THE RISE OF A GIANT:
SECURITIZATION AND THE GLOBAL FINANCIAL CRISIS

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The rapid growth of the securitization market was a primary factor in the 2008 global financial crisis. This article explores the emergence and explosive growth of asset securitization in the period leading up to the recent crisis. Understanding this basic and pressing issue is vital for future policy recommendations on the legal framework of securitization. The article thus offers both a pragmatic look at the rise of securitization as well as a theoretical analysis of its effects on third parties. It provides unique insight into the driving forces behind this financial tool, showing how the legal structure of securitization facilitates the shifting of the default risk to nonadjusting creditors. Finally, the article demonstrates how the potential gain from externalizing default risk creates distorted incentives for asset securitization, leading in turn to its excessive use, even when economically inefficient.

INTRODUCTION

Asset securitization is one of the most prominent financial tools in modern economies.1 It enables a company, known as the “originator,” to utilize assets that produce a predictable cash flow (typically rights to payments owed to the company2) to raise interim financing for its

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2 These assets usually originate in loans or property or services supplied to the originator's customers. See Kenneth C. Kettering, Securitization and Its Discontents, 29 CARDDOZO L. REV. 1553, 1564 (2008); Steven L. Schwarcz, The Alchemy of Asset Securitization, 1 STAN. J.L. BUS. & FIN. 133, 135 n.7 (1994).
business activity. By isolating specified assets from its other assets and securitizing them, the originator is able, in most cases, to fund its operations at a lower effective interest rate than through traditional financing methods, such as secured borrowing arrangements. Originators can obtain this lower effective rate because asset securitization shifts investors' focus from the creditworthiness of the originator itself to the credit quality of the underlying assets.

The prototypical securitization structure is based on separating specific assets—accounts receivable, for example—from the originator’s other assets and selling them to a separate legal entity. The latter is commonly referred to as a special purpose vehicle (SPV) because it is formed solely for the purpose of the securitization transaction. To minimize any risk entailed by the SPV’s operations, its activities are limited in its organic documents to only those required in connection with the transaction. The SPV finances the purchase of the securitized assets by issuing securities that are backed by those same assets, known as asset-backed securities (ABSs). The cash flow produced by the underlying assets funds the payments to the ABS investors.


4 For an empirical study that shows the savings securitization yields in financial costs, see James A. Rosenthal & Juan M. Ocampo, Analyzing the Economic Benefits of Securitized Credit, J. APPLIED CORP. FIN., Fall 1988, at 32 (finding that securitization produces financing cost savings of 1.3% per annum). See also Lowell Bryan, The Risks, Potential, and Promise of Securitization, in A PRIMER ON SECURITIZATION 171, 174 (Leon T. Kendall & Michael J. Fishman eds., 1996).


6 The SPV is sometimes referred to in the law and economics literature as a special purpose company or special purpose entity. See Ellis, supra note 5, at 299 (“[T]he borrower or issuer is often an intermediary entity, such as a wholly owned or completely separate ‘orphan’ corporate subsidiary, often referred to as a ‘Special Purpose Corporation’ or ‘SPC’ (although a limited partnership, limited liability company, or trust could easily serve this function, in which case the term ‘Special Purpose Vehicle’ or SPV would be employed”).); BOND MKT. ASS’N ET AL., SPECIAL PURPOSE ENTITIES (SPES) AND THE SECURITIZATION MARKETS 1 n.1 (2002), available at http://www.isda.org/speeches/pdf/SPV-Discussion-Piece-Final-Feb01.pdf (noting that the terms SPV and SPE can be used interchangeably).

7 Kettering, supra note 2, at 1564-65; Fidelis Oditah, Great Britain, in ASSET-BACKED SECURITIZATION IN EUROPE 99, 102 (Theodor Baums & Eddy Wymeersch eds., 1996); Schwarcz, supra note 2, at 135-36; Stark, supra note 3, at 215-16; Structured Financing Techniques, supra note 3, at 554; A. Brent Truitt & Bennett J. Murphy, Bankruptcy Issues in Securitizations, in SECURITIZATIONS: LEGAL AND REGULATORY ISSUES § 2.03 (Patrick D. Dolan & C. Van Leer Davis III eds., 2000 & Supp. 2006).

8 See Iacobucci & Winter, supra note 1, at 164.

There are other actors that participate in a typical securitization process. These include a servicer, usually the originator, which collects payments due on the securitized assets; a rating agency, which assesses the credit quality of the ABSs and assigns them a credit rating; a credit enhancer, which guarantees the repayment of the ABSs or insures their risk; a trustee acting on behalf of the ABS holders; and an underwriter, which purchases and distributes the ABSs. Securitization first emerged in the 1970s with the sale of securities backed by residential mortgages. However, it has since been expanded to a wide variety of assets that include credit card receivables, commercial mortgages, equipment leases, automobile loans, hotel and hospitality receivables, health care receivables, student loans, municipal rates, and franchise fees, in addition to other, even more nontraditional assets. One example of such an unconventional asset, which illustrates the considerable potential of securitization as a financing strategy, is the David Bowie Bond. In 1997, the singer securitized royalties from his music catalog in the amount of $55 million, demonstrating how virtually any type of asset with an income flow can be securitized.

The issuance of ABSs expanded significantly in the years leading up to the financial crisis. From its inception in the 1970s until the end of 2007, the popularity of securitization as a financing method ballooned in the United States, becoming a leading tool of corporate finance. There was a huge growth in mortgage loans, consumer credit, and trade receivables held by issuers of ABSs, peaking at $3737.4 billion by the end of 2007 and with an average annual

10 2 FRANKEL, supra note 5, at 91-98; id. at 76-84 (Supp. 1999); Stark, supra note 3, at 214.
11 Neil D. Baron, The Role of Rating Agencies in the Securitization Process, in A PRIMER ON SECURITIZATION, supra note 4, at 81, 84-88.
12 Entities that typically enjoy strong financial stability, such as banks or insurance companies, serve as credit enhancers in securitization transactions. The guarantee or insurance assists in decreasing the risk of the investment in the ABSs. See Schwarcz, supra note 2, at 139-40.
13 The duties of the trustee in the securitization transaction are outlined in the trust agreement. For further discussion, see generally Susan S. Steves Keiser, The Role of the Trustee in Securitization Transactions, in SECURITIZATION: ASSET-BACKED AND MORTGAGE-BACKED SECURITIES, at ch. 8 (Ronald S. Borod ed., 1991 & Supp. 2004).
14 Structured Financing Techniques, supra note 3, at 529.
16 1 FRANKEL, supra note 5, at 8, 37-38; id. at 9-12, 18-19 (Supp. 1999); Iacobucci & Winter, supra note 1, at 161-62; Lupica, supra note 5, at 602-03; Shenker & Colletta, supra note 9, at 1380; Structured Financing Techniques, supra note 3, at 538-39; Yuliya A. Dvorak, Comment, Transplanting Asset Securitization: Is the Grass Green Enough on the Other Side?, 38 HOUS. L. REV. 541, 546-47 (2001).
growth rate of about twenty-eight percent since 1984. More specifically, between 1998 and 2007, securitization increased from thirty-two percent of all new credit issuance to forty-nine percent, respectively.

This article explores the emergence and explosive growth of asset securitization, to understand the critical role it played in the onset of the recent global financial crisis. The article presents both a pragmatic look at the rise of securitization as well as a theoretical analysis of its effects on third parties. It offers a unique analysis of the driving forces behind this financial practice, showing how its legal structure enables originators to shift the default risk to their creditors. The potential gain from this externalization distorts the incentives for asset securitization, leading in turn to its excessive use, even when economically inefficient.

The article proceeds as follows. Part I discusses the direct effect of a securitization transaction—the removal of the securitized assets from the originator’s bankruptcy estate—and analyzes the legal frameworks on the federal and state levels that allow this outcome. Part II examines the impact of securitization transactions on the originator’s creditors, looking at the economic and legal ramifications of the detachment of the securitized assets from the company’s other assets. The conclusion reached in the discussion in this part is that a securitization transaction enables the originator to externalize its bankruptcy risk onto its creditors, because it increases the likelihood of default on their claims. Part III points to the adverse consequences of this externalization. I contend that the originator’s ability to externalize the default risk onto its creditors distorts the decision-making process in the choice of securitization as a financing strategy, so that it is preferred over other credit-raising methods even when they are likely to be more effective from an overall market perspective. The analysis presented here offers a unique perspective on the 2008 financial crisis, one that has yet to receive significant consideration in

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20 The Board of Governors of the Federal Reserve System began to report figures on assets held by issuers of ABSs in 1983. The amount of mortgages and trade credit at the end of 1984 stood at $12.5 billion. BD. OF GOVERNORS OF FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: ANNUAL FLOWS AND OUTSTANDINGS 1975-1984, at 73 tbl.I.126 ll. 5 & 10 (2012), available at http://www.federalreserve.gov/releases/z1/Current/annuals/a1975-1984.pdf. This figure does not include $8.8 billion in collateralized mortgage obligations backed by government agencies and government-sponsored enterprises that were held by these issuers at the end of that year. Id. l. 3.


