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The Death of Secured Lending

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INTRODUCTION

Historically and culturally, secured lenders have seen the Bankruptcy Code, bankruptcy lawyers, and bankruptcy scholars as the enemy.[1] And they have had reason to worry. Scholars such as Lynn LoPucki, with his proposed priority for tort claims,[2] and Lucian Bebchuck, Jesse Fried[3] and Elizabeth Warren,[4] with their proposal to recreate Gilmore's late lamented equity cushion,[5] would each undercut the ability of lending lawyers to offer inviolate security interests to their clients. On the legislative side, as well, the thrust and parry has been

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1 *See, e.g.*, Steven H. Nickles, *Consider Process Before Substance, Commercial Law Consequences of the Bankruptcy System: Urging the Merger of the Article 9 Drafting Committee and the Bankruptcy Commission*, 69 AM. BANKR. L.J. 589, 589 (1995) ("Bankruptcy is fueled by equity. It breathes equity, as fire breathes air. As the bankruptcy fire has spread, commercial law has responded by taking away the fuel of equity by increasing liens.").

2 Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887 (1994); *see also* Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 64-66 (1992).

3 Lucian Ayre Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 909-11 (1996) (proposing a "fixed-fraction" priority rule).

4 *See, e.g.*, Elizabeth Warren, *Article 9 Set Aside for Unsecured Creditors*, UCC BULL., Oct. 1996, at 1.

5 Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 GA. L. REV. 605, 620 (1981); *cf.* U.C.C. § 9-204 cmt. 4 (1972) (amended 1998):

> The widespread nineteenth century prejudice against the floating charge was based on a feeling, often inarticulate in the opinions, that a commercial borrower should not be allowed to encumber all his assets present and future, and that for the protection not only of the borrower but of his other creditors a cushion of free assets should be preserved. That inarticulate premise has much to recommend it.

Id.

between bankruptcy[6] and secured credit.[7] Bankruptcy partisans view the recent revisions to Article 9 as shifting previously settled allocation of property and regulatory rights[8] in favor of secured creditors, and against unsecured creditors such as employees, tort claimants and other disorganized interests. I suspect that I was invited to participate in this symposium because I fall into this group, as I have previously questioned the ability of the UCC drafting process to handle such distributive choices effectively.[9]

This Article, however, makes a different point. It suggests that while the fans of secured credit have been worrying about federal bankruptcy legislation and in particular bankruptcy courts,[10] they have been missing the real threat to secured lending as an institution, and, perhaps, to Article 9 as a relevant source of law. The real danger may come not from the rights-invading, autonomy-limiting world of bankruptcy, but from the rights-sanctifying, autonomy-enhancing world of non-uniform state property law.

The title of this symposium is "Threats to Secured Lending and Asset Securitization." This title assumes that both institutions face common threats. In this Article, I challenge that basic assumption. In my view, the biggest threat to secured lending *is* asset securitization itself—and securitization is on the march. Statutes have recently been adopted in Alabama,[11] Delaware,[12] Louisiana,[13] Ohio,[14] North

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6 *See* Employee Abuse Prevention Act of 2002 (also known as the Durbin-Delahunt bill), H.R. 5221, 107th Cong. §§ 103, 203.

7 William M. Burke, et al., Report on Avoidance, Subordination, Super Priority, and Recharacterization Provisions of the Proposed Employee Abuse Prevention Act of 2002 (Sept. 3, 2002) [hereinafter Durbin-Delahunt Report], *at* http://www.hewm.com/use/articles/durbin-delahunt.pdf (last visited April 10, 2004).

8 *See, e.g.*, G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 AM. BANKR. INST. L. REV. 3, 4 (2001); Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1392 (1997); Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 CORNELL L. REV. 1466, 1476-77 (1997); *cf.* William J. Woodward, Jr., *The Realist and Secured Credit: Grant Gilmore, Common-Law Courts, and the Article 9 Reform Process*, 82 CORNELL L. REV. 1511 (1997). I weigh in briefly on this point elsewhere in this Symposium. *See* Edward J. Janger, *The Reliance Interest in Insolvency Law: A Response to Harris and Mooney*, 25 CARDOZO L. REV. 1895 (2004).

9 Edward J. Janger, *Predicting When the Uniform Law Process Will Fail: Article 9, Capture, and the Race to the Bottom*, 83 IOWA L. REV. 569 (1998) [hereinafter Janger, *Uniform Law Process*].

10 *Compare* Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573 (1998), *with* Edward J. Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. 559 (2001) [hereinafter Janger, *Crystals and Mud*]; *see also* Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75, 99 (1995) (arguing that bankruptcy judges are not institutionally well situated to take community interests into account).

11 ALA. CODE § 35-10A-2(a)(1) (2003).

12 DEL. CODE ANN. tit. 6, §§ 2701A-2703A (2003).

13 LA. REV. STAT. ANN. § 10:9-109(e) (2003).

14 OHIO REV. CODE ANN. § 1109.75 (2003).

Carolina,[15] South Dakota,[16] and Texas,[17] that gerrymander state property law to provide a safe harbor for securitization transactions, provide an opt-out from Article 9's regulatory scheme, and provide an advantage to Wall Street-style structured finance at the expense of Main Street-style secured lending.[18] More troubling yet, the adoption in Revised Article 9 of choice of law rules that locate corporate debtors in their state of incorporation[19] may have turned secured lending into a lever in the

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15 N.C. GEN. STAT. §§ 53-425, 53-426 (2004).

16 S.D. CODIFIED LAWS § 54-1-10 (2003).

17 TEX. BUS. & COM. CODE ANN. § 9.109(e) (2004).

18 For this insight—and also the Wall Street/Main Street metaphor—I am indebted to Ken Kettering of New York Law School, who first made this point in a letter to the House/Senate Conferees on Section 912 of the Bankruptcy Reform Act of 2001. Letter from Ken Kettering, Associate Professor of Law, New York Law School, to U.S. Sen. Patrick Leahy and U.S. Rep. F. James Sensenbrenner, (Feb. 5, 2002) [hereinafter Kettering Letter], *reprinted in* EMERGING ISSUES IN WORKOUTS AND BANKRUPTCIES 2004, at 57 (Joseph Samet ed., 2004) [hereinafter EMERGING ISSUES]. Section 912 was included in various versions of the Bankruptcy Reform Acts proposed between 1998 and 2001; the provision was removed in early 2002 after a number of law professors (including both Kettering and myself) wrote the Conferees expressing their reservations about the provision. *See* Letter from Allan Axelrod, Professor Emeritus, Rutgers School of Law, et al., to U.S. Sen. Patrick Leahy and U.S. Rep. F. James Sensenbrenner (Jan. 23, 2002), *reprinted in* EMERGING ISSUES, *supra*, at 63; Letter from Edward J. Janger, Associate Professor of Law, Brooklyn Law School, et al., to U.S. Sen. Patrick Leahy and U.S. Rep. F. James Sensenbrenner (Jan. 28, 2002) [hereinafter Janger Letter], *reprinted in* EMERGING ISSUES, *supra*, at 71; Letter from Jonathan C. Lipson, Assistant Professor of Law, University of Baltimore, et al., to U.S. Sen. Patrick Leahy and U.S. Rep. F. James Sensenbrenner (Feb. 1, 2002), *reprinted in* EMERGING ISSUES, *supra*, at 53. In his letter Professor Kettering states:

> Section 912 is special interest legislation that creates an unlevel playing field for different methods of capital formation that are economically fungible and that should be on equal footing in bankruptcy. It permanently bestows a large advantage to capital formation a la Wall Street (i.e., securitization) over capital formation a la Main Street (i.e., simple secured lending). Specifically, section 912 relieves from the burdens of bankruptcy law a transaction that is in economic effect a secured loan, so long as that transaction is structured as a securitization—but those legal burdens will continue to fall with unabated weight on a simple secured loan of the kind traditionally made by Main Street lenders (i.e., commercial banks and finance companies).

Kettering letter, *supra*. Kettering's analysis (in his letter) and mine (in this article) diverge on two points. He focuses on how securitization frees investors in asset backed securities from the burdens of bankruptcy, and while I agree with Kettering on this point, I focus here on how securitization frees ABS investors even from the regulatory burdens of Article 9. *See infra* text accompanying notes 30-34, 54-77. Also, and more importantly, we differ over whether the appropriate response to this discrimination is to subject both secured loans and non-true sale securitizations to the burdens of Article 9 and Title 11, or to free both forms of financing from bankruptcy's burdens. Kettering is ambivalent. I am not. Kettering states:

> Whether the legal burdens to which secured lenders are subject under the current bankruptcy law are too heavy or not heavy enough is a question about which there is disagreement. But it is not rational to impose those burdens upon a simple secured loan while excluding from those burdens an elaborately and expensively structured securitization transaction which, when viewed as a whole, is effectively fungible with a simple secured loan.

Kettering Letter, *supra*. In contrast, I believe there are strong efficiency-based reasons for giving bankruptcy judges the power to determine when and whether an adequately protected secured creditor should be allowed to liquidate its collateral. Janger, *Crystals and Mud*, *supra* note 10.

19 Revised U.C.C. § 9-301 (2001). *See generally* Ingrid Michelsen Hillinger & Michael G.

competition of states for corporate charters.[20]

This Article is divided into five parts. In Part I, I seek to show that the line between "true sales" and "sales intended as security" is not a trivial, arcane doctrine which exists merely to frustrate efficient deals and increase the cost of credit. Instead, I argue that the distinction has a crucial regulatory component that enhances both financial transparency and helps maintain proper investment incentives. In Part II, I describe recent federal (unsuccessful) and state law (successful) initiatives to broadly undercut the "intended as security" doctrine (also known as the true sale doctrine). In Part III, I seek to show how these state statutes pose a danger to Revised Article 9 as a statute and secured lending as an institution. In Part IV, I explain how Article 9's own choice of law provisions turn state property law into a lever in the competition for corporate charters. I then argue that this competition is likely to lead to a race to the bottom that will inevitably advantage securitization at the expense of secured lending. I then explore whether the solution to the property definition problem can best—indeed, can only—be handled through federal law. Finally, Part V examines possible federal legislative and common law solutions, and suggests that bankruptcy and secured lending are indeed natural allies in pursuit of a federal law of "true sale."

