

February 5, 2002

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

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

Dear Chairman Leahy and Chairman Sensenbrenner:

I am an associate professor of law at New York Law School who specializes in bankruptcy law, commercial law and allied subjects. I 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. Specifically, I write with reference to section 912 of both bills, a provision intended to grant so-called "securitization" transactions immunity from scrutiny under the federal bankruptcy law.

You have already received at least two letters on section 912 from similarly-qualified law professors, one dated January 23, 2002 from 35 signatories headed by Messrs. Axelrod, Bates, Block-Lieb and Braucher, and the second dated January 28, 2002 from four signatories, Janger, Kettering, Lipson and Lupica. I shall refer to these two letters as the "Professors' Letters."

I share the skepticism of section 912 expressed in the Professors' Letters. I write because the Professors' Letters do not mention what, in the view of some, may be the most persuasive reasons why section 912 represents bad public policy. And I believe it equally important to emphasize that one need not believe securitization to be a bad thing in order to believe that section 912 is bad public policy. In part A of this letter I shall set forth briefly my reasons.

You have also received a letter dated January 30, 2002 from The Bond Market Association (the "BMA Letter") in response to the January 28 Professors' Letter. I cannot, of course, speak for all the signatories to the January 28 Professors' Letter, but I believe it would be valuable to respond briefly to some of the principal points of the BMA Letter, and I do so in part B of this letter.

A. Section 912 (a) creates an unlevel playing field for different methods of capital formation that are economically fungible and that should be on equal footing in bankruptcy, and (b) bestows its blessings only upon companies who pay the private gatekeepers it establishes.

Section 912 is special interest legislation that creates an unlevel playing field for different methods of capital formation that are economically fungible and that should be on equal footing in bankruptcy. It permanently bestows a large advantage to capital formation *a la* Wall Street (*i.e.*, securitization) over capital formation *a la* Main Street (*i.e.*, simple secured lending). Specifically, section 912 relieves from the burdens of bankruptcy law a transaction that is in economic effect a secured loan, so long as that transaction is structured as a securitization -- but those legal burdens will continue to fall with unabated weight on a simple secured loan of the kind traditionally made by Main Street lenders (*i.e.*, commercial banks and finance companies). As a result of this selective relief from the burdens of bankruptcy law, section 912 will permanently enable Wall Street financiers to offer financing at rates lower than Main Street lenders. Perversely, the cost advantage bestowed by section 912 would be available only to companies that own financial assets in quantities large enough to absorb the steep transaction costs of a securitization. Section 912 would leave out in the cold small companies that cannot absorb those transaction costs. And -- perhaps the real point of the legislation from a certain perspective -- section 912 bestows its blessings only upon those companies who pay the gatekeepers established by section 912: the securities industry and the rating agencies.

Whether the legal burdens to which secured lenders are subject under the current bankruptcy law are too heavy or not heavy enough is a question about which there is disagreement. But it is not rational to impose those burdens upon a simple secured loan while excluding from those burdens an elaborately and expensively structured securitization transaction which, when viewed as a whole, is effectively fungible with a simple secured loan. *If*

securitization is a good thing, and it is desirable to relieve securitization transactions from the risk of being subjected to the legal burdens to which secured loans are subject – a point on which this letter takes no position – the rational response would not be to enact section 912. Rather, the rational response would be for Congress to do directly and nondiscriminatorily what section 912 does indirectly and discriminatorily: namely, exempt from the burdens currently imposed by bankruptcy law *all* transactions that are functional equivalents of loans secured by financial assets – whether the transaction is a securitization, or is instead a simple loan secured by financial assets.

This nondiscriminatory approach would give the securitization industry all the protection that it asks for in section 912. Indeed, to the extent that the securitization industry touts the lower interests rates available to companies that raise capital through securitization, this approach would give companies the benefit of still lower costs, as the very elaborate structures used in securitization transactions as currently structured might be dispensed with. Thus, for example, it would no longer be necessary (though it might still be considered desirable by some companies for accounting reasons) to incur the expense of setting up and maintaining the elaborate chain of new entities that typically must be established to effect a securitization transaction. Instead, the company could simply pledge a pool of financial assets directly to secure a simple debt obligation. More important, this nondiscriminatory approach would level the playing field between large and small companies that seek the equivalent of financing secured by financial assets. Those companies who chose to raise capital against their financial assets through securitization, as opposed to simple secured borrowing, would do so because they genuinely wanted to tap the securities markets. Their choice would not be skewed by an exemption from the burdens of bankruptcy law that section 912 artificially grants only to the former.

