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The Impact of Bankruptcy Reform on "True Sale" Determination in Securitization Transactions[1]

by Steven L. Schwarcz[2]

Introduction. Both Houses of Congress have passed similar bankruptcy reform bills,[3] and President Bush signaled he will sign such a bill (hereinafter, the "Reform Act") once Congress reconciles the differences between the House and Senate versions. Among other things, the Reform Act would create, for the first time, a legislative "safe harbor" regarding what constitutes a bankruptcy true sale in securitization transactions.[4] Because both bills include identical forms of this safe harbor provision, it is expected that the Reform Act will include the safe harbor provision unchanged.

Due to the attacks against our country on September 11, 2001 and the resulting economic downturn, it is uncertain when, and indeed if, Congress will enact the Reform Act.[5] As of the time of this writing, there was some indication that the Reform Act would be placed back on track.[6] Even if the Reform Act is not ultimately enacted in full, it's possible that the provisions thereof that are identical in both House and Senate versions -- such as the aforesaid securitization safe harbor -- may be enacted separately.

Background. Securitization is reputed to be by far the most rapidly growing segment of the U.S. credit markets, and its use is rapidly expanding worldwide. In a typical transaction, a company, usually called the "originator," transfers rights to payment from income-producing assets such as accounts receivable, loans, or

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3 *See* Bankruptcy Reform Act of 2001, S. 220, 107th Cong. § 912 (2001); H.R. 333, 107th Cong. § 912 (2001).

4 The Reform Act's true sale "safe harbor" is solely for purposes of bankruptcy law. Whether a given transfer of receivables constitutes a sale for tax, accounting, regulatory reporting or other purposes is not covered by the Reform Act.

5 *See, e.g.*, *Bill to Alter Bankruptcy Law Remains Stalled*, ABI WORLD (Oct. 19, 2001), <http://www.abiworld.org/headlines/01oct19.html> (visited Oct. 26, 2001) (noting that "with consumer confidence considerably weaker since the terrorist attacks on Sept. 11, lawmakers' enthusiasm for the legislation may have dimmed [because] no one in Washington wants to be perceived as anti-consumer").

6 *See, e.g.*, Opening Statement of Chairman F. James Sensenbrenner, Jr. for the Conference on H.R. 333, the Bankruptcy Abuse Prevention and Consumer Protection Act (Nov. 14, 2001).

lease rentals (collectively, "receivables" or "financial assets") – or frequently undivided interests in such rights – to a special purpose vehicle, or "SPV." The SPV, in turn, issues securities to capital market investors and uses the proceeds of the issuance to pay for the receivables. The investors, who are repaid from collections of the receivables, buy the securities based on their assessments of the value of the receivables.

Perhaps the most critical issue in a securitization is whether the SPV's investors will continue to be repaid in the event of the originator's bankruptcy. If the SPV owns the receivables, its investors *will* continue to be repaid; if not, their right to be repaid will be suspended and subject to possible impairment. The SPV will own the receivables only if the transfer of those receivables from the originator to the SPV constitutes a sale under applicable bankruptcy law -- usually referred to as a "true sale."

This issue, and the concerns that surround it, are illustrated by the recent bankruptcy case of LTV Steel Company, Inc. LTV challenged its pre-bankruptcy securitization facilities, arguing that the transfers to the SPVs were not true sales and, therefore, that LTV should be able to use the collections of receivables as "cash collateral" by giving adequate protection under bankruptcy law. LTV's rationale was that, without such use, it might have to cease its operations, thereby jeopardizing employee jobs and retiree benefits and adversely affecting the local economy. The bankruptcy court permitted LTV to use these collections pending resolution of the true sale issue. LTV should have little importance as a legal precedent because, prior to such resolution, the parties reached a settlement that included a summary finding that the transfers were true sales. Nonetheless, to some extent this use had shaken financial market confidence in securitization.

The Reform Act: The Reform Act provides an explicit "true sale" safe harbor for most transfers of receivables in securitization transactions. It does this by amending Section 541 of the Bankruptcy Code, which defines property of the debtor's estate, to exclude from that estate any "eligible asset" transferred to an "eligible entity" in connection with an "asset-backed securitization." Because these terms are expansively defined, the exclusion is broad.