I. THE IMPORTANCE OF THE DOCTRINE OF TRUE SALE

My concern in this article is state law attempts to shift the line between secured lending and structured finance by manipulating, or indeed eliminating, the line between "security interests"[21] and "sales."[22]

Hillinger, *2001: A Code Odyssey (New Dawn for the Article 9 Secured Creditor)*, 106 COM. L.J. 105, 123-136 (2001) (discussing Revised Article 9's choice-of-law rules).

[20] *See* Janger, *Uniform Law Process*, *supra* note 9, at 625 ("As in prior law, no bifurcation exists for accounts, general intangibles, and mobile goods. Furthermore, corporations may choose to locate assets where a favorable rule exists. Thus, the amendment does not eliminate the race to the bottom entirely. . . .") (footnotes omitted). Revised Article 9 may actually increase the likelihood of a race to the bottom by shifting filing for corporate debtors from the location of their chief executive offices to their state of incorporation. While the law regarding the effect of perfection for tangible goods is the law of the jurisdiction where the collateral is located, for intangible goods—the types of assets that are frequently subject to securitization—the effect of perfection is governed by the law of the jurisdiction where the debtor is located. Revised U.C.C. § 9-301. Corporate debtors are deemed located in the jurisdiction where they are incorporated. *Id.* § 9-307. It is much easier for a debtor to change its state of incorporation than to move its chief executive offices. Thus, Delaware can compete for corporate charters by adopting a rule favorable to securitizations. Indeed, this appears to be exactly what it has done (at least with regard to intangible assets) by enacting the Asset Backed Securitization Facilitation Act.

[21] U.C.C. § 1-201(37) (1998). Note, the American Law Institute and the National Conference of Commissioners on Uniform State Laws have recently promulgated a revised version of Article 1 of the Uniform Commercial Code. The relevant provision in Revised Article 1 is § 1-201(35)

The core of this concern can be seen in the tension between two sentences. The first sentence can be found in section 9-109(a)(1) of the Uniform Commercial Code:

> Except as otherwise provided in subsections (c) and (d), this article applies to: (1) a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract. . . .[23]

When read against Article 9's definition of "security interest" as a property interest which secures "payment or performance of an obligation,"[24] this provision tells us that any conveyance of personal property that secures a debt will be treated as a security interest, whether that conveyance is denominated a "lien," a "conditional sale," a "sale," a "mortgage," or a "lease." The rules for characterizing conveyances, other than leases,[25] are not stated in the U.C.C., and, as Comment 4 to 9-109 expressly states, the inquiry is "left to the courts."[26] Courts, in turn,[27] treat a conveyance as a sale only if the

(2004), which makes no substantive changes to the relevant portion of the former section. Because, as of this writing, Revised Article 1 has only been adopted in Idaho, Texas, the U.S. Virgin Islands, and Virginia, this article will retain references to former Article 1, except where specified. Current information on the enactment status of Revised Article 1 can be found at the NCCUSL website: http://www.nccusl.org/nccusl/DesktopDefault.aspx (last visited Apr. 1, 2004).

22 Article 9 does not define the term "sale," but leaves the question to the courts. U.C.C. § 9-109 cmt. 4; *see also infra* text accompanying notes 24-26, and note 28. Article 2, however, defines a sale of goods as "the passing of title from the seller to the buyer for a price." U.C.C. § 2-106.

23 Revised U.C.C. § 9-109(a).

24 U.C.C. § 1-201(37) ("an interest in personal property . . . which secures payment or performance of an obligation"). Article 9 also covers the sale of certain financial assets. Whether the scope and definitional provisions of Article 9 carry with them an implicit and independent power to look past the form of a transaction to its substance is open to question. Comment 4 to § 9-109 does not provide an unambiguous answer; while acknowledging that Article 9 "applies to sales of accounts and chattel paper," it points out that "[i]n many commercial financing transactions the distinction is blurred," and then punts, stating: "Although this Article occasionally distinguishes between outright sales of receivables and sales that secure an obligation, neither this Article nor the definition of 'security interest' (Section 1-201(37)) delineates how a particular transaction is to be classified. *That issue is left to the courts.*" Revised U.C.C. § 9-109 cmt. 4 (emphasis added). Thus, in order to administer Article 9 it is sometimes necessary to "distinguish" between "outright sales" and "sales that secure an obligation," (or "sales intended as security"). However, Revised Article 9 does not "delineate[] how" to make this distinction. *Id.* On some level this question is purely metaphysical. Every state has a law of "true sale," which distinguishes between true sales and disguised security interests; conceptually, Article 9 could simply sit on top of that non-uniform law. Alternatively, the "regardless of form" language, coupled with Comment 4's statement that the "issue is left to the courts," can be read as an injunction, within Article 9, to create a judge-made state law of true sale. For the purposes of this Article it is not necessary to resolve this question, since in any event the content of the law of true sale will be left to the courts of the various states, unless it is supplanted by statutes of the type discussed *supra* notes 11-17.

25 Indeed, even though § 1-201(37) spells out the borders of the sale/lease distinction in exhaustive detail, this provision leaves substantial room for judicial intervention based upon the economic realities of the "facts of each case." U.C.C. § 1-201(37).

26 *See* sources cited *supra* notes 22 and 24. To distinguish a loan from a sale, courts look to a number of factors, including:

> (i) residual interest retained by the transferor, (ii) transfer price set at a fair market

transaction truly transfers the risks and benefits of ownership to the purchaser.[28]

The second sentence can be found in the Asset Backed Securities Facilitation Act, recently enacted in Delaware (the "Delaware ABS Statute"), and in various forms in other states: "[n]otwithstanding any other provision of law . . . [a]ny property, assets or rights purported to be transferred, in whole or in part, in [a] securitization transaction shall be deemed to no longer be the property, assets or rights of the transferor . . . ."[29]

> value . . ., (iii) recourse to the asset transferor, (iv) acquisition of dominion and control over the assets by the transferee, (v) the transfer of the benefits and burdens of ownership by the transferee, and (vi) the intent of the parties as expressed in their writings.

Lois R. Lupica, *Revised Article 9, the Proposed Bankruptcy Code Amendments and Securitizing Debtors and Their Creditors*, 7 FORDHAM J. OF CORP. & FIN. L. 321, 330 (2001); *see also, e.g.*, Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 542-44 (3d Cir. 1979) (listing factors relevant to true sale determination); *In re* Coronet Capital Co., 142 Bankr. 78 (Bankr. S.D.N.Y. 1992) (transferor continued to pay interest on default of principal); *In re* Evergreen Valley Resort, Inc., 23 B.R. 659 (Bankr. D. Me. 1982) (debtor/transferor's retained interest led to characterization as a loan); *In re* Hurricane Elkhorn Coal Corp., 19 B.R. 609 (Bankr. W.D. Ky. 1982) (debtor's retained interest); Federated Dep't Stores, Inc. v. Comm'r, 51 T.C. 500 (1968), *aff'd*, 426 F.2d 417 (6th Cir. 1970) (recourse retained by transferor led to characterization as a loan); *cf.* Fireman's Fund Ins. Cos. v. Grover (*In re* Woodson Co.), 813 F.2d 266, 272 (9th Cir. 1987) (retention of risk, and recourse for interest suggested a loan rather than a sale).

27 With a few exceptions, *see infra* note 32.

28 *See supra* note 26. Article 9's terminology confuses this distinction somewhat, because true sales of certain financial assets—accounts, chattel paper, payment intangibles and promissory notes—are also governed by Article 9, pursuant to Revised U.C.C. § 9-109(a)(3) (stating that Article 9 applies to "a sale of accounts, chattel paper, payment intangibles, or promissory notes"), and are even referred to as "security interests" (which includes "any interest . . . of a buyer of accounts, chattel paper, a payment intangible, or a promissory note in a transaction that is subject to Article 9."). U.C.C. § 1-201(37). There are, nonetheless, significant ramifications, even under Article 9, of classification as either an "interest in property which secures payment or performance of an obligation," or a "sale of accounts, chattel paper, payment intangibles, or promissory notes." Revised U.C.C. § 9-109(a). For examples of sections where the distinction makes a difference, see sections 9-209 (duty to notify account debtor of an assigned account of release), 9-309(3)-(4) (no filing required for sale of payment intangible or promissory note), 9-318(a) (seller of accounts, chattel paper, payment intangibles or promissory notes retains no interest), 9-318(b) (deemed rights of seller of accounts or chattel paper). Additionally, sections 9-323 (priority of future advances), 9-406 (anti-assignment override ineffective with regard to "sales" of payment intangibles and promissory notes), 9-408 (anti-assignment override for security interests in payment intangibles and promissory notes limited to security interests which arise out of sales), 9-608 (no right to surplus or liability for deficiency if underlying transaction is a sale (collection of rights to payment)), and 9-615(d) (no right to surplus or liability for deficiency if underlying transaction is a sale (disposition of collateral)) also require a court to distinguish a secured loan from a sale of assets covered by Article 9, and specify different treatment for the collateral.

29 DEL. CODE ANN. tit. 6, § 2703A(a)(1) (2003). A virtually identical statute has been enacted in Alabama. *See* ALA. CODE § 35-10A-2 (2003). A statute with virtually identical operative language but with an arguably more specific definition of securitization has been enacted in South Dakota. *See* S.D. CODIFIED LAWS §§ 54-1-9, 54-1-10 (2003). A slightly narrower version was recently enacted in North Carolina. *See* N.C. GEN. STAT. § 53-426 (2004). The operational sentence is the same in North Carolina, but the term securitization transaction is

The impact of the second sentence is to strip courts of the power granted, or more accurately, preserved,[30] by the first. Under the Delaware ABS Statute, any document contained in a "securitization transaction"—whatever that may be[31]—which purports to transfer assets (apparently of any type whatsoever), whether intended as a sale or a security interest, will be effective to transfer ownership.

In short, under the UCC, the question of whether a sale is treated as a sale is left to the courts. While some courts focus purely on the stated

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more limited, only applying to sales of financial assets to special purpose entities which issue publicly sold securities which receive an investment grade rating. *Id.* § 53-466(3). Ohio's statute is, in effect, limited to securitizations by federally insured banks. *See* OHIO REV. CODE ANN. § 1109.75 (2003). Finally, Texas and Louisiana have each enacted non-uniform versions of U.C.C. § 9-109. The Texas statute provides that "parties' characterization of a transaction as a sale of [] assets shall be conclusive that the transaction is a sale." TEX. BUS. & COM. CODE ANN. § 9.109(e) (2004). The Louisiana statute provides that "in the absence of fraud or intentional misrepresentation, the parties' characterization of a transaction as a sale of accounts, chattel paper, payment intangibles, or promissory notes shall be conclusive that the transaction is a true sale and is not a secured transaction and that title has passed to the party characterized as the purchaser." LA. REV. STAT. ANN. § 10:9-109(e) (2003).

