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Asset-Backed Securitization: Is Congressional Intervention Necessary?

by Craig D. Bloom*

INTRODUCTION

Corporations need cash to run their businesses and to invest in projects. Traditionally, they have raised the necessary funds by way of secured and unsecured loans or through the issuance of securities to investors. During the 1970s, the financial markets developed a new way for these corporations to raise capital.

The process, referred to as asset-backed securitization, involves the creation of a "bankruptcy remote" Special Purpose Vehicle ("SPV") that purchases the receivables from the company that originated them (the "Originator"). The bankruptcy remote SPV is structured so that it is unlikely to commence, or have commenced against it, a bankruptcy case. The SPV raises the funds to purchase the receivables by selling securities in the public or private debt securities markets. The entire transaction is structured in a manner that seeks to remove the assets from the estate of the corporation in the event of its bankruptcy.

Banks and other loan facilities are involved in the transaction and assume significant credit risk associated with the receivables. The banks offer third-party credit enhancement to ensure the payment of the securities issued by the SPV. The credit enhancements are usually in the form of a guaranty, surety

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1 "The terms 'securitization,' 'asset-backed securitization,' and 'structured finance' are used interchangeably' to refer "to a company's use of cash flows from its assets to raise funding. The term 'securitization' specifically refers to the issuance of securities backed by such cash flows." Steven L. Schwarz, The Alchemy of Asset Securitization, 1 STAN. J.L. BUS. & FIN. 133, 133 n.1 (1994) [hereinafter Schwarz, Alchemy].


3 Credit enhancement is a method of protecting investors in the event that cash flows from the underlying assets are insufficient to pay the interest and principal due for the security in a timely
bond, letter of credit, or an irrevocable credit line. Credit enhancement is a distinctive feature of asset-backed securitization that occurs "when a security's credit quality is raised above that of the sponsor's unsecured debt or that of the underlying asset pool." In addition, Originators will often offer internal credit enhancements to support the securities. However, as discussed infra, this support must be limited so that the transfer is not characterized as a secured loan transaction.

In order for the SPV to sell securities in the public markets one of the nationally recognized rating agencies must rate the financial instruments based on creditworthiness, probability of default, and the value of any assets or other credit enhancements that support them. Firms want their securities rated highly because that will lead to a lower interest rate and greater returns. To obtain a high rating, the rating agency will want assurance that if the Originator enters bankruptcy, the receivables will not become part of the bankruptcy estate. Of course, if the securities are sold to a private investor, ratings are not always necessary since sophisticated investors themselves can evaluate the risks.

Firms securitize their assets in order to fund special projects or simply for working capital. The objective is to inexpensively turn receivables and other assets into cash that can be used immediately, while at the same time removing the assets from the balance sheet, thus, improving the company's financial ratios. The benefits of asset-backed securitization include improving liquidity, increasing diversification of funding sources, lowering the manner.

See COMPTROLLER OF THE CURITY ADMINISTRATOR OF NATIONAL BANKS, ASSET SECURITIZATION, COMPTROLLER'S HANDBOOK 11 (November 1997).

A guaranty is a promise made by a third party to reimburse a trust for losses up to a stated maximum dollar amount. They can also agree to advance principal and interest as necessary and buy back defaulted loans. A surety bond is an insurance policy provided by a rated and regulated insurance company to reimburse the ABS for any losses incurred. A letter of credit is issued by a financial institution, typically a bank, which is paid a fee to stand by with cash to reimburse the trust for any losses actually incurred, up to the required credit-enhancement amount. See http://www.investinginbonds.com; See Stephen L. Schwarz, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION, at 13 (2d ed. 1993) [hereinafter Schwarz, Structured Finance].


The rating agencies will look at the insulation of the assets from the insolvency of the Originator in determining the rating. See id. at 383-84 (allowing for higher ratings based on creditworthiness of isolated assets not creditworthiness of Originator).

For instance, asset securitization improves a company's return on assets and return on equity by decreasing the firm's assets without increasing its liabilities. Return on assets (net income divided by average total assets) and return on equity (net income divided by average equity) are standard measures of financial performance.
The Journal of International Business & Law

effective interest rate, improving risk management, and achieving accounting-related advantages."

Asset-backed securitization is a practical and advantageous alternative to traditional financing. However, several problems arise in the context of bankruptcy. Section 541(a) of the United States Bankruptcy Code (the "Code") provides that upon the filing of a bankruptcy petition, an estate is created consisting of "all legal or equitable interests of the debtor in property as of the commencement of the case." Therefore, although steps have been taken to keep the assets out of a potential bankruptcy estate, once in bankruptcy, the trustee or debtor-in-possession will attempt to include the assets in the estate by attacking the asset-backed securitization.

This article will begin by describing asset-backed securitization and how it is accomplished, focusing on the steps taken by Originators to remove the assets from the jurisdiction of a Bankruptcy Court. This article will then discuss the benefits of asset-backed securitization from the perspective of the Originator as well as the common attacks against it in the context of bankruptcy. Next, the article will describe recent developments including a controversial court decision and a proposed amendment to the United States Bankruptcy Code. Finally, it will conclude by arguing that the decision by Congress to remove the proposed amendment was appropriate.

I. DESCRIPTION OF ASSET-BACKED SECURITIZATION

Over the past 20 years asset-backed securitization has become a popular financing method for corporations seeking to convert a predictable future income stream into current cash. Also known as structured finance, its purpose is to legally isolate assets from the transferor's potential bankruptcy estate so that the purchaser of securities backed by the assets can rely solely on the creditworthiness of those assets, instead of relying on the company's overall financial strength. It has been defined as:

The 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 the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than

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12 See Lupica, supra note 10, at 605 (stating, "by definition, the process of securitization transforms future payments into instant cash.").
14 See Lupica, supra note 10, at 618 (stating, "by definition, the process of securitization transforms future payments into instant cash); See also Robert Dean Ellis, Securitization Vehicles, Fiduciary Duties, and Bondholders Rights, 24 J. CORP. L. 295, 296 (1999) [hereinafter Ellis] (finding "asset securitization has quite rapidly become a popular form of financing").
15 See Schwarz, Structured Finance, supra note 4, at 16.
ownership interests in and loans against the underlying assets.\textsuperscript{16}

