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Senator Patrick Leahy
433 Russell Senate Office Bldg.
United States Senate
Washington, D.C. 20510

Congressman F. James Sensenbrenner
2332 Rayburn House Office Building
Washington, D.C. 20515-4909

Dear Chairman Leahy and Chairman Sensenbrenner:

The Enron tragedy should remind everyone of a fundamental principle of American regulatory and statutory law. The system does not work unless there is public disclosure and public accountability. Inexplicably, however, Congress seems poised to adopt, as part of the proposed bankruptcy legislation now in a conference committee, a "technical" amendment that would institutionalize and encourage one of the practices that has led to Enron's failure and its harsh consequences.

As law professors specializing in bankruptcy law, commercial law, corporate law and corporate finance, we write to you as the Chairman of the Senate delegation and the House of Representatives delegation to the Conference Committee on S. 420/H.R. 333. We call your attention to section 912 of both bills, which permits a debtor and one favored creditor to engage in a secret transaction to remove valuable, liquid assets from the corporate bankruptcy estate of a troubled borrower and place them beyond the reach of the courts and other creditors. Proposed section 912 would eliminate the ability of the courts to police one form of sham sales. This would permit a favored party to escape the rules applicable to all other creditors in bankruptcy and would encourage more companies to recast liabilities so that they no longer appeared on balance sheets, much to the detriment of the investing public and other creditors of the business.

Cloaked in highly technical language, the asset securitization proposal would fundamentally change American bankruptcy law. It would permit large, sophisticated, well-counseled lenders to engage in "off-book transactions" that are not publicly reported and, if the company gets into financial trouble, to avoid the bankruptcy process entirely--to the lasting detriment of the corporation's employees, its other creditors, and its very prospects for survival. Especially in this economy, with Enron only the latest example of what can happen when a company and its auditors do not make full public disclosure of financial circumstances, the Congress should not adopt this proposal.

Background

In any bankruptcy, all creditors are bound to a collective resolution of their relationships with a debtor. Every lender in every case would like a way to escape from bankruptcy, taking a disproportionate share of the assets and leaving behind the remaining creditors. Those left behind, of course, include the corporate debtor's employees, pension funds, trade creditors, tort victims, and everyone else who extended credit, in one form or another, to the debtor. In bankruptcy, secured creditors receive preferential treatment because they hold an interest in collateral, while others, such as equity investors, are subordinated. Federal bankruptcy law controls the priority and timing of payment. Chapter 11 reorganization and Chapter 7 liquidation work, however, only if all creditors are part of the bankruptcy process, and no single creditor is allowed more than its share from the estate.

The corporate bankruptcy system today, built on more than twenty years of experience and case law since the enactment of the Bankruptcy Code of 1978, generally works well. Indeed, the market for proper, deliberate asset securitization is booming under present law. There is no need for a change, especially one that would throw out a century of court decisions carefully distinguishing two types of transactions--sales and loans--that often look similar but have fundamentally different economic functions.

The proponents of section 912 make the claim that every credit group makes when it petitions Congress for preferential treatment in bankruptcy: financing costs will be reduced because of greater “predictability.” Unfortunately, it is not possible to lower total costs when total risks remain the same. Instead, section 912 simply gives one group of lenders a much better position than all the others, driving up the costs for all other parties. Naturally, giving one interest group the right to ignore the rules that all the other creditors have to obey makes it “predictable” that the favored group will do better if there is a bankruptcy of the debtor. Favored institutions may charge less to make loans if they know they will be given a substantial advantage over all the other creditors. Yet there is no reason that these securitized creditors should be given a special preference over banks, bondholders, suppliers, tort victims, pension funds and employees who will be forced to bear the increased risks whether they can afford it or not.

Bankruptcy courts have always been charged with looking through transactions to determine their economic effect. Labels do not govern, as bankruptcy courts are quick to point out that they will not be fooled by form over substance. Section 912 proposes to do exactly that: strip the court of the authority to analyze the economics of the transaction to see if it was a loan or a sale, instead binding the courts to the labels selected by the very parties who benefit from those labels.

