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INTRODUCTION

The transfer of property offers many opportunities for legal analysis. Much of this analysis examines the nature of the property interests transferred.[1] One variation of this inquiry is whether a transfer of property is a "true" sale of the property or merely a transfer of a security interest in the property to secure repayment of a loan.

Historically, this issue arose when an owner of real property borrowed money and gave the lender a deed purporting to be an absolute conveyance of the property.[2] The lender typically held the deed as security for the loan, often not recording it, and agreed to return it if the borrower repaid the debt. The lender used the deed as security instead of a mortgage to avoid the requirements for foreclosing the mortgage.[3] Courts consistently refused to recognize this subterfuge because it violated the basic principle of equity that a borrower, no matter how willing, may not give up her right to redeem her mortgaged property.[4]

The elements that courts analyze to determine whether the delivery of an absolute deed is intended as security for a loan are well set-

[1] *See, e.g.*, John F. Dolan, *The U.C.C. Framework: Conveyancing Principles and Property Interests*, 59 B.U. L. Rev. 811 (1979) (discussion of property interests); Ingrid M. Hillinger, *The Treatment of Consignments in Bankruptcy: Two Codes and Their Fictions, at Play, in the Fields*, 6 Bankr. Dev. J. 73 (1989); and *infra* note 16.

A more fundamental question is whether the nature of the property interest is relevant. *See, e.g.*, Karl N. Llewellyn, *Through Title to Contract and a Bit Beyond*, 15 N.Y.U. L.Q. 159 (1938); William A. Tabac, *The Unbearable Lightness of Title Under the Uniform Commercial Code*, 50 Md. L. Rev. 408 (1991); and *infra* note 60. Other related issues include the advisability of various requirements for an effective transfer, compliance with those requirements, and the extent of the interest received by the transferee. *See, e.g* Douglas Baird & Thomas Jackson, *Information, Uncertainty, and the Transfer of Property*, 13 J. Leg. Stud. 299 (1984); Dolan, *supra* (discussion of conveyancing principles); David Frisch, *Buyer Status Under the U.C.C.: A Suggested Temporal Definition*, 1987 Iowa. L. Rev. 531; Charles W. Mooney, Jr., *The Mystery and Myth of "Ostensible Ownership" and Article 9 Filing: A Critique of Proposals to Extend Filing Requirements to Leases*, 39 Ala. L. Rev. 683 (1988) [hereinafter *Mystery and Myth*]; and *infra* note 156.

[2] *See* Grant S. Nelson & Dale A. Whitman, Real Estate Finance Law §§ 3.4-3.16 (2d ed. 1985); Roger A. Cunningham & Saul Tischler, *Disguised Real Estate Security Transactions as Mortgages in Substance*, 26 Rutgers L. Rev. 1 (1972).

[3] Nelson & Whitman, *supra* note 2, § 3.5; Cunningham & Tischler, *supra* note 2, at 2-4.

[4] Nelson & Whitman, *supra* note 2, § 3.1. *See also* Peugh v. Davis, 96 U.S. 332, 337 (1877); 4 John N. Pomeroy, Equity Jurisprudence §§ 1193-96 (Spencer W. Symons ed., 5th ed. 1941).

tled.[5] Accordingly, courts, scholars, and lawyers are rarely faced with the prospect of analyzing or structuring real estate sales or secured loan transactions in an atmosphere of uncertainty.[6]

This degree of comfort does not exist, however, when an owner of loans,[7] such as a financial institution that makes mortgage loans, car loans, or advances on credit card accounts to borrowers, wishes to sell those loans.[8] The uncertainty increases when the owner sells the loans with credit recourse—that is, the seller agrees to repurchase any of the underlying loans that go into default or otherwise agrees to compensate the buyer for losses on defaulting loans.

A sale of loans with credit recourse typically arises in two situations. First, the parties may intend the transaction to be a secured secondary loan, but may call the transaction a sale to avoid requirements applicable to loans that do not apply to sales. For example, the "buyer" may want to avoid interest rate limitations of the usury laws, which generally apply only to loans and not to sales.[9] On the other hand, the

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[5] The two primary factors are the existence of a debt at the time of the conveyance and the inadequacy of consideration that the "seller" receives for the deed. *See infra* note 166 and accompanying text. Other factors include whether the grantor retained possession of the property, whether she made substantial improvements to the property, whether she had previously sought to borrow money using the property as security, and whether the grantee was principally a money lender or a buyer of property. Nelson & Whitman, *supra* note 2, § 3.8; Cunningham & Tischler, *supra* note 2, at 14-19.

[6] No doubt even today there are lenders of lesser knowledge or scruples who rely on an absolute deed intended as security, but these would appear to be on the fringes of economic activity. *See, e.g.*, McGill v. Biggs, 434 N.E.2d 772 (Ill. App. Ct. 1982), *discussed in* Nelson & Whitman, *supra* note 2, § 3.8 at 51-52, in which a dutiful son delivered to his uncle an absolute deed to property worth $15,000 to secure a loan of approximately $1,500 to pay the expenses of his mother's funeral.

[7] It is necessary to distinguish between two separate transactions: the underlying or primary loan transaction and the secondary sale or secured loan transaction. In the underlying loan transaction, an originator, A, makes a loan to a borrower, B. Once A makes the loan, A can use the loan in a secondary transaction: A can sell the underlying loan to a buyer, C, or can pledge the underlying loan to C as security for a secondary loan from C to A. As part of a secondary sale or loan transaction, A and C will agree either that A will continue to receive the payments on the primary loan and remit them to C (in which case B may not be notified of the secondary transaction) or that C will receive the payments from the underlying borrower B (in which case A or C will notify B to send the payments to C). *See infra* text accompanying notes 18-48.

[8] *See* 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); Homer Kripke, *Conceptual Obsolescence in Law and Accounting—Finance Relations Between Retailer and Assignee of Retail Receivables*, 1 B.C. Ind. & Com. L. Rev. 55, 60-61 (1959). *See also* Walter C. Cliff & Philip J. Levine, *Reflections on Ownership—Sales and Pledges of Installment Obligations*, 39 Tax Law. 37 (1985).

[9] *See infra* note 82 and accompanying text and the text accompanying and following note 118.

parties may intend the transaction to be a true sale, but the buyer may want to reduce the risk of losses from defaults by the underlying borrowers. The seller, who may be in a better position to estimate the future losses from defaults, may agree to provide credit recourse in exchange for a higher sales price.[10]

The uncertainty arises because courts do not rely upon any universally accepted set of factors in determining whether a purported sale is a true sale or merely a transfer as security for a secondary loan.[11] Although the cases that provide some analysis on this issue frequently mention the need to determine which party has retained the benefits and burdens of owning the loans, these cases do not sufficiently analyze the facts in a particular transaction to take into account all the elements of a sale or pledge of loans.[12] Generally, the cases pick out only a few of the more prominent elements in the particular transaction to arrive at a result. In concluding that a purported sale was a pledge, a number of cases rely heavily on the presence of credit recourse.[13] On

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[10] Often one party or a non-party will attempt to recharacterize an intended loan transaction after the fact to avoid adverse consequences applicable to the loan transaction. *See, e.g.*, Malone v. Celeron Oil & Gas Co. (*In re* Currie), 57 B.R. 224 (Bankr. M.D. La. 1986), in which a mortgagor assigned to the mortgagee payments from a mineral lease as additional security for a mortgage loan. When the borrower became bankrupt, the mortgagee unsuccessfully argued that the assignment was an absolute transfer of the mineral lease payments. *See also* Sarf v. Leff (*In re* Candy Lane Corp.), 38 B.R. 571 (Bankr. S.D.N.Y. 1984). Candy Lane assigned to Leff a portion of an expected condemnation award as part of a loan transaction. After Candy Lane went bankrupt, Leff filed a proof of claim and other pleadings stating that she had received the assignment as security for a loan and describing herself as a secured creditor. When Candy Lane's trustee in bankruptcy asserted that Leff had failed to perfect a security interest in the award and sought to avoid her interest in it, she claimed that the assignment was absolute and therefore was not subject to the requirements for perfecting a security interest. The court denied her motion for summary judgment because of the contradiction in how she treated the transaction. *See also* First Nat'l Bank v. Hurricane Elkhorn Coal Corp. II (*In re* Hurricane Elkhorn Coal Corp. II), 19 B.R. 609, *motion to alter judgment denied*, 20 B.R. 631 (Bankr. W.D. Ky. 1982), *rev'd on other grounds*, 32 B.R. 737 (W.D. Ky. 1983), *aff'd*, 763 F.2d (6th Cir. 1985), *discussed infra* note 66.

[11] Savings Bank of Rockland County v. FDIC, 668 F. Supp. 799, 804 (S.D.N.Y. 1987), *vacated per stipulation*, 703 F. Supp. 1054 (S.D.N.Y. 1988) ("The cases that address whether or not certain transactions are to be considered loans or sales do not lay down a clear rule of law on the issue . . . ."). *See also* Aicher & Fellerhoff, *supra* note 8, at 182.

[12] *See, e.g.*, Major's Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 546 (3d Cir. 1979), *discussed infra* at text accompanying notes 87-107, and the cases discussed *infra* at text accompanying notes 118-145.

[13] *See infra* text accompanying note 118; Fireman's Fund Ins. Cos. v. Grover (*In re* The Woodson Co.), 813 F.2d 266 (9th Cir. 1987), *discussed infra* at text accompanying note 137; Major's Furniture Mart v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979); Blackford v. Commercial Credit Corp., 263 F.2d 97 (5th Cir. 1959), *discussed infra* note 121; *In re* Carolina Util. Supply Co., 118 B.R. 412 (Bankr. D.S.C. 1990); Ables v. Major Funding Corp. (*In re* Major Funding Corp.) 82 B.R. 443 (Bankr. S.D. Tex. 1987), *discussed infra* at text accompanying note

the other hand, a substantial number of cases uphold a sale of loans even though the seller promised 100% credit recourse.[14]

The absence of a consistent analysis and the emphasis on credit recourse reduce the flexibility of a seller and a buyer in negotiating a sale of loans and increase the costs of the transaction. The buyer must either buy without credit recourse for a lower price or take the risk that a court will recharacterize the sale of the underlying loans to the buyer as a secured secondary loan from the buyer. Such a judicial recharacterization has significant consequences for the buyer.[15] Because of these consequences, the buyer will insist on structuring a sale transaction in a conservative way or will seek other ways to be compensated for taking the risk of recharacterization.

In an effort to promote greater certainty, this article examines the sale of loans with credit recourse in the context of all the factors that courts should analyze in deciding whether a transfer of loans is a true sale or merely a pledge. This examination proceeds from the premise that a sale of property has discrete elements that distinguish it from a transfer of property as security for a loan. An analysis of these elements and the property characteristics of loans provides a basis for a principled way to determine when a transfer of loans is a true sale of loans.

Part I of the article discusses the elements of a sale of loans and a secondary borrowing secured by loans. This section analyzes the property characteristics of loans and how these characteristics manifest

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164; Rechnitzer v. Boyd (*In re* Executive Growth Inv., Inc.), 40 B.R. 417 (Bankr. C.D. Cal. 1984), *discussed infra* note 148; Castle Rock Enter., Inc. v. S.O.A.W. Indus. Bank (*In re* S.O.A.W. Indus. Bank), 32 B.R. 279 (Bankr. W.D. Tex. 1983), *discussed infra* at text accompanying note 141; West Pico Furniture Co. v. Pacific Fin. Loans, 469 P.2d 665 (Cal. 1970); Milana v. Credit Discount Co., 163 P.2d 869 (Cal. 1945); Wayne Pump Co. v. Department of Treasury, 110 N.E.2d 284 (Ind. 1953); People v. Service Inst., 421 N.Y.S.2d 325 (Sup. Ct. 1979). *See infra note* 59 and accompanying text. *See also* Aicher, *supra* note 8, at 186.

[14] *See infra* text accompanying note 131. *See also* General Motors Acceptance Corp. v. Mid-West Chevrolet, 66 F.2d 1 (10th Cir. 1933), *on appeal after retrial*, 74 F.2d 386 (10th Cir. 1934), *discussed infra* at text accompanying notes 172 and 175; Goldstein v. Madison Nat'l Bank, 89 B.R. 274 (D.D.C. 1988), *discussed infra* note 90; Investors 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 Hiwassee Dev. Co. v. Pioneer Bank, 535 S.W.2d 323 (Tenn. 1976); A.B. Lewis Co. v. National Inv. Corp., 421 S.W.2d 723 (Tex. Civ. App. 1967); Val Zimmermann Corp. v. Leffingwell, 318 N.W.2d 781 (Wis. 1982), *discussed infra* note 133. *Cf. also* Refinance Corp. v. Northern Lumber Sales, Inc., 329 P.2d 109 (Cal. Dist. Ct. App. 1958) (20% recourse in the form of a reserve fund financed from sale proceeds plus 100% recourse for loans without the buyer's prior approval).

[15] *See infra* text accompanying notes 60-85.

themselves in a sale or secondary loan. It also discusses the business considerations of the parties and the role of recourse. Part II describes the legal significance of having a transfer of loans treated as either a sale or a pledge of security for a secondary loan. Part III explores the various judicial approaches in characterizing this transfer as a true sale or a pledge.[16]

Part IV proposes a general method for resolving the issue of whether a sale of loans is a true sale or a pledge. Using this method would decrease the current uncertainty pervading this issue and would increase the degree of predictability for parties and non-parties. Finally, Part V argues that the mere presence of credit recourse in a sale of loans should not cause a court to recharacterize a sale of loans as a secured loan transaction. Credit risk is only one of several burdens of owning loans. Courts have not questioned the sale of other property when the seller retains some burdens or risks normally associated with

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[16] The issues discussed in this article may be present in loan participations, in which a financial institution, the lead lender, sells a portion of, or participation in, a loan or pool of loans to one or more other institutions, the participants. Frequently, the question has arisen whether the participant has an equitable interest in the underlying loan or whether the participant has merely lent money to the lead lender in return for a security interest (often unperfected) in the underlying loan. There has been a great deal of discussion on the nature of participations and how this issue is resolved for participations. *See, e.g.*, Bradford Anderson, *Loan Participations and the Borrower's Bankruptcy*, 64 Am. Bankr. L.J. 39 (1990); W. Homer Drake & Kyle R. Weems, *Mortgage Loan Participations: The Trustee's Attack*, 52 Am. Bankr. L.J. 23 (1978); Jeffrey D. Hutchins, *What Exactly Is a Loan Participation?*, 9 Rut-Cam. L.J. 447 (1978); Kenneth M. Lapine, *Loan Participations and the Savings and Loan Association: A Sleeping Giant Stirs*, 11 Akron L. Rev. 457 (1978); Mark E. McDonald, *Loan Participations As Enforceable Property Rights in Bankruptcy—A Reply to the Trustee's Attack*, 53 Am. Bankr. L.J. 35 (1979); William M. Stahl, *Loan Participations: Lead Insolvency and Participants' Rights*, 94 Banking L.J. 882 (1978); Debora L. Threedy, *Loan Participations—Sales or Loans? Or Is That the Question?*, 68 Or. L. Rev. 649 (1989).

An analogous issue arises in determining whether a lease of property is a true lease, in which the lessor retains ownership, or a financed sale, in which the lessor is really the seller and lender and the lessee is really the owner and borrower. *See, e.g.*, U.C.C. §§ 2A-101 to -531 (1991). *See also* Corinne Cooper, *Identifying a Personal Property Lease Under the UCC*, 49 Ohio St. L.J. 195 (1988); Charles W. Mooney, *True Lease or Lease "Intended as Security"—Treatment by the Courts*, *in* 1C Peter F. Coogan et al., Secured Transactions Under the Uniform Commercial Code, § 29A.05 (1990); Thomas C. Homburger & Gregory R. Andre, *Real Estate Sale and Leaseback Transactions and the Risk of Recharacterization in Bankruptcy Proceedings*, 24 Real Prop. Prob. & Tr. J. 95 (1989).

Some of the concerns addressed in this article are also present in a specialized form of investment known as a repurchase agreement, or repo. *See, e.g.*, William F. Hagerty, Note, *Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities*, 37 Vand. L. Rev. 401 (1984); Elizabeth M. Osenton, Note, *The Need for a Uniform Classification of Repurchase Agreements: Reconciling Investor Protection with Economic Reality*, 36 Am. U. L. Rev. 669 (1987); Gary Walters, Note, *Repurchase Agreements and the Bankruptcy Code: The Need for Legislative Action*, 52 Fordham L. Rev. 828 (1984).

owning property, and therefore they should not recharacterize the sale of loans to be a pledge as security for a secondary loan simply because the seller of the loans retains some or all of the credit risk.

I. ANALYSIS OF THE TRANSACTION

A. *Background*

1. Characteristics of Loans

Banks, savings associations, insurance companies, finance companies, retailers, and other entities play a significant role in the economy by lending businesses and consumers money to buy homes, cars, boats, equipment, other goods, and services.[17] This lending activity takes a variety of forms, including 1) notes secured by mortgages on residential or other real property,[18] 2) retail installment sales agreements granting a security interest in personal property, such as cars, recreational vehicles, boats, and other types of personal property, 3) credit card accounts, trade account receivables or lines of credit that may or may not be secured by any property of the underlying borrower,[19] and 4) other

[17] For an excellent discussion of the circumstances in which much of the non-mortgage lending activity occurs, see Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. Pa. L. Rev. 929, 941-51 (1985) [hereinafter *Vacuum of Fact*].

[18] As of December 31, 1991, there was outstanding more than $2.9 trillion of mortgage loans secured by single family (one-to-four unit) residences. Domestic Financial Statistics, 78 Fed. Res. Bull. A36 (July 1992). Of the amount outstanding, commercial banks held $485 billion, savings institutions held $534 billion, life insurance companies held $12 billion, finance companies held $52 billion, and federal and related agencies held $164 billion in the form of whole loans; another $1,134 billion was held in the form of mortgage-backed securities insured or guaranteed by federal agencies (Government National Mortgage Association and Farmers Home Administration) or government sponsored entities (Federal Home Loan Mortgage Corporation and Federal Nation Mortgage Association). Individuals and others (such as mortgage companies, real estate investment trusts, state and local retirement funds, noninsured pension funds, credit unions, and other United States agencies) held $455 billion. *Id.* During 1988, 1989, 1990, and 1991, net borrowing for single family mortgage loans—the amount of new loans less the amount of principal repaid on existing loans and the amount of write-offs of defaulted loans—equalled more than $231 billion, $218 billion, $213 billion, and $139 billion, respectively. *Id.* at A39.

