Congress, they similarly constrain federal courts in bankruptcy.[327] Federal courts in bankruptcy may not develop federal common law bankruptcy rules, even in the name of "equity," that Congress could not prescribe.[328]

Under the Debtor-Creditor Adjustment Principle, Congress has complete discretion to adjust the debtor-creditor relationship. It may curtail the nonbankruptcy rights of a debtor for the benefit of that debtor's creditors, and it may curtail the nonbankruptcy rights of some or all of those creditors against the debtor for the benefit of the debtor or some or all of the other creditors. For example, Congress may provide that any property interest that the debtor could use to satisfy her debts outside of bankruptcy may, but need not be, distributed to creditors in bankruptcy. Congress may also provide that any liability of the debtor, regardless of how remote or contingent, may be reduced, subordinated, or discharged. Congress may also delay or modify any creditor remedies.[329]

Under the Non-Expropriation Principle, however, Congress may not expand the rights of debtors or their creditors beyond that necessary to adjust their relationship. Accordingly, Congress may not diminish the rights of Third Parties, that is, those persons who are outside of the debtor-creditor relationship. Nor may Congress diminish the nonbankruptcy rights of the debtor or the creditors for the benefit of these Third Parties. For example, Congress may not (a) create rights or property interests for insolvent debtors or their creditors that do not exist under nonbankruptcy law; (b) appropriate property interests of Third Parties for distribution to creditors, including disregarding inherent limitations in property interests of the debtor that inure to the benefit of a Third Party; (c) alter the substantive legal relationship between a debtor and a Third Party; or (d) create a liability that does not exist under nonbankruptcy law or expand an existing liability.[330]

In this regard, any person may be both a creditor and a Third Party. An example is the landlord of a tenant who becomes a debtor under the

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[327] *See* Thomas E. Plank, *The Erie Doctrine and Bankruptcy*, 79 NOTRE DAME L. REV. 633 *passim* (2004) [hereinafter Plank, *Erie and Bankruptcy*].
[328] *See id.* at 662-68.
[329] *See* Plank, *Bankruptcy and Federalism*, *supra* note 321, at 1089-91.
[330] *Id.* at 1091-92.

Bankruptcy Code. If the tenant owed rent due before the tenant became a debtor, the landlord is a creditor with respect to that prepetition claim.[331] On the other hand, the landlord is a Third Party and not a creditor with respect to the rights and duties of the landlord and the debtor/tenant under the lease after the filing of the petition. In applying these principles, courts must distinguish the respective roles of a creditor and a Third Party.

The Bankruptcy Code and federal courts generally conform to these two principles, although, in my view, the Bankruptcy Code violates that the Non-Expropriation Principle in a few instances not relevant to securitization.[332] Therefore, under the Non-Expropriation Principle, and consistent with the Bankruptcy Code, if an originator sells receivables to an SPE that is a separate legal entity, in compliance with generally applicable nonbankruptcy law, neither Congress nor federal courts may disregard the sale of the receivables or the separateness of the SPE. They may not do so even if the economic effect of the sale to the SPE, which then borrows on a secured basis, is similar to a direct secured loan to the originator. Under the Debtor-Creditor Adjustment Principle, Congress can adjust the relationship between a debtor and a secured creditor, including the relationship between an SPE and its secured creditors. Congress may not, however, eliminate a true sale to a separate legal entity.

There is one narrow limitation on the Non-Expropriation Principle: the Non-Interference Principle. This principle allows Congress and federal courts to prevent a Third Party from using its nonbankruptcy entitlements *solely* to interfere with the bankruptcy process.[333] It also

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331 *See* 11 U.S.C. § 101(10)(A) (2000) (providing that a creditor is an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor"); *id.* § 101(5) (defining a claim as a right to payment or a right to an equitable remedy for breach of performance if such breach gives rise to a right to payment); *id.* § 301 (providing that a voluntary case under the Bankruptcy Code is commenced by the filing with the bankruptcy court of a petition by an entity eligible to be a debtor and that the commencement of a voluntary case "constitutes an order for relief"); *id.* § 303 (providing for the filing of an involuntary petition by creditors against an eligible person and for the later entry of an order for relief by the bankruptcy court either in the case of an unconstested petition or in the case of a contested petition after hearing and a determination that (1) the debtor is generally not paying such debtor's undisputed debts or (2) the appointment of a custodian for the debtor's property within 120 days before the filing of the petition).

332 These include the abrogation of the rights of a Third Party as (a) a co-tenant with an enforceable agreement not to partition property held in co-tenancy, (b) a party to a lease or executory contract who has a generally enforceable right to restrict or prevent assignment of the debtor's rights under the contract or lease, (c) a creditor who has an independent claim against an entity that is a co-obligor with the debtor, (d) a tenant by the entirety, and (e) holder of a right to dower or courtesy. *See* Plank, *Bankruptcy and Federalism*, *supra* note 321, at 1089-91; Plank, *Erie and Bankruptcy*, *supra* note 327, at 668-74 (arguing that non-debtor co-obligor releases approved by bankruptcy courts violate the Non-Expropriation Principle).

333 *See* Plank, *Bankruptcy and Federalism*, *supra* note 321, at 1092-93; *see also* Hayhoe v. Cole (*In re* Cole), 226 B.R. 647, 651-52 654 nn.6-7, (B.A.P. 9th Cir. 1998) (holding that

allows them to prevent a Third Party from using the filing of a bankruptcy petition by a debtor to obtain a benefit that the third party could not obtain outside of bankruptcy. Accordingly, Congress may abrogate, and has abrogated, "ipso facto" clauses in contracts or nonbankruptcy law that cause a forfeiture of a debtor's interest in the contract or other property rights solely because the debtor has filed a bankruptcy petition.[334] In addition, in the absence of a specific statutory provision, federal courts have legitimately prevented a Third Party from canceling a contract when the sole reason for the cancellation was the filing of a bankruptcy petition.[335]

The Non-Interference Principle is a narrow exception to the Non-Expropriation Principle that only prevents direct interference with Congress's power to adjust the insolvent debtor-creditor relation. Many nonbankruptcy entitlements, including a security interest, "interfere" in some sense with the debtor's bankruptcy. In the case of a security interest, Congress can alter that entitlement under the Debtor-Creditor Adjustment Principle. On the other hand, if a particular state declares that, for all purposes, a particular thing or right is not an interest in property, or that a particular thing or right is subject to limitations, such as the limitations on transferability, then neither Congress nor federal courts may overrule those judgments, even if they may impede a debtor's reorganization or the creditors' proceeds.[336]