The term "eligible asset," for example, means any existing or future-arising financial assets, including interests therein and proceeds thereof, that by their terms convert into cash within a finite period of time. This would appear to include any conceivable type of receivable; and the definition's broad enumeration of examples, as well as the inclusion of (among other things) residual interests, rights designed to assure servicing, cash, and securities, is consistent with such an expansive interpretation.[7]

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7 There might, however, be a question whether sub-performing assets would qualify as "eligible assets." Although the definition itself is not restrictive, legislative history suggests this definition is based on the definition of the term "eligible assets" in Rule 3a-7 under the Investment Company Act of 1940. *See* S. Rep. No. 106-49 (Senate Committee on the Judiciary, Bankruptcy Reform Act of 1999). That definition, in turn, is substantially identical to the language in Form S-3 (permitting shelf registration of asset-backed securities). Because the SEC has issued a no-action letter restricting Form S-3 from being used for sub-performing asset pools, at least one commentator has queried whether the Reform Act's safe harbor is intended to apply to transactions that include substantial concentrations of delinquent assets. *See* Edward E. Gainor, *Pending Legislation Would Change True Sale Analysis*, ASSET SECURITIZATION REP. 15 (Mar. 12, 2001). Even that commentator notes, however, that "because the reasons for the SEC's position on what constitutes 'asset-backed securities' for Form S-3 eligibility are not relevant to whether an asset has been transferred for purposes of the Bankruptcy Code, and because the SEC has not formally taken the same position in connection with Rule 3a-7, practitioners may be able to conclude that such assets are eligible assets." *Id.*

The term "eligible entity" is likewise expansively defined to mean any entity engaged exclusively (aside from ancillary actions) in the business of either (x) acquiring and holding eligible assets (an "issuer"), or (y) acquiring and transferring eligible assets directly or indirectly to an issuer. This should include most SPVs used, directly or (as in a two-tier structure) indirectly, in securitization transactions. If, however, the SPV in question has been used in prior transactions – for example, where the SPV is a multi-seller securitization conduit – it may be prudent to obtain comfort that such SPV has engaged exclusively in the foregoing businesses and actions ancillary thereto.

The Reform Act's safe harbor breaks most dramatically with existing law when defining the term "transferred." Under existing law, the primary issue is whether a given transfer constitutes a bankruptcy true sale. After the Reform Act takes effect, *any transfer* in which the debtor represents in writing that the eligible assets in question are to be "sold, contributed, or otherwise conveyed with the intention of removing them" from the debtor's estate will, under bankruptcy law, accomplish such removal. 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.

The final requirement of the safe harbor is that the transfer of eligible assets to an eligible entity be made "in connection with an 'asset-backed securitization.'" This term is broadly defined to include virtually all transactions that one commonly thinks of as a securitization – that is, all transactions in which the transferred receivables are used as the source of payment on securities – so long as "at least one class or tranche of [those securities] was rated investment grade by one or more nationally recognized securities rating organizations, when the securities were initially issued." The reference to "nationally recognized securities rating organization" appears to be a misnomer; the correct reference should be to nationally recognized statistical rating organization, or NRSROs.[8] This requirement essentially means that a major rating agency, such as Standard & Poor's, Moody's, or Fitch, has rated at least one class or tranche of the issuer's securities investment grade in order for the safe harbor to apply.[9]

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8 *See, e.g.*, Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, U. ILLINOIS. L. REV. (forthcoming February 2002) (analyzing NRSROs).

9 *Id.*

Where the safe harbor applies, it *also* resolves the difficult issue of whether a transfer that otherwise constitutes a sale would fail because only a partial interest in receivables is being transferred.[10] In many securitization transactions, the SPV purchases undivided interests in receivables. The rationale for buying undivided interests is that it maximizes the statistical diversification of the receivables sold to the SPV and also permits the SPV to invest in newly arising receivables by simple readjustment of the SPV's fractional interest.[11] The undivided nature of the SPV's interest, however, raises concern because the law has generally been unsettled as to whether the transfer of a partial interest in receivables can constitute a true sale.[12] The Reform Act's safe harbor eliminates this concern by applying also to the sale of "interests" in receivables.