[19] As of December 31, 1991, there was outstanding more than $744 billion of consumer installment debt. This consisted of approximately $268 billion of automobile debt, $247 billion of revolving credit, $19 billion of mobile home debt, and $209 billion of other consumer debt. Of the amount outstanding, commercial banks held $341 billion, finance companies held $130 billion, credit unions held $93 billion, retailers held $43 billion, savings institutions held $36 billion, and gasoline companies held $4 billion. In addition, investors held $97 billion in the form of securities

types of documents such as loan agreements or negotiable or non-negotiable notes.[20] Each of these forms has its own special rules for creating, securing, enforcing, or assigning the loan, but all share one attribute: They evidence an obligation of the borrower to pay cash to the holder of the loan. The borrower must repay the principal amount of the money borrowed and may pay interest on the principal.[21] She may make loan payments periodically (monthly, quarterly, annually) or at the maturity date of the loan. The amount of the payments may be fixed at origination or may vary. In sum, these loans are assets whose principal characteristic is the generation of cash. Once created, the originator can hold them, sell them, or use them as security for a secondary loan. Frequently, she must sell them or pledge them as security for a secondary loan to obtain cash with which to make more loans or otherwise finance her operations.[22]

The owner of the loans must service them. Servicing encompasses receiving and processing payments on the loans, collecting payments

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backed by the loans. *Id.* at A37 (not seasonally adjusted figures). During 1988, 1989, and 1990, net consumer borrowing—the amount of new borrowing less the amount of consumer debt repaid and the amount of write-offs of defaulted loans—equalled $50 billion, $43 billion, and $14 billion, respectively. In 1991, repayment and write-offs of existing consumer debt exceeded new consumer debt by $67 billion. *Id.* at A39.

[20] An interesting example is a premium finance loan. Insurance companies often charge annual premiums for property and casualty insurance. Unless the insurance company has its own payment plan, the insured must pay the premium in advance. If the insurance is cancelled, the insurer will refund the unearned premium to the insured. Rather than using its working capital or general lines of credit, an insured can borrow from a premium finance company a substantial amount of the premium at a lower interest rate, repayable typically over a nine month period. As security for the loan, the insured will give the premium finance company an assignment of any unearned premium and a power of attorney to cancel the insurance policy if the insured fails to make a monthly payment on the premium finance loan. If the insured defaults on the loan, the premium finance company will cancel the policy (after any required notice) and use the unearned premium to pay the outstanding balance of the loan. Properly structured, the premium finance company will be fully secured for its loan. *See, e.g.*, Drabkin v. A.I. Credit Corp., 800 F.2d 1153, 1154-55 (D.C. Cir. 1986) (describing a premium finance loan from A.I. Credit Corporation in the amount of $1,357,347.99 to finance an annual premium for property and casualty insurance policies for the Auto-Train Corporation, which then went bankrupt). To raise money for additional premium finance loans, the premium finance company can pledge the existing loans as collateral for a secondary loan or can sell them.

[21] The payment of interest may be in the form of a "discount." The discount is the difference between the loan proceeds that the borrower receives and the stated principal amount of the loan. *See* David Thorndike & Donald S. Benton, Encyclopedia of Banking and Finance, 1992 Yearbook, pt. 2, app. at 155 (3d ed. 1991). For example, when a borrower receives $90 in cash and promises to pay the lender $100 in one year without interest, the $10 subtracted from the face amount of the loan is the discount. This loan has an annual true interest cost, or yield, of 11.1%, that is, $10 divided by $90.

[22] *See* Kripke, *Vacuum of Fact*, *supra* note 17, at 941-48.

due if the borrower stops paying, monitoring any security for the loan,[23] and foreclosing on any security for the loan upon default. If the owner of the loans does not want to service them, she will enter into a separate servicing agreement with a servicer specifying the duties of the servicer and the servicing fees. The servicing fees may be a percentage of the principal amount of the loan (say, 0.25% annually) or a dollar amount ($10.00 per loan per month) and are paid out of the interest payments on the loan. The servicer may also be entitled to receive additional amounts, such as late fees paid by the underlying borrower and reimbursement for collection costs out of foreclosure proceeds or from the owner of the loan. Finally, the servicing agreement generally provides for the resignation by the servicer and the termination and replacement of the servicer if the servicer fails to perform adequately.[24]

2. Elements of a True Sale or Pledge of Loans

There are three essential elements of a true sale of property: 1) the buyer pays a price for the property; 2) the buyer expects to enjoy the benefits of owning the property; and 3) the buyer assumes the burdens of ownership.[25] In its purest form, the seller relinquishes and the buyer assumes all of the property's benefits and burdens. In reality, sellers

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[23] An example of monitoring a mortgage loan is insuring that the underlying borrower has paid the property taxes on the real property and the premiums for the casualty insurance on the improvements. If the borrower has not made those payments, the servicer may make them on behalf of the borrower, which the borrower will be obligated to repay.

[24] Servicers treat the right to service loans as a separate asset which they may sell or pledge. Servicing rights represent a form of cash flow. The value of the servicing rights is the difference in the specified servicing fees and the servicer's actual cost of servicing the loans.

[25] Most cases state that a sale is the transfer of property for a price and thus emphasize the first element; the other two are generally implicit. *See, e.g.*, Bunch v. Signal Oil & Gas Co., 505 P.2d 41, 42 (Colo. Ct. App. 1972) (citing the definition of sale in § 2-106(1) of the U.C.C. in effect in Colorado, holding that a sale had occurred when the buyer paid for a used truck, took possession of it, and subsequently made repairs to it, even though he had not received a certificate of title as promised by the seller). A few cases, however, do analyze the other elements. *See* Wilson v. Whinery, 678 P.2d 354, 357 (Wash. Ct. App. 1984) (holding that an owner of a lot who conveyed a drain field easement on the lot and a lease of the lot to a neighbor, which effectively conveyed all of its beneficial use and destroyed substantially all of its market value, had "sold" the lot for purposes of a right of first refusal previously granted to the plaintiff). *See also* Commissioner v. Brown, 380 U.S. 566 (1965) (upholding a sale of stock for purposes of capital gains treatment, notwithstanding that the risk of loss on the stock remained with the seller, because the price paid for the stock was reasonable value for the stock and the seller relinquished and the buyer obtained the opportunity for future gain from owning the stock); Boone v. United States, 470 F.2d 232 (10th Cir. 1972) (similar to and citing *Brown*).

often retain some liability with respect to property sold[26] and may retain some benefits. The benefits and burdens of owning any type of property reflect that property's particular characteristics.

In a secured loan transaction, however, the borrower receives money and agrees to repay it at some future date.[27] The borrower also transfers to the lender the property or an interest in the property, with two conditions: a) if the borrower does not repay the money as agreed the lender may sell the property and use the proceeds of sale to satisfy the borrower's repayment obligation; and b) if the borrower does repay the money borrowed, then the borrower gets her property back, and the lender must relinquish his interest in it. Unless the borrower fails to pay and the lender forecloses her interest in the property, she retains the benefits and burdens of owning the property.[28] When the property securing the loan consists of underlying loans, very often the secondary borrower transfers the documents evidencing the underlying loans to the secondary lender.[29] The secondary borrower may retain the right to the underlying loan payments, or may direct the underlying borrowers to make their loan payments to the secondary lender as the means of repaying the debt.

The benefits of owning property generally are the right to use the property and the right to any future appreciation of the property's market value. Although the right to use property may be an indication of

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A number of commentators have noted the benefits of ownership. *See, e.g.*, Richard A. Epstein, *Property and Necessity*, 13 Harv. J.L. & Pub. Pol'y 2, 3 (1989) ("The standard definitions of property . . . tend to endow the owner of a particular thing with three rights: possession, use, and disposition."). *See also* Ray A. Brown, The Law of Personal Property § 1.5, at 6-7 (Walter B. Rausenbush ed., 3d ed. 1975); Roger A. Cunningham et al., The Law of Property §§ 1.1-1.2 (1984); 1 George W. Thompson, Commentaries on the Modern Law of Real Property § 1, at 2-5 (John S. Grimes ed., repl. ed. 1980).

[26] *See infra* text accompanying and following note 180.

[27] Western Auto Supply Co. v. Vick, 277 S.E.2d 360, 367, *aff'd on reh'g*, 283 S.E.2d 101 (N.C. 1981).

[28] The conditional transfer of an interest in property to secure repayment of the debt is the essence of a mortgage in the case of real property, *see* Nelson & Whitman, *supra* note 2, and of the security interest under U.C.C art. 9 (1991) in the case of personal property, *see, e.g.* U.C.C. § 9-205 (use or disposition of collateral), § 9-207 (secured party's rights and duties regarding collateral in its possession), and §§ 9-502 to -506 (secured party's rights and duties regarding collateral after debtor's default and debtor's right to redeem).

[29] If the loan is evidenced by a note or other instrument, *see* U.C.C § 9-105(1)(i) (1991), then the lender can generally perfect a security interest in the loan only by taking possession of the instrument. U.C.C. §§ 9-304(l), -305 (1991). If the loan is evidenced by chattel paper, such as an installment sale agreement creating a security interest in a car, then the lender can perfect a security interest in the loan either by filing a financing statement or by taking possession of the chattel paper. U.C.C. §§ 9-304(l), -305 (1991).

ownership, it need not be. One may, for example, acquire the use of real property or tangible personal property, such as a car, by leasing it. Nevertheless, in a true lease, the lessee buys the right to use the property for a specified term, but the lessor—the owner—retains the right to future appreciation in the market value when the term expires.[30]

The owner's right to the "use" of a loan is the right to receive the cash flow from the loan. When the originator sells the loan, the buyer receives this benefit. The right to receive the cash flow can be a distinguishing factor, but it need not be. An owner of loans who pledges her loans as security for a secondary loan may continue to receive the payments from her underlying loans or she may agree to apply those loan payments to repay the secondary loan. In the latter case, the benefit that the secondary lender receives—the cash flow from the underlying loans—will not be much different from the benefit received by a purchaser of the underlying loans, if that secondary loan has payment characteristics similar to the terms of the underlying loans.[31]

Only one party, however, will have the right to the future increase in the market value of the underlying loan. This right is an important characteristic of ownership. An originator who intends to sell her loans can enhance her ability to have a transfer of loans treated as a sale if she forfeits her right to reacquire the loans. An originator who transfers her loans merely as security for a secondary loan can generally assure that the transaction will be treated as a secondary loan if she retains the right to repay the secondary loan—and therefore to reac-

[30] *See* U.C.C. § 1-201(37) (1991) (distinguishing a true lease from a lease which is a security agreement). *See also* Mooney, *supra* note 16, § 29A.05; Homburger & Andre, *supra* note 16, at 138-39. Of course, these distinctions are not absolute. A lessee in a long-term lease at a fixed rent will also receive a benefit if the value of the leased facilities and comparable facilities and the rental rates for the comparable facilities rise. To the extent that the lessee has a long-term lease at rental rates that are below the market rents, the value of the lease to the lessee will rise.

[31] For example, assume that an originator of mortgage loans owns a pool of mortgage loans aggregating $10,000,000 bearing interest at a weighted average rate of 11%. If market conditions were right, she could sell them to a buyer for $10,000,000 but retain ownership of a portion of the interest payments equal to 1% of the principal amount, that is, she could sell all of the principal amount of the loans with interest at 10% and she would retain 1% on the principal amount of each loan, either in the form of a larger servicing fee or in the form of a separate interest only strip. On the other hand, she could borrow $10,000,000 from a secondary lender pursuant to a secondary loan bearing interest at a rate of 10%, retain ownership of all of the loans, and pledge as security for the secondary loan the underlying mortgage loans. Although generally a borrower can only borrow a fraction of the value of the property pledged as collateral, this transaction can be properly structured to be either a sale or a secondary loan. *See infra* note 48 and accompanying text.

quire the loans free of the secondary lender's security interest—at some future time when the underlying loans retain significant value.[32]

Unlike the market value of real or personal property, for which people generally have some feeling based on their experiences as buyers and consumers, understanding the market value of loans and the reasons why that market value may increase or decrease requires specialized knowledge. It requires an ability to analyze the interplay between the terms of the particular loans and the applicable general market forces. The terms of the particular loans include the principal amount, the maturity date, the interest rate, the likelihood of default, the adequacy of any security for the loans, and the extent to which the borrowers may or may not prepay the loans before maturity. Market forces include the prevailing interest rates and other factors that may affect the demand for or desirability of those loans and that may increase the risk of default or prepayment of those loans. Most people are not in the business of evaluating these elements and their effect on the value of the myriad of loans and other financial instruments in the marketplace.[33]

A significant market force affecting the value of loans is the general level of interest rates, especially for loans that bear interest at a fixed rate.[34] The beginning point for quantifying this effect is determin-

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[32] By itself, the right to future increase in the property's market value is not necessarily a determinant of ownership. *See, e.g.*, Redman Indus., Inc. v. Couch, 613 S.W.2d 787 (Tex. Civ. App. 1981). In this case, Redman sold to Associated Properties a $4,700,000 note secured by real estate for approximately $4,500,000. The sale agreement provided that, if the underlying borrower defaulted or prepaid the note, Redman would receive any amounts received by Associated in excess of the amount that Associated borrowed to buy the note. (The court did not specify this amount, but for discussion purposes, assume that this amount is approximately $4,500,000). Redman also retained the option to repurchase the note if the underlying borrower defaulted, but was not obligated to do so. The underlying borrower defaulted, and Redman did not exercise his repurchase option. Associated foreclosed on the real estate and purchased the property at the foreclosure sale for $4,000,000. It later sold the real estate for $5,900,000. Claiming that the transaction was an illegal usurious loan transaction, Redman sued to obtain the excess of $5,900,000 over $4,500,000. The court affirmed a summary judgment against Redman that the transaction was a sale transaction, not a loan transaction.

More generally, an owner of property who grants another person the option to purchase her property on or before some future date for a fixed price parts with the right to future increase in market value. She will nevertheless continue to be the owner if she retains the remaining burdens and benefits of ownership. *See generally* Ronald B. Brown, *An Examination of Real Estate Purchase Options*, 12 Nova L. Rev. 147, 153, 165-68, 188, 195-96, 203-06 (1987).

[33] This observation explains why courts have generally paid so little attention to the question of value in determining whether a transaction is a sale of loans or merely a secondary loan secured by the underlying loans. *See infra* text following note 166.

[34] Any interest rate includes a number of components—the "real" cost of money, the current inflation rate, and the components that compensate the lender for the risk of default by the bor-

ing the present value of the scheduled or expected loan payments. A few examples will illustrate this point. Assume a $100,000 mortgage loan originated in June 1992 that is prepayable without penalty at any time and bears interest at a fixed annual rate of 12%. Also assume that the 12% rate is the market rate for comparable loans. This loan has an initial present value of $100,000 and a monthly payment of $1,028.61[35] if it amortizes[36] monthly over 30 years.

After two years of payments, the principal balance of the loan will be $99,228.28.[37] If, however, interest rates for comparable mortgage loans in June 1994 fell to 10%, the present value at that time of the $1,028.61 monthly payments payable for the remaining 28 year term of the loan equals $118,334.63.[38] If the originator of this mortgage loan sells it for its present value after this two year period, she would realize a potential profit of $19,106.35 because of the decrease in market inter-

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rower, the risk of future increases in inflation, and the risk that the borrower may prepay the loan before maturity if interest rates fall and the lender must reinvest his principal at a lower interest rate. These can change over time. In a loan bearing interest at a fixed rate, the interest rate will reflect all of these components at the time of the creation of the loan. *See generally* Michael A. Goldberg, *The Determinants of Interest Rates*, *in* Handbook of Modern Finance 13-1 (Dennis E. Logue ed., 2d ed. 1990). *See also* Frank S. Alexander, *Mortgage Prepayment: The Trial of Common Sense*, 72 Cornell L. Rev. 288, 330-33 (1987) (discussing the effect of prepayment on mortgage interest rates); Joseph C. Hu, *Adjustable Rate Mortgages*, *in* The Handbook of Mortgage-Backed Securities 35, 45-48 (Frank J. Fabozzi ed., rev. ed. 1988) (discussing the components of interest rates for various types of adjustable and fixed rate mortgage loans).

[35] There is a standard formula for making these calculations. Nelson & Whitman, *supra* note 2, § 1.1 at 2-4; T. Craig Tapley, *Mathematics of Finance: Money and Time*, *in* Handbook of Modern Finance 6-8 to -13, 6-23 to -26, and 6-29 to -30 (Dennis E. Logue ed., 2d ed. 1990). If any three of four variables—the interest rate, the number of payment periods, the present value, and the amount of the payment to be made in each payment period—is known or assumed, then the fourth variable can be calculated. *Id.* These calculations and the calculations discussed *infra* at notes 38-42 can be done with any number of computer programs or financial calculators.

[36] An amortizing loan is one in which the principal of the loan is repaid each month so that by the end of the term of the loan, the principal amount has been reduced to zero. *See* Nelson & Whitman, *supra* note 2, § 1.1 at 2-4. *See also* Tapley, *supra* note 35, at 6-30 to -31. In the example discussed above, each monthly payment consists of interest in the amount of 1% on the outstanding principal balance of the loan and a monthly principal payment, which will reduce the principal amount of the loan. In the first month, the interest equals $1,000 and the principal payment is $28.61. Because the amount of each monthly payment remains constant, the portion of each monthly payment allocated to interest will decrease slightly as the outstanding principal balance of the loan reduces and the portion allocated to principal will increase by the same amount.

[37] The example uses a fixed rate amortizing loan, but the present value can be calculated for any form of cash flow instrument, such as a loan on which the borrower makes only interest payments until the maturity date of the loan, when the entire original principal amount of the loan is due. *See generally* Tapley, *supra* note 35, at 6-1 to -54.

[38] In other words, a loan in the principal amount of $118,334.63 bearing interest at an annual rate of 10% and maturing in 28 years would have a monthly payment equal to $1028.61.

est rates (disregarding any points or other charges that she may have collected when she made the loan).

She could not sell the loan for $118,334.63, however, because the underlying borrower can prepay the then outstanding balance of the loan, $99,228.28, at any time (typically by borrowing at the current rate of 10%). A potential buyer of this loan would not want to pay the full amount of the present value, $118,334.63, knowing that he will receive only $99,228.28 if the underlying borrower prepays. Accordingly, the buyer will estimate the probability of prepayment of this loan—which typically will be one of many loans in a pool to be sold—and agree to pay something more than the $99,228.28 outstanding balance of the loan but less than the $118,334.63 present value of the loan.[39]

Alternatively, if the current rate of interest for similar loans rose to 14% in June 1994, then the present value of the future monthly payments is only $87,141.09.[40] This is $12,087.19 less than the out-

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[39] A few examples will illustrate the effect of prepayment on the value of the mortgage loan described above when market rates are 10%. If the buyer of the loan were to assume that the underlying borrower will repay the loan in five years, the buyer would calculate the present value of the future payments (the five years of monthly payments and the then outstanding principal balance of $96,261.70 on the date of prepayment). The present value of these payments at a 10% discount rate is approximately $106,919.