22 On securitization as a primary factor in the 2008 financial crisis, see generally Kurt Eggert, The Great Collapse: How Securitization Caused the Subprime Meltdown, 41 CONN. L. REV. 1257 (2009) (arguing that one of the primary causes of the subprime meltdown and the resulting economic collapse was the structure of securitization as applied to subprime and other nonprime residential loans, along with the resecuritization of the resulting mortgage-backed securities); TIMOTHY F. GEITHNER, FIN. STABILITY OVERSIGHT COUNSEL, MACROECONOMIC EFFECTS OF RISK RETENTION REQUIREMENTS 10-14 (2011), available at http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20AL.pdf (describing the significant role that securitization played in the recent financial crisis); Gary B. Gorton & Andrew Metrick, Securitization, in THE HANDBOOK OF THE ECONOMICS OF FINANCE (George Constantinides et al. eds., forthcoming 2012), available at http://ssrn.com/abstract=1909887 (claiming that securitized bonds—even those unrelated to subprime mortgages—were at the center of the recent financial crisis); John D. Martin, A Primer on the Role of Securitization in the Credit Market Crisis of 2007, in LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE 199 (Robert W. Kolb ed., 2010) (analyzing the role of securitization in the financial crisis of 2007-2008).
the academic literature, by shedding light on what drove the hugely inflated growth of securitization in the years leading up to the crisis.

I. THE SCOPE OF THE ORIGINATOR’S BANKRUPTCY ESTATE

The securitization transaction is intended to ensure the insulation of the securitized assets from the risks entailed in the originator’s overall business activity. For the SPV and the investors in its securities to be isolated from the originator’s bankruptcy risk, the transfer of the assets to the SPV must be performed in the framework of a “true sale,” which will result in their detachment from the pool of assets to be distributed among the originator’s creditors.23 Structuring the securitization transaction as a true sale is essential for a high rating to be assigned to the ABSs issued over the course of the transaction.24 Consequently, rating agencies require a legal opinion determining the securitization transaction to be a true sale (known as a “true sale opinion”).25 However, due to certain controversial court rulings on this matter, lawyers active in the securities market tend to be reluctant to give a decisive ex ante true sale opinion.26 This uncertainty has led those active in the securitization industry to promote various legislative initiatives, on both the federal and state levels, which would provide definitively for the classification of securitization transactions as true sales and the exclusion of securitized assets from the bankruptcy estate. The discussion below analyzes the ambiguity currently surrounding this issue.

Section 541 of the U.S. Bankruptcy Code defines what property constitutes a debtor’s estate, namely, the scope of the debtor’s assets to be distributed among its creditors in bankruptcy.27 Under § 541(a)(1), the debtor’s estate includes all property in which it has “legal or equitable interests . . . as of the commencement of the case,”28 “wherever located and by


24 Ellis, supra note 5, at 305 n.58.


26 Lois R. Lupica, Revised Article 9, The Proposed Bankruptcy Code Amendments and Securitizing Debtors and Their Creditors, 7 FORDHAM J. CORP. & FIN. L. 321, 331 (2002). Lupica explains the difficulty faced by lawyers in preparing a legal opinion that deems a particular securitization transaction to be a true sale: “Because definitively concluding a particular asset transfer is a true sale is so difficult, lawyers have historically been reluctant, and in some instances unwilling, to offer unqualified legal opinions to that effect.” Id.

27 11 U.S.C. § 541 (2006). Some entities, however, are not subject to the Bankruptcy Code. See, e.g., id. §§ 101(41), 109(a) (providing that only a “person,” defined as an individual, partnership or corporation, may be a debtor in bankruptcy and excluding governmental units from the definition of “person” with some exceptions); id. § 109(b) (providing that a financial institution or insurance company may not be a “debtor” under the Bankruptcy Code); id. § 109(c) (providing that a municipality, but not the federal government or a state, may be a debtor in limited circumstances).

28 Id. § 541(a)(1).
whomever held.” Presumably, under the explicit terms of this provision, the bankruptcy estate includes all secured property in which the debtor retains residual rights, but not property that has been sold. In In re LTV Steel Co., however, the court ruled that the debtor retained a certain interest in the assets it had sold in the framework of a securitization transaction. The court rejected the claim that it had ceased to have any interest in assets deriving from the fruits of its labor. Accordingly, the securitized assets were included in the bankruptcy estate, with the court entering an interim order authorizing the debtor to use the cash collateral generated by those assets. The court based its decision on the Supreme Court’s broad interpretation of the scope of a debtor’s estate, which it pronounced in United States v. Whiting Pools, Inc.

The interim order in LTV Steel raised concerns about judicial intervention that subjects securitized assets to originators’ bankruptcy proceedings, thereby harming ABS investors. The decision gave rise to significant uncertainty in the ABS market about the legal ability to isolate securitized assets from the rest of the originator’s assets and achieve bankruptcy remoteness. Empirical evidence indicates that doubt over the insulation of ABS investors from an originator’s Chapter 11 proceedings led to a sharp increase in ABS credit spreads immediately subsequent to the LTV Steel decision. The securitization industry was quick to respond to this development in the case law, instigating the push for federal safe harbor legislation for securitization transactions. Accordingly, section 912 of the proposed bankruptcy reform bill categorically provided for the exclusion of securitized assets from an originator’s bankruptcy estate, with the exception of cases of fraudulent transfer to the SPV. Section 912 set two cumulative conditions

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29 Id. § 541(a).
30 See Grant Gilmore & David Gray Carlson, Gilmore and Carlson on Secured Lending—Claims in Bankruptcy 856 (2d ed. 2000). A debtor’s residual right in collateralized property has tangible expression when the property is of greater value than the debt secured by it. In such a case, the debtor will be entitled to the surplus amount in excess of the secured debt, which will be yielded during the collateral realization process.
32 Id. at 285.
33 Id. at 279. The parties to the proceedings reached an agreement before the court began its deliberations on whether to grant a final order. See Stark, supra note 3, at 223. For an analysis of the court’s decision and the conclusions that can be drawn from it, see id. at 219-29.
35 See Kenneth Ayotte & Stav Gaon, Asset-Backed Securities: Costs and Benefits of Bankruptcy Remoteness, 24 Rev. Fin. Stud. 1299 (2011) (finding that, following the interim order in LTV Steel, Chapter 11-eligible originators experienced a statistically and economically significant increase in their ABS issuance spreads relative to Chapter 11-ineligible originators, such as depository institutions, and thus arguing that “bankruptcy remoteness” is valuable to ABS investors in a way that is observable in prices).
37 Id. The Bankruptcy Code’s fraudulent transfer provision authorizes the bankruptcy trustee to avoid transfers of assets that are undertaken with actual intent to hinder, delay, or defraud creditors and transactions that provide the debtor with less than “reasonably equivalent value.” 11 U.S.C. § 548(a)(1) (2006). However, because the transferor of financial assets in securitization transactions is normally paid reasonably equivalent value for the assets, it is rare that such transfers are avoided. See Beale et al., supra note 5, at 244; Frost, supra note 5, at 114-15; LoPucki, supra note 1, at 27; Peter V. Pantaleo et al., Rethinking the Role of Recourse in the Sale of Financial Assets, 52 Bus. Law. 159, 185 (1996); Steven L. Schwarcz, The Impact of Bankruptcy Reform on “True Sale” Determination in Securitization Transactions, 7 Fordham J. Corp. & Fin. L. 353, 359 (2002).
for its application. The first was that the originator “represented and warranted” under written agreement that the assets were sold to the SPV with the intention of removing them from the originator’s estate. The second stipulation was that at least one class or tranche of securities that were issued in the transaction was rated investment grade by one or more nationally recognized securities-ratings organizations at the time the securities were initially issued. Toward the end of 2001, however, it became clear that a reconsideration of the ramifications of proposed section 912 was imperative, following the exposure of the manipulative accounting practices in the Enron crisis. The investigation into the company’s collapse revealed that Enron had made use of many hundreds of SPVs and off-book practices to conceal its liabilities from public scrutiny. Enron had routinely created such entities for the purpose of conducting transactions that were then intentionally misclassified and misrepresented in its financial reports. The problematic financial practices that came to light in the Enron scandal stoked the fear of improper use of SPVs in the securitization process. Shortly after the crisis erupted, thirty-five law professors voiced their strong objections to section 912 in a letter to the chairmen of the congressional committees that were reviewing the proposed reform of the Bankruptcy Code. Critics of the reform claimed that the provision had been designed to promote financial activity resembling what was exposed in the Enron affair, and its implementation would enable originators and SPVs to misrepresent their securitization transactions to third parties. Enron’s business practices served as concrete proof of the ease with which a transaction with an SPV could be abused even under then-prevailing law. Thus, critics asserted, given what had emerged in Enron, the desirability of a legal arrangement that automatically classifies such transactions as a true sale would be debatable. On the one hand this would enable originators to conceal some of the obligations they had undertaken through misrepresentation of securitization transactions, while on the other hand restricting courts’

