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Toward a More Efficient Bankruptcy Law: Mortgage Financing under the 2005 Bankruptcy Amendments

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TOWARD A MORE EFFICIENT BANKRUPTCY LAW: MORTGAGE FINANCING UNDER THE 2005 BANKRUPTCY AMENDMENTS

Thomas E. Plank*

I. INTRODUCTION

Many commentators have criticized the consumer[1] and business[2] provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Amendments").[3] The 2005 Amendments, however, do contain some good news for both consumers and entities in the business of originating mortgage loans. The 2005 Amendments expanded certain "protected transaction" provisions in the Bankruptcy Code that allow the immediate acceleration and liquidation of certain "repurchase agreements"[4] and "securities contracts"[5] and the liquidation of collateral pledged in

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* Joel A. Katz, Distinguished Professor of Law, University of Tennessee College of Law; A.B. 1968, Princeton University; J.D. 1974, University of Maryland; Of Counsel, McKee Nelson, LLP. I have personally benefited from securitization, both intellectually and financially. I have been involved in securitizations since 1987. I served as issuer's counsel and bankruptcy counsel for securitizations, as a partner with Kutak Rock, LLP until 1994, thereafter serving as a consultant on securitization transactions. Since June 2001, I have been Of Counsel to McKee Nelson, LLP, providing advice on bankruptcy and security interest matters in securitizations, including the drafting of true sale opinions and non-consolidation opinions and providing advice on structuring transactions to ensure true sales and non-consolidation. Nevertheless, my belief in the value and soundness of securitization reflects my convictions and not my economic interests. As will be apparent in this article, I believe that society would be better off if the Bankruptcy Code were amended to obviate the need for the structural limitations, including true sale opinions and non-consolidation opinions, required by securitizations.

1. *See* Professor Robert Lawless, *Small Business and the 2005 Bankruptcy Law: Should Mom & Apple Pie Be Worried?* 31 S. ILL. U. L.J. 585 (2007); *see also* Peter C. Alexander, *"Herstory" Repeats: The Bankruptcy Code Harms Women and Children*, 13 AM. BANKR. INST. L. REV. 571 (2005); Jean Braucher, *A Fresh Start for Personal Bankruptcy Reform: The Need for Simplification and a Single Portal*, 55 AM. U. L. REV. 1295 (2006); John Rao, *Testing the Limits of Statutory Construction Doctrines: Deconstructing the 2005 Bankruptcy Act*, 55 AM. U. L. REV. 1427 (2006); Eugene R. Wedoff, *Major Consumer Bankruptcy Effects of Bapcpa*, 2007 U. ILL. L. REV. 31.
2. Lawless, *supra* note 1; *see also* Ralph Brubaker, *Taking Exception to the New Corporate Discharge Exceptions*, 13 AM. BANKR. INST. L. REV. 757 (2005).
3. Pub. L. No. 109–8, 119 Stat. 23 (2005) (enacted April 20, 2005, generally effective for cases commenced on or after 180 days after its enactment). Congress enacted further clarifying amendments on December 12, 2006. *See* Pub. L. No. 109-390, 120 Stat. 2692.
4. *See* 11 U.S.C.A. § 101(47) (West Supp. 2006) (quoted *infra* note 68 and *discussed in* accompanying text.
5. *See* 11 U.S.C.A. § 741(7) (West Supp. 2006), *quoted infra* note 75 and *discussed in* accompanying text.

connection with those contracts to include transactions involving mortgage loans. This extension of the protected transaction provisions to mortgage loans will reduce both the costs of originating mortgage loans for the originators and the costs to mortgagors.

The purpose of this article is to describe how these protected transactions lower the costs of originating mortgage loans. This description, however, first requires an understanding of the costs the Bankruptcy Code imposes on secured creditors (described by David Carlson as a "bankruptcy tax"[6]) and the response to this tax: The development of securitization that significantly lowers the costs to originators of mortgage loans and their borrowers by avoiding most of this bankruptcy tax.[7] The 2005 Amendments do not eliminate the need for securitization, but for certain significant types of financing they will avoid the bankruptcy tax without the costs of securitization structures.

II. FINANCING MORTGAGE LOANS: AN OVERVIEW

A mortgage loan is a monetary obligation typically evidenced by a promissory note secured by a "mortgage" or "deed of trust" or similar instrument.[8] The most common use of a mortgage loan is to enable individuals to acquire homes. The basic type of mortgage loan is a 30 year, fixed rate, amortizing loan.[9] For example, a $100,000 mortgage loan bearing interest at the rate of 6% per annum repayable over 30 years requires 360 monthly payments of $599.55 each. The monthly payment consists of one month's interest on the outstanding balance at the beginning of the month plus a partial payment of principal, calculated to provide for the full payment of principal over 30 years.[10] Hence, the first monthly payment consists of an

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6. *See* David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055, 1064 (1998).
7. *See generally* Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655 (2004) [hereinafter, Plank, *Security of Securitization*] (describing securitization and its benefits and arguing that the legal and practical foundations of securitization are secure); *See also The Key to Securitization: Isolating the Assets to Be Securitized from the Risk of An Insolvency Proceeding* (ch. 7, pages 1-1 through 1-128), *in* JOHN ARNHOLZ AND EDWARD E. GAINOR, EDS., OFFERINGS OF ASSET BACKED SECURITIES (Aspen Pub. 2006) [hereinafter, Plank, *The Key to Securitization*] (describing in detail how securitizations are structured to reduce the risks of insolvency of an originator).
8. *See* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 1.1, at 1–4 (4th ed. 2001).
9. *See, e.g.*, Multistate Fixed Rate Note–Single Family–Fannie Mae/Freddie Mac Uniform Instrument Form 3200 1/01, *available at* http://www.freddiemac.com/uniform/unifnotes.html (last visited Mar. 16, 2007).
10. Calculations on file with the author. These calculations can be done on a Microsoft Excel program.

interest payment equal to 1/12th of 6% on $100,000, or $500, and a partial principal payment of $99.55. The next monthly payment consists of interest equal to 1/12th of 6% on $99,900.45, or $499.50, and a partial principal payment of $100.05. Assuming no prepayment of the mortgage loan, the last payment, the 360th payment due on the maturity date, would consist of $2.99 of interest and $596.56 of principal. A variation that would provide for faster repayment but a larger monthly payment is a 15 year fixed rate loan. For example, a $100,000 mortgage loan bearing interest at the rate of 6% per annum repayable over 15 years requires a monthly payment of $843.86, which is substantially higher than that for a 30 year mortgage loan.

There are other variations of a mortgage loan. A common variation is a variable rate mortgage loan in which the interest rate varies according to a variety of indices, such as Eleventh District Cost of Funds, six month LIBOR (London Interbank Offering Rate), one year LIBOR, or one year Treasury Index.[11] After the interest rate changes, the monthly payment is adjusted to provide for full amortization of the loan over the 30 year period. Another variation is an interest only loan for a certain period of time. To the extent that the monthly payment reflects only the payment of interest and not principal, the monthly payment will be smaller. A smaller monthly payment allows a mortgagor to qualify for a larger loan with less income.[12] In particular, commercial mortgage loans and home equity lines of credit often require only the payment of interest and, in some cases, some payment of principal but not enough to amortize the loan by its maturity date. Hence, at the maturity date of this kind of mortgage loan, there will be a "balloon" payment equal to the original balance of the loan less any partial principal payments.

Mortgage loans, as a type of receivable, present unique challenges. First, unlike government bonds and corporate bonds, which pay interest periodically and then pay all of the principal on the maturity date, mortgage loans pay portions of principal each month. Accordingly, any holder of a mortgage loan must be equipped to handle these dribbles of principal.

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11. *See e.g.*, Multistate Fixed Rate Note–Single Family–Fannie Mae/Freddie Mac Uniform Instrument Form 3200 1/01, *available at* http://www.freddiemac.com/uniform/unifnotes.html (last visited Mar. 16, 2007).

