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MUDDY RULES FOR SECURITIZATIONS

*Edward J. Janger**

Securitizations are big business.¹ In the last decade hundreds of companies (“Originators”) have found it worthwhile to raise capital by selling publicly issued, asset-backed, debt securities. Instead of issuing those securities directly, they sell the assets to a separately incorporated entity (the “issuer” or “special purpose vehicle,” or “SPV”) created for the sole purpose of buying and selling specified assets of the Originator. Market demand for this form of financing suggests that securitization reduces the cost of capital for many businesses. Demand for a product does not necessarily mean, however, that making it cheaper will be efficient. The efficiency of these transactions has yet to be established, and serious concerns have been raised by Lynn LoPucki² and others.³ Notwithstanding concerns

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1. In 1999, there were \$2.5 trillion in asset-backed securities outstanding. See Lois R. Lupica, *Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic*, 9 AM. BANKR. INST. L. REV. 287, 291-92 (2001); see also Lois R. Lupica, *Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization*, 33 CONN. L. REV. 199 (2000); Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595 (1998).

2. Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 25-26 (1996); see also Lynn M. LoPucki, *The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz*, 52 STAN. L. REV. 55 (1999). But see Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515 (1999); Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 STAN. L. REV. 1 (1999); Steven L. Schwarcz, *Judgment Proofing: A Rejoinder*, 52 STAN. L. REV. 77 (1999).

3. Lupica, *Asset Securitization*, *supra* note 1, at 597. Lupica states: Quite a few articles have appeared in the legal and financial journals on the subject of securitization, 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. *Id.*; see also Letter from Kenneth Klee on Behalf of the National Bankruptcy

about efficiency, recent legislative efforts have included special provisions designed to make securitizations cheaper to accomplish, and more certain in effect.⁴ In this Article, I will argue that these efforts, in particular the ones proposed for inclusion in Section 541 of the Bankruptcy Code,⁵ are misguided because of a failure by Congress to appreciate the role of “muddy rules” in deterring inefficient transactions, and because of a failure to pay proper attention to considerations of comparative institutional competence.

Part I of this Article will describe securitization transactions and identify the benefits and risks associated with such transactions. Part II will describe the proposed amendments to the Bankruptcy Code contained in Section 912 of the Bankruptcy Reform Bill of 2001, and the areas of uncertainty that those amendments seek to eliminate. Part III will explore the role of muddy rules in controlling possible abuses of securitization transactions. It will argue that the principal muddy rules which govern securitizations allow judges to sort between efficient and inefficient securitizations based on potential harm to the creditors of the Originator. An important second order effect of this muddiness is that it forces the parties to a securitization transaction to worry about the effect of the transaction on creditors of the Originator. Litigation risk serves as a proxy for a seat at the bargaining table. While the creditors of the Originator are not in the room, the threat of litigation forces the parties to the securitization are forced to ask what those creditors would say if they were present. Opponents of muddy rules often focus on the costs of litigation without acknowledging the salutary effect that litigation risk may have on transactions, even where

Conference to Senator Herbert Kohl (Aug. 17, 1998), *available at* <http://www.law.uchicago.edu/NBC/CurrentPostings/105thCongress/hr4393Kohl1.pdf> (last visited Mar. 13, 2001).

4. These legislative efforts include proposed amendments to the Bankruptcy Code, Bankruptcy Reform Act of 2001, S. 420, 107th Cong. § 912 (2001); H.R. 333, 107th Cong. § 912 (2001) [hereinafter Bankruptcy Reform Act of 2001], and the recently enacted revision to Article 9 of the Uniform Commercial Code, which contain many new provisions intended both to enhance the certainty of securitization transactions and to increase the types of assets that could be included in asset backed securitizations. *See, e.g.*, U.C.C. § 9-318 (2001); *see also* Steven L. Schwarcz, *The Impact on Securitization of Revised UCC Article 9*, 74 CHI.-KENT L. REV. 947 (1999) (“Revised Article 9 attempts to broaden its coverage to virtually all securitized assets.”).

5. *See* Bankruptcy Reform Act of 2001, *supra* note 4.

no litigation occurs. Finally, Part IV will show how the proposed bankruptcy reform eliminates muddiness and judicial sorting just at the points where it is likely to be most important. Instead, it replaces judicial sorting with sorting by rating agencies and legal opinion writers. This substitute for judicial sorting is, on one hand, circular and, worse yet, where it is not circular, it focuses attention on the wrong part of the transaction.

