

# SECURITIZATION POST-ENRON<sup>1</sup>

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### I. Introduction.

In the post-Enron economic and regulatory environment, various threats have been made to the future of securitization transactions. Unfortunately, recent policy discussions of securitization have been tainted by the questionable transactions that eventually led to Enron's downfall. Although Enron's deals have superficial similarities to securitization, they are fundamentally different. This article will explain the resulting threats to the trillions of dollars of securitization transactions and also will explore, more normatively, whether the threats are justified. To understand these threats, one must first understand securitization.

In a typical securitization transaction, the company originating, or sponsoring, the transaction (hereinafter, the "originator") sells rights to payment from income-producing financial assets, such as accounts receivable, loans, or lease rentals (collectively, "financial assets"), to a

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special-purpose entity or vehicle—variously referred to as an “SPE” or “SPV” (this article uses the latter term)—which in turn transfers such rights to a second SPV. The second SPV issues securities to capital market investors<sup>3</sup> and uses the proceeds of the issuance to pay the first SPV for the financial assets; the first SPV then uses those proceeds to pay the originator. The investors in the securities are repaid from collections of the financial assets. They therefore buy the securities based on their assessments of the value of the financial assets.<sup>4</sup>

Securitization has unquestionable benefits. It enables the originator to obtain lower-cost financing through disintermediation by removing the need for intermediaries, such as banks, that separate the originator from the ultimate source of funds, the capital markets.<sup>5</sup> It increases liquidity and better allocates risk and its distribution.<sup>6</sup> It also enables the originator to “deploy scarce and costly capital to other portions of its business that may be in need of it.”<sup>7</sup> To this extent, at least, it is viewed as socially desirable.<sup>8</sup>

Some scholars, however, charge that these benefits may simply reflect the shifting of uncompensated risk onto third-parties.<sup>9</sup> This result, they argue, is compelled by the Modigliani & Miller theorem, under which, in a perfect universe, any savings achieved by changing one part of a company’s capital structure will result in offsetting costs to other parts of the capital structure, including by taking advantage of third parties.<sup>10</sup>

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<sup>3</sup> The capital markets are “markets where capital funds—debt and equity—are traded. Included are private placement sources of debt and equity as well as organized markets and exchanges.” JOHN DOWNES & JORDAN GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 59 (3d ed. 1991).

<sup>4</sup> For a more complete discussion of securitization, including the transactional steps mentioned above, see STEVEN L. SCHWARCZ, *STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* (3d. ed. 2002) (hereinafter “STRUCTURED FINANCE”); Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 *STAN. L. REV.* 1, 6 (1999); Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 *STAN. J. L. BUS. & FIN.* 133 (1994).

<sup>5</sup> Steven L. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 *U. CIN. L. REV.* 1309, 1315 (2002).

<sup>6</sup> See *infra* notes 112 (liquidity) and 90-94 (allocation of risk) and accompanying text. See also James A. Rosenthal & Juan M. Ocampo, *Analyzing the Economic Benefits of Securitized Credit*, 1 *J. APPLIED CORP. FIN.* 32 (1992).

<sup>7</sup> I SECURITIZATION OF FINANCIAL ASSETS § 3.02[A], at 3-5 (looseleaf, J. Kravitt, ed.).

<sup>8</sup> See, e.g., Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 *WASH. U. L. Q.* 1061 (1996). See also *infra* Parts III.A & III.B (explaining other benefits of structured transactions). But cf. Lynn M. LoPucki, *The Death of Liability*, 106 *YALE L. J.* 1, 24 (1996) (arguing that structured transactions can lead to judgment proofing). I counter Prof. LoPucki’s arguments in Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 *STAN. L. REV.* 1 (1999).

<sup>9</sup> See *infra* note 150 (referencing these scholars, who argue that securitization harms non-adjusting creditors). I address these charges in Parts III.B & III.C, *infra*.

<sup>10</sup> Franco Modigliani & Merton Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 *AM. ECON. REV.* 261 (1958).

More recently, some politicians have joined in the criticism of securitization. Because it transfers substantive risk away from the originator, securitization facilitates off-balance sheet financing. This means that the financing raised by the SPV to purchase the financial assets need not be included as debt on the originator's balance sheet.<sup>11</sup> Unfortunately, this raises a guilt-by-association: Enron's abuses relied heavily on the use of special-purpose entities and off-balance sheet financing.<sup>12</sup> Although none of the troublesome Enron deals actually involved securitization<sup>13</sup> and, as will be shown, there are very fundamental differences between those deals and securitization transactions,<sup>14</sup> the fact that "the most common special-purpose entities" are SPVs used in securitization transactions<sup>15</sup> creates a taint.

Because of this taint, politicians can lose perspective when dealing with securitization. For example, shortly after the Enron controversy, and as a result thereof, Congress deleted from pending bankruptcy-reform legislation a long-awaited legislative "safe harbor" for determining what constitutes a sale in securitization transactions.<sup>16</sup> Then, in July of 2002, Senator Richard Durbin and Representative William Delahunt introduced legislation entitled the Employee Abuse Prevention Act of 2002, ostensibly protecting "employees and retirees from corporate practices that rob them of their earnings and retirement savings when businesses collapse into bankruptcy."<sup>17</sup> However, section 102 of that legislation (hereinafter, "Durbin-Delahunt") would confound true-sale characterization by authorizing bankruptcy judges, notwithstanding the parties' intentions and state-law characterization, to "recharacterize as a secured loan, a sale ... if the material characteristics of the sale ... are substantially similar to the characteristics of a secured loan."<sup>18</sup> As I will explain in more detail below,<sup>19</sup> recharacterization would seriously threaten the predictable treatment of securitization transactions in the event of bankruptcy.

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<sup>11</sup> STRUCTURED FINANCE, *supra* note 4, at 1-5 – 1-6.

<sup>12</sup> Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, *supra* note 5, at 1310.

<sup>13</sup> *Id.* at 1315-18.

<sup>14</sup> *See infra* Part III.A.

<sup>15</sup> Diana B. Henriques, *The Brick Stood Up Before. But Now?*, N.Y. TIMES, Mar. 10, 2002, at B\_.

<sup>16</sup> Section 912 of the pending Bankruptcy Reform Act would have created, for the first time, a legislative "safe harbor" for determining what constitutes a "true sale" in securitization transactions. This refers to a sale from the originator to the first SPV to the extent that sale removes the financial assets from the originator's estate in bankruptcy. For a discussion of the significance of a true sale, *see infra* note 24 and accompanying text. Both Houses of Congress had passed similar bankruptcy reform bills, including identical forms of § 912, and President Bush signaled he would sign such a bill once Congress reconciles the differences between the House and Senate versions. *See* Bankruptcy Reform Act of 2001, S. 220, 107<sup>th</sup> Cong. § 912 (2001); H.R. 333, 107<sup>th</sup> Cong. § 912 (2001). It therefore was expected, prior to Enron, that the Bankruptcy Reform Act would include the provision unchanged.

<sup>17</sup> S. 2798 and H.R. 5221.

<sup>18</sup> Section 102 of Durbin-Delahunt would do this by adding a new § 105(e) to the federal bankruptcy code (11 U.S.C.).

<sup>19</sup> *See infra* Part II.A.

Although Durbin-Delahunt was eventually withdrawn by its sponsors,<sup>20</sup> it is not inconceivable that similar legislation may be re-introduced in the future.

More recently, a U.S. Senate subcommittee issued a report on the role of financial institutions in Enron's collapse, mandating certain federal agencies to prepare joint guidelines on acceptable and unacceptable structured finance products, transactions, and practices.<sup>21</sup> Although the intention appears to have been to regulate only deceptive or sham transactions, the report's recommendations do not explicitly tie acceptability to a non-deception standard, thereby inviting the possibility of overly broad regulation.

Part II of this article examines these and other threats,<sup>22</sup> and the backlash that gives rise to them.<sup>23</sup> Part III then explores whether the backlash is justified, focusing first (in Part III.A) on the fundamental differences between, on the one hand, securitization and other structured finance transactions and, on the other hand, Enron's use of SPVs. The ability to distinguish these transactions does not, however, mean that securitization is desirable. Parts III.B, III.C, and III.D therefore next examine whether securitization is inefficient, unfair, or violates bankruptcy policy. Part IV concludes that the threats to securitization are unjustified.

## II. Threats to Securitization.

### A. *Recharacterizing True Sales.*

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 financial assets, 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 financial assets only if the transfer of

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<sup>20</sup> According to the Thomas Congressional Database, Durbin-Delahunt was referred to the Judiciary Committee where no action was taken and it died with the expiration of the last Congressional session.

<sup>21</sup> See *infra* Part II.C, notes 51-58 and accompanying text.

<sup>22</sup> Part II does not examine all possible threats. For example, it does not address recently promulgated FASB Interpretation No. 46 (governing accounting consolidation of SPVs), under which the Financial Accounting Standards Board is jeopardizing the use of multi-seller securitization conduits that use economies of scale to increase securitization's efficiency. See, e.g., e-mail from Terry D. Novetsky, securitization partner, Kaye Scholer LLP, to the author (Feb. 3, 2003) (on file with author) ("I don't believe that FAS 46 is intended as a mere tertiary attack on trick liquidity and similar excesses; rather, I believe it is a frontal attack on fundamental accounting and capital matters, perhaps an overreaction from Enron..."). See also Schwarcz, *The Alchemy of Asset Securitization*, *supra* note 4, at 140-41 (discussing multi-seller securitization conduits). My analysis of securitization's efficiency is independent of any increase in efficiency that can be achieved by using these conduits.

<sup>23</sup> This backlash was further exacerbated in late 2002, when the unexpected bankruptcy of NCFE rattled investor confidence in rating agencies. Prior to this bankruptcy, many investors believed they could rely on the rating agencies for a certain amount of ongoing surveillance of securitization and other transactions. The bankruptcy may motivate institutional investors to maintain more active surveillance, thereby potentially affecting the depth and pricing of the securitization market.

those assets from the originator to the SPV constitutes a sale under applicable bankruptcy law—usually referred to as a “true sale.”<sup>24</sup>

By enabling judges to recharacterize true sales,<sup>25</sup> Durbin-Delahunt if re-introduced or similar legislation if introduced (generically, “recharacterization-legislation”) pose perhaps the strongest threat to securitization. This is paradoxical. Durbin-Delahunt itself was intended to protect employees, yet if investors cannot be certain that the transactions in fact will be treated as sales in bankruptcy, the cost-saving benefits to these transactions will be lost; thus stripped of value, firms will not engage in these transactions; as a result, firms will have less capital with which to develop their businesses and pay employees.

The impact of recharacterization-legislation depends on the context in which the true-sale determination arises: whether under state common law, or under one of the recently-enacted state laws providing for a true-sale safe-harbor in securitization transactions. I discuss each in turn.

*1. Potential Impact of Recharacterization-Legislation on State Common Law:*

Recharacterization-legislation would federalize the question of whether a pre-bankruptcy sale should be recharacterized as a secured loan.<sup>26</sup> Presently, the matter of sale characterization is largely governed by state law. Although bankruptcy creates an “estate” that includes “all legal or equitable interests of the debtor in property as of the commencement of the case,”<sup>27</sup> courts generally must look to non-bankruptcy—normally state—law in order to determine whether and to what extent property of the debtor exists.<sup>28</sup>

Permitting this recharacterization would replace generally applicable and settled state law with a vague federal test.<sup>29</sup> Under the common law of most states, transfers of property—

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<sup>24</sup> See *supra* note 4 and accompanying text. In addition to the true-sale issue, there are other bankruptcy issues associated with securitization, such as the right of an originator’s trustee in bankruptcy to avoid a transfer of financial assets that may be recovered as a fraudulent conveyance under § 548 of the Bankruptcy Code. This risk should not be significant, however, because it is rare in securitization transactions for such transfers to be avoided. Peter V. Pantaleo *et al.*, *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 185 (1996) (“the buyer of financial assets normally will have paid reasonably equivalent value for the assets”). Another risk is that an originator and SPV could be substantively consolidated pursuant to the equitable powers of a bankruptcy court under § 105 of the Bankruptcy Code. Notwithstanding a true sale, substantive consolidation would treat the originator and SPV as the same consolidated entity in bankruptcy. Again, however, this risk appears minimal because substantive consolidation is a risk that can be controlled in securitization transactions by maintaining appropriate formalities (including limiting certain types of intercompany transactions) between the transferor and transferee.

<sup>25</sup> See *supra* note 18 and accompanying text.

<sup>26</sup> By its terms, Durbin-Delahunt also would have federalized the question whether of a pre-bankruptcy lease or other transfer of property, including possibly licenses and consignments and other bailments, should be recharacterized as secured loans.

<sup>27</sup> BC § 541(a)(1).

<sup>28</sup> *Butner v. United States*, 400 U.S. 48 (1979).

