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## ASSET-BACKED SECURITIZATION, SPECIAL PURPOSE VEHICLES AND OTHER SECURITIZATION ISSUES

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Perhaps the most revolutionary change in the financial markets is the increasing trend towards “disintermediation.”<sup>1</sup> Disintermediation is the elimination of intermediaries in the supply chain. This is commonly referred to as “cutting out the middlemen.” In the financial markets disintermediation is characterized by a weakening in the relationship between banks and their customers and a concomitant increase in direct relationships between the ultimate suppliers and users of financing. Rather than taking a permanent position as secured or unsecured lenders, financial institutions are increasingly acting as facilitators or conduits of financing transactions. Asset securitization, the increase of money market funds for investment of cash reserves, the growth of communications networks such as the internet, and the implementation of strict bank capital requirements have all contributed to this trend.<sup>2</sup> Asset securitization is a species of disintermediation inasmuch as it permits a company to acquire reduced-cost financing through the removal of intermediaries such as bank lenders, which previously stood between a company and the ultimate source of money, the financial markets. Through asset securitization, a company avoids the increased transaction costs charged by middlemen financial institutions. It also enables a company to raise funds cheaply based on allocation of risks that are assessed by parties having the most expertise, such as rating agencies.

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<sup>2</sup> See generally Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of “Technological Disintermediation” for Unregistered Offerings of Securities*, 2 J. Small & Emerging Bus. L. 1 (1998).

Asset securitization is a valuable and important financial tool in today's global financial markets. It has been described as "one of the most important financing vehicles in the United States."<sup>3</sup> Some commentators have even referred to asset securitization as "alchemy" because it purportedly creates value where none existed before.<sup>4</sup> Asset securitization, however, continues to fit like a square peg in a round whole when confronted with traditional financial, legal and regulatory structures in the United States. For example, commercial banks have been forced to expand into the capital markets activities of underwriting and dealing in securities of all types, as well as other investment banking activities, because of the decline in traditional commercial lending. Similarly, the convergence of asset securitization and federal bankruptcy law has created a plethora of legal issues and problems that, for the most part, remain unresolved. Because federal bankruptcy law lags reality when it comes to dealing with these issues, there is much debate about the degree of legislative reform necessary to improve the treatment of asset securitization transactions under title 11. However, great pause should be given before succumbing to the seduction of a "one-size fits all" prescription, which not only could affect the underlying financial markets, but also risk undermining the central tenets of federal bankruptcy law. At present, the sound discretion of courts is more critical than any reform legislation. This article proceeds of seven parts. First, the basics of asset securitization transactions are discussed. Second, is a discussion of bankruptcy waivers, and waivers of the automatic stay. Third, consists of the various elements used to "bankruptcy proof" entities: that is, make them remote from the possibility of either a voluntary or involuntary bankruptcy filing. Fourth, is an analysis of the one of the most common attacks on assets securitization transactions in bankruptcy—"true sale" v. disguised loan analysis. Fifth, we consider statutory reform with respect to asset securitization. Sixth, is an analysis of the application of substantive consolidation on asset securitization transactions. Finally, is an analysis of the application of fraudulent transfer law on asset securitization transactions.

## I. ASSET SECURITIZATION TRANSACTIONS

There exists no uniform definition of "asset securitization." Nevertheless, several commentators have attempted to provide a working definition. Joseph Shenker and Anthony Colletta, have narrowly and precisely defined asset securitization, as follows:

[T]he sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets.<sup>5</sup>

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<sup>3</sup> *Alchemy of Asset securitization* at 133.

<sup>4</sup> *Alchemy of Asset securitization* at 154 ("Securitization, in short, brings to financial technology what the sought-after philosopher's stone promised to bring to base metals – the ability to turn them into gold!").

<sup>5</sup> Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 *Tex. Law. Rev.* 1369, 1374-75 (1991)

Ronald Borod has more simply defined asset securitization as “the aggregation and pooling of assets with similar characteristics in such a way that investors may purchase interest or securities backed by those assets.”<sup>6</sup>

Asset securitization transactions are structured in a variety of ways. However, all asset securitization transactions consist of at least five basic steps. First, the asset securitization begins with an entity—commonly referred to as the “Originator”—identifying a pool of assets to be securitized. Second, the Originator then forms a wholly owned subsidiary, which is a special purpose vehicle (“SPV”) designed specifically for the asset securitization. Third, and contemporaneous with the creation of the SPV, the Originator attempts to make the SPV as “bankruptcy remote” as possible by utilizing several “bankruptcy proofing” techniques. Fourth, the Originator transfers the identified pool of assets to the SPV. Fifth, the SPV issues asset-backed securities and/or debt instruments to pay the Originator for the purchase of the assets.<sup>7</sup>

The asset securitization transaction begins with the Originator identifying a pool of assets. A variety of different types of loans and receivables have served as assets for securitization transactions, including car loans, car leases, credit card receivables, trade receivables and franchise fees.<sup>8</sup> The assets generally must have a steady, predictable income stream in order to service principal and interest payments. A large pool of assets is typically used to ensure that the risk of non-payment is diversified.<sup>9</sup> Once an appropriate asset pool bearing these qualities is identified, the Originator will isolate and prepare to transfer the assets to the SPV in the form of a “true sale.”<sup>10</sup>

The Originator then creates a subsidiary—the SPV—that serves as the purchaser of the identified assets to be securitized. The SPV is a separate legal entity from the Originator. The SPV serves three principal functions: (i) it is a pass-through vehicle that allows the Originator’s assets to be transformed into liquid securities that may be sold to investors; (ii) it protects the investors of the securitized assets from the SPV going bankrupt; and (iii) it protects the securitized assets from the Originator’s creditors.<sup>11</sup> The SPV can take a variety of legal forms. The SPV can be a corporation, trust, partnership or a limited liability company or partnership. In creating the SPV, the Originator uses several “bankruptcy proofing” techniques to make the SPV as “bankruptcy remote” as possible.<sup>12</sup> In addition to these “bankruptcy proofing” techniques and the basic asset securitization transaction outlined above, two alternative asset securitization structures are commonly utilized to further insulate the SPV from the Originator’s bankruptcy.

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<sup>6</sup> Ronald S. Borod, *Securitization, Asset Backed and Mortgage Backed Securities*, 1-7 (3d ed. 1991).

<sup>7</sup> See *New Developments* at 102-03; *Alchemy of Asset Securitization* at 135.

<sup>8</sup> See *Structured Financing Techniques* at 532. See also Lynn M. LoPucki, *The Death of Liability*, 106 Yale L.J. 1, 25-26 (1996) (Through the use of field warehousing, and other devices, real estate, equipment, and even inventory could be securitized.).

<sup>9</sup> See *Structured Finance* at 610 (“The default risk . . . can be managed by the SPV buying receivables having a statistically large number of obligors, and by analyzing the obligor concentrations.”).

<sup>10</sup> *Id.*

<sup>11</sup> See Thomas J. Gordon, *Securitization of Executory Future Flows as Bankruptcy-Remote True Sales*, 67 U. Chi. L. Rev. 1317, 1322-23 (2000).

<sup>12</sup> See *infra*.

The first is the so-called “multi-tier structure.”<sup>13</sup> Here, the Originator transfers the assets to a first-tier SPV by means of a “true sale.” The first-tier SPV then transfers the assets to a second-tier SPV. The second-tier SPV then issues the securities or debt instruments. Both transfers can be structured as “true sales” to avoid any risk of the Originator’s bankruptcy. But there may be no need to conduct the second transfer as a “true sale.” The second sale may be conducted as a sale for accounting purposes only.<sup>14</sup> The initial transfer to the first-tier SPV may itself insulate the assets from the Originator’s bankruptcy, while the second transfer to the second-tier SPV (a secured transaction for commercial law purposes) allows the first-tier SPV to provide internal credit enhancement to the investors at the second-tier SPV level.<sup>15</sup>

The second structure is the so-called “multiseller securitization conduit” (“MSC”). The MSC enables different Originators to reduce their transaction costs by selling receivables to a single pre-existing SPV. The MSC is in the business of completing these transactions, and can thus reduce the cost to participating Originators.<sup>16</sup> Besides the benefits from lower costs, the MSC may also be effective in reducing the potential for substantive consolidation should bankruptcy of the Originator arise. This structure, however, is contrary to the procedures taken to make the SPV “bankruptcy remote.” It increases the risk of an involuntary petition being filed against the SPV, because the MSC conducts business with multiple Originators who could potentially become the creditors necessary to bring an involuntary bankruptcy petition against the SPV.<sup>17</sup>

In many securitization transactions the Originator acts as servicer of the cash flow produced by the securitized assets.<sup>18</sup> The servicer’s role is to monitor the assets and administer the income. It makes sense for the Originator to act as the servicer. Because the Originator initially generated or held the assets, the Originator is in the best position to understand the nature of the assets and how to best service them. Appointing a new servicer could result in increased expense and inefficiency.<sup>19</sup> Problems can arise, however, when the Originator acts as the servicer. Where the Originator acts as servicer and maintains post-transfer control over the assets and their proceeds, concerns are raised as to whether a “true sale” has been effected. This might also increase the likelihood of substantive consolidation between the Originator and the SPV.

Because of the inherent risk that that the SPV will have insufficient funds to pay the asset-backed securities, credit enhancement devices are commonly used to ensure a high credit rating for the SPV.<sup>20</sup> For example, the asset-backed securities are often over-collateralized. The principal amount of the assets backing the SPV’s securities is greater than the principal amount of securities issued under the securitization transaction. Over-collateralization

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<sup>13</sup> See *Structured Financing Techniques* at 573.

<sup>14</sup> *Id.*

<sup>15</sup> See *New Developments* at 139-40.

<sup>16</sup> See *Traditional Bankruptcy Attacks* at 832-33.

<sup>17</sup> See *In re Kingston Square Assocs.*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997) (creditors brought an involuntary petition against an SPV).

<sup>18</sup> See *Structured Financing Techniques* at 546.

<sup>19</sup> See *Structured Finance Goes Chapter 11* at 627.

<sup>20</sup> See *Structured Financing Techniques* at 549.

protects the investors of asset-backed securities against the risk of non-payment or late payment. It further increases the likelihood that foreclosure on the assets will yield sufficient funds to compensate investors.<sup>21</sup> Over-collateralization, however, might increase the risk that the transaction will be attacked as a fraudulent transfer. The securities may also be backed by a letter of credit issued by a bank, a surety bond issued by an insurance company, or a guarantee issued by a financial company.<sup>22</sup> Another frequently used credit enhancement device is the senior debt/subordinated debt structure. This method of credit enhancement involves the acquisition of subordinated securities in the assets of the SPV by either an independent third-party, affiliate of the Originator, or the Originator itself in exchange for the transfer of the assets. The subordinated holders do not receive scheduled principal and payments unless the senior holders have received all of their principal and interest payments. The subordinated securities provide the SPV with an extra layer of capital protection because the subordinated debt absorbs losses on the underlying receivables.<sup>23</sup>

A successful asset securitization culminates in the issuance of asset-backed securities. Asset-backed securities have taken three principal forms: (i) debt (of varying classes); (ii) preferred stock; and (iii) certificates of beneficial interest.<sup>24</sup> Asset-backed securities in a single structure can provide a variety of priorities, maturities and rates of return to investors. For example, in some asset securitizations, the securities are sold in different classes. The senior class can be given priority on cash flow from the assets and the more junior class can garner higher interest rates.

Credit rating is essentially an assessment of credit risk of the SPV and its assets. Credit ratings by one or more of the prominent rating agencies are invariably required in order to sell asset-backed securities. These agencies study and examine the quality of the assets and publish credit ratings. The credit rating depends on a variety of factors including the quality of the assets and the level of over-collateralization and credit enhancement.<sup>25</sup>

One of the primary benefits of asset securitization transactions for the Originator is that if the transfer is a “true sale,” the assets and liabilities may be removed from the Originator’s balance sheet. In a secured financing, by contrast, the Originator preserves the assets on its balance sheet along with the additional liability in an amount equal to the secured financing.<sup>26</sup> To report a transfer of assets as a sale, a financial institution must satisfy the requirements of generally accepted accounting principles (“GAAP”) regarding sales of assets. The Statement of Financial Accounting Standards No. 140 (“FASB 140”), specifies circumstances under which transactions that “purport to be sales” of receivables with recourse to the seller should be accounted for as a financing. FASB 140 has a three-part test to determine whether a transfer of assets in a securitization transaction will be accounted for as a sale. The basic idea of FASB 140 is that to achieve a “true sale” characterization the transferor must

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<sup>21</sup> See *Structured Finance Goes* Chapter 11 at 625.

<sup>22</sup> *Id.* at 625-26.

<sup>23</sup> See *Structured Financing Techniques* at 550.

<sup>24</sup> See *Structured Finance Goes* Chapter 11 at 617.

<sup>25</sup> See generally Francis A. Bottini, Jr., *Comment, An Examination of the Current Status of Rating Agencies and Proposals for Limited Oversight of Such Agencies*, 30 San Diego L. Rev. 579 (1993).

<sup>26</sup> See *Structured Financing Techniques* at 531.

surrender control of the transferred assets or, in other words, structure the transaction so that the transferred assets are separated from the transferor.