I. SECURITIZATIONS

Securitization transactions can be value creating.⁶ They allow companies to carve up their asset-backed debt into smaller pieces, and thereby increase the number of people who can economically lend to the Originator.⁷ This may reduce the Originator's cost of capital.⁸ Securitization transactions can also be rent creating in that they may benefit the purchasers of the asset-backed securities and the shareholders of the Originator at the expense of the Originator's existing creditors.⁹ This section explains the mechanics of a securitization transaction and the ways in which it can be both efficient and inefficient (while still desirable to the immediate parties to the transaction).

Imagine, for example, that Originator Manufacturing Company manufactures widgets. Originator usually sells widgets on credit, and, as a result, has significant accounts receivable outstanding. In order to build a new high-speed widget manufacturing facility, Originator wants to borrow money against those receivables, and wants to do so at as

6. Steve Schwarcz has described what he calls the alchemy of secured credit. See Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 142 (1994).

7. See *id.* at 134.

8. *Id.* at 133; see also TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES (1991 & Supp. 1994); STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (2d ed. 1993); Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101 (1997); Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061 (1996).

9. See LoPucki, *Reply to Schwarcz*, *supra* note 2, at 62 ("The gains from judgment proofing are gains from the externalization of liability."); Lupica, *Asset Securitization*, *supra* note 1, at 597.

low a cost as possible. In the world before securitization, Originator had two options. First, it could simply borrow money, using its receivables as collateral for a secured loan. Second, Originator could sell the receivables to a factor, who would pay for them, and collect on them itself. In short, Originator could borrow money or it could sell assets.¹⁰

Both transactions have certain shortcomings from the perspective of the investor (be it a secured creditor or a factor). The secured creditor faces a number of risks if the debtor files for bankruptcy.¹¹ The automatic stay prohibits any effort to foreclose or otherwise realize on the collateral.¹² Section 363 of the Bankruptcy Code allows the debtor to use or sell the secured creditor's collateral under certain circumstances.¹³ The rule in the *Timbers* case deprives undersecured creditors of interest during the pendency of the case.¹⁴ Factors, by contrast, need not concern themselves with Originator's bankruptcy because the purchased receivables would be excluded from the bankruptcy estate.¹⁵ To receive this favored treatment, however, the factor must actually assume the risks of owning the receivables, and the Originator must part with the benefits of ownership. Instead of relying on the credit of the debtor for payment, the factor must rely exclusively on the creditworthiness of the account debtors, and hope that the account debtors will not assert defenses on the underlying obligations.¹⁶ These risks limit the number of investors who can invest

10. For an introduction to the fundamental principles of asset securitization, as well as the underlying legal and business considerations, see Steven L. Schwarcz, *Structured Finance, A Guide to the Principles of Asset Securitization*, PRACTICING LAW INST. (1993).

11. See Schwarcz, *Alchemy*, *supra* note 6, at 135-36 (stating that SPV "must be structured as bankruptcy remote" to gain acceptance as an issuer of capital market securities); see also 11 U.S.C. § 362 (2000).

12. See 11 U.S.C. § 362.

13. See *id.* § 363.

14. See *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assoc., Ltd.*, 484 U.S. 365 (1988).

15. See 11 U.S.C. § 541. The debtor would no longer have a legal or equitable interest in the asset. *Id.*

16. Defining the boundaries between sale and loan has bedeviled many securitizers. See, e.g., Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 159-63 (1996) (discussing types of permissible and impermissible recourse for sale treatment); Thomas E. Plank, *The*

in the Originator's receivables. Only banks and finance companies, able to make significant loans and handle the specific risks of the transaction, are in play.