<sup>29</sup> Much of the discussion in this Part 1A is based on William M. Burke *et al.*, Report on Avoidance, Subordination, Super Priority, and Recharacterization Provisions of the Proposed

particularly intangible property such as financial assets that are transferred in arm's length securitization deals—even though characterized as sales and made in exchange for reasonably equivalent value, may, in limited cases where the economic risks and rewards of the transferred asset are retained by the transferor, be recharacterized as secured loans.<sup>30</sup> However, the common law normally provides sufficient guidance and indeed has worked well historically in determining when transfers should be recharacterized.<sup>31</sup> Federal courts in bankruptcy cases are already able to apply these state-law recharacterization powers. Furthermore, even when state law does not permit such recharacterization, those federal courts can override state-law sale characterization if “some federal interest requires a different result.”<sup>32</sup>

Unlike the foregoing limited circumstances permitting recharacterization, however, Durbin-Delahunt provided no guidance on the factors relevant to recharacterization other than a vague “material characteristics”/“substantially similar” test. This would leave courts with little principled basis to evaluate transfers, and would place almost unbridled discretion on judges to recharacterize sales. Courts may well be willing to do so, for example, in securitization transactions where the originator needs, or at least claims it needs, the collections of “sold” financial assets in order to reorganize in bankruptcy.<sup>33</sup>

That discretion would undermine the securitization market. Some degree of certainty is essential for the market's functioning because rating agencies and investors customarily require, as a condition of these deals, that counsel opine that the transfer of financial assets should indeed constitute a true sale.<sup>34</sup> This opinion is intended to assure the parties that, in the event of the originator's bankruptcy, the transferred financial assets will be available to pay investors, and not

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Employee Abuse Prevention Act of 2002 (Sept. 3, 2002) (on file with author, a co-writer of this Report). Because Professor Charles W. Mooney acted as reporter for this Report, I will refer to it hereinafter as the Mooney Report.

<sup>30</sup> Hill, *Securitization: A Low-Cost Sweetener for Lemons*, *supra* note 8, at 1126; George P. Miller, *Regulatory Developments in Securitization*, 843 PLI/COMM. 733, 757 (2002).

<sup>31</sup> STRUCTURED FINANCE, *supra* note 4, at 4-5.

<sup>32</sup> *Butner v. United States*, 400 U.S. 48, 55 (1979). For a discussion of this case and its concept of “federal interest,” see Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 576-78 (1999).

<sup>33</sup> For example, in the 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 financial assets as “cash collateral” by giving adequate protection under bankruptcy law. LTV's rationale was that, without such use, it may 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. *In re LTV Steel Co.* 274 B.R. 278, 280 & 285-86 (Bankr. N.D. Ohio (2002)). (LTV should have little importance as a legal precedent, however, because prior to such resolution the parties reached a settlement that included a summary finding that the transfers were true sales. STRUCTURED FINANCE, *supra* note 4, at 4-4 n. 7.)

<sup>34</sup> Mooney Report, *supra* note 29, at 22-23.

treated as property of the originator's estate. Uncertainty would make it difficult if not impossible to render these opinions.<sup>35</sup>

2. *Potential Impact of Recharacterization-Legislation on State True-Sale Safe-Harbor Law:* To facilitate securitization, several states have enacted laws that would permit "true sale" treatment without regard to economic substance. The leading example is Delaware's Asset-Backed Securities Facilitation Act, enacted in early 2002.<sup>36</sup> This Act (hereinafter the "Delaware Act") creates a legislative "safe harbor" under Delaware state law for determining what constitutes a true sale in securitization transactions.<sup>37</sup> Superficially, recharacterization-legislation would have a devastating impact on the Delaware Act and these other laws. In practice, however, that impact would be minor.

To understand why, consider the Delaware Act, which provides that any financial assets purported, in the transaction documents, to be transferred in a securitization transaction<sup>38</sup> "shall be deemed to no longer be the property, assets or rights of the transferor."<sup>39</sup> To the extent

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<sup>35</sup> Uncertainty also could impose additional risks and costs in "repo" transactions in the securities markets as well as on more traditional non-recourse factoring arrangements. Mooney Report, *supra* note 29, at 23.

<sup>36</sup> 73 Del. Laws 214; 2001 Del. ALS 214; 2001 Del. HB 348; codified in Title 6, Chapter 27A, of the Delaware Code.

<sup>37</sup> At least two other state statutes have similarities to the Delaware Act. On July 1, 2001, an Ohio statute, which has substantially the same wording and premise as the Delaware Act, became effective. Ohio Rev. Code Ann. § 1109.75 (Supp. 2002). Under this statute, "[a]ny property, assets, or rights purported to be transferred, in whole or in part, in a securitization shall be deemed to no longer be the property, assets, or rights of the transferor." *Id.* § 1109.75(A)(1). The statute further states that "[i]n the event of the transferor's bankruptcy, receivership, or other insolvency proceedings, the property, assets, or rights purported to have been transferred by the transferor, in whole or in part, in a securitization shall not be deemed to be part of the transferor's property, assets, rights, or estate." *Id.* § 1109.75(A)(3). The Ohio statute, however, only applies to "a transfer of financial assets by a financial institution insured by the federal deposit insurance corporation." *Id.* § 1109.75(C). Texas also adopted a non-uniform version of § 9-109 of revised Article 9 of the Uniform Commercial Code (consistent with its prior non-uniform version in § 9-102) in order "to bring certainty to 'true sale' analysis." Eugene F. Cowell III, *Texas Article 9 Amendments Provide "True Sale" Safe Harbor*, 115 BANK. L. J. 699, 699 (1998) (discussing the prior non-uniform provision). Section 9.109(e) of the Code provides that, "[f]or all purposes, in the absence of fraud or intentional misrepresentation, the parties' characterization of a transaction as a sale of [accounts, chattel paper, payment intangibles, or promissory notes] shall be conclusive that the transaction is a sale and is not a secured transaction and that title, legal and equitable, has passed to the party characterized as the purchaser of those assets ...." Tex. Bus. & Com. Code Ann. § 9.109(e) (2002). There do not appear to be any cases interpreting either of these two statutes.

<sup>38</sup> Although the term "securitization transaction" is not defined, the Delaware Act states that "the General Assembly [intended] that the term 'securitization transaction' shall be construed broadly." 6 Del. Code. § 2702A.

<sup>39</sup> 6 Delaware Code § 2703A(a)(1). The Delaware Act goes on to clarify that the "transferor in the securitization transactions, its creditors [and any] bankruptcy trustee ... shall have no rights, legal or equitable, whatsoever to ... reclaim ... or recharacterize as property of the transferor any

Delaware law applies, the traditional substantive-law criteria of what constitutes a 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 assets—are thus irrelevant. This is because 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.”<sup>40</sup> Thus, unless “some federal interest requires a different result,” the Delaware Act will govern true-sale determination.

In practice, however, the Delaware Act and similar state laws have significance only to the extent they can be relied on by counsel to render true-sale legal opinions.<sup>41</sup> Such reliance, however, would be questionable because there is ambiguity whether the federal interests of bankruptcy *will* require a different result than that provided by the true-sale safe harbor of the Delaware Act.<sup>42</sup> Bankruptcy law has two primary interests: to assure equality of distribution of assets to creditors, and to rehabilitate debtors.<sup>43</sup> Although the Delaware Act should not impair the first interest (because securitization merely replaces one type of asset, financial assets, with

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property, assets or rights purported to be transferred....,” *id.* § 2703A(2); and, *id.* at § 2703A(3), that in “the event of a bankruptcy, receivership or other insolvency proceeding with respect to the transferor . . . , such property, assets and rights shall not be deemed to be part of the transferor’s property, assets, rights or estate.”

<sup>40</sup> *Butner v. United States*, 440 U.S. 48, 55 (1979). In the federal tax area, the Supreme Court has been more willing to re-characterize state-law property interests. *See, e.g.*, *U.S. v. Craft*, 122 S. Ct. 1414, 1420 (2002) (re-characterizing Michigan-law determination that a tenant by the entirety has no separate interest in entirety property that a federal tax lien may attach to). The extent, if any, to which these tax cases might influence bankruptcy-law re-characterization of state-law property interests is uncertain.

<sup>41</sup> *See supra* notes 34-35 and accompanying text (discussing the need for true-sale opinions).

<sup>42</sup> The discussion above focuses on originators that may become debtors in federal bankruptcy cases. The Delaware Act may provide greater opinion reliance in the context of originators (like many banks) that are not subject to federal bankruptcy law. Such greater reliance should not, however, be troublesome, because it facilitates express federal regulatory objectives. For example, banks are by far the most common type of originators in securitization transactions that are *not* subject to becoming debtors in federal bankruptcy cases. *See* 11 U.S.C. §§ 109(b)(2) & (d) (providing that banks insured by the Federal Deposit Insurance Corporation may not become debtors in federal bankruptcy cases). The preemption principles of federal banking law are limited to situations where there is “significant conflict between some federal policy or interest and the use of state law.” *O’Melveny & Myers v. FDIC*, 512 U.S. 79, 87 (1994). There do not, however, appear to be any significant conflicts. Troubled banks are subject to federal bank insolvency law, under which the Federal Deposit Insurance Corporation (FDIC) is authorized, like a trustee in a federal bankruptcy case, to conserve the debtor-bank’s assets. 12 U.S.C. § 1821(d)(2). The FDIC’s authority does not extend to assets that no longer are owned by the bank. Thus, the FDIC may not repudiate contracts in order to attempt to recover assets already sold thereunder. *See Treatment by the FDIC as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation*, 65 Fed. Reg. 49189, at 49191 (Aug. 11, 2000) (FDIC preamble to final rule) (providing that although 12 U.S.C. § 1821(e) authorizes the FDIC to repudiate certain contracts, the FDIC may not use that authority to repudiate a completed contractual sale of assets).

<sup>43</sup> Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, *supra* note 32, at 542.

another type, cash<sup>44</sup>), the safe harbor in the Delaware Act does, to some extent, act counter to the second interest, that of debtor rehabilitation. The safe harbor would prevent a court from re-characterizing a securitization “sale” as a secured loan even though, “in a reorganization case, the financial assets of a business are often a prime source of collateral for debtor-in-possession financing.”<sup>45</sup> Even though there are arguably countervailing federal interests—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”<sup>46</sup>—ambiguity remains as to whether those federal interests would preclude application of the Delaware Act.<sup>47</sup> The ambiguity undermines reliance by counsel on, and to that extent reduces the significance of, the Delaware Act and similar state laws.

B. *Sarbanes-Oxley Mandated Studies.*

The Sarbanes-Oxley Act of 2002 was intended in part as a response to the practices that led to Enron’s demise.<sup>48</sup> Section 401(c) of that Act requires the SEC to examine and report to the President and Congress on the extent of off-balance sheet transactions using special-purpose vehicles and whether, under generally accepted accounting principles, the economics of those transactions are transparent to investors of the originators. Section 705 of that Act further requires the Comptroller General of the United States to perform a study on the role of investment banks in the design and implementation of several financial techniques, including “transactions

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<sup>44</sup> See *infra* notes 84-85 and accompanying text. Creditors therefore have the same amount of assets to claim against after the securitization as they did before the securitization, and the Delaware Act does not affect their relative claims against such assets.

<sup>45</sup> *Rethinking the Role of Recourse in the Sale of Financial Assets*, *supra* note 24, at 186. Once sold, a debtor’s financial assets could no longer be used as collateral for debtor-in-possession financing.

<sup>46</sup> *Id.* at 187. The safe harbor also would help to “preserv[e] reasonable commercial expectations that insure efficiency and predictability in the marketplace.” *Id.* at 189.

<sup>47</sup> To the extent this ambiguity makes it difficult for counsel to render true-sale opinions, it makes it similarly difficult to render such opinions for reliance by accountants. Off-balance sheet accounting for securitization transactions is governed in the United States, for transfers of financial assets occurring after March 31, 2001, by Statement of Financial Accounting Standards No. 140 (FAS 140). This requires, among other things, that the transferred assets be “put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy.” FAS 140 ¶ 9.a. Although this determination should take into consideration “[a]ll available evidence that either supports or questions” the transfer as a sale, FAS 140 ¶ 27, in practice accountants rely almost exclusively on legal opinions. See, e.g., Financial Accounting Standards Board AU Section 9336, ¶¶ 1.01, 1.06 (providing that a “determination about whether the isolation criterion has been met to support a conclusion regarding surrender of control is largely a matter of law”). And only legal opinions that conclude that the transfer of financial assets “would be considered to be a” true sale are deemed to provide persuasive evidence that the transferred assets have been put presumptively beyond the reach of the transferor and its creditors in bankruptcy. AU Section 9336, ¶ 1.13. Given the ambiguities discussed above, counsel may not always be able, based on the Delaware Act alone, to render such definitive opinions.

<sup>48</sup> See S. Rep. 107-205 (July 3, 2002).

involving special purpose vehicles.”<sup>49</sup> The concern is whether their use will alter financial statements in ways that obscure a firm’s financial picture.<sup>50</sup>

C. *Senate Subcommittee Report.*

A recent report on the role of financial institutions in Enron’s collapse by the U.S. Senate Permanent Subcommittee on Investigations (“Subcommittee Report”) sparks the potential for open-ended regulation of securitization transactions.<sup>51</sup> Issued January 2, 2003, the Subcommittee Report focuses on four such transactions, finding that “[t]he first three transactions ... involved the transfer of assets at inflated values from Enron to special purpose entities (SPEs) or joint ventures that Enron orchestrated and, among other problems, established with sham outside investments that did not have the required independence or did not truly place funds at risk.”<sup>52</sup> The fourth transaction was found to be a “tax avoidance structure whose core transaction was a deception ....”<sup>53</sup>

Although none of these transactions was actually a securitization, and the Subcommittee’s findings indicate that legitimate structured-finance transactions are not to blame for Enron’s abuses, the Subcommittee Report concluded

that some U.S. financial institutions have been designing, participating in, and profiting from complex financial transactions explicitly intended to help U.S. public companies engage in deceptive accounting or tax strategies. This evidence also shows that some U.S.

