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The Uniform Commercial Code Survey: Introduction

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Much of the commercial litigation in the last year—and probably even more in the current year—has its roots in the subprime meltdown and resulting liquidity crisis. Although few of the developments reported on in this year's Survey deal directly with those events, we are impelled to offer a few comments and observations.

Securitization, by which we mean the bundling of debt obligations (such as home mortgages or credit card receivables) and selling pieces of the resulting bundle in the securities markets, has been a hot topic in commercial finance circles. Of particular note is Professor Ken Kettering's article, *Securitization and Its Discontents: The Dynamics of Financial Product Development*,[1] which won the American College of Commercial Finance Lawyers' Grant Gilmore Award. It is a thoughtful and provocative piece suggesting that securitizations are more vulnerable to attack as fraudulent transfers than is popularly believed.

Whether one agrees with Professor Kettering's assessment, the fact remains that securitizations are an offshoot of traditional secured transactions and are made possible by Article 9 of the Uniform Commercial Code. They are supposed to be a boon to the economy. For borrowers, they add liquidity by tapping sources of capital that were previously either unused or difficult to access. They therefore can bring down the cost of credit.[2] For lenders, they spread risk. No longer does the local bank hold most of the mortgages secured by property in a small geographic area and thereby bear excessive risk from a flood, hurricane, or localized economic downturn. For investors, they are egalitarian, allowing many different types of institutions and entities to participate in types of financing that they previously could not.

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1. 29 CARDOZO L. REV. 1553 (2008).

2. *See id.* at 1569–70; Robert Dean Ellis, *Securitization Vehicles, Fiduciary Duties, and Bondholder Rights*, 24 J. CORP. L. 295, 301 (1999).

Although some question whether these benefits are real,[3] we are inclined to accept that they are. However, the events of the last few years have also shown that securitizations have drawbacks too. We draw attention to two of them here in the hope that the financial markets will acknowledge and address them.

The Disassociation of Ownership from Responsibility

One of the lessons from Hurricane Katrina is the problem arising from the disassociation of ownership from responsibility. In most securitizations, an administrative agent is responsible for administering the bundled financial assets for the security holders and the agent has a fiduciary duty to the security holders.[4] Although the agent may also own some of the securities, its fiduciary duty as agent is unbridled by countervailing considerations. Thus, even though the agent may wish to agree to a forbearance after a Katrina-like event, it may not have (or may be unsure whether it has) the discretion to do that.

This is a far cry from the day when a mortgage loan or car loan originated by the local bank or savings and loan stayed with the originator. In such cases, the same entity that owned the financial asset also administered the financial asset. If the borrower sought forbearance or some other type of relief, the lender was free to give it if the lender thought that such relief was justified under the circumstances. The securitization structure makes the granting of such relief almost impossible. Even if the administrative agent believes relief is appropriate, it may not have or believe that it has the power to grant it without the security holders' consent. If, as is likely, the securities are diffusely held, obtaining that consent may be impossible or impractical.[5]

The Disassociation of Origination from Ownership

One of the many lessons from the subprime meltdown is the problem arising from the disassociation of origination from ownership. The loan originators may no longer have the incentive to make sure the borrowers will perform; they merely want to originate, sell, and take their commission. As a result, the system is primed for both fraud and reckless lending. For example, we see several reported cases involving the double-booking of loans, where the originator gets the borrower to sign duplicate original promissory notes and then sells each note to a different warehouse lender.[6] We see others where the originator makes off

3. *See, e.g.*, Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 Tex. L. Rev. 595, 597–99 (1998); Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 Tul. L. Rev. 101, 102–08 (1997).

4. *See* Ellis, *supra* note 2, at 309 (discussing the fiduciary duty of the entire special purpose entity to its bondholders).

5. While it would no doubt be possible to draft the securitization documents to ensure that the administrative agent has the requisite authority and discretion, such discretion may affect the rating of the securities and undermine the market for them.

6. *See, e.g.*, DLJ Mortgage Capital, Inc. v. Homeloan Mortgage Corp., No. B193493, 2008 WL 376941, at *1–2 (Cal. Ct. App. Feb. 13, 2008); Provident Bank v. Cmty. Home Mortgage Corp., 498 F. Supp. 2d 558, 561–63 (E.D.N.Y. 2007).

with the cash, leaving the borrower, the lender, or the lender's insurer with a substantial loss.[7] We also see cases in which the borrowers allege that the originator instructed them to put incorrect information on their loan applications in order to ensure that the loan would get approved.[8]

Neither of these types of disassociation is restricted to securitized loans, but the securitization process makes the abuses they enable more likely.

7. *See, e.g.*, Ohio Sav. Bank v. Progressive Cas. Ins. Co., 521 F.3d 960, 961–62 (8th Cir. 2008) (holding that bank's insurer not liable for originator's fraud in taking the money and not paying off the existing mortgages). Note, this problem can also arise from the disassociation of ownership from responsibility any time a loan servicer is used. *See, e.g.*, Balmer v. 1716 Realty LLC, No. 05 CV 839 (NG) (MDG), 2008 WL 2047888, at *1–3 (E.D.N.Y. May 9, 2008) (noting that loan servicer retained amounts received to pay 260 mortgage loans and, instead of remitting such amounts to mortgagee, simply continued to make monthly payments and report the loans as current).

8. There are also, of course, problems arising from misleading disclosures to the securities markets by the originators. *See, e.g.*, Robert B. Thompson, *Corporate Governance After Enron*, 40 Hous. L. Rev. 99, 114–15 (2003).