More commonly, potential buyers will use a standard mathematical formula for prepayments in estimating the value of a pool of mortgage loans. One common formula is the Public Securities Association standard prepayment model (referred to this article as "PSA"). This formula specifies a prepayment percentage for each month in the life of a pool of mortgages. For example, 100% PSA means that in the first month of a pool of mortgage loans (assuming that they were all originated at the same time), the loans will prepay at an annual rate of 0.2% of the outstanding balance of the pool, and that for each additional month the rate will increase by 0.2 percentage points until the 30th month; for the 30th month and later, the pool will prepay at an annual rate of 6%. 200% PSA means that the loans will prepay at twice those annual rates, i.e, annual rates of 0.4% in the first month, 0.8% in the second month, and 12% in the 30th month and later. *See* Public Securities Association, Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities, ch. SF, at SF-5 to -6 (1992); John A. Scowcroft et al., *Overview of the Methods for Analyzing Fixed Rate Mortgage-Backed Securities*, *in* The Handbook of Mortgage-Backed Securities 649, 653-55 (Frank J. Fabozzi ed., rev. ed. 1988).

For the loan described in the text, the buyer can estimate the value of the loan using various multiples of PSA and can calculate the present value of the future payments (the scheduled monthly payments and the assumed monthly prepayments). For example, using a prepayment assumption of 100% PSA, the present value is approximately $110,653. Assuming prepayment at 200% PSA, the present value is approximately $107,677. Because the interest rate on the loan is higher than the market rates, a prepayment assumption of 200% PSA or higher is more realistic.

[40] In other words, a loan in the principal amount of $87,141.09 bearing interest at an annual rate of 14% and maturing in 28 years would have a monthly payment equal to $1028.61.

standing balance of the loan.[41] If the originator retains this loan until June 1994, she will realize a loss of approximately this magnitude.[42]

Another major factor affecting market value is the probability that the underlying borrower will default. A default interrupts the monthly cash flow, a significant reason for buying the loan. Defaults also may cause the buyer to suffer a loss of principal, a likely occurrence for unsecured loans, such as credit card accounts, and a possible one for secured loans if the value of the security upon liquidation is insufficient to pay costs, accrued interest and the principal amount of the loan.[43] External factors that increase or decrease demand for a particular type of loan will also affect the loan's market value. These may include regulatory changes that affect the purchasing ability of a class of buyers, a perception in the marketplace that the type of loan is less desirable, or concern about an increase or decrease in the supply of similar loans.

The burdens of owning property include the responsibility of managing and preserving the property, the risk of the "physical" loss of the property, and the risk of the loss of the property's market value. Managing and preserving loans means servicing them and preserving the documents that evidence the loan obligation. The risk of physical loss has two parts—the risk that the documents evidencing the loan are

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[41] The shorter the maturity of the loan, the less dramatic are the changes in present value as interest rates change. A four year $10,000 loan, such as an automobile loan, payable monthly and bearing interest at 12% annually would have a present value of $9,636.75, a 3.6% decline, if rates on comparable loans suddenly increase to 14%, and a present value of $10,382.95, a 3.8% increase, if such rates suddenly fall to 10%.

Determining the price at which adjustable rate loans will sell is a more complicated matter. The key issue in the pricing is the way in which the adjustments in the interest rates on the loans reflect changes in the general level of interest rates for other financial instruments with similar terms, such as the maturity date. *See generally* Bella S. Borg & Andrew S. Carron, *The Valuation of Adjustable Rate Mortgages*, *in* The Handbook of Mortgage-Backed Securities 787-832 (Frank J. Fabozzi ed., rev. ed. 1988).

[42] Prepayment is still a factor. If a buyer buys the loan for $87,141.09, and the borrower prepays the loan, the buyer will realize a quick profit. When interest rates go up, the likelihood that a loan will prepay goes down, but borrowers still prepay for a variety of reasons, as when they move, become unemployed or suffer a divorce.

A few examples comparable to the examples set forth *supra* note 39 will illustrate the effect of prepayment on the value of the mortgage loan described above when market rates are 14%. First, if the buyer of the loan assumes prepayment in full in five years, the present value of the future payments at a 14% discount rate is approximately $92,203.

Second, if the buyer assumes that the loan will prepay each month at 100% PSA, the present value of the future payments is approximately $89,835. Assuming prepayment at 200% PSA, the present value is approximately $91,975.

[43] A buyer will assess the probability of a default on the loans in a pool, and will also adjust the price that he would be willing to pay to take into account that probability. *See infra* text accompanying note 52. *See also* Goldberg, *supra* note 34, at 13-29 to -33.

lost, destroyed or fraudulent, and the risk that the underlying borrower will default on her loan payments. The default risk is more significant because keeping custody of the documents is an easy task and fraudulent documents are rare. Finally, just as the owner has the benefit of increases in the market value, so too does she have the risk of loss of the market value of the loan if interest rates go up or if other extraneous events reduce the demand for her loans.

B. *Business Considerations*

1. Business Considerations for the Seller

Whether an originator of loans sells them or uses them as security for a secondary loan depends upon a number of considerations. One is whether she wishes to remove the loans from her balance sheet, in the case of a sale, or whether she wishes to retain the loans on her balance sheet as an asset along with the corresponding liability associated with a secondary borrowing. Another is whether she wishes to realize a gain or loss upon the sale of the loans, either for accounting purposes or for income tax purposes. If the originator needs to show a profit to keep her stockholders or bankers happy, and the market value of her loans has risen, she will be inclined to sell. If the market value of the loans has dropped, however, she will be more inclined to use them as collateral for a secondary loan.[44] She would only sell the loans if she wants to generate a loss to offset a profit on another part of her operations.[45] Finally, a decision to sell or pledge may depend upon which transaction

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[44] She could always try to obtain an unsecured loan for her operations, but she will generally be able to borrow more money on more favorable terms if she can give the lender security for the loan. Because she is in the business of making the underlying loans, those loans are the most readily available collateral.

[45] She may not be able to sell them if the realization of the loss would impair her capital significantly. *See generally* Kenneth E. Scott, *Never Again: The S & L Bailout Bill*, 45 Bus. Law. 1883, 1887-93 (1990). *See also* Cottage Savings Ass'n v. Commissioner, 111 S. Ct. 1503, 1506-07 (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.

gives her the most cash at the lowest cost and meets her other business goals.[46]

2. Business Considerations for the Buyer

A buyer buys loans for several reasons. These include an expectation of an increase in the market value of the loans and receipt of the anticipated cash flow. Cash flow consists of two components: interest earnings and repayment of principal. In the case of interest earnings, the buyer is seeking the maximum amount of interest earnings for the expected maturity of the loans given the amount of credit risk he is willing to take. As to principal, the buyer will want to receive principal in the amounts and at the scheduled or estimated times necessary for him to meet his payment liabilities, such as debt obligations in the case of a bank or a corporation, or insurance contract obligations in the case of a life insurance company.

Buyers, however, are not the only ones wanting to receive cash flow. A secondary lender will make a secondary loan secured by an underlying loan or pool of loans for the same reasons: to earn the most interest consistent with the maturity and risks involved, and to receive principal payments in the future when he expects that he will need them. Nevertheless, in any one transaction, it is easy to distinguish the buyer from the secondary lender if there is little correlation between the cash flow needs of the secondary lender and the cash flow of the underlying loans. An example is a warehouse loan. A lender will make a short-term loan to a loan originator, such as a single family mortgage loan originator. As the loan originator makes the mortgage loans, she will deliver them to the lender for a short time (i.e., warehouse them) until she has made enough loans to form a pool large enough to sell. She will then sell the underlying loans and use the proceeds to pay off the warehouse loan.[47]

[46] If she believes that her existing loans will increase in value, because of falling interest rates or other market conditions, she may want to retain the underlying loans and use them as security for a secondary loan which she retains the right to prepay. If the value of the underlying loans were to increase, she could then repay the secondary loan and sell the underlying loans at a profit. On the other hand, she may not want to take the risk that interest rates will rise and reduce the value of her loans and therefore she may want to shift that risk to someone else by selling the loans.

[47] Thomas S. LaMalfa, *The Inside Line on Warehouse Lending*, 51 Mort. Banking 51 (Nov. 1990). *See also* Jan Z. Krasnowicki et al., *The Kennedy Mortgage Co. Bankruptcy: New Light*

If, however, the cash flow needs of the potential buyer or secondary lender approximate the cash flow of the underlying loans, then whether the person buys the loans or makes a secured secondary loan turns on a finer evaluation of which form gives him a better return. Outside of extraneous legal considerations and a consideration of certain burdens and benefits of owning loans, often the person is indifferent to the form if his cash flow needs are met.[48]

C. *The Role of Recourse*

Because the underlying loans are cash flow assets whose value depends upon the ability and willingness of the underlying borrowers to make their loan payments, an originator who sells her loans may be willing to provide the buyer some degree of recourse if the underlying borrowers fail to make their payments.[49] She may provide this credit recourse in a variety of ways.[50] For example, she may agree to repur-

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Shed on the Position of Mortgage Warehouse Banks, 56 Am. Bankr. L.J. 325, 328-29 (1982); Murdock K. Goodwin, *Mortgage Warehousing—A Misnomer*, 104 U. Pa. L.R. 494 (1956).

[48] An example of two transactions that produce the same cash flow for a buyer or lender but that have different consequences for the originator are pass-through certificates and collateralized obligations. Pass-through certificates are securities issued pursuant to a trust agreement evidencing in the aggregate a 100% beneficial ownership interest in a pool of loans that the originator has sold to a trust. Collateralized obligations are debt securities issued pursuant to a trust agreement or indenture secured only by the pool of loans. For the originator, the form of the transaction has significant consequences because the pass-through certificates represent a sale of the loans, whereas the collateralized obligations are debt for state law and bankruptcy purposes. In addition to these differences, if the pass-through certificates are sold publicly, the trust agreement need not comply with the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1988), whereas the trust agreement for the collateralized obligations must comply. Yet in both cases, the cash flow of the two types of securities can be practically identical.

[49] Recourse also arises if a holder of a negotiable instrument, such as a note, endorses the note to another party without any restrictive endorsement. U.C.C. § 3-414(1) (1989), which is in effect in most states, provides:

> Unless the indorsement otherwise specifies (as by such words as "without recourse") every indorser engages that upon dishonor and any necessary notice of dishonor and protest he will pay the instrument according to its tenor at the time of his indorsement to the holder or to any subsequent indorser who takes it up, even though the indorser who takes it up was not obligated to do.

The 1990 revision to the Official Text of article 3 preserves this rule. U.C.C. § 3-415(a) (1991), and *id.* at cmt. 1.

[50] Aicher and Fellerhoff, *supra* note 8, at 186-87, include in the notion of credit recourse the failure of an "absolute assignment" to extinguish or reduce an independent debt. They cite Dewhirst v. Citibank (Arizona) (*In re* Contractor's Equip. Supply Co.), 861 F.2d 241 (9th Cir. 1988), Malone v. Celeron Oil & Gas Co. (*In re* Currie), 57 B.R. 224 (Bankr. M.D. La. 1986), *discussed supra* at note 10, *In re* Fort Dodge Roofing Co., 50 B.R. 666 (Bankr. N.D. Iowa 1985),

chase all or a specified number (or dollar value) of defaulting loans; she may allow the buyer to retain a portion of the purchase price to cover losses; she may establish a reserve fund, to be held by the buyer or a third party, that is financed out of the sale proceeds; or she may provide cash flow from other assets.[51]

The reason why the seller will provide credit recourse is to maximize her sale proceeds. As an example, suppose that an originator holds a pool of loans with a face amount of $1,000,000. She knows the credit quality of the loans, and therefore she can predict a probable 1% loss on this pool over the life of the loans. A potential buyer is not as confident about the credit quality of the loans, and may be willing to pay only 97% of the face amount of the loans without any recourse. He may, however, be willing to pay 100% if the seller guarantees that he will suffer no losses from default. By providing this recourse, the seller can receive $30,000 more in sale proceeds in exchange for a contingent liability that she estimates will be 1%, or $10,000, over the life of the loans. For accounting purposes, she will treat this transaction as a sale, and her sale proceeds will equal $990,000.[52]

In re Evergreen Valley Resort, Inc., 23 B.R. 659 (Bankr. D. Me. 1982), *In re* Bowen, 5 U.C.C. Rep. Serv. (Callaghan) 261 (Bankr. D. Or. 1968), and Geeslin v. Blackhawk Heating & Plumbing Co., 398 N.E.2d 1176 (Ill. App. Ct. 1979). The failure to reduce or extinguish an independent debt is not credit recourse because it is not the assumption of the risk of loss from default on an underlying loan. The recourse on the debt already exists. In *Dewhirst* and *Malone*, the assignments, though using words of "sale," arose in express loan transactions and served as additional security for the loan. In three other cases, the courts treated the failure as evidence of the intentions of the parties, that is, how they expressly treated the transaction. Indeed, in *In re Evergreen Valley Resort*, 23 B.R. at 662, the court quoted the language of the assignment, which stated that it was "made as security" for the existing debt. These courts could also have analyzed the failure to reduce the debt as paying no value for the assignment. In any event, the courts correctly did not treat the failure to reduce or pay a debt as credit recourse. Finally, in *Geeslin*, the court found the assignment to be absolute.

[51] A simple way of providing a secure source of cash flow is a senior/subordinated structure. The seller sells an undivided percentage, say 90% (the "senior percentage"), of a pool of loans, with the seller retaining the remaining percentage (the "subordinated percentage"). All of the cash flow from the pool will go first to the holders of the senior percentage until they receive all of the principal and interest to which they would be entitled assuming no defaults. Thus, the holder of the subordinated percentage will bear all of the losses until the losses equal the subordinated percentage. *See* Moody's Investors Service, Structured Finance Research & Commentary Special Report: Moody's Approach to Rating Residential Mortgage Pass-Throughs 23-24 (April 1990); Standard & Poor's Corporation, Structured Finance Criteria 101-09 (1988).

[52] To do so, she must surrender control over the future economic benefits, such as by not retaining a right to repurchase the loans; she must be able reasonably to estimate her obligation under the recourse provisions; and the buyer must not have a right to return the loans to her except under the recourse provisions. 1 Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 77, Reporting by Transferors of Transfers of Receivables with*

In addition to credit recourse, a seller commonly provides a buyer with certain warranties on the loans and agrees to replace or repurchase loans that breach any warranties if the seller cannot cure the breach. These warranties typically cover factual matters relating to the seller's ability to originate and sell the loans,[53] the significant elements of the origination of the loans,[54] and the performance of the loans before the date of sale.[55] This type of recourse generally does not increase the risk that a court will recharacterize a sale transaction as a secondary loan.[56] The lack of concern may derive from a court's perception that recourse for breach of warranty arises only out of factual matters that occurred before the sale. It resembles recourse that sellers of real property and other types of personal property frequently give.[57]

Credit recourse, however, *does* increase the possibility that a court will recharacterize the sale of the loans as a secondary loan secured by a pledge of the underlying loans.[58] Credit recourse covers the future

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Recourse, *in* Original Pronouncements—Accounting Standards as of June 1, 1991, at 755-65 (ed. 1991/1992). *See also* Aicher & Fellerhoff, *supra* note 8, at 207-08.

[53] The following are typical of these type of warranties: the seller is duly organized and in good standing in the state of its incorporation; it is qualified to do business in each of the states in which the loans were originated; the sale has been duly authorized by the necessary corporate action; the sale of the loans will not breach the seller's articles of incorporation or by-laws or any document, law, rule, regulation, or court order to which the seller is subject; and there is no litigation affecting the sale of the loans.

[54] Warranties about the elements of origination include: each underlying borrower had the capacity to enter into the loan; no loan violates various consumer or usury laws; and the information provided by the seller for each loan is accurate. If the underlying loan is secured by any property, the warranties will cover the security for the loan. In the case of real property securing a mortgage loan, the warranties would include: the mortgage has been duly recorded and constitutes a valid first lien, there is a valid title insurance policy in effect, and there is a standard hazard insurance policy insuring the improvements.

[55] Warranties about the performance of the loans may, depending upon the quality of the loans being sold, include: every loan is current as of the date of sale; no loan has been delinquent more than once in the last year; and any such delinquency did not exceed 30 days. Again, for mortgage loans, the seller may also warrant that the real property taxes on the property are current and that there are no condemnation proceedings pending.

[56] *See* Aicher & Fellerhoff, *supra* note 8, at 188-91.

[57] *See infra* text accompanying note 180.

[58] *See supra* note 13 and accompanying text. *See also* Standard & Poor's, *supra* note 51, at 69, specifying that in a structured issuance of securities backed by loans, there "should be no recourse against the seller for defaulted receivables beyond a reasonably anticipated default rate based on an historical analysis"; Asset Sales Report, Feb. 25, 1991, at 3, describing a transaction in which Ford Motor Credit Corporation sold automobile loans through a senior/subordinated structure. Ford Motor Credit had intended to retain the subordinated interest in the loans, which is a form of recourse, *see supra* note 51, but instead established a special-purpose corporation to hold the subordinated interests because of concern about the presence of recourse if Ford Motor Credit were to go bankrupt.

performance of the loans, that is, whether the underlying borrowers repay. In a secondary loan transaction in which the underlying loans are pledged as security, recourse always exists either to the loans pledged or to the general credit of the originator. From a superficial perspective, credit recourse in a sale transaction may cause the sale to be characterized as a loan transaction because the credit recourse may resemble a promise to repay a loan.[59]

II. THE LEGAL SIGNIFICANCE OF SALE TREATMENT

A. *Bankruptcy*

The treatment of a transaction as either a sale or a secured loan has significant legal ramifications for the parties as well as for nonparties.[60] A major legal consideration is the effect of the bankruptcy of

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[59] North Carolina follows this reasoning. Western Auto Supply Co. v. Vick, 277 S.E.2d 360, 368, *aff'd on reh'g*, 283 S.E.2d 101 (N.C. 1981). *See also*, Bynum v. Rogers, 49 N.C. (4 Jones) 399, 401 (1857), which summarized the early North Carolina cases as follows:

> These cases establish a clear rule by which to distinguish between a sale of a bill or note and a loan, to wit, when the instrument is transferred by the endorsement of the person receiving the money, it is a loan, because the endorser is liable for the debt; but when the transfer is simply by delivery, it is a sale, if the transaction is bona fide.

North Carolina seems to be the only jurisdiction that has consistently followed such a judicial *per se* rule. *See* 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, 685, 688-89 (1946), and *infra* note 133. The State of Washington's usury statute specifically defines a "loan" to include the discounting of commercial paper with recourse. Wash. Rev. Code § 19.52.010 (1989), *discussed in* Baxter v. Stevens, 773 P.2d 891 (Wash. Ct. App.), *cert. denied*, 784 P.2d 530 (Wash. 1989).

