The Uncertainty of “True Sale” Analysis in Originator Bankruptcy

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THE UNCERTAINTY OF “TRUE SALE” ANALYSIS IN ORIGINATOR BANKRUPTCY

Stephen Hoffman*

INTRODUCTION

While much of law is complex or unclear, it is unusual for a judge to comment that a legal doctrine is so unsettled that courts “could flip a coin” to decide an issue. Unfortunately for practitioners, determining what constitutes a “true sale” for bankruptcy purposes is such an issue. Add to

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this the recent novel and innovative processes of structured finance and asset-backed securitization, and you have the stuff of law students’—and corporate counsels’—nightmares. As a result, courts and legislatures need to provide clarity in this area so that originators can safely structure investments and transactions, not only for the benefit of originators and investors, but also for the benefit of bankruptcy courts forced to analyze these investments and transactions after the fact when the originator becomes insolvent.

I. STRUCTURED FINANCE AND SECURITIZATION BASICS

Structured finance, which describes virtually any type of financing other than conventional on-balance sheet securities such as common debt and equity instruments, has been around for centuries in one form or another.¹ These transactions almost universally center on structuring a deal to modify or redistribute the collateral’s risk among different classes of investors.² Because these products are designed to raising funding or reducing financial risk (“hedging”) for a business, as opposed to creating


² FRANK J. FABOZZI & VINOD KOTTHARI, INTRODUCTION TO SECURITIZATION 7 (2008).
illiquid or other nonmonetary benefits, the term “structured finance” does not include swaps of physical assets or trades of bonds with identical coupon terms.\(^3\) It is typically used to hedge risk or refinance obligations where more conventional securities are inadequate, unavailable, or more costly.\(^4\) Over the past few decades, these more complex financing structures have exploded in popularity among banks and investment firms.\(^5\) This dramatic increase is partly due to the versatility of these transactions and their ability to simultaneously address many issues of corporate management, such as lowering funding costs, increasing leverage, and reducing capital adequacy requirements.\(^6\)

One subcategory of structured finance is securitization.\(^7\)

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\(^3\) Jobst, supra note 1, at 202. Swapping coupons with different terms, on the other hand, is regularly done using structured finance, such as where parties swap the interest rates on bonds they hold (interest-rate swap).

\(^4\) See id. at 200-01.


\(^6\) See TAVAKOLI, supra note 1, at 1; FABOZZI & KOTHARI, supra note 2, at 7 & 14-17.

Securitization generally describes “the creation and issuance of securities backed by a pool of assets,” or asset-backed securities (ABS). For an illustration of how structured finance, securitization, and some financial products relate, see Figure 1.


8 TAVAKOLI, supra note 1, at 1. It must be understood that the term “securitization” itself has no all-encompassing definition, even today in the wake of the 2007 financial crisis. See id.; Lipson, supra note 5 (manuscript at 3. Therefore, the Reader should understand that any definition in this Paper is provided to simplify discussion.
This process “efficiently allocates risk with capital” by allowing the originator or issuer of the securitization (the securitizer) to package these underlying assets and sell the package in financial markets.9 Moreover, securitization allows a company to raise substantial funding by issuing securities of higher quality than its secured debt, which again leads to lower

deal costs.\textsuperscript{10} However, whether a particular package or issue of packaged assets will truly constitute a securitization depends on market regulation and enforcement.\textsuperscript{11}

The securitization process can—and often does—generate millions or even billions of dollars. Professors Frank J. Fabozzi and Vinod Kothari, foremost experts in securitization, assert that “[s]ecuritization is as necessary to any economy as organized financial markets.”\textsuperscript{12} So how does this amazingly important financial tool work?

Securitization, or asset securitization, can be an extremely complex process and varies widely depending on many different factors.\textsuperscript{13} In general, it is a process where the party owning rights to assets converts those rights into a repayment stream by pooling them together into a package and then issuing securities, where the payments on these securities mainly depend on the performance of the underlying assets.\textsuperscript{14} The

\textsuperscript{10} Fabozzi & Kothari, supra note 2, at 6.

\textsuperscript{11} John Deacon, Global Securitisation and CDOs 5 (2004).

\textsuperscript{12} Fabozzi & Kothari, supra note 7 (manuscript at 13).

\textsuperscript{13} The term “asset,” as it is used in this context, can refer to any enforceable right in the underlying property. Tavakoli, supra note 1, at 1 (“Virtually any combination of financial assets or stream of cash flows can be securitized.”); see also Deacon, supra note 11, at 1-3. Assets can be existing rights (existing asset securitization) or rights arising in the future (future flow securitization). Fabozzi & Kothari, supra note 2, at 8.

\textsuperscript{14} See Securitization of Assets: Problems and Solutions: Hearing Before
originator can then raise financing by using the package as collateral for a loan or by issuing debt securities to investors, often in the form of bonds. A bond is a fixed income instrument that guarantees a particular return (coupon price) over the life of the instrument, which can be as little as a few months or as much as thirty years. Generally, the originator does not issue the securities itself and instead sells the package of assets to an entity created specifically for that purpose—a “special purpose vehicle,” or

15 DEACON, supra note 11, at 1.

16 PERRY H. BEAUMONT, FINANCIAL ENGINEERING PRINCIPLES: A UNIFIED THEORY FOR FINANCIAL PRODUCT ANALYSIS AND VALUATION 3 (2004). For purposes of this Paper, the term “bond” also includes notes and money market instruments, which are fixed income instruments that reach maturity in no more than ten years and one year, respectively. Id. Furthermore, bonds must be distinguished from “participation certificates”: the latter instrument may be used to purchase a share of (“participate in”) receivables, while the former might be a debt instrument secured by those receivables. See Dale A. Whitman, How Negotiability Has Fouled Up the Secondary Mortgage Market, and What to Do About It, 37 PEPP. L. REV. 737, 738 (2010). In essence, participation certificates act very similarly to notes. Brent J. Horton, In Defense of Private-Label Mortgage-Backed Securities, 61 FLA. L. REV. 827, 840-42 (2009) (stating "they are a participation interest in the cash flows from a pool of such notes, the profitability of which is made possible by the efforts of others"). Note, however, that in securitization filings and documents—particularly the prospectus—the asset-backed securities issued by the SPV are actually referred to as certificates. FABOZZI & KOTHARI, supra note 2, at 10.
SPV—afterward paying the issue’s proceeds to the originator. Figure 2 illustrates a basic securitization.

