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Asset Securitization: The Unsecured Creditor's Perspective

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I. Introduction

When a corporation needs funds for working capital, inventory, or general operations, it can take one of two financing approaches: right hand side (RHS) balance sheet funding or left hand side (LHS) balance sheet funding. RHS funding methods include a firm's issuance of traditional debt (secured and unsecured) and equity obligations, which are backed by the general credit of the issuer. In contrast, when a firm uses an LHS funding approach, it raises capital based upon a specific asset pool's cash flow and value. Examples of LHS funding approaches include asset leasing,[1] project finance,[2] factoring,[3] and the most recent financial innovation, the securitization of financial assets.[4]

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1. Asset leasing involves the "transfer of the right to possession and use of goods for a term in return for consideration." U.C.C. § 2A-103(1)(j) (1994).

2. Project finance refers to a method of raising funds that relies on the value of the project being financed and the revenues generated. Typically, the project developer or borrower is a "single purpose entity whose only asset is the project being financed." Jonathan Birenbaum, *Credit and Related Documentation for Project Finance Transactions*, *in* PROJECT FINANCING 1993: DOMESTIC AND INTERNATIONAL, at 269, 271 (PLI Commercial Law & Practice Course Handbook Series No. 672, 1993).

3. Factoring originated in England in the fourteenth century as a way for textile manufacturers to liquidate their accounts receivable. Holders of accounts receivable sold them at a discount and without recourse to a "factor." In most cases, the factor accepted the account receivable's credit risk and took control of the accounts' collection. This benefitted the manufacturer in two ways: (1) the manufacturer did not have to review the credit of its customers, and (2) it enabled the manufacturer to liquidate assets quickly so that it was able to purchase more raw materials. *See generally* Peter H. Weil, *Factoring*, *in* ASSET-BASED LENDING INCLUDING COMMERCIAL FINANCE AND ACQUISITION FINANCING 1988, at 41 (PLI Commercial Law & Practice Course Handbook Series No. 443, 1988). Factors made their money by purchasing only the highest quality receivables—those with the greatest chance of full payment—at a substantial discount. *See* Harper v. Lloyd's Factors, Inc., 214 F.2d 662, 663 (2d Cir. 1954) (stating that the usual factoring commission was 15%); *see also* Morton M. Scult, *Accounts Receivable Financing: Operational Patterns Under the Uniform Commercial Code*, 11 ARIZ. L. REV. 1 (1969) (discussing both factoring and accounts receivable financing as pre-UCC methods of financing).

4. The term "asset securitization" will be used in this Article interchangeably with the terms "structured finance transaction," "asset-backed arrangements," "asset-backed financing," "asset securitization," and "structured securitized credit."

Quite a few articles have appeared in the legal and financial journals on the subject of securitization,[5] and implicit in much of this literature is the message that securitization transactions are efficient. This literature has invariably viewed these transactions from the perspective of the originator and the other transaction participants; its conclusion with respect to the efficiency of securitization is hardly surprising. The literature has not adequately considered the perspective of third parties—specifically, the perspective of the originators' unsecured creditors.

Viewing these transactions from an unsecured creditor's perspective is important because unsecured creditors are harmed when an originator sells its most valuable assets. In the event of bankruptcy, the originator's residual estate, available for pro rata distribution to unsecured creditors, likely will not include the securitized assets.[6] If the originator has used or spent the consideration it received from the sale of the securitized assets, its unsecured creditors will receive no benefit from the value of these assets.[7]

Predictably, bankruptcy trustees will use aggressive and creative techniques to try to recapture previously transferred assets.[8] As an increasing

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5. *See, e.g.*, THE ASSET SECURITIZATION HANDBOOK (Phillip L. Zweig ed., 1989); ASSET SECURITIZATION: INTERNATIONAL FINANCIAL AND LEGAL PERSPECTIVES (Joseph Jude Norton & Paul R. Spellman eds., 1991); 1 TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES (1991); THE GLOBAL ASSET BACKED SECURITIES MARKET: STRUCTURING, MANAGING AND ALLOCATING RISK (Charles A. Stone et al. eds., 1993); THE HANDBOOK OF ASSET-BACKED SECURITIES (Jess Lederman ed., 1990); MORTGAGE AND ASSET SECURITIZATION (Robert Lawrence Kuhn ed., 1990); JAMES A. ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE (1988); SECURITIZATION OF FINANCIAL ASSETS (Jason H.P. Kravitt ed., 2d ed. 1996 & Supp. 1997); Stephen I. Glover, *Structured Finance Goes Chapter 11: Asset Securitization by Reorganizing Companies*, 47 BUS. LAW. 611 (1992); Harold H. Goldberg et al., *Asset Securitization and Corporate Financial Health*, J. APPLIED CORP. FIN., Fall 1988, at 45; Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1065 (1996); James A. Rosenthal & Juan M. Ocampo, *Analyzing the Economic Benefits of Securitized Credit*, J. APPLIED CORP. FIN., Fall 1988, at 32; Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. L. BUS. & FIN. 133 (1994) [hereinafter Schwarcz, *Alchemy*]; Steven L. Schwarcz, *Structured Finance: The New Way to Securitize Assets*, 11 CARDOZO L. REV. 607 (1990) [hereinafter Schwarcz, *Structured Finance*]; Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEXAS L. REV. 1369 (1991); The Comm. on Bankr. and Corporate Reorganization of the Ass'n of the Bar of the City of N.Y., *Structured Financing Techniques*, 50 BUS. LAW. 527 (1995) [hereinafter *Structured Financing Techniques*].

6. The Bankruptcy Code was enacted through the Bankruptcy Reform Act of 1978. *See* Pub. L. No. 95-598, 92 Stat. 2549 (1978). Section 541(a) of the Bankruptcy Code states that an estate is created upon the commencement of the bankruptcy case. *See* 11 U.S.C. § 541(a) (1994). As part of the Bankruptcy Code's liquidation and asset distribution procedure, that property deemed to be a part of the debtor's bankruptcy estate, and not collateral securing a secured creditor's claim, is liquidated and distributed to the general unsecured creditors. *See id.* § 726(a); DAVID G. EPSTEIN ET AL., BANKRUPTCY 4 (1994).

7. *See infra* notes 205-08 and accompanying text.

8. Section 544(a) of the Bankruptcy Code gives the trustee so-called "strong arm powers," which include the power to avoid certain transfers of property made by the debtor prior to bankruptcy. 11 U.S.C. § 544(a).

number of financially marginal firms securitize an increasingly exotic array of assets and subsequently enter bankruptcy,[9] courts may be persuaded by trustees' legal, economic, and equitable arguments to unwind the securitization transaction and preserve the assets for the benefit of the bankruptcy underdogs—the unsecured creditors. Although neither trustees nor bankruptcy courts have the power or authority to unwind a transaction in the absence of adequate grounds, if the transaction results in significant harm to a firm's unsecured creditors at a time when the firm is in a precarious financial position, bankruptcy judges, in the exercise of their equitable discretion, will rely on existing equitable doctrines and may expansively interpret these doctrines to support their decisions to invalidate these transactions.[10] When this occurs, there will be a drastic adjustive reaction in the market for asset-backed securities.

This Article identifies the possible challenges to the claim of structured finance's efficiency and examines the potential equitable bases for a court's avoidance of these transactions. Part II defines structured finance and describes the nature of the current market for asset-backed securities. Part III outlines the benefits that securitization provides to originators and other transaction participants. Part IV outlines and discusses the debate on the efficiency of secured transactions, applies the substance of this debate to structured finance transactions, and then examines the equitable challenges that may be made to avoid securitized asset transfers. Finally Part V illustrates how the rapid expansion of the securitization market has subjected transaction participants and third parties to mounting uncertainty.

This Article begins a discussion of these issues—it provides no definitive answers. This Article predicts, however, that further research will support the conclusion that securitization is an inefficient transaction. Securitization's structure is designed to divert value away from the originator, in the absence of any compensating controls on either the consideration received in exchange for the asset sale, or the debtor's behavior. The originator enjoys the benefits of this distributional inefficiency, at the expense of its unsecured creditors.

This Article further predicts that courts, in the name of equity, will more carefully examine these transactions' structures in connection with their supervision of an originator's bankruptcy case. When the effects of these transactions on the recovery of unsecured creditors are fully recognized, courts and legislators will take steps to regulate these transactions to address this distributional inefficiency.

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9. *See* 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 ("'When everybody wants to securitize, and everyone is willing to buy, and everyone thinks nothing will go wrong, there gets to be a feeding-frenzy atmosphere, and you have to remain cautious,' says Paul Stevenson, managing director of Moody's Investors Service Inc.'s Asset-Backed Finance group.").

10. *See* discussion *infra* notes 209-79 and accompanying text.

Experiential and empirical evidence is needed before unqualified conclusions can be drawn concerning the effects of securitization on unsecured creditors.[11] Further exploration of the effects of securitization on other participants in the credit markets will become increasingly important as more originators face the prospect of bankruptcy and as more trustees and bankruptcy courts have the opportunity to scrutinize these transactions aggressively.

II. Structured Finance Defined

Securitization has been defined as a "structured process whereby loans and other receivables are packaged, underwritten, and sold in the form of securities."[12] The firm originally owning and selling the receivables is

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11. Empirical research, as with most types of research, begins with the identification of a problem. The problem this Article identifies is a distributional inefficiency experienced by the unsecured creditors of a securitizing firm. Since, ultimately, courts and legislators' policy choices concerning securitization will have profound societal effects, such policies must be supported by empirical evidence of the inefficiencies. This kind of empirical study requires complicated fact finding and analysis of a host of variable factors. Those variables that must be carefully identified and studied include: (1) the incidence of insolvency among securitizing firms; (2) the interest rate charged by secured creditors of securitizing firms; (3) the interest rate charged by unsecured creditors of securitizing firms; (4) the incidence of default payment to unsecured creditors by securitizing firms; and (5) the dividend paid to unsecured creditors of liquidating firms. The results of this study must be compared to a "control group" of similarly situated firms who utilize secured credit as a method of financing. To be truly valuable to those charged with securitization-related policymaking, such a study ought to be designed by those trained in the quantitative and statistical social sciences. There will be an extraordinary number of variables to account for, given the complexity of these transactions and the type of firms that commonly originate them, the great variation among the firms' capital structures, and the dearth of publicly available information regarding the financial and economic circumstances surrounding these transactions. Such challenges, however, should not overshadow the need for policy-informing studies, or chill the enthusiasm of those who, trained in the appropriate research methods, engage in them. *See* Teresa A. Sullivan et al., *The Use of Empirical Data in Formulating Bankruptcy Policy*, LAW & CONTEMP. PROBS., Spring 1987, at 195, 196 (theorizing that "empirical research is vitally needed in the formation of bankruptcy policy"); *cf.* Craig Allen Nard, *Empirical Legal Scholarship: Reestablishing a Dialogue Between the Academy and Profession*, 30 WAKE FOREST L. REV. 347, 348-49 (1995) (arguing that if law professors conduct more empirical research that focuses on the actual effect law has on society, the "gap" between the legal academy and the legal profession would narrow significantly); Howard A. Shelanski & Peter G. Klein, *Empirical Research in Transaction Cost Economics: A Review and Assessment*, 11 J.L. ECON. & ORG. 335, 352 (1995) (concluding that empirical studies of transaction cost economics prove that its predictions are usually accurate). *See generally* JOHN HENRY SCHLEGEL, AMERICAN LEGAL REALISM AND EMPIRICAL SOCIAL SCIENCE (1995) (explaining why law has not followed the path of other academic disciplines in adopting a natural science model of empirical inquiry).

12. ROSENTHAL & OCAMPO, *supra* note 5, at 3. Article 9 of the Uniform Commercial Code (UCC) does not, however, define the term "receivables." For purposes of this Article, the term receivables will mean payment obligations—such as accounts, general intangibles, or chattel paper—owed to a company from a third party. The UCC does define both "account" and "general intangibles." U.C.C. § 9-106 (1994). According to the UCC, an "account" is "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." *Id.* "General intangibles" are "any personal property

a financing-seeking firm, commonly referred to as the "originator,"[13] and the purchasing and securities issuing entity is generally an affiliated special purpose corporation (SPC).[14] SPCs are generally organized in one of two forms: either as a "pay-through" entity or as a "pass-through" entity. A pay-through entity is the transferee of receivables and the issuer of fixed-income securities. The return on these securities is based upon the transferred receivables' anticipated cash flow. A pass-through entity is typically a type of trust that serves as a conduit for the sale of the receivables to investors, with the receivables' payments merely passing through the trust.[15]

The sale of the receivables by an originator to an SPC returns a lump sum cash payment to the originator.[16] Once sold, the receivables' debtors pay on their accounts, either directly to the SPC as servicer, or through a servicing agent who in turn transfers the payment to the SPC.[17] The SPC

(including things in action) other than goods, accounts, chattel paper, documents, instruments, investment property, and money." *Id.* Further, the UCC defines "chattel paper" 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(b).

Other definitions of "securitization" include: (1) "the transformation of an illiquid asset into a tradeable security with a secondary market," *Changes in Our Financial System: Globalization of Capital Markets and Securitization of Credit: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., at 177 (1988) (statement of Prof. David A. Walker, Georgetown University) (cited in Shenker & Colletta, *supra* note 5, at 1373); (2) the trend toward financial assets being securities rather than loans, *see* Tim S. Campbell, *Innovations in Financial Intermediation*, BUS. HORIZONS, Nov.-Dec. 1989, at 70, 71-73; and (3) a process whereby traded instruments such as bonds, notes, and certificates of deposit are substituted for direct borrowing from financial institutions, *see* Cooper, *Innovations: New Market Instruments*, OXFORD REV. ECON. POL'Y, Winter 1986, at 1, 3. In her treatise, Professor Tamar Frankel broadly defines securitization as the transformation of an asset into securities. *See* 1 FRANKEL, *supra* note 5, § 1.1. This definition includes both loan participations as well as the substitution of securities for loans. While much of the discussion in this Article may be applicable to loan participations, the primary focus will be on transactions involving the raising of funds in the public and private markets through the issuance of securities backed by pools of assets.

13. Firms can originate such transactions when they have earnings in the form of cash flow from medium- to long-term obligations owed to them by debtors. Securitized assets commonly have standardized terms, uniform underwriting standards, and both delinquency probability and value that are capable of estimation. *See* Shenker & Colletta, *supra* note 5, at 1376 & n.25.

14. 1 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 5, § 2.02, at 2-13 (defining a special purpose vehicle as a "corporation, trust, or other person organized for a specific purpose, the activities of which are limited to those appropriate to accomplish such purpose, and the structure of which is designed to insulate the vehicle to some degree from the credit risk of an originator or seller of financial assets").

15. *See* 1 FRANKEL, *supra* note 5, § 1.1; *see also infra* note 288 (discussing a new trust entity created by statute, the Financial Asset Securitization Investment Trust (FASIT)).

16. *See* Joan Barmat, *Securitization: An Overview*, *in* THE HANDBOOK OF ASSET-BACKED SECURITIES, *supra* note 5, at 3, 9 (diagraming pay- and pass-through structures).

17. The servicer is the entity that receives payment from the securitized receivables' debtors. This entity may be the originator or may be a non-affiliated entity contracted specifically to perform the servicing function. If the servicing entity is not rated as highly as the ABS, rating agencies require some further protective devices. For example, Standard & Poor's requires payment made to the

issues securities backed by the receivables' cash flow (known as asset-backed securities or ABS) to investors in the capital markets.[18]

Asset-backed securities can be roughly characterized as either real-estate related or non-real-estate related.[19] Real-estate related asset-backed securities, known as mortgage-backed securities, or MBS, are securities backed by the payments on loans secured by residential or commercial real estate.[20] Non-real-estate ABS are backed by the cash flow on any non-real-estate related receivables.[21]

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investors' trustee within 48 hours of receiving the payments, and Moody's requires that there be a substitute servicer available if the original servicer fails. *See* M. Douglas Watson, Jr. & Stephen Joynt, *Rating Asset-Backed Transactions*, *in* THE ASSET SECURITIZATION HANDBOOK, *supra* note 5, at 225-29.

18. These securities may be either privately placed or sold in the public markets. *See* Lowell L. Bryan, *Structured Securitized Credit: A Superior Technology for Lending*, J. APPLIED CORP. FIN., Fall 1988, at 6 (noting that although public issuers dominate, the number of private issuers is increasing).

19. *See generally* WILLIAM W. BARTLETT, MORTGAGE-BACKED SECURITIES: PRODUCTS, ANALYSIS, TRADING 54-79 (1989).

20. *See id.*

21. The clear market distinction between mortgage-backed and all other asset-backed securities transactions can be traced to the difference in the respective market's historical development. The mortgage market has historically been the largest user of long-term credit. When the "credit crunch" of the 1960s decreased the funds available for residential real estate purchases, the secondary mortgage market flourished. *See id.* at 7. Although the real estate market is comprised of many different public and private players, the central asset that drives this securities market remains the single-family home and the corresponding loan and mortgage. *See id.* at 54-55. In the most basic formulation, shifts in the secondary mortgage market and the market for mortgage-backed securities correspond to the behavior of homeowners, as well as the economic and interest rate realities at a particular time. *See generally id.*

As the government-insured and guaranteed securities market developed, private sector lenders increasingly saw the advantages of selling off both their residential and commercial real estate loans in the secondary market. As a result, lenders interested in securitizing their real-estate-related assets tried to address investor concerns regarding portfolio quality and documentation uniformity. Consequently, uniform legal documentation for conventional loans for real estate purchases became more common, further facilitating the sale of these loans to secondary market investors. *See* Andrew Lance, *Balancing Private and Public Initiatives in the Mortgage-Backed Security Market*, 18 REAL PROP. PROB. & TR. J. 426, 438 (1983); Michael E. Stone, *Housing and the Dynamics of U.S. Capitalism*, *in* CRITICAL PERSPECTIVES ON HOUSING 56 (Rachel E. Bratt ed., 1986).

In 1984, the federal government once again supported and encouraged active trading in the secondary mortgage market by enacting the Secondary Mortgage Market Enhancement Act (SMMEA). *See* Pub. L. No. 98-440, 98 Stat. 1689 (1984) (codified in scattered sections of 12 U.S.C. and 15 U.S.C. (1988)); Shenker & Colletta, *supra* note 5, at 1385. This Act was designed to further facilitate the market for mortgage-backed securities by removing some of the legal impediments to the issuance of private mortgage-backed securities. The SMMEA removes legal impediments to the issuance of private mortgage-backed securities in four principal ways. First, it permits depository institutions to invest in privately issued, mortgage-related securities (as that term is defined in the Securities and Exchange Act of 1934, 15 U.S.C. § 78c(a)(41) (1994)). *See* 12 U.S.C. § 24, at 9 (1994); *id.* § 1757(7)(E). Second, it preempts certain state legal-investment laws thereby permitting state-regulated institutions to invest in mortgage-related securities, *see* 15 U.S.C. § 77r-1(a) (1994), although a number of states, including Arkansas, Louisiana, Minnesota, New Mexico, South Dakota, Utah, and West Virginia, have overridden SMMEA's preemption of its legal investment laws. *See* Shenker & Colletta, *supra* note 5, at 1385 (citing Pub. L. No. 98-440, 98 Stat. 1689 (1984) (codified in scattered sections of 12 U.S.C.

The market for non-real-estate-related asset-backed securities is relatively new compared to the MBS market.[22] The early non-real-estate-related, quasi-securitizations involved the issuance of standard accounts-receivable-backed commercial paper fully supported by letters of credit.[23] Following these early transactions, firms became increasingly more creative and began securitizing automobile loans, leases, and credit card receivables.[24] As the market for ABS has expanded in recent years, issuers have become even more imaginative with respect to the type of receivables securitized. Examples of recently issued ABS include bond issuances backed by unpaid real estate taxes,[25] securities backed by hotel and hospitality receivables,[26] taxi cab medallion-backed securities,[27] securities backed by the excess spread from previously issued credit card securitizations,[28] securities

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and 15 U.S.C.)). Third, it preempts state blue sky laws by exempting mortgage-related securities from registration under state securities laws to the same extent that securities issued or guaranteed by the government or a related agency or instrumentality are exempt. *See* 15 U.S.C. § 77r-1(c). Fourth, it amended § 7 of the Securities Exchange Act of 1934 by permitting delayed delivery of mortgage-related securities under certain conditions, thereby allowing a forward-trading market to develop. *See* 15 U.S.C. §§ 78g(g), 78h(a), 78k(d)(1). These developments have resulted in significant increases in the capital available to the residential housing market. *See* Shenker & Colletta, *supra* note 5, at 1386.

22. *See* William J. Haley, *Securitization Techniques for Non-Mortgage Assets*, *in* MORTGAGE AND ASSET SECURITIZATION 216, 216 (Robert Lawrence Kuhn ed., 1990); Barmat, *supra* note 16, at 14.

23. *See* ROSENTHAL & OCAMPO, *supra* note 5, at 26.

24. The asset-backed securities market saw its real start in 1985 when the Sperry Corporation originated the first true structured finance transaction, in which it sold, through a special purpose corporation, $192 million lease-backed notes in the public markets. General Motors Acceptance Corporation followed the Sperry deal with its securitization of more than $8 billion between late 1985 and 1986. Three investment banking firms, First Boston, Salomon Brothers, and Drexel Burnham Lambert captured the bulk of the lucrative commissions from these deals. Seeing an opportunity to expand into this market, at least 14 major investment banks, including Goldman, Sachs & Co., Merrill Lynch, Dean Witter Reynolds, Kidder Peabody, and the investment banking units of Citibank and Chemical Bank began aggressively seeking asset-backed security issuances to underwrite. *See* Bryan, *supra* note 18, at 4-5; *Structured Financing Techniques*, *supra* note 5, at 538-39.

25. New York City raised $208 million in a AAA-rated public bond offering backed by $1.5 billion in unpaid real estate taxes. In 1993, Jersey City, New Jersey was the first municipality to raise funds in the markets backed by unpaid real estate taxes. *See Big Apple Is Second City to Securitize Tax Liens; Chemical Underwrites Successor to Jersey City Deal*, INVESTMENT DEALERS' DIG., June 27, 1994, at 13. It has been predicted that the "municipal tax lien securitization market will grow to at least $5 billion a year," as governments get out of the tax collection business. Amy B. Resnick, *Tax Lien Market Is Set to Take-off, Industry Players Say*, BOND BUYER 1996, *available in* 1996 WL 564443. Securitization of tax liens offers municipalities the opportunity to raise cash and clean their balance sheets. *See id.*

26. *See* Ken Wilson, *Hotel Financing Returns; Securitization Provides Vehicle*, 209 HOTEL & MOTEL MGMT., Mar. 21, 1994, at 25, 25 (noting that securitization of hotel receivables could result in a $1 billion capital infusion into the hotel industry by 1996).

27. *See Myth Becomes Reality: Taxi Cab Medallions Securitized*, ASSET SALES REP., Dec. 19, 1994, at 1.

28. The collateral in this deal consisted of a portion of the difference between the interest rate on the underlying loans and coupons on the previously issued asset-backed security. *See* Jeanne Burke,

backed by health-care receivables,[29] and securities backed by government-contract receivables.[30]

In addition, new types of entities have been originating securitization transactions in recent years. Many banks, thrifts, and finance companies, at the urging of investment bankers, have transitioned from being "portfolio lenders"[31] to being substantial issuers of asset-backed securities.[32] Similarly, business entities with poor credit ratings and those

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First USA Securitizes Excess Spread, PRIVATE PLACEMENT REP., June 27, 1994, at 4, *available in* 1994 WL 3272622.

29. *See New Prescription for ABS Market*, TREASURY MANAGER'S REP., Mar. 1, 1996, *available in* 1996 WL 7867346 (reporting that a pharmacy group pooled $500 million in pharmacy receivables and issued ABS). For a comprehensive discussion of health care receivable financing, see Cathy M. Kaplan, *Securitization of Non-Traditional Assets*, *in* NEW DEVELOPMENTS IN SECURITIZATION 231 (PLI Real Estate Law & Practice Course Handbook Series No. N-385, 1992).

