January 28, 2002

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

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

Dear Chairman Leahy and Chairman Sensenbrenner:

We are law professors who teach in the area of bankruptcy, commercial and related business law. We write to you as the Chairmen 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 § 912 of both bills. This section is intended to facilitate securitization of certain financial assets. It would accomplish that goal, but at potentially significant cost to the financial transparency required for efficient functioning of securities markets and for effective investor protection. In short, § 912 will be good for the securitization industry specifically, but bad for securities markets generally. We urge you to oppose it.

Section 912 provides a bankruptcy safe harbor for asset sales to securitization vehicles, regardless of whether the so-called buyer retains recourse against the seller. For reasons discussed below, this will make it easier for corporations to move debt off their balance sheets and to create secret liens. Section 912 will allow corporations to disguise borrowing transactions, secured by receivables, as sales of assets, to the detriment of both creditors and equity investors.

Under current law, the Securities and Exchange Commission, public accountants and judges enforce the accurate depiction of transactions as secured loans or as sales. The *Enron* case makes it clear that this line can be manipulated, even under current law. Far from remedying the existing problem, § 912 will prohibit judicial policing of the sale/secured loan distinction in securitization transactions, and will knock one leg out from under a three-legged stool that is already wobbling. As such, § 912 will make it more difficult for investors to accurately assess the riskiness of investments in companies that securitize assets.

Securitization Described:

Under current law (even after the Bankruptcy Court decision in the *LTV* case)[1] the securitization market continues to boom. The structure of a securitization is simple. Instead of entering into a secured financing, a company that wishes to raise money (the "Originator"), sells assets to a separate entity, or special purpose vehicle ("SPV"), that exists solely for the purpose of buying assets from the Originator and issuing securities backed by those assets (known as "asset-backed securities" or "ABS"). The assets conveyed can take many forms: they may be mortgage loans, credit card receivables, lease receivables, or the accounts receivable of the Originator (collectively, the "Assets"). The principal attraction of securitization derives from the fact that the Originator can raise money more economically by securitizing the Assets than it can by borrowing against them. This cost advantage derives from two distinct characteristics of securitization. Securitization enhances the liquidity of asset-backed securities, by making them available in smaller denominations to non-specialized investors. This benefit does not come without costs, however. Because securitizations are structured as sales rather than loans, the

Assets, once sold, are removed from the potential bankruptcy estate of the Originator. This can, depending on the adequacy of consideration and how the proceeds are used, shift risk from investors in the securitized assets to the other creditors and equity owners of the Originator. This effect is well described in the separate letter previously submitted by Professors Janger, Lawless, Lopucki, Lupica, Warren, Westbrook and others, dated January 23, 2002, with which we agree.

Section 912 is troubling, however, even if one is not troubled by securitization generally. Section 912, if enacted, will allow the Originator to accomplish this risk alteration in secret. Section 912 will thus make the Originator's finances in general, and many of its financing transactions, less transparent, thereby undercutting the effectiveness of the financial disclosure laws so necessary to the smooth functioning of securities markets.

True Sales, Disguised Loans, Unperfected Security Interests and Financial Transparency

As the recent *Enron* debacle makes clear, a sale of Assets to an SPV can be used to move debt off the Originator's balance sheet. Under current accounting rules, so long as a small portion of the SPV's capitalization derives from sources unrelated to the Originator, the debt of the SPV is not treated as debt of the Originator. Similarly, because the sale of Assets to the SPV is booked as a sale, rather than a loan, no debt appears on the Originator's balance sheet either. In *Enron*, the concealment of business risks in two off-balance sheet special purpose entities caused a publicly traded company to fool its auditors and misstate shareholder equity by $1.2 billion.

Under current law, this pernicious effect of securitization is held in partial check by the centuries old distinction between "true sales" and "disguised secured loans," often known as "sales intended as security." To obtain the financial benefits of ownership, the purchaser must also accept the risks of ownership. Many securitizations, however, are sales in name only. They are structured so that the SPV gains all of the benefits of ownership but bears none of the risk. A common feature of securitization deals is that the SPV will have a "put" option with regard to the purchased Assets. If the value of the Assets falls below an agreed price, the Originator must buy them back for that price. Such a transaction is nothing more than a "disguised loan." Notwithstanding the "sale" of the Assets, the Originator retains the risks of ownership. Under current law, the disguised loan is recognized for what it is, and treated as a secured loan. Securitizations which are, in truth, disguised loans are not given effect.