Hence, the Non-Interference Principle is not a basis for abrogating properly structured securitizations. To be sure, one primary purpose of securitization is to separate receivables from the risk of the bankruptcy of an operating company. Nevertheless, securitization does not interfere with the bankruptcy process. As discussed above, an SPE can and would be expected to become a debtor in bankruptcy if the receivables that it owns fail to generate sufficient revenues to repay the debt holders

prepetition waiver of discharge was unenforceable against debtor in bankruptcy); *In re* Tru Block Concrete Prod., Inc., 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983) (holding void as against public policy covenant not to file bankruptcy petition in agreement among shareholders of debtor and creditors to liquidate debtor outside of bankruptcy); s*ee also* Tracht, *supra* note 28, at 303-15 (1997) (describing and questioning the conventional wisdom of unenforceability of bankruptcy waivers); David S. Kupetz, *The Bankruptcy Code is Part of Every Contract: Minimizing the Impact of Chapter 11 on the Non-Debtor's Bargain*, 54 BUS. LAW. 55, 67-69 (1998) (summarizing law on pre-bankruptcy waivers).

334 *See generally* Plank, *Bankruptcy and Federalism*, *supra* note 321, at 1126-28 (explaining the operation of ipso-facto clauses and the Non-Interference Principle).

335 *See, e.g.*, Holland Am. Ins. Co. v. Sportservice, Inc. (*In re* Cahokia Downs, Inc.), 5 B.R. 529, 531 (Bankr. S.D. Ill. 1980) (prohibiting the termination of the debtor's insurance policy under a general discretionary termination clause because the only reason for the termination was the filing of the petition); *see also* Plank, *Erie and Bankruptcy*, *supra* note 327, at 646-48 (discussing federal courts' use of federal common law in accordance with principle).

336 *See* Plank, *Bankruptcy and Federalism*, *supra* note 321, at 1119-22 (explaining why the abrogation of restrictions on assignment of leases violates the Non-Expropriation Principle).

and they initiate foreclosure proceedings.[337] Furthermore, a sale of receivables by an originator to an SPE avoids more than just the risk of the bankruptcy of the originator. It prevents other persons, such as lien creditors or subsequent secured parties, from obtaining an interest in the receivables that would adversely affect a first priority secured creditor.

On the other hand, to the extent that nonbankruptcy entitlements, whether created by contract or pursuant to state law, are directed *solely* at bankruptcy, Congress and courts may disregard them. For this reason, the Asset Backed Securitization Statutes enacted by several states that Professors Janger[338] and Mann[339] discuss in this Symposium may be vulnerable to Congress's and federal courts' power under the Non-Interference Principle. To the extent that their sole effect is to exclude assets from the bankruptcy estate of a debtor in bankruptcy, they are like the ipso-facto clause overridden by § 541(c)(1) of the Bankruptcy Code.[340] On the other hand, if these statutes have effect outside of bankruptcy, they must be respected. As discussed below, there may be doubts about whether bankruptcy courts would honor these statutes.

My final principle is the Debtor-Insolvency Principle.[341] I believe that, under the Bankruptcy Clause, a person may not be a debtor in bankruptcy unless that person is insolvent in some sense.[342] This is an

337 *See supra* note 99 and accompanying text.

338 *See* Edward J. Janger, *The Death of Secured Lending*, 25 CARDOZO L. REV 1759 (2004) [hereinafter Janger, *Death of Secured Lending*].

339 *See* Ronald J. Mann, *The Rise of State Bankruptcy Directed Legislation*, 25 CARDOZO L. REV. 1805 (2004).

340 *See supra* note 61 (quoting § 541(a)(1)).

341 *See generally* Plank, *Bankruptcy and Federalism*, *supra* note 321, at 1093-95; Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487 (1996) (arguing generally that the original understanding of the Bankruptcy Clause has not changed since the adoption of the Constitution, and arguing specifically that insolvency is a jurisdictional requirement for bankruptcy) [hereinafter Plank, *Constitutional Limits*].

342 Insolvency may be either balance sheet insolvency, that is, the debtor's liabilities must exceed the debtor's assets, or cash flow insolvency, that is, the debtor must be generally unable to pay debts as they become due. Most debtors are insolvent in both senses, but it is not uncommon to be solvent under a balance sheet test and still not be able to pay debts as they become due. For example, a debtor may have assets—such as land—the value of which exceeds the debtor's liabilities. However, the debtor may not have sufficient cash or other liquid assets to pay current debts and may not be able to convert its illiquid assets into cash quickly enough to pays those debts. Both concepts appear in the Bankruptcy Code. In most situations, the Bankruptcy Code uses the balance sheet meaning of "insolvency." *See* 11 U.S.C § 101(32)(A)-(B) (2000) (defining "insolvency" for most entities as balance sheet insolvency); *id*. §§ 547(b)(3), 548(a)(1)(B)(ii)(I) (2000) (using the balance sheet definition of insolvency in the case of preferential and fraudulent transfers). However, municipalities may not seek relief under chapter 9 of the Bankruptcy Code unless they are insolvent under a cash flow insolvency test. *See id.* §§ 109(c)(3) (requiring a municipality to be "insolvent"); 101(32)(C) (defining "insolvent" for a municipality to mean that the municipality "generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or . . . unable to pay its debts as they become due"). Also, creditors may not involuntarily cause a person to become a debtor under the Bankruptcy Code unless that person is insolvent under a cash flow test. *See id.* § 303(h)(1) (providing that the court

important qualification to the Debtor-Creditor Adjustment Principle. If a debtor is not insolvent, broadly defined,[343] Congress's discretion under the Debtor-Creditor Adjustment Principle does not apply.

Few courts have embraced my Debtor-Insolvency Principle, and the court in *In re Marshall*[344] has specifically rejected it. I disagree with the court's analysis, but that is a discussion for another day. In any event, if courts were to adopt my analysis, then they could more easily prevent opportunistic behavior by solvent debtors. Bankruptcy law alters the rights of debtors and creditors for the particular purpose of addressing the problem of an insolvent debtor who cannot repay its debts. Solvent debtors, obviously, do not have this problem. Nevertheless, they occasionally attempt to use bankruptcy law to obtain a rule change in bankruptcy, such as rejection of an executory contract or acceleration and summary disposal of unmatured claims,[345] that they could not obtain outside of bankruptcy. Courts reject these attempts on the grounds that the petitions were filed in "bad faith."[346] In these cases, however, the only distinguishing characteristic is that the debtor was solvent, not the nature of the particular rule change.