[60] Professor Threedy makes the point that the characterization of a loan participation as a sale or loan does not and should resolve many of the legal issues arising from the interaction between the participant in a loan participation and a third party, such as the underlying borrower or a creditor of the lead lender. Threedy, *supra* note 16. She concludes that labeling a loan participation as a sale or a loan transaction "is merely a shorthand way of saying that the court has balanced the competing interests of the participant and some third party and has reached a conclusion to protect the participant or not." *Id.* at 689. This is no doubt an accurate description of what many courts do.

The characterization of the nature of the transaction should not be determinative when there is a well-defined policy or legal rule prescribing a particular conclusion independent of that characterization. *See, e.g., In re* Cripps, 31 B.R. 541 (Bankr. W.D. Okla. 1983) (holding that the interest of a purchaser of accounts, who purchased them in a true sale and took possession of them, was subordinate to the seller's trustee in bankruptcy because the purchaser failed to file a financing statement as required by U.C.C. § 9-302(1) (1991)). Nevertheless, because of the pervasiveness of the concept of ownership of property, the legal ramifications that follow, and the reliance placed on the concept by the players in the commercial world, the analysis of who owns the property should determine the outcome of disputes, even with third parties, absent a more the originator. If a loan originator is subject to the Bankruptcy Code,[61] the originator's bankruptcy will not affect a prior sale of loans unless the sale was a fraudulent transfer.[62] If she borrowed money from a lender, however, and assigned the underlying loans as security, upon bankruptcy those underlying loans become the property of her bankruptcy estate.[63] The originator or its trustee in bankruptcy can then require the secondary lender to return the loans.[64] In addition, the lender is subject to the automatic stay provisions of the Bankruptcy Code,[65] and cannot sell the underlying loans if the originator stops pay-

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explicit policy or rule that applies in the particular situation. *See infra* text accompanying and following note 156. *See also* Tabac, *supra* note 1.

[61] The United States Bankruptcy Code applies to most debtors. 11 U.S.C. § 109 (1988). It does not apply to insurance companies, banks and savings institutions, which have their own statutory and regulatory provisions for insolvency. 11 U.S.C. § 109(b)(2) (1988).

[62] 11 U.S.C § 548(a) (1988), *discussed infra* at note 157 and accompanying text.

[63] 11 U.S.C. § 541 (1988) 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:
>
> > (1) Except as provided in subsections (b) [any power that the debtor may only exercise solely for the benefit of some other entity] and (c)(2) [spendthrift trust restrictions] of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

See generally George R. Pitts, *Rights to Future Payment As Property of the Estate Under Section 541 of the Bankruptcy Code*, 64 Am. Bankr. L.J. 61 (1990).

[64] 11 U.S.C. § 542(a) (1988) provides:

> [A]n entity, other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell or lease under section 363 of this title [*see infra* note 67] . . . shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.

See generally T. Edward Malpass, *A Bankruptcy Debtor's Right to Turnover of Property Held by Creditors: A Perspective on Sections 542 and 543 of the Bankruptcy Code*, 88 Com. L.J. 242 (1983).

[65] 11 U.S.C. § 362(a) (1988) provides:

> Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, . . . operates as a stay, applicable to all entities, of—
>
> (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
>
> (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
>
> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
>
> (4) any act to create, perfect, or enforce any lien against property of the estate;

ment on the secondary loan.[66] Moreover, if the originator also services the loans, she can retain the loan payments. Finally, the originator's trustee in bankruptcy can use the cash from the underlying loans for its own purposes so long as the lender is adequately protected.[67] Thus, if the transaction is treated as a secured loan, the originator's bankruptcy stops the cash flow to the secondary lender—a primary reason for making the loan—until the bankruptcy proceeding is resolved or until the court lifts the automatic stay.[68]

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

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

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

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

Banks and savings institutions are not subject to an automatic stay, *see* Letter from the General Counsel for the Federal Deposit Insurance Corporation, Fed. Banking L. Rep. ¶ 81,264 (Dec. 15, 1989), but the powers of conservators and receivers of banks and savings institutions are broad.

[66] The automatic stay can also be a concern to non-parties. *See, e.g.*, First Nat'l Bank v. Hurricane Elkhorn Coal Corp. II (*In re* Hurricane Elkhorn Coal Corp. II), 19 B.R. 609, *motion to alter judgment denied*, 20 B.R. 631 (Bankr. W.D. Ky. 1982), *rev'd on other grounds*, 32 B.R. 737 (W.D. Ky. 1983), *aff'd*, 763 F.2d (6th Cir. 1985). Hurricane Elkhorn had assigned to First National accounts receivable for coal shipments as part of an apparent secured lending transaction. The coal company's agent collected the accounts from the underlying borrower and paid the bank directly. The coal company filed bankruptcy, but the bank and the company continued to operate under the arrangement. The agent withheld payments due after the bankruptcy to recoup overpayments it made before bankruptcy. Charged by the bank and the coal company with violating the automatic stay for withholding postbankruptcy payments, the agent claimed that the assignment was absolute. If the assignment had been absolute, the payments would not have been part of the estate of the bankrupt coal company and the automatic stay would not have applied to them. The bankruptcy court held that the assignment was not absolute and the payments remained part of the bankrupt's estate. The court ordered the agent to repay to the bank the money withheld. On appeal, the district court agreed with the bankruptcy court's conclusion that the payments were part of the bankruptcy estate and that the agent violated the automatic stay. It nevertheless held that the agent would be allowed to set off the earlier overpayments on a constructive trust theory and would not have to repay the withheld money to the bank.

[67] 11 U.S.C. § 363 (1988). *See, e.g.*, *In re* Carolina Util. Supply Co., 118 B.R. 412 (Bankr. D.S.C. 1990); *In re* Evergreen Valley Resort, 23 B.R. 659 (Bankr. D. Me. 1982). *See also* David A. Warfield, *Is It Use of Cash Collateral or Post-Petition Borrowing: How Much Protection Does the Creditor Deserve?*, 94 Com. L.J. 369 (1989). *See generally* Kaaran E. Thomas, *Valuation of Assets in Bankruptcy Proceedings: Emerging Issues*, 51 Mont. L. Rev. 126 (1990).

There are other ramifications as well. Payments to the secondary lender may be recoverable as preferential payments under 11 U.S.C. § 547 (1988). *See infra* note 90. Under 11 U.S.C. § 364(d) (1988), a post-bankruptcy lender can receive a priority security interest in the underlying loans superior to the existing security interest. *See* Warfield, *supra*, at 372.

[68] 11 U.S.C. § 362(d) (1988) states:

Under these circumstances, the secondary lender will lend to an originator only if a) he is convinced that there is only a small risk of bankruptcy, b) he is compensated for the risk of bankruptcy through a higher interest rate on the loan, or c) the borrower can structure the transaction to avoid the problems presented by bankruptcy.[69]

B. *Applicability of Article 9 of the U.C.C.*

Article 9 of the Uniform Commercial Code applies to security interests in almost all types of personal property and to sales of accounts and chattel paper.[70] Accordingly, whether a transfer of loans is a sale

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> 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—
> (1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or
> (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.

[69] The originator can structure the transaction to avoid the bankruptcy risk by selling the loans to a special-purpose, bankruptcy-remote subsidiary whose only function is to issue secondary debt secured by the loans. The subsidiary uses the proceeds of its secondary debt to pay for the loans. If the subsidiary is set up in a way that would prevent a court from consolidating it with the parent, the bankruptcy of the parent would not affect the subsidiary, and therefore would not interrupt the cash flow from the loans, which is pledged to repay the secondary debt. *See generally* Standard & Poor's, *supra* note 51, at 23, 69-70, and 112-14.

[70] U.C.C. § 9-102(1) (1991) provides:

> Except as otherwise provided in Section 9-104 on excluded transactions, this Article applies
> (a) to any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts; and also
> (b) to any sale of accounts or chattel paper.

See also U.C.C. § 9-105(1) (1991), which states in part:

> (c) "Collateral" means the property subject to a security interest, and includes accounts and chattel paper which have been sold; and
> (d) "Debtor" means the person who owes payment or other performance of the obligation secured, whether or not he owns or has rights in the collateral, and includes the seller of accounts or chattel paper. . . .

Article 9 is intended to apply to the sale of accounts and chattel paper arising in the context of commercial financing transactions. U.C.C. § 9-104(f) excludes certain sales of accounts and chattel paper that "have nothing to do with commercial financing transactions." U.C.C. § 9-102 cmt. 2 (1991). *See* 1 Grant Gilmore, Security Interests in Personal Property, § 10.5 (1965); 2 James J. White & Robert S. Summers, Uniform Commercial Code § 23-9 (3d ed. 1988).

or a pledge as security for a secondary loan will have different consequences depending upon the form of the loans.

If the underlying loans are not chattel paper[71] or accounts,[72] but instead are instruments[73] or general intangibles,[74] whether a transfer of the loans is a sale or a pledge will dictate what steps the transferee must take to protect his interests. If the transfer is a pledge as security for a secondary loan, all of the requirements for creating and perfecting security interests, such as the requirement for filing financing statements or for taking possession to perfect the security interest, and the priority rules of article 9 will apply. If the transfer is a sale, they will not.

For example, a buyer of a loan that is a general intangible need not file a financing statement, but a lender secured by this loan must.[75] Accordingly, a buyer of this loan who does not file a financing statement will become a general unsecured creditor of the seller if a court were to recharacterize the sale transaction to be a secondary loan.

The perfection requirements, the priority rules and most of the other requirements of article 9 do apply to the sale of accounts and

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[71] U.C.C. § 9-105(1)(b) (1991) provides:

> "Chattel paper" means a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods, but a charter or other contract involving the use or hire of a vessel is not chattel paper. When a transaction is evidenced both by such a security agreement or a lease and by an instrument or a series of instruments, the group of writings taken together constitutes chattel paper.

Examples of chattel paper are retail installment sale agreements and security agreements evidencing car loans, manufactured housing loans and recreational vehicle loans.

[72] U.C.C. § 9-106 (1991) provides: " 'Account' means any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance." Examples of accounts are revolving department store accounts and trade account receivables.

[73] U.C.C. § 9-105(1)(i) (1991) provides:

> "Instrument" means a negotiable instrument (defined in Section 3-104), or a certificated security (defined in Section 8-102) or any other writing which evidences a right to the payment of money and is not itself a security agreement or lease and is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement.

Single family mortgage loans are typically evidenced by negotiable notes; commercial and multifamily mortgage loans are often evidenced by notes, which usually are not negotiable.

[74] U.C.C. § 9-106 (1991) provides: " 'General intangibles' means any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and money."

[75] U.C.C. § 9-302 (1991). *See, e.g.*, Sarf v. Leff (*In re* Candy Lane Corp.), 38 B.R. 571, 575 (Bankr. S.D.N.Y. 1984) (assignment of condemnation award), *discussed supra* note 10.

chattel paper.[76] Nevertheless, the characterization of a transfer of accounts or chattel paper as either a sale or a secured loan will affect the rights of the buyer[77] in collecting and retaining proceeds of the accounts or chattel paper and in disposing of the accounts or chattel paper. Section 9-502 of the Uniform Commercial Code provides that, in a loan transaction, the secured lender must account to the borrower for any surplus[78] from collections on the underlying accounts or chattel paper and that the borrower is liable for any deficiency.[79] If the transaction is a sale, however, the buyer may keep any surplus and the seller is not liable for any deficiency unless the parties otherwise agree.[80] Similarly, section 9-504 governs the disposition of collateral, including accounts and chattel paper. In a secured loan, if the lender sells the accounts or chattel paper, the borrower is entitled to any surplus and is liable for any deficiency. In a true sale, the buyer is entitled to any surplus and assumes the risk of any deficiency unless the parties otherwise agree.[81]

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[76] *See, e.g.*, *In re* Cripps, 31 B.R. 541 (Bankr. W.D. Okla. 1983) (holding that the interest of a purchaser of accounts, who purchased them in a true sale and took possession of them, was subordinate to the seller's trustee in bankruptcy because the purchaser failed to file a financing statement as required by U.C.C. § 9-302(1) (1991)).

[77] A buyer of accounts or chattel paper is by definition a "secured party." U.C.C. § 9-105(1)(m) (1991) (" 'Secured party' means a lender, seller or other person in whose favor there is a security interest, including a person to whom accounts or chattel paper have been sold. . . .").

[78] The surplus is the amount by which the collections from the underlying accounts or chattel paper exceed the amount paid by the transferee in exchange for the accounts or chattel paper—that is, the amount of the debt in a secured loan, and the purchase price in a sale—and other costs of the transferee.

[79] U.C.C. § 9-502 (1991) provides:

> (1) When so agreed and in any event on default the secured party is entitled to notify an account debtor or the obligor on an instrument to make payment to him whether or not the assignor was theretofore making collections on the collateral, and also to take control of any proceeds to which he is entitled under Section 9-306.
>
> (2) A secured party who by agreement is entitled to charge back uncollected collateral or otherwise to full or limited recourse against the debtor and who undertakes to collect from the account debtors or obligors must proceed in a commercially reasonable manner and may deduct his reasonable expenses of realization from the collections. If the security agreement secures an indebtedness, the secured party must account to the debtor for any surplus, and unless otherwise agreed, the debtor is liable for any deficiency. But, if the underlying transaction was a sale of accounts or chattel paper, the debtor is entitled to any surplus or is liable for any deficiency only if the security agreement so provides.

[80] *Id.*

[81] U.C.C. § 9-504(2) (1991) provides:

> If the security interest secured an indebtedness, the secured party must account to the debtor for any surplus, and, unless otherwise agreed, the debtor is liable for any defi-

C. *Other Implications*

As discussed in Part III, another major consequence from a recharacterization of a sale of loans as a secured loan transaction is the application of usury laws, which limit the interest rates that lenders may charge for a loan. Usury laws generally apply to loan transactions but not to sale transactions.[82] Other implications include various tax consequences,[83] and whether the loans are subject to garnishment[84] or a federal tax lien.[85]

III. EXISTING LAW

The risk that a court will recharacterize a purported sale as a secondary loan arises because courts do not use a consistent analytical approach when considering these transactions.[86] Few opinions analyze

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ciency. But if the underlying transaction was a sale of accounts or chattel paper, the debtor is entitled to any surplus or is liable for any deficiency only if the security agreement so provides.

[82] *See, e.g.*, Home Bond Co. v. McChesney, 239 U.S. 568 (1916), *discussed infra* at text accompanying note 118; West Pico Furniture Co. v. Pacific Fin. Loans, 469 P.2d 665 (Cal. 1970) (loan); People v. Service Inst., 421 N.Y.S.2d 325 (Sup. Ct. 1979) (a criminal usury case holding the "purchase" of funeral home account receivables to be a loan); Starker v. Heckart, 267 P.2d 219 (Or. 1954) (sale); Coast Fin. Corp. v. Ira F. Powers Furniture Co., 209 P. 614 (Or. 1922) (sale); A.B. Lewis Co. v. National Inv. Corp., 421 S.W.2d 723 (Tex. Civ. App. 1967) (sale). *See also infra* note 131 and accompanying text and notes and *supra* note 59.

[83] *See* Cliff & Levine, *supra* note 8. One of these implications was whether the seller of goods pursuant to an installment sale agreement had to recognize an immediate profit from the sale of the goods if she disposed of the installment agreement or whether she could use the installment method of recognizing the gain over the life of the installment sale agreement. Since the publication of the article by Cliff & Levine, the Internal Revenue Code was amended to provide that even pledging the installment agreement would require recognition of gain from the original sale of the goods. I.R.C. § 453A(d) (CCH 1992).

[84] *See* Deutscher v. Southern Indus. Banking Corp. (*In re* Southern Indus. Banking Corp.), 45 B.R. 97, 99 (Bankr. E.D. Tenn. 1984). A mortgage loan originator sold mortgage loans through a participation agreement but retained possession of the mortgage documents and serviced the loans. The court held that the originator did not retain an ownership interest in the loans and therefore the loan payments were not subject to garnishment by a judgment creditor, which was a debtor in a bankruptcy proceeding.

[85] *See* I.R.C. § 6321 (CCH 1992), which provides: "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount [of such tax plus interest and costs] shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person."

[86] Kripke, *supra* note 8, at 60-61; Aicher & Fellerhoff, *supra* note 8, at 206. *See also* Annotation, *When Transfer of Accounts or Other Choses in Action Is Deemed a Sale Rather Than a Pledge as Security for a Loan, and Vice Versa*, 95 A.L.R. 1197-1209 (1935).

which party has which benefits and burdens of ownership, and those that do focus on only *some* burdens or benefits, primarily credit recourse as a burden or risk of ownership. The opinions do not analyze all of the elements of a true sale transaction: Which burdens and benefits did the seller transfer? Which did she retain? How did the price that she received compare with the value of the loans that she purported to sell? How did she and the buyer treat the transaction?

A. *Major's Furniture Mart*

1. Background

The leading case analyzing whether a transfer of loans was a sale or a secondary loan is *Major's Furniture Mart v. Castle Credit Corp.*[87] The issue in *Major's* was which party had the right to surplus proceeds from collections on chattel paper under section 9-502 of the Pennsylvania Uniform Commercial Code.[88] Later courts, however, have cited *Major's* in cases involving the issue of whether underlying loans were the property of the debtor under the Bankruptcy Code[89] and whether payments on an underlying loan were a preference under the Bankruptcy Code.[90]

Major's sold furniture to retail customers and financed those sales through retail installment sale agreements. To obtain money for its operations, Major's entered into an agreement by which Major's "sold"

[87] 602 F.2d 538 (3d Cir. 1979). Aicher and Fellerhoff describe *Major's* as "one of the more thorough and detailed examinations of the sale vs. loan issue." Aicher & Fellerhoff, *supra* note 8, at 194.

[88] *See supra* text accompanying note 79.

[89] *In re* Carolina Util. Supply Co., 118 B.R. 412, 415 (Bankr. D.S.C. 1990); Hassett v. Sprague Elec. Co. (*In re* O.P.M. Leasing Services), 30 B.R. 642, 648 (Bankr. S.D.N.Y. 1983); *In re* Evergreen Valley Resort, 23 B.R. 659, 661 (Bankr. D. Me. 1982). *See supra* text accompanying note 63.

[90] A trustee for a debtor in bankruptcy can recover from a creditor certain preferential payments if the debtor made those payments on an antecedent debt within 90 days of the bankruptcy. 11. U.S.C. § 547 (1988). In Goldstein v. Madison Nat'l Bank, 89 B.R. 274 (D.D.C. 1988), the court held that an assignment by a debtor of amounts due on a third party contact in satisfaction of a preexisting debt was an absolute assignment and not merely a grant of a security interest is such amounts; accordingly, the payments by the third party to the lender during the preference period were not preferential payments because the debtor had absolutely assigned them before the preference period began. The court cited *Major's* for the proposition that an assignment with recourse does not automatically transform a sale into a mere grant of a security interest. *Goldstein*, 89 B.R. at 277.

the loans[91] to Castle with full recourse. The agreement, essentially an open-ended purchase and sale agreement, provided that each month Major's would sell loans to Castle for a purchase price equal to the principal amount of the loans less a 15% discount and less another 10% to be held in a reserve account. Castle could refuse to purchase any loan. The agreement required Major's to repurchase any loan that was more than 60 days delinquent for a purchase price of 100% of the principal amount plus any costs of collection incurred by Castle. The agreement also required Major's to repurchase all loans immediately if it went bankrupt, defaulted under the agreement, or discontinued its business.