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<sup>49</sup> Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 §§401, 705 (codified in scattered sections of 15, 18, and 28 U.S.C.).

<sup>50</sup> *Id.*

<sup>51</sup> *See generally* U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, REPORT ON FISHTAIL, BACCHUS, SUNDANCE, AND SLAPSHOT: FOUR ENRON TRANSACTIONS FUNDED AND FACILITATED BY U.S. FINANCIAL INSTITUTIONS, S. REP. NO. 107-82 (2003), *available at* <http://www.gpo.gov/congress/senate/senate12/p107.html> (recommending increased regulation and government oversight of structured transactions, after consulting with “key federal agencies including ... the Government of Canada ...”).

<sup>52</sup> *Id.* at 3. Thus, the first transaction, Fishtail, was “a sham joint venture which pretended to have more than one investor, but, in fact, relied solely on Enron. ... The evidence shows that Fishtail did not qualify for off-balance sheet treatment and should have been consolidated with Enron” because the equity investor’s “related party status ... disqualified [it] from providing the ‘independent’ equity investment necessary to an unconsolidated SPE or joint venture.” *Id.* at 10. The second transaction, Bacchus, failed “to qualify as a sale under SFAS 140” because “Enron guaranteed both the debt and equity ‘investment’ in the [Trust], thereby eliminating all risk associated with the ‘sale’ of the Fishtail assets to the Trust.” *Id.* at 19. The third transaction, Sundance, “provided the appearance but not the reality of having more than one investor, and should have been consolidated on Enron’s balance sheet.” *Id.* “Sundance needed two investors contributing capital in accordance with the Andersen 4:1 joint venture capitalization guidelines. In addition, a minimum three percent of the total capitalization had to be an independent equity investment at risk for the duration of the joint venture.” *Id.* at 27.

<sup>53</sup> *Id.* at 37 (“The deceptive nature of the Slapshot transaction is clear from its component parts. Serial billion-dollar-plus loans were issued to newly created shell companies such as Flagstaff and Hansen which had virtually no capitalization, assets, or business operations to justify the lending.”).

financial institutions and public companies have been *misusing structured finance vehicles*, originally designed to lower financing costs and spread investment risk, to carry out sham transactions that have no legitimate business purpose and mislead investors, analysts, and regulators about companies' activities, tax obligations, and true financial condition.<sup>54</sup>

In order to restore investor confidence,<sup>55</sup> the Subcommittee Report recommended possible regulation of structured finance, initiated through a "one-time, joint review of [financial institutions] participating in complex structured finance products ... to identify those structured finance products, transactions, or practices which facilitate a U.S. public company's use of deceptive accounting in its financial statements or reports."<sup>56</sup> Under this review, the applicable federal agencies,<sup>57</sup> "[b]y June 2003, ... should issue joint guidance on *acceptable and unacceptable structured finance products, transactions, and practices*."<sup>58</sup> By not explicitly tying the phrase "unacceptable structured finance products, transactions, and practices" to specifically deceptive or "sham" transactions, the Subcommittee Report invites the possibility of overly broad regulation.<sup>59</sup>

The foregoing discussion has explained the existing threats to securitization. I next explore, more normatively, whether or not those, or indeed any other, threats to securitization are justified.

### III. Are the Threats Justified?

#### A. *Perceptions and Reality.*

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<sup>54</sup> *Id.* at 2 (emphasis added).

<sup>55</sup> *See id.* at 40 ("The resulting loss of investor confidence in the honesty and integrity of U.S. companies and financial institutions is an ongoing problem that requires additional attention and action.").

<sup>56</sup> *Id.* The Subcommittee Report's other two recommendations are less troublesome: for the SEC to create a policy "to take enforcement action against a financial institution that offers a deceptive financial product" that results in misleading information in a company's financial statements or reports, *Id.*, and for federal bank regulators "to exercise regulatory authority within their jurisdiction to deter banks from aiding or abetting deceptive accounting, because such activities will constitute an unsafe and unsound banking practice." *Id.* at 41 (explaining that "Such Federal Reserve and OCC actions will help ensure that a meaningful mechanism is introduced into routine Federal bank examinations to deter banks' future misuse of structured finance transactions that aid or abet deceptive accounting").

<sup>57</sup> The Board of Governors of the Federal Reserve System, Office of Comptroller of the Currency, and SEC.

<sup>58</sup> *Id.* at 40 (emphasis added). The Subcommittee Report also contemplates that these federal agencies "take all necessary steps" to ensure financial institutions no longer engage in such practices. *Id.*

<sup>59</sup> *Cf.* Mark Adelson, *Senate Report Attacks Structured Finance*, NOMURA FIXED INCOME RESEARCH 1 (Jan. 6, 2003).

If Enron's woes were caused by securitization transactions, the foregoing threats might well be justified. Several fundamental differences, however, distinguish Enron's use of SPVs from securitization and other structured finance transactions.<sup>60</sup>

One difference is that securitization is normally used by an originator to obtain lower-cost financing through disintermediation, or removal of intermediaries such as bank lenders between the originator and the ultimate source of funds, the capital markets.<sup>61</sup> This avoids the mark-up charged by a middleman of funds, and also enables the originator to raise funds cheaply based on an allocation of risks that are assessed by parties having the most expertise.<sup>62</sup> This is markedly different from Enron's use of SPVs for mere financial-statement manipulation.

To the extent securitization is used to keep debt off an originator's balance sheet, it superficially resembles Enron's use of SPVs. But there are still important differences because securitization, unlike the Enron-SPV transactions, unambiguously transfers risk from the originator to the SPV and its investors; and transfer of risk is, and should be, central to the accounting determination of non-consolidation.<sup>63</sup>

The third and in certain ways most fundamental difference between securitization and Enron's use of SPVs results not from any particular deal structure but, rather, from the conflicts of interest in Enron. Significant conflicts of interest pervaded the Enron deals. As I argue elsewhere, the complexities of those deals, and perhaps even the complexities of certain securitization transactions, make it difficult for corporate directors and shareholders, under existing corporate-law procedures,<sup>64</sup> to knowledgeably approve the deals; in the face of complexity, they must also rely on the business judgment of the managers that structured the

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<sup>60</sup> For a more complete examination of these differences, see Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, *supra* note 5.

<sup>61</sup> *Id.* at 1315.

<sup>62</sup> See *infra* note 144.

<sup>63</sup> See Financial Accounting Standards Board, *FASB Interpretation No. 46, Consolidation of Variable Interest Entities (an interpretation of ARB No. 51)* Summary (Jan. 2003) (requiring the primary beneficiary of such entities to consolidate them unless the entities "effectively disperse risks among parties involved"). It should be noted, however, that although securitization deals do shift actual risk, they always require the originator to retain sufficient first-loss risk on the transferred assets, usually in the form of "overcollateralization," to minimize the investor risk to an investment grade level. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, *supra* note 5, at 1316 n. 38. There is nothing misleading or inappropriate about this; it logically follows from the asymmetric information between the originator, whose assets are being transferred, and the SPV's investors. *Id.*

<sup>64</sup> Corporation law permits transactions in the face of conflicts of interest if decisions are made or ratified by non-conflicted parties. In Delaware, for example, although courts can review the fairness of interested-party transactions, *Oberly v. Kirby*, 592 A.2d 445, 466 (Del. 1991), ratification by independent directors or shareholders reinstates the traditional business judgment rule, under which courts will not undertake to second-guess the expediency of business transactions so authorized. *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997); *Orman v. Cullman*, 2002 WL 416957, at 6 (Del. Ch. 2002).

deals, a reliance that may be misplaced where (as in Enron) those managers have material conflicts of interest.<sup>65</sup>

In contrast to Enron, management in securitization transactions would be expected to be free of material conflicts. Securitization transactions typically involve two SPVs,<sup>66</sup> of which the first is wholly-owned by the originator and managed by directors—who may include employees of the originator.<sup>67</sup> These directors receive compensation of \$5-15,000 per year,<sup>68</sup> hardly a material sum relative to corporate salaries. Even the Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. recognizes that it was the magnitude of the conflict that was most problematic in the Enron SPV transactions.<sup>69</sup> The second SPV in a securitization transaction (*i.e.*, the SPV that issues securities to capital market investors) is typically owned and managed completely independently of the originator,<sup>70</sup> so conflicts again should not arise.

I believe that this absence of material conflicts explains why actual securitization transactions have not raised any of the excesses found in Enron or other corporate scandals. To ensure that future securitization transactions do not give rise to any such excesses, I have argued for regulation to limit the existence of material conflicts in these transactions.<sup>71</sup>

The absence of excesses does not, however, mean that securitization is desirable. I therefore next examine whether securitization is efficient<sup>72</sup> and, even if efficient, whether securitization is fair.<sup>73</sup>

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<sup>65</sup> Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity* (forthcoming University of Illinois Law Review, 2003) (arguing—based on the Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. [William C. Powers, Jr., Chair] 18, 21, 144, 166-67 (Feb. 1, 2002) (observing that Enron’s Chief Financial Officer pressured Enron personnel to give favorable terms to the Enron SPVs, even though such terms were not in the best interests of Enron’s shareholders)—that non-conflicted managers would not have attempted to overrule or intimidate those employees, and may even have independently resisted or at least questioned Enron’s entering into dubious structured transactions that, if failed, could (and did) bring down the company).

<sup>66</sup> *See supra* notes 3-4 and accompanying text.

<sup>67</sup> Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, *supra* note 5, at 1318.

<sup>68</sup> *Id.*

<sup>69</sup> Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. *supra* note 65, at 148.

<sup>70</sup> Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, *supra* note 5, at 1318.

<sup>71</sup> *See* Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, *supra* note 65.

<sup>72</sup> *See infra* Part III.B. The claim of securitization’s efficiency has been “less substantiated than the same claim with respect to secured credit.” Lois R. Lupica, *Asset Securitization: The Unsecured Creditor’s Perspective*, 76 TEX. L. REV. 595, 621 (1998). Indeed, Professor Lupica not only argues that “structured finance’s efficiency is unproven” but predicts “that securitization is inefficient.” *Id.* at 659.

B. *Is Securitization Efficient?*

To determine whether something is efficient, one must agree on the standard by which to measure efficiency. The law and economics literature generally defines efficiency as meaning either Pareto or Kaldor-Hicks efficiency. Pareto efficiency means, in the context of a securitization transaction, that the transaction would make the parties to the securitization—the originator and the SPV’s investors—better off,<sup>74</sup> and no other parties worse off.<sup>75</sup> The only other parties susceptible to being made worse off are the originator’s unsecured creditors. Securitization transactions therefore would be Pareto efficient only if they do not harm the originator’s unsecured creditors. In contrast, Kaldor-Hicks efficiency means, in the context of a securitization transaction, that the aggregate benefit to the parties to the securitization exceeds any net harm to other parties, i.e., to the originator’s unsecured creditors.<sup>76</sup>

Economists generally accept Kaldor-Hicks, and not Pareto, as the operating standard of efficiency: “Because the conditions for Pareto superiority are almost never satisfied in the real world, . . . it is pretty clear that the operating definition of efficiency in economics is not Pareto superiority. When an economist says that [something] is efficient, nine times out of ten he means Kaldor-Hicks efficient.”<sup>77</sup> Securitization transactions therefore should be considered efficient if the aggregate benefit to the SPV’s investors and the originator exceeds any net harm to the originator’s unsecured creditors.

For purposes of analysis, call the originator’s benefit X, the SPV-investors’ benefit Y, and any net harm to unsecured creditors Z. Under the Kaldor-Hicks standard, a securitization transaction is thus efficient where  $X + Y$  equals or exceeds Z.<sup>78</sup> Because commercial parties typically do not voluntarily engage in transactions unless they expect material gains, we may assume X and Y is each material, and thus their sum is even more material. If, therefore, Z is

<sup>73</sup> See *infra* Part III.C (addressing the argument that securitization harms involuntary and other non-adjusting creditors, such as tort creditors).

<sup>74</sup> The originator and the SPV’s investors clearly expect a benefit; otherwise, they would not have freely entered into the securitization transaction.

<sup>75</sup> See Jules L. Coleman, *Efficiency, Utility & Wealth Maximization*, 8 HOFSTRA L. REV. 509 (1980); Thomas J. Miceli & Kathleen Segerson, *Defining Efficient Care: The Role of Income Distribution*, 24 J. LEGAL STUD. 189, 192-93 (1995).

<sup>76</sup> See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 1.2, at 13-14 (4th ed. 1992). By “net harm,” I mean the harm to the originator’s unsecured creditors minus any benefit to them. See *id.* § 1.2, at 14. A transaction is Kaldor-Hicks efficient even if the “winners” (the originator and the SPV’s investors) do not compensate the “losers” (the unsecured creditors). See *id.*

<sup>77</sup> *Id.* § 1.2, at 14. Accord, Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 1015 (2001) (arguing it is infrequent that a policy is under consideration that will make all parties better off, and therefore a Pareto-efficiency standard is usually unhelpful for policy determinations).

