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Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization

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"In the growth of the law there are periods of relative stability and periods of rapid change."[1]

"It sounds good if you say it fast."[2]

I. INTRODUCTION

Over the past twenty years, commercial law and practice has seen a period of rapid change. Since Article 9 of the Uniform Commercial Code (U.C.C.)[3] was ratified and widely adopted by the states,[4] the country's credit markets have burgeoned. We live in a credit economy, and most consumers and businesses survive and thrive on the basis of the ready availability of both long term and short term credit.

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1. 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 288 (1965).

2. David Conner, *Conner's Unfamiliar Quotations*, *at* http://www.h2net.net/p/connect2/quotes.html (quoting J. Alton Templin on the Chalcedonian Formula, which describes the nature of Christ as being both "fully God and fully man") (last visited Sept. 25, 2000).

3. In this Article, Article 9 of the Uniform Commercial Code (U.C.C.) as currently enacted will be referred to as "Article 9" (unmodified) or "Current Article 9," and specific Code provisions as *e.g.*, "Section 9-102" or "Current Section 9-102." The version of Article 9 as approved by the National Conference of Commissioners of Uniform State Law (NCCUSL) and the American Law Institute (ALI) on July 30, 1998 will be referred to as "Revised Article 9" or the "Revised Code," and specific Code provisions as *e.g.*, "Revised Section 9-102."

4. Louisiana was the final holdout state, adopting the 1972 version of Article 9 of the U.C.C. in 1988. Act effective Jan. 1, 1990, No. 528, 1988 La. Acts 1367-422 (codified at LA. REV. STAT. ANN. §§ 10:9-101 to 9-605 (West 1993)).

Since its enactment in 1950,[5] Article 9 has institutionalized the system of secured credit.[6] During the years since Article 9 was first introduced, the types of collateral involved in secured transactions have expanded, and through revisions and fine tuning, Article 9 has sought to keep up with and facilitate the commercial credit markets.[7] It has further tried to strike a fair balance between the interests and rights of debtors, secured creditors and unsecured creditors.

The recent Article 9 revision and the particular sections of the bills crafted to amend the Bankruptcy Code introduced in two consecutive Congressional sessions and passed in the House and Senate during the 106th Congress[8] will, if enacted into law,[9] have a significant effect upon secured credit transactions, as well as on the financial innovation known as asset securitization. Asset securitization is a process whereby assets are sold to a buyer, transformed into securities and resold to investors in the public and private markets.[10]

The Article 9 changes address two fundamental issues relevant to securitization transaction participants: (i) the characterization of the asset transfer and (ii) the clarity and certainty of the process taken to perfect the transferee's interest in the assets. These changes will eliminate some of the uncertainty that asset-backed security investors and securitization originators face. What the Article 9 changes will also do, however, when read in conjunction with the recent amendments to the Bankruptcy Code, will be to allow certain financial market participants to avoid participation in the bankruptcy process, notwithstanding their provision of financing to a debtor in bankruptcy. A consequence of these changes is the unwitting abandonment of two socially desirable objectives inherent in the bankruptcy process: (i) the reorganization of potentially viable businesses and (ii) the equality of distribution of a debtor's assets among creditors. Accordingly, securitization under the combined Revised Article 9/Amended Bankruptcy scheme may become the most effective judgment proofing

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5. The process of drafting a uniform code governing secured credit transactions began in 1946. By 1950, the basic construct of Article 9 was complete. GILMORE, *supra* note 1, at 289 n.1.

6. *See* Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783, 1791-99 (1994).

7. The Permanent Editorial Board for the Uniform Commercial Code established a committee to assess the effectiveness of Article 9 in 1967. The work of this committee was reflected in the 1972 Official Text of Article 9. *See* PEB STUDY GROUP, PERMANENT EDITORIAL BD. FOR THE U.C.C. ARTICLE 9 (Dec. 1, 1992) [hereinafter PEB STUDY GROUP].

8. S. 625, 106th Cong. § 903 (2000); H.R. 833, 106th Cong. § 1012 (1999).

9. On November 1, the Senate defeated a cloture petition on the Bankruptcy Bill, thereby minimizing the chances that the bill would be passed in this Congressional session. Senate Majority Leader Trent Lott said, however, that the bill would be resurrected, and that there would be "another vote before the year is out." ABI World, Bankruptcy Headlines, at <http://www.abiworld.org/headlines/00nov1.html> (last visited Nov. 2, 2000).

10. These transactions have attributes of both traditional debt security issuances and secured credit transactions. *See generally* SECURITIZATION OF FINANCIAL ASSETS (Jason H.P. Kravitt ed., 2d ed. 1997 & Supp. 2000) (describing securitization as a method of finance).

mechanism for those debtors able to take advantage of it.[11]

Unfortunately, the impact of such a mechanism will be felt not merely by the parties consenting to the securitization transaction, but by all the participants in the credit markets, as well as all those affected by a securitizing firm's business. The Bankruptcy Code amendments affirmatively carve out from the definition of the debtor's estate certain securitized assets, notwithstanding the circumstances surrounding their transfer, which will result in fewer assets available for distribution to a bankrupt firm's other creditors. The significance and substantive importance of the definition of what assets are included in the debtor's bankruptcy estate to the commercial markets cannot be overstated.

Moreover, the Article 9 revisions and the proposed revisions to the Bankruptcy Code fail to address the normative issues raised by the further proliferation of securitization as a method of finance. Securitization, even in the absence of bankruptcy, has significant economic and distributive effects—not only upon the parties to the transactions, but also upon an originator's shareholders, creditors and other stakeholders. The concerns of these parties are important and should have been considered more carefully by the drafters.

While the changes to Revised Article 9 affecting securitization likely met the drafters' objectives of increasing the efficiency of securitization transactions through the elimination of transaction costs that are an outgrowth of an uncertain legal regime, the normative issues raised by the explosion in the use of securitization were not adequately considered. Moreover, the proposed change in the Bankruptcy Code granting a superpriority of payment to an exclusive class of asset-backed security investors will have significant negative effects upon a bankrupt debtor's unsecured creditors.

Part II of this Article discusses the origins and history of Article 9. Part III defines and explains securitization and the legal and structural risks to which securitization participants are subject. Part IV examines Revised Article 9's provisions affecting securitization and their potential impact. Part V then looks at the proposed changes to the Bankruptcy Code and the impact of these changes on the securitizing debtor and its creditors. Part VI outlines and examines the normative effects these legislative revisions will have upon the debtor, as well as upon participants in the market for secured and unsecured credit. Part VI also argues that securitization has

11. *See* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 23-31 (1996) [hereinafter LoPucki, *Death of Liability*] (distinguishing between securitization as a financing method and securitization as a strategy for judgment proofing); *see also* Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147, 149 (1998) [hereinafter LoPucki, *The Essential Structure*] (discussing the issue of judgment proofing as having a "single essential structure"); Lynn M. LoPucki, *The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz*, 52 STAN. L. REV. 55 (1999) [hereinafter LoPucki, *The Irrefutable Logic*] (discussing further the issue of judgment proofing).

profound third party effects that policy makers should take into consideration. This Article concludes that such significant and far-reaching changes to Article 9 and the Bankruptcy Code are premature, as there must be further judicial consideration of securitization transactions, both in and outside of the bankruptcy context, before provisions with such potentially extreme implications are enacted.

II. ARTICLE 9'S ORIGIN AND HISTORY

Prior to the enactment of Article 9,[12] lenders used a variety of security devices to secure the repayment of borrowed money with collateral.[13] For example, the contours of what constituted, and what types of collateral were subject to, a pledge, a chattel mortgage and a conditional sale were defined by both the common law and a variety of state statutes.[14] Different consequences followed from characterizing a financing transaction as one

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12. Between 1952 to 1967, every state legislature adopted Article 9, except Louisiana. PEB STUDY GROUP, *supra* note 7, at 1.

13. The initial adoption of Article 9 was accompanied by the corresponding repeal of, inter alia, the Uniform Conditional Sales Act, Chattel Mortgage Act, Factor's Lien Act, Uniform Trust Receipts Act and Assignment of Accounts Receivable Act. *See* OSCAR SPIVAK, SECURED TRANSACTIONS 1 (2d ed. 1963) (predicting this repeal); *see also* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 21-1, at 714-16 (4th ed. 1995) (discussing Article 9's substitution of these devices with one device and one set of terms).

14. The following example was cited by Oscar Spivak in his 1963 handbook on secured transactions prepared under the auspices of the Joint Committee on Continuing Legal Education of the American Law Institute and the American Bar Association:

> For example, in a pre-Code State today, suppose the same borrower were to apply at his bank for a secured loan to enable him (1) to purchase a new delivery truck for his business, (2) to install a new piece of equipment in his plant, (3) to purchase a quantity of raw materials abroad for processing into finished goods at his plant and (4) to meet payroll and operating costs during the manufacturing season when income from sales are low. Faced with such an application, the bank would view the circumstances as requiring four separate transactions:
>
> (1) The purchase of the motor vehicle might be accomplished by the bank's discount or purchase of a conditional sales contract between the borrower and the seller of the truck.
>
> (2) The equipment might be purchased by the borrower with funds advanced by the bank in exchange for a chattel mortgage on the equipment.
>
> (3) The raw material acquisition might require the use of a letter of credit and trust receipt transaction whereby the bank pays the foreign seller and permits the borrower use of the raw materials for the process of manufacture in exchange for trust receipts.
>
> (4) The payroll and operating expense problems might be met by funds advanced under a factor's lien device which includes a general type of lien on the borrower's inventory and an assignment by the borrower of his accounts receivable as they are created by open credit sales of finished goods.
>
> The flexibility or rigidity with which the bank might accommodate its borrower in the foregoing illustration will depend upon the availability in the particular state of the appropriate security device statutes. If the state does not have a factor's lien act or a trust receipt act, the problem will be complicated and resort to expensive non-statutory devices such as field warehousing may be necessary.

SPIVAK, *supra* note 13, at 4-5. This excerpt remained unchanged from Spivak's 1960, first edition handbook. *See* OSCAR SPIVAK, SECURED TRANSACTIONS 4-5 (1st ed. 1960).

type or another.[15] Moreover, the common law and statutory provisions varied from state to state, infusing chaos, confusion and redundancy into multi-state transactions.[16] Pre-Article 9 law also had a less concentrated focus on the rights of secured creditors as well as on debtor and consumer protection.[17] The legal regime's primary goal was not to facilitate the expansion of the commercial economy, and it was criticized by some commercial actors as embodying a per se prejudice against secured financing.[18] Parties entering into commercial transactions faced considerable uncertainty with respect to the creation of their security arrangement, the efficacy of their priority position and the remedies available and enforceable in the event of default.[19]

As the twentieth century progressed, the commercial economy expanded. Commercial actors increasingly used a wider variety of property as collateral to secure loans.[20] In addition to tangible personal property pledges, inventory and accounts receivable financing became established. Moreover, the substantive differences in the legal provisions governing the credit transactions differentiated by type of collateral began to blur and even disappear.[21] For example, by the middle of the century, many states failed to distinguish, as a practical matter, between conditional sales and chattel mortgages.[22] The introduction of a uniform law governing all devices intended as security, regardless of their form or former characterization, was a natural next step in the process toward synthesizing the law of secured transactions that had already begun in many states.[23] In the words of Grant Gilmore, Article 9 served to "record what [had], imperceptibly,

15. For example, under the common law, there were inherent differences depending on whether a security interest was characterized as a pledge or as a mortgage. While most states recognized the subsequent perfection of a previously created security interest with respect to both types of security interests, whether or not such a security interest was vulnerable to defeat by general creditors, good faith purchasers or lien creditors often turned upon the security interest's characterization. Moreover, prior to the unification of law and equity, debtors and creditors found the distinction between a pledge and a mortgage to have another significance. A pledgor had the right to redeem collateral from the pledgee at law, whereas, in contrast, a mortgagor's right to redeem was found in equity. Thus, if the creditor could effectively prove himself a mortgagee, he could defeat the debtor's action for redemption in a court of law. If the action for redemption were brought in a court of equity, the creditor could defeat the debtor's claim by proving himself a pledgee. *See* GILMORE, *supra* note 1, at 6.

16. *See* SPIVAK, *supra* note 13, at 2.

17. *See id.* at 4-6 (discussing example of pre-Code State).

18. *See id.*

19. *See id.*

20. *See* GILMORE, *supra* note 1, at 289.

21. *See id.*

22. *See, e.g.*, Francis M. Burdick, *Codifying the Law of Conditional Sales*, 18 COLUM. L. REV. 103, 107 (1918); Grant Gilmore & Allan Axelrod, *Chattel Security: I*, 57 YALE L.J. 517, 548 (1948), *cited in* GILMORE, *supra* note 1, at 289 n.2. Gilmore cites in his treatise a number of early law review articles noting that, while functionally the chattel mortgage and the conditional sale were identical and courts recognized this, many states persisted in formalistically recognizing a distinction. *See* GILMORE, *supra* note 1, at 289 n.2.

23. *See id.* at 288.

already taken place."[24]

A further impetus for the development of Article 9 was the idea that the unification of the disparate bodies of law creating and governing security devices would remove some of the impediments to further proliferation of collateralized transactions.[25] By replacing the haphazard and inconsistent body of state decisions with a uniform statute of broad application,[26] Article 9 corrected variations in the rights of debtors, creditors and affected third parties whose pre-Article 9 rights were dependent upon the characterization of each financing transaction.[27]

Current Article 9 reflects the belief that secured credit transactions ought to be facilitated. The Article 9 statutory scheme is a streamlined process by which secured credit agreements can be entered into and enforced. Moreover, Article 9 makes it easier and less costly to take and perfect security interests in a greater number of types of debtor assets.[28] Secured creditors are empowered to place security interests on most debtor assets through the use of floating lien and after acquired property provisions.[29] These features of Article 9 place secured creditors in a uniformly superior position with respect to debtor assets, relative to parties extending credit on an unsecured basis.

The theory of secured creditors' supremacy has been reinforced by the drafters of Revised Article 9. The revised code reflects the drafters' resistance to a re-examination of the assumptions underlying the secured credit system.[30] Indeed, by expanding the types of collateral that can be taken as

24. *Id.*

25. Initially, the drafting committee thought that the uniform statute governing secured credit transactions would actually be an amalgam of related statutes, each addressing a different type of state law security device. The five statute types, based upon the category of collateral initially identified, were: (i) inventory and accounts receivable, (ii) contract rights or other intangibles, (iii) equipment, (iv) agricultural products and (v) consumer goods. In addition, there was a separate statute addressing pledges, or possessory security interests. Ultimately, noting that these different types of collateral had more similarities in a transactional context than differences, the drafters concluded that one statute, divided into separate parts addressing the most compelling issues, was the simplest and most logical approach. *See id.* at 290-92.

26. *See* 68A AM. JUR. 2D *Secured Transactions* § 2 (1993).

27. *See id.*

28. *See* U.C.C. § 9-109, 3 U.L.A. 47 (West Supp. 2000) [hereinafter U.C.C.] (classifying the types of collateral governed by Article 9).

29. *See id.* § 9-204 (providing for security interests in after-acquired property and for future advances).