Scope of the Reform Act: Once enacted, the Reform Act's safe harbor provision will apply to all bankruptcy and analogous state-law cases thereafter commenced.[13] Existing law on true sale characterization will continue to apply, however, in all bankruptcy and analogous state-law cases commenced *before* the Reform Act's enactment.[14]

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10 *See* Steven L. Schwarcz, *Intermediary Risk in a Global Economy*, 50 DUKE L. J. (forthcoming April 2001). *Accord*, 1 SECURITIZATION OF FINANCIAL ASSETS § 3.09, at 3-52 (Jason H. P. Kravitt, ed., 2d ed. 1999 & 2000-1 Supplement) (observing that "[i]t is also possible to argue that a court will more likely find a sale of a discrete group of receivables than a sale of an undivided interest in a pool to be a true sale, though there is no obvious analytical reason that this must be so").

11 Undivided interests are widely used, for example, in collateralized loan obligation and bank credit card securitizations. *See also* SECURITIZATION OF FINANCIAL ASSETS, *supra* note 6, § 3.03[A], at 3-13 (noting that the advantage of the undivided interest structure when securitizing pools of medium term receivables is "that one may avoid the transaction costs associated with numerous separate purchases"); at 3-14 (observing that "mortgage-backed securitizations are generally handled using the [undivided interest] structure"); at 3-14 - 3-16 (observing that securitization of credit card receivables also generally uses the undivided interest structure); and at 3-17 (observing that "[t]he most practicable structure [for securitization of trade receivables] has been the purchase of an undivided, fractional interest in a pool of receivables").

12 *See, e.g.*, 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 COLUMBIA BUS. L. REV. 139, 150 (1993) (referring to the "unfounded perception that the transfer of only a partial interest in a future payment stream ... cannot be a true sale"); Peter V. Pantaleo *et al.*, *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159 (Nov. 1996).

13 [•Why do newspapers say 180 days after?]

14 For a discussion of this law, *see* STEVEN L. SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION 28-35 (2d. ed. 1993).

The Reform Act does not purport to resolve all bankruptcy issues associated with securitization. For example, the Act continues to permit a transferor's trustee in bankruptcy to avoid a transfer of receivables that may be recovered as a fraudulent conveyance under Section 548 of the Bankruptcy Code. This should not be significant, however, because it is rare in securitization transactions for such transfers to be avoided: "the buyer of financial assets normally will have paid reasonably equivalent value for the assets."[15]

Transfers also may be avoided where the transferor and transferee are substantively consolidated pursuant to the equitable powers of a bankruptcy court under Section 105 of the Bankruptcy Code. Even though the transfer may be effective when viewed in isolation, substantive consolidation treats the transferee and transferor as the same entity in bankruptcy. Again, this risk appears minimal because substantive consolidation is a risk that can be controlled in securitization transactions by maintaining appropriate formalities between the transferor and transferee.

It nonetheless is likely that bankruptcy counsel will, as under present law, be asked to opine on the possibility of substantive consolidation. Counsel also may be asked to opine that the transfer of receivables is not a fraudulent conveyance, and that the constituent elements of the safe harbor (*i.e.*, that the receivables are "eligible assets" that have been "transferred" to an "eligible entity" in connection with an "asset-backed securitization") have been met.

As wide as the safe harbor is, there are significant exceptions. For example, securitization transactions that lack NRSRO-investment grade ratings, such as unrated private placements or private placements relying on National Association of Insurance Commissioners (NAIC) ratings, are not covered. Bankruptcy counsel then will need to address the traditional true sale criteria. Also, because the Reform Act only purports to resolve the true sale question for transferors that become debtors under U.S. bankruptcy law, that question will continue to have vitality for cross-border securitization transactions involving non-U.S. transferors.

