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Asset Securitization and Corporate Risk Allocation

Christopher W. Frost*

Asset securitization is a financial innovation in which corporations sell financial assets to a specially formed entity that in turn taps financial markets for the purchase price. The device provides firms an alternative to raising capital through traditional debt and equity markets. Practitioners of the approach tout securitization as a means through which a firm can lower its overall cost of capital by limiting the risk facing investors in the securitized assets. Commentators have described asset securitization as "one of the most important financing vehicles in the United States." Interest in the device is increasing dramatically as more companies see it as a way to decrease their cost of capital. This Article examines the reasons for which asset securitization has become such a popular financing device. It develops an analytical model that focuses on the market failures that explain the reasons firms use asset securitization—identifying two possible explanations of the device and examining the normative problems associated with each.

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Traditionally, corporations have conducted both capital raising and operational activities within a single entity. Corporations financed operations through the issuance of equity and through general borrowings, each creating a claim to the firm’s entire asset base. Under this traditional approach, investors must conduct their assessments of the risk of a potential investment with an eye toward the risk of failure of the business operations, rather than focusing solely on the value of a particular asset or group of assets. Such an assessment must not only account for the variability of returns to discrete assets, but must also consider the financial structure of the business and the effect of that structure on expected returns if the business fails.

We might view the growth of secured lending as a response to this holistic approach to finance. By providing a means through which creditors may obtain a priority in particular assets, secured lending allows lenders to tie more closely their risk assessments to the value of particular assets. Still, the incomplete protection accorded secured creditors under the bankruptcy system, coupled with the fact that those
assets in which the creditor has obtained a priority reside in a larger entity, requires that even secured creditors' risk assessments include the risk of the firm as a whole.

Asset securitization (or as it is sometimes called, structured finance) is intended, at least in part, to segregate particular assets from the business operation completely.\(^1\) By segregating assets from the business itself, the device permits firms to insulate those assets from the general operational risk of the firm. In their simplest form, asset securitizations involve a "sale" of financial assets (such as trade or consumer accounts receivable)\(^2\) by the firm seeking to raise capital (the "originator") to a separate, specially created corporation or trust (usually called a special purpose vehicle or SPV).\(^3\) The SPV raises the purchase price of the assets by selling debt or equity interests in public markets or through private placements.\(^4\) This series of transactions leaves the investors with claims against the SPV, the SPV with the assets transferred by the originator, and the originator with the proceeds of the sale transaction. Usually, the originator continues to service the accounts after the transaction—collecting the accounts, maintaining records and, where required, taking action to enforce delinquent accounts.\(^5\) The transaction "securitizes" the assets—converting them to standardized, readily tradeable instruments—and insulates these securitized assets from the general risk of the business.\(^6\)

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2. See id. at 4. Normally, asset securitizations involve purely financial assets, such as accounts receivable, mortgage notes, or other payment streams. These assets lend themselves to segregation. As a general matter, purely financial assets have little to do with the ongoing productive function of the business, and the value of such assets is only loosely related to the health of the productive side of the business. The value of a financial asset is thus subject to analysis on the basis of indicators relating to the type of asset generally, rather than the asset as grouped with other productive assets. Theoretically, however, through the use of sale-leasebacks, field warehousing, and other devices, real estate, equipment, and even inventory could be securitized. See Lynn M. LoPucki, The Death of Liability, 106 Yale L.J. 1, 25-26 (1996) [hereinafter LoPucki, The Death of Liability].
4. See id. at 4.
5. See id. at 33-34.

[Securitization is] the sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets.
Asset securitization has its origins in the efforts of the federal government during the 1960s to increase the liquidity of home mortgage debt. Banks and finance companies soon began to offer interests in a wide variety of their loan portfolios. More recently, industrial companies have begun to use asset securitization as a replacement for traditional bank loans. The device is touted as a means through which noninvestment grade companies can achieve direct access to financial markets, thereby reducing their cost of capital. Over the first six months of 1994, securitization of "nontraditional assets" (including trade receivables of industrial companies, airline ticket receivables and delinquent tax receivables) more than doubled to $5.3 billion.

Commentators describe this expanded use of the device with breathless euphoria. Asset securitization has been described as "one of the most important financing vehicles in the United States," "a technology that is fundamentally altering traditional forms of fundraising," and "a boon to every participant in the capital markets." But few commentators have closely examined the device in an effort to uncover the reasons it might be so attractive. Perhaps asset

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7. See James A. Rosenthal & Juan M. Ocampo, Securitization of Credit: Inside the New Technology of Finance 4 (1988). The Government National Mortgage Association (widely known as Ginnie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal National Mortgage Association (Fannie Mae) purchase home mortgage obligations and market interests in mortgage pools (generally known as collateralized mortgage obligations). The result of these activities has been the development of an active secondary market for interests in home mortgages and, presumably, wider availability of mortgage funds. See Shenker & Colletta, supra note 6, at 1383-88. For a history of securitization in the mortgage and banking industry, see Claire A. Hill, Securitization: A Low Cost Sweetener for Lemons, 74 Wash. U. L.Q. 1061, 1119 (1996).

8. See Shenker & Colletta, supra note 6, at 1388-91.

9. See Frankel, supra note 6, at 6.

10. See Schwarcz, Alchemy, supra note 6, at 136-38; Aidun & Farley, Capital for Middle Market Companies, Bus. Credit, Sept. 1995, at 9 (stating that the minimum threshold for cost effective access to securitization markets for working capital is $20 million and that companies needing $40 million are "attractive candidates" for this market).


12. Schwarcz, Alchemy, supra note 6, at 133.


14. Shenker & Colletta, supra note 6, at 1371.
securitization is "alchemy"—creating value where none existed before—or perhaps it is not. An examination of the reasons for asset securitization is important as companies rush headfirst into what may be a normative and doctrinal quagmire.

The conventional explanation for the increasing popularity of asset securitization focuses on the risk allocation attributes of the device. The sale of assets to the SPV segregates those assets from the general risk of the business. This segregation permits the creditors of the SPV to lend at an interest rate that takes into account only the risk inherent in the segregated assets. Because these assets are usually accounts owed by a large number of borrowers, the risk of nonpayment is spread over many loans and can be priced very accurately, enabling investors in asset securitizations to charge a lower rate of interest than a bank would charge on a comparable loan secured by nonsegregated receivables.

But this explanation is incomplete. Under an assumption of perfect markets, Modigliani and Miller demonstrated that the capital structure of the firm (particularly the mix of debt and equity) does not affect the firm’s overall value, and therefore should not change its investment decisions. In essence, their "irrelevance hypothesis" recognizes the common-sense idea that the size of the pie is the same regardless of the way in which it is sliced. Thus, while asset securitization should result in a reduced interest rate on loans to

15. See Schwarz, Alchemy, supra note 6, at 154 ("Securitization, in short, brings to financial technology what the sought-after philosopher’s stone promised to bring to base metals—the ability to turn them into gold").


17. See Rosenthal & Ocampo, supra note 7, at 8-12; Schwarz, Structured Finance, supra note 1, at 5-13; Steven L. Schwarz, Structured Finance: The New Way to Securitize Assets, 11 Cardozo L. Rev. 607, 610 (1990) [hereinafter Schwarz, The New Way to Securitize] ("The default risk . . . can be managed by the SPV buying receivables having a statistically large number of obligors, and by analyzing the obligor concentrations.").

18. Rosenthal and Ocampo estimate that a GMAC asset securitization deal involving $4 billion of auto loans saved the company 1.3% in interest costs over traditional financing. See Rosenthal & Ocampo, supra note 7, at 90-95.


21. While Modigliani and Miller’s hypothesis was developed in the context of the choice between debt and equity, most commentators agree that the analysis is applicable to all financing decisions. See Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 400-01 (3d ed. 1988).

22. See id. at 409.
the SPV itself; it is not obvious why the device should lower a firm's overall cost of capital. The reduction in risk faced by the asset securitization investors might be offset by a corresponding increase in the risk facing the firm's general creditors. If the inherent risk of the company (as measured by its variability of returns) remains unchanged, these transactions might simply reallocate risk, rather than eliminate it.

If this proposition holds, we should look with suspicion on costly schemes that reallocate the risk of a business enterprise, particularly when the originator enters bankruptcy. Obviously, firms find it to their advantage to engage in this risk allocation. The question addressed here is whether the value that firms see in these deals is due to some real advantage to a particular risk allocation or to the exploitation of an opportunity to foist uncompensated risk onto other creditors.

The existing doctrinal context in which practitioners and commentators analyze asset securitization fails to address the normative problems associated with particular risk allocations. Asset securitization literature is replete with discussions of ways to assure the integrity of the transactions against attack in the bankruptcy of the originator. But what many of these discussions lack is a critical examination of the reasons firms use asset securitization instead of more traditional methods of raising capital. As a result, the doctrinal analysis of securitization is disconnected from the fundamental risk allocation issues raised by these transactions. It is necessary to reestablish this connection.

There are many potential sources of value in asset securitizations, and isolating the implications of this new device for

23. See SCHWARTZ, STRUCTURED FINANCE, supra note 1, at 16-24 and sources cited therein. See also infra notes 34-48 and accompanying text.

24. One source of gain from asset securitizations comes from the market components of the transaction. Asset securitization envisions direct access to market sources of funds, rather than access through financial intermediaries. This disintermediation may reduce the costs of financing by replacing institutions with markets. Intermediation is the process through which capital moves from investor to end user. Traditionally, institutions such as banks, insurance companies, and pension funds have functioned as intermediaries in aggregating and loaning capital. Securitization reduces the economy's reliance on institutional intermediation and places relatively more reliance on markets. See FRANKEL, supra note 6, at 65-129; ROSENTHAL & OCAMPO, supra; note 7, at 5-12.

At least with respect to single-originator asset securitizations, it is not clear that the risk allocation aspects of these transactions are necessary to achieve the benefits of the securitization components. As both portfolio theory and experience suggest, markets can securitize the debt of the operating entity. See LoPucki, The Death of Liability, supra note 2, at 29 (finance theory does not "explain why asset securitization would be chosen over business securitization."). From the perspective of the firm seeking to reduce its cost of capital, the savings resulting from securitization could be achieved without insulating the
corporations, the capital markets and the legal system will require time and intensive theoretical and empirical study. We have developed neither of these to the extent necessary to wholeheartedly support or condemn this new financial technology. This Article offers a framework for analyzing asset securitization that focuses on the risk allocation properties of the device. By beginning with Modigliani and Miller's insight and then selectively relaxing some of the perfect market assumptions underlying their hypothesis, different stories about the reasons for, and normative problems associated with, asset securitization begin to emerge.\textsuperscript{25} Using this analytical framework, this Article then illustrates the plausibility of, and normative problems associated with, two possible explanations for asset securitization.

Part I provides a brief overview of the doctrinal context for asset securitization. This discussion is intended to situate the financial and economic analyses that follow within the broader question of defining the boundaries of property that is subject to creditors' claims.

Part II examines the effect of capital structure on firm value under perfect market conditions. Part II also examines the distributional effects of various capital structures given that investors may be unable to adjust their interest rates in response to the risk that capital structures impose on them. This analysis provides the basis for what I have called the distributional explanation for asset securitization.

Part III examines the effect of bankruptcy costs and the efficiency of the bankruptcy process on capital structure. Under what I call the bankruptcy opt-out hypothesis, asset securitization can be viewed as a rational response to inefficiencies in the bankruptcy reorganization process. Part IV examines the normative problems that remain unresolved even if the bankruptcy opt-out hypothesis provides an efficiency-based justification for asset securitization.

Part V concludes with a reexamination of the doctrinal context in which these transactions are likely to be challenged. The courts have not thoroughly analyzed the risk allocation attributes of asset securitizations, but challenges to the transactions will become more likely as the device increases in popularity. In the meantime, attorneys

\textsuperscript{25} This approach is inspired by the work of Alan Schwartz analyzing the justifications for security interests and bankruptcy priorities. See Alan Schwartz, \textit{Security Interests and Bankruptcy Priorities: A Review of Current Theories}, 10 J. LEGAL STUD. 1 (1981) [hereinafter Schwartz, \textit{Security Interests and Bankruptcy Priorities}]. For a similar application of the approach, see Hill, \textit{supra} note 7.
involved in these transactions have erected an analytical framework that borrows heavily from situations that have only a passing similarity to asset securitization. Part V illustrates the ways in which that framework fails to capture the normative problems associated with asset securitization.

I. THE DOCTRINAL CONTEXT FOR ASSET SECURITIZATION

Until recently, the routine use of asset securitization was limited to banks (which are subject to a unique regulatory structure) and to large, stable companies.\textsuperscript{26} Doctrinal analysis of asset securitization, therefore, is limited by the fact that the courts have yet to consider the device.\textsuperscript{27} The legal risks presented by asset securitization are currently the domain of the rating services and the attorneys involved in structuring the transactions, and these risks are worked through in opinion letters issued to the rating services by asset securitization specialists.\textsuperscript{28} As a result, existing analyses of asset securitization make use of doctrinal categories that do not directly address the risk allocation issues raised by the device.

Doctrinal analysis of asset securitization is complicated further by the fact that these transactions are true hybrids. Asset securitization can be seen as combining elements of sales, secured financing transactions, and intercorporate/intra-enterprise transactions between members of a commonly controlled corporate group. The analysis of an asset securitization depends upon which element of the transaction is examined. Viewed from one perspective, asset securitizations are difficult to distinguish from any other asset sale. The sale of accounts to an SPV might be viewed as a simple extension or natural outgrowth of the sale of business inventory. A different perspective emerges when we look at the actual use of the device. From this vantage point, asset securitization appears indistinguishable from a loan secured by accounts receivable. The device offers a way for businesses to accelerate the cash flows from financial assets. Financial assets are usually self-liquidating. Unless the account debtor defaults, the firm

\textsuperscript{26} See generally Shenker & Colletta, supra note 6, at 1380-1406 (discussing the history and current trends in securitization).

\textsuperscript{27} In the few cases involving asset securitization, most issues were settled on terms relatively favorable to the SPV investors. See Structured Financing Techniques, 50 BUS. LAW. 527, 565-67 (1995) (explaining the history and structure of, and legal justification for, structured financing).

need only wait until the account is paid. Thus, it is the need for cash, sooner rather than later, that drives these transactions. This acceleration of cash flow is a hallmark of lending relationships. Finally, focusing on the corporate structure of the originator and the SPV provides a perspective from which asset securitizations appear to be straightforward strategic applications of the doctrine of corporate limited liability.

Most commentators place great emphasis on the appropriate characterization of asset securitizations. Characterization of the transactions as a true sale is thought to be a doctrinal trump card over concerns that the deal may create intolerable distributional effects. Maintaining the formal separateness of the SPV alleviates any concerns that creditors will be misled into believing that the accounts are available for the satisfaction of claims against the originator.

These perspectives drive the doctrinal context in which asset securitization is analyzed, but tend to obscure the substantial risk allocation attributes of the device. The differences in perspective are mere rhetorical devices—ways to describe a single transaction that seem to implicate differing modes of analysis. The mode of analysis does not change the essential character of asset securitization, however; nor does it lessen the effects of the device on others with interests in the firm. This Part examines the doctrinal context for asset securitization and the implications of describing the device in various ways.