Securitizations typically come in two general forms. The first form, termed a “true sale” securitization, occurs where the underlying assets themselves are transferred by the originator to the SPV, removing the assets from the originator’s balance sheet.\textsuperscript{17} In contrast, synthetic securitizations (termed “synthetics”) center on a transfer of only the assets’ credit risk through the use of credit derivatives; as a result, synthetics do not remove the underlying assets from the originator’s balance sheet.\textsuperscript{18}

The securitization process is immensely versatile, and has been used to package rights as diverse as pharmaceutical patents, music royalties, household utility payments, movie ticket revenues, life insurance payouts, and legal settlement proceeds.\textsuperscript{19} However, because this process is so

\textsuperscript{17}Criado & Rixtel, supra note 7, at 2.

\textsuperscript{18}FABOZZI & KOTHARI, supra note 2, at 10; Ramos Muñoz, supra note 7, at 219. Because synthetics do not transfer the assets themselves, they do not constitute a “true sale” for accounting purposes. TAVAKOLI, supra note 1, at 9.

\textsuperscript{19}See MALCOLM S. DORRIS, DECHERT LLP, THE SECURITIZATION OF
versatile, many legal hurdles exist to protect the integrity of financial markets and deter reckless and perilous uses of such financing.

A. Special Purpose Vehicles and Risk Transfer

To eliminate or reduce credit and insolvency risks, an originator must transfer the package off of its balance sheet. Originators generally use a special purpose vehicle, or SPV, as the package’s recipient. An SPV

20 “The transfer of ownership is crucial because it allows the firm to establish the bankruptcy remoteness of the SPV and the transferred assets.” Kenneth Ayotte & Stav Gaon, Asset-Backed Securities: Costs and Benefits of "Bankruptcy Remoteness,” 24 REV. FIN. STUD. 1299, 1300 (2011) (emphasis omitted).

21 These entities are also known as “special purpose entities” (SPEs), “special purpose corporations” (SPCs), or by other names. See TAVAKOLI, supra note 1, at 117; BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT’L SETTLEMENTS, THE JOINT FORUM: REPORT ON SPECIAL PURPOSE ENTITIES 47 (2009) [hereinafter BIS REPORT ON SPVs], available at http://www.bis.org/publ/joint23.pdf. Regardless of their titles, they serve roughly identical purposes and “can be used interchangeably.” Id.; TAVAKOLI, supra note 1, at 16.
is an entity formed by the sponsoring firm for a very limited purpose, typically investment or the holding of assets. An SPV may be legally formed as “a limited partnership, a limited liability company, a trust, or a corporation,” but most often takes the form of a commercial trust. These entities come in a variety of forms and acronyms based on the type of assets held. Furthermore, an originator typically forms the SPV in such a way that results in a particular investment rating from a rating agency. The originator does this for several reasons.

Foremost, the transfer allows the originator to move those assets off

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23 Gorton & Souleles, supra note 22, at 550.

24 Id. at 555.

25 See id. at 550. For instance, the entity type commonly used to hold mortgages is known as a real estate mortgage investment conduit (REMIC). John Crawford, CDO Ratings and Systemic Instability: Causes and Cure, 7 N.Y.U. J.L. & BUS. 1, 7 (2010). Other entities, such as a real estate investment trust (REIT) here, may also be used for the same purpose, but may be inferior due to legal or financial considerations. TAVAKOLI, supra note 1, at 135-36.

its balance sheet. This often improves profit margins or other indicators of the originator’s health or performance, which also improves its ability to obtain traditional financing (e.g., secured loans) at competitive rates. In addition, so long as the transfer qualifies as a “true sale” under bankruptcy law, it prevents the assets from being seized by the originator’s creditors in the event the originator becomes insolvent. This protection from

27 While this is true as a general principle, not all jurisdictions allow the assets to be removed from the originator’s balance sheet after they have been transferred to an SPV, e.g., residential mortgage loans under German Pfandbrief legislation. See Erik Banks, Synthetic and Structured Assets: A Practical Guide to Investment and Risk 77 (2006).

28 Fabozzi & Kothari, supra note 7 (manuscript at 10) (stating that off-balance sheet financing "can help enhance . . . key financial ratios"). These include return on assets, tangible capital, regulatory capital, and leverage ratios. BIS Report on SPVs, supra note 21, at 13.

29 These securitizations are known as true sale securitizations. Tavakoli, supra note 1, at 117. However, the originator may still be liable for losses, regardless of whether the assets were transferred in a true sale, if it has breached a representation or warranty. Adam B. Ashcraft & Til Schuermann, Understanding the Securitization of Subprime Mortgage Credit 6-7 (Federal Reserve Bank of New York, Staff Rep. No. 318, 2008); Deacon, supra note 11, at 37. For instance, in the realm of residential mortgage-backed securities, these representations and warranties include: that a licensed appraiser valued the property; that the originator verified the borrower’s income, employment, and assets in accordance with its underwriting standards; that the mortgage loan complied with all applicable law; that the mortgage loan is covered by any applicable insurance policies as required; and many others. See American Securitization Forum, ASF Model RMBS Representations and Warranties (2009) [hereinafter ASF Model Reps], available at http://www.americansecuritization.com/uploadedFiles/ASF_Project_REST_ART_Reps_and_Warranties_121509.pdf. Breaching a representation or warranty compels the originator to repurchase the offending assets or securities. Ashcraft & Schuermann, supra note 29, at 6.
bankruptcy creditors is a key advantage of securitization, since assets remaining on a business’s balance sheet could otherwise be subject to claims. For this reason, SPVs used in securitizations are appropriately termed “bankruptcy-remote entities,” or BREs.\textsuperscript{30}

The SPV, after receiving the package of pooled assets, will then issue bonds or other securities backed by the underlying assets (asset-backed securities, or ABS) and pay the proceeds to the originator.\textsuperscript{31} The SPV then issues the securities in tranches, with more highly-rated tranches receiving payment priority and other perks.\textsuperscript{32} Because pricing is inversely correlated to default risk, highly-rated tranches almost universally receive lower average coupon prices (i.e., lower payments to investors), thus reducing the funding cost of the deal.\textsuperscript{33}

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\textsuperscript{30} BIS REPORT ON SPVs, supra note 21, at 47 (referring to bankruptcy-remoteness as “[a] critical and defining feature of an SPE”). In more technical terms, the transfer of a securitization to a BRE removes the underlying assets from the originator’s bankruptcy estate. Ayotte & Gaon, supra note 20, at 1307. Additionally, some commentators state that SPVs “cannot in practice go bankrupt, as a matter of design.” Gorton & Souleles, supra note 22, at 549.

