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2002 was an odd year for securitization in Congress. In January, it appeared that the structured finance industry was on the verge of achieving its noble dream: legislated approval and protection.[1] And Congress seemed sure to grant this favor.[2] But by September the dream was dead and at least one industry group was fighting against new legislation, inspired by the dramatic failure of Enron Corporation, that "would throw into doubt the structural integrity of several trillion dollars of existing [securitizations]."[3] Now, almost two years latter, the industry

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1 The terms "securitization" and "structured finance" are interchangeable. *See* Steven L. Schwarcz, *The Parts Are Greater Than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies*, 1993 Colum. Bus. L. Rev. 139, 140.

2 Steven L. Schwarcz, *The Impact of Bankruptcy Reform on "True Sale" Determination in Securitization Transactions*, 7 Fordham J. Corp. & Fin. L. 353 (2002) [hereinafter, Schwarcz, *Impact of Bankruptcy Reform*].

3 Letter from Dwight Jenkins, Executive Director, American Securitization Forum, to Senator Richard Durbin, dated Sept. 16, 2002 (available at www.securitization.net/pdf/asf_durbin_091602.PDF).

may have avoided the fallout from Enron, but any hopes of obtaining Congressional help appear as feeble as ever.

This sudden reversal was more than a byproduct of one of the largest and most startling corporate failures since the Penn Central railroad slipped into bankruptcy court one Sunday in 1970[4] – but that certainly helped to make the once sure legislation political poison.[5] At heart, the failure to enact the industry's legislative salvation simply continued the long reality that what is so often termed the "fastest growing" financing technique is based on a foundation of doubt and risk.[6]

Securitization's benefits come from a faith that the creation of formalized legal structures will protect a group of assets from the

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4 *See* Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. – (forthcoming, Sept. 2004) (discussing the Penn Central bankruptcy case). The sudden collapse of the Penn Central Railroad, often asserted as the largest corporate bankruptcy of its day, spawned litigation that continues to this day. *See* USX Corp. v. Penn Cent. Corp., 130 F.3d 562 (3d Cir. 1997). The collapse of Enron can be expected to produce a similar result.

5 Jonathan C. Lipson, *Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?*, 11 J. Bankr. L. & Prac. 1, 16 (January/February 2002).

6 Thomas E. Plank, *Bankruptcy Professionals, Debtor Dominance, and the Future of Bankruptcy: a Review and a Rhapsody on a Theme*,18 Bank. Dev. J. 337, 362 (2002) (Book Review) ("Securitization has become tremendously important in the economy, and it continues to be one of the fastest growing forms of capital formation.").

undertow of a firm's collapse. But these formal structures will only work if that formality is respected by a collection of judges – those that preside over the federal bankruptcy courts – that pride themselves on being courts of equity, with the ability to find creative solutions to tough problems. Often they respect the nature of a securitization – but not always.[7]

Securitization exists in tension with the Bankruptcy Code, and, in particular, the broad policies of chapter 11. On the one hand, Congress enacted chapter 11 to save business from liquidation by compelling creditors to negotiate a solution with the bankrupt firm. On the other, securitization exists to remove a debtor's credit risk from the cost of financing. Unlike a typical secured lender, the investors in a securitization have no intention of monitoring a firm, negotiating new concessions in exchange for forgiving a covenant, or formulating a reorganization plan.[8] But what if a firm will fail without the inclusion of

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[7] In re LTV Steel Co., 274 B.R. 278 (Bankr. N.D. Ohio 2001). This case sent shockwaves through the securitization industry when the Bankruptcy Court entered an interim order authorizing the Debtors' use of "cash collateral" that was held by a related SPV. The case ultimately settled before the court held a final hearing. *See*, *infra* note __ and accompanying text.

[8] *See*, *infra* note __ and accompanying text.

securitized assets in a debtor's estate? Do the policies of chapter 11 trump the deal the firm worked out with the financial markets in earlier (better) days?

To date, attempts to answer these questions have reflected the extremes. Not unexpectedly, I attempt to mediate between the reality that securitizations serve useful, efficient purposes and the goal of preventing unnecessary corporate liquidations. Starting from the premise that the decision to include any party in a chapter 11 reorganization involves line drawing, I attempt to explain a principled reason for excluding some securitizations from the scope of chapter 11, while including other transactions – such as most of those at issue in Enron. Specifically, by considering the reasons why we ignore formalities in other related situations – under veil piercing, equitable subordination, and fraudulent transfer law – I explain why a line can be drawn that excludes typical securitizations from the chapter 11 estate. In the process, I suggest a functional analysis that would be more useful in making these types of determinations than the present reliance on whether or not there has been a "true sale" of assets as part of the securitization.

The remainder of the article is therefore comprised of two large halves. Part I sets the stage by briefly explaining securitizations and their unsettled relationship with the Bankruptcy Code. I also review current chapter 11 policy, Congress' now abandoned securitization legislation, and the academic debate concerning these three topics. I explain why securitizations enhance social welfare and thus deserve recognition, if not exactly in the way Congress originally proposed. Part II then develops my argument that a functional analysis of securitizations – which considers why a transfer of assets to a third-party should be unwound – does a better job than the traditional "true sale" analysis of identifying those putative securitizations that should be subject to a debtor's chapter 11 case. This part of the article also argues that the functional approach avoids the overbroad approach that Congress almost embraced. My goal is not to solve the messy policy disputes imbedded in many discussions of securitization – such as whether we should attempt to reorganize all or even most distressed firms – but rather to offer a simple, common-sense refinement to existing law that will allow all parties to consider the basic choices involved in allowing some forms of financing but not others.