39 Id. § 912(2)(f)(1).
40 Jonathan C. Lipson, Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?, 11 J. BANKR. L. & PRAC. 101, 101 (2002). Enron, at the time the seventh largest corporation in the United States, unexpectedly collapsed following the revelation of its accounting fraud, which was intended to misrepresent profits and hide losses. The company’s sudden crash led to its scores of employees losing their place of work. In addition, the company’s stocks plummeted, and shareholder confidence in the capital market was severely shaken. With the goal of restoring investor confidence, the Sarbanes-Oxley Act of 2002 set new stringent reporting requirements for corporate financial reports. Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, 29 U.S.C.).
45 eeS Lipson, supra note 40, at 113.
authority to reclassify the transactions and restore securitized assets to a debtor originator’s estate. At the end of the day, the huge public outcry that followed the Enron fiasco led Congress, in early 2002, to call a last-minute halt to the safe harbor legislation.46

The securitization industry did not limit its efforts to the federal legislative level in its quest to ensure blanket recognition of the removal of securitized assets from an originator’s estate, targeting also the Uniform Commercial Code (U.C.C.). The latter campaign was in direct response to the decision in Octagon Gas Systems, Inc. v. Rimmer,47 where the court reiterated that the legal framework that applies to sales of accounts—that is, article 9 of the U.C.C.—also regulates security interests.48 From this the court concluded that the seller of accounts retains a certain property interest in the accounts sold, just as a debtor retains a certain interest in collateralized property. Because under the Bankruptcy Code a bankruptcy estate comprises all property in which the debtor has some interest,49 the estate also includes any secured property as well as any accounts it has sold. Having determined that a debtor retains an interest in accounts it has sold, the court could then include such accounts in the bankruptcy estate.50

The Octagon Gas decision was the target of considerable criticism in the legal literature.51 Its opponents stressed that the broad extension of article 9 to a range of transactions, including sales of accounts, was intended mainly to provide later creditors and purchasers with notice of the status of the transferred assets through the requirement for public notice filing.52 In other contexts, however, such as in determining surplus entitlement, article 9 explicitly distinguishes between a sale of accounts and a secured transaction.53 The application of article 9 to sales of accounts, then, should not be taken as a sweeping abolishment of the fundamental distinctions between sales and secured transactions. Hence, the Octagon Gas court’s conclusion that a seller of accounts retains some interest in the transferred property, similar to the interest a debtor retains in collateral, is unfounded.

The sharp reaction to the Octagon Gas decision was also due to its expected ramifications for the securitization industry.54 In the words of one scholar, the decision “sounds the death knell

46 See Kettering, supra note 2, at 1652-53.
47 995 F.2d 948 (10th Cir. 1993).
48 Id. at 957. Article 9’s provisions are applied to sales of accounts under section 9-109(a)(3) of the revised version of the U.C.C. U.C.C. § 9-109(a)(3) (1999) (replacing version formerly at U.C.C. § 9-102(1)(b)).
50 See Octagon Gas, 995 F.2d at 955.
52 See, e.g., Plank, Critique, supra note 51, at 48-49.
53 Compare U.C.C. § 9-608(a)(4) (1999), with U.C.C. § 9-608(b) (1999). See also Major’s Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 542 (3d Cir. 1979) (determining surplus entitlement by classifying a transaction as a sale of accounts or a secured transaction).
54 See, e.g., 1 FRANKEL, supra note 5, at 133-36 (Supp. 1999); Structured Financing Techniques, supra note 3, at 541 n.42.
for structured financing as a reliable fundraising mechanism.”\textsuperscript{55} Adoption of the view that a seller of accounts retains some interest in those accounts would bar any possibility of shielding securitized assets from the reach of the originator’s creditors in bankruptcy. Hence, the \textit{Octagon Gas} court’s approach exposed SPVs and investors in its ABSs to the originator’s bankruptcy risk.

The objections to the \textit{Octagon Gas} decision found concrete expression in the sweeping 1999 reform of the U.C.C.\textsuperscript{56} The revised version of the U.C.C. added article 9-318(1), which clarified that “a debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold.”\textsuperscript{57} The application of article 9 to both sales of accounts transactions and transactions that create a security interest had not been intended to imply that, just as a debtor has an interest in its collateralized property, so does a seller retain some right in property it has sold. The comments explicitly stated that “[t]he fact that a sale of an account or chattel paper gives rise to a ‘security interest’ does not imply that the seller retains an interest in the property that has been sold.”\textsuperscript{58} Thus, the revised U.C.C. clearly rejected the \textit{Octagon Gas} approach, adopting instead the view that securitized assets must not be included in the originator’s estate.

In addition, a number of U.S. states passed legislation amenable to the securitization market, with the aim of promoting securitization transactions in their territory. In the last few years, state legislators have tended to employ one of two central legislative models to this end. The first has been to draft a special law for the securitization field that provides that an originator retains no rights in the securitized assets in a transaction intended to be a sale by the parties. Such legislation is designed, in its implementation, to lead to recognition under the Bankruptcy Code of the segregation of securitized assets from the originator’s estate. Counted among the states that opted for this legislative framework are Delaware,\textsuperscript{59} Alabama,\textsuperscript{60} South Dakota,\textsuperscript{61} North Carolina,\textsuperscript{62} and Ohio.\textsuperscript{63} The second model is to append a subsection (e) to the conventional formulation of U.C.C. section 9-109, providing that the application of article 9 also to sales of

\textsuperscript{55} Bjork, supra note 23, at 143.


\textsuperscript{57} U.C.C. § 9-318(a) (1999).

\textsuperscript{58} Id. official cmt. 2.


\textsuperscript{61} S.D. CODIFIED LAWS §§ 54-1-9 to -10 (2003).

\textsuperscript{62} N.C. GEN. STAT. §§ 53-425 to -426 (2002).

\textsuperscript{63} Ohio Rev. Code Ann. § 1109.75 (LexisNexis 2003).
accounts does not recharacterize those sales as secured transactions. Subsection (e) stresses further that a sale of accounts will be classified as a sale even if the purchaser has a recourse right against the seller or if the latter is entitled to any surplus. The states that opted for this legislative route—Texas and Louisiana—were seeking to counteract a series of court judgments that had deemed the existence of a right of recourse against the transferor of accounts and surplus entitlement for the transferor as criteria for characterizing the particular transaction a secured transaction. The appended provision’s definition of such transactions as sales was aimed at ensuring the exclusion of the securitized assets from the originator’s bankruptcy estate.

II. EXTERNALIZATION ONTO THE ORIGINATOR’S CREDITORS

This part examines the impact of a securitization transaction on an originator’s creditors, analyzing the economic and legal implications of segregating securitized assets from the company’s bankruptcy estate. My analysis will lead to the conclusion that a securitization transaction enables the originator to externalize its bankruptcy risk onto its creditors, by increasing the risk of default on their claims.

A. Increased Exposure of Creditors to the Risk of Default

Insolvency is an economic accident. When a company becomes insolvent, its assets are no longer of sufficient economic value to cover all of its obligations to its creditors in full, and its bankruptcy estate will then be of insufficient size to satisfy all claims. The removal of securitized assets from the originator’s diluted estate prevents creditors of the originator from collecting payments from those assets and worsens their situation. A securitization transaction thus exacerbates creditors’ risk of the originator defaulting on the debt they are owed.