12. The ratio of the monthly payments on the mortgage loan plus other required payments, such as property insurance payments and real estate taxes, may not exceed specific percentages of the mortgagor's stable monthly income. *See, e.g.*, FREDDIE MAC SINGLE FAMILY SINGLE-FAMILY SELLER/SERVICER GUIDE, Volume 1, Ch. 37, Underwriting the Borrower, 37.15: Monthly housing expense-to-income ratio (5/21/04), *available at* http://www.allregs.com/fhlmc (last visited Mar. 16, 2007).

Second, most mortgage loans have a 30 year term. Most mortgage loans are prepayable without penalty at any time, and most buyers of mortgage loans assume that a certain percentage of mortgage loans prepay every month. However, even if a pool of mortgage loans–say, a pool of $100,000,000–were to prepay at a constant annual rate of 10%, the pool of mortgage loans would not be prepaid for more than ten years.[13] Accordingly, a change in market mortgage rates will have a dramatic effect on the value of the loan. For example, for a pool of $100,000,000 of 30 year mortgage loans bearing an annual fixed interest rate of 6%, if market mortgage rates were to rise to 8%, the present value of the mortgage loans would decrease dramatically to less than $82 million, assuming no prepayment, and to approximately $92.1 million assuming a constant annual prepayment rate of 10%. In addition, when market mortgage interest rates increase, the rate of prepayment also tends to decline. Hence, if a buyer had bought a pool of mortgage loans assuming a 10% prepayment rate, and an increase in market rates by 2 percentage points caused the prepayment rate to fall to 5%, the present value of the mortgage loans would decrease by $2.8 million to $89.3 million.

Accordingly, mortgage loans bear a significant risk of gain or loss because of changes in market interest rates. This specific feature of mortgage loans led to the entire insolvency of the savings and loan industry in the early 1980s, which held low rate long term mortgage loans whose value declined when inflation and mortgage rates went up.[14] This particular aspect of mortgage loans produced a significant change in the 1970s and the 1980s in the way mortgage loan were financed.[15]

As of the end of 2006, there were over $13.3 trillion of mortgage loans outstanding, of which approximately $10.2 trillion were single family

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13. Calculations on file with the author. These calculations can be done on a Microsoft Excel program.
14. *See* Robert J. Laughlin, Note, *Causes of the Savings and Loan Debacle*, 59 FORDHAM L. REV. s301, S302–11 (1991); Kenneth E. Scott, *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. S57, S61–65 (1991); *See also* Cottage Sav. Ass'n v. Comm., 499 U.S. 554, 556–58 (1991). In this case, Cottage Savings Association had 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. A regulatory directive of the former Federal Home Loan Bank Board, which was later succeeded by the Office of Thrift Supervision, allowed such an exchange without recording 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.
15. *See generally* Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1380–97 (1991).

mortgage loans.[16] Over $9.7 trillion of these mortgage loans represented obligations of households, and of this amount, approximately $9 trillion were first lien single family mortgage loans, and approximately $1 trillion were home equity line of credit or second lien single family mortgage loans.[17] That is a lot of money. Indeed, the outstanding balance of mortgage loans exceeded the outstanding obligations of the federal government ($4.9 trillion)[18] and the non-mortgage credit market debt of non-financial businesses ($5.8 trillion), the bulk of which consisted of corporate bonds ($3.2 trillion).[19]

The money used to finance the origination of mortgage loans come from a variety of sources. Table 1 shows the primary sources as of the end of 2006, as well as the end of each of 1996 and 2001.

16. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, ACCOUNT FLOWS AND OUTSTANDINGS 1995–2006, tbl L. 217, Total Mortgages, lines 1, 2 (Mar. 8, 2007) [hereinafter, "FRB FLOW OF FUNDS"] *available at* http://www.federal reserve. gov/releases/z1 (last visited May 31, 2007).

17. *See* FRB FLOW OF FUNDS, *supra* note 16, tbl L. 218, Home Mortgages, lines 2, 22.

18. *See* FRB FLOW OF FUNDS, *supra* note 16, tbl L. 2, Credit Market Debt Owed by Nonfinancial Sectors, line 23.

19. *See* FRB FLOW OF FUNDS, *supra* note 16, tbl L. 101, Nonfinancial Sectors, lines 18, 21, 24 ($8.992 trillion less $3.220 mortgage debt).

Table 1: Home Mortgages Held by Sectors 1996–2006[20]
Amounts in Billions

Holder	1996	%	2001	%	2006	%
Household	86.8	2.4%	94.9	1.7%	67.6	0.7%
Commercial banking	677.6	18.4%	1,023.9	18.2%	2,053.0	20.1%
Savings institutions	513.7	14.0%	620.4	11.0%	869.6	8.5%
Life insurance companies	7.0	0.2%	4.9	0.1%	4.9	0.0%
Government-sponsored enterprises	198.5	5.4%	225.6	4.0%	342.6	3.4%
Agency- and GSE-backed mortgage pools	1,678.8	45.7%	2,748.5	48.7%	3,822.2	37.5%
ABS issuers	215.4	5.9%	434.1	7.7%	1,834.5	18.0%
Finance companies	87.0	2.4%	209.7	3.7%	539.2	5.3%
Other[21]	209.9	5.7%	277.5	4.9%	656.6	6.4%
Total	3,674.7	100%	5,639.5	100%	10,190.2	100%
Total in December 2006 Dollars	4,675.6		6,440.6		10,190.2	

As a comparison, Table 2 shows the primary sources as of the end of each of the years 1946, 1956, 1966, 1876, and 1986.

20. *See* FRB FLOW OF FUNDS, *supra* note 16, tbl L. 217, Total Mortgages, lines 15–31.
21. "Other" consists of nonfinancial business; state, local, and federal governments; credit unions; private pension funds; state and local government retirement funds; and REITS.

Table 2: Home Mortgages Held by Sectors 1946–1986[22]
Amounts in Billions

Holder	1946	%	1956	%	1966	%	1976	%	1986	%
Household	6.2	27%	8.9	9%	18.1	8%	21.3	4%	91.9	5%
Commercial banking	4.6	20%	16.2	16%	32.8	14%	86.2	16%	232.0	13%
Savings institutions	8.8	38%	47.1	48%	131.8	57%	307.0	57%	568.3	33%
Life insurance companies	2.5	11%	20.1	20%	30.2	13%	16.1	3%	12.8	1%
Government-sponsored enterprises	0.0	0%	0.6	1%	4.4	2%	31.4	6%	101.4	6%
Agency- and GSE-backed mtg pools	0.0	0%	0.0	0%	0.3	0%	37.3	7%	519.5	30%
ABS issuers	0.0	0%	0.0	0%	0.0	0%	0.0	0%	16.6	1%
Finance companies	0.1	0%	1.1	1%	3.3	1%	9.1	2%	52.4	3%
Other	0.8	3%	4.7	5%	11.8	5%	26.6	5%	127.1	7%
Total	23.0	100%	98.7	100%	232.7	100%	535.0	100%	1,722.0	100%
Total In December 2006 Dollars	215.9		721.7		1,427.3		1,855.0		3,144.8	

Table 1 shows that as of the end of 2006, the largest holder of single family mortgage loans were pools formed by two federal agencies, the Government National Mortgage Association (Ginnie Mae) and the successor agency to the Farmers Home Administration (FmHA), and two GSEs or

22. *See* FRB FLOW OF FUNDS, *supra* note 16, tbl L. 217, Total Mortgages, lines 15–31.

governmentally sponsored enterprises, Fannie Mae and Freddie Mac, interests in which have been sold to investors. The next largest group of holders were commercial banks, with the issuers of asset backed securities a close third. Table 1 shows the dramatic growth of the amount of mortgage loans held by issuers of asset backed securities, from only 5.9% of the total in 1996 to 18% ten years later. Table 2 also shows that issuers of asset backed securities began holding mortgage loans in 1986.

In addition, Tables 1 and 2 demonstrate the decline in holdings by savings associations, from close to or above 50% from 1946 though 1976, to less than 8.5% in 2006. In addition, from 1946 through 1976, life insurance companies and individuals held substantial portions of outstanding mortgage loans, but those percentages declined to almost nothing by 2006.