30 Judicial policing of "true sales" predates Article 9. RESTATEMENT (FIRST) OF CONTRACTS § 529 (1932) states:

> Where the intent of a party to a bargain is to make a loan of money or an extension of the maturity of a pecuniary debt for a greater profit than is allowed by law, the agreement is illegal though the transaction is put in whole or in part in the form of a sale, a contract to sell or other contract.

Id.; *see also* Benedict v. Ratner, 268 U.S. 353 (1925) (treating assignment of accounts as an unperfected secured loan); Obendorff v. Wolfson, 228 N.Y.S.2d 240 (N.Y. App. Div. 1964) ("In this action upon written agreements for the sale of stock, requiring the seller, at the purchaser's option, to repurchase the stock at an advanced price, there are issues of fact concerning the usury defense which cannot be resolved by summary judgment."). Justice Brandeis, writing for the Court in *Benedict*, appears to have understood the link between true sale and transparency, discussed *infra* Part I.D. *See* Edward J. Janger, *Brandeis, Progressivism, and Commercial Law: Rethinking* Benedict v. Ratner, 37 BRANDEIS L.J. 63, 76 (1998-99) ("[B]y requiring creditor monitoring, Brandeis, in effect, turned the institution of secured credit into a disclosure device. The creditor had to monitor, the debtor had to disclose, and all of the creditors benefited."). As Grant Gilmore explained:

> It is clear that a lender who scrupulously adhered to [] *Benedict*-inspired practices as all the professionals did could not help but keep close watch over his debtor's affairs; the term that came into common use to describe the assignee's unremitting supervision of the assignor's enterprise was "policing." All the receivables passed through his hands. The amount of the loan was adjusted at frequent intervals. Furthermore, the loan agreement always gave the assignee the right to examine the assignor's books. In a large operation the assignee might put his own man in the assignor's office to maintain a continuous supervision; even if he did not do that, any suspicious fluctuation in the amount of receivables assigned would be the occasion for the assignee's men to make a check of the books.
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> . . . We may conclude that the *Benedict* rule produced some exceedingly good results in forcing non-notification receivables financing into a desirable pattern.

GRANT GILMORE, 1 SECURITY INTERESTS IN PERSONAL PROPERTY 260-61 (1965).

31 There is no scope-limiting statutory definition of the term "securitization" in the Delaware ABS statute; there is only a provision which states that "[i]t is intended by the General Assembly that the term 'securitization transaction' shall be construed broadly." DEL. CODE ANN. tit. 6, § 2702A (2003); *see also supra* note 29 (discussing other ABS statutes, some of which contain restrictive definitions).

intention of the parties,[32] most look to the intention of the parties as manifested in the deal itself and find a true sale only if a court concludes that the risks and benefits of ownership have been transferred to the purchaser.[33] By contrast, under the Delaware ABS Statute, a "sale" pursuant to a "securitization transaction" is treated as a "true sale," regardless of its economic attributes, if the documents call it a "sale."[34]

A. *True Sale and Securitization Explained*

The Delaware ABS Statute is intended to abolish the "intended as security" or true sale doctrine. Under that doctrine, the law of contracts[35] and property law[36] treat transactions denominated "sales" by

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[32] *See, e.g.*, *In re* Kassuba, 562 F.2d 511, 514 (7th Cir. 1977) ("[T]he parties by contract may create a set of mutual economic benefits that is similar to a mortgage without conferring on each other the rights and liabilities of judicial foreclosure, if that is what they actually intend."); *In re* OMNE Partners II, 67 B.R 793, 795 (Bankr. D. N.H. 1986) ("In the context of sale-leaseback realty transactions, however, this power should be exercised only upon a showing of 'clear and convincing evidence' by the debtor that the transaction should be deemed a disguised financing transaction.") (citing Fox v. Peck Iron and Metal Co., 25 B.R. 674, 688 (Bankr. S.D. Cal. 1982)); Cohen v. Army Moral Support Fund (*In re* Bevill, Bressler & Schulman Asset Mgmt. Corp.), 67 B.R. 557, 598 (Bankr. D. N.J. 1986) ("There is an ever present need for certainty and predictability in commercial transactions of any sort. To ignore the voluntary decision of contracting parties to structure their transactions in a particular manner, and to disregard widely recognized and accepted industry practices would only foster confusion within the repurchase market.").

[33] *See, e.g.*, Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 546 (3d Cir. 1979) ("[O]n this record none of the risks present in a true sale is present here. Nor has the custom of the parties or their relationship, as found by the district court, given rise to more than a debtor/creditor relationship . . . bringing the transaction within the ambit of 12A P.S. § 9-502."); *see also* Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159 (1996) (arguing that warranties relating to collection risk should not endanger true sale treatment, but that sales accompanied by warranties relating to rate of return should be treated as loans).

[34] *See supra* text accompanying note 29.

[35] *See* RESTATEMENT (FIRST) OF CONTRACTS § 526 (1932), which provides:

> Where the intent of a party to a bargain is to make a loan of money or an extension of the maturity of a pecuniary debt for a greater profit than is allowed by law, the agreement is illegal though the transaction is put in whole or in part in the form of a sale, a contract to sell or other contract.

Id.; *see also* Butts v. Samuel, 174 N.Y.S.2d 325 (N.Y. App. Div. 1958); A. M. Swarthout, Annotation, *Advance in Price for Credit Sale as Compared with Cash Sale as Usury*, 14 A.L.R.3d 1065 (2004) (collecting cases).

[36] RESTATEMENT (THIRD) OF PROPERY: MORTGAGES § 3.2(a) (1997) ("Parol evidence is admissible to establish that a deed purporting to be an absolute conveyance of real estate was intended to serve as security for an obligation, and should therefore be deemed a mortgage."); *see also id.* §3.3(a):

> Parol evidence is admissible to establish that a deed purporting to be an absolute conveyance of real estate accompanied by a written agreement conferring on the grantor a right to purchase the real estate, was intended to serve as a security for an obligation, and should therefore be deemed a mortgage.

the parties as "loans" if the buyer has not assumed the risks or purchased the benefits of ownership, but has instead advanced funds in return for a guaranteed rate of interest. Therefore, if the transaction is "in substance" a loan, it will be treated as such. In short, the doctrine of true sale governs the line between sales law and the law of mortgages or secured credit. This recharacterization doctrine has a number of important consequences:

- First, lenders are not able to evade a state's mandated foreclosure procedures, including Part 6 of Article 9,[37] which protect a borrower's right to redeem collateral (or "equity of redemption")[38] from overreaching creditors who may seek to extract a windfall upon a minimal default, or by engaging in a collusive sale.[39]
- Second, lenders are not able to evade a state's mandated notice provisions for secured loans,[40] such as Article 9's perfection rules.
- Third, property held by a debtor subject to a security interest is still property of the debtor's bankruptcy estate,[41] and, while the creditor is entitled to "adequate protection," foreclosure may be delayed by the automatic stay.[42]

The effect of the Delaware ABS Statute is to allow certain creditors to opt-out of regulation by the Bankruptcy Code, and, more importantly for the purposes of this Article, to opt-out of the regulatory components of Article 9[43] and the law of mortgages by structuring their

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Id.

[37] *See* Revised U.C.C. § 9-601(g) ("Except as otherwise provided in Section 9-607(c), this part imposes no duties upon a secured party that is a consignor or is a buyer of accounts, chattel paper, payment intangibles, or promissory notes."). Comment 9 makes clear that buyers of accounts, chattel paper, payment intangibles and promissory notes have no duties to the seller, or the seller's collateral with regard to the collateral's disposition. *Id.* § 9-601 cmt. 9 ("Although denominated 'secured parties,' these buyers own the entire interest in the property sold and so may enforce their rights without regard to the seller ('debtor') or the seller's creditors.").

[38] *Id.* § 9-623.

[39] *Id.* §§ 9-625, 9-626.

[40] Where "accounts" and "chattel paper" are involved, filing is required to perfect a sale, as well as a property interest which secures a debt obligation, so notice is assured either way, *id.* § 9-310, but where "promissory notes," "payment intangibles," "general intangibles," and "goods" are involved, no filing is required to perfect a sale. *Id.* §§ 9-309(3)-(4), 9-318 ("promissory notes" and "payment intangibles"), 2-403 (goods).

[41] 11 U.S.C. § 541(a) (2000). David Carlson has argued that, for a number of reasons, even property subject to a true sale securitization may be "property of the estate." David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055 (1998)

[42] 11 U.S.C. §§ 361, 362 (2000).

[43] Where non-financial assets are involved, the opt-out of Article 9's remedies provisions may be slightly more difficult to accomplish than with financial assets. U.C.C. § 9-301 bifurcates the choice of law decision for tangible assets. *See supra* note 20. The law of the jurisdiction where the debtor is located governs perfection, while the law of the jurisdiction where the collateral is located governs the effect of perfection. Thus while the Delaware ABS statute may reach intangible assets wherever located, it may only reach tangible assets in Delaware.

deals as "securitizations."[44]

The Delaware ABS Statute and its siblings[45] (collectively, the "ABS Statutes") appear to be, as their titles and effect indicate, a product of lobbying by the "securitization" or "structured finance" industry.[46] Securitization is a financing device whereby business entities raise money by selling assets, instead of borrowing against them.[47] The basic structure of a securitization is a creative twist on a secured loan. Instead of entering into a secured financing, where assets are used as collateral for a loan, a company that wishes to raise money (the "Originator") sells assets to a separately organized entity—a special purpose vehicle ("SPV")—that exists solely for the purpose of buying assets from the Originator[48] and issuing securities backed by those assets ("Asset Backed Securities" or "ABS"). The assets conveyed can

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44 Paradoxically, while the principle focus of the Delaware ABS statute appears to be to exclude securitized assets from the Bankruptcy estate, for reasons discussed below this effort may or may not work. Recent and not-so-recent Supreme Court precedent suggests that the definition of "property of the estate" for bankruptcy purposes is a question of federal, rather than state law. *See* 11 U.S.C. § 541(a) (2000); United States v. Whiting Pools, 462 U.S. 198, 203 (1983) ("The reorganization effort would have small chance of success, however, if property essential to running the business were excluded from the estate."); *cf.* United States v. Craft, 535 U.S. 274, 278 (2002) ("Whether the interests of respondent's husband in the property he held as a tenant by the entirety constitutes 'property and rights to property' for the purposes of the federal tax lien statute is ultimately a question of federal law.") (citation omitted). As such, the principal effect of this law may simply be to provide an opt-out from Article 9's remedial provisions (such as the requirement of a commercially reasonable sale of the collateral) for secured loans, and, perhaps from the requirements of perfection. In at least some cases, characterization as a "sale" will relieve the securitization vehicle (or special purpose vehicle) from the need to disclose its interest in property by filing. For example, Revised U.C.C. § 9-318(b), which is discussed at length by Professor White, *see* James, J. White, *Chuck and Steve's Peccadillo*, 25 CARDOZO L. REV. 1743 (2004), requires filing to perfect a sale of "account[s]," and "chattel paper," but *not* promissory notes or payment intangibles. By contrast, to perfect a "security interest" in "payment intangibles," filing *would* be required, Revised U.C.C. § 9-310, and to perfect a security interest in "promissory notes" filing or possession (to the extent the promissory notes were "instruments") would be required. *Id.* § 9-313.