30. *See* Kaplan, *supra* note 29, at 250-58. Other creative securitization products include the following: (1) The U.S. Postal Service, American Express, and Daiwa Corp. created a special-purpose corporation to sell bonds in the structured-finance markets backed by the money orders sent by Mexican immigrants to their families in Mexico. *See* Anne Schwimmer, *Post Office, Amex Securitize Money Orders Sent to Mexico: Daiwa Raises $100 Million in Unusual ABS Deal*, INVESTMENT DEALERS' DIG., July 4, 1994, at 12. (2) Citicorp issued bonds backed by a cash stream of money predicted to be spent by tourists in Jamaica. *See id.* The legal issue with respect to these securitized assets was whether a "money future" is deemed to be an "account" under Article 9 of the Uniform Commercial Code. For a discussion of the unsettled nature of the law relating to securitization, *see infra* Part V. (3) Harley-Davidson, Inc., securitized $21 million of motorcycle loan receivables in 1994 through a private placement of debt securities. *See Harley-Davidson Returns with Triple-A Deal*, ASSET SALES REP., June 27, 1994, at 6, *available in* 1994 WL 3765508. (4) A relatively complex securitization of the cash flow proceeds from corporate jet sales subjected investors to the contingencies in the payment flow of the receivables and, thus, offered them high yields in exchange for increased risk. *See* John Hintze, *Bombardier Drops Off-Balance Sheet Deal with Hot Spread*, ASSET SALES REP., June 29, 1990, at 5. (5) The Pacific Lumber Co. has issued notes backed by the expected revenue from the sale of timber. *See Structured Financing Techniques*, *supra* note 5, at 539 (noting that this issuance is "[p]erhaps the most unusual transaction to date"). (6) David Bowie had bonds issued that were backed by future royalties from his old songs. *See* Andrew Fraser, *Staid Prudential Rocks with Ziggy*, PORTLAND PRESS HERALD, Feb. 15, 1997, at 6D ("They allow Bowie to collect $55 million up front instead of waiting for the royalty checks to trickle in over many years. They provide Prudential with a 7.9 percent return on its investment over 10 years—an even higher return than the 6.37 percent yield on the new 10-year Treasury note."); *see also* Woolley, *supra* note 9, at 64 (describing securitization as a "red hot financing technique," and listing new asset types securitized to include security alarm contracts, student loans, mutual fund fees, delinquent child-support payments, royalty streams from films, home improvement loans, and suggesting that "parking tickets and bridge tolls may be next").

31. A portfolio lender is a lender that makes loans and holds them in its own portfolios as assets to earn the interest paid by borrowers. *See* Robert I. Reich & Charles W. Sewright, Jr., *The Bank Role*, *in* THE ASSET SECURITIZATION HANDBOOK, *supra* note 5, at 385.

32. Although banks have historically sold loans to free up cash and increase their liquidity, following bank deregulation the sale of entire loan portfolios accelerated. Deregulation increased competition among banks; as a result, banks had greater trouble attracting deposits to maintain the liquidity and reserve levels necessary for active lending programs. This led banks to view more favorably the practice of selling their loans to raise cash for continued lending. *See id.* at 386. In 1985, Marine Midland Bank in partnership with Salomon Brothers issued the first nonmortgage receivable-backed securities. The Certificate of Automobile Receivables (CARS) grantor trust was created to issue securities in a private placement backed by consumer automobile loans. Later that year, Valley National Bank together

entities who, because of high interest rates, are reluctant to borrow money conventionally from banks are increasingly turning to securitization as a way to secure capital at lower cost.[33]

Recently, the ABS market was characterized by one market observer as one of "increased competition, greater volume and [one that is increasingly trading in] exotic asset classes."[34] The substantial volume of ABS issuances has been attributed to "an almost insatiable appetite for new offerings."[35]

This appetite has resulted in substantial profit being realized by many of the securitization transaction participants.[36] The list of participants includes the originator, the asset transferee, the rating agency or agencies,[37] the financial institution or other type of insurer for the purpose of providing credit enhancement,[38] an entity charged with the responsibility of servicing the credit,[39] a trustee as representative of the security holders, counsel for the originator and underwriters, accountants,

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with First Boston issued securitized automotive receivable-backed securities to the public. Since 1985, billions of dollars in automotive loans and credit card receivables have been sold in structured securitized transactions. *See id.* at 388.

33. The annual issuance of securities backed by assets other than mortgages increased from slightly over $1 billion in 1985 to almost $43 billion by the end of 1990. *See* Franklin D. Dreyer, Address Before the Subcommittee on Policy, Research and Insurance of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives (July 31, 1991), *in* FED. RESERVE BULL., Sept. 1, 1991, at 7, *available in* 1991 WL 2861665. According to Chase Securities, $111 billion in asset-backed securities were sold on the public markets through September 30, 1996, and $7.5 billion of ABS were sold on the private market through that date. *See* Aaron Elstein, *Merrill Sees Danger In Surging Growth of Asset-Backed Market*, AM. BANKER, Oct. 2, 1996, at 24. Because of the increasing popularity of structured financing as an alternative to traditional commercial lending, banks, investment banks, and other financial institutions—including Citicorp (the ground-breaker in issuing asset-backed commercial paper), Bankers Trust, First Boston Corp., Donaldson, Lufkin & Jenrette, and Salomon Brothers—have developed expertise in structured finance transactions and have created departments specializing in securitizations. *See* Michael Liebowitz, *Can Corporate America Securitize Itself*, INVESTMENT DEALERS' DIG., Jan. 27, 1992, at 14.

34. *Private Market Dotes on Exotic Asset Classes*, INS. ACCT., Sept. 16, 1996, at 1, *available in* 1996 WL 11827605.

35. Elstein, *supra* note 33, at 24.

36. *See* John C. Edmunds, *Securities: The New World Wealth Machine*, FOREIGN POL'Y, Fall 1996, at 118, 118 (1996) (stating that securitization has become the most powerful engine of wealth creation in today's world economy).

37. *See infra* note 52 and accompanying text.

38. Credit enhancement devices include letters of credit, private insurance, guarantees, or other payment assurances. Credit enhancement is designed to ensure that payment will be made on the issued securities as they become due. If there is a payment shortfall on the underlying assets, the SPC draws upon the credit enhancement and pays investors from this draw. Rating agencies, in employing what they refer to as the "weak link policy," will not rate asset-backed securities higher than the credit rating of the third-party provider of the credit enhancement. *See* 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 5, at 195, 204, 203-04.

39. *See supra* note 17.

the underwriters responsible for placing the ABS issuance,[40] the ABS traders, and the ABS investors.[41] The extent to which third parties experience corresponding negative effects from the proliferation of these transactions is an issue not yet well explored.

Although securitization can take many forms, this Article will focus on the most common model or prototype of securitization. Such a structure assumes that the originator is a corporation and the assets securitized are accounts receivable. Such a structure also assumes that the SPC is a corporate subsidiary of the originator formed for the exclusive purpose of purchasing the originator's pool of assets and then issuing securities backed by these assets in either the public or private markets.[42]

III. Why Firms Securitize Assets

Firms securitize their assets for the same reason firms borrow money: to raise money for either special projects or working capital.[43] Rational firms choosing to securitize their assets rather than use them as collateral for a secured loan conclude, on balance, that securitization's net benefits exceed the benefits of the possible financing alternatives.[44] These benefits include improving liquidity, increasing diversification of funding sources, lowering the effective interest rate, improving risk management, and achieving accounting-related advantages.[45] Further, firms may securitize their assets because of the persuasive influence of professional advisors

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40. *See* Woolley, *supra* note 9, at 64 (asserting that, according to the head of Standard & Poor's New Assets group, Calvin R. Wong, "There is a huge investment-banking community going after [securitization] business and an insatiable demand from investors").

41. *See* ROSENTHAL & OCAMPO, *supra* note 5, at 12-17.

42. Variations on this prototype include: (1) the use of Multi-Seller Vehicles (MSVs), which are SPCs created specifically to purchase and fund receivables portfolios from a variety of originators and are not subsidiaries of their originators (for bankruptcy-remote purposes, the SPC may be a subsidiary of the investment bank or underwriter); and (2) originators in the form of partnerships, limited liability companies, banks, thrifts, or any other entity holding eligible receivables. *See generally The Lure of Multi-Seller Vehicles*, CORP. FIN., Oct. 1994 (Supp.), at 6.

43. *See* 1 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 5, § 1.01, at 1-3 to -8 (suggesting that the general purpose of securitization is to effect business financing, and describing more particular secondary goals as well).

44. *See* Meredith S. Jackson, *Leap of Faith: Asset-Based Lending to Asset-Backed Securitization—A Case Study*, STAN. J.L. BUS. & FIN., Winter 1996, at 193 (discussing in the context of a case study some of the challenges faced by securitizing originators, as well as the potential benefits).

45. In a recent article entitled *The Death of Liability*, Professor Lynn LoPucki offered another reason firms may decide to securitize their assets: to judgment-proof themselves. Professor LoPucki characterized asset securitization as both a "substitute for borrowing and a powerful new strategy for judgment proofing," and described a model in which a corporation sells its assets and distributes them to its shareholders in the form of dividends. Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 24 (1996) (footnote omitted). The corporation then leases back the assets and continues to operate as it did prior to the securitization, except that the corporation, now devoid of assets, is completely judgment proof. *See id.* at 25-26.

who stand to benefit financially from an increasing number of securitization transactions.

A. *Trends in the Financial Industry*

In recent years, securitization has become quite trendy,[46] and trends in the financial industry are as influential as trends in other market sectors. Trends are driven by industry leaders, and in the financial services sector, the leaders have had significant power and influence.[47] When a firm is seeking financing, it will in most cases seek the advice of legal counsel and financial advisors. In many cases, these advisors counsel their clients to engage in types of financing schemes with which the advisors are most familiar at the moment and those that are the most profitable for the advisors.[48] In this way, legal advisors are able to distinguish themselves

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46. *See* James C. Allen, *1st Union Card Issue Clears Way for More Offerings*, AM. BANKER, March 1, 1996, at 18 ("A successful credit card securitization by First Union Corp. last week has set the stage for a number of commercial banks looking to tap the asset-backed securities market as another funding tool."); *The Card Bond Express Keeps Picking Up Steam*, CREDIT CARD NEWS, Feb. 15, 1996, at 1, *available in* 1996 WL 8385627 (noting that "almost nothing can dull the luster of securities backed by credit card receivables," because, despite an "uptick in delinquencies and charge offs, 1995 proved to be another record breaking year, with securitizations totalling $43 billion, up 31% from $32.8 billion in 1994;" further, "most observers expect a repeat performance in 1996"); *Frontlines: The Markets: ABS Issues Hit Record in 1995*, PENSIONS & INVESTMENTS, Feb. 19, 1996, at 8 ("Asset backed securities issuance [in 1995] shattered the prior year's record. The public asset-backed market recorded total volume of $107.792 billion in 1995, a 42% increase from 1994's $75.925 billion."); *Have Asset, Will Securitize*, TREASURY MANAGER'S REP., July 7, 1995, *available in* 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 . . . .").

47. Allen, *supra* note 46, at 18 (quoting a senior banker with CS First Boston's asset securitization group who stated, "We expect to see an overall rise in volume of asset-backed securities by banks in 1996"); *ITT Hartford Stays Bullish on ABS Opportunities*, INS. ACCT., Feb. 5, 1996, at 2, *available in* 1996 WL 5569096 (praising ABS as "sterling" investments).

48. Securitization transactions have higher up-front expenses compared to RHS funding arrangements, and the bulk of these up-front transaction costs end up in the pockets of the deal professionals. Transaction costs include legal fees, underwriter fees, fees charged in connection with credit enhancement, rating agency fees, accounting fees, and financial advisory fees. How high the transaction costs are depends upon a number of factors, including the quality of the receivables to be securitized, the necessity of credit enhancement, the type of credit enhancement, the experience of the originator and the legal and financial advisors, the size of the proposed transaction, and the availability of funding alternatives. Rating agencies charge sizable fees to perform the diligence necessary to rate a security issuance. In addition, because ABS are relatively new financial products, the market has demanded that they carry a high credit rating. This means that credit enhancement must be a component of the transaction, and credit enhancement can be very costly. The losses against which credit enhancement protects investors include default on the underlying receivables, returns for defective or damaged goods, discounts given by the originator for early payments, and carrying costs incurred in connection with late payments or delinquencies. The level of credit enhancement is usually based upon a historical ratio, in the range of three times the highest default rate over the past 12 months, or 5% of the face value of the assets. If the securitization does not have sufficient credit enhancement, investors must be compensated in the yield they receive on their investment.

In addition, accounting and legal fees for a structured-finance transaction can be significant largely because of the complexity of their structure and the multitude of legal issues that must be from those who might recommend more traditional and less profitable forms of financing.

Because it is an extremely time-consuming and complex undertaking for legal and financial counselors to structure securitization transactions, once a firm has completed one transaction and has developed an expertise, the pieces are in place for that firm to participate in other similar transactions.[49] This natural phenomenon has not only resulted in an increasing number of originators engaging in repeat securitizations, but it has also led to the proliferation of structured-finance boutique groups within large law firms,[50] structured finance legal departments, structured finance groups in investment banks,[51] and in the nationally recognized statistical-rating agencies (referred to herein as rating agencies or NRSROs).[52] These "experts" have a significant influence upon potential

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addressed in the documentation. For example, the SPC must be formed, and boards of directors must be put into place. Disclosure documents must be prepared, and the transaction must be in compliance with the governing body of law, which includes Article 9 of the UCC, the Securities Act of 1933 and the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Internal Revenue Code. The governing law is still evolving, and to successfully avoid legal pitfalls, a legal advisor must be fully familiar with the relevant statutes and legal issues. *See infra* Part V (discussing the current unsettled state of both statutory and caselaw in response to the evolving market). As is the case with all public security issuances, underwriting fees, financial advisory fees, and Securities and Exchange Commission (SEC) registration fees are also significant. These fees are not incurred when a company uses RHS bank financing to raise capital. *See, e.g.*, Jonathan E. Keighley, *Risks in Securitisation Transactions*, *in* THE GLOBAL ASSET BACKED SECURITIES MARKET, *supra* note 5, at 99, 100-02; Kenneth P. Morrison, *Documenting the Asset-Backed Securities Transaction: Managing the Process Toward a Quality Outcome*, *in* NEW DEVELOPMENTS IN SECURITIZATION 1993, at 281, 300-02 (PLI Commercial Law & Practice Course Handbook Series No. 677, 1993) (explaining the transaction costs inherent in an ABS and suggesting ways by which a lawyer can help a client reduce unexpected cost overruns); Watson & Joynt, *supra* note 17, at 234-35 (discussing the functions and fees of the servicer and the trustee).

49. *See* Morrison, *supra* note 48, at 287-88 (describing the tension between the complexity of these transactions and the need to keep costs low).

50. The Westlaw Legal Directory lists approximately 65 law firms who have identified themselves as having structured-finance expertise. Search of WL, WLD (Nov. 23, 1997). Structured-finance legal work is best suited to large law firms due to the many different areas of substantive expertise the work requires, such as familiarity with the Securities Act of 1933, the Internal Revenue Code, Article 9 of the UCC, and the Bankruptcy Code.

51. Investment banks include JP Morgan, Morgan Stanley, Salomon Brothers, CS First Boston, and Oppenheimer. Chase Manhattan Bank and Manufacturer Hanover Trust each have investment banking arms. The growth in volume, total value, and complexity of the securitization market can be attributed in part to increased competition among financial advisors. Investment banks have been motivated by the substantial underwriting fees and trading profits earned from securitization transactions. *See* Bryan, *supra* note 18, at 13-14 (noting that the expanded potential for revenue generated by ABS has provided strong incentives for investment banks to become involved); Paresh Mashru & Mark Rhys, *Asset-Backed Finance—Risk Control for Traders in Asset-Backed Securities*, *in* THE GLOBAL ASSET BACKED SECURITIES MARKET, *supra* note 5, at 217, 217 (pointing out that financial advisors have recognized that the increased interest-rate volatility and changing credit conditions inherent in ABS have improved the market's potential to create earnings, sparking heightened competition among advisors).

52. There are six nationally recognized statistical-rating organizations that all have structured-finance "groups" or "departments": Moody's, Standard & Poor's, Fitch Investors, Duff & Phelps,

originators and the originators' willingness to utilize securitization as a funding and financing strategy.[53]

Furthermore, rating agencies have significant influence on the behavior of a transaction originator's legal advisor and the scope of the legal opinion prepared in connection with a transaction.[54] The rating agencies' insistence on legal opinions that place the transaction in its most favorable light to market investors has led, in certain instances, to a "race to the bottom," with some law firms drawing conclusions in their opinions that are not substantiated by the present state of the law.[55] In these times of increasing competition and drive for profits, firms with a hunger for lucrative structured-finance clients may be swayed by the persuasive powers of

IBCA Banking Analysis, and Thomas Bankwatch. The specialists who work in these departments conduct the research necessary to rate the ABS issuances, as well as to analyze the structure and nature of each proposed transaction. The designation of a rating institution as an NRSRO is made by the SEC Division of Market Regulation through the issuance of no-action letters. If a rating agency wishes the designation of NRSRO, it sends a letter to the SEC requesting that the SEC recommend no regulatory enforcement action against the rating agency if it designates itself an NRSRO. Formal standards for such a designation have not been developed; the SEC instead relies on the market acceptance of rating agencies using such designation. *See* Nationally Recognized Statistical Rating Organizations, Exchange Act Release Nos. 33-7085, 34-34616, 59 Fed. Reg. 46314, 46316 (Sept. 7, 1994) (noting that the Division of Market Regulation "believes that the single most important criterion is that the rating agency is in fact nationally recognized by the predominant users of ratings in the United States as an issuer of credible and reliable ratings"); 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); *see also* Gregory Husisian, Note, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411, 424-25 (1990) (noting the market impact of agency ratings and the hands-off approach to date by lawmakers and courts).

53. *See* Note, *A Conceptual Framework for Imposing Statutory Underwriter Duties Involved in the Structuring of Private Label Mortgage-Backed Securities*, 70 ST. JOHN'S L. REV. 779, 789-90 (1996) (stating, in the mortgage-backed securities context, that competition in the ratings industry may be leading to lower rating standards because, as economically self-interested market participants, issuers are motivated to use rating agencies that provide the most favorable rating, and thus, the lowering of rating standards by some rating agencies has had a positive impact on those agencies' market share); *see also* ROSENTHAL & OCAMPO, *supra* note 5, at 13-17 (explaining that asset-backed securitization will lead to a more efficient financial-services industry and predicting that firms that capitalize on this new trend will benefit from the industry's evolution, while firms that lack skills or fail to adapt to the new industry structure will suffer).

54. These types of legal opinions are known as "third-party opinions." In third-party opinions, attorneys draw conclusions with respect to specific legal issues, and these conclusions may only be relied upon by the addressee—not the public at large or even other participants in the transaction. *See* Tribar Opinion Comm., *Special Report by The TriBar Opinion Committee: Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions*, 46 BUS. LAW. 717, 724 (1991) [hereinafter TriBar Report].

55. Historically, lawyers have not given legal opinions on bankruptcy law; even today, bankruptcy issues are carved out of the remedies opinion. *See id.* at 718. As securitization and other complex financing transactions have become more common, the market (that is, rating agencies) has increasingly begun to request that these kinds of opinions be issued by the transaction originator's counsel. *See id.* at 719-20; *infra* notes 260-63 and accompanying text for a more complete discussion of legal opinions delivered in connection with securitization transactions.

the rating agencies to offer a legal opinion that less hungry firms would not agree to deliver.[56] The financial services industry and its counterpart, the legal community serving the financial services market, are motivated by profit, and profit often drives decisionmaking. As Part V will discuss, this does not always result in the greatest net benefit to the market.

B. *Improvement of Liquidity*

All originators who securitize their assets enjoy an improvement in asset liquidity management. By definition, the process of securitization transforms future payments into instant cash,[57] and this transformation allows entities to recognize immediately the value of these assets for a variety of uses, including current business needs.[58] The sale of assets, even at a discount,[59] results in a lump sum cash payment to the originator.

There are many positive consequences of a firm's increased liquidity.[60] In the case of originators with trade creditors, enhanced liquidity may permit a more fluid cycling of inventory, thus increasing the chance that a firm may become able to pay its suppliers' invoices as they become due.[61] Because in many cases suppliers of inventory are

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56. *Cf.* Steven Brill, *Ruining the Profession*, AM. LAW., July-Aug. 1996, at 5 (challenging the contention that the public dissemination of large law firm profits has led to the decline of professionalism among lawyers).

57. The degree of liquidity, however, depends upon the degree of collateralization required of the asset-backed security. The transformation of an asset worth $1000 into $1000 cash provides the issuer with maximum liquidity. More likely, however, conservative rating agencies as well as risk-averse investors would require that the asset value exceed the cash proceeds by certain specified percentages. For example, in a 1991 securitization of computer leases by Comdisco Receivables, Inc., the principal amount of the ABS sold represented 92% of the initial aggregate-discounted lease balance. *See* David L. Gold & Julie P. Schlueter, *Credit Risks and Their Analysis in Asset Securitization*, *in* THE GLOBAL ASSET BACKED SECURITIES MARKET, *supra* note 5, at 153, 159-60 (discussing a transaction underwritten by Salomon Brothers that featured a particularly complex credit analysis).

58. For companies with trade receivables, securitization can result in more efficient management of a firm's cash requirements and growth-related expenses. *See* Glenn B. McClelland, Jr. & James W. McDonald, Jr., *Securitizing Trade and Lease Receivables*, *in* THE ASSET SECURITIZATION HANDBOOK, *supra* note 5, at 123, 130. In the case of financial institutions, securitizing loan portfolios and other receivables enables them to retain the difference between the rate of return received upon the sale of the receivables and the interest rate paid by the financial institution's borrowers. *See* Bryan, *supra* note 18, at 15.

59. For example, in a trade receivable-backed transaction, the SPC's

> purchase of receivables from the originator is generally [made] at a discount to reflect: [First, an] interest component for the expected payment period[; second, a] component for dilutions, such as returns and warranty claims, offsets, volume discounts, early payment credits and rebates[; and third, a] factor for expected losses.

Securitizing Receivables in the U.S., CORP. FIN., Oct. 1994 (Supp.), at 28, 29. In a credit card receivable-backed transaction, there is no discount for the interest component because a predetermined finance charge is established. *Id.*

60. *See generally* FEDERAL RESERVE BANK OF N.Y., FUNDING AND LIQUIDITY: RECENT CHANGES IN LIQUIDITY MANAGEMENT AT COMMERCIAL BANKS AND SECURITIES FIRMS (1990).

61. For a discussion of the extent to which creditors are paid from the cash received by a business with a steady cash flow, see *infra* text accompanying notes 176-78.

unsecured trade creditors, this cash infusion may improve their chance of repayment.[62]

The transformation of a future payment stream into immediate cash may further enable an originator to pursue a potentially profitable project or merely meet its regular obligations. Cash represents generalized purchasing power and is needed by businesses to invest in research and development, to pay dividends to shareholders, and to engage in other long-term investments,[63] a need not always satisfied by a firm's erratic payment stream of receivables. These investments, in turn, may enable a firm to grow in profitability and, therefore, be in a better position to pay its creditors—including its unsecured creditors—when the firm's debts become due. Cash flow concerns are often paramount in management's mind, and the ability to readily transform assets into cash may provide a firm with a competitive advantage, both for long-term development planning and for short-term credit problem resolution.[64]

C. *Diversification of Funding Sources*

Even firms ordinarily able to get financing may be able to tap a new market of investors through securitization; individuals and institutional investors who would not ordinarily invest in an originator directly may be willing to invest in that originator's asset-backed securities.[65] This potential market expansion is important for rapidly growing firms that have exhausted their typical funding sources or whose typical funding sources are offering financing at prohibitively high rates.[66]

Moreover, a firm may find that due to the presence of restrictive covenants in the documentation of existing financing arrangements, securitization is the *only* possible way for it to raise funds; a bad credit history or a lack of a financial track record has a limiting effect on alternative financing methods that rely on the firm's credit rating.[67]

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62. Even when trade creditors are secured by a floating lien on their debtor's inventory, they are often vulnerable to inventory value fluctuations. If a debtor uses cash received upon the sale of inventory for purposes other than paying the inventory supplier or purchasing additional inventory, the supplier may find itself without collateral, or with collateral valued at less than the amount of the credit extended. *See* LYNN M. LOPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 199 (1995).

63. *See* GEORGE W. GALLINGER & P. BASIL HEALY, LIQUIDITY ANALYSIS AND MANAGEMENT 41-42 (2d ed. 1991); WILLIAM L. MEGGINSON, CORPORATE FINANCE THEORY 29 (1997).

64. *See id.*

65. *See Structured Financing Techniques*, *supra* note 5, at 529-30 (explaining that funding resources can be structurally isolated and thereby protect investors from bankruptcy risk). Citicorp and Sears, Roebuck and Co. marketed their credit-card-backed securities to retail institutional investors. Chrysler Credit Corp. marketed its auto-loan-backed securities to money market mutual funds and medium term investors. *See* 1 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 5, § 3.02[c].

66. *See Structured Financing Techniques*, *supra* note 5, at 529-30.

67. *See* Barbara A. Nunemaker, *Credit Ratings on International Asset-Backed Securities*, *in* ASSET SECURITIZATION, *supra* note 5 at 134, 136-37.

Diversification of funding sources may also improve the originator's overall credit rating; a firm with a diversity of funding options generally has somewhat higher credit quality than a firm that solely utilizes commercial lending financing sources.[68] Credit ratings reflect the likelihood that investors will be repaid their investment, plus interest, on time and on the terms described in the transaction's offering documents, and provide investors with a means to compare a variety of investment products. The lower a security is rated, the higher risk it is deemed to be and thus the higher return paid. As such, lower rated securities result in more expensive funding for their issuers.[69] In some cases, a firm may find it financially prudent to engage in a securitization in order to improve its credit rating and then to return to the traditional commercial finance market as a better credit risk.[70]

D. *Improved Risk Management*

Risk management is often a fundamental objective of securitizing firms.[71] Unlike traditional lending arrangements, a successful securitization is dependent upon investors' satisfaction with the quality of the assets backing the ABS, not the credit quality of the originator.[72]

In a traditional lending arrangement, the same institution originates the loan, structures the terms, bears the credit risk, provides the funds, and services the collection of principal and interest.[73] As such, whatever risks the borrower offers are fully absorbed by the lender.[74] These risks include the possibility that the value of the collateral will decline, the potential for nonpayment or late payment of the underlying collateral, the prospect of the borrower becoming subject to unexpected (or expected) liability, the uncertainty of interest rate fluctuation, any fallibility associated with the borrower's previous borrowing record, the uncertainty associated with a limited borrowing history, and the potential of borrower's bankruptcy.[75] These risks are commonly referred to as "event

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68. *See* Goldberg et al., *supra* note 5, at 49 (outlining the approach taken by Moody's Investor Service to assess the impact of securitization on the general credit quality of originators).