Adding to the injury caused to creditors by asset securitization is the fact that a far less harmful alternative exists for raising credit: giving the lender a security interest in the debtor’s property as collateral for the loan. In contrast to securitized assets, secured assets remain in the debtor’s ownership and are included in the bankruptcy estate. Moreover, when a debtor initiates bankruptcy proceedings, the Bankruptcy Code provides for an automatic stay of proceedings, 64


65 LA. REV. STAT. ANN. § 10:9-109(e) (2003). The introductory remarks to section 9-109(e), which Louisiana adopted, stressed that the section was drafted in response to the case law that had destabilized the securitization market. See id. official rev. cmt. o (“[T]his provision rejects the widely criticized holding in Octagon Gas Systems . . . ”); see also James A. Stuckey, Louisiana’s Non-Uniform Variations in U.C.C. Chapter 9, 62 LA. L. REV. 793, 824 (2002) (stating same).

66 See, e.g., Bear v. Coben (In re Golden Plan of California, Inc.), 829 F.2d 705, 709 (9th Cir. 1986); Major’s Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 542 (3d Cir. 1979); Ables v. Major Funding Corp. (In re Major Funding Corp.), 82 B.R. 443, 448 (Bankr. S.D. Tex. 1987); see also 2 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 1230 (1965) (claiming that a right of recourse should lead to a transaction being characterized as a secured transaction).

67 E.g., 11 U.S.C. § 101(32)(A) (2006) (“The term ‘insolvent’ means . . . [a] financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation . . . ”).
which temporarily suspends secured creditors’ right to realize the collateral. This inclusion of the collateral in the bankruptcy estate and the delay in the implementation of the secured creditor’s right against the collateral increase the size of the estate. In turn, the position of the debtor’s unsecured creditors is improved in bankruptcy, because their chances of recovery are improved. In other words, the Bankruptcy Code preserves certain rights in the secured assets, in contrast to securitized assets, for the benefit of the bankruptcy estate, despite the security interest given to secured creditors.

The relatively enhanced situation of unsecured creditors if a company chooses to raise credit by creating a security interest in its assets rather than securitizing them emerges also in the context of rehabilitating a distressed company. When the secured assets are the company’s rights to payments for loans and accounts receivable—assets that normally tend to be securitized—the cash flow from those receivables is a critical source of financing for the company’s continued operation as a going concern. When a secured creditor’s interest is adequately protected, the Bankruptcy Code allows the debtor in possession to make use of the cash flow from the encumbered property in the effort to rehabilitate the company. The successful turnaround of an insolvent company should improve the unsecured creditors’ situation, by boosting their usually low recovery rate in liquidation procedures. When assets are securitized, as opposed to collateralized, the cash flow they generate cannot be used to keep the originator afloat during the rehabilitation attempt, because the securitization transaction leads to their removal from the originator’s bankruptcy estate. This absence of a crucial source of financing for the company’s recovery is likely to undermine the entire process and even bring it to a premature halt, thereby thwarting the central objective of the Bankruptcy Code: to facilitate

68 A secured creditor is a creditor that has been given a security interest in the debtor’s assets. U.C.C. § 9-102(a)(72) (1999) (definition of “secured party”).

69 11 U.S.C. § 362(a) (2006). Although a secured creditor has the right to have the stay lifted if its security interest is not adequately protected, such adequate protection has not been construed to require that the secured creditor be paid interest by way of compensation for the long delay in realization that the stay itself imposes on the secured creditor. See id. § 362(d)(1); United Sav. Ass’n v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 370-72 (1988).


71 But see Plank, supra note 25, at 629 (arguing that the continued ownership of receivables is not essential to an originator’s business and thus not necessary for implementing a reorganization process).

72 See 11 U.S.C. §§ 363(c)(2), 363(e) (2006). Adequate protection could be provided to a secured creditor by granting it a replacement lien on some illiquid substitute assets or even by doing nothing at all if there is a sufficient equity cushion in the collateral. See id. § 361.

73 Unsecured creditors are supposed to be paid more of their claims in Chapter 11 reorganization cases than Chapter 7 liquidation cases. See Lynn M. LoPucki, A General Theory of the Dynamics of the State Remedies/Bankruptcy System, 1982 Wis. L. REV. 311, 311 (presenting empirical research findings that, in eighty percent of liquidation cases, no money was left to pay the unsecured creditors’ claims at the end of the procedure, while for the remaining twenty percent of the cases, unsecured creditors were paid on average 4.5% of their claims; in contrast, in reorganization cases, unsecured creditors receive approximately thirty percent of the money they are owed). Compare Lynn M. LoPucki & William C. Whitford, Bargaining over Equity’s Share in the Bankruptcy Reorganization of Large, Publicly Held Companies, 139 U. PA. L. REV. 125, 142 (1990) (stating that in reorganization of large publicly held corporations the average return is fifty percent), with Michelle J. White, Bankruptcy, Liquidation, and Reorganization, in HANDBOOK OF MODERN FINANCE, at E7-1, E7-34 (Dennis E. Logue ed., 3d ed. 1994) (stating that the average return in liquidation of small firms is around four percent).
the recovery of distressed companies with rehabilitative potential.\textsuperscript{74} Thus, unsecured creditors incur a considerably lesser extent of harm from secured credit transactions than from asset securitization.

But does the removal of securitized assets from the originator’s bankruptcy estate necessarily result in injury to creditors? A securitization transaction simply leads to the exchange of one type of asset—accounts receivable, for example—for another type of asset—liquid cash. Presumably, when reasonable consideration is given for the securitized assets,\textsuperscript{75} the originator’s creditors are not impaired by the securitization transaction, because the conversion of the assets into an equivalent sum of cash\textsuperscript{76} should not affect the scope of the originator’s estate.\textsuperscript{77} What is more, the securitization transaction should, supposedly, actually increase the likelihood of recovery for the originator’s creditors, for two reasons. First, asset securitization usually involves lower financing costs than do the traditional financing methods, such as issuing bonds.\textsuperscript{78} The money that is saved accumulates in the originator’s general pool of assets and can be used to repay creditors.\textsuperscript{79} Second, in converting receivables into cash, a securitization transaction leads to an overall increase in the originator’s liquidity,\textsuperscript{80} which, in turn, decreases its chances of defaulting on its short-term obligations to creditors.\textsuperscript{81} Accordingly, some commentators assert

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\item \textsuperscript{74} Kettering, \textit{supra} note 2, at 1575; Lubben, \textit{supra} note 44, at 97-100; Steven L. Schwarcz, \textit{Collapsing Corporate Structures: Resolving the Tension Between Form and Substance}, \textit{60} BUS. LAW. 109, 138 (2004).
\item \textsuperscript{75} A securitization transaction is a financing transaction with the purpose of raising credit for the originator. The originator has an interest in maximizing the consideration received in the deal and therefore should refuse any cash payment that is less than the fair value of the securitized assets.
\item \textsuperscript{76} The consideration paid in the transaction incorporates a discount rate that reflects the time value of the money and the risk that the receivables will not be paid in full; it is therefore lower than the nominal value of the securitized assets. However, it is the assets’ real value, and not their nominal value, that is relevant for assessing their worth. Prior to the securitization transaction, too, when the securitized assets are still included among the originator’s assets, their real value incorporates a discount rate that reflects the time value of the money and the risk of the receivables not being paid in full. When the originator’s creditors assessed, before the securitization transaction, the worth of the assets from which they could collect their debts, they took into account the real, and not nominal, value. Thus, the conversion of the receivables into liquid cash should not harm the originator’s creditors because the consideration in the securitization transaction, in including a discount rate, reflects the real value of the securitized assets. \textit{See} Steven L. Schwarcz, \textit{Securitization Post-Enron}, \textit{25} CARDOZO L. REV. 1539, 1555-56 (2004).
\item \textsuperscript{77} Schwarcz, \textit{supra} note 2, at 146.
\item \textsuperscript{78} The securitization transaction leads to the insulation of the securitized assets from the risks entailed in the originator’s overall business activity, so that the cost of raising credit derives solely from the value of the assets and not from the company’s general credit rating. \textit{See supra} references in notes 4-5.
\item \textsuperscript{79} For a similar claim regarding the decrease in monitoring cost resulting from the use of secured credit, which is beneficial to unsecured creditors as well, see Thomas H. Jackson & Anthony T. Kronman, \textit{Secured Financing and Priorities Among Creditors}, \textit{88} YALE L.J. 1143, 1149-58 (1979) (claiming that a security agreement allows secured and unsecured creditors to reduce their total monitoring cost, making each better off than it would be if both had an equal pro rata claim to the debtor's property).
\item \textsuperscript{80} Lupica, \textit{supra} note 5, at 609-10; \textit{see also} Jo Anne Bradner, \textit{The Secondary Mortgage Market and State Regulation of Real Estate Financing}, \textit{36} EMORY L.J. 971, 982 (1987) (making this point in the context of mortgage securitization).
\item \textsuperscript{81} \textit{See} Schwarcz, \textit{supra} note 76, at 1560-62. Defaulting on debtor’s obligations brings on insolvency. For the “cashflow” or “equitable” solvency test, see J.B. Heaton, \textit{Solvency Tests}, \textit{62} BUS. LAW. 983, 988-89 (2007) (referring to the cash-flow or equitable solvency test, which determines whether the debtor has generally ceased to pay debts in the ordinary course of business and is unable to pay them as they become due).
that, were an originator’s creditors to be asked for their ex ante opinion on the securitization transaction, they would express approval of such financial activity.\textsuperscript{82}