45 *See supra* note 29.

46 *See infra* text accompanying notes 94-96.

47 The Comptroller of the Currency Comptroller's Handbook describes a securitization as:

> the structured process whereby interests in loans and other receivables are packaged, underwritten, and sold in the form of "asset backed" securities. From the perspective of the credit originators, this market enables them to transfer some of the risks of ownership to parties more willing or able to manage them. By doing so, originators can access the funding markets at debt ratings higher than their overall corporate ratings, which generally gives them access to broader funding sources at more favorable rates. By removing the assets and supporting debt from their balance sheets they are able to save some of the costs of on-balance-sheet financing and manage potential asset-liability mismatches and credit concentrations.

COMPTROLLER OF THE CURRENCY, ADM'R OF NAT'L BANKS, ASSET SECURITIZATION: COMPTROLLER'S HANDBOOK 2 (1997), *available at* http://www.occ.treas.gov/handbook/assetsec.pdf.

48 Sometimes the deal is structured with two SPVs. In such a deal, the sale to the first SPV is structured as a true sale for bankruptcy purposes, while the second sale is structured as a true sale for accounting purposes. Pantaleo et al., *supra* note 33, at 162 n.8.

take many forms. They may be mortgage loans receivables, credit card receivables, lease receivables, or the accounts receivable of the Originator (collectively, the "Assets"). In most securitizations the assets can be loosely characterized as "financial assets." However, the ABS Statutes, with the exception of those enacted in Louisiana and North Carolina, are not, by their terms, limited to such assets.[49] Conceptually, a securitization could include just about anything.[50] The principal attraction of securitization derives from the fact that the Originator can raise money more economically by selling the Assets than it can by borrowing against them. According to one commentator, securitized lending offers a 150 basis point spread over conventional secured lending.[51] And, by all accounts, securitization is booming. More than $2 trillion of home mortgages alone "[h]ave been bundled into securities and investors from around the world own these securitized mortgages."[52]

B. *The Value of Securitization: Liquidity and Risk Pooling*

This cost advantage of securitization derives, in part, from two distinct value creating characteristics. First, securitization enhances the liquidity of asset backed debt, making it available in smaller denominations to non-specialized investors. Second, it allows smaller investors to enjoy the benefits of risk pooling.[53] For an example of both effects, imagine an individual investor with $100,000 to invest. This investor might not want to invest all her money in one residential real estate mortgage for two related reasons. First, she might want to diversify her investments into stocks, residential real estate lending, and other investments. Second, she is only in a position to invest in small mortgages of $100,000 or less. However, she might be very interested in investing $10,000 into a mortgage backed security that represented a share in a mortgage pool containing thousands of real estate mortgages of varying sizes and risk attributes. By investing in Asset Backed Securities, she can both invest a small amount, and spread the risk of

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[49] *See supra* note 29.

[50] *See, e.g.*, *In re* LTV Steel Co., 274 B.R. 278, 280 (Bankr. N.D. Ohio 2001) ("In 1998, Debtor entered into another ABS financing arrangement. . . . Debtor created LTV Steel Products, LLC ('Steel Products'), another wholly-owned subsidiary. Debtor entered into an agreement with Steel Products which purports to sell all of Debtor's . . . *inventory* to Steel Products on a continuing basis.") (emphasis added).

[51] Lowell Bryan, *The Risks, Potential and Promise of Securitization*, *in* A PRIMER ON SECURITIZATION 171-73 (Leon T. Kendall & Michael J. Fishman eds., 1996).

[52] Christopher Farrell, *Why Things Aren't a Whole Lot Worse*, BUS. WK. ONLINE, June 15, 2001, *at* http://www.businessweek.com/bwdaily/dnflash/jun2001/nf20010615_907.htm.

[53] *See* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 134 (1994).

default across a large number of mortgages. Thus, securitization provides the investor with the benefits of both diversification and risk spreading, while it provides to the borrower the benefits of liquidity and risk pooling.

C. *The Costs of Securitization: Risk Alteration and Transparency*

The benefits of liquidity and risk pooling do not come without costs, and these costs are often overlooked. Because securitizations are structured as sales rather than loans, the Assets, once sold, are placed beyond the reach of the creditors of the Originator,[54] and the Originator may be deprived of any protections of its "equity" in the Assets provided by Article 9 or state mortgage law.[55] This can shift risk from investors in the assets held by the SPV to the creditors of the Originator.[56] This risk alteration is similar in nature and effect to the risk alteration caused by secured credit. However, the effect is enhanced, because securitization is thought to place the Assets conveyed to the SPV beyond the reach of sections 541, 362 and 363 of the Bankruptcy Code. The "sold" assets are not "property of the estate," so the creditor/purchaser's collection efforts will not be barred by the "automatic stay" imposed on creditors when the Originator files for bankruptcy, or delayed by the Originator/Debtor's power to "use" cash collateral.[57]

This risk alteration effect of securitization is further compounded by what might be called "transparency costs." One source of transparency costs results from the peculiarities of the rules for off-

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[54] There is some division of opinion as to how effective this insulation is. *Compare* Carlson, *supra* note 41, *with* Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 EMORY L.J. 1193 (1998), *and* Paul M. Shupack, *Making Revised Article 9 Safe for Securitizations: A Brief History*, 73 AM. BANKR. L.J. 167 (1999).

[55] Where goods or real property are involved, Delaware incorporation will not be sufficient. *See supra* note 20. A true sale statute likely only governs real estate in the jurisdiction where it is enacted.

[56] *See* Lynn M. LoPucki, *The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz*, 52 STAN. L. REV. 55, 64-66 (1999) (discussing structured finance as judgment proofing device); Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 649 (1996) ("In leveraged finance transactions, the increase in a corporation's debt burden often works to the detriment of existing creditors .... The same conflict can arise in structured finance and securitization transactions."). Schwarcz, however, unlike LoPucki, seems to think that the benefits outweigh the costs. *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). For my views, see Edward J. Janger, *Muddy Rules for Securitizations*, 7 FORDHAM J. CORP. & FIN. L. 301 (2002); Janger Letter, *supra* note 18.

[57] Again, compare Carlson, *supra* note 41, with Plank, *supra* note 54.

balance sheet accounting for securitized assets.[58] These rules (while currently in flux)[59] have historically allowed the Originator of an ABS transaction to retain substantial dominion over the assets and substantial ownership of the SPV, and allowed the SPV to retain significant recourse against the Originator, while nonetheless leaving both the value and the risk associated with securitized assets off the Originator's balance sheet.[60] As the recent Enron debacle makes clear, a sale of Assets to an SPV can be used to move debt off the Originator's balance sheet, to accelerate (or even manufacture) earnings, or to hide assets, as the parties to the transaction desire.[61]

However, accounting rules are not the only source of transparency costs that result from securitization. Some of these costs inhere in the interaction between sales law and the law of secured credit, and are compounded by the ABS Statutes. As a general rule, to perfect a security interest, notice must be given to creditors through a filing in the UCC system or by taking possession.[62] For sales, as a general rule, no such notice is required.[63] Exceptions exist. For example, sales of "accounts" and "chattel paper" must be filed in the Article 9 system to be effective against third parties,[64] and real estate sales must be recorded in the land records.[65] Other sales, however, even those of assets otherwise subject to Article 9,[66] are not subject to this requirement. Thus, even under current law, securitization has some transparency costs.

An example of this effect leaps from the pages of Jim White's Article.[67] When one compares subsection (a) of revised sections 9-318

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[58] *See* FIN. ACCOUNTING STANDARDS BD., ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES — A REPLACEMENT OF FASB STATEMENT NO. 125, *available at* http://www.fasb.org/st (issued Sept. 2000).

[59] For the current state of the Financial Accounting Standards Board's efforts to amend the accounting rules regarding securitizations, see Fin. Accounting Standards Bd., Project Updates: Qualifying Special-Purpose Entities and Isolation of Transferred Assets, *at* http://www.fasb.org/project/qualifying_spe.shtml (last updated Jan. 30, 2004).

[60] These transparency costs are discussed in Janger, *Muddy Rules for Securitizations*, *supra* note 56, and became a substantial issue in the debate over Section 912 to the Bankruptcy Reform Act of 2001. Indeed, these costs led a large number of securities professors to object to Section 912 as well.

[61] Second Interim Report of Neal Batson, Court-Appointed Examiner, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. filed Dec. 2, 2001); *see also* Special Investigative Committee of the Board of Directors of Enron, Report of Investigation (Feb. 1, 2002) [hereinafter Powers Report], *available at* http://news.findlaw.com/hdocs/docs/enron/sicreport/index.html (last visited April 21, 2004).

[62] Revised U.C.C. § 9-310 (2001).

[63] *Id.* § 2-403.

[64] *Id.* § 9-310.

[65] *See, e.g.*, N.Y. REAL PROP. LAW § 291 (McKinney 1989 & Supp. 2004).

[66] Revised U.C.C. § 9-309.