The three-part test is, as follows: (i) the transferred assets have been isolated from the transferor; that is put presumptively beyond the reach of the transferor and its creditors, even in the bankruptcy of the transferor; (ii) the transferee or, if the transferee is a trust, corporation or other legal that holds title to the transferred assets, each holder of its beneficial or debt interests, has the right to pledge or exchange the assets or beneficial or debt interests it received, and no condition constrains the transferee or holder from taking advantage of its right to pledge or exchange and provides more than trivial benefit to the transferor; and (iii) the transferor does not maintain effective control over the transferred assets through an agreement that entitles the transferor to repurchase the assets before their maturity or to repurchase or redeem assets that are not readily obtainable.

Allocation of risk is another one of the primary benefits of asset securitization.<sup>27</sup> A “true sale” of assets to the SPV isolates those assets from the general financial risk the Originator, including bankruptcy. This isolation permits the creditors of the SPV to lend at an interest rate that takes into account only the risk inherent in the SPV and the securitized assets without regard for the Originator. Accordingly, the financial risk of the investors of the SPV’s securitized assets is reduced. However, while asset securitization results in a reduction in risk faced by the SPV’s investors, there might be a concomitant increase in the risk facing the Originator’s creditors.<sup>28</sup> The inherent risk of the Originator may remain unchanged; assets securitization may simply reallocate that risk to the Originator’s general creditors, rather than reduce or eliminate it.<sup>29</sup> Asset securitization may reduce the risk of non-payment for the SPV’s investors, but it may increase the risk of non-payment for the Originator’s general creditors. If asset securitization does not create value by reducing risk but rather simply reallocates risk to general creditors, including involuntary tort creditors, then it should be viewed with caution, particularly when the Originator suffers financial distress and files for bankruptcy relief.<sup>30</sup>

Enron is an example of the potential abuse of asset securitization. Enron created over 3,000 “off-balance sheet” SPVs, many of which were designed for asset securitization transactions.<sup>31</sup> It now appears that Enron’s motivation in creating these SPVs was to minimize losses on financial statements, artificially inflate the value of assets, accelerate profits, and avoid

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<sup>27</sup> See *Alchemy of Asset securitization* at 146-51 (maintaining that benefits derived from risk allocation reduce net cost of capital); *Circumvention of the Bankruptcy Process* at 200 (explaining that one of the main reasons companies securitize assets is benefit of improved risk management).

<sup>28</sup> See *The Unsecured Creditor’s Perspective* at 634 (“Not surprisingly, the securitizing firm’s unsecured creditors are assuming a risk of nonpayment, as a result of the securitization, that is arguably greater than the risk unsecured creditors experience when their debtor borrows money on a secured basis.”); *Circumvention of the Bankruptcy Process* at 232-36 (discussing diminished chance of unsecured creditor repayment).

<sup>29</sup> See Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 *Tul. L. Rev.* 101, 105-06 (1997).

<sup>30</sup> *Id.* (questioning whether securitization merely reallocates risk to other creditors rather than lowering a firm’s overall capital costs).

<sup>31</sup> See *Enron, Asset Securitization and Bankruptcy Reform* at 2.

adding debt to its balance sheet.<sup>32</sup> Specifically, Enron used SPVs and derivatives to manipulate its financial statements in three ways. First, Enron concealed speculator losses it suffered on technology stocks. Second, it concealed huge debts incurred in financing unprofitable new business ventures. Third, it inflated the value of other troubled businesses.<sup>33</sup>

In a typical SPV transaction, Enron would transfer its own stock to an SPV in exchange for a note or cash. Enron would also guarantee the SPV's value.<sup>34</sup> The SPV, in turn, would hedge the value of a particular investment on Enron's balance sheet, using the transferred Enron stock as the principal source of payment.<sup>35</sup> Enron's faulty assumption, however, was that the risk of having to pay on the guarantees was minimal based on the strength of its stock. However, when Enron's stock price subsequently crashed, the SPV's value also fell. This confluence triggered the guarantees, which in turn further reduced Enron's stock value, triggering additional guarantees. The SPVs lacked sufficient assets to perform its hedge, when the stock of both the value of both Enron's investment and Enron's stock price dropped simultaneously. Additionally, these drops in value caused the SPVs to breach the 3% (now 10%) independent equity requirement for non-consolidation, which in turn brought the SPV's debt onto Enron's balance sheet.<sup>36</sup>

These transactions were initially beneficial to Enron for accounting purposes, because they allowed it to recognize the value of the loan immediately and avoid recognizing on an interim basis any future losses. In all, Enron had derivative instruments on 54.8 million shares of Enron common stock at an average price of \$67.92 per share, or \$3.7 billion. At the start of these deals, Enron's obligation constituted 7% of all of its outstanding shares. As Enron's share price declined, that obligation increased and Enron's shareholders were diluted substantially. Moreover, even as the various SPVs' assets and Enron's shares declined in value, Enron did not reflect those declines in its quarterly financial reports.

Enron's abuse of asset securitization and SPVs raises fundamental questions regarding the legitimacy of trillions of dollars invested in these transactions. What, if anything, distinguishes Enron's abuse of asset securitization from all of the other asset securitization transactions? After all the same financial techniques used to create thousands of non-Enron asset securitization transactions were also used to construct the convoluted and complex SPVs blamed for Enron's financial collapse.

There are certain differences between Enron's use of SPVs and the prototypical asset securitization set forth hereinabove. First, consists of the transfer of risk of loss to the SPV. In the prototypical asset securitization in which a "true sale" occurs, the Originator transfer the risk of loss on the securitized assets to the SPV and its investors.<sup>37</sup> In Enron's transactions with its SPVs, Enron did not completely transfer risk of loss to the SPVs. Although Enron had the

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<sup>32</sup> See Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. [William C. Powers, Jr. Chair] 4, 68, 78, 97 (Feb. 1, 2002) (the "Powers Report").

<sup>33</sup> See Testimony of Frank Partnoy, Hearing Before the U.S. Senate Comm. On Gov. Affairs, 17th Cong. (2002).

<sup>34</sup> See Powers Report at 13, 36-37.

<sup>35</sup> *Id.* at 13.

<sup>36</sup> See *Id.* at 41-42, 49-50, 52.

<sup>37</sup> See *infra*.

right to require the SPVs to purchase these assets at a pre-determined price should their values fall, that right was precarious because the SPVs were capitalized solely with Enron stock. Thus, when Enron's asset and stock values fell, the SPVs were unable to perform their hedges. In a typical asset securitization, on the other hand, the Originator purportedly transfers actual risk of loss by way of a "true sale" to the SPV. Frequently, however, in asset securitization transactions risk of loss is not completely transferred to the SPV; rather the Originator retains a certain degree of risk.<sup>38</sup> Thus, the difference between Enron and thousands of other asset securitizations might only be in degree instead of in kind.

Another difference is the level of disclosure of the conflicts of interest in Enron's SPV structures. Disclosure may have been inadequate.<sup>39</sup> The disclosure may have been intentionally minimized to avoid disclosing the extent to which Enron executives were enriching themselves through transactions with SPVs.<sup>40</sup> Enron's asset securitization transactions, on the other hand, were so convoluted that disclosure may have been necessarily inadequate. Enron had a choice of either substantially oversimplifying the transactions, or providing detail and sophistication beyond the level of an ordinary, reasonable investor. Enron's investors therefore had to rely on the business judgment of management who had a conflict of interest.<sup>41</sup> These explanations concerning the inadequate disclosure in Enron raise problems with asset securitization in general. Competent professionals can provide sufficient depth and detail to adequately inform a sophisticated investor in the SPV's securities; however, such disclosure may sometimes go over the head of an ordinary investor. On the other hand, a more superficial disclosure will oversimplify the complex.

Are securitization transactions, then, so inherently complex that the ordinary investor cannot fully understand the risks associated with such transactions? One of the principal purposes of asset securitization is to make the SPV "bankruptcy remote" from the bankruptcy of the Originator. But why is "bankruptcy remoteness" so valuable to financial investors?

## II. Bankruptcy Waivers: Another Form of Bankruptcy Remoteness

The most direct way in which to protect investors of an SPV from the risk of a voluntary bankruptcy would be to require the SPV to completely waive its right to file a voluntary bankruptcy petition.<sup>42</sup> The Bankruptcy Code does not expressly prohibit a waiver of the right to file for bankruptcy protection. However, the legislative history to section 706(a) of the Bankruptcy Code—which provides that any waiver of the right to convert a case filed under chapter 7 is unenforceable—indicates that a waiver of the right to file a voluntary bankruptcy petition is equally unenforceable.<sup>43</sup> Courts are in agreement that a waiver of the right to file for bankruptcy protection is unenforceable as against public policy. This principle is based upon the

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<sup>38</sup> See *infra*.

<sup>39</sup> See Powers Report at 197, 200-01.

<sup>40</sup> *Id.* at 197, 201.

<sup>41</sup> *Id.* at 18, 21, 144, 166-67.

<sup>42</sup> See *Bankruptcy Remote Vehicles* at 112-16.

<sup>43</sup> See 124 Cong. Rec. H 32, 401 (1978) ("The explicit reference in title 11 forbidding the waiver of certain rights is not intended to imply that other rights, such as the right to file a voluntary bankruptcy case under section 301, may be waived.").

strong legislative purpose and intent of bankruptcy laws to provide a “fresh start” to debtors.<sup>44</sup> The use of SPVs is simply a disguised form of bankruptcy waiver. Thus, regardless of the efficiency and benefits derived from assets securitization, much like bankruptcy waivers, they operate in a much broader system of debt collection that, as a general rule, frowns upon contracts that completely seek to avoid the effects of bankruptcy.

In a line of single-asset real estate cases, the Bankruptcy Court for the Middle District of Florida, enforced a debtor’s prepetition agreement in workout that its subsequent bankruptcy filing would be considered to be made in “bad faith,” thereby warranting dismissal of the case for cause pursuant to Bankruptcy Code section 1112(b).<sup>45</sup> It should be noted that all three of these cases involved situations in which the usual indicia of “bad faith” filings were present: that is, single asset real estate entities; no employees; timing of filing of petition evidences intent to delay or frustrate legitimate efforts of creditors to enforce their rights after a workout had failed; no or few unsecured non-insider creditors, and those who do exist have small claims; no cash flow; and no realistic chance of rehabilitation or reorganization.<sup>46</sup>

However, in *In re South East Fin. Assocs., Inc.*,<sup>47</sup> the same court held that the debtors’ prepetition agreement that a breach by them of a stipulation would constitute “bad faith” entitling the secured creditor to obtain dismissal of the cases, was not binding on the debtors’ general unsecured creditors who would be “detrimentally impacted by a dismissal.”<sup>48</sup> The court determined that, although the debtors had voluntarily executed the agreement, it would be “inappropriate to enforce the prepetition waiver” as against third-party creditors.<sup>49</sup> The court distinguished the decision in *In re University Commons, L.P.*<sup>50</sup> by noting that the creditor in that case had not relied solely upon the language of the prepetition waiver, but instead had made an independent showing of bad faith. The court held that the prepetition waiver was by itself “insufficient as a matter of law to establish bad faith for purposes of dismissal.”<sup>51</sup>

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<sup>44</sup> See *In re Huang*, 275 F.3d 1173, 1177 (9th Cir. 2002) (“It is against public policy for a debtor to waive the prepetition protection of the Bankruptcy Code.”); *In re Shady Grove Tech Center Assocs. Limited Partnership*, 216 B.R. 386, 389 (Bankr. D. Md. 1998) (“The courts have uniformly held that a waiver of the right to file a bankruptcy case is unenforceable.”); *In re Tru Block Concrete Prods., Ins.*, 27 B.R. 486, 492 (Bankr. E.D. Pa. 1995) (advance agreement to waive the benefits conferred by bankruptcy law is void as against public policy); *In re Madison*, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995) (dicta that even bargained-for and knowing waivers of the right to seek bankruptcy protection must be deemed void); *In re Club Tower L.P.*, 138 B.R. 307, 312 (Bankr. N.D. Ga. 1991).

<sup>45</sup> See *In re Orange Park S. Partnership*, 79 B.R. 79, 82 (Bankr. M.D. Fla. 1987) (debtors’ agreement that petition, if filed, would be admitted to be totally unfounded and filed solely for purpose of delay is binding because nothing in record warranted conclusion that it was obtained by coercion, fraud or mutual mistake of material facts; *In re Aurora Invs.*, 134 B.R. 982, 985 (Bankr. M.D. Fla. 1991) (debtor’s agreement that petition, if filed, would be in “bad faith” if its primary purpose is to delay foreclosure sale, is binding); *In re University Commons, L.P.*, 200 B.R. 255, 259 (Bankr. M.D. Fla. 1996) (debtor’s agreement that in the event debtor becomes subject of bankruptcy case secured lender shall be entitled to order dismissing case as “bad faith” filing and determining that (i) no rehabilitation or reorganization is possible, and (ii) dismissing all proceedings is in the best interest of parties and all other creditors, is binding).

<sup>46</sup> See, e.g., *In re Little Creek Dev. Co.*, 779 F.2d 1068, 1073 (5th Cir. 1986).

<sup>47</sup> 212 B.R. 1003, 1005 (Bankr. M.D. Fla. 1997).

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> 200 B.R. 255 (Bankr. M.D. Fla. 1996).