A. Characterization of the Asset Transfer: The True Sale/Financing Device Dichotomy

A debtor’s filing of a bankruptcy petition creates an estate containing “all legal or equitable interests of the debtor in property.” The Bankruptcy Code casts a broad jurisdictional net over all of the debtor’s property interests, requiring that even remote interests be included within the bankruptcy process. The broad reach of the bankruptcy court’s jurisdiction creates the risk that assets sold in an

30. See Schwarz, Alchemy, supra note 6, at 146-49.
31. See FRANKEL, supra note 6, § 10.8.5-.6 (discussing the problems associated with pools organized as subsidiaries); SCHWARTZ, STRUCTURED FINANCE, supra note 1, at 24-27 (discussing the risk of substantive consolidation to the SPV in asset securitizations).
asset securitization will be subjected to the originator’s bankruptcy, thereby upsetting the risk allocation attributes of the transaction.\textsuperscript{34}

This concern arises in a doctrinal context that examines whether the asset transfer is a true sale or a transfer intended to secure a loan. If the asset transfer has the attributes of a sale, the transfer will extinguish the originator’s interest in the assets, insulating them from the originator’s bankruptcy.\textsuperscript{35} If, however, the transfer looks like it was intended to secure a loan, the assets will be subject to the bankruptcy court’s jurisdiction.\textsuperscript{36} Although no cases have analyzed this issue in connection with an asset securitization, the question has often arisen in connection with other types of sales of accounts\textsuperscript{37} and equipment leases.\textsuperscript{38}

Loan characterization of asset securitizations would eliminate one of the principal benefits of the transaction. The result of such a characterization is that the SPV would become a creditor of the originator with a security interest in accounts. While the priority provided by the security interest would be respected in a bankruptcy,\textsuperscript{39} the process would delay the secured creditor’s recovery on the assets and, as more fully discussed below,\textsuperscript{40} might impose uncompensated risks on the SPV investors.

B. Substantive Consolidation

Many asset securitizations follow the long-standing corporate practice of separating risky operations from those that are less risky by placing them in separate subsidiaries.\textsuperscript{41} Companies engaging in asset

\begin{itemize}
  \item \textsuperscript{34} See Schwarcz, \textit{Structured Finance}, supra note 1, at 28-35.
  \item \textsuperscript{35} See id.
  \item \textsuperscript{36} See id.
  \item \textsuperscript{37} See Plank, supra note 29, at 322-28.
  \item \textsuperscript{38} See, e.g., \textit{In re J.A. Thompson & Son, Inc. v. Shepherd Mach. Co.}, 665 F.2d 941 (9th Cir. 1982) (finding creditor’s security interest, rather than lessor’s reversionary interest, where an option allowed purchase of the equipment for little additional consideration); \textit{In re Marhoefer Packing Co.}, 674 F.2d 1139 (7th Cir. 1982) (observing that a lease is a sale where the lessee is bound to pay rent for a period of time and may at the end become the owner of the goods for nominal consideration); John D. Ayer, \textit{On the Vacuity of the Sale/Lease Distinction}, 68 Iowa L. Rev. 667 (1983) (discussing the lack of justification for a lease-sale distinction).
  \item \textsuperscript{39} The security interest in the securitized assets should be perfected regardless of whether the transaction appears to be a true sale or a loan. See U.C.C. § 9-102 (including sales of accounts receivables within the scope of Article 9).
  \item \textsuperscript{40} See infra notes 77-82 and accompanying text.
  \item \textsuperscript{41} See generally Christopher W. Frost, \textit{Organizational Form, Misappropriation Risk, and the Substantive Consolidation of Corporate Groups}, 44 Hastings L.J. 449 (1993) [hereinafter, Frost, \textit{Substantive Consolidation}] (determining whether corporate groups should be consolidated in bankruptcy by analyzing the economic principles of separate incorporation and limited liability).
\end{itemize}
securitization sometimes retain an equity interest in the SPV as part of their overall corporate structure. The retention of this interest increases the danger that the risk allocation aspects of the transaction will not be respected in a bankruptcy of the originator.

Substantive consolidation is an equitable doctrine that results in the combination of two or more distinct entities into one bankruptcy estate. In effect, substantive consolidation is a merger of the entities, resulting in a pooling of the assets and liabilities of the pre-consolidation entities. The effect of substantive consolidation on an asset securitization would be to merge the SPV into the operating entity. Investors with security interests in the assets of the financing vehicle would then find that their collateral is property of the originator’s estate and subject to the jurisdiction of the bankruptcy court. While their security interests in the securitized assets would remain effective, the transaction would fail to achieve its principal goal—avoidance of bankruptcy.

C. Competing Values Underlying the Doctrinal Context

The sale/finance dichotomy and the substantive consolidation concerns emphasized by commentators are directed toward resolving the persistent problem of defining the boundaries of the bankruptcy estate. Any coherent system of property that includes the concept of debt must devise some method of including and excluding property subject to creditors claims. Debt collection law, including bankruptcy, must recognize that at least some asset sales effectively remove the sold asset from the reach of the creditors and must provide some means of defining the entity against which the creditors can assert those claims.

42. See Schwarcz, Structured Finance, supra note 1, at 21-23 (discussing two-tier structure in which the originator retains the equity interest in the SPV).
43. See Frankel, supra note 6, at 370-71.
45. See Frankel, supra note 6, § 10.8.5; Schwarcz, Structured Finance, supra note 1, at 24.
46. See FDIC v. Hogan (In re Gulfco Inv. Corp.), 593 F.2d 921, 930 (10th Cir. 1979) ("Consolidation is not to be used to defeat the security of secured creditors.").
47. See LoPucki, The Death of Liability, supra note 2, at 5-7.
48. This boundary issue in the context of asset securitization is somewhat obscured by the fact that the inclusion of the securitized assets in the estate does not directly implicate the priority of creditors' claims to the assets. Even if an asset securitization transaction failed to completely insulate the assets of the estate from the originator's bankruptcy, the asset securitization investors would retain a priority in the securitized assets by virtue of the SPV's security interest. See supra note 39 and accompanying text. If bankruptcy law truly
1. Exchange, Entity-Based Liability and Property of the Estate

The boundaries of the bankruptcy estate flow naturally from our traditional value of free alienability of property, coupled with the norm of entity-based, rather than enterprise- or asset-based, liability. Few question the notion that a sale of assets for market value should remove the sold assets from the reach of the creditors of the transferor. The sale should extinguish the interest of the selling entity but should not create liability on the part of the buying entity. These norms find their way into the property of the estate analysis through section 541’s reference to “interests of the debtor in property”49 and the Code’s entity-based definition of “debtor.”50

But resort to notions of free alienability and entity liability merely begs the broader question of what types of transactions and corporate structures should be protected. The question here is not so much whether we should protect exchanges, but how we should define “exchange.” The definition derives from our reason for protecting free alienability—voluntary exchange increases aggregate utility by unlocking surplus value.51 Take the example of a two-person economy with only two goods (apples and oranges). If I value one of your oranges at three of my apples, and you value one of my apples at one orange, an exchange of one orange for one to three apples leaves both of us better off. In this simplified example, there is little question whether the law should enforce the exchange of apples and oranges.

Adding additional players complicates matters. Most relevant here are our creditors and potential creditors. If my personal preference for oranges is not shared by my creditor (to whom I owe apples), she will find that our exchange reduces her wealth. Still, the law normally will protect our exchange from my creditor’s challenge.52 The value-enhancing properties of free alienability trump creditor protection by granting the purchaser a superior claim to the purchased goods.

followed nonbankruptcy collection law, asset securitization investors would be indifferent to the boundary issue. It is because the bankruptcy process impairs secured creditors’ priorities relative to their treatment outside of the process that the boundary issue is important. See infra notes 102-103 and accompanying text.

50. 11 U.S.C. § 101(13) (1997) (defining “debtor” as the “person ... concerning which a case ... has been commenced”); § 101(41) (defining “person” as including an “individual, partnership or corporation”).
52. Of course, secured transactions provide a means through which creditors can guard against transactions that reduce their wealth. With a few exceptions, a perfected Article 9 security interest is effective against purchasers. See U.C.C. § 9-201 (1996).
Our view changes, however, when the transaction does not unlock surplus value. For example, suppose that it is clear to everyone concerned that I do not value your oranges more highly than I value my apples. Exchange under these circumstances is immediately suspect, and with good reason. Why should anyone want to enter into such a transaction? One obvious answer is that the exchange is simply a ruse to defeat my creditor’s interests. We may have a side deal that will allow me to retrieve my apples once my creditor tires of the pursuit of her claim. Instead, I may simply prefer that you receive my apples over my creditor (because you are a close friend or family member, or because I suspect that you may be in a position to do me a good turn sometime, or simply because I dislike my creditor). While these motivations may create value, they only do so at the expense of my creditor. The exchange is merely distributional.

The same concerns underlie the notion of entity-based liability. A general rule allowing creditors of the seller to execute on property in the hands of the buyer would impede value-creating exchanges.\(^53\) In our example, you may be unwilling to exchange an orange for an apple if the apple is subject to the claims of my creditors.\(^54\) In the corporate context, entity-based liability also provides a means for the creation of value by limiting liability to particular assets. Corporate limited liability allows the parties to assign the risk of the enterprise to those in the best position to bear the risk.\(^55\) At least with respect to fully informed consensual creditors,\(^56\) this risk allocation should result in a reduction in the overall cost of risk in the enterprise—thus creating value through the saving of otherwise necessary costs. Here again, if the method of structuring the business enterprise creates no value, except at the expense of a group of creditors, the reason for entity-based liability fails.\(^57\)

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54. Again, Article 9 provides limited inroads on this notion. See supra note 52.
55. See Richard A. Posner, Economic Analysis of Law 394 (4th ed. 1992) (explaining that creditors are in a better position than shareholders to appraise risk and, therefore, all of the investors may benefit from the risk allocation created by limited liability).
56. Shareholder limited liability for torts committed by the corporation cannot be justified by pointing to such an \textit{ex ante} risk allocation. See Henry Hansmann & Reinier Kraakman, Toward Unlimited Shareholder Liability for Corporate Torts, 100 Yale L.J. 1879, 1894-95 (1991); David W. Leebron, Limited Liability, Tort Victims, and Creditors, 91 Colum. L. Rev. 1565, 1612-26 (1991); \textit{infra} text accompanying notes 79-85.
57. See Frost, Substantive Consolidation, supra note 41, at 492-94.
2. Value-Creating Exchanges and the Fraudulent Transfer Laws

These competing concerns provide a robust explanation of fraudulent transfer law and its interrelationship with the concept of property of the bankruptcy estate. Section 548 of the Bankruptcy Code and state fraudulent transfer laws allow the bankruptcy trustee to avoid property transfers that are undertaken with actual intent to defraud creditors and transactions providing the debtor with less than "reasonably equivalent value." These laws allow creditors to disregard an exchange when the reasons underlying the norm of free alienability are not present.

Of course, an ex post determination of the value created by all exchanges would place an intolerable burden on exchange generally. Purchasers would be subject to the risk that the surplus value they obtained in the exchange would be found to be merely distributional and subject to avoidance under the fraudulent transfer laws. Recognizing the burden that the vagaries of valuation would place on exchange, the fraudulent transfer laws are limited to transactions that occur while the debtor is insolvent or that leave the debtor insolvent.

Fraudulent transfer law is not a significant source of risk for participants in asset securitization, however. These transactions are not conducted in secret and generally carry none of the earmarks of intentionally fraudulent transfers. In addition, the transfer is unlikely

63. See Baird & Jackson, supra note 62, at 834.
64. The earmarks of intentionally fraudulent transfers are often referred to as the badges of fraud. The badges of fraud were first defined in Twyne's Case, 3 Coke Rep. 80b, 76 Eng. Rep. 809 (Star Chamber 1601), in an attempt to address evidentiary problems associated with the subjective determination of fraud under the Statute of 13 Elizabeth. See Peter A. Alces, The Law of Fraudulent Transactions § 502(1)(a) (1989). In Twyne's Case,

[i]he court recognized the operation of six certain badges of fraud in the fraudulent disposition calculus:

1st. That this gift had the signs and marks of fraud, because the gift is general, without exception of his apparel, or any thing of necessity; for it is commonly said, quod dolus versatur in generalibus.
to be considered constructively fraudulent, because the overall effect of the deal usually will not render the originator insolvent, and normally the originator will receive a market value for the assets.\textsuperscript{65} Thus, fraudulent transfer law as currently applied does not loom large in the assessment of legal risks accompanying these deals.

Practically, then, fraudulent transfer law has not been important to the analysis of asset securitization. Conceptually, however, it is likely to provide a useful mode of analysis. One way of approaching the question of whether the sale in an asset securitization should effectively remove the assets from the bankruptcy estate of the seller is to ask whether such exchanges create real (as opposed to merely distributional) value to the company. This is precisely the conceptual question asked by fraudulent transfer law.\textsuperscript{66} The focus in fraudulent transfer analysis is whether the transaction creates value from the perspective of all of the firm's investors—that is, whether the reason for the transfer is efficiency-based or only distributional.\textsuperscript{67}

Finance theory provides a method through which this question might be answered. The analysis starts with Modigliani and Miller's fundamental observation—in a perfect market the value of a firm is independent of how the firm is financed.\textsuperscript{68} This hypothesis suggests that no one method of financing a particular project (equity, debt, secured debt, or asset sales) creates value compared to any of the other possible methods. The following discussion begins from this point, then relaxes various components of the perfect market assumptions in order to develop a better understanding of the reasons for, and the normative desirability of, asset securitization.

\begin{itemize}
\item \textit{2nd.} The donor continued in possession, and used them as his own; and by reason thereof he traded and trafficked with others, and defrauded and deceived them.
\item \textit{3rd.} It was made in secret, \textit{et dona clandestina sunt semper suspiciosa.}
\item \textit{4th.} It was made pending the writ.
\item \textit{5th.} Here was a trust between the parties, for the donor possessed all, and used them as his proper goods, and fraud is always appareled and clad with a trust, and a trust is a cover of fraud.
\item \textit{6th.} The deed contains, that the gift was made honestly, truly and \textit{bona fide: et clausae inconstuet semper inducunt suspicionem.}
\end{itemize}

\textit{Id.} (citations omitted).

\textsuperscript{65} \textit{See} Schwarcz, Structured Finance, supra note 1, at 36.

\textsuperscript{66} \textit{See} 2 David G. Epstein et al., Bankruptcy 20-36 (1992) (discussing the reasonably-equivalent-value prong of constructive fraudulent transfer analysis).

\textsuperscript{67} The classic example of a constructively fraudulent transfer is the payment of a dividend by an insolvent firm. \textit{See} Robert C. Clark, Corporate Law § 2.2.1 (1986). The principal effect of the transfer is distributional—from creditors to shareholders.

\textsuperscript{68} \textit{See} Modigliani & Miller, supra note 20, at 268-76.
II. THE RISK ALLOCATION EFFECTS OF CAPITAL STRUCTURE

Most explanations of the growth of asset securitization tout the ability of the device both to reduce the cost of credit and to open new sources of capital to businesses.\textsuperscript{69} The explosive growth of asset securitization and the increase in the securitization of nontraditional assets provide ample evidence of these benefits. The willingness of firms to incur the transaction costs of a securitization\textsuperscript{70} indicates that the private gains of this method of finance exceed its private costs. What remains uncertain, however, is whether asset securitization produces net social benefits. This question requires inquiry into the sources of gain. If securitization is efficient, it must be more than distributional—it must produce real gains that more than offset the costs of the transactions.