The Risks Associated with Asset Securitization

Some creditors have attempted to use the fundamental distinction in bankruptcy law between loans and true sales to disguise a commercial loan so that lenders will be treated instead as “buyers” of the debtor’s property. If they can reclassify themselves as buyers, these lenders will be free from the collective treatment of bankruptcy. Not every asset securitization is a disguised loan transaction, and asset securitization is a valuable financial tool. Yet it is essential that the Bankruptcy Code not be amended to open a massive loophole so that parties interested in dealing with certain assets who simply rename a “loan” a “sale” will be exempt from bankruptcy because the property was no longer part of the debtor’s estate.

There are significant risks associated with permitting loans to be treated as sales, as the proponents of section 912 would do:

- **Asset securitization will prevent many businesses from being reorganized at all.** Chapter 11 depends on a collective disposition of *all* assets of the estate. Lenders who have taken property of the debtor as collateral for a loan receive extensive protection under the Bankruptcy Code, but they are not granted the unilateral ability to walk away from the bankruptcy with the assets of the estate--leaving a business that cannot be reorganized. This has a direct impact on jobs. The most obvious case in point is LTV Steel, which would have shut down immediately on filing if the creditor claiming it had “purchased” LTV’s accounts had been allowed to remove the corporation’s most liquid assets. Currently, several airlines have securitized their receivables. The result: they could be cut off from their principal sources of cash if they filed for bankruptcy and section 912 were law. We could face the spectacle of the government giving the airlines

billions in tax dollars, only to have substantial assets of the business removed from the company in "off-book" transactions for which no one would be held accountable.

- **Creating an unregulated safe harbor for asset securitization has ominous implications for the securities markets.** In the wake of the Enron debacle, when regulators, former employees and the investing public are calling for strengthened reporting requirements, section 912 moves in the opposite direction. It would give safe harbor protection to transactions that facilitate the undisclosed reallocation of risk. While Article 9 security interests and real estate mortgages are always public, parties dealing with a business with securitized assets have no similar public notification that assets that appear to belong to the debtor have been, in fact, removed from the bankruptcy estate altogether. By its terms, Section 912 appears to exclude assets from the estate that would otherwise be treated as estate assets subject to only an unperfected security interest.

- **Enron demonstrates that the "off-book" transactions of asset securitization can mislead other creditors, investors, auditors and the public.** Enron already has disclosed that it moved at least $2.4 billion in assets off its balance sheet but retained the risks associated with those assets through swap agreements. The employees, creditors, pension funds and other investors in Enron were forced to bear risks that were not disclosed. If the current proposal were in place, the bankruptcy court would be denied the opportunity to make certain these kinds of transactions were not disguised loans and to allocate the risks approximately.

Under current law, if a company in bankruptcy pays its workers and buys supplies to produce new goods, those goods belong to all the creditors collectively as property of the estate. When they are sold, the accounts receivable enrich the estate and give the business a chance to survive. Section 912 appears to alter this result. Anything the business produces that creates an account receivable would be swallowed by the party to the asset securitization who had "purchased" all the accounts, leaving the estate with nothing to pay the employees who did the work, the trade creditors who furnished the raw materials, and the other creditors who hoped to profit from the going concern value of the business. Under those circumstances, it is fair to say that no business could survive. If this is not the intent of the proponents, then the whole section should be dropped or sharply amended.

The Border Between Sales and Loans

The question presented by section 912 of H.R. 333 is how to patrol the border between a loan and a true sale--between what a company owns and what it owes. Under current law, that determination is based on who bears the risks and who receives the benefits of owning the asset. Property that has been sold is not part of the bankruptcy estate. Property that is collateral for a loan remains property of the estate, albeit subject to the creditor's lien. Section 912 would virtually eliminate this distinction from the law, so long as a private rating agency deemed at least one tranche of the securities issued under the securitization as "investment grade." Having this critical distinction turn on an assessment by a private rating agency is wholly inadequate:

- Section 912 confers its extraordinary favors only upon transactions rated by private rating agencies, delegating to those rating agencies an extraordinary and very valuable power. There is no reason to suppose that the rating agencies will not consider their own self-interest in exercising that power. Rating agencies have virtually no accountability to anyone but their shareholders.