<sup>51</sup> *Id.*

In the alternative to exacting an agreement from the borrower not to file bankruptcy, an agreement not to contest a motion seeking relief from the automatic stay may be utilized.<sup>52</sup> Section 362(a) of the Bankruptcy Code provides that the filing of a bankruptcy petition operates as an automatic stay of most acts against the debtor's property. Thus, for example, the automatic stay enjoins a secured lender from taking action to realize the value of its collateral. Under section 362(d), the automatic stay can be lifted for "cause." Sufficient cause includes situations involving the lack of adequate protection of the secured lender, or in which the debtor has no equity in the property and the property is not necessary for an effective reorganization.

Waivers of the automatic stay are sometimes given in workout situations in which a creditor agrees to forebear foreclosure and/or to make other concessions, but in return requires the debtor to forego the protection of the automatic stay if the restructuring fails and the debtor subsequently seeks bankruptcy protection.<sup>53</sup> An Originator can enter into a prebankruptcy contract which waives any future application of the automatic stay against the SPV. Absent the automatic stay, the debtor would not need to transfer its financial assets to the SPV as a "true sale" in a complex "multi-tier structure" because the SPV could continue using the proceeds of the financial assets to pay investors even if the Originator goes into bankruptcy.<sup>54</sup>

While some courts have held prepetition waivers of the automatic stay to be enforceable, others have held them to be unenforceable. Cases enforcing prepetition waivers of the automatic stay tend to focus upon: (i) the financial sophistication of the borrower; (ii) the creditor's demonstration that significant consideration was given for the prepetition waiver; (iii) the effect of the enforcement of the prepetition waiver upon other parties having legitimate interests in the outcome; (iv) circumstances of the parties at the time enforcement of the prepetition waiver is sought; (v) the enforcement of the prepetition waiver being consistent with public policy of encouraging out of court restructurings and settlements with creditors; and (vi) other indicia which support granting relief from stay, such as "bad faith" criteria (i.e. single-asset case, two-party dispute, long history of prepetition workouts, newly formed entity, filing on eve of foreclosure, no ongoing business to reorganize, few employees, no unencumbered funds, etc.).<sup>55</sup>

Courts enforcing prepetition waivers of the stay frequently do so on public policy grounds of encouraging out of court workouts.<sup>56</sup> Several courts, however, have refused to

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<sup>52</sup> See generally *Bankruptcy Remote Vehicles* at 114-16; Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 Tex. L. Rev. 515 (1999).

<sup>53</sup> See, e.g., *In re Club Tower L.P.*, 138 B.R. 307, 311-12 (Bankr. N.D. Ga. 1991).

<sup>54</sup> See Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 Tex. L. Rev. 515, 597-99 (1999).

<sup>55</sup> Cases holding prepetition stay waivers enforceable include: *In re Shady Grove Tech Ctr. Assocs., L.P.*, 216 B.R. 386, 390 (Bankr. D. Md. 1998); *In re Atrium High Point L.P.*, 189 B.R. 599, 607 (Bankr. M.D.N.C. 1995); *In re Darrell Creek Assocs., L.P.*, 187 B.R. 908, 910 (Bankr. D.S.C. 1995); *In re Cheeks*, 167 B.R. 817, 818 (Bankr. D.S.C. 1994); *In re Powers*, 170 B.R. 480, 483 (Bankr. D. Mass. 1994); *In re McBride Estates, Ltd.*, 154 B.R. 339, 343 (Bankr. N.D. Fla. 1993); *In re Citadel Properties, Inc.*, 86 B.R. 275, 276 (Bankr. M.D. Fla. 1988); *In re Gulf Beach Development Corp.*, 48 B.R. 40, 43 (Bankr. M.D. Fla. 1985).

<sup>56</sup> See, e.g., *In re Darrell Creek Assocs., L.P.*, 187 B.R. 908, 913 (Bankr. D.S.C. 1995) ("out of court workouts are to be encouraged and are often effective"); *In re Cheeks*, 167 B.R. 817, 819 (Bankr. D.S.C. 1994) ("the most

enforce a prepetition waiver on one or more of the following grounds: (i) the prepetition waiver is the equivalent to an *ipso facto* clause; (ii) such clause is void as against public policy by depriving the debtor of the use and benefit of property upon the filing of a bankruptcy case; (iii) the borrower lacks the capacity to act on behalf of the debtor in possession; (iv) the debtor has a business with a reasonable chance at reorganization and enforcement of the waiver would otherwise prejudice third-party creditors; (v) the automatic stay is designed to protect all creditors and may not be waived by the debtor unilaterally to the detriment of creditors; and (vi) the waiver was obtained by coercion, fraud or mutual mistake of facts.<sup>57</sup> Courts that have refused to enforce prepetition waivers of the automatic stay have reasoned that the automatic stay protects not only debtors but also other creditors.<sup>58</sup>

The conflicting cases cited above regarding the enforceability of prepetition waivers of the automatic stay cannot be reconciled. There is a sharply divergent view among the courts regarding the utility, benefits and desirability of the enforcement of such waivers. Courts are in agreement, however, that prepetition stay waivers are not self-executing, and creditors in whose favor the waiver was given must therefore move for relief from the automatic stay.<sup>59</sup> Some courts have held that a prepetition automatic stay waiver may be considered as a factor in determining whether cause exists for relief from the stay.<sup>60</sup> Thus, in some cases, courts granting a creditor's motion to lift the stay relief in part on the stay waiver and in part on determining that independent cause existed to lift the stay.<sup>61</sup>

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compelling reason for enforcement of the forbearance agreement is to further the public policy in favor of encouraging out of court restructuring and settlements"); *In re Club Tower L.P.*, 138 B.R. 307, 312 (Bankr. N.D. Ga. 1991) ("enforcing pre-petition settlement agreements furthers the legitimate public policy of encouraging out of court restructurings and settlements").

<sup>57</sup> Cases holding prepetition automatic stay waivers unenforceable include: *In re Southeast Financial Assocs., Inc.*, 212 B.R. 1003, 1005 (Bankr. M.D. Fla. 1997); *In re Graves*, 212 B.R. 692, 694 (B.A.P. 1st Cir. 1997); *In re Pease*, 195 B.R. 431, 433 (Bankr. D. Neb. 1996); *In re Jenkins Court Assocs. L.P.*, 181 B.R. 33, 37 (Bankr. E.D. Pa. 1995); *Farm Credit of Cent. Fla., ACA v. Polk*, 160 B.R. 870, 873-74 (M.D. Fla. 1993).

<sup>58</sup> See, e.g., *Farm Credit of Cent. Fla., ACA v. Polk*, 160 B.R. 870, 873-74 (M.D. Fla. 1993) ("The policy behind the automatic stay is to protect the debtor's estate from being depleted by creditor's lawsuits and seizures of property before the debtor has had a chance to marshal the estate's assets and distribute them equitably among creditors."); *In re Sky Group Int'l, Inc.*, 108 B.R. 86, 89 (Bankr. W.D. Pa. 1989) ("To grant a creditor relief from stay simply because the debtor elected to waive the protection afforded the debtor by the automatic stay ignores the fact that it also is designed to protect all creditors and to treat them equally") (citing *Assoc. of St. Croix Condominium Owners v. St. Croix Hotel Corp.*, 682 F.2d 446 (3d Cir. 1982)).

<sup>59</sup> See, e.g., *In re Shady Grove Tech Ctr. Assocs., L.P.*, 216 B.R. 386, 393-94 (Bankr. D. Md. 1998); *In re S.E. Fin. Assocs., Inc.*, 212 B.R. 1003, 1005 (Bankr. M.D. Fla. 1997); *In re Darrell Creek Assocs., L.P.*, 187 B.R. 908, 910 (Bankr. D.S.C. 1995); *In re Powers*, 170 B.R. 480, 483 (Bankr. D. Mass. 1994); *In re Cheeks*, 167 B.R. 817, 819 (Bankr. D.S.C. 1994).

<sup>60</sup> *In re Shady Grove Tech Ctr. Assocs., L.P.*, 216 B.R. 386, 393-94 (Bankr. D. Md. 1998) (granting stay relief for cause based upon finding which included debtor's prepetition agreement not to contest request for stay relief given as part of prepetition restructuring in which debtor was afforded substantial consideration); *In re Powers*, 170 B.R. 480, 484 (Bankr. D. Mass. 1994) ("waiver is a primary element to be considered in determining if cause exists for relief from the automatic stay").

<sup>61</sup> See, e.g., *In re Darrell Creek Assocs. L.P.*, 187 B.R. 908, 910 (Bankr. D.S.C. 1995) (prepetition stay waiver valid where debtor did not demonstrate reasonable likelihood of reorganization); *In re Citadel Properties, Inc.*, 86 B.R. 275, 276 (Bankr. M.D. Fla. 1988) (prepetition stay waiver is binding and sufficient cause exists to lift stay because petition was filed in bad faith).

### III. “Bankruptcy Proofing” an SPV

Although an SPV can never be truly “bankruptcy proofed,” as shown above, certain techniques are commonly used in an attempt to make the SPV as bankruptcy remote as possible. A corporation is a common form for an SPV because of its inherent flexibility and the financial and legal communities better understanding of how bankruptcy courts will treat corporations in bankruptcy.<sup>62</sup> Authority to file a voluntary bankruptcy petition on behalf of a corporation derives from state corporate governance law and the corporate charter and by-laws.<sup>63</sup> Unless the corporate governance instruments provide otherwise, the power to file a voluntary petition resides with the board of directors, and a valid board resolution is a prerequisite to the filing of a voluntary bankruptcy petition on behalf of a corporation.<sup>64</sup> The charter or by-laws of a corporate SPV often require a unanimous or supermajority vote of the board of directors to authorize the bankruptcy filing. By placing one or more “independent” directors on the board of directors, a unanimous or supermajority vote authorizing the filing is less likely.<sup>65</sup>

Additional protection can be provided if (i) the SPV issues two classes of stock; that is, preferred stock and common stock, and (ii) the charter or by-laws require an affirmative vote of the holders of the preferred stock (or directors appointed by such holders) as a requirement for filing a bankruptcy petition.<sup>66</sup> A provision in a charter or by-laws allowing a holder the direct right to veto the filing of a voluntary petition or requiring the holder’s consent for the filing of a petition may, however, be invalid as an excessive restriction on the right to file for bankruptcy.<sup>67</sup>

One of the keys to the bankruptcy remote structure of a corporate SPV is placement of an “independent” director on the board of directors of the SPV. The “independent” director’s allegiance is with the investors of the SPV’s securities. The SPV’s organizational documents will provide the independent director veto power over board actions that jeopardize the bankruptcy remoteness of the SPV, including filing a voluntary bankruptcy petition. The “independent” director acts as a check on the SPV’s board of directors (which generally is otherwise chosen by the Originator) to ensure the board acts in the best interest of the SPV’s investors.<sup>68</sup> The “independent” director in the securitization context, therefore, has an inherent

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<sup>62</sup> See *Structured Financing Techniques* at 569.

<sup>63</sup> See, e.g., *In re Gen-Air Plumbing & Remodeling, Inc.*, 208 B.R. 426, 430 (Bankr. N.D. Ill. 1997); see also *Price v. Gurney*, 324 U.S. 100, 116 (1945).

<sup>64</sup> See *In re Runaway II, Inc.*, 159 B.R. 537, 538 (Bankr. W.D. Mo. 1993).

<sup>65</sup> Compare *In re Minor Emergency Ctr. of Tamarac, Inc.*, 45 B.R. 310, 311 (Bankr. S.D. Fla. 1985) (case dismissed where corporate bylaws required both members of the board of directors to vote for bankruptcy filing and only one director voted in favor of the filing) with *In re Buckhead America Corp.*, Nos. 91-978 through 91-986 (Bankr. D. Del. Aug. 13, 1992) (court permitted corporation to file voluntary petition without the unanimous vote of directors even though the corporation’s charter had required such a vote) (unpublished opinion) (discussed in Malcolm S. Dorr and Edward J. O’Connell, *Problem Cases in Bankruptcy*, 732 PLI/Comm 99, 125-27 (1995)).

<sup>66</sup> See Special Report by the TriBar Opinion Committee, *Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions*, 46 Bus. Law. 717, 729 (1991).

<sup>67</sup> See *In re KTI of North Carolina, Inc.*, Case No. 94-01423-5-ATS (Bankr. E.D.N.C. Dec. 21, 1994) (unpublished order) (cited in Peter S. Partee, *Structured Bankruptcy Report Entities in Securitization Deals: The Basics*, ABA Presentation (1996)).

<sup>68</sup> See Sheryl A. Gusset, *A Not-So-Independent Director in a Bankruptcy Remote Structure*, 17 Am. Bankr. Inst. J. 24 (1998).

conflict between his fiduciary duties as a member of the board of directors of the SPV and his obligations to the investors of the SPV's securities.

A corporation's directors owe fiduciary duties only to its shareholders.<sup>69</sup> However, when a corporation approaches insolvency (the "zone of insolvency") or actually becomes insolvent, the fiduciary duties of its directors extend to the corporation's general creditors as well.<sup>70</sup> Regardless of whether the SPV is insolvent, an independent director may find himself in a conflict of interest situation if his corporate fiduciary duties require him to vote in favor of the filing of a voluntary petition, while his obligations to the investors of the asset-backed securities require him to vote against it.