A. Capital Structure and Firm Value in Perfect Markets

The Modigliani-Miller irrelevance hypothesis provides the starting point for this analysis by isolating the firm’s financing decisions from the real-world effects of taxes, transaction costs, imperfect information, and costs of financial distress (most notably direct and indirect bankruptcy costs).\textsuperscript{71} Under the strictures of their assumptions, Modigliani and Miller have shown how arbitrage would eliminate any disparities in firm value attributable to differences in capital structure.\textsuperscript{72}

Modigliani and Miller’s insight is quite straightforward. Since the risk facing all of a firm’s investors is a function of the variability of the cash flow generated by the firm, capital structures that decrease the risk of one group will \textit{ceteris paribus} increase the risk facing all of the others.\textsuperscript{73} If creditors can adjust their required return on investment to take account of the increase in risk, the firm should not expect to see any change in its overall cost of capital.\textsuperscript{74}

At first blush, the application of the irrelevance hypothesis to asset securitization seems somewhat strained. Because securitizations are formally structured as a sale of assets to the SPV, they appear to

\textsuperscript{69} See, e.g., Shupack, \textit{supra} note 16, at 2296-97 (discussing reduction in cost of credit through improved credit quality).

\textsuperscript{70} The effect of a bankruptcy of the originator in asset securitizations involves substantial legal analyses and ultimate uncertainty relative to the fairly simple requirements and certain outcomes under Article 9. See \textit{infra} notes 90-93 and accompanying text.

\textsuperscript{71} See \textit{Halley & Schall}, \textit{supra} note 19.

\textsuperscript{72} See \textit{id.} at 268-73.

\textsuperscript{73} See \textit{id.} at 268-76.

\textsuperscript{74} See \textit{id.}
affect the asset structure of the originator, rather than the capital structure. As noted above,\textsuperscript{75} one way of viewing an asset securitization is as a sale of assets like any other.

Such a view exalts form over substance, however. When faced with a need for funds to invest in a project, the sale of assets is but one of an array of financing options that affect the level of risk faced by investors in the firm. As the numerical example in the Appendix illustrates, investors are not indifferent to the method of financing. Existing creditors, for example, prefer that additional investment take the form of debt or equity that is subordinated to their contractual claims. Thus, the question here is not whether the firm needs the additional cash that asset securitization will generate. Instead, securitization raises the question of how the firm should obtain the additional funds.

Securitization allows the firm to divide risk between the investors in the SPV and investors in the firm through firm organization rather than capital structure.\textsuperscript{76} Nevertheless, under the assumptions of the irrelevance hypothesis, securitization should not reduce the overall cost of capital compared to other financing methods. While the SPV investors will reduce their required rate of return to account for the quality of the receivables sold to the SPV, the investors with interests in the operational assets of the firm might raise their rates to account for the loss of the high-quality receivables.

\textbf{B. A Closer Look at the Assumptions and a Distributional Explanation for Financing Choice}

Of course, the irrelevance hypothesis fails to predict the behavior of firms regarding financing choice. It nevertheless provides a useful starting point for the analysis of these transactions. Relaxing various assumptions may provide an explanation of the reasons firms choose particular financial structures and may inform the normative debate over the legal system's response to various financing devices.

As a general matter, the hypothesis incorporates three broad categories of assumptions. The first relates to investors' behavior. The hypothesis assumes that investors are risk-neutral and hold homogenous expectations about the likely payoffs on both the project and the firm's other assets. The second category relates to investors' information and investment contracts. The irrelevance hypothesis

\textsuperscript{75} See supra notes 30-31 and accompanying text.

\textsuperscript{76} See generally Douglas G. Baird, Security Interests Reconsidered, 80 VA. L. REV. 2249, 2260 (1994) (examining the priority effects of corporate structure).
assumes that investors have information regarding the precise method of financing and that they are able costlessly to adjust their required returns in response to the risks posed under the various alternatives. The third category relates to the firm itself. The hypothesis assumes that various financing alternatives do not change the overall value of the firm’s assets by changing the character of the firm’s investments or by reducing the nonrisk-related costs of running the firm.

Of these categories of assumptions, the second has perhaps the most obvious normative implications for the regulation of financial structures in general and of asset securitization in particular. Relaxing the assumptions regarding the ability of existing investors to adjust their required compensation in response to added risk raises distributional concerns. One reason for the popularity of asset securitization may be that the firm’s other creditors may not raise their required rate of return to compensate for the added risk imposed by the transaction.\footnote{77} From the firm’s perspective, the transaction might result in an overall reduction in the cost of capital, but this reduction may result from the undercompensation of claimants who cannot adjust their interest rates. Corporate managers are likely to exploit the opportunity to engage in transactions that undercompensate some creditors, because at least some of the reduction in capital costs will be captured by the shareholders of the corporation.\footnote{78}

While large, sophisticated creditors probably can and do adjust their interest rates to account for the increased risk of particular financial structures,\footnote{79} many creditors may not.\footnote{80} Involuntary claimants, of course, cannot increase their required returns in response to additional risk.\footnote{81} In addition, small claimants may be unwilling to

\footnote{77. For simplicity, the example in the Appendix examines only the ability of existing creditors to adjust their interest rates. Future creditors are more likely to adjust their required rates of return to account for the financial structure of their borrowers but may also have difficulty adjusting. See infra notes 222-226 and accompanying text.}

\footnote{78. See Rutheford B. Campbell, Jr., Corporate Fiduciary Principles for the Post-Contractarian Era, 23 FLA. ST. U. L. REV. 561, 579 (1996) (discussing the incentives for corporate managers to promote the interests of shareholders over other constituencies).

79. See STANDARD & POOR’S, CORPORATE FINANCE CRITERIA 24 (1994) (noting that Standard & Poor’s adjusts the firm’s financial statements to eliminate the distorting effects caused by off-balance-sheet financing techniques).


81. See Bebchuk & Fried, supra note 80, at 882-84; LoPucki, The Unsecured Creditor’s Bargain, supra note 80, at 1896-1916.
incur the transaction costs required to obtain information regarding the financial structure of their borrowers.82

Such a distributional explanation for asset securitization cannot serve as a normative justification for the device, even under the Kaldor-Hicks standard for efficiency. For a transaction to be Kaldor-Hicks efficient, it must result in gains sufficient to allow the winners to compensate the losers, even if such compensation is not legally required.83 If the only reason the firm engages in securitization is to reallocate the risk of an investment to investors who will not charge the firm for the increase, the winners’ gains will exactly offset the losers’ losses. If the transaction costs associated with asset securitization are higher than those of other options, the transaction will not yield gains in excess of losses.84

The specific concern underlying the requirement that transactions be Kaldor-Hicks efficient lies in the allocative effects of such redistributions. If the losses created by the transaction offset the gains, the transaction costs of the deal are simply wasted. Perhaps more importantly, the distributional effects of these transactions raise familiar problems of externality. If some investors are unable to discover the nature of these transactions, or adjust their required return in response to the added risk, the transactions are likely to result in an inefficient overinvestment in risky projects.85 If securitization allows

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82. See Bebchuk & Fried, supra note 80, at 885-87 (setting forth a numerical example to show why small creditors may remain rationally ignorant of the existence of security interests); LoPucki, The Unsecured Creditor’s Bargain, supra note 80, at 1916-20 (pointing to the low level of sophistication of many lenders).

Of course, the fact that small creditors do not adjust their required rates of return to account for the increased risk of financial structures does not necessarily mean that they are undercompensated. Such creditors could charge an interest rate that accounts for the average risk imposed by the financial structures of all of their borrowers. See Bebchuk & Fried, supra note 80, at 886. Still, the inability of these creditors to adjust their interest rates for firms with particular financial structures probably leads to an inefficient overuse of “riskier” financial structures. See id. at 891-95; see also Schwartz, Security Interests and Bankruptcy Priorities, supra note 25, at 31-33 (discussing the “‘defensive’ distributional explanation” of secured credit).


84. Under the more restrictive Pareto standard, asset securitization could probably never be justified. The Pareto standard not only requires that compensation be possible, it requires that compensation, in fact, be paid. See Calabresi, supra note 83, at 1215; Schwartz, Security Interests and Bankruptcy Priorities, supra note 25, at 2-3 n.7. For an argument that corporate managers should be held to the Pareto criterion of efficiency, see Campbell, supra note 78, at 588-95.

85. See Bebchuk & Fried, supra note 80, at 898-900. Hansmann and Kraakman discuss this problem in connection with shareholder limited liability for corporate torts. See Hansmann & Kraakman, supra note 56, at 1882-83.
firms to avoid paying the full cost of the risk of their operations, they will be willing to invest in projects paying a rate of return that is insufficient to compensate for their risk.

This distributional explanation is but one of a number of explanations for the various financial structures firms adopt. Once one leaves the pristine world of perfect market theory and enters the messy world of reality, many plausible explanations appear. Firms are subject to taxes—explaining, in part, the choice between debt and equity.\(^\text{86}\) Managers are less than perfect agents of firm owners—providing a partial explanation for the existence of some types of secured finance.\(^\text{87}\) Investors hold varying information about the quality of firms' investments and may hold different attitudes towards risk.\(^\text{88}\) Contract enforcement is costly.\(^\text{89}\) All of these realities push and pull firms to adopt various financial structures. Part III develops an alternative to the distributional explanation by focusing on the effect of bankruptcy costs on financial structure.

III. ASSET SECURITIZATION, SECURED FINANCE, AND THE BANKRUPTCY OPT-OUT HYPOTHESIS

Given the vast array of possible financial structures and the many factors that may influence firm financing decisions, it is unlikely that the distributional explanation provides a full explanation for the diverse financing behavior of firms. It is more likely that some combination of factors explains financing choice, and that those factors change depending on the type of instrument under consideration.

As shown in the Appendix, from the perspective of the firm and its investors, in a perfect capital market, asset securitization and

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\(^\text{86}\) See, e.g., BREALEY & MYERS, supra note 21, at 408-20 (explaining how tax rates affect a firm's capital structure).

\(^\text{87}\) See, e.g., Barry E. Adler, An Equity-Agency Solution to the Bankruptcy-Priority Puzzle, 22 J. LEGAL STUD. 73 (1993) (noting that loan terms reflect the creditor's estimation of management's honesty and competence); Thomas H. Jackson & Anthony T. Kronman, Secured Financing and Priorities Among Creditors, 88 YALE L.J. 1143 (1979) (explaining that management misbehavior increases a firm's cost of capital); Hideki Kanda & Saul Levmore, Explaining Creditor Priorities, 80 VA. L. REV. 2103 (1994) (examining the problem of the propensity of debtors to invest in risky ventures and assume increased debt and the response of Article 9 and other systems of creditor priorities); Saul Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 YALE L.J. 49 (1982) (arguing that creditors provide shareholders with valuable information regarding management misbehavior).


\(^\text{89}\) See BREALEY & MYERS, supra note 21, at 421.
secured finance yield identical results. Asset securitization appears to operate as little more than a priority device, similar in effect to that provided by Article 9 of the Uniform Commercial Code. The sale of assets to an SPV results in a structural priority by insuring that creditors of the operating entity will not share in the assets purchased by the SPV. The first step in analyzing asset securitization, therefore, is to distinguish it from secured credit.

The similarity in results between secured finance and asset securitization is due to the assumption of cost-free debt collection. Relaxing this assumption explains the growing use of asset securitization over the simpler and less costly approach of Article 9 and highlights the bankruptcy system's shortcomings in protecting security interests.

While secured creditors can be expected to fare better than unsecured creditors in a liquidation or reorganization, their priority is far from complete. The bankruptcy reorganization process provides numerous opportunities for unsecured creditors to extract concessions from secured creditors. Thus, one of the principal reasons for asset securitization is that it allows the creditors of the SPV to opt out of the reorganization process.

A. Some Evidence

Support for this bankruptcy opt-out hypothesis can be found in the interest that attorneys and rating agencies involved in securitizations show in preserving them against bankruptcy. There has yet to be a reported case that challenges a securitization head-on, but concerns that the Bankruptcy Code or underlying equitable principles may interfere with the careful planning of the participants in these deals are evident from the literature. No discussion of asset securitization is complete without a substantial discussion of how to make the SPV "bankruptcy remote" and of the consequences of failing

91. See generally Baird, supra note 76 (noting the priority effects of corporate structure).
92. See infra notes 103-111 and accompanying text.
93. See discussion infra Part III.C.
94. One of the most important practical aspects of an asset securitization is that one or more national rating agencies rate the SPV's securities. See Schwarcz, Alchemy, supra note 6, at 136-37; FRANKEL, supra note 6, § 3.4.3, at 97; ROSENTHAL & OCAMPO, supra note 7, at 86-88.
to do so.\textsuperscript{95} Rating agencies typically require opinion letters from counsel for the originator, stating that the SPV likely will not be substantively consolidated\textsuperscript{96} with the originator and that the transaction will effectively remove the assets from the originator’s bankruptcy estate.\textsuperscript{97} Of course, the rating agencies’ insistence on such opinions is less telling than attorneys’ willingness to give such opinions. Traditionally, bankruptcy effects have been an exception in opinion letters.\textsuperscript{98} These relatively new opinions, coupled with attorneys’ natural reluctance to expand the scope of their liability, serve as some evidence of the importance of bankruptcy remoteness.

Perhaps a more telling bit of data is the response of the rating agencies and the asset securitization bar to the Tenth Circuit case, \textit{Octagon Gas Systems, Inc. v. Rimmer}.\textsuperscript{99} The court in \textit{Octagon} interpreted section 9-102(1)(b) of the Uniform Commercial Code to limit the effect of a sale of accounts to the creation of a security interest in those accounts.\textsuperscript{100} If \textit{Octagon} were widely followed, its effect would be to eliminate the protection asset securitization provides against a bankruptcy of the originator, essentially turning these deals into secured loans by the SPV to the originator. Moody’s and Standard & Poor’s responded to the decision by tying their ratings to the creditworthiness of the originator when the originator had a principal place of business in the Tenth Circuit.\textsuperscript{101} The asset securitization bar also responded by taking an exception in their opinions based on the case and promptly pressuring the Permanent Editorial Board of the Uniform Commercial Code to issue a commentary to 9-102(1)(b) critical of the \textit{Octagon} reasoning.\textsuperscript{102}

\begin{itemize}
\item \textsuperscript{95} See, e.g., SCHWARM, \textit{STRUCTURED FINANCE}, supra note 1, at 16-36 (discussing protecting the SPV from bankruptcy, government claims, and substantive consolidation); FRANKE, \textit{supra} note 6, at 403-49 (analyzing the protection of assets from bankruptcy).
\item \textsuperscript{96} Substantive consolidation is a bankruptcy doctrine, the effect of which is similar to that of "piercing the corporate veil" under general corporate law. The concern here is that creditors of the originator may seek to assert their claims against the assets of the SPV. See infra notes 207-219 and accompanying text.
\item \textsuperscript{97} See Report by the Tribar Committee, \textit{supra} note 28, at 720-29. See also ROSENTHAL & OCAMPO, \textit{supra} note 7, at 86-88 (discussing the importance of bankruptcy remote structuring to the AAA rating of the GMAC deal discussed \textit{supra} note 18).
\item \textsuperscript{98} See Report by the Tribar Committee, \textit{supra} note 28, at 718.
\item \textsuperscript{99} 995 F.2d 948 (10th Cir. 1993).
\item \textsuperscript{100} See id. at 954.
\item \textsuperscript{102} See Peter Blackman, \textit{Damage Control: Federal Ruling Prompts New UCC Commentary}, N.Y. L.J., June 30, 1994, at 5 (describing efforts of asset securitization attorneys in advancing the PEB Commentary); Steven L. Schwarcz, \textit{'Octagon Gas' Ruling Creates Turmoil for Commercial and Asset-Based Finance}, N.Y. L.J., Aug. 4, 1993, at 1 (calling for
\end{itemize}
It is not difficult to understand this obsession with bankruptcy remoteness. The reorganization provisions of Chapter 11 of the Bankruptcy Code present numerous opportunities for unsecured claimants, equity, and the management of the business to dilute the priority of secured creditors. The principal problem Chapter 11 creates for secured creditors is the natural advantage that time gives to junior claimants. Delay in the liquidation of an insolvent business favors those claimants who, in the absence of delay, would receive no distribution. For example, if equity claimants would receive no distribution on the liquidation of the business, there is no reason for that group to support liquidation. They bear none of the risks of failure but may lay claim to some of the benefits of a successful reorganization. Thus, equity holders will use every tool at their disposal to delay the liquidation. Fully secured creditors, on the other hand, have nothing to gain and much to lose from delay in enforcing their claims. They are more likely to favor an immediate liquidation.

