

JONATHAN C. LIPSON  
ASSISTANT PROFESSOR OF LAW  
PHONE: 410.837.4054  
E-MAIL: JLIPSON@UBMAIL.UBALT.EDU

February 1, 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

Re: *Asset Securitization – Technical Flaws With Section 912*

Dear Chairman Leahy and Chairman Sensenbrenner:

This letter supplements the letter signed by 35 law professors (including many of us) dated January 23, 2002 addressing problems with Section 912 of S. 420/H.R. 333 (“**Section 912**”) and responds to certain inaccuracies in the letter dated January 30, 2002 by the Bond Market Association (the “**BMA Letter**”).

The BMA Letter argues that Section 912 would create greater certainty for securitization providers, which would, in turn, reduce the cost of asset securitization transactions. This may or may not be true. Unfortunately, Section 912 also appears calculated to eliminate virtually every judicial tool in the Bankruptcy Code for scrutinizing and undoing suspect transactions when they involve securitizations. Section 912 would therefore eliminate important checks and balances in the financial system. By eliminating these checks and balances, Section 912 would, perversely, seem to encourage bankruptcy court filings – a result we find troubling.

**A. Problems with Section 912 – Technical Flaws**

It appears to us that Section 912 has two goals. First, and as discussed in the letter of January 23, 2002, Section 912 is intended to deprive bankruptcy courts of the ability to recharacterize transactions that are denominated “sales” but are, in substance, secured loans.

Second, it will insulate any transaction denominated a securitization from meaningful judicial scrutiny if the “originator” in the transaction (that is, the debtor who originates the financial assets sold in the securitization) commences a bankruptcy case. This is because Section 912 excludes “eligible assets” from the originator’s bankruptcy estate *unless* the sale of those assets was a “fraudulent transfer” under federal bankruptcy law. As discussed below, the fraudulent transfer provisions of Bankruptcy Code Section 548 are quite limited. Section 912, by its terms, therefore appears to eliminate *every other judicial power* under the Bankruptcy Code and at state law to return these assets to the originator’s bankruptcy estate. These judicial powers provide an important check on these complex and risky transactions. They should not be eliminated lightly.

1. *Strong Arm Power – Secret Liens and Transfers – Section 544(a)*. Contrary to the claims of the BMA Letter, it appears that Section 912, by its terms, would eliminate a bankruptcy court’s ability to use the so-called “strong arm” power of Bankruptcy Code Section 544(a).

Section 544(a) of the Bankruptcy Code provides, in essence, that a lien or asset transfer that is not “perfected” under state law may be avoided (that is, undone), and the subject property recovered for the benefit of the debtor’s estate. “Perfection” is a technical way of describing the public notice that parties generally provide in sophisticated financial transactions.<sup>[1]</sup>

A principal purpose of the strong arm power is to prevent or undo “secret” (i.e., “unperfected”) transfers.<sup>[2]</sup> Secret transfers avoidable by Section 544(a) include unperfected (that is, undisclosed) security interests and unperfected sales of financial assets. In the case of asset securitizations, this notice is typically provided by filing a form known as a “UCC-1” financing statement in the office of the secretary of state where the debtor (the originator) is incorporated.<sup>[3]</sup> Other creditors of an originator – trade creditors, service providers, even other lenders – typically rely heavily on these filings to determine the creditworthiness of the originator.

The BMA letter claims that “securitizers may either be required by law, or elect as a precaution, to file public financing statements under the Uniform Commercial Code to make an asset sale effective against third parties, including bankruptcy trustees.”<sup>[4]</sup> In a world without Section 912, this would be true, because Section 544(a) – the “strong arm” power – invalidates undisclosed transactions. By exempting asset securitizations from Section 544, however, Section 912 significantly reduces the impetus to file these disclosures. In other words, by eliminating the threat of avoidance, Section 912 inadvertently eliminates the checks and balances of public notice currently central to asset securitizations.

2. *State Law Avoidance Powers – Section 544(b)*. Section 912 also eliminates the trustee’s power to avoid “fraudulent transfers” under Bankruptcy Code Section 544(b). This Section allows the bankruptcy trustee to sue under state fraudulent transfer law, such as the Uniform Fraudulent Transfer Act or the Uniform Fraudulent Conveyance Act, which have been adopted by virtually all states.<sup>[5]</sup>

Although Section 912 would permit a bankruptcy trustee to use federal fraudulent transfer law under Bankruptcy Code Section 548, the federal provision has a much shorter limitations period than state law. A transfer under federal law is generally avoidable only if it occurred within one year of bankruptcy.<sup>[6]</sup> State fraudulent transfer law, by contrast, provides much longer statutes of limitations -- from four to six years (six in New York).