30. The PEB Commentary contained the following explanation of its mission:

> [One could ask] . . . whether Article 9 should limit the types of property that can be subjected to a security interest or the extent to which a debtor's property can be so encumbered. Or one might question whether any perfection step should be necessary to obtain priority over judicial lien creditors or other competing claimants. Or one might question whether security interests ought to be enforceable at all.
>
> Although it is well aware of challenges to the validity of some basic principles that underlie Article 9, the Committee chose not to undertake a thorough reexamination of those principles. Nor did the Committee's deliberations reflect strong support for making major adjustments in the balance that Article 9 now strikes between secured parties and unsecured

security,[31] limiting the scope of purchase money security interest[32] and extending the definition of "proceeds" that may come within a lender-with-a-floating-lien's reach,[33] the drafters have perpetuated and enhanced the dominance of the highly leveraged secured lenders. Each of these changes, in the event of a debtor's bankruptcy, will result in a more limited unencumbered estate available for distribution to the bankrupt debtor's unsecured creditors.[34]

In addition to providing rules for secured lending transactions, Current Article 9 includes provisions designed to govern certain aspects of transactions involving sales of accounts and chattel paper.[35] In response to the increasingly common commercial practice of account and inventory financing, the drafters of Current Article 9 included certain sales transactions within the statute's reach.[36] The language of such provisions can be traced to the pre-Code accounts receivable statutes,[37] which were very broad in scope and required the public filing of a sale, assignment and transfer for

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> creditors. But insofar as the Committee's recommendations would make it easier and less costly to take and perfect security interests, they are likely to have the effect of improving the position of secured parties relative to that of unsecured creditors .... The Committee believes that any necessary adjustments for the protection of third parties should be made directly, as by changing Article 9's priority rules or by modifying the avoidance powers or other distributional rules of the Bankruptcy Code, and not indirectly, as by increasing the difficulty and expense of creating perfected security interests.

PEB STUDY GROUP, *supra* note 7, at 8-9 (footnotes omitted); *see also* James J. White, *Work and Play in Revising Article 9*, 80 VA. L. REV. 2089 (1994) (declaring the efficiency of Article 9 irrelevant to the revision process).

31. *See, e.g.*, U.C.C. § 9-102(a)(64) (Proposed Revision 1998) (expanding definition of "proceeds"); *id.* § 9-304 (providing for perfection of a security interest in deposit accounts by control).

32. "A security interest is a 'purchase money security interest' to the extent that it is taken or retained by the seller of the collateral to secure all or part of its price." U.C.C. § 9-107(a) (Supp. 2000) (internal quotations omitted). A purchase money security interest (or PMSI) can also be taken by a third party financier whose financing enables the purchase of collateral. *See id.* § 9-107(b); *see also* U.C.C. § 9-102(a)(75) (Proposed Revision 1998) (revising Code's definition of "software"); *id.* § 9-324 (providing for purchase money security interests in goods and related software). Read together, the section providing for purchase money security interest, coupled with the definition of "software," results in a narrow definition of the types of software in which a party may take a purchase money security interest (only software that is related to goods, such as, for example, an item of power equipment containing a computer program for operation).

33. *See id.* § 9-102(a)(64) (Proposed Revision 1998).

34. *See* Robert E. Scott, *The Truth About Secured Financing*, 82 CORNELL L. REV. 1436, 1441-42 (1997). In the event of bankruptcy, unsecured creditors share in a pro rata distribution of the debtor's assets that remain after secured creditors are paid the value of their collateral, and after payment of administrative expenses and priority claims. *See* 11 U.S.C. § 726 (1994).

35. *See* U.C.C. § 9-102(1)(a)-(b) (1992).

36. The original version of Article 9 governed the sales of "contract rights." *See* U.C.C. § 9-106 (1952). The term "contract rights" was originally defined in Article 9 as "any right to payment under a contract not yet earned by performance and not evidenced by an instrument of chattel paper." *Id.*; *see also* GILMORE, *supra* note 1, at 379. This definition meant that once performed, some contract rights became accounts and others became general intangibles. *See* GILMORE, *supra* note 1, at 382. As such, under the original version of Article 9, the statute potentially governed the sale of general intangibles. *See id.*

37. *Id.* at 308.

security of an account. This requirement was implemented to avoid the traditional problem of the "secret lien,"[38] as well as to address a glitch in the former Bankruptcy Act that made any unrecorded transfer subject to the preference provision.[39] The drafters recognized that the distinction between sales and collateral transferred as security was often blurred, and accordingly, they chose not to differentiate between the two for purposes of Article 9's notice requirement.[40] These transactions are distinguished only upon the debtor's default.

Current Section 9-102(1)(b) explicitly states that Article 9's provisions apply "to any sale of accounts or chattel paper."[41] Moreover, Section 9-302 requires that purchasers of accounts and chattel paper publicly file a financing statement, in accordance with Article 9's procedures, in order to perfect their interests in such property.[42] Accounts are currently defined in

38. *See id.* at 274-81. Since accounts were commonly used as collateral for credit, as well as sold to factors for a discount in exchange for cash, in the absence of a public filing, unscrupulous debtors could both sell their accounts and use them as collateral, thus defeating the interests of the account financier. *See infra* note 47.

39. Section 60 of the Bankruptcy Act provided that, for purposes of the preference provision, transfers of property were not perfected until a good faith purchaser could no longer obtain rights in such property superior to the rights of a prior transferee. The common law rule in a number of states provided that a later recorded assignee could take priority of a prior unrecorded assignee. *See Corn Exch. Nat'l Bank v. Klauder*, 318 U.S. 434, 435-37 (1943). In *Klauder*, the Supreme Court held that in a nonnotification accounts receivable financing (where the account debtors are not notified of the account assignment), as between two assignees, priority is granted to the party who first notifies the debtor of the assignment, notwithstanding the relative temporal priorities. The Court held that the effect of this rule under Section 60 of the Bankruptcy Act was to give the bankruptcy trustee priority over any transferee of accounts that had failed to provide notification of their interests. *Id.* at 436.

40. The definition of "account" in the 1972 Amendments to Article 9 (the first version adopted by all fifty states), however, was narrowed in scope from its original definition. Sales of contract rights and other general intangibles were excluded. *See* Dan T. Coenen, *Priorities in Accounts: The Crazy Quilt of Current Law and a Proposal for Reform*, 45 VAND. L. REV. 1061, 1106 (1992); *see also* Morton M. Scult, *Accounts Receivable Financing: Operational Patterns Under the Uniform Commercial Code*, 11 ARIZ. L. REV. 1, 2-4 (1969) (describing accounts receivable financing prior to the enactment of Article 9 and under the U.C.C.).

41. U.C.C. § 9-102(1)(b) (1992); *see also id.* § 1-201(37) (defining security interest to include the "interest of a buyer of accounts . . . subject to Article 9").

42. *See id.* § 9-302. If a purchaser of accounts or chattel paper fails to file—and thus, perfect—in accordance with the formalities and procedures outlined in Article 9, its interest is vulnerable to defeat by a party with a perfected, and therefore, superior, interest. *See id.* § 9-301(1)(b). Filing provides notice to the public and third parties that the transferred assets are encumbered by another's interest. Once a creditor's interest is perfected, it is common for a security agreement to provide that nonpayment constitutes an event of default. Once a default is declared, the lender is entitled, if she has complied with the attachment and perfection formalities of Article 9, to priority over all of the debtor's unsecured creditors, as well as priority over subsequent judgement creditors, secured parties and lien creditors with competing claims to the same collateral. The most common competitor for such an unperfected transferred interest is likely to be the debtor's trustee in bankruptcy. Section 544 of the Bankruptcy Code gives the trustee in bankruptcy all of the rights under state law of a hypothetical creditor with a lien on the debtor's property. *See* 11 U.S.C. § 544 (1994). If the debtor's property at issue had been previously transferred to a third party, § 550 of the Bankruptcy Code grants the trustee the right and power to recover such property for the benefit of the debtor's bankruptcy estate. *Id.* § 550 (1994). Once this property is recovered, it is included in the debtor's estate and is available for pro rata

Article 9 as "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."[43] Read together, § 544 of the Bankruptcy Code and Section 9-301(1)(b) of the U.C.C. grant the bankruptcy trustee priority in the unperfected transferred accounts.[44]

Given both their value and ready liquidity, accounts have regularly been pledged as collateral for secured loans.[45] Moreover, since well before the enactment of the U.C.C., debtors have engaged in sales of their accounts as a means of financing their business operations.[46] The early purchasers of accounts were known as factors, and the transaction characterized as factoring.[47]

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distribution to the unsecured creditors. U.C.C. § 9-301(1)(b) provides: "(1) Except as otherwise provided in subsection (2), an unperfected security interest is subordinate to the rights of . . . (b) a person who becomes a lien creditor before the security interest is perfected . . . ." U.C.C. § 9-301(1)(b) (1992).

43. U.C.C. § 9-106 (1992 & 2000 Supp.). Chattel paper is defined as "a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods." *Id.* § 9-105(1)(b).

44. *See* 11 U.S.C. § 544 (1994); U.C.C. §§ 9-302, 9-304, 9-502(1) (1992 & 2000 Supp.); *see also* WHITE & SUMMERS, *supra* note 13, §§ 22-1 to 22-14 (outlining the procedure for the creation, perfection and enforcement of Article 9 interests).

45. Account financing can take three basic forms. *See* JOHN F. DOLAN, COMMERCIAL LAW ESSENTIAL TERMS AND TRANSACTIONS 146 (2d ed. 1997). First, because it is common for accounts to be the borrower's most valuable asset, lenders of working capital often require that businesses pledge their accounts as collateral for working capital loans. *Id.* The accounts' liquidity means that the lender may receive its repayment from the account proceeds (cash). *Id.* The second form of account financing involves lenders who are involved in the credit evaluation of the accounts, as well as the account debtors. *Id.* These types of lenders generally have an industry-specific focus and often are involved in receiving account debtors' payments directly (through, for example, the establishment of a lock-box arrangement). *Id.* The third form of accounts receivable financing has historically been known as factoring. *Id.*

46. *See* GILMORE, *supra* note 1, at 288-89.

47. With its origins in the textile industry, factoring involves the transfer of accounts to a third party, at a discount, in exchange for funds. Common to factoring arrangements, the factor purchases the accounts, conducts the account debtor's credit review and functions as the account servicer. *See* Scult, *supra* note 40, at 2. These adjunct services provide fees to factors. *See* SUSAN CRICHTON & CHARLES FERRIER, UNDERSTANDING FACTORING AND TRADE CREDIT 7-9, 22-26 (1986). In situations where the accounts are sold with the understanding that if the account debtor does not pay its account in full to the detriment of the factor, the borrower will reimburse the factor for any losses, and there are other indicia of retained ownership, under current law, the transaction is more likely to be characterized as a loan. Such a transaction is known as recourse financing. If, however, the accounts are transferred to the third party, together with the risk of non-payment, then courts have more often deemed this transfer a true sale. *See* Major's Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 542-44 (3d Cir. 1979) (noting that the absence of recourse to the debtor is one of several relevant factors in determining the existence of a true sale). *See generally* Robert D. Aicher & William J. Fellerhoff, *Characterization of a Transfer of Receivables as a Sale or a Secured Loan upon Bankruptcy of the Transferor*, 65 AM. BANKR. L.J. 181, 182-84 (1991) (stating that a bankruptcy court must consider the context of the transfer to determine whether a transfer is a sale or loan); Coenen, *supra* note 40, at 1066-67 (discussing the emergence and development of factoring); Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON L. REV. 287, 290 (1991) (observing that there is no one universal criteria for the determination of a transfer's sale or loan status); Peter L. Mancini, Note, *Bankruptcy and the UCC as Applied to Securitization: Characterizing a Mortgage Loan Transfer as a Sale or a Secured*

A cousin of factoring, albeit a more formidable one in terms of transaction numbers and dollar volume, is the financial innovation known as securitization.[48] First introduced to the market in the form of mortgage-backed securities over thirty years ago,[49] clever investment bankers realized in the mid-1980s that the same financial innovation could be applied to non-real estate related receivables.[50] Once discovered, the securitization market grew quickly, and currently, it is the fastest growing segment of the capital markets.[51] More than $2.5 trillion of asset-backed securities are outstanding,[52] and over the past fifteen years, the market has grown at a rate of thirty percent per year.[53] Industry experts have observed that virtually any asset with an income stream can be securitized,[54] and recent years have seen a volume of $150 billion in issuances.[55] An estimated $700 mil-

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Loan, 73 B.U. L. REV. 873, 877-82 (1993) (noting the absence of guidelines in the U.C.C. for resolving the sale verse loan issue).

48. *See generally* Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595 (1998) (describing securitization and its risks). Securitization has been referred to in an article by Professor Steven L. Schwarcz as "alchemy." Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. L. BUS. & FIN. 133, 134 (1994). Credit securitization, also known as "structured finance," has further been defined as a "stuctured process whereby loans and other receivables are packaged, underwritten, and sold in the form of securities." JAMES A. ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 3 (1988). *See generally* 1 TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET BACKED SECURITIES (1991 & Supp. 2000) (describing structured financing, financial asset pools and asset-backed securities); THE GLOBAL ASSET BACKED SECURITIES MARKET: STRUCTURING, MANAGING AND ALLOCATING RISK (Charles Stone et al. eds. 1993) (describing the structure, management and risks of asset-backed securities); THE HANDBOOK OF ASSET-BACKED SECURITIES (Jess Lederman ed. 1990) (describing securitization and asset-backed securities).

49. Mortgages (homeowners' obligations to repay the loan used to purchase their home, coupled with a security interest in the real estate) are sold in pools to intermediaries, who sell them as securities to the public market. *See generally* WILLIAM W. BARTLETT, MORTGAGE-BACKED SECURITIES: PRODUCTS, ANALYSIS, TRADING 54-79 (1989) (describing mortgage-backed securities products, analysis and trading).

50. The first securitization transaction was originated by the Sperry Corporation in 1985. Bernadette Minton, Tim Opler et al., *Asset Securitization Among Industrial Firms*, *at* http://www.timopler.com/opler/absabs.htm (last visited Sept. 25, 2000), at 3. General Motors Acceptance Corporation followed Sperry with a $4 billion new issue in October 1986. Lowell L. Bryan, *Structured Securitized Credit: A Superior Technology for Lending*, J. APPLIED CORP. FIN., Fall 1988, at 10-11.

51. *See* Minton et al., *supra* note 50, at 3. *See also Have Assets, Will Securitize*, TREASURY MANAGER'S REP., July 7, 1995, *available at* 1995 WL 6849505 ("Unheard of a decade ago, ABS emerged in the mid-1980s and now have become a familiar, almost humdrum form of finance . . . .").

52. Gary Silverman et al., *A $2.5 Trillion Market You Hardly Know*, BUS. WK., Oct. 26, 1998, at 122 ("According to Leon T. Kendall, a finance professor at Northwestern University: 'Securitization is one of the most important and abiding innovations to emerge in the financial markets since the 1930s.'").

53. *See* Minton et al., *supra* note 50, at 2.

54. Suzanne Woolley & Stan Crock, *You Can Securitize Virtually Everything*, BUS. WK., July 20, 1992, at 78.

55. *See* Kim Clark, *On the Frontier of Creative Finance; How Wall Street Can Securitize Anything*, FORTUNE, Apr. 28, 1997, at 50; *see also* Ron Feldman, *Will the Securitization Revolution Spread?*, *at* http://woodrow.mpls.frb.fed.us/pubs/region/reg959b.html (discussing small business loan securtizatlon)

lion in public asset-backed securities are now issued in an average business day.[56]

III. SECURITIZATION AND ARTICLE 9

Securitization is, in essence, a method of financing that involves the sale of assets with an underlying payment stream, and the assets' repackaging and sale as securities.[57] The assets are sold by an originator[58] to a special purpose corporation (SPC),[59] and interests in these packages, backed by the assets' payment stream, are then sold to investors entitling them to some or all of the assets' repayments.[60] Revised Article 9 includes myriad provisions designed to facilitate securitization[61] in an attempt to

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(last visited June 25, 1999); Lupica, *supra* note 48, at 602-03 nn.25-30 (describing representative examples of the array of exotic asset categories currently being securitized). *See, e.g.*, Michael Gregory, *S.G. Cowen Brings First Rights Deal*, ASSET SALES REP., Mar. 13, 2000 (describing the first securitization of a sports stadium naming rights contract); Adam Reinebach, *As Franchise Loan Industry Expands, Securitization Deals are Following; Pool of Receivables May Widen To Include Golf Course, Movie Theatres*, INVESTMENT DEALERS' DIG., May 11, 1998, at 13 (forecasting franchise asset class will significantly expand in the next years); Adam Reinebach, *The Outlook for ABS is so Rosy That It's Scary: New Asset Categories, New Players, New Regions are Proliferating*, INVESTMENT DEALERS' DIG., June 1, 1998, at 26 (describing the securitization of intellectual property futures, utility losses, reinsurance risk); Matthew Schifrin & Howard Rudnitsky, *Rx for Receivables*, FORBES, May 6, 1996, at 52 (describing a scheme for securitizing pharmaceutical receivables).