The Debtor-Insolvency Principle and the prevention of opportunistic behavior applies directly to securitization. If an SPE is solvent, the parent of the SPE should not be able to cause the SPE to file for bankruptcy. Recognition of the Debtor-Insolvency Principle would be a more secure foundation than the requirement of the consent of the independent director to filing a petition.[347]

A good illustration of how this principle strengthens securitization is the case of *In re WE Financial Co.*[348] In this case, the owners of a solvent SPE caused the SPE to file for bankruptcy for the sole purpose of accelerating the payment of the SPE's $125 million high interest debt that by agreement was not prepayable. The collateral securing the debt consisted of Government National Mortgage Association mortgage

shall order relief against the debtor that controverts an involuntary petition only if "the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute").

343 In determining insolvency, either in a cash flow or balance sheet sense, it is appropriate to take into account all potential contingent liabilities of the debtor, such as future tort claims.

344 *See In re* Marshall, 300 B.R. 507, 509 (Bankr. C.D. Cal. 2003).

345 *See, e.g.*, Plank, *Bankruptcy Judges*, *supra* note 325, at 631-34 (describing the chapter 11 bankruptcy case of Krystal Co., a company whose stock was listed on the New York stock exchange, who filed for bankruptcy for the sole purpose of accelerating, consolidating, and adjudicating litigation claims in the bankruptcy court).

346 Plank, *Constitutional Limits*, *supra* note 341, at 545-56 (explaining the extent to which courts refuse to permit solvent debtors from abusing the bankruptcy process to obtain a benefit that they could not obtain outside of bankruptcy).

347 *See supra* notes 29-36 and accompanying text (describing the role of the independent director in securitizations). The independent director would still be an important element in ensuring that the SPE were a separate legal entity. *See supra* note 38 and accompanying text.

348 No. 92-01861-TUC-LO (Bankr. D. Ariz. filed June 11, 1992).

pass-through certificates that had appreciated in value to an amount greater than their face amount because of a decline in interest rates. Upon acceleration, the SPE as debtor in possession could sell the underlying collateral,[349] use the proceeds to pay off the debt, and retain a profit of about $11 million to be distributed to its owners. The trustee for the debt holders strenuously objected on the grounds that, among other things, the petition was filed in bad faith. Because of the trustee's forceful opposition, the SPE and its owners settled this case with a reinstatement of all but a small portion of the debt.[350]

The trustee's objection on the grounds of bad faith, and the resulting settlement, thwarted the opportunistic use of bankruptcy law by a solvent SPE for reasons that had no relation to the purpose of bankruptcy law. A straightforward recognition of the Debtor-Insolvency Principle would be a more effective and equally justifiable way to preserve an SPE that was fully cash flow and balance sheet solvent. Of course, there may be close cases, and litigating solvency would be another cost. The Bankruptcy Code or the courts could reduce these problems by placing the burden of proof on those who claim that an SPE, or any debtor, is fully solvent and should not be in bankruptcy. Congress placed this burden on creditors in the case of ordinary preferential transfers[351] because of the objective fact that substantially all debtors are insolvent in one or the other sense.[352] The most important point is to honor the jurisdictional requirement of insolvency.

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349 *See supra* note 239 and accompanying text (describing the power of the trustee to sell property free of a security interest under § 363(f)(3) (2000)).

350 *See* Findings of Fact and Conclusions of Law (for Order Confirming the Amended Plan as Modified) at 2-4, *In re* WE Fin. Co., No. 92-01861-TUC-LO (Bankr. D. Ariz.) (filed Feb. 23, 1993); Amended Disclosure Statement of WE Fin. Co., GWS, and WE 7, Inc. Dated Jan. 11, 1993, as Modified, at 10-21, *In re* We Fin. Co., No. 92-01861-TUC-LO; Settlement Agreement Dated as of September 1, 1992, at 1-3, *In re* We Fin. Co., No. 92-01861-TUC-LO; *Bankruptcy Case Tests Builder Bonds*, 7 Mortgage-Backed Securities Letter, Aug. 10, 1992, at 1, 9, *available at* 1992 WL 2747060; Ernie Heltsley, *Estes Unit, in Chapter 11, Seeks Control of Bonds*, ARIZ. DAILY STAR, June 17, 1992, at 5B (containing some inaccuracy in describing the structure of the transaction), *available at* 1992 WL 7629436; Ernie Heltsley, *Estes Firm's Chapter 11 Dispute Called Threat to Bond Payments*, ARIZ. DAILY STAR, June 18, 1992, at 5B, *available at* 1992 WL 7629465 (Jun 18, 1992); Ernie Heltsley, *Bondholders to Receive Timely Payoff*, ARIZ. DAILY STAR, July 1, 1992, at 9B (referring to interim payment of interest on the funding agreements), *available at* 1992 WL 7629824; *Fitch Puts Amer Southwest Financial AAA CMOs on Alert Neg.*, DOW JONES NEWS SERVICE, June 19, 1992; *American Southwest Financial 'AAA' CMOs on Fitch Alert Negative*, PR NEWS WIRE, June 19, 1992; *American Southwest Financial Ends Dispute with WE Financial Co.*, ARIZ. DAILY STAR, March 15, 1993, at 6D, *available at* 1993 WL 5743065 (Mar. 15, 1993); Abby Schultz, *American Southwest Bondholders Safe After Court Okays Plan*, DOW JONES NEWS SERVICE, March 11, 1993; *S&P Affirms Amer Southwest CMO Ratings; Off Watch*, DOW JONES NEWS SERVICE, March 25, 1993.

351 *See* 11 U.S.C § 547(f).

352 H.R. REP. NO. 595, 95th Cong., 2d Sess. 178 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138-39 (describing the preference provisions of the bill that became the Bankruptcy Code, and acknowledging that a bankruptcy trustee should not have to prove a fact that was almost always true).

V. THE FUTURE OF SECURITIZATION

The future of securitization is secure. Properly structured securitizations comply with the requirements of both the Bankruptcy Code and general principles of nonbankruptcy law. Securitization also saves consumers and business huge amounts of money. As the LTV Corporation bankruptcy demonstrates, these consumers and businesses, or the financial services industry that services them, would not likely sit idly by if courts were to disregard the language of the Bankruptcy Code and these general principles and collapse a properly structured securitization into a direct secured transaction of an originator.