This concern is most salient in the early stages of a case. Consider a corporation entering bankruptcy with a desperate need for cash to meet its payroll and pay for supplies and raw materials. If the corporation has not granted security interests in its accounts, it may use customer payments to fund the business during the bankruptcy

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PEB commentary). PEB Commentary No. 14, Section 9-102(1)(b), amends the comments to 9-102 to include language intended to reverse the effect of Octagon.


104. See Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U.PA.L.REV. 669, 685 (1993) (“The holders of underwater claims and interests often have reason to oppose liquidation until the distributions to them under a reorganization plan have been fixed.”); see also Laura Lin, Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors’ Duty to Creditors, 46 VAND. L.REV. 1485, 1496 (1993) (“Shareholders [of an insolvent firm] are highly motivated to overinvest in risky propositions and to underinvest in stable ones. Shareholders are also likely to delay liquidation, even if this strategy causes further loss to the firm.”); Douglas G. Baird & Thomas H. Jackson, Corporate Reorganization and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy, 51 U. CHI. L.REV. 97, 107 (1984) [hereinafter Baird & Jackson, Adequate Protection] (“Members of any group of investors that would be eliminated by a present liquidation or sale of assets have nothing to lose by seeking a solution that avoids a final distribution today.”).

105. Because such claimants have fixed claims, they will not benefit from any potential increase in value resulting from the reorganization. In the event of catastrophe, however, such creditors may bear some of the losses. See Lin, supra note 104, at 1491 (“Unlike shareholders, creditors prefer management to risk as little as possible because they have little to gain if risky ventures succeed and will suffer further loss should these projects fail.”).
case. If customer payments are inadequate, the accounts will provide a base of unencumbered assets against which a post-petition lender might be persuaded to advance funds. If the corporation has, pre-petition, granted a security interest in the accounts, obtaining necessary cash flow is complicated, but possible. The pre-petition lender might be persuaded to release its claim to post-petition payments on the pre-petition accounts in return for a security interest in newly created accounts or other unencumbered property. Part of the impetus for such a deal is the possibility that the court might allow the debtor to borrow from another source, granting the new lender a security interest that “primes” the old lender’s interest. As adequate protection of the pre-petition lender’s interest, the court may grant replacement liens on illiquid or unstable collateral. Thus, even though the pre-petition lender’s security interest will be respected in the bankruptcy, the process itself creates the risk that the protection will be incomplete. Asset securitization is intended to remove this risk by placing the assets beyond the reach of the bankruptcy process.

But while this strengthening of priorities may explain why asset securitization reduces the risk facing the SPV investors, it alone cannot counter the distributional explanation. The fact that the bankruptcy


109. See 11 U.S.C. § 364(d) (1997) (allowing the court to authorize debt secured by a senior or equal lien on property of the estate that is subject to a lien).

110. For example, in In re Beker, 58 B.R. 725, 736 (Bankr. S.D.N.Y. 1986), the court granted the debtor’s request for authorization to grant priming liens on a manufacturing facility to secure a post-petition loan. The court found that the existing secured creditors were adequately protected by second liens in other manufacturing facilities. See id. at 736-37. The court rejected the creditor’s argument that the liquidation value of the substitute collateral was insufficient to adequately protect their interests in the primed liens, holding that a higher going concern value should be used to value the substitute collateral. See id. at 737.

The court justified its use of the higher values, in part, because the debtor had shown “a remarkable ability to rise again and again ‘from the ashes.’” Id. at 738. This despite the fact that the debtor was “hemorrhaging cash in the amount of $100,000-$125,000” daily. Id. at 729 (citations omitted); see also White Rose Food v. General Trucking Co. (In re Clinton Street Food Corp.), 170 B.R. 216 (S.D.N.Y. 1994) (granting security interest in leasehold as adequate protection for priming lien); Besler v. Northwest Prod. Credit Ass’n (In re Besler), 19 B.R. 879 (Bankr. D.S.D. 1982) (granting a lien on real estate and on equity interests in farming operations as a substitute for the debtor’s use of cash proceeds of collateral).

111. In so doing, however, the device makes it more likely that the corporation’s bankruptcy reorganization will fail before it has even a chance to succeed. Unless the debtor has unencumbered assets or can convince potential lenders to lend without security interests, the debtor might be forced to suspend operations, incurring irrevocable losses of customer and supplier goodwill and confidence.
process impairs the priority accorded secured claimants merely establishes the legal backdrop against which secured claimants make financing and interest rate decisions. Bankruptcy treatment of secured claims thus forms a part of the definition of a secured claim and its value. All investors assess the risk of their investments against this backdrop. From the perspective of the firm, the overall cost of capital might not be expected to change by a strengthening of priorities any more that it would change by a granting of the priorities in the first place. If asset securitization strengthens priorities for one group, it might do so simply at the expense of others, who would again increase their interest rates to account for the change. Again, the irrelevance hypothesis suggests that the overall cost of capital would remain unchanged—that is, unless some creditors do not adjust their interest rates to account for the increased risk or some efficiency-based explanation can be found.

For the bankruptcy opt-out hypothesis to provide an efficiency-based explanation of asset securitization, two conditions must be satisfied. First, since asset securitization simply enhances the priority already accorded secured creditors, the efficiency of asset securitization depends on an efficiency explanation of secured finance. Second, the efficiency of asset securitization under the bankruptcy opt-out hypothesis depends on the inefficiency of the bankruptcy reorganization process. The following sections explore these issues in more detail.

B. The Efficiency of Secured Finance

If asset securitization is best viewed as a means of strengthening the priority accorded secured lenders, efficient secured finance is a necessary, but insufficient, condition for efficient asset securitization. The bankruptcy opt-out hypothesis is premised on the desirability of avoiding Chapter 11’s interference with the secured creditor’s priority. But it is possible that the priority, and not the interference, is the problem. Secured credit itself may effect an inefficient distribution of risk. To the extent that the bankruptcy process corrects inefficient distributive effects of secured finance, asset securitization might be an unjustified interference with that correction.

For more than fifteen years, commentators have debated the institution of secured credit in light of the teachings of the irrelevance hypothesis. A number of competing explanations have emerged from the efforts of these commentators to provide a plausible alternative to a
purely distributational explanation of secured credit.\textsuperscript{112} Secured credit may reduce agency costs by allocating the responsibility for monitoring managers’ behavior to investors with a special expertise in monitoring,\textsuperscript{113} or by reducing investors’ incentive to free-ride on the monitoring activities of other investors.\textsuperscript{114} The device may reduce management’s ability to overinvest in perquisites by reducing the free cash flow available for such investments.\textsuperscript{115} It may cure information asymmetries by providing a signal to the capital markets of managers’ faith in the firm’s operations.\textsuperscript{116} It may reduce the costs involved in lenders’ screening of potential borrowers.\textsuperscript{117} In addition to these explanations, several commentators have rejected the analytic method suggested by the irrelevance hypothesis, stating that secured credit is efficient because it makes possible loans that might not be made otherwise.\textsuperscript{118} Commentators continue to debate these explanations for secured credit and the implications each holds for bankruptcy treatment of security interests, but, despite their efforts, none of their explanations has drawn significant theoretical support or been

\textsuperscript{112} Lynn LoPucki remains unconvinced that secured credit can ever be proven to be efficient. See LoPucki, The Unsecured Creditor’s Bargain, supra note 80, at 1920-23.

\textsuperscript{113} See Jackson & Kronman, supra note 87, at 1158-61.

\textsuperscript{114} See Levmore, supra note 87, at 52-59.


\textsuperscript{116} See Schwartz, Security Interests and Bankruptcy Priorities, supra note 25, at 14-21; Triantis, Imperfect Information, supra note 88, at 252-55.


\textsuperscript{118} See Steven L. Harris & Charles W. Mooney, Jr., A Property-Based Theory of Security Interests: Taking Debtors’ Choices Seriously, 80 VA. L. REV. 2021, 2028-37 (1994). Harris and Mooney attempt to demonstrate that secured credit is not necessarily harmful to unsecured creditors, because it may make possible loans that will allow the debtor to invest in positive-net-present-value projects (or simply to weather a financial downturn); see also James J. White, Efficiency Justifications for Personal Property Security, 37 VAND. L. REV. 473 (1984) [hereinafter White, Efficiency Justifications] (arguing that Article 9, bankruptcy law, and common law rules have made the granting and taking of security simple and efficient); Homer Kripke, Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact, 133 U. PA. L. REV. 929 (1985) (defending secured chattel financing). This criticism of the analytical model developed in the economic literature is based on the unproven notion that the market for capital would shrink if the institution of secured credit were abolished. It also begs the question addressed by the economic literature. One way that secured credit could increase the availability of credit is to reduce the risk of lending. But that reduction of risk to secured creditors might increase the risk faced by all other capital providers. Without further analysis, there is no reason to conclude that overall capital would be less available in a regime that did not recognize security interests. Even if we come to the conclusion that secured credit increases the availability of credit, the reasons for that increase are relevant. Capital availability is not an intrinsic good. Like all allocational choices, business projects are only justifiable if they are profitable after taking into account all of their social costs. If the only way to make a project profitable is to externalize some of its costs, it represents a poor allocational choice.
subjected to rigorous empirical testing. At present, about the best that can be said of the institution of secured finance is that it is "probably efficient." The probable efficiency of secured finance is a reasonable starting point for the analysis of asset securitization for three reasons. First, given the diversity of secured financing transactions, it is unlikely that one over-arching efficiency justification will emerge. Most likely, secured finance can be explained only under an amalgam of theories requiring extensive empirical analyses that have yet to be conducted. In the meantime, secured finance is deeply imbedded within our general corporate finance and debt collection law and is consistent with principles of free alienability and market-based risk allocations. It therefore seems appropriate to require substantial evidence of inefficiency before condemning secured credit. Second, while the distributional explanation of secured finance is troubling, there are good reasons to believe that unsecured consensual claimants are not undercompensated for the risk that security interests impose upon them. It is not necessary that all unsecured creditors be informed of the increased risk for the market as a whole to adjust. Given markets' tendencies to discipline those creditors who are unaware of the risk of the loans they are making, it is plausible that, in the long run, unsecured credit markets adjust to the increased risk. Third, the legal issues that surround asset securitization call into question its efficiency vis-à-vis secured finance. The effect of a bankruptcy court's refusal to recognize the separateness of the SPV would not be a demotion to general or subordinated status. Under current law, the

119. Recent work by Ronald Mann is an exception. Mann eschews any attempt to develop an overarching theoretical explanation for secured credit, however, choosing instead to approach the question from the bottom up. His approach involves interviewing a variety of lenders and borrowers in an effort to develop a model that explains the use of secured credit in a variety of contexts. See Ronald J. Mann, Explaining the Pattern of Secured Credit, 110 Harv. L. Rev. 625 (1997) (examining secured credit from the viewpoint of numerous participants in the process).


121. For example, real estate secured lending might be easily explained as a means of monitoring the debtor to ensure against its substitution of riskier assets after the loan has been made. This monitoring explanation is not particularly strong when applied to short term financing secured by receivables and inventory. See Schwartz, Security Interests and Bankruptcy Priorities, supra note 25, at 9-14.

122. See White, Work and Play, supra note 120, at 2090-91.

123. See Harris & Mooney, supra note 118, at 2047-53.

124. See Frost, Substantive Consolidation, supra note 41, at 469-73.

worst that an asset securitization lender can expect is to be treated as a secured creditor.\textsuperscript{126} Thus, while an understanding of the efficiency justifications of secured finance remains a worthwhile goal, it is appropriate at this point to examine asset securitization under an assumption of efficient secured finance.

C. \textit{The Bankruptcy Opt-Out Hypothesis and the Efficiency of Chapter 11}

Assuming the efficiency of secured finance does not lead inevitably to the conclusion that asset securitization is efficient. A little priority may be a good thing, but we may stop short of approving the kind of complete priority that asset securitization seems to entail. As outlined above, the principal reason firms choose asset securitization over secured finance is that, by completely segregating assets from the operating entity, asset securitization avoids bankruptcy redistributions from secured creditors to unsecured creditors and equity owners. This segregation reduces the risk facing asset securitization investors but should increase the risk to the firm’s other investors. The question is whether the increased risk offsets the reduced risk.

Consider again the corporation entering bankruptcy with a need for cash.\textsuperscript{127} If the corporation has sold its accounts in an asset securitization transaction before bankruptcy, the SPV investors will assert that neither the customer payments on those pre-petition accounts nor the accounts themselves are subject to the jurisdiction of the bankruptcy court.\textsuperscript{128} If the sale of assets eliminates all ownership of the originator in the accounts and if the SPV itself is not subject to substantive consolidation with the originator, the SPV investors should prevail.\textsuperscript{129} Starved for cash, the debtor-originator will be forced to close its doors. On the other hand, if the asset securitization fails to completely segregate the assets by eliminating all of the debtor-originator’s ownership interest, the securitized assets will be property of the estate and available for use in the reorganization—subject, of course, to the requirement of adequate protection.\textsuperscript{130}

In this scenario, the arguments surrounding the characterization of the asset securitization transaction displace arguments over the

\textsuperscript{126} See \textit{supra} note 39 and accompanying text.
\textsuperscript{127} See \textit{supra} notes 105-106 and accompanying text.
\textsuperscript{128} See \textit{id}.
\textsuperscript{129} The Code’s authorization to grant liens extends only to property of the estate. See 11 U.S.C. § 364(d) (1997).
\textsuperscript{130} See \textit{supra} notes 106-109 and accompanying text.
fundamental issues arising from financial distress. Financial distress requires that some assessment be made regarding the best use of the business assets. At the same time, the decisionmaker must distribute the value of the business to its pre-bankruptcy owners. These fundamental issues underlie most of the litigation in a bankruptcy case. Bankruptcy reorganization may not be the best way to address such issues, however.