As illustrated by the decision in *In re Kingston Square Assocs.*,<sup>71</sup> a bankruptcy court may be unsympathetic of an "independent" director who appears to be employing stalling tactics to block or delay a bankruptcy filing, even where the prospects for unsecured creditor recovery are highly uncertain. The *Kingston Square* case illustrates one of the traditional attacks on asset securitization transactions; that is, an attack on the "bankruptcy remoteness" of the SPV. In *Kingston Square* eleven corporations were set up as SPVs specifically formed for the purpose of securitizing mortgages.<sup>72</sup> The by-laws of the SPVs contained a "bankruptcy proofing" provisions that required a unanimous vote of the board of directors to file a voluntary bankruptcy petition.<sup>73</sup> The underwriter of the asset securitization transaction placed an "independent" director on the SPVs' board of directors.<sup>74</sup> The independent director's loyalties were to the underwriter of the asset securitization transaction and not the SPVs upon whose board he was sitting.<sup>75</sup> The SPVs defaulted on all of the mortgages and the underwriter began foreclosure proceedings on all of the securitized properties.<sup>76</sup> When the SPVs defaulted on their securities and mortgage foreclosure proceedings were commenced, the SPVs' principal, believing it to be futile to attempt to obtain the vote of the independent director to file for bankruptcy, orchestrated the solicitation of trade creditors and professionals to file an involuntary bankruptcy petition against the 11 SPVs.<sup>77</sup> The underwriter moved to dismiss the case pursuant to Bankruptcy Code section 1112(b) on the grounds that the bankruptcy petitions were collusive and filed in "bad faith."<sup>78</sup> In denying the motion to dismiss, the court held that "a bankruptcy proof provision in a corporate bylaw does not prevent outside creditors from banding together to file an involuntary petition."<sup>79</sup> The court further found that, while the orchestration was "suggestive of bad faith,"

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<sup>69</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986).

<sup>70</sup> *In re Kingston Square Assocs.*, 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787-90 (Del. Ch. 1991).

<sup>71</sup> 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

<sup>72</sup> *Id.* at 715.

<sup>73</sup> *Id.* at 716.

<sup>74</sup> *Id.* at 717.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.* at 720.

<sup>78</sup> *Id.* at 724.

<sup>79</sup> *Id.* at 738-39.

that fact alone “was not sufficient grounds for dismissal.”<sup>80</sup> The court expressly declined to address whether the bankruptcy remote provisions might be void as against public policy.

The *Kingston Square* court was critical of the independent director and suggested that he was not mindful of his fiduciary duties to unsecured creditors who might benefit from a chapter 11 filing. The independent director had, in fact, not attended board meetings for years, and had never asked any questions until he inquired about late payment of his director fees. Although the Court noted the integral involvement of the principal in circumventing the bankruptcy remote protections, the Court expressed no sympathy for the goal of the underwriter to protect against bankruptcy but, instead, appointed a chapter 11 trustee (which was a grant of alternatively requested relief). At minimum, *Kingston Square* teaches that courts should scrutinize whether the “independent” director is truly independent and ensure that the director is complying with his fiduciary obligations. More broadly, *Kingston Square* can be read to stand for the proposition that corporate formalities can be disregarded if there is a legitimate ability or reason for the SPV to be a debtor under the Bankruptcy Code.<sup>81</sup>

Often corporate SPVs have protective provisions in their charter or bylaws negating the board’s discretion to file a bankruptcy petition, unless the decision to so file is consistent with fulfilling certain fiduciary obligations to the SPV’s creditors. These provisions are designed to prohibit claims that the SPV’s board owes a fiduciary duty to its equity holders. These provisions typically call for appointment of an “independent” director, whose vote is required to materially alter the investor protections afforded therein. Additionally, such independent director’s statutory fiduciary duties are expanded to include the SPV’s creditors and are often waived with respect to the SPV’s shareholders. In essence, this uses state law to create an impediment to federal bankruptcy law.<sup>82</sup>

As an alternative to the corporate form, SPVs can be created in the form of a partnership. The partnership form is generally not the most effective form for securitization transactions, because of the potential dissolution of the partnership upon bankruptcy. Limited liability companies (LLCs”) are being increasingly used as SPVs, because they avoid issuer level taxation but maintain corporate protection. Moreover, virtually every state has enacted limited liability statutes.<sup>83</sup> The limited liability structure reduces the difficulty of the conflicts issues created by the corporate and partnership forms, because an SPV can be structured as a LLC for which fiduciaries’ duties can be contractually specified and limited.<sup>84</sup> Recently, the use of LLCs having a non-bankruptcy remote operating company (typically the Originator or one of its

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<sup>80</sup> *Id.*

<sup>81</sup> See Sheryl A. Gusset, *A Not-So-Independent Director in a Bankruptcy Remote Structure*, 17 Am. Bankr. Inst. J. 24 (1998).

<sup>82</sup> See Robert Dean Ellis, *Securitization, Fiduciary Duties, and Bondholders’ Rights*, 24 J. Corp. L. 295, 309 (1999).

<sup>83</sup> See *Bankruptcy Remote Vehicles* at 103-06; *New Developments* at 143; Marsha E. Simms, *Asset Securitization*, 754 PLI/Comm 335, 341 (1997).

<sup>84</sup> See *Structured Financing Techniques* at n.88; Richard M. Graf, *Use of LLCs as Bankruptcy-Proof Entities Widens*, Nat’l L.J., April 10, 1995, at B16.

affiliates) as a single member has become increasingly popular in asset securitization transactions.<sup>85</sup>

Among the reasons for the popularity of the LLC structure is the ability of the owners/members of the LLC to participate in its management without exposing themselves to the liability for its obligations.<sup>86</sup> The fiduciary duties of LLC managers may be contractually specified, so it may be possible to prevent the independent director's conflict of interest situations discussed above (*i.e. Kingston Square*) by providing in the LLC agreement that the manager's fiduciary duties are owed primarily to the holders of the securities and only secondarily to the LLC's members. To reduce the risk of the commencement of a bankruptcy case by the LLC, the LLC agreement for a bankruptcy remote LLC typically requires that the filing of a bankruptcy petition must be authorized by a unanimous vote of the "board of managers" of the LLC. In turn, the board of managers would be independent of the single member and, pursuant to the express provisions of the LLC agreement, would not owe their fiduciary duties primarily to the single member. In some instances, LLC agreements contain provisions automatically adding one or more independent managers as a member, in the event of a ratings downgrade or insolvency of the original member, but this structure imposes tax risks and raises enforceability issues (*i.e.* it is arguably an ipso facto clause).

The effect of bankruptcy on a single member LLC is uncertain. It is reasonably clear that LLCs are eligible as debtors under the Bankruptcy Code.<sup>87</sup> But it is unclear whether a single member LLC continues to exist after the bankruptcy of its single member. The risk in the use of single member LLCs is the potential dissolution of the LLC upon the sole member's bankruptcy leading to uncertainty as to the continued existence of the LLC.<sup>88</sup> The underlying issue is whether to treat a LLC as a partnership for these purposes (which would arguably mandate dissolution) or a corporation (which would not).<sup>89</sup>

The Delaware Limited Liability Company Act (Del. Code Ann. Tit. 6, Sections 18-101 to 18-1109) explicitly provides that (i) unless otherwise provided in the LLC agreement, a LLC does not dissolve upon the bankruptcy or dissolution of any member (section 18-801(b)), and (ii) a LLC agreement may provide that the personal representative of the last remaining member must agree in writing to continue the LLC and to admit the personal representative of such member or its nominee or designee to the LLC as a member (section 18-801(a)(4)). Whether a bankruptcy court would actually enforce the statutory and contractual provisions and would find that a LLC survives the bankruptcy or dissolution of its single member, depends largely on whether the LLC is viewed as a partnership or as a corporation.

Following are the few cases that help inform the issue of whether a single member LLC with a non-dissolution provision would survive the bankruptcy of its members. The court

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<sup>85</sup> See *New Developments*, 56 Bus. Law. 146; Moody's Investors Serv., *Structured Finance Special Report, Handle With Care: Single member LLCs in Structured Finance Transactions* (March 19, 1999).

<sup>86</sup> See *New Developments* at 147.

<sup>87</sup> *In re ICLNDS Notes Acquisition, LLC*, 259 B.R. 289, 293 (Bankr. N.D. Ohio 2001).

<sup>88</sup> See *New Developments* at 147.

<sup>89</sup> *Id.* at 149.

in *In re Garrison-Ashburn, L.C.*,<sup>90</sup> examined the Virginia Limited Liability Company Act (Va. Code Ann. Sections 13.1-1000 to 13.1-1073), which provides – similar to the effect of the Delaware Limited Liability Company Act – that, except as provided in the articles of organization or the operating agreement, the association of a member (which occurs upon a member becoming a debtor in bankruptcy) does not cause the LLC to be dissolved or its affairs to be wound up and that the LLC is continued without dissolution (section 13.1-1040.2). In *Garrison-Ashburn*, a bankruptcy member of a LLC claimed that a real estate transaction which had been authorized by the operating manager/member of the LLC was ineffective because his consent had not been obtained. The court disagreed, noting that under the Virginia statute a dissociated member has only those rights an assignee of a membership interest would have, *i.e.* entitlement to a share of profits and losses and to distributions but no right to participate in the management and affairs of the LLC or to become or to exercise any rights of a member (section 13.1-1040.2 and 13.1-1039).<sup>91</sup>

Addressing the “lurking federal question” whether the dissociation of a member upon filing of a bankruptcy petition is effective in light of sections 365(c), 365(e), and 541(c) of the Code, the court examined whether the LLC operating agreement was an executory contract.<sup>92</sup> The court noted that the LLC operating agreement merely provided “the structure for the management of the company” (such as making provision for offices, meetings, voting, committees, officers and formal issues such as membership certificates, etc.) and did not create “any additional duties or responsibilities on the members” (such as an obligation to provide additional capital, participate in management, provide expertise or service the company).<sup>93</sup> Thus, the court concluded that it was not an executory contract. Since under the operating agreement a member could, without being in breach of the operating agreement, resign from all of his offices and committee positions and no longer actively participate in the affairs of the company, the court found that such a member would stand in an analogous position to the company as a shareholder to a corporation.<sup>94</sup> Adoption of a *Garrison-Ashburn* analysis should lead to survival of a single member LLC beyond its member’s bankruptcy.

However, the *Garrison-Ashburn* approach has not been uniformly adopted. Prior to July 1, 1998, the Virginia Limited Liability Company Act provided that a LLC would dissolve upon, among other events, the bankruptcy of a member unless the business of the LLC is continued by all or such lesser percentage or number (but not less than a majority in interest) of the remaining members as may be provided in writing in the articles of organization or operating agreement of the LLC (section 13.1-1046).<sup>95</sup> The court in *In re DeLuca*,<sup>96</sup> enforced a Virginia LLC agreement that provided for the dissolution of the LLC upon the bankruptcy of a member, noting that the provision in the LLC agreement was consistent with section 13.1-1046. The court examined whether the LLC agreement was enforceable in light of sections 541 and 365 of the Bankruptcy Code and held that it was. Since it had found that the LLC agreement involved a

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<sup>90</sup> 253 B.R. 700 (Bankr. E.D. Va. 2000).

<sup>91</sup> *Id.* at 704.

<sup>92</sup> *Id.* at 707.

<sup>93</sup> *Id.* at 708.

<sup>94</sup> *Id.* at 709.

<sup>95</sup> See *Garrison-Ashburn*, at 705070 (discussing 1998 amendment to section 13.1-1046).

<sup>96</sup> 194 B.R. 79 (E.D. Va. 1996).

“development project” in which the identity of the manager was material to the existence of the enterprise, it held that the LLC agreement was in the nature of a non-assumable “personal services contract.”<sup>97</sup>

In addition, the court in *In re Daugherty Construction, Inc.*,<sup>98</sup> held that a Nebraska statute, which provided that a LLC automatically dissolves upon the bankruptcy of one of its members unless the remaining members vote to continue the LLC and which purported to terminate the debtor/member’s interest in the LLC, to be inconsistent with sections 541, 363 and 365 of the Bankruptcy Code and thus unenforceable.<sup>99</sup> Since both the LLC and the member had materially unperformed obligations under the LLC agreement, the court viewed the LLC agreement as an executory contract that the debtor had the right to assume or reject.<sup>100</sup>

Since in typical asset securitization transactions, the single member LLC has only limited responsibilities (that may have been delegated to a board of managers), it may be expected that the bankruptcy case of such a LLC created under a statute which provides that the LLC survives the bankruptcy of one of its members (as in the LLC statutes of Delaware and Virginia) a court would respect the separate and continued existence of the LLC independent of that of its member. However, with respect to LLCs created under statutes, which do not contain such language, the situation is unclear as shown by the decisions in *DeLuca* and *Daugherty*.