\textsuperscript{31} Crawford, supra note 25, at 7.

\textsuperscript{32} Id.

\textsuperscript{33} Taylor D. Nadauld & Shane M. Sherlund, The Role of the Securitization Process in the Expansion of Subprime Credit 11 (Federal Reserve Board, Finance and Economics Discussion Series No. 2009-28, 2009); see Banks, supra note 27, at 73 (tranching provides credit enhancement, which lowers deal costs); Fabozzi & Kothari, supra note 7 (manuscript at 10-11).
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B. Tranching, Security Interests, and Payment

Financial markets are generally predicated on a risk-versus-reward model. In other words, the more risk assumed by an investor, the higher the potential return. Since different investors seek different levels of risk or return, originators try to structure their securities into a series of bonds with a range of credit ratings and characteristics in order to maximize the issue’s value. These securities are usually then grouped by seniority (i.e., payment priority) into tranches, which create senior and junior classes of debt.

The senior-most tranches are first-lien secured interests. Lower

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35 LAURIE S. GOODMAN ET AL., SUBPRIME MORTGAGE CREDIT DERIVATIVES 89 (2008). This is often done using sophisticated computer models which create a probability distribution of default risk, generally based on the default risk associated with other similar securities (where possible). See Fabozzi & Kothari, supra note 7 (manuscript at 8).

36 Gorton & Metrick, supra note 22, at 4; Ayotte & Gaon, supra note 20, at 1300. An additional two terms are commonly used together with “senior” and “junior”: “mezzanine,” which describes the tranches between the highest- and lowest-rated tranches; and “equity,” which describes the lowest-rated tranche. Credit Derivatives: At the Risky End of Finance, supra note 34; Ayotte & Gaon, supra note 20, at 1308. While the lowest-rated tranche does not constitute an equity interest in the way corporate stock does, it typically provides “share-like returns of 15-20% or so.” Credit Derivatives: At the Risky End of Finance, supra note 34.

tranches, in contrast, are either second-lien secured interests or unsecured interests and are subordinate to all tranches with higher priority. As a result, for a tranche to default, all collateral junior to that tranche must be eroded. Understandably, this protection can help senior tranches obtain high-quality credit ratings even where the underlying assets are seen as risky or, if the assets are other securities, do not or could not receive such ratings themselves.

Payments to holders are made in a “waterfall” payout structure based on priority. This means all holders of the highest-rated tranche receive full payment on their coupons, then full payment is made to the next highest-rated tranche, and so on, until either the payment stream has been exhausted or all holders’ coupon payments have been satisfied. Oppositely, losses due to default or deficiency are first distributed

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38 *Id.* It should be emphasized that the securities issued in each tranche are still part of the same underlying asset pool. As a result, higher-rated tranches do not necessarily contain safer *securities*, but instead provide additional risk protection against default than that provided to investors of lower-rated tranches.


40 Crawford, *supra* note 21, at 7.

41 *Id.* Principal payments, on the other hand, are typically paid only to the senior tranche for a period of time. After that time, those payments can also be distributed based on the “waterfall” structure. *Id.* at 7-8.
completely among members of the lowest-rated tranche before applying to members of the next lowest-rated tranche, creating a “reverse waterfall.”

Tranches are often structured by credit rating. For example, an originator might group all AAA-rated bonds—regardless of each individual bond’s coupon terms—into a single tranche of securities. Also, an originator could group all non-investment-grade securities into a single tranche. However, such groupings can instead (or in addition) account for many other characteristics including payment priority, repayment terms, and coupon terms. In contrast to the example above, an originator could thus group together all bonds with identical coupon terms, regardless of the credit rating of the individual bond or bond issue.

II. CHAPTER 11 BANKRUPTCY

Chapter 11 of the U.S. Bankruptcy Code is particularly relevant to securitization transactions since such bankruptcies—unlike other types available under federal law—allow an originator to reorganize rather than liquidate. Keeping the debtor entity “alive” through the use of Chapter 11

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42 Id. at 10-11.

43 See Deacon, supra note 11, at 13-14.

44 See, e.g., id. at 30 (fast-pay and slow-pay tranches).

45 This Paper focuses only on pre-bankruptcy securitizations. For a detailed discussion of securitizations executed after filing for Chapter 11 bankruptcy protection, see Lois R. Lupica, Asset Securitization: The Unsecured Creditor's Perspective, 76 Tex. L. Rev. 595 (1998).
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Bankruptcy protection is not only better for the entity, but also “offers a greater benefit to the debtor’s creditors, employees, suppliers, and customers, compared to a liquidation proceeding.” This principle is generally accepted, “even when reorganizing the firm may conflict with the goal of maximizing distributions to creditors.”