III. THE BANKRUPTCY TAX ON SECURED CREDIT

Outside of bankruptcy, unsecured creditors could obtain payment of their debts from defaulting borrowers by obtaining a judgment and attaching or garnishing the borrower's property.[23] Secured creditors, however, can obtain payment by obtaining possession of their collateral and selling it at a foreclosure sale and, in the case of collateral that consists of mortgage loans and other receivables, such as automobile loans, equipment loans and leases, credit card receivables, trade receivables, student loans, and other payment obligations, by collecting those receivables from the persons obligated on the receivables.[24]

Historically, bankruptcy law replaced the single creditor collection remedies with a collective proceeding that adjusted the relationship between an insolvent debtor and his, her, or its unsecured creditors.[25] As I have

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23. *See, e.g.*, N.Y. C.P.R.L. § 5201 (McKinney 2006) (specifying the property against which a money judgment may be enforced); § 5230 (providing for the issuance of a property execution); § 5231 (specifying the issuance of an income execution); § 5232 (providing for levy on personal property); § 5236 (providing for sale of personal property levied upon); § 5235 (providing for levy on real property); § 5236 (providing for sale of real property levied upon).
24. *See, e.g.* U.C.C. § 9–609 (2006) (permitting a secured creditor to take possession of collateral); § 9–610(a) (permitting disposition of collateral); § 9–615(a) (providing for distribution of proceeds to secured creditor and other persons, including the debtor); § 9–607(a) (permitting a secured party to collect from and enforce collateral).
25. Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487 (1996) (describing the different types of bankruptcy laws in effect in England and America before the adoption the U.S. Constitution and the federal bankruptcy laws enacted in the nineteenth and twentieth centuries); Thomas E. Plank, *Why Bankruptcy Judges Need Not and Should Not be Article III Judges*, 72 AM. BANKR. L.J. 567 (1998) (describing the adjudication of bankruptcy cases under eighteenth-century English and American bankruptcy laws); Charles J. Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5 (1995); Charles J. Tabb, *The Historical Evolution*

described elsewhere, however, before 1933 a bankruptcy liquidation case had little effect on secured creditors that had possession or control of their collateral, and a secured creditor in possession or control could generally liquidate its collateral notwithstanding a borrower's bankruptcy.[26] This happy state for secured creditors ended with several amendments to the Bankruptcy Act of 1898, beginning in 1933 and culminating in the Chandler Act of 1938. These Depression era amendments, which extended the jurisdiction of the bankruptcy court in reorganizations to all of the debtor's property wherever located, empowered a debtor in possession to prevent a secured creditor's liquidation of its collateral.[27] The Bankruptcy Code of 1978 further limited secured creditors' rights in bankruptcy.

Currently, under Section 541(a)(1) of the Bankruptcy Code, the commencement of a bankruptcy case by the filing of a voluntary[28] or involuntary[29] petition creates an estate that consists primarily of "all legal or equitable interests of the debtor in property as of the commencement of the case."[30] In addition, a trustee is appointed that takes control of the property of the estate. In a chapter 7 liquidation, the trustee is an independent third person.[31] In a chapter 11 reorganization, the debtor in possession is normally the bankruptcy trustee.[32] In a chapter 12 or 13, a separate trustee is appointed

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of the Bankruptcy Discharge, 65 AM. BANKR. L.J. 325, 329–31 (1991).

26. Thomas E. Plank, *The Creditor in Possession Under the Bankruptcy Code: History, Text, and Policy*, 59 MD. L. REV. 253, 264–68 (2000) [hereinafter "Plank, *Creditor in Possession*"].
27. *See id.* at 268–81.
28. *See* 11 U.S.C. § 301 (2000).
29. *See* 11 U.S.C. § 303(a), (b), (h) (2000).
30. *See* 11 U.S.C. § 541(a)(1) (2000):

> (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 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.

The other enumerated items refer to community property § 541(a)(2), and to property added to the estate after the commencement of the case. 11 U.S.C. § 541(a)(3)–(7) (West Supp. 2006).

31. *See* 11 U.S.C. § 701(a) (2000) (appointment of interim trustee by United States trustee); 11 U.S.C. § 702(b),(d) (2000) (election of permanent trustee by creditors or, if no election, continuation of the interim trustee); 11 U.S.C. § 704(a)(1) (2000) (duty of trustee to "collect and reduce to money the property of the estate for which such trustee serves").
32. *See* 11 U.S.C. § 1101(1) (2000) (defining the "debtor in possession" as the debtor unless an independent person is appointed as trustee); 11 U.S.C. § 1107(a) (2000) (providing that the debtor in possession has most of the rights, powers, and duties of a trustee); 11 U.S.C. § 1108 (2000) (providing that the trustee may operate the debtor's business).

but the debtor retains control over the property of the estate and has some of the duties of the bankruptcy trustee.[33]

A bankruptcy case affects secured creditors in several ways. First, all of the debtor's claims, including the claims of secured creditors, are accelerated.[34] Although unsecured creditors are not entitled to interest that accrues on their claims after the commencement of the case,[35] a secured creditor continues to accrue interest on its claim so long as the value of its collateral exceeds the amount of its claim.[36] Undersecured creditors do not accrue interest because there is no excess value. For example, a creditor with an $80 claim secured by a property item worth only $60 has a secured claim for $60 and an unsecured claim for $20.

Second, although the debts of secured creditors are immediately accelerated, they are not paid immediately. Under Section 362, the commencement of a case imposes an automatic stay of any creditor collection action against the debtor or property owned by the debtor.[37] In particular, the commencement of a case stays any act to obtain possession or control of

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33. *See* 11 U.S.C. § 1202(a) (2000) (providing, in chapter 12, for appointment of a trustee to perform certain duties); 11 U.S.C. § 1203 (2000) (providing, in chapter 12, that the debtor, which is implicitly treated as a debtor in possession, has most of the rights, powers, and duties of a trustee and may operate the debtor's farm or commercial fishing business); 11 U.S.C. § 1302(a) (2000) (providing, in chapter 13, for appointment of a trustee to perform certain duties); 11 U.S.C. § 1303 (2000) (providing, in chapter 13, that the debtor has certain rights and powers of a trustee, including the power to use, sell, or lease property of the estate); 11 U.S.C. § 1304 (2000) (providing, in chapter 13, that a debtor engage in business may continue to operate the business).
34. *See* 11 U.S.C. § 502(b) (2000) (providing that the bankruptcy court, after notice and a hearing, shall determine the amount of the claim of a creditor as of the date of the filing of the petition).
35. *See* § 502(b)(2) (providing that after determining the amount of a creditors claim, the bankruptcy court "shall allow such claim in such amount, except to the extent that . . . such claim is for unmatured interest").
36. *See* 11 U.S.C. § 506(a)(1) (2000) (providing that "an allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest [sic] in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest [sic] or the amount so subject to setoff is less than the amount of such allowed claim"). This section is incorrectly worded. If a debtor owns a property item worth $100 in which a creditor has a security interest to secure an $80 debt, the estate's interest in the property item–its equity–is $20 and the creditor's interest is $80. The creditor has no interest in the estate's interest. Instead of referring to the "creditor's interest in the estate's interest [sic] in such property" the section should have referred to the "creditor's interest in such property." *See generally See* Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 EMORY L. J. 1193, 1230 (1998) [hereinafter Plank, *Bankruptcy Estate*]. It may be that the property owned by the estate is less than the entire property item, such as a leasehold or a co-tenant's interest, but the creditor's interest can never exceed the property interest owned by the debtor and now by the estate. To obviate any concern on that point, however, the provision could refer to the "creditor's interest in the property interest owned by the estate."
37. *See* 11 U.S.C. § 362(a)(1) (2000).