<sup>78</sup> “[I]f A values the wood carving at \$5 and B at \$12, so that at a sale price of \$10 . . . the transaction creates a total benefit of \$7 ( . . . A considers himself \$5 better off and B considers himself \$2 better off), then it is an efficient transaction, *provided that the harm (if any) done to third parties (minus any benefit to them) does not exceed \$7. . . . The winners [A and B] could compensate the losers [the third parties], whether or not they actually do.*” POSNER, *supra* note 76, § 1.2, at 13-14 (emphasis added).

nonmaterial,  $X + Y$  will exceed  $Z$  for most securitization transactions,<sup>79</sup> making securitization efficient.<sup>80</sup> I next argue that  $Z$  is not only likely to be nonmaterial, but also to be zero or even negative.<sup>81</sup>

$Z$  is likely to be zero or negative because securitization transactions do not, in the aggregate, result in net harm but instead create net *value* for unsecured creditors. My argument has three steps. First, because securitization provides the originator with new money, unsecured creditors are not harmed absent the originator investing or otherwise using that money in a manner that reduces its value (“overinvestment”).<sup>82</sup> Second, even though overinvestment sometimes occurs, it only harms unsecured creditors where the originator becomes insolvent<sup>83</sup>; that harm should be more than offset by the originator’s lower interest-cost burden (thereby preserving value to pay unsecured creditors) and the fact that securitization provides liquidity to companies that need liquidity but are unable to borrow, thereby enhancing creditor recovery. Third, both empirical evidence and the relative rarity of covenants restricting securitization transactions demonstrate that unsecured creditors themselves view securitization as providing net value.

1. *Absent Overinvestment, Unsecured Creditors Are Not Harmed:* Securitization always provides the originator with new money in the form of cash received for the sale of financial

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<sup>79</sup> The likelihood, if true, of  $Z$  being nonmaterial does not, of course, exclude the possibility that sometimes  $Z$  will be quite material. It thus is theoretically possible that sometime  $Z$  will be so large that, on an aggregate basis, the sum of all  $Z$ s will exceed the sum of all the  $X$ s and  $Y$ s. In reality, however, there is, however, no reason to believe that  $Z$  will ever be significantly greater than  $X$  or  $Y$ .

<sup>80</sup> Some may argue that efficiency is usually measured *ex post*, with reference to the outcome of a particular transaction, and not *ex ante* as I have proposed. However, when the outcome of an exchange is uncertain or risky, economists measure the efficiency of the exchange *ex ante*. See, e.g., Kenneth J. Arrow & Robert C. Lind, *Uncertainty and the Evaluation of Public Investment Decisions*, 60 AM. ECON. REV. 364 (1970); Milton Friedman & L.J. Savage, *The Utility Analysis of Choices Involving Risk*, 56 J. POL. ECON. 279, 304 (1948) (“individuals seek to maximize expected utility”).

<sup>81</sup>  $Z$  would be negative where there is net benefit, not harm, to unsecured creditors.

<sup>82</sup> See, e.g., Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 CORNELL L. REV. 1396, 1410 (1997) (defining overinvestment as “the taking of a negative net present value project”).

<sup>83</sup> If the overinvestment causes a downgrading of the originator’s bond rating, bondholders (a subset of unsecured creditors) could be harmed, absent the originator’s bankruptcy, to the limited extent their bonds become more difficult to trade. However, being voluntary investors, bondholders can prevent that harm by demanding covenants restricting securitization or, failing to obtain such covenants, by not investing in the bonds. Bondholders rarely demand such covenants (see *infra* notes 129-131 and accompanying text); and the only court to have considered the issue held, in a related context, that absent restrictive covenants the fact that an event causes a downgrading of bond ratings is not actionable at law because bondholders have the right only to payment of principal and interest on their bonds. *Metropolitan Life v. RJR Nabisco*, 716 F. Supp. 1504 (S.D.N.Y. 1989). Moreover, I later discuss empirical data that show that securitization transactions generally have a net *positive* effect on bond prices. *Infra* notes 137-138 and accompanying text.

assets.<sup>84</sup> Thus it merely substitutes for one type of asset, financial assets, another type, cash. As a result, absent overinvestment,<sup>85</sup> unsecured creditors have the same amount of unencumbered assets to levy against after as before the securitization.

For example, assume an originator has assets worth  $\$U$  and unsecured claims of  $\$V$ . The originator proposes to raise  $\$W$  of new money in a securitization, by selling  $\$W + \mu$  face-amount of financial assets to an SPV— $\mu$  representing the necessary overcollateralization.<sup>86</sup> Before the securitization, the unsecured creditors would be paid their  $\$V$  of claims from the  $\$U$  of assets. After giving effect to the securitization, the originator's assets would be  $\$U - (W + \mu) + W$ ,<sup>87</sup> which equals  $\$U - \mu$ . Although this might appear to be a reduction in value equal to  $\mu$ , in fact it is not:  $\mu$  merely reflects that valuation of the face amount of financial assets sold must take into account the time value of money—collections on those financial assets being due at future dates—and the risk that those assets may default.<sup>88</sup>

Therefore, before the securitization, the  $\$V$  of unsecured creditor claims can be paid from the  $\$U$  face amount of assets, whose real value (discounting for time value of money and risk of default) equals  $\$U - \mu$ . After the securitization, the  $\$V$  of unsecured creditor claims likewise can be paid from  $\$U - \mu$  of assets. The unsecured creditors have not been harmed.<sup>89</sup>

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<sup>84</sup> STRUCTURED FINANCE, *supra* note 4, at 4-16.

<sup>85</sup> Recall that overinvestment is the originator investing or otherwise using that cash proceeds in a manner that reduces its value.

<sup>86</sup> See STRUCTURED FINANCE, *supra* note 4, at 2-3 (discussing overcollateralization).

<sup>87</sup> That is, the originator would have the original  $\$U$  of assets minus  $\$(W + \mu)$ , the face amount of financial assets sold, plus the  $\$W$  of securitization proceeds.

<sup>88</sup> STRUCTURED FINANCE, *supra* note 4, § 2:1.1, at 2-2 – 2-4. In other words, because of the time value of money and the risk of default, the financial assets with a face value of  $\$W + \mu$  have a real value of only  $\$W$ .

<sup>89</sup> To the extent securitization is used to achieve off-balance-sheet financing, unsecured creditors that focus exclusively on the originator's debt-to-equity (or similar) ratio to assess credit risk might claim harm if the originator later fails. Any such claim, however, would be unwarranted. Although generally accepted accounting principles, or GAAP, requires only certain contingent risks to be disclosed as liabilities in the originator's financial statements, other contingent risks—such as those resulting in a loss that is merely reasonably possible (as opposed to probable) or which cannot be reasonably estimated—still must be disclosed in the footnotes to the financial statements. See Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5: Accounting for Contingencies (Mar. 1975) (allowing only remote risks to remain undisclosed). Post-Enron, no reasonable investor can claim ignorance of financial statement footnotes; investors have been widely educated to carefully review those footnotes as part of their investment or credit decisions. See, e.g. Anne Tergesen, *The Fine Print: How to Read Those Key Footnotes*, BUS. WK., Feb. 4, 2002, at 94 (“it is vital to look behind the numbers companies release in quarterly and annual financial statements. That's why *Business Week* Investor is launching The Fine Print, a series in which we will periodically examine various sorts of footnotes you'll find in company reports”). Moreover, the recent Financial Accounting Standards Board Interpretation No. 45 of Guarantor's Accounting and Disclosure Requirements for Guarantees (2002) requires guarantors to at least recognize on their balance sheets a liability for the fair value of the guarantee-obligation.

In fact, the sale of financial assets may actually *benefit* the originator and its creditors by transferring the risk on those assets. Unlike a secured loan, where any collateral shortfall gives rise to an unsecured deficiency claim in that amount,<sup>90</sup> in a securitization the SPV and its investors only have recourse against the financial assets purchased, and not against the originator or its other assets.<sup>91</sup> Accordingly, the SPV and its investors—and not the originator or its unsecured creditors—bear the risk that those financial assets may be insufficient to repay the investors.<sup>92</sup> If it turns out in retrospect that  $\mu$  was too small—meaning that the discount from face value of the financial assets sold, taking into account time value of money and risk of default, should have been greater than  $\mu$ , only the SPV and its investors take that risk.<sup>93</sup> On the other hand, if, in retrospect,  $\mu$  is too big, most securitization deals permit the originator, at deal’s end, to recover the surplus value from the SPV.<sup>94</sup>

2. *Any Harm from Overinvestment Should be More than Offset:* The foregoing analysis concedes that overinvestment of securitization proceeds can, and undoubtedly sometimes does, occur. I next show, however, that the risk of overinvestment does not make securitization inefficient.

This risk first must be placed into perspective. Overinvestment is a normal—though minimal<sup>95</sup>—business risk of any financing, not just securitization. In fact, given the scrutiny imposed by rating agencies, securitization may present fewer opportunities for intentional overinvestment than other financing methods.<sup>96</sup> It is nonetheless possible that securitization may become suspect if implemented—even though this use of securitization is rare<sup>97</sup>—when the originator is on the brink of insolvency.<sup>98</sup> That potential for dissipating cash proceeds is not,

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<sup>90</sup> 11 U.S.C. § 506(a).

<sup>91</sup> Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 463 (1997) (hereinafter “*Easy Case*”).

<sup>92</sup> *See id.* (“Creditors are also unconcerned [about non-recourse financing, including securitization], precisely because the creditor making the non-recourse loan does not have access to any of the debtor’s other assets”).

<sup>93</sup> Schwarcz, *The Alchemy of Asset Securitization*, *supra* note 4, at 149 n. 55.

<sup>94</sup> STRUCTURED FINANCE, *supra* note 4, at 3-15.

<sup>95</sup> One cannot assume wasteful behavior simply because a company obtains financing.

<sup>96</sup> *Cf.* Schwarcz, *Easy Case*, *supra* note 91, at 482-83 (discussing overinvestment of secured lending proceeds). *See also* Edward M. Iacobucci & Ralph A. Winter, *Asset Securitization and Asymmetric Information 4* (Apr. 15, 2003) (unpublished manuscript, on file with author) (arguing that securitization limits overinvestment by “limiting managerial discretion over cash flows [since it is easier] for monitors to scrutinize the use of a large, one-time payment of cash instead of future streams of cash”).

<sup>97</sup> Schwarcz, *The Alchemy of Asset Securitization*, *supra* note 4, at 137 (observing that “[o]ne might expect securitization to be of greatest benefit to riskier companies [but] [a]s a company moves toward the extremes of financial instability and towards the brink of bankruptcy, ... the SPV has a higher than normal risk of being challenged by the originator’s trustee in bankruptcy, and risk-averse investors tend to avoid these transactions”).

<sup>98</sup> *See, e.g.*, Chase W. Ashley, *Comment: When a Company Securitizes, Its Creditors Face Higher Risks*, AM. BANKER, May 7, 1993, at 4 (arguing that securitization could hurt creditors because

however, unique to securitization. The same concern would arise, for example, if an insolvent company sold, or borrowed money by encumbering, a factory or equipment. But questionable uses of proceeds are already, and more appropriately, addressed by preference<sup>99</sup> <http://web2.westlaw.com/find/text.wl?RecreatePath=/find/-FN;F49> and fraudulent conveyance laws.<sup>100</sup>

To the limited extent overinvestment occurs, it only harms unsecured creditors if the company—in our case, the originator—becomes insolvent. This is because unsecured creditors of a solvent company are eventually repaid.<sup>101</sup> Because securitization is rarely used for originators on the brink of insolvency<sup>102</sup> and, as discussed, the risk of overinvestment itself is minimal, there should be few cases where unsecured creditors are harmed by overinvestment of securitization proceeds.

Furthermore, viewing securitization transactions in the aggregate, any harm to unsecured creditors in those few cases arguably will be more than offset by securitization's benefits. There are two such benefits that indirectly profit an originator's unsecured creditors: securitized debt—by which I mean debt issued by the SPV to purchase the originator's financial assets—generally has a lower interest-rate cost than the originator's corporate debt,<sup>103</sup> so the cost differential is available to pay unsecured creditors<sup>104</sup>; and securitization can be used to provide needed liquidity

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the cash received is unlikely to stay within the originator). *But compare Credit Lyonnais Bank v. Pathe Communications*, No. 12150, 1991 LEXIS 215, at 108 (Del. Ch. Dec. 30, 1991) (holding that the board of directors of a corporation in the “vicinity of insolvency” owes a fiduciary duty not only to the corporation's shareholders but also to its creditors). This decision makes it less likely that insolvent or near-insolvent originators will dissipate cash to the detriment of creditors.

<sup>99</sup> 11 U.S.C. §547.