The company seeking financing through securitization, referred to as the Originator, begins by identifying and isolating the pool of assets it will use.\textsuperscript{17} Although, the assets chosen usually consist of the right to payment in the future and are typically referred to as “receivables,” asset-backed securitization can be accomplished through the use of many different types of financial assets.\textsuperscript{18} Most importantly, the pool of assets should have a predictable stream of income.\textsuperscript{19} A more predictable income stream will lead to a higher rating for the securities and provide a greater return for the Originator.\textsuperscript{20}

In order to securitize the assets, the Originator will utilize SPVs, through which it will complete the financing transactions.\textsuperscript{21} SPVs can be formed as several different types of legal entities, such as a corporation or a trust.\textsuperscript{22} Typically, the SPV will have just been created so that it has no claims against it.\textsuperscript{23} During the SPV’s formation stage the Originator will take the steps necessary to ensure the SPV is unlikely to voluntarily file for bankruptcy or have an involuntary bankruptcy petition filed against it.\textsuperscript{24} In addition, steps will


\textsuperscript{17} See Peter J. Lahny IV, Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation, 9 AM. BANKR. INST. L. REV. 815, 829 (2001) (describing a prototypical securitization transaction) [hereinafter Lahny].

\textsuperscript{18} See Committee, supra note 2, 532 (noting, “the assets that can be securitized through structured financings are virtually limitless.”).

\textsuperscript{19} Id. (stating, “the cash flow or liquidation value of the assets must be predictable. Unless cash flow or liquidation value can be predicted reliably, the securities that can be supported by the assets cannot be determined ... this predictability is at the heart of the evaluation by the rating agencies.”);

\textsuperscript{20} See Teresa N. Kerr, 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, 372 (2000) (explaining “if the payments on the assets are predictable, the assets will receive a higher valuation from the ‘rating agencies.’”); Committee, supra note 2, at 532 (discussing the importance of predictability in evaluation by rating agencies).

\textsuperscript{21} See Committee, supra note 2, at 553-54 (discussing the formation of special purpose vehicles).

\textsuperscript{22} See Id. at 568 (asserting, “the first fundamental structural variation occurs in the legal form of the special purpose vehicle or special purpose vehicles used to effectuate a structured financing ... commonly used forms include the corporation, grantor trust and owner trust. Less commonly used are business cooperatives, limited partnerships and limited liability companies.”)

\textsuperscript{23} See Committee, supra note 2 (stating, “The SPV is typically a newly created entity with no prior business activities that could have given rise to preexisting creditors, or potential tort, environmental or other claims.”)

\textsuperscript{24} See Ellis, supra note 14, at 307 (explaining that firms can minimize the likelihood of involuntary petitions through contractual covenants and prohibiting the SPV to have unsecured creditors).
be taken to keep the assets out of the estate of an Originator in the event of its own bankruptcy.\textsuperscript{25}

Originators have the option to create their own SPV or to use an existing SPV known as a “multi-seller securitization conduit.”\textsuperscript{26} Multi-seller securitization conduits allow Originators to minimize their transaction costs by selling their receivables to a single pre-existing SPV.\textsuperscript{27} Commercial and investment banks usually administer such conduits in order to achieve economies of scale by allowing multiple Originators to sell receivables to a pre-existing SPV.\textsuperscript{28}

Originators that choose to create their own SPVs, instead of using a multi-seller securitization conduit, can structure them in a various ways.\textsuperscript{29} Generally, the Originator will use what is known as a “one-off” structure, through which it will offer securities to investors publicly or through private placement.\textsuperscript{30} One-off structures involve high transaction costs because the SPVs are created for that one particular transaction.\textsuperscript{31} Furthermore, it is usually necessary for a third party “credit enhancement facility” such as a bank or surety company to guarantee the repayment of securities issued in a one-off securitization structure, thus adding to the transaction costs.\textsuperscript{32}

The most commonly used one-off structures utilize two-tiers of SPVs in order to protect investors from the risk of the Originators bankruptcy and in turn lower their own cost of capital.\textsuperscript{33} Using this method, the Originator will transfer receivables to a wholly owned first-tier SPV (“SPV1”) in a transaction that constitutes a “true sale”\textsuperscript{34} for bankruptcy purposes.\textsuperscript{35} Next, SPV1 will

\textsuperscript{25} See Lupica, supra note 10, at 618 (stating in bankruptcy remote structure assets are removed from purview of Originator’s Trustee in bankruptcy); See also Committee, supra note 6, at 536 (stating the structured financing market understands that “bankruptcy remote” does not mean “bankruptcy proof”).

\textsuperscript{26} See Schwarcz, Alchemy, supra note 1, at 140 (“A ‘multiseller securitization conduit’ offers Originators the opportunity to minimize their transaction costs by utilizing a common SPV.”).

\textsuperscript{27} Id. at 140 (stating “these conduits are typically administered by commercial or investment banks and are able to achieve a transaction cost economy of scale by allowing multiple Originators to sell receivable to a single pre-existing SPV.”).

\textsuperscript{28} See Adam Grant, Ziggy Stardust Reborn: A Proposed Modification of the Bowie Bond, 22 CARDOZO L. REV. 1291, 1310 (2001) (stating “the primary benefit of multi-seller securitization conduit is that it allows Originators who would not traditionally be able to afford the transaction costs of one-off securitizations to engage in securitization.”).

\textsuperscript{29} See Schwarcz, Alchemy, supra note 1, at 138 (describing “one-off” securitization structures).

\textsuperscript{30} Id.

\textsuperscript{31} Id.

\textsuperscript{32} Id. at 139.

\textsuperscript{33} See Committee, supra note 2, at 573 (asserting, “[a] widely used method of providing investor protection in a structured financing while retaining structural integrity involves the use of two or more special purpose entities in a ‘multi-tier’ structure.”); Schwarcz, Alchemy, supra note 1, at 142 (stating bankruptcy risk is minimized by use of a two tier structure).

\textsuperscript{34} See notes 94 - 116, infra for a discussion on what constitutes a “true sale.”

\textsuperscript{35} See Dawson, supra note 7, at 388 (stating, “to avoid the risk that bankruptcy may cause a court to deem some or all of the assets transferred to the intermediate SPV to be part of the transferor’s bankruptcy estate, ... each transfer should be structured as a ‘true sale.’”); Schwarcz, Alchemy, supra note 1, at 142 (asserting bankruptcy risk is minimized by selling receivables to a wholly owned SPV in a transaction constituting a “true sale”).
transfer the assets to a second-tier SPV ("SPV2") in a transaction that constitutes a sale for accounting purposes. SPV2 will then sell the securities to investors backed by the assets to pay the Originator. After SPV2 has paid off the securities to the investors it will transfer back any remaining receivables and collections to SPV1. SPV1 will then transfer the funds back to the Originator as dividends or simply be merged into the Originator.