property of the estate[38] or to collect a claim against the debtor.[39] Therefore, a secured creditor may not obtain payment of its debt through a foreclosure sale of its collateral, even if it has possession of the collateral. This prohibition arises not because–as commonly but mistakenly thought–a foreclosure sale is an act to obtain possession or control of property of the estate, but because it is an act to collect a claim.[40] A secured creditor can only be paid at the conclusion of the bankruptcy case–liquidation and distribution[41] in a chapter 7 or payment under a confirmed plan[42]–or upon obtaining relief from the automatic stay, the success and timing of which are uncertain.[43]

Third, the bankruptcy trustee may use property of the estate, either with or without court approval, including the estate's interest in property items subject to a security interest.[44] Fourth, the trustee may grant a lender to the debtor-in-possession a security interest in collateral pledged to a secured creditor, including a security interest that has priority over the pre-petition secured creditor.[45]

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38. *See* § 362(a)(3) (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").
39. *See* § 362(a)(6) (stay of "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case").
40. 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, or violating § 362(a)(4) or (5), which stays acts to create or enforce a "lien.". *See* Plank, *Bankruptcy Estate*, *supra* note 36, 1259–62, 1264–67; Plank, *Creditor in Possession*, *supra* note 26, at 312–15.
41. *See* 11 U.S.C. § 726 (2000) (requiring the trustee to distribute property of the estate).
42. *See* 11 U.S.C. §§ 1129(a)(7)–(9), 1129(b), 1225(a)(5), 1125 (b)(1), 1325(a)(5), 1325(b)(1) (2000) (specifying minimum treatment of creditors for confirmation of plan); 11 U.S.C. §§ 1141(a), 1227(a), 1327(a) (2000) (providing that a confirmed plan binds all creditors).
43. *See* § 362(c) (providing that, with certain exceptions, the automatic stay continues until the earliest of the time the case is closed, the case is dismissed, or if the case is a case under chapter 7 concerning an individual or a case under chapters 9, 11, 12, or 13, a discharge is granted or denied); § 362(d) (providing for relief from the automatic stay).
44. *See* 11 U.S.C. § 363(b)(1) (2000) (use of property of the estate not in the ordinary course of business); § 363(c)(1) (use of property of the estate other than cash collateral in the ordinary course of business without court approval); § 363(c)(2) (use of cash collateral in the ordinary course of business with consent of the secured creditor or court approval); § 363(a) (defining cash collateral as "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").
45. *See* 11 U.S.C. § 364(c)(3) (2000) (providing that the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt "secured by a junior lien on property of the estate that is subject to a lien"); § 364(d)(1) (providing that, the "court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if (A) the trustee is unable to obtain such credit otherwise; and (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted"). These subsections also incorrectly refer to "property of the estate subject to a lien." The only time that property of the estate can be subject to a lien is when a property of the estate is pledged to secure a post-petition debt. If

Fifth, under the poorly reasoned and erroneously decided Supreme Court case of *United States v. Whiting Pools*,[46] a debtor that files for bankruptcy after a secured creditor has repossessed the debtor's tangible property items may require the secured creditor to return the property items to the debtor–now the debtor in possession. This case, however, does not apply to payment obligations due to the debtor. In *Citizens Bank of Maryland v. Strumpf*,[47] the Court held that an administrative hold on a bank account did not violate the automatic stay. In this case, a bank at which the debtor had a checking account–which consists of an obligation of the bank to pay money to the order of the debtor–was also a creditor of a debtor. Under non-bankruptcy law, the bank had a right to set off the debt owed by the debtor to the bank against the amounts the bank was obligated to pay to the order of the debtor. The Court correctly noted:

> Respondent's reliance on [the automatic stay] provisions rests on the false premise that petitioner's administrative hold took something from respondent, or exercised dominion over property that belonged to respondent. That view of things might be arguable if a bank account consisted of money belonging to the depositor and held by the bank. In fact, however, it consists of nothing more or less than a promise to pay, from the bank to the depositor, . . . and petitioner's temporary refusal to pay was neither a taking of possession of respondent's property nor an exercising of control over it, but merely a refusal to perform its promise.[48]

Nevertheless, although any creditor that owes money to the debtor and therefore to the bankruptcy estate need not pay that debt to the extent of its right of set off, that creditor may not actually exercise its right of set off.[49] The creditor must continue to account for, and reserve capital against, a non-performing asset (the debt owed by the debtor to the creditor) and also continue to carry on its books as a liability its debt owed to the debtor.

The limitations on the non-bankruptcy entitlements of secured creditors impose a cost on them. The most significant costs arise from the immediate

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a person owned a property interest–say, worth $100–subject to a lien–say for a debt equal to $80–and becomes a debtor in bankruptcy, the property of the estate is only the debtor's interest–the equity interest consisting of legal title and its rights under non-bankruptcy law, such as the right to redemption. The debtor's equity and therefore the estate's interest–the property of the estate–is not subject to a lien. *See* Plank, *Bankruptcy Estate*, *supra* note 36, 1230–31 & n. 160.

46. 462 U.S. 198 (1983).

47. 516 U.S. 16 (1995).

48. *Strumpf*, 516 U.S. at 21.

49. *See* 11 U.S.C. § 362(a)(7) (2000) (staying "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor"). This subsection is not really necessary. The automatic stay of an act to collect a claim, *discussed supra* note 39 and accompanying text, would also prevent such a set off.

acceleration of secured claims, and the inability to obtain immediate or quick payment of those claims. These costs are equivalent to a tax levied on secured creditors, the benefits of which go to the administrative expenses of the bankruptcy case and the unsecured creditors. To recoup these costs, secured lenders must charge a higher interest rate or other fees, a bankruptcy premium, to all of their borrowers.

For many types of property items in the possession of the debtor, such as goods being used in the debtor's business or personal life, these limitations on secured creditors may make some sense. If a trucking company becomes a debtor in bankruptcy and seeks to reorganize, it will not be able to do so if a creditor with a security interest in the fleet of trucks can foreclose its security interest against the fleet. If a steel producer becomes a debtor in bankruptcy and seeks to reorganize, it will not be able to do so if a creditor with a security interest in the raw material necessary for such processing can foreclose its security interest. In my view, however, these considerations do not apply to mortgage loans and other receivables.

The essential nature of receivables–which are characterized under the Uniform Commercial Code as accounts, chattel paper, promissory notes, or payment intangibles–is a monetary obligation of an obligor to pay money.[50] The essential "use" of a receivable is the receipt of money in the future–the return of the principal amount of the monetary obligation and any interest that is payable on the principal amount.

To be sure, as Professor Robert Lawless has pointed out, the owners of all business assets expect to earn a return, or yield, and such owners must take action to realize this yield. Hence, the owner of a trucking company must operate its equipment, the producer of steel must process its raw material inventory into finished products, and the owners of mortgage loans and other receivables must collect the payments, enforce the obligations against

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50. *See* U.C.C. § 9–102(a)(2) (defining an "account" to mean "a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of, (ii) for services rendered or to be rendered," and for a variety of other enumerated purposes, such as insurance, a secondary obligation, energy, hire of a vessel, credit card charges, and lottery winnings, but excluding chattel paper or an instruments and other specialized types of payment obligations, including commercial tort claims, deposit accounts, investment property, and rights to payment for money or funds advanced other than credit card receivables); § 9–102(a)(11) (providing that "chattel paper" is primarily "a record or records that evidence both a monetary obligation and a security interest in . . . [or] a lease of specific goods"); § 9–102(a)(65) (defining "promissory note" to mean "an instrument that evidences a promise to pay a monetary obligation, does not evidence an order to pay, and does not contain an acknowledgment by a bank that the bank has received for deposit a sum of money or funds"); § 9–102(a)(61) (defining "payment intangible" to mean "a general intangible under which the account debtor's principal obligation is a monetary obligation"). A "general intangible" is any personal property that is not included in another Article 9 type of collateral. *See* § 9–102(a)(42).

defaulting obligors, and otherwise service the mortgage loans or receivables. In this sense, mortgage loans and other receivables are similar in kind to other assets, such as equipment or goods.

