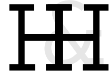

Hahn & Hessen LLP

Asset Securitization:

The Bankruptcy Perspective

MARK S. INDELICATO

Hahn & Hessen LLP
Telephone: (212) 946-0263
Fax: (212) 594-7167
E-mail: mindelicato@hahnhessen.com
Address: 350 Fifth Avenue, New York, NY 10118

Asset Securitization: The Bankruptcy Perspective

by Mark S. Indelicato

I. Overview

Since the mid-1980's, securitizations have increased at a rapid rate for banks and finance companies and has become an attractive alternative source of financing for corporate America. Securitizations appeal to a broad range of companies, large and small, in many different industries. Loan warehousing transactions are often a prelude to asset securitization, a form of "structured financing". Since the bankruptcy concerns of the warehouse lender are often coterminous with those of the underwriter or issuer in connection with a securitized offering, for purposes of this discussion the terms "asset securitization" and "mortgage loan warehousing" shall be used interchangeably.

Structured financing refers to a method of financing pursuant to which the originating company transfers assets that generate a steady stream of income to a separate entity, in order to isolate these assets from the potential financial decline of the originating company, particularly the potential that the originating company could become the subject of a proceeding under the provisions of the Bankruptcy Code.[1] This separate entity, often affiliated with the originator, generally known as a special purpose entity ("SPE"), then issues securities, either debt or equity, backed by these assets and uses the proceeds generated from the issuance of these securities to pay the originator for the assets that have been transferred by the originator to the SPE, thereby providing the originator with capital for its business needs. The SPE then uses the income stream generated by these assets to make payments to the holders of the asset backed security issued by the SPE. In certain circumstances companies are now seeking to securitize non-liquid assets such as inventory, but such securitizations can be problematic.[2]

In addition to the originator of the assets and the SPE, structured financing transactions typically include many, if not all, of the following additional entities: credit enhancers

1. Unless otherwise stated, all section references are to the Bankruptcy Reform Act of 1978, as amended, codified at 11 U.S.C. § 101 et seq. (the "Bankruptcy Code").
2. See In re LTV Steel Co., 2001 Bankr. Lexis 131 (Feb. 5, 2001).

(i.e., financial guarantors); the servicer (the party that collects on the assets transferred to the SPE, directs cash flow allocation, and may otherwise act as agent for the bondholders); a liquidity provider (letter of credit bank); a trustee or collateral agent; a securities underwriter or placement agent; and a rating agency.

The continuous introduction of a vast array of new asset classes has re-energized the structured market. Among others, the new asset classes include: structured settlement, lottery, and viatical settlement annuity payments; utility stranded costs; delinquent tax liens; intellectual property royalties; "catastrophic" risk payments; mutual fund fees; and unsecured personal loans. The most significant new type of public security in terms of volume has been stranded cost recovery receivables, which are above market investments made by utility companies as part of their regulatory structure. In the private market, structured settlement transactions, which involve the securitization of annuity payments to litigation claimants, have shown great promise.

Credit ratings express an opinion about both absolute credit risk of payment default or expected loss to a security-holder and relative credit risk through other rating categories. In order to achieve a rating that reflects a lower level of credit risk than that of the originator, structured transactions may involve some form of credit enhancement. Conventional forms of external credit enhancement include letters of credit, surety bonds, subordinated loans from third parties, and guarantees. Internal credit enhancement can include over-collateralization and capital contributions to the equity of the SPE. The credit rating given to the SPE security from Moody's or Standard & Poor's will generally be higher than the credit rating that would have been received by the originator, because the securities issued by the SPE are generally either over-collateralized or subject to one of the other credit enhancement devices intended to ensure that timely payment is made on the underlying obligation.

Asset securitization enables the originator to go directly to the credit market for its working capital needs instead of seeking traditional financing; direct access to the credit markets reduces the originator's cost of funds and thereby increases its net operating income. It allows considerable flexibility by using either discrete or revolving asset pools, allocating asset cash flow to match bond payments, and accelerating cash flow from assets, thereby allowing a more efficient redeployment of those assets.

A primary consideration in asset securitization is to ensure, to the greatest extent possible, that the SPE and its assets will not be affected by the financial deterioration or bankruptcy of the originator. It is the premise of structured financing to separate, as a legal matter, the credit quality of the assets being securitized from the credit risk of the originator. The SPE is created to be "bankruptcy remote" - i.e., to lessen the possibility that the SPE

itself will be a debtor under the provisions of the Bankruptcy Code. It is the bankruptcy avoidance mechanisms that justify the additional cost and expenses associated with a securitized transaction, as compared to the costs of traditional financing.

In structuring the transaction it is also important to ensure that the transfer from the originator to the SPE be treated as a true sale as opposed to a secured loan if the transaction is later scrutinized by a bankruptcy court. To accomplish such an absolute sale, the transferor should convey both the benefits and burdens of ownership to the SPE. If the transfer of the assets to the SPE is treated as a true sale the originator will have no interest in the assets of the SPE and the SPE will be permitted to continue collecting the income generated from these assets unaffected by the bankruptcy of the originator.[3] If, however, the transaction is deemed to be a loan instead of a sale the assets will constitute property of the originator's bankruptcy estate pursuant to the provisions of section 541 of the Bankruptcy Code.[4] The SPE will then be stayed[5] from its efforts to collect the income stream generated from the transferred assets[6] or may be subject to a motion by the originator seeking to either sell the transferred assets or utilize the income stream generated from the transferred assets[7] by providing the SPE with adequate protection

3. But see Octagon Gas Systems, Inc. v. Rimmer, 995 F.2d 948 (10th Cir. 1993) (The Tenth Circuit found that even in the event of true sale of accounts, the accounts would constitute assets of the bankrupt seller's estate.) This case has been widely criticized as a misreading of the law.