To seek voluntary protection under Chapter 11, debtors generally file for bankruptcy when the value of outstanding claims by creditors exceeds the value of the debtor’s assets. This is true whether the debtor entity is a securitization originator or any other business, although this analysis focuses only on bankruptcy of originator-debtors. Once a debtor petitions for Chapter 11 bankruptcy protection, an automatic stay is statutorily imposed on the debtor’s assets. The stay arises immediately upon filing and, practically speaking, prevents creditors from taking any further action against the originator-debtor, his property, or the newly-created bankruptcy estate to collect payments, recover assets, or enforce liens. Moreover, the stay typically remains in effect until the debtor’s

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discharge, but can be terminated as to particular claims or assets where they are no longer part of the estate.\(^{50}\)

Chapter 11 bankruptcy also significantly alters the creditor landscape, “replac[ing] creditors’ individual rights with a collective regime.”\(^{51}\) A debtor’s Chapter 11 estate is “very broad,” and may include property “even if Debtor does not have a possessory interest in that property.”\(^{52}\) In order to ensure fair distributions to creditors, the bankruptcy trustee, under his statutory authority as a lien creditor,\(^{53}\) will seek to avoid any transfers or conveyances that would leave a creditor without recourse.\(^{54}\) These avoiding powers may require judicial intervention, such as where a creditor—or the debtor itself—objects to a recharacterization of the transaction. However, as case law has amply demonstrated, there is little consistency among courts regarding what will be recognized as a proper transfer of assets (a so-called “true sale”) or instead be deemed avoidable.

\(^{50}\) 11 U.S.C. §§ 362(c)(1)-(2). Other grounds for termination of the stay also exist. See, e.g., 11 U.S.C. §§ 362(c)(3)-(4) (restricted to debtors who previously filed bankruptcy) & § 362(d) (request by an interested party for cause).

\(^{51}\) Lubben, supra note 47, at 98. Unsurprisingly, this “what’s good for the goose is good for the gander” approach is only successful if all creditors adhere to its tenets. See id.


\(^{54}\) See Lupica, supra note 45, at 597-98.
and subject the underlying assets to creditor claims. 55

III. TRUE SALES

For purposes of securitization transactions, it is virtually necessary to transfer ownership in the underlying assets to a third party known as a “bankruptcy-remote entity.” 56 This transfer removes the assets from the originator’s bankruptcy estate by way of a “true sale” of the assets from the originator to an independent firm (the SPV), 57 thus putting them beyond the reach of the originator’s creditors in the event of its insolvency. 58 This

55 See infra note 61 and accompanying text.

56 In this Paper, the term “bankruptcy-remote entities” includes special purpose vehicles, trusts, and investment companies because each of these entities are structured in part to avoid problems if the originator becomes insolvent. See BANKS, supra note 27, at 39-41; DEACON, supra note 11, at 45-46.

57 It should be emphasized that these entities are bankruptcy-remote, not bankruptcy-proof. Prohibiting an entity from voluntarily filing for bankruptcy, even if in the best interest of the entity and its creditors, is against public policy and thus no entity can ever be bankruptcy-proof. Peter J. Lahny IV, Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation, 9 AM. BANKR. INST. L. REV. 815, 833-34 (2001); Gorton & Souleles, supra note 22, at 557 (“The most straightforward way to achieve [a bankruptcy-proof entity] would be for the SPV to waive its right to file a voluntary bankruptcy petition, but this is legally unenforceable[..]”; Kenneth N. Klee & Brendt C. Butler, Asset-Backed Securitization, Special Purpose Vehicles and Other Securitization Issues, 35 UCC L.J. 23, 30-31 (2002). Even so, there are several other valid methods to make an SPV’s voluntary filing extremely unlikely. Gorton & Metrick, supra note 22, at 32-33.

58 Klee & Butler, supra note 57, at 28. This is also incredibly important to investors, who do not want their payment streams modified or halted.
understandably conflicts with the desires of creditors, who invariably want to increase the value of the estate, consequently increasing distributions.\(^{59}\)

A true sale is generally thought of as “a transaction which legally and equitably removes the assets and any interest in the assets from the estate of the transferor.”\(^{60}\) If an asset transfer is not deemed a true sale, the bankruptcy trustee or a bankruptcy court can avoid the transfer and draw the assets back into the debtor’s estate, subjecting it to creditor claims.\(^{61}\) To determine whether a transaction constitutes a true sale, bankruptcy courts focus on many factors, including whether the originator retains any interest in the transferred assets, the transfer price is fair to the parties, the transferee’s recourse options against the transferor, and the parties’ actual intent in entering the transaction.\(^{62}\)

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\(^{59}\) Kale, *supra* note 58, at 313.


\(^{61}\) Klee & Butler, *supra* note 57, at 42. Because of this, most originators or other parties to the deal will request a true sale opinion letter from a law firm stating that the proposed transaction will qualify as a true sale in any ensuing bankruptcy proceedings. Fabozzi & Kothari, *supra* note 2, at 9.

\(^{62}\) See Lubben, *supra* note 47, at 96. However, this list is not exhaustive and some of the listed factors might not even be considered by a particular bankruptcy court, since it has wide discretion in exercising its equitable powers. Id. at 96-97.
In structured finance, a true sale allows the company to retain control over the assets (indirectly, through the BRE) as well as allow the securitization to receive or maintain a particular credit rating. This bankruptcy-remote structure also eliminates the need for investors to conduct additional credit risk analysis. Other considerations, such as favorable tax treatment, limited recourse by creditors, and ensuring the entity cannot undertake additional obligations (and, thus, additional risk) than that necessary for issuing the securities.

Because this “true sale” quality is of utmost importance, originators often structure the transfer among multiple SPVs to ensure a bankruptcy court will not negate the sale later. In the first such structure, known as the

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64 DEACON, supra note 11, at 43.

65 *See infra* Part IV.I.A. .

66 Kenneth C. Kettering, *True Sales of Receivables: A Purposive Analysis*, 16 AM. BANKR. INST. L. REV. 511, 516 (2008). A security offers limited recourse if the payments are only owed on the obligation “to the extent that equivalent amounts are received on the underlying assets.” TAVAKOLI, supra note 1, at 22. Claims on amounts beyond those received are extinguished. *Id.*

67 Klee & Butler, supra note 57, at 40-41.

68 DEACON, supra note 11, at 43-44.
“multi-tier structure,” the originator transfers the assets to the first-tier SPV which then transfers the assets to another, second-tier, SPV, which can be repeated as many times as the originator wishes. This structure also benefits the originator since, for example, some non-U.S. jurisdictions require that a seller of receivables (commonly-pooled assets in securitization) notify each debtor of the receivables, i.e., the payees, that the owed receivable has been transferred. In the securitization context, where hundreds or thousands of accounts are pooled and sold or where debtors frequently change, this notice requirement can be particularly burdensome and can negatively affect the originator’s relationships with the debtors.