I. *Securitization, Chapter 11 Policy, and Proposed Section 912*

In this section I provide the background for my discussion of the "true sale" analysis of securitizations in Part II of the article. Lest there be any doubt about my own position, this Part shows that I find securitizations to be socially useful, but I reject the effort to provide stability to these transactions through section 912 of the Bankruptcy Reform Act. Section 912 is both circular and overbroad, and would undoubtedly condone certain types of deception that no creditor would voluntarily agree to accept, even if it could be priced *ex ante*.

A. *Securitization*

Stated at a very basic level, a securitization involves the sale of an asset or a group of similar assets to a separate but related legal entity that then borrows against those assets to pay the purchase price to the selling party. More formally, in a securitization transaction the owner of the assets (the "originator") transfers assets to a newly created subsidiary called a "special purpose vehicle" (the "SPV") that issues debt or comparable securities to the market, based on the cash-flows anticipated from the assets.[9] The funds generated from the sale of these securities are used by the SPV to pay the originator for the purchased assets.[10] Figure 1 graphically illustrates a simple securitization structure.

{Figure 1 Here}

The growth of securitizations is often traced to the creation of the Government National Mortgage Association and the Federal Home Loan Mortgage Corporation,[11] but the basic concept of isolating assets from a firm for financing purposes dates back a least a century or more to the issuance of equipment trust certificates by railroads.[12] Typically, however, the term "securitization" is used by industry participants to refer

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9 The SPV is alternatively referred to as the "SPE," or special purpose entity.

10 *See generally*, Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 Stan. J.L. Bus. & Fin. 133, 135 (1994) [hereinafter, Schwarcz, *Alchemy*].

11 *E.g.,* Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 Tul. L. Rev. 101, 104 (1997).

12 *See generally,* Arthur S. Dewing, *Railroad Equipment Obligations*, 7 Amer. Econ. Rev. 353 (1917).

to the sale of financial rights to receive payments in the future, rather than lending based upon real or tangible personal property.[13]

At first blush, a securitization transaction might be equated to a secured loan, and many articles have done just that.[14] But the lenders in a securitization transaction rarely undertake the same sort of "hands on" relationship with a debtor that banks and other secured lenders typically accept.[15] Indeed, one of the cost benefits of a securitization is the lack of any need to monitor the originator's business, and the corresponding reduction in costs associated with negotiating the myriad covenants that give a standard loan agreement its heft.[16] More broadly, many of the

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13 *But see* Claire A. Hill, *Whole Business Securitization in Emerging Markets*, 12 Duke J. Comp. & Int'l L. 521 (2002).

14 *E.g.*, Lois R. Lupica, *Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic*, 9 Am. Bankr. Inst. L. Rev. 287, 312 (2001); Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 Tex. L. Rev. 595, 616 (1998) [hereinafter Lupica, *Asset Securitization*].

15 *Cf.* Robert E. Scott, *A Relational Theory of Secured Financing*, 86 Colum. L. Rev. 901, 950 (1986); Triantis & Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 Calif. L. Rev. 1073 (1995).

16 Minh Van Ngo, *Agency Costs and the Demand and Supply of Secured Debt and Asset Securitization*, 19 Yale J. Reg. 413, 462 (2002). Of course, securitizations are not without documentation costs, but the terms can be standardized by asset type, rather than by debtor. *See, infra* note __.

benefits of securitization are closely associated with the reduced level of intermediation in securitization transactions, as compared to traditional bank loans.

Securitizations also reduce the costs associated with the originator's bankruptcy filing.[17] While the direct costs of chapter 11 have been show to be relatively modest,[18] they are still costs, and the indirect costs (such as customer losses due to the pending bankruptcy) are difficult to measure and largely unknown.[19] Moreover, a traditional secured lender faces the possibility that a debtor in possession may use the lender's collateral to aid in the debtor's reorganization or incur debt with a lien that is superior to the lender's lien.[20] Securitizing a group of assets reduces these costs by isolating the asset from an originator's potential bankruptcy

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[17] As its name implies, the SPV's only purpose is to issue securities based on the newly acquired payment stream. If the SPV is properly constituted, it has no reason, and no ability, to file bankruptcy itself.

[18] *See generally* Stephen J. Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*, 74 Am Bankr. L.J. 509 (2000).

[19] *See Id*.

[20] *See* 11 U.S.C. §§ 363 & 364.

estate, allowing the lender to price the loan solely on the financial characteristics of the transferred assets, without regard to the credit of the originator. This has the further benefit of allowing the SPV to issue securities that have a credit rating independent from, and sometimes superior to, the credit rating of the originator.[21] In essence, securitization thrives on the difference between reality and theory: despite what unadulterated Modigliani-Miller might suggest, disaggregation of the firm can sometimes be value increasing.[22]

Of course the benefits of a securitization are not obtained without some costs. From the originator's perspective, these costs include the costs of establishing the SPV, transferring the assets to the SPV, and

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[21] Petrina R. Dawson, *Ratings Games with Contingent Transfer: a Structured Finance Illusion*, 8 Duke J. Comp. & Int'l L. 381, 385-86 (1998); Donald J. Weidner, *Synthetic Leases: Structured Finance, Financial Accounting and Tax Ownership*, 25 J. Corp. L. 445, 449 (2000).