56. Minton et al., *supra* note 50, at 3; *see also* Adam Reinebach, *Once Again, ABS Market Proves it Can Shake Off Threats, Bad News; Both Resiliency and Creativity Came in Handy in a Record First Half*, INVESTMENT DEALERS' DIG. July 6, 1998, at 21 (characterizing the securitization market as resilient).

57. This Article will assume the following prototype: the originator is a corporation, its securitized assets are a form of receivables and the special purpose corporation (SPC) is a corporate subsidiary of the originator, formed exclusively for the purpose of purchasing the originator's receivables and issuing asset-backed securities.

58. The firm originally owning and selling the assets is a financing-seeking firm and is referred to as the "originator."

59. The asset purchaser is a SPC created by the originator for the purpose of purchasing the originator's assets and issuing securities backed by these assets' payment stream. The securities offered to investors are referred to as asset-backed securities (ABS). A firm most commonly originates securitization transactions if it has earnings in the form of cash flow from long term obligations owed to it by a debtor. This cash flow must be unencumbered by any other party's interests. *See* Lowell L. Bryan, *Introduction*, *in* THE ASSET SECURITIZATION HANDBOOK 3-4 (Phillip L. Zweig ed. 1989) (describing typical securitization transaction structures). It is possible, however, to securitize even illiquid assets. *See* Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1380 (1991) (describing the variety of illiquid assets that are ripe for securitization).

60. *See generally* ROSENTHAL & OCAMPO, *supra* note 48 (describing structured financing, whereby loans and other receivables are packaged, underwritten and sold in the form of securities). Professor Tamar Frankel, in her treatise, broadly defines "securitization" as the transformation of an asset into securities. *See* 1 FRANKEL, *supra* note 48, at 4-5.

61. *See, e.g.*, U.C.C. § 9-102(a)(2) (Proposed Revision 1998) (expanding the definition of "accounts"); *id.* § 9-102(a)(64) (expanding the definition of "proceeds"); *id.* § 9-109(a)(3) (applying Revised Article 9 to the sale of notes and payment intangibles); *id.* § 9-309 (providing that no filing is

catch up with a market for asset-backed securities that has developed with astonishing speed.[62] These provisions in Revised Article 9 are in response to Current Article 9's inability to address the full range of securitization transaction participants' legal concerns with any degree of certainty.

A. *Securitization*

One of the central reasons firms securitize their assets, in lieu of offering them as collateral for secured loans, is because they conclude, on balance, that securitization's net benefits to them exceed the benefits of possible financing alternatives.[63] These benefits, from the perspective of the originator, may include improved liquidity, increased diversification of funding sources, a lower effective interest rate, improved risk management and accounting-related advantages.[64]

Because of the distensive structure of securitization transactions, originators, as compared to debtors collateralizing secured loans, are better able to offer their financiers a more limited exposure to risks associated with the

required to perfect an interest in the sale of a payment intangible); *id.* §§ 9-406, 408 (enhancing the assignability of accounts, general intangibles and promissory notes).

62. This is true in spite of the fact that the development of the law governing the issuance of these ABS has not kept pace with the level of market activity. In addition to the law governing commercial transactions, ABS implicate a variety of other areas of the law. For example, the issue of whether interests in asset-pools are "securities" under the Securities Act of 1933 and the Securities Exchange Act of 1934 is currently under debate. *See* 2 FRANKEL, *supra* note 48, at 4-9, 53-54. *See also* Park McGinty, *What is a Security?*, 1993 WIS. L. REV. 1033, 1036 (1993) (discussing the issue of ABS classification as securities).

63. Traditional secured financing can be very costly if a firm has a large quantity of debt on its books, little or no financing track record or financial history or is lacking an exposure to a broad base of investors. Moreover, it is estimated that the cost of borrowing funds from a typical regulated financial institution must include the cost of required reserves, FDIC insurance, equity costs, loan loss reserves and operating costs. *See* Lowell L. Bryan, *Conclusion* to THE ASSET SECURITIZATION HANDBOOK, *supra* note 60, at 549; *see also* Harold H. Goldberg et al., *Asset Securitization and Corporate Financial Health*, J. OF APPLIED CORP. FIN., Fall 1988, at 45, 50 (discussing the credit impact of asset securitization on the originator of a loan); 1 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 10, § 1.01, at 1-4 to 1-7; Meredith S. Jackson, *Leap of Faith: Asset-Based Lending to Asset-Backed Securitization—A Case Study*, 2 STAN. J. L. BUS. & FIN., 193 (outlining some of the benefits of securitization to financing seeking firms); Michael Liebowitz, *Can Corporate America Securitize . . . Itself?*, INVESTMENT DEALERS' DIG., Jan. 27, 1992, at 14 (discussing securitization as an attractive financing alternative for below investment grade companies). The point must be made, however, that there may be short-term benefits flowing from a firm's decision to securitize its assets, but long-term adverse consequences. *See infra* pp. 235-40.

64. ROSENTHAL & OCAMPO, *supra* note 48, at 6-12. Further, firms may securitize their assets due to the influence of professional advisors who stand to benefit financially from an increasing number of securitizations. *See* Lupica, *supra* note 48, at 606 & n.48 (describing securitization's transaction costs and the parties, including attorneys, investment bankers, rating agencies and accountants, who financially benefit from a proliferation of these transactions); Geoffrey Richards, *Services: Securitization is a Boon for Valuation Firms*, *at* http://www.nreionline.com/pubs/nrei/98jan/ nre9801p.html (last visited June 24, 1999) (describing how securitization has increased the business of asset appraisers and has required assessments of the durability of income streams). These benefits, to the extent they are present, may be counterbalanced by some very significant costs. *See infra* pp. 236-40.

originating firm as a whole.[65] These risks include exposure to external events, business downturns, interest rate fluctuations, management decisions and the potential for the originator's insolvency or bankruptcy—the risks that are of greatest concern to secured creditors.[66] In contrast, securitized asset investors are concerned with two central issues: (i) the character and quality of the payment stream of their investment's underlying assets and (ii) the efficacy of the transaction's structure.

Built into every asset securitization transaction are risk containment measures that have as their primary focus the quality of the underlying assets.[67] For example, to obtain a credit rating in the public markets that enables their sale, asset-backed securities are most often accompanied by some form of credit enhancement.[68] Typical credit enhancement devices include letters of credit, private insurance or third party guarantees.[69] This credit enhancement is a form of insurance that guarantees, in whole or in part, that payment will be made to ABS investors as the securities come due.[70] In the event of an underlying asset payment delay or shortfall, the SPC draws upon the credit enhancement and investors are paid from this draw.[71] Thus, notwithstanding a firm's lack of a financing track record, its poor credit rating or debt overload,[72] there will likely be a market for the

65. *See* Nicholas Millard, *The Management and Transfer of Credit, Liquidity and Contingency Risks*, *in* THE GLOBAL ASSET BACKED SECURITIES MARKET: STRUCTURING, MANAGING AND ALLOCATING RISK, *supra* note 48, at 127-33.

66. Secured creditors first look to the general credit of the debtor for repayment. As a payment-enforcement device, secured creditors identify collateral that, upon debtor's default, is available to satisfy the debtor's obligation. *See generally* LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH (2d ed. 1998) (outlining the procedures by which secured creditors seek repayment of a loan after the debtor has defaulted). The debtor's bankruptcy may have the effect, however, of altering secured creditors' priorities in collateral and diluting the value of secured creditors' interests. *See* 11 U.S.C. § 363(b)(1) (1994) (allowing the trustee to use, sell or lease property of the estate, including property encumbered by a security interest); *id.* § 364(c) (authorizing the debtor to borrow money, post-petition, on a secured basis); *id.* § 364(d) (authorizing the debtor to borrow money secured by a senior or equal lien on property with an existing security interest attached).

67. *See* Standard & Poor's, *at* http://www.standardandpoors.com/ratings/structuredfinance/index.htm (last visited Sept. 29, 2000); *see also* William J. Curtin & Stephen H. Deckoff, *Asset-Backed Securities: An Attractive Addition to the Low-Duration Sector of the Fixed Income Market*, *in* THE HANDBOOK OF ASSET-BACKED SECURITIES, *supra* note 48, at 203-04 (discussing the methods of loan rating agencies).

68. *See generally* Paul M. Shupack, *On Boundaries and Definitions: A Commentary on Dean Baird*, 80 VA. L. REV. 2273, 2296-97 (1994) (outlining the role of credit rating agencies).

69. *See id.*

70. *See id.*

71. *See id.*

72. When a rating agency rates a traditional corporate security issuance (including debt securities), the financial condition and performance of a company, the quality of management and its impact upon the company's performance are all factors that are taken into account in arriving at a rating. *See* Standard & Poor's, *at* http://www.standardandpoors.com/ratings/corporates/index.htm (last visited Mar. 15, 2000).

asset-backed securities if the credit enhancement is of sufficient quality[73] and the asset-backed securities yield a return commensurate with their rating.[74]

The efficacy of the transaction's structure, however, turns in part on the characterization of the asset transfer, which in turn determines how the ABS investors will be affected by the originator's bankruptcy. Notwithstanding some market participants' touting of securitization as a "bankruptcy proof" method of finance,[75] ABS investors are not entirely and definitively removed from the effects of the originator's bankruptcy.[76]

If a securitization originator files for bankruptcy, its trustee will carefully examine each of the originator's transactions in connection with the trustee's duty to enhance the value of the bankruptcy estate.[77] The trustee will seek to defeat the claims of any party with an interest in any of the debtor's potential assets. If a debtor in bankruptcy has securitized a portion of its assets, its trustee will be concerned with two issues: (i) the nature and characterization of the asset transfer and (ii) the securitized assets'

73. The threshold market evaluation is conducted by the rating agencies. *See* Shupack, *supra* note 68, at 2296-97. The ratings supplied by these agencies dictate the price at which the securities will sell in the market. Rating agencies adopt a "weak link policy" in determining an ABS rating, meaning their rating will not be higher than the credit rating of the credit enhancement provider. *See* Curtin & Deckoff, *supra* note 67, at 203-04.

74. *But see* Frederick Dannen, *The Failed Promise of Asset-Backed Securities*, INSTITUTIONAL INVESTOR, Oct. 1989, at 261 (observing that market prices for ABS have not always been an accurate reflection of their credit-enhanced quality); Silverman, *supra* note 52 (observing that there is an "illusion of liquidity" in the ABS market which is leading to more expensive credit for originators, who in turn are passing the higher costs on to consumers); Gary Silverman, *Commentary: Securitization Is No Security Blanket*, BUS. WK., Oct. 26, 1998, at 140 (noting that banks are securitizing safe loans, and keeping the risky ones, thereby masking their true insolvency probability); Suzanne Woolley, *What's Next, Bridge Tolls? Almost Any Risk Can Be Securitized—But Quality May Be Iffy*, BUS. WK., Sept. 2, 1996, at 64 (quoting a rating agency managing director urging caution to ABS investors).

75. Commentators touting securitization's benefits have regularly referred to these transactions as "bankruptcy-proof." *See, e.g.*, STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION 16-36 (2d ed. 1993) (discussing ways that a special-purpose vehicle (SPV) can be made "bankruptcy-remote"); Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Priority Debates*, 82 CORNELL L. REV. 1373, 1393 (1997) (recognizing that asset securitization is a tool to "bankruptcy-proof" security interests).

76. It should be noted that bankruptcy-related risks do not exclusively involve the issue of asset transfer and perfection. *See generally In re* Kingston Square Assocs., 214 B.R. 713 (Bankr. S.D.N.Y. 1997) (assessing a situation where an SPC became the subject of an involuntary bankruptcy, jeopardizing ABS investors' interests). One highly publicized case in which a securitization structure collapsed in bankruptcy was the Towers Financial affair. *See In re* Towers Fin. Corp. Noteholders Litig., No. 93 Civ 0810(WK)(AJP), 1995 WL 571888 (S.D.N.Y. Sept. 20, 1995). In that case, the originator and five of its SPCs, which had issued health-care receivable backed bonds, filed for bankruptcy which resulted in substantial losses for the ABS investors. *But see In re* Federated Dep't Stores, Inc., No. 1-90-00130, 1992 Bankr. LEXIS 392 (Bankr. S.D. Ohio Jan. 10, 1992) (respecting the bankruptcy remote structure of the transaction); *In re* Carter Hawley Hale Stores, Inc., No. LA 91-64140 JD, 1991 Bankr. LEXIS 2186 (Bankr. C.D. Cal. Apr. 8, 1991) (respecting the bankruptcy remote structure of the transaction).

77. *See* 11 U.S.C. § 544 (1997) (authorizing the trustee to defeat the interest of any unperfected creditor, this provision is referred to as the "strong arm clause").

classification and the steps necessary to perfect the transferee's interest in the assets.[78]

B. *The Asset Transfer*

The determination of whether an asset transfer is a "true sale" or a secured loan is not governed by a statutory rule; rather, it is an equitable determination made by the courts based upon the presence (or absence) of a variety of factors.[79] While parties may intend one characterization, the facts and circumstances of the transfer may suggest another.[80] The factors considered by courts include, inter alia, the presence of a residual interest to be retained by the originator,[81] the sale price set at fair market value by independent appraisers,[82] the absence of recourse to the asset seller,[83] the

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78. *Id.*

79. *See* Aicher & Fellerhof, *supra* note 47, at 182-84; Mancini, *supra* note 47, at 877-82; Plank, *supra* note 47, at 290.

80. *See, e.g., In re* S.O.A.W. Enters., Inc., 32 B.R. 279, 283 (Bankr. W.D. Tex. 1983) (holding that participation agreement was a loan transaction because the rate of repayment to the participant was greater than that to the lead lender, while the participant bore no risk); Boerner v. Colwell Co., 577 P.2d 200, 204-05, 208 (Cal. 1978) (holding that transaction involving construction contracts was a sale and not a loan, even though the contracts were assigned to a financing company). Illustrative of the uncertainty that reigns with respect to this issue is the common reluctance on the part of legal advisors to definitively conclude in their legal opinion that a specific asset transfer is a true sale. Historically, legal advisors would not give opinions with respect to bankruptcy issues because of the equitable discretion afforded bankruptcy courts. As an increasing number of structured finance transactions came to market in the 1980s, rating agencies began to require legal opinions on certain bankruptcy issues that affected their rating process. *See generally* George W. Bermant, *The Role of the Opinion of Counsel: A Tentative Reevaluation*, 49 CAL. ST. B.J. 132 (1974) (suggesting lawyers' restraint on the "urge to demand as much as possible" when drafting legal opinions in business transactions); Scott Fitzgibbon & Donald W. Glazer, *Legal Opinions in Corporate Transactions: The Opinion on Agreements and Instruments*, 12 J. OF CORP. L. 657 (1987) (outlining the meaning and process of providing a legal opinion in a corporate transaction); Robert J. Harter, Jr. & Kenneth N. Klee, *The Impact of the New Bankruptcy Code on the "Bankruptcy Out" in Legal Opinions*, 48 FORDHAM L. REV. 277 (1979) (discussing specifically legal opinions in the context of bankruptcy); Special Comm. on Legal Opinions in Commercial Transactions, N.Y. County Lawyers' Ass'n, *Legal Opinions to Third Parties: An Easier Path*, 34 BUS. LAW. 1891 (1979) (encouraging the elimination from legal opinions of "ambiguity, uncertainty and stylistic differences of a nonsubstantive nature").

81. *See, e.g., In re* Evergreen Valley Resort, 23 B.R. 659 (Bankr. D. Maine 1982) (holding that assignment created a security interest because of debtor's retained interest); *In re* Hurricane Elkhorn Coal Corp., 19 B.R. 609 (Bankr. W.D. Ky. 1982) (holding that assignment created a security interest because of debtor's maintenance of an interest); *In re* Nixon Mach. Co., 6 B.R. 847 (Bankr. E.D. Tenn. 1980) (holding that debtor's assignment of security interest was a secured transaction to the extent that it agreed to take back any defaulted notes when security interest assigned); *see also* U.C.C. § 9-502 (Supp. 2000) (discussing collection rights of secured party).