The "true sale" nature of the transfer from the Originator to SPV1 insulates the assets from the Originator's possible bankruptcy and the risk the assets will be subject to an automatic stay. The transfer from SPV1 to SPV2 allows SPV1 to provide an "internal credit enhancement" to the investors at the SPV2 level through the retention of a subordinated interest in the assets. Subordinated interests protect senior classes by absorbing defaults before the senior position's cash flows are disrupted.

During its formation, the Originator will take the necessary steps to make the SPVs "bankruptcy remote." The charter and by-laws of the SPV will contain restrictions on its business activities. The SPVs will be prohibited from incurring additional debt beyond that of the asset-backed securities and obligations to credit enhancers and liquidity providers. Restricting the SPVs' business activities and allowing it to only incur debt necessary or incidental to the financing will limit the amount of creditors and the potential for an involuntary bankruptcy petition to be filed. Further, language will be included restricting the SPVs' ability to subject the securitized assets to voluntary liens.

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36 See Dawson, supra note 7, at 400 (stating, "[a] true sale of an asset is a transfer that is effective against the transferor, its creditors, its regulator, its liquidator or receiver, and can be enforced against the borrower... such a transfer legally separates the credit risk of the assets from that of the transferor."); Committee, supra note 2, at 573 (stating, "the transfer of those assets from SPV1 to SPV2 will be an accounting sale, but not a true sale, and forms the basis for a financing with a commercially acceptable level of credit enhancement.").
37 See Id.
38 Id.
39 See Schwarz, Alchemy, supra note 1, at 142.
40 See Committee, supra note 2, at 542.
41 See Committee, supra note 2, at 573 (maintaining if transfers are properly structured an acceptable level of credit enhancement will be formed).
42 See Schwarz, Structured Finance, supra note 4, at 614 (stating, "this limitation normally is accomplished by drafting the SPVs charter or articles of incorporation or other organizational documents...").
43 See Committee, supra note 2, at 554 (noting that debt of the SPV is limited to asset-backed securities, obligations to credit enhancers and liquidity providers); See Dawson, supra note 7, at 392 (stating that "the entity should be restricted from incurring additional debt.").
44 See Id., at 554 (stating, "the activities of an SPV are restricted to those necessary or incidental to the filing."); Schwarz, Alchemy, supra note 1, at 135 (reasoning by limiting SPV's business activities prevent creditors from having claims against SPV).
45 See Committee, supra note 2, at 555 (stating that "the constituent documents typically provide that the securitized assets cannot be subject to a voluntary lien or security interest in favor of anyone other than the holders of the asset-backed securities, except to the extent those assets are permitted to be pledged to a provider of credit enhancement or liquidity support.").
It has been held to be against public policy to completely prohibit an SPV from filing a voluntary bankruptcy petition. However, the Originator can take steps to restrict the SPVs’ ability to file for bankruptcy protection. The SPVs’ articles of incorporation will contain a provision requiring a unanimous vote by the board of directors to file a voluntary bankruptcy petition. The SPVs will have at least one “independent director” on the board of directors in order to minimize the possibility that the Originator, for its own purposes, can influence the board of an SPV to file for bankruptcy. However, this technique is not a guarantee that an SPV will never file a voluntary bankruptcy petition because the fiduciary duties of all the directors includes creditors as an entity approaches insolvency.

The Originator will also take certain steps to reduce the risk of the SPVs being forced into bankruptcy by the filing of an involuntary bankruptcy petition. One safeguard is to make sure the SPVs are sufficiently funded so that they can meet obligations to creditors as they come due. In addition, the Originator may be able to reduce this risk through contractual agreements.

The transfer of the assets from the Originator to SPV 1 will typically be in the contractual form of an absolute assignment. The objective is to fully

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46 See Ellis, supra note 14, at 307 (stating “as a general principle, waivers or prohibitions on bankruptcy petitions are void as a matter of public policy.”).

47 Id. at 309 (stating “the charter restrictions in a typical securitization expressly negate the boards discretion to file a bankruptcy petition.”).

48 See Committee, supra note 2, at 555 (stating “a super-majority vote, necessarily including all or at least one of the independent directors, is required in order for the board of directors to approve a voluntary bankruptcy.”).

49 See James F. Penrose, Special-Purpose Entities in Project Finance Transactions, S&P STRUCTURED FINANCE, Nov. 1995, at 73 (“‘Independent Director’ means a duly appointed member of the board of directors, who shall not have been, at the time of such appointment or at any time in the preceding five years, (a) a direct or indirect legal or beneficial owner, (b) a creditor, supplier, employee, officer, director, family member, manager, or contractor of such entity or one of its affiliates.”).

50 See Ellis, supra note 14, at 308 (stating “the real issues that need to be addressed are opportunistic insolvency petitions that come about when the issuer’s management seeks to benefit itself, or some other interest group, through the reorganization process ... to deal with this problem, securitizations rely on the form of the issuer to reduce the likelihood of a voluntary petition.”).

51 See In re Kingston Square Assocs., 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997) (asserting “it is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors fiduciary duties expand to include general creditors.”).

52 See 11 U.S.C. 303(b) (2003) (allowing for an involuntary bankruptcy petition); See also Committee, supra note 2, at 557 (explaining “structuring can be done to reduce the likelihood of involuntary bankruptcy.”).

53 See Lahny, supra note 17, at 837 (asserting, “the Originator should be sure that the SPV is properly funded to eliminate foreseeable obligations as they come due for payment.”).

54 See Committee, supra note 2, at 558 (stating, “in order to substantially reduce the risk of an involuntary filing, all or most of the consensual creditors of the SPV may be required to sign an agreement not to file an involuntary bankruptcy case against the SPV until at least 366 days after the asset backed securities have been paid.”), Dawson, supra note 7, at 393 (stating, the transaction documents should contain a covenant preventing the parties from filing, instigating or joining in any involuntary bankruptcy proceeding against the entity so long as the rated securities are outstanding.”).

55 See Committee, supra note 2, at 533.
remove the assets from the ownership of the Originator to the SPV in what constitutes a "true sale." However, whether the transfer is a "true sale" is not determined by the intent of the parties, but upon a judicial characterization of the transaction.

