Reforming the True-Sale Doctrine

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The true-sale doctrine is central to the multi-trillion dollar asset-backed securities (ABS) market. The assets backing ABS are only bankruptcy-remote if they were assigned in a true sale, rather than as collateral for a loan, and it is the true-sale doctrine that distinguishes sales from loans. Despite its importance, the doctrine is inconsistent, lacks normative direction, and is under-theorized. Negotiations regarding the status of securitized assets in bankruptcy—affecting creditors such as employees, retirees, and tort claimants—happen in the shadow of the law. This Essay argues that state lawmakers should formulate true-sale rules that codify the relevance of price in true-sale analyses. The price that a company receives in exchange for securitized assets represents value with which to distinguish between problematic judgment-proofing on the one hand, and, on the other hand, assignments that isolate assets from bankruptcy in a way that is fair and produces efficiencies. Reforming the true-sale doctrine to ensure economic substance-based determinations that consider price terms could fortify unsecured creditors' positions. In addition, such reform would reinforce appropriate boundaries between state commercial laws and federal bankruptcy policy.

Introduction

The true-sale doctrine determines the status of securitized assets: it is the state-law doctrine that distinguishes sales from loans. When companies assign large pools of receivables to a special-purpose entity in order to raise capital, the true-sale doctrine governs characterization of the assignment, and therefore whether creditors can reach such assets in bankruptcy. Despite the fact that the

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true-sale doctrine governs transactions that are central to the multi-trillion-dollar securitization market, the doctrine is inconsistent, lacks normative direction, and is under-theorized.[1] This Essay argues that lawmakers should formulate state, statutory true-sale rules and that such rules should establish the relevance of price in true-sale analyses.[2]

This Essay builds directly upon my recent work, *Property and the True-Sale Doctrine*.[3] That article maps arguments about the efficiency and desirability of securitization[4] to varying formulations of the true-sale doctrine.[5] While discussion of securitization's efficiency is plentiful, scholars and policy-makers have not sufficiently related positions on securitization to formulations of the true-sale doctrine. Different views on securitization would suggest

1. *See* Heather Hughes, *Property and the True-Sale Doctrine*, 19 U. PA. J. BUS. L. 870 (2017) [hereinafter Hughes, *Property*]; Robert D. Aicher & William J. Fellerhoff, *Characterization of a Transfer of Receivables as a Sale or a Secured Loan Upon Bankruptcy of the Transferor*, 65 AM. BANKR. L.J. 181, 186-98 (1991); Steven L. Harris & Charles W. Mooney, Jr., *When Is a Dog's Tail Not a Leg?: A Property-Based Methodology for Distinguishing Sales of Receivables from Security Interests That Secure an Obligation*, 82 U. CIN. L. REV. 1029 (2014); Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 161 (1996).

2. This Essay is not the first call to clarify and codify the true-sale doctrine. Edwin E. Smith proposed a drafting committee to formulate true-sale rules in 2001. *See* Edwin E. Smith, *Proposal for a Uniform State Law on What Constitutes a True Sale of a Right to Payment* (Confidential Discussion Draft in Process, 2002) (on file with author). Steven L. Harris and Charles W. Mooney, Jr. published an article in 2014 calling for true-sale rules that mirror the uniform commercial code true-lease provisions. *See* Harris & Mooney, *supra* note 1. These existing proposals have not yielded model provisions or other codified reform. This Essay, along with *Property and the True-Sale Doctrine*, builds upon and departs from these prior proposals. It joins them in calling for coherent true-sale rules. It builds upon the notion that true-sale rules should look to economic substance of a transaction and should be explicitly property-based. It departs from prior efforts in that it (i) overtly links the doctrine to the literature on the efficiency and fairness of securitization, and (ii) focuses on the relevance of price terms and the property concept of rights of exclusion, considering when and why companies should exclude unsecured creditors from securitized assets. (The minority of states that enact asset-backed securities facilitation acts, of course, do have statutory true-sale rules, albeit very different ones from what this Essay, or Smith, or Harris and Mooney would propose. *See infra* text accompanying notes 27, 35; Hughes, *supra* note 1, at 905-910.)

3. Hughes, *Property*, *supra* note 1. This piece is the third in a series about the under-explored potential of state private laws for market governance and financial regulation. The first such article explores the emerging relevance of property concepts for financial product regulation. *See* Heather Hughes, *Financial Product Complexity, Moral Hazard, and the Private Law*, 20 STAN. J. L. BUS. & FIN. 179 (2015) [hereinafter Hughes, *Financial Product Complexity*]. The second, *Property and the True-Sale Doctrine*, considers a particular doctrine integral to the creation of financial products—the true-sale doctrine—and its relationship to arguments about securitization's efficiency and to property law.

4. The term "securitization" often lacks definition in secondary sources and in laws that reference the term. *See* Jonathan C. Lipson, *(Re)Defining Securitization*, 85 S. CAL. L. REV. 1229, 1232-33 (2012) (arguing for a coherent definition of "securitization"). Lipson finds "over two dozen regulatory and statutory definitions of the word 'securitization,'" compounded by various definitions used by market actors and commentators. *Id.* at 1257. This Essay refers specifically to receivables securitizations: transactions in which a company (the originator) assigns receivables to a bankruptcy-remote special purpose entity (SPE) that issues securities that are backed by the pool of receivables. In order to successfully isolate the assets from bankruptcy risk of the originator, the SPE must be a separate entity not subject to consolidation, and the assignment of receivables must be a true sale (not a secured loan). For a more extensive definition of "receivables securitization," see Hughes, *Property*, *supra* note 1, at 881.