82. *See, e.g., In re* Comet Capital Corp., 142 B.R. 78 (Bankr. S.D.N.Y. 1992) (holding that assignment was a loan because of lender's continued payment of interest to participants, notwithstanding borrower's default).

83. *See, e.g.*, Major's Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 542-44 (3d Cir. 1979) (holding that transaction was a loan, rather than a sale because of risk retained by assignor and the presence of recourse, coupled with the conduct of the parties). If the value of the collateral is less than the debtor's outstanding obligations to the lender, a lender with recourse may sue the debtor personally

acquisition of dominion and control over the assets by the purchaser,[84] the assumption of the benefits and burdens of ownership by the purchaser[85] and the intent of the parties as evidenced by their writings.[86] Many securitization transactions, however, combine indicia of both a true sale and a secured loan, which leaves the ultimate decision up to the court's discretion.[87]

There are clear consequences to the characterization of an asset transfer as a true sale or a secured loan. If an originator transfers an Article 9-defined account intending to engage in a true sale, Article 9 governs the

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on the note, seeking full payment. *See* ROBERT W. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS 9 (1989).

84. Courts have identified the following additional factors in determining whether a transfer is a true sale or secured loan:

a. whether the transferee or transferor bears the risk the receivables will be uncollectible;
b. whether even a limited right of recourse is related to account debtor defaults;
c. whether there is a right of redemption by the transferor;
d. whether collections on receivables are made to lock box accounts;
e. whether valid business reasons exist for not notifying account debtors of the account transfers.

In re Federated Dep't Stores, Inc., 1990 Bankr. LEXIS 1557 (Bankr. S.D. Ohio July 26, 1990).

85. *See, e.g.*, Federated Dep't Stores v. Comm'r, 51 T.C. 500, 519 (1968), *aff'd*, 426 F.2d 417 (6th Cir. 1970) (because seller of installment accounts retained a measure of risk, such transfer was recognized as a loan). *See also* Fireman's Fund Ins. Cos. v. Grover, 813 F.2d 266 (9th Cir. 1987) (holding that because the debtor retained a degree of risk in connection with a transfer and the fact that the interest rate charged was tied to prevailing borrowing rates, the equities of the case suggested a loan rather than a sale).

86. *See, e.g.*, *In re* Lemons & Assocs., 67 B.R. 198, 209-10 (Bankr. D. Nev. 1986) (holding that transaction was a sale of notes, not a loan, because of buyers' objective expressions of intent that transaction was a loan).

87. *See, e.g.*, Bear v. Coben, 829 F.2d 705, 707, 710 (9th Cir. 1986) (holding that the transactions were sales, not loans). Rules promulgated by the Financial Accounting Standards Board state:

> A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:
>
> a. The transferred assets have been isolated from the transferor—put presumable beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership . . . .
>
> b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right . . . —to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity . . . and the holders of beneficial interest in that entity have the right—free of conditions that constrain them from taking advantage of that right . . . —to pledge or exchange those interests.
>
> c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity . . . or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable . . . .

STATEMENT OF FIN. ACCOUNTING STANDARDS NO. 125, Accounting for Transferors and Servicing of Financial Assets and Extinguishments of Liabilities 3-4 (Fin. Accounting Standards Bd. 1996). However, bankruptcy courts have, at times, used their equitable discretion to conclude that, notwithstanding the presence of several substantive indicia, an asset transfer ought to be construed with consideration of the equities. *See, e.g.*, *In re* Lemons & Assocs., 67 B.R. at 209-10.

transfer and requires the transferee to file publicly its interest in the account in the Article 9 filing records.[88] Once filed, and thus perfected, the asset transferee's interest in the account is not subject to defeat by any subsequent creditor, or to defeat by the trustee.[89]

Similarly, even if, arguendo, the account transfer is deemed to be a secured loan, once a proper Article 9 filing is made, the asset transferee, upon the originator's bankruptcy, will continue to have an enforceable interest in assets transferred.[90] The practical distinction between characterizations, however, is that a secured loan transferee is a "party in interest" in the originator's bankruptcy,[91] and as such it is required to participate in the proceedings and is subject to collateral substitution, reduction in priority of payment and other alteration of rights.[92] In contrast, the perfected true sale asset transferee is not required to continue its relationship with its originator and may take its assets and go home.[93]

If, however, the transferee in either a sale or loan transaction fails to publicly record its interest in accordance with Article 9's requirements, upon the originator's bankruptcy, the transferred assets are subject to reclamation by the trustee for the benefit of the bankruptcy estate.[94] The asset transferee, notwithstanding its status as a purchaser or creditor, is relegated to the ranks of an unsecured creditor of the originator.[95]

C. *Securitized Assets' Classification and Perfection*

The most significant problem for securitization originators and ABS purchasers arises when the transferred asset falls outside of the Current Article 9 definition of accounts or chattel paper.[96] If, for example, the asset transferred is a general intangible and the transfer is deemed a collateralization of a secured loan, the transfer is governed by Article 9. The transferee, once properly filed and perfected, is a fully secured party of the originator. In contrast, however, if the transfer of a general intangible is deemed a sale, the transfer is not governed by Article 9, but by other law. This is a risk to which many of the securitizations currently being brought

88. *See* U.C.C. §§ 9-401, 9-402 (Supp. 2000) (describing the filing requirements for various types of collateral).

89. *See* U.C.C. § 9-301(1)(b) (1992); 11 U.S.C. § 506(a) (1994).

90. *See id.*

91. Section 1109(b) of the Bankruptcy Code defines "party in interest" to include a creditor. *See* 11 U.S.C. § 1109(b) (1994).

92. *See* 11 U.S.C. § 1129(b) (1994).

93. *See* United States v. Whiting Pools, Inc., 462 U.S. 198, 204 n.8 (1983) (stating, in dictum, that when a debtor's estate retained minor interest in estate property, the ability of a trustee to regain possession of the property is not limited). *But see* David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055, 1063-64 (1998) (arguing that, in reliance on *Whiting Pools*, the originator retains an interest in assets transferred in connection with a securitization).

94. *See* 11 U.S.C §§ 544(a), 550(a) (1994).

95. *See id.*

96. *See* U.C.C. § 9-102(b) (Supp. 2000).

to the market are vulnerable.

Notwithstanding the fact that Current Article 9 governs, in addition to traditional secured credit transactions, the sale of accounts and chattel paper, numerous securitizations involve the sale of assets that fall outside of the Article 9 definition of "accounts." Parties to securitization transactions have had to look to non-Article 9 law (federal and state common or statutory law) to determine their responsibilities and rights. For example, sales of various rights to payment, including licensing receivables, are not explicitly included under the Current Article 9 definition of "accounts."[97] They are, in all likelihood, general intangibles. If an owner of a licensing receivable wants to pledge this asset as collateral for a secured loan, the lender has to comply with Article 9's formalities for attachment[98] and perfection.[99] If, however, under current law, the owner of the licensing receivable wants to sell or securitize this asset, any and all requirements for public notification of the sale are found under non-Article 9 state law.

The purchaser of the interest in the licensing receivable must engage in a complicated analysis of a number of issues. The threshold determination involves the nature of the transaction contemplated: is it a sale or a secured loan? Notwithstanding the parties' intention, the transfer must meet certain objective tests to be deemed a sale.[100] Assuming the transferee is satisfied that the transfer meets the tests of a sale, then applicable non-Article 9 statutory and case law must be examined to determine the steps necessary to protect the transferee's interest. Once all the non-Ariticle 9 procedures are complied with, the transferee should not be vulnerable to the strong arm of the originator's trustee in the event of bankruptcy.[101]

If, however, the transfer is ultimately characterized as a transfer of collateral for a loan, notwithstanding the transferee's expressed intent to engage in an asset sale, then the assets must be returned to the bankruptcy estate upon the transferor's bankruptcy unless an Article 9 financing statement[102] has been filed.[103] The transferee is disgorged of what it thought were its assets and must wait in line as a general unsecured creditor in the

97. *See* U.C.C. § 9-106 (1992 & Supp. 2000).

98. A security agreement describing the collateral would have to be prepared and signed by both parties to the transaction, thus creating a security interest. In addition, value must have been given and the debtor must have rights in the collateral. *See* U.C.C. § 9-203(1)(a)-(c) (1992 & Supp. 2000).

99. A financing statement must be filed in the office of the Secretary of State in the state of the debtor's principal place of business. *See* U.C.C. § 9-401. *See also id.* § 9-402 (describing the formal requirements of the financing statement).

100. *See supra* notes 78-86 for authorities examining the sale versus loan dilemma under common law and Article 9.

101. *See* 11 U.S.C. § 544 (1994) (enumerating the types and scope of the powers of the trustee in bankruptcy).

102. *See* U.C.C. § 9-302 (1992 & Supp. 2000) (outlining when a filing is required to perfect security interests).

103. *See* 11 U.S.C. §§ 547, 550 (1994) (granting authorization to bankruptcy trustees to disgorge assets of the debtor from the hands of third parties).

transferor's bankruptcy proceeding.[104] The drafters of Revised Article 9 were interested in eliminating this risk and related uncertainty, as well as in augmenting the ability of willing originators to securitize a greater number of their assets with enhanced certainty and predictability. Accordingly, they added numerous provisions in Revised Article 9 that are designed to address these issues.

IV. REVISED ARTICLE 9 AND THE NEW SECURITIZATION SAFE HARBORS

On April 15, 1998, a revised version of Article 9 was proposed for enactment by the National Conference of Commissioners of Uniform State Laws and the American Law Institute.[105] According to the drafting committee,[106] the growth and continued innovation of the credit markets since the statute's last revision in 1972, coupled with the desire to reconsider some of the Code's provisions in light of Article 9 case law and the Bankruptcy Reform Act of 1978, led to the need for the statute's revision.[107] One of the issues the drafters sought to address was Current Article 9's imperfect application to new types of collateral and innovative financing transactions. As stated in the PEB Report, "[b]ecause Article 9 regulates important relationships among creditors and purchasers of collateral, uncertainty concerning its application adds to transaction costs and also can result in decreased availability of credit."[108] Thus, Article 9 has undergone the revision process to address ostensibly issues of uncertainty and to facilitate further commercial credit and sales transactions, thus having the effect of institutionalizing securitization transactions.

Under Current Article 9, there are safe harbors for parties seeking to securitize the sorts of assets that fall under the current definitions of "accounts" and "chattel paper." Parties engaged in the securitization of other types of assets, however, are currently governed not by Article's 9's provision, but by other law. That law may be common law or remnants of pre-

104. *See* 11 U.S.C. § 726 (1994) (setting forth Chapter 7 liquidation distribution scheme); *id.* § 1123(a)(1)-(4) (1994) (asserting that treatment of unsecured claims in Chapter 11 is determined by class).

105. *See* THE AM. LAW INST. & NAT'L CONF. OF COMM'RS ON UNIF. STATE LAWS, UNIFORM COMMERCIAL CODE, REVISED ARTICLE 9, SECURED TRANSACTIONS (Proposed Revision 1998).

106. As stated in the Official Comment to Revised Section 9-101:

> In 1990, the Permanent Editorial Board for the UCC with the support of its sponsors, the American Law Institute and the National Conference of Commissioners on Uniform State Laws, established a committee to study Article 9 of the UCC. The study committee issued its report as of December 1, 1992, recommending the creation of a drafting committee for the revision of Article 9 and also recommending numerous specific changes to Article 9. Organized in 1993, a drafting committee met fifteen times from 1992 to 1998. This Article was approved by its sponsors in 1998.

U.C.C. § 9-101 official cmt. 2 (Supp. 2000).

107. PEB STUDY GROUP, *supra* note 7, at 2.

108. *Id.*

Code accounts receivable statutes. The following sections describe the changes made to Article 9 and their potential impact on securitization transactions.

A. *Expanded Definition of "Account"*

Revised Article 9 has redefined the term "account."[109] Whereas Current Article 9 limits the definition of "account" to a "right to payment for goods sold or leased or for services rendered,"[110] Revised Section 9-102(a)(2) reads:

> "[A]ccount" means a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned or otherwise disposed of, (ii) for services rendered or to be rendered, (iii) for a policy of insurance issued or to be issued, (iv) for a secondary obligation incurred or to be incurred, (v) for energy provided or to be provided, (vi) for the use or hire of a vessel under a charter or other contract, (vii) arising out of the use of a credit or charge card or information contained on or for use with the card, or (viii) as winnings in a lottery or other game of chance operated or sponsored by a State, governmental unit of a State . . . . The term includes health-care-insurance receivable.[111]

The change in this definition is significant because the assets that fall under Revised Article 9's expanded definition of "account" are deemed, under current law, to be either instruments, general intangibles, accounts or non-Article 9 governed property.[112] The potential for such a non-uniform classification of what, under Current Article 9, may be different pools of the same asset makes it difficult to determine the proper method of perfec-

109. *See* U.C.C. § 9-102(a)(2) (Proposed Revision 1998).

110. Current Section 9-106 defines "account" as "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." U.C.C. § 9-106 (1992 & Supp. 2000).

111. U.C.C. § 9-102(a)(2) (Proposed Revision 1998). Revised Section 9-102(a)(2), defining "account," further reads:

> The term does not include (i) rights to payment evidenced by chattel paper or an instrument, (ii) commercial tort claims, (iii) deposit accounts, (iv) investment property, (v) letter-of-credit rights or letters of credit, or (vi) rights to payment for money or funds advanced or sold, other than rights arising out of the use of a credit or charge card or information contained on or for use with the card.

Id.

112. The proper classification often turns on the terms of the parties' underlying contractual arrangements. *See* Stephen L. Sepinuck, *Classifying Credit Card Receivables Under the U.C.C.: Playing with Instruments?*, 32 ARIZ. L. REV. 789, 792-95 (1990) (describing the difficulties attendant in the classification of credit card receivables due to differing requirements under Current Article 9 for perfection of various types of collateral).

tion of an interest in a particular asset with any certainty.[113]

For example, credit card receivables, depending upon the terms of the underlying credit transaction could, under Current Article 9, be classified as instruments, general intangibles or accounts. A credit card issuer securitizing its credit card receivables currently has no unequivocal assurance that it has classified the asset properly. Accordingly, the issuer can have little confidence that the correct steps necessary to protect the transferor's interests were in fact taken. This uncertainty is a threat to the value of the transferor's investment as well as to the efficacy of the entire transaction.[114]

To address these concerns, Revised Article 9 includes a wider variety of rights to payment arising from the transfer of rights in both tangible and intangible property within the definition of "accounts."[115] The sale of the right to payment arising from the sale, lease, license or assignment of auto loans, consumer credit (including credit card receivables), equipment leases, aircraft leases, public utility services, hotel services/leases, insurance, franchises and intellectual property are all deemed to create accounts under the Revised Article 9 definition.[116] Thus, there is no doubt that the securitization of, for example, intellectual property futures are accounts and thus subject to the filing and priority rules of Revised Article 9.[117] Once properly filed, an account transferee will be able to predict with certainty that its transfer will survive the strong arm powers of the originator's

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113. Under Current Article 9, instruments can be perfected by possession, whereas general intangibles can be perfected only by the filing of a financing statement. U.C.C. §§ 9-302, 9-304 (1992 & Supp. 2000).

114. Curiously, the volume of credit card receivable-backed securities issued in the market over the past decade does not suggest that this uncertainty in the underlying law has chilled the enthusiasm of either investors or issuers. *See supra* notes 49-51.

115. This extension of the concept of "accounts" in Revised Article 9 has the effect of reducing the range of assets which will qualify as general intangibles and payment intangibles. *See* U.C.C. § 9-102(42) (Proposed Revision 1998). To illustrate, a licensor's payment under a software license is an account, whereas the license itself is a general intangible.