Securitization transactions are also, however, likely to have negative effects on an originator’s creditors, because they diminish, in a very concrete way, the likelihood of their debts being repaid. Because of shareholders’ practical control of the decision-making procedures in the company and their limited liability, creditors bear a risk of the company choosing speculative projects, which will be influenced by the conflicts of interest existing between them and the shareholders. It is in the interest of the creditors that the company should adhere to a conservative business model, with the purpose of ensuring ongoing solvency. Shareholders, however, are likely to make opportunistic decisions that could endanger creditors’ money, while any profit resulting from those decisions is pocketed by the shareholders alone. The company’s creditors therefore face an agency problem\textsuperscript{83}: despite the inbuilt conflicts of interest with creditors, shareholders have been granted by corporate law the position of the agent that makes the decisions on the company’s behalf.\textsuperscript{84}

Following a securitization transaction, the originator’s creditors are likely to face the risk that the cash payment for the securitized assets will be used in a way that dilutes their rights and hinders their chances of recovery. Liquid cash—in contrast to securitized assets such as contractual rights against the company’s customers to receive future payments—offers easier opportunities for concealing assets\textsuperscript{85} and engaging in business ventures that put debt repayment at risk. Consequently, concern arises that the originator’s use of the money from the securitization deal will result in the devaluation of the bankruptcy estate.\textsuperscript{86} This claim, however, is valid in regard to a wide assortment of transactions, including sales and the creation of security interests in tangible assets. If admitted, claims of this nature could completely block companies in financial distress from obtaining financing to support their ongoing activity and to stave off insolvency. Presumably, so long as the consideration in the securitization transaction is of equal value to the securitized assets and there is no clear indication of fraudulent intentions on the part of the originator, the conversion of the assets into an equivalent sum of money cannot, in itself, provide the grounds for attacking the transaction as asset concealment.\textsuperscript{87}

\textsuperscript{82} See, e.g., Schwarcz, supra note 37, at 363 n.50; cf. Schwarcz, supra note 76, at 1563-65 (claiming that originators’ creditors regard securitization transaction to be beneficial to them, based on both empirical data that show that the prices of public bonds issued by originators rose immediately after the companies announced the securitization transaction, as well as the fact that the negative-pledge covenants creditors include in the loan agreements to protect their interests usually restrict the borrowing company’s ability to incur secured debt but not to enter into securitization transactions).

\textsuperscript{83} For a general discussion of agency problems generated by the corporate form, see Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976). My analysis here focuses on the agency problem generated between the company’s shareholders and its creditors.


\textsuperscript{85} An example of such asset concealment would be when a company distributes the money payment from the securitization transaction to shareholders through dividends. See LoPucki, supra note 1, at 25-28.

\textsuperscript{86} Lubben, supra note 44, at 102.

\textsuperscript{87} Pantaleo et al., supra note 37, at 186 n.102; Schwarcz, supra note 2, at 147; Schwarcz, supra note 76, at 1557-58.
Regardless, a substantive difference still exists between securitization transactions and sales or secured transactions, in that securitization, unlike the latter types of transactions, puts the company’s creditors at real risk of default on repayment of their claims. In a typical arm’s-length sale or secured transaction, the company’s assets are sold or pledged to an unrelated party that is separate and autonomous from the company and the specific transaction. In contrast, in a securitization transaction, assets are transferred to a special purpose entity that has been set up by the originator specifically for the transaction. The complex structure of securitization transactions, in which a new legal entity is created for the sole purpose of receiving the securitized assets, can arouse suspicion that, from the outset, the intention was to strip the originator of its assets and transfer them to a SPV, out of creditors’ reach. Indeed, securitization can be abused as a judgment-proofing strategy, namely, to divest the originator’s creditors of any practical ability—as opposed to legal right—to execute their claims against the company.\(^{88}\)

An additional substantive difference between a securitization transaction and a typical secured transaction is that in asset securitization there is a greater concrete risk that the cash received for the securitized assets will be used in a way that jeopardizes creditors’ chances of recovery. The financial situation of ABS investors depends not on the value of the entirety of assets retained by the originator but on the worth of the assets backing the securities and the quality of the credit enhancement mechanisms the securitization transaction provides. Thus, the investors have no interest in restricting the originator’s actions in using the cash it receives for the securitized assets.\(^{89}\) In contrast to this indifference, a secured creditor has a decidedly significant interest in preserving the value of the debtor’s pool of assets. First, when the value of the collateral falls below the amount of the secured claim,\(^{90}\) the claim splits into two parts: the amount still covered and secured by the collateral and the remaining unsecured balance with no priority in bankruptcy. In such cases, the secured creditor is supposed to collect its unsecured claim from the bankruptcy estate.\(^{91}\) Second, regardless of whether a creditor’s interest is fully

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\(^{88}\) A debate over the use of securitization as a judgment-proofing tool is found in the scholarly literature. Compare LoPucki, supra note 1, at 23-30 (claiming that companies are likely to use securitization for judgment proofing), and Lynn M. LoPucki, The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz, 52 STAN. L. REV. 55 (1999) (asserting that securitization is the most effective judgment-proofing instrument), with Steven L. Schwarcz, The Inherent Irrationality of Judgment Proofing, 52 STAN. L. REV. 1 (1999) (arguing that the sweeping use of securitization as a judgment-proofing technique is unreasonable), and James J. White, Corporate Judgment Proofing: A Response to Lynn LoPucki’s The Death of Liability, 107 YALE L.J. 1363 (1998) (presenting empirical data that counter the claim that the increased use of securitization transactions is for judgment-proofing purposes).

\(^{89}\) In this context, the value of the claim includes the loan principal, the cumulative interest, and the foreclosure costs. See 11 U.S.C. § 506(b) (2006) (“To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.”); id. § 506(c) (“The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property.”).

\(^{90}\) Id. § 506(a). This is true when the loan arrangement provides the lender with a right of recourse against the borrower. If the foreclosure sale proceeds do not satisfy the borrower’s obligation on a recourse loan, the lender may obtain a deficiency judgment for the balance. However, if a borrower defaults on a nonrecourse loan, the lender is limited to repayment only by foreclosure of the secured asset. On the difference between recourse and nonrecourse loans, see Dov Solomon & Odelia Minnes, Non-Recourse, No Down Payment and the Mortgage Meltdown: Lessons from Undercapitalization, 16 FORDHAM J. CORP. & FIN. L. 529, 537-41 (2011).

\(^{91}\) Id. supra note 18, at 239.
secured or even oversecured, a bankruptcy petition will lead to a delay in repayment, and use may be made of the collateral for the debtor company’s reorganization. Indeed, a major concern for secured creditors is that their right to realize the collateral will be suspended by a stay of proceedings and the secured property will go toward rehabilitating the company. This explains their interest in preserving the value of the debtor company’s general pool of assets so as to diminish its risk of insolvency. A secured creditor will seek to monitor the debtor’s business activities and prevent the use of the loaned money in a risky or wasteful manner. To this end, the secured creditor will usually include in the security agreement covenants restricting the company’s activities in how it uses the cash it receives from the lender-creditor. Covenants come in a variety of forms. For example, a covenant may require that the debtor seek the lender’s consent before spending the money on any projects that deviate from the ordinary course of business. A covenant might even limit the debtor to using the cash solely for a specified project. Covenants sometimes prohibit the debtor from further encumbering any of its assets. Such covenants are intended to preserve the worth of the debtor’s bankruptcy estate, thereby safeguarding the interests of all of its creditors. Yet, as noted, unlike a secured creditor, ABS investors have no particular need for imposing such contractual limitations on the originator. As a result, the originator’s creditors are exposed to an even greater risk that the money from the securitization transaction will be employed in a way that dilutes their interests and impairs their chances of recovery.