This observation suggests a contractual justification for asset securitization. If the bankruptcy process is an inefficient means of making the asset deployment and distributional decisions raised by financial distress, asset securitization may be a means by which all investors could make a binding promise to avoid the process (at least with respect to the securitized assets). Such an agreement should produce genuine cost savings that could be shared by all investors. If, on the other hand, the bankruptcy process is an efficient means of resolving these problems, an agreement intended to avoid the process (and unjustified on other grounds) would itself be inefficient.

1. Investment Incentives in Corporate Reorganizations

Bankruptcy scholars have long debated the efficiency of the corporate reorganization process. Their major concern is with a


132. Again, under the Kaldor-Hicks criterion of efficiency, we could say that the gains from asset securitization would be sufficient to enable the winners to compensate the losers. See supra note 83 and accompanying text.

133. See, e.g., David A. Skeel, Jr., Rethinking the Line Between Corporate Law and Corporate Bankruptcy, 72 TEX. L. REV. 471 (1994) (suggesting that authority over corporate bankruptcy be shifted to the states, with Congress retaining the authority to regulate personal bankruptcy); Michael Bradley & Michael Rosenzweig, The Unwieldy Case for Chapter 11, 101 YALE L.J. 1043 (1992) (arguing for the repeal of Chapter 11); Robert K. Rasmussen, Debtor's Choice: A Menu Approach to Corporate Bankruptcy, 71 TEX. L. REV. 51 (1992) (arguing that firms should be allowed to choose in their articles of incorporation between several reorganization options); Barry E. Adler, Bankruptcy and Risk Allocation, 77 CORNELL L. REV. 439 (1992) (suggesting that bankruptcy reorganization provisions should be abolished because they serve only as reallocation tools); Barry E. Adler, Financial and Political Theories of American Corporate Bankruptcy, 45 STAN. L. REV. 311 (1993) (observing that corporate bankruptcy is an expensive, lengthy process with political as well as economic motivations); Philippe Aghion et al., The Economics of Bankruptcy Reform, 8 J.L. ECON. & ORG. 523 (1992) (proposing a new bankruptcy procedure for countries in transition to capitalist economies with suggestions for improving current Western bankruptcy procedures); Lucian A. Bebchuk, A New Approach to Corporate Reorganizations, 101 HARV. L. REV. 775 (1988) (proposing an options-based approach to dividing reorganization gains among participants in order to improve efficiency and fairness); Douglas G. Baird, The Uneasy Case for Corporate Reorganizations, 15 J. LEGAL STUD. 127 (1986) (arguing that going concern value could be preserved in a Chapter 7 auction); Mark J. Roe, Bankruptcy
species of agency costs generally referred to as overinvestment.\textsuperscript{134} Overinvestment refers to the tendency of managers of insolvent firms to invest in projects that have a high potential payoff but a negative net present value.\textsuperscript{135} The problem results from the conflict of incentives that characterize an insolvent firm.

Inside or outside of bankruptcy, the enforcement of credit contracts against a truly insolvent firm would eliminate the interests of the equity holders of the firm and most likely terminate managers' employment. From the perspective of shareholders or managers in this position, any gamble of firm assets that stands a chance of increasing the value of the firm looks attractive. After all, shareholders and managers are playing entirely with assets that otherwise would go to creditors. Thus, shareholders and managers may seek projects with high, but unlikely, potential payoffs.\textsuperscript{136} Creditors in this situation have a powerful incentive to exercise their contractual rights to eliminate shareholder and manager control over the firm by foreclosing on security interests or obtaining and enforcing judgments. Bankruptcy stays creditor action, eliminating this control on the overinvestment incentive.\textsuperscript{137}

The reorganization provisions of Chapter 11 reduce, but do not eliminate, the overinvestment problem. Chapter 11 contemplates a negotiated reorganization of the firm on the premise that the value of the firm's assets as a going concern will exceed their value in a liquidation.\textsuperscript{138} In furtherance of this goal, the bankruptcy process leaves the pre-bankruptcy managers of the business in control of the business and the negotiations over the deployment of the firm's assets and the division of ownership interests in the post-bankruptcy entity.\textsuperscript{139} Judicial controls and the investor representation structure of Chapter


135. \textit{See id.}

136. \textit{See authorities cited supra in note 87}.


138. \textit{See} H.R. Rep. No. 95-595, at 220 (1978), \textit{reprinted in} 1978 U.S.C.C.A.N. 5963, 6179 ("The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.") This premise is also illustrated by the requirement that a Chapter 11 plan of reorganization provide creditors with at least as much as they would have received in a liquidation under Chapter 7 of the Code. \textit{See} 11 U.S.C. § 1129(a)(7)(A)(ii) (1997).

11 ameliorate somewhat the overinvestment problem engendered by this scheme. Managers are subject to judicial oversight for investment decisions that are outside of the ordinary course of the debtor's business, limiting the ability of managers to gamble with creditors' funds.\footnote{140}

While judicial oversight provides an effective control over overinvestment in new business projects, it may be less effective in controlling the incentive that shareholders and managers have in prolonging the reorganization. Furthermore, while Chapter 11 is premised on the belief that the firm's assets are best used in continuing the work of the business,\footnote{141} in many cases a liquidation of the assets and distribution of the proceeds would produce a higher value. In these cases, the attempt at reorganization itself presents an overinvestment problem—shareholders and managers stand to gain from the remote chance that the business prospects will improve but bear none of the costs of the more likely prospect of failure.

Compounding the problem is the likelihood that creditors who are practically assured repayment in full, regardless of the success or failure of the reorganization, have an incentive to withdraw their capital from the reorganization at the earliest possible moment.\footnote{142} Accordingly, the presence of fully secured creditors may create a countervailing underinvestment problem. Because fully secured creditors reap none of the gains of a successful reorganization but bear a remote chance of losing in the event the reorganization ends catastrophically,\footnote{143} they may attempt to end those reorganizations that can be characterized as creating positive net present value.

Somewhere in this morass of conflicting incentives lies a group of investors who stand either to gain or lose from the success or failure of the project. This group holds the correct set of incentives to make objective decisions regarding the possible values of the reorganization/liquidation choices.\footnote{144} If the process could locate decisionmaking power in this group, it could reduce substantially the

\begin{itemize}
\item \footnote{140} See Frost, Running the Asylum, supra note 138, at 125-27.
\item \footnote{142} See supra note 105.
\item \footnote{143} See Frost, Running the Asylum, supra note 137, at 130; Lin, supra note 104, at 1490-93.
\item \footnote{144} See Stuart C. Gilson & Michael R. Vetsuyvens, Creditor Control in Financially Distressed Firms: Empirical Evidence, 72 WASH. U. L.Q. 1005, 1005-06 (1994) ("The goal of economic efficiency will be best served when decision and control rights in the firm reside with the firm's residual claimholders—those whose wealth directly rises or falls with marginal changes in firm value.").
\end{itemize}
inefficiencies generated by under- and overinvestment. The problem with this approach is that finding this group requires answers to the very valuation questions the bankruptcy process is intended to resolve.\footnote{\textsuperscript{145}}

What we are left with is a process that attempts to mediate the conflict between incentives through an allocation of negotiating leverage coupled with judicial oversight for significant business and distributional decisions. Of course, such a process makes errors. Every bankruptcy lawyer can tell a tale (smaller in scope but similar in kind) like the Eastern Airlines Chapter 11 case.\footnote{\textsuperscript{146}} Error does not imply inefficiency, however. Markets can make errors yet be considered efficient. In evaluating the quality of decision made by market and nonmarket institutions, our standard cannot be the absence of error but rather the minimization of error.

But even under this standard, the measurement of the efficiency of the reorganization process presents difficulties. A finding of "error" implies that we have some means of measuring not only the outcome of the particular decision but also the likely outcomes of all of the alternatives available to the decisionmaker. Even with good empirical data, it may be impossible to achieve consensus on whether the bankruptcy process results in "correct" decisions.

In the absence of such a consensus, the efficiency of the process might be measured by the presence or lack of systematic bias in its decisionmaking. More specifically, we should ask whether the group controlling the most significant investment decisions (including the decision to continue in business and attempt a reorganization) is free of incentives toward over- or underinvestment.\footnote{\textsuperscript{147}}

\footnote{\textsuperscript{145}} David Skeel has suggested that such difficulty could be avoided by allocating control over pre-confirmation sales of substantial assets to the general unsecured creditors as a class. \textit{See} David Arthur Skeel, Jr., \textit{The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases}, 78 VA. L. REV. 461, 499-501 (1992).

\footnote{\textsuperscript{146}} The Eastern Airlines bankruptcy provides the most notorious example of the failure of the Chapter 11 process to strike an appropriate balance between the two types of inefficiency. In \textit{Eastern}, the court allowed the debtor to continue to use cash in a money-losing attempt to salvage a dying airline. The debtor used $500 million in cash between the time that the creditors nearly unanimously moved to liquidate and the time the plug was finally pulled. \textit{See} Aaron Bernstein et al., \textit{Eastern: The Wings of Greed}, BUS. WK., Nov. 11, 1991, at 34.

2. Overinvestment Bias and the Bankruptcy Reorganization Process

There are several reasons to believe that the structure of the reorganization process leads to decisions that are biased toward overinvestment.\(^{148}\) Most significant is the fact that Chapter 11 leaves control over the day-to-day business decisions and over the negotiations that characterize the process to the pre-bankruptcy managers of the business.\(^{149}\) These managers may see their function in a reorganization as a continuation of their pre-insolvency role as protector of the shareholder.\(^{150}\) Even absent such leanings, managers may have a powerful incentive to prolong the reorganization to preserve their jobs. In any event, managers may be biased toward overinvestment, because they do not bear the full costs of failure.\(^{151}\)

Managers’ control over the business and negotiations provides them with substantial information and agenda-setting advantages over the other participants and even over the ultimate decisionmaking authority—the bankruptcy judge. These advantages might not only affect fundamental decisions, such as whether the business should be liquidated or reorganized, but may also implicate subsidiary decisions, such as the decision to borrow (and on what terms), the decision to sell assets, and the decision to expend corporate funds to continue contractual relationships. The difficult business issues these decisions entail have caused courts to grant managers broad latitude\(^ {152}\)—leading in turn to a structural bias toward overinvestment.

Another bias toward overinvestment that perhaps more directly implicates the specific concerns of asset securitization investors is the bankruptcy system’s failure to compensate undersecured creditors for the delay in foreclosure that the reorganization process entails.\(^ {153}\) This

\(^{148}\) See generally Michelle J. White, Does Chapter 11 Save Economically Inefficient Firms?, 72 WASH. U. L.Q. 1319 (1994) (providing a thorough theoretical model of the reasons this may be).


\(^{150}\) See Miller, supra note 149, at 1488-97 (arguing that management’s representation of equity interests is consistent with the rehabilitative policies of Chapter 11).

\(^{151}\) See Charles Jordan Tabb, Emergency Preferential Orders in Bankruptcy Reorganizations, 65 AM. BANKR. L.J. 75, 79 (1991) ("[M]anagement decisions almost inevitably are biased in favor of survival."). Recent studies suggest that claims of managerial bias in favor of overinvestment may be overstated, however. See Gilson & Vetsuypens, supra note 144, at 1011-1021 (summarizing studies and providing examples).

\(^{152}\) See Frost, Running the Asylum, supra note 137, at 125-29.

\(^{153}\) In United Sav. Ass’n of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 382 (1988), the Court held that undersecured creditors (those creditors with claims in excess of the value of their collateral) were not entitled to receive monthly payments for the use value of their collateral.
failure provides investors holding lower priority claims an ability to avoid some of the cost of extending the reorganization.\textsuperscript{154} By separating those in control of the decision to reorganize from the group bearing the cost of an incorrect decision, the nonpayment of interest leads to a bias in favor of overinvestment.

Thus, the ability to invoke the reorganization process is a valuable entitlement held by claimants who would otherwise find their interests eliminated in a foreclosure or bankruptcy liquidation (herein called junior claimants). Bankruptcy allows these claimants to forestall the inevitable liquidation of firms that are not economically viable. The delay right has value as an out-of-the-money option—no matter how grim the prospects for the firm, there always remains a remote chance that those prospects might improve enough to allow a return on the junior claimants’ interests.

But while the delay right can be said to be valuable, its exercise can hardly be said to be efficient. The use of the delay right creates inefficiencies in two ways. First, the legal wrangling associated with the exercise of the delay right consumes valuable resources. The uncertainty surrounding the bankruptcy process increases direct costs in the form of expenditures to lawyers, investment bankers, accountants, and in the form of judicial resources. In addition, the process consumes managerial time and attention, resulting in an acceleration in the decline of the company’s assets.\textsuperscript{155} Second, the overinvestment itself is inefficient. Overinvestment diverts funds away from other, more valuable uses for the period during which they continue to be overinvested, resulting not only in losses to creditors but to society as well.

But while the process itself may create a delay right, the inefficient exercise of the right is not inevitable. The Coase Theorem suggests that the secured claimants and the junior claimants and managers might bargain to eliminate the overinvestment problem.\textsuperscript{156} If one views the right to overinvest the business assets as an entitlement granted by the Bankruptcy Code to junior claimants and managers, the impetus for a bargain becomes clear. Holders of the entitlement should be willing to sell, because the ability to force overinvestment is worth less to its holders than it costs the secured creditor. Thus, the overinvestment problem might be eliminated through a post-bankruptcy bargain in which the secured claimants

\textsuperscript{154} See Baird & Jackson, \textit{Adequate Protection}, supra note 104, at 129.
\textsuperscript{155} See Lynn M. LoPucki, \textit{The Trouble With Chapter 11}, 1993 Wis. L. Rev. 729, 737-38.
make a side payment to managers and equity holders in return for foregoing their entitlement. In fact, junior claimants do make use of their delay rights in negotiations over the plan of reorganization. Violations of the absolute priority rule are common as junior claimants exercise their ability to hold up the eventual reorganization.

This ex post approach to the problem of overinvestment, however, presents the familiar problems and costs of bargaining under conditions of a bilateral monopoly. In addition, side payments are limited by criminal prohibitions against knowingly and fraudulently giving any compensation for acting or forbearing to act in a bankruptcy case. It is easy to imagine the kinds of strategic behavior that accompany bankruptcy negotiations in which managers and particular investors peddle their influence over the case. Thus, post-bankruptcy negotiations are not only costly, they are likely to be prone to failure. If post-bankruptcy negotiations are not an effective solution to the problem, managers and junior claimants may profit from their entitlement only through continuing the reorganization process. The ability to hold out against the small chance that a firm's prospects might improve enough to support continued operation and provide a return to shareholders is worth something even if the managers and junior claimants cannot sell the right back to the secured creditor.

Asset securitization may be a means through which the parties can sell the right pre-bankruptcy, thus avoiding difficult and costly post-bankruptcy negotiations. By insulating particular assets from the bankruptcy process, the device eliminates the ability of junior claimants to overinvest those assets in a continuing effort to reorganize. If the reorganization process is inefficient, an agreement to avoid its effects should result in gains to the firm.