4.11 U.S.C. § 541(a) provides that the commencement of a case under the Bankruptcy Code creates an estate, comprised of, among other things, "all legal or equitable interests of the debtor in property as of the commencement of the case", "wherever located and by whomever held". As stated by the United States Supreme Court in United States v. Whiting Pools, Inc., 462 U.S. 198, 204-105 (1983), "the House and Senate Reports on the Bankruptcy Code indicate that § 541(a)(1)'s scope is broad." See e.g., United States v. Rauer, 963 F.2d 1332, 1337 (10th Cir. 1992) (property of estate includes all property interests, whether reachable by state-law creditors or not, and whether vested or contingent).

5. The commencement of a bankruptcy proceeding automatically stays any action by a creditor to "obtain possession of property of the estate or of property from the estate or excise control over property of the estate" or to "create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title". 11 U.S.C. § 362(a)(3) and (5). If the securitized transaction is deemed a loan from the SPE to the originator instead of a sale the SPE will be prohibited from proceeding against and liquidating the transferred assets, see, e.g., Rice v. Indiana Lawrence Bank, 90 B.R. 386 (N.D. Ind. 1988) as well as belatedly perfecting its interest in the transferred assets.

6. 11 U.S.C. § 363(a)(1984) defines cash collateral as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, product, offspring, rents or profits of property subject to a security interest . . ."

7. If the transferred assets are deemed to be part of the originator's bankruptcy proceeding the proceeds of those assets will constitute "cash collateral" pursuant to 11 U.S.C. §363(a). The originator is prohibited from using cash collateral absent a bankruptcy court order. The originator may make a motion seeking authorization to utilize the SPE's cash collateral to continue the operation of its business, if it can provide the SPE with "adequate protection" of its interest in the transferred assets, see 11 U.S.C. § 363(e). If cash collateral is not sufficient to satisfy its working capital needs, the originator could also seek authorization to obtain debtor-in-possession financing from a new lender by granting that lender a lien pari passu with liens of existing creditors pursuant to 11 U.S.C. § 364(c) or a lien superior to existing liens (a "priming lien") pursuant to 11 U.S.C. § 364(d).

of its interest in the transferred assets. Bankruptcy courts are reluctant to immediately curtail a debtor's access to the funding needed to operate its business.[8] In addition, if the SPE's interest is not perfected, the SPE may be subject to attack by the originator's bankruptcy trustee[9] to avoid the SPE's interest as a preference and recover payments already received by the SPE from the income stream of the transferred assets.[10]

Even if the transfer of assets from the originator to the SPE is determined to be a true sale, the assets of the SPE could still become subject to the bankruptcy proceeding of the originator if, upon proper motion, the bankruptcy court were to approve the "substantive consolidation" of the estate of the nondebtor, solvent SPE with that of the originator to create one common fund to satisfy creditors of both the originator and the SPE.

8. The Bankruptcy Code and preceding acts are construed liberally in favor of the debtor. The purpose for this construction is to give debtors "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt." In re Wilson, 144 B.R. 318, 319 (Bankr. W.D. Va. 1992).
9. Although Section 1108 provides that "the trustee may operate the debtor's business" unless the court orders otherwise in a Chapter 11 proceeding, generally it is the debtor itself which continues operation of the business as debtor-in-possession during its reorganization efforts. Section 1104 allows court-ordered appointment of a trustee "for cause" or if appointment of a trustee is in the interest of those parties with interest in the estate. 11 U.S.C. § 1104(e)(1). Cause has been held to exist where current management was or is involved in "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor".
10. See 11 U.S.C. § 547.

II. The LTV Steel Co. Decision

The recent decision in the LTV Steel Co. bankruptcy case has caused some controversy regarding the safety and remoteness of an SPE in structured transactions. LTV Steel Co. and several affiliates filed for bankruptcy with the U.S. Bankruptcy Court for the Northern District of Ohio on December 12, 2000. Simultaneously with its petition, LTV filed a motion to use the cash generated in its two separate securitizations with two separate banks, one securitized by accounts receivable and one by inventory. LTV argued first, that it would have to close its doors and cease operations, and second, that the transfer of assets were disguised financings and not a "true sale." This cash was needed because LTV had securitized virtually all of its liquid working capital assets and did not have sufficient cash flow to continue to operate. Despite bank opposition to the use of the cash, the court granted a temporary order permitting the use of the cash and set a future date for determination of the true sale/disguised financing issue with respect to the securitization. Ultimately, the dispute was resolved when both banks provided debtor-in-possession (DIP) financing to LTV that took out the securitization debt. The court reached no conclusion on the merits of the case. Instead, it issued a summary finding that a true sale had occurred.

DIP financing has been a key factor in past securitizations allowing for quick exit upon a bankruptcy filing by the originator. In this case, DIP financing was not provided because the accounts receivable financer, Abbey National Treasury Services (Abbey), did not want to share its collateral on a pari passu basis with the inventory financer. Abbey claimed that it did not want to relinquish its favorable position of being repaid solely by "high quality, short-term, liquid" accounts receivables in exchange for sharing an interest in "inventory, which is of uncertain value, especially under distressed conditions," which take time to realize their value.[11] Clearly, the problem in this case, and the failure to negotiate a workout facility, was caused by the separate securitization of inventory in addition to accounts receivable. Abbey's argument demonstrates the problem from the perspective of the receivables lender who did not take part in the securitization of inventory. Inventory is a much harder asset to securitize in a troubled company.