5. *See* Hughes, *Property*, *supra* note 1.

different normative positions on true-sale rules. *Property and the True-Sale Doctrine* does the work of mapping descriptions of securitization's efficiency to varying normative positions on the true-sale doctrine.[6] This Essay will not repeat that exercise. *Property and the True-Sale Doctrine* fills a gap in the literature by (i) explicitly linking true-sale rules to views on securitization's efficiency and by (ii) elucidating how we might better ground true-sale rules in property law principles. In doing so, it demonstrates the importance of the doctrine and its current lack of normative direction or consistency.[7] However, it is agnostic on the question of what approach to the true-sale doctrine is the right or the best approach.

This Essay takes the next step of proposing an approach to true sales of receivables that confers rights of exclusion from securitized assets in a way that is better justified and clearer than the current law. It argues that states should consider statutory provisions to codify the relevance of price as a factor in true-sale analyses. Enacting an approach to true sales that is rooted in an economic substance analysis that considers price would ground true-sale rules and the legal underpinnings of receivables securitization in well-established property law strategies for determining the scope of a conveyance and the rights of exclusion it creates.[8] Price terms are relevant and important,[9] and their relevance in true-sale determinations should therefore be codified. The price that a company receives in exchange for securitized assets represents value with which to distinguish problematic judgment proofing[10] from assignments that are more likely to be efficient and more likely to be fair to non-adjusting creditors.[11]

Some commercial law scholars entertain creating a model act or revising the uniform commercial code only in the context of industry demand for change or clarification.[12] There is at present no such industry demand for true-sale doctrine reform. This Essay contends that maintaining the rule of law in capital markets and protecting the positions of creditors in weak bargaining positions, warrants the custodial work of improving the true-sale doctrine regardless of the financial industry's lack of urgency or concern. Currently, negotiations regarding the status of securitized assets in bankruptcy—affecting creditors such as employees, retirees, and tort claimants—happen in the

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6. *Id.*

7. *Id.* at 875.

8. *See* Hughes, *Property*, *supra* note 1, at 914-19.

9. *See infra* text accompanying note 55.

10. For discussion of "judgment proofing" and its relevance here, see *infra* text accompanying notes 56-59.

11. Non-adjusting creditors are parties (like employees or suppliers) who extend credit to the company but cannot adjust their rate of return in response to the increased risk that a change in capital structure may present. For citations and discussion of non-adjusting creditors, Franco Modigliani's and Merton Miller's irrelevance theorem, and "the puzzle of secured credit," see Hughes, *Property*, *supra* note 1, at 884.

shadow of the law. A true-sale doctrine that ensures economic substance-based determinations could fortify such creditors' positions and would ground the legal infrastructure of securitization in well-established commercial law principles.

In addition, true-sale rules operate within an allocation of institutional authority that distinguishes states' authority over commercial law and private-law rights from federal authority under the bankruptcy code. True-sale rules that contravene established property or commercial law principles to direct bankruptcy outcomes may face federal preemption.[13] Statutory provisions codifying an approach to true sales that is economic substance-based would ground the doctrine within the scope of states' commercial law rulemaking authority.[14]

This Essay advances a type of rule-of-law project. True-sale rules are property law—they determine the scope of interest that an assignment of receivables creates in any given transaction. Yet the property-based nature of the true-sale doctrine is obscured by statutes and confusing factors-based approaches that suggest that a contract's form—rather than the economic substance of the transaction the contract reflects—controls characterization of receivables assignments.[15] The doctrine is meant to align property rights and risk. Characterizing a deal according to its actual economic content prevents regulatory arbitrage. If the doctrine is well-administered, parties cannot avoid bankruptcy rules or UCC Article 9 rules for disposition of collateral by calling their transaction a "sale" when it reflects intent to create a loan.

By arguing for property-based true-sale rules in which the relevance of price is codified, this Essay adds to a larger project on the under-explored potential of property-law doctrines for market governance.[16] This larger project seeks to fortify the legal infrastructure of capital markets by (i) asserting that property-law concepts have untapped potential for market governance,[17] (ii) explicating the relationship between one private-law doctrine (the law of true sales of receivables) and the extensive financial market to which it is integral (securitization),[18] and now (iii) proposing an approach to the true-sale doctrine that is rooted in property-law strategies for characterizing the scope of a conveyance and that improves the doctrine's coherence while contemplating its potential externalities.

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13. *See* Ronald J. Mann, *The Rise of State Bankruptcy-Directed Legislation*, 25 CARDOZO L. REV. 1805, 1819 (2004); Tara L. Carrier, *Unsafe Harbors: Why State Securitization Statutes Won't Protect Against Recharacterization in Bankruptcy* (March 19, 2018) (unpublished manuscript) (on file with author); *infra* text accompanying note 51.

14. Mann, *surpa* note 13.

15. *See* Hughes, *Property*, *supra* note 1, at 914.

16. *See supra* note 3.

17. *See* Hughes, *Financial Product Complexity*, *supra* note 3.

18. *See* Hughes, *Property*, *supra* note 1.

Part I summarizes the true-sale doctrine and the inadequacy of current formulations and academic recommendations. It then contends that uniform state statutory provisions are appropriate to reform the doctrine. It argues in favor of state laws that codify an economic substance-based approach to true-sale determinations, and it discusses the relationship between commercial law and bankruptcy law. Part II argues for codifying the relevance of price as a factor in distinguishing sales of receivables from loans collateralized by receivables. Part III calls for a Uniform Law Commission[19] drafting committee to create a model act, or to revisit relevant provisions of the Uniform Commercial Code (UCC), to engage in the task of formulating better true-sale rules.

I. The Case for Uniform True-Sale Rules

The true-sale doctrine distinguishes assignments to secure loans from true sales, after which assets are the property of a special-purpose entity,[20] reachable exclusively by investors. Given that the doctrine governs receivables securitizations,[21] bankruptcy and, in some instances, accounting outcomes[22] hinge on this doctrine's correct administration.