Securitization seeks to provide a remedy for all of these problems. Securitization transactions work as follows. First, the Originator identifies an asset or group of assets that will serve as a basis for financing, in this case Originator's accounts receivable. Originator then incorporates a second company, commonly referred to as a Special Purpose Vehicle ("SPV").¹⁷ The SPV exists for the sole purpose of purchasing accounts from Originator, and issuing securities against the asset pool. When it works properly, securitization allows a company like Originator to raise money more cheaply than by either borrowing against the receivables or selling them to a factor. This is because (1) like factoring, the sale of receivables keeps the securitized assets out of the bankruptcy estate of the Originator if the Originator fails; (2) unlike either factoring or secured lending, the ability of the SPV to issue securities makes the investment available to a much wider range of smaller and less specialized investors; and (3) in order to enhance the creditworthiness of the SPV, the Originator may agree to repurchase bad receivables or otherwise cushion the market risk and credit risk faced by the SPV.¹⁸ As such, the SPV is treated like a buyer for upside purposes, but like a secured creditor with recourse against the debtor if the underlying assets should happen to lose value.¹⁹

To the extent that securitizations correct an imperfection in the credit market and thereby reduce the Originator's financing costs, they

True Sale of Loans and the Role of Recourse, 14 GEO. MASON L. REV. 287 (1991).

17. See Schwarcz, *Alchemy*, *supra* note 6, at 135 ("[A]fter identifying the assets to be used in securitization, the originator transfers the receivables to a newly formed special purpose corporation, trust, or other legally separate entity — often referred to as a special purpose vehicle, or "SPV."); see also Commission on Bankruptcy & Corporate Reorganization of the Ass'n of the Bar of the City of N.Y., *Structured Financing Techniques*, 50 BUS. LAW. 527, 588-89 (1995) [hereinafter *Structured Financing Techniques*] (defining a special purpose vehicle as "[o]ne or more entities specially created for structured financing that acquire ownership of the assets to be securitized and/or issue the asset-backed securities").

18. See Lupica, *Circumvention*, *supra* note 1, at 211 ("Built into every asset securitization transaction are risk containment measures that have as their primary focus the quality of the underlying assets.").

19. See *Structured Financing Techniques*, *supra* note 17, at 550.

are beneficial. However, part of the value of securitizations to the creditor and the debtor may arise because securitizations also shift the risk of the Originator's insolvency onto the unsecured creditors of the Originator.²⁰ Again, this is not problematic if the creditors of the Originator can adjust the interest rate they charge, or exit the credit, to respond to the increased riskiness of the investment. But the "market" on this side of the equation is not perfect either. Existing creditors, like employees, may not be in a position to leave. Trade creditors and other small creditors may face a collective action problem, and not be in a position, individually, to monitor the debtor.²¹ Therefore, the trade creditors may calculate interest and payment terms across their customer base, rather than setting the price based on the Originator's capital structure.²² Finally, many creditors, such as the taxing authority and tort claimants, are nonconsensual and cannot adjust the interest rate they charge because they do not "choose" to enter into the debtor/creditor relationship with the Originator.²³ Torts and taxes simply happen.²⁴ Because the credit market is not perfect, this risk alteration may result in a subsidy to the parties to the securitization transaction.

Thus, creditors and debtors may wish to engage in securitization transactions for two distinct reasons. They may wish to benefit from the market perfecting, value creating attributes of the securitization transaction, or they may wish to benefit from the risk alteration effects. It might be useful to think about these two effects of securitizations respectively as "value creation," and "risk alteration." The danger lies not in the fact that these two distinct effects exist, but in the fact that

20. See Lupica, *Circumvention*, *supra* note 1, at 235 ("A policy carving securitized assets out of a reorganizing debtor's bankruptcy estate also shifts the risk of a debtor's bankruptcy away from its largest financier to smaller, more vulnerable enterprises such as trade creditors, consumers, employees, tort claimants and other unsecured creditors.").

21. See Lucian Ayre Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 881-87 (1996) (detailing various types of non-adjusting creditors).

22. See *id.*

23. See Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. 559, 611 (2001).

24. See Bebchuk & Fried, *supra* note 21, at 882-87; see also Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887 (1994); Paul M. Shupack, *Solving the Puzzle of Secured Transactions*, 41 RUTGERS L. REV. 1067 (1989).

the immediate parties to a securitization transaction – the shareholders of and the investors in the SPV – benefit from both the efficiency enhancing and the efficiency reducing effects of securitization. The creditors of the SPV benefit from risk pooling and liquidity *and* they also benefit from risk alteration. The shareholders of the Originator are able to reduce the Originator's cost of capital both because of the economics of risk pooling and liquidity, and because of the subsidy received from involuntary and non-adjusting creditors.