As a result, originators often structure the transaction so that the first transfer (for which notice is required) is to a wholly-owned subsidiary SPV—likely creating less friction with debtors compared to a transfer to an unrelated entity—followed by a subsequent transfer (where no notice is required) from the wholly-owned SPV to an independent SPV, thus creating

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69 Lahny IV, supra note 57, at 831; Klee & Butler, supra note 57, at 26.

70 Deacon, supra note 11, at 37-38. However, using offshore SPVs or a combination of onshore and offshore SPVs can get around these types of problems. For example, Law 130 companies in Italy can avoid this notice requirement by establishing and utilizing onshore and offshore SPVs in a transaction. See id. at 38. For interests in land transferred via mortgage-backed securities, however, regulatory concerns as well as legal complexities may necessitate using onshore SPVs even where offshore treatment could alleviate these problems. Id. at 45.

71 Id. at 38.
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the needed “true sale” of the assets.72

Although both transfers can be designed as true sales, other
considerations usually make it more appropriate to structure only the first
transfer as a true sale and the second transfer as a sale for accounting (but
not bankruptcy) purposes.73 A two-tier structure, illustrated in Figure 3, is
commonly used in the U.S. and internationally.74

Figure 3: Common Two-Tier Securitization Structure

The second structure, the “multiseller securitization conduit” or
MSC model, allows many originators to transfer assets to a single, pre-
existing SPV.75 The assets of all the originators are then pooled together,
after which the SPV issues securities on these undivided assets, shown on
Figure 4.76 While this makes it far less likely a court will find substantial

72 Id. This second SPV often takes the form of a trust. Kettering, supra note 66, at 565.

73 Lahny IV, supra note 57, at 831-32; Gorton & Souleles, supra note 22, at 555.

74 DEACON, supra note 11, at 38 (referring to this approach as a "refinement" of the two-tier structure previously described).

75 Lahny IV, supra note 57, at 832-33; Klee & Butler, supra note 57, at 26.

76 TAVAKOLI, supra note 1, at 37.
consolidation between an originator and its SPV, discussed infra, it tends to exacerbate the problems caused by originator insolvency since there would be even more potential creditors.  

A. Finding No True Sale

In the event a bankruptcy court does not characterize the transfer as a true sale, the court has some options in exerting its equitable jurisdiction over the underlying assets. First, it can find that the asset transfer was a disguised secured loan on the underlying assets. Second, some bankruptcy courts have fashioned rules specifically regarding more intangible assets such as chattel paper or accounts receivable, which are

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77 Lahny IV, supra note 57, at 833.

78 Id. at 820; Kettering, supra note 66, at 511.
commonly securitized assets, and treat such assets as merely collateral.\textsuperscript{79} Last, the transfer can be viewed as a fraudulent conveyance and the assets would be returned to the bankruptcy estate.\textsuperscript{80}

The secured loan analysis is particularly relevant in securitizations and especially problematic for corporate counsel. Such a finding brings the securitized assets “back into the originator’s bankruptcy estate."\textsuperscript{81} This distinction between a true sale and a secured loan is also especially important to investors: if the SPV (and not the originator) owns the securitized assets, investors will continue to be repaid on their investment;

\textsuperscript{79} Ryan E. Scharar, \textit{The Limits of Securitization: Why Bankruptcy Courts Should Substantively Consolidate Predatory Sub-Prime Mortgage Originators and Their Special Purpose Entities}, 2008 MICH. ST. L. REV. 913, 926 (2008); Lahny IV, \textit{supra} note 57, at 846. However, both commentators and the drafters of UCC Article 9 argue that this is an improper reading of the law. \textit{Id.} at 847. \textit{But see} Lupica, \textit{supra} note 46, at 299 (stating that this analysis “is arguably doctrinally unsound[ ] and was widely criticized," but "it has not been without its supporters").

\textsuperscript{80} Lahny IV, \textit{supra} note 57, at 848; Scharar, \textit{supra} note 79, at 926. Although fraudulent conveyance analysis—determining whether a transfer of assets was for “inadequate consideration to friendly parties”—is very important in non-securitization bankruptcies, “[c]ommentators seem to agree that there is little risk that most securitization transfers will be invalidated on fraudulent-conveyance grounds” since there usually exists an “exchange of reasonably equivalent values.” John Patrick Hunt et al., \textit{The End of Mortgage Securitization? Electronic Registration as a Threat to Bankruptcy Remoteness} 6-7 (2011), available at http://works.bepress.com/john_hunt/. Obviously this will not always be true, but as a result this Paper focuses on the “true sale” aspect of asset transfers. \textit{See} \textit{id.} at 7.

\textsuperscript{81} Lahny IV, \textit{supra} note 57, at 820; Klee & Butler, \textit{supra} note 57, at 41.
if not, their repayment rights will be suspended and the assets may be subject to claims by the originator’s creditors, subject to the automatic stay and possibly liquidation to satisfy these claims. By extension, the distinction is very relevant to the originator profiting from the issue of securities, since failure to generate investors’ interest will result in an unsuccessful issue. Additionally, since many common law jurisdictions have adopted filing requirements for taking a security interest, recharacterizing a transaction as a secured loan may further result in the purchaser-SPV having only an unsecured claim in the purchased assets, giving the purchaser a subordinated interest in the SPV’s assets.

What constitutes a true sale—even outside of the securitization context—is still unsettled by courts and legislators, prompting an Illinois federal district court to opine that “a court could flip a coin[,] and find support in the case law for a decision either way.” The court continued,

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83 Deacon, supra note 11, at 40. While some jurisdictions such as the U.S. allow purchasers to file a security interest to protect against a possible recharacterization as a secured loan, other jurisdictions may not allow it or even go so far as to use it as evidence that the purchase was intended to be a taking of a security interest. See id. (England).

stating that “predicting the outcome of a loan/true sale dispute [is] nearly impossible.”