On the other hand, it seems doubtful that the securitization industry can obtain the special protections from the detrimental provisions of the Bankruptcy Code that would eliminate the necessity for the strict, two-transaction structure of a securitization. The securitization industry tried, but the bankruptcy of Enron Corporation derailed this effort.

For several years, Congress has been contemplating a revision of the Bankruptcy Code. The bankruptcy "reform" bills introduced in 2001,[353] similar to the bill that Congress passed in 2000 but that President Clinton vetoed in December 2000,[354] contained § 912 on securitization.[355] This section would have modified § 541 of the Code

[353] *See* Bankruptcy Reform Act of 2001, S. 420 107th Cong. (2001); Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, H.R. 333, 107th Cong. (2001).

[354] *See* H.R. 2415, 106th Cong. § 1 (2000). Section 1 of this bill had the caption "ENACTMENT OF BANKRUPTCY REFORM ACT OF 2000," and states simply that the "provisions of S. 3186 of the 106th Congress, as introduced on October 11, 2000, are hereby enacted into law." On October 11, 2000, the H.R. 2415 conference committee struck all of the House bill after the enacting clause and inserted the provisions of S. 3186, the Bankruptcy Reform Act of 2000. The text of S. 3186 is included in the H.R. 2415 conference report: H. Rept. 106-970.

[355] *See* Bankruptcy Reform Act of 2001, S. 420 107th Cong. § 912 (2001) (entitled "Asset-Backed Securitizations"):

> Section 541 of title 11, United States Code, is amended—
>
> (1) in subsection (b), by inserting after paragraph (7), as added by this Act, the following:
>
> > (8) any eligible asset (or proceeds thereof), to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization, except to the extent such asset (or proceeds or value thereof) may be recovered by the trustee under section 550 by virtue of avoidance under section 548(a); and
>
> (2) by adding at the end the following new subsection:
>
> > (f) For purposes of this section—
> >
> > > (1) the term 'asset-backed securitization' means a transaction in which eligible assets transferred to an eligible entity are used as the source of payment on securities, including, without limitation, all securities issued by governmental units, at least one class or tranche of which was rated investment grade by one or more nationally recognized securities rating organizations, when the securities were initially issued by an issuer;

to exclude from an originator's bankruptcy estate receivables transferred to an SPE in a securitization in which one class of securities received an investment grade rating if the originator had represented in a written agreement that the assets were sold with the intention of removing them from the estate of the debtor.[356]

After the collapse and bankruptcy filing of the Enron Corporation, however, several bankruptcy academics wrote a letter to Congress on January 23, 2002 opposing § 912 for a variety of reasons, including a charge that § 912 would permit future Enrons.[357] Other academics also

(2) the term 'eligible asset' means—

(A) financial assets (including interests therein and proceeds thereof), either fixed or revolving, whether or not the same are in existence as of the date of the transfer, including residential and commercial mortgage loans, consumer receivables, trade receivables, assets of governmental units, including payment obligations relating to taxes, receipts, fines, tickets, and other sources of revenue, and lease receivables, that, by their terms, convert into cash within a finite time period, plus any residual interest in property subject to receivables included in such financial assets plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders;

(B) cash; and

(C) securities, including without limitation, all securities issued by governmental units;

(3) the term 'eligible entity' means—

(A) an issuer; or

(B) a trust, corporation, partnership, governmental unit, limited liability company (including a single member limited liability company), or other entity engaged exclusively in the business of acquiring and transferring eligible assets directly or indirectly to an issuer and taking actions ancillary thereto;

(4) the term 'issuer' means a trust, corporation, partnership, or other entity engaged exclusively in the business of acquiring and holding eligible assets, issuing securities backed by eligible assets, and taking actions ancillary thereto; and

(5) the term 'transferred' means the debtor, under a written agreement, represented and warranted that eligible assets were sold, contributed, or otherwise conveyed with the intention of removing them from the estate of the debtor pursuant to subsection (b)(8) (whether or not reference is made to this title or any section hereof), irrespective and without limitation of—

(A) whether the debtor directly or indirectly obtained or held an interest in the issuer or in any securities issued by the issuer;

(B) whether the debtor had an obligation to repurchase or to service or supervise the servicing of all or any portion of such eligible assets; or

(C) the characterization of such sale, contribution, or other conveyance for tax, accounting, regulatory reporting, or other purposes.

Id. Section 912 of the House bill was identical. *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, H.R. 11, 107th Cong. § 912 (2001); *see also* Financial Contract Netting Improvement Act of 2000, H.R. 1161, 107th Cong. § 13 (introduced in the House January 3, 2001) (using language almost identical to § 912).

356 *See* Bankruptcy Reform Act of 2001, S. 420 107th Cong. § 912, proposed § 541(f)(5) (defining "transferred").

357 *See* Letter from Alan Axelrod, Professor Emeritus, Rutgers School of Law, Newark, et al. to Senator Patrick Leahy and Congressman F. James Sensenbrenner (January 23, 2002)

criticized § 912.[358] After these letters, the sponsors of the bankruptcy legislation removed § 912. However, Professor Lipson has suggested that § 912 could be resurrected.[359]

I was not a big fan of § 912. True securitizations do not need § 912.[360] Further, § 912 limits its benefits to securitizations in which the securities achieve an investment grade rating.[361] As Professor Kettering pointed out, and Professor Janger remarks, this distinction privileges "Wall Street" over "Main Street."[362] But there is nothing unusual about this. The Bankruptcy Code contains several provisions that protect both the United States government[363] and certain sophisticated transactions[364] from the automatic stay and other provisions that increase the costs of

reproduced in AM. BANKR. INST. J., Mar. 2002, at 6 *available at* www.abiworld.org/resources/research/letter1.html [hereinafter Law Professors' Letter] (arguing that § 912 "would institutionalize and encourage one of the practices that has led to Enron's failure and its harsh consequences").

358 *See* Letter from Edward J. Janger, Associate Professor, Brooklyn Law School, et al. to Senator Patrick Leahy and Congressman F. James Sensenbrenner (January 28, 2002) [hereinafter Janger Letter], *available at http://* www.abiworld.org/resources/research/lawletter.html; Kettering Letter, *supra* note 113; *see also* Edward J. Janger, *Muddy Rules for Securitizations*, 7 FORDHAM J. CORP. & FIN. L. 301 (2002) (arguing that § 912 is misguided).