The parties to "arms-length" securitization transactions cannot, therefore, be relied upon to sort between securitization transactions that are driven by value creating/market perfecting benefits, and those that are driven by rent-creation. If sorting is to occur, it must come either from countervailing imperfections in the market, like investor risk aversion, or from law acting on the market. The appropriate legal response to this dynamic turns on an empirical inquiry that has not been undertaken. If the value created by securitization is significant, and the cost of risk alteration trivial, then a regime of freedom to contract might be desirable. If the risk alteration effect is the dominant reason for securitization, then such transactions should be prohibited. Assuming that the truth lies somewhere in between, the question becomes whether the benefits of sorting outweigh the costs. This raises two subsidiary questions: (1) who (i.e., what institution) is in the best position to accomplish the task of sorting; and (2) what should the legal basis for sorting be?

II. MUDDY RULES, RISK ALTERATION AND SECTION 912

As I have discussed elsewhere,²⁵ sorting can be conducted in the marketplace with legislative or judicial guidance from clear legal rules (if the permitted and proscribed conduct can be easily defined), or the sorting can be carried out jointly by judges under muddy rules (or standards) and by the marketplace in the shadow of judicial, standard based, decision making.²⁶ Under current law, two grey areas, one

25. See Janger, *supra* note 23.

26. The literature on rules versus standards is extensive. See Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 600 (1988); see also RICHARD A. POSNER, *THE PROBLEMS OF JURISPRUDENCE* 42-61 (1990); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992);

statutory and the other judicially created, govern securitization transactions.²⁷ Both are aimed at identifying and prohibiting transactions that are driven by risk alteration and delegate the sorting function to judges. Section 912 of the Bankruptcy Reform Act of 2001 seeks to severely limit both opportunities for subjecting securitization transactions to such judicial sorting.

A. Fraudulent Conveyance Law and the Intended as Security Doctrine:
Transparency and Risk Alteration

The first legal grey area governing securitization is fraudulent conveyance law,²⁸ which seeks to ensure that the Originator receives full value for the assets transferred to the SPV. By scrutinizing the adequacy of consideration, when the Originator is insolvent or near insolvency, fraudulent conveyance law ensures that creation of the SPV does not alter the risk faced by creditors of the Originator. Under Section 5 of the Uniform Fraudulent Transfer Act (“UFTA”), a transfer can be avoided as fraudulent if the transfer was made while the debtor was insolvent, and not for “reasonably equivalent value.”²⁹ Section 4(a)(1) allows avoidance of intentional fraudulent transfers,³⁰ and Section 4(a)(2) prohibits transfers that the debtor should reasonably have known would have left it insolvent, or with unreasonably small capital.³¹ Fraudulent conveyance law protects the Originator’s creditors from securitizations which would have the effect of forcing them to bear the risk associated with the Originator’s business operations, while investors in the SPV would gain the benefit. Limiting the scope of fraudulent conveyance law would make it easier for debtors to externalize risk.

Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976).

27. See *infra* Part II.A-II.B.

28. As discussed below, in addition to fraudulent conveyance law, securitization transactions may be subject to challenge under a variety of veil piercing theories under state corporation laws. The issue under both theories is the same: Did Originator receive fair value for the assets conveyed to the SPV? For ease of exposition, I will only discuss fraudulent conveyance law.

29. UNIF. FRAUDULENT TRANSFER ACT § 5.

30. *Id.* at § 4(a)(1).

31. *Id.* at § 4(a)(2).

The second grey area is the line between true sales and sales intended as security. Under the “intended as security” doctrine, courts invalidate transactions that function as a “clog” on a debtor’s “equity of redemption.”³² The doctrine arose as a mechanism for protecting individual debtors from overreaching creditors,³³ but it has been retained for a number of reasons. First, since it preserves equity for the debtor, it has the secondary effect of protecting the creditors from risk alteration as a result of such overreaching. Second, and perhaps more importantly, the sale/loan distinction encourages financial transparency. When a debtor enters into a sale transaction, the seller exchanges one asset for another. Receivables are exchanged for cash. One asset is removed from the seller’s balance sheet, and another asset arises. When a debtor enters into a sale that is really a secured loan, the receivables are exchanged for cash, but the purchaser retains recourse against the debtor. Three things should therefore happen on the seller/debtor’s balance sheet: (1) the receivables should be removed from the asset column; (2) the cash should be added to the debit column; and (3) the recourse obligation should be booked as debt. Often, however, these transactions fall into a gap in the current accounting standards where the recourse obligation can be ignored or merely noted in the footnotes.³⁴ The recent failure of Enron shows how manipulation of SPVs can confuse both auditors and financial markets.³⁵ Thus, a sale intended as security can make it more difficult

32. *Accord* Janger, *supra* note 23, 573; *see also* Grant S. Nelson, *The Contract for Deed as Mortgage: The Case for the Restatement Approach*, 1998 B.Y.U. L. REV. 1111, 1141 (1998).