The first major U.S. case holding that an asset transfer by an originator did not constitute a true sale was In re LTV Steel Co. In LTV Steel, the named company had securitized and sold rights to its receivables, in the amount of $270 million, to U.K. financial company Abbey National in 1994. When LTV Steel later petitioned for Chapter 11 bankruptcy protection in 2000, it sought to have the securitization reclassified as a secured loan. By doing this, the company could use the cash collateral created by the securitization as working capital for use during the reorganization process. In granting LTV Steel’s request and finding the transaction to be a secured loan, the Ohio District Court emphasized that failing to do so would not only put LTV out of business but would also, as a

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original). It should be noted that even though the decision in Commercial Loan Corp. was issued thirteen years after the article was published, very little had changed.

85 316 B.R. at 700-01.

86 In re LTV Steel Co., 274 B.R. 278 (Bankr. N.D. Ohio 2001). While the Bankruptcy Court’s ruling—characterizing the transfer as a secured loan rather than a true sale—surprised many industry professionals (to say the least), Kettering states that “the procedural posture of the ruling deprives it of much heft as precedent.” Kettering, supra note 66, at 12.

87 LTV Steel, 274 B.R. at 280. LTV Steel also securitized its inventory, but the receivables analysis is more relevant to this discussion. Id.

88 Id.
direct result, impair the claims of its other creditors to the benefit of Abbey National.\(^\text{89}\) Furthermore, the Court found that, even though LTV sold its receivables to Abbey National, “[t]o suggest that [LTV] lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept.”\(^\text{90}\) Hence, while LTV was not legally entitled to the cash collateral, it had an equitable interest in the proceeds of its labors, which brought it into LTV’s bankruptcy estate.\(^\text{91}\) *LTV Steel* was subsequently settled before the court’s ruling was entered, which included a summary finding that the transfers constituted true sales.\(^\text{92}\) As a result of the settlement, no precedent was formally set, but the confusion continued.\(^\text{93}\)

B. *Finding a True Sale: The Substantive Consolidation Problem*

Even where a transfer between an originator and its bankruptcy-remote entity *does* constitute a judicially-recognized true sale, it may still be

\(^{89}\) *Id.* at 285-86.

\(^{90}\) *Id.* at 285.

\(^{91}\) See 11 U.S.C. § 541(a)(1) (2010) (including “all legal or equitable interests of the debtor in property as of the commencement of the [Chapter 11 bankruptcy case]” in the debtor’s bankruptcy estate). Professor Fabozzi asserts, however, that allowing LTV to use the cash flows prior to settlement was “troubling” to securitization investors. Fabozzi & Kothari, *supra* note 7 (manuscript at 7).

\(^{92}\) Schwarcz, *supra* note 82, at 356.

within a bankruptcy court’s jurisdiction. If the parent and its subsidiary entity are significantly intertwined—such as by commingling assets, capital, officers, etc.—a court may find there has been “substantive consolidation” of the two firms. Substantive consolidation “may take multiple forms, but it usually results in, *inter alia*, pooling the assets of, and claims against, the two entities; satisfying liabilities from the resultant common fund; eliminating intercompany claims; and combining the creditors of the two companies for the purposes of voting on reorganization plans.” In essence, this means that the two entities are not independent and should instead be combined into one entity, with the assets of both in a single bankruptcy estate.

Substantive consolidation is generally the worst of all possibilities

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for the parent company and investors of either entity—not only would their payment stream be impaired but they may be prevented from foreclosing on the collateral’s underlying assets.\textsuperscript{97} A finding of substantive consolidation generally requires that there is “substantial identity” between the entities and that, since bankruptcy courts are courts of equity,\textsuperscript{98} consolidation is necessary to avoid some harm or realize some benefit.\textsuperscript{99}

In contrast, consolidation is typically welcome news for creditors. Substantive consolidation brings the property of both the parent and its investment vehicle into the bankruptcy estate, which means both that there are additional assets to satisfy creditors’ claims as well as additional creditors laying claims to these assets.\textsuperscript{100} However, this can also create many problems for creditors, since consolidation may redistribute payment priorities or amounts available to pay the claims.\textsuperscript{101} For instance, the sole creditor of the parent may have to wait in line or receive less than his claim is worth if the SPV to be joined has many creditors.

\textsuperscript{97} Lahny IV, \textit{supra} note 57, at 817.


\textsuperscript{100} Kale, \textit{supra} note 58, at 331.

\textsuperscript{101} \textit{See} Amera & Kolod, \textit{supra} note 96, at 1; Kale, \textit{supra} note 58, at 332-33.
Substantive consolidation is generally considered “an extreme and unusual remedy” even outside the realm of structured finance and asset securitization. Moreover, substantive consolidation between originators and their SPVs has “remained relatively untested in bankruptcy courts,” and courts have emphasized the special nature of these bankruptcy-remote entities in substantive consolidation analysis.

IV. INTERNATIONAL ISSUES

Although securitization provides an excellent financing mechanism for businesses, many issues may arise where an entity in the process is

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102 Pearce II & Lipin, supra note 94, at 205 (citing In re Gandy, 299 F.3d 489, 499 (5th Cir. 2002)); Pacific Lumber, 584 F.3d at 249. But see William H. Widen, Corporate Form and Substantive Consolidation, 75 GEO. WASH. L. REV. 237, 252-53 (2007) (based on the author’s empirical analysis, 11 of the 21 largest corporate bankruptcy filings from 2000 to 2004 proposed or used substantive consolidation). It should also be noted, however, that substantive consolidation may become more prevalent—especially in the securitization context—in the wake of the recent financial crisis. In re General Growth Properties, Inc., 409 B.R. 43, 62-63 (Bankr. S.D.N.Y. 2009).

103 Scharar, supra note 79, at 926; Lubben, supra note 47, at 96. “The use of an SPV as a bankruptcy-remote entity has provided uneven results because of numerous judicially created exceptions to the treatment of an SPV as a separate legal entity.” Pearce II & Lipin, supra note 94, at 225.