[22] *See* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 Amer. Econ. Rev. 261 (1958). The Modigliani-Miller irrelevance hypothesis provides that, in a world without taxes, transaction costs, imperfect information, and any costs of financial distress, changes to a firm's financial structure are a zero-sum game: changes that decrease risk for one claimant will increase the risk of some other claimant, and the overall costs of financing will be the same to the firm. In short, the overall value of the firm remains unchanged by changes to the financial structure. As with most theories, the assumptions are key. *See* Merton H. Miller, *The Modigliani-Miller Propositions After Thirty Years*, 2 J. Econ. Persp. 99 (1988).

generally documenting the transaction.[23] Thus the benefit of securitizations is the spread between a securitization as compared with a traditional secured loan, which some industry participants estimate to be as high as 150 basis points.[24]

These benefits are obtained only by ensuring that the separateness of the SPV is respected upon an originator's chapter 11 filing. To achieve this result, the parties must structure the transaction to prevent the bankruptcy court from "substantively consolidating" the assets and liabilities of the originator with that of the SPV – which essentially means avoiding the same kind of problems that would lead a court to pierce the corporate veil.[25] And the transfer of assets must be a "true sale" under state law, as opposed to a disguised loan. The true sale requirement ensures that the transferred assets will not be considered property of the

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23 The potential costs to third-parties are discussed *infra*.

24 Stephen H. Case, *I Thought I Put That Where You Couldn't Reach It: Bankruptcy-Remote Entities, Special-Purpose Vehicles and Other Securitization Issues*, 840 PLI/Comm 51 (2002) (available on Westlaw).

25 Alexander v. Compton (In re Bonham), 229 F.3d 750, 764 (9th Cir. 2000); *see also* Peter J. Lahny IV, *Securitization: A Discussion of Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation*, 9 Am. Bankr. Inst. L. Rev. 815, 865 (2001).

originator's bankruptcy estate[26] nor subject to the automatic stay if the originator seeks chapter 11 protection.[27]

This later test is obviously difficult to meet with any certainty, especially since the case law describing a true sale is often replete with the imprecise language of all equitable doctrines, and, more importantly, none of the case law deals with the specific context of a securitization.[28] Among other things, courts will consider the extent of the residual interest retained by the originator, whether the transfer price was set at fair market value by independent appraisers, the extent of the lender's recourse to the originator, the extent of the SPV's control over the assets, and, of course, the intent of the parties as expressed in their

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26 11 U.S.C. § 541.

27 11 U.S.C. § 362.

28 *See, e.g.,* Endico Potatoes, Inc. v. CIT Group/Factoring. Inc., 67 F.3d 1063, 1069 (2d Cir. 1995)*;* Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 546 (3d Cir. 1979). *See also* Robert Stark, *Viewing the LTV Steel ABS Opinion in its Proper Context*, 27 J. Corp. L. 211, 212 (2002) ("Uncertainty is exacerbated by the fact that ABS [Asset Backed Securitization] is a relatively recent development in the world of corporate finance and, consequently, there does not appear to be any case law directly addressing whether a contested ABS transaction is a sale or a financing.").

writings.[29] Recourse is often highlighted as the most important factor,[30] but even that factor is of limited import and may impose burdens on the sale of financial assets that are not similarly imposed on the sale of tangible assets.[31] Moreover, even the most exhaustive list of factors must be considered in light of the reality that every bankruptcy court will start with the proposition that "[a]s a court of equity, the bankruptcy court is permitted to look beyond the form to the substance of a transaction in order to determine the true nature of a transaction as it relates to the rights of parties against a debtor's estate."[32]

Ultimately, this true sale analysis is only helpful if it tells us why a particular asset should or should not be included in a debtor's

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29 Steven L. Schwarcz, Structured Finance: A Guide to the Principles of Asset Securitization 31 (2d ed. 1993); *see also* Standard & Poor's, Structured Finance Legal Criteria 183 (2000) (Appendix I: Typical Factors Considered by Courts in Determining Existence of a True Sale).

30 *See* Dawson, *supra* note __, at 389, n.52.

31 Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 Bus. Law. 159, 159-63 (1996) (discussing types of permissible and impermissible recourse for true sale treatment).

32 Corporate Fin. v. Fidelity Nat'l Title Ins. Co. (In re Corporate Fin.), 221 B.R. 671, 682 (Bankr. E.D.N.Y. 1998).

chapter 11 estate. As I will argue in Part II of this article, both chapter 11 policy and the parties to securitizations would be better served by a more functional test that considers the reasons for this inclusion or exclusion.

B. *Chapter 11 Policy*

Securitization transactions are only able to achieve the foregoing benefits if they can be reconciled with Congress' broad powers to reshape contracts and property rights under the Bankruptcy Code.[33] The foundations of securitizations push up against Congress' power and policy in ways that keep originators from realizing the full benefits of securitizing their assets.

In particular, it is often argued – perhaps most vocally by debtors' counsel – that "the paramount policy and goal of Chapter 11, to which all other bankruptcy policies are subordinated, is the rehabilitation

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[33] *See* Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 192 (1902) (upholding Bankruptcy Act of 1898 against constitutional challenges); *see also* SEC v. Albert & Maguire Sec. Co., 378 F. Supp. 906, 912 (E.D. Pa. 1974) ("[U]nder its bankruptcy power, Congress may so legislate as to affect, modify or perhaps destroy vested rights. The test is whether the Congressional solution is so 'grossly arbitrary and unreasonable as to be incompatible with fundamental law.'").

of the debtor."[34] And the purpose of rehabilitation is often said to include protection of jobs and avoidance of economic disruption.[35] In short, whether good or bad, it is generally agreed that chapter 11 as currently enacted encourages the reorganization of firms as a distinct good, perhaps even when reorganizing the firm may conflict with the goal of maximizing distributions to creditors.[36]

In addition, chapter 11 reorganization is typically seen as a collective process, that will only work if all parties are compelled to

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[34] In re Ionosphere Clubs Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989); *see also* United States v. Whiting Pools, Inc., 462 U.S. 198, 204 (1983); Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 422-23 (1972) ("In contradistinction to a bankruptcy proceeding where liquidation of a corporation and distribution of its assets is the goal, a Chapter X proceeding is for the purposes of rehabilitating the corporation and reorganizing it.").