The importance of the true-sale doctrine may not be obvious given that, regardless of how true-sale disputes are resolved, investors in securitized receivables prevail over competing claimants. But focusing on investor priority regardless of deal characterization underestimates the consequences of true-sale rules. Assets reachable in bankruptcy, even if subject to a first-priority security interest, may be used to service obligations during bankruptcy proceedings and may be assigned to obtain continuation financing.[23] Bankruptcy-remote assets, on the other hand, cannot be used in these ways. Also, whether a company can

19. The Uniform Law Commission, in conjunction with the American Law Institute (ALI), creates model laws. The Commission convenes drafting committees to craft model acts or provisions that then may be enacted by state legislatures.

20. This entity isolates assets from bankruptcy risk. *See infra* text accompanying note 21. In some instances, the entity is also off-balance sheet. *See* Thomas E. Plank, *Securitization of Aberrant Contract Receivables*, 89 CHI.-KENT L. REV. 171, 187 n.56 (2013).

21. Again, these are transactions in which a company assigns receivables to a bankruptcy-remote special purpose entity (SPE) that issues securities backed by the receivables. The SPE is a distinct legal entity not subject to consolidation with the originator in bankruptcy; the assignment of receivables is a true sale, not a secured loan. The true-sale doctrine determines whether the assignment from the originator to the SPE is actually a sale as opposed to an assignment of collateral. *See* Hughes, *Property*, *supra* note 1, at 871.

22. *See* Fin. Accounting Standards Bd. [hereinafter FASB], Accounting Standards Codification, Topic 860*, Transfers and Servicing* (2009) (replacing FASB, Statement of Financial Accounting Standards [hereinafter FAS] No. 166, which replaced FAS No. 140); Summary of Statement of No. 140: *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities – A Replacement of FASB Statement No. 125*, FASB (Sept. 2000), http://www.fasb.org/summary/stsum140 [http://perma.cc/EK5M-R4NE].

23. *See* Hughes, *Property*, *supra* note 1, at 872.

reach assets in bankruptcy affects the efficiency of continuation and liquidation decisions.[24] In short, the fact that investors can assert the priority of their interests regardless of whether they obtained them in a true sale does not mean that the true-sale doctrine is inconsequential for unsecured creditors.

At present, the true-sale doctrine lacks consistency and normative direction. Factors-based common law approaches do not cohere around an established list of factors, though price and recourse often emerge as important.[25] Statutory true-sale rules enacted in a minority of states override economic substance-based true-sale determinations and disregard the interests of unsecured creditors, creating uncertainty regarding the application of such rules in bankruptcy proceedings.[26]

Commercial law scholars Steven Harris and Charles Mooney have proposed a "property-based methodology" for making true-sale determinations that disregards both recourse and price and asks only whether a company retains an interest in securitized assets that secure an obligation.[27] Their proposal does not sufficiently explicate the property interest a company retains, and it relies on an analogy to the true-lease context that does not fully consider important distinctions between receivables securitizations and leasing transactions.[28] In short, each existing approach or proposal is problematic.

The UCC leaves the task of determining true sales of rights to payment to the courts. Given the fact-specific nature of characterizing assignments of receivables, it may seem infeasible to codify true-sale rules that root characterization in economic substance.[29] Uniform true-sale provisions, however, do not need to determine characterization in all contexts. Provisions that create a safe harbor, or that codify the relevance of specific factors, could provide clarity and coherence without requiring statutory language that disposes of fact-specific, true-sale analyses. In fact, in 2001 Uniform Law Commissioner Edwin Smith suggested that the Commission consider a uniform law to create a safe harbor as to what will qualify as a true sale of rights to payment and to determine which state's law applies when determining whether

24. *See* Kenneth Ayotte & Stav Gaon, *Asset-Backed Securities: Costs and Benefits of Bankruptcy Remoteness*, 24 REV. FIN. STUD. 1299; Hughes, *Property*, *supra* note 1, at 872.

25. *See* Hughes, *Property*, *supra* note 1, at 901.

26. *Id.* at 905.

27. *See* Steven L. Harris & Charles W. Mooney, Jr., *When Is a Dog's Tail Not a Leg?: A Property-Based Methodology for Distinguishing Sales of Receivables from Security Interests That Secure an Obligation*, 82 U. CIN. L. REV. 1029 (2014).

28. *See* Hughes, *Property*, *supra* note 1, at 877.

29. *See, e.g.*, National Conference of Commissioners of State Laws, Committee on Scope and Program, Minutes of January 11, 2002, meeting, Baltimore, Maryland, http://www.uniformlaws.org/Shared/meetings/Sp011102mn.pdf [http://perma.cc/V5QW-BU5P] (discussing Commissioner Smith's report on whether there should be a uniform law on what constitutes a true sale of a right to payment and noting concern about "whether such an act could be effective in a fact-specific area").

there is a true sale.[30] Commissioner Smith issued a discussion draft outlining reasons for codifying true-sale rules,[31] but his proposal did not ultimately result in draft provisions.[32]

The reasons cited in 2001 for proposing the possibility of uniform true-sale rules included: (i) that lawyers' true-sale opinion letters create "considerable transaction costs"[33] because the result is not clear, (ii) that "quirky statutes and decisions"[34] exist, (iii) that "some states are passing legislation that ignores creditors' rights issues,"[35] and (iv) that the federal government was considering the issue in the bankruptcy law context.[36] Today, some of Smith's reasons for proposing uniform true-sale rules are still salient, while others are less so. True-sale opinions still involve considerable cost. However, the "quirky" decision in *Octagon Gas Systems, Inc.*,[37] to which Smith presumably refers, has been widely criticized, including by the Permanent Editorial Board of the Uniform Commercial Code.[38] On the other hand, the "quirky" interim order issued in *In re LTV Steel Company* to which Smith presumably refers continues to shape discussion of securitization and true sales despite the fact that it is not a true-sale doctrine precedent.[39] On the legislative front, a number of states do enact asset-backed securities facilitation acts ("ABS statutes")—legislation that ignores creditors' rights issues.[40] However, the proposed federal bankruptcy law provisions regarding true sales

30. *See* National Conference of Commissioners of State Laws, Committee on Scope and Program, Minutes of August 11, 2001, meeting, White Sulphur Springs, West Virginia, http://www.uniformlaws.org/shared/minutes/scope_081101mn.pdf [http://perma.cc/7VH5-UN56].