Accordingly, when an originator becomes insolvent, its estate has been significantly diluted. The transfer of assets to the SPV through the securitization transaction and their consequential removal from the originator’s bankruptcy estate prevent creditors from claiming payment from those assets, which intensifies creditors’ predicament. As explained above, the fact that the originator receives cash consideration for the securitized assets is not sufficient to ensure that its creditors are not harmed by the transaction. Rather, the securitization transaction in fact enables the originator to externalize the bankruptcy risk onto its creditors, by increasing the risk of default on the debt they are owed.

B. Harm to Nonadjusting Creditors

Given the conclusion that a securitization transaction increases the default risk for the originator’s creditors, a question arises as to whether and how they can shield themselves from this risk. One way to prevent this negative externalization is for creditors to include in their loan agreements with the originator a mechanism for compensating them fully for their heightened exposure to the risk of default resulting from securitization transactions. This compensatory mechanism forces the originator to take into account the external effect of asset securitization on its creditors’ welfare when choosing a financing strategy.

Under the Modigliani-Miller (M&M) Theorem, which assumes the existence of perfect capital markets, there is no correlation between a company’s capital structure and its market

92 On the interest that secured creditors have in monitoring the debtor company’s financial situation, see Jackson & Kronman, supra note 79, at 1149-50; Schwarcz, supra note 2, at 150.


94 Iacobucci & Winter, supra note 1, at 179; Lupica, supra note 5, at 634-35.
value. Any savings achieved by changing one component of a company's capital structure will be accompanied by added costs entailed in other components of the capital structure. Thus, companies are supposedly indifferent to any changes in their capital structure. In the context of the possible techniques for raising credit, then, under the M&M Theorem, the transfer of wealth from one group of creditors to another does not impact the value of the debtor company. The savings in costs to the company due to the change in its capital structure are completely offset by the additional costs it incurs due to the harm to some of its creditors from the change.

Alan Schwartz has applied the M&M Theorem to the context of secured credit. The priority enjoyed by a secured creditor in the collateral decreases its default risk and, therefore, allows it to charge the debtor a lower rate of interest. At the same time, in response to the security interest, the debtor company’s unsecured creditors will demand an increased rate of interest to compensate for their heightened risk due to the subordination of their claims to the secured claim. The additional return paid to the unsecured creditors thus offsets the savings in the cost of raising credit resulting from the lower interest paid to the secured creditor. Consequently, the debtor company reaps no profit from creating a security interest. Applying the M&M Theorem to the securitization market context yields a similar outcome: the savings in financing costs deriving from the securitization transaction should be offset by the higher return that will be demanded by the originator’s creditors to compensate them for their elevated risk due to the removal of the securitized assets from the originator’s bankruptcy estate.

Presumably, were all creditors able to negotiate a mechanism ensuring full adjustment of their interest rates to any changes in the company’s capital structure, they would bear no negative externalizations. The external effect on creditors’ welfare of a shift in the capital structure would be reflected in tangible monetary terms through the compensation mechanism and, therefore, included in the company’s set of considerations. The problem is, however, that a

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95 See Franco Modigliani & Merton H. Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, 48 AM. ECON. REV. 261 (1958). The M&M Theorem assumes perfect capital markets, that is, markets have no taxes, no transaction costs, and no bankruptcy costs and investors have perfect information. See Frost, supra note 5, at 116. Steven Schwarz calls into doubt the extent of the M&M Theorem’s contribution to the securitization context, because, he claims, capital markets are imperfect due to, among other things, asymmetric information and intermediation costs. Schwartz, supra note 76, at 1572. Some of the premises on which the M&M Theorem rests do not arise in the reality of the securitization market, and thus it does not predict well the financial decisions of originators. However, the M&M Theorem’s contribution to the discussion in this article should not be assessed on its ability to predict originators’ financial decisions per se but rather its explanatory power regarding originators’ choice of securitization as a financing strategy. An analysis of the M&M Theorem’s underlying premises should demonstrate that the fact that financial decisions in the securitization market are made in conditions in which some of these premises do not hold actually serves as an efficient starting point for a normative discussion of originators’ motives in choosing securitization as a financing method and how the legal system should respond to the use of securitization. See Frost, supra note 5, at 117; Iacobucci & Winter, supra note 1, at 169. And, indeed, identifying those fundamental premises that do not arise in the context of the securitization market will assist me below in detecting a possible motive for an originator’s choice of asset securitization: the possibility of reducing the costs of raising credit by externalizing the bankruptcy risk onto some of its creditors.


97 See Lucian Arye Bebchuk & Jesse M. Fried, The Uneasy Case for the Priority of Secured Claims in Bankruptcy, 105 YALE L.J. 857, 864 (1996); Jackson & Kronman, supra note 79, at 1148 (“In general, whatever level of risk he faces, if his transaction with the debtor is a voluntary one, a creditor may be expected to adjust his interest rate accordingly and to take whatever risk-reducing precautions he deems appropriate.”).
company usually has involuntary creditors as well—creditors that do not choose of their own free will to give the company credit and have no credit contract with the company. This category of creditors comprises, on the one hand, tort creditors who were harmed by a certain act or omission by the company and have a possible tort claim against it and, on the other hand, federal, state, and local government agencies that the company owes mandatory payments, such as corporate income tax, property taxes, and Social Security contributions.\footnote{99} These creditors do not negotiate for the adjustment of their interest rates in accordance with changes to the company’s capital structure. They are in no way compensated for their increased risk following such an occurrence.\footnote{100}

In many cases, moreover, even voluntary creditors are not in a position to adjust their return rates following a change to the company’s capital structure.\footnote{101} When their contracts with the company set fixed terms, without providing for any mechanism for adjusting those terms in accordance with future occurrences,\footnote{102} these creditors will not be entitled to compensation in the event that the company enters into a securitization transaction. And even when the contract contains an adjustment clause, a creditor generally will be unable to implement it in practice. Many creditors are unsophisticated and unable to administer a mechanism for monitoring the company’s financial activities through the acquisition of information about changes to the company’s capital structure and those changes’ implications for any particular creditor. For voluntary creditors with small claims against the company, such as customers, employees, and trade creditors, there is no economic justification for acquiring information about changes to the company’s financial structure.\footnote{103} I contend that the difficulties of voluntary creditors in protecting themselves from the effects of changes to the company’s capital structure is even more significant in the context of the securitization market. Voluntary creditors are less able to shield themselves from the impact of asset securitization than from the effects of a security interest in company assets, because protecting themselves against future securitization transactions is costlier than protecting themselves against secured transactions. The reasons for

\footnote{99}{Contrast this to situations in which government authorities are contractual parties, in which case they should be regarded as voluntary creditors.}

\footnote{100}{Judicial criteria determine the level of compensation to which the tort creditors are entitled. These parameters do not take into account the potential for an increase in their exposure to the company’s bankruptcy risk due to changes in its capital structure. Similarly, legislation arranges mandatory payments to governmental authorities, which is not influenced by the extent to which these creditors are exposed to the company’s bankruptcy risk due to possible changes to its capital structure. See Bebchuk & Fried, supra note 98, at 882-84; Lynn M. LoPucki, The Unsecured Creditor’s Bargain, 80 Va. L. Rev. 1887, 1897-99 (1994); James H. Scott, Jr., Bankruptcy, Secured Debt, and Optimal Capital Structure, 32 J. Fin. L. 1, 2-3 (1977); Paul M. Shupack, Solving the Puzzle of Secured Transactions, 41 Rutgers L. Rev. 1067, 1094-95 (1989).}

\footnote{101}{Bebchuk & Fried, supra note 98, at 885-91. The voluntary creditors of the debtor company enter into different transactions with the company and lend it money over the course of its activities. This group of creditors includes, amongst others, the following entities: professional lenders, such as banks, insurance companies, and other financial institutions; suppliers that sell the company goods on credit; customers that purchase goods from the company and pay either full or partial purchase price before receiving the merchandise; and the company’s employees, who are paid salaries at the end of a certain work period. Id. at 885.}