359 *See* Jonathan C. Lipson, *Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?*, 11 J. BANKR. L. & PRAC. 101 (2002) (also criticizing several unjustified aspects of § 912).

360 The Law Professors' Letter of January 23, 2002, criticizing § 912, acknowledges the current robustness of securitization. *See* Law Professors' Letter, *supra* note 357, at 36 (noting that the "deliberate asset securitization is booming under current law" and that not every asset securitization is a disguised loan); Jonathan C. Lipson, *Section 912 is Dangerous*, BUS. L. TODAY, Aug. 2002, at 33. The bankruptcy reform legislation considered in the 107th Congress has been reintroduced in the 108 Congress, and this legislation does not contain any provisions on securitization. *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2003, H.R. 975, 108th Cong.; *see also* Financial Contracts Bankruptcy Reform Act of 2003, H.R. 2120, 108th Cong. § 13 (omitting any provisions on securitization, unlike its counterpart in the 107th Congress).

361 *See supra* note 355 (quoting § 912 and in particular the proposed § 541(f)(1) (defining of "asset-backed securitization")).

362 *See* Kettering Letter, *supra* note 113; *see also* Janger, *Death of Secured Lending*, *supra* note 338.

363 *See, e.g.*, 11 U.S.C § 362(b)(8) (2000) (excepting from the automatic stay an action by the Secretary of Housing and Urban Development to foreclose a mortgage insured under the National Housing Act); *id.* § 362(b)(12) (excepting from the automatic stay an action involving a chapter 11 debtor brought by the Secretary of Transportation to foreclose a preferred ship or fleet mortgage, or a security interest held by the Secretary of Transportation in or relating to a vessel); *id.* § 362(b)(13) (excepting from the automatic stay an action by the Secretary of Commerce to foreclose a preferred ship or fleet mortgage in a vessel or a other security interest in a fishing facility held by the Secretary of Commerce).

364 *See, e.g.*, 11 U.S.C §§ 362(b)(6) (excepting from the automatic stay setoffs by a commodity broker, forward contract merchant, stockbroker, financial institutions, or securities clearing agency of certain debts in connection with commodity contracts, forward contracts, or securities contracts); 362(b)(7) (excepting from the automatic stay the setoff by a repo participant of certain mutual debts under a repurchase agreement); 362(b)(17) (excepting from the automatic stay the setoff by a swap participant of certain mutual debts under a swap agreement); 556, 559-660 (authorizing the termination or liquidation of certain commodities contracts, forward contracts, repurchase agreements, or swap agreements, even under "ipso facto" clauses).

secured creditors. My objection to § 912 is that it would reduce the pressure for reform of the Bankruptcy Code that would provide greater respect of secured creditors rights, which I propose in Part VI below.

The Delaware Asset Backed Securities Facilitation Act[365] and the Texas nominal sale amendment to Article 9 of the UCC[366] and their clones, discussed by Professor Janger and Professor Mann in this Symposium, may not provide significant structural help to securitizations. A bankruptcy court might not exclude from an originator's bankruptcy estate receivables transferred to an SPE in a securitization if the transfer fails to meet the standard of a true sale under general legal principles.

Indeed, these state law attempts to exclude receivables if the transfer is in substance a grant of true security interest may produce more bad law. To respond to these efforts, bankruptcy courts may go too far in ruling that federal bankruptcy law, and not state law, determines whether assets may be included in the bankruptcy estate.[367] This line of reasoning would be unfortunate. Bankruptcy law can determine whether an interest in property created by nonbankruptcy law

[365] DEL. CODE ANN. tit. 6, § 2703A (Supp. 2003):

> (a) Notwithstanding any other provision of law, including, but not limited to . . . § 9-623 of the title, "Right to redeem collateral," which became effective July 1, 2001, to the extent set forth in the transaction documents relating to a securitization transaction:
>
> (1) Any property, assets or rights purported to be transferred, in whole or in part, in the securitization transaction shall be deemed to no longer be the property, assets or rights of the transferor;
>
> (2) A transferor in the securitization transaction, its creditors or, in any insolvency proceeding with respect to the transferor or the transferor's property, a bankruptcy trustee, receiver, debtor, debtor in possession or similar person, to the extent the issue is governed by Delaware law, shall have no rights, legal or equitable, whatsoever to reacquire, reclaim, recover, repudiate, disaffirm, redeem or recharacterize as property of the transferor any property, assets or rights purported to be transferred, in whole or in part, by the transferor; and
>
> (3) In the event of a bankruptcy, receivership or other insolvency proceeding with respect to the transferor or the transferor's property, to the extent the issue is governed by Delaware law, such property, assets and rights shall not be deemed to be part of the transferor's property, assets, rights or estate.

Id.

[366] TEX. BUS. & COM. CODE ANN. § 9-109(e) (Vernon 2002):

> (e) The application of this chapter to the sale of accounts, chattel paper, payment intangibles, or promissory notes is not to recharacterize that sale as a transaction to secure indebtedness but to protect purchasers of those assets by providing a notice filing system. For all purposes, in the absence of fraud or intentional misrepresentation, the parties' characterization of a transaction as a sale of such assets shall be conclusive that the transaction is a sale and is not a secured transaction and that title, legal and equitable, has passed to the party characterized as the purchaser of those assets regardless of whether the secured party has any recourse against the debtor, whether the debtor is entitled to any surplus, or any other term of the parties' agreement.

[367] *See, e.g.*, Plank, *Erie and Bankruptcy*, *supra* note 327, at 682-84 (discussing the ambiguous treatment of property interests by the Supreme Court in *Chicago Board of Trade v. Johnson*, 264 U.S. 1 (1924)).

should be included in or excluded[368] from the property of the estate. Only nonbankruptcy law—primarily state law—can determine whether something is an interest in property or who may have an interest in property.[369]

Bankruptcy courts may also disregard these statutes on the ground that they seem to be directed only at federal bankruptcy power. This may or may not be a legitimate reason. The statutes are not expressly limited to just bankruptcy cases. In the case of the Texas nominal sale amendment, the Texas Bar commentary mentioned the necessity for certainty in addressing the Texas usury law.[370] Under the Delaware Act, the provision that a transferor does not retain a right to redeem is used to enable accountants to treat transfers by financial institutions as sales under Financial Accounting Standard 140 when the lawyers cannot give a true sale opinion on the transfer.[371] Moreover, both types of statutes seem to abrogate the normal rights of debtors who have pledged assets to secure a debt. Nevertheless, it may be that, in fact, these statutes have no effect outside of bankruptcy. If the transfer by an originator is in substance still only a pledge and not a sale, calling it a sale does not make it one, even if the state allows the parties to call it a sale.