After the SPVs have been properly structured and the assets transferred, the SPV’s interest will be perfected by the filing of a U.C.C.-1 statement. The purpose of perfection is to “place third parties on notice of the transfer of the interest in the receivables, so they will not be misled when extending credit to or otherwise dealing with the Originator.”

II. THE BENEFITS OF ASSET-BACKED SECURITIZATION

Rather than relying on an erratic payment stream of receivables, businesses prefer having cash up front for use in research and development and payment of dividends to shareholders. Asset-backed securitization improves a firm’s overall liquidity. Liquidity enables the firm to pursue long-term investment opportunities and meet current payment obligations, while increasing overall creditworthiness. In addition, the increase in cash flow provides the firm with a significant competitive advantage.

Asset-backed securitization provides firms with access to lower cost debt by structuring the transactions so that the securitized assets are “bankruptcy remote.” Assets are bankruptcy remote when they are held by an entity that is unlikely to become insolvent or be subject to claims by creditors. Therefore, in a properly structured asset-backed securitization, the assets transferred by the Originator to the SPV and used to back the securities will not be deemed part of the Originator’s bankruptcy estate should a petition be filed. Bankruptcy remoteness allows rating agencies to consider only the character and quality of the underlying asset or payment stream, rather than examining the Originator for...

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56 Id.
57 See Jeffrey E. Bjork, Seeking Predictability in Bankruptcy: An Alternative to Judicial Recharacterization in Structured Financing, 14 BANK. DEV. J. 119, 124 (1997) [hereinafter Bjork] (stating, “A true sale, in reality, is more a product of judicial characterization of a transaction than it is an intended creation between the seller and as SPV.”); See also Discussion infra notes 94 - 116.
58 See Schwarcz, Structured Finance, supra note 4, at 37.
59 Id.
61 See Committee, supra note 2, at 531 (noting, “structured financings of receivables also can accelerate the receipt of cash flows, allowing the quicker redeployment of the proceeds of those assets.”); Lupica, supra note 10, at 609 (stating, “all Originators who securitize their assets enjoy an improvement in asset liquidity management.”).
62 See Lupica, supra note 10, at 610 (stating, “the transformation of a future payment stream into immediate cash may further enable an Originator to pursue a potentially profitable project or merely meet its regular obligations.”).
63 See Committee, supra note 2, at 530 (stating, “one of the principal benefits from structured financings is a reduction in the cost of financing.”).
65 See discussion infra notes 94 - 116 and accompanying text.
its creditworthiness. This financing structure removes some risk for the investors, leading to higher ratings from the agencies for securities issued by the SPV rather than the Originator.

Asset-backed securitization also provides firms with advantages through its treatment by accounting rules as compared with other forms of financing. A transfer with recourse is one in which the Originator agrees to either repurchase defaulting loans or compensate the SPV for any losses caused by defaulting loans. A transfer without recourse is a transfer in which the Originator gives up the option to repurchase the receivables at a later date. Under the Generally Accepted Accounting Principles (GAAP), a transfer of assets in connection with a structured finance transaction is treated as a sale so long as the transfer is made without "recourse." Therefore, the off-balance sheet nature of the sale will benefit the firm by improving its financial ratios.

III. BANKRUPTCY ATTACKS ON ASSET-BACKED SECURITIZATION

Rating agencies give high ratings to asset-backed securities issued by SPVs because of the many steps taken to separate the assets from the bankruptcy estate of the Originator. However, if the Originator ultimately does wind up in bankruptcy, the Creditors, trustee or debtor-in-possession may attempt to attack the securitization transaction and include the assets in the bankruptcy estate.

There are four common types of bankruptcy attacks on the asset transfer in an asset-backed securitization. First, the transfer is subject to fraudulent transfer law. However, as will be discussed, these transactions generally do not fail based on fraud per se. Second, there is the type of attack used in *Octagon Gas Systems Inc. v. Rimmer,* which stands for the proposition...
that based on the U.C.C. Article 9, even true sales of accounts and chattel paper do not remove assets from the bankruptcy estate. However, as will be discussed, this attack is no longer applicable since the revision of the U.C.C. Article 9. The third and fourth common bankruptcy attacks are still effective and often raised when an Originator enters bankruptcy. Under such circumstances, the Bankruptcy Court will address whether the asset transfer is a true sale and whether substantive consolidation is appropriate. As one commentator stated, "the potential problems associated with [asset-backed] securitization in the bankruptcy context are properly attributable to inconsistent judicial evaluation of these transactions."76

A. FRAUDULENT TRANSFER LAW

The sale of assets from an Originator to an SPV qualifies as a "transfer of an interest of the debtor in property," and thus will be subject to fraudulent transfer analysis.77 Fraudulent transfer law allows the trustee to avoid prepetition transfers by the debtor through state law and the Code.78

Section 548 (a)(1)(A) of the Code requires an actual intent to hinder, delay or defraud creditors for the court to find fraudulent transfer.79 Generally, an Originator's actual intent to defraud is an independent circumstance not necessarily attributable to the structure of the asset-backed securitization and can be avoided through the vigilance of the attorneys involved.80 Section 548 (a)(1)(B) of the Code identifies conduct that amounts to a constructive fraudulent transfer.81 The elements of a constructive fraudulent transfer are that

76 See Bjork, supra note 57, at 122.
77 See 11 U.S.C. § 548 (2003) (stating, "the Trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor ... subject to various conditions.").
(a)(1) The Trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntary –
(A) made such transfer or incurred such obligation with actual intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted...
80 See Lupica, supra note 10, at 648 (stating, "the harm faced by the Originator's unsecured creditors as a result of the fraud in not necessarily attributable to securitization as a method of financing, but the Originator's fraudulent behavior.").
(a)(1) The Trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily-
(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
(ii) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
the debtor received less than reasonably equivalent value, and was either insolvent at the time of the transaction, rendered insolvent as a result of the transaction, or left unable to pay its debts as they come due.\textsuperscript{82}

In practice, “due to the scrutiny imposed by rating agencies, credit enhancers, and the various other market participants, securitization may present fewer opportunities for self-dealing than alternative financing methods,” making the applicability of fraudulent transfer law to asset-backed securitization unlikely.\textsuperscript{83}

\textbf{B. \textit{OCTAGON GAS}}

In 1993, the securitization industry was shaken by dictum in a decision handed down by the Tenth Circuit Court of Appeals.\textsuperscript{84} In \textit{Octagon Gas}, the court addressed the question of whether the property claimed by a sale transferee was part of the transferor’s bankruptcy estate and thus subject to the interests of the creditors.