Major's began to "sell" loans to Castle in June 1973. In August 1973, Castle notified Major's that Castle would increase the 15% discount from the purchase price to 18% for loans delivered in September 1973 and that thereafter the discount for loans delivered in each month would be the prime rate plus 6 ½%. The parties did not amend the agreement to reflect this change, but Major's continued to deliver loans. After June 1975, Major's stopped delivering loans to Castle and sued Castle for an accounting of all the proceeds Castle received on the loans and for repayment of the surplus proceeds under section 9-502 of the Pennsylvania Uniform Commercial Code.[92]

Under section 9-502, if the transaction were a sale of loans, Castle was entitled to any surplus. If the transaction were a loan, Major's was entitled to any surplus. Hence, the court had to decide whether the transaction was a true sale or a secured secondary loan. The district court, on a motion for summary judgment, found that Major's "sale" of the loans was a transfer for security and was not a true sale and that Major's was entitled to the surplus proceeds. The court of appeals affirmed.

The court of appeals rejected Castle's argument that the language of the agreement, which spoke in terms of "sale," controlled. The court stated that it was appropriate to review the conduct and relationship of the parties as well as their business activities and objectives to deter-

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[91] The court refers to these loans as accounts receivable, although it noted that under the Pennsylvania Uniform Commercial Code these retail installment sales agreements constituted chattel paper. *Major's*, 602 F.2d at 540 n.3. These loans were installment loans with a fixed principal amount and regularly scheduled monthly payments for a fixed period of time, such as two years. *See* Major's Furniture Mart v. Castle Credit Corp., 449 F. Supp. 538, 545 (E.D. Pa. 1978).

[92] *See supra* note 79 and accompanying text. The relevant provisions of the U.C.C. in effect in Pennsylvania were not materially different from the official text of the U.C.C.

mine the true nature of the transaction, and in particular to determine whether Castle treated the transaction as a sale or a secured secondary loan. On the other hand, the court rejected Major's argument that the recourse provisions of the agreement *per se* required a finding that the transaction was a secondary loan and not a true sale.

Nevertheless, finding the recourse provisions "extremely relevant",[93] the court quoted the district court's observations of the obligations that the agreement imposed upon Major's:

> (1) Major's retained "all conceivable risks of uncollectibility of these accounts;"
>
> (2) Major's warranted that
>
> (a) the underlying buyers met the criteria established by Castle;
> (b) Major's conducted credit checks to verify compliance;
> (c) the loans were legally enforceable; and
> (d) the loans were " 'fully and timely collectible' ";
>
> (3) Major's was to indemnify Castle from the reserve account a) for losses from an underlying borrower's failure to pay moneys due on the underlying loan or b) for any breach of Major's representations and warranties; and
>
> (4) Major's was to repurchase any loan that was in default for more than 60 days.[94]

As a result, the court concluded that "Castle attempted to shift all risks to Major's and incur none of the risks or obligations of ownership."[95]

The court also relied upon Castle's unilateral increase of the discount applicable to the "purchase price" for new loans as evidence that Castle treated the transaction as a loan. In particular, it quoted the trial court's conclusion that in a true sale Castle "would not have been able to impose these new conditions by fiat. Such changes in a sales contract would have modified the price term of the agreement, which could only be done by a writing signed by all the parties."[96]

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[93] *Major's*, 602 F.2d at 545.

[94] 602 F.2d at 545-46 (quoting 449 F. Supp. at 543). Of these, the obligations described in clauses 1, 2d, 3a, and 4 constitute credit recourse.

[95] *Id.*

[96] *Id.*

2. Analytical Deficiencies of *Major's*

Neither the court of appeals nor the district court examined all of the relevant factors in determining whether the transaction was a true sale of the loans or merely a secured secondary borrowing. First, neither court examined the disparity between the principal amount of the loans and the price paid for them, which initially was between 15% and 18% less than the principal amount. On the one hand, one could speculate that the discounted purchase price represented fair value for the loans.[97] On the other hand, absent any evidence to the contrary, one may assume that the loans' value was close to their principal amount, in which case the purchase price appears to be less than fair value.[98] As discussed below,[99] the price paid is one of the most important factors in determining whether a transfer is a true sale or a pledge to secure a secondary borrowing.

Neither court relied upon the requirement in the agreement that Major's repurchase all of the loans if it became bankrupt, defaulted under the agreement, or discontinued its business. As a matter of economic substance, this provision is not significant.[100] As a matter of form, it suggests that the parties intended the transaction to be a secondary loan, not a true sale. This type of provision routinely appears in loan documents, but serves no purpose in a true sale agreement.[101]

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[97] Late in the proceedings, Castle argued to the district court that the purpose of the discount (initially 15%, then 18%, and then a floating rate of the prime rate plus 6 ½) was to compensate Castle for the high credit risks and collection costs posed by Major's low-income customers and by Major's weak financial condition. However, the district court stated that the record gave no indication of any collection costs to Castle during the life of the agreement that would justify the discount. At the end of the district court proceedings, after all of the factual information had been presented, Castle moved for permission to present evidence on these collection costs. The court denied the motion as untimely. *Major's*, 449 F. Supp. at 545 n.8.

[98] *See infra* note 169 and accompanying text.

[99] *See infra* note 166 and accompanying text.

[100] This is an example of the type of *in terrorem* provision that a party with superior bargaining position, as most lenders, imposes upon the other party in a transaction. Although it appears to put Major's as the weaker party under the control of Castle, in reality it does not give Castle any additional advantage. The repurchase upon bankruptcy is unenforceable, and if any of these events were to occur, Majors' ability to repurchase all of the loans is questionable. This provision only adds to the appearance of unfairness on the part of Castle as the superior party.

[101] In a true sale, the buyer of loans may no longer want to buy additional loans if the seller defaulted on her sale agreement obligations, but he would not want his ownership interests in the loans that he already bought to be terminated because of later events or actions that affected the seller.

Additionally, neither court addressed other significant burdens of owning the loans. For instance, neither court discussed which party had custody of the loan documents, and there is no direct discussion of which party was responsible for servicing the loans. It appears that Major's continued to collect the payments on the loans, including the premiums for insurance with respect to the loans, until Castle declared Major's in default in 1975.[102] Also, Major's was liable for all collection costs. These facts indicate that Major's retained the burdens of servicing the loans. There is no other evidence that Castle had assumed the servicing burden. It did not contract with Major's to service the loans pursuant to a servicing agreement, which would normally specify a servicing fee and include provisions for the resignation or the replacement of the servicer.

Indeed, Major's obligation to repurchase any outstanding loans if it were to discontinue business strongly suggests that Castle did not want the burden of servicing the loans. If a servicer goes bankrupt or defaults under its servicing agreement, the true owner of the loans takes over the servicing or sells the servicing rights to another servicer. Thus, besides retaining the risk of loss as a result of the credit recourse, Major's retained other significant burdens of ownership. Neither court mentioned these reasons for finding Major's to be the owner of the loans.

Further, neither court seriously addressed which party bore the risk of a decline in the market value of the loans or had the benefit of any appreciation in their market value.[103] Major's had no right to repurchase the loans, and therefore any increase in market value would accrue to Castle. Similarly, Castle had no right to require Major's to repurchase the loans other than in the case of default. Therefore, Castle retained the risk of a loss in the market value of the loans for any reason other than default.

The only discussion even touching the question of who had the benefits of ownership occurred in the district court proceedings regarding the accounting of the proceeds of the loans. Castle argued that paragraph five of the agreement, granting Castle "all the rights possessed

[102] 449 F. Supp. at 546.

[103] The price of the loans purchased on any day may have changed as the prime rate adjusted, but once the loan was purchased this price remained in effect during the life of the loan. If the prime rate subsequently increased dramatically, the value of the loan would decrease, and if the prime rate decreased dramatically, the value of the loan would increase. *See supra* text accompanying note 34.

by" Major's in each loan,[104] gave it the right to retain all of the moneys it collected on the loans. This language suggests that Castle intended that it, not Major's, have all the benefits of owning the loans. The district court did not analyze this element of the parties' intent. It merely rejected this argument on the grounds that this language did not change its conclusion on the overall character of the transaction.

It appears that Major's retained significant burdens of owning the underlying loans—the servicing burden as well as the risk of loss from default by the underlying borrowers. Major's received "sale" proceeds that were significantly less than the principal amount of the loans. Castle could require Major's to repurchase the loans if it became bankrupt, defaulted under its agreement, or discontinued its business. These elements of the transaction overpower the force of the general "sale" language in the agreement, the language giving Castle all of Major's rights in the loans, and the apparent shifting to Castle of the risk of changes in the market value of the loans from fluctuations in prevailing interest rates and other market conditions.

Not only did the court fail to discuss all the significant elements of a sale, it incorrectly relied upon Castle's unilateral change of the price paid to purchase the loans. The court may have simply misunderstood the pricing formula. The market value risk for the loans would have remained with Major's if the amount of the "sale" proceeds of each loan changed after the date of purchase based on the fluctuation of the prime rate. This type of provision looks more like a floating interest rate on a debt.[105] Once Castle purchased each loan, however, the purchase price of the loan did not change.[106] The fact that a purchaser unilaterally initiates a change in a contract term in an open-end sales agreement to which the seller acquiesces does not denote a loan transaction rather than a sale.[107]

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[104] 449 F. Supp. at 546.

[105] *See infra* note 120.

[106] Castle also deducted the 10% reserve from Major's sale proceeds. The actual cash that Major's received for each loan could vary depending upon the performance of the underlying borrower. Nevertheless, the 10% reserve represents security for the credit recourse. Major's was entitled to this money if the loans performed, and it therefore is part of the sale price.

[107] Parties to a contract may modify the contract without both parties executing the modification; acceptance of the modification can be established by the conduct of the parties. Gorbett v. Estelle, 438 N.E.2d 766, 768 (Ind. Ct. App. 1982) (conditional land sales contract); Son-Shine Grading, Inc. v. ADC Constr. Co., 315 S.E.2d 346, 349 (N.C. Ct. App. 1984) (construction subcontract); Adair Homes, Inc. v. Jarrell, 650 P.2d 180, 183 (Or. Ct. App. 1982) (building construction contract).

3. Recourse and the Gilmore Quote

Both courts noted that the presence of credit recourse in a transaction does not by itself require recharacterization of a purported sale transaction as a secured borrowing. They nevertheless said that the recourse provisions were extremely relevant. Unfortunately, neither court explained why credit recourse evidenced a secured borrowing other than to conclude incorrectly that the credit recourse and the recourse for breach of warranty left all of the burdens of ownership on Major's.[108] Both courts essentially came to the conclusion that this transaction looked more like a loan than a sale: "The question for the court then is whether the *nature* of the recourse and the true nature of the transaction are such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction or to a sale."[109]

The court of appeals also stated that Professor Gilmore "would place almost controlling significance on the one factor of recourse."[110] In a note, it quoted Gilmore's statement that if "there is a right to charge back uncollectible accounts (a right, as § 9-502 puts it, of 'full or limited recourse') or a right to claim a deficiency, then the transaction should be held to be for security and thus subject to Part 5 as well as the other Parts of the Article."[111] The court did not explain why Gilmore would make recourse such a critical factor. A review of the section of Gilmore's treatise from which the quote is taken suggests that, in context, Gilmore does not mean what the court implies.

First, in the sentence preceding the quote, Gilmore commented that article 9 does not attempt to specify when a transfer is for sale or for security. He also stated that "[g]iven the infinite number of points which are situated along the line which runs from 'full recourse' to 'no recourse,' the decision to leave the distinction between security transfer and sale to the courts is a wise one."[112] If Gilmore truly meant that any right to full or limited recourse should cause a transaction to be one for security and not be a sale, then there is not much left for the courts to decide.

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[108] *See supra* text at note 95.

[109] *Major's*, 602 F.2d at 544 (citation omitted) (emphasis in original).

[110] *Id.* at 545 n.12 (citing 2 Gilmore, *supra* note 70, § 44.4 at 1230.

[111] *Id.* This language is also quoted in Aicher & Fellerhoff, *supra* note 8, at 188 n.30.

[112] Gilmore, *supra* note 70, § 44.4 at 1230.

Second, if Gilmore intended to propose such a rule, he provided no support for it. Indeed, such a rule would contradict the provisions of section 9-502(2). The last sentence of that section states that if the transfer is a sale, the debtor (seller) is entitled to any surplus or is liable for any deficiency only if the security agreement (sale agreement) so provides. A right to full or limited recourse is an example of such a provision. But if full or limited recourse transforms a transaction into one for security, then, according to the court's interpretation of Gilmore, this last sentence of section 9-502(2) becomes nonsensical. Such a rule also directly contradicts comment 4, which states that "there may be a true sale of accounts or chattel paper although recourse exists."[113]

Consequently, it is unlikely that Gilmore intended to assert the rule that the court derived from the quoted sentence. When placed in context, the quoted language appears to have a totally different purpose. The quote is one chain in the development of a subtle point Gilmore makes about how the language of article 9—which speaks in terms of security interest, debtor and secured party—actually applies to sales of accounts and chattel paper.

In the paragraph preceding the quote, Gilmore makes the point that section 9-502 and section 9-504 require the purchaser of accounts and chattel paper to account to the seller for any surplus and to collect from the seller any deficiency only if the sale agreement so provides.[114] He then states that section 9-502 imposes upon a secured party, which includes a purchaser of accounts, an obligation to carry out collections from the underlying borrower "in a commercially reasonable manner"[115] if the secured party, including a purchaser, is entitled to full or limited recourse against the debtor or seller.[116] Gilmore argues that this obligation, though not stated explicitly, should also apply to the sale of accounts and chattel paper under section 9-504.[117]

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[113] U.C.C. § 9-502 cmt. 4 (1991).

[114] Gilmore, *supra* note 70, § 44.4 at 1229-30.

[115] U.C.C. § 9-502(2) (1991), *quoted supra* note 79.

[116] Gilmore, *supra* note 70, § 44.4 at 1230.

[117] *Id.* Gilmore is touching upon the problem of applying the specific provisions of article 9, and in particular part 5, to sales of accounts and chattel paper. Part 5 applies if there is a default. The notion of default in the sale of accounts or chattel paper is substantially different from the concept of default in a secured loan transaction, where the primary default is the failure to repay a debt. Gilmore's suggestion that the commercially reasonable requirement should apply to sales of accounts is problematical. Gilmore states that, in the case of recourse, a purchaser who is obligated to collect the accounts in a commercially reasonable manner should not be allowed to dump them "or perhaps to sell them to himself." It makes no sense, however, to speak of a pur-

He continues by stating that the default provisions of part 5 of article 9 do not apply to a sale without any recourse. Of course, the provisions of part 5 literally *do* apply to a sale without recourse—it is just that they have no operative effect. The quote can be interpreted as further developing the point that a sale with recourse, because the seller remains liable for a deficiency to the extent of the recourse, is like a transaction for security. Therefore, the buyer should remain subject to the requirements of part 5, including the requirement to collect or dispose of the accounts or chattel paper in a commercially reasonable manner.

B. *Other Decisions*

A review of other court opinions involving the issue of whether a sale is a true sale or a secured secondary loan reveals either lack of analysis or inconsistent analysis. More than thirty years ago, Professor Kripke discussed a line of cases, beginning with *Home Bond Co. v. McChesney*,[118] holding that the sale of open accounts receivable through the "indirect collection, non-notification method" constituted a loan transaction subject to the relevant usury statutes rather than a true sale.[119] These transactions involved sales of short-term accounts (30 to 180 days' duration) in which the buyer advanced 70% to 80% of the principal amount of the receivables. The buyer charged an additional amount based on a percentage of either the amount advanced or the principal amount; this additional charge varied according to the time that the accounts remained unpaid.[120] The seller continued to col-

chaser of accounts or chattel paper selling them to himself. A purchaser is in the business of owning and reselling assets of this kind, and his motivation is to maximize the value of his assets, either for investment purposes or for resale. He will not be motivated to dump them in the way that a lender might be to collect on a debt. Further, a buyer of loans with recourse to the seller who resells the loans to a subsequent buyer will often assign his recourse rights to the subsequent buyer, and may also give credit recourse to the subsequent buyer. Further, note that the second sentence of section 9-504(3) states that "every aspect of the disposition [of collateral] including the method, manner, time, place and terms must be commercially reasonable."

[118] 239 U.S. 568 (1916).

[119] Kripke, *supra* note 8, at 60-61.

[120] In *McChesney*, one of the elements in the purchase price was a discount that varied according to how long the accounts were actually outstanding. If the underlying borrower paid the account within 15 days, the discount was 1%, if paid within 30 days, 2%, and if paid within 60 days, 3%. For each 30 days thereafter, the discount increased by one percentage point. 239 U.S. at 568 n.1.

lect the receivables without notifying the underlying borrowers of the "sale" of the receivables. The seller provided full credit recourse.

On the other hand, Kripke observed that the *McChesney* line of cases had not been followed in cases involving the sale of other types of loans.[121] He specifically noted that the presence of recourse in sales of automobile loans in similar transactions did not cause the sales to be recharacterized as a secured borrowing in a variety of contexts, such as usury, the applicability of the installment basis for tax purposes, or other tax purposes.[122]

Kripke did not mention as a relevant factor the extent to which the discounted purchase price reflected the fair value of the loans, no doubt because the courts did not analyze the reasonableness of the price of the loans as a factor. If they had done so, they might have discovered an analytically useful way for distinguishing a true sale from a secured secondary loan.

The courts that concluded that the "sales" were financing transactions generally did not analyze which party had which burdens or benefits of owning the loans.[123] These courts repeated the characteristics of the loans described above: that the "seller" collected payments and bore all of the costs of collecting the accounts,[124] the sale proceeds varied directly according to how long the loans were outstanding, and the

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[121] Kripke, *supra* note 8, at 60-61. A Lexis search reveals that *McChesney* was last cited in Blackford v. Commercial Credit Corp., 263 F.2d 97, 106 (5th Cir. 1959) (holding that an assignment of accounts pursuant to the non-notification, indirect collection method with full recourse was a security transaction, not a true sale).

[122] Kripke, *supra* note 8, at 61. Kripke concluded that all of the factors that courts had cited in trying to determine whether a transaction was a true sale or a pledge were not in fact determinative. He suggested that with careful drafting lawyers could choose the form that suited their clients and there was perhaps a need for lawyers to rethink the meaningfulness of the distinction between the categories of sale and loan. *Id.* at 61-63. He also questions the meaningfulness of the distinction between a sale and a pledge of loans in Homer Kripke, *Book Review*, 46 N.Y.U. L. Rev. 1220, 1224-25 (1972). *See also* Kripke, *Vacuum of Fact, supra* note 17, at 976-77 (discussing four different ways a department store can obtain essentially similar financing for its accounts receivables, using either a sale or secured lending transaction).