104 Pacific Lumber, 584 F.3d at 249 n.25 (“Substantive consolidation is of special concern in cases involving special purpose entities . . . .”). The Court then added: “If courts are not wary about substantive consolidation of special purpose entities, investors will grow less confident in the value of the collateral securing their loans; the practice of securitization, a powerful engine for generating capital, will become less useful; and the cost of capital will increase.” Id.
subject to the laws of a different jurisdiction. Because this Paper examines the interactions between an originator and its SPV for purposes of operation and bankruptcy, the focus here shall similarly be restricted to originators and SPVs.

A. Taxation

SPVs (and particularly BREs) are often incorporated or registered in low-tax or tax-exempt jurisdictions, unless doing so would create additional difficulties such as regulatory or legal issues. This would not be a problem for the SPV itself where it takes the form of a pass-through entity such as a U.S. limited liability company or S-corporation, but investors would be the ones responsible to pay any required income taxes. Not only does this tax-focused policy provide beneficial and predictable tax rates, but the originator forming the SPV can enter into an arrangement with

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105 Yuliya A. Dvorak, *Transplanting Asset Securitization: Is the Grass Green Enough on the Other Side?*, 38 Hous. L. Rev. 541, 553-54 (2001). This is only one of many ways corporate arbitrageurs—people seeking the highest return on the lowest input in a facet of the business transaction—use their skills to avoid or minimize financial exposure to the entity. See generally BIS REPORT ON SPVs, supra note 21, at 47.

106 JoongHo Han et al., *Corporate Taxes and Securitization* 2 (Korea Development Institute, KDI Sch. of Pub. Pol'y & Mgmt. Paper No. 10-12, 2010), available at http://ssrn.com/abstract=1600008. It must be understood that the reference here is to pass-through taxation, not pass-through payment structures. The former refers to single taxation for investors of specific types of entities such as U.S. LLCs and S-corporations (profits “pass through” to the investors); the latter term refers to payments by an SPV to investors which coincide with payments on underlying
tax authorities that failure to pay taxes will not be grounds for winding up the entity.\footnote{107} This helps lower funding costs of the issue, but can also present several thorny issues regarding conflict of laws or deciding which state—or nation—has the ultimate decision on corporate matters.

\section*{B. Conflicts of Laws}

Where an originator and its SPV adopt laws of different jurisdictions, the central question is not which jurisdiction does the originator follow or which does the SPV follow, but instead how discrepancies among these two sets of laws should be resolved. As a result, conflicts of laws become a key issue in resolving problems arising in the securitization context.\footnote{108} However, it should be apparent that, before a conflict of laws can be found, it must be determined which laws apply to the individual entities.

The law applicable to a corporate entity is oftentimes decided by the entity itself, through its board of directors or similar governing body, or by the parties that initially form the entity. Since the entity selects which law controls its conduct either directly (e.g., through an express decision) or

\footnote{107} See DEACON, supra note 11, at 43.

\footnote{108} Even where non-U.S. law would apply to the entity’s insolvency, “the success of securitization in the United States has been followed by widespread use in other countries[.]” Kettering, supra note 7, at 1557.
indirectly (e.g., by incorporating in a particular jurisdiction), this is generally referred to as a “choice of law.” Such elections typically fall within the following theories:

1. Incorporation Theory

The incorporation theory (widely known as the “internal affairs doctrine”), in simple terms, applies the laws of the jurisdiction where the entity was incorporated regardless of other factors. For an unincorporated business, such as a U.S. limited liability company, the jurisdiction of registration is used. This applicable law controls not only incorporation (or registration) and the winding up of the business, but also the internal affairs and governance of the entity.

2. Free Choice Theory

In contrast to incorporation theory which applies the law of where the entity is incorporated or registered, the free choice theory allows the


110 See Larry E. Ribstein & Erin Ann O'Hara, Corporations and the Market for Law, 2008 U. Ill. L. Rev. 661, 664-65 (2008). Although technically the internal affairs doctrine has not been applied to unincorporated businesses (since the doctrine specifically refers to an entity’s state of incorporation), an extremely similar rule has been adopted and used for partnerships, LLCs, and other such businesses. Id. at 702-03.

111 Ramos Muñoz, supra note 109, at 352.
parties to voluntarily elect to follow the law of a particular jurisdiction regardless of where the entity is formed.\textsuperscript{112} However, an entity’s home jurisdiction (where it is incorporated or registered) often places restrictions on this ability, e.g., by requiring that the entity have a significant connection to the jurisdiction.\textsuperscript{113}

Although this category is termed “free choice theory,” the incorporation theory provides substantial leeway in that the entity or the forming parties may choose to incorporate or register the entity in any jurisdiction that will allow it.

On the other hand, an entity may not be able to elect which law governs it for some purposes or, more commonly, where an entity has selected a particular jurisdiction’s law by a choice of law provision or by incorporating there, but a competent court later finds that the entity should not be governed by that law. For instance, the seat theory, currently followed in many European jurisdictions, is a key mechanism for such purposes.

3. Seat Theory

Under the seat theory (also called “real seat theory”), the law

\begin{footnotesize}
\begin{enumerate}
\item\textsuperscript{112} \textit{Id.} at 353.
\item\textsuperscript{113} \textit{Id.} at 354-56.
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\end{footnotesize}
governing an entity is the jurisdiction where it sits. This differs significantly from the incorporation or free choice theories in that it looks to where the entity conducts its business. For instance, if an industrial company incorporates in Delaware but maintains all of its offices and factories in Singapore, seat theory might find that Singapore law governs the company’s internal affairs. Some jurisdictions, including many European nations, require that an entity have an actual connection to the jurisdiction other than mere incorporation. This theory, however, can become difficult in practice as courts employ different tests for determining where an entity sits. Additionally, Professor David Ramos Muñoz admits


115 Kersting, supra note 114, at 37 (defined as “where the basic decisions of the board are effectively transformed into daily managerial and administrative decisions”).

116 RAMOS MUÑOZ, supra note 109, at 354-55; see Kersting, supra note 114, at 51. While seat theory has been prominent in Europe, EU countries have begun to follow U.S. law more closely. See Ribstein & O’Hara, supra note 110, at 706 (stating that Europe, through case law, has recently adopted a version of the internal affairs doctrine); Benjamin Angelette, The Revolution that Never Came and the Revolution Coming—de Lasteyrie du Salliant, Marks & Spencer, SEVIC Systems and the Changing Corporate Law in Europe, 92 VA. L. REV. 1189, 1221 (2006) (”The [ECJ]’s interpretation of Articles 43 and 48 of the EC Treaty threatens to make the place of central administration [the "real seat"] wholly irrelevant for corporate law purposes.”).