These gains may provide an alternative to the distributional explanation of asset securitization. In other words, the bankruptcy opt-

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157. In the absence of a negotiated solution to the financial restructuring, the Code applies a rule of absolute priority to the distribution. See 11 U.S.C. § 1129(b) (1997). The absolute priority rule requires each class of claimants to be paid in full in cash or in reorganization securities prior to the retention or receipt of any property by junior claimants. For a general discussion of the absolute priority rule, see Kenneth N. Klee, All You Ever Wanted to Know About Cram Down, 53 AM. BANKR. L.J. 133 (1979), and Kenneth N. Klee, Cram Down II, 64 AM. BANKR. L.J. 229 (1990).

158. The empirical research showing frequent violations of the absolute priority rule is collected in Jagdeep S. Bhandari & Lawrence A. Weiss, The Increasing Bankruptcy Filing Rate: An Historical Analysis, 67 AM. BANKR. L.J. 1, 3 n.7 (1993).

out hypothesis could explain the use of asset securitization even if all of the creditors of the business were fully informed and could adjust their interest rates. The distributional explanation of asset securitization is most compelling if the financing device under scrutiny cannot be explained by pointing to some real cost savings. If asset securitization allows investors to avoid some cost that is unrelated to the enterprise risk inherent in the business, perhaps the legal system should permit its use, even if the device has some distributional consequences.\footnote{160}

D. Bankruptcy Opt-Out Contracts and Chapter 7

One serious difficulty with the normative power of the bankruptcy opt-out hypothesis is that it says nothing about the effect of asset securitization on Chapter 7 liquidations. The overinvestment problems that form the basis for the above criticisms of the bankruptcy system are caused by the leverage and control granted to managers and junior claimants in the reorganization process.\footnote{161} This control and leverage is practically nonexistent when a corporation is liquidating under Chapter 7 of the Bankruptcy Code.\footnote{162}

Unlike Chapter 11, it is likely that Chapter 7 corrects market failures that otherwise would lead to an inefficient redeployment of the debtor’s assets. Chapter 7 provides for an orderly liquidation of the debtor’s assets by eliminating creditors’ incentive to dismember the debtor in uncoordinated foreclosure actions.\footnote{163} The automatic stay against individual debt collection, coupled with the control the disinterested trustee exercises over the sales, insures that assets can be bundled in a way that makes them attractive to potential purchasers.

\footnote{160. Of course, it is unlikely that all creditors can adjust their interest rates. See supra notes 79-85 and accompanying text. Thus, regardless of the efficiency gains of asset securitization, some creditors will find themselves worse off in a regime that permits the use of the device. Whether we are willing to tolerate the distributional consequences of such a regime depends on whether the appropriate criterion for review is the Pareto standard or the Kaldor-Hicks standard. See supra notes 83-84 and accompanying text.}

\footnote{161. See supra notes 148-154 and accompanying text.}

\footnote{162. Chapter 7 of the Code requires the appointment of a disinterested trustee in all liquidation cases. See 11 U.S.C. §§ 701, 702 (1997). Section 704 charges the trustee with collecting and reducing to money the property of the estate “as expeditiously as is compatible with the best interests of parties in interest.” 11 U.S.C. § 704(1).}

For example, the debtor corporation may own a piece of equipment that is best used as part of a continuous manufacturing process. If creditors could act collectively, all would agree that the entire manufacturing process should be sold to a single buyer. If creditors act individually, there is a risk that the manufacturing process will be sold to different buyers. Chapter 7 forces the creditors to act collectively through the trustee to maximize the sale price of the assets.\footnote{164}

The risk allocation aspects of asset securitization may eliminate this source of bankruptcy efficiency. The complete insulation of assets from the bankruptcy process eliminates, or at least erects obstacles to,\footnote{165} collective action. This is not a significant concern so long as asset securitizations involve only financial assets. The value of consumer and trade receivables is unlikely to depend significantly on their synergy with other business assets. But as asset securitization continues to develop to include tangible assets, its effect on this collective action problem will require close scrutiny.

\textbf{IV. NORMATIVE IMPLICATIONS}

The bankruptcy opt-out hypothesis offered above is only one of many possible explanations for the risk allocation attributes of asset securitization.\footnote{166} The hypothesis seems the most plausible alternative to the distributional hypothesis, but empirical evidence necessary to establish the efficiency of asset securitization under the bankruptcy opt-out hypothesis is lacking. The plausibility of the bankruptcy opt-out hypothesis requires inefficiency in the reorganization process. A definitive case for such inefficiency has yet to be made, and it is possible that whatever inefficiency exists may not be substantial enough to offset the transaction costs of asset securitization.

Even if such evidence were available, however, the normative case for protecting the risk allocation attributes of these transactions would be far from complete. This part examines some of the normative issues such an explanation raises.

\footnote{164} See Baird & Jackson, supra note 62, at 865.  
\footnote{165} One might envision a post-bankruptcy bargain in which the trustee and the asset securitization investors agree to share the gains from the more sensible sale. The problem with this alternative is that it ensures that such bargains take place in the context of a bilateral monopoly. After bankruptcy, the parties have no choice but to deal with one another. This condition may dramatically increase the costs of bargaining.  
\footnote{166} Claire Hill has offered an explanation of asset securitization that focuses on information asymmetries and specialization. See Hill, supra note 7.
A. Asset Securitization and Bankruptcy Reform

Pointing to inefficiencies in the bankruptcy process as the reason for the risk allocation aspects of securitization only vindicates those aspects in a world where the inefficiencies exist. In other words, asset securitization may only be justified as a second-best result. The opt-out hypothesis may say more about the deficiencies of the bankruptcy process than the justifiability of securitization.

Douglas Baird has suggested that the inefficiencies of the bankruptcy system might result in firms opting out by refusing to issue debt. In a similar vein, James J. White has suggested that the failure to recognize personal property security interests will result only in innovations designed to assure the continued priority of certain claimants. Both commentators recognize that financial markets are adaptable. It may be difficult to sustain legal structures designed to allocate risk in a particular way. The growth of asset securitization appears to be further evidence of this market adaptability.

One fix for inefficiency is financial innovation designed to avoid the inefficiency. Another is to change the procedures that create the inefficiency in the first place. Over the past several years, dissatisfaction with Chapter 11 has increased, and many commentators have called for its repeal or radical reform. Most recently, the Bankruptcy Review Commission has completed work examining all aspects of the bankruptcy process. If the bankruptcy opt-out hypothesis explains asset securitization, reforms that eliminate the inefficiencies in the reorganization process ultimately may moot lingering concerns over the effects of the device.

The promise of significant reform of the bankruptcy process, however, is distant at best. The desire for substantial reform in the process is by no means broad-based. The Bankruptcy Review Commission, following its limited mandate, has not suggested substantial reforms to the reorganization process. In addition,
public-choice problems involved in bankruptcy reform are likely to be substantial. Thus, while significant bankruptcy reform might provide the ultimate empirical test of the bankruptcy opt-out hypothesis, the risk allocation aspects of asset securitization will likely demand some response from the courts well before Congress effects a broader solution to the problem of inefficiency in the bankruptcy system.

Regardless of the ultimate desirability of bankruptcy reform, we must consider whether the reasons for asset securitization are consistent with existing normative commitments. This concern operates on two levels. As a theoretical matter, an explanation of asset securitization that centers on correcting inefficiencies in the bankruptcy process will be unconvincing to those who reject an efficiency-based justification of the bankruptcy process. Thus, theoretical debate over the justification of asset securitization must consider the bankruptcy system as a whole.

On a more pragmatic level, the Bankruptcy Code itself prohibits a variety of contractual and legal provisions designed to keep property interests out of the estate. As a general matter, contracts that seek to completely avoid the effects of a bankruptcy proceeding are unenforceable. The point here is that, regardless of the efficiency or

172. See Adler, Financial and Political Theories, supra note 133, at 341-46 (analyzing the public-choice problems associated with bankruptcy reform).

173. See sources cited supra note 133.

174. These prohibitions operate on two levels. So-called “ipso facto” provisions render unenforceable particular contractual terms and state law property rules that take effect only in bankruptcy. See 11 U.S.C. § 541(e)(1) (1997) (providing that interests of the debtor become property of the estate notwithstanding provisions in agreements or applicable law that restrict or condition transfers of the interest by the debtor or which are conditioned on the insolvency of the debtor or filing of a bankruptcy case); 11 U.S.C. § 365(e)(1) (1997) (prohibiting termination or modification of an executory contract because of a provision in the contract that is conditioned on the insolvency of the debtor or the filing of a bankruptcy case).

On a more general level, an agreement not to file a bankruptcy case is unenforceable. See In re Tru Block Concrete Prod., Inc., 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983) (“It is a well settled principal that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy.”); In re Adana Mortgage Bankers, Inc., 12 B.R. 989, 1009 (Bankr. N.D. Ga. 1980) (“A waiver, even a bargained-for and knowledgeable one, of the right to seek protection of the Bankruptcy Act is void.”); In re Weitzen, 3 F. Supp. 698, 698 (S.D.N.Y. 1933) (“The agreement to waive the benefit of bankruptcy is unenforceable.”).

Of course, there are exceptions. In a few cases, courts have been willing to enforce pre-bankruptcy waivers of the automatic stay. See Robert K. Rasmussen & David A. Skeel, Jr., The Economic Analysis of Corporate Bankruptcy Law, 3 A.B.I. L. REV. 85, 97-101 (1995). Most of these cases have involved debtors with a single asset and one principal creditor. See id. at 99. These types of cases do not typically raise the distributional issues discussed here.
inefficiency of asset securitization, the device operates within a much broader system of debt collection. Right or wrong, the bankruptcy process may reflect some normative commitments that may be at odds with the value of allocative efficiency. The following sections examine the implications of asset securitization in a bankruptcy system that tolerates some inefficiency as a means of promoting other values.

B. Asset Securitization and the Distributional Goals of Chapter 11

The attractiveness of the bankruptcy opt-out hypothesis as a normative justification of asset securitization requires a somewhat narrow view of the goals of the bankruptcy process. The bankruptcy opt-out hypothesis is premised on a hypothetical bargain among managers and investors in the firm. The underlying idea is that junior claimants and managers might willingly forego their ability to overinvest the firm’s assets. Asset securitization is a means through which such a bargain might be effected. If that is the purpose of the device, then it provides an explanation to compete with the distributive hypothesis.

In addition to the economic benefits overinvestment bias provides to junior claimants and managers are the benefits the bias provides to noninvestor constituencies of the firm. Employees, suppliers, and the surrounding community may benefit from a process that keeps failing firms in business. These noninvestor groups stand to lose from financing devices intended to reduce the overinvestment bias in the bankruptcy process.

Whether the losses of noninvestor groups should matter has been a central question in recent debates over the purpose behind Chapter 11. Rejecting the narrow creditor focus of most economic accounts of bankruptcy law, several commentators have pointed to the distributive character of the reorganization process as a justification for some of the inefficiencies Chapter 11 creates. We have always been of two minds in thinking about the business bankruptcy system. On one

The NBRC has recommended that all such waivers be held invalid. See NBRC Report, supra note 170, at 21.

175. See supra notes 156-160 and accompanying text.

hand, we may view the process as a means of maximizing the returns to the investors of the failed entity. On the other, we see the system as providing a corporate safety net that preserves jobs and communities when firms encounter financial difficulties. The difficulty is that in many bankruptcies the two purposes conflict.

If the bankruptcy system is intended to protect the interests of noninvestors, the bankruptcy opt-out hypothesis fails as a normative justification for asset securitization. Overinvestment certainly introduces inefficiencies into the corporate finance system, but these inefficiencies are simply the result of a redistribution from those holding explicit contractual entitlements (investors) to those without such entitlements (noninvestors). Advocates of this broader vision of bankruptcy policy would tolerate some inefficiency in an effort to achieve a distributional result. While I believe this distributional vision of Chapter 11 is flawed, it is nonetheless a vision that is well represented in the legislative history of the Bankruptcy Code and therefore cannot be disregarded.

C. Tort Claimants and the Bankruptcy Opt-Out Hypothesis

The hypothetical contract underpinnings of the bankruptcy opt-out hypothesis create normative difficulties when considering the problems of involuntary claimants. Tort creditors cannot participate in any ex ante bargain regarding the division of value created in opt-out transactions. At first blush, asset securitization may appear to be a raw transfer of risk to such claimants. Such a risk transfer not only violates the paretinian’s strictures against distributional effects, but it may also violate the Kaldor-Hicks test of efficiency by creating allocative inefficiencies. Asset securitization enables a firm to externalize the risk of producing a hazardous product or using

178. See Frost, Bankruptcy Redistributive Policies, supra note 147.
179. For an analysis of the legislative history, see Warren, Imperfect World, supra note 176, at 355 n.45.
180. This problem is not unique to the analysis presented here. Contract-based analyses of corporate law seem always to stumble when they encounter the odd claimant who cannot participate in the bargain. See, e.g., Easterbrook & Fischel, supra note 125, at 52-54 (providing a weak justification of the doctrine of limited liability based on the corporation’s incentives to insure against tort losses). Only recently have economic analysts of corporate law begun to turn their attention to the plight of the involuntary claimant. See, e.g., Hansmann & Kraakman, supra note 56 (arguing for imposing liability on shareholders for tort damages exceeding the value of a corporation’s net assets).
181. See LoPucki, The Unsecured Creditor’s Bargain, supra note 80, at 1896-1916.
182. See supra notes 79-85 and accompanying text (discussing Pareto and Kaldor-Hicks efficiency).
hazardous processes by insulating assets, and the investors with claims against those assets, from the risky operations.\textsuperscript{183}

This objection is not unique to asset securitization, however. Secured finance creates the same type of priority—albeit one subject to erosion in the bankruptcy process.\textsuperscript{184} Again, the analysis here takes place at the margin. Asset securitization simply strengthens the priority of the secured lender by assuring it against that erosion. But even if the priority of secured creditors over tort claimants is justifiable (and I am not convinced that it is,\textsuperscript{185} the additional insulation of assets through asset securitization is not necessarily justifiable. Given the precarious position of tort claimants in bankruptcy (caused, in part, by the priority over them that secured creditors enjoy), it is likely that tort claimants are benefited by the bankruptcy process’s erosion of secured creditors’ priority.

V. REVISITING THE DOCTRINAL CONTEXT

These normative considerations, coupled with the more general distributional concerns associated with asset securitization, require an approach to the legal analysis of these transactions that illuminates, rather than obscures, the risk allocation properties of the device. Commentators’ focus on the true sale/financing device dichotomy\textsuperscript{186} and substantive consolidation doctrine\textsuperscript{187} reflects a preoccupation with doctrinal validity. This would be no cause for concern if the tests for validity bore some relationship to the normative issues underlying the doctrine. These approaches could simply be explained as rough attempts to provide clear rules. While the rules might be under- or overinclusive, precision could be sacrificed for clarity. But the elements of the doctrinal context do not seem to bear any relationship to the normative implications of asset securitization. This lack of compatibility is not surprising, given the fact that the widespread use of the device is a fairly recent phenomenon. But, as more companies use the device, the need for a more nuanced analytical framework will become clear.