31. *See* Smith, *supra* note 2.

32. *See* National Conference of Commissioners of State Laws, Committee on Scope and Program, Minutes of January 11, 2002, meeting, Baltimore, Maryland, http://www.uniformlaws.org/Shared/meetings/Sp011102mn.pdf [https://perma.cc/V3VR-URMK]; *see also* Kenneth C. Kettering, *True Sale of Receivables: A Purpose Analysis*, 16 AM. BANKR. INST. L. REV. 511, 524-25, 560 (2008) (mentioning Smith's proposal and that it did not result in model provisions).

33. *See* National Conference of Commissioners of State Laws, Committee on Scope and Program, Minutes of January 11, 2002, meeting, Baltimore, Maryland, *supra* note 30, at 8.

34. *See id.* at 8.

35. *See id.* at 8. Smith is referring to the ABS statutes, presumably. *See* Hughes, *Property*, *supra* note 1, at 905-09.

36. National Conference of Commissioners of State Laws, Committee on Scope and Program, Minutes of August 11, 2001, meeting, White Sulphur Springs, West Virginia, http://www.uniformlaws.org/shared/minutes/scope_081101mn.pdf [http://perma.cc/H7K2-XFB2].

37. Octagon Gas Systems, Inc. v. Rimmer, 995 F.2d 948 (10th Cir. 1993), *cert. denied*, 114 S. Ct. 554 (1993).

38. *See* PEB Commentary No. 14, June 10, 1994.

39. *See* Hughes, *Property*, *supra* note 1, at 899.

40. These statutes deem all assignments of receivables for purposes of securitization to be sales, regardless of economic substance. They confer "sale" status on transactions the economic substance of which would not otherwise warrant that status. *See* ALA. CODE § 35-10A-2(a)(1) (2016); DEL. CODE ANN. tit. 6, §§ 2701A-2703A (West 2016); LA. STAT. ANN. § 109-109(e) (2016); NEV. REV. STAT. §§ 100.200-100.230 (West 2017); OHIO REV. CODE ANN. § 1109.75 (West 2016); N.C. GEN. STAT. ANN. §§ 53-425, 53-426 (West 2015); S.D. CODIFIED LAWS § 54-1-10 (2016); TEX. BUS. & COM. CODE ANN. § 9-109(e) (West 2015); VA. CODE ANN. § 6.1-473 (West 2008); *see also* Hughes, *Property*, *supra* note 1, at 876.

of receivables in Section 912,[41] to which Smith presumably refers, were withdrawn in 2002.[42]

The Uniform Law Commission responded to Smith's suggestion by declining to move forward with a drafting effort,[43] citing the difficulties that arise from the fact-intensive true-sale determinations, and the absence of a need for such effort given the lack of industry demand for revised rules.[44]

Again, this Essay rejects the notion that reforming true-sale rules should only happen in response to industry demand. Lack of industry demand may be a function of the fact that the financial industry potentially benefits from approaches that fortify investors' positions at the expense of unsecured creditors. In theory, bringing clarity to the legal foundations of asset-backed securities is in the interest of investors as well as companies securitizing assets. But in practice creditors in weak bargaining positions have more to gain from the type of approach articulated here than investors, and it is investors who would articulate industry demand to which uniform law commissioners would respond.

The true-sale doctrine is integral to capital markets and can affect the positions of non-adjusting and non-consenting creditors.[45] When a company is in financial distress, the state of the law informs negotiations and proceedings regarding the status of securitized assets. Rules that codify an economic substance-based approach to true sales could fortify the positions of such creditors. In addition, proposing uniform, statutory true-sale rules is a type of rule-of-law project; it is custodial. In addition to clarifying the law, codifying an economic substance-based approach that establishes the relevance of price terms reinforces appropriate boundaries between state commercial laws and federal bankruptcy policy.

Ronald Mann discusses the federalism concerns that securitization presents when state true-sale rules are formulated to direct bankruptcy outcomes, calling out the ABS statutes as problematic.[46] The bankruptcy code generally leaves to state law the determination of property rights in a bankruptcy estate.[47] Therefore, the rules governing commercial transactions affect bankruptcy outcomes. The bankruptcy code attempts to maintain a boundary between state rulemaking authority (which includes elucidating

41. *See* Bankruptcy Reform Act of 2001, S. 220, 107th Cong.; H.R. 333, 107th Cong. § 912(i) (2001).

42. *See* Hughes, *Property*, *supra* note 1, at 924.

43. *See* National Conference of Commissioners of State Laws, Committee on Scope and Program, Minutes of January 11, 2002, meeting, Baltimore, Maryland, at 2, http://www.uniformlaws.org/Shared/meetings/Sp011102mn.pdf [http://perma.cc/2CJL-S8HM].

44. *Id.*

45. Non-consenting creditors (like tort judgment holders) are not only non-adjusting, they did not consent to extend credit to the company in the first place. *See infra* text accompanying note 58.

46. *See* Mann, *supra* note 13.