69. *See id.*

70. *See id.*

71. *See* ROSENTHAL & OCAMPO, *supra* note 5, at 12 (describing how credit securitization can lead to a more efficient financial-services industry).

72. *See id.* ("Investors in asset-backed securities are structurally protected from the event risk that the originator's credit quality may deteriorate.").

73. *See id.* at 6-13.

74. *See id.*; Rosenthal & Ocampo, *supra* note 5, at 33.

75. There are some securitization structures, however, that provide for the originator to absorb the first loss tranche, up to a specified level. This is most often the case when the originator is performing the servicing function. The theory behind this structure is that, in connection with its performance of the account servicing, the originator has direct contact with the receivables borrower and,

risks."[76] Secured lenders address the issue of risk by reviewing the debtor's likelihood of default and evaluating the borrower's character, repayment capacity, and economic and financial projections for the entire term of the loan.[77] This may involve the ongoing monitoring of the debtor's business behavior and practices.

The ABS investors, in contrast to secured lenders, do not bear all of the risks associated with the originator and its business and instead rely upon risk-containing measures that are made a part of the transaction.[78] For example, credit enhancement allows the party providing the letter of credit or guaranty to bear a portion of the risk of nonpayment or late payment, in exchange for a fee.[79] In addition, when an originator securitizes its highest quality assets it minimizes the ABS investors' risk. Conversely, the risk exposure of the firm's other creditors is heightened by this asset division.[80] Furthermore, because there are no unknown or uncertain events in the future that could alter the quality of the ABS investors' investment, the investors are not subject to the vagaries of the originator's business behavior, and their risk exposure is limited to the obvious risks associated with the assets in the pool.[81]

Finally, securitization, as a risk-contained method of financing, has proven to be a useful strategy for firms which have filed for bankruptcy under Chapter 11 of the Bankruptcy Code[82] and who need to raise post-petition funds.[83] After the originator in bankruptcy structures its securitization, it must file a motion with the bankruptcy court pursuant to

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as such, is in the best position to evaluate the risk of and absorb this first loss. *See* Rosenthal & Ocampo, *supra* note 5, at 34.

76. Nicholas Millard, *The Management and Transfer of Credit, Liquidity and Contingency Risks*, *in* THE GLOBAL ASSET BACKED SECURITIES MARKET, *supra* note 5, at 127, 127 (defining event risks as "the risk that the rating of the party which has assumed the credit and liquidity risks may have its own credit status lowered, thereby leading to an overall reduction in the rating on the security").

77. *See* DUANE B. GRADDY ET AL., COMMERCIAL BANKING AND THE FINANCIAL SERVICES INDUSTRY 256-59 (1985). In addition, asset quality risk can be addressed by segmenting the assets into tranches with common risk characteristics and then marketing them to appropriate investors. Those market participants willing to absorb, for example, a higher risk of default, late payment, or prepayment can be offered a class of ABS with a higher yield than that offered by ABS with a lower risk of default. *See* ROSENTHAL & OCAMPO, *supra* note 5, at 13.

78. *See* ROSENTHAL & OCAMPO, *supra* note 5, at 13.

79. *See supra* note 38.

80. *See infra* Part IV.

81. Because many originators tend to extend credit within certain limited geographic areas, economic downturns or declines in such areas often impact originators' financial health (as well as cash flow) in significant ways. *See* Interview with Susan A. Papacostas, President of Nika Prescription Services (Dec. 13, 1996) (on file with the *Texas Law Review*).

82. 11 U.S.C. §§ 1101-1129 (1994).

83. Since 1990, three department store companies in Chapter 11 (Federated Corporation, Carter Hawley Hale, and P.A. Bergner & Co.) have securitized their credit card receivables following their filing for relief from creditors' claims under Chapter 11. *See generally* Glover, *supra* note 5, at 612-13.

section 363 of the Bankruptcy Code[84] requesting court approval of the sale of the pool of assets to a special purpose corporation.[85] In addition, the originator must file a motion under section 364 of the Bankruptcy Code[86] describing in detail the proposed transaction, and outlining any and all expected benefits to the debtor and the estate.[87] Because the bankruptcy court confirms at the outset of the transaction the soundness and efficacy of the transaction's structure, including the evaluation that the transfer of assets from the originator to the SPC is a "true sale"[88] and that the SPC and the originator will not be substantively consolidated,[89] the risk that a court will avoid the asset transfer on these bases is reduced.[90]

E. *Funding at More Favorable Rates*

Because securitizing originators can better manage event risks, securitization enables most firms to fund their operations at a lower effective interest rate than through a secured borrowing arrangement.[91] RHS funding 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 lacks exposure to a broad base of investors.[92]

An originator can obtain this lower effective rate because the capital markets do not consider its creditworthiness in pricing the rate of return for the securitization of a firm's receivables. Rather, the quality of the underlying assets determines the rate.[93] In cases where the originator's credit rating is deficient, the capital markets (meaning the rating agencies) may give a higher credit rating to the asset-backed securities issued by the SPC than to the securities issued by the originator directly.[94] This

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84. *See* 11 U.S.C. app. Rule 4001(a)(1) (1994) (requiring that a motion to condition the use, sale, or lease of property shall be made in accordance with Rule 9014, which provides adverse parties with notice and a hearing).

85. *See* Glover, *supra* note 5, at 635.

86. *See* 11 U.S.C. § 364 (governing a reorganizing company's right to obtain credit and grant liens on assets).

87. *See* Glover, *supra* note 5, at 635.

88. *See infra* section IV(D)(1).

89. *See infra* section IV(D)(2).

90. *See generally* discussion *infra* subpart IV(D).

91. The traditional credit system in this country is very expensive. 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: Asset Securitization's Role in a Better Financial World*, *in* THE ASSET SECURITIZATION HANDBOOK, *supra* note 5, at 549, 550; Goldberg et al., *supra* note 5, at 50 (stating that asset securitization has become popular because, among other reasons, it is less expensive than traditional financing methods).

92. *See* Liebowitz, *supra* note 33, at 14 (discussing securitization as an attractive financing alternative for below investment grade companies).

93. *See Overview of Structured Financings*, CREDITREVIEW, Oct. 25, 1993, at 3, 3.

94. When a rating agency rates a traditional corporate security issuance, agency analysts evaluate the financial condition and performance of a company, assess the quality of management and its impact

translates into a lower effective interest rate. Because the quality of the asset-backed security issued depends upon the quality of the payment stream of the underlying assets, it is the character and quality of the assets that are under the rating agencies' intense scrutiny.[95]

The diminished possibility that ABS investors will be affected by the originator's potential for bankruptcy also improves the chance that the markets will view an originator's ABS more favorably than its direct debt issuances. Ideally, securitization transactions are structured so that the securitized assets are "bankruptcy remote."[96] In such a case, if the integrity of the transaction's structure is not compromised,[97] the assets transferred by the originator to the SPC and used to back the asset-backed securities will be deemed not to be part of the originator's bankruptcy estate should the originator fold.[98] Thus, because of the severance of the credit risk to the originator from the credit of the ABS and because of the bankruptcy-remote nature of the transaction's structure, smaller, less established, or more financially debilitated firms may be able to fund themselves through a securitization on net terms similar to those offered to larger, more established and financially sound firms.[99] This in turn may enable certain firms to expand at a more rapid pace by utilizing a less expensive source of funds for operations and long-term development.

F. *Accounting-Related Advantages*

Securitization further allows a firm to isolate a pool of financial assets and match them with liabilities with similar maturities, tenor, and price.[100] If a firm decides to take advantage of this financing option as part of its overall financing strategy, it reduces the necessity to hedge its funding obligations to eliminate a mismatch in asset and liability term and interest rate.[101] This arrangement may prove to be advantageous to

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upon the company's performance, and offer an educated guess with respect to the company's future prospects. *See Legalities in Rating Mortgage-Backed Securities*, CREDITREVIEW, Oct. 25, 1993, at 9, 9-11.

95. *See id.* at 11-12.

96. Assets are "bankruptcy remote" when they are held by an entity that is unlikely to become insolvent or subject to creditors' claims. *See id.* at 10; discussion *infra* notes 205-07 and accompanying text. Professor Marshall Tracht in his article suggesting a reconsideration of the enforceability of bankruptcy waivers, referred to securitization as "[t]he most important development in limiting bankruptcy access." Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 310, 310-11 (1997).

97. This, however, is a very big "if." For a discussion of the possible equitable challenges to the structure of securitization transactions, see *infra* subpart IV(D).

98. *See* discussion *infra* notes 205-07 and accompanying text.

99. For any firm with less than a double-A credit rating, the interest savings by securitizing, as compared with traditional commercial lending, may be significant. *See* Bryan, *supra* note 91, at 550.

100. *See* Goldberg et al., *supra* note 5, at 49.

101. This means that for floating-rate obligations, once assets are securitized, the originator no longer has to worry about a future asset/liability mismatch. *See id.*

customers and other creditors because the credit risk of the securitized asset pool is segregated from the rest of the firm's assets, thus decreasing the risk of interest rate fluctuation and a resulting disruption in the firm's cash flow.[102]

A related advantage to securitization is its treatment under the accounting rules as compared with other forms of financing. Generally Accepted Accounting Principles (GAAP),[103] established by the Financial Accounting Standards Board (FASB), are the body of rules applicable to many securitizing firms.[104] Pursuant to the Statement of Financial Accounting Standards (SFAS) No. 77,[105] a transfer of assets in connection with a structured finance transaction will be treated as a sale for accounting purposes if the transfer is made without "recourse."[106] This type of transfer is known as an off-balance sheet sale and offers a firm enormous flexibility in raising capital, without risking a violation of

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102. *See id.*

103. The Generally Accepted Accounting Principles (GAAP) outlines the conventions, rules, and procedures used in accounting practice. *See* Robert W. Berliner, *Audit Reports*, *in* ACCOUNTANTS' LIABILITY 1992: AUDITING FOR LAWYERS 41, 44 (PLI Litig. & Admin. Practice Course Handbook Series No. 440, 1992). GAAP includes both broad general guidelines as well as detailed practices and procedures. *See id.*

104. The Financial Accounting Standards Board (FASB) is a standards institute recognized by the SEC and the American Institute of Certified Public Accountants; it also works closely with the Federal Reserve Board. Its mission is to develop accounting standards for business, industry, and finance. Insured depository institutions such as national banks and savings associations are subject to more restrictive regulatory account principles (RAP). As a standards body, the FASB has no enforcement authority. Enforcement is in the hands of the SEC for nonbanking companies. The Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (FDIC) have the authority to enforce FASB pronouncements with respect to banks. *See generally* DIMITRIS N. CHORAFAS & HEINRICH STEINMANN, OFF-BALANCE FINANCIAL INSTRUMENTS 129-34 (1994).

105. *See* REPORTING BY TRANSFERORS FOR TRANSFERS OF RECEIVABLES WITH RECOURSE, Statement of Financial Accounting Standards No. 77 (Financial Accounting Standards Bd. 1983).

106. The FASB defines recourse as:

> The right of a transferee of receivables to receive payment from the transferor of those receivables for:
>
> (a) failure of the debtors to pay when due,
>
> (b) the effects of prepayments, or
>
> (c) adjustments resulting from defects in the eligibility of the transferred receivables.

Id. § 12.

A transfer with recourse is a transfer in which a seller agrees to repurchase any of the underlying loans that go into default or otherwise agrees to compensate the buyer for losses on defaulting loans. A transfer without recourse is one in which an originator surrenders control of the future economic benefits of the assets. Because sales of receivables with recourse have many of the same characteristics as loans collateralized by receivables, SFAS No. 77 outlines the circumstances under which a transfer of receivables with recourse should be treated for accounting purposes as a loan, rather than a sale. *See* Raymond T. Sloane, Jr. & Thomas A. Tranfaglia, Jr., *Accounting for Asset-Backed Transactions*, *in* THE HANDBOOK OF ASSET-BACKED SECURITIES, *supra* note 5, at 79, 85-87 (stating that SFAS No. 77 provides guidance on whether to treat a particular transaction involving receivables as a sale or loan, and explaining the three conditions listed in the standard).

covenants and restrictions potentially found in its other financing documents.[107]

The three elements required of an asset sale under SFAS No. 77 are (1) the surrender of economic control and future benefit of the assets,[108] (2) strictly limited recourse by the SPC to the originator,[109] and (3) the existence of recourse provisions to the originator that are subject to reasonable estimation.[110] SFAS No. 77 allows for off-balance-sheet treatment of the sale of receivables if these specific criteria are met.[111] This benefits a firm by improving its financial ratios, allowing it to stay within the ratios found in the firm's other loan document covenants, or to simply enable it to channel scarce capital to its business segments that may be in need.[112]

IV. Securitization Viewed from the Unsecured Creditor's Perspective

As outlined above, securitization offers clear economic and financial benefits to originators, ABS investors, and other transaction participants. Rational economic actors will engage in securitization transactions only if they believe that the net benefits of this choice exceed the net benefits of the next most favorable financing alternative. The current volume of ABS issuances[113] suggests that the parties making the decision to securitize are concluding that securitization's net benefits do indeed exceed the benefits of the alternatives. There is, however, another relevant perspective from which to evaluate the economic impact of securitization: that of the

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107. It should be noted that if the receivables are sold and the originator retains the servicing role, the servicing fee must be within normal market range. If there is a variation from the normal range, the sales price of the receivables must be adjusted to provide for a normal servicing fee for each subsequent servicing period. *See* ACCOUNTING FOR CERTAIN MORTGAGE BANKING ACTIVITIES, Statement of Financial Accounting Standards No. 65, § 2 (Financial Accounting Standards Bd. 1982). This adjustment ensures that the transferor does not reduce the amount of loss or increase the gain recorded in the reporting sale period thereby leaving the originator recourse through a back door arrangement. *See* Sloane & Tranfaglia, *supra* note 106, at 97.

108. If the transferor has the option to repurchase the receivables at a later date, then she has not surrendered control. *See* Sloane & Tranfaglia, *supra* note 106, at 86.

109. The transferor may retain a reversionary interest in the receivables if the interest is minor or relatively insignificant. *See id.*

110. This may be difficult if the transferor does not have sufficient experience with the type of receivables at issue to be able to make a reasonable estimate of the bad debt loss. *See id.*

111. If the originator is a regulated financial institution subject to RAP, it is subject to the capital adequacy standards, which were adopted by the Basle Committee on Banking Regulations and which the federal bank regulators follow. *See* 2 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 5, § 13.03 (discussing the adoption of risk-based capital guidelines for regulating financial institutions). Securitization is a particularly attractive financing method to such institutions because once an originator removes an asset pool and a corresponding financing from its balance sheet, it will not have to maintain capital on its balance sheet against the related asset. *See* Rosenthal & Ocampo, *supra* note 5, at 90-95 (discussing the benefits of securitization).

112. *See* Sloane & Tranfaglia, *supra* note 106, at 87.

113. *See supra* note 33.

securitizing firm's unsecured creditors. The position an unsecured creditor finds itself in when its debtor has securitized some or all of its assets is analogous to the subordinate position afforded an unsecured creditor when its debtor has provided assets as security to another creditor. In both cases, the debtor's assets are earmarked and removed from the pool of assets available to unsecured creditors. In the event of a debtor's default or insolvency, unsecured creditors have a subordinate interest in such previously identified assets; in the absence of an avoidance of the transfer of or lien on these assets, they become unavailable to satisfy the unsecured creditors' claims.[114]

The obvious parallel between the plight of unsecured creditors when a debtor offers its assets as collateral for a loan and when the same debtor securitizes such assets begs consideration of the issue of securitization's efficiency. The ongoing debate concerning secured credit's efficiency, refreshed by the current Article 9 revision process,[115] provides a useful framework for the discussion and analysis of the economic efficiency of securitization transactions.[116]

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114. For a secured creditor to have the right to enforce its claim of a priority interest in an identified asset against third parties with claims on the same asset, the creditor must perfect its security interest by filing a financing statement in the appropriate state office. *See* U.C.C. § 9-304(12) (1994). In the case of money and instruments, perfection can only be accomplished by possession. *See id.* In addition, § 9-102 requires the filing of a notice in the public records in connection with the *sale* of accounts (and chattel paper) in the same way debtors file notices with respect to the grant of collateral. The purpose of the filing requirement is to provide notice to the public and to the debtor's other creditors of the status of the transferred assets taken as collateral or sold. If creditors perfect their security interests, security agreements commonly provide that the lender has a right to declare a default if there is an interruption in payment. This declaration will, in most cases, entitle the lender, if she has adequately secured and perfected her interest pursuant to the provisions of Article 9, to priority over all of the debtor's unsecured creditors as well as priority over subsequent judgment creditors and secured parties with competing claims to the same collateral. *See* U.C.C. §§ 9-302, 9-304, 9-502(1) (1994); *see also* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 22-1 to -14 (4th ed. 1995) (discussing the creation, perfection, and enforcement of Article 9 interests).

115. In 1972, the Official Text of Article 9 of the UCC was revised and adopted by virtually all of the American states. Prior to Article 9's statutory scheme, various bodies of substantive law governed pre-Code security devices. *See* WHITE & SUMMERS, *supra* note 114, at § 21-1.

116. The risks assumed by a potential acquirer of an originator parallel the risks assumed by unsecured creditors of a securitizing originator. A potential acquiring company will be primarily focusing upon its target's business value and the offering price. An acquirer, however, may not be fully aware of how to evaluate a company with a securitized portfolio of assets. As such, any potential adjustments to income that might occur if any of the securitized assets loss or prepayment assumptions turn out to be false are going to be of great concern. Thus, the extent to which risk is retained by the originator and acquired by the acquirer will be a fundamental issue to the acquiring company. The four primary issues pertaining to retained risk include recourse risk, prepayment risk, interest rate risk, and the risk that the servicing arrangements are inadequate. An acquirer will most likely request indemnification from the originator against this type of future harm. *See generally* Kathryn A. Cassidy, *Securitization Trade-Offs—How Deal Structure Can Influence the Future Value of Your Company or Portfolio*, *in* THE GLOBAL ASSET BACKED SECURITIES MARKET, *supra* note 5, at 227, 227 (identifying six areas of risk in such acquisitions, and stressing the need to consider the impact of securitization structure on future flexibility and company valuation).

A. *Secured Credit's Efficiency and Equitable Justifications, as Applied to the Securitization Model*

One of the most frequently cited advantages to securitization is that it provides a firm with financing at a less expensive effective interest rate than the firm could obtain through a direct secured lending arrangement.[117] As stated above, this lower effective financing rate can be attributed, in large part, to securitization's prototypical bankruptcy-remote structure, in which the assets transferred are removed from the purview of the originator's trustee in bankruptcy.[118] Indeed, neither academic commentators nor transaction participants have offered an apology for the fact that the financial advantages gained by an originator from the movement of these assets beyond the reach of its general creditors are among the driving forces behind the proliferation of the number and types of originators securitizing assets.[119]

Once the bankruptcy risk is effectively eliminated from the transaction, the sale of the assets can return a relatively high price to the originator. This price is analogous to the lower interest rate charged by secured creditors who have identified and earmarked a secondary source of repayment in the event of a debtor default (commonly known as collateral), as compared to the higher interest rate charged by unsecured creditors who have no such payment back-up arrangement.[120] In a secured lending context, in the event of a debtor's liquidation, it is the secured creditors who have priority of payment over the unsecured creditors, precisely because of the presence of the earmarked collateral.[121]

This priority arrangement forms the basis for one of the fundamental premises of Article 9 and the Bankruptcy Code; in the event of a debtor's liquidation, secured lenders get paid from their collateral (or its equivalent in value) before unsecured creditors.[122] Unsecured creditors must be

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117. *See supra* subpart III(E).

118. *See supra* text accompanying note 205.

119. *See* ROSENTHAL & OCAMPO, *supra* note 5, at 8-23 (summarizing the benefits of securitization of credit). *See generally* THE EMERGED AND EMERGING NEW UNIFORM COMMERCIAL CODE (ALI-ABA Course of Study, Dec. 12-14, 1996); Schwarcz, *Structured Finance*, *supra* note 5, at 613-18; *see also* Tracht, *supra* note 96, at 310-11.

120. The interest rate charged is a factor of the nonpayment risk. When a lender perfects a security interest in collateral in connection with a loan, it has increased its chance of repayment, either directly by the debtor, or from the value of the collateral. The equation P (probability) x L (loss suffered from default) illustrates the concept. The loan loss value, L, will be offset by the chance, P, that collateral will be used to satisfy the debt. *See* Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 8 (1981). *See generally* WEIR M. BROWN, BANK LENDING TO BUSINESS BORROWERS: INTEREST RATES AND U.S. MONETARY POLICY (1992).

121. *See* 11 U.S.C. § 726 (1994).

122. *See* WHITE & SUMMERS, *supra* note 114, § 25-10, at 919-20.

satisfied with a pro rata share of whatever is left over.[123] Notwithstanding the endurance of this accepted commercial practice, whether secured creditors ought to continue to have priority over the subordinated claims of general unsecured creditors has been and continues to be a topic of dispute among academics and commercial practitioners.[124] Indeed, the recent Article 9 revision process has renewed the enthusiasm for this discussion and has resulted in placing the question of secured creditor priority at the top of the revision committee's discussion list.[125]

The essence of this discussion is the question of whether secured credit is efficient and whether secured claims' priority status in bankruptcy results in an inequitable outcome. Implicit in this question is the issue of whether secured creditors are realizing gains at the expense of unsecured creditors in a way that challenges accepted principles of efficiency and equity.

In their seminal article written in 1979, Professors Thomas H. Jackson and Anthony T. Kronman argued that the legal rules allowing creditors to take security for loans are economically efficient.[126] They rest their conclusion on two arguments. First, they argued that unsecured creditors are compensated for their subordinated status by being paid an interest rate premium.[127] Second, they contended that even in the absence of a legal regime providing for secured credit, creditors would establish a parallel priority scheme because of the market advantages inherently available for riskier unsecured loans.[128]

Professor Alan Schwartz challenged this conclusion and its underlying assumptions in a 1981 article.[129] Professor Schwartz took issue with the

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123. *See id.*

124. *See generally Symposium on the Revision of Article 9 of the Uniform Commercial Code*, 80 VA. L. REV. 1783 (1994); *see also* Memorandum from Professor Elizabeth Warren, Harvard Law School, to the Council of the American Law Institute (Apr. 25, 1996) (on file with the *Texas Law Review*) (stating that she had initiated her draft of a proposed amendment to Article 9 which would "set aside . . . assets for unsecured creditors" following "an extensive debate over the efforts of the current Article 9 drafting committee to extend the reach of security interests to lock up all the property of a debtor").

125. *See* Article 9 Reporter's Statement of Policy Issues for the NCCUSL 1996 Annual Meeting (June 17, 1996) (on file with the *Texas Law Review*). Some of the issues set forth in the statement include: (1) whether "the revised Article 9 [should] continue to facilitate and promote the creation and enforcement of security interests"; (2) whether "the revised Article 9 [should] retain its [current] priority scheme under which perfected security interests are senior to the rights of lien creditors and unperfected security interests are junior to those rights"; (3) whether "the revised Article 9 [should] subordinate, in whole or in part, perfected security interests to the rights of some or all classes of unsecured creditors"; and (4) whether "the revised Article 9 [should] subordinate the rights of lien creditors to unperfected security interests." *Id.*; *see* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996).

126. *See* Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1157 (1979).

127. *See id.* at 1148.

128. *See id.* at 1157.

129. *See* Schwartz, *supra* note 120.

conclusion of secured credit's efficiency[130] and outlined the difficulties with the "conventional efficiency story" offered to explain secured debt.[131] He suggested that the savings gained by debtors borrowing from some creditors on a secured basis are offset by the premiums demanded by unsecured creditors for their heightened risk of noncollection. He further questioned whether one can conclude that security is efficient without identifying a reduction in social cost and explored the issue of whether the aggregate benefits of security equal or exceed its aggregate costs.[132] Unable either to identify the reduced costs or to effectively quantify benefits of a system of security, Schwartz concluded that the efficiency of secured debt was unproven.[133]

Since the publication of Professor Schwartz's article, many academics have addressed the efficiency of secured transactions. Some have concluded that secured credit's efficiency is unproven, or at least problematic,[134] and others have sought to substantiate their contention of efficiency by cataloging a roster of justifications for its continued existence.[135] The justifications offered for the persistence of secured

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130. *See id.* at 7. Professor Schwartz's position is essentially a statement of the Miller-Modigliani irrelevance theorem, which provides that, under ideal conditions, a firm should be indifferent to its capital structure; the level of investment made by a firm is unaffected by the type of security used to finance the investment. *See* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and The Theory of Investment*, 48 AM. ECON. REV. 261, 288-93 (1958). Professor Schwartz demonstrated that the Miller-Modigliani theory of indifference can be applied to a firm's mix of secured and unsecured debt. *See* Schwartz, *supra* note 120, at 7-8.