The only way to eliminate entirely the risks of both a valid voluntary and involuntary bankruptcy filing of a SPV is to use a SPV that, because of its legal form, is ineligible to be a debtor under the Bankruptcy Code. Pursuant to section 109(a), only a “person” may be a debtor under the Bankruptcy Code. Section 101(41) defines “person” to include “corporation,” and section 101(9)(A)(v) defines “corporation” to include “business trust.” Thus, a trust other than a “business trust” is ineligible to be a debtor under the Bankruptcy Code.<sup>101</sup> The term “business trust” is not defined in the Bankruptcy Code or the legislative history. Most courts have held that federal law determines whether a trust is a “business trust” for purposes of eligibility to be a debtor under the Bankruptcy Code.<sup>102</sup>

Bankruptcy courts are divided on the meaning of the term “business trust.” Since the Bankruptcy Code’s definition of “corporation” includes “business trust,” some courts have

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<sup>97</sup> *Id.* at 91-92.

<sup>98</sup> 188 B.R. 607 (Bankr. D. Neb. 1995).

<sup>99</sup> *Id.* at 611.

<sup>100</sup> *Id.* at 612-13.

<sup>101</sup> See *In re Hunt*, 160 B.R. 131, 134 (Bankr. 9th Cir. 1993); *In re Medallion Realty Trust*, 103 B.R. 8, 10 (Bankr. D. Mass. 1989), *aff’d*, 120 B.R. 245 (D. Mass. 1990).

<sup>102</sup> See *In re Gurney’s Inn Corp. Liquidating Trust*, 215 B.R. 659, 661-62 (Bankr. E.D.N.Y. 1997) (question of eligibility is determined by reference to federal, not state, law); *In re Sung Soo Rim Irrevocable Intervivos Trust*, 177 B.R. 673, 676 (Bankr. C.D. Cal. 1995) (“whether a debtor is a ‘business trust’ under state law is given the status of a rebuttable presumption which must be tested against the fundamental federal purpose of the restrictions on eligibility to file a bankruptcy petition”); *In re Arehart*, 52 B.R. 308, 310-11 (Bankr. M.D. Fla. 1985) (“whether an entity is eligible for relief . . . is purely a matter of federal law”). But see *In re Heritage North Dunlap Trust*, 120 B.R. 252, 254 (Bankr. D. Mass. 1990) (“Since the Code does not define what constitutes a business trust, we look to state law.”).

determined a trust to be a “business trust” if it has the attributes of a corporation.<sup>103</sup> Several courts have applied the six-factor test set forth in *Morrissey v. Commissioner*<sup>104</sup> to determine whether the entity is a “business trust” under the Internal Revenue Code. Under *Morrissey*, a trust is a “business trust” if it has the following characteristics: (i) business functions; (ii) title to property is held by trustees; (iii) centralized management; (iv) continuity of life; (v) transferability of interests; and (vi) limited liability.<sup>105</sup>

Several courts have held that the basic distinction between “business trusts” and “non-business trusts” is that “business trusts” are created for the purpose of carrying on some kind of business or commercial activity for profit, whereas the purpose of a “non-business trust” is to protect and preserve the trust res.<sup>106</sup> The court in *In re Eagle Trust*<sup>107</sup> combined the factors used by other courts and held that the key attributes of a business trust are: (i) trust was formed for the primary purpose of transacting business or commercial activity, as opposed to preserving assets; (ii) trust was formed by a group of investors who contribute capital to the enterprise with the exception of receiving a return on their investment; (iii) trust was created in compliance with state law; and (iv) the beneficial interests in the trust must be freely transferable.

The decision whether a trust qualifies as a “business trust” must be based on a fact-specific analysis of the trust at issue,<sup>108</sup> and “the inquiry must focus on the trust documents and the totality of the circumstances, not solely on whether the trust engages in a business.”<sup>109</sup> In *In re Secured Equip. Trust of Eastern Air Lines, Inc.*,<sup>110</sup> the Second Circuit held that a trust created in a structured finance transaction was not a “business trust” eligible for relief under the Bankruptcy Code. The trust was created to issue trust certificates to investors and to use the sale proceeds of the certificates to purchase a portion of Eastern Airlines’ fleet. The purchased fleet was then leased back to Eastern in exchange for rental payments in an amount necessary to service the outstanding certificates. The Second Circuit held that the trust was not created to generate a profit but merely to secure repayment of the certificate holders’ loans to Eastern.<sup>111</sup> It further held that the trust was not established to “transact business” and that any business activities the trustee was engaged in were merely incidental to the trust’s sole responsibility of protecting the certificate holders’ interests.<sup>112</sup>

In addition to the legal form of the SPV, other techniques are utilized in order to make the SPV as bankruptcy remote as possible. Restricting the SPV’s ability to incur debt is

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<sup>103</sup> See, e.g., *In re Secured Equip. Trust of Eastern Air Lines, Inc.*, 38 F.3d 86, 89 (2d Cir. 1994) (citing *In re Woodsville Realty Trust*, 120 B.R. 2, 3 (Bankr. D.N.H. 1990)); *In re DeHoff Trust I*, 114 B.R. 189, 191 (Bankr. W.D. Mo. 1990).

<sup>104</sup> 296 U.S. 344 (1935).

<sup>105</sup> See, e.g., *In re Mosby*, 61 B.R. 636 (E.D. Mo. 1985), *aff’d per curiam*, 791 F.2d 628 (8th Cir. 1986).

<sup>106</sup> See, e.g., *In re Secured Equip. Trust of Eastern Air Lines, Inc.*, 38 F.3d 86, 89 (2d Cir. 1994); *In re Treasure Island Land Trust*, 2 B.R. 332, 334 (Bankr. M.D. Fla. 1980); *In re DeHoff Trust I*, 114 B.R. 189, 191 (Bankr. W.D. Mo. 1990).

<sup>107</sup> Nos. CIV. A.93-2531, 97-23298, 1998 WL 635845, at \*5 (E.D. Pa. Sept. 16, 1998).

<sup>108</sup> See *Eastern Enterprises*, 38 F.3d at 89

<sup>109</sup> *Id.* at 90-91 (citing *In re St. Augustine Trust*, 109 B.R. at 496).

<sup>110</sup> 38 F.3d 86 (2d Cir. 1994).

<sup>111</sup> *Id.* at 90.

<sup>112</sup> *Id.*

one technique used to reduce the risk of involuntary filings.<sup>113</sup> Such restrictions are usually found in the SPV's organizational or financing documents. Similarly, prohibitions on the granting of liens and security interests in the securitized assets in favor of parties other than the security holders are regularly included in the organizational or financing documents of the SPV to limit the number of the SPV's creditors and prevent the problems incurred in *Kingston Square*.<sup>114</sup> To reduce the risk that the SPV engages in activities which could give rise to additional credit risk, the organizational documents generally limit the purpose and activities of the SPV to the purchase and ownership of the securitized assets, the issuance of the securities and activities related to these functions.<sup>115</sup>

The SPV's organizational documents may also require the SPV to obtain agreements from its creditors (i) not to file an involuntary petition against the SPV (the so-called "no-petition agreements") and/or (ii) that their claims shall not constitute "claims" for purposes of Bankruptcy Code section 101(5) for as long as the debt securities are outstanding (the so-called "no-claim agreements"). A no-petition agreement generally covers the one-year period following payment of the securities to protect against avoidance actions. Obviously, these provisions are not effective in dealing with involuntary creditors, such as tort claimants.

To minimize the risk that the remote structure is defeated by substantive consolidation of the SPV with the Originator and/or the Originator's affiliates, the organizational documents usually prohibit the SPV from loans and guarantees and require that the SPV maintain all corporate formalities, such as maintaining separate books and records, maintaining separate accounts, preparing separate financial statements, avoiding commingling of its assets with those of any other person, acting solely in its own corporate name and through its own officers and agents, and conducting only arms-length transactions with affiliated entities.<sup>116</sup>

In some instances, owners or principals of the SPV are required to enter into agreements imposing direct liability on them for the securities of the SPV if the owner or principal (i) commences a voluntary bankruptcy case for the SPV, (ii) encourages creditors to file an involuntary petition against the SPV, (iii) violates a fundamental agreement of the SPV or (iv) otherwise impedes the exercise of the security holders' remedies. The existence of such agreements, however, can be a negative factor in assessing the SPV's separateness from the Originator and, depending on the terms, may make the securitization structure more vulnerable to a substantive consolidation attack.<sup>117</sup> Finally, an important element of any asset securitization in which the Originator or an affiliate acts as servicer are bank account arrangements designed to eliminate or minimize the access of the Originator and its affiliates to the cash generated by the securitized assets. Typically, payments from the underlying obligors would be paid (i) directly to an account maintained for the benefit of the security holders with the custodian or (ii) to the affiliated servicer, with a requirement that amounts relating to the securitized assets be paid promptly into an account maintained for the benefit of the security holders with the custodian.

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<sup>113</sup> See *Structured Financing Techniques* at 554-55.

<sup>114</sup> *Id.* at 555.

<sup>115</sup> *Id.* at 554.

<sup>116</sup> See James R. Stillman, A "No Substantive Consolidation, No Fraudulent Conveyance" Opinion Letter from Counsel to the Bankruptcy Remote Entity, SC37 ALI-ABA 611, 629 (1997).

<sup>117</sup> See *Structured Financing Techniques* at 561.

#### IV. Disguised Loan v. “True Sale”: An Attack on the Foundations of the Asset Securitization Transaction

One of the common bankruptcy attacks on a securitization transaction is characterizing (or recharacterizing) the transaction as a disguised loan rather than a “true sale.” Determination of whether an asset transfer is a “true sale” or a disguised loan is not governed by a statutory rule. It is an equitable determination made by the courts based upon a variety of factors.<sup>118</sup> If the transaction is characterized as a secured financing, in which the Originator borrowed funds from the SPV and pledged the securitized assets to the SPV as collateral, but retained an interest in the assets, the trustee of the Originator might seek to recapture the assets on the ground that they are part of the Originator’s bankruptcy estate under Bankruptcy Code section 541. Because the Originator’s bankruptcy estate is defined by its “legal and equitable interests,” a court’s determination of the sale/secured loan question affects the size of the bankrupt Originator’s estate. If a court determines that the transfer was a “true sale,” then the SPV retains all of the legal and equitable interests in the assets, and thus the court will not include the assets in the Originator’s bankruptcy estate.<sup>119</sup> Conversely, if a court determines that the transfer of the assets constitutes a secured loan resulting in a security interest that was never perfected, the trustee can avoid the security interest pursuant to Bankruptcy Code section 544(a). This essentially avoids the asset transfer and returns to the Originator’s bankruptcy estate all legal and equitable interests in the assets. Accordingly, the SPV would become a creditor of the Originator with a security interest in the securitized assets. The priority provided by the security interest would be respected in bankruptcy if it was properly perfected, but the secured creditor’s recovery on the assets would be delayed by the bankruptcy process. There is, of course, an inherent tension between several important techniques that may be used to enhance the credit of the securities (*e.g.*, recourse to the Originator, over-collateralization, etc.) and the facts that determine whether the Originator has, in fact, sufficiently transferred ownership of the assets so as to justify characterizing the transfer as a “true sale.”

Although there is no bankruptcy court decision that has expressly decided whether an asset securitization is a “true sale” or a disguised loan, bankruptcy courts have considered asset securitization transactions in the “true sale” context, and also as they apply to other legal doctrines.<sup>120</sup> To determine whether an asset securitization transaction is a “true sale” courts would look to state law. A “true sale” involves the transfer by the Originator of all of its right, title and interest in the assets to be securitized by the SPV. In the securitization context, a “true sale” has been defined as, “a transfer of financial assets in which the parties state that they intend a sale, and in which all of the benefits and risks commonly associated with ownership are

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<sup>118</sup> Robert D. Aicher & William J. Fellerhoff, *Characterization of a Transfer of Receivables as a Sale or a Secured Loan upon Bankruptcy of the Transferor*, 65 Am. Bankr. L. J. 181, 182-84 (1991).

<sup>119</sup> See *Structured Financing Techniques* at 541.

<sup>120</sup> See, *e.g.*, *In re LTV Steel Co.*, 274 B.R. 278 (Bankr. N.D. Ohio 2002) (court analyzed asset securitization in the “true sale” context, but did not hold whether it was a disguised loan or a “true sale”); *In re Kingston Square Assocs.*, 214 B.R. 713, 714 (Bankr. S.D.N.Y. 1997) (examining asset securitization in the context of whether to uphold bad faith involuntary bankruptcy filing by an SPV’s creditors).

transferred for fair value in an arm's length transaction.”<sup>121</sup> There are many factors to determine whether a transfer of assets should be treated as a “true sale” or as a disguised secured loan.