116. Since the issuance of the so-called "Bowie-Bonds" in 1997 ($55 million of asset-backed securities backed by royalties from the future sale of David Bowie's first twenty-five albums), Luciano Pavarotti, Michael Jackson, Iron Maiden, Joan Jett, as well as the estates of Elvis Presley, John Lennon, Jimi Hendrix, Bob Marley, Jerry Garcia and Kurt Cobain have issued bonds backed by royalties expected to be earned by existing recordings in the future. Pioneered by investment bankers on behalf of David Bowie, these securitizations of what are essentially intellectual property futures have become a more common phenomenon. Investment banker David Pullman, architect of the Bowie deal observed: "[t]here is a tremendous shift in wealth from hard assets—steel and manufacturing—to intellectual property [ ] entertainment." Kathy Bergen, *100 Shares of Pavarotti? Stars Turn to Securitization*, SUN-SENTINEL (Ft. Lauderdale), Dec. 6, 1997, at 16C, *available at* LEXIS, News Library, Sunsen File; *see also* Irv Lichtman, *Joan Jett Song A Financial Rocket?*, BILLBOARD, Sept. 15, 1998, *available at* http://www.billboard.com/daily/0915_02.html; Peter Newcomb, *Dead Men Earning*, FORBES, Mar. 22, 1999, *available at* <http://www.forbes.com> (last visited Oct. 27, 2000); Brendan Weston, *The Bonds Formerly Known as Artists*, ROB MAG. REP., May 1999, *available at* <http://www.pullmanco.com/article095.htm> (last visited Oct. 27, 2000).

117. *See* U.C.C. § 9-102(42) (Proposed Revision 1998).

trustee in bankruptcy.

B. *Article 9's Expanded Scope: Inclusion of Sales of "Payment Intangibles" and "Promissory Notes"*

In addition to governing accounts and chattel paper sales transactions, Revised Article 9 extends its coverage to the sale of payment intangibles and promissory notes.[118] Payment intangibles, a newly identified category of collateral defined in Revised Section 9-102(61), are a subset of general intangibles,[119] but one in which "the account debtor's principal obligation is a monetary obligation."[120] Read together with the expanded definition of "account," the residual category of "payment intangibles" means that all conceivable payment streams are governed by Revised Article 9.[121]

The classic example of a payment intangible is a loan pool participation. Some drafters and commentators thought that the sale of promissory notes and loan pool participations ought not be subject to Revised Article 9 at all. Under current law, loan pool participations are deemed to be general intangibles, and thus, their sale falls outside of the reach of Current Article 9. Because, however, securitizations may involve the sale of loans, and because securitization market participants were looking to Revised Article 9 to eliminate the uncertainty inherent under current law, a compromise was reached: sales of such assets were included under Revised Article 9, but purchasers of loan pool participations were not subject to the Revised Article 9 filing requirement.[122] As such, a security interest in payment intangibles and promissory notes subject to sale are automatically perfected, thus eliminating the uncertainty present under current law and ensuring the

118. *See id.* § 9-109(a)(3). ("[T]his article applies to . . . a sale of accounts, chattel paper, payment intangibles, or promissory notes . . . .") The inclusion of these assets within Article 9's realm does not mean that all of the Article 9 rules apply—the sale of payment intangibles and promissory notes are merely subject to the rules addressing the issues of perfection and priority.

119. General intangibles are a "residual category of personal property" under Revised Article 9. *Id.* § 9-102 official cmt. 5.d. Revised Section 9-102(a)(42) states: "any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction" are general intangibles. *Id.* § 9-102(a)(42). Examples cited in the Official Comment include intellectual property and the right to payment of a loan of funds that is not evidenced by chattel paper or an instrument. *Id.* § 9-102 official cmt. 5.d.

120. *Id.* § 9-102(a)(61). Official Comment 5.d to the definition offers the following explanation and examples: "payment intangible" is a subset of the definition of "general intangible," and the sale of a general intangible is subject to Revised Article 9. *See id.* §§ 9-102 official cmt. 5.d, 9-109(a)(3). Virtually any intangible right could rise to a right to payment of money once one hypothesizes, for example, that the account debtor is in breach of its obligation. The term "payment intangible," however, embraces only those general intangibles "under which the account debtor's *principal* obligation is a monetary obligation." *See id.* § 9-102 official cmt. 5.d.

121. *See* Paul M. Shupack, *Making Revised Article 9 Safe for Securitizations: A Brief History*, 73 AM. BANKR. L.J. 167, 176 (1999).

122. *See* 1 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 10, at § 6.02(B) (describing loan pool participations as not generally covered under Current Article 9).

priority position of loan pool purchasers as against competing buyers.[123]

C. *Enhanced Assignability of Accounts, General Intangibles (Including Payment Intangibles) and Promissory Notes*

Current Section 9-318(4) explicitly denies the effectiveness of contractual provisions that prohibit the assignment of accounts.[124] The original justification for the enactment of this provision was to respond to the economic reality of accounts and other rights under contracts increasingly being used as collateral for financing and the importance of facilitating such financing.[125] Even prior to the enactment of Section 9-318, courts commonly recognized the commercial business practices of account financing and often "construed the heart out of prohibitory or restrictive terms and held the assignment good."[126]

Revised Sections 9-406(d) and (f) expand Current Section 9-318(4)'s free assignability policy to accounts, chattel paper and promissory notes, specifically addressing both restrictions and prohibitions on assignment of such property.[127] Revised Section 9-406(d) renders ineffective any provision in a contract between a debtor and an account debtor which prohibits an assignment or transfer of an account, chattel paper, general intangible, payment intangible or promissory note.[128] Moreover, Revised Section 9-406(f) extends this extinguishment of anti-assignment provisions to any provision found in statutes or common law.[129] Revised Section 9-406(e) renders Revised Sections 9-406(d) and (f) inapplicable to sales of payment intangibles and promissory notes, but Revised Sections 9-408(a) and (c)

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123. *See* U.C.C. § 9-309(3) (Proposed Revision 1998) ("The following security interests are perfected when they attach: . . . (3) a sale of a payment intangible."). The extension of coverage of Revised Article 9 to the sale of these categories of assets could result in a secret securitization of such assets and represents a drifting away from the historical rule against secret liens and interests in personal property. The allowance of automatic perfection means that those seeking to purchase (or use as collateral) promissory notes or payment intangibles cannot simply search the public filing records to determine whether another party has an interest in such assets. Purchasers and parties secured by these types of collateral, to satisfy their prior encumbrance concerns, must secure an affirmative representation from the originator that no other party has any interest in such payment intangibles. *See generally* Shupack, *supra* note 121, at 176.

124. U.C.C. § 9-318(4) (1992).

125. *See id.* § 9-318(4) official cmt. 2.

126. *See id.*

127. *See* U.C.C. § 9-406 official cmt. 5 (Proposed Revision 1998).

128. Under Current Article 9, there is no specific definition of a payment intangible—merely the descriptive category of a general intangible for the payment of money due or to become due. *See* U.C.C. § 9-318(4) (1992). Receivables that are not chattel paper or instruments and that are not accounts because they do not arise from the sale or lease of goods or provision of services are general intangibles for the payment of money—meaning payment intangibles.

129. It was thought at the time Current Section 9-318(4) was enacted that most of the anti-assignment provisions in the law had largely disappeared. Revised Section 9-406(d) continues the codification of the concept of free assignability, in both law and contract, for both chattel paper and accounts. *See* U.C.C. § 9-406(d) (Proposed Revision 1998).

step in to fill this void by making invalid attempts to restrict a Revised Article 9 sale of payment intangibles and promissory notes.[130] This section further extends the prohibitions on contractual and legal restrictions on assignment to health-care insurance receivables and certain other general intangibles.[131]

The expanded invalidation of provisions restricting the assignment of promissory notes, health-care-insurance receivables and payment intangibles is limited, however, by Revised Section 9-408(d).[132] This subsection has the effect of preserving the rights and obligations of account debtors and those obligated on a promissory note, notwithstanding the assignment of such account or note.[133] This means that, notwithstanding contractual

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130. *See id.* § 9-408(a), (c).

131. Revised Section 9-408(a), (c) declares ineffective any contractual term or law, statute or regulation that:

> (1) would impair the creation, attachment or perfection of a security interest; or
>
> (2) provides that the creation, attachment or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the promissory note, health-care-insurance receivable, or general intangible.

Id.

132. *See id.* § 9-408(d).

> To the extent that a term in a promissory note or in an agreement between an account debtor and a debtor which relates to a health care insurance receivable or general intangible or a rule of law described in subsection (c) would be effective under law other than this article but is ineffective under subsection (a) or (c), the creation, attachment, or perfection of a security interest in the promissory note, health-care-insurance receivable, or general intangible:
>
> (1) is not enforceable against the person obligated on the promissory note or the account debtor;
>
> (2) does not impose a duty or obligation on the person obligated on the promissory note or the account debtor;
>
> (3) does not require the person obligated on the promissory note or the account debtor to recognize the security interest, pay or render performance to the secured party, or accept payment or performance from the secured party;
>
> (4) does not entitle the secured party to use or assign the debtor's rights under the promissory note, health-care-insurance receivable, or general intangible, including any related information or materials furnished to the debtor in the transaction giving rise to the promissory note, health-care-insurance receivable, or general intangible;
>
> (5) does not entitle the secured party to use, assign, possess, or have access to any trade secrets or confidential information of the person obligated on the promissory note or the account debtor; and
>
> (6) does not entitle the secured party to enforce the security interest in the promissory note, health-care-insurance receivable, or general intangible.

Id.

133. *See id.* Official Comment 5 to Revised Section 9-408 further makes clear that the term "account debtor," defined in Revised Section 9-102(3), refers to

> the party, other than the debtor, to a general intangible, including a permit, license, franchise, or the like, and the person obligated on a health-care-insurance receivable, which is a type of account. The definition of "account debtor" does not limit the term to persons who are obligated to pay under a general intangible. Rather, the term includes all persons who are obligated on a general intangible, including those who are obligated to render performance in exchange for payment.

Id. § 9-408 official cmt. 5.

provisions or laws prohibiting transfer, the sale of payment intangibles is now provided for under Revised Article 9 without affecting the substantive rights of the party obligated under such accounts or promissory notes.

In the same way that Current Section 9-318(4) was enacted for the purpose of facilitating account-based financing, Revised Sections 9-406 and 9-408 have expanded the scope of the anti-assignment provisions to reach commonly securitized assets. Revised Sections 9-406 and 9-408 enhance the ability of debtors to securitize a broader range of assets by limiting the circumstances an asset transfer would be prohibited by contract or by law.

D. *Expanded Definition of "Proceeds"*

Current Article 9 defines "proceeds" as what "is received upon the sale, exchange, collection, or other disposition of collateral or proceeds."[134] Revised Article 9 expands the definition of "proceeds" to include, "whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral," and "rights arising out of collateral."[135] The significance of this change is primarily realized once the debtor files for bankruptcy.

One of the central tenets of the bankruptcy system is its respect for prepetition security interests granted by the debtor.[136] A security interest that is perfected under state law (and not vulnerable to defeat under the preference and fraudulent conveyance provisions of the Bankruptcy Code)[137] is fully effective in bankruptcy to the extent of the value of the collateral.[138] In certain defined circumstances, however, Bankruptcy Code § 552 offers an exception to this rule. Section 552(a) cuts off secured parties' interests in collateral acquired by a debtor after that debtor has filed a petition in bankruptcy, except to the extent that post-petition collateral is proceeds of original collateral.[139] Section 552(b)[140] provides that a secured party's in-

134. U.C.C. § 9-306(1) (Supp. 2000).

135. *See* U.C.C. § 9-102(a)(64) (Proposed Revision 1998). The expanded definition of "proceeds" is designed to explicitly include "cash or stock dividends distributed on account of securities or other investment property that is original collateral." *Id.* § 9-102 official cmt. 13.a. The Official Comment states that the revised definition of "proceeds" was to explicitly reject the holding of *In re Hastie*, 2 F.3d 1042 (10th Cir. 1993), which held that in bankruptcy, postpetition cash dividends on stock subject to a prepetition pledge are not "proceeds" under Bankruptcy Code § 552(b).

136. *See* 11 U.S.C. §§ 506, 361 (1994). While this concept is not explicitly found in the text of the Bankruptcy Code, it can be inferred from the language of §§ 506 and 361.

137. *See id.* § 544 (granting so-called "strong-arm" powers to the trustee for the defeat of unperfected security interests, fraudulent transfers and preferences).

138. *See id.* § 506.

139. Section 552(a) of the Bankruptcy Code provides that "[e]xcept as provided in subsection (b) . . . property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." *Id.* § 552(a).

140. Section 552(b) provides an exception to the rule announced in § 552(a) that, in the securitization context, potentially swallows it.

terest in "proceeds, product, offspring, or profits" of the collateral continues, notwithstanding the bankruptcy.

The purpose of § 552(a) is consistent with one of the most commonly accepted norms of the bankruptcy system: to preserve the value of the estate for the benefit of those parties with a claim to the residual interest in the debtor's estate (unsecured creditors), as well as to give the debtor a "fresh start."[141] To the extent bankruptcy courts derive the definition of "proceeds" from Article 9,[142] the expansion of the definition of "proceeds" in Revised Article 9 will serve to allow the secured party (or asset purchaser) potentially to claim an interest in a greater number of the debtor's post-petition assets.

This is relevant in the securitization context to the extent that the securitized assets fall under the Bankruptcy Code's definition of "proceeds." When a pool of securitized assets includes some assets that arise after the consummation of the original agreement creating a security interest, the assets are Article 9 "after acquired property."[143] These after acquired assets, pursuant to Bankruptcy Code § 552(a), are at risk of being cut off from the claims of asset purchasers once the debtor files for bankruptcy. To the extent, however, that the securitized assets are not only after acquired property, but also proceeds of the original collateral under the Bankruptcy Code, then the creditor's interests in them is saved by § 552(b). Under Revised Article 9, the asset purchaser will have an enforceable claim to what is a broader definition of the proceeds of the original asset to

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> [I]f the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, or profits of such property, then such security interest extends to such proceeds, product, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

Id. § 552(b)(1).

141. The "fresh start" rationale for bankruptcy, as well as its enabling discharge provision, are grounded in the notion that the long term rehabilitation of a debtor is in the best interest of the public. For a business, the opportunity for a fresh start may preserve jobs and offer the firm an opportunity to once again contribute to the commercial economy. *See id.* § 1141(d).

142. Courts have been inconsistent in their interpretation of what is meant by "proceeds, product, offspring, or profits" in § 552(b). Moreover, the door left open by the exception "except to any extent that the court . . . based on the equities of the case, orders otherwise" has only added to the inconsistency of court opinions with respect to this issue. *Id.* § 552(b)(1). However, many courts do rely upon Article 9 language and state courts' interpretation of the concept of proceeds. *See, e.g., In re* Hastie, 2 F.3d 1042, 1045-46 (10th Cir. 1993) (relying upon state law definition of "proceeds" in holding that a security interest in stock dividends were not perfected because they were not the substitute for disposed of stock (the collateral), as per § 9-306(4)); *In re* Bumper Sales, Inc., 907 F.2d 1430, 1437 (4th Cir. 1990) (holding that Article 9's definition of "proceeds" was the definition to be applied in determining the scope of Bankruptcy Code § 552(b)); J. Catton Farms, Inc. v. First Nat'l Bank, 779 F.2d 1242, 1246 (7th Cir. 1985) (holding that a party with a security interest in receivables and accounts had a perfected interest, as proceeds, in a payment received post-petition pursuant to a pre-petition account).

143. U.C.C. § 9-204 (1992 & Supp. 2000).

the same degree as if the asset was original collateral.

E. *Revised Article 9's Market Impact*

Revised Article 9's expanded definition of "accounts," the allowance of a broader range of asset sales to be subject to Article 9, the inclusion within Article 9's reach of sales of payment intangibles and promissory notes, the expanded definition of "proceeds," as well as the enhanced assignability of prime assets for securitization will do much to facilitate the further expansion of the market for asset-backed securities. That this is a positive development for the commercial markets appears to be an implicit assumption of the Revised Article 9 drafters. The Article 9 revisions, together with the Bankruptcy Code amendment, create risks to the securitization originator and its unsecured creditors. In light of these risks, the assumption that the market for securitization ought to be further facilitated must be rigorously challenged.