On other hand, equipment and inventory do not by themselves turn into cash, but the essential nature of a mortgage loan or other receivable is to turn itself into cash. Indeed, the amount of effort to turn a mortgage loan or other receivable into cash is minuscule in comparison to the amount of effort necessary to earn a return from equipment or inventory. The effort is measured by the amount of servicing fees that a servicer charges for servicing mortgage loans and other receivables, an amount that varies–depending on the type of receivables–from less than 0.25% per annum in the case of mortgage loans to about 2% for credit card receivables.[51]

Except in the case of the prohibition of the use of cash collateral without court approval, even in the ordinary course of business, and *Strumpf*'s recognition that a failure of an obligor to pay money owed to a debtor is not exercising control of property of the estate, the Bankruptcy Code does not generally recognize the difference between receivables and other kinds of property, such as goods. Nevertheless, the market place does recognize the difference between mortgage loans and other receivables, on the one hand, and other types of property such as goods.[52] This difference is the foundation of the several trillion dollar securitization industry. As I have described elsewhere in greater detail,[53] securitization reduces the bankruptcy tax on secured lenders to originators and owners of mortgage loans and other receivables, and therefore has reduced the bankruptcy premiums charged to the obligors of mortgage loans and other receivables.

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51. *See* Standard and Poor's Rating Services, *Structured Finance Credit Card Criteria* 44 (1999) (stating that the standard credit card servicing fee is 2%), (*available at* http://www 2.standardandpoors.com/spf/pdf/fixedincome/creditcardcriteria_092004R.pdf) (last visited Apr. 3, 2007).

52. The LTV Steel case provides a good illustration. *In re LTV Steel Co.*, 274 B.R. 278 (Bankr. N.D. Ohio 2001), then a BB rated steel producer, structured a trade receivables securitization in 1994 that achieved a AAA rating, the highest possible, for the notes secured by the trade receivables. In 1998, it also structured an inventory "securitization" that enabled the issuance of notes secured by inventory owned by an SPE. Because the credit quality for the these notes depended so much on the ability of LTV Steel to process the inventory, however, the notes achieved only a BBB rating, one rating category higher than LTV Steel's rating. *See* Plank, *Security of Securitization, supra* note 7 at 1687–88. I served as an expert witness for Abbey National Treasury Services PLC, on the true sale of the trade receivables and the proper structuring of the LTV trade receivables securitization in the *In re LTV Steel Co.*

53. *See generally* Plank, *Security of Securitization, supra* note 7; Plank, *The Key to Securitization supra* note 7.

IV. RESPONSE TO THE BANKRUPTCY TAX: SECURITIZATION

The raw material for an originator of mortgage loans and most other receivables is the cash to be lent to the mortgagors and other obligors.[54] Originators of mortgage loans and other receivables raise this cash in several ways. Originators must start with an equity investment, but such equity is usually not sufficient. One way of raising cash is to sell the mortgage loans and other receivables. Until an originator has a sufficiently large pool of receivables to make such sales economical, the originator must borrow on a short term basis pursuant to a "warehouse" line of credit. Further, the buyer of the mortgage loans or other receivables must also finance the cost of acquisition. In essence, whether as an originator or a buyer, owners of mortgage loans or other receivables must eventually rely on long term credit.

Any owner of a pool of receivables faces two distinct risks: those associated with the pool itself, and those not associated with the pool but associated with its operations. In the case of the pool itself, the risks include: (a) the credit quality of the particular obligors and the risk of default; (b) the possibility that the market value of the receivable will change because of changes in market interest rates after the interest rate on the receivable has been fixed at the origination of the receivable; and (c) the risk that the receivable will prepay slower or faster than expected at origination, which may also affect the yield on the receivable.[55] The risks not associated with the pool itself include risks associated with other pools originated by the originator and all of the other risks associated with an operating company, such as the risk of generating insufficient revenue to pay overhead and profit and the risks of tort and contract claims arising out of the business.

Lenders to originators also face these risks. In particular, a lender that takes a security interest in a particular pool of receivables takes the risk that the pool will not generate sufficient cash flow to repay the secured loan. In addition, however, regardless of how well the pool performs, the lender also takes all of the other risks associated with the operating company. The originator may get into financial difficulty for reasons not associated with the

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54. In the case of trade receivables, sellers of property or services that sell to their buyers on credit create the trade receivables. In the case of many automobile loans and similar loans, automobile dealers sell vehicles in exchange for chattel paper. In both cases, the owners of these receivables sell or pledge them to obtain financing to acquire new property or to pay the cost of providing services or to repay lenders that had financed the sellers' activities.

55. *See generally* Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON U. L. REV. 287, 293–302 (1991) [hereinafter, Plank, *True Sale*] (describing the benefits and burdens of owning receivables).

pool and become a debtor in bankruptcy. Even if the particular pool of receivables is performing well, the secured lender would then become subject to the automatic stay, would not be able to foreclose on its collateral, and would be required to participate in the bankruptcy case to ensure repayment of all or most of its claim. Securitization reduces the bankruptcy premium on receivables because it separates the risks associated with the pool from the risks of an operating company. It does so through two well recognized legal principles: the sale of assets to a separate legal entity. In the case of mortgage loans, the most common form of securitization is the sale of the mortgage loans to a trustee that issues pass-through certificates to investors. The trustee is the legal owner of the mortgage loans, but the investors–the certificate holders–are the beneficial owners of the mortgage loans.

In the case of some mortgage loans, such as home equity lines of credit, and most kinds of other receivables, securitization takes the form of a sale of these receivables to a special purpose, bankruptcy remote legal entity, such as a corporation, limited liability company, Delaware statutory trust, or limited partnership. This special purpose entity, or SPE, has a limited purpose: to hold the receivables, to issue debt securities or obligations secured by the receivables, and to enter into transactions related only to those activities, such as servicing agreements, guarantees, and other related documents. Neither the certificate trustee nor the SPE is empowered to be an operating company, and in fact both are prohibited from engaging in any operations other than owning the loans and, in the case of an SPE, issuing debt securities or obligations.[56]

The sale of the receivables by the originator to a certificate trustee or an SPE separates the risks associated with the assets from the risks associated with an operating company. Investors can more easily assess the risks associated with the pool of receivables than they can the risks of an operating company. Accordingly, a rating agency can issue a rating for securities backed by a pool of receivables that is higher than the credit rating of an originator, and indeed many securitizations involve receivables originated by originators that do not have investment grade ratings.[57]

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56. *See* Plank, *Security of Securitization, supra* note 7, at 1662–66.

57. 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 Commission, Rating Agencies and the Use of Credit Ratings Under the Federal Securities Laws, 68 Fed. Reg. 35,258 (June 12, 2003) (concept release and request for comments). 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 (last visited Apr. 3, 2007); Plank, *Security*

Securitization saves originators and borrowers money. One study estimated that in 1993 securitization of mortgage loans saved mortgagors about $2 billion in origination fees on $1 trillion of mortgage loans originated.[58] Another study of a $4 billion securitization by General Motors Acceptance Corporation ("GMAC") of automobile loans estimated that GMAC saved 1.3% annually on the declining balance the $4 billion pool.[59]

There are several causes for these savings. First, securitization transforms fairly liquid assets into highly liquid securities. Although mortgage loans and other receivables are reasonably easy to transfer, buyers of mortgage loans and other receivables must do substantial due diligence to ensure the quality of the underlying receivables. In a securitization, however, all of the legal requirements for transfer of the receivables have been satisfied, the issuance of the securities is accompanied by legal agreements and disclosure documents designed to ensure and describe the quality of the underlying receivables, and securities backed by receivables are extremely easy to transfer.

Second, the conversion of receivables into securities expands the universe of investors in receivables. A higher demand for receivables raises the price of the receivables, and in the world of debt instruments, a higher price translates into lower interest or yield on the debt instrument.[60] Securitization also allows for the carving up of cash flows into several tranches of different maturities. For example, by creating separate classes of securities and directing all of the payment of principal on 30 year mortgage loans first to one class until that class is paid in full, and then to another class, securitization takes advantage of the yield curve–the phenomena that, at most times, interest rates for shorter term debt obligations will be lower than the interest rate on longer term debt securities. This carving up of cash flows also permits an easier matching of assets and liabilities for investors.