[67] White, *supra* note 44.

with subsection (b),[68] one notes an odd anomaly. According to 9-318(a), when "accounts," "chattel paper," "promissory notes," and "payment intangibles" are sold, the seller retains no property interest. However, 9-318(b) requires perfection by filing only for "accounts" and "chattel paper." Sections 9-309(3) and (4) confirm this reading: sales of "payment intangibles" and "promissory notes" are perfected without filing.[69] This is true, even though filing (and/or possession in the case of "promissory notes" that are "instruments") is (are) required to perfect a security interest in "promissory notes" and "payment intangibles" that secures an obligation.[70] Thus, for these assets, creditors and other potential purchasers would be given notice of the lesser interest (a lien), but not the greater interest (a sale).

This anomaly predates Article 9's recent expansion to cover sales of "payment intangibles" and "promissory notes,"[71] and its costs may be tolerable, given that under current law it applies only to "true sales." However, the ABS Statutes, by giving effect to all conveyances that are denominated sales in "securitization" transactions, may free the parties of the need to disclose even "non-true sale" securitizations.[72] In short, the ABS Statutes don't just undercut the Bankruptcy Code, they undercut the Article 9 filing requirement. Indeed, a not particularly aggressive reading of the Delaware ABS Statute[73] suggests that it might go even further, and override the Article 9 filing requirement altogether for all sales pursuant to securitization transactions.[74]

When considering these risk alteration and transparency costs, it is important to recognize that the securitization form is not limited to sales of financial assets. While these transactions often take the form of a commercial bank securitizing its mortgage receivables, or a merchant bank securitizing its credit card receivables, the structure encompasses, and many of the ABS Statutes reach, a wider variety of transactions. Conceptually, an SPV can hold many types of assets, financial or otherwise. Nothing in the the Delaware ABS Statute, for example, stops an Originator from using the SPV as a form of field warehouse, where operations are conducted by one entity, but all of the assets are held by another.[75]

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68 Revised U.C.C. § 9-318(a)-(b).

69 *Id.* § 9-309(3)-(4).

70 *Id.* § 9-310.

71 Former Article 9 only covered sales of "accounts" and "chattel paper." U.C.C. § 9-102 (1998).

72 *See supra* note 29.

73 DEL. CODE ANN. tit. 6, § 2703A(a)(1) (2003); *see also supra* note 29 and accompanying text.

74 I am not advancing this horrible as a conclusion, but merely as a possibility. The "notwithstanding" and "no-rights" language in the Delaware ABS Statute, *see supra* note 29 and accompanying text, might be read by a court as a trump.

75 Indeed, while not directly at issue in the opinion, the securitization described in the *LTV*

Similarly, while the driving financial motivation for a securitization transaction *might* be the efficiency associated with liquidity enhancement and/or risk pooling, the motivation might instead be to capture the benefits of secrecy (because no Article 9 filing is required for sales of assets other than "accounts" and "chattel paper"). Worse yet, the transaction might be driven by a desire to use off-balance sheet accounting to accelerate earnings through the use of "mark to market" accounting, move assets off the balance sheet, move debt off the balance sheet, or conceal risk. And, lest these risks be viewed as trivial, in Enron, the concealment of business risks in off-balance sheet special purpose entities caused a publicly traded company to fool its auditors and misstate shareholder equity by billions of dollars.[76]

Thus, the source of the apparent 150 basis point advantage enjoyed by securitization over secured debt[77] is generated in part by value-creating, efficiency-enhancing attributes of securitization transactions, and in part by the externalities created by (1) shifting risk of default to non-adjusting and non-consensual creditors of the Originator, (2) concealing liens, and (3) distorting the balance sheet of the Originator by taking opportunistic advantage of accounting rules to call something a sale which is really a loan. Originators of securitization transactions may therefore choose to use this method of capital formation for two distinct sets of reasons, one efficiency enhancing, and the other rooted in moral hazard.

D. *Institutional Mechanisms for Controlling Risk Alteration and Transparency Costs: The Role of True Sale*

There are a number of institutional mechanisms that could, if they worked properly, limit the pernicious effects of securitization, even in the absence of the doctrine of "true sale." First, corporate officers and directors are bound by their fiduciary duties to shareholders *not* to knowingly distort the balance sheet of the company,[78] and, to the extent that the debtor is in the zone of insolvency, *not* to use financial

case involved both "accounts" *and* "inventory." *In re* LTV Steel Co., 274 B.R. 278, 280 (Bankr. N.D. Ohio 2001). Douglas Baird, in his contribution to this symposium describes a Volvo plant in South America, where each of the functions is carried out by a different subcontractor; Volvo is merely the name on the front door. Douglas G. Baird, *Secured Lending and Its Uncertain Future*, 25 CARDOZO L. REV. 1789 (2004).

[76] *See* Second Interim Report of Neal Batson, Court-Appointed Examiner, *In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. filed Dec. 2, 2001); *See also* Powers Report, *supra* note 61, at 2.

[77] *See supra* note 51 and accompanying text.

[78] *See, e.g.*, Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) ("[D]irectors who knowingly disseminate false information that results in corporate injury or damage to an individual stockholder violate their fiduciary duty, and may be held accountable in a manner appropriate to the circumstances.").

structures to harm creditors.[79] Second, a "Final Four"[80] accounting firm could rigorously police the debtor's balance sheet, and ensure that creative structures are not being used to distort the financial picture of the company that is presented to investors. However, the recent spate of corporate accounting scandals makes it very difficult to list these protections with a straight face. Corporate officers face inevitable conflicts of interest, and the accountants appear to as well.[81]

This is where the doctrine of true sale fits into the legal architecture; its effects are both substantive, in that it regulates transactions themselves, and procedural or governance based, in that it allocates risk to the professionals who implement securitizations. The doctrine of true sale causes difficulties for securitization, because the *sine qua non* of the form is said to be asset isolation—the purchasers of asset backed securities need only look at the financial attributes of the securitized assets, not at the financial characteristics of the Originator.[82] But, in order to get the benefit of asset isolation, the assets must be truly isolated. In other words, the seller must relinquish, and the buyer must bear the benefits and risks of ownership.

The difficulty lies in the fact that many securitization transactions live very close to the line between sales and loans. The Originator may wish to retain an equity interest in the SPV, thus retaining a piece of the upside, if the value of the financial assets conveyed exceeds the "purchase" price. On the flip side, the Originator may warrant, or guaranty to the SPV that certain assets will yield certain amounts, and promise to make up the difference if they do not. Thus the Originator also retains a piece of the downside risk associated with owning the asset.[83] The doctrine of true sale endangers transactions that tread too close to this divide.

The muddy line between a true sale and a "sale intended as security" has important institutional and practical consequences for securitizations. Because favorable bankruptcy treatment requires the

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79 *See, e.g.*, *In re* Buckhead Am. Corp., 178 B.R. 956, 968 (Bankr. D. Del. 1994); Odyssey Partners, L.P. v. Fleming Cos., 735 A.2d 386, 417-18 (Del. Ch. 1999); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, mem. op. at 84 & n.55 (Del. Ch. Dec. 30, 1991).

80 First it was the "Big Eight," then the "Big Six," then the "Big Five," and now, with the demise of Arthur Andersen, the "Final Four."

81 *See generally* ENRON: CORPORATE FIASCOS AND LEGAL IMPLICATIONS (Nancy Rapoport & Jeff van Niel eds., 2004). As noted above, *see supra* note 59, the Enron scandal has led the Financial Accounting Standards Board to modify its rules for off-balance sheet accounting. However, the new rules are still a work in progress, and they remain to be tested.

82 *See, e.g.*, Mark C. Ellenberg, *"Structured Finance" Technique an Asset in Bankruptcy*, WASH. BUS. J., Sept. 7, 2001 ("In simple terms, structured finance isolates assets from the insolvency risk associated with an operating company"), *available at* http://washington.bizjournals.com/washington/stories/2001/09/10/focus7.html (Sept. 7, 2001).

83 *See* Pantaleo et al., *supra* note 33, at 162-63 (distinguishing between "warranties of collectibility" and "economic recourse").

transaction to be characterized as a "true sale," rating agencies, such as Moody's or Standard and Poor's routinely insist on assurance that the SPV, and the assets it holds, are "bankruptcy remote." They generally require the Originator to obtain an opinion of counsel stating (1) that the sale of assets by the Originator to the SPV is a "true sale" to a "separate entity;" and (2) that the sale is not subject to substantive consolidation.[84] In short, the attorneys must concern themselves with the questions of "risk alteration" and "transparency" by predicting how a judge might view the transaction *ex post.*

It is possible to criticize these opinion letters. They tend to be very long, highly qualified, and quite expensive. This is not, in and of itself, a reason to abandon the doctrine of "true sale." First, even if these opinions are of limited value, they operate as a tax on securitizations that limits the effect to which risk alteration and transparency costs will justify the transaction.[85] In addition, and more importantly, the doctrine of true sale provides an opportunity for judicial examination of the substance of the transaction. The fear of a judicial determination that a transaction is not a true sale will also deter inefficient transactions at the margin.

The doctrine of true sale thus plays a crucial role in limiting (though not entirely eliminating) risk alteration and transparency costs associated with securitization.[86] Its abolition, all else being equal, is likely to increase the number of inefficient transactions.

II. THE CAMPAIGN TO ABOLISH THE DOCTRINE OF TRUE SALE

The securitization industry has grown over the last decade and a half from almost non-existent, to one of the dominant institutions for capital formation, and it has done so under current law. So why is there suddenly such a need for a statutory safe harbor? The problem is that the securitization industry grew by promising the benefits of liquidity, risk pooling and asset isolation without ever truly testing the legal basis or contours of the third promise. The campaign to abolish true sale began when courts and commentators had the bad manners to call

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84 Edwin E. Smith, Recent Developments in the Characterization in Bankruptcy of Prepetition Transfers of Rights to Payment: True Sales or Disguised Loans?—Proposal for a Uniform State Law on What Constitutes a True Sale of a Right to Payment, Address Before the Business Transactions Subcommittee, Business Bankruptcy Committee, of the Business Law Section of the American Bar Association 7 (Oct. 3, 2002).

85 Gillian K. Hadfield, *Judicial Competence and the Interpretation of Incomplete Contracts*, 23 J. LEGAL STUD. 159 (1994); Janger, *Crystals and Mud*, *supra* note 10, at 603-06; Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 NW. U. L. REV. 749, 753 (2000).