V. PROPOSED BANKRUPTCY AMENDMENT PROVISIONS

The current bankruptcy debate, both in the popular press[144] and among academics,[145] has primarily centered around consumer-related issues.[146] The furor over bankruptcy reform arose because of the perceived abuses of the bankruptcy system by consumer debtors; at least that is what the consumer credit industry has spent $61.6 million dollars since 1987 getting

144. *See, e.g.*, Andrew Conte, *Easy Credit Sets Up Some for a Hard Fall*, CINCINNATI POST, June 24, 1999, at 1A, *available at* 1999 WL 4337988; William P. Delahunt, *Bankruptcy Laws Go Easy on the Rich*, WASH. POST, June 7, 1999, at A18; Lisa Hill Fenning, *Bankruptcy Reform Bills Would Make Things Worse: Those Deserving Relief Would Face Unfair Obstacles*, L.A. TIMES, June 21, 1999, at AM4, *available at* LEXIS, News Library, Lat File; Michele Jacklin, *U.S. House Gives a Boost to the Credit Card Sharks*, HARTFORD COURANT, June 23, 1999, at A15; Jacob M. Schlesinger, *House Approves Bankruptcy Overhaul Amid Criticism Bill May Be Too Tough*, WALL ST. J., May 6, 1999, at A28.

145. *See, e.g.*, KAREN GROSS, FAILURE AND FORGIVENESS (1997); Brenda Anthony, *"Substantial Abuse" under Section 707(b) of the Bankruptcy Code: American Consumers Learn Declaring Bankruptcy May Cease to be a Way Out*, 67 U. CIN. L. REV. 535 (1999); Douglas G. Baird, *Essay: Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573 (1998); Colloquium, *Consumer Bankruptcy*, 67 FORDHAM L. REV. 1311 (1999); Carlos J. Cuevas, *The Consumer Credit Industry, The Consumer Bankruptcy System, Bankruptcy Code Section 707(b), and Justice: A Critical Analysis of the Consumer Bankruptcy System*, 103 COM. L.J. 359 (1998); Susan L. DeJarnatt, *Once Is Not Enough: Preserving Consumers' Rights to Bankruptcy Protection*, 74 IND. L.J. 455 (1999); Edith H. Jones & Todd J. Zywicki, *It's Time for Means-Testing*, 199 B.Y.U. L. REV. 177 (1999); Robert K. Rasmussen, *Behavioral Economics, The Economic Analysis of Bankruptcy Law and the Pricing of Credit*, 51 VAND. L. REV. 1679 (1998); Henry J. Sommer, *Causes of the Consumer Bankruptcy Explosion: Debtor Abuse or Easy Credit?*, 27 HOFSTRA L. REV. 33 (1998); Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L.J. 1079 (1998).

146. *See generally*, GROSS, *supra* note 145 (discussing the role of bankruptcy in our culture and its impact upon consumers).

Congress and the public to believe.[147] In two consecutive Congressional sessions, the House and Senate proposed Bankruptcy Reform Bills which included a variety of provisions designed to make bankruptcy less attractive and more burdensome to consumer debtors.[148] The House passed its version of the Bankruptcy Reform Act of 1999 on May 5, 1999, and on February 2, 2000, the Senate passed its version of the Bill by a veto proof margin of eighty-three to fourteen.[149] Currently, the House and Senate bills are in committee for reconciliation.[150]

In addition to the consumer-focused amendments, there is a little-noticed and mentioned provision contained in both the House and Senate versions of the bill which, if enacted, will have the effect of completing the institutionalization of securitization transactions by allowing certain securitization investors to circumvent the bankruptcy process. Both the House and Senate versions of the bankruptcy reform bill contain a provision amending § 541 of the Bankruptcy Code,[151] which broadly defines the scope of the debtor's bankruptcy estate. This proposed section[152] provides that "eligible assets" transferred by the debtor in connection with a securitization are affirmatively deemed to be excluded from the debtor's bankruptcy estate.[153]

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147. This figure includes $50.8 million in Political Action Committee (PAC) contributions and $10.8 million in soft money donations. According to a Common Cause study on lobbying efforts by the consumer credit industry, 420 Representatives and ninety-eight Senators have taken contributions from banking and consumer credit interests. Senators have received, on average, $100,836 each from consumer credit industry PACs. Members of the House of Representatives have received an average of $47,724 from this group's contribution coffers. By comparison, the tobacco industry, during the same period, spent less than half of the credit card industry's $61 million in soft money donations and contributions to PACs. *Going for Broke: Big Money, Big Banks & Bankruptcy*, *at* http://www.commoncause.org/publications/goingforbroke.htm (last visited July 7, 1999).

148. H.R. 833, 106th Cong. (1999); S. 625, 106th Cong. (2000).

149. Eric Schmitt, *Senate Approves Bill to Toughen Bankruptcy Rules*, N.Y. TIMES, Feb. 3, 2000, at A1.

150. *See supra* note 9; *see also American Bankruptcy Institute Legislative Watch*, *available at* http://www.abiworld.org (last visited Feb. 24, 2000).

151. Section 541 of the Bankruptcy Code reads in part:

> (a) The commencement of a case under section 301, 302 or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
>
> > (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

11 U.S.C. § 541 (1994).

152. H.R. 833 was passed by the House of Representatives on May 5, 1999. Stephen Labaton, *House Votes to Make It Tougher to Escape Debt Through Personal Bankruptcy*, N.Y. TIMES, May 6, 1999, at A28.

153. S. 625 was introduced on May 3, 1999. Section 903 of the Senate bill reads:

> SEC. 903. ASSET-BACKED SECURITIZATIONS.
>
> Section 541 of title 11, United States Code, is amended
>
> (1) in subsection (b) by striking 'or' at the end of paragraph (4); and
>
> (2) by redesignating paragraph (5) of subsection (b) as paragraph (6);
>
> (3) by inserting after paragraph (4) of subsection (b) the following new paragraph:

Read together with the expanded definition of "account" in Revised Section 9-102(a)(2),[154] the term "eligible assets," as used in the bankruptcy bill, is a broad one indeed.[155] Receivables (including credit card receivables), intellectual property licenses, cash and securities are all deemed to be "eligible" for purposes of this provision.[156]

Moreover, the provision amending the § 541 definition of "bankruptcy estate" in Senate bill 625 and House bill 833 is a substitution of Congressional judgment for that of state courts on the issue of whether an asset transfer is a transfer of collateral or a "true sale," which federalizes the

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> (5) any eligible asset (or proceeds thereof), to the extend that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization, except to the extent such asset (or proceeds or value thereof) may be recovered by the trustee under section 550 by virtue of avoidance under section 548(a); or; and
>
> (4) by adding at the end of the following:
>
> (e) For purposes of this section, the following definitions shall apply:
>
> (1) The term 'asset-backed securitization' means a transaction in which eligible assets transferred to an eligible entity are used as the source of payment on securities, the most senior of which are rated investment grade by 1 or more nationally recognized securities rating organization, issued by an issuer.
>
> (2) The term 'eligible asset' means–
>
> (A) financial assets (including interests therein and proceeds thereof), either fixed or revolving, including residential and commercial mortgage loans, consumer receivables, trade receivables, and lease receivables, that, by their terms, convert into cash within a finite period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders;
>
> (B) cash; and
>
> (C) securities.
>
> (3) The term 'eligible entity' means–
>
> (A) an issuer; or
>
> (B) a trust, corporation, partnership, or other entity engaged exclusively in the business of acquiring and transferring eligible assets directly or indirectly to an issuer and taking actions ancillary thereto.
>
> (4) The term 'issuer' means a trust, corporation, partnership, or other entity engaged exclusively in the business of acquiring and holding eligible assets, issuing securities backed by eligible assets, and taking actions ancillary thereto.
>
> (5) The term 'transferred' means the debtor, under a written agreement, represented and warranted that eligible assets were sold, contributed, or otherwise conveyed with the intention of removing them from the estate of the debtor pursuant to subsection (b)(5), irrespective, without limitation of–
>
> (A) whether the debtor directly or indirectly obtained or held an interest in the issuer or in any securities issued by the issuer;
>
> (B) whether the debtor had an obligation to repurchase or to service or supervise the servicing of all or any portion of such eligible assets; or
>
> (C) the characterization of such sale, contribution, or other conveyance for tax, accounting, regulatory reporting or other purposes.

S. 625, 105th Cong. § 903 (2000).

154. *See supra* pp. 218-20.

155. *See supra* pp. 218-20.

156. *See supra* pp. 218-20.

analysis.[157] The provision's definition of "transfer" deems an asset transfer to be a sale as long as the characterization is consistent with the parties' intention.[158] This definition does more than provide a safe harbor for securitization transactions; it has the potential effect of excluding assets used as collateral from a debtor's bankruptcy estate in abrogation of the policy defining the estate broadly in order to facilitate business reorganizations whenever feasible.[159] The net effect of this provision will be to carve out of the debtor's estate any transfer that the parties declare to be a securitization, even if under state law, courts would find it to be a transfer of collateral in connection with a secured financing.

The proposed revision to the definition of "estate" extends the risks that may be borne by the unsecured creditors of securitizing originators to cases where the parties have not formally taken the steps necessary to effectuate a true sale of a firm's assets. It further enables securitizing originators to obtain the benefits of the potential for lower effective rates of financing by declaring a securitization, as well as potentially reaping the benefits of a mischaracterized secured financing transaction (e.g., asset cash flow in excess of predictions at the time of pricing)—both at the expense of a bankruptcy debtor's unsecured creditors.[160]

Furthermore, the definition of "asset securitization" in the amendment results in the classification of some kinds of assets as included in the debtor's bankruptcy estate, and others as deemed excluded from the estate, with the distinction dependent upon the source of the consideration for the assets. The language identifies transactions that result in the issuance of not just debt obligations, but debt obligations consisting of at least one issue of securities rated investment grade or better by a nationally-

157. *See* S. 625, 106th Cong. § 903 (2000); H.R. 833, 106th Cong. § 1012 (1999). *See also supra* notes 77-85 and accompanying text.

158. *See supra* note 84 outlining the factors applied by state courts in their determination of whether a transfer is a "true sale" or a transfer of collateral in connection with a secured loan. When a debtor makes an asset transfer, whether the transfer is a transfer of collateral for a secured loan or what is known as a "true sale" is determined under state law. As noted previously, there is no hard and fast rule that readily and consistently makes this determination; rather, courts apply a set of factors developed under the common law. Cases have held that even when the parties intended a true sale, but certain indicia of a secured loan were present, the transfer was made in connection with a loan.

159. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 367 (1977). Congress intended that virtually of all debtor's property be included in the debtor's estate and be sorted out by interests in the course of the bankruptcy proceeding. *See id.*

160. *United States Committee on the Judiciary Subcommittee on Administrative Oversight and the Courts: Hearings Regarding the Business Bankruptcy Act*, 105th Congress (May 19, 1998) (testimony of Randal C. Picker), *available at* WL 12760356 [hereinafter Picker Testimony] (arguing against adoption of the broad exemption set forth in § 215 because it would allow people to opt out of bankruptcy). *See also* Letter from Kenneth N. Klee, Chairman, Committee on Legislation, National Bankruptcy Conference, to Senator Herb Kohl (Aug. 17, 1998) (referring to a provision introduced to the 105th Congress, identical to the provision introduced in the 10th Congress) (on file with author).

recognized statistical rating organization.[161] This definition has the effect of limiting the "carve out" from the definition of "estate" to offerings only in the public markets. Accordingly, excepted from this exception are assets securitized in private issuances that the market does not deem necessary to rate. As described by one observer, "[t]his [provision] is wonderfully tailored to favor Wall Street over other sources of debt capital . . . . [T]here is no rational basis for distinguishing amongst sources of debt capital based upon whether it results in the issuance of a [rated] 'security.'"[162]

The bankruptcy bill provision brings into sharp focus the debate in the academic literature questioning the wisdom of what has been called the "privatization" of business bankruptcy.[163] On one side of this debate are those who see benefits to contractual substitutes for business bankruptcies.[164] Those holding this position believe that the bankruptcy system is inefficient and generates high administrative costs.[165]

Those holding the contrary position believe that the bankruptcy system works, but that it may still benefit from reform measures.[166] These com-

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161. Otherwise known as NRSROs, these rating agencies research the efficacy of a securities issuance and issue what are known as credit ratings. There are currently six NRSROs engaged in the rating of asset-backed securities: Moody's, Standard & Poor's, Fitch Investors, Duff & Phelps, IBCA Banking Analysis and Thomas Bankwatch. The Securities and Exchange Commission designates a rating agency as an NRSRO, using, in the absence of formal standards, the acceptance by the market itself of the agency. Nationally Recognized Statistical Rating Organizations, Exchange Act Release Nos. 33-7085, 34-34616, 59 Fed. Reg. 46314, 46316 (1994); Shupack, *supra* note 68, at 2296-97; Francis A. Bottini, Jr., Comment, *An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies*, 30 SAN DIEGO L. REV. 579, 611 (1993).

162. Comments of Kenneth Kettering, Partner, Reed, Smith, Shaw and McCay (June 21, 1999) (on file with author).

163. *See* Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1850 (1998) (offering arguments in favor of privatizing bankruptcy); *see generally* Susan Block-Lieb, In the Center of the Great Bankruptcy Divide: Comparing the Choice Among Business Bankruptcy Legislation and Private Law Alternatives (1999) (manuscript on file with author) (describing the scholarship on contract-based debt collection schemes as compared to the collective action of bankruptcy).

164. *See, e.g.*, Barry E. Adler, *The Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 352-54 (1997) (proposing a metamorphosizing form of equity, referred to as Chameleon Equity, in lieu of debt as an alternative to the bankruptcy solution to financial distress); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1050 (1992) (outlining a private-law alternative to bankruptcy); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 53-54 (1992) (proposing bankruptcy as a default rule subject to alternative contractual arrangements between debtors and creditors); Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 534 (1999) (advocating for contractual alternatives to bankruptcy).

165. Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 315-18 (1993) (noting the high costs of corporate bankruptcy).

166. *See* Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WISC. L. REV. 729, 729-31 (1993) (arguing that the major flaw in Chapter 11 is that the process takes too long); Ronald J. Mann, *Bankruptcy and the Entitlements of the Government: Whose Money Is it Anyway*, 70 N.Y.U. L. REV. 993, 1000 (1995) (arguing that government entitlement to value for operating the bankruptcy system preempts creditors' complaints that they do not receive the full value due to them); *see generally* GROSS,

mentators see benefits to collective debt collection, instead of contract-based insolvency remedies, especially for those affected by bankruptcy without the resources to craft a fair bargain ex ante.[167] What the revised definition of estate does, however, is sanction a contractual alternative to bankruptcy for some creditors, at the same time leaving the bankruptcy system intact for others. Not surprisingly, it is the financial markets' most powerful participants who are allowed to contract out of the bankruptcy system.[168]

VI. PREMATURE INSTITUTIONALIZATION OF SECURITIZATION: NORMATIVE ISSUES

Embedded in the Current Article 9 and Bankruptcy Code provisions is the implicit assumption that securitization should proliferate and become a universal financing method. Such an assumption and the ensuing changes in the governing law serve to facilitate and encourage securitization transactions, and thus inevitably raise two normative questions: first, whether given its significant effects on third parties, securitization transactions ought to be institutionalized to the degree provided for in Revised Article 9, and second, whether we should adopt a system that not only sanctions, but endorses bankruptcy avoidance by a discrete and powerful class of creditors. When evaluating such questions, it is important to keep in mind that the widespread proliferation of asset securitization will likely result in some unintended (and intended) consequences for both the debtor and third parties.

A. *Securitization as a Strategy for Judgment Proofing*

In a series of articles, Professor Lynn M. LoPucki asserts that asset securitization is both a substitute for borrowing, as well as a strategy with the diabolical potential to offer companies a relatively streamlined method of judgment proofing.[169] Referring to asset securitization as "the silver

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supra note 145 (challenging certain aspects of the bankruptcy system while accepting the system as a whole).