131. Professor Schwartz observed three fundamental difficulties with the efficiency explanations for the existence of secured debt: (1) the explanations fail to accurately predict the effects of the absence or presence of security (for example, the effects security has on firm debt-monitoring, the type of signal security sends, or the benefits to a firm of interest rates that are staggered over time); (2) the explanations fail to explain why security is used by debtors, rather than alternatives; and (3) the explanations do not prove that secured debt's social gains exceed its social costs. *See* Schwartz, *supra* note 120, at 7-29.

132. This is a slightly different formulation than the definition of efficiency known as "Pareto efficiency," so named after the Italian economist Vilfredo Pareto. A situation is said to be Pareto efficient or Pareto optimal if there is no change from that situation which can make someone better off without making someone else worse off. *See, e.g.*, A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 7 n.4 (1983).

133. *See* Schwartz, *supra* note 120, at 37 ("[N]o plausible showing that secured debt actually increases welfare exists.").

134. *See* Bebchuk & Fried, *supra* note 125, at 857.

135. *See* Barry E. Adler, *An Equity-Agency Solution to the Bankruptcy-Priority Puzzle*, 22 J. LEGAL STUD. 73 (1993) (contending that the priority secured credit enjoys over unsecured credit is beneficial because it encourages more scrutiny by unsecured creditors); Richard L. Barnes, *The Efficiency Justifications for Secured Transactions: Foxes with Soxes and Other Fanciful Stuff*, 42 KAN. L. REV. 13, 15-16 (1993) (describing attempts by legal scholars to provide economic justifications for secured credit); James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27, 36-37 (1991) (arguing that secured and unsecured credit options give creditors choices in demonstrating their preferences, thus increasing the incentive to contract); F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1395-96 (1986) (noting that security grants reduce both screening costs and incentive costs of

credit include the potential for secured credit to (1) protect against asset wasting or dissipation,[136] (2) signal that a debtor with secured credit is a good credit risk,[137] (3) reduce the total costs of monitoring the debtor's business behavior,[138] and (4) generally increase the availability of credit.[139]

The claim of securitization's efficiency is less substantiated than the same claim with respect to secured credit. Although many of the same justifications for secured credit's continued existence have been used to justify and explain the increasing number of securitization transactions, these justifications do not fully or accurately explain securitization's place in the credit market.[140]

B. *Challenges to the Efficiency of Securitization*

1. Securitization's Efficiency Is Unproven.—On its face, securitization appears to be a creative, albeit complex, way of reducing a firm's effective interest rate while offering it positive strategic advantages. In a hypothetical vacuum where the only parties' interests to be considered are those of the originator and the ABS investors, the fact that an increasing number of firms are securitizing assets to meet the market's "insatiable" demand[141] for ABS suggests that the economic benefits exceed the costs for these parties. This conclusion assumes that parties are acting

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creditors, in turn increasing value to the firm); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 68-72 (1982) (arguing that secured creditors may contribute to reduce the freerider problem among shareholders, helping lower a firm's capital costs); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 646 (1992) (arguing that "secured credit is a sensible response to the problem of creditor misbehavior"); Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984) (arguing that such efficiencies can not be known with assurance); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 970 (1986) (contending that a debtor-creditor relational model for understanding secured transactions enhances the argument that such mechanisms can increase firm value); Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067, 1073-83 (1989) (describing attempts to justify the efficiency of secured credit); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225 (1992) (noting the need to examine information imperfections in debt markets in order to evaluate various efficiency theories); James J. White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984) (outlining the general efficiency justifications, and challenging the assumptions regarding differential risk aversion as an efficiency justification). *See generally*, *Symposium*, *supra* note 124.

136. *See* White, *supra* note 135, at 487-89.

137. *See id.* at 476-77.

138. *See* Jackson & Kronman, *supra* note 126, at 1149-61 (analyzing the impact of monitoring allocation among parties and outlining factors which influence creditors' desire and ability to monitor); Levmore, *supra* note 135, at 55-57 (arguing that a secured creditor's motivation to monitor would solve the freerider problem).

139. *See* Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929, 941-46 (1985).

140. *See generally supra* note 5.

141. *See generally supra* note 33.

with sufficient rationality to accurately assess the costs and benefits to them.

When securitization's third-party distributional effects are taken into account, a firm may be securitizing assets even when the transaction results in economic inefficiencies. When firm managers pursue investments and financing strategies that increase expected creditor losses more than such strategies increase expected shareholder return, such investments are inefficient.[142] The dissonance between what decisions are good for the firm, versus what is good for the firm's creditors, results in an inefficient enrichment of shareholders at the expense of creditors.[143]

To illustrate, suppose a firm has $100 in assets and $100 in liabilities. Upon liquidation, the firm's creditors would get paid in full and its shareholders would be left with nothing. The firm knows of an investment opportunity that will cost $100 and will return $200 if successful, but zero if unsuccessful. There is a one-in-two chance of success or failure.

Should the firm make this investment? From the creditors' perspective, it should not. If the investment succeeds, the firm creditors will get no more than $100, but if the investment does not succeed, the creditors will be left with nothing. However, from the standpoint of the firm (that is, its shareholders), it should make the investment. If the investment loses, it is the creditors that bear the loss. Because the firm is insolvent anyway, the shareholders lose nothing if the firm loses its investment, but if the investment pays off, it is they, not the creditors, who reap the benefit.[144]

Furthermore, an originator's ability to divert value from its unsecured creditors to its ABS investors results in costs to unsecured creditors who fail to adjust to and adapt their behaviors to their heightened post-securitization risk. To the extent a creditor can understand and predict the effect securitization will have on its chance of repayment, both in the absence of and in bankruptcy, it can negotiate terms to reflect this risk. If the originator did not bargain with its unsecured creditors prior to the securitization, either because the creditors are involuntary or otherwise

142. *See* Bebchuk & Fried, *supra* note 125, at 873.

143. *See* George G. Triantis, *A Free-Cash-Flow Theory of Secured Debt and Creditor Priorities*, 80 VA. L. REV. 2155, 2155 (1994) ("The premise of agency theory is that self-interested managers make the decisions of a corporation, and these decisions may enrich the managers or their shareholders at the expense of the firm's creditors.").

144. Another example makes the same point, but more dramatically. A firm makes an investment of $100 at a Las Vegas gaming table, and the $100 is put on a number that has a one-in-a-hundred chance of coming up. This investment also has an expected value of $100 (a 1% chance of making $10,000 and a 99% percent chance of making nothing). So what would the debtor and creditors say about this "investment proposal"? The rational debtor-shareholder-originator's response should be identical to the creditors. *See* DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS AND MATERIALS ON BANKRUPTCY 372-74 (2d ed. 1990).

nonadjusting,[145] a transfer of value from the creditor to the firm's shareholders will result. As is the case with secured credit, it is primarily these nonadjusting creditors that are subject to the greatest economic costs when a firm securitizes. Securitization may result in a transfer of value from these nonadjusting creditors, and to the extent there is no corresponding adjustment in the cost of unsecured credit, the shareholders of the securitizing firm have captured such value.

Even if one can assume perfect information and consent on the part of unsecured creditors and other third parties with claims against securitizing originators,[146] the conclusion that securitization is an efficient way for a firm to finance its operations and thus ought to be encouraged remains unproven.

2. *Securitization's Justifications*.—In the absence of bankruptcy, secured credit results in a number of benefits to a debtor and its other creditors that support and enhance the efficient outcome of the secured credit transaction. These benefits relate to a secured party's ability to control what has been referred to as "debtor misbehavior" and have been used to justify secured credit's prominent position in our commercial economy. These justifications include the potential for secured credit resulting in: (1) protection against asset wasting or dissipation,[147] (2) the provision of a signal that a debtor with secured credit is a good credit risk,[148] (3) a reduction in the total costs of monitoring the debtor's business behavior,[149] and (4) a general increase in the availability of credit.[150] These controls on a debtor's post-financing behavior, however, are not available to a firm's unsecured creditors when the firm engages in a securitization.

a. Securitization prevents a debtor from wasting assets.—When an asset transfer is characterized as a transfer of collateral for a loan (and thus a transfer made in connection with a secured financing), the originator

145. *See* Bebchuk & Fried, *supra* note 125, at 869-70. Nonadjusting creditors include tort claimants; government tax and regulatory agencies; creditors with claims so small it is not practical to seek information about the debtor on an ongoing basis or adjust lending terms accordingly; and unsecured creditors who extend credit on fixed terms, foreclosing the opportunity for adjustments in the future. *See id.* at 870. Such nonadjusting creditors are also known as involuntary and voluntary uninformed creditors. For a discussion of implied consent by these creditors, see *infra* subpart IV(C).

146. For a discussion regarding the assumption of perfect information and consent, see *infra* subpart IV(C).

147. *See* White, *supra* note 135, at 487-89.

148. *See id.* at 476-77.

149. *See* Jackson & Kronman, *supra* note 126, at 1149-61; Levmore, *supra* note 135, at 55-57.

150. *See* Kripke, *supra* note 139, at 941 (arguing that in most transactions involving secured credit, the credit could not have been obtained without granting security).

with title to the assets pledges them to a lender as collateral, but retains an ownership interest in them.[151] In such a case, the debtor who enjoys the secured credit extended by its lender no longer has the freedom to do what it wants with its encumbered assets, notwithstanding its retention of title to them.[152] The debtor is commonly precluded by agreement from giving away, selling, or wasting these assets.[153]

In contrast, the objective of a securitizing originator is to remove, through a sale, certain assets of the originator from its ownership and control. Once removed, neither contract nor statute requires the originator to preserve these assets or their value, and upon their sale, the securitized assets become the property of the purchaser. The originator is not required or motivated to preserve the consideration received from the asset sale; as stated above, it is free to spend this cash any way it chooses—or to simply squander it.[154]

In addition, asset purchasers, in contrast to lenders, have no interest in contractually prohibiting an originator from inefficient decisionmaking—which may include both imprudent business decisions and the wasting of non-securitized assets. Lenders may, and indeed often do, outline a set of behaviors foreclosed to the debtor because of their potential for adverse distributional consequences. These behaviors may include restrictions against encumbrances on the transfer of certain assets, restrictions on certain investment activity, restrictions on the creation of certain security interests, and even a prohibition against a change in the debtor's business policies, practices, or type of industry.[155] These restrictions serve as a check on a borrower's post-credit extension behavior and protect the interests of the borrower's unsecured creditors. Post-securitization, there is no party with sufficient interest in the originator to control any aspect of its ongoing behavior.

Moreover, a further objective of a securitizing originator is to remove its securitized assets from its potential bankruptcy estate. Indeed, that is what a bankruptcy-remote transactional structure is designed to do—transfer

151. If the borrower uses its assets as collateral for a loan, the lender may make a single advance against a pool of current and after-acquired accounts or may extend a line of credit to the borrower up to a specified amount. *See generally* WHITE & SUMMERS, *supra* note 114, at 756 (introducing the concept of attachment by a creditor).

152. Constraints with respect to collateral are generally imposed upon the debtor by contract. *See* LOPUCKI & WARREN, *supra* note 62, at 255-56 (discussing the types of contractual default provisions included in security agreements).

153. Exceptions to this rule include the ability to substitute collateral and the ability to take a security interest in assets that regularly turn over in the ordinary course of the debtor's business, such as inventory and accounts. *See* LOPUCKI & WARREN, *supra* note 62, at 195-99 (discussing security interests tied to debtor assets which have changing components but stability of identity and collateral value).

154. *See supra* section IV(B)(1).

155. *See* Bebchuk & Fried, *supra* note 125, at 879 (discussing the ways that covenants can be used to control inefficient behavior).

the assets to an entity that is not required to participate in the debtor's bankruptcy. The fundamental difference in a bankruptcy context between a secured financing and a securitization is that a secured creditor, by statute, is a necessary party to the debtor's bankruptcy,[156] whereas securitization participants (meaning the SPC as asset transferee and the ABS investors) have as their goal the establishment of a remote position from the bankrupt originator.[157] In such a case, if the asset transfer is upheld by the court, the asset transferee (the SPC) is not subject to the reach of the automatic stay, and the payment source of the ABS (the securitized assets) is effectively separated from the bankruptcy estate of the originator.[158]

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156. Bankruptcy constrains both debtors and creditors from altering their rights in the collateral. All property in which the debtor has an interest at the time of the bankruptcy filing is no longer deemed to be the debtor's but becomes part of the estate that is created automatically upon the debtor's bankruptcy filing. This includes the debtor's interest in *property encumbered by a security interest* as well as unencumbered property. The trustee is charged with the responsibility of preserving and protecting the value of the debtor's finite and often limited estate for the benefit of the debtor's unsecured creditors. Upon bankruptcy filing, secured creditors become necessary parties to their debtor's bankruptcy. The automatic stay (§ 362 of the Bankruptcy Code) comes into effect immediately upon the filing for bankruptcy and precludes all creditors, including *secured creditors*, from demanding payment from the debtor and from taking possession of, selling, leasing, or otherwise disposing of collateral until the bankruptcy process is complete and the debtor is discharged. Unless the stay is lifted, a secured party is constrained from simply exiting the debtor's bankruptcy without being forced to participate fully in the process. Participation means that, in many instances, a secured creditor must wait out the duration of the bankruptcy process before it can claim its collateral. The trustee engages in an independent examination of the claim of the creditor's secured status. Following such examination, the trustee may discover that the ostensible secured party's "priority lien" in the collateral was not adequately created or perfected. Even if properly perfected, the trustee may find that this collateral has increased or decreased in value, or is subject to the conflicting claims of another purported secured creditor. If the creation or perfection of the security interest is flawed or if it is determined that a competing claimant to that particular collateral has priority, the creditor is no longer deemed to be adequately secured. The identified collateral is then either "earmarked" for the other party with priority security or it is returned to the estate without a priority claim on it and becomes available for pro rata distribution to the debtor's general unsecured creditors. During the period of time that a secured creditor has a claim on assets, whether or not it is ultimately determined to be properly perfected, the debtor is prohibited from wasting such assets. *See* 11 U.S.C. §§ 362(d)(1)-(2), 363 (1994); DAVID G. EPSTEIN ET AL., BANKRUPTCY, *supra* note 6, § 3-1 to -3, -11 to -13.

157. The asset purchaser, unlike the secured creditor, is not a "party in interest" in the securitizing debtor's bankruptcy estate. Section 1109(b) of the Bankruptcy Code defines "party in interest" to include "the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee." 11 U.S.C. § 1109(b) (1994); *see In re* Martin Paint Stores, 199 B.R. 258, 264 (Bankr. S.D.N.Y. 1996) (stating that "party in interest" for purposes of lifting an automatic stay under 11 U.S.C. § 362 (1994) includes only the debtor and its creditors (citing *In re* Comcoach Corp., 698 F.2d 571, 573 (2d Cir. 1983) (stating that, for standing purposes, "party in interest" is reserved to one that is able to seek legal redress under applicable substantive law))), *aff'd sub nom.* Southern Blvd., Inc. v. Martin Paint Stores (*In re* Martin Paint Stores), 207 B.R. 57 (S.D.N.Y. 1997).

158. This is not to say that assets sold in a securitization or any other context may never be returned to the bankruptcy estate of the originator. The Bankruptcy Code gives the trustee powers that allow it, under certain defined circumstances, to bring back into the debtor's estate property that may have been previously transferred to a third party that is outside the control and possession of the debtor. Section 544 of the Bankruptcy Code confers on the trustee all the rights under state law of a hypothetical creditor with a lien on all the property of the debtor. *See* 11 U.S.C. § 544. The

b. Securitization provides a signal to third parties with respect to the credit risk of the originator.—Another justification commonly offered for secured debt is that it provides a signal to unsecured creditors of debtor's prospects.[159] According to this "signaling" explanation, secured credit allows unsecured creditors to extend credit at a reduced interest rate because such debtor is a better risk than other debtors without secured credit.[160]

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avoidance of a transfer under § 544(a) does not happen automatically upon the request of a party in interest or upon a motion to confirm a plan under Chapter 11, but must be the subject of an adversary proceeding. *See* FED. R. BANKR. P. 7087. The Advisory Committee Notes to Part VII of the Bankruptcy Rules state that "[p]roceedings to which the rules in Part VII apply directly include those brought to avoid transfers by the debtor under §§ 544, 545, 547, 548 and 549 of the Code." FED. R. BANKR. P. 7001 advisory committee note. Transferees must be served with a complaint, a summons, and a notice of trial, and the burden is shifted to the trustee to defeat the prima facie evidence presented by the transferee that the transfer should not be avoided. 11 U.S.C. §§ 362(g), 547(g); 11 U.S.C. app. Rule 7004. Thus, a party in interest must affirmatively challenge the transferee's claim of interest in the identified assets. If at the time the trustee exercises its avoiding powers under § 544(a) the assets have been transferred to a third party (such as an SPC), § 550 of the Bankruptcy Code gives the trustee the power to recover the assets for the benefit of the estate. Section 550 reads:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544 . . . the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of the property, from
>
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
>
> (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550.

Once the assets are recovered, they come back into the fold of the estate and are available for pro rata distribution to the debtor's unsecured creditors. The relevant state law is UCC § 9-301(1)(b), which 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) (1994). This blending of state and federal bankruptcy law allows the trustee to take priority over any and all unperfected security interests. Thus, once a bankruptcy petition is filed, the failure of a creditor or transferee to comply with the relevant requirements of Article 9 gives the trustee priority in the property subject to the interests of the creditor-transferee. *See* 11 U.S.C. § 544. The discussion in Part V of this Article examines the courts' confusion with respect to this issue.

As such, the transferee of assets who has failed to perfect or maintain its security interest under the terms of Article 9 competes with the trustee for a priority position with respect to the particular assets at issue. This means that if the transferee of securitized accounts does not perfect the transfer in accordance with the rule set forth in UCC § 9-102 by an appropriate filing in compliance with the provisions of UCC § 9-203, its interest may be voided by the trustee. Section 9-102, outlining the transactions to which Article 9 applies, states that the provisions of Article 9 apply to any *sale of accounts or chattel paper*. *See* U.C.C. §§ 9-102, 9-203; WHITE & SUMMERS, *supra* note 114, § 21-1 to -3.

159. *See* Jackson & Kronman, *supra* note 126, at 1161, 1149-61 (arguing that "it is to the benefit of all concerned that monitoring burdens be shifted to those creditors who are able to bear them at least cost"); *see also* White, *supra* note 135, at 476-77 (stating that such justification conflicts with the common understanding of security that the greater the risk, the greater the need for security).

160. *But see* Schwartz, *supra* note 120, at 17, 14-21 (challenging the conclusion that secured credit sends a signal that the borrower is a good risk because debtors who are good credit risks need not give collateral, and thus security is at best an "ambiguous" signal).

Whatever the merits of this explanation for secured credit,[161] the signal broadcasted when an entity securitizes its assets should not be read the same way as the secured credit signal. As stated previously, the current market of originators is largely comprised of firms with low credit ratings, those with little or no borrowing track records, and entities with a lack of exposure to a diversity of investors.[162] Indeed, it is because of these qualities that many of the newest securitization market originators have turned to structured finance. If the market demands (and rating agencies and investors do) that the originators securitize only their highest quality assets, then the prevailing signal to unsecured creditors is not that the originator is a good risk—and therefore unsecured creditors should charge a discounted interest rate—but that the originator's highest quality assets have been sold—with only "junk" remaining from which the unsecured creditors can satisfy their claims.

Moreover, unsecured creditors may not have access to sufficient information to read the broadcasted signal; the adequacy of disclosure of the quality of securitized assets has been called into question in recent years.[163] In response to the market's concerns, the SEC is considering revising its disclosure standards for certain ABS issuances.[164] The securitization signal is a difficult one to read and, as such, the interest rates charged by the unsecured creditors are not an accurate reflection of the risks being borne.

c. Securitization reduces monitoring costs to creditors.—Theorists posit two distinct models of monitoring by secured creditors: (1) secured creditors monitor the assets encumbered by the security interest, or (2) they monitor the debtor's entire business to determine the probability of default.[165] Monitoring may serve either as a private good, having no

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161. *See* White, *supra* note 135, at 477, 476-77 (challenging the signaling explanation on the basis that, because security "impedes the debtor's possibility for subsequent borrowing, minimizes its maneuvering room on the verge of default, and gives greater power to the creditor upon default," the grant of security is a greater burden to a high risk debtor than it is to a low risk one).

162. *See supra* Part II.

163. The Public Securities Association (PSA), a Wall Street trade group, suggested in a letter to the SEC that the existing disclosure rules "stand in the way of disseminating useful information to investors." *PSA Urges Disclosure Overhaul*, COM. MORTGAGE ALERT, Nov. 11, 1996, at 7, 7, *available in* 1996 WL 7983320. Specifically, the PSA is concerned that ABS investors should have at least 48 hours before the securities are sold to review information with respect to the underlying assets. A further issue raised by the PSA is that "many new issuers have entered the securitization market with little or no operating history," and as such, this fact ought to be disclosed. Aaron Elstein, *SEC Considers Increasing Disclosure on Asset-Backeds*, AM. BANKER, Oct. 10, 1996, at 20.

164. *See* Elstein, *supra* note 163.

165. *See* Jackson & Kronman, *supra* note 126, at 1161 (positing that the burdens of monitoring debtors should be shifted to those creditors who are able to bear them at the least cost); Levmore, *supra* note 135, at 53 (arguing that large commercial lenders are in a better position to police a debtor for risky behavior).

direct effect upon the firm's other creditors, or it may result in a public good, where the other creditors of the debtor (and often the unsecured creditors) reap the benefit of the monitor's diligence.[166] Monitoring may have positive consequences for creditors: the monitor takes on the role of a "joint venturer" of the debtor, attuning its radar to the issue of creditor repayment.[167] Alternatively, monitoring may inflict negative externalities on interested third parties. For example, a creditor's monitoring of a debtor may allow the creditor to detect an imminent default more quickly and thereby give that creditor the advance information and opportunity to seize the debtor's assets first.[168]

If purchasers of securitized assets monitor at all, they do so in the form of short-term private monitoring. The asset purchaser's concern in the course of its pre-securitization diligence is with the quality of the assets sold and the corresponding credit enhancement. Beyond this initial diligence, there is no reason for ongoing monitoring of the originator's business behavior.[169]

In contrast, one of the primary concerns of unsecured creditors is the debtor's post-credit-extension behavior. They want to ensure that the debtor refrains from engaging in any behavior riskier than the behavior engaged in when their initial bargain was struck.[170] If the securitized assets are moved from the originator's purview to a bankruptcy-remote entity, ultimate purchasers of the ABS have no continuing incentive to monitor the debtor for risky behavior. As a result, the originator's unsecured creditors are left with one of two alternatives: (1) to maintain their lending relationship with the debtor in the absence of monitoring, or (2) to monitor the debtor themselves.[171]

A debtor-creditor relationship in the absence of monitoring is a risky one; the less information available to the creditor, the higher the risk that

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166. *See* Levmore, *supra* note 135, at 53-54.

167. *See id.* at 54-55 (stating that credit agencies that collect and report information with respect to a debtor's lending history are common in the world of commercial finance). These credit agencies, however, do not report whether and to what extent a firm has securitized a portion of its assets.

168. *See* Picker, *supra* note 135, at 657.

169. *See supra* text accompanying notes 96-99 (discussing the diminished possibility that the purchaser of securitized assets will be involved in the originator's bankruptcy).

170. Debtors and creditors have different motivations following the extension of credit. Post credit extension, a creditor is interested in decreasing the risk of the loan, thereby increasing its effective interest rate. The debtor, by contrast, has the incentive to engage in riskier behavior, thus retroactively decreasing the effective interest rate charged. *See* BAIRD & JACKSON, *supra* note 144, at 373. This incentive has been referred to as the phenomenon of "the threat of debtor misbehavior." Jackson & Kronman, *supra* note 126, at 1150, 1149-50; *see also* Schwartz, *supra* note 120, at 9-10 (discussing debtor pursuit of higher-risk projects after making loans, thereby reducing retroactively the loans' effective interest rates).

171. The degree to which unsecured creditors will monitor the debtor depends upon their perception of the "risk that the debtor will misbehave." Jackson & Kronman, *supra* note 126, at 1151, 1150-51.

the creditor will be unable to preempt a catastrophic event that leads to default.[172] Furthermore, monitoring by an unsecured creditor is expensive and should result in a higher interest rate charged for the credit; correspondingly, a relationship in the absence of monitoring should require higher interest costs.[173] Because, however, unsecured creditors of securitizing firms are not operating in a world of perfect information,[174] they may not know or understand the extent to which the debtor is being monitored and, as such, they may find themselves in either a position of bearing higher risk or higher expenses than if their debtor used its assets as collateral for a secured loan.

d. Securitization results in a general increase in the availability of credit (and is this a good thing?).—Securitization, with its focus on the quality of the assets to be securitized and not the general credit quality of the originator, may, in some circumstances, make credit more available to an increasing number and variety of entities.[175] Securitization may be the only way for a particular originator to raise money. As a result, securitization may benefit a securitizing entity's unsecured creditors by increasing the overall liquidity of the borrowing party.[176] If securitization results in the improvement of the financial health of the originator and thus signals the continuation of the originator, securitization should give comfort to those unsecured creditors who rely on the cash flow of their debtor's business—the so-called "cash-flow surfers."[177] Once the originator's assets are sold (securitized), the originator is "awash with cash."[178] Arguably, the unsecured then have a far better chance of getting paid.[179]

This justification, however, rests upon a fundamental assumption: that the cash that results from the liquidated assets is used to pay unsecured

172. *See id.* at 1150.