47. Butner v. United States, 440 U.S. 48, 54-55 (1979); Mann, *supra* note 13, at 1808.

contract and property rights) and federal rulemaking authority (to administer the kinds of relief and asset disposition that bankruptcy contemplates). Mann observes that states challenge this boundary, however, when they "cheat" by issuing "rules that formally operate as ordinary rules of commercial law but in fact are directed at situations of business failure, i.e., state-promulgated bankruptcy-directed legislation."[48]

The ABS statutes present an example of such legislation. As Mann states:

> [T]hose statutes allow the parties to have their transaction treated as a sale for bankruptcy purposes without obligating the purchaser to take on the risks that would be inherent in a complete transfer of the assets from the purported seller. Again, because the principal purpose of those statutes is to affect bankruptcy outcomes, they afford a prime example of bankruptcy-directed legislation.[49]

Mann undertakes the tricky task of distinguishing legitimate state laws from problematic, boundary-violating laws by focusing on a statute's effects. He asserts that the concern lies with laws that have no notable effect outside of bankruptcy.[50]

Mann's approach raises complex questions. For example, one might ask what effects any true-sale rules, or UCC Article 9 priority rules for that matter, have outside of bankruptcy. The point here is to identify that true-sale rules are state commercial laws that operate within an allocation of institutional authority that distinguishes states' authority over private-law rights from federal authority under the bankruptcy code. If state true-sale rules depart from established property or commercial law concepts, they may be preempted by federal bankruptcy law.[51] Uniform, statutory provisions codifying an approach to true sales based on economic substance would ground the doctrine within the purview of states' commercial law rulemaking authority.

Uniform, state statutory provisions face the challenge that state legislatures may decline to enact them. States that already enact an ABS statute, for example, may not consider replacing that legislation with a proposed alternative along the lines discussed here. Given the risk that an ABS statute could be preempted in bankruptcy,[52] and given the current state of the true-sale doctrine, Congress could consider adding provisions to the bankruptcy code to effectuate state statutory true-sale rules devised by a Uniform Law Commission drafting committee regardless of how widely states adopt them. The Uniform Law Commission and federal statute drafters have contemplated this approach when a federal law would require UCC reform to achieve its objectives, but not all states will necessarily enact the reform provisions.

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48. Mann, *supra* note 13, at 1810.
49. *Id.* at 1818.
50. *Id.* at 1819.
51. *Id.*
52. *See* Carrier, *supra* note 13; Hughes, *Property*, *supra* note 1, at 908.

The Federal Reserve Bank of New York has been drafting a "National Mortgage Note Repository Act" for possible enactment by Congress.[53] The act would create a national note registry to clarify questions such as who is a holder of a note with enforcement capacity, thereby addressing issues that can destabilize foreclosure proceedings. The Uniform Law Commission has convened a committee to draft revisions to UCC Articles 1, 3, 8, and 9, to harmonize the UCC with the proposed federal law. The UCC drafting committee has created draft choice-of-law provisions for the Repository Act that direct a court to look to state law to resolve a commercial law matter. However, the provisions direct the court to "apply the law of that State if the UCC Amendments are in force in that State . . . . If the UCC Amendments are not in force in that State, the court would resolve the commercial-law matter by applying the law of that State as if the UCC Amendments are in force in that State."[54]

The Repository Act has a very different purpose from the bankruptcy code, and a different relationship to state commercial laws given its objectives. Drafters are still formulating the Repository Act. The related UCC amendments are under construction as well. While lawmakers may ultimately reject the Repository Act's approach, the concept that a federal law could generate the effect of uniform enactment of Uniform Law Commission statutory provisions with this type of federal statutory provision raises an interesting possibility for reforming the true-sale doctrine.

II. The Relevance of Price Terms

Literature on the efficiency of securitization impliedly assumes that companies receive an adequate price for assets assigned for purposes of securitization.[55] For example, Steven Schwarcz distinguishes "legitimate securitization transactions from judgment proofing"[56] by explaining that in a securitization, originators receive value in exchange for assets securitized. Schwarcz responds to critics who contend that securitization is an inefficient and unfair form of judgment proofing against claims of unsecured creditors.[57]

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53. *See* Draft of the National Mortgage Note Act of 2018 (January 28, 2018), http://www.uniformlaws.org/shared/docs/UCC%201,%203,%209/2017AM_UCC139_NatlMortRepAct_PublicDraft.pdf [http://perma.cc/MGN5-YAHQ].

54. Steven L. Harris, Reporter, Memorandum re: Choice of Law in the National Mortgage Note Repository Act of 2018 (February 22, 2018), http://www.uniformlaws.org/shared/docs/UCC%201,%203,%209/2018mar_UCC1389_Memo%20re%20Choice%20of%20Law_Harris_2018feb22.pdf [http://perma.cc/7L3U-2QSW].

55. *See* Hughes, *Property*, *supra* note 1, at 886-87.

56. Steven L. Schwarcz, *Ring-Fencing*, 87 S. CAL. L. REV. 69, 83 n.94 (2013); Steven L. Schwarcz, *The Conundrum of Covered Bonds*, 66 BUS. LAW. 561, 583-84 (2011).

57. *See* Lynn M. LoPucki, *The Irrefutable Logic of Judgment Proofing*, 52 STAN. L. REV. 55, 59-67 (1999) (analyzing Steven L. Schwarcz's response to LoPucki's *The Death of Liability* to refute the argument that the costs of judgement-proofing outweigh the benefits); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L. J. 1 (1996). *But see* Steven L. Schwarcz, *The Inherent Irrationality of*

These critics point out that securitization artificially depresses costs of capital for originators by shifting those costs to non-adjusting creditors.[58] Some critics find both securitization and first-priority secured lending to be an unfair form of judgment proofing in that it permits companies and investors to contract away the claims of non-adjusting third parties. Critics also find securitization, and secured lending, to be inefficient in the sense that these transactions externalize costs onto non-adjusting creditors.

The responses to these criticisms vary and include the observation that many forms of established commercial activity could be called "judgment proofing." Consider the "judgment proofing" effects, for example, of limited liability entities or of property conveyances creating rights of exclusion generally. Commentators respond on the efficiency point as well, arguing that the wealth generated by securitization is greater than the costs externalized to unsecured creditors.

This Essay takes the view that we do not know, as an empirical matter, whether securitization is in fact efficient. As such, this Essay works from the premises that securitization can present the possibility of inefficient externalization of costs onto non-adjusting creditors, and that the isolation of assets from company bankruptcy proceedings should correspond to added value contributed to the company in order to mitigate the risks of unfairness and inefficiency. The distinction between problematic judgment proofing and legitimate securitization implies that originators are exchanging assets for cash of equivalent value. If the true-sale doctrine does not assess price provisions, then companies are free to securitize assets on terms that extract an unfair and inefficient subsidy from non-adjusting creditors.