167. *E.g.* GROSS, *supra* note 145, at 101 (describing the effect of bankruptcy on a debtor's unsecured creditors and other stakeholders); *see* Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887 (1994) (citing TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS 294-98 (1989) (describing two classes of unsecured creditors, involuntary (such as tort victims) and voluntary but uninformed (less sophisticated creditors lacking the resources to monitor), as needing the protection of a debt collection process)).

168. *See* S. 625, 106th Cong. § 903 (2000); H.R. 833, 106th Cong. § 1012 (1999).

169. LoPucki, *Death of Liability*, *supra* note 11, at 5 (noting that technological advances are contributing to the failure of the system for the enforcement of money judgments); *see* LoPucki, *The Essential Structure*, *supra* note 11, at 149 (observing that judgment proofing is a relationship between two entities where one generates high risks of liability while the other owns a high level of assets); LoPucki, *The Irrefutable Logic*, *supra* note 11, at 56 (observing that asset securitization is the most effective judgment proofing tool currently available). *But see* Steven L. Schwarcz, *The Inherent Irrationality of*

bullet capable of killing liability,"[170] LoPucki posits that firms can use asset securitization to either intentionally or unintentionally render themselves devoid of assets, and thus judgment proof.[171] LoPucki offers the following illustration:

> Through asset securitization, a company potentially could divest itself of all of its assets, yet continue to use all of those assets in the continued operation of its business. To grasp the enormous potential, assume that, through a series of asset securitizations, Exxon Corporation disposes of all of its assets. As the cash from these transactions becomes available, Exxon distributes the cash to its shareholders in the form of dividends, leaving the company with neither assets nor liabilities.[172]

In this example, Professor LoPucki contemplates that a company could securitize virtually any asset through a sale and lease-back.[173] He further observes that firms have the capacity to distribute the proceeds of the securitization to shareholders in the form of dividends, thereby rendering it improbable, if not impossible, that a creditor would be able to collect what it is owed.[174] Professor LoPucki recognizes that while securitization has not been utilized on a widespread basis as a judgment proofing technique, it has proliferated because of the advantages finance-seeking firms have perceived—namely, its ability to allow investors to avoid the securitization originator's bankruptcy, thus reducing the cost of capital, relative to secured and unsecured financing.[175]

The risk that an increasing number of companies will become more

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Judgment Proofing, 52 STAN. L. REV. 1, 2-4 (1999) (arguing that widespread use of securitization as a judgment proofing technique is unlikely); Steven L. Schwarcz, *Judgment Proofing: A Rejoinder*, 52 STAN. L. REV. 77 (1999) (arguing that asset securitization is unlikely to cause the "death of liability").

170. LoPucki, *Death of Liability*, *supra* note 11, at 27.

171. *Id.* at 4.

172. *Id.* at 25-26 (footnotes omitted).

173. *Id.* at 24-25. LoPucki sees the danger of securitization as a judgment proofing tool as expanding beyond those companies with receivables to other income producing assets. *See also* Shenker & Colletta, *supra* note 60, at 1380.

174. *See* LoPucki, *Death of Liability*, *supra* note 11, at 28-29. There are theories pursuant to which creditors could pursue the proceeds of the securitized assets—even in the hands of third parties. State fraudulent conveyance law might offer those creditors who were able to argue that the securitization was made with actual intent to "hinder, delay or defraud" and for less than "reasonably equivalent value" the ability to avoid the asset sale. *See* UNIF. FRAUDULENT TRANSFER ACT § 4(a) (1985). If the transfer, however, was at arms length, it is unlikely these elements would be satisfied. *See id.* § 4(a)(2)(i) (1985). The payment of dividends to shareholders might be argued to be a fraudulent transfer, but as a practical matter, even if such a conclusion was reached by a court, the creditor with unsatisfied claims would find itself trying to collect the dividend payment from potentially thousands of shareholders. *See* LoPucki, *Death of Liability*, *supra* note 11, at 29.

175. LoPucki, *Death of Liability*, *supra* note 11, at 28-29. *See also* Schwarcz, *supra* note 48, at 151 (explaining how asset securitization eliminates asset-backed securities investors' exposure to originator's bankruptcy).

culturally acclimated to and proficient in the variety of judgment proofing techniques will likely become more pronounced as technology improves and companies become better informed.[176] This will result in inequities, to the extent that it will wound, if not kill, our existing liability system.

Many of the risks attendant to securitization as a judgment proofing system have the potential to be present, however, when securitization is used not only as a liability limiting measure, but as a financing method as well. The wisdom of Article 9 and the Bankruptcy Code's facilitation of securitization as a financing method turns on whether the debtor, prior creditors and other third parties affected by a debtor's choices are better off—or at least not harmed—relative to both unsecured credit and secured credit, by virtue of the debtor's choice to securitize its assets.[177] Whether securitization increases the risk of non-payment to these parties, and thus functions as both a financing method and a judgment proofing strategy, will be discussed in the following section.

B. *Third Party Effects*

Unsecured creditors rely for repayment, not on any collateral offered by debtors, but on the debtors' cash flow, coupled with the overall value of a debtor's unencumbered assets.[178] Studies have concluded that many unsecured creditors systematically fail to adjust their interest rates to later secured debt.[179] Due to a lack of resources and information, unsecured creditors may not know or be in a position to understand the nature of the other transactions their debtor has engaged in and thus do not react to an

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176. LoPucki, *Death of Liability*, *supra* note 11, at 5. It has been noted that securitization transactions are "mind numbingly complex," and therefore require sophisticated computing technologies. Bryan, *supra* note 51, at 11.

> These kinds of transactions would not even be possible without computers, first, to keep track of cash flow and loan defaults from individual loans and, second, to ensure that all participants get exactly the returns due them. To make this process work, each loan and interest payment must be tagged as it flows from the borrower, to the intermediary who made the loan, to the special purpose vehicle, and, finally, to the end investor who bought the security. Moreover, all of these transfers must be documented in accordance with complex legal requirements to ensure that with each cash payment there is a proper transfer of both return and risk. Without sophisticated computers, all of this would be impossible. . . . Computer-based analysis of cash flows is critical to understanding the expected returns for all participants, and it is particularly important for understanding the credit risk and the prepayment risk inherent in the transactions.

Id.

177. *See* Scott, *supra* note 34, at 1440-56 (examining the wisdom and virtues of secured credit).

178. *See* LoPucki, *supra* note 167, at 1931-32. Unsecured creditors, who rely on both the cash flow of the debtor, as well as the debtor's residual asset pool for repayment, are victim to a reduction in residual value each time a debtor uses its unencumbered assets as collateral for a loan. This is similarly true when a firm securitizes its assets. By definition, such assets are no longer available to satisfy the claims of the debtor's unsecured creditors. *See* Scott, *supra* note 34, at 1445.

179. Lucian Arye Bebchuck & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 880-95 (1996) (observing that a secured creditor's priority may not always be fair).

increase in their risk of nonpayment. The transaction costs are too high in many cases for unsecured creditors to keep track of debtors' behavior or to charge an interest rate that reflects the heightened risk associated with secured credit.[180]

Moreover, involuntary creditors—including tort claimants, suppliers, trade creditors, consumers with warranty claims, employees with wage claims and other small creditors—may not have the opportunity or resources to conduct an initial diligence of debtor's potential to offer secured debt and therefore charge a compensating interest rate.[181] Nor may they be capable of ongoing debtor monitoring.[182]

There is no reason to conclude that unsecured creditors will be any more responsive to a later securitization than to a secured financing. Unsecured creditors of securitizing debtors do not operate in a world with perfect information and they may not know if their debtor is securitizing its assets or of its plans to securitize. Therefore, their interest rates may not fully reflect the heightened risk to which they may become subject.

Moreover, involuntary unsecured creditors do not have the opportunity to adjust the value of their claims in response to financing decisions of debtors.[183] In the absence of such adjustments, to the extent securitization increases the debtor's risk of default, insolvency or results in a decrease in liquidity, it has the potential to reduce the value of an earlier unsecured claim.[184] Likewise, if a party becomes an unsecured creditor following a securitization, it may find itself a creditor of a debtor that is, for practical purposes, judgment proof.[185]

The diminished chance of unsecured creditor repayment may be true both in and outside of the bankruptcy context, but the unsecured creditor's plight is especially poignant in bankruptcy. Because of the ability of ABS investors to avoid the bankruptcy process, fewer unencumbered assets will be included in debtor's bankruptcy estate for a debtor's residual claimants.[186] Accordingly, gains to originators and ABS may be realized at the expense of unsecured creditors, employees and other third parties with

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180. *See id. See also* Larry Lang et al., *Asset Sales, Firm Performance, and the Agency Costs of Managerial Discretion*, J. OF FIN. ECON. 37 (1995) 3-37 (arguing that "management sells assets when doing so provides the cheapest funds to pursue its objectives rather than for operating efficiency reasons alone.").

181. *See* LoPucki, *supra* note 167, at 1895 (identifying involuntary creditors as "nonadjusting creditors" and arguing that secured credit adversely impacts these parties' chances for repayment).

182. *See* Bebchuck & Fried, *supra* note 179, at 880-95.

183. LoPucki, *supra* note 167, at 1916 (explaining that creditors would decide differently if armed with the necessary information about the debtors and the law). Other involuntary creditors include victims of securities fraud and other frauds (including patent, copyright and trademark infringements), *id.* at 1896-97, customers with pre-payments, and warranty and insurance claimants.

184. *See* Minton et al., *supra* note 50, at 4.

185. *See supra* pp. 22-30 and accompanying notes.

186. Lupica, *supra* note 48, at 621-23.

a relationship to the originator in bankruptcy.[187]

The significance and substantive importance of the definition of what assets are included in the debtor's bankruptcy estate cannot be overstated. Upon a bankruptcy filing, an estate is automatically created comprised of all of a debtor's legal and equitable interests in property, including property encumbered by security interests.[188] The holder of a security interest is entitled, at some point in the bankruptcy process, to walk away from the debtor's bankruptcy with the money owed to it by the debtor, up to the value of its collateral.[189] It may not, however, decide to do so immediately and unilaterally—secured parties are subject to bankruptcy's automatic stay and are precluded from exercising any and all remedies they may have under state law with respect to the collateral until the stay has been lifted.[190]

The Supreme Court has recognized that secured creditors have a cognizable property interest in their collateral that must be protected, notwithstanding debtor's bankruptcy.[191] This protection, however, may not be in the form of a grant of the creditor's specific state law rights, but rather must be in the form of a grant of the value of its state law rights.[192] The debtor's actual collateral (for example, the cash flow from accounts in an account financing context) may be necessary for an effective reorganization under Chapter 11.[193] In such a case, the secured creditor will be granted "adequate protection" of its interests, likely in the form of a collateral substitute.[194] While this substitution may technically be the "indubitable equivalent"[195] of the secured creditor's collateral, it may still result in

187. *See* GROSS, *supra* note 145, at 101 (discussing how viewing the bankruptcy process from the "strongest and most powerful" creditors' perspective "addresses only a limited number of those affected by a bankruptcy filing. It fails to take into account the myriad parties touched by a bankruptcy case and the economic consequences of their situations.").

188. 11 U.S.C. § 541(a) (1994). *See generally* CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 274-81 (1997) (explaining § 541(a)(1) and its various requirements).

189. *See* 11 U.S.C. § 506(a) (1994).

190. *See id.* § 362(a). The automatic stay is terminated by operation of law upon the debtor's grant of a discharge. *See id.* § 362(c)(2). Alternatively, individual creditors may petition the court for what is known as "relief from stay" in order for it to be able to foreclose on its collateral. *See id.* § 362(d). The essence of § 362(d) allows for a lifting of a stay with respect to a creditor, unless there is a good bankruptcy reason to keep it in place. *See id.*

191. United States v. Sec. Indus. Bank, 459 U.S. 70, 81 (1982). *See also* H.R. Rep. No. 595, 95th Cong., 1st Sess. 339 (1977) (intending to give the secured creditor the value of the collateral for which he bargained).

192. *See* 11 U.S.C. § 361 (1994).

193. *See id.* § 362(d)(2)(B).

194. *See id.* § 361.

195. *Id.* § 361(3). This phrase was first used by Judge Learned Hand, *In re* Murel Holding Corp., 75 F.2d 941, 942 (2d Cir. 1935), and was later adopted by Congress in the language of § 361(3) of the Bankruptcy Code. 11 U.S.C. § 1129(b)(2)(B) (1997).

the incomplete protection of the creditor's interest.[196]

In contrast, when a debtor securitizes its assets, it sells them to a third party transferee. If the transfer is determined to be a true sale and all necessary steps are taken under applicable law to protect the third party's interests (which may include the filing of a financing statement under Article 9), upon an originator's bankruptcy, the assets are not deemed to be included in the originator's bankruptcy estate. As such, the automatic stay does not apply to the asset transferee nor to the transferred assets, and these assets are not available to contribute to the debtor's "effective reorganization."

The securitized assets, most commonly "accounts" (as expansively defined under Revised Article 9), may be the only cash or cash equivalent that are available to pay trade creditors, employees, consumer claims and other unsecured creditors under a reorganization plan. If an originator's liquid collateral, such as "accounts," is deemed not to be part of the bankruptcy estate available to fund the reorganization plan, then reorganization will not be feasible, leaving business failure as the only alternative. This is inconsistent with the federal policy of promoting the reorganization of a viable business for the benefit of not only the debtor, but also for those third parties affected by the continued existence of the debtor's business enterprise.[197]

A policy carving securitized assets out of a reorganizing debtor's bankruptcy estate also shifts the risk of a debtor's bankruptcy away from its largest financier to smaller, more vulnerable enterprises such as trade creditors, consumers, employees, tort claimants and other unsecured creditors. The result will be a greater number of liquidations of potentially viable businesses, with smaller dividends paid to residual claimants.

The Article 9 revisions, coupled with the proposed amendment to the definition of the bankruptcy estate, are a significant departure from a system that has been in place for over one hundred years.[198] At least one scholar has observed that the wisdom of securitization as a vehicle for bankruptcy avoidance turns on the efficiency of the bankruptcy reorgani-

196. The collateral that may be provided in substitute for, e.g., the cash flow, may be less liquid or less stable. Moreover, the secured creditor may have a different perception of the likelihood of success of debtor's reorganization and strongly prefer to liquidate its collateral immediately. The bankruptcy procedure may make the accomplishment of this desire impossible. *See infra* pp. 39-40 and accompanying notes.

197. *See* GROSS, *supra* note 145, at 101.

198. *See* Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 303-04 (1997) (describing the bankruptcy avoidance techniques that are currently used in practice against the backdrop of the generalized public policy against bankruptcy waivers, and challenging the popular notion that bankruptcy waivers are unenforceable under the Bankruptcy Code). *But, c.f.*, Schwartz, *supra* note 163, at 1808 ("[P]arties cannot contract in lending agreements to use a bankruptcy system other than the one the state supplies.").

zation process.[199] If reorganization bankruptcy is inefficient, then securitization may be an important vehicle for investor avoidance of the bankruptcy process, resulting in cost savings that could be redistributed to other creditors of the debtor.[200] If, however, reorganization bankruptcy is efficient, then an avoidance of bankruptcy by an exclusive class of creditors would likewise be inefficient.[201] The efficiency or inefficiency of reorganization bankruptcy, while having been enthusiastically debated in the scholarly literature, has not yet been proven.[202] Nevertheless, a rule enabling a discrete, powerful class of creditors to opt-out of bankruptcy, even if it is an inefficient process, is unfair to those remaining parties who are unable to take advantage of this opportunity.

C. *The Long-term Impact of Securitization*

A rational firm in need of financing will seek the most cost-efficient financing method. The determination of cost-efficiency turns on whether managers making the financing decision are taking into consideration both long-term and short-term consequences. If, for example, securitized credit can be had at 100 basis points less than secured credit, all things being equal, rational managers, in consideration solely of the short-term effects, may choose to securitize their receivables, rather than offer them as collateral for a loan.[203] Correspondingly, if securitized financing is more expensive in the short run than secured credit, due to poor asset quality or high transaction costs,[204] a firm may choose to offer the assets as collateral for a loan.