In determining whether a particular transaction is properly characterized as a “true sale” or a secured loan, courts frequently refer to the intent of the parties. Courts will ignore the labels used by the parties and conduct an investigation of the true nature of the transaction. Courts will examine all of the factual circumstances, including the parties’ practices, objectives, business activities and relationships. Most courts focus on the true intention of the parties rather than the actual words used in the contract. For example, in *Major’s Furniture Mart, Inc. v. Castle Credit Corp.*,<sup>122</sup> the United States Court of Appeals for the Third Circuit rejected the argument that an agreement’s explicit reference to “sales and purchases” proved that the parties’ intended a “true sale” of accounts and not a security transfer.<sup>123</sup> The court rejected this argument and instead analyzed the parties’ business activities, objectives and relationship.<sup>124</sup> Nevertheless, some courts have focused on an agreement’s language when it supported their determination. For example, in *Bear v. Coben (In re Golden Plan of California, Inc.)*,<sup>125</sup> the Ninth Circuit found substantive indicia of a sale where the parties’ agreement contained phrases such as “assigns, sets over and transfers all rights, title and interest,” and concluded that the parties intended a “true sale” not a disguised loan.<sup>126</sup>

The most important factor in the true sale/disguised loan characterization analysis has been the extent to which the risks and benefits associated with ownership have either been retained by the Originator or transferred to the SPV.<sup>127</sup> One of the risks of ownership that is always examined is whether the SPV and its investors, as opposed to the Originator, bear the risk of loss with respect to the transferred assets. If the SPV fails to retain any of the risks or obligations of ownership, “a court is likely to consider the transaction a secured loan.”<sup>128</sup> The agreement in *Major’s* placed all risk of account uncollectibility upon the seller, thus limiting the buyer’s risk to the possibility that the seller could not fulfill its obligations.<sup>129</sup> Conceding that guaranties of quality or collectibility alone “might be consistent with a true sale,” the Third Circuit held that a shifting of all risk indicates a security interest.<sup>130</sup> In *Fireman’s Fund Insurance Co. v. Grover (In re Woodson Co.)*,<sup>131</sup> the Ninth Circuit came to a similar conclusion. Determining that a transaction constituted a loan and not a sale, the court attributed great weight to the factor of risk allocation. The court reasoned that because the seller bought an insurance contract in order to guarantee a fixed return to investors, the investors retained no risk of loss.<sup>132</sup>

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<sup>121</sup> Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 Bus. Law. 159, 159 (1996).

<sup>122</sup> 602 F.2d 538 (3d Cir. 1979).

<sup>123</sup> *Id.* at 543.

<sup>124</sup> *Id.*

<sup>125</sup> 829 F.2d 705 (9th Cir. 1986).

<sup>126</sup> *Id.* at 709.

<sup>127</sup> See *Structured Financing Techniques* at 543

<sup>128</sup> *Major’s Furniture Mart, Inc. v. Castle Credit Corp.*, 602 F.2d 538, 543 (3d Cir. 1979).

<sup>129</sup> *Id.* at 545.

<sup>130</sup> *Id.* at 545-46.

<sup>131</sup> 813 F.2d 266 (9th Cir. 1987).

<sup>132</sup> *Id.* at 271.

The court noted that in a true sale the loan pool investors would share in the risk of default and would have to “rely on the creditworthiness of the borrowers [mortgagors] and the collateral.”<sup>133</sup>

The presence of recourse is the most important aspect of risk allocation because it suggests that the parties intended a loan and not a sale. If the parties had intended a sale, then the buyer would have retained the risk of default, not the seller. The greater the recourse the SPV has against the Originator, through for example chargebacks or adjustments to the purchase price, the more the transfer resembles a disguised loan rather than a sale. Courts differ on the weight they attach to the presence of recourse provisions. Some courts view the presence of such a provision as nearly conclusive of the parties’ intent to create a security interest, while others view recourse as only one of a number of factors.

The Ninth Circuit, focusing on the factor of risk allocation, concluded that a true sale had transpired in *Bear v. Coben (In re Golden Plan of California, Inc.)*.<sup>134</sup> Examining all the “facts and circumstances surrounding the transaction,” the court held that the parties intended a true sale, emphasizing the fact that the seller sold the notes without recourse and did not guarantee the buyers any compensation in the case of foreclosure.<sup>135</sup> The Third Circuit in *Major’s Furniture Mart, Inc. v. Castle Credit Corp.*,<sup>136</sup> declined to adopt the seller’s suggestion of a per se rule converting a sale into a secured loan based upon the presence of recourse in the agreement. The courts stressed that it must determine whether the “nature of the recourse, and the true nature of the transaction, are such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing agreement or to a sale.”<sup>137</sup> Thus, the court examined the dynamics and consequences of the agreement, including risk allocation, to determine the parties’ true intent. In *Major’s Furniture Mart*, a transaction was deemed to be a secured financing when an accounts receivable originator (i) warranted that the accounts were legally enforceable and fully collectible, and (ii) indemnified the purchaser from losses arising from a failure of account obligors to pay any breaches of warranties. There, the court found that the originator retained too many of the risks of ownership for a true sale to exist.<sup>138</sup>

Related to transference of risk of loss to the SPV, is the retention of the benefits of ownership by the Originator.<sup>139</sup> The issue here is whether the Originator has the right to repurchase the assets transferred or to substitute other property for the assets transferred. If the Originator were permitted to do this, it could capture any increase in the value of the transferred assets and thus would have retained a significant benefit of ownership. If there is an obligation on the part of the SPV to transfer to the Originator surplus in excess of the purchase price paid for the assets (or in excess of the purchase price plus a reasonable interest rate or rate of return), or an ability of the Originator to repurchase the assets, then the benefits of ownership appear to

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<sup>133</sup> *Id.* at 271-72.

<sup>134</sup> 829 F.2d 705 (9th Cir. 1986).

<sup>135</sup> *Id.* at 709.

<sup>136</sup> 602 F.2d 538 (3d Cir. 1979).

<sup>137</sup> *Id.* at 544 (footnote omitted).

<sup>138</sup> *Id.* at 544, 545.

<sup>139</sup> See *Structured Financing Techniques* at 546.

have been retained by the Originator, and this transaction resembles a secured financing rather than a “true sale.”<sup>140</sup>

To the extent the Originator continues to service the assets transferred, this factor can lead to a secured financing characterization because the Originator is retaining post-transfer control over the assets.<sup>141</sup> Once the Originator has received the purchase price for the assets, it should not have control over the assets. Two cases support this view. In *Petron Trading Co. v. Hydrocarbon Trading & Transport Co.*,<sup>142</sup> the court declined to uphold a “true sale” when an assignor continued to prepare invoices for contract payments, did not notify its account debtor that its debt had been assigned, and retained rights under the assignment contract to petition the account debtor for price adjustment.<sup>143</sup> Likewise, in *In re Major Funding Corp.*,<sup>144</sup> the court characterized a transaction where the assignor collected mortgage receivables and then paid the proceeds out to its investors/assignees as a secured lending arrangement rather than a true sale.<sup>145</sup> The court focused on the fact that the assignor did not segregate specific receivables to pay its investors, but rather paid each investor a specified return from its general pool of mortgage receivables. The return amount was not linked to the collectibility of any particular mortgage or mortgages, but was instead a guaranteed fixed amount paid out from the general pool.<sup>146</sup> While holding against the assignor, the court did not necessarily object to the assignor acting as collection agent for the assignees.<sup>147</sup>

In *Octagon Gas Systems, Inc. v. Rimmer (In re Meridian Reserve, Inc.)*,<sup>148</sup> the seller transferred to the purchaser an “overriding royalty interest” in gross proceeds received from gas sold from a business operating a natural gas gathering system.<sup>149</sup> The court first found that the purchaser’s interest in the proceeds of the natural gas was an “account” for purposes of Article 9.<sup>150</sup> Applying Article 9, the court found that under section 9-102(1)(b) Article 9 applies to “any sale of accounts or chattel paper.”<sup>151</sup> Following an analysis of Uniform Commercial Code sections 1-201(37), 9-105(1)(m), 9-105(1)(d), and 9-105(1)(c), the court concluded that, “these provisions clearly indicate that the buyer of an account is treated as a secured party, his interest in the account is treated as a security interest, the seller of the account is a debtor, and the account sold is treated as collateral.”<sup>152</sup> The court further stated that “the impact of applying Article 9 to [the purchaser’s] account is that Article 9’s treatment of accounts sold as collateral

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<sup>140</sup> See *In re Evergreen Valley Resort, Inc.*, 23 B.R. 659, 661 (Bankr. D. Me. 1982) (if surplus is returned to the originator, “a security interest is indicated.”). See also Thomas J. Gordon, *Securitization of Executory Future Flows as Bankruptcy-Remote True Sales*, 67 U. Chi. L. Rev. 1317, 1334 (2000).

<sup>141</sup> See *Structured Financing Techniques* at 548.

<sup>142</sup> 663 F. Supp. 1153 (E.D. Pa. 1986).

<sup>143</sup> *Id.* at 1159.

<sup>144</sup> 82 B.R. 443 (Bankr. S.D. Tex. 1987).

<sup>145</sup> *Id.* at 449.

<sup>146</sup> *Id.*

<sup>147</sup> *Id.* But see *In re Golden Plan of California*, 829 F.2d 705 (9th Cir. 1987) (finding that seller’s control over collection and administration process did not alter the true sale characterization).

<sup>148</sup> 995 F.2d 948 (10th Cir.), *cert. denied*, 510 U.S. 993 (1993).

<sup>149</sup> *Id.* at 951.

<sup>150</sup> *Id.* at 955.

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

would place [the purchaser's] account within the property of [the seller's] bankruptcy estate.”<sup>153</sup> Therefore, the court found that any seller of an account or chattel paper retains an interest in the account or chattel paper under Article 9 for bankruptcy purposes.<sup>154</sup>

The upshot of this decision is that it would place all securitized accounts or chattel paper of the SPV within the bankruptcy estate of the Originator under Bankruptcy Code section 541, regardless of whether the transfer was a “true sale.” The Permanent Editorial Board of the Uniform Commercial Code, however, has criticized this decision.<sup>155</sup> Revised Article 9 also rejects the decision in *Octagon Gas*. Revised Article 9 section 9-318(a) states: “(a) [Seller retains no interest.] A debtor that has sold an account, chattel paper, payment intangible or promissory note does not retain a legal or equitable interest in the collateral sold.”<sup>156</sup> Nevertheless, a recent bankruptcy court decision, *In re LTV Steel Co.*, suggests that the issue raised in *Octagon Gas* is not finished.

The decision in *In re LTV Steel Co.*,<sup>157</sup> involving the chapter 11 case of LTV Steel Company, Inc. (“LTV”), one of the largest steel manufacturers in the United States, received significant attention from the securitization industry. LTV had entered into two separate securitization transactions with separate bank groups prepetition, one backed by receivables and the other by inventory.<sup>158</sup> Each transaction involved a transfer of identified assets to a SPV, and in each case a major law firm provided an opinion to the banks to the effect that the asset transfer from LTV to the SPV was a “true sale.” LTV’s two securitization facilities followed the two-tiered structure described above.<sup>159</sup>

LTV attacked the two asset securitization transactions. LTV argued that the transactions did not involve “true sales”; rather, they constituted financing designed to deprive “unsecured creditors of the ability to realize any meaningful recovery from the lenders’ enormous equity cushion, and to enable the lenders to exercise remedies without any accountability to this court or any other parties in interest.” LTV further asserted that “through a bewildering and complex array of documents . . . the lenders have conjured the illusion that the debtors do not own their inventory, do not own their accounts and are not in the business of manufacturing and selling steel products.” LTV focused on the five indicia that it believed established a security financing instead of a “true sale” of inventory and receivables: (i) absence of fair market value or standard payment terms under the sale agreements; (ii) allocation of risk to LTV if the value of the inventory or accounts would be insufficient to repay the debtors; (iii) amount of control that LTV exercised over the inventory and receivables; (iv) economic benefit that LTV would receive if the inventory and receivables generate excess proceeds; and (v) failure to maintain corporate formalities.

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<sup>153</sup> *Id.*

<sup>154</sup> *Id.*; see also David Gray Carlson, *The Rotten Foundations of Securitization*, 39 Wm. & Mary L. Rev. 1055 (1998).

<sup>155</sup> See Permanent Editorial Board of the Uniform Commercial Code, *Commentary No. 14, Transfer of Accounts or Chattel Paper* (1994) (stating that *Octagon Gas* decision was “erroneous”).

<sup>156</sup> Revised U.C.C. § 9-318(a).

<sup>157</sup> 274 B.R. 278 (Bankr. N.D. Ohio 2001).

<sup>158</sup> *Id.* at 280.

<sup>159</sup> *Id.* at 280-81.

The bankruptcy court authorized LTV to use the cash proceeds of the transferred assets as “cash collateral” on an interim basis pursuant to Bankruptcy Code section 363. The agent bank for each group of lenders consented to this use. The adequate protection provided under the order consisted of a combined package of rights to inventory and receivables. The largest lender under the receivables arrangement (“Abbey”) filed an emergency motion for modification of the interim cash collateral order. Abbey argued that it was not a lender to LTV inasmuch as the assets had been transferred as a “true sale” to the SPVs.<sup>160</sup> It further argued that the triple A rating of the SPV and the lower interest costs of the SPV were based on the understanding of all parties, including LTV, that the SPV was bankruptcy remote. Abbey concluded that the bankruptcy court lacked jurisdiction because the assets were not part of LTV’s bankruptcy estate under Bankruptcy Code section 541.<sup>161</sup> The court denied Abbey’s motion stressing that the interim cash collateral order was “necessary to enable debtor to keep its doors open and continue to meet its obligations to its employees, retirees, customers and creditors,” and that denial of the use of the assets “would put an immediate end to the debtor’s business, would put thousands of people out of work, would deprive 100,000 retirees of needed medical benefits, and would have far reaching economic effects on the geographic areas where the debtor does business.”<sup>162</sup>

The court’s discussion regarding the ownership of the receivables is as follows: “Furthermore, there seems to be an element of sophistry to suggest that Debtor does not retain at least an equitable interest in the property that is subject to the interim order. Debtor’s business requires it to purchase, melt, mold and cast various metal products. To suggest that Debtor lacks some ownership interest in products it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept. Accordingly, the court concludes that Debtor has at least some equitable interest in the inventory and receivables, and that this interest is property of the estate. This equitable interest is sufficient to support the entry of the interim cash collateral order.”<sup>163</sup> Abbey subsequently filed an appeal but the matter was settled prior to a decision thereon when the parties agreed upon a debtor in possession financing arrangement. Even though the court’s decision was not a final decision on the merits of the “true sale” issues, it created a good deal of concern in the financial industry. The court, however, did not hold this was a disguised financing. Similar to the decision in *Octagon Gas*, the court appeared to hold that there could never be a “true sale” of accounts receivables.