While many courts consider the purchase price as a factor in true-sale analyses, they are not obligated to do so, as there is no codified list of factors.[59] In states that enact an ABS statute, price is explicitly irrelevant.[60] While some commentators disagree on the relevance and importance of price terms in characterizing assignments of receivables,[61] this Essay argues that the

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Judgment Proofing, 52 STAN. L. REV. 1 (1999) (arguing, through an economic analysis, that judgment-proofing techniques, such as LoPucki's, may not be standard practice); James J. White, *Corporate Judgment Proofing: A Response to Lynn LoPucki's The Death of Liability*, 107 YALE L.J. 1363 (1998) (arguing that American businesses are making themselves increasingly judgment-proof).

58. *See* Richard Squire, *The Case for Symmetry in Creditors' Rights*, 118 YALE L.J. 806, 838-42 (2009) (stating that debtor opportunism in shifting costs to non-adjusting creditors is the most likely explanation for the persistence of asymmetrical asset partitioning). *Cf.* Yair Listokin, *Is Secured Debt Used to Redistribute Value from Tort Claimants in Bankruptcy? An Empirical Analysis*, 57 DUKE L.J. 1037, 1076 (2008) (finding that firms with high uninsured tort risk do not issue more secured debt than other firms, negating the redistribution theory of secured credit).

59. *See* Harris & Mooney, *supra* note 27, at 1040; *see also* Robert D. Aicher & William J. Fellerhoff, *Characterization of a Transfer of Receivables as a Sale or a Secured Loan Upon Bankruptcy of the Transferor*, 65 AM. BANKR. L.J. 181, 186-98 (1991) (detailing the various factors courts use in examining sale and loan determinations for purposes of the true-sale doctrine); Hughes, *Property*, *supra* note 1, at 901.

60. *See* Hughes, *Property*, *supra* note 1, at 905-910.

61. *See* Hughes, *Property*, *supra* note 1, at 910.

relevance of price terms should be codified to ensure that true-sale determinations take price into account.

Price terms may be challenging to evaluate given the complexity of receivables securitization and the intricate combinations of recourse, servicing obligations, and discounting that receivables assignments involve.[62] Yet despite this complexity, scholars have argued before that true-sale analyses should tackle the question of adequate price.[63] For example, Thomas Plank has stated that "[t]he first and most significant element of economic substance is the price paid for the loans,"[64] along with the parties' ostensible characterization in the deal documents. In addition to price and the parties' characterization, Plank argues that courts should determine how a transaction allocates the burdens and benefits of ownership. Determining which party has the preponderance of burdens and benefits of ownership, according to Plank, should be undertaken as a legal analysis, not an economic one.[65] The economic value of the burdens and benefits of ownership is relevant to assess whether the purchase price is of fair-market value for the receivables.[66] Aicher and Fellerhoff also direct courts to assess the adequacy of price when they characterize receivables assignments, despite the complexity of such assessment. They state that if the price paid by the purchaser—taking into account recourse provisions—is significantly less than what an informed buyer would pay a willing seller, then the transaction should be treated as a secured loan.[67]

This Essay builds on these earlier calls for the consideration of price in true-sale determinations by focusing on the significance of price in establishing the fairness and efficiency of the rights of exclusion from securitized assets that sale characterization creates. If investors have property rights in receivables sufficient to exclude non-adjusting creditors in bankruptcy, they should have completed a fair-market-value exchange for those receivables.

III. Directive for a Drafting Committee

This Part discusses the possibility of creating a model act or revising relevant UCC provisions to codify an economic substance-based approach to true sales that considers price terms.[68] A model act would be a stand-alone, state statute that enacts true-sale rules. Alternatively, there are a number of UCC sections that could be appropriate sites for provisions addressing true

62. *See id.* at 902-903; Aicher & Fellerhoff, *supra* note 59, at 209.

63. *See* Hughes, *Property*, *supra* note 1, at 876-877.

64. Plank, *supra* note 20, at 334.

65. *Id.* at 337-39.

66. *Id.* Plank notes that although courts have not always considered price in true-sale determinations, "using an analysis of the price paid for the loans would not have significantly changed the results of many court decisions." *Id.* at 334-335.

67. Aicher & Fellerhoff, *supra* note 59, at 207.

68. A drafting might also take up the issue of governing law. *See* Smith, *supra* note 2.

sales of receivables, such as Article 9's section 9-109, or Article 1's definitional provisions.

In order to formulate true-sale rules grounded in economic substance that establish the relevance of price, the Uniform Law Commission would need to convene a drafting committee. Drafting committees typically assume responsibilities in response to industry directives to facilitate certain types of transactions, to lower transaction costs, to allocate burdens of due diligence, and to complete other such goals. However, as discussed above, this Essay contends that industry demand is not a pre-requisite for engaging in the process of lawmaking to improve the rules governing a market-dominant transaction.[69] Taking seriously the custodial work of maintaining clear commercial law doctrines, grounded in private-law principles, supports Uniform Law Commission engagement with statutory true-sale rules.

The UCC maintains that although the question of deal characterization is left to the courts; it is economic substance that determines the status of a deal.[70] The UCC generally governs receivables securitizations (as defined in this project)[71] because the scope of Article 9 extends to "a sale of accounts, chattel paper, payment intangibles, or promissory notes."[72] In other words, Article 9 covers both secured loans and true sales of these assets. Section 9-318 confirms that a "debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold."[73]

This Essay concerns the integrity of state commercial laws and the expression of property principles to fortify the legal bases of securitization within the proper scope of states' rulemaking authority.[74] The federal bankruptcy code could be a viable site for true-sale reform as well.[75] The bankruptcy code could enact substantive true-sale rules along the lines of a model state act, or it could enact provisions designating certain state law provisions to be in effect for purposes of true-sale characterizations in bankruptcy.[76]

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69. *See supra* text accompanying notes 44-45.