[35] In re Pac. Gas & Elec. Co, 2002 U.S. Dist. LEXIS 16449 (N.D. Cal. Aug. 30, 2002); In re Teligent, Inc., 282 B.R. 765 (Bankr. S.D.N.Y. 2002); Note, *A Case for the Use of a Broad Court Equity Power to Facilitate Chapter 11 Reorganization*, 12 Bank. Dev. J. 775 (1996).

[36] *See, e.g.*, Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775, 788 (1987) ("Congress intended bankruptcy law to address concerns broader than the immediate problems of debtors and their identified creditors; they indicate clear recognition of the larger implications of a debtor's wide-spread default and the consequences of permitting a few creditors to force a business to close.").

participate in a single forum.[37] Bankruptcy, and chapter 11 in particular, replaces creditors' individual rights with a collective regime, but that regime only works if it is mandatory and all-inclusive. This conception of bankruptcy as a solution to a common pool problem lends itself to arguments that chapter 11's goals will only be served by compelling all creditors to participate in the debtor's reorganization.[38]

These two basic chapter 11 policies are in obvious tension with the existence of securitization. A broad commitment to reorganization of most, if not all, corporate debtors will often require resort to the equitable powers, despite the formal structures of state or federal debtor-creditor law. Consider, for example, the frequent use of the

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37 Public Service Company of New Hampshire v New Hampshire (In re Public Serv Co), 108 BR 854, 890 (Bankr. D.N.H. 1989); Douglas G. Baird & Thomas H. Jackson*, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97, 107 (1984); Lynn M. LoPucki, *Strange Visions in a Strange World: A Reply to Professors Bradley and Rosenzweig,* 91 Mich. L. Rev. 79 (1992); David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory,* 1993 WIS. L. REV. 465, 492.

38 *See* Thomas H. Jackson, Avoiding Powers in Bankruptcy, 36 Stan. L. Rev. 725, 728 (1984) ("Bankruptcy law is designed to assure that the asset 'pie' is as large as possible, given a set of relative entitlements."); *see also* T. Jackson, The Logic and Limits of Bankruptcy Law 17 (1986).

"necessity of payment" doctrine,[39] which allows the debtor to pay select pre-petition unsecured creditors – in full and before confirmation of a plan – to secure supplies or services necessary to a successful reorganization, notwithstanding that such payments plainly violate the absolute priority rule.[40] More directly, the *LTV* court's decision to allow the debtor to use cash that was formally the property of a non-debtor entity to avoid the possibility of a complete shutdown of the debtor's operations illustrates the risks to securitization inherent in a strong commitment to reorganization.[41]

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39 *See* In re Just for Feet, Inc., 242 B.R. 821, 825 (D. Del. 1999) ("[C]ourts have used their equitable power under section 105(a) . . . to authorize the payment of pre-petition claims when such payment is deemed necessary to the survival of a debtor in a chapter 11 reorganization.").

40 Stephen J. Lubben, *Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory*, 106 DICK. L. REV. 267, n.128 (2001) (citing recent examples) [hereinafter, Lubben, *Some Realism*].

41 In re LTV Steel Co., 274 B.R. 278 (Bankr. N.D. Ohio 2001). LTV Steel Company, Inc. ("LTV") and certain of its affiliates filed voluntary Chapter 11petitions in the United States Bankruptcy Court for the Northern District of Ohio on December 29, 2000. With its bankruptcy petition, LTV launched a broadside attack on its SPVs and the concept of securitization in general. For example, in its "first day" motion to authorize the use of proceeds in the SPVs, LTV argued that

> [T]hrough a bewildering and complex array of documents, and through the establishment of the SPVs (which have no real function), the Lenders have conjured the illusion that the Debtors do not own their inventory, do not own their accounts, and are not in the

A belief that chapter 11 works best with the maximum number of participants feeds this trend by encouraging courts to define broadly the scope of the debtor's estate[42] and prevent attempts to opt out of chapter 11 by contract.[43] Taken together, a strong preference for reorganization of all debtors, combined with a belief that chapter 11

> business of manufacturing and selling steel products.... The Lenders' complex documents and legal constructs are designed to create the appearance of a daily "arms-length sale" of all the Debtors' current business assets (inventory and proceeds in the form of accounts) to the Inventory SPV and the further "arms-length sale" of the Debtors' accounts from the Inventory SPV to the accounts SPV. The purpose of this fiction is obvious: to remove all of the Debtors' current assets from the jurisdiction of the Bankruptcy Court, to deprive the Debtors' 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.

Motion by Debtors/D.I.P. for (1) Order Granting Interim Authority to Use Cash Collateral and (2) Scheduling and Establishing Deadlines Relating to a Final Hearing. Memorandum of Points and Authorities and Affidavits of John Delmore and James W. Croll in Support Thereof (on file with author).

[42] *See Octagon Gas Systems v. Rimmer*, 995 F.2d 948 (10th Cir. 1993) (holding that accounts sold by the debtor before its bankruptcy were includable in debtor's bankruptcy estate).