This longer period of coverage is an important check on risky transactions. Those who engage in such transactions under current law understand that the transactions must be able to stand the test of time. Under current law, if an originator engages in a highly leveraged transaction and then goes into bankruptcy within four (or six) years, the transaction will be closely scrutinized as a fraudulent transfer under state law, as incorporated by Bankruptcy Code Section 544(b). By enacting Section 912, Congress would eliminate this important check, thus inviting potentially harmful transactions.

The BMA Letter obliquely claims that “[b]y itself, the existence of [the Section 912 safe harbor] does not operate to override other provisions in the Bankruptcy Code regarding the power to avoid fraudulent conveyances.”<sup>[7]</sup> We think this misleading. If this were true, Section 912 would also expressly include Section 544. But it does not. We doubt this is a drafting oversight.

3. *Other Judicial Powers*. By eliminating all avoidance powers except Section 548 of the Bankruptcy Code, Section 912 also appears to limit a host of other well-established judicial powers to scrutinize and avoid suspect transactions. These include the turnover power under Section 542, the

power to avoid preferential transfers under Section 547, the power to avoid post-petition transfers under Section 549, and other equitable powers that bankruptcy courts have historically had to scrutinize and undo transactions that may harm debtors and their creditors. The threat of this scrutiny is undoubtedly one of the “costs” that Section 912 would eliminate. Yet, the threat of this scrutiny is also a critical check on misconduct in the financial system. In the wake of *Enron*, eliminating these checks strikes us as unsound.

### C. Perverse Results

By eliminating these checks and balances, Section 912 could lead to a perverse result. Since the Section 912 safe harbor described above would only be available inside bankruptcy, those with an interest in protecting securitized assets may find bankruptcy for the originator irresistibly enticing – even if not in the best interests of the originator or the originator’s other creditors. Section 912 could therefore lead to an increase in bankruptcy court filings by originators that have engaged in asset securitizations.

### D. Conclusion

At the heart of Section 912 and the BMA Letter is a paradox. On the one hand, the BMA Letter expresses concern about the costs of judicial uncertainty. On the other hand, the BMA readily acknowledges – as it must – that the securitization market has, despite this uncertainty, become a “multi-trillion dollar [] market [that] has played a significant role in the growth of the American economy.” Because the securitization market is so robust, we believe a strong case must be made to eliminate the well-established checks and balances described above. So far, that case has not been made.

The BMA Letter also attempts to cast the signatories to the January 23 letter as opponents of asset securitization transactions. This is simply false. Some question the merits of securitization; some do not. What all agree on, however, is that Section 912 is a dangerous and needless amendment to existing law. Section 912 would not simply promise greater certainty for securitization providers. It would also strip bankruptcy courts of important, well-established checks and balances on complex and risky transactions simply because they are denominated securitizations. At a time when scrutiny of complex and risky transactions should be increasing, not decreasing, this is unwise.

We urge you to reconsider Section 912. If we can be helpful in any way, please feel free to call on us.

Yours truly,

Nicholas Georgakopoulos  
Professor of Law  
Indiana University School of Law -  
Indianapolis

Jonathan C. Lipson  
Assistant Professor of Law  
University of Baltimore

Joann H. Henderson  
Professor of Law  
University of Idaho

Lois R. Lupica  
Professor of Law  
University of Maine School of Law

Margaret Howard  
Professor of Law  
Washington and Lee School of Law

Juliet M. Moringiello  
Associate Professor of Law  
Widener University School of Law

Edward Janger  
Associate Professor of Law

Charles Shafer  
Professor of Law

Brooklyn Law School

University of Baltimore

Corinne Cooper  
Professor (Emerita)  
University of Missouri – Kansas City

---

[1] See UNIF. COMM. CODE § 9-310 (2000).

[2] See Jonathan C. Lipson, *Financing Information Technologies: Fairness and Function*, 2001 WIS. L. REV. 1067, 1146 (citing 45 CONG. REC. 2271 (1910)).

[3] UNIF. COMM. CODE §§ 9-310, 307(e) & 501 (2000).

[4] BMA Letter, p. 7.

[5] Every state has enacted one of the uniform fraudulent transfer laws. See UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 2 (1918); UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 266 (1984), or a predecessor statute with similar effect. See, e.g., VA. CODE ANN. § 55-81 (Michie 1991).

[6] 11 U.S.C. § 546.

[7] BMA Letter, p. 8.