Finally, the avoidance of the bankruptcy tax on secured credit is a substantial source of the savings. In this regard, the GMAC study is instructive. This study compared GMAC's costs of raising capital through the

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of Securitization, *supra* note 7, at 1661 n. 16.

58. *See* Steven K. Todd, *The Effects of Securitization on Consumer Mortgage Costs*, 29 REAL ESTATE ECONOMICS 50 (Jan 2001) (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).

59. *See* James A. Rosenthal & Juan M. Ocampo, *Analyzing the Economic Benefits of Securitized Credit*, J. APPLIED CORP. FIN. Vol. 1, No. 3, p. 32, 36–40 (Fall 1988).

60. For example, assume that you own a receivable with a principal of $1,000 that pays 6% in one year. If someone were to offer to buy that receivable for $1010, the buyer is implicitly willing to accept a yield not of 6% but 4.95%, which is (1.06*1,000/1010)–1. *See* Plank, *Security of Securitization*, *supra* note 7, at 1693 nn.158–60.

issuance of $18 billion of its own AA rated corporate debt securities with the costs of its $4 billion AAA rated asset backed securities backed by automobile loans. This comparison eliminated the costs savings attributable to issuance of securities and highlighted the savings from avoidance of the bankruptcy tax. The following table comparing the cost components for each set of securities illustrates this source of the saving. First, the actual interest rate savings between GMAC's AA debt and the AAA asset backed securities was only 10 basis points, that is, 0.10 percentage points. Second, the greater costs of structuring the AAA asset backed securities–fees and credit enhancement costs of 8 basis points–ate up most of those interest rate savings. Significantly, however, the cost of the large amount of equity capital necessary for GMAC to maintain a AA rating on its debt securities was 128 basis points. This equity capital was necessary to assure investors that GMAC's likelihood of becoming a debtor in bankruptcy was remote.

Table 3: GMAC Debt and Securitization Cost Comparison

GMAC transaction and rating	Corp debt AA+	ABS AAA
principal amount	$18 billion	$4 billion
interest rate*	7.01%	6.91%
fees*	0.20%	0.26%
loss reserve/credit enhancement*	0.50%	0.52%
net cost of capital*	1.28%	0.00%
total*	8.99%	7.69%
net difference*	1.30%	

* Interest rates and costs per annum

Although securitizations save originators money, the costs of structuring a securitization can be higher than traditional financing, as the GMAC study shows. To ensure the benefits of securitization, the receivables must be isolated in a separate legal entity. Investors must look to the receivables themselves and not to the originators. Hence, even if it would further lower costs, originators may not incur any substantial liability for or retain any substantial benefits from the future performance of the asset backed securities.[61] In the case of asset backed securities issued by an SPE, there are the costs of creating and maintaining a separate legal entity with separate accounts, books, records, and assets, and a separate board of directors or managers with an independent director or manager or, in the case of a

61. *See* Plank, *Security of Securitization*, *supra* note 7, at 1674–77.

Delaware statutory trust, a separate trustee. Law firms must issue an opinion to the effect that the receivables would not be included in the bankruptcy estate of the seller (a "true sale opinion"), and, in the case of SPEs, an opinion that the assets and liabilities of the SPE would not be substantively consolidate with those of the SPE parent issuing debt securities (a "non-consolidation opinion"). The 2005 Amendments, however, enable mortgage originators in some transactions to achieve the benefits of securitization without the costs of securitizations.

V. EXTENDING PROTECTED TRANSACTIONS TO MORTGAGE LOANS

Before the enactment of the 2005 Amendments, the Bankruptcy Code exempted certain transactions from the automatic stay,[62] from those provisions of the Bankruptcy Code that prevented a party to a contract from terminating the contract because the other party became a debtor in bankruptcy,[63] and from those provisions of the Bankruptcy Code that permitted the bankruptcy trustee to avoid unperfected transfers,[64] preferential transfers,[65] and constructively fraudulent transfers.[66] These protected transactions included "repurchase agreements" and "securities contracts." These provisions have long been

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62. 11 U.S.C. § 362 (2000), *discussed supra* note 37 and accompanying text.

63. *See* 11 U.S.C. § 365(a) (2000) (permitting a bankruptcy trustee to assume or reject executory contracts); § 365(e)(1):

> Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on--
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
> (B) the commencement of a case under this title; or
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

64. *See* 11 U.S.C. § 544(a)(1) (2000) (providing that the bankruptcy trustee has the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by a hypothetical lien creditor).

65. *See* 11 U.S.C. § 547(b) (2000) (permitting a bankruptcy trustee to avoid certain prepetition transfers of an interest of the debtor in property to or for the benefit of credits on account of antecedents if such transfers enabled the creditors to obtain more than they would obtain had they received a distribution in a chapter 7 liquidation).

66. *See* 11 U.S.C. § 548(a)(1)(B) (2000) (providing that the trustee may avoid certain pre-petition transfers or obligations if the debtor received less than a reasonably equivalent value for such transfer or obligation; and either (i) was insolvent or became insolvent as a result of such transfer obligation or (ii) was left with unreasonably small capital or (iii) intended to incur debts beyond its ability to pay).

important in the securities and financial industry, and the 2005 Amendments were designed to increase their effectiveness.[67]

Significantly for mortgage loan originators, the 2005 Amendments broadened the definition of "repurchase agreements" and "securities contracts" to include agreements for the purchase and sale of mortgage loans and interests in mortgage loans. Specifically, the 2005 Amendments broadened the definition of a "repurchase agreement,"[68] previously limited to

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67. *See, e.g.*, H.R. Rep. No. 109-31 pt. 1, at 20 (2005).

68. *See* 11 U.S.C.A. § 101(47) (West Supp. 2006), *as amended by* Pub. L. No. 109-8, § 907(a)(1)(C), 119 Stat. 23, 171-72 (2005):

> The term "repurchase agreement" (which definition also applies to a reverse repurchase agreement)–
>
> (A) means–
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> (i) an agreement, including related terms, which provides for the transfer of one or more certificates of deposit, mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, interests in mortgage related securities or mortgage loans, eligible bankers' acceptances, qualified foreign government securities (defined as a security that is a direct obligation of, or that are fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development), or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds;
>
> (ii) any combination of agreements or transactions referred to in clauses (i) and (iii);
>
> (iii) an option to enter into an agreement or transaction referred to in clause (i) or (ii);
>
> (iv) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), or (iii), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a repurchase agreement under this paragraph, except that such master agreement shall be considered to be a repurchase agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), or (iii); or
>
> (v) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in clause (i), (ii), (iii), or (iv), including any guarantee or reimbursement obligation by or to a repo participant or

obligations of the United States and other highly rated securities, to include mortgage loans and interests in mortgage loans:

> "[R]epurchase agreement" means (A) an agreement, including related terms, which provides for the transfer of one or more . . . mortgage loans [or] interests in . . . mortgage loans . . . against the transfer of funds by the transferee of such . . . mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof . . . mortgage loans, or interests . . . at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds.[69]

This definition requires that the seller of the mortgage loans must repurchase the loans within one year.

Any party to a "repurchase agreement" may terminate, liquidate or accelerate any repurchase agreement whenever the other party becomes a debtor in bankruptcy.[70] Notwithstanding the automatic stay, the non-debtor counterparty may exercise any contractual right under any security agreement or may set off or net out any transfer obligation arising in connection with a repurchase agreement.[71] The bankruptcy trustee may not avoid any pre-

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> financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562 of this title; and
>
> (B) does not include a repurchase obligation under a participation in a commercial mortgage loan.

69. *Id.*

70. *See* 11 U.S.C.A. § 559 (West Supp. 2006), *as amended by* Pub. L. No. 109-8, § 907(i), 119 Stat. 23, 179 (2005):

> The exercise of a contractual right of a repo participant or financial participant to cause the liquidation, termination, or acceleration of a repurchase agreement because of a condition of the kind specified in section 365(e)(1) of this title [*quoted supra* note 63] shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title, unless, where the debtor is a stockbroker or securities clearing agency, such order is authorized under the provisions of the Securities Investor Protection Act of 1970 or any statute administered by the Securities and Exchange Commission.