\footnote{102}{For a discussion of this category of voluntary creditors, see Bebchuk & Fried, supra note 98, at 887-91.}

\footnote{103}{Bebchuk & Fried, supra note 98, at 885-87 (explaining, using a numerical example, why small claims voluntary creditors do not implement the mechanism that allows them to adjust their interest rates to changes in the company’s capital structure).}
III. EFFECT OF EXTERNALIZATION ON THE ORIGINATOR’S ACTIVITY

This part describes one of the side effects of the negative economic externalization described above. Securitization transactions have distributive effects, because they improve the situation of the direct parties to the transaction at the expense of third parties. The distributive gain that originators can reap from securitization induces them to engage in such activity out of the desire to maximize their own private utility without having to consider its impact on the rest of the players in the securitization market.108 I claim that the opportunistic profit to be gained from asset securitization incentivizes companies to choose this financing strategy even when it is economically inefficient.109 An

104 Aicher and Fellerhoff, in their review of the judicial decisions regarding the characterization of securitization transactions, reach the conclusion that “the court decisions are . . . inconsistent and difficult to interpret.” Robert D. Aicher & William J. Fellerhoff, Characterization of a Transfer of Receivables as a Sale or a Secured Loan upon Bankruptcy of the Transferor, 65 AM. BANKR. L.J. 181, 211 (1991). Plank reaches a similar conclusion. He criticizes the courts’ approach in classifying securitization transactions for “not us[ing] a consistent analytical approach when considering these transactions.” Thomas E. Plank, The True Sale of Loans and the Role of Recourse, 14 GEO. MASON U. L. REV. 287, 313 (1991). Lupica points out the case law’s inconsistent application of the tests for characterizing securitization transactions. Lupica, supra note 5, at 640 (“Bankruptcy courts, however, have applied the ‘true sale’ factors inconsistently.”). Kettering, for his part, compares the court decisions in this matter to a coin toss. Kenneth C. Kettering, Pride and Prejudice in Securitization: A Reply to Professor Plank, 30 CARDOZO L. REV. 1977, 1983 (2009) (“These signs of uncertainty are not surprising, for the incoherence of the cases addressing the true sale issue is so complete that courts in search of precedent have declared that they might as well decide such cases by tossing a coin.”); see also Bjork, supra note 23, at 122, 126 (discussing the problem of inconsistent characterization of securitization transactions). For a more extensive discussion, see supra Part I.

105 See Michael Simkovic, Secret Liens and the Financial Crisis of 2008, 83 AM. BANKR. L.J. 253, 265-66 (2009) (asserting that creditors underestimate the extent to which the originator is leveraged through securitization because securitization transactions are less transparent than secured loans).

106 Lupica, supra note 5, at 632-33.

107 Frost, supra note 5, at 118-20; Edward J. Janger, Muddy Rules for Securitizations, 7 FORDHAM J. CORP. & FIN. L. 301, 305-07 (2002); Lupica, supra note 5, at 622-23.

108 Frost, supra note 5, at 119-20; Lupica, supra note 5, at 622.

109 The two predominant tests of economic efficiency are the Pareto criterion and Kaldor-Hicks criterion. Pareto is an ordinal test that assumes that utility levels can be ranked but not quantified. Under Pareto efficiency, any change will be considered economically efficient if, as a result, at least one individual in society experiences an increase in
originator has an incentive to engage excessively in securitization, which gives it a larger piece of the social welfare pie at the expense of the creditors’ share, regardless of whether the activity is likely to shrink the size of the pie overall. The negative externalization onto third parties therefore distorts an originator’s considerations when weighing securitization as a financing strategy, leading to its preference over credit-raising methods that are likely to be more generally market efficient.

The following simple numerical example illustrates this claim. A company needs $900,000 to finance a certain project. It applies to three financing institutions, A, B, and C, and receives $300,000 from each.\textsuperscript{110} Suppose that there is a five percent chance that the company will fail by the end of the loan periods. And, indeed, in the end, the project in which the company invested does not succeed, the bankruptcy risk materializes, and the company initiates liquidation proceedings. Assume that the only assets in the company’s bankruptcy estate are accounts receivable valued at $300,000.

Two possible alternatives can be described. Under one scenario, A, B, and C loaned the company money as unsecured credit. Because the value of the company’s bankruptcy estate is $300,000, under the rule of pro rata distribution among unsecured creditors, all three lenders are supposed to receive equal shares of the company’s assets, which amounts to $100,000 each.\textsuperscript{111} Under an alternative scenario, A transferred $300,000 to the company in the framework of a transaction in which the company’s receivables were securitized. B is an unsecured creditor that

wealth and no individual experiences a decrease in wealth. \textit{See Richard A. Posner, Economic Analysis of the Law} 12 (6th ed. 2003). Criticism of the Pareto criterion focuses on its narrow application in the practical world, because in the overwhelming majority of legal actions, there is an injured party and change that is to the benefit of all is very rare. \textit{See id.} at 13; Louis Kaplow & Steven Shavell, \textit{Fairness Versus Welfare}, 114 Harv. L. Rev. 961, 1015 (2001). Thus, the Pareto criterion considerably limits the possibility of effecting legal change, acting as a sort of “sanctification” of the status quo. This criticism usually leads to a preference for the Kaldor-Hicks criterion over Pareto as an applicable measure of economic efficiency. Kaldor-Hicks efficiency seeks maximization of the aggregate wealth, while ignoring specific injury to any one individual. \textit{See J.R. Hicks, The Valuation of Social Income,} 7 Economica 105 (1940); J.R. Hicks, \textit{The Foundations of Welfare Economics}, 49 Econ. J. 696 (1939); Nicholas Kaldor, \textit{Welfare Propositions of Economics and Inter-Personal Comparisons of Utility}, 49 Econ. J. 549 (1939). In light of the difficulties of measuring wealth, Kaldor and Hicks used a monetary criterion of willingness and ability to pay as a measure of welfare. Under the Kaldor-Hicks test, change is considered efficient if the aggregate willingness to pay for that change is greater than the aggregate willingness to pay for its nonexecution. An action is efficient under Kaldor-Hicks when the overall gain to those who benefit from the action is greater than the overall harm to those injured by it, so that, even after the former have compensated the latter for the entirety of their harm, they still benefit from the action. The criterion does not require compensation in practice because it allows injury to certain individuals when the overall net aggregate profit is positive. If actual compensation for the entire harm were required, then once compensation had been given, there would be no injured party and the action would be efficient also under Pareto efficiency. Accordingly, some commentators call the Kaldor-Hicks criterion a “potential Pareto criterion,” because it is potentially possible to compensate those injured by the action even though not required under the criterion. \textit{See Robert Cooter & Thomas Ulen, Law and Economics} 42-43 (6th ed. 2012); Posner, \textit{ supra}, at 13. For a comparison of the two criteria, see Jules L. Coleman, \textit{Markets, Morals and the Law} 84-86 (1988).

\textsuperscript{110} For purposes of simplicity, I assume that the company pays the interest to the financing entities in one lump sum upon receipt of the credit.

\textsuperscript{111} The pro rata principle requires proportional distribution among the creditors, so that each one recovers the same proportion of its claim. Because the overall value of the company’s bankruptcy estate stands at $300,000 and the overall value of its debts at $900,000, each of the unsecured creditors will recover a third of its claim. \textit{See 11 U.S.C. § 726(b) (2006); Nathanson v. NLRB, 344 U.S. 25, 29 (1952) (indicating equal distribution is the theme of bankruptcy law).}
can adjust its interest rate in accordance with changes to the company’s capital structure. And C is an unsecured nonadjusting creditor. To demonstrate how a company is likely to opt for the securitization strategy even when it is not economically efficient, I assume that the securitization transaction does not lead to a drop in the company’s chance of failing from the original five percent chance. I additionally assume that, due to the relatively complex structure of the securitization transaction and the stringent particularized requirements ratings agencies set for the parties to the transaction as a condition for an investment-grade rating for the ABSs, the costs of the securitization transaction are $4000 greater than the costs of the unsecured credit agreement between the company and A in the first scenario. The costs of the transaction are borne equally by the company and A, so that each incurs an additional cost of $2000 in the second scenario. The securitization transaction leads to the exclusion of the securitized assets, which are valued at $300,000, from the company’s bankruptcy estate and the transfer of ownership to A. Thus, under the second scenario, the company’s estate is left with no assets from which B and C can collect their debts.