- Private rating agencies rely, in turn, primarily on letters from attorneys, who are serving the

parties to the transaction, to make legal proclamations about what is and what is not a "true sale." This bill provides no regulation or oversight of the agencies' own self-interest in the transactions. The agencies will not function as insurers, paying their own money if it turns out that the "selling" party was left with the risks commensurate with a loan, so that form of market discipline is missing. Instead, the agencies collect their fees whether the parties subsequently succeed or fail, pushing losses onto thousands of unsuspecting creditors and investors.

- Legal opinions from the parties' own lawyers provide inadequate protection. The lawyers signing these letters are paid by the parties; they do not represent the interests of all the other creditors and investors affected by the characterization of the transaction--including the employees, retirees, pension funds, trade creditors, and tort victims. Moreover, once the law is amended to eliminate any review standards, the opinion letter will simply reflect the state of the law. If the law has no standards, then the attorneys can truthfully say that no transaction fails those standards.

- Section 912 specifically prohibits consideration of virtually all of the evidence that tells us today whether a transaction is a loan rather than a sale. Whether a debtor remains liable if the value of the asset is not as great as the amount advanced by the buyer/lender, whether the debtor continues to administer the asset, how the transaction is treated for accounting purposes, how the transaction is treated for tax purposes--these factors are all relevant to whether the transaction is a sale or a loan. Yet the statute specifically prohibits consideration of these factors to determine whether it is a loan or a sale. In other words, the statute is designed to ratify an asset securitization even if every economic and legal standard otherwise applicable would hold it to be a loan--and, accordingly, property of the estate subject to creditor, investor and judicial oversight.

Fraudulent Conveyance Law Cannot Police Fraud in this Area

Section 912 does provide that a transaction will continue to be subject, after a fashion, to application of fraudulent conveyance law under 11 U.S.C. §548(a). This provision will do nothing, however, to protect investors and other creditors from being deceived by the mischaracterized transactions. Fraudulent conveyance law affords insufficient protection against a secured loan transaction disguised as a sale for purposes of helping lenders escape the bankruptcy laws:

- Section 912 would erase the "intent to hinder, delay or defraud" standard of current fraudulent conveyance law. Under current law, an action taken with no intent other than to avoid the consequences of bankruptcy may be treated by a court as fraudulent under the "intent to hinder, delay or defraud" standard. But if federal law says that asset securitization, regardless of deliberate intent, is legally permissible, then any protection offered by fraudulent conveyance law would be overridden. According to its sponsors, the financial device is *always* undertaken to avoid bankruptcy; most courts probably would then read section 912 as Congressional authorization of these devices without regard to the intent of the parties.

- Fraudulent conveyance law is the wrong vehicle to police the difference between a loan and a sale. Loans from a lender to a debtor pass the "reasonably equivalent value" tests of fraudulent conveyance law; the debtor receives consideration and, if the loan is secured, the lender receives a security interest in collateral. Fraudulent conveyance law is designed to stop gifts or other transfers for too little value when a debtor is insolvent. It does nothing to police the boundary between a sale and a loan. The problem--disguising a loan so that it will be treated as a sale

under bankruptcy law--is not solved with the “reasonably equivalent value” tests of fraudulent conveyance law.

- Section 912 even limits the application of fraudulent conveyance law to section 548(a), which has a one year statute of limitations. This means that state fraudulent conveyance laws, which come into the Bankruptcy Code through section 544, will be deemed inapplicable. State statutes of limitation are typically four to six years. Under section 912, any “look back” would be limited to one year. This effectively means that one year after a securitization, there would be no legal oversight of any kind.

Protecting the Securitization Market

The result of this proposal will be to render impossible untold corporate reorganizations that would save jobs and would give most creditors a much higher return from a company in financial trouble. Instead, if section 912 becomes law, those companies will liquidate, leaving little for creditors and nothing for stockholders and employees. It will also sharply reduce the public disclosure essential for a healthy marketplace.

The advocates for this bill repeatedly point out that asset securitization is a rapidly growing, multi-trillion dollar business. If so, it does not need help to survive, particularly if that help comes at the expense of smaller creditors, investors, jobs and increased business failures. In any case, as the Enron experience dramatically illustrates, the law in this area should not be changed without much greater investigation into current business practices and a thorough and thoughtful consideration of the implications of such change.

If we can be helpful in any way as you evaluate section 912, please feel free to call on us.

Yours truly,

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