These statutes might be helpful in close cases. For example, under current case law, when an originator sells receivables for fair market value but retains 100 percent recourse for obligor default, some courts will nevertheless uphold the sale and others will not.[372] These statutes

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[368] *See, e.g.*, 11 U.S.C § 522(b) (2000) (allowing an individual debtor to exempt from property of the estate certain interests in property).

[369] *See* Plank, *Bankruptcy and Federalism*, *supra* note 321, at 1092, 1099-1100; Plank, *Erie and Bankruptcy*, *supra* note 327, at 679-84.

[370] TEX. BUS. & COM. CODE ANN. § 9-109 State Bar Committee cmt. 2.

[371] Under FAS 140, *supra* note 63, ¶¶ 9(a), 27-28, at 4, 21, one of the requirements for sale treatment is legal isolation from the transferor's estate if the transferor becomes a debtor under the Bankruptcy Code or, in the case of banks and other insured depository institutions, becomes subject to receivership or conservatorship by the Federal Deposit Insurance Corporation (the "FDIC"). *See infra* note 389 (describing the FDIC's ability to become a conservator or receiver of a FDIC-insured depository institution). Under the FDIC's regulation, "Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation," *see infra* note 394 and accompanying text (discussing the regulation), a federally insured depository institution could obtain sale treatment for accounting purposes without a true sale opinion.

However, another element of FAS 140 is that the transferor not retain control over the receivables transferred. FAS, 140, *supra* note 63, ¶¶ 9(c), 50-54, at 5, 30-31, & 153 (defining a clean up call). Accountants became concerned that, even though the FDIC would not attempt to recover receivables pledged to an SPE in a securitization, and therefore the receivables were legally isolated from the receivership estate, the transferor retained its right of redemption under state law, that is, U.C.C. § 9-623 (2001) and therefore retained "control" over the transferred assets. Section 2703A(2) of the Delaware Asset-Backed Securitization Facilitation Statute, *see supra* note 365 (quoting the statute), removes that right.

[372] *See supra* note 82.

might push more courts toward upholding the sale. But if an originator sells for less than fair market value, retains credit recourse and retains either an express right to surplus proceeds or an option to repurchase the receivables at a reduced price, the originator's rights will be included in its bankruptcy estate notwithstanding the state statutes. It would not be a stretch to apply the *Whiting Pools* federal common law rule to the underlying receivables.

In my view, one motivation for these statutes, as well as the ill-fated § 912,[373] is a desire to accommodate originators and investors who desire greater flexibility in structuring securitizations and in avoiding the bankruptcy premium on secured credit. Sellers in some securitizations may wish to retain a portion of benefits of ownership—such as the ability to get the receivables back. Similarly, investors will want greater protections than those afforded solely by the assets. Originators may be willing to provide these protections against risk, such as recourse for defaults greater than historical loss or changes in the yield to the purchaser, to obtain a higher purchase price for the receivables or to avoid having the SPE pay a third party a greater amount to cover some particular risk that arises.

There may exist securitizations having too many features that are inconsistent with a true sale of receivables to an SPE that is a separate legal entity. One of these days, an originator of one of these transactions may become a debtor under the Bankruptcy Code and may successfully challenge the securitization structure. A bankruptcy court might recharacterize the transfer of receivables as a pledge or consolidate the SPE with the originator/parent because of the problematic features.

This result would not destroy securitization. Just as the Supreme Court's disapproval of an accounts receivable financing transaction in *Benedict v. Ratner*[374] did not destroy accounts receivable financing but instead strengthened it,[375] the collapse of a securitization with problematic features will only strengthen those securitizations that do not have those features. The market would adjust. Those transactions that contain problematic features may be downgraded either by the rating agencies or by the market. After some period of uncertainty and adjustment, those transactions without the problematic features would be unaffected. After all, although some have tried to impute to

[373] *See supra* note 353-59 and accompanying text.

[374] 268 U.S. 353 (1925). In this case, the Court invalidated an assignment of accounts as security for a loan arrangement in which the assignor retained control over the accounts. The Court reasoned that allowing the assignor to retain control over the accounts pledged as security was inconsistent with the notion of a lien on property and therefore was fraudulent as a matter of law. *See id.* at 360-61.

[375] *See* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 8.3, at 257-61 (1965).

securitizations the misuse of SPEs by Enron,[376] the Enron debacle, its misuse of SPEs, and the susceptibility of the Enron SPE transactions to consolidation or abrogation of the sale of assets[377] do not appear to have damaged securitizations.

Parties to securitizations sometimes become frustrated by the requirements for a properly structured securitization. Underlying this frustration is a belief, evidenced in their daily business lives, that secured credit is a great benefit for them, their clients, and society and that the bankruptcy premium in direct secured lending required by the Bankruptcy Code is inefficient and irrational. It is my hope that the continuing success of securitization, including the tremendous cost savings, without any demonstrable harm to unsecured creditors, will induce a reform of the Bankruptcy Code that will recognize the full value of a secured creditor's security interest.

VI. THE FUTURE OF SECURITY

Securitization demonstrates the costs and inefficiency of the bankruptcy premium on secured credit. I think it possible to reform the Bankruptcy Code to eliminate the bankruptcy premium on all secured credit. The reforms I suggest would also, I believe, make the reorganization process more efficient. To the extent that the broadest reforms are not palatable, more narrowly tailored reforms directed toward the pledge of receivables would at least reduce the bankruptcy premium on these transactions. They could even remove the necessity for the complicated, two step transactions required now, involving a sale to an SPE that is a separate legal entity.

A. *Respecting the Value of the Secured Creditor's Property Interest*

My broadest suggestion is to reverse, by legislation, the Supreme Court's decision in *United Savings Ass'n*.[378] In this case, the Court held that the right of an undersecured creditor to adequate protection does not include interest payments to compensate the creditor for the delay of

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376 *See supra* note 357.