Whether the LTV Steel Co. case has precedential value remains to be seen. What it does is demonstrate how structured financings are susceptible to entanglement in the originator's bankruptcy. As discussed earlier, bankruptcy court's have the power to balance the equities

11. Abbey's Brief in Support of its Appeal of the Memorandum Opinion and Order Entered by the Bankruptcy Court on February 5, 2001 (Feb. 15, 2001) (Appeal to U.S. District Court, N.D. Ohio, E. Div.).

in its determination of whether a true sale or secured loan has occurred. In LTV Steel Co., the court found that LTV had retained at least an equitable interest in the products that it created with its own labor, as well as the proceeds it derived from that labor. Based on that, the court concluded that that interest was sufficient to support the cash collateral order.[12] It is likely that this "equitable interest" referred more to inventory than to receivables. As will be discussed in more detail in section IV, one factor in a court's determination is a seller's "control" over the assets transferred. LTV's inventory and much of the personal property characteristics such as melting, molding and casting of metal and steel, is more than what a transferor normally performs in securitizing a liquidated pool of assets like receivables. Thus, some form of control was found by the court.

It appears that LTV Steel Co. is unique and distinguishable from most structured financings. Whether its distinguishable due to the use of manufactured products or the use of inventory in general as an asset, the LTV Steel Co. case should not pose a problem to lenders in the structured finance industry. Notwithstanding any arguments which may be based upon this case, one can always point to the fact that the court ultimately concluded that a true sale took place.

12. Memorandum Opinion and Order Entered by the Bankruptcy Court for the Northern District of Ohio (Feb. 5, 2001).

III. Proposed Section 912 of the Bankruptcy Reform Act of 2001

Proposed Section 912 of the Bankruptcy Reform Act has caused some concern in the bankruptcy community. Section 912 would remove the ability of the bankruptcy judge to recharacterize 'sales' as secured transactions, even where the transaction would not be a sale under state law. Bankruptcy judges would no longer be able to determine whether an asset-backed securitization is a disguised financing transaction or a true sale, essentially wiping out any possibility of the LTV Steel Co. decision becoming precedent. Detractors argue, that in instances such as the LTV Steel Co. case where many jobs were on the line, the provision could prove to be disastrous.

The bankruptcy community has pushed for the deletion of proposed Section 912, or at least for amendment of the true sale protection provision. Many believe that this provision only favors a few creditors. Others argue that Section 912 is essentially a "waiver" of the right to file bankruptcy because it allows debtors to isolate assets which would otherwise become part of the bankruptcy estate.

Ultimately, detractors believe such protection could hamper any possibility of reorganization. Arguments from the lending industry obviously favor the provision because it ensures that hundreds of billions of dollars in securitizations would be safe from the bankruptcy court's scrutiny. Both industries will be closely watching Congress' determination of the issue.

IV. The Creation of The Special Purpose Entity

Establishment of a bankruptcy remote entity may be accomplished by the inherent structure of the particular SPE because not all entities are eligible for bankruptcy protection. Section 109 of the Bankruptcy Code provides that a domestic insurance company, bank, savings bank, cooperative bank, savings and loan association, building and loan association, credit union or a domestic industrial bank are not eligible for relief under the Bankruptcy Code. If a party is not eligible for the protections of the Bankruptcy Code but either files a petition or has an involuntary petition filed against it, the case must be dismissed because the bankruptcy court will lack jurisdiction.[13] Furthermore, a trust generally is not considered a "person" under the provision of the Bankruptcy Code, and is also ineligible for relief under the provisions of the Bankruptcy Code.[14]

An SPE may be a corporation, or a grantor trust which has a finite existence and fixed purpose.[15] The different tax treatment afforded to a trust as well as its inability to seek bankruptcy protection may be the impetus for creating an SPE as a trust instead of a corporation. If the SPE is to be a trust, however, the trust must be established so as to ensure that it will not be deemed a “business trust”[16] by the bankruptcy courts. Unlike grantor trusts, business trusts may be subject to a filing under the provision of the Bankruptcy Code because as a business trust it would be considered a corporation.[17]

A new form of SPE which has become increasingly employed has been the limited liability company (LLC).[18] Compared with the corporate SPE, the LLC offers its owners full control of management without exposure to personal liability for the LLC's obligations. Additional advantages include flexibility of structuring ownership interests, low cost, and the ability to disregard the LLC for federal and state income tax purposes. Delaware law has been the leader in providing a statutory framework for LLC's to be used as SPE's. There is a concern regarding single-member LLC's and their degree of bankruptcy risk. The risk is the potential dissolution of the

13. See In re Independent Clearing House, Co., 77 B.R. 843, 850 (D. Utah 1987).
14. See In re Medallion Realty, 103 B.R. 8, 11 (Bankr. D. Mass. 1989), aff'd, 120 B.R. 245 (D. Mass. 1990).
15. The entity may be so structured as to permit its treatment as a partnership for tax purposes.
16. According to case law, the primary consideration in determining whether a trust constitutes a business trust for Bankruptcy Code purposes is whether the trust was actually operating a business or at least had a business objective. See, e.g., In re The Ophir Trust, 112 B.R. 956 (Bankr. E.D. Wis. 1990).
17. See Kravitts, Securitization of Financial Assets (“Securitization of Financial Assets”), § 502[c][2], at 5-24, N.N. 44, 45 (Supp. 1992).
18. See generally, The Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, New Developments in Structured Finance, 50 BUS. LAW. 95, 146-158 (2000) (discussing fully LLC as a new form of SPE to achieve bankruptcy protection).

LLC upon the sole member's individual bankruptcy, depending upon whether the court determines that the LLC is a partnership or corporation for bankruptcy purposes. If the court deems the LLC a partnership for bankruptcy purposes, the LLC may dissolve upon the bankruptcy of its member and have its assets distributed. Corporations, on the other hand, do not dissolve upon the bankruptcy of its last remaining shareholder. Under Delaware law, the consensus has been that the LLC agreement is deemed analogous to a certificate of incorporation, and that LLC status is respected as a separate legal entity.[19] If the consensus holds true to form, this would eliminate the risk of courts finding LLC's to be partnerships and dissolving the SPE.