The case involved a business that bought and resold natural gas.\textsuperscript{85} The business transferred to Mr. Rimmer, an “overriding royalty interest” in gross proceeds from the gas sold.\textsuperscript{86} After the filing of the debtor’s Chapter 11 bankruptcy petition, the court was asked to determine whether the interest in the proceeds was property of the bankruptcy estate. Pursuant to section 541 of the Code, a bankruptcy estate includes “all legal or equitable interests of the debtor in property as of the commencement of the case.”\textsuperscript{87}

The court found that Mr. Rimmer’s interest was an “account” for U.C.C. Article 9 purposes.\textsuperscript{88} Upon further analysis of Article 9, the court stated 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.”\textsuperscript{89} The court concluded that “Article 9’s treatment of accounts sold as collateral

\textsuperscript{82}Id.
\textsuperscript{83}See Lupica, supra note 10, at 648.
\textsuperscript{84}See Octagon Gas Systems, Inc. v. Rimmer (\textit{In re Meridian Reserve Inc.}), 995 F.2d 948 (10th Cir. 1993) (holding account is part of bankruptcy estate); David Gray Carlson, \textit{The Rotten Foundations of Securitization}, 39 WM. & MARY L. REV. 1055, 1059 (1998) [hereinafter Carlson] (recognizing the impact and reaction caused by Octagon Gas System’s holding).
\textsuperscript{85}See \textit{Id}. at 955.
\textsuperscript{86}See \textit{Id}. at 951.
\textsuperscript{87}\textit{Id}. at 955 (quoting 11 U.S.C. § 541(a)(1) (1988)).
\textsuperscript{88}See \textit{Id}. at 955 (defining the interest acquired to be an account); \textit{See also} U.C.C. § 9-106 (1995) (amended 2001) (defining account as “any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper).
\textsuperscript{89}Octagon Gas, 955 F.2d, at 956.
would place Rimmer's account within the property of [the seller's] bankruptcy estate.\(^9\)

The decision in \textit{Octagon Gas} was not well received by the Securitization industry because if adopted nationwide it would place securitized accounts or chattel paper\(^9\) in the Originator's bankruptcy estate regardless of all other factors. In fact, the decision prompted the U.C.C. Permanent Editorial Board to issue a commentary disagreeing with the \textit{Octagon Gas} decision.\(^9\) Furthermore, it prompted the U.C.C. Drafting Committee to propose an amendment to the U.C.C. Article 9 explicitly addressing the issue of whether sold accounts are property of the seller's bankruptcy estate.\(^9\)

The result was Revised Article 9 that includes the Permanent Editorial Board’s commentary and a revised section 9-318(a) which 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.” Therefore, the bankruptcy attack used in \textit{Octagon Gas} is no longer available to Trustees and debtors.

\subsection*{C. True Sale v. Disguised Secured Loan}

In bankruptcy, any property in which the debtor has an interest is included in the debtor's bankruptcy estate.\(^9\) “True sales” are those that are effective against creditors and the estate of a bankrupt Originator, so that the property is no longer “property of the debtor’s estate” under Section 541 of the Code.\(^9\) It is critical to the success of the asset-backed securitization that the transfers of the assets from the Originator to the SPV are “true sales” so that creditors of the bankrupt Originator are unable to reach the payment stream.\(^9\)

Should the Originator enter bankruptcy, the court will decide the question of whether the transfer was a sale of assets or a loan secured by the assets. The court will look to substance over form in determining the true nature of the transaction.\(^9\) If the court deems the transfer from the Originator to the

\(^{90}\) \textit{Id.} at 955.

\(^{91}\) “Chattel paper” means a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods, but a charter or other contract involving the use or hire of a vessel is not chattel paper. When a transaction is evidenced both by such a security agreement or a lease and by an instrument or a series of instruments, the group of writings taken together constitutes chattel paper. \textit{U.C.C.} § 5-105(b)(1) (1998).

\(^{92}\) Commentary No. 14 (U.C.C. § 9-102(1)(b) (1994)).

\(^{93}\) See Lupica, supra note 10, at 658.

\(^{94}\) 11 U.S.C. § 541(a)(1) (2003) (providing bankruptcy estate includes “all legal or equitable interests of the debtor in property as of the commencement of the case.”).

\(^{95}\) See Schwarz, Structured Finance, supra note 4, at 28-29.


\(^{97}\) \textit{In re Joseph Kanner Hat Co.}, 482 F.2d 937, 940 (2d Cir. 1973) (Friendly, J.) (quoting Grant Gilmore, \textit{Security Interests in Personal Property} § 2.6, at 47 (1965)) (“Courts will determine the true
THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

SPV to be a secured loan, the assets will become part of the Originator’s bankruptcy estate and subject to the automatic stay. Therefore, the transaction must be structured as a “true sale” to be acceptable to the banks and for the securities to receive a high rating from the rating agencies.

The majority of the courts will evaluate several factors to determine whether the transaction is a true sale or merely a disguised secured loan transaction. “These factors include but are not limited to: (1) the degree to which the risk of loss is transferred to the special purpose vehicle; (2) the amount of recourse against the transferor; (3) the degree of control exercised by the transferor over the transferred assets; (4) the purchase price paid; (5) and the contractually expressed intent of the parties.”

The court’s decision may also be influenced by whether the Originator is in Chapter 7 liquidation or Chapter 11 reorganization. In the context of a Chapter 7 bankruptcy proceeding, the consequence of the court treating the transaction as a loan would only serve to delay payment to the SPV, assuming the security interest in the assets were perfected. Therefore, a court may be willing to accept the transaction as a sale because ultimately the SPV will obtain the property anyway.

In the case of a Chapter 11 debtor, however, if the court determines the transfer was a loan and thus part of the bankruptcy estate, the court may permit the debtor to “use, sell or lease” such property, so long as others with an interest receive “adequate protection.” This determination would permit the Originator to retain control of the cash flow and would be invaluable to the insolvent company’s rehabilitation. In light of this, the court may be less willing to treat the transfer as true sale, thus removing this cash resource from the estate.