173. *See id.* at 1149-50.

174. *See supra* section III(B)(3).

175. *See* George J. Bentson, *The Future of Asset Securitization: The Benefits and Costs of Breaking up the Bank*, *in* THE GLOBAL ASSET BACKED SECURITIES MARKET, *supra* note 5, at 3, 4-6.

176. *See supra* subpart III(B).

177. This term originated in Professor Lynn M. LoPucki's article, *The Unsecured Creditor's Bargain*. In this article, Professor LoPucki describes two types of unsecured lending: (1) "asset-based" unsecured lending, and (2) "cash-flow surfing." Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1891 (1994). Asset-based unsecured lending is "functionally indistinguishable from secured lending," in that unsecured creditors rely upon the unencumbered assets of the borrower for their recovery in the event of liquidation. *Id.* at 1924, 1924-31. In contrast, unsecured creditors are cash-flow surfers when they rely upon the debtor's cash flow for repayment. *See id.* at 1931-47.

178. *See* Paul M. Shupack, *The Politics of Article 9: On Boundaries and Definitions: A Commentary on Dean Baird*, 80 VA. L. REV. 2273, 2298 (1994).

179. *Cf.* LoPucki, *supra* note 177, at 1938 (explaining that unsecured creditors expect to be paid from the debtor's bank account).

creditors. Although the originator may choose to channel the cash resulting from this increase in liquidity to repay unsecured creditors, it may instead spend the cash on inventory that fails to turn over, or on projects that do not succeed or do not increase the firm's profitability. What an originator chooses to do with an increase in its liquidity is determinative of whether such an increase is a benefit or a detriment to its unsecured creditors. Because investors have no incentive to monitor an originator once the asset transfer is complete, there are even fewer controls on a firm's post-securitization behavior than there are on a firm's post-secured-credit behavior.[180]

This justification for securitization raises the question of whether the common welfare is improved by the enhancement of a firm's ability to raise cash in the public markets, even though that firm has an unproven credit performance or low credit rating. Arguably, firms that have been unable to establish a borrowing track record based upon the traditional credit profile have one or more indicia that flag them as a credit risk. Firms that are a high credit risk are significantly more likely to end up in bankruptcy.[181] If securitization enables these high-risk firms to transfer their highest quality assets to a third party and provides no corresponding controls on the consideration for this transfer, upon bankruptcy, the unsecured creditors are left with a smaller residual pool of assets to share.[182]

Furthermore, as a greater number of financially marginal parties enter the securitization market, an increasing number of poorly structured transactions occur because of haste, volume, or simple ineptitude.[183] To the extent there is a heightened risk factor for the unsecured creditors of originators with "well structured" securitization transactions, there is an even greater risk for an unsecured creditor of an originator with a structured financing destined to collapse.

The high volume of ABS issuances in recent years has led at least one commentator to observe that investors have been so eager to invest in them that they have not diligently required that the assets or the company behind them "prove their reliability."[184] If the securitized assets are not of high

180. *See supra* subsection IV(B)(2)(c) for a discussion of originator monitoring.

181. *See* TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 282-92 (1989) (describing the loan losses that commercial lenders suffer when they extend credit to small businesses).

182. The decline in consumer credit quality has increased the risk of payment delinquencies. The "new generation of assets are piggybacking on the reputation of traditional asset-backed securities as safe investments, but many of them have little or no track record." Woolley, *supra* note 9, at 64.

183. *See* Elstein, *supra* note 33 ("Sam Tillinghast, managing director of SunAmerica Corporate Finance . . . said . . . that as more parties seek to enter the securitization market, they are increasingly failing to structure deals properly.").

184. *Id.*

quality or if they do not have sufficient credit enhancement or if the deal is structured so that the originator is to absorb the first loss up to a specified level,[185] the originator's remaining assets will be further drained, leaving even fewer assets in its residual pool.

C. Consent as an Implicit Assumption

The implicit assumption supporting each of these justifications for secured credit, as well as for the proliferation of securitization transactions, is that unsecured creditors consented to their status. This implied consent suggests that unsecured creditors (1) have agreed to whatever consequences the law attaches to their credit extension, and (2) have contracted with perfect information.[186]

This "bargain model" of secured credit was originally articulated by Professor Thomas Jackson.[187] His theory "view[s] bankruptcy as a system designed to mirror the agreement one would expect the creditors to form among themselves were they able to negotiate such an agreement from an *ex ante* position."[188] The bargain model is based on the idea that the pre-bankruptcy position of creditors should be altered in bankruptcy only when such an alteration maximizes the net repayment of assets as a collective.[189] To the extent that the failure of a debtor's business is anticipated by the creditors' pre-bankruptcy bargain, allowances and adjustments were made at the time of the bargain.[190] It is the job of the bankruptcy laws to provide the omitted terms of the bargain for those parties who had no opportunity to participate in the bankruptcy process—the unsecured creditors.[191]

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185. *See* Rosenthal & Ocampo, *supra* note 5, at 35 (noting that a successful securitization lowers the cost of lending by reducing a portion of the needed equity capital and funding yield premiums).

186. *See generally* Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336 (1993) (outlining and comprehensively analyzing various theories of business bankruptcy-policy objectives).

187. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 860 (1982). The "bargain model" is a shift from the conveyance model of secured credit which is a property based theory. The conveyance model views security as a grant of property that leaves the debtor with the use and ownership of the collateral, but without the ability to commit the property to unsecured creditors. *See* Steve Knippenberg, *The Politics of Article 9:* The Unsecured Creditor's Bargain*: An Essay in Reply, Reprisal, or Support?*, 80 VA. L. REV. 1967, 1968 (1994).

188. *See* Jackson, *supra* note 187, at 860.

189. *See* Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 155-56 (1989) ("[P]rebankruptcy entitlements should be impaired in bankruptcy only when necessary to maximize net asset distributions to the creditors as a group . . . .").

190. *See id.* at 160-61 (explaining that creditors consider the risk of insolvency, both when deciding whether to take a security interest and when deciding the terms of the security interest).

191. *Cf. id.* at 158 (asserting that a "primary objective" of bankruptcy law is to regulate "conflicts among different groups having separate claims against a debtor's assets and income stream").

Professor Lynn LoPucki forcefully challenged the assumption of consent in a recent article advocating the reordering of the priority scheme for certain specified creditors.[192] In *The Unsecured Creditor's Bargain*,[193] LoPucki contends that secured debt facilitates the exploitation of involuntary creditors, as well as voluntary but uninformed creditors, by imposing on them a bargain to which they have provided no "meaningful consent."[194] He argues that involuntary creditors, such as tort victims and environmental claimholders,[195] have no opportunity to negotiate their subordinate status and therefore cannot charge an interest rate that offsets their heightened risk of non-payment in the event of a debtor's insolvency.[196] He further argues that uninformed voluntary creditors (those participants in the credit markets who miscalculate their likelihood of recovery from an insolvent debtor) also fail to negotiate an interest rate premium.[197] LoPucki proposes that security interests be subordinated to the claims of these voluntary uninformed and involuntary unsecured creditors.[198]

The bargain model, when used to explain an unsecured creditor's subordinate position after its debtor securitizes its valuable assets, is likewise based upon false assumptions. Neither involuntary nor voluntary uninformed unsecured creditors have the information or the opportunity to make *ex ante* adjustments in their bargain to reflect their actual risk. The interest rate charged does not reflect the heightened risk they are subject to because of the asset securitization.

Furthermore, although most voluntary uninformed unsecured creditors are probably aware that their debtor has the option to incur secured debt, they are less likely to be familiar enough with the structural intricacies of securitization transactions to ask the right questions and understand the implications of securitization.[199] Because of the complex nature of

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192. *See* LoPucki, *supra* note 177.

193. *Id.*

194. *See id.* at 1890-91.

195. Other involuntary creditors include insurance claimants; children and former spouses; airline ticket holders; and victims of securities and other frauds, including antitrust violations, unfair competition, and patent and trademark infringements. *See id.* at 1896.

196. *See id.* at 1893.

197. *See id.* at 1916, 1936. These unsecured creditors are often trade creditors or consumers, both of whom are less sophisticated, less informed, and have less clout in the credit markets than the most common secured lenders—that is, money center banks and finance companies. *See* SULLIVAN ET AL., *supra* note 181, at 287-88, 293.

198. *See* LoPucki, *supra* note 177, at 1963-64. *But see* Susan Block-Lieb, The Unsecured Creditor's Bargain: *A Reply*, 80 VA. L. REV. 1989, 1991 (1994) (challenging LoPucki's conclusion that the subordination of secured debt to involuntary debt is the most effective means of internalizing the risk of exposure to claims brought by involuntary creditors).

199. Indeed, commentators have often noted that many ABS investors do not understand the risks involved in securitization transactions. *See supra* notes 9-116; *see also* Frederick Dannen, *The Failed Promise of Asset-Backed Securities*, INSTITUTIONAL INVESTOR, Oct. 1989, at 260.

securitization, even these unsecured creditors may not know how to evaluate a firm with a securitized portfolio. They may not be equipped to effectively analyze the extent to which risk is retained by the securitizing firm or to understand how to quantify the firm's loss and prepayment assumptions. Securitization documentation is considerably more complex than the documents customarily prepared in connection with secured lending, and the party conducting the diligence must be alert to the issues of hidden liabilities, unacceptable operational constraints, and the various economic, operational, and reporting obligations incurred.[200]

Finally, the unsecured creditor must be prepared to respond to any representations, warranties, and covenants found in the securitization documentation that unduly restrict the firm's future ability to operate in a way that benefits the creditor. The creditor should also be wary of any alteration in assumptions made at the time of the securitization that adversely affects it. The unsecured creditor needs to know whether the transaction will interfere with its contractual relationship with the debtor-originator and, if so, whether the parties can make a correction in a previously negotiated interest rate. It is not at all clear, however, that the information sought by even the most tenacious unsecured creditor will be discoverable or comprehensible.[201] As such, it is unrealistic to assume that full information and consent have informed the interest rate charged by these largely uninformed or involuntary unsecured creditors.

To illustrate the extent to which unsecured creditors are excluded from the pre-bankruptcy bargaining process, suppose the securitizing firm is a consumer retailer and the receivables securitized are credit card accounts. The consumer goods customer's purchases that result in accounts receivable are purchased with service contracts or repair or replacement warranties,

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200. For a discussion of the challenges facing parties that attempt to examine a securitizing originator's portfolio of assets, see *supra* note 116.

201. The financial literature has proudly proclaimed that securitization is advantageous because a securitizing firm is not required to disclose to the public information about its business to the same extent it is required to do so in connection with a direct public offering. When an originator securitizes its assets, securities are issued by the affiliated SPC, rather than directly by the issuer. Because the substantive information relevant to the market includes (1) the asset pool's quality, (2) the presence and nature of any credit enhancement, (3) the transaction's structure, (4) an analysis of the entity providing the servicing of these assets, and (5) the nature of the SPC itself, the amount and type of information that needs to be disclosed is not of the same type and magnitude as would be the case if the originator were the direct security issuer; the complete business and financial history of the originator does not have to be included in the security disclosure documents. Although the public disclosure that is required for a public issuance of ABS is far greater than that required for a privately secured financing, it does not rise to the level required of a firm that is directly issuing securities in the public markets. This type of abbreviated disclosure is less expensive, less time-consuming to complete and assemble, and does not require a firm to reveal itself for full public scrutiny. From the perspective of the originator, this may prove to be a valuable advantage. *See* Barmat, *supra* note 16, at 5 (noting that nondisclosure is one of the compelling reasons to securitize assets).

and these customers are entitled to their money back or an exchange if the goods are defective.

If a portion of these credit card accounts are sold (securitized), and therefore not available to satisfy the warranty claims of the originator's customers,[202] the purchase risks of the customers are increased and their unsecured claims against the firm will be more difficult to satisfy. As a result, consumers who purchase goods from firms that securitize a portion of their assets are more likely to become unpaid unsecured creditors than consumers who purchase from firms that have only secured credit. As such, the securitizing firms should charge these consumers/potential unsecured creditors lower prices.[203]

If the consumers/potential unsecured creditors are unaware of the retailer's securitization, the prices they are willing to pay for the goods of securitizing firms will be unaffected by the securitization. The consumers (and other unsecured creditors with claims against this retailer) will consequently pay higher prices than they *should* pay and the securitizing firm will enjoy the transactional inefficiency surplus, at the expense of the unknowing or involuntary unsecured claimants.[204]

If a securitizing firm ultimately declares bankruptcy, uninformed and involuntary unsecured creditors may find themselves in an even less advantageous position. Unless the integrity of the transaction's structure is challenged,[205] a securitizing firm is transferring assets out of its potential bankruptcy estate and consequently, in the event of a bankruptcy, these assets are not available to the firm's unsecured creditors. As such, the asset purchasers are not motivated to aid the firm in preserving the value of the estate. Not surprisingly, the securitizing firm's unsecured creditors are assuming a risk of nonpayment, as a result of the securitization, that is arguably greater than the risk unsecured creditors experience when their debtor borrows money on a secured basis.

In contrast, in a secured lending arrangement, if the debtor enters bankruptcy, the collateralized assets remain in the debtor's estate and the debtor gets the benefit (the upside potential) of any increase in value of a collateralized asset during the pendency of the bankruptcy proceeding.[206]

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202. Presumably, the credit card accounts receivable sold (securitized) will be the highest quality pool, leaving those accounts of the less credit-worthy debtors behind for the benefit of that originator's general creditors in the event of a bankruptcy. *See* Gold & Schlueter, *supra* note 57, at 154-56 (outlining the asset-risk analysis conducted by rating agencies to identify and minimize potential credit-related problems).

203. These lower prices are the product-market equivalent of the higher interest rates that unsecured creditors should charge to a firm that securitizes assets (or issues secured debt).

204. This illustration has its origin in Schwartz, *supra* note 120, at 16-18 (illustrating the failure of secured debt, though not securitization, to adequately signal risks to creditors).

205. *See infra* subpart IV(D).

206. The secured creditors, if overcollateralized, are entitled to interest and contracted-for costs pursuant to Bankruptcy Code § 506(b) to the extent of any surplus value in the collateral. *See* 11

The secured creditor is required to participate in the debtor's bankruptcy and is motivated to encourage the preservation of the estate; in the event of a decrease in the value of the collateral, the estate may be the pool from which it receives a portion of its recovery.[207] The secured creditor may not just walk away from the debtor in bankruptcy with its collateral—it is constrained by the automatic stay imposed at the time of the bankruptcy filing, and the debtor has use of the collateral during the pendency of the bankruptcy if the stay is not lifted.[208] Thus, the relationship established between the debtor and the secured lender survives the debtor's bankruptcy, which has the potential to benefit the unsecured creditors.

Because of the different relationship ABS purchasers have with their financing seeking originator, the interest rates charged the securitizing originator by its unsecured creditors *should* be higher than those charged to debtors whose other funding comes from secured credit. If the unsecured interest rate does indeed reflect the risk differential, then one can conclude that securitization, pursuant to the analysis laid out by Jackson and Kronman, is indeed efficient. This analysis, however, rests upon the fundamental assumption of perfect information and fully informed consent by the unsecured creditors. This assumption, subject to considerable challenge when applied to secured credit, is even less reliable when a firm with unsecured creditors is securitizing assets.

U.S.C. § 506(b) (1994). If, during the pendency of the bankruptcy, the collateral increases in value in excess of the obligation owed to the secured party, that value is available for the benefit of the debtor's unsecured creditors. *See* 11 U.S.C. § 506(a)-(b).

207. Pursuant to Bankruptcy Code § 506(a), a claim is secured to the extent of the value of the collateral and is unsecured as to any deficiency in the collateral. *See* 11 U.S.C. § 506(b). An undersecured claim is thus bifurcated into a secured and unsecured claim. The portion of the claim that is unsecured is treated the same as any other unsecured claim. *See id.* § 506(a).

208. Section 362 of the Bankruptcy Code outlines the types and kinds of activities engaged in by creditors that must be halted once bankruptcy is declared. *See* 11 U.S.C. § 362 (listing several activities that are stayed once a bankruptcy petition is filed, including: judicial and administrative actions against the debtor that could have been commenced before bankruptcy, enforcement of judgments against the debtor, actions to obtain possession of property of the estate, and actions to create or perfect any lien against the property of the estate). Pursuant to the automatic-stay provision, all collection efforts by creditors must stop automatically upon the filing of a bankruptcy petition. *See id.* § 362(a). Furthermore, the stay freezes the creditors' state-law relationships among themselves and maintains the priority positions in effect upon filing. *See id.* Creditors are also stayed from pursuing any and all legal and administrative actions against the debtor and his property, including any action undertaken to create or enforce a lien. *See id.* This means that secured creditors may not enforce their security interests by levying upon property in which they have a security interest. *See id.* The stay with respect to the collateral of a particular creditor, however, may be lifted by a court following an application for relief from the stay pursuant to § 362(d). Section 362(d) sets out two separate grounds for relief from the stay. First, a court will lift the stay if the creditor successfully claims that it lacks "adequate protection." *Id.* § 362(d). The second ground is relied upon when the debtor has no equity in the property, and such property is not necessary for an effective reorganization. *See id.*

D. Equitable Challenges to Securitization Transactions

The best that may be concluded in the absence of empirical evidence is that the justifications for securitization are unpersuasive and unproven. Securitized transactions may be efficient, or they may be inefficient, with unsecured creditors subject to effects which are in many circumstances more detrimental than those effects they are subject to when their borrower uses its assets as collateral for a secured loan.

Unsecured creditors of securitizing originators may be exposed to the further risk that a bankruptcy court, in scrutinizing a structured finance transaction, will reverse the asset transfer in the exercise of its equitable discretion. The ensuing litigation will be expensive, time consuming, and, until there has been a full resolution of this issue, will lead to even greater uncertainty in the credit markets.

Bankruptcy courts' equitable powers were codified in section 105(a) of the Bankruptcy Code.[209] That section authorizes a court to "issue any order . . . necessary or appropriate to carry out provisions of this title."[210] Notwithstanding the apparent breadth of this Code language, the Supreme Court has taken a narrow view of its equitable powers under the Code.[211] In the last Supreme Court case decided under the Bankruptcy Act, *Butner v. United States*,[212] the Court addressed the question of whether applicable state law or a "federal rule of equity" should be applied in deciding which party had the right to rents collected during bankruptcy.[213] The Court distinguished between bankruptcy courts' powers as courts of equity and their equitable interpretation of the Bankruptcy Act and recognized the importance of the courts' equity powers in dealing with "particular, individualized problems."[214] The Court, however, made clear its hostility to a purely equitable interpretation of the Code in refusing to adopt a uniform federal rule on the basis of "undefined considerations of equity."[215]

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209. *See* 11 U.S.C. § 105(a).

210. *Id.*

211. Bankruptcy courts were more liberal in the use of their equitable powers under the Bankruptcy Act. Their broad use of equitable interpretations of the Act evolved from the efforts of judges to fill in the gaps left by the language of the statute. The Bankruptcy Act, which had not been amended in many years, did not reflect the commercial realities of the day. As such, judges were left to use their equitable discretion to further the underlying goals of bankruptcy. *See* Adam James Wiensch, Note, *The Supreme Court, Textualism, and the Treatment of Pre-Bankruptcy Code Law*, 79 GEO. L.J. 1831, 1860 (1991).

212. 440 U.S. 48 (1979). *Butner* was decided with reference to the provisions of the Bankruptcy Act, but after Congress's enactment of the Bankruptcy Code.

213. *Id.* at 49.

214. *Id.* at 56, 55-56.

215. *Id.* at 56.

In *NLRB v. Bildisco & Bildisco*,[216] the Supreme Court decided the issue of whether collective bargaining agreements were covered by section 365(a) by looking to the plain meaning of the language of the Code.[217] The Court refused to consider the equitable, public-policy arguments advocating for collective bargaining agreements' exemption from this section offered by the National Labor Relations Board and the union.[218] The Court admonished bankruptcy courts to limit the use of their equitable powers by requiring a written finding on the record if the "equities" weighed in favor of the rejection of collective bargaining agreements.[219]

The Supreme Court further refined the contours of its view of the equitable powers of bankruptcy courts in *Norwest Bank Worthington v. Ahlers*.[220] In *Ahlers*, the Court was faced with the question of whether a claim for an exception to the absolute priority rule, supported by both pre-Code practice and a variety of equitable justifications, should be allowed.[221] The Court dismissed the equitable arguments offered by the debtor and expressly stated, "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."[222]

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216. 465 U.S. 513 (1984).

217. *See id.* at 521-23.

218. *See id.* at 525, 524-27. The Court unanimously concluded that collective bargaining agreements were covered by § 365(a) of the Bankruptcy Code because, "by its terms[, it] includes all executory contracts except those expressly exempted." *Id.* at 521. The Court observed that Congress had expressly exempted collective bargaining agreements from other sections of the Code, thus indicating its intent to include them under the language of § 365(a). *See id.* at 522. The Court's reading of the Code in this case can be characterized as "textualism" because it strictly focused on the language and structure of the Code, ignoring the public policy implications (and arguably the third-party effects) of its interpretation. *See* Peter H. Carroll, III, *Literalism: The United States Supreme Court's Methodology for Statutory Construction in Bankruptcy Cases*, 25 ST. MARY'S L.J. 143 (1993); Carlos J. Cuevas, *Public Values and the Bankruptcy Code*, 12 BANKR. DEVS. J. 645, 645-46 (1996); Walter A. Effross, *Grammarians at the Gate: The Rehnquist Court's Evolving "Plain Meaning" Approach to Bankruptcy Jurisprudence*, 23 SETON HALL L. REV. 1636, 1638-39 (1993); Robert K. Rasmussen, *A Study of the Costs and Benefits of Textualism: The Supreme Court's Bankruptcy Cases*, 71 WASH. U. L.Q. 535, 565 (1993); Charles Jordan Tabb & Robert M. Lawless, *Of Commas, Gerunds, and Conjunctions: The Bankruptcy Jurisprudence of the Rehnquist Court*, 42 SYRACUSE L. REV. 823, 825 (1991) (all acknowledging that textualism is a primary method of interpreting the Bankruptcy Code and is one used extensively by the Supreme Court).

219. *See Bildisco*, 465 U.S. at 527. The Court stated, "The Bankruptcy Code does not authorize freewheeling consideration of every conceivable equity, but rather only how the equities relate to the success of the reorganization." *Id.* It is interesting to note that organized labor successfully lobbied for the legislative repeal of this decision. *See* 11 U.S.C. § 1113 (1994) (prohibiting the unilateral rejection of a collective bargaining agreement by a trustee, requiring first a court hearing and ruling); H.R. CONF. REP. NO. 98-882 (1984), *reprinted in* 1984 U.S.C.C.A.N. 576 (containing several statements from congressional leaders who reference organized labor).

220. 485 U.S. 197 (1988).

221. *See id.* at 199. The debtors in *Ahlers* were farmers who promised to contribute their "labor, experience, and expertise" to the reorganization of their farm in return for retaining an equity interest in it. The Court rejected this unenforceable promise and held that there was not a permissible exception to the plain statutory language of the absolute priority rule. *See id.* at 203-05.

222. *Id.* at 206.

It is clear from this line of cases that bankruptcy courts do not have unbridled equitable powers under section 105(a). Courts do, however, have the power to scrutinize asset transfers and the circumstances surrounding such transfers. Such scrutinization may lead a court to conclude (1) that the circumstances suggest that the asset transfer ought to be recharacterized as a transfer of collateral in connection with a secured loan, rather than an asset sale; (2) that, because "economic prejudice caused by continued entity separateness outweighs the potential prejudice that accompanies consolidation,"[223] the assets and liabilities of the SPC should be substantively consolidated for bankruptcy purposes with the assets and liabilities of the originator; or (3) that the asset transfer, in unjustly diminishing the debtor/originator's bankruptcy estate, falls within the prohibitions of fraudulent transfer law.[224]

If courts adopt any of these bases for concluding that securitization transfers should be undone when the originator is in bankruptcy, further harm will be done to the originator's unsecured creditors.

1. When the Equities Suggest that Assets Transferred Are Really Disguised Collateral for a Secured Loan.—If a transaction under the bankruptcy trustee's scrutiny involves the retention of some measure of recourse, risk, or control by the originator in connection with the asset transfer,[225] the trustee can make the argument that the transfer of assets was a transfer of collateral for a loan, rather than a sale of assets.[226] Historically, courts have exercised some latitude in determining whether or not a certain asset transfer was a sale or a transfer of collateral for a loan.[227]

223. J. Stephen Gilbert, Note, *Substantive Consolidation in Bankruptcy: A Primer*, 43 VAND. L. REV. 207, 208 (1990); *see also* Christopher W. Frost, *Organizational Form, Misappropriation Risk, and the Substantive Consolidation of Corporate Groups*, 44 HASTINGS L.J. 449, 449-51 (1993) (discussing the effects of substantive consolidation).