The SPE should be structured to ensure not only that it is not subject to the bankruptcy proceeding of the originator, but also that it will not be subject to a bankruptcy proceeding of its own for reasons other than the creditworthiness of the transferred assets. Activities of the SPE should be limited to those related to structured financing. In order to insulate the SPE from attack the SPE must:

a) observe corporate formalities;
b) be able easily to distinguish its assets and liabilities from those of the originator;
c) have a separate corporate existence that is disclosed to third parties;
d) have adequate capital to conduct its business operations; and
e) be subject to limitations on its investments, indebtedness, business and ownership.

The stock of the SPE could be owned by the originator, a third party or even a charitable organization depending on the business structure of the transaction. It might not make business sense, however, to have the stock of the SPE owned by a third party or charitable organization (even though this might make the SPE "bankruptcy proof")[20] if the SPE is significantly overcollateralized. In such an instance, it would make business sense to have the stock of the SPE owned by the originator so that the originator would retain the residual value of the transferred assets.

It is also important to ensure that the SPE is adequately capitalized. This will be helpful in defeating any bankruptcy court motion to substantively consolidate the assets of the SPE with those of the originator in the originator's

19. See 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGS, LIMITED LIABILITY COMPANIES § 14.04, at 14-18 (2000) ("From a policy standpoint, LLC's probably should be considered corporations for bankruptcy purposes because special bankruptcy provisions that apply to partnerships primarily relate to the general partner's duty to contribute to payment of the firm's debts.").
20. The legislative history to Section 303(a) states that "[t]he exceptions contained in current law that prohibit involuntary cases against farmers and eleemosynary institutions are continued. ... Eleemosynary institutions, such as churches, schools, and charitable organizations and foundations, likewise are exempt from involuntary bankruptcy." H. Rep. No. 95-595, 95th Cong., 1st Sess. (1977) pp. 321-324. See In re Allen University, 497 F.2d 346, 347-48 (4th Cir. 1943) ("main purpose of education" rendered institution exempt from involuntary bankruptcy, even though it carried on a number of commercial activities); see also In re United Kitchen Associates, Inc., 33 B.R. 214 (Bankr. W.D. La. 1983) (noting divergence in cases decided under Bankruptcy Act regarding whether status of entity under state law is determinative for purposes of Section 303(a)).

bankruptcy proceeding. It will also reduce the risk that the SPE will be subject to a bankruptcy proceeding because the SPE will have sufficient capital to meet its financial obligations. Provisions in the articles of incorporation of an SPE that is affiliated with the originator could also be of assistance in ensuring that the SPE is independent and bankruptcy remote, if they:

a) limit the number of officers and directors of the originator that can be officers and directors of the SPE;
b) require at least one member (preferably two) of the SPE's board of directors to be independent of the originator; and
c) the unanimous consent of the board of directors be required to file a voluntary proceeding under the Bankruptcy Code.

The inclusion of these provisions in the SPE's articles of incorporation will make it harder for a solvent SPE to file a bankruptcy petition. These provisions, however, are not the same as an express, absolute waiver by the SPE of its right to seek bankruptcy protection; any such provision would be void as against public policy.[21] The SPE could, however, agree not to file a voluntary bankruptcy proceeding if it is solvent; this provisions, may be acceptable because the voluntary waiver by a solvent entity of its ability to file a voluntary bankruptcy proceeding when solvent may not violate public policy. These provisions will not, however, prevent an involuntary bankruptcy petition from being filed against the SPE.[22] In fact, in Kingston, the court found that the orchestration of the involuntary petition by the principals of the originator was not bad faith requiring dismissal of the bankruptcy proceeding pursuant to section 1112(b) of the Bankruptcy Code.[23]

The underlying purchase agreement between the originator and the SPE should contain the following covenants, representations and warranties which not only will foster the goals of making the SPE bankruptcy remote, but also will diminish the possibility that the SPE will be substantively consolidated in the bankruptcy proceeding of the originator:

a) all intercompany transactions between the SPE and the originator will be arm's-length transactions;
b) the SPE will observe all corporate formalities and hold itself out to creditors as a separate distinct legal entity;

21. Congress' "strong legislative desire that deserving debtors be allowed to get a fresh start" renders void as against public policy "an advance agreement to waive the benefits" of federal bankruptcy law. Fallick v. Kehr, 369 F.2d 899 (2nd Cir. 1969); In re Adana Mortgage Bankers, Inc., 12 B.R. 989, 1009 (N.D. Ga. 1990) (waiver of right to file bankruptcy petition, even if "bargained-for and knowledgeable", is void); In re Peli, 31 B.R. 952, 956 (Bankr. E.D.N.Y. 1983) ("Agreements waiving the right to file a petition in bankruptcy violate public policy and will not be given effect.").
22. See In re Kingston Square Associates, 214 B.R. 713, 725-26 (Bankr. S.D.N.Y. 1997).
23. Id.

c) the SPE will maintain proper books and records setting forth its assets and liabilities; and

d) the SPE will not, unless required and then only for such time as is necessary, commingle its assets with those of the originator.[24]

Another structural option to help minimize the effects of a bankruptcy by the SPE is an agreement by the SPE to grant lenders or purchasers immediate relief from the provisions of the automatic stay[25] upon the filing of a bankruptcy proceeding.