[43] *See* Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 Cornell L. Rev. 301, 305 (1997) ("Although there is little case law on this question, courts seem to accept, almost as a matter of faith, that commercial agreements waiving the right to file for bankruptcy are unenforceable."). *Contra* Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 Yale L.J. 317, 334 (1999) (arguing that the degree to which bankruptcy contracts are void has been overstated).

should mandate full participation in the debtor's reorganization, runs against the basic idea that securitizations can produce cost savings by removing some assets – sometimes vital assets – from the scope of the originator's chapter 11 case. In light of this tension, it is hardly surprising that the securitization industry sought to shore up the foundations of its favored form of financing.

C. *Proposed Section 912*

Former Section 912 of the still pending Bankruptcy Reform Act contained a safe harbor for most securitizations, which would have been inserted in Bankruptcy Code § 541, providing that once "eligible assets" are transferred to an "eligible entity" as part of an "asset-backed securitization," these assets would not be property of the debtor's chapter 11 estate.[44] They key to the provision was the definition of an "asset-backed securitization" as a transaction that had been "rated investment grade by one or more nationally recognized securities rating organizations, when the securities were initially issued by an issuer." The provision

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[44] *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, H.R. 333, 107th Cong. 912 (2001). As noted, the provision has since been deleted from both the House and Senate bills.

quickly died when several academics asserted that enactment of the measure would enable the next Enron and, citing the broad chapter 11 policies discussed above, argued that it would "render impossible untold corporate reorganizations that would save jobs and would give most creditors a much higher return from a company in financial trouble."[45]

While the general idea of bringing more certainty to securitizations and their relationship to chapter 11 is at the heart of this article, section 912 was an unfortunate way to achieve this goal. First, the notion the rating agencies should determine what constitutes a true securitization introduces the potential for circularity into the process. At present, rating agencies reach their conclusions by consideration of relevant law.[46] If the agencies' rating decisions are themselves the source of substantive law, the potential for abuse becomes acute. At the extreme, it might have resulted that the definition of an "asset-backed securitization" for purposes of the Bankruptcy Code would have meant

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[45] Letter from Alan Axelrod, Professor Emeritus, Rutgers School of Law, Newark, et al. to Senator Patrick Leahy and Congressman F. James Sensenbrenner, dated Jan. 23, 2002 (available at www.abiworld.org/resources/research/letter1.html).

[46] *See*, *supra* note ___.

any transaction in which the originator that pays the rating agency a fee of $ *x*, where *x* increases with every increase in the grade of the rating.[47]

Second, section 912 would have protected transactions that allowed firms to seriously misrepresent their financial condition. For example, one part of section 912 would have sanctioned transactions that *required* the originator to repurchase *all* transferred assets from the SPV at some point in the future. This would have indeed legitimized the kind of "asset parking" schemes that Enron engaged in.

In short, section 912 represented a serious example of industry overreaching, and even those of us who think securitizations are socially desirable should not regret its demise.

D. *The Academic Debate Regarding Securitization*

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[47] The apparent lack of competition in the credit-rating industry simply intensifies these concerns. *See* Michael Schroeder & Gregory Zuckerman, *Regulators to Probe Competitive Practices of Rating Agencies*, Wall St. J., January 27, 2003, at C1. Of course, currently ratings are independent of the fee paid to the rating agency. *See* Steven L. Schwarcz*, Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. Ill. L. Rev. 1, 16 & 16 n.96 (observing that the amount of the fee is independent of the rating).

As might be expected, the academic debate surrounding securitization intensified with the advent of section 912. At the extremes, some argue that Congress "overacted" when it abandoned section 912,[48] while, at the other extreme, others argue that securitizations only achieve their cost savings by extracting rents from unsecured creditors.[49]

More specifically, the initial critique of securitization is that it allows managers to place assets beyond the reach of creditors. Of course, those assets are exchanged for cash, so the transaction is neutral to the corporation from the perspective of overall assets. The critique is then often refined to suggest that the conversion of assets to cash allows management to misappropriate those assets before the chapter 11 filing.[50]

This refined version of the critique only holds if two assumptions are true. First, we must assume that management is more

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48 Schwarcz, *Impact of Bankruptcy Reform*, *supra* note __, at n.*.

49 Lupica, *Asset Securitization*, *supra* note __, at 598 ("Securitization's structure is designed to divert value away from the originator, in the absence of any compensating controls on either the consideration received in exchange for the asset sale, or the debtor's behavior. The originator enjoys the benefits of this distributional inefficiency, at the expense of its unsecured creditors.").

50 *Id.* at 625.

likely to waste the proceeds of a securitization than any other form of financing, otherwise the critique is just a general complaint about managerial behavior on the verge of insolvency. The latter could be corrected by a more animated enforcement of management's fiduciary duties to creditors when the firm approaches insolvency.[51] Second, we must assume that this management misbehavior outweighs the benefits to a firm on the brink of insolvency, such as the liquidity a securitization might bring.[52] Some small degree of management self-compensation is probably tolerable if it comes hand-in-hand with saving a greater number of firms (and those firms' creditors) from unneeded chapter 11 cases.

This debate has also been informed by the boarder debate concerning the privileged statutes of secured debt. Specifically, Professors Fried and Bebchuk argue that the presence of "non-adjusting creditors"– creditors who do not adjust interest rates in response to a debtor's encumbering its assets – suggests that secured debt may redistribute

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[51] *Cf.* Off. Comm. of Unsecured Creditors v. Lafferty & Co., Inc., 267 F.3d 340, 350-51 (3d Cir. 2001); LaSalle National Bank v. Perelman, 82 F. Supp. 2d 279 (D. Del. 2000).