Section 912 would do away with this crucial distinction between sales and disguised secured loans. Eliminating this distinction will allow the Originator to both retain undisclosed risk relating to assets that it has apparently sold, and to create enforceable secret liens on assets that it would, by all outward appearances, still own.

- First, § 912 makes it absolutely clear that a "sale" can be subject to a "put" option that leaves the risks of ownership on the Originator, and the "sale" will be treated as a "true sale" – regardless of whether it would be treated as such under applicable state law (including Article 9 of the Uniform Commercial Code), accounting rules, disclosure rules, or by the IRS. Thus, § 912 will allow Originators to sell Assets, but retain undisclosed risks of ownership.

- Second, and as if this were not enough, § 912 also allows the Originator to retain assets on its balance sheet, while conveying away all the benefits of ownership. In order to be treated as a sale, there need only be a private written agreement with the SPV ("eligible entity" in the language of § 912), saying that the assets are *intended* to be removed from

the Originator's bankruptcy estate. Under current state law, this "agreement" would create a secret lien that would be treated as an unperfected security interest and be invalidated in bankruptcy. Because § 912 treats such a transaction as a sale, and also cuts off the power of the Originator's bankruptcy trustee to avoid unperfected security interests under 11 U.S.C. §544, such an "agreement" would, be even better than a perfected security interest or properly perfected sale of financial assets; it would not only remove the Asset from the Originator's bankruptcy estate entirely, it would do so in secret.

These are just a few of the ways in which § 912 will make the finances of public companies less transparent.

Rating of Securities Issued by the SPV Does Not Protect Investors in the Originator

Section 912 confers its extraordinary favors only upon transactions where one tranche of the securities issued by the SPV are rated by private rating agencies (to which the bill refers by the term used in the Securities and Exchange Commission's regulations, "nationally recognized statistical rating organizations," or "NRSROs") as investment grade. There are two reasons why rating agency scrutiny does not solve the transparency problem created by §912.

· First, rating agencies, charged with rating the asset backed securities, do not ask the same questions as an attorney or judge, charged with evaluating whether a transaction is a loan or a sale. Rating agencies look only at the finances of the SPV, and whether the Assets conveyed to the SPV, together with other credit enhancements included in the securitization, are sufficient to merit a particular rating. By contrast, the issue of whether an asset transfer is a sale or a collateral transfer in connection with a secured loan has a huge impact on the finances of the Originator. The resolution of this issue requires the answer to a number of questions. Is securitization being used to hide liabilities that should be carried on the books of the Originator as debt? Is the securitization being used to shift assets away from the Originator? Is the securitization being used to manipulate financial ratios? Legal opinion writers and judges must look at the substance of the transaction and its effect on the finances of the Originator to determine the nature of the asset transfer. The benefits of this scrutiny redound to the creditors of and investors in the Originator. Rating agency scrutiny of the asset backed securities, by contrast, does nothing to encourage transparent reporting of the finances of the Originator.

· Second, the rating agencies, unlike judges, are unaccountable. Rating agencies have virtually no responsibility to anyone but their shareholders and their clients. The SEC recognizes particular rating agencies as being NRSROs, but a rating agency that has been so recognized is not thereafter subject to material oversight. When sued by investors who assert that they were misled by faulty ratings, rating agencies have successfully invoked First Amendment and asserted that they are mere publishers of opinion. Yet rating agencies are subject to a fundamental conflict of interest. They receive their compensation from the issuers of the rated securities, not from the investors who rely on the ratings they issue. Moreover, the NRSROs are virtually immune from market discipline, consisting of only four entities, of which two (Moody's and Standard & Poor's) dominate the market. Barriers to entry by competitors have proven insurmountable since the NRSRO concept was added to the SEC's regulations in 1973.

Concerns have often been voiced in Congress, in the financial community and among academics that rating agencies are too powerful and too unaccountable. Section 912, far from checking that power,

enhances it.

Conclusion

In conclusion, it is risk concealment, not just risk reallocation that makes §912 particularly dangerous, and which benefits the securitization industry at the expense of the securities markets. The sale/secured loan distinction encourages Originators to disclose the true nature of their financing transactions. Proper disclosure of risks encourages investor confidence in the securities markets. By contrast, a statute that allows companies to misdescribe what they own and what they owe increases the risk of more *Enron* like scandals, and poses a danger to investor confidence generally.

If we can help in any way, please feel free to call on us.

Yours truly,

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[1]In that case, a Bankruptcy Court allowed a debtor to use securitized assets during the early stages of a Chapter 11 case. *See* LTV Steel Co., Inc. 2001 Bankr. LEXIS 131 (2001).