70. The UCC as enacted in Louisiana and Texas depart from this baseline for receivables assignments, as discussed above, by enacting non-uniform section 9-109(e). *See infra* text accompanying notes 95-96.

71. *See supra* note 4; Hughes, *Property*, *supra* note 1, at 880-881 n.54.

72. *See* U.C.C. § 9-109(a)(3). Article 9 generally applies to secured transactions—meaning assignments of personalty to secure obligations. *See* U.C.C. § 9-109(a)(1). However, it extends its reach to commercial consignments and to sales of certain assets for policy reasons that are not at issue here. *See* U.C.C. § 9-109(a)(3) and (4).

73. *See* U.C.C. § 9-318(a).

74. *See supra* text accompanying notes 51-52; Mann *supra* note 13.

75. *See* Hughes, *supra* note 1, at 921-924.

76. *See supra* text accompanying note 54.

Model act. A number of states enact free-standing ABS statutes.[77] A drafting committee could undertake the task of formulating an alternative model of asset-backed securities act.

The ABS statutes call for broad construction of the term "securitization transaction."[78] An alternative model act could follow this same approach or could undertake a definition that specifies the category of deals to which the rules apply, providing a substantive formulation of "receivables securitization." As noted above and discussed elsewhere, the term securitization often lacks definition.[79] A model true-sale act could add definitional clarity.

To the extent lawmakers want simply to clarify the doctrine and fortify the legal infrastructure of securitization in a way that comports with states' commercial law rulemaking authority, a model act that references securitization generally and that construes the term broadly may be desirable. To the extent lawmakers agree with the contention of this Essay that true-sale rules should confer rights of exclusion against unsecured creditors in a way that is more likely to be fair and efficient, it may make sense to define "securitization" to limit the rules to contexts in which the transaction could, possibly, extract a subsidy from non-adjusting creditors.[80]

A model act could provide that in determining the legal characterization of an assignment of receivables, courts (i) may consider various factors, and (ii) shall consider price terms. Factors courts have considered, and could consider under a true-sale statute, include recourse to the seller, retention of servicing and commingling of proceeds, investigation of account debtors' credit, seller rights to excess collections, seller repurchase options, rights to unilaterally adjust pricing terms, rights to unilaterally alter other terms of transferred assets, the language of the documents, and the conduct of the parties.[81] The model act could authorize consideration of such factors, along with any other factor a court finds relevant to determining the economic substance of the transaction at issue.

The model could then include provisions stating that courts shall consider the adequacy of the price that the purchaser paid to the seller for the receivables, taking into account any relevant terms of the transaction. After such consideration, if the price the purchaser paid is inconsistent with what an informed buyer would pay an informed seller for the risks and benefits

77. *See* ALA. CODE § 35-10A-2(a)(1) (2016); DEL. CODE ANN. tit. 6, §§ 2701A-2703A (West 2016); NEV. REV. STAT. §§ 100.200-100.230 (West 2017); N.C. GEN. STAT. ANN. §§ 53-425, 53-426 (West 2015); OHIO REV. CODE ANN. § 1109.75 (West 2016); S.D. CODIFIED LAWS § 54-1-10 (2016); VA. CODE ANN. § 6.1-473 (West 2008).

78. DEL. CODE ANN. tit. 6 § 2702A ("It is intended by the General Assembly that the term 'securitization transaction' shall be construed broadly.").

79. *See supra* note 4; Hughes, *Property*, *supra* note 1; Lipson, *supra* note 4.

80. *See supra* text accompanying notes 56-58.

81. *See* Aicher & Fellerhoff, *supra* note 59, at 186-94; Hughes, *Property*, *supra* note 1, at 901.

transferred,[82] then the court shall find that the assignment constitutes security for a loan and not a true sale.

This type of approach would leave the heavy lifting of true-sale determinations to the courts. A model act could merely establish that true-sale determinations, to the extent the state's laws apply, are based on economic substance and sensitive to the relationship between price and intent to convey an ownership interest.

A drafting committee could consider any number of formulations, of course. A model act could delineate factors more precisely and it could create presumptions or allocate burdens of proof. The concept expressed here is a broadly conceived alternative to the existing ABS statutes. If those statutes codify an approach that elevates form over substance, an alternative model could codify the authority of economic substance while requiring consideration of price terms.[83]

UCC Article 1. Article 1 contains provisions that apply throughout the UCC, including important definitions. A drafting committee could revise Article 1 to contain: (i) a definition of true sale of receivables that creates a safe harbor for conforming transactions[84] or (ii) a definition of value, specific to the securitization context, that establishes a connection between the value given for receivables, and the scope of the interest a receivables assignment creates.

UCC Article 1 enacts a provision for distinguishing a true lease from a secured loan.[85] In the context of equipment finance, companies frequently acquire equipment in transactions that take the form of a lease, even though the transaction's objective is for the company to purchase the equipment. If the financing party is a lessor, then it owns the equipment and does not have to enforce its interest as a lien in the event the company files for bankruptcy. The true-lease doctrine distinguishes transactions that have the economic substance of a lease from those that are secured financings, taking the form of a lease solely for the purpose of avoiding UCC Article 9 and bankruptcy rules that protect debtors.

Equipment leasing presents a market context quite different from receivables securitization in which transacting parties enter into deals that may require re-characterization in the event of bankruptcy. In the true-sale context, a safe harbor that establishes when a sale of receivables occurs, but then directs courts to do a case-by-case characterization analysis in any context involving ambiguity may also make sense.[86] Harris and Mooney argue that the residual

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82. This formulation tracks Aicher and Fellerhoff's approach to true-sale determinations. *See* Aicher & Fellerhoff, *supra* note 59, at 207.