33. Overreaching creditors are oversecured creditors who seek to use the debtor’s default as an opportunity to both obtain repayment and seize the debtor’s “equity” in the property.

34. *See* ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES – A REPLACEMENT OF FASB STATEMENT NO. 125, Statement of Financial Accounting Standards No. 140 (Financial Accounting Standards Bd. 2000); *see also* ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENT OF LIABILITIES, Statement of Financial Accounting Standards No. 125 (Financial Accounting Standards Bd. 1996).

35. Joseph F. Berardino, Managing Partner and Chief Executive Officer, Arthur Andersen, Remarks Before the U.S. House of Representatives Committee on Financial Services (Dec. 12, 2001), *available at* <http://www.arthurandersen.com/website.nsf/content/MediaCenterBerardinoFullTestimony!OpenDocument> (last visited Mar. 13, 2002).

for other investors of the debtor to determine what the debtor owns and how much the debtor owes.

If the transfer of assets from the Originator to the SPV is a “true sale,” it is appropriate to exclude the assets transferred to the SPV from the bankruptcy estate of the Originator if it fails. On the other hand, if a transfer of the assets to the SPV is deemed “intended for security,” then risk alteration and financial obfuscation are more likely, and it makes sense to treat the securitized assets as part of the Originator’s bankruptcy estate.³⁶

In sum, both of these grey areas require judges to determine whether the dominant effect of a securitization is value creation or risk alteration and deception.

B. Section 912: A Safe Harbor for Deceptive and Risk Altering Securitizations

Section 912³⁷ operates under the assumption that legal uncertainty is bad because it is costly and chills transactions. As such, the proposed amendments seek to eliminate both of these areas of legal uncertainty in a wholesale fashion.

First, they attempt to limit the risk of fraudulent conveyance faced by investors in the SPV. Subsection 1 amends Section 541 of the Bankruptcy Code to exclude from the definition of property of the estate:

(8) any eligible asset (or proceeds thereof), to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization, except to the extent such asset (or proceeds or value thereof) may be recovered by the trustee under section 550 by virtue of avoidance under section 548(a)³⁸

Thus, so long as the assets “transferred” to the SPV by the Originator are “eligible assets,” and so long as the SPV is an “eligible entity,” the assets transferred to the SPV are excluded from the

36. See Hill, *supra* note 8.

37. For a complete text of Section 912, see Appendix I, immediately following this Article, *infra* pp. 319-20.

38. See Bankruptcy Reform Act of 2001, *supra* note 4; see also Appendix I, *infra* pp. 319-20.

Originator's bankruptcy estate, unless the transfer itself can be avoided under Section 548 of the Bankruptcy Code.

What is interesting about this section is what it excludes. Section 548 allows the trustee to avoid intentional and constructive fraudulent conveyances by the debtor.³⁹ As such, it does leave some place for judicial sorting along the risk alteration axis, but only so long as the bankruptcy occurs within one year of the securitization.⁴⁰ In the absence of Section 912, the Originator's creditors would have at their disposal all of the avoidance powers listed in Section 550.⁴¹ These include the power to avoid transfers under Section 547,⁴² the power to avoid unperfected security interests under Section 544(a),⁴³ and most importantly, the power under Section 544(b) to avoid any transaction that could have been avoided by a creditor at state law as of the moment of the bankruptcy, including state law fraudulent conveyance actions and state law veil piercing actions.⁴⁴ In addition, while Section 548(a) tracks the causes of action available under the UFTA at state law, it has an unusually short statute of limitations of one year.⁴⁵ Most states have longer limitation periods,⁴⁶ including New York which has a six-year statute of limitations applicable to fraudulent transfers.⁴⁷

Second, Section 912 also tries to eliminate any concern that the sale of assets to the SPV might be considered a "sale intended as