117 For example, some courts look for where the central decision-making is conducted by management (the “brain” approach); others look to where
that “it is hard to conclude how [seat theory] could apply to financial vehicles or SPVs.”\textsuperscript{118}

4. Significant Relationship/Substantial Connection Theory

Similar to seat theory but more useful in the SPV context, this approach looks to where an entity has a substantial connection or, more clearly, to which jurisdiction it has its most significant relationship.\textsuperscript{119} As this phrasing indicates, only one jurisdiction will satisfy this analysis.\textsuperscript{120} While the substantial connection theory is generally considered a “secondary rule” to only be applied in the absence of other evidence, it is the default approach described in the Hague Convention.\textsuperscript{121}

C. Transnational Jurisdiction and COMI

In many jurisdictions, including those most relevant to and popular for securitization, courts typically look to the entity’s jurisdiction of incorporation before examining the location of its real seat in deciding what the company actually conducts its business, e.g., where a manufacturer’s plants are located or where a service provider actually provides services (the “muscle” approach). \textit{See} RAMOS MUÑOZ, \textit{supra} note 109, at 355.

\textsuperscript{118} \textit{Id.}

\textsuperscript{119} \textit{Id.} at 355-56; Ribstein & O'Hara, \textit{supra} note 110, at 677.

\textsuperscript{120} \textit{See} Kersting, \textit{supra} note 114, at 4 n.17.

\textsuperscript{121} RAMOS MUÑOZ, \textit{supra} note 109, at 355-56.
law governs an entity’s insolvency.\textsuperscript{122} The distinctions between these theories are generally irrelevant when examining an SPV’s governing jurisdiction, since SPVs commonly only have one “office,” which sits in its jurisdiction of incorporation.\textsuperscript{123} However, limitations on the SPV’s activities by its originator may provide evidence that its decision-making activities actually take place where the originator sits.\textsuperscript{124}

In the United States, the representative of a foreign insolvency estate can seek bankruptcy recognition under Chapter 15 of the Bankruptcy Code.\textsuperscript{125} This Chapter, based closely on the UNCITRAL Model Law on Cross-Border Insolvency, adopts the “center of main interests” (COMI) approach implemented in the EU.\textsuperscript{126} An entity’s COMI determines which jurisdiction’s law applies to its insolvency.\textsuperscript{127} It does this by designating an insolvency proceeding in the debtor’s COMI as the “main proceeding,”

\textsuperscript{122} See id. at 364-66 (referring to the EU and United States). That view may be changing among U.S. bankruptcy courts, however. See In re Millennium Global Emerging Credit Master Fund Ltd., 458 B.R. 63 (Bankr. S.D.N.Y. 2011).

\textsuperscript{123} RAMOS MUÑOZ, supra note 109, at 355.

\textsuperscript{124} Id. As a result, an SPV’s insolvency may still be governed by the law governing its originator even though both its incorporation and real seat exist in the same jurisdiction. Id. at 364.

\textsuperscript{125} In re Millenium Global, 458 B.R. at 69.

\textsuperscript{126} RAMOS MUÑOZ, supra note 109, at 366-68.

\textsuperscript{127} Id. at 363-64.
while proceedings in any other jurisdiction “where the debtor carries out a nontransitory economic activity”128 are designated “nonmain proceedings.”129 Under this approach, a debtor’s COMI is presumed to be the debtor’s registered office “[i]n the absence of evidence to the contrary.”130 However, Congress and U.S. courts have recognized that this presumption is not preferred where an entity’s jurisdiction of incorporation and where its real seat is located are not the same.131 While this may seem clear-cut for courts to apply, “[n]either the Model Law nor chapter 15 defines the term ‘COMI.’”132 As a New York bankruptcy court put it in 2011, the “deceptively simple terms” used in the Model Law and adopted pursuant to Chapter 15 “have engendered considerable litigation.”133

Notwithstanding the international consistency and uniformity sorely needed in insolvency matters, UNCITRAL has not provided adequate guidance to make COMI analysis effective.134 Moreover, few cases have

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129 In re Millenium Global, 458 B.R. at 70-71.


132 In re Millenium Global, 458 B.R. at 70.

133 Id.

134 Id. at 73.
arisen so far that require U.S. courts to determine an entity’s COMI. This problem has become particularly more onerous in the wake of the recent financial crisis, when many nonbank institutions and their investment vehicles entered into insolvency proceedings. Consequently, courts and lawmakers must improve the soundness of Chapter 15 and its interpretations since securitization has not only skyrocketed in popularity, but has become increasingly transnational due to technological advances.

CONCLUSION

Securitizations, complex financial transactions in themselves, present even more confusion and uncertainty in the realm of bankruptcy or other insolvency proceedings. Not only is it unclear when an asset transfer to an SPV can or will be avoided because it is not a legitimate transaction, but even where the transfer is sufficiently a “true sale,” the transfer can still effectively be avoided by a bankruptcy court through substantive consolidation of the entities. The significant degree of uncertainty among judicial doctrines, tests, or elements hinders courts’ abilities to fairly and consistently distribute wealth among creditors. While the lack of clarity may make originators more reluctant to engage in questionable behavior—probably a good thing, in light of the recent financial crisis—it provides little to no benefit if the courts overseeing this behavior are equally

\[135\] Id. at 71.
confused. Because bankruptcy courts are courts of equity, they are not forced to comply with any judicially-fashioned test where it would create an unjust result. Moreover, where an originator or its SPVs are created or operate under non-U.S. law, this can add even more uncertainty due to unsettled legal principles regarding jurisdiction. Therefore, courts and legislatures both in the United States and abroad must craft clear rules, tests, or factors that allow originators to form reasonable and consistent expectations of how their actions (or transactions) will be viewed in the event of bankruptcy.

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