[52] *Cf.* Lupica, *Asset Securitization*, *supra* note __, at 609-10.

wealth from unsecured creditors to secured creditors.[53] The extent to which non-adjusting creditors actually exist is a matter of debate. Sophisticated unsecured creditors, such as bondholders and banks, can undoubtedly predict such behavior and price or contract against this risk *ex ante*.[54] Moreover, even relatively unsophisticated players, such as trade creditors, may not be non-adjusting creditors to the extent they typically lend on a short-term basis.[55] These creditors may not anticipate the debtor's secured borrowing *ex ante*, but once it occurs they should be able to price it within short order. This is especially true in the securitizations context – since securitizations are typically used by larger firms,[56] save for

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53 Lucian Ayre Bebchuk & Jesse M. Fried, The Uneasy Case for the Priority of Secured Claims in Bankruptcy, 105 Yale L.J. 857, 882 (1996).

54 *See* Ngo, *supra* note __, at 436.

55 *See* Lubben, *Some Realism*, *supra* note __, at ___ (discussing the mointoring role trade creditors play in distressed firms).

56 Larger firms would be more likely to absorb the fixed costs associated with the commencement of a securitization transaction. *See* Schwarcz, *Alchemy*, *supra* note __, at 139 ("[P]ublic securitization is rarely cost effective for transactions of less than $ 50 million and is more common for transactions in the $ 100 million or higher range.").

the occasional (multi-millionaire) rock star[57] – where a number of the trade creditors are likely to be other, large corporations. In effect, the most likely potential "victims" of secured debt, and securitizations, are involuntary creditors.[58]

Of course, unpaid creditors, particularly unpaid involuntary creditors who can never price the risk of non-payment *ex ante*, are one of the harsh realities of limited liability in all contexts.[59] Its not clear that securitization changes this reality in any meaningful way – a point that also holds with respect to voluntary non-adjusting creditors.

In short, securitizations involve some cost-shifting from securitization creditors to unsecured creditors, including costs associated with shifting risks, but no more cost shifting than unsecured creditors

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57 *See* Adam Grant, Note, *Ziggy Stardust Reborn: A Proposed Modification of the Bowie Bond*, 22 Cardozo L. Rev. 1291 (2001) (discussing David Bowie's securitization of his royalty payments); Teresa N. Kerr, Comment, *Bowie Bonding in the Music Biz: Will Music Royalty Securitization be the Key to the Gold for Music Industry Participants?*, 7 UCLA Ent. L. Rev. 367 (2000) (same).

58 *See generally*, Lynn Lopucki, *The Death of Liability*, 106 Yale L. J. 1 (1996).

59 *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 Yale L.J. 1879, 1894-95 (1991).

already face,[60] and some of securitization's champions have even argued that securitization involves less cost shifting and perhaps even benefits unsecured creditors.[61] With or without securitization, voluntary unsecured creditors always face the risk that debtors will change the form of the debtor's assets or increase the variance associated with those assets. Unsecured creditors also face the risk of claim dilution resulting from the debtor's decision to take on more leverage.[62] When a firm sells unsecured debt, the price of that debt necessarily includes assumptions about losses that could be incurred if additional debt of equal or higher priority is issued or if the debtor decides to engage in high variance projects.

But even if all creditors can price a world with securitization (and involuntary creditors are no worse off than before) it

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60 The implicit assumption in this article is that there is little or no "real world" support for efforts to radically change either (a) corporate limited liability or (b) secured lending. If we remove this assumption, and posit a rule that barred sophisticated creditors from transferring risks to less sophisticated creditors – *i.e.*, no shifting costs to other parties without their consent, securitization would inevitably fail. *Cf.* Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 Va. L. Rev. 1887 (1994).

61 *See* Steven L. Schwarcz, *Securitization Post-Enron*, 25 Cardozo L. Rev. – (2004) (forthcoming).

62 *See* Kupetz v. Wolf, 845 F.2d 842, 846 (9th Cir. 1988).

does not necessarily follow that securitizations are socially efficient. It might be that the overall costs to the originator are the same – that is, securitization might simply redistribute the costs without lowering total costs. For example, while there is less need for securitization creditors to monitor the originator's business *ex post*, arguably there is an increased need of other creditors to do so. The resulting increases and decreases in monitoring costs may be a wash.

In such a case the originator has incurred the transaction costs associated with the securitization without receiving any corresponding benefit. If all creditors can price the effects of the securitization, this outcome suggests that securitizations are nothing more than a way for professionals to extract value from the debtor-originator.

This is also the point where empiricism probably fails to provide clear answers. Marginal interest rates as between securitization and traditional secured financing, or even securitization and risk-free borrowing, are modest under normal circumstances.[63] Contained within

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[63] *See*, *supra* note ___ and text (citing one industry participant who estimates that the spread between secured loans and securitizations is about 1.5%). Small is, of course, a relative term – when negotiating the loan every basis point counts and 150

this marginal rate are a host of factors – including lenders' estimates of default risk and bankruptcy costs, the likelihood and extent to which the debtor will engage in activities to increase the variance of its enterprise or dilute the lender's claim, the gains from shifting risks to less savvy creditors, and the excess amount which a lender can charge because no real loan market is perfectly competitive – so that it may be impossible to attribute the spread to any particular element. Moreover, lenders, even sophisticated lenders, probably price these factors in the aggregate rather than individually.

The choice between a world with securitization (and traditional secured financing) and one without then turns on our intuitive sense of whether these types of financing do something more than shift risks and costs among creditors. Because I believe that the real world is made up of exceedingly heterogenous investors, and that partitioning the firm can sometimes help a debtor capture various clientele effects, I answer the question in the affirmative.

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basis points covers enough ground to kill a deal.