To conclude that securitization is in the best interest of a firm in the long run, however, begs a consideration of myriad factors beyond the short-term cost of the financing. The long-term costs of a securitization may embrace not only the cost of the money, but the qualitative and quantitative toll the financing takes on the debtor's remaining assets, and in turn, on a debtor's other creditors. Securitization transforms the debtor's expected cash flow into a lump sum infusion of cash. Whether this cash infusion has the potential to adversely affect a debtor depends upon what the debtor does with this cash, coupled with the quality and quantity of the debtor's assets that remain following the securitization.

For firms to receive the greatest cost-of-financing-related benefit, they

199. Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101, 128-29 (1997) (describing the costs and benefits of securitization).

200. *Id.*

201. *Id.*

202. *Id.*

203. Similarly, debtors may offer collateral for loans because secured credit is cheaper than unsecured credit. *See* Scott, *supra* note 34, at 1450.

204. Transaction costs include, inter alia, costs of credit enhancement, legal fees, accounting fees, underwriting fees and valuation of asset portfolio. *See* Lupica, *supra* note 48, at 606 n.48.

will likely securitize their highest quality assets.[205] If that is the case, then what assets remain with the debtor may, in some circumstances, be fairly characterized as junk.[206] This junk may constitute, in the event of debtor's bankruptcy, the debtor's residual estate, resulting in a diminished dividend available to the debtor's unsecured creditors.

The more significant variable to consider, however, in the evaluation of the long-term impact of a securitization is the use to which the proceeds of the asset sale are put. If the proceeds of the securitization remain liquid in the firm's coffers or are invested in a project with a positive value or one with a high degree of liquidity, then the securitzation may not adversely affect the debtor or third parties.[207]

Experience has shown, however, that a predictable consequence of a securitization is the reduction of a firm's ratio of assets to liability risk.[208] This occurs when the proceeds of securitization are used to make payments to creditors and/or distribute dividends to shareholders.[209] In such circumstances, what results is an expropriation of value from the firm's creditors.[210]

Moreover, as suggested by a study of the explanations for asset-backed securities issuances conducted by academics at Ohio State University, firms may use securitization as a way of expropriating value from existing

205. An asset-backed security issuance pricing is contingent upon the risk offered to the investor, which, in turn, is based upon the quality of the underlying asset. The lower the quality of an asset, the more expensive the financing will be for the originator—either due to a low credit rating in the market or to the expense of a high degree of credit enhancement. *See* Curtin & Deckoff, *supra* note 67, at 203-04.

206. Lupica, *supra* note 48, at 627.

207. Such explicit policies would be necessary because the ABS investors have no motivation to insist upon such provisions as a term of their deal, nor do they have the incentive to engage in debtor monitoring. *See* Bebchuck & Fried, *supra* note 179, at 880-95 (discussing the ways that covenants in loan documentation can be used to control debtor's inefficient behavior).

208. *See* LoPucki, *The Irrefutable Logic*, *supra* note 11, at 58. This point was illustrated by Professor LoPucki in the following example:

> Exxon has assets with a value slightly in excess of $40 billion and liabilities to unsecured bank lenders of exactly $40 billion. Exxon sells its assets for their fair market value and pays $40 billion of the proceeds to the banks. Exxon now has assets of nominal value and no liabilities. By leasing its assets back, it is able to operate its business in the same manner as before the transaction. Prior to this transaction, a tort creditor who won a judgment against Exxon in the amount of $10 billion could reasonably have expected to recover eighty percent of that amount [in a bankruptcy proceeding]. After payment of the proceeds of the asset securitization to the bank, such a tort creditor would have been able to achieve only a nominal recovery. The investors who replaced the banks in Exxon's financial structure—the purchasers of securities in the asset securitization—would be the absolute owners of all the assets used in Exxon's business. That is judgment proofing.

Id.

209. *CNH Capital Prices Largest ABS Transaction in Company History; First Transaction Since merger of Case Corporation and New Holland N.V.*, BUS. WIRE, Mar. 9, 2000, *available at* LEXIS, News Library, Bwire File ("CNH Capital will apply the proceeds from this securitization to repay outstanding debt and fund its growing portfolio of receivables."); *see also* LoPucki, *The Irrefutable Logic*, *supra* note 11, at 59 n.21.

210. *See* Minton et al., *supra* note 50, at 8-10.

unsecured creditors.[211] If a firm uses the proceeds from a securitization of a "low risk" asset to invest in "riskier activities," such investment is made at the expense of its unsecured creditors and shareholders.[212] In addition, securitization proceeds could be spent on negative net present value investments, in cases where managers were seeking to "avoid the disciplinary effects of poor performance."[213]

If the securitization of a firm's liquid assets (such as receivables) results in an overall drop in a firm's liquidity (as would be the case if the securitization proceeds were used to cover current expenses, pay current debt, were distributed as dividends or were invested in non-liquid assets), the diminished cash flow may in time result in a higher incidence of payment (or covenant)[214] defaults to a firm's later creditors. If such cash flow deficiencies persist, the chance of a firm's overall cash flow insolvency[215] will be increased, thus leading the debtor to seek bankruptcy protection.[216] Bankruptcy has the potential to harm not only a firm's creditors, but also a firm's equity owners by requiring full payment to creditors before equity holders' interests can be retained.[217] Thus, the greater the chance of bankruptcy, the greater the chance that a securitizing firm's owners will lose the value of their equity interest.[218]

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211. *Id.*

212. *Id.*

213. Minton et al., *supra* note 50, at 9, (*citing* Lang et al., *supra* note 179, at 3-38). Citing the Lang, Poulsen and Stulz study, Minton's article continues:

> [A]sset sales may allow non value-maximizing managers to pursue poor projects by creating liquidity for investment. Asset securitization can be viewed in a similar vein. Asset-backed proceeds can be reinvested in poor projects. Alternatively, the proceeds from the sale of asset-backed debt can be used to retire existing debt thereby lowering the firm's future payouts and the likelihood that the manager will have to face the discipline of the capital markets. In addition, firms that issue asset-backed debt may face less discipline from capital markets than firms that issue unsecured debt if asset-backed deals involve less monitoring by capital markets. If this motivates issuers, than shareholders of firms that securitize would experience wealth losses. Firms that generate large cash flows but have low growth opportunities face the greatest pressure to invest in unprofitable projects, therefore, we would expect the issuing firms to have these characteristics.

Id. at 9-10.

214. Events of default in a creditor's loan documentation may include the payment delays or interruptions, failure to make payments to third parties, judgment creditor obtaining possession of collateral and breach of warranties or covenant. *See* RICHARD T. NASSBERG, THE LENDER'S HANDBOOK 151-53 (1986).

215. "Cash flow insolvency" is commonly defined as debtor's inability to pay its debts as they become due. Section 101(32)(A) of the Bankruptcy Code defines a firm as "insolvent" if "the sum of such entity's debts is greater than all of such entity's property, at fair valuation." 11 U.S.C. § 101(32)(A) (1997). This is commonly known as "balance sheet insolvency."

216. *See* Minton et al., *supra* note 50, at 7 (concluding that firms that securitize are much closer to financial distress than firms that do not).

217. *See* 11 U.S.C. § 1129(b) (1997). The fundamental maxim that creditors must be paid before equity owners is known as the "absolute priority rule." BLACK'S LAW DICTIONARY 7 (7th ed. 1999).

218. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle Street P'ship, 526 U.S. 434 (1999); *see also In re* Bonner Mall P'ship, 2 F.3d 899 (9th Cir. 1993), *cert. granted*, 510 U.S. 1039

While the risk of improvident or short-sighted proceeds investment is also present when a firm offers collateral as security, secured creditor monitoring of both the collateral's value and the debtor's business enterprise as a whole provides some protection for the secured creditor, as well as potential protection for the debtor's other creditors. The secured creditor, whose primary interest is in the debtor's repayment, will be alert for signs of debtor's imprudent decision making, undue risk-taking and mismanagement. Moreover, since the secured creditor's secondary interest is in the value and efficacy of its collateral, it will take great pains to ensure that the debtor does not engage in acts that will jeopardize the value of its collateral. In addition to subjecting a debtor to the attention and scrutiny of a secured creditor, security provides leverage for the enforcement of loan covenants, including covenants addressing the issue of how loan proceeds are invested and the tolerable level of riskiness of investments.[219] Secured creditors' ability to present the threat of foreclosure, coupled with covenants in loan documents have been found to significantly increase the debtor's willingness and ability to repay its creditors.[220]

In contrast, securitization investors have no incentive to monitor the debtor's post-securitization behavior. Once they purchase the debtor's assets, their link with the debtor is severed. While securitization investors will, as an initial matter, evaluate the quality of the assets being securitized,[221] once that assessment is complete, they have no reason to be interested in the impact of the sale of its assets on the debtor, the debtor's other creditors or what is done with the sale proceeds.[222] Thus, securitization provides no public monitoring for the benefit of a debtor's other creditors, nor private monitoring of the debtor's business decision-making, including the use of the financing proceeds.[223] There is no psychological leverage, such as that exerted by secured creditors' ability to foreclose on collateral, to encourage a securitizing originator to abstain from using its cash as fast as it arrives in an attempt to stay afloat. Thus, a securitizating firm has a greater chance of having little, if any cash at the time it ultimately files for bankruptcy.

Investors who provide financing to firms through their purchase of

(1994), *vacated as moot*, 511 U.S. 1002 (1994) (noting the extent to which absolute priority rule affects the interest of a debtor's equity holders).

219. Scott, *supra* note 34, at 1450, *citing* Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 945 (1986). *See also* Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 625 (1997).

220. *See* Mann, *supra* note 219, at 638-39, 647-48.

221. Securitization investors also evaluate the quality and amount of any credit enhancement. *See* Lupica, *supra* note 48, at 620.

222. *See id.* at 627-29.

223. *See* Saul Levmore, *Monitors and Free Riders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 53-54 (1982) (noting the distinction between public monitoring for third party benefit and private monitoring for a secured party's benefit).

asset-backed securities are not required to participate in that firm's bankruptcy proceedings;[224] by contract, they opt out of the process of the financing-seeking firm's potential collective debt recovery process. Upon the financing-seeking firm's bankruptcy, these investors take their assets and go home, leaving whatever assets remain for the repayment of the debtor's unsecured creditors. Indeed, this is the most attractive feature of securitization as a financing method to originating firms: the ability to create a "bankruptcy-proof" financing structure, thus lowering the risk of nonpayment to investors, in turn lowering the originating firm's financing costs relative to the cost of secured credit.[225]

It has been argued with respect to securitization that "[t]he possibility that securitization or other financing techniques might be misused should not undermine their overall legitimacy."[226] As illustrated by the scholarship describing securitization as a strategy for judgment proofing, securitization has been,[227] and may continue to be, used in ignoble ways to avoid liability to tort and other creditors. Nevertheless, securitization presents the prospect—even when an originator intends not to judgment proof itself, but to simply finance its operations at a favorable rate—of expropriating the value of claims of existing or later unsecured creditors and shareholders.

D. *The Need for Further Study*

Third party creditors and other stakeholders will be subject to significant harm from the further proliferation of securitization. Moreover, securitization has the potential to adversely impact not only the debtor's other creditors, but the value of the debtor's equity. The drafters of Revised Article 9 and the Bankruptcy Code amendments have relied upon the unchallenged assumption that the more securitization, the better. The arguments supporting the conclusion that this assumption is fallacious are sound, but they have not been definitively proven. Nor have there been extensive

224. *See, e.g.*, Boyd v. United States of America/FmHA (*In re* Boyd), 11 F.3d 59 (5th Cir. 1994) (denying property transferred by debtor as included in debtor's bankruptcy estate). *But see* Carlson, *supra* note 93, at 1064 (arguing that because debtor retains some residual interest in assets sold in connection with a securitization, such assets should properly be returned to debtor's estate upon a bankruptcy filing).

225. *See* ROSENTHAL & OCAMPO, *supra* note 48, at 8-23 (outlining securitization's benefits to originators). Pursuant to the Modigliani and Miller theory, however, while securitization may reduce the cost of financing to the originator relative to an alternative financing method, this savings may be offset by a corresponding interest rate increase charged by the firm's general creditors. *See* Frost, *supra* note 199, at 116-20, 124. This is true to the extent that debtor's general creditors have sufficient resources and information to adjust their interest rate in reaction to the added risks of securitization. *See id.* at 118, 124; *see also* Lupica, *supra* note 48, at 635.

226. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, *supra* note 170, at 14.

227. *See* Christopher Drew & Andy Newman, *Taxi Owners Deftly Dodge Claims of Accident Victims*, N.Y. TIMES, May 24, 1998, at 1, *cited in* LoPucki, *The Irrefutable Logic*, *supra* note 11, at 61 n.33.

studies demonstrating securitization's inefficiency, at the expense of third parties.[228]

Clearly, there is an information gap that must be bridged. One of the reasons offered for this information gap is the lack of widespread judicial scrutiny of securitization transactions. As argued by Professor Randal C. Picker on behalf of the National Bankruptcy Conference in his testimony before the United States Senate Committee on the Judiciary Subcommittee on Administrative Oversight and The Courts:

> These issues are unresolved, because there have been almost no cases addressing the consequences of securitization in bankruptcy. There are a handful of unreported opinions and almost no reported opinions. We are not learning, because we are not litigating. Usually, judicial development of an area gives us a full sense of the issues raised by any new practice. It is the interaction of case law and legislation that is the genius of the American System. We will artificially truncate this process were Congress to adopt the broad exemptions set forth in Section [903].[229]

Because of the significant prospect of securitization, used as a financing strategy, adversely affecting an originator's unsecured creditors and other parties with interests in the originator, it is important that we learn all we can before changes of this magnitude are enacted.

VII. CONCLUSION

Many of the changes found in both Revised Article 9 and the Bankruptcy Reform Act of 2000 go a long way toward minimizing some of the structural risks attendant to securitization transactions. The extent of asset purchasers' obligations to comply with the filing requirements of Article 9 will be clearer. Investors will have greater confidence in the efficacy of their interests in securities backed by what are proceeds of assets originally transferred at the time of the transactions, which becomes significant in the event of bankruptcy. Anti-assignment provisions found in contract and in law will be more thoroughly and completely eliminated, paving the way for smoother asset transfers. Moreover, the proposed revision to § 541 of the Bankruptcy Code excepting assets the originator intended to securitize will allow ABS investors the luxury of avoiding the bankruptcy quagmire. Clearly, when Revised Article 9 is enacted by the state legislatures and if the equivalent of Senate bill 833 § 903 is enacted into law, ABS investors will gain greater certainty and predictability and protection from the external effects of bankruptcy. This should result in an even greater increase in

228. *See* Lupica, *supra* note 48, at 599 n.11 (describing the nature of the empirical studies that need to be conducted).

229. Picker Testimony, *supra* note 160.

the dollar volume of securitized debt.

These statutory revisions address the structural risks to which securitizing originators and ABS investors are subject. They do not, however, adequately consider the economic risks or third party effects of the further proliferation of securitization transactions. Moreover, the decision on the part of Congress to alter fundamentally the core of our country's business bankruptcy system—in what could be called a stealth manner—is at best, premature. The revisions to Article 9 designed to facilitate securitization will result in fewer unencumbered assets available upon bankruptcy for debtor's residual claimants bankruptcy, rendering many securitization originators essentially judgment proof. Moreover, an entire class of investors (purchasers of investment rated ABS) need no longer concern themselves with the effects of a debtor's bankruptcy. If it is in the best interest of society as a whole to reform the business bankruptcy system or to substitute private contractual alternatives, then that is what ought to be done. What should not take place is a circumvention of the bankruptcy process by a discrete class of powerful financial market participants at the expense of those parties least able to bear the resulting loss. Until the normative issues raise in this Article are fully considered, the law should not be so drastically changed.