<sup>100</sup> 11 U.S.C. §548 and applicable state laws. For a discussion of fraudulent conveyance law, see Steven L. Schwarcz, *The Impact of Fraudulent Conveyance Law on Future Advances Supported by Upstream Guaranties and Security Interests*, 9 CARDOZO L. REV. 729 (1987). Professor Lupica has argued that “[t]he originator is not required ... to preserve the consideration received from the asset sale; [instead], it is free to spend this cash any way it chooses—or to simply squander it.” Lupica, *The Unsecured Creditor's Perspective*, *supra* note 72, at 624. That, however, ignores fraudulent-conveyance law, and also ignores the existence of any covenants that, prior to the sale, restricted the originator from squandering the assets sold and therefore now restricts the originator from squandering the sale proceeds (such proceeds also being assets).

<sup>101</sup> Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 STAN. L. REV. 1, 18 n. 79 (1999). *See also supra* note 83 (noting that, absent restrictive covenants, the fact that an event causes a downgrading of bond ratings is not actionable at law because bondholders have the right only to payment of principal and interest on their bonds).

<sup>102</sup> *See supra* note 97.

<sup>103</sup> Schwarcz, *The Alchemy of Asset Securitization*, *supra* note 4, at 137; Thomas E. Plank, *Bankruptcy Professionals, Debtor Dominance, and the Future of Bankruptcy: A Review and a Rhapsody on a Theme*, 18 BANKR. DEV. J. 337, 358 (2002) (explaining that “despite the higher transaction costs of a securitization, it saves money for the originators”).

<sup>104</sup> Although transaction costs further subtract from the cost differential available to pay unsecured creditors, there should be a net positive cost differential for every completed securitization transaction. That is because originators will engage in securitization transactions only where, *ex ante*, they expect net positive cost differentials. Thus, the level of transaction costs

to viable companies unable to borrow,<sup>105</sup> keeping them out of bankruptcy (and thus enhancing creditor recovery). Consider each such benefit in turn.

Securitized debt often has a lower interest-rate cost than corporate debt because it provides a new source of financing, the capital markets, whose rates are systematically lower than the rates at which many companies commonly borrow.<sup>106</sup> For example, the following chart shows that the interest rate on commercial paper, a common form of securitized capital-market debt,<sup>107</sup> as well as on Aaa-rated bonds (most securitized debt securities being similarly rated Aaa),<sup>108</sup> was generally lower than that of the bank prime loan rate for the three-year period measured:

	2000	2001	July, 2002
Commercial Paper 1-month	6.28	3.80	1.74
Commercial Paper 2-month	6.30	3.71	1.75
Commercial Paper 3-month	6.33	3.65	1.76
Moody's Series Aaa <sup>109</sup>	5.58	4.99	4.81
Prime Rate	9.23	6.92	4.75

will only impact the volume of securitization transactions that are approved, not whether approved transactions yield net cost savings for the originator. *See* Schwarcz, *The Alchemy of Asset Securitization*, *supra* note 4, at 137-138 (“A company considering securitization should compare (i) the expected differential between interest payable on non-securitized financing and interest payable on securities issued by an applicable SPV with (ii) the expected difference in transaction costs between the alternative funding options.”). *Cf.* Hill, *Securitization: A Low-Cost Sweetener for Lemons*, *supra* note 8, at 1103 (arguing that securitization may even decrease transaction costs in the absolute because it offers unique bundles of risk products that otherwise would be expensive or impossible to put together).

<sup>105</sup> By liquidity, I mean sufficient cash flow to pay the company's maturing debts. *See* J. Bradley Johnston, *The Bankruptcy Bargain*, 65 AM. BANKR. L.J. 213, 221 n.39 (1991); Schwarcz, *Easy Case*, *supra* note 91, at 448.

<sup>106</sup> I am not suggesting that securitized debt always has a lower interest-rate cost than corporate debt. Companies whose corporate debt is rated investment-grade can borrow directly from the capital markets. Thus, in the above example, such companies may be able to borrow by issuing commercial paper directly to capital-market investors. Even in those cases, however, securitized debt would, depending on transaction costs, have a lower interest-rate cost than corporate debt where the rating on the securitized debt is higher than the rating on the corporate debt.

<sup>107</sup> Schwarcz, *The Alchemy of Asset Securitization*, *supra* note 4, at 140 n. 25; Michael Durrer, *Asset Backed Commercial Paper Conduits*, 1 N.C. BANKING INST. 119, 119 (1997) (summarizing the common practice of asset-backed commercial paper securitizations).

<sup>108</sup> *See, e.g.*, George P. Miller, *Regulatory Developments in Securitization Transactions*, 843 PLI/COMM 733, 819 (2002) (observing that “the vast majority [of securitized debt securities] are rated-AAA”).

<sup>109</sup> General obligations bonds based on Thursday figures; Moody's Investors Service.

Source: 88 FED. RES. BULL., A23, A22, Domestic Financial Statistics (Nov. 2002).<sup>110</sup>

If, therefore, an originator funds a portion of its financing needs through securitization, the interest-cost saving would be available to pay the originator's unsecured creditors.<sup>111</sup>

Securitization also can be used to provide needed liquidity to otherwise viable companies unable to borrow.<sup>112</sup> Because lack of liquidity is perhaps the leading cause of business bankruptcies,<sup>113</sup> increasing liquidity is likely to decrease bankruptcies.<sup>114</sup> That, in turn, increases unsecured creditor value. To understand why, consider the expected value of an originator's unsecured claims with, and without, the availability of liquidity from securitization.

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<sup>110</sup> This chart shows interest rates on commercial paper generally. The actual interest rates on securitized commercial paper (sometimes called asset-backed commercial paper, or ABCP) tend to be slightly higher than the rates on commercial paper of the same credit rating directly issued by companies. See Swasi Bate, Stephany Bushweller, & Everett Rutan, *The Fundamentals of Asset-Backed Commercial Paper*, MOODY'S INVESTORS SERVICE SPECIAL REPORT 57 (Feb. 3, 2003). That rate differential, however, is *de minimis* compared to the rate differentials shown in the chart. *Id.* (reporting that "in a study conducted by Moody's using reported yields from Bloomberg, ABCP spreads over [directly-issued commercial paper] have averaged 6.27 bps [i.e., 6.27 basis points, or 0.0627%] for the one-year period from February 2001 through February 2002").

<sup>111</sup> Although the foregoing analysis focuses on the benefit of securitization's lower interest-rate cost whereas the analysis in Part III.B.1 already takes into account—through the factor,  $\mu$ , the overcollateralization—the time value of money, there is no double-counting. Part III.B.1 does not derive any utility from the size of  $\mu$ . In this Part III.B.2, however, I show that securitization lowers the interest-rate cost; in mathematical terms, that would reduce the required size of  $\mu$ , thereby enabling the originator to derive more value from the same \$U face amount of assets.

<sup>112</sup> See *supra* note 46 and accompanying text (observing that the proceeds of a securitization can provide liquidity to help an originator stave off an earlier bankruptcy filing or even avoid bankruptcy altogether). Although secured debt also can be a source of needed liquidity (Schwarcz, *Easy Case*, *supra* note 91, at 444-45), negative-pledge covenants often prevent an originator from borrowing on a secured basis. *Id.* at 450 (noting, at 451-52, that the widespread use of negative-pledge covenants to restrict secured borrowing results from factors unrelated to the importance of liquidity). Securitization, however, is much less frequently restricted by covenants (see *infra* notes 127-131 and accompanying text), and therefore may be available as a source of needed liquidity even where secured debt is unavailable.

<sup>113</sup> Most studies aimed at defining predictive ratios and univariate models of bankruptcy emphasize liquidity ratios. See, e.g., CHARLES L. MERWIN, FINANCING SMALL CORPORATIONS IN FIVE MANUFACTURING INDUSTRIES, 1926-36, at 99 (1942) (stating that the liquidity ratio "provides the most definite indications of ultimate discontinuance"); Tyler Shumway, *Forecasting Bankruptcy More Efficiently: A Simple Hazard Model* 74 J. BUS. 101, 117 (Jan. 2001) (finding that "firms with higher earnings relative to assets are less likely to fail [and] firms with higher working capital are also relatively safe").

<sup>114</sup> See, e.g., JOHN D. FINNERTY, CORPORATE FINANCIAL ANALYSIS: A COMPREHENSIVE GUIDE TO REAL-WORLD APPROACHES FOR FINANCIAL MANAGERS 271 (1986) ("A corporation will determine the desired degree of liquidity . . . with a view to reducing the risk of technical insolvency to an acceptable level. The higher the degree of liquidity, the lower this risk." (footnotes omitted)).

The expected value of those claims equals the probability of the originator's bankruptcy multiplied by the amount of its unsecured creditors' recovery in bankruptcy, plus the probability of the originator staying out of bankruptcy multiplied by the amount of its unsecured creditors' recovery outside of bankruptcy.<sup>115</sup> For purposes of illustration, assume a hypothetical originator, faced with a 10% risk of bankruptcy unless it obtains liquidity, with \$1 million of assets and \$1 million of unsecured claims. Assuming a 75% bankruptcy valuation of the assets,<sup>116</sup> the expected value of the originator's unsecured claims, absent liquidity, is equal to  $(0.1 \times \$750,000) + (0.9 \times \$1,000,000) = \$975,000$ . However, to the extent securitization—by providing liquidity—reduces the risk of bankruptcy, the expected value of the originator's unsecured claims will increase. For example, if securitization reduces the originator's risk of bankruptcy merely from 10% to 9%, the expected value of those claims would increase to  $(0.09 \times \$750,000^{117}) + (0.91 \times \$1,000,000) = \$977,500$ . If securitization reduces the originator's risk of bankruptcy to 5%, the expected value of those claims would increase to as much as  $(0.05 \times \$750,000) + (0.95 \times \$1,000,000) = \$987,500$ . And, of course, to the extent securitization reduces the originator's risk of bankruptcy below 5%, the expected value of the originator's unsecured claims would increase even more.

This result—that securitization, by providing liquidity, reduces the risk of bankruptcy thereby increasing the expected value of an originator's unsecured claims—obtains irrespective of the starting numbers. If, for example, an originator is faced with a minimal (say 5%) risk of bankruptcy, the expected value of the originator's unsecured claims, absent the liquidity provided by securitization, is then equal to  $(0.05 \times \$750,000) + (0.95 \times \$1,000,000) = \$987,500$ . If securitization, by providing liquidity, reduces the originator's risk of bankruptcy merely from 5% to 4%, the expected value of those claims would increase to  $(0.04 \times \$750,000) + (0.96 \times \$1,000,000) = \$990,000$ . The greater the reduction in the risk of bankruptcy, the higher the increase. Thus, if an originator is faced with certain bankruptcy unless it obtains liquidity but

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<sup>115</sup> See VICTOR BRUDNEY & WILLIAM W. BRATTON, *CASES AND MATERIALS ON CORPORATE FINANCE* 55-56 (4th ed. 1993); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* §15.1, at 471-72 & n.1 (4th ed. 1992) (both illustrating the expected value computation).

<sup>116</sup> On average, the value of assets in a bankruptcy will be less than their market value because many attempts at reorganization fail and the debtor ends up being liquidated. See, e.g., JAMES J. WHITE & RAYMOND T. NIMMER, *CASES AND MATERIALS ON BANKRUPTCY* 664 (3d ed.1996) (“It is not uncommon for a corporate debtor who has filed initially in Chapter 11 to convert to Chapter 7 for liquidation.”). In liquidation, the debtor's assets rarely will realize their market value. See MARK S. SCARBERRY ET AL., *BUSINESS REORGANIZATION IN BANKRUPTCY: CASES AND MATERIALS* 760 (1996) (“The liquidation value will, in most cases, be much less than going concern values. For example, inventory in the garment industry is often worth no more than one third of its cost in situations where the business is liquidated.”). Additionally, even in a reorganization, bankruptcy administration costs must be paid out of asset value before unsecured creditors are paid. 11 U.S.C. §§ 507(a) & 1129(a)(9) (requiring payment of bankruptcy administration claims before a plan of reorganization may be approved).

<sup>117</sup> This \$750,000 represents 75% of the cash proceeds of the securitization plus 75% of the originator's remaining assets. Absent overinvestment, the sum of those proceeds and remaining assets will always equal \$1,000,000 because securitization merely sells financial assets in return for cash, keeping the bottom-line of the asset and liability sides of an originator's balance sheet unchanged. *STRUCTURED FINANCE*, *supra* note 4, at 1-5 – 1-6. See also *supra* Part III.B.1 (same).

securitization reduces the originator's risk of bankruptcy to 25%,<sup>118</sup> the expected value of the originator's unsecured claims, absent liquidity, is equal to  $(1 \times \$750,000) + (0 \times \$1,000,000) = \$750,000$  and the expected value with securitization is equal to  $(0.25 \times \$750,000) + (0.75 \times \$1,000,000) = \$937,500$ .<sup>119</sup> Moreover, varying the bankruptcy valuation numbers will not change this result.<sup>120</sup>

Indeed, the only way securitization can reduce the expected value of unsecured claims is by increasing the risk that originators will go bankrupt. That should generally not happen. The availability of liquidity usually decreases, not increases, the risk of bankruptcy.<sup>121</sup> Furthermore, investors will not invest where the originator, notwithstanding the securitization, is likely to go bankrupt.<sup>122</sup> Originators at risk of going bankrupt are able to utilize securitization only if the liquidity thereby provided makes their bankruptcy unlikely. Thus, securitization should generally increase, or have a neutral impact on, the expected value of unsecured claims.