39. See 11 U.S.C. § 548 (2000).

40. See *id.*

41. See *id.* § 550(a).

42. See *id.* § 547(b).

43. See *id.* § 544(a).

44. See *id.* § 544(b).

45. See *id.* § 548(a)(1).

46. See, e.g., ALA. CODE § 8-9A-9 (2001) (creating a ten-year statute of limitations after transfer of real property and a six-year limitation after the transfer of personal property in Alabama); ARIZ. REV. STAT. § 44-1009 (2001) (setting the statute of limitations for fraudulent transfers at four years after the transfer of real or personal property); PA. CONS. STAT. § 12-5109 (2001) (setting the statute of limitations for fraudulent transfers in Pennsylvania at two years after the transfer of real or personal property); MASS. GEN. LAWS ch. 109A § 10 (2001) (setting the statute of limitations for fraudulent transfers in Massachusetts at four years after the transfer of real or personal property); R.I. GEN LAWS § 6-16-9 (2001) (setting the statute of limitations for fraudulent transfers in Rhode Island at four years after the transfer of real or personal property).

47. N.Y. DEBT. & CRED. LAW § 273 (2001).

security.” Section 912(2) would add a new section to the Bankruptcy Code, Section 541(f)(5), which would provide:

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

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

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

(C) the characterization of such sale, contribution, or other conveyance for tax, accounting, regulatory reporting, or other purposes.⁴⁸

Section 5(B) is the language that significantly alters the current law.⁴⁹ Under that provision, a transfer will be sufficient to remove assets from the Originator’s bankruptcy estate, even if the debtor has an obligation to repurchase the assets. This provision creates the possibility that the conveyance of assets to the SPV will be sales in name only, while in substance they will be loans secured by the “transferred” assets.

The effect of this provision is striking when it is read together with subsection 1. Such an agreement would, in the absence of this section, be recharacterized as a “sale intended for security,”⁵⁰ and would therefore create an unperfected security interest, avoidable by the trustee.⁵¹ As such, the purchaser would be treated as a mere

48. See Bankruptcy Reform Act of 2001, *supra* note 4; see also Appendix I, *infra* pp. 319-20.

49. At least insofar as it eliminates an area of legal uncertainty.

50. U.C.C. § 1-201(37) (2001).

51. 11 U.S.C. § 544(a) (2000). This is already the law with regard to “Repurchase Agreements” as defined in Section 103 of the Bankruptcy Code. 11 U.S.C. § 559; see also *In re Bevill*, Bressler and Schulman Asset Mgmt. Co., 67

unsecured creditor under state law and in the Originator's bankruptcy case. Under Section 912, by contrast, the agreement would not just create a perfected security interest, but would operate as a true sale, removing the asset entirely from the Originator's bankruptcy estate.⁵²

In short, the intention of Section 912 is to ensure that any assets conveyed to an SPV in a securitization transaction will be excluded from the bankruptcy estate of the Originator, regardless of whether the transaction is a true sale, a sale intended as security, or the creation of an unperfected security interest. The effect is to create a crystalline rule that any assets conveyed to an SPV in a securitization will be insulated from the Originator's bankruptcy estate.

III. THE BENEFITS OF MUDDY RULES

Section 912 thus substitutes a crystalline safe harbor for the muddy rules governing state law fraudulent conveyances and sales intended as security. This is likely to save transaction costs. Indeed, saying, "Section 912 will reduce transaction costs and facilitate securitizations," rolls so trippingly off the tongue that it tempts one not to look behind the statement to ask whether anything is being lost when these muddy rules are abandoned. Muddy rules create uncertainty. Uncertainty makes lawyers nervous. Nervousness in the abstract seems bad. But one needs to ask a second question: "Nervousness about what?" Muddy rules create uncertainty about outcomes. This uncertainty has two related effects. First, it increases the likelihood that a dispute, if it arises, will have to be resolved by a judge. Second, since judicial decision-making is costly, it places a tax on transactions that fall within the zone of legal uncertainty. Whether the costs

B.R. 557 (D.N.J. 1986). However, Section 912 would generalize this result. There may be some perceived urgency in this regard after the decision in *In re LTV Steel, Inc.*, No. 00-43866, 2001 Bankr. LEXIS 131 (Bankr. N.D. Ohio Feb. 5, 2001).