What utility do the different financing institutions derive in the second scenario, with the securitization transaction, as opposed to their levels of utility in the first scenario? To answer this, it is necessary first to examine A’s expected loss in each of the two scenarios in the event that the company fails. Expected loss is calculated by multiplying the amount of loss by the probability of the materialization of the risk of loss. As indicated in Figure 1, under the first scenario, A recovers only $100,000 of the $300,000 it is owed. Thus, it incurs a loss of $200,000. Because the probability of the company becoming insolvent is five percent, the expected loss to A under this scenario is $10,000 (i.e., the amount of loss multiplied by the probability of loss). In contrast, in the second scenario, ownership of the receivables worth $300,000 is transferred in its entirety to A, which should, therefore, not suffer any loss. Accordingly, A’s expected loss under the second scenario is zero. Hence, the securitization transaction in the second scenario improves A’s situation because it decreases A’s risk of loss by $10,000.

Now consider the expected loss for the two unsecured creditors, B and C, in the event of bankruptcy under the two scenarios. Under the first scenario, each unsecured creditor recovers $100,000, and thus each incurs a loss of $200,000. Because there is a five percent probability of the company failing, the expected loss for B and C in this scenario is $10,000 each. Under the second scenario, in contrast, neither collects any part of their debt, amounting to a loss of $300,000 for both. Here, if the amount of loss is multiplied by the probability of its occurrence,

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112 See Jonathan C. Lipson, Re: Defining Securitization, 85 S. Cal. L. Rev. (forthcoming 2012), available at http://ssrn.com/abstract=1996017 (“The complexity of these transactions, among other things, requires significant amounts of time and analysis, which are not cheap.”).

113 Rating agencies set guidelines for constructing the securitization transaction from the economic, legal, and operational perspectives so as to diminish the exposure of the parties to the transaction as well as third parties to the risks it entails. As part of the rating process and in order to improve the ABSs’ rating, the rating agencies place various limitations regarding the structure of the transaction. See Eilis Ferran, Mortgage Securitisation—Legal Aspects 17 (1992); I Frankel, supra note 5, at 394-95.

114 From A’s perspective, giving credit by way of securitizing the company’s receivables is preferable to the traditional method of creating a security interest in the receivables. In contrast to a secured creditor, whose right to realize the collateral can be suspended by an automatic stay of proceedings, the characterization of the securitization transaction as a true sale shields the SPV and the investors in its ABSs from any possible stay of proceedings. See supra Part II.A.

115 The divergence in the risk of loss is manifested in the change in expected loss between the two scenarios.
the result is an expected loss for $B$ and $C$ of $15,000 each. Thus, in the second scenario, the securitization transaction harms unsecured creditors $B$ and $C$, because it increases the risk of loss for each by $5000$. Figure 1 summarizes the foregoing example.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of Loss</td>
<td>200,000</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>in Scenario 1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expected Loss in</td>
<td>200,000 x 0.05 =</td>
<td>200,000 x 0.05 =</td>
<td>200,000 x 0.05 =</td>
</tr>
<tr>
<td>Scenario 1</td>
<td>10,000</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Amount of Loss</td>
<td>0</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>in Scenario 2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expected Loss in</td>
<td>0 x 0.05 = 0</td>
<td>300,000 x 0.05 =</td>
<td>300,000 x 0.05 =</td>
</tr>
<tr>
<td>Scenario 2</td>
<td>0</td>
<td>15,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Divergence in Risk of</td>
<td>-10,000</td>
<td>+5000</td>
<td>+5000</td>
</tr>
<tr>
<td>Loss</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Figure 1: Losses to the Financing Institutions When the Company Fails.*

Therefore, the securitization transaction decreases $A$’s risk of loss by $10,000. According to the figures in this example, the securitization transaction entails $2000 more in costs for $A$ than the costs it bears in the first scenario. Thus, investors in the ABSs issued by $A$ in the second scenario will be willing to charge a lower rate of interest for the credit given to the company, in contrast to the interest rate $A$ charges the company in the first scenario. Overall, then, the amount that the company pays in interest will decrease by $8000. In the second scenario, $B$, an unsecured adjusting creditor, will charge the company a higher interest rate than in the first scenario, so that its interest return will increase by $5000 and will compensate for the harm caused to $B$ by the securitization transaction. In contrast, because $C$ is an unsecured nonadjusting creditor, the amount it receives in interest from the company will not change, so that overall the securitization transaction causes $C$ $5000 in harm.

The securitization transaction in the second scenario leads, then, to a decrease in the interest paid by the company to $A$ and the ABS investors by $8000, an increase in the interest paid to $B$ by $5000, and $2000 in additional transaction costs for the company. Accordingly, the company yields an overall profit of $1000 from using asset securitization as a financing tool.
rather than the method chosen in the first scenario.\textsuperscript{116} Given the underlying premise that the company acts to maximize its own private utility, it will prefer the securitization alternative over the first financing option. This utility analysis clearly leads to the conclusion that the company will choose to engage in the securitization transaction. The problem is, however, that it profits from the securitization activity at C’s expense. Because the harm to C’s utility (in the amount of $5000) is greater than the utility derived by the company from the transaction (a profit of $1000), the securitization transaction reduces the aggregate welfare and is not Kaldor-Hicks efficient.\textsuperscript{117}

This example demonstrates that the securitization transaction facilitates the externalization of the bankruptcy risk onto nonadjusting unsecured creditors. The company exploits the distributive effects of the transaction to improve its own position at the expense of C, without heed for the transaction’s impact on all of the market players. The distributive profit the company reaps from the securitization transaction induces it to engage in such activity so as to maximize its own private utility, even though, as I showed, the transaction does not achieve an efficient outcome from the overall market perspective. This creates a distortion in the company’s set of considerations when choosing asset securitization as a financing strategy, which leads to its preference over more efficient alternatives for raising credit in the concrete circumstances.\textsuperscript{118}

**CONCLUSION**

Asset securitization expanded significantly in the period leading up to the global financial crisis. Why did this practice emerge and develop as a tool of corporate finance? This seems a most basic and pressing question in light of the recent crisis. Indeed, future policy recommendations on the legal framework of securitization depend on the answer to this crucial question.

Over the past few years, the securitization field has been a subject of much inquiry in law and economics research. Some researchers have examined it from the viewpoint of aggregate social welfare and analyzed its utility.\textsuperscript{119} Others have taken a distributive perspective, focusing on the distributive implications of the use of asset securitization.\textsuperscript{120} This article moves one step further in the academic scholarship on this issue and points to the link between the distributive effects of securitization transactions and the efficiency of their use. The conclusion that arises from the discussion here is that the distributive gain that originators reap from securitization at the expense of their creditors drives its excessive and inefficient use, which, in turn, diminishes the aggregate welfare.

\textsuperscript{116} The profit gained by the company in the second scenario is calculated as follows: 8000 - 5000 - 2000 = 1000.

\textsuperscript{117} The aggregate welfare equation calculates the utility derived by those who benefit from the security transaction in contrast to the harm caused to those injured by it. A and B are sophisticated lenders that can adjust their interest rates to changes in the company’s capital structure. Because the change in their interest rates in the second scenario completely offsets the securitization transaction’s effect on them, their utility levels do not vary between the two alternative scenarios and have no impact on the aggregate welfare equation. In contrast, the securitization transaction affects components of the originator’s and C’s respective utility, and therefore it is necessary to adjust the aggregate welfare equation for the variance in their utility levels between the two scenarios.

\textsuperscript{118} In fact, the originator will have a constant incentive to engage in securitization transactions so as to benefit from the distributive profit that they yield, with the exception being those instances in which the profit is less than the transaction costs.

\textsuperscript{119} See, e.g., Iacobucci & Winter, supra note 1; Schwarz, supra note 2; Schwarz, supra note 76.

\textsuperscript{120} See, e.g., Frost, supra note 5; Janger, supra note 107; LoPucki, supra note 1, at 23-30; Lupica, supra note 5.
The rapid growth in the use of securitization and the enormous scope of the securitization market are central issues in the recent broad debate over the causes of the 2008 global financial crisis. Alongside the theoretical analysis presented in this article, the discussion’s conclusions shed unique light on the process that led to the crisis and the legal framework that enabled its occurrence. A novel explanation was offered for what induced the huge, inflated growth of asset securitization prior to the crisis. Indeed, the discussion demonstrated how the opportunistic profits this financial instrument yields for originators generated a constant and steady increase in securitization transactions, even when they led to inefficient outcomes from the overall market perspective.