Conclusions: Once the Reform Act becomes effective, the question of whether a given transfer of receivables will constitute a true sale for bankruptcy will be readily answered in the affirmative for a broad range of securitization transactions. Within this range, the concerns raised by the LTV case should be greatly mitigated. If, for example, a debtor argues that a transfer made in a securitization transaction is not a true sale, the issue can be promptly resolved by examining the transactional documentation.[16] Furthermore, because the safe harbor criteria allow virtually no judicial discretion, it should be irrelevant that a court (as in LTV) is influenced by the debtor's argument that it may have to cease its operations, thereby jeopardizing jobs and the local economy.[17]

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15 *Rethinking the Role of Recourse in the Sale of Financial Assets, supra* note 8, at 185.

16 A debtor nonetheless might argue that the securitization safe harbor is unconstitutional, in that the Supreme Court has ruled that "[p]roperty interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." Butner v. United States, 440 U.S. 48, 55 (1979). One would think, however, that the Reform Act itself constitutes the requisite "federal interest" requiring a different result.

17 Indeed, the true sale safe harbor should not be viewed as undermining the policies of bankruptcy law. *Cf. Rethinking the Role of Recourse in the Sale of Financial Assets, supra* note 8, at 185-89 (arguing that the concept of a true sale with recourse for collectibility should not undermine these policies).

The safe harbor provision also might provide a basis to do away with the present need in many securitization transactions for a two-tier structure. If so, that would significantly reduce transaction costs and potentially extend the benefits of securitization to smaller companies. The primary purpose of a two-tier structure is to "avoid the risk that recourse [to the transferor] might disqualify true sale treatment for a transfer."[18] For transactions within the safe harbor, however, recourse is no longer a relevant criterion for sale treatment. Thus, the originator may be able to transfer its receivables, in a simplified "one-tier" structure, directly to a non-affiliated SPV that issues the securities and has recourse against the originator. If the originator also has the right to take back any surplus collections once the transaction has ended, the one-tier structure may replace the two-tier structure. The only proviso is that an originator seeking "off-balance sheet" treatment of its transfer of receivables would need to clear the one-tier structure with its accountants.[19] It is arguable, however, that at least some one-tier structures should be able to qualify for off-balance sheet treatment.[20]

My colleagues on this panel nonetheless oppose the Reform Act's legislative safe harbor for securitization. Professor Janger argues that he is not sure that securitization is uniformly economically efficient, whereas the existing "muddy" rules on true sale create an opportunity for judicial sorting and also "tax" securitization transactions at the margin. Professor Lupica argues that the safe harbor provides participants in securitization with an ordinate degree of protection and immunity from the normal operation of the bankruptcy system at the expense of other creditors and debtors that seek to reorganize under the shelter of the bankruptcy laws.

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18 *Rethinking the Role of Recourse in the Sale of Financial Assets, supra* note 8, at 162.

19 As appropriate, the originator also may wish to clear the one-tier structure with its tax and other regulatory advisors.

20 Off-balance sheet accounting for securitization transactions is governed in the United States, for transfers occurring after March 31, 2001, by Statement of Financial Accounting Standards No. 140 (FAS 140). FAS 140 generally requires that (a) the transferred receivables be put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy; (b) if the transferee is a qualifying special purpose entity (SPE), each holder of its beneficial interests (i.e., its securities) has the right to pledge or exchange those interests; and (c) the transferor does not have the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call. FAS 140 ¶ 9. These conditions may well be satisfied in some one-tier structures. The first condition would be explicitly satisfied by the Reform Act's safe harbor. The second condition (b) should be feasible because, in practice, many SPVs that constitute "eligible entities" under the Reform Act may also constitute "qualifying SPEs" under FAS 140 – *see* FAS 140 ¶ 35 (setting forth the criteria of a qualifying SPE) – and each holder of the SPV's securities would normally have the right to pledge or exchange those assets. *Cf.* FAS 140 ¶ 173. Condition (c) also should be feasible because FAS 140 interprets the phrase "unilaterally" to permit a transferor, consistent with sale accounting, to retain the right to remove defaulted receivables from the SPV, and also permits the transferor to remove cash collections of receivables. *See* FAS 140 ¶¶ 87.b, 189, 42, 43, 35.d.