86 *See* Janger, *Muddy Rules for Securitization*, *supra* note 56, at 313-16.

attention to this fact. The movement arose in the wake of the Tenth Circuit's poorly reasoned decision in *Octagon Gas v. Rimmer*,[87] and gathered steam after David Carlson wrote an article making a more coherent argument for the proposition that securitized assets remain property of the Originator's bankruptcy estate.[88] The clamor for abolition of true sale became deafening after the *LTV* case,[89] in which a bankruptcy court in the Northern District of Ohio allowed the debtor to use securitized assets as cash collateral during the early part of a Chapter 11 case. Each of these events struck fear into the hearts of the bond lawyers who had given "bankruptcy remoteness" opinions, and rating agencies who had assumed, when they rated asset backed securities, that they did not need to consider the solvency of the Originator. Having backed themselves into a corner, they have looked to state and federal legislators for a way out.

The first attempt was at the federal level, by inserting a safe harbor into the various proposed Bankruptcy Reform Acts from 1999 through early 2002.[90] That proposed provision applied only to securitizations where at least one tranche of securities issued by the SPV would receive an "investment grade" rating from a nationally recognized statistical rating organization ("NRSRO").[91] For those deals, however, the provision would have abolished the true sale doctrine, and eliminated any state law avoidance actions based on fraudulent conveyance or other causes of action.[92] That provision was removed from the bill when a number of law professors, myself included, pointed out that the provision contained a number of technical glitches, and more importantly, that it might increase transparency costs, by facilitating the opportunistic use of off-balance sheet accounting as occurred at Enron.[93]

By contrast to their failure to enact a safe harbor at the federal level, proponents of asset backed securitization have had more success at the state level and in the Uniform Law process. Section 9-318[94] is an

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87 995 F.2d 948 (10th Cir. 1993).

88 Carlson, *supra* note 41.

89 *In re* LTV Steel Co., 274 B.R. 278 (Bankr. N.D. Ohio 2001).

90 This provision can be found in the Bankruptcy Reform Act of 1999, S. 625, 106th Cong. § 903 (1st Sess. 1999), and H.R. 833, 106th Cong. § 1012 (1st Sess. 1999). H.R. 833 was passed by the House on May 5, 1999, and adopted as a substitute for S.625 by the Senate on February 2, 2000. That Bill was pocket vetoed by President Clinton on Dec. 19, 2000. The provision then reappeared in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, S. 220, 107th Cong. § 912 (1st Sess. 2001), H.R. 333, 107th Cong. § 912 (1st Sess. 2001), but was removed in early 2002 in response to academic criticism. *See supra* note 18.

91 274 B.R. 278. For a description of NRSROs, see Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1.

92 Though fraudulent, conveyance avoidance would have remained available for transactions within one year of the bankruptcy under 11 U.S.C. § 548 (2000).

93 *See supra* note 18.

94 *See supra* notes 68-70 and accompanying text; *see also* White, *supra* note 44.

example of the securitization industry's effect on the Article 9 drafting process, and the ABS Statutes seek to accomplish precisely what the proposed bankruptcy safe-harbor would have accomplished, and more.[95] The Delaware ABS Statute, described above, is not limited in effect to "rated deals;" neither are its siblings in South Dakota, Alabama, Texas, Louisiana, and Ohio.[96] These statutes are spreading like kudzu, and I do not entirely understand why the partisans of secured credit appear to be standing idly by.

III. THE DEATH OF SECURED LENDING

This passivity may be a mistake. The ABS Statutes[97] pose a threat to secured lending as well as to bankruptcy. With the ABS Statutes in place, when would a debtor ever choose to borrow if it could afford to securitize? Assuming that the ABS Statutes accomplish what they purport to, the answer would appear to be almost never. As noted above, all of these ABS Statutes provide companies in need of financing with the ability to opt out of Article 9's internal regulatory structure, and seek to free securitized assets from the burdens often placed on them by the Bankruptcy Code. In particular, ABS investors are freed from the burden of the bankruptcy trustee's power to "use" property of the estate, including, on court approval, "cash collateral."[98] This advantage comes regardless of whether the transaction provides either the risk pooling or liquidity enhancing benefits that are the *raison d'etre* for securitization.

Because these statutes are not limited in effect to securitizations that provide risk pooling and liquidity benefits, they are available as a substitute for virtually any type of secured loan. Not only that, they are a substitute that comes free of certain "regulatory" costs. Why lend money when you can buy assets, retain recourse against the debtor, streamline the foreclosure process, and avoid the bankruptcy estate? Why borrow money when you can sell assets, and retain the upside, not list the debt on your balance sheet, get a better rate of interest, and more effectively externalize risk to non-consensual and non-adjusting creditors?

Secured lending runs the risk of becoming the poor cousin of securitization, not because securitization offers greater efficiency, but because it facilitates regulatory evasions and creates economic

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[95] *See supra* note 29.

[96] *See supra* note 29. North Carolina has enacted a statute that tracks the proposed federal provision in this regard. *See* N.C. GEN. STAT. § 53-426 (2004).

[97] *See supra* note 29 and accompanying text.

[98] 11 U.S.C. § 363 (2000).

distortions. These distortions alter risk, undercut transparency, and as a side effect, favor consolidation among both borrowers and lenders. First, while securitizations may provide an interest rate advantage, they are expensive to construct, and therefore are only economic for transactions of significant size. Securitization thus favors larger enterprises over smaller ones. Second, securitization favors large financial supermarkets over traditional commercial banks. Prior to the enactment of the Gramm-Leach-Bliley Act in 1999 ("GLB"),[99] the Glass-Steagall Act enforced a separation between the businesses of commercial banks and thrifts both of which engage in secured lending, and that of investment banks, which could underwrite securities. GLB eliminated the wall of separation.[100] Therefore, the same financial institutions can now loan money *and* underwrite securitizations. Nonetheless, not all financial institutions embrace both the functions of commercial and investment banking. Favoring securitization over lending favors consolidated financial supermarkets over either independent investment banks or independent banks. Indeed, in a world where ABS Statutes were the norm, there might be only a very few debtors who would choose to raise money by actually borrowing it—those who couldn't afford to securitize, and secured loans would only be offered by banks that lacked the wherewithal to structure securitizations.

IV. THE ABOLITION OF TRUE SALE AND THE "RACE TO THE BOTTOM"

Having raised concerns about the abolition of the true sale doctrine, one might be tempted to respond that this is just an example of states experimenting with their own property law. Brandeis described states as the laboratories of democracy.[101] Is there any reason not to let

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[99] Gramm-Leach-Bliley Act of 1999 (also known as the Financial Services Modernization Act), Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified in scattered sections of 12 and 15 U.S.C.).

[100] The Gramm-Leach-Bliley Act repeals sections of the Banking Act of 1933 (also known as the Glass-Steagall Act). 12 U.S.C. §§ 378, 1843 (2000). The critical sections of the Glass-Steagall Act, sections 20 and 32, restricted banks and security firms from affiliating with each other. *See* Neal R. Pandozzi, *Beware of Banks Bearing Gifts: Gramm-Leach-Bliley and the Constitutionality of Federal Financial Privacy Legislation*, 55 U. MIAMI L. REV. 163, 171 (2001). Section 4 of the Bank Holding Company Act of 1956, ch. 240, § 4, 70 Stat. 135 (1956) (current version at 12 U.S.C. § 1843 (2000)), had generally prevented a bank from controlling a non-bank company without a finding by the Federal Reserve Board of a close relation of the activities of the non-bank company to banking. GLB eliminated this restriction as well. *See* the Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, §§ 102(a), 103(a), (c)(2), 107(a), (b), (d)-(f), 113 Stat. 1341-1342, 1351, 1359-1361 (1999); *see also* Pandozzi, *supra*, at 171.

[101] *See* New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) ("There must be power in the States and the Nation to remould, through experimentation, our economic practices and institutions to meet changing social and economic needs.").

Delaware, South Dakota, Alabama, Texas, Ohio, and North Carolina[102] engage in local experimentation? The answer is "yes," and the reason lies in the dynamics of federalism.

One revolutionary and widely applauded change accomplished by Revised Article 9 was to rewrite the choice-of-law rules for secured transactions. In one fell swoop, however, the Article 9 drafting committee may have inadvertently turned commercial law into a lever in the competition of states for incorporation. Under former Article 9, the law of the jurisdiction where the collateral was located governed tangible collateral, and the law of the jurisdiction where the debtor was located governed intangible collateral and mobile goods.[103] Revised Article 9 simplified matters considerably. The law of the jurisdiction where the debtor is located now governs perfection for all types of collateral and the effect of perfection for intangible collateral and mobile goods. Furthermore, for corporate debtors, the debtor's location is deemed to be its state of incorporation.[104] While it is not easy for a corporation to move its corporate headquarters and tangible assets to take advantage of favorable law in a particular jurisdiction, it is not particularly difficult to reincorporate. As I speculated in an earlier article,[105] state of incorporation filing may make it possible for Delaware, by non-uniform enactment, to favor Delaware incorporators over non-Delaware incorporators by enacting favorable rules regarding perfection, and, to the extent that choice of law rules allow, with regard to substantive treatment as well. This concern is validated by the ABS statutes.[106]

Simply saying that a law is chosen to engage in interstate regulatory competition does not, by itself, compel the conclusion that the competition is inefficient. State competition can lead to a race to the top (efficiency) or a race to the bottom (inefficiency). Again, as I have argued elsewhere,[107] it is possible to predict whether state competition will be efficient or inefficient by asking two questions about the statute. First, does it give rise to the possibility of intra-firm externality by allowing one corporate constituency (such as shareholders or managers) to impose costs on another (such as creditors or rank and file employees)? Second, does the statute give rise to the possibility of interstate externality, by allowing one state to impose costs on the

[102] *See supra* note 29 and accompanying text.

[103] U.C.C. § 9-103 (1998).

[104] Revised U.C.C. §§ 9-301, 9-307(e) ("A registered organization that is organized under the law of a State is located in that State.").

[105] Janger, *Uniform Law Process*, *supra* note 9, at 623-25.

[106] *See supra* note 29.