83. *See supra* text accompanying notes 55-67.

84. *Cf.* Harris & Mooney, *supra* note 27, at 1049-1053.

85. *See* U.C.C § 1-203.

86. For example, in bankruptcy, a true lease finding may permit the bankrupt lessee to continue to use the equipment as long as it makes lease payments. In contrast, a true sale finding for a receivables assignment means that the bankrupt company has no further access to an important cash

interest test in Section 1-203 provides a useful analogy for the true-sale context.[87] Whereas Section 1-203 looks to the existence of a residual interest in determining true-lease status, Harris and Mooney state that the law should ask whether or not an originator retains an economic interest in receivables it assigned to an SPE that secures an obligation.[88]

There are significant differences between the equipment leasing and the receivables securitization contexts that call into question the desirability of treating true sales as analogous to true leases for purposes of determining when assets will be bankruptcy remote.[89] However, a version of Harris and Mooney's proposal—one that more substantively defines "economic interest"—could lead to welcome true-sale doctrine reform. Determining whether an originator retains an economic interest in securitized receivables could involve, for example, consideration of whether investors paid a full, fair market value for the loans. A drafting committee could explore the validity of creating a safe harbor for true sales, drawing on Section 1-203 as a model.

For example, the beginnings of a draft provision could read:

> [Section 1-__] Sale of Receivables Distinguished from Security Interest.
>
> (a) Whether a transaction in the form of a sale of receivables creates a sale or security interest is determined by the facts of each case.
>
> (b) "Receivables" for purposes of this section shall mean [accounts, chattel paper, payment intangibles, or promissory notes].
>
> (c) A transaction in the form of a sale of receivables creates a security interest if the consideration that the purchaser is to pay the seller for the assignment of receivables [reflects an amount that is significantly less than what an informed buyer would pay a willing seller, taking into consideration all terms of the transaction].

The definition of "receivables" here tracks Section 9-109(a)(3).[90] A broader (or narrower) definition could be appropriate. The language in subsection (c) tracks Aicher and Fellerhoff,[91] but a more formulaic approach could be better.

UCC Article 1 contains a general definition of "value."[92] "Value" for a sale of receivables contemplated by Section 9-109(a)(3), as opposed to an

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flow. For discussion of distinctions between the equipment leasing and receivables securitization contexts, see Hughes, *Property*, *supra* note 1, at 910-914.

87. *See* Hughes, *Property*, *supra* note 1, at 911-913.

88. *See* Harris & Mooney, *supra* note 27, at 1031.

89. *See* Hughes, *Property*, *supra* note 1, at 877.

90. U.C.C. § 9-109(a)(3).

91. *See* Aicher & Fellerhoff, *supra* note 59, at 207.

92. The definition reads: "Value. Except as otherwise provided in Articles 3, 4, [and] 5, [and 6], a person gives value for rights if the person acquires them: (1) in return for a binding

assignment of collateral within the scope of Section 9-109(a)(1), could be defined to mean a price that "an informed and willing buyer would pay a willing seller for the risks and benefits transferred."[93] (UCC Article 9 requires that value be given in order to create an enforceable security interest.)[94]

A drafting committee may have a more precise method of expressing adequacy of price or may prefer a broad formulation. The purpose here is to identify a concept: model provisions to establish the relevance of price in a true-sale determination based on economic substance could take the form of a definition of "value" which distinguishes Section 9-109(a)(3) transactions from those that fall under 9-109(a)(1).

UCC Section 9-109. Texas and Louisiana enacted a non-uniform provision 9-109(e) that overrides the common-law true-sale doctrine,[95] with content and effect similar to the ABS statutes enacted elsewhere. A drafting committee could explore the possibility of an alternative form of Section 9-109(e), taking the approach described above for a free-standing model true-sales act. It could authorize courts to consider various factors to determine economic substance and require them to consider price.[96]

Other possibilities. A committee of experts, empaneled to draft model provisions, and receiving advice from a range of interested participants, may identify approaches to codification not contemplated here. Such a committee could take up related questions, such as governing law for true-sale analyses. This Essay calls for the Uniform Law Commission to convene a drafting committee to undertake the task of expressing the relevance of price in codifying an economic substance-based approach to true sales.

Conclusion

A better approach to true-sale rules—one that would create rights of exclusion from securitized assets in a way that is better justified and more coherent than the current law—is overdue. By arguing for such an approach, this Essay tends to the legal infrastructure of the multi-trillion dollar securitization market. The relevance of price terms in true-sale determinations should be codified. The price that a company receives in exchange for securitized assets represents value with which to distinguish between problematic judgment proofing on the one hand, and assignments that isolate

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commitment to extend credit or for the extension of immediately available credit, whether or not drawn upon and whether or not a charge-back is provided for in the event of difficulties in collection; (2) as security for, or in total or partial satisfaction of, a preexisting claim; (3) by accepting delivery under a preexisting contract for purchase; or (4) in return for any consideration sufficient to support a simple contract." U.C.C. § 1-204.

93. Aicher and Fellerhoff, *supra* note 59, at 207.

94. *See* U.C.C. § 9-203(b)(1).

95. *See* LA. STAT. ANN. § 10:9-109(e) (2016); TEX. BUS. & COM. CODE ANN. § 9-109(e) (West 2015).

96. *See supra* text accompanying note 81.

assets from bankruptcy in a way that is fair and produces efficiencies on the other hand.

Industry demand is not a pre-requisite for convening a uniform law commission drafting committee to undertake true-sale doctrine reform. Negotiations about the status of securitized assets, affecting creditors in weak bargaining positions, are happening in the context of current true sale rules—rules that are inconsistent and lack normative direction, or, alternatively, are codified to eliminate creditors' positions and that raise federalism concerns. Maintaining the rule of law in capital markets demands the custodial work of clarifying the true-sale doctrine, regardless of the financial industry's lack of concern.