71. *See* 11 U.S.C.A. § 362(b)(7) (West Supp. 2006), *as amended by* Pub. L. No. 109-8, § 907(d)(1)(B),(o)(2), 119 Stat. 23, 176, 182 (2005), and *as further amended by* Pub. L. No. 109-390, § 5(a)(2)(A), 120 Stat 2692, 2696 (2006):

> The filing of a petition . . . does not operate as a stay under subsection (a) of this section . . . (7) of the exercise by a repo participant or financial participant of any contractual right (as defined in section 559) under any security agreement or arrangement or other credit enhancement forming a part of or related to any repurchase agreement, or of any contractual right (as defined in section 559) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master

petition transfer of property to the counterparty in connection with a repurchase agreement[72] on the grounds that such transfer was an unperfected,[73] preferential[74] or constructively fraudulent[75] transfer. The definition of a "securities contract,"[76] originally broader than "repurchase agreement," has

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agreement for such agreements.

72. *See* 11 U.S.C.A. § 546(f) (West Supp. 2006), *as amended by* Pub. L. No. 109–8, § 907(o)(2), 119 Stat. 23, 182 (2005), and *as further amended by* Pub. L. No. 109-390, § 5(b)(2), 120 Stat 2692, 2698 (2006):

> Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer made by or to (or for the benefit of) a repo participant or financial participant, in connection with a repurchase agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

73. *See* 11 U.S.C. § 544(a)(1) (2000) *discussed supra* note 64.

74. *See* 11 U.S.C. § 547(b) (2000), *discussed supra* note 65.

75. *See* 11 U.S.C. § 548(a)(1)(B) (2000), *discussed supra* note 66.

76. *See* 11 U.S.C.A. § 741(7) (West Supp. 2006), *as amended by* Pub. L. No. 109–8, § 907(a)(2), 119 Stat. 23, 173–74 (2005), and *as further amended by* Pub. L. No. 109-390, § 5(a)(3), 120 Stat 2692, 2697 (2006):

"securities contract"--

(A) means--

(i) a contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement," as defined in section 101);

(ii) any option entered into on a national securities exchange relating to foreign currencies;

(iii) the guarantee (including by novation) by or to any securities clearing agency of a settlement of cash, securities, certificates of deposit, mortgage loans or interests therein, group or index of securities, or mortgage loans or interests therein (including any interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such settlement is in connection with any agreement or transaction referred to in clauses (i) through (xi);

(iv) any margin loan;

(v) any extension of credit for the clearance or settlement of securities transactions;

(vi) any loan transaction coupled with a securities collar transaction, any prepaid forward securities transaction, or any total return swap transaction coupled with a securities sale transaction;

(vii) any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph;

(viii) any combination of the agreements or transactions referred to in this subparagraph;

(ix) any option to enter into any agreement or transaction referred to in this

also been expanded to include mortgage loans and interests in mortgage loans. It specifically means:

> a contract for the purchase, sale, or loan of a security, . . a mortgage loan, any interest in a mortgage loan, a group or index of . . . or mortgage loans or interests therein . . . , or option on any of the foregoing, . . . and including any repurchase or reverse repurchase transaction on any [of the foregoing] (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement", as defined in section 101).[77]

Although the definition of "securities contract" is broader, the parties protected by the protected transaction provisions for securities contracts are somewhat narrower.

In the case of a "securities contract," any financial institution or any "financial participant" may terminate, liquidate or accelerate the securities contract notwithstanding the bankruptcy of the other party.[78] Without regard to the automatic stay, a financial institution or financial participant may exercise any contractual right under any security agreement related to any securities contract and any contractual right to offset or net out any

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> subparagraph;
> (x) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), (iv), (v), (vi), (vii), (viii), or (ix), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a securities contract under this subparagraph, except that such master agreement shall be considered to be a securities contract under this subparagraph only with respect to each agreement or transaction under such master agreement that is referred to in clause (i), (ii), (iii), (iv), (v), (vi), (vii), (viii), or (ix); or
> (xi) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee or reimbursement obligation by or to a stockbroker, securities clearing agency, financial institution, or financial participant in connection with any agreement or transaction referred to in this subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562; and
>
> (B) does not include any purchase, sale, or repurchase obligation under a participation in a commercial mortgage loan.

77. § 741(7).

78. *See* 11 U.S.C.A. § 555 (West Supp. 2006), *as amended by* Pub. L. No. 109–8, § 907(g),(o)(7), 119 Stat. 23, 177–78, 182 (2005):

> The exercise of a contractual right of a stockbroker, financial institution, financial participant, or securities clearing agency to cause the liquidation, termination, or acceleration of a securities contract, as defined in section 741 of this title, because of a condition of the kind specified in section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title unless such order is authorized under the provisions of the Securities Investor Protection Act of 1970 or any statute administered by the Securities and Exchange Commission.

termination value, payment amount, or other transfer obligation arising under or in connection with the securities contract.[79] Finally, the bankruptcy trustee cannot avoid any pre-petition transfer of property to the financial institution or financial participant in connection with a securities contract[80] on the grounds that such transfer was unperfected,[81] or was a preferential[82] or a constructively fraudulent transfer.[83]

The limitation to "financial institution" is not a large impediment to using the protected transaction provisions. A financial institution means a bank but also includes a customer of the bank when the bank is acting as an agent or custodian for a customer.[84] A "financial participant" is any entity that has engaged in significant transactions involving repurchase agreements, securities contracts, and other derivatives.[85]

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79. *See* 11 U.S.C.A. § 362(b)(6) (West Supp. 2006), *as amended by* Pub. L. No. 109-8, § 907(d)(1)(B),(o)(1) 119 Stat. 23, 176, 181 (2005), and *as further amended by* Pub. L. No. 109-390, § 5(a)(2)(A), 120 Stat 2692, 2696 (2006):

> The filing of a petition . . . does not operate as a stay under subsection (a) of this section . . . (6) under subsection (a) of this section, of the exercise by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any contractual right (as defined in section 555 or 556) under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract, or of any contractual right (as defined in section 555 or 556) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such contracts, including any master agreement for such contracts.

80. *See* 11 U.S.C.A. § 546(f) (West Supp. 2006), *as amended by* Pub. L. No. 109-8, § 907(o)(2), 119 Stat. 23, 182 (2005), and *as further amended by* Pub. L. No. 109-390, § 5(b)(2), 120 Stat 2692, 2698 (2006):

> Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer made by or to (or for the benefit of) a repo participant or financial participant, in connection with a repurchase agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

81. *See* 11 U.S.C. § 544(a)(1) (2000), *discussed supra* note 64.
82. *See* 11 U.S.C. § 547(b) (2000), *discussed supra* note 65.
83. *See* 11 U.S.C. § 548(a)(1)(B) (2000), *discussed supra* note 66.
84. *See* 11 U.S.C. § 101(22) *as amended by* Pub. L. No. 109-8, § 907(b)(1), 119 Stat. 23, 175 (2005) and *as further amended by* Pub. L. No. 109-390, § 5(a)(1)(A), 120 Stat. 2692, 2695 (2006): The term "financial institution" means–

> (A) a Federal reserve bank, or an entity that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union, or receiver, liquidating agent, or conservator for such entity and, when any such Federal reserve bank, receiver, liquidating agent, conservator or entity is acting as agent or custodian for a customer (whether or not a "customer", as defined in section 741) in connection with a securities contract (as defined in section 741) such customer.

85. *See* § 101(22A), *as added by* Pub. L. No. 109-8, § 907(b)(2), 119 Stat. 23, 175 (2005), and *as further amended by* Pub. L. No. 109-390, § 5(a)(1)(A), 120 Stat. 2692, 2695 (2006): The term "financial participant" means–

> (A) an entity that, at the time it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of

These protected transaction provisions will replace and have replaced some securitization structures and may in the future replace more. Originators can now obtain financing by entering into "repurchase agreements" or "securities contracts" with financial institutions, including financial institutions acting on behalf of investors, and financial participants. These financial institutions or financial participants will be able to liquidate any mortgage loans sold to them without regard to the later bankruptcy of the originator and therefore be able to avoid some of the bankruptcy tax on secured credit. As of today, however, these protected transaction provisions may not eliminate all securitization of mortgage loans.