My colleagues's arguments raise, of course, the larger question of whether securitization is efficient and fair. I believe, and have argued, that it is.[21] Because this symposium issue does not permit space for a complete analysis, I refer readers to several works on this subject.[22] A summary analysis nonetheless follows.

Securitization merely replaces one type of asset, receivables, with another type, cash. Unsecured creditors have the same amount of unencumbered assets to levy against after the securitization as they did before the securitization. Some may argue that securitization nonetheless could hurt creditors where the cash received is wasted by the originator. But one cannot assume wasteful behavior simply because an originator sells its receivables for cash. In fact, given the scrutiny imposed by rating agencies, securitization may present fewer opportunities for such behavior than other financing methods.[23]

Nonetheless, securitization, just like any other sale of assets by an originator, may become suspect if implemented when an originator is on the brink of bankruptcy. The potential for such suspect actions, however, is not unique to securitization transactions. The same issues would arise, for example, if on the eve of bankruptcy an originator sold, or borrowed money by encumbering, a factory or equipment and similarly sought to dissipate the sale or loan proceeds. Such questionable uses of proceeds are more appropriately addressed by preference and fraudulent conveyance laws.

Moreover, securitization increases overall value by providing a new source of financing, the capital markets, whose rates are systematically lower than the rates at which many companies commonly borrow. So long as the added transaction costs are less than the interest saved by using securitization instead of secured financing, there is a net gain.

This begs the question, however, why the capital markets should be prepared to fund securitization transactions at a lower rate than secured financing. It's because a securitization based on a "true sale" effectively can separate the source of payment of the SPV's securities from the risks associated with the

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21 My colleagues on this panel argue that there is no empirical study of whether securitization is efficient, and therefore it should be limited. But it would seem that for a type of financing as important and widespread as securitization, those attempting to set limits should bear the burden of producing persuasive empirical evidence that securitization is inefficient. *Cf.* Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 428 (1997) (arguing that those attempting to set limits on secured credit should bear the burden of producing persuasive empirical evidence that such credit is not efficient).

22 *See* Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH.U. L.Q. 1061 (1996); Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STANFORD J. L., BUS. & FIN. 133 (1994); STEVEN L. SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION Appendix A (*Is Securitization a Zero-Sum Game?*) (3d ed. 2002).

23 In this context, I have shown that even though proceeds of secured borrowing can likewise be wasted or unwisely invested, unsecured creditors, given a choice *ex ante* the borrowing, would want the debtor to be able to borrow. Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 482-83 (1997). Because securitization similarly provides liquidity to a debtor, indeed at a lower cost than secured borrowing, unsecured creditors given a choice *ex ante* likewise should would want the debtor to be able to engage in a securitization transaction.

originator, largely eliminating the need for investors to monitor the originator's financial condition. Although the risks associated with servicing and collecting the receivables still necessitate some monitoring, these risks are borne by providers of credit enhancement or investors in subordinated securities, parties who are in the business of precisely assessing and absorbing such risks.

I acknowledge that -- all other things being equal -- the safe harbor for securitization proposed in the Bankruptcy Reform Act to some extent would act counter to the bankruptcy goal of debtor rehabilitation. That's because the safe harbor would prevent a court from re-characterizing a securitization "sale" as a secured loan[24] even though, "in a reorganization case, the financial assets of a business are often a prime source of collateral for debtor-in-possession financing."[25] But other things *are not equal*. For example, "the proceeds of the [securitization] may have provided liquidity to help a debtor stave off an earlier bankruptcy filing" or "could allow sufficient liquidity to [help the debtor] avoid bankruptcy altogether."[26] The safe harbor also would help to "preserv[e] reasonable commercial expectations that insure efficiency and predictability in the marketplace."[27] For these reasons, I favor, on balance, the Bankruptcy Reform Act's "safe harbor."

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24 Once sold, a debtor's receivables could no longer be used as collateral for debtor-in-possession financing.

25 Peter V. Pantaleo *et al.*, *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 186 (1996).

26 *Id.* at 187.

27 *Id.* at 189.