This is, of course, a very powerful result. In comparison, secured debt, unlike securitization, has a more ambiguous impact on the expected value of unsecured creditor claims.<sup>123</sup> The dramatic difference in the impact of these two forms of financing on those claims is due to the fact that secured debt is, *to the full extent of such debt*, a claim that, in bankruptcy, has priority over the originator's unsecured creditors; whereas the proceeds of such debt constitute an asset that, in bankruptcy, potentially loses a portion of its value.<sup>124</sup> In contrast, securitization does not create debt but merely substitutes assets—cash in return for financial assets.<sup>125</sup> Unsecured creditors are thus not subordinated to anyone in their recovery.<sup>126</sup>

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<sup>118</sup> Although I earlier argued that securitization will not generally be used for originators on the brink of insolvency, securitization may well be used in these circumstances because the originator will be likely to avoid bankruptcy.

<sup>119</sup> Of course, to the extent securitization reduces the originator's risk of bankruptcy below 25%, the expected value of the originator's unsecured claims would increase even more.

<sup>120</sup> For example, even if we assume a bankruptcy valuation of 90%, rather than 75%, for an originator faced with only a 10% risk of bankruptcy, a mere decrease of that risk to 9% would increase the expected value of the originator's unsecured claims from \$990,000 (that is,  $\{0.1 \times \$900,000\} + \{0.9 \times \$1,000,000\}$ ) to \$991,000 (that is,  $\{0.09 \times \$900,000\} + \{0.91 \times \$1,000,000\}$ ).

<sup>121</sup> *Rethinking the Role of Recourse in the Sale of Financial Assets*, *supra* note 24, at 187.

<sup>122</sup> See *supra* note 97 (explaining that capital market investors do not want to take the risk that, in a bankruptcy of the originator, a court will challenge the sale of financial assets). If such a challenge were successful, the SPV would become merely a creditor of the originator secured by the financial assets and, as such, would be subject to the automatic stay against enforcement of collateral remedies and the risk that the court would allow the originator to "use, sell, or lease" the collateral. *STRUCTURED FINANCE*, *supra* note 4, at 4-3 – 4-4.

<sup>123</sup> See Schwarcz, *Easy Case*, *supra* note 91, at 441-43, 466 (arguing that the availability of secured credit will benefit unsecured creditors only if the liquidity it creates reduces the probability of bankruptcy sufficiently more than the decreased recovery by unsecured creditors should bankruptcy occur).

<sup>124</sup> See *id.* at 472-74.

<sup>125</sup> Whereas I assume—as in a bankruptcy case involving secured debt—that proceeds of the securitization constitute an asset that, in bankruptcy, potentially loses a portion of its value, that

For these reasons, unsecured creditors generally should benefit from securitization, notwithstanding possible harm to creditors in individual cases. As shown below, unsecured creditors themselves believe that securitization is beneficial.

3. *Unsecured Creditors Themselves View Securitization as Providing Net Value:* Both empirical evidence and the widespread exclusion of securitization transactions from negative-pledge,<sup>127</sup> asset-sale,<sup>128</sup> and similar covenants demonstrate that unsecured creditors themselves view securitization as providing net value. First consider covenants.

To protect their interests, unsecured creditors traditionally impose these types of restrictive covenants on borrowing-companies, usually by including the covenants in loan agreements.<sup>129</sup> These covenants almost always include negative-pledge covenants, which restrict the company's ability to incur secured debt.<sup>130</sup> In contrast, unsecured creditors rarely impose covenants restricting the company's ability to enter into securitization transactions:

We often have to navigate our way through restrictive covenants in both secured and unsecured debt indentures in connection with trade receivables securitizations. As you indicated, these restrictions are often contained in sections dealing with restrictions on liens and sale of assets. We also encounter the restriction in the context of restrictions on the formation of subsidiaries (which, of course, are needed to allow the company to realize the residual value of the receivables) or requirements that cause newly-formed subsidiaries to become guarantors of the secured or unsecured debt (obviously, not permitted in securitization transactions). *Having said all that, I believe that your premise that securitization transactions are more favored by other lenders in [sic] basically correct. This can be seen through the development over the last several years of general exceptions from the negative covenants for securitization transactions. Moreover, some*

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factor would be neutral because, absent securitization, the unsold financial assets would likewise lose value.

<sup>126</sup> The only debt to which securitization is remotely comparable is non-recourse debt, in which “the obligation to repay borrowed money is secured by specific assets of the debtor, but the creditor does not have general recourse to the debtor’s remaining assets.” Schwarcz, *Easy Case*, *supra* note 91, at 462-63. Non-recourse debt “does not generally reduce the expected value of unsecured claims.” *Id.* at 464.

<sup>127</sup> Negative pledge covenants are imposed by a creditor to restrict a company’s ability to grant collateral to other creditors. Schwarcz, *Easy Case*, *supra* note 91, at 450.

<sup>128</sup> Asset-sale covenants are imposed by a creditor to restrict a company’s ability to sell or otherwise transfer assets to third parties. *See, e.g.,* Daniel J. Weiser and Allan Mouw, *The Basics of Debt Financing: Indenture Basics, Issues to Consider in Drafting Covenants and How to Conduct an Exxon Capital Exchange Offer*, 1307 PLI/CORP 197, 248, 249 (2002).

<sup>129</sup> *See, e.g.,* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 922 (1996) (referring to the “tremendously widespread use of negative pledge covenants in loan agreements”).

<sup>130</sup> *See supra* note 127.

*indentures will permit securitization transactions as long as the proceeds realized in connection therewith are reinvested in the business of company.*<sup>131</sup>

I recognize, of course, that the relative rarity of restrictions on securitization transactions is not dispositive evidence of securitization's efficiency.<sup>132</sup> The scarceness of those restrictions might be explained, for example, by a greater desire on the part of originators themselves to preserve the option to engage in securitization transactions, and therefore to more vehemently oppose the imposition of covenants restricting securitization than covenants restricting secured lending. Nonetheless, such scarcity at least indicates that unsecured creditors are not overtly threatened by securitization transactions.

Moreover, empirical evidence appears to support the stronger claim—that unsecured creditors view securitization as providing net value. This can be confirmed by observing how the prices of unsecured debt are affected by securitization. To this end, my research assistant, DongJu Song,<sup>133</sup> and I examined the data on public bond prices, because these data are at least somewhat available. A drop in bond prices following a securitization suggests that investors believe the securitization will hurt bondholders, whereas an increase in bond prices suggests the opposite.

We randomly selected several thousand securitization debt issues listed as outstanding in the 1999 Mergent Bond Record.<sup>134</sup> From that set, we identified to the extent publicly ascertainable the originator of each such securitization. We then excluded originators that, at the time of the relevant securitization, were distressed or otherwise appeared to be subject to exogenous factors that might influence bond prices. From that subset, we next attempted to examine each such originator's public bond prices for the 24-hour period prior to and after the announcement of the securitization. Using all of the available data services—Datastream, Bloomberg, Lexis, Dow Jones News Retrieval Service, Westlaw, Moody's, Standard & Poor's, the *Wall Street Journal*, and the Internet—we were able to locate originator bond data for 145 securitization transactions<sup>135</sup> issued between 1994 and 1999.<sup>136</sup> We were unable to obtain bond

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<sup>131</sup> E-mail from Henry G. Morriello, securitization partner, Kaye Scholer LLP, to the author (Feb. 3, 2003; emphasis added) (on file with author). *Accord*, e-mail from Terry D. Novetsky, securitization partner, Kaye Scholer LLP, to the author (Feb. 3, 2003) (on file with author) (agreeing that “it is quite typical of indentures today to specifically ‘carve out’ receivables securitization transactions and not secured lending against receivables in its covenants relating to future transactions”).

<sup>132</sup> *But cf.* Alan Schwartz, *Taking the Analysis of Security Seriously*, 80 VA. L. REV. 2073, 2078 (1994) (arguing that “negative pledge clauses, which prohibit later secured borrowings, are almost ubiquitous. Therefore, there is no empirical uncertainty respecting the effect of later secured debt on earlier unsecured debt: the former reduces the value of the latter.”). To the extent this logic can be conversely applied, the relative rarity of covenant restrictions on securitization suggests that securitization does not reduce the value of unsecured claims.

<sup>133</sup> J.D./M.B.A. 2003, Duke University.

<sup>134</sup> We choose historical data that would not be influenced by the collapse of Enron and resulting investor irrational avoidance of even beneficial complex transactions. *See* Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, *supra* note 65, at \_\_\_.

<sup>135</sup> These 145 transactions included fewer than 145 originators because some originators engaged in multiple transactions.

data for all of the originators because some did not have bonds outstanding during the relevant period and most of the bond-price information services limit their archived data to bonds rated investment grade or better.

Subject to these limitations, the data from the bond test suggest that bondholders believe they will benefit from securitization. The average price change for the bonds of these 145 transactions, adjusting for the effect of general corporate bond market performance, was an eight-cent, or 0.08%,<sup>137</sup> increase in bond price, with statistical significance of 88.27%. This means that our sample demonstrates an 88% probability that the effect of a securitization transaction on the originators' unsecured creditors is positive.<sup>138</sup>

These data, the relative rarity of covenants restricting securitization transactions, and the fact that securitization provides the originator with sale proceeds equal to the value of the assets sold and any harm from overinvestment of those proceeds should be more than offset, indicate that securitization creates net value for unsecured creditors. As a result,  $Z$ , the net harm to unsecured creditors, should be zero if not negative<sup>139</sup>—and thus certainly non-material. Accordingly,  $X + Y$  will equal or exceed  $Z$ , making securitization Kaldor-Hicks efficient.<sup>140</sup>

For any still unconvinced, I next argue that securitization's efficiency even survives scrutiny under a "black-box" test, which examines the originator and its creditors both before and after the securitization and asks whether securitization adds anything of net value. The hurdle to reaching this conclusion is that the principle of "exposure conservation" asserts that asset-based financing, and therefore presumably securitization,<sup>141</sup> cannot add net value:

Secured creditors will charge lower interest rates because security reduces their risks, but unsecured creditors will raise their interest rates in response because security reduces the assets on which they can levy, and so increases their risks.

<sup>136</sup> That is, after using the 1999 Mergent Bond Record to identify outstanding securitization transactions, we then went back to each transaction's date of issuance—representing, for all such transactions, dates between January 1994 and July 1999.

<sup>137</sup> Because bond prices are, by convention, measured at \$100 at the time of issue, the 0.08% price increase is \$0.08 expressed as a percentage of \$100.

<sup>138</sup> We also examined each such originator's public bond prices for the month prior to and month after the relevant securitization. The average price change for the bonds was then a two-cent, or 0.02%, decrease, with statistical significance of 61.45%. Although this suggests that the longer term effect of a securitization transaction on the originator's unsecured creditors may be negative, that result is not nearly as statistically significant as the positive result described above. Furthermore, it is harder to account for exogenous factors influencing bond price within that longer time period.

<sup>139</sup> Recall that  $Z$  would be negative where there is net benefit to unsecured creditors.

<sup>140</sup> See *supra* note 78 and accompanying text. Furthermore, if  $Z$  is zero or negative, then no parties are harmed by securitization, making it at least class Pareto efficient. See *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, *supra* note 32, at 563 (applying Pareto efficiency not to affected individuals but to affected classes).

<sup>141</sup> Although this principle is stated above in the context of secured financing, for purposes of argument I will assume—against the interest of what I am trying to prove—that it is applicable to securitization, another form of asset-based financing.

The interest rate reductions are precisely matched by interest rate increases; hence, the firm makes no net gain from granting security.<sup>142</sup>

The question for securitization then becomes: will unsecured creditors raise their rates in response to an originator's securitization,<sup>143</sup> such that the rise in unsecured interest rates will precisely match the rate reduction afforded by the securitization? If so, the originator would realize no net gain.

Because securitization permits a dramatic rate reduction, I next argue that the aforesaid rise in unsecured interest rates will generally be less than the rate reduction afforded by securitization. As discussed, securitization enables the originator to access a new source of financing—the capital markets—whose rates are systematically lower than secured debt borrowing rates.<sup>144</sup> This transformation to low-cost capital market funding reduces net financing

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<sup>142</sup> Alan Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051, 1054 (1984) (emphasis deleted). Cf. Modigliani & Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, *supra* note 10.

<sup>143</sup> This assumes that unsecured creditors can raise their rates. To the extent they are unable to raise their rates, the above analysis would take into account any harm to such creditors because of that inability.