224. *See infra* sections IV(D)(2)-(3).

225. 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 on the note, seeking full payment. *See* ROBERT W. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS 9 (1989). For a discussion of recourse and retained risk, see *supra* notes 75, 77, 106.

226. *See, e.g.*, Fireman's Fund Ins. Co. v. Grover (*In re* Woodson Co.), 813 F.2d 266, 271-72 (9th Cir. 1987) (concluding that, because the investor retained a degree of risk in connection with a transfer and the interest rate charged was tied to prevailing borrowing rates, the transfer was a loan, rather than a sale).

227. *See id.*; *see also* Robert D. Aicher & William J. Fellerhof, *Characterization of a Transfer of Receivables as a Sale or Secured Loan upon the Bankruptcy of the Transferor*, 65 AM. BANKR. L.J. 181, 183, 182-84 (1991) ("[A] bankruptcy court's conclusion that a transfer is indeed a secured loan may depend on the context in which the court examines the issue."); Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON L. REV. 287, 290 (1991) ("[C]ourts do not rely upon any universally accepted set of factors in determining whether a purported sale is a true sale or merely a transfer as security for a secondary loan."); Peter L. Mancini, Note, *Bankruptcy and the UCC as Applied to Securitization: Characterizing a Mortgage Loan Transfer as a Sale or a Secured Loan*,

Whether a particular asset transfer is a true sale or a secured loan is not governed by a bright-line test.[228] Parties may intend one characterization, but the facts and circumstances of the transfer may suggest another.[229] Courts faced with "true sale versus secured loan" questions have made reference to a number of relevant factors, the presence of a critical mass of which would suggest a true sale. These factors include the intent of the parties as evidenced by their writings,[230] the absence of recourse to the asset seller,[231] the presence of a residual interest to be retained by the originator,[232] the sale price set at fair market value by independent appraisers,[233] the assumption of the benefits and burdens of ownership by the purchaser,[234] and the acquisition of dominion and control over the assets by the acquirer.[235] Many securitization

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73 B.U. L. REV. 873, 877, 877-82 (1993) ("The UCC . . . does not establish . . . relevant guidelines to determine whether the parties intended a particular transfer to represent a loan with a security interest or a sale.").

228. *See* Aicher & Fellerhof, *supra* note 227, at 182-84.

229. *See, e.g.*, Castle Rock Indus. Bank v. S.O.A.W. Enters., Inc. (*In re* S.O.A.W. Enters., Inc.), 32 B.R. 279, 283 (Bankr. W.D. Tex. 1983) (stating that even though the participation agreement in a loan-participation arrangement discussed the "sale of a participation," the arrangement should be considered a loan because, in reality, it contemplated the making of a loan to be secured by collateral); Boerner v. Colwell Co., 577 P.2d 200, 204-05 (Cal. 1978) (postulating that the substance, not the form, of the transaction dictated whether the transfer of construction contracts constituted bona fide credit sales rather than usurious loans).

230. *See, e.g.*, Hatoff v. Lemons & Assocs. (*In re* Lemons & Assocs.), 67 B.R. 198, 209-10 (Bankr. D. Nev. 1986) (basing its decision on the weight of objective manifestations of the parties' intent to consummate a sale transaction, including executed agreements and other documentary evidence).

231. *See, e.g.*, Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 542-44 (3d Cir. 1979) (noting that the absence of recourse to the seller is one of several relevant factors in determining the existence of a true sale).

232. *See, e.g.*, *In re* Evergreen Valley Resort, Inc., 23 B.R. 659, 661 (Bankr. D. Me. 1982) ("A security interest is indicated where the assignee retains a right to a deficiency on the debt . . . ."); First Nat'l Bank v. Hurricane Elkhorn Coal Corp. II (*In re* Hurricane Elkhorn Coal Corp. II), 19 B.R. 609, 614-15 (Bankr. W.D. Ky. 1982) (determining that because assignments of accounts receivable did not divest the debtor of all interest in the receivables, the assignments were given as security for a bank loan), *aff'd in part and rev'd in part*, 32 B.R. 737 (W.D. Ky. 1983), *aff'd*, 763 F.2d 188 (6th Cir. 1985); Credit Alliance Corp. v. Nixon Mach. Co. (*In re* Nixon Mach. Co.), 6 B.R. 847, 850 (Bankr. E.D. Tenn. 1980) ("A Chapter 11 . . . debtor's property generally is anything in which it has an interest.").

233. *See, e.g.*, *In re* Coronet Capital Co., 142 B.R. 78, 80 (Bankr. S.D.N.Y. 1992) (stating that a discrepancy between the interest rate due on the underlying note and the interest rate specified in the participation is a factor indicating an intention to create a loan rather than a participation).

234. *See, e.g.*, Federated Dept. Stores, Inc. v. Commissioner, 51 T.C. 500, 514-15 (1968) (holding that because the taxpayer was required to pay an indexed interest rate on the exact amount of the outstanding balance in connection with the transfer of accounts, and was further required to pledge future accounts when an account the taxpayer characterized as sold became delinquent, such transfer was deemed to be a secured loan), *aff'd*, 426 F.2d 417 (6th Cir. 1970).

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

a. whether the transaction covers specifically identified receivables, rather than an interest in a pool of receivables;

b. whether notice of the transfer of the receivables is given to the account debtors;

transactions, however, combine indicia of both a true sale and a secured loan, which makes a court's ultimate decision an exercise in the weighing and balancing of these factors.[236]

Further confusing courts and complicating the true sale analysis is the fact that an asset transfer may constitute a sale for accounting purposes and yet not be deemed to be a sale pursuant to the equities of bankruptcy.[237] If certain specified indicia of recourse are present,[238] then the transaction is considered a sale under the FASB rules. Bankruptcy courts, however, have historically taken a broader view, giving consideration to a long list of factors, including but not limited to, the presence of recourse when analyzing the sale versus loan issue.[239] Bankruptcy courts, however, have applied the "true sale" factors inconsistently.

Those transaction participants who exercise their creativity and develop new types of securitization structures offer a further challenge to

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c. whether the purchase price of the receivables is computed with reference to the expected life of the receivables, rather than by means of some interest-like monthly payment program. A purchase of assets at a fixed discount, which covers projected funding costs, is more like a sale than a purchase based on a floating rate, which is typically found in commercial loans;

d. whether the purchaser has no ability to alter the terms of a sale after the closing and the originator has no right to receive any surplus collections of transferred assets;

e. whether the related books and records are transferred and delivered to the purchaser. This may not be the case, however, if the originator contracts to service the receivables.

See Dewhirst v. Citibank (*In re* Contractors Equip. Supply Co.), 861 F.2d 241, 245 (9th Cir. 1988); Glover, *supra* note 5, at 621; Peter H. Weil, *Bankruptcy Issues for the Secured Creditor*, *in* ASSET-BASED LENDING INCLUDING COMMERCIAL FINANCE AND ACQUISITION FINANCING 1991, at 421, 424-26 (PLI Commerical Law & Practice Course Handbook Series No. 563, 1991).

236. *See, e.g., Major's Furniture*, 602 F.2d at 544 (characterizing the legally relevant question as "whether the *nature* of the recourse, and the true nature of the transaction, are such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction or to a sale" (emphasis in original) (footnote omitted)).

237. Rules promulgated by the FASB have stated that a transaction should be treated as a true sale rather than a secured loan for accounting purposes if the following factors are present: "The transferor surrenders control of the future economic benefits embodied in the receivables . . . . The transferor's obligation under the recourse provisions can be reasonably estimated . . . . The transferee cannot require the transferor to repurchase the receivables except pursuant to the recourse provisions." ORIGINAL PRONOUNCEMENTS: ACCOUNTING STANDARDS AS OF JUNE 1, 1990, Statement of Financial Accounting Standards No. 77, at 755, 756-57 (Financial Accounting Standards Bd. 1990). Bankruptcy courts, however, at times have used their equitable discretion to conclude that, notwithstanding the presence of several substantive indicia that an asset transfer was a true sale, the bankruptcy court should also consider the equities of the matter when construing the transfer. *See, e.g.*, Hatoff v. Lemons & Assocs. (*In re* Lemons & Assocs.), 67 B.R. 198, 210-13 (Bankr. D. Nev. 1986) (weighing the sale versus loan indicia, and concluding that the transfer was in fact a sale); *see also supra* note 106 and accompanying text.

238. *See supra* note 106 (defining a "transfer with recourse").

239. *See supra* text accompanying notes 216-25 (explaining how courts scrutinize and define asset transfers).

trustees who are inherently suspicious of this type of financing.[240] This kind of financial creativity may provide the impetus for a court, already uncomfortable about securitization's potential for circumventing the bankruptcy process, to recharacterize the asset transfer as a transfer of collateral due to the presence of recourse.

Incontrovertibly, this discretion allows bankruptcy judges the latitude to agree with a trustee who argues that securitization transactions are nothing more than extravagant and embellished security interests designed to circumvent the bankruptcy process, and to conclude that, notwithstanding the presence of certain "true sale" indicia, the asset transfer should be deemed to be a secured loan. If a court is persuaded that securitization financing is tantamount to a disguised secured financing transaction, it is likely to look through the transaction's form and take steps to protect the debtor's unsecured creditors from the effects of the complete removal of valuable assets from the debtor's bankruptcy estate.[241]

Illustrative of the uncertainty that reigns with respect to this issue is the common reluctance on the part of legal advisors to definitively conclude that a specific asset transfer is a true sale.[242] As stated previously,

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240. For example, Professor Steven L. Schwarcz suggests a structure that theoretically enables an originator to receive both the benefit of the upside potential of securitized assets as well as shielding the asset investors from the effects of the originator's bankruptcy. *See* Schwarcz, *Alchemy*, *supra* note 5, at 135-36. Professor Schwarcz explains in his article how selling receivables to an SPC, which in turn transfers its receivables to an independent SPC, can best protect the originator's assets:

> [T]he originator first sells receivables to a wholly owned SP[C] in a transaction that constitutes a true sale for bankruptcy purposes and thus achieves bankruptcy protection. The wholly owned SP[C] then transfers its receivables to an independent SP[C] in a transaction that constitutes a sale for accounting purposes but not necessarily for bankruptcy purposes. The independent SP[C] issues securities in the capital markets to fund the transfer. After the independent SP[C] pays off the securities, it can reconvey the remaining receivables and collections to the wholly owned SP[C] without impairing the accounting characterization as a sale. The wholly owned SP[C] is then merged into the originator, or alternatively, the remaining receivables and collections are transferred back to the originator as dividends. This structure thus allows the originator to realize the value of excess receivables and collections created by the original overcollateralization.

Id. at 142.

241. UCC § 9-102(1)(b) requires that, subject to certain exceptions, Article 9 will "apply to any sale of accounts or chattel paper." U.C.C. § 9-102(1)(b) (1994). Section 9-302 requires that purchasers of accounts file a financing statement to perfect their interest in such accounts. *See id.* § 9-302(1). If the purchaser fails to file and, thus, fails to perfect its interest, upon the debtor's bankruptcy the trustee may avoid the asset transfer and return the asset to the debtor's bankruptcy estate. *See id.* §§ 9-102, 9-302; *supra* note 158.

242. Historically, legal advisors would not give opinions with respect to bankruptcy issues, due to 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* TriBar Report, *supra* note 54, at 718-20. *See generally* George W. Bermant, *The Role of the Opinion of Counsel: A Tentative Reevaluation*, 49 CAL. ST. B.J. 132 (1974) (discussing the need for accurate legal opinions to characterize transactions); Scott FitzGibbon & Donald W. Glazer, *Legal Opinions in Corporate Transactions: The Opinion on Agreements and Instruments*, 12 J. CORP. L. 657 (1987) (arguing that standard bankruptcy-qualification

rating agencies responsible for evaluating the credit of the ABS put a special demand upon originator's counsel to opine that a transaction is structured so that the purchasers of the ABS are isolated from the potential bankruptcy of the originators.[243] As such it has become common practice for law firms to deliver reasoned legal opinions as to the bankruptcy-remote nature of the transaction's structure.[244] Investors may not recognize the subtle, yet significant distinction between a "bankruptcy-remote" structure and one that is "bankruptcy-proof"—which is to say, invulnerable to the possibility of bankruptcy.[245]

In addition, rating agencies may require that the transaction's structure provide for a form of recourse to the originator[246] or the requirement of credit enhancement,[247] and in such cases, it is even more difficult to deliver the "true sale" opinion. This fact, coupled with rating agencies' insistence upon "clean" opinions,[248] has led in some instances to an ethical race to the bottom, with those firms hungrier for lucrative structured finance deals expressing a greater willingness to offer unqualified opinions, even in the face of legal uncertainty.[249] Although more prudent

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clauses in legal opinions should not prevent attorneys from advising clients about the reasonably foreseeable bankruptcy implications of a 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 the effect of an enforceability opinion on a "bankruptcy out"); Special Comm. on Legal Opinions in Commercial Transactions, N.Y. County Lawyers' Ass'n in Cooperation with Corp. Law Comm., Ass'n of the Bar of the City of N.Y. and Corp. Law Comm. of the Banking, Corp., and Bus. Law Section, N.Y. State Bar Ass'n, *Legal Opinions to Third Parties: An Easier Path*, 34 BUS. LAW. 1891 (1979) [hereinafter *Legal Opinions*] (discussing the importance of legal opinions in corporate practice and advising how such opinions should be written).

243. Opinion negotiations between a rating agency and counsel to the securitizing originator have as their central theme the struggle between the rating agency's desire to be able to hold the opining counsel liable in the event a court concludes that the transaction was not "bankruptcy proof," and the opining counsel's desire to insulate and protect itself from liability for false and misleading statements. *See Legalities in Rating Mortgage-Backed Securities*, CREDITREVIEW, Oct. 25, 1993, at 9, 9-11 (noting that Standard & Poor's often attempts to reduce bankruptcy concerns by securing legal opinions from counsel for "bankruptcy-remote" subsidiary companies that the subsidiary will not be consolidated should the parent corporation become insolvent); Bottini, *supra* note 52, at 611; TriBar Report, *supra* note 54, at 735-37 (arguing that in order to make lawyers willing to offer bankruptcy opinions, courts should recognize the inherent uncertainties of bankruptcy equity power and hold opining counsel liable only for negligence); Husisian, *supra* note 52, at 421.

244. *See* TriBar Report, *supra* note 54, at 721, 734.

245. *See* Dannen, *supra* note 199, at 261. In three well known cases, SPCs filed for voluntary bankruptcy, notwithstanding their bankruptcy-remote structure. *See In re* P.A. Bergner & Co. Holding Co., 187 B.R. 964 (Bankr. E.D. Wisc. 1995); *In re* Buckhead Am. Corp., 161 B.R. 11 (Bankr. D. Del. 1993); *In re* Towers Fin. Corp., No. 93-41558 (Bankr. S.D.N.Y. filed Mar. 26, 1993).

246. *See* Curtin & Deckoff, *supra* note 38, at 204.

247. *See* Rosenthal & Ocampo, *supra* note 5, at 39.

248. A "clean opinion" is one that draws unqualified conclusions. TriBar Report, *supra* note 54, at 721.

249. It is very difficult to impose malpractice liability on a law firm based upon the delivery of a legal opinion if there is even a semblance of reasoning supporting the conclusions reached. *Cf.* Richard E. Mendales, *Looking Under the Rock: Disclosure of Bankruptcy Issues Under the Securities*

law firms have been willing to opine as to the efficacy of the transaction's structure, they have more cautiously qualified their conclusions and outlined the assumptions upon which their opinions are based.[250]

The foregoing illustrates how vulnerable an asset transfer can be when the transferor becomes a debtor in bankruptcy. Once bankruptcy is declared, an aggressive trustee will be looking for any weakness in the process or structure and any inequity in the effects of the asset transfer to bolster its assertion that equitable principles demand a reversion of the transferred assets to the debtor's bankruptcy estate. As the securitization of lower quality assets by marginal originators becomes more common, securitization market participants must be prepared for courts to denounce such creative structures and take steps to unwind these transactions.

2. *The Equitable Doctrine of Substantive Consolidation.*—Substantive consolidation is an equitable doctrine that involves the pooling of two or more entities' assets and results in the claims of one of the entity's creditors being treated as claims against the common fund.[251] A court may

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Laws, 57 OHIO ST. L.J. 731, 775 (1996) ("It is difficult, but not impossible, to impose liability upon attorneys for legal opinions."). During securitization's infancy, the "law" relied upon by transaction advisors may be the last transaction's documentation; participants in the financial markets have become very adept at relying upon previously created structures. The portfolio of securitization transactions successfully brought to the market becomes the "common law" relied upon by future parties. Such a transaction structure may suffice during the period where no court or legislature has stated otherwise. *See* Telephone Interview with Professor Richard E. Mendales, University of Miami School of Law (Aug. 28, 1996) (on file with the *Texas Law Review*); *see also* Thomas P. Hourican, *Overview of Rating Agency Criteria for Asset-Backed Transactions*, *in* THE HANDBOOK OF ASSET-BACKED SECURITIES, *supra* note 5, at 34 (stating that "[o]utside counsel to the seller should provide an unqualified opinion indicating that the transfer . . . is sufficient to remove the receivables from the seller's estate for purposes of Section 541 of the [Bankruptcy] [C]ode and that Section 362(a) would not apply . . . in the event of the seller's bankruptcy").

250. Opinions laden with foundational assumptions are known as "reasoned opinions." A reasoned, "true sale" legal opinion applies the various true sale factors to the transaction at hand and draws a qualified conclusion that the transfer is a true sale rather than a secured financing. *See* TriBar Report, *supra* note 54, at 721, 734. In a 1983 article, Moody's made a distinction between reasoned opinions—in which the basis for reaching a conclusion is outlined in the opinion—and "unqualified" or "unequivocal" opinions—in which, in Moody's view, the "risk attendant to the issue opined on has in the opinion of such lawyer been 'substantially eliminated.'" TriBar Report, *supra* note 54, at 734 (quoting *Moody's Approach to Rating Bank-Supported Debt Securities*, 75 MOODY'S BOND SURVEY 3979, 3980 (1983)). The TriBar Opinion Committee found Moody's distinction between reasoned opinions and unqualified opinions to be "unacceptably simplistic." TriBar Report, *supra* note 54, at 734-35. The Report by the Special Committee on Legal Opinions in Commercial Transactions takes the position that no opinion should be drawn so broadly that the lawyer becomes generally responsible for the legal or business risks inherent in a transaction. *See Legal Opinions*, *supra* note 242, at 1895. Further, the Report by the Special Committee makes clear that it is inappropriate to seek an "unqualified opinion on an uncertain or disputed legal principle. An opinion cannot change the facts or the state of the law." *Id.*; *see* TriBar Report, *supra* note 54, at 726-27, 735.

251. In one of the early cases outlining the contours of the substantive-consolidation doctrine, the Second Circuit upheld the lower court's consolidation of a liquidating debtor and its nonbankrupt affiliates because the affiliates were mere "instrumentalities of the bankrupt with no separate existence of

decide to substantively consolidate a securitizing originator and its related SPC if it appears that the two entities are perceived by the market as one entity and the equities of the interest of the firms' creditors are best served by a consolidation.[252] As one commentator noted, the trend in recent years has been for courts to be more willing to order a substantive consolidation of assets for economically integrated affiliated entities, when such an order will aid in the rehabilitation of the debtor and facilitate the administration of the bankruptcy estate.[253]

their own," and because adherence "to the separate corporate entities theory would result in an injustice to the bankrupt's creditors." Soviero v. Franklin Nat'l Bank, 328 F.2d 446, 448 (2d Cir. 1964). Another court has identified seven factors that should be considered in deciding whether a substantive consolidation of assets should be ordered. *See In re* Vecco Constr. Indus., 4 B.R. 407, 410 (Bankr. E.D. Va. 1980). These factors are: (1) "the presence or absence of consolidated financial statements," (2) "the unity of interests and ownership between the various corporate entities," (3) "the existence of parent and inter-corporate guarantees on loans," (4) "the degree of difficulty in segregating and ascertaining individual assets and liabilities," (5) "the transfer of assets without formal observance of corporate formalities," (6) "the commingling of assets and business functions," and (7) "the profitability of consolidation at a single physical location." *Id.*; *see also* Eastgroup Properties v. Southern Motel Ass'n, 935 F.2d 245, 249 (11th Cir. 1991) (holding that consolidation is appropriate when the entities are substantially identical and when the equities favor the consolidation); *In re* Augie/Restivo Banking Co., 860 F.2d 515, 520 (2d Cir. 1988) (holding that consolidation was inappropriate when the debtors had little in common); *In re* Auto-Train Corp., 810 F.2d 270, 279-80 (D.C. Cir. 1987) (holding that a creditor's reliance was sufficient to make consolidation improper, when the creditor had relied upon public manifestations that a subsidiary's assets, liabilities, and operations were separate from those of the parent); *In re* Food Fair, Inc., 10 B.R. 123, 126 (Bankr. S.D.N.Y. 1981) (applying the *In re Vecco* factors as a formula and not relying on the weighing and balancing of equitable considerations); Joy Flowers Conti, *An Analytical Model for Substantive Consolidation of Bankruptcy Cases*, 38 BUS. LAW. 855, 862 (1983) (proposing an analytical model for determining whether or not to apply substantive consolidation in a bankruptcy case); Frost, *supra* note 223 (discussing how bankruptcy courts use the doctrine of substantive consolidation to disregard the separation between commonly owned corporations); Timothy J. Hogan, *Substantive Consolidation: Observations and Suggestions*, 1986 ANN. SURV. BANKR. L. 63 (describing the evolution and scope of the doctrine of substantive consolidation); Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975) (discussing the problems arising when a corporation affiliated with another corporation becomes bankrupt); William H. Thornton, *The Continuing Presumption Against Substantive Consolidation*, 105 BANKING L.J. 448, 458 (1988) (analyzing the presumption against substantive consolidation and concluding that "[s]ubstantive consolidation should only be ordered over creditor opposition if the proponent has successfully borne the burden of proving either that misrepresentation has taken place or that the affairs of the entities concerned are a hopeless hash").

252. A bankruptcy court ordered the substantive consolidation of an SPC and an originator on the basis of the court's factual findings, which included its conclusion that the transfer involved the commingling of bank accounts, the payment of all expenses from one joint account, an entangled relationship among the parties, and the reliance by creditors on the credit of the consolidated debtors. *See In re* Buckhead Am. Corp., 161 B.R. 11, 13-15 (Bankr. D. Del. 1993). Consistent with the standard announced in the leading substantive consolidation cases, the court stated that the benefit of consolidation outweighed the prejudice that would result. *See id.* at 3.

253. *See* PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS, PROBLEMS IN THE BANKRUPTCY OR REORGANIZATION OF PARENT AND SUBSIDIARY CORPORATIONS, INCLUDING THE LAW OF CORPORATE GUARANTIES § 10.10.5 (1985 & Supp. 1994). Further factors courts have considered in recent opinions include: (1) the degree of economic integration of the components of corporate

Courts have looked to Section 105(a) of the Bankruptcy Code as the source of their equitable powers to order a substantive consolidation.[254] Consistent with the language in *Norwest Bank Worthington v. Ahlers*, however, they have narrowly exercised these powers and have in certain instances expressed a reluctance to consolidate affiliated corporations because of the risk of injury to certain of the parties' other creditors.[255] Only when it appears that the two entities being considered for consolidation have actually been functioning as one entity, and the determination to consolidate will not unfairly prejudice creditors of the debtor, will a court make this ruling.[256]

There is authority, albeit limited, to support the consolidation of a nondebtor (an SPC) into the bankruptcy case of a debtor (the originator).[257] In such cases where courts have ordered a substantive consolidation, the courts have found either that the affiliated nondebtor was

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groups and their common conduct of a unitary business, *see, e.g.*, *In re* Drexel Burnham Lambert Group, Inc., 138 B.R. 723, 741-44 (Bankr. S.D.N.Y. 1992); *In re* IRCC Inc., 105 B.R. 237, 241-42 (Bankr. S.D.N.Y. 1989); Holywell Corp. v. Bank of N.Y., 59 B.R. 340, 347 (S.D. Fla. 1986); *In re* Turead, 45 B.R. 658 (Bankr. N.D. Okla. 1985), *aff'd*, 59 B.R. 973 (N.D. Okla. 1986); (2) to what degree the creditor relied on the credit of the enterprise, *see, e.g.*, Eastgroup Properties, 935 F.2d at 251; *In re* Drexel Burnham Lambert Group, Inc., 138 B.R. 723, 744 (Bankr. N.D. Tex. 1985); (3) whether the new entity intermingled formerly separate accounts, *see, e.g.*, Drabvkin v. Midland Ross Corp. (*In re* Auto Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987); Chemical Bank N.Y. Trust Co. v. Kheel (*In re* Seatrade Corp.), 369 F.2d 845, 847 (2d Cir. 1966); *In re* Murray Indus., 119 B.R. 820, 831 (Bankr. M.D. Fla. 1990); (4) whether the new entity intermingled formerly separate assets, *see, e.g.*, *In re* Baker & Getty Fin. Servs., Inc., 78 B.R. 139, 142 (Bankr. N.D. Ohio 1987); *In re* Richton Int'l Corp., 12 B.R. 555, 558 (Bankr. S.D.N.Y. 1981); and (5) the guidance provided by veil-piercing jurisprudence, *see, e.g.*, FDIC v. Colonial Realty Co., 966 F.2d 57, 60-61 (2d Cir. 1992).