52. Indeed, Section 912 might go further. An asset is "transfer[red]" if it is "sold, contributed, or otherwise conveyed with the intention of removing [it] from the estate of the debtor." Bankruptcy Reform Act of 2001, *supra* note 4; *see also* Appendix I, *infra* pp. 319-20. Under this language, it is possible to imagine that the mere creation of a security interest would qualify as a "conveyance," and, so long as the security agreement provided that the intention was to remove the asset from the bankruptcy estate, the result would be to take a security interest, unperfected outside of bankruptcy, and leave it out of the bankruptcy estate.

associated with judicial decision-making are beneficial will depend on whether the potential liability relates to conduct where either judicial sorting is necessary, or where taxation at the margin will likely deter inefficient transactions.

Both fraudulent conveyance law and the “intended as security” doctrine operate on the “risk alteration” or “subsidy” axis of securitization. Both seek to ensure that a securitization will not harm the other creditors of the Originator. Fraudulent conveyance law seeks to ensure that the Originator receives a fair price received for any assets conveyed,⁵³ while the relationship between “intended as security” and risk alteration is somewhat more complex. First, because assets that are sold prior to bankruptcy are excluded from the debtor’s bankruptcy estate, creditors have an incentive to characterize a transaction as a sale rather than a secured loan. The “intended as security doctrine” seeks to ensure that substance rather than form determines the characterization of a transaction. The line is determined by asking: “Who has the risk of ownership of the property?” If the benefits and risks of ownership transfer to the purchaser, then the transaction is treated as a sale. If the benefits and risk of ownership remain with the seller, then the transaction creates a security interest. If the creditor retains recourse against the debtor, the asset remains in the debtor’s bankruptcy estate. Risk alteration is thus prevented.

The second effect of the “intended as security” doctrine is to mandate accurate disclosure of assets and liabilities. On its face, the “intended as security” doctrine appears to have its basis in naked paternalism clothed as equity. Individual debtors, it was feared, would be willing to give away the farm in the future, in return for cash today. As a modern cognitive psychologist might put it, the debtor would overvalue present consumption and discount the probability of default in the future. The Chancellor’s response was to invalidate “clogs” on the debtor’s “equity of redemption.”⁵⁴ While such “consumer protection” might make sense in the case of loans to individuals, securitization does not deal with assets of consumer debtors. So, one might argue, the “intended as security” doctrine loses its vitality in commercial, arms-length transactions.

53. See Lupica, *Asset Securitization*, *supra* note 1, at 647.

54. See *supra* note 32.

This “cognitive” problem in the consumer context, however, has a parallel in the commercial context. An agency problem exists in the corporations, which leads to the same result.⁵⁵ Because many creditors cannot adjust the interest rate that they charge to account for increased risk, securitization benefits the shareholders, who can externalize (place the burden of) some of the cost of a risky business strategy onto existing creditors, who are not at the table when the securitization deal is constructed. Thus rational shareholders (or officers) may make the same “cognitive” mistake as irrational consumers. The intended as security doctrine limits the effect of this agency problem because it creates litigation risk. The salutary effect of such litigation risk may be to force the shareholders to internalize the additional cost of a risky strategy.

In short, what is striking about both of the muddy rules that govern securitizations is that they force the parties to the securitization transaction to think about the effect that the transaction will have upon affected parties who are not in the room. Section 912, by eliminating both muddy regimes, is likely to facilitate risk alteration. By eliminating Section 544(b) avoidance actions, much of the risk of fraudulent conveyance and veil piercing actions is eliminated once a year has passed. By characterizing virtually any “transfer” as a true sale, securitizers can manipulate the components of a debtor’s bankruptcy estate virtually at will.

55. While few people think of corporate managers as agents of creditors, this does not mean that an agency problem does not exist. It is important to recognize that economists do not use the term “agency” in the same way that lawyers do. It is not necessary for a corporate officer to be an “agent” of the shareholders in the legal sense, for there to be an “agency” problem in the economic sense. As Frank H. Easterbrook has noted, the reason that shareholders are given the power to control a corporation is that they are the residual claimants. The logic is that any action that helps the residual claimant will increase the value of all claims against the enterprise. See Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983); see also FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 11 (1991). This logic collapses when the shareholders can increase the risk faced by one class of claimants, without paying a corresponding risk premium. The shareholders, who have voting power, can impose uncompensated risk on creditors, who do not have control of the debtor’s business strategy. This creates an opportunity for intra-firm externalities and creates an incentive for opportunistic behavior by the residual claimant.