Recourse refers to the risk the Originator retains in the transaction. The extent and nature of the recourse that the SPV has against the Originator is a major factor courts will consider to determine whether a transaction is a true sale.

nature of a security transaction, and will not be prevented from exercising their function of judicial review by the form of words the parties may have chosen.”

98 See Dawson, supra note 7, at 388-89 (stating, “to avoid the risk that bankruptcy may cause a court to deem some or all of the assets transferred to the intermediate SPE [special purpose entity] to be part of the transferor’s bankruptcy estate (and thus subject to the automatic stay or distribution to other creditors of the transferor), each transfer should be structured as a ‘true sale.’”).

99 See Bjork, supra note 57, at 128.

100 See Robert D. Aicher and 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, 183 (1991) [hereinafter Aicher] (stating, “Whether the debtor is a liquidating or a rehabilitating debtor could influence a court’s decision to uphold sale treatment.”).

101 See Id.

102 11 U.S.C. § 363(e)(2003); See Aicher, supra note 100, at 184 (explaining, “A court in a rehabilitation, as opposed to a liquidation, might be less willing to view the transfer as a sale, since such a determination will remove from the estate cash flow which the debtor may desperately need for a successful rehabilitation.”).

103 See Aicher, supra note 100, at 184.

104 Id. at 183.
or a secured loan. If recourse is present, the issue is "whether the nature of the recourse, and the true nature of the transaction, are such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction [a secured loan] or to a sale." As the degree of recourse increases, so does the chance the court will find the transfer was a disguised secured loan. However, the courts have established a clear standard for determining a satisfactory level of recourse.

The existence of a right or obligation to repurchase the assets is a form of recourse that would indicate a loan instead of a true sale. For example, in Major's Furniture Mart v. Castle Credit Corp., the Third Circuit held that the sale of accounts with "full recourse," with monies from the purchase price held back against future nonpaying accounts, as well as an agreement requiring the seller to repurchase delinquent accounts, constituted a disguised loan. Accordingly, in Bear v. Coben (In re Golden Plan of California, Inc.), the Ninth Circuit held a transfer made "without recourse," with no guarantee of repayment or compensation was a true sale.

Although courts recognize recourse to the Originator as an important factor indicative of a secured loan, recourse alone, without other factors suggesting a loan, will not necessarily preclude true sale treatment. Furthermore, because the SPV is contracting to buy valid rights to payment, warranties relating to title, validity, and eligibility of receivables are forms of recourse that are not indicative of a secured loan.

An agreement that the Originator retains the right to surplus collections once the SPV has collected its investment plus an agreed yield would be indicative of a secured loan. Likewise, the retention of surplus collections by the SPV would indicate the transaction was a true sale.

If the sale price of the receivables were based upon a fluctuating interest index, this would indicate the transaction was a true sale. Likewise, if the price is retroactively adjusted based on actual collections rather than agreed upon based expected collections, this would indicate a secured loan.

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105 See Aicher, supra note 100, at 186 ("Recourse can take the form of a repurchase obligation, a guaranty of collectability by the [Originator], a failure to extinguish or reduce an independent obligation for which an 'absolute assignment' was made, or a hold back of reserves from the purchase price which are released to the [Originator] only as receivables are paid.").


107 See Bjork, supra note 57, at 125 (stating, "the courts have failed to clearly articulate what constitutes an acceptable level of recourse in a sale transaction.").

108 602 F.2d 538, 546 (3d Cir. 1979).


110 See id. at 545; People v. Service Institute Inc., 101 Misc.2d 549, 421 NYS.2d 325, 327 (Sup. Ct. 1979).

111 See Committee, supra note 2, (stating, "Warranties relating to title, validity and eligibility of receivables (as opposed to collectibility of receivables) normally do not have a loss recourse component.").


113 See Schwarcz, Parts, supra note 96, at 147.
THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

The administration and control over the collection of the receivables are additional factors the court will consider in determining the nature of the transaction.\(^{114}\) If the transaction is a true sale, the SPV should have the authority to control collection of the payments. Therefore, in the case where collection of the receivables has clearly remained in the control of the Originator, the court is more likely to deem the transaction a secured loan. However, under certain circumstances it is more economically efficient for the Originator rather than the SPV to act as a "servicer."\(^{115}\) In that case, it is important for the SPV to deal with the Originator on an arms-length basis.\(^{116}\)

D. THE EQUITABLE DOCTRINE OF SUBSTANTIVE CONSOLIDATION

Substantive consolidation is an equitable remedy of the court that involves pooling the assets and liabilities of two or more separate entities, and results in the claims by creditors of one to be treated as claims against the common fund.\(^{117}\) "Deficiencies in structural separation" between the Originator and SPV may result in their substantive consolidation by the Bankruptcy Court.\(^{118}\)

Substantive consolidation is a judicial creation arising from the court's equity jurisdiction pursuant to section 105(a) of the Code.\(^{119}\) It is widely accepted that courts have the power to substantively consolidate a debtor corporation and a solvent non-debtor affiliate.\(^{120}\) Accordingly, a court may decide to substantively consolidate the Originator and an SPV if the market perceives them as one entity and the creditors interests are equitably served by consolidation.\(^{121}\) In general, courts have expressed a reluctance to consolidate...
affiliated corporations because of the risk to creditors who would be negatively impacted, for instance the investors in the securities issued by the SPV. However, there is authority to support the consolidation of a non-debtor SPV into the bankruptcy case of an Originator.

The court in In re Vecco Construction Industries, Inc. identified seven factors that should be considered in deciding whether to order substantive consolidation. These factors are:

1. the presence or absence of consolidated financial statements,
2. the unity of interests and ownership between the various corporate entities,
3. the existence of parent and inter-corporate guarantees and loans,
4. the degree of difficulty in segregating and ascertaining individual assets and liabilities,
5. the transfer of assets without formal observance of corporate formalities,
6. the commingling of assets and business functions, and
7. the profitability of consolidation at a single physical location.

Clearly the risk of substantive consolidation and fear that the court can bring a solvent affiliated SPV into an Originator's bankruptcy proceeding is a major concern for the securitization industry. In response, rating agencies will require that the Originator's counsel provide a “non-consolidation opinion,” representing that all steps have been taken to minimize the chance that the court will substantively consolidate the Originator and its affiliated SPV.