[123] *See, e.g., McChesney*, 239 U.S. at 575: "But it seems to us so entirely clear that the conclusions reached by the special master and approved by both courts were correct that we deem it unnecessary to discuss the matter at any length." The Court then quoted from the opinion of the district court, which gave no analysis, only a recitation of the elements of the transactions and a characterization of them as " 'mere shams and devices to cover loans of money at usurious rates of interest.' " *Id.*

[124] *See* Milana v. Credit Discount Co., 163 P.2d 869 (Cal. 1945). In *Milana*, the seller notified the underlying borrowers of the "sale" of the amounts and requested that checks be made payable to the purchaser. However, the seller continued to collect the amounts and paid all costs of collection. Further, if the seller was unable to repurchase delinquent accounts, she could and did "resell" them back to the purchaser at an additional discount.

seller provided credit recourse for defaulted accounts.[125] These facts suggest, of course, that the sellers retained the burdens of owning the loans. They alone had the burden of servicing them and they bore the risk of loss if the borrower defaulted. Since the sellers' actual sale proceeds fluctuated with the amount of time that the loans were outstanding, the payment provisions resemble a discount on a secondary loan that varies directly with the maturity of the secondary loan.[126] The transactions certainly looked like loans.

The cases holding that a true sale did occur reveal a similar dearth of analysis. For example, in one case Kripke cited as not following the *McChesney* line of cases, *In re Eby*,[127] the seller sold accounts pursuant to the non-notification method at a 20% discount. The only facts distinguishing this case from those following *McChesney* are that the seller noted on its books that it had sold its accounts receivable and that the purchaser could end the seller's right under its agreement to collect the accounts any time. These factors suggest that the seller transferred some of the burdens of owning the accounts. In reversing the referee's findings that the seller had not sold the accounts, however, the court failed to provide any reasons for its conclusion that a true sale existed. It merely cited *Nichols v. Fearson*.[128]

In *Nichols*, the Supreme Court held that an indorsement on a note negotiated at a discount by the holder to a third party did not transform a sale into a loan subject to the usury laws. The indorsement had the effect of guaranteeing payment by the underlying obligor.[129] The Court stated that "[t]here could be inferred no treaty for a loan from such a transaction, nor any device to evade the [usury] statute. It is a plain contract for bargain and sale with a warranty of the soundness of the property."[130] *Nichols* is one case in a long line of cases holding that the sale of an instrument at a discount with full recourse to the seller is

[125] In most cases, the recourse is 100%. *But see* Wayne Pump Co. v. Department of Treasury, 110 N.E.2d 284 (Ind. 1953) (the aggregate limit on recourse was 20% of the face amount of the loans "sold").

[126] *See supra* note 21.

[127] 39 F.2d 76 (E.D.N.C. 1929).

[128] 32 U.S. (7 Pet.) 103 (1833).

[129] *See supra* note 49.

[130] 32 U.S. (7 Pet.) at 111.

not a loan for purposes of the usury laws.[131] This line of cases has been called the "great weight of authority."[132]

In many of these cases, the courts reason that the recourse to the seller is a contingent liability; it only arises if the underlying borrower does not pay. A loan, in contrast, is an absolute liability. The courts therefore reason that the recourse provision does not convert the sale of the loan into a secondary loan.[133] Although this reasoning has a certain formalistic appeal, it does not provide much assistance in analyzing any particular case. More significant is the fact that, in many of these cases, the seller retained only the recourse liability, and transferred the burden of servicing or collecting the notes and all risk or reward from a decrease or increase in market value.[134]

Two other cases, *Fireman's Fund Insurance Cos. v. Grover (In re The Woodson Co.)*[135] and *Castle Rock Enterprises, Inc. v. S.O.A.W. Industrial Bank (In re S.O.A.W. Industrial Bank)*,[136] deserve mention. In finding the purported sale of participation interests in underlying loans to be disguised secondary loans, both emphasized that the sellers retained all of the risk of loss. Although they cited other factors, the primary "risk of loss" they referred to is the risk from 100% credit recourse. In focusing on the credit recourse, both did an incomplete analysis.

In *Woodson*, the court's statement that the purported seller retained all of the risk of loss is literally not correct. The court itself

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[131] *See generally* 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, 684-97 (1946) [hereinafter Usury Annotation].

[132] Coast Fin. Corp. v. Ira. F. Powers Furniture Co., 209 P. 614, 615 (Or. 1922), *quoted in* Refinance Corp. V. Northern Lumber Sales, Inc., 329 P.2d 109, 114 (Cal. Dist. Ct. App. 1958); Val Zimmermann Corp. v. Leffingwell, 318 N.W.2d 781, 786 (Wis. 1982).

[133] *See, e.g.*, Lake Hiwassee Dev. Co. v. Pioneer Bank, 535 S.W.2d 323, 325 (Tenn. 1976); Val Zimmermann Corp. v. Leffingwell, 318 N.W.2d 781, 790-91 (Wis. 1982). *Val Zimmerman Corp.* is interesting for another reason. There is a line of cases, principally in North Carolina, that hold that the sale of an instrument at a discount with full recourse to the seller is a loan for purposes of the usury laws. Usury Annotation, *supra* note 131, at 685 and 688-89; Western Auto Supply Co. v. Vick, 277 S.E.2d 360, 368-69, *aff'd on reh'g*, 283 S.E.2d 101 (N.C. 1981); *see also supra* note 59. The Usury Annotation cites a case in Wisconsin, Cowles v. McVickar, 3 Wis. 725 (1854), as following the North Carolina rule. Usury Annotation, *supra* note 131, at 689. However, the Supreme Court of Wisconsin in *Val Zimmermann Corp.* characterized the discussion of the general rule in *Cowles* as dicta, and distinguished *Cowles* on the grounds that the seller of the notes in *Cowles* had indorsed and transferred them after they matured. 318 N.W.2d at 789.

[134] *See, e.g.*, Lake Hiwassee Dev. Co. v. Pioneer Bank, 535 S.W.2d 323, 325 (Tenn. 1976); Val Zimmermann Corp. v. Leffingwell, 318 N.W.2d 781, 782 (Wis. 1982).

[135] 813 F.2d 266 (9th Cir. 1987).

[136] 32 B.R. 279 (Bankr. W.D. Tex. 1983).

noted that the investors who "bought" the participation interests would not be repaid until the underlying loans repaid.[137] These investors therefore assumed the risk of loss of market value for reasons other than default, such as changes in interest rates. On the other hand, the seller apparently retained the burden of servicing.

The court also relied upon what it considered a large disparity of from 1 to 6 percentage points between the higher interest rates on the underlying loans and the interest paid to the investors. Using a "looks like a loan" analysis, the court reasoned: "This [disparity] suggests that the rates [paid to the investors] were tied to prevailing borrowing rates at the time the permanent investors made funds available, rather than representing a servicing fee, an indication of lending, not purchase."[138] This analysis is flawed. A true buyer will purchase loans giving him a return that is comparable to "prevailing borrowing rates."[139] The disparity in the rates may have been relevant to the question of fair value—the amount of money that the investors paid and the value of the property interest that they received. Unfortunately, the court did not discuss this more important issue.

The analysis in *S.O.A.W. Industrial Bank* is more cryptic. S.O.A.W. Industrial sold a 30% participation interest in installment land sale contracts. Without providing any details, the court stated that the buyer received "a greater rate of repayment and return" than the seller.[140] Therefore, the "rate of repayment and the return provided for [the buyer] are incompatible with the concept of participation, and more compatible to that of a loan and a debtor/creditor relationship."[141] The court does not explain why this is so. In finding that the buyer had no real risk, the court stated: "A 'participant' in a loan normally assumes the same risk as that of the person selling the participa-

[137] 813 F.2d at 269.

[138] *Id.* at 272.

[139] The court also asserted that the transaction was different from a typical participation transaction because the seller did not retain a percentage participation as lead lender. *Id.* at 271. On the contrary, it is common for sellers to sell a 100% participation interest in a loan or pool of loans to one or more buyers. Selling loans through issuing participation interests enables buyers to purchase a portion of a loan or pool of loans without becoming a mortgagee of record as a tenant in common with other buyers and enables them to resell their interests in the loans without rerecording the mortgage documents. In using this form of transaction, buyers will either have confidence in the solvency and integrity of the seller or will take steps to protect their interests, such as by having the mortgage documents endorsed and assigned in blank and delivered to an independent custodian answerable only to the buyers.

[140] 32 B.R. at 282.

[141] *Id.*

tion or generating the loan."[142] This statement is factually incorrect[143] and analytically irrelevant.

The court does note that the seller provided 100% recourse. In addition, the buyer received 100% of the cash flow until its participation was repaid. Thus, the buyer had a smaller risk of loss from changes in prevailing interest rates than the seller because the maturity of its 30% of the loans was shorter than that of the remaining 70%.[144] The seller, it appears, retained the burden of servicing the underlying loans. For all of the risks that the seller retained and the benefits that the buyer received, the court does not discuss the value of what the buyer received for the price that it paid.[145]

Recently, Aicher and Fellerhoff reviewed a number of cases involving the sale or pledge of various types of loans. Noting a lack of consistency among the decided cases, they suggested as an analytical approach that, if the purchaser of the loans "has paid the reasonable equivalent of a fair market price" taking into account the credit recourse provisions, then a court should not recharacterize the transaction as a loan.[146] The authors, however, stated that no court has adopted such an approach. They concluded that to ensure sale treatment in a bankruptcy proceeding it would be necessary to show "that most or all of the economic risks and benefits of the receivables (including control of the receivables and the relation with the account debtor) has been transferred."[147]

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[142] *Id.*

[143] *See, e.g.*, Hutchins, *supra* note 16, at 449; MacDonald, *supra* note 16, at 38; Threedy, *supra* note 16, at 658-59.

[144] *See supra* note 41 and accompanying text.

[145] If by "return" the court meant the interest rate on the buyer's 30% participation, the court's emphasis on the greater return to the buyer may have reflected an intuitive concern about value. Because the buyer's 30% interest had lower credit risk, based on both the preferential right to cash flow and the seller's repurchase obligation, and the shorter maturity, one would expect that the interest rate to the buyer would be lower than that of the underlying loan, not higher. *See infra* note 167. On the other hand, the underlying loans were installment land sale contracts on land that the seller sold. The seller may have sold the land for more than its real value and incorporated a substantial amount of the credit risk on the loans in the price for the land and therefore in the principal amount of the loans. *See infra* text accompanying notes 167-173. For example, if a loan had an interest rate of 10% on a principal amount of $100,000 but the value of the loan was only $60,000, the real return to the seller would be substantially higher than 10%. (Assuming a 15 year monthly amortizing loan and no prepayment, the return would be approximately 20%.) Accordingly, an interest rate to the buyer of 12% may have reflected the fair value of the buyer's participation, and the value of its participation may not have substantially exceeded the $30,000 that it paid for its participation.

[146] Aicher & Fellerhoff, *supra* note 8, at 211.

[147] *Id.*

Given the lack of a consistent analysis by the courts,[148] the conclusion of Aicher and Fellerhoff reflects a safe approach to structuring sales transactions. This conservative approach, however, reduces the flexibility of the parties. A more developed analytical methodology would obviate this limitation on flexibility.

IV. AN ANALYTICAL METHODOLOGY

A. *The Rule and Its Rationale*

The most desirable legal context for commercial transactions is one in which 1) the parties can expect predictability in the way in which courts will treat a particular transaction, and 2) the parties can most efficiently obtain their goals. The analytical approach this article suggests for resolving the issue of whether a particular transfer of a loan is a true sale or a secondary loan transaction meets these goals. Under this approach, if the documents evidencing the transaction and the actions of the parties unambiguously characterize a particular

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[148] Another example of the confused thinking on the issue of sale or transfer for security is Rechnitzer v. Boyd (*In re* Executive Growth Inv., Inc.), 40 B.R. 417 (Bankr. C.D. Cal. 1984), which involved a transfer with recourse of an interest in a secured note. The court reasoned:

> [T]he dispositive issue may be: who bears the risk of loss in the event of non-payment? Traditionally, risk of loss has been regarded as one of the hallmarks of ownership. . . . Division 9 [Article 9 of the U.C.C.] appears to adopt the risk of loss approach in distinguishing between sale and security transfer of "accounts." And lacking any other standard, it seems a workable standard for this case.

Id. at 422 (citations omitted). The court then concluded that, because the transferor bore the risk of loss, the transfer was "something less than an absolute transfer. I thus conclude that [the transferee] can have at best no more than a security interest."

There are two problems with the court's analysis. First, the court's reliance on the U.C.C. is mystifying. The court cited California's version of U.C.C. § 9-504(c)(2), *discussed supra* at note 81 and accompanying text and *supra* at note 117. This section, found in Cal. Com. Code § 9504(c)(2) (West 1990), offers no support for the court's conclusion. The court also ignored U.C.C § 9-502 cmt. 4 (1991) (found in Cal. Com. Code § 9502 cmt. 4 (West 1990)), which acknowledges that there can be a true sale with recourse. *See supra* text accompanying note 113.

Second, after proposing this standard, the court then discusses, but does not consider as part of its analysis, other more significant facts that preclude treatment of the transaction as a true sale. For example, the language of the assignment characterized the transferee as the "Lender," promised the return of "principal" (the purchase price of $10,000) in one year, and gave the transferor the right to "substitute another property as collateral within this contract." 40 B.R. at 422. The assignment also promised a specific rate of return of 12%. The court does not reveal the relationship between this rate and the rate on the underlying note, another indication of intent. Consequently, this case cannot support the proposition that the presence of credit recourse precludes true sale treatment.

transaction as a sale, a court should not disregard this characterization if the buyer paid fair value[149] for the property, unless the seller retains substantially *all* of the benefits and burdens of ownership.[150] If the buyer assumes some burdens or benefits, or if the transfer is one in which the burdens and benefits of a loan or a sale transaction are hard to distinguish, a court should respect the characterization that the documents and other conduct of the parties give to the transaction.[151] In other words, if the buyer pays fair value, any doubts are resolved in favor of the characterization that the parties chose.[152]

This rule establishes a safe harbor, or at least a presumption, for a transaction that the parties characterize as a sale if certain prerequisites are met. Respecting the characterization by the parties will enhance predictability in the many aspects of a transaction. For example, to call a transaction a sale or a loan affects the seller's or borrower's tax liabilities, her profit and loss statements, and her balance sheet.

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[149] "Fair value" is an amount that approximates what a buyer would pay for the loans in an arm's length transaction, given all of the circumstances of the transaction of which the parties were aware at the time of the sale, including the allocation of burdens and benefits of ownership. It is not what an appraiser would testify after the fact is "full market value." It is desirable to avoid second guessing the price paid for the loans after later events have altered the value of the loans.

Aicher & Fellerhoff, *supra* note 8, at 206-10 provide a good discussion of "fair value." A comparable standard is "reasonably equivalent value," one of the standards for a constructively fraudulent transfer. *See infra* note 157. The cases analyzing the delivery of an absolute deed to real property as security for a loan have discussed whether the price paid for the land was "grossly inadequate," "greatly less," "greatly inadequate," "considerably inadequate," and "considerably less". Annotation, *Value of Property as Factor in Determining Whether Deed Intended as Mortgage*, 90 A.L.R. 953 (1934). *See also* Annotation, *Deed from Mortgagor or Privy to Mortgage Holder As Extinguishing Equity of Redemption*, 129 A.L.R. 1435, 1504-10, 1523-30 (1940).

[150] The most common burden of ownership that the seller would retain is credit recourse. Nevertheless, the seller could also retain other burdens and benefits, such as the servicing burden or an option to repurchase the loans. The analytical method described in this Part applies to all of these burdens and benefits, not just credit recourse.

[151] Characterization in this context means not just the use of the word "sale" in the documents, but also other actions showing how the parties are consciously treating the transaction, such as how the parties describe the transaction to third parties or how they list the transaction on their books and records. *See infra* text accompanying and following note 159.

[152] There is a corollary to this rule: If the documents and the actions are ambiguous on the characterization of the transaction, then the courts should weigh the price paid for the property against the allocation of burdens and benefits. If the buyer pays an amount that is in the higher range of fair value for the property, the transaction should be characterized as a sale if the buyer assumes a substantial portion of the benefits and burdens, but not necessarily a preponderance. If the buyer pays a price in the lower range, then he would need to assume a preponderance of those benefits and burdens. If the transferee paid less than fair value for the property, the transaction should be characterized as a secured loan unless he had substantially all of the benefits and burdens.

These in turn may affect the way in which she conducts her business. Increased certainty in predicting how a court will treat a transaction will enable the parties to structure the transaction in ways more favorable to both of them. Without such certainty, the parties may avoid the transaction and the seller will have fewer options for raising money to continue her operations. If the parties proceed with some form of the transaction, uncertainty exacts costs. These costs arise not only because the reduced flexibility may impair the seller's ability to maximize her net proceeds, but also because structuring around the uncertainty may increase transaction costs.[153]

An opposite approach would be to disregard the form that the parties chose and simply analyze the economic substance of the transaction—that is, the price paid and the allocation of the benefits and burdens. Professor Threedy has suggested that, in the case of loan participations and the rights of third parties, the economic substance of the transaction should control.[154] The difficulty with this approach is that there will never be a bright line upon which future parties to sales transactions or loan transactions and affected non-parties can rely. The analysis suggested above provides greater certainty, if not a bright line. If the parties' words and actions clearly state how they characterize their transaction, and the consideration received and the shifting of the burdens and benefits of ownership meet a certain threshold, then the courts should respect the characterization given by the parties. If an analysis of the economic substance produces an ambiguous result, then the parties have satisfied the threshold. Only if an economic analysis of the transaction overwhelmingly favors a result different from the stated characterization should a court disregard the stated characterization.

B. *Effect on Non-Parties*

It is fair to ask whether the increased certainty from the safe harbor exacts other costs that override the benefits of increased certainty. These other costs arise from the effect of the parties' characterization upon non-parties.[155] One effect is the possibility that the allocation of

[153] *See, e.g.*, *supra* note 69. The uncertainty by itself gives the buyer an additional negotiating tool for getting a lower price or greater protection.

[154] Threedy, *supra* note 16, at 657-61.

[155] *See, e.g.*, Douglas G. Baird & Thomas H. Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 Stan. L. Rev. 175, 177-78, 187 (1983), which criticizes courts upholding certain divisions of rights in personal property, such as between bailor and bailee, lessor and lessee, and seller and buyer, without taking into account the effect upon third parties.

burdens and benefits will mislead non-parties about the financial condition of the seller or the buyer.[156] This may happen if the seller retains some burdens of owning loans, such as credit recourse or the servicing burden, and these burdens are not disclosed to non-parties, such as general creditors who lend to the seller on the basis of her financial health. This risk, however, is no greater than the risk that arises any time someone assumes liabilities by obligating herself to perform services or to pay money. To the extent that these risks to third parties are not

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See also Douglas G. Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. Legal Stud. 53, 56 (1983).