Furthermore, while the trend has been to compare securitizations to secured loans, the more salient comparison might be to a sale of the assets to a third party for cash. For the most part, if a corporation sells its key plant to an independent corporation, in an arms-length transaction for cash, we will not disturb that transaction even if the selling corporation latter becomes insolvent.

But we will disturb the transaction in certain, special circumstances. For example, if transaction does not result in the exchange of "reasonably equivalent value," it may be voidable by the harmed corporation or its creditors.[64] This is basic fraudulent transfer law, which protects creditors against an *ex post* change in the terms of their deal – a change that none would likely have agreed to *ex ante*. More succinctly, fraudulent transfer law protects against borrowers deceptively (fraudulently) changing their asset position after an obligation has been

[64] Uniform Fraudulent Transfer Act § 4; § 5.

incurred. Veil piercing and equitable subordination law serve similar purposes.[65]

Is there any reason to treat a securitization transaction differently solely because the asset sale is typically to a related corporation, the SPV? If not, what does non-securitization law tell us about how to distinguish which securitizations should be folded into the chapter 11 process? These two questions animate the remainder of this article.

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65 *See, e.g.*, Browning-Ferris Industries of Illinois, Inc. v. Ter Maat, 195 F.3d 953, 959-60 (7th Cir. 1999) ("In the case of a voluntary creditor, for example someone who had lent money to the corporation, the strongest case for piercing the veil is presented when the corporation had led potential creditors to believe that it was more solvent than it really was.").

II. *Drawing Lines*

I start with the basic premise that Congress could include or exclude a wide range of parties in the chapter 11 process.[66] Merely stating that a particular party is a creditor or a shareholder does not answer the fundamental question of why that party should be compelled to participate in the debtor's chapter 11 case. Determining inclusion by whether a not a party has a claim against the debtor's assets on the date of filing also does not answer the question – since we already recognize that in some instances transactions that have seemingly been completed will be reversed for purposes of the chapter 11 case.[67]

Moreover, a "creditor" for purposes of the Bankruptcy Code is simply a party with a "claim,"[68] which is already broadly defined

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66 *Accord* Frost, *Asset Securitization*, *supra* note __, at 111 ("The sale/finance dichotomy and the substantive consolidation concerns emphasized by commentators are directed toward resolving the persistent problem of defining the boundaries of the bankruptcy estate. Any coherent system of property that includes the concept of debt must devise some method of including and excluding property subject to creditors claims.").

67 *See* 11 U.S.C. § 547 (providing for the reversal of certain payments made withing 90 or 180 days of the filing); 11 U.S.C. § 548 (providing for the avoidance of fraudulent transfers).

68 11 U.S.C. §101(10).

to include any right to payment, no matter how contingent or remote.[69] Arguably, Congress could choose to include a wider range of parties within the debtor's bankruptcy estate by expanding the definition of "claim," subject only to the far outer limits of Congress' power under the Bankruptcy Clause and perhaps, in the case of secured creditors, the constitutional limits on takings.[70]

For example, a corporate reorganization could proceed on the basis that all of the debtor's business transactions within some period of time before the bankruptcy, perhaps a year, are subject to review by the bankruptcy court and possible readjustment. All transactions that were deemed to be "unwise" would be reversed and the counter-party to the transaction would take its place among the firm's "creditors" who would be compelled to participate in the firm's chapter 11 case. This approach

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69 11 U.S.C. §101(5).

70 *But see* James Stevens Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 Harv. L. Rev. 973, 979 (1983) ("[M]any possible proposals for amending the present reorganization provisions will be doomed from the outset by the assumption that the proper treatment of secured creditors' rights in reorganization is dictated by constitutional requirements rather than by policy considerations that are within the discretion of Congress.").

would be highly paternalistic – it would protect creditors and shareholders against management's ill-considered business decisions – and would therefore have obvious harmful effects, especially since it might discourage contacts with distressed firms. But there is no reason Congress could not decide to discount these harmful effects to favor a robust form of the debtor rehabilitation policy discussed above.

In short, deciding whether or not a party is a "creditor" for purposes of chapter 11 requires the use of a line-drawing tool, at least at the margins. The "true sale" analysis purports to provide such a tool, but it does not provide a very good tool in the context of securitizations.

As noted earlier, while the notion of true sale is the single most important issue in determining the characterization of a securitization, there is no single, concrete definition of "true sale." In determining whether a true sale has occurred, courts often look to the parties and the true nature of the transaction, and consider factors such as the amount of recourse to the transferor, whether or not the seller retains any rights in the assets, and the relationship between the fair value of the assets and the price paid.

But these factors are highly contextual.[71] Recourse arguably is of no import if the selling firm receives additional consideration from the buyer in exchange for the right to return the asset. Recourse is only a problem when it means that the seller is insuring the buyer's return on the transferred asset and the buyer has not paid any consideration for that insurance. Similarly, if the seller has reduced the sale price in exchange for certain rights in the asset after the sale (*e.g.*, an easement in real property) the selling corporation has not changed, it has simply repackaged its assets in new forms. Where once the selling-firm owned land, it now owns cash and a right to enter onto the land. Even considering the purchase price in relation to the asset transferred seems to serve little purpose, beyond what is already addressed by fraudulent transfer law.[72]

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71 Courts have made similar observations with respect to the substantive consolidation part of the analysis. Central Claims Servs., Inc. v. Eagle- Picher Ind., Inc. (In re Eagle-Picher Ind., Inc.), 192 B.R. 903, 905 (Bankr. S.D. Ohio 1996) ("Because the cases so much turn on their individual facts, we find that the lists presented by the several courts in their decisions, of factors which must be present in order to determine the issue of substantive consolidation, are of limited use").