\textsuperscript{183} See LoPucki, The Death of Liability, supra note 2, at 23-30.
\textsuperscript{184} See id. at 13-18; LoPucki, The Unsecured Creditor’s Bargain, supra note 80, at 1903-06.
\textsuperscript{185} James White argues that the primacy of tort claimants over Article 9 secured parties is not justifiable because not all tort claimants are worthy of protection. See White, Work and Play, supra note 120, at 2101. While it may be true that the tort system is a runaway train, imposing liability on seemingly unprincipled bases, it is not at all clear why the bankruptcy priority system is an appropriate way to solve this problem.
\textsuperscript{186} See infra notes 189-201 and accompanying text.
\textsuperscript{187} See discussion supra Part I.A-B.
As more fully explained above, the issue of how to draw boundaries around property of the estate is illuminated by the twin principles of free alienability of property and entity-based liability. The desire to encourage and preserve value-enhancing exchange unifies these principles into a coherent theory. The conceptual underpinnings of the fraudulent transfer laws support this value creation idea. Where an exchange produces no obvious value (that is, where its impetus appears purely distributional), it becomes subject to attack under the fraudulent transfer laws.

Isolating the value-enhancing properties of a particular transaction may be a mere first step, however. Even if a transaction can be shown to create value, normative concerns may dictate its regulation. At a minimum, the analysis should consider our tolerance for distributional effects. Capital structures that meet the Kaldor-Hicks standard of efficiency are unlikely also to satisfy the Pareto standard, with its strictures against uncompensated distributional effects. For example, in analyzing asset securitizations, this concern requires that some decision be reached regarding the merit of claims that the effect of the device on the ability of companies to reorganize foists uncompensated risk onto tort victims.

These observations suggest that while the sale/finance dichotomy and substantive consolidation might be useful rubrics under which asset securitization may be discussed, the question of whether the transaction is truly a sale or whether two entities should be treated as one should focus, first, on the value-creating properties of the exchange and, second, on the lingering normative concerns that are somewhat removed from the question of efficiency. As the following discussion illustrates, the application of these doctrines to asset securitization fails to focus properly on even the first of these questions.

A. The Sale/Finance Dichotomy and the Question of Recourse

In general, courts often begin their analysis of the true sale/financing device question by stating that while the question hinges on the intent of the parties, the label attached to the transaction is not controlling. The analysis must instead turn on whether the transaction has the attributes of a sale or a loan—as one commentator

188. See supra Part I.A-B.
189. See, e.g., Major's Furniture Mart, Inc. v. Castle Credit Corp., Inc., 602 F.2d 538 (3d Cir. 1979) (noting that although the parties characterized their agreement as a sale of accounts receivable, the transactions were not sales).
has put it, whether the putative buyer has received the "benefits and burdens" of owning the assets.\textsuperscript{190}

Commentators analyzing asset securitizations under this rubric place the most emphasis on who bears the risk of loss and the potential for gain with respect to the assets transferred.\textsuperscript{191} If the transferor retains a substantial risk of loss or potential for gain after the transaction, the transfer is likely to look more like a loan than a sale. When looking at a putative sale of financial assets, such as accounts receivable, the question is whether the transferor retains the risk of the account debtors' failure to pay the receivables—in commercial terms, whether the accounts are sold with or without recourse.

While accounts are normally transferred at a discount that takes into account some of the risk of nonpayment, SPV investors often require further recourse against the originator in the event that collections on the accounts fall short of expectations.\textsuperscript{192} This recourse obligation is believed to increase the risk that the courts will recharacterize the transaction as a loan.\textsuperscript{193} Loan treatment is also more likely where the originator benefits from collections that are in excess of those required to repay the asset securitization investors.\textsuperscript{194} Concomitantly, transactions in which the originator retains none of the risk of inadequate collections and shares in none of the potential excess collections look most like a true sale.\textsuperscript{195}

Commentators rely on the substantial case law focusing on recourse in attempting to draw the line between a true sale of accounts and a sale that is merely a disguised security interest.\textsuperscript{196} Courts often confront the true sale/financing device distinction in attempting to determine whether the debtor is entitled to surplus collections from the receivables and whether the creditor/purchaser is entitled to a

\textsuperscript{190} See Plank, \textit{supra} note 29, at 290. \textit{See also} SCHWARCZ, \textsc{Structured Finance}, \textit{supra} note 1, at 31 ("future economic risks and benefits of ownership of the receivables purported to be sold").

\textsuperscript{191} \textit{See} SCHWARCZ, \textsc{Structured Finance}, \textit{supra} note 1, at 31-32; SCHWARCZ, \textit{The New Way to Securitize}, \textit{supra} note 17, at 618-22; FRANKEL, \textit{supra} note 6, at § 7.14.3; cf. Plank, \textit{supra} note 29, at 345-46 (concluding that recourse should not be the determinative factor, but merely one factor to be considered, in analyzing the nature of a sale of loans).

\textsuperscript{192} \textit{See} SCHWARCZ, \textsc{Structured Finance}, \textit{supra} note 1, at 31-32.


\textsuperscript{194} \textit{See} SCHWARCZ, \textsc{Structured Finance}, \textit{supra} note 1, at 32.

\textsuperscript{195} \textit{See} Bear v. Coben \textit{(In re Golden Plan of Cal. Inc.)}, 829 F.2d 705, 709-11 (9th Cir. 1986).

\textsuperscript{196} \textit{See generally} SCHWARCZ, \textit{supra} note 1; Plank, \textit{supra} note 29; FRANKEL, \textit{supra} note 6.
deficiency judgment.\textsuperscript{197} In other cases, the courts have utilized recourse to determine whether a transaction is subject to usury laws.\textsuperscript{198}

But these cases can tell us little about the utility of recourse in addressing the distributional and other normative concerns associated with asset securitization. Asset securitization raises distributional issues affecting the buyer of assets and the other creditors of the debtor. Most of the cases using recourse to analyze the nature of the transaction are focused on disputes between the debtor and putative buyer.\textsuperscript{199} Courts in these cases are called upon to interpret the contract between the parties to determine whether recourse or a right to a surplus is present.\textsuperscript{200} Recourse is not the means of answering the question of whether the debtor is liable for a deficiency; it is the question. Where the question is the debtor’s entitlement to surplus collections, recourse merely provides a method of expressing the court’s conclusions regarding the debtor’s and the buyer’s contractual intent; it says nothing about the distributive issues between the buyer and the debtor’s other creditors.

Still, the emphasis on recourse as a hallmark of a loan rather than a sale is consistent with the analysis of property sales generally.\textsuperscript{201} An important attribute of most property transfers is that they allow the buyer to profit from post-sale increases in value and insulate the seller from post-sale decreases. This transfer of market risk creates value by enabling the seller to exchange a low-valued potential for gain for a higher-valued reduction in the risk of loss. At the same time, the buyer exchanges low-valued insulation from market risk for a higher-valued potential for profit. Where the exchange truly accomplishes this task, there is little reason to unwind it in a bankruptcy of the seller.

\textsuperscript{197} See Major’s Furniture Mart, Inc., 602 F.2d at 538.

\textsuperscript{198} See Home Bond Co. v. McChesney, 239 U.S. 568 (1916); Brierley v. Commercial Credit Co., 43 F.2d 730 (3d Cir. 1930); Wayne Pump Co. v. Department of Treasury, 110 N.E.2d 284 (Ind. 1953); Milana v. Credit Discount Co., 163 P.2d 869 (Cal. 1945).

\textsuperscript{199} See Major’s Furniture Mart, Inc., 602 F.2d at 544-45; Western Auto Supply Co. v. Vick, 277 S.E.2d 360, 368-69 (N.C. 1981).

\textsuperscript{200} See Major’s Furniture Mart, Inc., 602 F.2d at 344-45.

\textsuperscript{201} For years courts have attempted to draw distinctions between true leases of personal property and leases intended to operate as security devices by focusing on whether the lessor has retained the upside potential and downside risk of owning the property. See, e.g., Taylor Rental Corp. v. Ted Godwin Leasing, Inc., 681 P.2d 691 (Mont. 1984) (exemplifying this type of analysis in the distinguishing of a lease from a secured transaction). Where the lessor retains the risk of losses in market value and reaps the benefits of increases, the transaction is more likely to be characterized as a lease. Section 1-201(37) of the Uniform Commercial Code somewhat awkwardly incorporates this concept in its definition of security interest. See U.C.C. § 1-201(37) (1996); Ayer, supra note 38, at 668-74.
The focus on recourse seems to capture the ideal of this means of value creation. The buyer of receivables in a no-recourse/no-surplus transaction takes all of the post-sale gains and losses, whereas the seller takes none. But with respect to accounts sold in an asset-securitization transaction, this transfer of risk may be somewhat insignificant. Given the large numbers of accounts securitized in an asset securitization, the economic risks associated with the nonpayment of some of the accounts can be determined quite accurately. If the value of accounts is stable over a wide range of contingencies, there is little risk to be transferred. While even the best actuarial methods cannot account for some residual systematic risk of nonpayment or excess payment, it is unlikely that the originator and the SPV investors (or rating agencies) will hold substantially differing expectations regarding this risk.

In this respect, asset securitization may be distinguished from factoring, a closely related financing device. In a traditional factoring transaction, the factor not only purchases the accounts on a nonrecourse basis but also approves specific credits for the business and functions as servicer on the accounts. Thus, traditional factoring is a nearly complete outsourcing of all of the credit functions of the originator. The outsourcing itself provides the source of value in a factoring transaction. Given the factor’s expertise in credit determinations and the economies of scale produced by servicing accounts from a number of originators, the factor places a higher value on the accounts than does the originator. There is every reason for the bankruptcy process to respect such transactions.

202. See Rosenthal & Ocampo, supra note 7, at 8-12.

203. A pool of accounts is different from a piece of real property or other secured property in this respect. The sale price of realty reflects the buyer’s and seller’s expectations regarding the risk of market value changes. There is less likelihood that a buyer and seller of the pool will view the sale transaction as substantially altering the risks and rewards of owning the assets.

204. In an early discussion of factoring, Professor Phelps defined the device as:

[A] continuing agreement under which a financing institution assumes the credit and collection function for its client, purchases his receivables as they arise without recourse to him for credit losses, and, because of these relationships, performs other auxiliary functions (usually financial or advisory in nature) for its client.

Clyde W. Phelps, The Role of Factoring in Modern Business Finance, in STUDIES IN COMMERCIAL FINANCE 14 (1956); see also Peter H. Weil, Factoring in Asset Based Financing: A TRANSACTIONAL GUIDE § 27.01[1] (1985) (noting the collection and credit risk aspects of factoring).

205. Professor Phelps noted this source of value as early as 1956:

[E]conomies are achieved for society in general through the elimination of duplication in heavy work and equipment costs in credit investigation, in accounts
Finally, the lack of recourse does not make the normative concerns associated with asset securitization disappear. Lack of recourse may provide some benefit to the company's investors by eliminating the asset securitization investors as potential claimants, but this benefit is likely to be small in comparison to the cost to them of losing the ability to use the assets in a bankruptcy.\textsuperscript{206} The focus on recourse or lack thereof as a means of determining whether a transaction is truly a sale, therefore, appears to be unwarranted.

B. \textit{Substantive Consolidation and the Role of Creditor Expectations}

Substantive consolidation—like its nonbankruptcy analog, piercing the corporate veil\textsuperscript{207}—provides a means through which the court can override the norm of entity liability. Courts order consolidation in three types of situations. In many consolidation cases, the assets of the entities sought to be consolidated are so entangled with one another that consolidation is the only practical course of action.\textsuperscript{208} A second category of cases involves some affirmative misrepresentation of either the corporate structure or the asset ownership of the operating entity.\textsuperscript{209} These two categories of cases

\textsuperscript{206} See supra notes 107-111 and accompanying text for a discussion of the cost to non-SPV investors of losing access to the accounts.

\textsuperscript{207} Veil piercing is the more common means of defeating entity liability, but because the distributive issues surrounding asset securitization surface principally under the corporate reorganization process, substantive consolidation is the more relevant doctrine for our purposes.

\textsuperscript{208} See, e.g., G.M. Mather v. G.K. Pipe Corp. \textit{(In re Moran Pipe \\& Supply Co.)}, 130 B.R. 588 (Bankr. E.D. Okla. 1991) (noting that the court was unable to determine whether legal requirements for corporate separateness had been observed due to inadequate records); \textit{In re Murray Indus., Inc.}, 119 B.R. 820 (Bankr. M.D. Fla. 1990) (noting that determining the balance owed in intercompany exchanges of funds and properties which were never paid for would be complex, expensive, and time-consuming); \textit{In re Baker \\& Getty Fin. Servs., Inc.}, 78 B.R. 139 (Bankr. N.D. Ohio 1987) (considering commingling of assets and business functions in decision to consolidate); \textit{In re Luth}, 28 B.R. 564 (Bankr. D. Idaho 1983) (holding that, because the separation of liabilities would be difficult, case was subject to consolidation); \textit{In re Lewellyn}, 26 B.R. 246, 251 (Bankr. S.D. Iowa 1982) (observing that commingling of funds and inadequate records demonstrates the need for consolidation); \textit{In re Food Fair, Inc.}, 10 B.R. 123, 126-27 (Bankr. S.D.N.Y. 1981) (citing lack of internal controls and poor accounting).

\textsuperscript{209} See, e.g., Eastgroup Properties v. Southern Motel Ass'n \textit{(In re Eastgroup Properties)}, 935 F.2d 245, 250 (11th Cir. 1991) (discussing misrepresentation of ownership of assets to creditor); \textit{In re I.R.C.C., Inc.}, 105 B.R. 237, 243 (Bankr. S.D.N.Y. 1989) (observing that debtor entities used a common name on invoices); Munford Inc. v. TOC Retail, Inc. \textit{(In
should present little difficulty to the participants in asset securitizations. Essentially, these cases present monitoring and structuring problems with which attorneys and bankers are particularly adept at dealing.210

The final category of cases presents a much greater risk of upsetting the expectations of investors in asset securitizations. In an increasing number of cases, courts have ordered consolidation without evidence of entanglement or misrepresentation.211 These cases instead seek to balance perceived prejudice, resulting from a failure to consolidate, against the harm the consolidation order may visit on particular creditors212—readily admitting a liberal trend toward consolidating related corporate entities.213 The basis for consolidation in these cases is that creditors have dealt with the separate entities as one business.214 In these cases, courts justify consolidation as a mechanism to fulfill the contractual expectations of the creditors.215

_re Munford_, 115 B.R. 390, 395 (Bankr. N.D. Ga. 1990) (finding it significant that business stationery and public representations in brochures, press releases, and interviews indicated that the 800-store chain operated as a single economic unit); _Stone v. Eacho_ (in _re_ Tip Top Tailors), 127 F.2d 284, 286-87 (4th Cir. 1942) (noting that parent paid operating expenses of subsidiary store, with exception of payroll and bills less than $10).

210. _See_ FRANKEL, _supra_ note 6, at § 10.8.6 (discussing means through which the legal risks associated with excessive entanglement might be reduced).


212. _See_, e.g., _F.A. Potts & Co._, 23 B.R. at 573 (observing that the benefits of substantive consolidation outweighed the harm to objecting creditors); _Richton_, 12 B.R. at 558 (considering “equitable treatment of creditors”).