254. *See, e.g.*, *Colonial Realty*, 966 F.2d at 59, 61; *see also In re* Richton Int'l Corp., 12 B.R. 555, 557 (Bankr. S.D.N.Y. 1981).

255. *See, e.g.*, *Drabvkin*, 810 F.2d at 277-78 (denying trustee's *nunc pro tunc* consolidation of a subsidiary's assets into the parent's bankruptcy estate because it would be detrimental to the creditor's reliance); *Kheel*, 369 F.2d at 848 ("Equality among creditors who have lawfully bargained for different treatment is not equity . . . , and the argument for equality has a specially hollow ring when made by the United States whose priority over other creditors will necessarily be enhanced by having the assets of all these corporations thrown into hotchpot."); *In re* DRW Property Co., 54 B.R. 489, 497 (Bankr. N.D. Tex. 1985) (refusing to order a consolidation of assets among affiliated entities because the potential harm to creditors outweighed the benefits of substantive consolidation); *In re* Snider Bros., Inc., 18 B.R. 230, 238-39 (Bankr. D. Mass. 1982) (denying a substantive consolidation request by unsecured-creditors committees for six corporate debtors). *See generally* Frost, *supra* note 223, at 449 (presenting an economic analysis of substantive consolidation and limited liability in bankruptcies involving affiliated corporations).

256. BLUMBERG, *supra* note 253, § 10.1.6.

257. *See, e.g.*, Bracaglia v. Manzo (*In re* United Stairs Corp.), 176 B.R. 359, 369 (Bankr. D.N.J. 1995) (allowing substantial consolidation of a nondebtor after applying a balancing of equities test); *In re* 1438 Meridian Place, N.W., Inc., 15 B.R. 89, 96-97 (Bankr. D.D.C. 1981) (relying on traditional veil-piercing jurisprudence in reaching its decision to consolidate a debtor with a nondebtor); *see also* Patrick C. Sargent, *Bankruptcy Remote Finance Subsidiaries: The Substantive Consolidation Issue*, 44 BUS. LAW. 1223, 1233-36 (1989) (discussing consolidation of a debtor with a nondebtor affiliate). *But see* Raslavich v. Ira S. Davis Storage Co., (*In re* Ira S. Davis, Co.), No. 92-142595, 1993 WL 384501, at *6 (Bankr. E.D. Pa. Sept. 22, 1993) (holding that consolidating a debtor and nondebtor violates the Bankruptcy Code's requirements for commencing an involuntary case).

the "alter ego" of the debtor, or that elements of fraud existed in the relationship between the parties.[258]

Because of the substantial implications the risk of substantive consolidation has on the market for asset-backed securities,[259] rating agencies, in addition to requiring "true sale" opinions, require that counsel for securitization originators represent that all steps have been taken to minimize the chance that a court will substantively consolidate the originator and its affiliated SPC.[260] Counsel, however, find it much more difficult to deliver this kind of opinion because of the opinion's forward-looking perspective.[261] The TriBar Opinion Committee has described a substantive consolidation opinion as an

> opinion as to a discretionary, equitable judgment to be made in the future, in the context of the congressional goal of promoting reorganizations, with respect to the interplay of facts, circumstances, relationships, and other considerations, some of which may exist at the time the opinion is rendered and some of which may arise in the future.[262]

Because of the nature of the equitable jurisdiction bankruptcy courts have, opining counsel traditionally include a litany of qualifications and assumptions in their opinions in order to avoid potential misunderstandings concerning the definitive nature of any conclusions drawn.[263] These opinion

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258. *See In re* 1438 Meridian Place, N.W., Inc., 15 B.R. 89, 97 (Bankr. D.D.C. 1981) (deciding to substantively consolidate nondebtor affiliates with a debtor because such nondebtors were the alter egos of the debtor's shareholders); Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215 (1941) (basing its decision to substantively consolidate a debtor and its affiliated nondebtor on the presence of fraud); Mark L. Prager & Jonathan A. Backman, *Pursuing Alter-Ego Liability Against Non-Bankrupt Third Parties: Structuring a Comprehensive Conceptual Framework*, 35 ST. LOUIS U. L.J. 657, 706 (1991) (arguing that substantive consolidation provides a "more coherent and equitable method for dealing with excessively entangled entities" than does the alter ego doctrine). *But cf.* Baker Ostrin, *A Proposal to Limit the Availability of Substantive Consolidation of Solvent Entities with Bankrupt Affiliates*, 91 COM. L.J. 351, 363 (1986) (suggesting that the remedy of substantive consolidation be limited to cases in which there has been a fraudulent representation).

259. In the absence of complete credit enhancement or over-collateralization, the return of the transferred assets into the estate of the debtor means that such assets are subject to the claims of the debtor's unsecured creditors. *See supra* note 158. This liability clearly diminishes the security and value of the purchasers' investment in the ABS.

260. Rating agencies are going to be fundamentally concerned with the risk that a court will bring a solvent, affiliated SPC into its parent's bankruptcy proceeding. *See* Sargent, *supra* note 257, at 1233-34.

261. *See* TriBar Report, *supra* note 54, at 727.

262. *Id.*

263. According to the TriBar Report, opining counsel should:

> (i) state[] that substantive consolidation is an equitable doctrine, that relevant facts may arise in the future, and that courts have accorded different degrees of importance to different factual matters;
>
> (ii) assume[] that the entities involved will act in accordance with limitations designed to promote separateness drafted into the relevant documents;

guidelines make clear how difficult it is for legal counsel to draw definitive conclusions when the issue concerned is an equitable matter.

3. *The Application of a Quasi-Fraudulent Conveyance Analysis.*— Section 548(a) of the Bankruptcy Code provides authority for a trustee to challenge a transfer of assets that was actually fraudulent or constructively fraudulent.[264] Section 548, as well as state fraudulent transfer statutes,[265] sets out very clear conditions under which a transfer can be avoided.[266] Specifically, transfers that run afoul of fraudulent conveyance law are those made with the "actual intent to hinder, delay, or defraud any entity to which the debtor was" indebted, "or became" indebted "on or after the date that such transfer was made."[267] In addition, trustees may avoid transfers that are made for less than reasonably equivalent value, and made when the debtor, irrespective of its intention, (1) becomes insolvent, (2) was engaged in business with unreasonably small capital, or (3) intended to incur debts that would be beyond its ability to pay.[268]

(iii) assume[] a number of objective facts which have been drafted into the documents to support separateness;

(iv) assume[] certain subjective or conclusory facts, such as the newly-created entity has "sufficient employees" and will not be bound by business decisions of the parent without independent approval by the newly-created entity pursuant to its own corporate governance procedures;

(v) assume[] the absence of any factors inconsistent with the other express assumptions; and

(vi) qualif[y] the opinion by stating that there is no case directly on point and that there are uncertainties in rendering a substantive consolidation opinion.

Id. at 726-27.

264. *See* 11 U.S.C. § 548 (1994).

265. In addition, § 544(b) of the Bankruptcy Code incorporates state fraudulent transfer law and authorizes the trustee to avoid any transfers by the debtor that an unsecured creditor with an allowable claim under § 502(e) of the Bankruptcy Code could avoid under state fraudulent transfer law. *See id.* § 544(b).

266. The modern fraudulent transfer statutes were derived from the Statute of Elizabeth, 13 Eliz. c.5 (1571). The statute applied to conveyances made with the intent to "delaye hynder or defraude Creditors and others of theyr juste and lawfull Actions Suites [and] Debtes." *Id.* At present, thirty-six states and the District of Columbia have adopted the Uniform Fraudulent Transfer Act (UFTA), *see* 7A U.L.A. 209 (Supp. 1997), and its precursor, the Uniform Fraudulent Conveyance Act (UFCA), is in effect in five states. *See* 7A U.L.A. 159 (Supp. 1997). Both statutes are considered to be codifications of cases applying the Statute of Elizabeth. Section 548 of the Bankruptcy Code empowers a bankruptcy trustee to avoid a transfer of a debtor's property, or any obligation incurred by the transfer, that was fraudulently made or incurred under certain defined circumstances within one year prior to the filing of the bankruptcy petition. *See* 11 U.S.C. § 548. *See generally* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985) (analyzing fradulent conveyance as a species of contract law); Michael L. Cook & Richard E. Mendales, *The Uniform Fraudulent Transfer Act: An Introductory Critique*, 62 AM. BANKR. L.J. 87 (1988) (comparing the UFTA to the UFCA and the Bankruptcy Code).

267. 11 U.S.C. § 548(a)(1).

268. Section 548 of the Bankruptcy Code allows a trustee to avoid transfers that occurred within one year of bankruptcy, *id.* § 548(a), and the UFTA generally allows creditors a period of four years

To the extent securitization transactions involve actual fraud, trustees can avoid the asset transfer based upon the clear language of section 548 of the Bankruptcy Code. It is worth noting, however, that the harm faced by the originator's unsecured creditors as a result of the fraud is not necessarily attributable to securitization as a method of financing, but to the originator's fraudulent behavior. Such fraud could occur in a secured credit context as well. Moreover, if there is less than reasonably equivalent value exchanged at a time when the originator is in a precarious financial condition, the trustee has a clear basis for avoiding an asset transfer as a constructive fraudulent conveyance. Market forces provide a check, however, on whether the securitized assets transferred to the SPC are in exchange for "reasonably equivalent value,"[269] and even low quality assets transferred in exchange for a deeply discounted amount would probably survive the scrutiny of a court under a constructive fraudulent conveyance challenge.[270] Indeed, due to the scrutiny imposed by rating agencies, credit enhancers, and the various other market participants, securitization may present fewer opportunities for self-dealing than alternative financing methods.

As stated previously, the movement of assets away from the reach of the originator's unsecured creditors is central to securitization's structure. In fact, it is the transaction's bankruptcy-remote feature that has attracted this year's market to invest over one-hundred billion dollars in asset-backed securities.[271] This removal of valuable assets from the reach of the originator's unsecured creditors is the type of harm the fraudulent conveyance doctrine is designed to address.[272] The debate in recent years concerning the proper limits of fraudulent transfer law has been in the context of certain modern day transactions that have resulted in an unjust diminution of the debtor's bankruptcy estate.[273] Because courts have applied the

from the transfer in which to commence an avoidance suit. UNIF. FRAUDULENT TRANSFER ACT § 9 & cmt., 7A U.L.A. 666 (1985). If the transfer occurred more than a year before the petition, the trustee may be able to avoid it by using state law pursuant to § 544(b), even though it cannot avoid it under § 548. *See* 11 U.S.C. § 544(b).

269. 11 U.S.C. § 548(a)(2)(A).

270. This is particularly true when asset-backed securities are sold in the public markets.

271. *See supra* note 46.

272. In an article examining the disclosure of bankruptcy issues under the securities laws, Professor Mendales observed that substantive consolidation and recharacterization of true sales as secured loans "collapses analytically" into the fraudulent conveyance model. Mendales, *supra* note 249, at 783, 782-83.

273. *See, e.g.*, Baird & Jackson, *supra* note 266 (arguing that fraudulent conveyance laws should not be used to protect debtors in foreclosure sales because such efforts might be counterproductive); David Gray Carlson, *Leveraged Buyouts in Bankruptcy*, 20 GA. L. REV. 73 (1985) (discussing the impact of six different leveraged-buyout transaction structures on bankruptcy estates); Emily L. Sherwin, *Creditors' Rights Against Participants in a Leveraged Buyout*, 72 MINN. L. REV. 449 (1988)

fraudulent conveyance doctrine to challenge transfers made in connection with leveraged buy-outs,[274] there is a precedent for expansion of this doctrine.[275] Furthermore, securitization results in an increase in a firm's unsecured creditor's overall post-lending risk—another evil fraudulent transfer law addresses.

To illustrate, when unsecured creditors lend money, they do so at an interest rate that reflects the debtor's level of risk at the time of lending. Once the debtor receives the unsecured credit, it then has an incentive to engage in risky behavior with the promise of not only great rewards but also the corresponding chance of losing it all. In many instances, unsecured creditors have neither the knowledge nor the money to bargain for an interest rate that reflects a change in behavior. Insolvent firms are especially motivated to gamble in this way because, in the event of liquidation, the firm owners receive nothing; if the firm does reap a profit, however, it is the owners—not the creditors—who receive the windfall.[276]

When this risky behavior is financed by a firm securitizing its highest quality assets, the unsecured creditors may find themselves in an even worse position. They remain subject to securitization's negative externalities[277] and have a lower chance of repayment upon liquidation, without having been paid an interest rate that reflects this risk. At a

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(analyzing the ways courts have approached creditors' rights in the context of LBOs financed either by independent lenders or by selling shareholders); Jack F. Williams, *Revisiting the Proper Limits of Fraudulent Transfer Law*, 8 BANKR. DEVS. J. 55 (1991) (discussing the limits of fraudulent transfer law while professing to remain faithful to its basic principles).

274. *See, e.g.*, United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986). *But see* Kupetz v. Wolf, 845 F.2d 842, 847-49 (9th Cir. 1988) (refusing to find a fraudulent conveyance in the instance of the sale of a debtor corporation in a leveraged buyout); Mellon Bank v. Metro Communications, Inc. (*In re* Metro Communications, Inc.), 95 B.R. 921, 932 (Bankr. W.D. Pa. 1989) (asserting that the bankruptcy statute prohibiting fraudulent transfers applies to leveraged buyouts), *amended* 135 B.R. 17 (Bankr. W.D. Pa. 1989) *and aff'd in part and rev'd in part*, 135 B.R. 15 (W.D. Pa.), *rev'd*, 945 F.2d 635 (3d Cir. 1991); Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488, 500 (Bankr. N.D. Ill. 1988) ("Although . . . fraudulent conveyance laws generally are applicable to [leveraged-buyout] transactions, a debtor cannot use these laws to avoid any and all [such transactions]."); Ohio Corrugating Co. v. DPAC, Inc., 91 B.R. 430, 439-40 (Bankr. N.D. Ohio 1988) (determining that the plaintiffs failed to show a fraudulent conveyance because they did not prove that the defendant was insolvent at the time of the leveraged buyout). *See generally* Baird & Jackson, *supra* note 266, at 850-54; Carlson, *supra* note 273, at 73; Sherwin, *supra* note 273, at 449.

275. Professors Baird and Jackson argued in *Fraudulent Conveyance Law and its Proper Domain* that "using the fraudulent conveyance remedy to undo bad deals . . . can be justified only if its benefits are greater than the costs of the uncertainty such a rule brings." Baird & Jackson, *supra* note 266, at 838. "Fraudulent conveyance law should never apply to arms-length transactions, even if it appears after the fact that the debtor's actions injured the creditors." *Id.* at 854.

276. BAIRD & JACKSON, *supra* note 144, at 373.

277. Securitization's negative externalities include the diminished chance for repayment, even in the absence of liquidation, because the firm securitized its highest quality assets; the complete severance of the securitized assets from the bankruptcy estate of the debtor firm; the absence of debtor monitoring; and the debtor's freedom to waste the consideration it gained from the sale of its assets.

minimum, a court might find that the securitization transaction did not serve to advance the creditors' collective interests.[278]

Is there a place within the domain of fraudulent conveyance law for the avoidance of a transaction that is designed to manipulate a debtor's assets so as to move them from the reach of its unsecured creditors? Is it a failing of fraudulent transfer law not to provide a cause of action to address such a harm? Is there room within bankruptcy courts' narrowly circumscribed equitable powers for an extension of the fraudulent transfer doctrine? Will such a pragmatic judgment survive appellate review?[279] If not, should there be a legislative response to this identified harm? In the coming years, as the asset-backed securities market continues its expansion, courts and legislatures may increasingly be persuaded that the answer to these questions is "yes," and we may see the evolutionary development of what may be characterized as quasi-fraudulent conveyance jurisprudence.

V. The Unsettled Nature of the Law Relating to Structured Finance

As more securitizations come to the market, the extent to which the present state of the law does not neatly fit this transaction is becoming increasingly clear.[280] One illustration involves the threshold issue of whether interests in asset pools are "securities" under the Securities Act of 1933 (the 1933 Act)[281] and the Securities Exchange Act of 1934 (the

278. The diminished incentive and opportunity for the monitoring of the debtor may, however, provide in some cases greater opportunity for fraudulent behavior. *See* Hilary Rosenberg, *The Amazing Towers Financial Affair*, INSTITUTIONAL INVESTOR, June 1994, at 126.

279. Equity, in a bankruptcy context, can be viewed as a form of legal pragmatism. Legal pragmatism has been described as "a theory of law that asserts that 'judges do and should make whatever decisions seem to them best for the community's future, not counting any form of consistency with the past as valuable for its own sake.'" Steven D. Smith, *The Pursuit of Pragmatism*, 100 YALE L.J. 409, 413 (1990) (quoting RONALD DWORKIN, LAW'S EMPIRE 95 (1986)). If bankruptcy courts exercise pragmatic judgments in their review of securitized asset transfers, they could rely upon their equitable powers to reach a just result.

280. For example, the securitization of pools of assets is in part governed by the Investment Company Act of 1940; issues remain open under this Act. *See generally* 15 U.S.C. § 80a (1994 & Supp. 1995). The 1940 Act requires that an entity principally engaged in owning or holding "securities" must register with the SEC as an "investment company," unless one of the statutory exemptions applies. *Id.* at § 80a-3(a)(3). Because of the burdensome nature of registration under the 1940 Act, securitization participants generally seek to have the transaction fall within one of the statutory exemptions. Until recently, however, securitization transactions did not fit neatly into the categories of investment companies outlined in the 1940 Act because of the statute's focus on the types of assets securitized, rather than on the economic principles underlying the transaction. As a result, similar types of securitizations were treated differently under the 1940 Act, depending upon the types of assets transferred by the originator. *See generally* Investment Company Act Rules, 17 C.F.R. § 270 (1996); 1 FRANKEL, *supra* note 5, § 3.15.2.

281. The 1933 Act imposes standards of disclosure and requires the filing of a registration statement with the SEC in connection with any public offering of non-exempt securities. *See* Securities Act of 1933, 15 U.S.C. § 77 (1994).

1934 Act).[282] Notwithstanding the developed jurisprudence in this area, the issue has not yet been definitively resolved. Courts and the SEC have tried to fit asset-backed instruments into the definition of "security" found in section 2(1) of the 1933 Act, but because securitization involves the partial metamorphosis of an obligation from a contract to a form of personal property, the current securities-related jurisprudence does not fully resolve the ambiguity.[283] Courts have reached conflicting resolutions of this question, often in response to arguments focusing upon different attributes of the interests at issue.[284] While the current, prevailing view is that

282. The 1934 Act imposes standards of disclosure and liability for certain types of fraudulent statements or omissions, as well as registration and ongoing reporting requirements for certain publicly held issuers. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78 (1994).

283. *See* 2 FRANKEL, *supra* note 5, § 9.16 to -.17.2. Professor Frankel explains that the policies of both contract and property law include creating certainty and predictability to reduce the parties' planning and transaction costs, but the rules under contract and property have different focuses. Contract law focuses on the parties to the contract and their specific agreement, whereas property law focuses upon a bundle of rights held by participants in the market. The different emphasis under these respective classifications can potentially result in different rules. *See id.*; *see also* Jay M. Feinman, *The Jurisprudence of Classification*, 41 STAN. L. REV. 661, 673 (1989) ("Classification is a shaping and developing of traditional systematic conceptions and traditional systematic categories in order to organize the body of legal precepts so that they may be: (1) [s]tated effectively with a minimum of repetition, overlapping, and potential conflict, (2) administered effectively, (3) taught effectively, and (4) developed effectively for new situations." (quoting Roscoe Pound, *Classification of Law*, 37 HARV. L. REV. 933, 944 (1924))); Tamar Frankel, *The Legal Infrastructure of Markets: The Role of Contract and Property Law*, 73 B.U. L. REV. 389, 392 & n.13 (1993) (describing the contract prototype as a relationship consisting of promises enforceable by law and the property prototype as a relationship between a person with property rights and other people, with rights ranging from the right to entry and use of the property to entitlements to exclude others from the property).

284. The SEC said in Union Home Loans, Exchange Act Release No. 19,346, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,308, at 85,681 (Dec. 16, 1982), that whether a mortgage-backed security is a security or a commercial loan depends upon whether it falls within § 2(1) of the 1933 Act's definition of "investment contracts." *Id.* at 85,682 (citing SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 353 (1943)). Section 2(1) of the 1933 Act defines the term security to include "certificates of interest or participation in any profit-sharing agreement," "investment contract," and, "in general, any interest or instrument commonly known as a 'security.'" Securities Act of 1933 § 2(1), 15 U.S.C. § 77b(1) (1994). The definition of security announced in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), focuses on investment contracts. *Id.* at 297-301. The Court in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), discussed the "risk capital test," *id.* at 857 n.24, but declined to adopt the test, stating that risk-capital would not apply to this case even if they had adopted it. The *Forman* Court also examined the "economic realities" test, describing it as a "basic principle test that has guided all of the Court's decisions in this area." *Id.* at 848, 848-51. Both *W.J. Howey* and *Forman* have provided lower courts with some guidance. For example, one district court has held that mortgage-backed securities are not investment contracts because they do not meet the *Howey* test. *See In re* Epic Mortgage Ins. Litig., 701 F. Supp. 1192, 1248 (E.D. Va. 1988) (setting forth the four elements of the *Howey* test), *aff'd in part and rev'd in part sub nom.* Foremost Guar. Corp. v. Meritor Sav. Bank, 910 F.2d 118 (4th Cir. 1990); *see also In re* National Mortgage Equity Corp. Mortgage Pool Certificates Sec. Litig., 723 F. Supp. 497, 501-05 (C.D. Cal. 1989) (deciding that mortgage-backed certificates were not investment contracts under the *Howey* test and, therefore, not securities). The *National Mortgage* court based its findings on the fact (1) that the investors were investing in loans, not in the business of the issuer; (2) that there was no common-enterprise risk; (3) that there was a recourse provision in the investment contract; and (4) that the investors did not rely

ABS are securities, especially when ABS investors are not individually negotiating their investment, as is the case when ABS are offered in the public markets, courts continue to rely upon a facts-and-circumstances analysis.[285]

In addition to securities-related issues, these transactions implicate multifarious issues in many other areas of the law,[286] and yet few structured finance transactions have been examined by courts. As such, the market has not had the benefit of courts' studied analyses of these transactions and their effects upon various market participants.[287] In a hurried effort to keep up with the evolving market, there have been numerous statutory revisions and new rulemaking in recent years, all designed to address

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on the efforts of others for profitability, other than portfolio selection prior to the investment. *Id.* at 503-05.

285. The party arguing that the instruments are not securities has the burden of demonstrating that the investors are active lenders and not passive investors. Ultimately, the resolution of the issue is fact specific and factors such as the documentation of the arrangement between the parties, the nature of the parties' negotiations, whether the particular investors needed the protection of the securities acts, and whether the investor was acting as a "lender" or was purchasing the instrument as a passive investor are factors courts consider in reaching their decisions. *See* 1 FRANKEL, *supra* note 5, § 1.1. *But see* Resolution Trust Corp. v. Stone, 998 F.2d 1534, 1538-40 (10th Cir. 1993) (holding that pools of automobile-loan receivables sold to financial institutions were not securities under the 1933 Act definition). *See generally* Park McGinty, *What Is a Security?*, 1993 WIS. L. REV. 1033, 1103-06 (discussing the question of whether or not ABS are securities).

286. Professor Frankel succinctly made this point when she wrote:

> The legal issues that securitization raises touch on almost every legal area: banking and bankruptcy, securities acts and the Uniform Commercial Code, contract, property, and fiduciary law. The law of securitization cannot focus on types of instruments, transactions, institutions, laws, or principles because it touches on all of these. Securitization is a process.

1 FRANKEL, *supra* note 5, at xlvii.

287. The market has not fully understood the nature of ABS, and trading prices for ABS have, in some circumstances, reflected this confusion. Investors insist upon a triple-A credit rating (and as such, credit enhancement is almost always an element of the transaction), and according to one observer, ABS trade like a "weak- or middling-A security." The observation has been made by one Wall Street participant that an "A" rated originator can raise funds in the bond market fifteen to twenty basis points less than through a securitization. *See* Dannen, *supra* note 199, at 261.