IV. QUID PRO QUO?

Thus, Section 912 eliminates judicial sorting along the subsidy/risk alteration axis. This is not necessarily a bad thing if the result is that society benefits from more securitization related alchemy. This is particularly true if Section 912 finds a way to replace judicial sorting with some other form of sorting. On its face, Section 912 appears to do this. The device it uses is the definition of an “eligible entity.” An SPV is an “eligible entity” only if the securities it issues are, at least in part, investment grade, as rated by one of the nationally recognized bond rating agencies.

Sorting by rating agencies is, however, a curious substitute for judicial sorting. Rating agencies care principally about two things when they rate securities. They care first about the creditworthiness of the underlying assets, and second about whether those assets are likely to be swept back into the bankruptcy estate of the Originator. To guard against this risk, they generally request an opinion of counsel stating that the SPV is “bankruptcy remote.” In other words, a lawyer must state that it is not likely that the assets conveyed to the SPV will be swept back into the estate of the Originator, should the Originator fail. Under current law, whether counsel can give such an opinion turns on whether there is fraudulent conveyance risk and on whether the sale was a true sale or a sale intended for security. In other words, counsel needs to look at the transaction to determine whether it is efficient or inefficient. The opinion writer must look at the transaction through the eyes of a judge adjudicating under a muddy standard and offer an opinion. The threat of judicial sorting *ex post* creates a regime where opinion writers sort the transactions *ex ante*.

If Section 912 is enacted, then most fraudulent conveyance risk would be eliminated, and all risk from the “intended as security” doctrine would be eliminated as well. In other words, once a rating agency has determined that the bonds will be investment grade (i.e., the receivables are high quality), then the risk to the opinion writer virtually disappears. The inquiry becomes, essentially, circular. The effect of Section 912 will be to eliminate judicial sorting *ex post* and consequently to eliminate lawyer sorting *ex ante*.

The second curiosity is the basis for the sorting by rating agencies. Remember, the potential inefficiency of securitization transactions lies in the creditworthiness of the Originator, and in the potential of the

securitization to alter the risk faced by creditors of the Originator. Determining whether the securities of the SPV are going to be investment grade asks the wrong question. Instead of asking about the creditworthiness of the Originator, Section 912 asks about the creditworthiness of the SPV. That turns on the quality of the assets conveyed to the SPV, not on whether such conveyance is likely to impose costs on the creditors of the Originator.

CONCLUSION

In short, Section 912 substitutes a crystalline safe harbor for the muddy rules that currently govern securitization transactions. While, at first glance, it may appear that Section 912 simply shifts the sorting function from courts to attorneys, placing the burden on them to ensure that the transaction is not driven by risk alteration, the elimination of judicial sorting has the effect of relieving the attorneys and rating agencies of their own burden of reviewing the effect of the transaction on the creditors of the Originator.

APPENDIX I - COMPLETE TEXT OF § 912 OF S. 420
AND H.R. 333

SEC. 912. ASSET-BACKED SECURITIZATIONS.

Section 541 of title 11, United States Code, is amended—

(1) in subsection (b), by inserting after paragraph (7), as added by this Act, the following:

(8) any eligible asset (or proceeds thereof), to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization, except to the extent such asset (or proceeds or value thereof) may be recovered by the trustee under section 550 by virtue of avoidance under section 548(a); and

(2) by adding at the end the following new subsection:

(f) For purposes of this section—

(1) the term “asset-backed securitization” means a transaction in which eligible assets transferred to an eligible entity are used as the source of payment on securities, including, without limitation, all securities issued by governmental units, at least one class or tranche of which was rated investment grade by one or more nationally recognized securities rating organizations, when the securities were initially issued by an issuer;

(2) the term “eligible asset” means—

(A) financial assets (including interests therein and proceeds thereof), either fixed or revolving, whether or not the same are in existence as of the date of the transfer, including residential and commercial mortgage loans, consumer receivables, trade receivables, assets

of governmental units, including payment obligations relating to taxes, receipts, fines, tickets, and other sources of revenue, and lease receivables, that, by their terms, convert into cash within a finite time period, plus any residual interest in property subject to receivables included in such financial assets plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders;

(B) cash; and

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

(3) the term “eligible entity” means—

(A) an issuer; or

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

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

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

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

(B) whether the debtor had an obligation to repurchase or to service or supervise the servicing of all or any

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