The *LTV* case illustrates the stress that can be placed on a securitization transaction if any of the following are true: (i) the debtor has no or inadequate sources of working capital other than the collateral and/or its cash flow; (ii) the collateral includes operating assets required for the continuation of the debtor’s business, not just pure financial assets (i.e. inventory); and (iii) cessation of the debtor’s business would result in the loss of many jobs and create other widespread personal hardships. All of these were true with respect to *LTV*. The collateral comprised substantially all of its working capital, without which LTV would not have been able to obtain debtor in possession financing. It could not continue operating without the

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<sup>160</sup> *Id.* at 285.

<sup>161</sup> *Id.*

<sup>162</sup> *Id.* at 286.

<sup>163</sup> *Id.* at 285.

inventory. LTV employed 17,500 people and provided medical coverage and other benefits for 100,000 retirees and their dependents. The court was located near LTV's headquarters and principal facility, and the initial hearing was reportedly attended by the Local Congressman. Under these circumstances, it is entirely unsurprising that a bankruptcy judge would find a way to circumvent the structuring of the securitization transactions in order to provide LTV a chance to reorganize.

## V. Statutory Reform: The Institutionalization of Asset Securitization

Surprisingly little case law exists addressing the legal, factual and philosophical issues implicated by the confluence of asset securitization and federal bankruptcy law. Bankruptcy courts, for the most part, have not had the opportunity to analyze these financial structures and how they interact with the fundamental tenets of bankruptcy law. This dearth of decisional law has been noted in Congressional testimony:

[T]he possible harm to the bankruptcy estate and other creditors that may result from securitized financings . . . are unresolved, because there have been almost no cases addressing the consequences of securitization in bankruptcy. There are a handful of unreported opinions and almost no reported opinions. We are not learning, because we are not litigating. Usually, judicial development of an area gives us a full sense of the issues raised by any new practice. It is the interaction of case law and legislation that is the genius of the American system.”<sup>164</sup>

Despite the lack of cases analyzing the effect of asset securitization on the bankruptcy dynamic, Congress has been poised for several years to pass bankruptcy reform which will provide a safe harbor for asset securitization transactions. Similarly, Delaware has already passed a law which provides a statutory basis for excluding securitized assets from a bankruptcy estate. Is there, as Lois Lupica questions, a “premature institutionalization of securitization”?<sup>165</sup>

Before it was jettisoned in Conference, Section 912 of H.R. 333, the proposed Bankruptcy Reform Act of 2001, proposed to amend Bankruptcy Code section 541 by adding a new subsection 541(b)(8) that specifically excludes from a debtor's estate “any eligible asset (or proceeds thereof) to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization, except to the extent that such asset (or proceeds thereof) may be recovered by the trustee under section 550 by virtue of avoidance under section 548(a).” The term “eligible assets” includes only financial assets, cash and securities. Receivables, loans and other types of payment obligations that by their terms will be reduced to cash are covered, but inventory and other operating assets are not. The term transferred is defined to mean that “the debtor, under a written agreement, represented and warranted that eligible assets were sold, contributed, or otherwise conveyed with the intention of removing them from the estate of the debtor pursuant to

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<sup>164</sup> The Business Bankruptcy Reform Act: Hearing on S. 1914 Before Subcomm. On Admin. Oversight and the Courts, 105<sup>th</sup> Cong., 2d Sess., 67, 67-68 (1998).

<sup>165</sup> See *Circumvention of the Bankruptcy Process* at 230.

subsection (b)(8) (whether or not reference is made to this title or any section hereof), irrespective and without limitation of (A) whether the debtor directly or indirectly obtained or held an interest in the issuer or in any securities issued by the issuer; (B) whether the debtor had an obligation to repurchase or to service or supervise the servicing of all or any portion of such eligible assets; or (C) the characterization of such sale, contribution, or other conveyance for tax, accounting, regulatory reporting, or other purposes.” “Eligible entity” is defined expressly to include a single member LLC.

If the proposed legislation is enacted, as long as the transaction is structured so as to fit within the parameters of Bankruptcy Code section 541(b)(8), it will no longer be possible for the bankruptcy court to use its discretion to recharacterize a transfer documented as a “true sale” as a disguised loan, even if, under prior case law, courts would have viewed the transfer as a secured financing. The proposed legislation promotes asset securitization and possibly the problems associated with Enron. Section 912 would also partially affect a case like *LTV*. Inventory and receivables served as securitized assets in that case, but only receivables would be covered under section 912. Although promoted as a “technical” amendment to the Bankruptcy Code, Section 912 would have two principal effects: (i) it would force courts to accept the “true sale” character of an asset securitization, regardless of the economics of the transaction; and (ii) it would prevent a bankruptcy court from recovering assets conveyed in an asset securitization under the fairly narrow, one-year avoidance power of section 548. All other avoidance actions would be eliminated by Section 912.<sup>166</sup> Section 912 would overturn a long tradition in commercial law by allowing the mere rubber stamp of the debtor to determine how a transaction is characterized.

Another issue with section 912 is its impact on avoidance powers. It eliminates virtually all judicial powers to avoid asset securitization transactions as fraudulent or preferential transfers. Section 912 does not expressly say that it is eliminating avoidance powers. Rather, it excludes “eligible assets” from the Originator’s bankruptcy estate unless the sale of those assets was a “fraudulent transfer” under federal bankruptcy law, which is quite limited. It therefore eliminates all other avoidance powers under the Bankruptcy Code and state law.

In January 2002, 35 law professors raised certain problems with the proposed legislation in a letter to Congress (the “Professors’ Letter”). The Professors’ Letter argued that section 912’s solution to the “true sale” problem is troubling inasmuch as it deprives the bankruptcy court of the power to recharacterize a purported “true sale” as a disguised secured financing. Depriving bankruptcy courts of this power would seriously impair the ability of many viable entities to reorganize.<sup>167</sup> It would also permit parties to place assets beyond the reach of unsecured creditors, such as employees and tort claimants. The Professor’s Letter further argued that section 912 might place too much power in the hands of credit rating agencies. These organizations work for the parties to the transactions, and do not have the interests of the Originator’s general creditors in mind.

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<sup>166</sup> See *Enron, Asset Securitization and Bankruptcy Reform* at 9.

<sup>167</sup> See *supra*.

Similarly, Delaware has recently enacted the “Asset-Backed Securities Facilitation Act” in response to the increasing use of asset securitization in the financial industry. This statute provides in pertinent part, as follows:

- (1) Any property, assets or rights purported to be transferred, in whole or in part, in the securitization transaction shall be deemed to no longer be the property, assets or rights of the transferor;
- (2) A transferor in the securitization transaction, its creditors or, in any insolvency proceeding with respect to the transferor or the transferor’s property, a bankruptcy trustee, receiver, debtor, or debtor in possession or similar person, to the extent the issue is governed by Delaware law, shall have no rights, legal or equitable, whatsoever to reacquire, reclaim, recover, repudiate, disaffirm, redeem or recharacterize as property of the transferor any property, assets or rights purported to be transferred, in whole or in part, by the transferor; and
- (3) In the event of a bankruptcy, receivership or other insolvency proceeding with respect to the transferor or the transferor’s property, to the extent the issue is governed by Delaware law, such property, assets and rights shall not be deemed to be part of the transferor’s property, assets, rights or estate.

Does the “Asset-Backed Securities Facilitation Act” really provide a safe harbor for securitization transactions in a title 11 case? Does federal bankruptcy law preempt Delaware’s “Asset-Backed Securities Facilitation Act” under the Supremacy Clause?

## **VI. Substantive Consolidation of the Originator and the SPV**

Substantive consolidation by the bankruptcy court is a prominent issue in many asset securitization transactions because the SPV is often a wholly owned subsidiary of the Originator.<sup>168</sup> Under this doctrine, the bankruptcy court can order the substantive consolidation of a non-debtor SPV into the bankruptcy estate of the Originator or other bankrupt operating affiliate of the Originator. “Stemming as it does from Section 105 of the Code, the power to substantively consolidate is often said to be an equitable doctrine.”<sup>169</sup> The doctrine permits a court to disregard the separateness of legal entities and to consolidate and pool the entities’ assets and liabilities and treat them as though held and incurred by one entity. The main purpose of substantive consolidation is to pool assets and liabilities of the consolidated entities, eliminate inter-entity claims, and effect a more equitable distribution of property among the creditors.<sup>170</sup>

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<sup>168</sup> See generally *Traditional Bankruptcy Attacks*.

<sup>169</sup> *In re Standard Brand Paints Co.*, 154 B.R. 563, 570 (Bankr. C.D. Cal. 1993).

<sup>170</sup> See *In re Baker & Getty Fin. Servs.*, 78 B.R. 139, 141 (Bankr. N.D. Ohio 1987).

The effect of substantive consolidation on an asset “securitization” is to consolidate the “bankruptcy remote” entity into the originator.<sup>171</sup> The effect is to combine the assets and liabilities of the Originator and SPV into a “common pool” with one common balance sheet. The effect of substantive consolidation is truly “substantive” (i.e. intercompany claims are eliminated, entities are combined for purposes of voting on a plan of reorganization, duplicative claims are eliminated, and subsidiary equity ownership interests, joint and several liability claims and guarantees are eliminated, unless the consolidation order provides otherwise).<sup>172</sup>

There is no express authority for substantive consolidation in the Bankruptcy Code. Instead, courts use equitable powers granted under Bankruptcy Code section 105(a) as authority for effectuating a substantive consolidation.<sup>173</sup> Substantive consolidation can work an inherent unfairness – this may result in windfalls to creditors of an undercapitalized entity and penalties or losses to creditors of a more solvent entity.<sup>174</sup> Courts recognize that as a general rule “[t]he power to consolidate should be used sparingly because of the possibility of unfair treatment of creditors of a corporate debtor who have dealt solely with that debtor without knowledge of its interrelationship with others.”<sup>175</sup> At least one commentator has even suggested that substantive consolidation is no longer an equitable remedy available to a bankruptcy judge under Bankruptcy Code section 105(a) after the Supreme Court’s decision in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*<sup>176</sup>

The modern legal standard for substantive consolidation essentially uses a two-part balancing test: under this test, the proponent of substantive consolidation must show that (1) there is a substantial identity between the entities to be consolidated; and (2) that substantive consolidation is necessary to avoid some harm or to realize some benefit.<sup>177</sup>

The first prong of the test generally is determined by utilizing the seven-factor analysis set forth in *In re Vecco Constr. Indus.*<sup>178</sup> The seven factors include: (i) degree of difficulty in segregating and ascertaining individual assets and liabilities; (ii) presence or absence of consolidated financial statements; (iii) profitability of consolidation at a single location; (iv) unity of interest and ownership between the various corporate entities; (v) existence of parent and inter-corporate guarantees or loans; (vi) commingling of assets and business functions; and

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<sup>171</sup> See *In re Standard Brand Paints Co.*, 154 B.R. 563, 572 (Bankr. C.D. Cal. 1993) (court permitted substantive consolidation for plan voting and distribution purposes only while allowing the entities to remain as separate entities after plan confirmation).

<sup>172</sup> See *In re John Cooper*, 147 B.R. 678, 682 (Bankr. D.N.J. 1992); *Eastgroup Properties v. South Motel Assoc., Ltd.*, 935 F.2d 245, 248 (11th Cir. 1991); *In re Parkway Calabasas, Ltd.*, 89 B.R. 832, 837 (Bankr. C.D. Cal. 1988), *aff’d*, 949 F.2d 1058 (9th Cir. 1991).

<sup>173</sup> See *In re Hemingway Transport, Inc.*, 954 F.2d 1 (1st Cir. 1992); *Eastgroup Properties v. South Motel Assoc., Ltd.*, 935 F.2d 245 (11th Cir. 1991); *In re Augie/Restivo Baking Co. Ltd.*, 860 F.2d 515 (2d Cir. 1988).

<sup>174</sup> See *Flora Mir Candy Corp. v. R.S. Dickson & Co.*, 432 F.2d 1060, 1062-63 (2d Cir. 1970).

<sup>175</sup> See *Chemical Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966).

<sup>176</sup> 527 U.S. 308 (1999). See *J. Maxwell Tucker, Grupo Mexicano and the Death of Substantive Consolidation*, 8 Am. Bankr. Inst. L. Rev. 427 (2000).

<sup>177</sup> See *In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515 (2d Cir. 1988). See also *Eastgroup Props. V. Southern Motel Assocs., Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991); *In re Auto-Train Corp., Inc.*, 810 F.2d 270 (D.C. Cir. 1987); *Flora Mir Candy Corp. v. R.S. Dickson & Co. (In re Flora Mir Candy Corp.)*, 432 F.2d 1060, 1062-63 (2d Cir. 1970).