In order to further minimize the risk that the SPE will be subject to its own bankruptcy proceeding the SPE may seek an agreement from its existing creditors (which should be few in number) that they will refrain from filing an involuntary petition against the SPE. Unlike a waiver by the SPE agreeing not to file an voluntary proceeding for relief under the provisions of the Bankruptcy Code, an agreement by a nondebtor third party to waive its rights under the Bankruptcy Code is enforceable.[26] If the SPE has additional unsecured creditors, even its own professionals, an involuntary proceeding could be commenced against the SPE.

24. An issue arises under the Uniform Commercial Code when the collections from the transferred assets are not paid directly to the SPE but instead are paid to the originator as servicer or mistakenly commingled with the originator's general funds. Section 9-306(3) of the UCC governs perfection of the SPE's interest in those proceeds prior to the bankruptcy of the originator; upon the commencement of the originator's bankruptcy Section 9-306(4) governs the SPE's perfection of its interest in the proceeds of the transferred assets. In order to ensure that the SPE retains its interest in the proceeds of the transferred assets, at a minimum, the servicing agreement (as well as the purchasing agreement) should provide: (1) that the allocation of all collections must occur within ten days (or less) of receipt by the originator, and (2) that collections received by the originator are to be segregated and held in trust for the benefit of the SPE until paid by the originator (servicer) to the SPE.
25. A series of reported decisions from the United States Bankruptcy Court for the Middle District of Florida hold that prepetition agreements between debtors and creditors, in which the debtor agrees not to oppose the granting of relief from the automatic stay to the creditor, are enforceable. These agreements were held "significantly different" from agreements wherein the debtor waives the right to file a petition in bankruptcy, which are held void as against public policy. See, e.g., In re Citadel Properties, Inc., 86 B.R. 275 (Bankr. M.D. Fla. 1988); In re Orange Park South Partnership, 79 B.R. 79 (Bankr. M.D. Fla. 1987); see also In re Club Tower L.P., 138 B.R. 307 (Bankr. N.D. Ga. 1991).
26. See, e.g., In re Harry C. Partridge, Jr. & Sons, 43 B.R. 669, 671 (Bankr. S.D.N.Y. 1984).

V. Is a Securitized Transaction a True Sale or a Secured Loan?

Whether a securitized transaction constitutes a true sale or a secured loan will be determined not by the Bankruptcy Code but by reference to applicable state law.[27] As previously stated, if the transaction is treated as a loan from the SPE to the originator, secured by the assets transferred to the SPE by the originator, the originator will retain an interest in these assets and these assets will be subject to the bankruptcy of the originator; all actions by the SPE to collect the proceeds from the transferred assets will be stayed. The originator could also seek to sell the transferred assets or obtain additional financing utilizing the transferred assets as collateral provided the SPE's interest in the transferred assets is adequately protected.[28] A sale or further lien granted on the transferred assets would adversely affect the interests of the SPE.

Whether a transaction constitutes a true sale is determined on a case by case basis. A bankruptcy court as a court of equity may look through form to substance to determine the nature of the transaction and recharacterize the transaction as appropriate.[29] Certain courts give presumptive weight to the intent of the parties.[30] Other courts consider the parties' intent as only one attribute of the transaction, and balance those attributes which indicate a true sale against those attributes that indicate a loan, to determine based on the totality of the transaction's attributes whether the transaction constituted a loan or a sale.

Most courts, however, have held that the characterization does not depend on the labels affixed by the parties to the contract.[31] In determining whether a transaction constitutes a true sale "[s]imply calling transactions' sales does not make them so. Labels cannot change the true nature of the underlying transactions."[32] The courts will consider whether

27. In re The Woodson Co., 813 F.2d 266 (9th Cir. 1987); In re S.O.A.W. Enterprises, Inc., 32 B.R. 279 (Bankr. W.D. Tex 1983).
28. On September 27, 1991 Days Inns of America, Inc. and its affiliates, including, an SPE created prepetition, Days Inns Receivables Funding Corp. ("DIRF") filed petitions for reorganization under Chapter 11 of the Bankruptcy Code. The independent director of DIRF approved the bankruptcy filing even though DIRF was solvent. On October 2, 1991, the debtors including DIRF, filed a motion pursuant to Section 363 of the Bankruptcy Code to sell substantially all their assets including the assets owned by DIRF. The secured noteholders of DIRF would not have been paid in full as a result of this sale and therefore had the right pursuant to Section 363(e) of the Bankruptcy Code to require that the debtors provide them with adequate protection of their interests in the assets of DIRF. The secured noteholders of DIRF ultimately settled their dispute by agreeing to accept a slight discount on the secured notes to avoid the time, expense and potential adverse effects litigation of the adequate protection issue would have had on the debtors and the assets of the estate.
29. Pepper v. Litton, 308 U.S. 295, 304 (1939).
30. In re Omne Partners II, 67 B.R. 793, 796 (Bankr. D.N.H. 1986).
31. See, e.g., In re Major Funding Corp., 82 B.R. 443 (Bankr. S.D. Tex. 1987) (documents labeling transactions as a "sale" of a participation interest on deeds of trusts nevertheless found to constitute unsecured loans); In re Alda Commercial Corp., 327 F. Supp. 1315, 1317 (S.D.N.Y. 1971) (party labeled as "participant" in document was a lender, not a "joint owner" of a participation interest); In re Eagle's Estate, 169 Misc. 140, 7 N.Y.S.2d 173 (Sur. Ct. N.Y. Cty. 1938)(participation not a "true" mortgage investment).
32. In re The Woodson Co., 813 F.2d 266, 272 (9th Cir. 1987).