213. “[T]he fact that while creditors may be adversely affected by a substantive consolidation, this alone is not controlling and the bankruptcy court must weigh the conflicting interests which should be balanced in such way [sic] as to reach a rough approximation to some rather than to deny justice to all.” _Murray Indus._, 119 B.R. at 832 (citing _in re_ Commercial Envelope Mfg. Co., 14 C.B.C. 191, 202 (S.D.N.Y. 1977)). See also _Eastgroup Properties_, 935 F.2d at 248 (noting that a “liberal” trend toward allowing substantive consolidation has its basis in judicial recognition of a corporation’s use of corporate structures by subsidiary corporations); _in re_ Drexel Burnham Lambert Group, Inc., 138 B.R. 723, 765 (Bankr. S.D.N.Y. 1992) (applying the “liberal trend” formula as construed by the Eleventh Circuit); _F.A. Potts & Co._, 23 B.R. at 571 (recognizing the “liberal trend,” but noting that the court has a duty to consider and balance all conflicting interests); _in re_ Vecco Constr. Indus., 4 B.R. 407, 409 (Bankr. E.D. Va. 1980) (listing factors courts may use when deciding whether there is substantial identity between the entities to be consolidated).

214. _See_, e.g., _Eastgroup Properties_, 935 F.2d at 250; _Soviero v. Franklin Nat’l Bank_, 328 F.2d 446 (2d Cir. 1964) (noting that affiliates of the bankrupt did not have a separate existence even though they filed separate tax returns). See also PHILLIP BLUMBERG, _THE LAW OF CORPORATE GROUPS: BANKRUPTCY LAW_ 420 (1985):

Where a creditor reasonably thought that it was dealing with the enterprise as a group rather than with one of the affiliated corporations conducting the business,
With its focus on creditor expectations, substantive consolidation provides a doctrinal alternative that appears better suited to capture the normative difficulties raised by asset securitization than does the true sale/financing device dichotomy. The essence of substantive consolidation doctrine is that substance should prevail over form and that structures with little purpose other than to mislead creditors ought to be unraveled. 216 But while flexibility is a doctrinal advantage, it is also the principal disadvantage of the use of substantive consolidation to police asset securitization deals. For asset securitization to achieve the efficiencies set out above, the risk allocation aspects of the transaction must be determinate from the start of the transaction. Uncertainty over whether the transaction will be “bankruptcy proof” will result in investors in the SPV, and the rating agencies involved in the transaction, treating the transaction as a secured loan. Firms, in turn, would have little reason to prefer these transactions over conventional secured loans. The deterrent effect of a doctrine that focused on an ex post examination of creditor expectations would eliminate any potential advantages of the device.

In addition, the application of substantive consolidation is limited to situations in which the originator retains an equity interest in the SPV. But equity ownership has little to do with the normative issues that asset securitization implicates, and therefore, the equity-ownership requirement causes the doctrine to be overly narrow. The role of ownership in asset securitizations is quite different from the role ownership serves in coordinating the use of productive assets. 217 Since securitizations involve simple assets, the value and productivity of which do not depend on consolidated ownership, the ownership itself serves no function that could not be served through contract. Instead, in asset securitizations ownership is a substitute for recourse. 218 Equity ownership in the SPV allows the originator to capture collections on the accounts in excess of those required to repay the SPV investors, thereby making possible deeper discounts from the face value of the assets when they are sold to the SPV. These deep discounts place

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215. See cases cited supra note 211.
216. See, e.g., cases cited supra note 211.
218. See Frankel, supra note 6, at 370-71.
relatively more of the risk of nonpayment of the securitized receivables on the originator in the same manner as would recourse.\footnote{219}{See supra notes 30-33 and accompanying text.}

Accordingly, a doctrinal analysis of asset securitization that turns on the ownership of the SPV will fail to capture fully the normative issues that the device raises. These issues turn not on whether the originator owns the SPV but rather on whether the overall effect of the device is distributive, what kind of effect these transactions have on tort claimants, and whether the economic effects of these transactions are consistent with our existing normative commitments. The answers to these questions are largely independent of the ownership of the SPV.

C. Toward a New Doctrinal Context

The foregoing observations should not be taken as advocating the overturning of the risk allocation effects of these transactions in all cases. Asset securitization may well be justified on a number of grounds. The point here is simply that the way in which the transactions have been analyzed has not adequately focused on the reasons for the device and how those reasons might comport with broader notions of how we should define the boundaries of property of the estate.

A focus on the value created by asset securitization provides a conceptual center around which these boundaries might be defined. Value creation is the fundamental reason that we protect exchange. The idea also provides limits on that protection through the operation of the fraudulent transfer laws. But the doctrinal context for asset securitization fails to consider adequately this critical aspect of the device.

This is not to say that inquiries into the validity of asset securitizations should devolve into wide-ranging \textit{ex post} determinations of the value created by particular transactions. Such a regime might create a level of uncertainty sufficient to eliminate even those uses of the device that most would agree should pass muster. Instead, the doctrinal context under which these transactions should be analyzed should focus on broad categories of transactions that, as a general rule, will pass or fail to pass the test of value creation. For example, most analysts might agree that the value created by traditional factoring transactions is sufficient to insulate the property subject to those exchanges from the bankruptcy process. At the same time, it may be that the formal asset transfers occurring in a full-recourse, single-originator asset securitization of the type considered
here do not create sufficient value to justify their distributive effects and the other normative concerns associated with such transactions.

Naturally, many cases will fall somewhere between these two extremes. For example, a pool of receivables from many small businesses may provide those businesses with access to markets for capital that they otherwise would be unable to obtain. If the amount of capital individual participants in the pool wish to raise is small, the transaction costs of an individual offering might be prohibitive. In the absence of a vehicle that is bankruptcy remote, however, such multi-seller pools would require the market to assimilate information on each of the individual originators, greatly increasing the cost of the transaction. Thus, while such multi-seller transactions raise the distributional concerns addressed here, the efficiencies resulting from the securitization component of such securitization may require that the SPV remain bankruptcy remote.

In addition, it may be that even transactions that seem, at first blush, to have little to distinguish them from bare fraudulent transfers create value in ways that are not considered here. At present, it is impossible to provide definitive answers to these questions, but a focus on the value created by asset securitization will bring us closer to answers than will an approach that is based on the existing doctrinal categories.

VI. CONCLUSION

Asset securitization is an emerging legal technology that provides a response to perceived inefficiencies in the bankruptcy process. Like most emerging technologies, however, implications of its widespread use are obscure. Part of the reason for this obscurity is that asset securitization was developed through the extension of doctrinal tools that cannot account for the impact the device has on the firm and all of its constituencies. We cannot understand or discuss the normative implications of asset securitization by reference to the doctrinal validity of the transactions underlying it any more than we can understand or discuss the implications of the nuclear age by reference to the validity of Einstein’s mathematics.

The increase in the number of companies attempting to lower their cost of capital through asset securitization will eventually force a

220. See Schwarz, Alchemy, supra note 6, at 140 (discussing scale economies resulting from multi-seller conduits).
221. See Hill, supra note 7 (discussing the beneficial effect of securitization in reducing information problems and costs of raising capital by firms that are not well-known in the capital markets).
judicial response to the risk allocation effects of these transactions. As illustrated above, the normative issues are complex and, to some extent, interwoven. These transactions raise fundamental questions regarding the efficiency of the bankruptcy reorganization and liquidation processes, the desirability of using bankruptcy as a distributive tool, and the effect of bankruptcy and the institution of secured credit on involuntary claimants. These are controversial issues about which there has emerged no consensus. We are only beginning to develop the empirical data necessary to develop a clear picture of the effect of the bankruptcy process on the diverse interests affected by financial failure. We have no empirical evidence regarding the distributional aspects of asset securitization.

This Article is intended to provide a theoretical framework against which such empirical study might be conducted. An essential first step is to move beyond viewing asset securitization as a sale of assets. Instead, the device should be regarded as but one of a wide array of financing choices. Once we view asset securitization as a method of finance, an arsenal of theoretical tools becomes available to enable us to look beyond the form of the transactions and focus on the more important efficiency and distributive consequences of this new technology.
A PERFECT MARKET EXAMPLE

A simple example illustrates the application of Modigliani and Miller’s insight to various financing options a firm faces when seeking to invest in a project.\(^{222}\) Consider a firm with assets of $500 capitalized with $400 of debt and $100 of equity. The firm’s management has an opportunity to invest in a project with a 50% probability of returning $750 and a 50% probability of returning only $250, one year after the investment is made. The expected value of the project therefore is \(0.5(750) + 0.5(250) = 500\). Assume further that the project requires an investment of $400, generating an expected return of 25% for the year. Finally, assume the risk-free rate of interest \((R_f)\) is 5% and that equity requires a return on its entrepreneurial skills \((R_{ent})\) (for finding and managing the project) of 1.25%. Taking the desirability of the project itself as a given,\(^{223}\) the following analysis considers the effect of (1) financing the project through new equity capital, (2) financing the project through new unsecured debt financing, (3) financing the project through secured financing, and (4) financing the project through a sale of receivables. The results of this analysis are summarized in Table 1.

The required return on the project can be determined by adding \(R_f\), \(R_{ent}\), and a risk premium \((R_p)\) determined by the formula \(R_p = p(L)/C\), where \(p\) is the probability of failure, \(L\) is the total amount of loss in the event of failure, and \(C\) is the investment in the project. \(L\) can be further defined as \(I - S\), where \(I\) is the amount of the investor’s investment in the firm and \(S\) is the amount obtained at the end of the project under the worst case scenario.\(^{224}\) Thus, the risk premium demanded by all investors is \(R_p = p(I-S)/C = 18.75\%\). The following

\(^{222}\) The following example should not be taken as an attempt at a proof of the irrelevance hypothesis itself. The example assumes that the hypothesis holds—that is, that the value of the firm’s assets is constant regardless of the financing options chosen. Modigliani and Miller have provided a theoretical proof of this proposition by showing that arbitrage would eliminate any disparity in firm market value between two firms with identical risks but with different financial structures. See Modigliani & Miller, supra note 20, at 268-73.

\(^{223}\) In order to isolate the effect of various financing options, it is necessary to assume here that management and the investors consider the overall return of the project as adequate to compensate the firm for the project’s risk.

\(^{224}\) This formula is a slight modification of a formula used by Alan Schwartz in determining the risk allocation effects of secured finance under the strictures of the irrelevance hypothesis. See Schwartz, Security Interests and Bankruptcy Priorities, supra note 25, at 8.
analysis isolates the return that would be demanded by various investor groups, assuming perfect information and (with respect to the existing investors) the ability to costlessly adjust the rate of interest charged on their loans.

Alternative 1: Equity Financing. Under the circumstances presented here, equity financing results in the shareholders bearing all of the risk of loss of the project and receiving all of the returns on the project. The existing debt holders are not adversely affected by the project. The balance sheet for the firm after the investment is:

| Assets (old) | 500 | Debt | 400 |
| Assets (new) | 250-750 | Equity | 350-850 |
| Total Assets | 750-1250 | Total | 750-1250 |

Even under the worst case scenario, the debt holders’ prospects for repayment are not impaired by the project. Formally, \( R_{p\text{, debt}} = \frac{.5(400 - 400)}{400} = 0 \).\(^{225}\) Equity investors bear all of the risk of the project. In this example, \( R_{p\text{, equity}} = \frac{.5(400-250)}{400} = 18.75\% \). Adding \( R_f \) (5%) and \( R_{\text{ent}} \) (1.25%) to \( R_{p\text{, equity}} \) (18.75%), we find that equity also receives all of the gains of the project (25%).

Alternative 2: Debt Financing. If the project is financed entirely by the issuance of new unsecured debt, all of the investors share in the risk of project failure, and all will demand a return sufficient to compensate them for bearing that risk. The balance sheet under this alternative is:

| Assets (old) | 500 | Debt | 800 |
| Assets (new) | 250-750 | Equity | <50> - 450 |
| Total Assets | 750-1250 | Total | 750-1250 |

Both the new investors and the old will demand return based on \( R_{p\text{, debt}} = \frac{.5[400 - .5(750)]}{400} = 3.125\% \).\(^{226}\) In addition, the new investors will demand and receive \( R_f \) to compensate them for the time value of the new money. Equity’s return on the project will equal

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225. In fact, the debt holders’ risk is actually reduced in this example, because the additional project provides additional assets to insure against a decline in the value of the original assets. This effect is not depicted here, because the example analyzes the effect of financing decisions regarding the new investment only.

226. For simplicity, this example assumes that the firm will be liquidated under the bankruptcy code, when insolvent. Thus, where, as here, the assets are insufficient to satisfy their claims, investors will share pro-rata in the available assets. Since each group of investors have invested $400 in the firm, they will share 50-50 in all available assets. The effect of relaxing the assumption of pro-rata sharing can be seen in Alternative 3 below. Also, because they are protected by limited liability, equity will not be required to pay over $50 to the debt holders on account of the negative equity balance.
\( R_{p\text{ equity}} = 0.5(100-0)/400 = 12.5\% \) plus \( R_{\text{ent}} (1.25\%) \) for a total return of 13.75\%. Again the total return \( (R_f + R_{\text{ent}} + 2R_p \text{ debt} + R_p \text{ equity}) \) equals 25\%.

**Alternative 3: Secured Financing.** The only change in this alternative is that the new debt investors have a priority in all of the firm’s assets upon failure of the project. Therefore, the new debt investors are assured of repayment and \( R_p \text{ new debt} = 0 \). New debt will demand only \( R_f \). Equity faces the same prospects under this alternative as under Alternative 2 (\( R_{p\text{ equity}} = 0.5(100-0)/400 = 12.5\% + R_{\text{ent}} = 13.75\%) \). The old debt holders find their risk increased under this alternative and will demand \( R_p \text{ old debt} = 0.5(400-350)/400 = 6.25\% \). Of course, this increased interest is matched by a decrease in the amount demanded by the new debt holders because of their security interest.

**Alternative 4: True Sale of Assets.** Except for the introduction of a new participant—the buyer of assets—and a change in the balance sheet, the results for old debt and equity under this alternative are the same as those obtained under Alternative 3. The balance sheet for this alternative is:

\[
\begin{array}{ccc}
\text{Assets (old)} & 100 & \text{Debt} & 400 \\
\text{Assets (new)} & 250-750 & \text{Equity} & <50> - 450 \\
\text{Total Assets} & 350-850 & \text{Total} & 350-850 \\
\end{array}
\]

In this example, \( R_f \) goes to the buyer of assets, who then ends its relationship with the firm and is thereafter unaffected by the results of the project. Equity demands and receives \( R_{p\text{ equity}} = 0.5(100-0)/400 = 12.5\% \) and \( R_{\text{ent}} = 1.25\% \) (for a total of 13.75\%). Old debt holders demand and receive \( R_p \text{ old debt} = 0.5(400-350)/400 = 6.25\% \). The risk allocation and return are the same in this alternative as under Alternative 3.
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<tr>
<th>Alternative 1</th>
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**TABLE 1**

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(Values are in percentages; $R_p$ is the required rate of return, $R_f$ is the risk-free rate, $R_{c, equity}$ is the cost of equity, $R_{p, equity}$ is the required rate of return on equity, $R_{p, old debt}$ is the required rate of return on old debt, and $R_{p, new debt}$ is the required rate of return on new debt.)
This example illustrates the ways in which financing choice allocates risk to various classes of investors. Because the overall cost of capital is 25% under each of the alternatives, the firm should have no preference for any particular financial structure over another. It should simply pick the structure that is the cheapest and quickest means of obtaining capital. In this world of perfect markets, there would be no reason for firms to incur the transaction costs involved in asset securitization. In fact, given that the initial development of the approach is costly, there would be no reason for asset securitization to exist in the first place.