72 *Cf.* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 Vand. L. Rev. 829, 837 (1985).

Long lists of factors like these, comprising the primordial goo of some ill-explained balancing test, inevitably cost borrowers more *ex ante*, and add to the cost and length of a debtor chapter 11 case *ex post*. In the securitization context, additional legal certainty would provide greater assurance that the bankruptcy of the seller will not affect the securitization transaction, thus reducing the costs of securitizations to originators.

Plainly there has to be some way to filter out the "good" securitizations from the "bad." Section 912, if it is ever enacted, simply avoids this issue by adoption of a sort of hyper-formality: if it's called a securitization, it will be treated as a securitization. As Enron has shown, simply because a firm calls it a securitization does not mean it is not simply a way to hide liabilities or underperforming assets by putting them in some other entity's name.[73]

Instead of vague, multi-factor tests derived from other, marginally relevant areas of the law, both chapter 11 policy and the parties

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[73] Indeed, most of the Enron transactions were not securitizations at all. *See, e.g.*, Steven L. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. Cin. L. Rev. 1309 (2002).

to securitizations would be better served by a more functional test that considers the reasons for inclusion or exclusion of an asset in a debtor's estate. Specifically, an asset should be included in an estate when its removal from the debtor's balance sheet was done in a way that triggers concerns about misrepresentation of the firm's overall financial situation or the transfer of the asset is of the kind that no reasonable creditor would have agreed to allow *ex ante*. If a reasonably sophisticated unsecured creditor would have been mislead by the failure to include a particular transaction on the balance sheet, the securitization is inherently suspect.[74]

For example, if a trade creditor could not know that a sale of an asset to an SPV was accompanied by a swap which left the originator with all or much of the risk associated with that asset, so that the originator's assets were subject to greater burdens than apparent, the securitization should become part of the originator-debtor's estate, to be administered as part of the larger reorganization. If, however, the originator was paid for all risks it took with regard to the securitization,

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[74] By phrasing the test in terms of a hypothetical creditor, it also works to provide some protection to involuntary creditors, despite the lack of true reliance.

and a reasonably sophisticated creditor could have learned of those risks with reasonable effort, the transaction should not be disturbed because there is no indication of balance-sheet deception.

Securitizations should also be unwound if the transaction is of the kind that no reasonable creditor would have agreed to allow. For example, a reasonable creditor would anticipate and consent to a transaction in which the debtor transfers assets to an SPV in exchange for cash consideration equal to the fair market value of those assets. Again, this transaction just changes the form of the debtor's assets – and increases the value of the assets in the amount of the marginal difference between the value of cash compared with the value of the transferred assets. But no reasonable creditor would consent to the transfer of assets to an SPV in exchange for nothing more than equity in the SPV and, accordingly, the assets in such a transaction should be administered as part of the debtor-originator's bankruptcy case.[75] Run of the mill securitizations would meet this test, but aggressive uses of securitization structures for purposes other than strait conversion of assets in to cash would not.

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75 *Cf.* In re Bay Plastics, Inc., 187 B.R. 315, 328 (Bankr. C.D.Cal. 1995).

In short, I am urging a functional approach while also making a contracting cost argument. On the one hand, some securitizations really just repackage a debtor's assets and should not be disturbed, but other putative securitizations are deceptive, even fraudulent. Creditors – particularly "non-adjusting" creditors – should not have to protect themselves against this type of balance sheet deception, especially since virtually every creditor would want contractual protection against this sort of deception. The functional approach implies a kind of default term and asks whether that term has been violated.

This functional approach also encourages plain, understandable disclosure of securitization transactions. By phrasing the analysis in terms of what an objective, reasonably sophisticated creditor could have discovered or anticipated, the functional approach will lead participants in a securitization to demand that the originator disclose the key terms of the transaction, to give the SPV's securities added protection against the risk of an originator bankruptcy filing. While some firms already do this,[76] Enron again shows the need for further work in this regard.

The traditional "true sale" factors continue to have some relevance under the functional analysis, inasmuch as they shed some light on the question of whether or not the securitization triggers concerns about misrepresentation of a firm's financial situation or the transfer of the asset is of the kind that no reasonable creditor would have agreed to allow. But the traditional true sale factors are subservient to this larger, functional question and I see no good reason to continue to hide the relevant analysis within the language of "true sale."

Because the functional approach to securitizations represents a reconceptualization of the existing analysis, it does not preclude attempts to unwind a securitization to save an ongoing business. The functional approach simply seeks to clarify and streamline the analysis. This is in clear contrast to proposed section 912 of the

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[76] The Neiman Marcus Group, *2001 Annual Report*, at page 34 (Note 3: Securitization of Credit Card Receivables) (available online at http://media.corporate-ir.net/media_files/NYS/nmg.a/reports/ar01.pdf).

Bankruptcy Reform Act, which represented a clear choice in favor of securitizations and against reorganization – in a broad array of cases.

Conclusion

The question that any critique of securitization has to answer is why sales to SPV should be treated differently from sales to third-parties. Too often, however, the true sale factors seem to move the analysis away from this basic consideration and allow for the consideration of terms that would be of no import in a more traditional sale. With this in mind, I have attempted to present a functional view of the issue, with the aim of refocusing the discussion of the basic question of whether the purported sale of assets as part of a securitization really involves the repackaging of assets with no net effect to creditors (as would be the case in a traditional sale) or whether the transfer is deceptive and therefore unworthy of legal recognition. Under this basic rubric, the certainty the securitization industry seeks can mesh with the policies of chapter 11, without one subsuming the other.