"the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction or to a sale."[33] If the court determines that based on the totality of the transaction the transaction constitutes a loan and not a sale, the assets will be deemed part of the originator's bankruptcy estate.[34] One of the most compelling criteria for determining the nature of the transaction is the course of conduct between the parties.[35]

In In re Major Funding Corp.,[36] the investors sought a determination by the bankruptcy court "that certain mortgages assigned to them [were] not property of the Debtor's estate" pursuant to Section 541(d) of the Bankruptcy Code. The investors argued that the documents referred to the transaction as a purchase and sale, and described the investors as owners. The bankruptcy court rejected these arguments, concluding that "Major Funding's business practice[37] reveal[ed] the true intent of the Debtor" to treat the transaction as a loan.

In addition to the analysis in Major Funding, courts have also considered the absence or presence of the following elements as indicative of either a financing transaction or a true sale:

1) Recourse - If the originator retained the majority of the risk that the assets transferred to the SPE will not generate the desired return, a bankruptcy court might consider this a significant factor in determining that the transaction constitutes a financing arrangement instead of a true sale.[38] In structuring the transactions the parties must consider the need for yield protection or credit enhancement in the form of recourse against the originator with the need to ensure that the transaction is classified as a true sale and not a financing transaction in a bankruptcy of the originator. In In re Federated Dep't Stores, Inc., Allied Stores Corp., and In re Carter Hawley Hale Stores, the bankruptcy court approved a post-petition securitized transaction as a true sale partially because the SPE

33. Major's Furniture Mart, Inc. v. Castle Credit Corporation, Inc., 602 F.2d 538, 544 (3rd Cir. 1979).
34. See, e.g., In re Carolina Utilities Supply, Co., Inc. 118 B.R. 412 (Bankr. D.S.C. 1990)
35. Old Colony Trust Co. v. Omaha, 230 U.S. 100, 118 (1913) ("Generally speaking, the practical interpretation of a contract by the parties to it for a considerable period of time before it comes to be the subject of controversy is deemed of great, if not controlling, influence."); In re Golden Plan of California, Inc., 829 F.2d 705, 709 (9th Cir. 1986) ("Whether the parties intended outright sales or loans for security is determined from all the facts and circumstances surrounding the transaction at issue").
36. 82 B.R. 443 (Bankr. S.D. Tex 1987).
37. The pivotal business practices found by the Major Funding Court to evidence the true nature of the transaction to be loans, included the following:
First, the investors were promised a set return on their investment regardless of the rate on the 'assigned' note. The transactions lacked the direct pass-through of funds from homeowners to the investors that is characteristic of secondary mortgage transactions. Instead all funds were commingled in a single operating account. Second, in the event of default or full payout, Major Funding would 'repurchase' the old lien and assign a new lien to the investor. Such practices indicate that the investors did not shoulder the normal risks of ownership.
38. Major's Furniture Mart, Inc. v. Castle Credit Corporation, Inc. 602 F.2d 538, 543-46 (3rd Cir. 1979).

had only limited recourse against the originator which did not transform a true sale into a financing transaction.[39]

2) Irrevocability of the transfer of assets - If the agreement between the SPE and the originator provides that the SPE can return the assets to the originator or the originator can call the assets back from the SPE, thereby insulating the SPE from a drop in the value of the transferred assets and/or permitting the originator to realize any gain in their value, courts have held that this would indicate a financing transaction instead of a true sale.[40]

3) Control of the Assets - The degree of control of the assets maintained by the originator may also be indicative of a loan transaction. Although it is not uncommon for the SPE to retain the originator to service the transferred assets because of the originator's knowledge and expertise with regard to the transferred assets, the SPE (and/or the investor) must retain the right to replace the originator as servicing agent either as a result of a default under the purchase agreement (e.g., the bankruptcy of the purchaser) or without cause.[41] Notice to third parties of the sale by the originator to the SPE of the transferred assets would also affect the originator's perceived control over the assets and represent a clear indication of the intent of the parties to treat the transaction as a true sale.

A determination that a transaction is either a true sale or a financing transaction must be made on a case by case basis. In order to structure a transaction so that it is likely to be considered a true sale the parties should:

a) disclose their intent to treat the transaction as a sale to third parties (to the extent practicable),
b) limit the recourse to the originator based on the business needs of the transaction,
c) maintain control over the transferred assets with the investor, including the ability to appoint the servicing agent, and

39. UCC § 9-502 Official Comment 4 provides:
Financing arrangements of the type dealt with by this section are between businessmen. The last sentence of subsection (2) therefore preserves freedom of contract, and the subsection recognized that there may be a true sale of accounts or chattel paper although recourse exists.
40. Carolina Utilities, 118 B.R. at 416.
41. If the originator is the servicing agent for the SPE at the time of the originator's bankruptcy proceeding the servicing contract will be deemed an executory contract and part of the originator's bankruptcy estate. Since the servicing fee income stream may be necessary to the originator's operations, the bankruptcy court may not permit the SPE to terminate the servicing agreement or compel rejection of the executory contract absent compelling circumstances, because the income stream generated from the servicing agreement may be necessary to the reorganization of the originator. See Cardinal Industries, Inc. v. Buckeye Federal Savings & Loan Ass'n, 105 B.R. 834, 854-55 (Bankr. S.D. Ohio 1989).

d) limit the circumstances under which the assets will be transferred back to the originator.[42]

In determining whether a transfer of accounts constituted a true sale the Tenth Circuit Court of Appeals, in Octagon Gas Systems, Inc. v. Rimmer,[43] ignored both the clear intent of the parties' and the totality of the circumstances as evidenced by the parties course of conduct for fifteen years, to determine that purchased accounts still constituted property of the selling debtor's estate.[44] The Court held in Octagon that because Article 9 of the U.C.C. applies to sales of accounts as well as collateral assignments of accounts, the accounts constitute property of the debtor's estate regardless of the underlying transaction. Octagon could have a significant impact on securitized transactions because it will increase the risk that the transferred assets will be included in the originator's bankruptcy proceeding when the transferred assets constitute accounts. This added risk may eliminate the economic benefits of securitized transactions when accounts are involved in the Tenth Circuit.