[156] One example is the problem of ostensible ownership in transactions between a secured creditor, who claims to have a security interest in personal property, and a debtor who is allowed by the creditor to retain possession of the property. Without a formal way to provide notice of the secured creditor's interest in the property, non-parties, such as subsequent secured creditors and general creditors, will not know of the secured creditor's interest. *See* Baird & Jackson, *supra* note 155; Baird, *supra* note 155; Dolan, *supra* note 1. Threedy also mentions this as a concern in the context of loan participations. *See* Threedy, *supra* note 16, at 660-69, 672-73, 686-88. *But see* Jeffrey Helman, *Ostensible Ownership and the Uniform Commercial Code*, 83 Com. L. J. 25 (1978), questioning the concern with ostensible ownership as a general matter, and Mooney, *Mystery and Myth*, *supra* note 1, questioning the application of the doctrine of ostensible ownership in particular circumstances.

Ostensible ownership is generally not a problem in the sale of loans because the parties will satisfy the necessary formalities for transferring ownership. If the loan is evidenced by a negotiable note, the seller will deliver the note properly indorsed. *E.g.*, Billingsley v. Mitchell, 262 A.2d 746 (Md. 1970) (note secured by a deed of trust). In states that require recording of assignments of mortgages, the seller will record the assignment. *See* Fla. Stat. Ann. § 701.02 (West 1969 & Supp. 1992) ("No assignment of a mortgage . . . shall be good or effective in law or equity, against creditors or subsequent purchasers, for a valuable consideration, and without notice, unless the assignment is contained in a document which . . . is recorded according to law."); Md. Real Prop. Code § 7-103(a) ("The title to any promissory note, other instrument, or debt secured by a mortgage . . . conclusively is presumed to be vested in the person holding the record title to the mortgage."); *Billingsley*, 262 A.2d at 747-49 (distinguishing between a mortgage and deed of trust in Maryland); Nelson & Whitman, *supra* note 2, § 5.34. *But see* Jan Z. Krasnowicki et al., *The Kennedy Mortgage Co. Bankruptcy: New Light Shed on the Position of Mortgage Warehouse Banks*, 56 Am. Bankr. L.J. 325, 333-39 (1982), in which the authors argue that the recording acts do not apply to transactions between an assignor and an assignee of a mortgage. In this regard, the reference to "purchaser" in Section 701.02 of the Florida Statutes quoted above may have been intended only to refer to purchasers of the land encumbered by a mortgage, and not to subsequent purchasers of the mortgage.

If the loan is an account, the seller will file financing statements, and if the loan is chattel paper, the seller will file financing statements or take possession of the chattel paper. *See supra* note 70 and accompanying text. *See also In re* Cripps, 31 B.R. 541 (Bankr. W.D. Okla. 1983), *discussed supra* note 76, illustrating the consequences to a buyer of accounts if he fails to file a financing statement and the seller becomes bankrupt.

The seller or the buyer may also give notice of the assignment of a loan that is not evidenced by a negotiable instrument. *See, e.g., In re* Modern Settings, Inc., 74 B.R. 358 (Bankr. E.D.N.Y. 1987) (holding that, because neither the assignor nor the assignee of a right to receive payment of a claim notified the obligor, the assignor's trustee in bankruptcy retained the right to discharge the contract right and to receive the money).

sufficient to restrict the freedom of the parties to contract in other transactions, they should not do so in a sale of loans.

The most significant cost to non-parties is that the parties will make a bad deal. The buyer may pay too much, and therefore impoverish himself to the detriment of his general creditors. The seller may receive too little consideration, also to the detriment of general creditors. The seller may retain too much in the way of contingent liability, in the form of credit recourse or the servicing burden. The buyer may not obtain sufficient assurance of the quality of the loans for the price that he pays. Under certain circumstances, paying too much or receiving too little could be overturned as a fraudulent conveyance.[157] Absent a fraudulent conveyance, or absent other specific policies that would

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[157] Under section 548(a) of the Bankruptcy Code, 11 U.S.C. § 548(a) (1988):

> The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor—
>
> (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became . . . indebted; or
>
> (2)(A) received less than reasonably equivalent value in exchange for such transfer or obligation; and
>
> (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (ii) was engaged in business, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

Many state laws, which generally follow the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act, provide for avoiding transfers under similar circumstances. *See* 4 Collier's on Bankruptcy ¶ 548.01 (15th ed. 1991). For discussions of the origins of and the policies behind fraudulent conveyance law, see Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 Vand. L. Rev. 829 (1985); Robert C. Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 Harv. L. Rev. 505 (1977); Michael L. Cook, *Fraudulent Transfer Liability under the Bankruptcy Code*, 17 Hous. L. Rev. 263 (1980); Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 Stan. L. Rev. 725 (1984); Allen J. Littman, *Multiple Intent, Veil-Piercing, and Burdens and Benefits: Fraudulent Conveyance Law and Multiparty Transactions*, 39 U. Miami L. Rev. 307, 308-12 (1985); John C. McCoid II, *Constructively Fraudulent Conveyances: Transfers for Inadequate Consideration*, 62 Tex. L. Rev. 639 (1983); Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 Bankr. Dev. J. 55 (1991). Fraudulent conveyance can also be a concern of secured lenders. *See* Richard J. Sabella, *When Enough Is Too Much: Overcollaterization as a Fraudulent Conveyance*, 9 Cardozo L. Rev. 773 (1987).

Under section 548(a)(2), receiving less than "reasonably equivalent value" is grounds for avoiding a transfer of property under certain circumstances. For discussions of "reasonably equivalent value," see Cook, *supra*, at 276-81; McCoid, *supra*, at 656-63; Williams, *supra*, at 79-86.

dictate a different result,[158] however, concerns about a buyer paying too much or a seller receiving too little consideration or retaining too great a contingent liability should not affect the analysis of a true sale of loans any more than it would affect a true sale of cars or other property.

C. *Elements of the Rule*

1. The Parties' Characterization of the Transaction

The characterization of the transaction is not limited to the words "sale" used in a sale document. The characterization includes other provisions of the agreement that, although without any substantial economic effect, show how the parties are treating the transaction. A good example is the provision in the agreement in *Major's* that required Major's to repurchase from Castle all loans that Major's sold if it went bankrupt, defaulted under the agreement, or discontinued business. This provision suggests a loan agreement, not a sale agreement.[159] Another part of the characterization is how the parties describe the transaction in their books and records for accounting and tax purposes[160] and how they describe the transaction to third parties.[161]

Most of the cases do not contain an extensive discussion of the parties' characterization of the transaction, simply because that characterization consists only of an agreement entitled "sale" agreement and a clause in which the "seller" "sells" the loans to the "buyer." Two recent cases that have focused on the parties' characterization are

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[158] The agencies that regulate banks or savings associations that sell loans with recourse do not generally have a concern with the broader question of who owns the loans. Rather, the concern is the amount of capital that those institutions must reserve against the liability that the institutions retain. *See* Federal Financial Institutions Examination Council, Request for Comment on Issues Related to Recourse Arrangements, 55 Fed. Reg. 26,766 (June 29, 1990). For example, if a bank "sells" loans with recourse, it must treat the loans as assets of the bank against which it must reserve capital for regulatory accounting purposes. *See also* Aicher & Fellerhoff, *supra* note 8, at 200-05.

[159] *See supra* note 100 and accompanying text.

[160] *Compare In re* Eby, 39 F.2d 76 (1929) (sale transaction; notation in books of accounts as a sale), *with* West Pico Furniture Co. v. Pacific Fin. Co., 469 P.2d 665 (Cal. 1970) (loan transaction; after entering into a "sale" agreement, the seller informed the buyer that it intended to report the transaction as a loan and pledge for tax purposes).

[161] *See, e.g.*, Sarf v. Leff (*In re* Candy Lane Corp.), 38 B.R. 571, 575 (Bankr. S.D. 1984), *discussed supra* note 10.

Hatoff v. Lemons & Associates, Inc.,[162] and *Ables v. Major Funding Corp. (In re Major Funding Corp.)*[163] In *Hatoff*, the court examined the documents that the seller of mortgage loans, Lemons & Associates, executed with buyers of interests in the mortgage loans. These included an assignment of the underlying deed of trust (which was often recorded in the appropriate land records), advertising material that spoke only in terms of sale, a repurchase agreement (giving the seller the right to repurchase the loan from the buyer), and a collection agency agreement authorizing the seller to collect payments for the buyer. The court concluded that these documents were sufficient to override the other rather substantial indications of a secured borrowing, such as the fact that buyers were promised a guaranteed rate of interest that often was higher than the rate on the underlying mortgage loans, and that the buyers purchased one-year investments in the mortgage loans which were much shorter than the term of the mortgage loans.

Ables involved a purported sale of interests in mortgage loans on terms similar to those in *Hatoff*. There, in concluding that no true sale of the loans had occurred, the court commented that the advertising and correspondence of the purported seller spoke in terms of security as often as it spoke of sale and ownership.[164]

2. The Price Paid

After examining the characterization of a transaction by the parties, the courts still need to examine all of the elements of the economic substance of the transaction to decide whether the threshold test has been met.[165] The first and most significant element of economic substance is the price paid for the loans. Although courts have not paid much attention to this aspect in the sale or pledge of loans, they certainly do so in other relevant areas. For example, in resolving whether an absolute deed conveying real property is in fact a mortgage, the

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[162] 67 B.R. 198, 210 (Bankr. D. Nev. 1986).

[163] 82 B.R. 443, 449 (Bankr. S.D. Tex. 1987).

[164] *See also In re* Evergreen Valley Resort, Inc., 23 B.R. 659 (Bankr. D. Me. 1982), in which the assignment stated that it was "made as security" for an existing debt.

[165] Courts have refused to respect the characterization of a transaction because they determined that it was not consistent with the economic substance of the transaction. *See, e.g.*, Major's Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 543 (3d Cir. 1979); *In re* Carolina Util. Supply Co., 118 B.R. 412, 414-15 (Bankr. D.S.C 1990); *In re* Evergreen Valley Resort, 23 B.R. 659, 661 (Bankr. D. Me. 1962). If courts are going to do so, they should at least analyze all of the elements of the economic substance.

most significant evidence (aside from the existence of a debt obligation) is the amount paid for the property.[166]

Using an analysis of the price paid for the loans would not have significantly changed the results of many court decisions, given the facts as discussed by those courts. In *Major's* and the other cases holding a purported sale to be a secured borrowing, the "purchase price" for the loans was between 70% and 85% of the principal amount of the loans. One can only speculate on the extent to which the fair value

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[166] *See* Nelson & Whitman, *supra* note 2, § 3.8 at 50. An extreme example of the significance of this element is Russell v. Southard, 53 U.S. (12 How.) 139 (1851). In this case, the seller gave the buyer an absolute deed to a farm and received an accompanying memorandum giving the seller an option to repurchase within four months. The seller did not exercise the option, and the buyer retained possession of the property for 19 years. Nevertheless, in an action by the seller's heir to redeem the property, the Court concluded that the transaction was a secured loan principally because the amount advanced by the "buyer" was slightly more than one-third of the price that the "seller" had paid for the farm just 16 months before. *Id.* at 148-49. Interestingly, the Court noted that the absence of any personal liability on the part of the seller to repay the money advanced was not conclusive. *Id.* at 152. *See also* Aicher & Fellerhoff, *supra* note 8, at 209.

The discussion in the text applies to the transfer of the borrower's right of redemption when she receives the initial loan. She may later transfer her right of redemption—her "equity" in the property—to the lender. For example, if she defaults on the mortgage, she may give the lender a deed in lieu of foreclosure in satisfaction of the mortgage debt. Courts will permit this transfer but will look closely at its fairness, and especially at the adequacy of the consideration. Peugh v. Davis, 96 U.S. 332, 337 (1877) (value of property three times the amount of the debt paid).

A further complexity arises from the escrow delivery of a deed in lieu of foreclosure. If the borrower defaults on her mortgage loan, the lender will begin foreclosure proceedings. To forestall foreclosure, the borrower may agree to deliver a deed in lieu of foreclosure to the lender's agent to be held in escrow while the borrower tries to cure the default, refinance the loan, or sell the property. If she is successful within the agreed time, the escrow agent will return the deed. If she is not successful, the agent will deliver the deed to the lender, who will record it. The only purpose for delivering the deed in escrow is to give the lender security for the borrower's obligation to perform the conditions. Conceptually, the escrow arrangement is a mortgage. *See, e.g.*, Cal. Civ. Code § 2924 (West Supp. 1992), which provides: "Every transfer of an interest in property, other than in trust, made only as a security for the performance of another act, is to be deemed a mortgage . . . ." One would expect an equity court to prevent the lender from keeping the deed without foreclosing the borrower's equity of redemption. Yet, courts have not uniformly condemned this transaction. They look at the circumstances and decide whether the escrow arrangement was fair to the borrower. In the analysis, the major factor is the value of the property in relation to the amount of the debt extinguished. *Compare* Deming v. Smith, 66 P.2d 454 (Cal. Dist. Ct. App. 1937) (the value of the property was $67,500, and the debt extinguished was $135,000) and Baldwin v. American Trading Co., 243 P. 710 (Cal. Dist. Ct. App. 1925) *with* Bradbury v. Davenport, 46 P. 1062 (Cal. 1896) (reversing a judgement sustaining a demurrer because the mortgagor alleged that the value of the property greatly exceeded the debt) (*Bradbury I*). *See also* Bradbury v. Davenport, 52 P. 301 (Cal. 1898) (on appeal from the trial after the remand from *Bradbury I*, upholding the delivery of the deed; the transaction was fair, and the value of the property exceeded the debt). These decisions upholding the escrow delivery did not acknowledge the conceptual inconsistency. They also ignored Cal. Civ. Code § 2924, cited above, which was first enacted in 1872.

of the loans in these cases was less than their principal amount, as there is no discussion of the point and little evidence. The interest rate on the underlying loans may have included compensation for the risk of default on the loans.[167] If so, the fair value of the short-term loans approximated their principal amount. On the other hand, the seller of the loans may have included expected losses on the loans in the purchase price of the goods or services financed by the loans, which losses in turn would be reflected in the principal amount of the loans. If so, the fair value of the loans was less than the principal amount.

For example, in *Major's*, Major's sold its furniture with almost 100% financing. If the underlying borrowers failed to pay, the borrowers would lose their furniture and their previous payments. Without having made any significant down payment, the borrowers quite reasonably could have concluded that they would not be worse off than before they bought the furniture. In essence, their loan payments would have been rental payments for using the furniture. In the face of other greater financial needs, they would have had less incentive to repay their loans than if they had risked more of their own money.[168] Additionally, if Major's included part of the expected default rate in the price of the furniture, the price of the furniture and the loan amount would have exceeded the fair value of the furniture. These facts suggest that the fair value of the loans was less than the principal amount of the loans.

Nevertheless, after Castle deducted its discount and reserve fund from the purchase price for the loans, Castle collected about $66,000 of surplus on loans that the court found had a net value of approximately $527,000.[169] In other words, Castle paid approximately 12% less than the net proceeds remaining after Castle deducted all losses and all costs of collection that it paid from the principal amount of the loans that it "bought." Given that Major's retained the cost of servicing the loans and that Castle made no serious attempt to show that it had paid fair

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[167] The interest rate on any loan includes an element that compensates the lender for the risk that the borrower will not repay the loan. *See supra* note 34. Compare a 30-year United States Treasury Bond with an average yield of 8.45%, 8.61%, and 8.14% in 1989, 1990, and 1991, Domestic Financial Statistics, 78 Fed. Res. Bull. A24 (July 1992), to a 30-year single family mortgage yielding an average of between 10.2%, 10.1%, and 9.2% per annum in 1989, 1990, and 1991, *id.* at A35 (HUD Series), to an average rate on credit cards of more than 18% in 1989, 1990 and 1991, *id.* at A38. *See also* Michael A. Goldberg, *The Determinants of Interest Rates, in* Handbook of Modern Finance 13-29 to -33 (Dennis E. Logue ed., 2d ed. 1990).

[168] *See infra* text accompanying note 184.

[169] Major's Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 546 (3d Cir. 1979).

value,[170] it is more likely that Castle paid less than fair value for the loans.[171]

On the other hand, in *General Motors Acceptance Corp. v. Mid-West Chevrolet*,[172] the court described a purchase of one-year automobile loans as a true sale despite 100% credit recourse to the seller. General Motors Acceptance Corp. (GMAC) purchased the loans from Mid-West Chevrolet for 100% of their principal amount. The loan amount represented only part of the purchase price of the cars sold and initially financed by Mid-West. The underlying borrowers paid a considerable down payment, typically 33%.[173] The borrowers therefore had much more to lose by failing to pay than the borrowers in *Major's*. Furthermore, because of the sizeable downpayment, the value of the collateral for the underlying loans—the cars—probably exceeded the principal amount of the loans. Presumably, the purchase price of the loans approximated their fair value.

3. Allocation of Benefits and Burdens

The other significant part of the economic substance of a sale or secured loan transaction is the allocation of the benefits and burdens of ownership. A more exacting analysis of this allocation would have produced substantially similar results in the existing cases.[174] In all of the cases concluding that a purported sale was, instead, a secured secondary loan, the preponderance of the burdens and benefits remained with the sellers. As in *Major's*, the sellers retained almost all of the risk of loss in the form of credit recourse, the burden of servicing the loans, and the costs of collecting the loans.

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[170] *See supra* note 97.

[171] The discussion in the text serves only to illustrate some of the facts that might be relevant in determining the fair value of loans. It is not meant to suggest that a court should value loans on the basis of how those loans performed after the sale. Instead, the court should analyze the value of the loans on the date of sale, taking into account the parties' expectations of all relevant factors, such as the number and principal amount of loans to be sold in the future, the seller's other financing alternatives, the buyer's cost of funds, loan default rates, loan servicing and collection costs, and future prevailing interest rates.

[172] 66 F.2d 1 (10th Cir. 1933).

[173] *Id.* at 7.

[174] This phenomena raises an interesting question of whether the judges in these cases used an unconscious or unarticulated analysis, such as that suggested in this article or some other analysis, that if articulated would offer a greater degree of predictability on the issue of the true sale of loans.