[107] Janger, *Uniform Law Process*, *supra* note 9, at 579-80; *see also* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992).

citizens of another state? Unfortunately, the Delaware ABS Statute[108] implicates both concerns.[109]

First, the Delaware ABS Statute creates an opportunity for intra-firm externality. Like secured credit, securitization gives shareholders and managers the power to shift risk to non-consensual and non-adjusting creditors such as tort claimants and employees of the originator. But the risks of securitization go beyond those associated with secured credit. Securitization seeks to insulate the securitized Assets more effectively from the claims of an Originator's creditors. This is not necessarily a problem for true true sale securitizations (where the seller has truly parted with the asset, and received consideration in return). But for those "non-true sale" securitizations which would be insulated by the ABS Statutes, the use of the "sale" form leads to a difference in treatment without a difference in substance. Worse yet, state competition is particularly likely to lead to a race to the bottom when it reduces the effect of market discipline on corporate managers.[110] Legislation that reduces transparency allows incumbent management to hide the costs of inefficient management decisions. As noted above, the ABS Statutes give the officers of the Originator the power to impose transparency costs on shareholders, through off-balance sheet accounting and reduced filing obligations. Securitization, therefore, creates an opportunity for intra-firm externality.

Second, the Delaware ABS Statute[111] creates an opportunity for interstate externality. Under Article 9's choice of law rules, where financial assets are involved,[112] the Originator need only be incorporated in Delaware to take advantage of the Delaware ABS Statute.[113] A plurality of American public companies incorporate in Delaware. However, the employees, creditors, and shareholders who are harmed by the Delaware ABS Statute are not, for the most part, citizens of Delaware. For this reason, Delaware can benefit from the franchise taxes associated with additional Delaware incorporations,

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108 DEL. CODE ANN. tit. 6, § 2703A(a)(1) (2003); *see also supra* note 29 and accompanying text.

109 *See* Janger, *Uniform Law Process*, *supra* note 9, at 593.

110 *See* Bebchuck, *supra* note 107, at 1461. Bebchuck contends:

> The effectiveness of market discipline . . . varies greatly across issues. In particular, there are two types of issues with respect to which market discipline can hardly be relied on to induce managers to seek value-maximizing rules. These two types of issues are those that are "significantly redistributive" and those that directly affect the strength of market discipline.

Id.

111 DEL. CODE ANN. tit. 6, § 2703A(a)(1); *see also supra* note 29 and accompanying text.

112 As noted above, *see supra* note 20, and elsewhere, Janger, *supra* note 9, at 625, the drafters of Revised Article 9 limited the extent to which Article 9 *increased* the incentive to race to the bottom by bifurcating the law governing perfection and the law governing effect of perfection for tangible assets. However, the incentive still exists.

113 Revised U.C.C. §§ 9-301, 9-307(e); *see also supra* note 104 and accompanying text.

while not bearing the cost of the inefficient legislation.[114]

State competition and experimentation with regard to securitization will more likely lead to a race to the bottom, rather than a race to the top, and the Delaware ABS Statute fits the predicted pattern with chilling precision. A state that can externalize costs appears to be competing for incorporations by adopting a law that allows corporate managers and shareholders to externalize risk.

V. THE NEED FOR A FEDERAL SOLUTION AND SOME ALTERNATIVES

In the preceding four sections, I have painted a picture of the securitization movement, and the ABS Statutes[115] that should give proponents of secured lending and Article 9 pause. The Delaware ABS Statute,[116] if it works, creates an opportunity for lenders and borrowers to opportunistically avoid the regulation of secured credit contained in the perfection and foreclosure rules of Article 9. The doctrine of true sale, which these statutes would abolish, operates as a protection against risk alteration and transparency reducing securitizations.[117] These effects of the Delaware statute are independent of any special treatment under the Bankruptcy Code.

However, making these arguments to the Delaware (or South Dakota, Ohio, Texas, Louisiana, North Carolina, or Alabama) legislature(s) is unlikely to gain much headway. States which adopt ABS statutes benefit from precisely the moral hazard that the doctrine of true sale limits. Worse yet, as has been observed in the corporate law area, as goes Delaware, so goes the nation. So, if the Delaware ABS Statute is an example of a race to the bottom, the only way to solve the problem is through federal law. In short, those who believe in secured lending, and that Article 9's regulatory provisions matter should support a federal override of the ABS Statutes, and a federal doctrine of "true sale."

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114 Indeed, the reach of the Delaware ABS Statute may be enhanced for securitized personal property, other than accounts, chattel paper, promissory notes, and payment intangibles, because Revised Article 1 increases the extent to which contractual choice of law clauses are enforceable, even where the chosen law bears no relation to the transaction. Revised U.C.C. § 1-301 (2001). Under that provision, in unconventional securitizations—where the SPV holds assets, the sale of which are not governed by Article 9—debtors may, unless a state court decides that it violates a fundamental policy, simply be able to opt into Delaware law, and thereby opt out of the doctrine of true sale. This is by no means a certainty, however. Cases under UCC 1-105 held fairly uniformly that choice of law clauses that implicated the sale/lease distinction were held unenforceable because they implicated the rights of third parties. *See, e.g., In re* Eagle Enterprises, 223 B.R. 290, 294-95 (Bkrtcy.E.D.Pa.1998) (collecting cases).

115 *See supra* note 29.

116 *See id.* and accompanying text.

117 *See* discussion *supra* Part I.A.

Such a solution can be reached either through federal legislation or through judge-made law under current bankruptcy law.

A. *Statutory Solution*

During the summer of 2002, a statutory override to the ABS Statutes was proposed in Congress. Section 102 of the Durbin-Delahunt Bill provided as follows:

> (e)(1) Notwithstanding any otherwise applicable provision of law, the court may recharacterize as a secured loan, a sale, lease, or transaction if the material characteristics of the sale, lease, or transaction are substantially similar to the characteristics of a secured loan.
>
> (2) Nothing in paragraph (1) shall be construed to modify, impair, or supersede any other authority under federal or state law that the court has to recharacterize a sale, lease, or transaction.[118]

This provision, which would have federalized the law of "true sale," was roundly criticized as an invasion of the province of state law.[119] A "report" signed by, among others, the reporters of Revised Article 9 and some of the strongest proponents of securitization, shows that the secured lending/securitization alliance is still holding together, at least for these purposes.[120] However, the rhetoric of the response is quite interesting, in that it may reveal that the marriage may no longer be one of common interest. Rather than attack the substance of the doctrine of "true sale," or the particular formulation (which might have benefited from greater specificity), the critique was phrased as follows:

> We do not question the proposition that a court should attempt to characterize the economic substance of a transaction in determining its appropriate character for purposes of applying bankruptcy law. This happens regularly under current law by the application of well established state laws. We do question, however, the wisdom of statutorily federalizing this important issue of property law for purposes of bankruptcy—at least without additional thought and deliberation. We are aware that a very few states have enacted laws that would permit true sale treatment for transactions without regard to economic substance and we express no view on the merits of those laws. Instead, we suggest that the question of the effectiveness of those laws in bankruptcy be left to the courts in their determination as to whether a conflicting federal interest exists, as *Butner* instructs. Thus, to the extent that state law may create or lead to abuses from a bankruptcy perspective, federal law already contains the cure. The

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118 Employee Abuse Prevention Act of 2002, H.R. 5221, 107th Cong. § 102.

119 Durbin-Delahunt Report, *supra* note 7.

120 *Id.*

> proposed statutory fix is totally unnecessary, particularly given the devastating impact that it would have on an industry that supplies much needed capital to business enterprises both here and abroad. State law, when examined in the bankruptcy context, for the most part has proved workable and sensible.[121]

This remarkable paragraph shows that the unified front may have a few cracks. The paragraph starts by questioning the federalization of the law of "true sale," because state courts can, do, and should apply the doctrine as a matter of state common law. It then acknowledges the existence of the ABS Statutes, but declines to criticize them, notwithstanding their evident purpose of abolishing the true sale doctrine just praised. Next, the authors state that a federal statute is unnecessary because federal bankruptcy courts have the power, under *Butner v. United States*,[122] to do precisely what the statute that they just criticized does by overriding the ABS Statutes in the name of a federal common law doctrine of "true sale." Finally, the authors state that the federal statute would cause grievous injury to the securitization industry, because it would give bankruptcy courts the power to do something that in the previous sentence they said the bankruptcy courts already had the power to do under current law.[123] This critique of Durbin-Delahunt section 102[124] is intriguing, not because what it says is correct, but because it may point toward a division among the drafters of the report, some of whom trace their roots to secured lending, some of whom are advocates of securitization. It is almost as if each group was given the opportunity to write a sentence, and the finished product was not edited for logical consistency.

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121 *Id.* at 23 (referring to Butner v. United States, 440 U.S. 48 (1979)).

122 440 U.S. 48 (1979).

123 The analysis hinges on *Butner*, a case where the Supreme Court unanimously inveighed against bankruptcy rules that overrode state law property interests. The *Butner* Court reasoned as follows:

> The constitutional authority of Congress to establish "uniform Laws on the subject of Bankruptcies throughout the United States" would clearly encompass a federal statute defining the mortgagee's interest in the rents and profits earned by property in a bankrupt estate. But Congress has not chosen to exercise its power to fashion any such rule. The Bankruptcy Act does include provisions invalidating certain security interests as fraudulent, or as improper preferences over general creditors. Apart from these provisions, however, Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law. *Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.* Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy."

Butner, 440 U.S. at 54-55 (citing Lewis v. Mfrs. Nat'l Bank of Detroit, 364 U.S. 603, 609 (1961)) (emphasis added) (footnotes omitted).

124 *See supra* note 118 and accompanying text.

Thus, the alliance between secured lending securitization may be one of convenience, and habit, rather than interest. So long as it persists, however, Section 102 of Durbin-Delahunt (or anything like it) stands little chance of enactment, and the proponents of secured lending may have unwittingly facilitated inefficient securitization at their own expense.

B. *Judicial Solution*

The Durbin-Delahunt Report's discussion of federal power[125] does, however, raise an even more interesting question. Was Durbin-Delahunt 102 necessary at all? To what extent does current bankruptcy law, and the existing Bankruptcy Code, give bankruptcy courts the power to look past state law pronouncements of whether something is property of the estate? At what point does § 541 preempt state property law? Broadly speaking there are three points that a court could choose. The first is the position articulated by David Carlson, that any retention of an interest by the debtor is property of the estate, and sweeps the property, *in toto*, into the estate.[126] The second is the position articulated by most scholars, that transactions in the form of true sales will be excluded from the bankruptcy estate, while transactions with the substance of loans will be included.[127] Finally, there is the position taken by the ABS Statutes.[128] These statutes state that regardless of substance, if a transaction is labeled a "sale," it will be treated as one under state law. To the extent that bankruptcy law respects state law, potential debtors will have the power to exclude assets from their bankruptcy estates simply by securitizing them.