Investors and lenders involved in transactions subject to the Tenth Circuit precedent should take some comfort in knowing that the Octagon decision is at odds with Major's Furniture Mart, Inc. v. Castle Credit Corp., Inc.,[45] in the Third Circuit and In re Contractors Equipment Supply Co., Inc., in the Ninth Circuit. The ultimate impact of Octagon on securitized transactions outside the Tenth Circuit should not be substantial because the Octagon reasoning is flawed, as clearly set forth in the dissent, and may not be followed by courts in other circuits.

42. The purchase agreement may contain a provision permitting the originator to repurchase the transferred assets once their value has reached such minimum level that administration of the transferred assets has become uneconomical. See Securitization of Financial Assets § 503[D] ft 146.
43. 995 F.2d 948 (10th Cir. 1993).
44. Id. at 956 (dissent of J. Seth).
45. 602 F.2d 538 (3rd Cir. 1979); see notes 26, 29-30, supra.

VI. The Potential For Substantive Consolidation of The SPE in The Originator's Bankruptcy

The doctrine of "substantive consolidation" in bankruptcy permits "the assets and liabilities of different entities [to] be consolidated and dealt with as if the assets were held by, and the liabilities incurred by, a single entity."[46] The provisions of the Bankruptcy Code, however, do not specifically authorize a bankruptcy court to substantively consolidate the assets and liabilities of different corporate entities. Substantive consolidation is a creature of court-made law and is derived from the equitable powers granted to the bankruptcy court pursuant to Section 105 of the Bankruptcy Code.[47] The focus of the bankruptcy court's analysis in determining whether substantive consolidation is warranted is the nature of the relationship between the entities and the effect of consolidation upon creditors of each entity.[48] Substantive consolidation should be "used sparingly" because of the potential detrimental effect it could have on creditors of the entities being consolidated.[49]

The bankruptcy court in In re Vecco Construction Industries, Inc.[50] set forth the following elements which were utilized by various courts[51] to determine if substantive consolidation should be granted:

a) the degree of difficulty in segregating and ascertaining individual assets and liabilities;
b) the presence or absence of consolidated financial statements;
c) the profitability of consolidation at a single physical location;
d) the commingling of assets and business functions;
e) the unity of interests and ownership between the various corporate entities;
f) the existence of parent and inter-corporate guarantees on loans;
g) the transfer of assets without formal observance of corporate formalities;
h) the ownership by the parent of a majority of stock of the subsidiary;
i) common officers or directors;
j) the gross undercapitalization of the subsidiary;

46. 5 Collier on Bankruptcy ¶ 1100.06[1] at 1100-32, 1100-32 (15th ed. 1988).
47. Section 105 of the Bankruptcy Code provides in pertinent part as follows:
(a) The Court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title . . .11 U.S.C. § 105.
48. See, e.g., Union Savings Bank v. Augie/Restivo Banking Company Ltd., 860 F.2d 515 (2d Cir. 1988); In re Food Fair, Inc., 10 B.R. 123, 126 (Bankr. S.D.N.Y. 1981).
49. James Talcott, Inc. v. Wharton, 517 F.2d 997, 1001 (2d Cir. 1975).
50. 4 B.R. 407, 410 (Bankr. E.D. Va. 1980).
51. See In re DRW Property Co., 82, 54 B.R. 489, 495 (Bankr. N.D. Tx. 1985); In re Donut Queen Inc., 41 B.R. 706, 709 (Bankr. E.D.N.Y. 1984); In re Foodfair, Inc., 10 B.R. 123 (Bankr. S.D.N.Y. 1981); In re Richton International Corporation, 12 B.R. 555, 557 (Bankr. S.D.N.Y. 1981).

k) the transaction of business by the subsidiary solely with its parent;
l) the disregard by both entities of the legal requirements of the subsidiary as a separate organization.[52]

The Second Circuit Court of Appeals in In re Augie/Restivo Baking Co. held that the above elements can be distilled into two critical factors that must be analyzed to determine if substantive consolidation is warranted: "(i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit . . . ; or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."[53]

In applying these standards courts should not be inflexible; the presence of any one of these factors, or even all of them, is not dispositive of the issue of consolidation but only probative. The court must apply a balancing of the equities favoring consolidation against the equities favoring continued independence of the entities. In the context of a securitized transaction the equities would generally favor the retention of the separate corporate identities of the originator and the SPE because the SPE has limited operations, is not incurring additional liabilities, is solvent, and has its own independent creditors.

Court have permitted substantive consolidation where:

a) the separate entity was created to delay, hinder or defraud creditors;[54]
b) creditors have been justified in relying on the credit and assets of the combined group;[55]
c) the interrelationships of the group are hopelessly obscured and the time and expense necessary to unscramble them threatens any distribution to creditors; and[56]
d) to permit consolidation will facilitate or expedite the reorganization proceedings.[57]
If the facts of the case justify consolidation,