377 *See, e.g.*, Second Interim Report of Neal Batson, Court-Appointed Examiner, at 1-3, 12-13, *passim*; *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y filed Jan. 3, 2003) (copy on file with the author) (concluding that Enron used SPEs to manipulate its financial statements in violation of generally accepted accounting principles and failed to make appropriate disclosures of its SPE transactions required by law, and that many of the transactions were susceptible to substantive consolidation of the SPEs with their parents or to abrogation of the transfer of assets to the SPEs as not having been true sales).

378 484 U.S. 365 (1988).

foreclosure caused by the bankruptcy case. I think the decision is correct as a matter of statutory analysis.[379] The result follows from the general rule in § 502(b)(2) of the Bankruptcy Code that creditors are not to receive interest on their claims[380] and the special exception for secured creditors in § 506(b), who receive interest only to the extent that the value of the collateral exceeds the amount of the claim.[381]

This rule adversely affects an undersecured creditor. Assume that a debtor owes a creditor a debt of $120 that accrues interest at a rate of 12 percent annually and that is secured by collateral worth $100. In bankruptcy, the secured creditor will not receive interest on either its claim or the value of the collateral. Absent the automatic stay, the creditor could foreclose the security interest, apply the $100 value of the collateral to its debt, and at least reinvest the $100. The automatic stay of acts to recover a claim[382] prevents the foreclosure. If the collateral is necessary for reorganization, the creditor cannot obtain relief from the stay.[383] Accordingly, the creditor must continue to loan, interest free, $100 to the debtor.[384] The creditor must make up the loss from other borrowers or go out of business.

I would revise § 506(b) to provide that the undersecured creditor is entitled to the payment of interest (or adequate protection of such payment) on the lesser of the creditor's claim or the value of the collateral securing the creditor's claim. Until the undersecured creditor obtains relief from the automatic stay, the interest rate for an undersecured creditor would be the greater of the contract rate or the market rate. This rule is designed to prevent the debtor from engaging in opportunistic behavior, that is, continuing to fight relief from the stay when the contract rate is lower than the market rate. When the contract rate is higher than the market rate, the rule prevents the debtor and the bankruptcy judge from underestimating the market rate.[385] However, after the secured creditor gets relief from the automatic stay or the trustee abandons the debtor's equity interest in the collateral to the secured party,[386] the secured creditor is no longer entitled to interest.

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[379] *But see* David Gray Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577, 601-10 (1989) [hereinafter Carlson, *Postpetition Interest*] (criticizing the Court's analysis).

[380] *See* 11 U.S.C § 502(b) (2000).

[381] *See id*. § 506(b).

[382] *See supra* note 50 and accompanying text (quoting and discussing the provisions of the automatic stay that prevent a secured creditor from foreclosing its security interest).

[383] *See supra* note 56 (quoting § 362(d)(2) providing for relief from the automatic stay).

[384] *See also* Carlson, *Rotten Foundations*, *supra* note 8, at 1064, 1102-03 (noting that Congress intended that secured creditors contribute value to the debtor's reorganization effort that they would otherwise retain under nonbankruptcy law).

[385] If the contract rate were truly higher than the market rate, the debtor could obtain refinancing and pay off the undersecured creditor.

[386] *See* 11 U.S.C § 554(a)(b) (providing that, after notice and a hearing, the trustee on her own motion or at the request of a party in interest, "may abandon any property of the estate that is

This rule would prevent the secured creditor delaying foreclosure to extract value from the debtor.

This rule would put additional financial pressure on debtors trying to reorganize. I think this pressure is appropriate. If the collateral is truly necessary for reorganization, the debtor should be allowed to continue to use the collateral. On the other hand, if reorganization is good for the debtor and the unsecured creditors, they should pay for the use of the secured creditor's collateral. If it does not make sense for them to pay, then the debtor should not be in reorganization. It should liquidate. Until it allows the undersecured creditor to foreclose, the undersecured creditor should receive compensation for its inability to obtain the value of its interest in the collateral. If this change in law is too broad, then it should at least apply to receivables.

B. *Quick Liquidation of Receivables*

In addition to the broader rule for all undersecured creditors described above, I also propose an amendment that directly relates to receivables. I would provide that the automatic stay does not extend to any action by a creditor to liquidate receivables that have been pledged as security for a debt so long as the liquidation is conducted in a commercially reasonable fashion.[387] The exclusion would extend to tangible receivables in the possession of the debtor.

This rule would not eliminate securitizations but it would eliminate the necessity, for the most part, in having a sale to a separate SPE. The originator could issue debt securities directly. Those investors who require the timely receipt of current interest may still need to use the current two transaction securitization structure to avoid the interruption of the cash flow by the automatic stay. On the other hand, because investors will be assured the ultimate payment of interest or will be able to foreclose on the collateral, the reduction in the costs to the originator of direct secured lending may outweigh the costs of the securitization structure for many transactions. For example, the originator's debt securities could obtain an investment grade rating if there were sufficient collateral to ensure that any delays in liquidating the collateral would not prevent the holders of the debt securities from receiving the full value of their investment. The major risk for these direct debt securities would be a prepayment risk if the originator became a debtor in bankruptcy. Prepayment is a risk for which the market imposes a premium. The only question would be whether the prepayment risk

burdensome to the estate or that is of inconsequential value and benefit to the estate").

387 *See* Tracht, *supra* note 28, at 354-55 (arguing that borrowers should be able to waive bankruptcy protections in securitizations).

premium would be greater than or less than the costs of the current two transaction securitization.

This rule change raises one concern. If the secured creditor is oversecured, it has no incentive to maximize the sale proceeds. In the case of used goods as collateral, this concern probably outweighs the desirability of quick foreclosure so that the collateral can be put to productive use. Receivables, however, present a different case. Receivables are more liquid, and there is an active market for almost all kinds of receivables. Moreover, sales by the bankruptcy trustee out of the ordinary course of business require court approval. This requirement gives participants in the bankruptcy case an opportunity to object to a sale simply to obtain greater leverage in the case. Accordingly, even with the imperfect incentives in the case of creditors' sales, foreclosure sales by oversecured creditors may in fact produce more than the regulatory sales conducted by bankruptcy trustees.

My proposal would bring the Bankruptcy Code in line with the regulatory regime for insolvent financial institutions. State and national banks and state and federal savings associations are not subject to the Bankruptcy Code.[388] When one of these depository institutions that is insured by the Federal Deposit Insurance Corporation (the "FDIC") becomes insolvent, the FDIC is usually appointed as receiver or conservator.[389] The FDIC has broad powers as a receiver or conservator of a depository institution. These include the power to succeed to all

388 *See* 11 U.S.C. § 109(b)(2), (d).