Furthermore, even the regulatory bodies may not understand the nature of the product they regulate. For example, the California Department of Corporations recently began enforcing an unpublished policy whereby they reject any asset-backed securities registration application unless the securities are backed by third-party credit enhancement equal to at least 13% of the outstanding principal balance, notwithstanding the rating of the securities and the fact that the California Department of Corporations allows an exemption for evidences of indebtedness (which does not include pass-through securities) rated in the top four rating categories. *See* Rodney S. Dayan, *Current Legal Developments in Securitization*, *in* NEW DEVELOPMENTS IN SECURITIZATION 7, 24-26 (PLI Comm. Law & Practice Course Handbook Series No. A-677, 1993). Thus, investment-grade ABS structured as pass-throughs are subject to registration under California's blue sky laws and will be approved only with a 13% credit enhancement arrangement in place. Not surprisingly, pricing for these highly rated securities does not reflect the costs incurred by the issuer in obtaining an "AA" or "AAA" rating, and as such, securitization can be quite an expensive funding method. Accordingly, this funding strategy may not be appropriate for every company to which it is being marketed. *See id.*

the unique issues raised by securitizations.[288] Because of the complexity and ambiguity of these transactions, and uncertainties and gaps in the law relating to securitization,[289] many courts examining a collapsed structured

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288. For example, in 1992, the SEC proposed a new rule under the 1940 Act for the purpose of excluding certain issuers that pool income-producing assets and issue securities backed by those assets from the definition of "investment company." The new Rule 3a-7, adopted in November 1992, permits structured financings to publicly offer securities in the United States without registering under the 1940 Act and complying with the 1940 Act's substantive conditions if the financing meets specified conditions. These requirements include that issuers must (1) issue primarily fixed-income securities, with payments based upon cash flow derived from the pooled assets; (2) offer only highly rated fixed-income securities to the public; (3) hold substantially all of the financing's assets, with limited exceptions, until maturity; and (4) deposit assets, cash flows, and other property not needed for the financing's operations in a segregated account maintained by an independent trustee. Investment Company Act of 1940, 17 C.F.R. § 270.3a-7 (1997). The stated purpose of Rule 3a-7 is to remove "an unnecessary and unintended barrier to the use of structured financings in all sectors of the economy, including the small business sector." *See* 57 Fed. Reg. 56,248 (1992).

Moreover, tax law regarding securitizing entities has been undergoing revision. Recently, the Small Business Job Protection Act of 1996 created a new tax entity for use in securitization transactions, known as the "financial asset securitization investment trust" or "FASIT." Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1621, 110 Stat. 1755, 1858-68 (codified at 26 U.S.C.A. §§ 860H, 860J, 860K, 860L (West Supp. 1997)). A FASIT is a pass-through vehicle, which means that all income, gain deduction, loss, and credit pass-through to the holder of the FASIT's ownership interest. The impetus behind this new creation is to make it easier for lenders to pool assets and to issue to the public debt secured by such assets at a lower cost than under previous law. Entities will not be able to elect FASIT status until the September 1, 1997 effective date. *See* Willys H. Schneider, *FASITS Provide New Flexibility, Challenges*, ASSET SALES REP., Sept. 30, 1996, at 1, *available in* 1996 WL 5618245. Thomas Humphreys and John Fernando have noted that:

> From a tax standpoint, the primary concern [in a structured financing] is with the tax treatment of the [SPC].
>
> . . . First, and most important, the [SPC] cannot pay a corporate level tax, *i.e.*, it must be "transparent" from a tax standpoint.
>
> . . . A second concern is timing and character of the income to the Investor and the [SPC].
>
> . . . A third concern is timing and character of income (or loss) to the [originator].

Thomas A. Humphreys & John C. Fernando, *Tax Treatment of Structured Finance Transactions* 1025, 1030 (PLI Tax Law & Estate Planning Course Handbook Series No. 393, 1994).

Additionally, the Office of the Comptroller of the Currency recently issued new asset securitization guidelines. These guidelines "focus on the need for bankers to understand fully the risks involved in securitization and to take steps to manage those risks effectively." *OCC Issues Asset Securitization Guidelines*, O.C.C. News Release 96-104 (Sept. 25, 1996), *available in* 1996 WL 539961.

Finally, Congress introduced a bill known as the Business, Commercial, and Community Development Secondary Market Development Act, which according to its billing, was designed to "promote economic growth and credit formation by facilitating the development of a secondary market for business, commercial, and community development debt and equity investments." H.R. 2600, 103rd Cong. (1993). The Community Development Banking and Financial Institutions Act of 1994, 12 U.S.C.S. § 4701 (Law. Co-op. 1997), incorporated the substance of that bill through provisions relaxing capital requirements and other regulations for private sector market loans for small businesses. *See Alternative Lenders Get Assistance*, 50 CONG. Q. ALMANAC 100, 102 (1994).

289. Bank credit card issuers are vulnerable to extraordinary losses in the event that their securitized credit card accounts are sold with recourse. If these accounts are not paid, they may be returned to the bank's balance sheets. Because no capital is required to be set aside to cover such losses, these banks will be exposed to large loan losses. "A prime reason for securitization on the part

financing transaction may not completely appreciate the full measure of issues before them. Moreover, due to the inadequacy of the information surrounding these transactions, the parties participating in the public and private debt markets, including the unsecured creditors of the world, are not making their decisions with the benefit of full information.[290]

Even questions with respect to the most fundamental issues involved in securitization persist among market participants as well as courts. As recently as 1992, the United States Court of Appeals for the Tenth Circuit in *Octagon Gas Systems, Inc. v. Rimmer*[291] addressed the question of whether the property claimed by a sale transferee was part of the transferor's bankruptcy estate and thus subject to the interests of the creditors of the transferor's estate. *Octagon* involved a series of transactions resulting in the transfer of an interest in the proceeds of certain gas sales made by Poll Gas Systems, Inc. (Octagon's predecessor in interest).[292] Following the filing of debtor Poll Gas System's bankruptcy petition, the court was asked to determine whether the interest in the proceeds was property of Poll's Chapter 11 bankruptcy estate.[293]

The Tenth Circuit misunderstood the nature of the bankrupt debtor's asset transfer and took issue with the lower courts'[294] summary rejection

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of card issuers is to reduce their capital and loan-loss reserve requirements," said George Salem, senior vice-president of Gerard Klauer Mattison. Brian Caplen, *Financial Shocks: Where Next?*, EUROMONEY, Sept. 15, 1996, at 54, *available in* 1996 WL 11120815.

290. *See supra* note 201. The lack of adequate disclosure requirements for ABS issuances is a current concern of market participants, and the SEC is presently considering more stringent disclosure requirements to provide more information and time for investors to evaluate new ABS issuances. *See supra* note 163.

291. 995 F.2d 948 (10th Cir. 1993).

292. *See id.* at 951-52.

293. *See id.* at 952. The parties to *Octagon Gas Systems v. Rimmer* were not involved in a classic securitization, but in fact a much more complex series of transactions; however, the same issues with respect to the nature of asset transfers were implicated. United States District Judge Lee R. West stated in his order that although the gas sale interest is most often described as an "overriding royalty interest," Bankruptcy Judge Ryan found this description to be incorrect in the absence of any underlying oil and gas leasehold estate. *See In re* Meridian Reserve, Inc., No. 88-06519, at 5-7 (Bankr. W.D. Okla. July 26, 1991) (order granting intervenor-plaintiff Rimmer's motion for summary judgment) (on file with the *Texas Law Review*).

294. The bankruptcy court held that the Rimmer Interest was not part of Poll's bankruptcy estate. *See In re* Meridian Reserve, Inc., No. 88-06519, at 5-7 (Bankr. W.D. Okla. July 26, 1991) (order granting intervenor-plaintiff Rimmer's motion for summary judgment) (on file with the *Texas Law Review*). In its order outlining its conclusions of law, the court stated that a practical construction of the conveyances, as well as the usage of the term "overriding royalty," led it to conclude that the parties intended to convey a "separate, distinct and proportionate ownership right to the future cash proceeds from gas sale," and as such, the interest held by Rimmer was for the benefit of Rimmer, not the bankruptcy estate. *Id.* at 6. The bankruptcy court further rejected the debtor's conclusion that an analysis under Article 9 was relevant to the decision, stating that Article 9 does not determine, in the face of a conflict, whether or not an item of personal property is part of a debtor's bankruptcy estate. *Id.* at 6-7. The District Court for the Western District of Oklahoma summarily affirmed the decision of the bankruptcy court, *see In re* Meridian Reserve, Inc., No. 88-06519 (W.D. Okla. Jan. 22, 1992)

of an analysis of the respective parties' rights and interests under Article 9.[295] The court observed that, pursuant to section 541 of the Bankruptcy Code, a bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case."[296] Relying upon the Supreme Court's interpretation of the definition of an "estate" in *United States v. Whiting Pools, Inc.*,[297] the *Octagon* court concluded that, because property of the estate includes property subject to a security interest, and because the statutory scheme governing security interests governs *sales* of accounts, the accounts thus sold remain the property of the debtor's bankruptcy estate.[298]

It was error for the *Octagon* court to conclude, in reliance on what it perceived to be the holding of *Whiting Pools*, that the sold assets were property of the debtor's bankruptcy estate.[299] Although *Whiting Pools*

(order affirming the bankruptcy court's summary judgment) (on file with the *Texas Law Review*), and Octagon appealed this decision to the Tenth Circuit.

295. The Tenth Circuit concluded as a threshold matter that the transferred interest was an account under Article 9 and observed that, notwithstanding the fact that the "transactions giving rise to [the] account were not intended to secure a debt," the sale of property is covered by Article 9. *Octagon*, 995 F.2d at 955. Because natural gas, once extracted and sold, is a "good," the right to receive payment from the sale of that good is an "account." *See id.* at 954-55. Article 9 defines an account as "any right to payment for goods sold . . . which is not evidenced by an instrument or chattel paper . . . ." OKLA. STAT. ANN. tit. 12A, § 9-106 (West Supp. 1998). The court observed that § 9-102(1)(b) "states that Article 9 applies 'to any outright sale of accounts.'" *Octagon*, 995 F.2d at 955 (citations omitted). Further, the term "security interest" as defined by Article 9 expressly includes "any interest of a buyer of accounts," and "secured party" includes "a buyer [to whom] accounts . . . have been sold." *Id.* The Official Comments to § 9-102 of the Oklahoma Commercial Code explain that in the case of commercial financing on the basis of accounts, "the distinction between a security transfer and sale is blurred, and a sale of such property is therefore covered by [§ 9-102](1)(b) whether intended for security or not. . . . The buyer then is treated as a secured party, and his interest as a security interest." OKLA. STAT. ANN. tit. 12A, § 9-102 cmt. 2 (West Supp. 1998).

296. *Octagon*, 995 F.2d at 955 (quoting 11 U.S.C. § 541(a)(1) (1988)).

297. 462 U.S. 198 (1983). The *Whiting Pools* Court, citing both the legislative history and the language of Bankruptcy Code § 541(a)(1), noted that the provision is "intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code." *Id.* at 205. The Court stated that, in order to "facilitate the rehabilitation of the debtor's business, all of the debtor's property must be included in the reorganization estate," including property "in which a creditor has a security interest." *Id.* at 203. The Court continued by noting that Congress could have specifically excluded property subject to a security interest from the bankruptcy estate, but "chose instead to include such property in the estate and to provide secured creditors with 'adequate protection' for their interests." *Id.* at 204. Because property encumbered by a security interest is included in a debtor's bankruptcy estate, regardless of whether it is in the possession of the debtor or another party, the trustee has the authority pursuant to § 542(a) to demand that the party in possession of estate property turn such property over to the debtor's estate. *See id.* at 208. Failure to perfect a sale of accounts will bring the transferred accounts under the authority of §§ 544(a), 541(3), and 550(a). *See* 11 U.S.C. §§ 541(3), 544(a), 550(a) (1994). Failure to perfect a transfer, however, will bring the transferred property under the authority of §§ 541(3), 544(a)(1), and 550(a). *See id.*

298. *See Octagon*, 995 F.2d at 954-56.

299. The Supreme Court in *Whiting Pools* addressed a situation in which the United States held a tax lien on all of the property of Whiting. The IRS had seized and was planning to sell Whiting

sketches the contours of what property should properly be included in a debtor's bankruptcy estate,[300] the case does not stand for the proposition that all property in the possession of other parties, which Article 9 governs, is part of the debtor's bankruptcy estate, regardless of the circumstances of the transfer.[301]

Pools's property to satisfy the tax lien. As a step in enforcing this lien, the United States seized all of Whiting's property, anticipating a sale of the property. Before the sale could take place, however, Whiting filed a petition in bankruptcy under Chapter 11. Thus, at the time of the bankruptcy filing, the United States had both possession of the property and a lien on it, but not title to it. The United States then claimed that the seized property was not property of Whiting's bankruptcy estate. The Supreme Court held that the IRS was required to return the property to Whiting Pools as debtor-in-possession under § 542(a) of the Bankruptcy Code because Whiting retained a significant interest in the property: its residual right of redemption. *See Whiting Pools*, 462 U.S. at 199-201, 204-06.

300. The Court further observed that the Code safeguards security interests by providing secured creditors with adequate protection. Because the procedural devices available to the IRS to protect and satisfy its liens are analogous to those available to private secured creditors when the debtor files for bankruptcy, § 542 of the Bankruptcy Code simply requires the creditor to "seek protection of its interest according to the congressionally established bankruptcy procedures, rather than by withholding the seized property from the debtor's efforts to reorganize." *Id.* at 212.

301. Moreover, not only do the state law provisions of Article 9 treat the granting of a security interest differently from a sale of accounts, but the term security interest is not defined in the same way under the Bankruptcy Code as it is in Article 9. The Bankruptcy Code's definition of security interest does not include the interest of a purchaser of accounts, whereas § 1-201(37) of the UCC states that the term "security interest" also "includes any interest of a buyer of accounts or chattel paper which is subject to Article 9." U.C.C. § 1-201(37) (1994). Section 101(51) of the Bankruptcy Code defines security interest as a lien created by an agreement. *See* 11 U.S.C. § 101(51).

Thus, as stated above, for the limited purpose of providing for a notice mechanism to third parties, Article 9's filing system applies to both sales of accounts and borrowings secured by accounts; Article 9 does not control, however, which assets constitute property of the bankruptcy estate. This is determined with reference to the Bankruptcy Code provisions.

Further, the Court in *Whiting Pools* did *not* address the issue of under what circumstances transferred property is deemed part of a transferor's bankruptcy estate, nor the issue of when, and under what circumstances, the trustee has the power and authority to avoid certain pre-bankruptcy transfers of property and recover such transferred property for the benefit of the estate. Although it is true that § 9-102 of the UCC requires the filing of a notice in the form of a UCC-1 financing statement in connection with the *sale* of accounts in the same way debtors file financing statements giving notice of the grant of collateral, this does not suggest that the property *sold* is governed by the provisions of Article 9 for all purposes and in all circumstances. Section 9-102 requires perfection of a buyer's interest in both accounts and chattel paper. *See* U.C.C. § 9-102 (1994). This filing requirement serves the purpose of announcing to third parties that the property identified in the financing statement is no longer available to third-party creditors, either as collateral or, if the third-party creditors have generally unsecured claims regarding the debtor's bankruptcy, as part of the bankruptcy estate. Article 9 clearly distinguishes, in many instances, between the sale of assets and the grant of a security interest. For example, both § 9-502(2) and § 9-504(2) provide that, if the transaction between parties is a sale of accounts, the debtor is not entitled to any surplus and is not liable for any deficiency, absent an agreement to the contrary. Thus, Article 9 distinguishes in certain commercial contexts a sale of assets from the grant of a security interest in connection with a loan. *See In re* Southwest Freight Lines, Inc., 100 B.R. 551, 535 (Bankr. D. Kan. 1989) (holding that accounts receivable were not part of the bankruptcy estate because the debtor did not retain an interest in them); *In re* National Equip. & Mold Corp., 64 B.R. 239, 245 (Bankr. N.D. Ohio 1986) (holding that a debtor relinquished his ownership rights in accounts receivable because he did not retain an interest in the property); U.C.C. §§ 9-502(2), 9-504(2).

Furthermore, the cases—*In re Contractors Equipment Supply Co.*,[302] *Major's Furniture Mart, Inc. v. Castle Credit Corp.*,[303] and *In re Evergreen Valley Resort, Inc.*[304]—have all more squarely addressed these issues and each suggests that the outright sale of accounts by a debtor prior to its bankruptcy filing places it beyond the reach of the trustee and the bankruptcy estate.[305] As logical as this analysis and conclusion may be,

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302. 861 F.2d 241 (9th Cir. 1988). In *Contractors Equipment*, the debtor, Contractors Equipment, granted its creditor, Citibank, a security interest in all of its accounts receivable, including any future accounts. Citibank then notified an account debtor, Pima, that it must make its payments directly to Citibank. Following this proper notification pursuant to § 9-318 and § 9-502, the debtor, Contractors Equipment, filed for bankruptcy. Following the bankruptcy filing, Pima began making its payments directly to the bankrupt debtor. Citibank then filed a complaint against the account debtor in state court, alleging that Pima's payments to the debtor were in violation of the provisions of Article 9. In response, the account debtor filed an adversary proceeding in the bankruptcy court, requesting a declaration that it discharged its obligation by paying the debtor in full. The Bankruptcy Court granted summary judgment in favor of Pima, holding that Citibank had only a security interest in the account receivable and that the account receivable was property of the estate. The district court affirmed the decision of the bankruptcy court. The Ninth Circuit held that because the assignment involved a security interest and not an outright sale of accounts, the future accounts receivable were assets of the bankruptcy estate, pursuant to § 541 of the Bankruptcy Code. The court suggested that the accounts receivable would not be part of the bankruptcy estate if the accounts were sold outright to Citibank prior to the bankruptcy filing. *See id.* at 242-45.

303. 602 F.2d 538 (3d Cir. 1979). The issue in *Major's Furniture* was whether the transfer of receivables was a true sale or a transfer of collateral for a loan. The court held that all relevant factors surrounding the circumstances of transfer must be examined and that the parties' characterization of the transfer was not determinative. The court found that the transfer in this case was for security and not for sale because of the retention of risk, including full recourse, by the transferor. *See id.*

304. 23 B.R. 659 (Bankr. D. Me. 1982). The *Evergreen Valley* bankruptcy court further defined the indicia of collateral granted in connection with a secured loan, as opposed to an outright sale, in a bankruptcy context. *See id.* at 661. These indicia include: (1) the retention by the transferee of the rights to pursue a deficiency, (2) acknowledgement by the transferee that its rights in the property would be extinguished if the debt were paid through some other source, (3) a requirement that the transferee account to the transferor for any surplus, (4) evidence that the transferor's debt was not reduced on account of the transfer, and (5) contract language expressing the intent that the transfer was for security only. *See id.*

305. The Permanent Editorial Board (PEB) for the Uniform Commercial Code has amended UCC § 9-102 comment 2 as follows:

> Neither Section 9-102 nor any other provision of Article 9 is intended to prevent the transfer of ownership of accounts or chattel paper. The determination of whether a particular transfer of accounts or chattel paper constitutes a sale or a transfer for security purposes (such as in connection with a loan) is not governed by Article 9. Article 9 applies both to sale of accounts or chattel paper and loans secured by accounts or chattel paper primarily to incorporate Article 9's perfection rules. The use of terminology such as "security interest" to include the interest of a buyer of accounts or chattel paper, "secured party" to include a buyer of accounts or chattel paper, "debtor" to include a seller of accounts or chattel paper, and "collateral" to include accounts or chattel paper that have been sold is intended solely as a drafting technique to achieve this end and is not relevant to the sale or secured transaction determination.

U.C.C. § 9-102 cmt. 2; *see* Thomas E. Plank, *Sacred Cows and Workhorses: The Sale of Accounts and Chattel Paper Under the U.C.C. and the Effects of Violating a Fundamental Drafting Principle*, 26 CONN. L. REV. 397, 456 n.268 (1994).

not all courts have understood the nature of asset transfers in a bankruptcy context.[306]

The *Octagon* court got it so wrong[307] that the decision sparked the UCC Article 9 Drafting Committee to propose an amendment to the UCC specifically addressing the issue of whether or not accounts sold to a third party remain subject to the seller's bankruptcy proceeding.[308] Furthermore, on April 8, 1996, the *Oklahoma Commercial Code* was amended[309] to provide that Article 9 "does not prevent the transfer of ownership of accounts or chattel paper" and that "[t]he determination of whether a particular transfer of accounts or chattel paper constitutes a sale or a transfer for security purposes is not governed by" Article 9.[310] As predicted by market participants, the *Octagon* decision has not had the effect of chilling the creativity of tenacious structured-finance originators;[311] these transactions continue to proliferate.[312] The decision does illustrate, however, some of the uncertainties that remain with respect to even the most fundamental issues raised by asset securitization.

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306. Section 361(3) of the Bankruptcy Code authorizes the trustee to propose adequate protection by giving the secured claimant any form of relief that will result in the realization of the "indubitable equivalence" of the claimant's interest in the property. This phrase originated in an opinion written by Learned Hand. *See* 11 U.S.C. § 361(c) (1994); *In re* Murel Holding Corp., 75 F.2d 941, 942 (2d Cir. 1935).

307. *See* BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 4.04[5] (rev. ed. 1993) (arguing that *Octagon* is wrong because, if a financing statement is filed by the buyer of accounts receivable, then the accounts should be removed from the bankruptcy estate); *Debtor's Estate Doesn't Have Interest in Account that was Sold, Buyer Asserts*, Bankr. L. Daily (BNA) (Nov. 18, 1993), *available in* Westlaw, 11/18/93 BLD; Thomas S. Kiriakos et al., *Bankruptcy*, *in* 1 SECURITIZATION OF FINANCIAL ASSETS, *supra* note 5, § 5, at 5-1, -32 to -33 (arguing that the *Octagon* decision is "clearly incorrect" because it misconstrues the UCC and is inconsistent with other court decisions); Steven L. Schwarcz, Octagon Gas *Ruling Creates Turmoil for Commercial and Asset-Based Finance*, N.Y. L.J., Aug. 4, 1993, at 1, 2 (criticizing the *Octagon* opinion on the grounds that it is contrary to the UCC and other court decisions).

308. *See* U.C.C. § 9-601(d) (Discussion Draft No. 2, 1997).

309. Act of Apr. 8, 1996, ch. 56, 1996 Okla. Sess. Laws 224.

310. OKLA. STAT. ANN. tit. 12A, § 9-102(4) (West Supp. 1998).

311. Recently, an originator located in the Tenth Circuit designed a securitization transaction intended to avoid as a matter of law the effects of *Octagon*, which has not been overruled. The creative deal structure dictated that the laws of Illinois—not the laws of Utah, where the originator's principal place of business is located—should govern the rights and responsibilities of the parties. This choice of law was based upon § 1-105 of the Utah Commercial Code which states that, "Except as provided in this section, when a transaction bears a reasonable relation to this state and also to another state or nation, the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties." UTAH CODE ANN. § 70A-1-105 (1953). Counsel for the originator delivered a conflict-of-law opinion under Utah law which concluded that Illinois law should govern the true sale status of the asset transfer based upon the fact that the SPC was established in Illinois, transaction payments were made and received in Illinois, and certain transaction records were kept in Illinois. The opinion further concluded that under Illinois law, a non-Tenth Circuit state, the transfer of assets from the originator to the SPC was a true sale. *See* Jack Wagler, *Overcoming* Octagon: *Part II*, ASSET SALES REP., Oct. 21, 1996, at 1, *available in* 1996 WL 5618294.

312. *See supra* note 33.

VI. Conclusion

It has been said that the "majority of innovations on Wall Street die young."[313] An innovation that falls within an exception to this maxim is asset securitization, whose market has been increasing in volume every year since the first issuance in the mid-1980s.[314] It is clear that a great many people are making a great deal of money from the billions of dollars of ABS that are brought to market every year. It is equally clear that there remain unanswered questions with respect to the economic and social efficiency of structured finance transactions.

The most modest conclusion that may be drawn is that structured finance's efficiency is unproven. A bolder assertion, and one this Article predicts will be supported by empirical evidence, is that securitization is inefficient.[315] When value is diverted from nonadjusting creditors to parties with greater knowledge, resources, and opportunity to bargain *ex ante* for greater leverage to encourage voluntary repayment (and in the event of bankruptcy, to guarantee priority repayment), then this value represents a distributional inefficiency. Moreover, unsecured creditors of securitizing originators do not receive the benefits of protection from the phenomenon of debtor misbehavior that they receive when their debtor uses its assets as security for credit. In the absence of such protections, unsecured creditors are more vulnerable to the risk of nonpayment as well as the risk of debtor's bankruptcy.

Presumably, even if the efficiency of securitization is ever proven to unanimous satisfaction, the distributional consequences of some parties being preferred over others will result in inequities. Such consequences will continue to fuel the flame of commercial law scholars, practitioners, bankruptcy trustees, and eventually courts and legislatures concerned about "stronger" market participants benefitting at the expense of their weaker counterparts—the unsecured creditors. If this prediction is realized at a time when the volume and type of securitizing originators in bankruptcy mirrors the profile of the newest securitization transaction originators, the ABS market will be subject to a drastic adjustment. Investors will lose the value of their investments as the previously transferred assets are returned to the originator's bankruptcy estate.

Empirical data is needed to conclusively demonstrate the harm experienced by the unsecured creditors of securitizing originators. Such a study would track dollar values with respect to securitization's benefits and its

313. John Thackray, *Corporate Finance: The Golden Age of Innovation*, FORBES, Apr. 29, 1985, at 136, 146 (special advertising supplement).

314. *See supra* note 33.

315. For a discussion of the type of data that should be analyzed in connection with a study of the third-party effects of securitization transactions, see *supra* note 11.

costs to third parties. This empirical examination will have to be conducted over time to observe and quantify the market effects of widespread originator bankruptcies.