<sup>144</sup> See, e.g., Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101, 105 (1997) (observing that “[b]ecause these assets are usually accounts owed by a large number of borrowers, the risk of nonpayment is spread over many loans and can be priced very accurately, enabling investors in asset securitizations to charge a lower rate of interest than a bank would charge on a comparable loan secured by nonsegregated receivables”). Although it is empirically evident that the capital markets fund securitization transactions at a lower interest rate than the rate on secured debt, one might ask why. One answer is that securitization uniquely reduces the information asymmetry between the originator and investors. Because the originator's financial assets are sold to a bankruptcy remote SPV in a “true sale,” investors in the SPV only take the risk that those assets will fail to be paid (“no-pay” risk), or will be paid late (“slow-pay risk”). See STRUCTURED FINANCE, *supra* note 4, § 2:1.1 (describing these risks). Because financial assets are discrete and have a “reasonable predictability of payment” (*id.* § 2:1, at 2-1), investors can assess the no-pay and slow-pay risks more easily, and with greater accuracy, than the risks associated with the originator as a whole. This bankruptcy remoteness also reduces creditor “monitoring costs.” Creditors generally monitor borrowers to help ensure that the borrower's actions do not unduly increase the loan's riskiness. Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L. J. 1143, 1149 (1979). A secured creditor has the cost of monitoring not only the collateral but also the borrower; this is because if the borrower enters bankruptcy, an automatic stay will freeze the secured creditor's ability to exercise remedies against the collateral and thereby impair the secured creditor's collateral position. 11 U.S.C. § 362(a). See also Schwarcz, *The Alchemy of Asset Securitization*, *supra* note 4, at 150; SECURITIZATION OF FINANCIAL ASSETS § 5.05 (Jason H.P. Kravitt ed., 2d ed. 1996). In a securitization, in contrast, bankruptcy remoteness assures the ability of the SPV's creditors to be repaid, even in the event of the originator's bankruptcy (assuming, of course, that the financial assets themselves are not adversely affected by the originator's bankruptcy—in securitization transactions, financial assets are usually selected based on their independence from the originator's risks, STRUCTURED FINANCE, *supra* note 4, §§ 2:1, 2:2). Another reason that capital market rates are lower is that “[c]apital markets are the ‘deepest’ and most ‘liquid’ of all financial markets, offering the greatest number of investors and transactions and often the lowest

costs. To understand why, consider the following example. Assume that an originator with \$100 million of unsecured debt bearing an interest rate of  $R$  percent repays \$50 million of this unsecured debt with the proceeds of a new \$50 million issuance of secured debt. The principle of exposure conservation states that if the interest rate on the secured debt is reduced to  $R-S$  percent, this reduction in rate will be matched by an interest rate increase on the remaining unsecured debt to  $R+S$  percent—assuming, of course, that the unsecured creditors are free to adjust to a market rate.<sup>145</sup> Therefore, according to this principle, the originator obtains no net gain from the issuance of secured debt. If, however, the originator repays the \$50 million of unsecured debt from the proceeds of a securitization, instead of from the issuance of secured debt, the interest rate on the remaining unsecured debt should rise no higher than  $R+S$  percent.<sup>146</sup> However, because capital market rates are generally lower than secured debt rates,<sup>147</sup> the effective interest rate for the securitization will reduce to  $R-S-\Delta$  percent (where  $\Delta$  percent represents the rate differential between capital market and secured debt rates).

If securitization bore no transaction costs, the originator in this example would save  $\Delta$  percent of \$50 million in annual interest costs by refinancing through a securitization rather than through secured debt. The originator's actual cost saving, however, would be at least partially offset by the transaction costs of implementing the securitization. But as long as the originator's interest and transaction costs for a securitization are less than the equivalent costs for secured debt, securitization will create a net cost savings by providing access to lower-cost capital-market funding.

4. *Securitization is Efficient Notwithstanding its Impact on Non-Adjusting Creditors:* This article so far has not explicitly addressed securitization's efficiency in light of its impact on unsecured creditors that cannot adjust their interest rates to compensate for problems ("non-adjusting creditors"). Non-adjusting creditors include involuntary creditors, such as tort creditors, as well as voluntary creditors that, for whatever reason—e.g., they extend credit on fixed terms or, like some trade creditors, their claims are so small that it is impractical to monitor—cannot adjust their interest rates.<sup>148</sup> There is a perceived uneasiness that securitization may harm non-adjusting creditors without any offsetting compensation,<sup>149</sup> and that such uncompensated harm

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cost source of financing.” Claire A. Hill, *Securitization, A Low Cost Sweetener For Lemon*, 74 WASH. U.L.Q. 1061, 1073,1074 (1996).

<sup>145</sup> This also assumes, arguendo, that the principle of exposure conservation is true.

<sup>146</sup> The actual increase in the unsecured borrowing rate may well be less for securitization than for secured borrowing. Although financial assets sold in a securitization are theoretically more insulated from the originator's bankruptcy than are assets pledged as collateral (*see supra* note 122 and accompanying text), if those financial assets are insufficient to repay the SPV's creditors such creditors will have no claim against the originator's remaining assets. In contrast, if the collateral in a secured financing is insufficient to pay the secured debt, the secured creditors still may assert unsecured deficiency claims against the originator's remaining assets—claims that will be *pari passu* with, and therefore reduce recovery on, existing unsecured claims. *See* 11 U.S.C. § 506(a).

<sup>147</sup> *See supra* note 144.

<sup>148</sup> Bebchuk & Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, *supra* note 129, at 869-70.

<sup>149</sup> One commentator even contends that non-adjusting creditors *will* be harmed. Lupica, *The Unsecured Creditor's Perspective*, *supra* note 72, at 622-23 (“[I]f the originator did not bargain

might make securitization inefficient or unfair.<sup>150</sup> I discuss the matter of potential unfairness in Part III.C, below. This Part III.B.4 focuses on the issue of efficiency.

There are at least three explanations why, notwithstanding possible harm to non-adjusting creditors, securitization is efficient. First, Kaldor-Hicks efficiency is a function of aggregate benefit and harm, not harm to any particular sub-class (such as non-adjusting creditors). Thus, a transaction can be efficient even though non-adjusting creditors are harmed. My analysis shows that securitization is efficient even though unsecured creditors—a class which includes non-adjusting creditors—may be harmed. Thus, securitization is efficient even though non-adjusting creditors may be harmed.

The second explanation why securitization is efficient follows from the work of Professor Robert Scott in the secured-lending context, which should have similar application here. Scott has argued that the efficiency effects of non-adjustment turn on whether subsequent positive-value projects would be financed without secured credit.<sup>151</sup> In our context, the parallel argument would be that the efficiency effects of non-adjustment turn on whether subsequent positive-value projects would be financed without securitization. Although an empirical question, it appears that securitization is, indeed, sometimes the only method of financing positive-value projects.<sup>152</sup> To that extent, any adverse impact of non-adjustment would be mitigated.

Scott notes, however, that even if some positive-value projects can only be financed with secured credit—or, in our context, with securitization—the ultimate question is, “[w]hat are the relative values of these two offsetting effects.”<sup>153</sup> In other words, does the value of financing those positive-value projects sufficiently offset any harm to non-adjusting creditors? In the

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with its unsecured creditors prior to the securitization, either because the creditors are involuntary or otherwise nonadjusting, a transfer of value from the creditors to the firm’s shareholders will result.”). Just because one has not bargained, however, does not mean one will be harmed. The inability to bargain only calls for the next level of inquiry, into whether non-adjusting creditors in fact are harmed and, if so, what are the consequences.

<sup>150</sup> This uneasiness, expressed at the Cardozo symposium by Alan Schwartz of Yale Law School, is mirrored in the writings of Professors Lupica and Janger. See Lupica, *The Unsecured Creditor’s Perspective*, *supra* note 72, at 659; Edward J. Janger, *Muddy Rules for Securitizations*, 7 *FORDHAM J. CORP. & FIN. L.* 301, 306 (2002). See also Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 *YALE L.J.* 857, 869-70 (1996) (originally raising this uneasiness in the context of examining the efficiency of secured lending). The uneasiness can be understood from the standpoint of the Coase theorem, which predicts that, under restrictive assumptions including costless bargaining, parties adversely affected by externalities will bargain with the source of the externalities to arrive at a socially optimal result. Where there are non-adjusting creditors, however, the Coase theorem assumption of costless bargaining is violated because such creditors usually cannot bargain. Thus, one cannot rely on the theorem’s prediction, and must make further inquiry.

<sup>151</sup> Robert E. Scott, *The Truth About Secured Financing*, 82 *CORNELL L. REV.* 1436, 1443 (1997).

<sup>152</sup> See *Rethinking the Role of Recourse in the Sale of Financial Assets*, *supra* note 24, at 187 (arguing that “the proceeds of [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”).

<sup>153</sup> Scott, *The Truth About Secured Financing*, *supra* note 151, at 1461.

secured lending context, he answers, “[a]t this point we do not have a clue.”<sup>154</sup> In the securitization context, though, we have more than a clue. The net harm to non-adjusting creditors is likely to be zero or negative.<sup>155</sup> Thus, few if any additional positive-value projects—and, as mentioned, there may be many such projects—would be needed to offset the harm.

The third explanation why securitization is efficient is the most straightforward: as shown in Part III.C below (and already implicitly shown in the discussion above), non-adjusting creditors, as a class, are *not actually harmed* by securitization.

### C. *Is Securitization Fair?*

The foregoing analysis has shown only that securitization is efficient under the Kaldor-Hicks model of efficiency. But that model merely requires that the aggregate benefit to the parties to the securitization—the originator and the SPV’s investors—exceeds any net harm to the originator’s unsecured creditors.<sup>156</sup> Kaldor-Hicks efficiency alone does not ensure that securitization is fair to unsecured creditors.

My analysis, however, implicitly demonstrates that securitization is indeed fair to, and does not prejudice, unsecured creditors as a class.<sup>157</sup> Although individual unsecured creditors certainly could, and undoubtedly sometimes will, be harmed by securitization transactions,<sup>158</sup> I have shown that Z, the net harm to unsecured creditors as a class, is not only non-material but also likely to be zero or negative. This is because securitization transactions, in the aggregate, create net value for unsecured creditors.<sup>159</sup> Even though unsecured creditors sometimes will be harmed where an originator that goes bankrupt overinvests the securitization proceeds, that harm should be more than offset in the aggregate by the lower interest-cost burden on originators and the liquidity provided to originators that are unable to borrow.<sup>160</sup>

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<sup>154</sup> *Id.*

<sup>155</sup> *See supra* notes 81-147 and accompanying text.

<sup>156</sup> *See supra* note 77 and accompanying text.

<sup>157</sup> This Part III.C focuses solely on distributional fairness. *Cf.* Kaplow & Shavell, *Fairness Versus Welfare*, *supra* note 77 (arguing that it is inappropriate to consider conceptions of fairness other than distributional fairness in making a policy decision).

<sup>158</sup> My discussion of distributional fairness uses an *ex ante* analysis to consider the effects of the legal rules surrounding securitization on unsecured creditors as a class, as opposed to actual individual creditors. *Cf. Easy Case*, *supra* note 91, at 432 (describing this type of fairness analysis as an *ex ante*, or “class,” Pareto analysis). I conclude that securitization is fair because it makes all parties better off, at least viewed *ex ante*. That, *ex post*, individual creditors sometimes will be harmed by securitization transactions should not be dispositive of the fairness issue: *ex ante* analysis takes into account all possible effects of a legal rule, while *ex post* analysis only considers effects of a legal rule given the events that actually occurred. Kaplow & Shavell, *Fairness Versus Welfare*, *supra* note 77, at 1007-1011.

<sup>159</sup> *See supra* notes 81-126 and accompanying text.

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

Thus unsecured creditors *as a class* benefit from, and therefore are not harmed by, securitization. Absent favoritism or prejudice,<sup>161</sup> fairness must be judged by reference to a class, not its individual members.<sup>162</sup>

Nonetheless, my article must respond to perceived uneasiness that securitization would be unfair to the extent it harms non-adjusting creditors.<sup>163</sup> My analysis, however, already *implicitly* demonstrates that securitization does not harm non-adjusting creditors as a class.<sup>164</sup> This is because the claims of unsecured creditors are *pari passu*,<sup>165</sup> and nothing in my analysis turns on unsecured creditors being voluntary or involuntary or having the ability to adjust their interest rates to offset harm. Therefore, by showing that securitization has a positive, or at worst neutral, impact on repayment of the undifferentiated class of creditors holding unsecured claims, the analysis necessarily shows that securitization has that same positive or at worst neutral impact on repayment of the subclass of non-adjusting creditors.

Furthermore, the conclusions of Part III.B.3, which confirm this analysis by examining the experience of voluntary creditors,<sup>166</sup> should apply equally to involuntary and other non-adjusting creditors. That Part studies empirical data on bond-market pricing as well as the relative rarity of contractual covenants restricting securitization to show that unsecured creditors themselves view securitization as providing net value. Although any decision to (or not to) impose contractual covenants restricting securitization would necessarily be voluntary, the scarcity of such covenants also should reflect the views of non-adjusting creditors. That is because the creditors studied, having decided *ex ante* not to impose such covenants, are unable to adjust their rates in the event of a future securitization.<sup>167</sup> Therefore, *except as discussed in the next paragraph*, they will not be “adjusting” creditors who can raise their interest rates to

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<sup>161</sup> There is no reason to believe that securitization favors or prejudices any particular subset—including tort creditors or other involuntary or non-adjusting creditors—of the class of unsecured creditors.

<sup>162</sup> See, e.g., Anthony T. Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472, 487 (1980) (“unlike a court, a legislature must evaluate the effects of proposed rules on classes of persons rather than on particular, identifiable individuals”).

<sup>163</sup> See *supra* note 150 and accompanying text.