389 Pursuant to § 11(c)(2)(A)(ii) of the Federal Deposit Insurance Act, the FDIC must be appointed as the receiver whenever a receiver is appointed for the purpose of liquidation an insured federal depository institution, including a national bank and a federal savings association. 12 U.S.C. § 1821(c)(2)(A)(ii) (2000). The FDIC may also be appointed as a conservator of a federal depository institution when one is appointed to conserve its assets pending either appointment of a receiver for liquidation of the institution or the return of the institution to normal business. *See id.* § 1821(c)(2)(A)(i). The Comptroller of the Currency decides when to appoint a receiver or conservator of a national bank. *See id.* §§ 191, 203. The Office of Thrift Supervision decides when to appoint a receiver or conservator of a federal savings institution. *See id.* § 1464(d)(2).

For state banks and savings associations that are insured by the FDIC, the FDIC may be appointed as a receiver or conservator. *See id.* § 1821(c)(3)(A). If a state bank is a member of the Federal Reserve System, the Federal Reserve Board decides when to appoint the receiver or conservator. *See id.* § 248(o). State statutes also provide for the appointment of the FDIC as receiver. *See, e.g.*, CAL. FIN. CODE §§ 3220, 3221 (West 1999) (appointment as a receiver of insured state bank); 8253 (appointment as a receiver of insured state savings association); MD. CODE ANN., FIN. INST. §§ 5-605 (Michie 1998) (appointment as a receiver of insured state banking institution (bank, trust company, and savings bank)); 9-709 (appointment as a receiver of insured state savings and loan association); N.Y. BANKING LAW § 634 (McKinney 2001) (appointment as a receiver of insured state banking organization (including banks, trust companies, savings banks, and savings and loan associations)).

In some circumstances, the FDIC may appoint itself as a conservator or receiver of an insured state institution even if the state authorities do not seek such appointment. *See* 12 U.S.C. § 1821(c)(4). The FDIC may also appoint itself as conservator or receiver of any insured institution to prevent loss to the deposit insurance fund. *See id.* § 1821(c)(10).

rights, titles, powers, and privileges of the institution, to operate the institution, to exercise the functions of the institution's officers, directors and stockholders, to pay obligations of the institution, and, as receiver, to liquidate the institution and to determine claims.[390]

Nevertheless, the act granting the FDIC these broad powers does not contain any automatic stay and it does not contain any general turnover power. If the creditor has possession of property items, whether as the result of a pledge or repossession, it may liquidate the collateral so long as it does so in a commercially reasonable manner.[391]

The FDIC may also repudiate contracts to which the institution is a party if the FDIC determines that performance of the contract would be burdensome, and the disaffirmance or repudiation would promote the orderly administration of the institution's affairs.[392] These avoidance powers, however, do not permit the avoidance of any legally enforceable or perfected security interest in the assets of any institution except when an interest was taken in contemplation of the institution's insolvency or with intent to hinder, delay, or defraud the institution or the creditors of the institution.[393] Further, the FDIC has issued a regulation providing that the FDIC may not exercise its authority to disaffirm or repudiate contracts to recover or recharacterize as property of the institution or the receivership any financial assets transferred by the institution in connection with a securitization if the transfer meets all conditions for sale accounting treatment under generally accepted accounting principles other than the "legal isolation" condition.[394] This financial institution insolvency regime is friendlier to secured creditors. These institutions commonly engage in securitizations, obtain ratings, and avoid some of the structural costs of a securitization.

The greater flexibility to the financial institutions does not seem to

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[390] *See* 12 U.S.C. § 1821(d)(2)-(3).

[391] *See* Letter from John L. Douglas, General Counsel of the FDIC 89-49 [1989-1990 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,265, at 55,457 (Dec. 15, 1989). In this letter, the General Counsel opined that the Financial Institutions Reform, Recovery and Enforcement Act of 1989, which substantially revised federal law relating to bank conservatorships and receiverships, does not contain an automatic stay provision similar to that found in the Bankruptcy Code, and that a secured creditor of a federally insured bank for which a receiver had been appointed may undertake to liquidate the creditor's properly pledged collateral by commercially reasonable "self-help" methods, so long as there has been a default in the underlying agreement other than the mere appointment of a receiver. The General Counsel's letter notes, however, that if some action is required by the receiver or if the liquidation of the collateral would require judicial action, then the creditor would have to follow the claims procedure set forth in the FDI Act. Accordingly, when the FDIC has control of property of the institution subject to a security interest, an automatic stay would not be necessary.

[392] *See* 11 U.S.C. § 1821(e).

[393] *See id.*

[394] *See* "Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation," 12 C.F.R. § 360.6 (2003).

harm their unsecured creditors, of which the FDIC is often the largest by virtue of the insurance coverage of deposits up to $100,000 for each depositor.[395] It will not hurt the unsecured creditors of originators of receivables who are eligible to be debtors under the Bankruptcy Code.[396] Because a debtor cannot use its interest in cash collateral without the consent of the secured party or providing adequate protection to the secured party, my proposal would only prevent use of the proceeds of the receivables when the secured creditor receives a security interest in other collateral. Preventing the debtor from using the secured creditor as an involuntary debtor in possession financer and requiring the debtor to obtain a voluntary debtor in possession financer seems like a good thing to me.

CONCLUSION

The legal foundations of securitization are very secure. These foundations are firmly established, deeply rooted legal principles: the sale of property and the establishment of separate legal entities. Securitization saves businesses and consumers large amounts of money, and as a result it has created its own constituency. This constituency will not sit idly by if properly structured securitizations are attacked by opportunistic originators that become debtors. If improperly structured securitizations are collapsed in bankruptcy, such a collapse will not weaken securitization. It may in fact strengthen it. Finally, that securitization appears to be an end run around the risks of the bankruptcy of the originator is a good thing. It reveals the hidden costs that the Bankruptcy Code imposes on businesses and consumers debt who borrow on security. This revelation may lead to reform of the Bankruptcy Code that would benefit all.

[395] 12 U.S.C. §§ 1811(a), 1821(a) (authorizing deposit insurance by the FDIC).

[396] Or, for those who think secured credit hurts unsecured creditors, my proposal does not hurt unsecured creditors any more.