Both the first and third options are problematic. Carlson's view that any retained interest brings property into the estate *must* be overbroad. Putting aside the odd never-neverland world of securitizations, there must be some boundary between loan and sale, and certain sales must exclude the sold assets from the seller's bankruptcy estate. For example, if the debtor was in the business of selling cars, it would be bizarre to subject an automobile sold to a consumer to turnover based on the fact that the purchaser might at some indistinct point in the future avail him or herself of the right, under a warranty or lemon law, to return the car. Indeed, even if the seller retained a security interest, the seller's bankruptcy trustee could not recover the car unless the buyer defaulted. While the secured loan

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125 Durbin-Delahunt Report, *supra* note 7.

126 Carlson, *supra* note 41.

127 *See, e.g.*, Pantaleo et al., *supra* note 33; Plank, *supra* note 54; Shupack, *supra* note 54.

128 *See supra* note 29 and accompanying text.

would obviously be property of the estate, the car would not. On the other hand, allowing states to gerrymander their property law at will also seems undesirable, because in so doing states may permit *their* debtors to override the Bankruptcy Code.

As undesirable as the third option may be, is there anything in current federal law that stands in its way? In a number of contexts, the Bankruptcy Code expressly defers to state law. Section 541(c)(2)[129] respects spendthrift trusts that are enforceable under state law. Section 522[130] respects state exemption laws. Both provisions allow debtors from particular states to opportunistically exclude property from their estates. Indeed, Delaware and Alaska have revised their spendthrift trust laws[131] to allow settlors of trusts to retain almost unfettered control over the contents of those trusts, while nonetheless respecting the trusts as spendthrift, and unreachable by creditors.[132] While these are clearly judgment-proofing devices, no court has yet invalidated such a trust under federal bankruptcy law. Moreover, the language of § 541(a),[133] by its terms appears to piggy-back on applicable non-bankruptcy law. The estate consists of "all legal or equitable interests of the debtor in property . . . ."[134] What constitutes a legal or equitable interest turns on non-bankruptcy law entitlements.

But there are two answers, one based in case law, the other based in a structural reading of the Bankruptcy Code. First, the Supreme Court's decision in *United States v. Whiting Pools*,[135] makes clear that the legal or equitable interest need not be a possessory "property" interest.[136] Even an unexercised right to redeem was sufficient to bring property within the estate, and subject it to turnover.[137] Indeed, the Court acknowledged that this gave the estate more rights than the debtor would have had outside of bankruptcy, because the debtor could not have recovered the property without paying off the creditor (the IRS). This position is bolstered by the Supreme Court's recent decision in *United States v. Craft*.[138] In that case, the Supreme Court had to determine whether a federal tax lien relating to the tax liability of one

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129 11 U.S.C. § 541(c)(2) (2000).

130 *Id.* § 522.

131 *See supra* note 29; DEL. CODE ANN. tit. 12, §§ 3570-3576 (Supp. 1998); ALASKA STAT. § 34.40.110 (Michie 1998).

132 *See* sources cited *supra* note 131; *see also* Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 CORNELL L. REV. 1035, 1037-39 (2000).

133 11 U.S.C. § 541(a).

134 *Id.* § 541(a)(1).

135 462 U.S. 198 (1983).

136 *Id.* at 204 n.8 (stating that the estate includes tangible as well as intangible property).

137 *Id.* at 207.

138 535 U.S. 274, 278 (2002) ("Whether the interests of respondent's husband in the property he held as a tenant by the entirety constitutes 'property and rights to property' for the purposes of the federal tax lien statute is ultimately a question of federal law.") (citation omitted).

spouse attached to property held by a husband and wife by the entireties. Under Michigan law, no lien could attach to entireties property, yet the Supreme Court held that whether a spouse had a "property" right that could be reached under the Tax Code was a matter of federal law, not state law. Even though a lien could not attach to the property, the husband had sufficient rights with regard to the entireties property[139] to constitute property under the Internal Revenue Code.[140] What is striking is that the language in the section 6321 of the Internal Revenue Code at issue in *Craft* is quite similar to § 541 of the Bankruptcy Code.[141] Section 26 U.S.C. 6321 provides:

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon *all property and rights to property, whether real or personal, belonging to such person.*[142]

The Bankruptcy Code defines property of the estate as "all legal or equitable interests of the debtor in property as of the commencement of the case."[143] It seems entirely possible that the Supreme Court would give similar meaning to the Bankruptcy Code's definition of property of the estate, and would look past state law property definitions to determine whether the state law rights constituted "property" under the federal statute. Indeed, at least one lower federal Court has already done so.[144]

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139 The Court stated:

> In determining whether respondent's husband possessed "property" or "rights to property" within the meaning of [the federal tax lien statute], we look to the individual rights created by these state law rules. According to Michigan law, respondent's husband had, among other rights, the following rights with respect to the entireties property: the right to use the property, the right to exclude third parties from it, the right to a share of income produced from it, the right of survivorship, the right to become a tenant in common with equal shares upon divorce, the right to sell the property with the respondent's consent and to receive half the proceeds from such a sale, the right to place an encumbrance on the property with the respondent's consent, and the right to block respondent from selling or encumbering the property unilaterally.

Id. at 282.

140 *Id.* at 283. The Court observed:

> The statutory language authorizing the tax lien "is broad and reveals on its face that Congress meant to reach every interest in property that a taxpayer might have." "Stronger language could hardly have been selected to reveal a purpose to assure the collection of taxes." We conclude that the husband's rights in the entireties property fall within this broad statutory language.

Id. (citations omitted).

141 11 U.S.C. § 541 (2000).

142 26 U.S.C. § 6321 (2000) (emphasis added).

143 11 U.S.C. § 541(a)(1).

144 At least one federal court has chosen to ignore a state ABS law providing that a transaction denominated as "sale" will be treated as a "sale" regardless of its economic attributes. Reaves Brokerage Co. v. Sunbelt Fruit & Vegetable Co., 336 F.3d 410 (5th Cir. 2003). Texas has a non-

If federal common law is to create a definition of "property" for the purposes of § 541, how should it be defined? What should shape its contours? Ronald Mann, in his contribution to this Symposium, suggests that § 541's definition of property should preempt state statutes that are what he calls "bankruptcy directed."[145] In his view, any state statute which reshapes state property law for the purposes of obtaining better bankruptcy treatment for a particular class of creditors should be deemed preempted by the Bankruptcy Code.[146] Mann's approach is, however, overbroad, and difficult to administer. It is hard to imagine that the drafters of the Bankruptcy Code intended to freeze property definitions as they were in 1978, and would divest states of significant power over property located in their own jurisdictions. I, by contrast, would advocate a somewhat narrower, more functional, and to borrow a term from Hanoch Dagan, more "realist"[147] approach to the federal limits to state law discretion to reshape their property law. States need to be free to adjust their property law to serve local policies and local interests. State environmental law may, for example, affect bankruptcy priorities. Similarly, a state which adopted a lien in favor of tort claimants might also affect bankruptcy priorities, or the shape of the bankruptcy estate. Only where state competition will tend to lead state property law to race to the bottom should Congress or the federal courts reach out to preempt state property law. However, where, as with the ABS Statutes, the risk of such a race to the bottom is palpable and manifested, the argument for preemption is strong, and, that failing, the need for federal legislation is acute.

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uniform version of Section 9.109(e), which provides, in part:

> For all purposes, in the absence of fraud or intentional misrepresentation, the parties' characterization of a transaction as a sale of such assets [that is, accounts, chattel paper, payment intangibles, or promissory notes] shall be conclusive that the transaction is a sale and is not a secured transaction and that title, legal and equitable, has passed to the party characterized as the purchaser of those assets regardless of whether the secured party has any recourse against the debtor, whether the debtor is entitled to any surplus, or any other term of the parties' agreement.

TX. BUS. & COM. § 9.109(e) (2002). Nonetheless, in the *Reaves* case the Fifth Circuit held that PACA, a federal statute, governed a factoring agreement deemed to evidence a secured loan, not a sale, notwithstanding the Texas law to the contrary. Further support for such an argument might be found in the Supreme Court's recent decision in *Archer v. Warner*, 538 U.S. 314 (2003) (holding that where debtor settled a claim based in fraud in return for a promissory note, the settlement did not operate as a waiver of the creditor's right to seek to have the debt found non-dischargeable under 11 U.S.C. § 523). Thus, even in jurisdictions that have adopted ABS Statutes, bankruptcy courts might not be bound by the party's characterization of their transaction, particularly where that characterization involves the waiver of important rights in bankruptcy.

145 Ronald J. Mann, *The Rise and Fall of State Bankruptcy Directed Legislation*, 25 CARDOZO L. REV. 1805 (2004).

146 *Id.*

147 Hanoch Dagan, *The Craft of Property*, 91 CAL. L. REV. 1517, 1520 (2003).

CONCLUSION

The purpose of this essay is not to argue for section 102 of Durbin-Delahunt,[148] or to claim that the Delaware ABS Statute[149] is preempted by § 541 of the Bankruptcy Code.[150] Instead my claim is somewhat more complicated, but also more limited. First, as a policy matter, state law statutes which enable non-true sale securitizations encourage inefficient transactions that are driven not by the value creating aspects of securitization (liquidity enhancement and risk pooling), but by the inefficient attributes of securitization (risk alteration and financial obfuscation). Second, statutes which facilitate non-true sale securitizations encourage forum shopping away from secured lending under Article 9, and toward disguised sales as the dominant method of capital formation. Third, because Delaware can use its ABS Statute as a means to attract Delaware incorporation, while externalizing the costs of inefficient securitizations, we cannot count on jurisdictional competition to act as a corrective for the inefficient Delaware ABS Statute. Therefore, and this is my main point, those who care about the health of secured lending as an institution, and about Article 9 as a statute, should support a federal doctrine of true sale whether it is adopted through statutory enactment, or as a matter of common law.

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[148] Employee Abuse Prevention Act of 2002, H.R. 5221, 107th Cong. § 102 *see also supra* text accompanying note 118.

[149] DEL. CODE ANN. tit. 6, § 2703A(a)(1) (2003); *see also supra* note 29 and accompanying text.

[150] 11 U.S.C. § 541 (2000).