<sup>164</sup> Recall the analysis shows that Z, the net harm to unsecured creditors, is likely to be zero or negative. This is because securitization provides the originator with new money; therefore, unsecured creditors are not harmed absent overinvestment; and, even though overinvestment sometimes occurs, it only harms unsecured creditors where the originator goes bankrupt, and that harm should be more than offset by the originator’s lower interest-cost burden and the fact that securitization provides needed liquidity. See *supra* Parts III.B.1 and III.B.2.

<sup>165</sup> See 11 U.S.C. § 726(a) (setting forth order of payment of claims in bankruptcy). *Pari passu* means that claims have equal and ratable priority of repayment, particularly in bankruptcy.

<sup>166</sup> See Part III.B.3, *supra*.

<sup>167</sup> Nor, in my experience, do contracts typically obligate originators that later engage in a securitization to pay a higher interest rate.

compensate for possible securitization risk.<sup>168</sup> Their favourable views of securitization thus should reflect the views of non-adjusting creditors, with whom they are *pari passu*.

The only counter-argument is that unsecured credit unprotected by covenants restricting securitization may be priced *ex ante* at high interest rates to offset later securitization risk. That argument is weak, however, since most unsecured credit lacks the protection of these covenants.<sup>169</sup> Moreover, Part III.B.3's empirical data on bond-market pricing belie that argument.<sup>170</sup> If the bonds were priced *ex ante* to offset future securitization risk, the effect of a subsequent securitization on bond pricing would be neutral. The data, however, show a price increase.<sup>171</sup>

The empirical data on bond-market pricing likewise confirm my analysis. Although those data result from voluntary purchases and sales, bonds are usually fixed-rate instruments<sup>172</sup> and thus investors in the bonds are not "adjusting" creditors except to the extent they buy at a discount (buying at a discount being the economic equivalent of raising the bonds' interest rate).<sup>173</sup> However, whereas buying at a discount lowers bond prices, the empirical data show that securitization instead has the effect of *raising* bond prices.<sup>174</sup> This suggests that voluntary bond investors are effectively non-adjusting creditors insofar as securitization is concerned. Their favourable views of securitization therefore, as before, should reflect the views of non-adjusting creditors, with whom their claims are *pari passu*.

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<sup>168</sup> Another way to think about this is that, absent covenants restricting securitization, originators can engage in securitization deals freely, making the voluntary creditors non-adjusting creditors insofar as securitization is concerned.

<sup>169</sup> See *supra* note 131 and accompanying text.

<sup>170</sup> Note that the bonds that are the subject of these empirical data were randomly chosen. See *supra* note 171 and accompanying text. Therefore, virtually all of these bonds would be expected to lack covenants restricting securitization, making the comparison above valid.

<sup>171</sup> Even if the aforesaid counter-argument (that unsecured credit unprotected by covenants restricting securitization is already priced at high interest rates to offset possible securitization risk) were true, one could make a similar argument about the largest class of involuntary creditor, the tort creditor in a products liability case. A person that chooses to buy a product of dubious manufacture (for example, an electrical device that is not Underwriters' Laboratory certified) and is later injured by that product's malfunctioning might well be said to be an adjusting creditor; after all, he almost certainly paid a lower purchase price than if he bought a higher quality competing product and therefore was compensated for the risk by the lower price.

<sup>172</sup> See, e.g., *DICTIONARY OF FINANCIAL TERMS* (Lightbulb Press 2003) ("Bonds are, in fact, loans that...investors make to the issuers in return for the promise of being paid interest, usually but not always at a fixed rate") (available at <http://206.114.147.62/lbp/dictionary.asp>).

<sup>173</sup> I use the term "adjusting" in this limited sense of buying at a discount to achieve the economic equivalent of raising the bonds' interest rate. Although creditors "adjust" in a broader sense when they pay more than face value for a bond, thereby achieving the economic equivalent of lowering the bond's rate, that type of adjustment does not signal a problem and therefore is irrelevant to this article's discussion.

<sup>174</sup> A rise in bond prices means that investors believe the bonds' interest rate is attractively high, and they are therefore prepared to pay more for the bond.

This conclusion stands to reason: securitization benefits unsecured creditors as a class; the claims of non-adjusting creditors are *pari passu* with the claims of all other unsecured creditors; therefore non-adjusting creditors are benefited or at least not materially harmed by securitization, the same as other unsecured creditors. Nonetheless, one might ask how this conclusion comports with the Modigliani & Miller theorem, that in a perfect universe any savings achieved by changing one part of a company's capital structure will result in offsetting costs to other parts of the capital structure.<sup>175</sup> At least part of the answer is that the universe in which securitization operates is *not* perfect. Its imperfections include, among other things, information asymmetry and intermediation costs.<sup>176</sup> An answer also is provided by recent scholarship, which finds that "incentives for asset securitization ... involve forces purely internal to the contractual parties."<sup>177</sup> This finding "responds to normative criticism of [securitization] by those who see it simply as a means of responding to external factors, like the possibility of involuntary creditors."<sup>178</sup>

#### D. Does Securitization Undermine Bankruptcy Policy?

Notwithstanding securitization's efficiency and fairness, securitization is sometimes seen as undermining bankruptcy policy.<sup>179</sup> The concern is that securitization sometimes will be used, in lieu of secured financing, as a means of avoiding certain bankruptcy-law restrictions. For example, if a company goes bankrupt, the bankruptcy court, after notice to creditors and the opportunity of a hearing, could order the cash collections of the collateral to be used by the company in its business as working capital if the lender receives adequate protection.<sup>180</sup> In addition, if credit is not otherwise available, the company, by providing adequate protection, can raise cash by granting to new lenders a lien that is either *pari passu* with that of the pre-petition secured lender or, if needed, having priority over such lender.<sup>181</sup> Securitization, however, typically transfers ownership of

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<sup>175</sup> See *supra* note 10 and accompanying text.

<sup>176</sup> See *supra* notes 5-8 and accompanying text. *Accord*, Schwarcz, *The Alchemy of Asset Securitization*, *supra* note 4, at 148 n. 53: "In a perfect universe [referring to Modigliani-Miller theorem], every savings achieved by changing one part of a company's capital structure will result in off-setting costs to other parts of the capital structure .... Securitization achieves a net cost savings because the universe is imperfect."

<sup>177</sup> Iacobucci & Winter, *Asset Securitization and Asymmetric Information*, *supra* note 96, at 3 (arguing that securitization reduces agency costs).

<sup>178</sup> *Id.* at 18.

<sup>179</sup> See *supra* note 33 (discussing the bankruptcy case of LTV Steel Company, in which the bankruptcy court held that respecting the securitization transaction as a true sale would deprive the debtor of liquidity, thereby jeopardizing jobs and retiree benefits and adversely affecting the local economy).

<sup>180</sup> See 11 U.S.C. § 363. "Adequate protection" is not defined in the Bankruptcy Code. Instead, section 361 of the Bankruptcy Code provides examples of what may constitute adequate protection, such as making periodic cash payments to the creditor (§ 361(1)) or granting a lien on other unencumbered property of the company (§ 361(2)), and leaves it for the courts to decide on a case-by-case basis what constitutes "adequate protection" in the circumstances. See, e.g., *In re Timbers of Inwood Forest Ass'n*, 808 F.2d 363 (5th Cir. 1987), *aff'd*, 484 U.S. 365 (1989); *In re AIC Indus.*, 83 B.R. 774, 777 (Bankr. D. Colo. 1988); *In re O.P. Held, Inc.*, 74 B.R. 777, 782-84 (Bankr. N.D.N.Y. 1987).

<sup>181</sup> 11 U.S.C. § 364.

financial assets from the originator to the SPV,<sup>182</sup> thereby obviating the originator's ability, in bankruptcy, to use their cash collections or to raise cash by granting to new lenders a lien on such collections.<sup>183</sup>

However, the argument that securitization thereby undermines bankruptcy policy is a chimera. The originator, after all, freely makes the choice of its financing transactions. Securitization has a lower cost *precisely due to bankruptcy remoteness*.<sup>184</sup> If, therefore, the originator chooses securitization in order to benefit from that lower cost, it should not have the right to later complain.<sup>185</sup> Moreover, the very availability of securitization as a financing option, by providing liquidity to otherwise viable originators unable to borrow, has been shown to facilitate the fundamental bankruptcy policy of debtor rehabilitation.<sup>186</sup>

#### IV. Conclusions.

This article has explained the threats to securitization in the post-Enron economic and regulatory climate, and has explored, more normatively, whether the threats are justified. Because securitization uses special-purpose vehicles and facilitates off-balance sheet financing, it has been tainted by Enron's abuses, which relied heavily on special-purpose entities and off-balance sheet financing. Because of this taint and its complexities, politicians often lose perspective when dealing with securitization.

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<sup>182</sup> This transfer of ownership assumes a true sale.

<sup>183</sup> STRUCTURED FINANCE, *supra* note 4, at 4-3 – 4-5. *Cf. Rethinking the Role of Recourse in the Sale of Financial Assets*, *supra* note 24, at 186. Although the court in LTV Steel Company's bankruptcy temporarily allowed the debtor to use securitization proceeds pending resolution of the true-sale issue, that case "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." STRUCTURED FINANCE, *supra* note 4, at 4-4.

<sup>184</sup> *See supra* notes 107 & 144 and accompanying text (discussing securitization's lower interest-rate cost).

<sup>185</sup> Although some may argue that the pre-petition originator is, technically, a different entity from the bankrupt company, that "separate entity" theory has been largely discredited by the Supreme Court and by most commentators and other courts. *See, e.g.*, NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984) (rejecting the "new entity" characterization); Thomas G. Kelch, *An Apology for Plain-Meaning Interpretation of the Bankruptcy Code*, 10 BANKR. DEV. J. 289 (1994) (showing that the separate entity doctrine has been discredited); Thomas G. Kelch, *The Phantom Fiduciary: The Debtor in Possession in Chapter 11*, 38 WAYNE L. REV. 1323, 1334 (1992) (observing that the new entity theory "is near death and is being replaced by a less occult conceptual model of the debtor in possession"); Stephen McJohn, *Person or Property? On the Legal Nature of the Bankruptcy Estate*, 10 BANKR. DEV. J. 465, 466 (1994) (reviewing the decline of the separate entity doctrine); Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 235-36 (1989) (asserting that judicial wariness of the new entity theory "is likely correct because the notion of a 'new entity' not bound by the contract conflicts with the trustee's duty to pay damages for rejecting the contract").

<sup>186</sup> *See supra* notes 46 & 112-114, and accompanying text.

There are, however, very fundamental differences between Enron's deals and securitization transactions. Securitization is normally used by companies to obtain lower-cost financing through removal of intermediaries between the company and the ultimate source of funds, the capital markets. This is markedly different from Enron's use of special-purpose vehicles for mere financial-statement manipulation. Even where securitization is used to keep debt off a company's balance sheet, it unambiguously transfers risk from the company to third parties.

Perhaps the most fundamental difference, however, turns on conflicts of interest. The complexities of the Enron deals, and perhaps of certain securitization transactions, make it difficult for corporate directors and shareholders under existing corporate-law procedures to knowledgeably approve the deals. In the face of complexity, they also must rely on the business judgment of the managers that structure the deals—a reliance that may be misplaced where, as in Enron, those managers have significant conflicts of interest. In contrast, management in securitization transactions have been free of material conflicts. Although the absence of material conflicts may well explain why actual securitization transactions have not raised any of the excesses found in Enron or other corporate scandals, I have argued elsewhere for regulation to limit the existence of such conflicts to ensure that future securitization transactions likewise do not give rise to excesses.

The absence of excesses does not, however, mean that securitization is desirable. I therefore next examined whether securitization is efficient and fair, and concluded it is both. Securitization enables companies to obtain low-cost capital market financing, and provides liquidity for otherwise viable companies that need but cannot otherwise obtain financing. And it does this without prejudicing any third-parties, such as unsecured creditors. Moreover, any contention that securitization violates bankruptcy policy is not only false but inverted; the very availability of securitization as a financing option facilitates bankruptcy rehabilitation policy.

For these reasons, and because securitization is an integral part of the fabric of modern finance in the United States and abroad,<sup>187</sup> anyone seeking to limit or restrict it should bear the burden of proof.<sup>188</sup>

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<sup>187</sup> See, e.g., First Interim Report of Neal Batson, Court-Appointed Examiner, in *In re Enron Corp.*, Case No. 01-16034 (AJG) (Sept. 21, 2002), at 22 (observing that securitization transactions “reflect the innovation for which the U.S. capital markets are known[,] ... have many legitimate uses and comprise a significant part of our capital markets”; and also noting that “total outstanding mortgage-backed and asset-backed securities in the United States alone exceed \$6 trillion”); Tamar Frankel, *Asset Securitization: Marvel of the Marketplace, But Should We Be Uneasy?*, 73 B.U. L. REV. 271, 271 (1993) (recognizing securitization as playing “a significant role in our financial markets”); Joseph Phillip Forte, *Wall Street Remains a Key Player in Commercial Real Estate Financing Despite Capital Market Fluctuations*, 73 N.Y. ST. B. J. 34, 38 (Aug. 2001) (“commercial mortgage securitization is and will continue to be an integral as well as critical factor in real estate finance”).

<sup>188</sup> Cf. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, *supra* note 91 (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).