### IV. RECENT DEVELOPMENTS IN ASSET-BACKED SECURITIZATION

#### A. IN RE LTV STEEL

In early 2001 the securitization industry was again shaken to its core by another court decision. William T. Bodoh, United States Bankruptcy Judge for

106 See Committee, supra note 2, at 595-606 (providing “Form of Non-Consolidation Opinion”).
THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

the Northern District of Ohio, wrote an opinion in LTV Steel Company’s (“LTV Steel”) Chapter 11 case, questioning the legal foundation of asset-backed securitization.\(^{127}\) The decision authorized the use of cash collateral despite the prior absolute transfer of the debtor’s present and future receivables to an SPV.

LTV Steel is one of the largest manufacturers of integrated steel products in the United States. The company employs approximately 17,500 people and provides medical coverage and other benefits to approximately 100,000 retirees and their dependants. Prior to commencement of this Chapter 11 case, LTV Steel entered into a series of asset-backed securitization transactions.\(^{128}\)

In 1994, after a successful emergence from a previous Chapter 11 reorganization, LTV Steel created a wholly owned subsidiary SPV called LTV Sales Finance Co. (“Sales Finance”), which it intended to be a bankruptcy remote entity. LTV Steel then transferred its present and future accounts receivable to Sales Finance on a continuing basis. Abbey National, a large financial institution located in the United Kingdom, agreed to loan $270 Million to Sales Finance in exchange for Sales Finance granting Abbey National a security interest in the receivables.\(^{129}\)

In 1998, LTV Steel created another wholly owned subsidiary SPV called LTV Steel Products, LLC (“Steel Products”), which was also intended to be a bankruptcy remote entity. LTV entered into an agreement to sell all of its rights, title and interest in its present and future inventory to Steel Products on a continuing basis. Chase Manhattan and several other financial institutions then agreed to loan Steel Products $30 Million in exchange for a security interest in the inventory.\(^{130}\)

On December 29, 2000, LTV Steel and 48 of its subsidiaries filed voluntary petitions for relief under Chapter 11 of the Code. Among the motions made at the first-day hearings was a motion to use cash collateral, including the receivables sold to Sales Finance and the inventory sold to Steel Products. LTV Steel stated at the hearing that it would be forced to shut its doors and cease operations if it did not receive authorization from the court to use the cash collateral. Abbey National was not present at the hearing.\(^{131}\)

The court granted the motion on an interim basis after determining the order was necessary to permit LTV Steel to continue business operations. The court found “that the interests of Abbey National and all other creditors who had an interest in the cash collateral were adequately protected by the order, and that entry of the order was in the best interests of the estate and creditors of the estate.”\(^{132}\) The court scheduled a hearing for a final order approving the full usage of cash collateral.

\(^{128}\) Id. at 279.
\(^{129}\) Id. at 279.
\(^{130}\) Id. at 280.
\(^{131}\) Id.
\(^{132}\) Id. at 281.
Thereafter, Abbey National made a motion to vacate the interim cash collateral order. It argued that the Bankruptcy Court lacked jurisdiction over the property of Sales Finance and Steel Products because LTV Steel had sold them and therefore the court exceeded its authority by permitting LTV Steel to use the assets.

The court ignored prior judicial recognition of asset-backed securitizations and denied Abbey National’s motion.\footnote{Id at 287.} The court agreed that absent the use of the cash collateral LTV Steel would be forced to close its doors and would be unable to successfully reorganize. Finding an equitable interest in the receivables and inventory to be property of LTV Steel’s bankruptcy estate under section 541(a), the court concluded that it was “sufficient to support the entry of the interim cash collateral order."\footnote{Id at 20.} In the decision, the court stated:

There seems to be an element of sophistry to suggest that [LTV Steel] does not retain at least an equitable interest in the property that is subject to the interim order. [LTV Steel]’s business requires it to purchase, melt, mold and cast various metal products. To suggest that [LTV Steel] lacks some ownership interest in products that it creates with its own labor as well the proceeds to be derived from that labor, is difficult to accept.\footnote{See LTV Steel, at 19-20.}

The courts reasoning appears to have been influenced by the inventory securitization, which was wholly separate from the receivables securitization. However, the sweeping language of the opinion cannot be confined to those facts. The court relied on a public policy argument to support its result, stating:

Allowing Abbey National to modify the order would allow Abbey National to . . . look to the collateral in satisfaction of this debt. This circumstance would put an immediate end to Debtor’s business, would put thousands of people out of work, would deprive 100,000 retirees of needed medical benefits, and would have more far reaching economic effects on the geographic areas where Debtor does business. However, maintaining the current status quo permits Debtor to remain in business while it searches for substitute financing, and adequately protects and preserves Abbey National’s rights.\footnote{Id at 20-21.}

Finally, the court held that Abbey National had adequate protection for its property interests because it had been given a replacement lien. Abbey
THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

National argued that since the pre-petition receivables were being rapidly depleted, its position was threatened. The court’s response to that argument was that the “Debtor’s use of the pre-petition receivables will inevitably lead to an increase in the value of post-petition receivables and inventory, in which Abbey National has a security interest …”\(^\text{137}\)

Thereafter, the court granted motions for certain parties to appear Amicus Curiae and submit memoranda in opposition to LTV Steel’s motion for an Order granting final authority to use cash collateral. Mayer, Brown & Platt submitted a memorandum on behalf of a cross section of participants in the securitization market.\(^\text{138}\) Sullivan & Cromwell submitted a memorandum on behalf of Clearing House Association L.L.C., an association of twelve leading commercial banks.\(^\text{139}\)

The Mayer, Brown & Platt memorandum characterized LTV Steel’s argument as “challenging the very concept of a true sale or true contribution from a parent to a subsidiary.”\(^\text{140}\) Mayer, Brown & Platt’s argument was that asset-backed securitization is based upon long recognized economic and legal principles that allow parent corporations to transact business with wholly owned subsidiaries, limited only by good faith and fair dealing.\(^\text{141}\) The memorandum indicated that the securitization market has become a major component of the United States economy, citing the Bond Market Associations estimate that over the past ten years, more than $9.3 trillion in asset-backed term securities (excluding commercial paper) were issued in the United States.\(^\text{142}\) The memorandum cautioned the court that a decision accepting LTV Steel’s “extreme legal arguments” could cause “a seismic disruption in the capital markets.”\(^\text{143}\)

\(^{137}\) Id at 22.
\(^{140}\) Mayer, Brown & Platt, at 2.
\(^{141}\) Id at 4.
\(^{142}\) Id. at 7.
\(^{143}\) Id. at 17-18.
Sullivan and Cromwell’s memorandum made similar arguments. In addition it characterized the effort of LTV Steel as “short-sighted and narrow-minded.”\(^4\) It stated:

It is short-sighted because, in an apparent effort to gain short-term negotiating leverage, LTV is prepared to sacrifice the very form of financing that was successful in aiding its rehabilitation in the past and, unless LTV prevails, could be used to aid its current efforts at rehabilitation. It is narrow-minded because LTV is willing to disregard the adverse impact of its Motion on thousands of companies with millions of employees, as well as the millions of investors with interests in securitizations through pension funds, mutual funds, and other investment vehicles.\(^5\)

A settlement was reached prior to the hearing on the LTV Steel’s motion for a final order approving the use of cash collateral.\(^6\) LTV Steel agreed to stipulate that its prior securitization transactions were, in fact, “true sales.” Abbey National and the other lenders agreed to “roll up” Sales Finance and Steel Products into a post-petition, debtor-in-possession loan.\(^7\) The settlement prevented the Bankruptcy Court from reaching the question of whether the transfer from LTV to Sales Finance and Steel Products was a “true sale.”

One Commentator, Stephen L. Schwarcz believes “LTV should have little importance as a legal precedent” because the settlement was reached and included a summary finding that the transfers were true sales.\(^8\) Although others argue, the damage was already done because the decision has lead investors to question whether the ratings assigned to asset-backed securities are accurate reflections of the actual risk.\(^9\)

**B. THE BANKRUPTCY REFORM ACT**

In 2001, it seemed as though the issues raised by the LTV Steel case would be put to rest when both houses of the United States Congress passed

\(^{14}\) See Sullivan & Cromwell, at 3.

\(^{15}\) Id. at 3-4.


\(^{17}\) Id. at 17-20.


similar bankruptcy reform bills (the “Bankruptcy Reform Act”). Section 912 [See Appendix] of the Bankruptcy Reform Act was to create a “safe harbor” for asset-backed securitization transactions by amending section 541 of the Code, which defines property of the debtor’s estate.

The new section was to exclude from the bankruptcy estate any “eligible asset” transferred to an “eligible entity” in connection with an “asset-backed securitization.” Under the new law, an Originator would be able to accomplish removing the assets from its potential bankruptcy estate simply by representing in writing that the eligible assets are to be “sold, contributed, or otherwise conveyed with the intention of removing them” from the debtors estate under bankruptcy law. This law would have effectively eliminated the substantive law criteria (i.e. recourse against the seller) used to determine whether a transaction was a true sale of secured loan transaction. Most importantly, it would have removed the judicial discretion used in the LTV Steel case, where the judge was influenced by LTV Steel’s argument that it would be forced to cease operations if it could not use the cash collateral.

However, before the Congress actually enacted the Bankruptcy Reform Act, the Enron bankruptcy raised serious concerns about the use of SPVs. Enron used SPVs to execute its off-balance sheet transactions and to misstate shareholder equity, ultimately leading to the collapse of the energy-trading firm. Thereafter, Congress withdrew the “safe harbor” provision from the Bankruptcy Reform Act.

V. CONCLUSION

Congress acted properly when it removed section 912 from the Bankruptcy Reform Act. Section 912 would have explicitly eliminated the court’s authority to analyze the economics of a transaction to determine if it was a true sale or a secured loan. Every legal standard that has been used by the court in the past would no longer be applicable. Instead, the form of the transfer rather than its substance would bind the court, a complete reversal of present law.

Proponents of section 912 argue that increasing the predictability of securitized asset’s treatment under bankruptcy would lower financing costs, increase liquidity, and achieve greater access to the capital markets for corporations. The achieved market efficiencies, they argue, would be passed on to consumers and businesses in the form of lower interest rates for car loans.

152 See Bankruptcy Reform Act of 2001, supra note 150, 912(2).
153 See Bankruptcy Reform Act, supra note 150.
154 See Schwartz, Impact of Bankruptcy Reform, supra note 148, at 357 (stating, “The substantive law criteria of what constitutes a bankruptcy true sale – such as the amount and nature of the transferee’s recourse against the transferor, and whether the transferor has any right to take back transferred receivables – have simply been eliminated.”).
155 See Id. at 361.
mortgages, credit card debt, and all other extensions of credit. However, this favorable predictable treatment for financing institutions would also come at the expense of an insolvent Originator’s other lenders, creditors, tort victims, pension funds and employees.

Asset-backed securitization is a valuable financial tool, however, there are two sides to the coin. Although several parties may reap the benefits, others can be negatively impacted. For instance, suppose section 912 became the law and a bankruptcy case with similar facts as LTV Steel was commenced, the outcome would be quite different. The court would be required to exclude the debtor’s accounts receivable and inventory from the bankruptcy estate, the financial institutions would be able to walk away with the full value of their securities, forcing the debtor to liquidate. The liquidation would leave all other creditors, including the pension funds, with unsatisfied claims, employees without jobs and shareholders without a company. Notwithstanding the prevailing view that the LTV Steel decision was based more upon the court’s desire to save the debtor than it was based on legal principles, it did ultimately save the company and the local economy.

Under the current law, the “true sale” analysis is based on who bears the risk and who receives the benefits associated with owning the assets. Assets that have been sold are not included in the bankruptcy estate, whereas assets used as collateral for a loan are included. Section 912 would automatically exclude the assets from the bankruptcy estate so long as a rating agency rated one tranche of the issued securities as “investment grade.” Therefore, the rating agencies, which have no accountability except to their shareholders, would make the true sale determination instead of the courts.

Congress acted appropriately by removing the amendment to section 541 of the Code because it is unnecessary to change the current judicial characterization system. Such a change would only serve to benefit financing institutions to the detriment of the smaller creditors. The asset-backed securitization market has flourished under the current judicial scheme, despite the courts’ role, and will continue to do so without the help of Congress.

156 See Bond Market Association, letter to Senator Patrick Leahy and Congressmen F. James Sensenbrenner, Chairman of the Senate delegation and the House of Representatives delegation to the Conference Committee on S.420/H.R. 333 (January 30, 2002).
157 See Bankruptcy Reform Act, App. § 912 (defining asset-backed securitization as “a transaction in which eligible assets transferred to an eligible entity are used as the source of payment on securities, including, without limitation, all securities issued by governmental units, at least one class or tranche of which was rated investment grade by one or more nationally recognized securities rating organizations, when the securities were initially issued by an issuer.”).