<sup>178</sup> 4 B.R. 407, 410 (Bankr. E.D. Va. 1980).

(vii) transfer of assets without observance of corporate formalities.<sup>179</sup> Courts analyzing the propriety of substantive consolidation have employed “a balancing of the equities favoring consolidation against the equities favoring continued debtor separateness.”<sup>180</sup> The second prong of the test is an equitable determination by the bankruptcy court as to whether substantive consolidation is necessary to avoid harm or to realize a benefit.

Even if the asset securitization avoids all of these factors by properly structuring the transaction as a “true sale,” substantive consolidation case law indicates that a court may still find an identity of interest between the debtor Originator and the non-debtor SPV. As shown below, courts have substantively consolidated a non-debtor with a debtor.<sup>181</sup> The court in *In re Augie/Restivo Baking Co., Ltd.*,<sup>182</sup> stated that “[t]he sole purpose of substantive consolidation is to ensure the equitable treatment of all creditors.”<sup>183</sup> Likewise, the court in *In re Snider Bros.*,<sup>184</sup> states that “[w]hile several courts have recently attempted to delineate what might be called ‘the elements of consolidation’ . . . the only real criterion . . . the economic prejudice of continued debtor separateness versus the economic prejudice of consolidation. There is no one set of elements which, if established, will mandate consolidation in every instance.”<sup>185</sup> The court in *Vecco Construction* stated, “the subsidiaries were but instrumentalities of the bankrupt with no separate existence of their own. Consequently, there existed a unity of interest and ownership common to all corporations, and that to adhere to the separate corporate entities theory would result in an injustice to the bankrupt creditors.”<sup>186</sup> The *Vecco Construction* court further stated that “where a corporation is a mere instrumentality . . . of the bankrupt corporation, with no independent existence of its own, equity would favor disregarding the separate corporate entities.”<sup>187</sup>

The SPV is created specifically to enable the Originator to complete the asset securitization. The SPV is clearly a mere instrumentality of the Originator designed to complete this transaction. The Originator and SPV are hardly two separate entities operating two separate businesses. Therefore, a court could find an identity of interest. If the court were to take the position that an identity of interest does exist between the Originator and the SPV, substantive consolidation could occur in these cases any time it is necessary to avoid harm or realize a benefit. In this context, when balancing the equities, the court must weigh the benefit to the creditors of the Originator, with the harm to the investors of the SPV.<sup>188</sup>

Because of the bankruptcy proofing techniques used in creating SPVs, the threat of voluntary insolvency of the SPVs is, in fact, remote. One of the primary concerns, then, is the SPV being substantively consolidated with the Originator in bankruptcy. While the majority of

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<sup>179</sup> See *In re Vecco Constr. Indus.*, 4 B.R. 407, 410 (Bankr. E.D. Va. 1980).

<sup>180</sup> See *In re Donut Queen, Ltd.*, 41 B.R. 706, 709 (Bankr. E.D.N.Y. 1984).

<sup>181</sup> See *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215 (1941).

<sup>182</sup> 860 F.2d 515 (2d Cir. 1988).

<sup>183</sup> *Id.* at 518.

<sup>184</sup> 18 B.R. 230 (Bankr. D. Mass. 1982).

<sup>185</sup> *Id.* at 234.

<sup>186</sup> See *In re Vecco Construction Industries, Inc.*, 4 B.R. 407, 411 (Bankr. E.D. Va. 1980) (quoting *Soviero v. Franklin National Bank of Long Island*, 328 F.2d 446, 448 (2d Cir. 1964)).

<sup>187</sup> *Id.* at 411.

<sup>188</sup> See *Traditional Bankruptcy Attacks* at 881.

substantive consolidation cases concern the consolidation of entities already in bankruptcy, non-debtor solvent entities may also be consolidated with a debtor under appropriate circumstances. For example, in *Sampsel v. Imperial Paper & Color Corp.*,<sup>189</sup> the Supreme Court found that substantive consolidation of a non-debtor corporation into the bankruptcy estate of an individual was appropriate where the transfer of property to the non-debtor corporation was not in good faith; but rather the transfer was made in order to place it beyond the reach of the individual's creditors. The Supreme Court focused on fraud perpetrated on the individual's creditors.<sup>190</sup> Similarly, the court in *In re 1438 Meridian Place, N.W., Inc.*,<sup>191</sup> consolidated the debtor with affiliated corporations and the individual shareholders' estates based on the fact that all such entities were the alter ego of the shareholders.<sup>192</sup> The court held that a debtor corporation's creditors, who could not comply with section 303(b) of the Bankruptcy Code with respect to the non-debtor affiliates because the creditors did not have a claim against the affiliates, could nevertheless bring them before the court where such affiliates were alleged to be the alter ego of the debtor.<sup>193</sup> Finally, in *In re Crabtree*,<sup>194</sup> the court held that the right to add additional parties before the bankruptcy court who are the alter ego of the debtor is independent of the right of creditors to force a person into bankruptcy under section 303. The court stated that the creditors could have achieved the same result by filing a separate petition against the corporation, since it was an asset of the debtor.<sup>195</sup>

## VII. Application of Fraudulent Conveyance Law

An asset securitization is also susceptible to attack as a fraudulent conveyance under either federal bankruptcy law or state law. If the transfer of assets from the Originator to the SPV is considered a fraudulent conveyance, the SPV could be forced to return the assets to the Originator's bankruptcy estate.<sup>196</sup> Under Bankruptcy Code section 548, a conveyance is fraudulent if (i) it is made with the actual intent to harm the creditors or if the assets are transferred for less than their reasonably equivalent value; and (ii) as a result of the transfer, the Originator is left undercapitalized, or has insufficient assets to pay its debts as they come due, or is insolvent at the time the transfer is made, or becomes insolvent as a result of the transfer.<sup>197</sup> Most states apply similar tests. Bankruptcy Code section 544(b) of the bankruptcy Code affords the trustee the authority to avoid any prepetition transfer that would be invalidated as a fraudulent conveyance under state law. "Because courts have applied the fraudulent conveyance doctrine to challenge transfers made in connection with leverage buyouts, there is precedent for expansion of this doctrine."<sup>198</sup>

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<sup>189</sup> 313 U.S. 215 (1941).

<sup>190</sup> *Id.* at 218-19.

<sup>191</sup> 15 B.R. 89 (Bankr. D.D.C. 1981).

<sup>192</sup> *Id.* at 95-96.

<sup>193</sup> *Id.*

<sup>194</sup> 39 B.R. 718 (Bankr. E.D. Tenn. 1984).

<sup>195</sup> *Id.* at 722. *But see In re Alpha & Omega Realty, Inc.*, 36 B.R. 416 (Bankr. D. Ida. 1984) (stating that a solvent general partnership affiliated with the debtor corporation would not be substantively consolidated with the debtor corporation's estate because the general partnership was not itself a debtor).

<sup>196</sup> See *Unsecured Creditors Perspective* at 647 (examining fraudulent conveyance in asset securitization context).

<sup>197</sup> See 11 U.S.C. § 548.

<sup>198</sup> See *Unsecured Creditors Perspective* at 648-49.

It is the common view among scholars that fraudulent transfer law is not very applicable to asset securitization transactions because market forces will prevent such a transaction from occurring.<sup>199</sup> Market forces, however, will not always prevent a fraudulent transfer from occurring simply because the asset securitization is in the form of a financing transaction. The Originator will always receive cash for the transactions. In addition, credit rating agencies, credit enhancement devices and other market participants might help to ensure that the transaction is for reasonably equivalent value. However, credit ratings focus exclusively on the SPV and its assets, and whether they are sufficient to protect the interests of the SPV's investors. Credit rating agencies do not focus on protecting the interests of the Originator or its creditors. Similarly, credit enhancement devices are designed to provide protection for the investors of the SPV, not the Originator or its creditors.

Thus, fraudulent transfer law can be a useful tool in avoiding an asset securitization transactions as either an actual or constructive fraudulent transfer. For example, one way of approaching the analysis of whether the sale in an asset securitization should effectively remove the assets from the bankruptcy estate of the Originator is to question whether such exchange creates real (as opposed to merely distributional) value to the Originator where the Originator is distributing the proceeds from the sale to the SPV as dividends or preferences while it is insolvent. Under this circumstance, the asset securitization could potentially be set aside as an actual fraudulent transfer if the SPV or its investors know that the funds are going to be used to effectuate a fraudulent transfer.<sup>200</sup> Similarly, if the Originator transfers the assets to the SPV and does not receive reasonably equivalent value, such as where the Originator over-collateralizes the SPV, then the transfer can be set aside as a constructive fraudulent transfer.

## VIII. Conclusion

If disintermediation is the only effect of asset securitization, then there will be no need for revisions to the Bankruptcy Code providing for, or from, asset securitization. If, however, asset securitization somehow frustrates the twin pillars of bankruptcy law—the equitable treatment of creditors and a “fresh start” for the honest debtor—then it might be necessary for a legislative response in the future. One of the principal purposes of asset securitization is to make the SPV and its assets as remote as possible from the Originator's bankruptcy. The removal of assets from the Originator's bankruptcy estate through securitization has the potential to dramatically alter the bankruptcy system. If the Originator ends up in bankruptcy, the ability to use the securitized assets might be the difference between a successful emergence from chapter 11 and liquidation. Arguably the greatest effect

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<sup>199</sup> Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 Tul. L. Rev. 101, 115 (1997) (stating while fraudulent transfer law provides conceptually useful mode of analyzing securitization transactions, it is rarely actually applied); see also Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 838 (1985) (cautioning "fraudulent conveyance law should never apply to arms-length transactions, even if it appears after the fact that the debtor's actions injured the creditors."). But see *Alchemy of Asset Securitization* at 147 (suggesting fraudulent transfer laws are appropriate means of dealing with questionable asset securitization transactions).

<sup>200</sup> See *Dean v. Davis*, 242 U.S. 438, 447-48 (1917) (mortgage given to secure credit where proceeds used to pay preference is actual intent fraudulent transfer where mortgagee knew debtor was insolvent and making preference); see also Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 Tul. L. Rev. 101, 115 (1997).

securitization will have on bankruptcy will be the demise of a debtor's use of cash collateral, which would essentially doom the reorganization of many viable businesses before they even get started.<sup>201</sup> Debtors in bankruptcy frequently require the cash flow from their receivables in order to reorganize under chapter 11.<sup>202</sup> Harm to unsecured creditors is another potential negative impact asset securitization may have on the bankruptcy dynamic. As Thomas A. Jackson stated:

The basic problem that bankruptcy law is designed to handle, both as a normative matter and as a positive matter, is that the system of individual creditor remedies may be bad for the creditors *as a group* when there are not enough assets to go around. Because creditors have conflicting rights, there is a tendency in their debt-collection efforts to make a bad situation worse. Bankruptcy law responds to this problem. Debt-collection by means of individual creditor remedies produces a widespread problem.<sup>203</sup>

Securitized assets may make the whole of the debtor's bankruptcy estate greater than its individual parts, thereby creating value for unsecured creditors. Unsecured creditors rely not on any collateral offered by the debtor, but on the debtor's cash flow, coupled with the overall value of the debtor's unencumbered assets.<sup>204</sup> Removal of securitized assets from a debtor's bankruptcy estate circumvents the bankruptcy process, potentially harms unsecured creditors, and makes it difficult for, otherwise viable organizations, to reorganize. This is inconsistent with federal bankruptcy policy.<sup>205</sup>

Several scholars have questioned the priority of secured claims in bankruptcy over unsecured claims. These scholars have questioned whether the priority afforded secured financing incorrectly distributes assets by relegating unsecured creditors to residual recipients.<sup>206</sup> This problem is intensified where asset securitization is concerned, because the securitized assets are purportedly not even included within the Originator's bankruptcy estate.

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<sup>201</sup> See *Bankruptcy Dynamic* at 314; *Circumvention of the Bankruptcy Process* at 231-36.

<sup>202</sup> See *In re LTV Steel Co., Inc.*, 274 B.R. 278 (Bankr. N.D. Ohio 2001); see also *In re Dynaco*, 162 B.R. 389, 393 (Bankr. D.N.H. 1993) ("Debtors seeking to reorganize under chapter 11 of the Bankruptcy Code frequently need to use their cash and proceeds therefrom in order to continue with their business operations."). See also Bankruptcy Reform Act of 1999 (Part II): Hearing on H.R. 833 Before Subcomm. On Commercial & Admin. Law, 106th Cong. 46-58 (1999) (testimony of Kenneth Klee on behalf of the National Bankruptcy Conference), available at <http://www.house.gov/judiciary/106-klee.htm>.

<sup>203</sup> Thomas A. Jackson, *The Logics and Limits of Bankruptcy Law* (Harvard University Press 1986).

<sup>204</sup> See Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 Va. L. Rev. 1887, 1931-32 (1994).

<sup>205</sup> See generally Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 Wash. U.L.Q. 1061 (1996); *Alchemy of Asset Securitization*; Thomas A. Jackson, *The Logics and Limits of Bankruptcy Law* (Harvard University Press 1986).

<sup>206</sup> See Lucian Arye Bebchuck & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 Yale L. J. 857, 865 (1996); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 Va. L. Rev. 1894-95 (1994).