In many cases in which the court concluded that the transaction was a true sale, although the seller retained some benefits and burdens of ownership, the seller transferred other burdens and benefits to the buyer. For example, in *General Motors Acceptance Corp.*,[175] the buyer, GMAC, assumed the primary burden of servicing the loans and collecting delinquent payments, although the seller retained the risk of loss in the form of 100% credit recourse.[176] In *Bear v. Coben (In re Golden Plan)*,[177] the buyer, not the seller, assumed the risk of loss because the loans were sold without recourse, but the sellers retained possession of the documents and the servicing responsibility pursuant to a form agreement with the buyers prepared by the seller. It is not clear from the opinion whether the seller transferred the ultimate burden of servicing to the buyers, because there is no discussion of whether the buyers had the right to terminate the seller as servicer, whether the seller could resign as servicer, or how the servicer was to be paid for its services. Also, it appears that the seller retained some control over the payments on the loans because it commingled such payment with its own funds.

Because there are various components of burdens and benefits that can be distributed in different ways, courts must decide how to weigh the different components. Is retaining the risk of loss on any or all of the loans through credit recourse more significant than the burden of servicing the loans? Is the potential for increase or decrease in market value of these loans more or less significant than either of these burdens?

In applying the analytical methodology suggested by this article, courts should consider the significance of these components in their legal context, and not their economic context. This will enhance the predictability of the legal conclusion a court will reach on any transaction. Of course, the possibility of an increase in the market value of a 30-year fixed rate loan term is greater than that of a one-year fixed rate loan if interest rates change,[178] and the value of credit recourse from a financially stronger seller is greater than from a financially weaker one. Courts can consider the economic value of these components in determining whether the purchase price for the loans is fair value, a purely factual question. To assess whether the buyer or the seller has the pre-

[175] 66 F.2d 1 (10th Cir. 1933), *on appeal after retrial*, 74 F.2d 386 (10th Cir. 1934).

[176] *See also supra* note 134 and accompanying text.

[177] 829 F.2d 705 (9th Cir. 1986).

[178] *See supra* note 41 and accompanying text.

ponderance of the benefits and burdens of ownership, each of the separate significant components should have roughly the same weight. Courts should evaluate the allocation of the benefits and burdens of ownership for their legal implications arising from the structure of the transaction. In sum, the allocation of benefits and burdens, aside from the effect on the price for the loans, reveals the actual intentions of the parties.

V. SALE WITH RECOURSE

As discussed above, courts have cited credit recourse to the seller as an important factor in determining that a transfer of loans is not a true sale but is a secured loan. Credit recourse is, however, only one burden of owning loans. Accordingly, when the parties transfer loans with full or limited credit recourse and they characterize the transaction as a sale, courts should honor the sale characterization if the buyer pays fair value for the loans and the buyer acquires most or all of the other burdens and benefits of owning the loans. This rule is a subset of the analytical method discussed in Part IV. Independent of that method, the cases involving the sale or pledge of loans and the delivery of absolute deeds to real property allegedly as security for a loan either support this rule or generally do not contradict it.[179] Finally, this rule follows from the treatment of the sale of other property with some type of recourse.

A. *Recourse in the Sale of Other Property*

Recourse is one way in which a seller retains the risk of the "physical loss" of a loan. For goods, the risk of physical loss includes the risk that the goods will cease to function in the manner the buyer intended. The buyer can reduce this to some extent by using due diligence in investigating the goods before purchase and by obtaining express and implied warranties from the seller.

First, a seller may sell goods with an express warranty, which may include a "money back guarantee" if the buyer is not satisfied. The express warranty may extend for a limited amount of time, and it may

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[179] The *per se* approach that North Carolina follows, *see supra* note 59, does contradict this rule. The other cases that rely heavily on credit recourse to decide that a purported sale transaction was a secondary loan transaction do not contradict the rule because they contain other elements, either discussed by the courts or ignored by the courts, supporting the courts' conclusions.

only relate to the condition of the property at the time of sale, but it need not.[180] Many sellers sell goods with an express warranty of future performance. They promise that, if the item sold should prove defective or wear out while the original buyer owns it, they will repair the item for free or replace it, perhaps with a deduction for depreciation. Examples include automobile one-year, 12,000-mile, limited warranties; a clothing store's promise to perform free alterations or repairs for the buyer of a suit during its lifetime; a tire seller's tire protection policy that will replace any tire damaged for any reason, less an allowance for tread wear; or a representation that a certain grinding mill would produce 3,200 pounds of ground sulphur per hour capable of passing through an 80-mesh screen.[181] These express warranties of future performance are the functional equivalent of credit recourse in loans.

The seller of goods or real property provides other types of recourse against loss. In the sale of goods, a buyer will have recourse to the seller for a breach of the implied warranty of merchantability under section 2-314 of the Uniform Commercial Code.[182] To protect himself from the possibility of defects in or the existence of hazardous materials on real property, a buyer can obtain representations and warranties from the seller, for which the buyer will have recourse against the seller if there is a significant breach. Buyers of real property frequently receive title covenants that sellers make in their deeds, the broadest of which is the covenant of general warranty.[183]

To the extent that seller warranties, whether express or implied, are based on the knowledge or actions of the seller, they are similar to the warranties that a seller of loans makes, for which there may be recourse. They do not, superficially, seem to resemble credit recourse.

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[180] U.C.C. § 2-313(1) (1991) provides:

Express warranties by the seller are created as follows:

> (a) Any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise.

See generally Ronald A. Anderson, The Uniform Commercial Code § 2-313:46, at 39-41 (3rd ed. 1983) ("The seller may make an express warranty which relates to the future condition or operation of the goods.").

[181] Sweco, Inc. v. Continental Sulfur & Chemical, 808 S.W.2d 112 (Tex. Ct. App. 1991) (upholding a judgment for the buyer against the seller for breach of an express warranty).

[182] U.C.C. § 3-214(1) (1991) provides: "Unless excluded or modified (Section 2-316), a warranty that the goods shall be merchantable is implied in a contract for their sale if the seller is a merchant with respect to goods of that kind. . . ."

[183] *See generally* Roger A. Cunningham et al., The Law of Property § 11.13 at 809-20 (1984).

Credit recourse concerns the future behavior of the underlying borrower—the risk that the underlying borrower will not repay the underlying loan. It does not appear to relate back to the time when the seller owned the loan.

Further analysis, however, suggests a different story. Statistically, the default rate of loans in a pool relates directly to the characteristics of the underlying borrowers and the loans at the time of origination. For example, the single most important predictor of default on single family mortgage loans is the amount of down payment that the underlying borrower makes toward purchasing a home.[184] Other variables also affect the degree of loss from default.[185] Although any one loan can always default in the future, the underwriting standards that the seller uses in making the loans significantly affect the way the pool of loans performs in the future.[186]

Similarly, in the covenant of general warranty, the seller of the land warrants that none of the seller's predecessors in title did anything to affect the buyer's title to the real property adversely.[187] Although the title defect must have occurred in the past to cause a breach, the loss will occur after the sale. The seller may have had no knowledge of such a defect and may have had no control over it, but she nevertheless bears the loss.

In the sale of goods and the implied warranty of merchantability, a breach manifests itself after the sale. Recovery for a breach of warranty requires proof of some defect or condition that existed in the goods at the time of sale.[188] The buyer need not show, however, that

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[184] *See* Moody's, *supra* note 51, at 8; Standard & Poor's, *supra* note 51, at 84. *See also* David J. Askin & Linda Lowell, *The Rating of Mortgage-Backed Securities*, *in* The Handbook of Mortgage-Backed Securities 305, 315-17 (Frank J. Fabozzi ed., rev. ed. 1988).

[185] Additional predictors of default losses (and for each predictor the relevant category from the lowest risk to the highest risk) include the following: the type of secured property (single family detached; low rise condominium, single family attached, and two family detached; high rise condominium and three and four family detached); loan purposes (primary residence, refinancing, or second home), lien status (first or second), payment characteristics (level payment, increasing payment or variable payment), the age of the mortgage loan, the size of the loan (loans of $300,000 or less, and larger loans), and the thoroughness with which the seller required full verification of income and employment history. In addition, the quality of any pool of mortgage loans will be enhanced if the loans are less concentrated in one geographic area and if the pool contains a larger number of loans. Moody's, *supra* note 51, at 11-19; Standard and Poor's, *supra* note 51, at 85-91; Askin & Lowell, *supra* note 184, at 314-17.

[186] Very often the seller of loans is also the servicer of the loans. Credit recourse against the seller/servicer is one means by which the buyer can ensure that the seller/servicer is using its best efforts to service the loans on behalf of the buyer. *See infra* note 201 and accompanying text.

[187] *See generally* Cunningham, *supra* note 183, § 11.13 at 809-20.

[188] Anderson, *supra* note 180, § 2-314:57 at 164-66.

the manufacturer or seller knew of the defect or condition.[189] Moreover, the existence of a subsequent defect itself may be sufficient evidence that the defect existed at the time of the sale.[190] In any event, the manufacturer often does not know or have any reason to know of the defect (other than perhaps to know that, statistically, there will be a certain percentage of various kinds of defects). Although not directly analogous, credit recourse in the sale of loans bears some resemblance to recourse for the breach of express or implied warranties.[191]

No one has suggested that sales of goods or real property be recharacterized as secured loans because sellers retain some risk of loss from express "money back guarantee" types of recourse or recourse for breaches of warranties. One reason for this, of course, is that generally a buyer of goods or real property pays fair value and more clearly assumes the other burdens and benefits of owning the property, such as the use of the property, the responsibility to manage and preserve it, and the possibility of gain or loss of the market value. This suggests either that the role of credit recourse in the sale of loans should not be given the prominence that certain cases and writers suggest, or that

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[189] *Id.* § 2-314:59 at 166-67. *See* Vlases v. Montgomery Ward & Co., 377 F.2d 846 (3rd Cir. 1967). Vlases bought one-day old chickens that after nine months developed a type of bird cancer which can be inherited or which can be acquired from an unhealthy environment. The inherited condition could not have been detected at the time of sale. Because of the evidence that the chickens were not kept in the kind of unhealthy environment that would cause the cancer, the court upheld a judgment for the buyer for breach of the implied warranties of merchantability and fitness for a particular purpose.

[190] *See, e.g., Vlases*, 377 F.2d at 852 ("Plaintiff's task was to develop facts and circumstances from which the jury could reasonably conclude that the chickens were diseased at the time of delivery."); Virgil v. "Kash N' Karry" Serv. Corp., 484 A.2d 652 (Md. Ct. Spec. App. 1984) (explosion of thermos bottle, after several months of continuous daily use, when hot coffee had been poured into it was sufficient evidence of a defect for purposes of showing a breach of the implied warranty of merchantability), *cert. denied*, 490 A.2d 719 (Md. 1985). *Cf.* Rogers v. Johnson & Johnson Products, 565 A.2d 751 (Pa. 1989) (adopting the malfunction theory for proving the existence of a defect in a strict liability action). The court explained:

> [This theory] permits a plaintiff to prove a defect in a product with evidence of the occurrence of a malfunction and with evidence eliminating abnormal use or reasonable, secondary causes for the malfunction. . . . It thereby relieves the plaintiff from demonstrating precisely the defect yet it permits the trier of fact to infer one existed from evidence of the malfunction . . . .

Id. at 754. *Cf. also* Sharon N. Peart, Comment, *The Malfunction Theory: A Feasible Means to Prove a Defect in Strict Products Liability*, 94 Dick. L. Rev. 733 (1990).

[191] *See, e.g.*, Venturelli v. Cincinnati, Inc., 850 F.2d 825 (1st Cir. 1988), upholding a judgment for breach of the implied warranty of merchantability against the manufacturer of a 1947 metal plate shearing machine that crushed a worker's finger because the machine did not have sufficient safety devices to prevent such an accident.

trustees in bankruptcy are missing an opportunity to expand the property of the estate of bankrupt sellers of other kinds of property.

B. *Beyond the Resemblance Approach*

Credit recourse for loans has received much attention because of the approach courts have generally taken. They essentially look at the transaction and conclude whether it looks more like a loan or a sale.[192] If an essential feature of a loan is a promise to repay money borrowed, then the sale of an underlying loan with 100% credit recourse to the seller makes the transaction look like a loan. This resemblance test, however, is not sufficient. It does not account for the nature of loans as property and it does not analyze fully all of the elements of the sale of loans.

Admittedly, this analysis can be difficult. Some of the more obvious benefits and burdens of owning the underlying loans can be hard to distinguish from what a lender receives if it makes a secondary loan secured by the underlying loans. Credit recourse is not the only way in which a sale of loans can resemble a secondary loan. For example, if someone buys a loan, he expects to receive the "use" of his property—the right to receive cash flow, including interest on the loan. If he made a secondary loan secured by a pool of loans, he also expects to receive the cash flow from his secondary loan, including interest on his loan.[193] If the cash flow from the secondary loan approximates the cash flow from the underlying loans, then the secondary loan looks like a sale of the underlying loans in this one respect.

Further, a buyer of a fixed-rate long-term loan has the right to future appreciation in the market value of the loan. Although it is most common in a loan transaction involving a fixed-rate long-term loan for the borrower to have the right to prepay his loan, at common law there was no right to prepay,[194] and there are many debt instruments, such

[192] *See, e.g.* Major's Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 544 (3d Cir. 1979), *quoted supra* in the text accompanying note 109, Fireman's Fund Insurance Cos. v. Grover (*In re* The Woodson Co.), 813 F.2d 266, 272 (9th Cir. 1987), *quoted supra* in the text accompanying note 138, and Castle Rock Enter., Inc. v. S.O.A.W. Indus. Bank (*In re* S.O.A.W. Indus. Bank), 32 B.R. 279, 282 (Bankr. W.D. Tex. 1983), *quoted supra* in the text accompanying note 141.

[193] *See supra* text accompanying note 31.

[194] Promenade Towers Mut. Hous. Corp. v. Metropolitan Life Ins. Co., 597 A.2d 1377, 1379-80 (Md. 1991); Alexander, *supra* note 34; Nelson & Whitman, *supra* note 2, § 6.1 at 421-22.

as United States Treasury notes and bonds, which the borrower may not prepay before maturity.[195] If the borrower may not prepay her loan, then the lender realizes a gain in the market value of his loan if interest rates fall or if the demand for that type of loan increases. Nevertheless, the borrower repays the loan at the maturity date, and she then reacquires all property she had pledged for the loan. If the security for the loan was a pool of underlying loans and if those underlying loans still have substantial value, then the transaction looks like a loan. If those underlying loans do not have any substantial value at the maturity of the secondary loan, there is some question whether, despite calling her transaction a loan, she in fact sold those loans.[196] Yet, the right to reacquire the property, an admittedly essential element in a secured loan,[197] is not standing alone inconsistent with a true sale, any more than conveying an option to purchase property effects a sale of the property.[198]

Short-term loans or variable rate loans in which the interest rate varies according to some index[199] present additional difficulties in analyzing a transaction as a true sale or a secured loan. For short-term loans, the right to future appreciation becomes less of a consideration because changes in prevailing interest rates will not cause the value of such loans to increase or decrease significantly.[200] The interest rate risk for variable rate loans rests not with either the seller or the buyer of the loans but primarily with the underlying borrower.

It is nevertheless possible to find elements that distinguish the burdens and benefit of being an owner of loans and a lender secured by

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[195] *See supra* note 34. Borrowers will sometimes offer to give up a right to prepay in order to achieve a lower interest rate for the loan.

[196] The courts should respect the characterization of the transaction as a loan if the borrower retains some of the benefits and burdens of owning the underlying loans. Even if the secondary loan is without recourse to the borrower, and the maturity date of the secondary loan coincides with the maturity date of the underlying loans, the borrower can retain the benefit of ownership by retaining the right to prepay the secondary loan at some future date when the underlying loans will have some remaining value and by retaining the burden of servicing the underlying loans.

[197] *See supra* note 28.

[198] *See supra* note 32.

[199] Commercial loans, home equity lines of credit and other personal lines of credit will commonly bear interest at the prime rate of a major bank plus a specified number of percentage points. This may explain why the court in *Major's* became confused by Castle's change in the way it calculated the discount in its purchase price for the loans. *Major's*, 602 F.2d at 546, *discussed supra* at text accompanying notes 96 and 105. Nevertheless, it is also common for buyers of loans to negotiate a price expressed in terms of the dollar amount that will yield a percentage rate equal to some index, such as the prevailing rate of five year United States Treasury notes, plus a specified number of percentage points.

[200] *See supra* note 34 and accompanying text.

those loans. One significant difference is the burden of servicing the underlying loans.[201] The owner of the loans must service them or contract with someone else to do so. One difficulty courts have had in distinguishing between a sale of loans and a secondary loan secured by loans is that very often the seller of the loans also continued to act as the servicer of the loans. If an owner of loans pledges them as security for a secondary loan, she retains the burden of servicing the underlying loans. If she sells them, she may also continue to service them. If the documents do not provide that the seller is acting in a separate capacity as servicer, such as by providing for a separate servicing fee as compensation, the resignation of the servicer, and the termination of the servicer by the owner with or without cause, then it appears that a seller has not transferred an important burden. However, if the documents do make such a distinction, the seller will have transferred the burden of servicing, even if she has not transferred the functions, because the buyer assumes the risk that the servicer may decide that it no longer wants to service the loans for the specified fee.

In sum, there are several important elements, not just credit recourse, in a sale of loans that may make a sale look like a secondary loan or a secondary loan look like a sale. There is no reason why courts should rely more heavily on the seller's retaining the burden of the credit risk through credit recourse than on other specific elements that may resemble a loan feature or a sale feature.

CONCLUSION

There are legitimate business reasons why a seller of loans may retain some burdens of owning the loans, for example, by providing credit recourse in selling her loans, while transferring other burdens and benefits.[202] In evaluating a particular transaction, a court should not use a superficial "looks like a loan" analysis, but should analyze all

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[201] An important factor in the way a single loan or a pool of loans performs is the servicing capabilities of the servicer of the loans. *See* Standard & Poor's, *supra* note 51, at 90-91, 98-100.

[202] Standard & Poor's Corporation has taken the position in the securitization of credit cards and other loans that any recourse greater than historical loss patterns raises a question about the nature of the transaction. *See supra* note 58. However, to a buyer, recourse limited to historical default rates is not much protection, and would affect the price the buyer is willing to pay for the loans. The buyer may also want protection from future, unexpected losses. On the other hand, although some have taken comfort in limited recourse, there seems to be little difference between recourse limited to some multiple of historical loss (say 15% recourse instead of 3% recourse for mortgage loans) and 100% recourse.

of the components of a sale of loans. They should also be willing to use analytical tools well established in comparable areas of the law to determine whether a sale is a true sale or a secured loan, such as the analysis of the value of the consideration for the transaction. If a seller and buyer clearly treat the transaction as a sale, courts should respect those deliberate choices and not overturn them, as long as the price paid for the loans is fair value. At the very least, courts should overturn the characterization given to the transaction by the parties only if the allocation of a clear preponderance of the burdens and benefits peculiar to owning loans—such as the right of future gain and the risk of loss in market value, the credit risk, and the servicing burden—clearly contradicts what the parties say they are doing. A sale of loans for a fair price in which the buyer assumes the servicing burden and the risk of gain or loss in the market value is a true sale, even if the seller provides to the buyer full credit recourse.