52. But See In re Snider Bros., 18 Bankr. 230, 238 (Bankr. D. Mass. 1982) (While several courts have recently attempted to delineate what might be called "the elements of consolidation," . . .the only real criterion is . . .the economic prejudice of continued debtor separateness versus the economic prejudice of consolidation. There is no one set of elements which, if established, will mandate consolidation in every instance. Moreover, the fact that corporate formalities may have been ignored, or that different debtors are associated in business in some way, does not by itself lead inevitably to the conclusion that it would be equitable to merge otherwise separate estates).
53. In re Augie/Restivo Banking Co., 860 F.2d 518 (2d Cir. 1988).
54. Fish v. East, 114 F.2d 177 (10th Cir. 1940) ("The Court held that the corporation was organized to defraud creditors and constitutes 'more legal paraphernalia' observing form only and not existing in substance or reality as a separate entity"); In re Tureaud, 45 Bankr. 658 (Bankr. N.D. Okla. 1985), aff'd, 59 Bankr. 973 (Bankr. N.D. Okla. 1986); Soviero v. Franklin Nat'l Bank of Long Island, 328 F.2d 446, 448 (2d Cir. 1964).
55. Soviero v. Franklin Nat. Bank, 328 F.2d 446, 448 (2d Cir. 1964) (The court made clear findings of commingling of assets and flagrant disregard of corporate formalities. Creditors were also advised that the entities were a consolidated enterprise and further received consolidated financial statements from the entities); In re Richton International Corp., 12 Bankr. 555 (Bankr. S.D.N.Y. 1981).
56. Chemical Bank New York Trust Co. v. Kheel (In re Seatrade Corp.), 369 F.2d 845 (2d Cir. 1966).
57. In re F.A. Potts & Co., 23 B.R. 569, 572-74 (Bankr. E.D. Pa. 1982) (substantive consolidation of two interrelated companies was granted as a first step in proposing a feasible plan of reorganization, the court having determined that the benefit of possibly achieving a successful reorganization outweighs the harm associated with consolidation).

the mere fact that the SPE was created as a bankruptcy remote entity may not be sufficient to prevent it from being brought into the originator's bankruptcy proceeding. The bankruptcy court has the authority to consolidate the assets of an otherwise solvent nondebtor with those of the debtor pursuant to the provisions of Section 105 of the Bankruptcy Code.[58] Once the party seeking consolidation has satisfied its evidentiary burden to justify consolidation, the bankruptcy court may then consider whether the consolidation should be deemed nunc pro tunc (i.e. should the date of the filing of the solvent, nondebtor SPE be the date of the filing of the debtor's original petition).[59] A retroactive consolidation will have a significant impact on the creditors of the SPE because it will establish an artificial date for determining whether transfers made by the SPE are subject to avoidance as preferential or fraudulent transfers. The bankruptcy court will only grant nunc pro tunc relief if it is satisfied that the benefits provided by such relief far outweigh the harm that this would inflict.[60]

In a securitized transaction it appears that at least one significant creditor, the purchaser from or lender to the SPE, is relying on the separate corporate structure of the entities. As previously stated, the SPE must covenant to keep separate and distinct books and records which should be constantly monitored to insure compliance. Provided the assets and liabilities of the SPE are not hopelessly intertwined with those of the originator, and the steps set forth previously for designing the SPE are implemented, the risk of substantive consolidation of the estate of the originator with that of the SPE can be minimized.

In structuring a securitized transaction the parties should also be mindful of the tax implications to the originator; the SPE and the investors of the SPE. Compliance with the securities law will also be required by the SPE in the issuance of any securities.

58. Sampsell v. Imperial Paper Corp., 313 U.S. 215, reh'g denied, 313 U.S. 600 (1941) (Court permitted bankruptcy referee to consolidate nondebtor estate with that of the debtor).
59. In re Auto-Train Corp., Inc., 810 F.2d 270, 276-77.
60. Id.

VII. FASB 140 And Securitization Under The Bankruptcy Code

FASB 140 sets forth the standards for accounting for securitizations and other transfers of financial assets and requires certain disclosures in financial statements.[61] FASB 140 contains the standards for distinguishing transfers of financial assets that are sales from secured borrowings. Overall, FASB 140 is applicable to numerous types of financial transactions, including securitizations, transfers of receivables with recourse, loan syndications, factoring arrangements, and maybe repurchase agreements. The sale treatment of securitizations for accounting purposes is problematic because of the continuing involvement of the transferor in the transaction through its ownership of the SPE, its retention of residual interests in the transferred assets, and its role as servicer of the assets.

If all of the prescribed standards are followed, the transferor would be able to treat the transaction as a sale for accounting purposes, likely recognize a gain and remove the assets and liabilities from the its balance sheet. If the standards are not met however, the transaction would be recorded by the originator for recording purposes as a secured borrowings. The key under FASB 140 is for the transferor to surrender control or structure the transaction such that the assets are isolated from the transferor.[62]

FASB 140 has a threefold test to determine whether the transfer of assets in a securitization will be accounted for as a sale. FASB 140 requires that:

a) The transferred assets have been isolated from the transferor; that is, put presumptively beyond the reach of the transferor and its creditors, even in the bankruptcy of the transferor;
b) the transferee or, if the transferee is a QSPE,[63] each holder of its beneficial or debt interests, has the right to pledge or exchange the assets or beneficial or debt interests it received, and no condition constrains the transferee or holder from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor;[64] and
c) the transferor does not maintain effective control over the transferred assets through an agreement that entitles the transferor to repurchase the assets before their maturity or to repurchase or redeem assets that are not readily obtainable.

61. Accounting for Transfers and Servicing of Financial Assets and Extinguishing Liabilities – a replacement of FASB Statement No. 125, Statement of Financial Accounting Standards No. 140 (Financial Accounting Standards Board 2000) [hereinafter FASB 140].
62. See FASB 140, supra note 7, at ¶ 153 (stating legal isolation should serve as important factor in determining whether sale for accounting purposes should be recognized).
63. A QSPE is a trust, corporation, or other legal entity that holds title to the transferred assets, can issue beneficial interests, collects and distributes the proceeds of the assets, and has separate legal status.
64. See FASB 140, supra note 7, at ¶ 35 (setting forth requirements of QSPE).