A necessary precondition to a securitization is a true sale of mortgage loans by an originator to a separate legal entity that removes the loans from the future bankruptcy estate of the originator. Such a true sale eliminates both the risk of acceleration of asset backed securities as well as the risk of the automatic stay. Under the protected transaction provisions, there would no longer be any need for a "true sale" of the mortgage loans to a separate legal entity to eliminate the risk of the automatic stay. Nevertheless, without a true sale, there remains the risk of acceleration.

Therefore, for the many term securitizations of mortgage loans, that is, the sale of mortgage loans to a certificate trustee and the issuance of certificates evidencing a beneficial ownership interest in the mortgage loans, investors may still insist on a true sale to ensure that a bankruptcy trustee for the originator could not attempt to recharacterize the transfer of the mortgage loans as a pledge to secure a borrowing. Without a true sale, a bankruptcy trustee might have an incentive for such an attempt if the value of the mortgage loans has increased.

For example, assume that an originator sponsored a securitization of $100,000,000 of 30 year mortgage loans bearing an annual fixed interest rate of 8% by selling the loans to a trustee and issuing $100,000,000 of mortgage pass-through certificates. If market mortgage rates were to decline to 6%, the present value of the mortgage loans would increase dramatically to more than $122 million without any assumption for prepayment, and to more than $108

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the filing of the petition, has one or more agreements or transactions described in paragraph (1), (2), (3), (4), (5), or (6) of section 561(a) with the debtor or any other entity (other than an affiliate) of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding at such time or on any day during the 15-month period preceding the date of the filing of the petition, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) at such time or on any day during the 15-month period preceding the date of the filing of the petition.

million assuming a constant annual prepayment rate of 10%, which would cause the entire pool to be paid in a little over 10 years.[86] If the originator became a debtor in bankruptcy, the bankruptcy trustee could seek to accelerate the certificates, after having them recharacterized as debt obligations, prepay the certificates at par, that is, $100 million, and pocket the difference, which could be several millions of dollars. The certificate trustee could liquidate the mortgage loans upon such an attempt, but this protection from the automatic stay would not protect the investors' expectations. Although there certainly can be a true sale without a true sale opinion, without the assurance of a true sale opinion, investors may not want to bear the risk of such premature prepayment at par of their above market value certificates upon the liquidation of the mortgage loans.[87]

On the other hand, for securitization transactions that do not involve long term securitizations or that otherwise solve the risk of acceleration, originators can obtain financing without the costs of structuring a securitization. The most obvious example is warehouse financing or revolving lending securitizations. In the past, an originator would sell mortgage loans to an SPE, and the SPE would enter into a warehousing or revolving lending arrangement with a financial institution. As the originator originated mortgage loans, it would immediately sell them to the SPE, and the SPE would borrow from the warehouse lender. The SPE would use the proceeds of the borrowing plus other cash on hand, including draws on subordinated debt financing, to pay the purchase price of the mortgage loans. When the SPE had accumulated a sufficient volume of mortgage loans, the SPE would then sell the mortgage loans into a term securitization and use the proceeds from the sale to repay the warehouse lender.

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86. Calculations on file with the author.

87. A sponsor of a securitization attempted just such opportunistic expropriation of investors' value. *In re WE* Financial Co. No. 92–01861–TUC-LO (Bankr. D. Ariz. filed June 11, 1992) (on file with the author). 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 without a prepayment premium. The collateral securing the debt consisted of Government National Mortgage Association mortgage 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, use the proceeds to pay off the debt, and retain a profit of about $11,000,000 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. *See* Findings of Fact and Conclusions of Law (for Order Confirming the Amended Plan as Modified) at 2–4, *In re* WE Financial Co., *supra* (filed Feb. 23, 1993) (on file with the author); Amended Disclosure Statement of WE Financial Co., GWS, and WE 7, Inc. Dated Jan. 11, 1993, as Modified, at 10–21, *In re* We Financial Co., *supra*; Settlement Agreement Dated as of September 1, 1992, at 1–3 (on file with the author); *see also* Plank, *Security of Securitization*, *supra* note 7, at 1728–79 & n.350.

These structures are cumbersome, and they create some tensions for both the originator and the warehouse lender. To ensure sufficient isolation of the mortgage loans from the bankruptcy risk of the originator, the structure must resist the desires of the originator to exercise direct control over the mortgage loans and the desires of the warehouse lenders for additional protection in the form of guarantees from the originator. Increasingly, instead of these warehouse lending SPEs, originators and lenders are using "repurchase agreements" and "securities contracts," as defined in the Bankruptcy Code, both of which are documented in the industry through "repurchase agreements"[88] even if they do not meet the restricted Bankruptcy Code definition of "repurchase agreement." In these cases, the lenders are not concerned about the risk of acceleration. They obtain the full benefit of immediate relief from the automatic stay to liquidate the mortgage loans if the originator becomes a debtor in bankruptcy. Originators do not need to incur the costs of establishing a separate SPE, true sale and non-consolidation opinions, and the restrictions on the structure required for such opinions.

Other mortgage loan transactions may also benefit from the 2005 Amendments. To the extent that the mortgage loans are adjustable rate mortgage loans, or the parties can otherwise cover the risk of the acceleration of premium mortgage loans, protected transactions for mortgage loans may replace securitizations. The market, which is the best forum for allocating resources, will find the optimum level, even at the cost of early experimentation and losses.

VI. CONCLUSION

The Bankruptcy Code contains provisions that transfer value from secured creditors to the bankruptcy professionals that control, and that benefit from, bankruptcy cases and, theoretically, to the unsecured creditors of debtors in bankruptcy. I have argued elsewhere that the Bankruptcy Code should be amended to require bankruptcy professionals and the unsecured creditors to bear the full costs of a chapter 11 reorganization by respecting the value of a

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88. *See* Bond Market Association, Master Repurchase Agreement § 19(a) at 11 (Sept. 1996 version) (copy on file with the author):

> The parties recognize that each Transaction is a "repurchase agreement" as that term is defined in Section 101 of Title 11 of the United States Code, as amended (except insofar as the type of Securities subject to such Transaction or the term of such Transaction would render such definition inapplicable), and a "securities contract" as that term is defined in Section 741 of Title 11 of the United States Code, as amended (except insofar as the type of assets subject to such Transaction would render such definition inapplicable).

secured creditor's property interest, including the payment of interest to undersecured creditors to the extent of the value of their collateral.[89] But short of that more radical change, the Bankruptcy Code should be amended to eliminate the bankruptcy tax on secured creditors that lend to originators of all receivables.[90] The very existence of a several trillion dollar securitization industry dramatically illustrates the irrationality of the Bankruptcy Code's treatment of receivables. The 2005 Amendments take one step closer to rationality by exempting mortgage loans from the bankruptcy tax on secured creditors. The only regret is that these 2005 Amendments were limited to mortgage loans.[91]

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89. *See* Plank, *Security of Securitization, supra* note 7, at 1736–38.

90. *See id.* at 1738–41.

91. The bills that eventually became the 2005 Amendments contained a provision, the famous "Section 912," that would have excluded from the bankruptcy estate financial assets sold in a securitization in which the securities received an investment grade rating. In another display of the irrationality of Congress' regulation of financial markets, at the prodding of parties adverse to securitization, Congress eliminated this section after the collapse of Enron corporation. Plank, *Security of Securitization, supra* note 7, at 1730–33. I also opposed the inclusion of § 912, but for different reasons. This section would have eliminated much of the structural costs of a securitization, but only for those securities that achieved an investment grade rating. A better solution would be an elimination of the structural costs of securitization for all receivables, and the bankruptcy tax on all secured creditors that finance the originators of receivables.