The structure of section 912 limits its benefits to securitization transactions, as opposed to functionally equivalent forms of capital formation through secured borrowing. Section 912 excludes from the bankruptcy estate of a company any “eligible assets” that the company declared that it transferred to an “eligible entity.” Section 912 is thus specifically tailored to the distinctive structural feature of a securitization transaction: *i.e.*, the assets to be securitized are transferred to an entity known in the jargon of the trade as a “special purpose entity.” Of the other industry-limiting features of section 912, two in particular may be noted. These both appear in the definition of “asset-backed securitization,” the key term that effectively defines the class of transactions entitled to the benefit of section 912.

First, in order to qualify as an “asset-backed securitization,” a transaction must be one in which “eligible assets transferred to an eligible entity are used as the source of payment on *securities*.” The significance of the word “securities” is easily missed. It has the effect of excluding simple secured loans by Main Street lenders such as banks and finance companies, which are evidenced by simple promissory notes rather than securities.

Second, in order to qualify as an “asset-backed securitization,” the securities that are backed by the “eligible assets” in question must include “at least one class or tranche... rated investment grade by one or more nationally recognized securities rating organization, when the securities were initially issued by an issuer”. That requirement serves no discernable purpose other than to assure that a rating agency must be involved, and hence be entitled to collect a substantial fee, as a condition of a transaction receiving the benefit of section 912. Certainly this requirement serves no investor protection function, as it can be trivially satisfied no matter how low-grade the “eligible assets” being securitized may be. For example, given a pool of \$1,000,000 of low-grade “eligible assets” (let us assume for specificity they are accounts receivable), the transaction can be structured so that the topmost class of securities issued against that pool represents, say, a \$1,000 interest, and thus is entitled to receive the first \$1,000 of collections on the pooled receivable. It is all but certain that \$1,000,000 of even low-grade receivables will net at least \$1,000 in collections, so an investment-grade rating for that topmost class is assured (and if in doubt, one could simply structure the transaction with an even smaller topmost class). For a transaction to qualify under section 912 only *one class* of securities, however small, backed by the securitized assets, need be rated investment grade. Other classes of securities sold to investors, which may represent the vast bulk of the investor interests, could be rated as junk, or not be rated at all.

Moreover, Congress should be very wary of granting the rating agencies a franchise as gatekeepers to the benefits of section 912 in any form. As the January 28 Professors’ Letter notes (p. 4), rating agencies’ unaccountability and conflicts of interest would make them potentially dangerous as guardians.

B. The BMA Letter.

It would not be proper or useful for me to respond comprehensively to the BMA Letter, but I believe that it is useful to comment briefly on what I perceive to be its principal points.

Shifting costs to third parties is not “efficiency.” The BMA Letter touts the “efficiency” of securitization, noting that it results in lower financing costs to companies seeking to raise capital. It is profoundly true that securitization does result in lower financing costs, assuming that the legal form of the securitization will be respected. However, those lower costs are achieved not by creation of value out of nothing, but rather by relieving investors in the securitized assets of costs they would have to bear in the event of the company’s later bankruptcy, and placing those costs on other constituencies who were not parties to the securitization transaction – constituencies that Congress sought to protect in the Bankruptcy Code.

As the BMA Letter emphasizes,¹¹ the critical point on which securitization depends (and which section 912 seeks to enshrine) is the purported ability of a company that holds financial assets to insulate those assets from the creditworthiness of the company as a whole. If that insulation is legally recognized, investors who provide capital to the company in exchange for a right to be repaid from those assets can be confident that their repayments will not be delayed or otherwise affected by a hypothetical future bankruptcy filing by the company. If that insulation is not legally recognized, the investors’ right to be paid from those assets will be subjected to all of the usual burdens to which a secured lender is subject. For example, payments to the investors will be interrupted, and the investors will be stayed from seizing the assets; the bankruptcy court may deprive the investors of their interest in those assets in exchange for an interest in other assets judged by the court to be an adequate equivalent; and a plan of reorganization may ultimately be “crammed down” on the investors, so that they may be forced to accept a very different economic deal than the one they contracted for.

There is nothing in any way unusual or penal about the burdens just described. They are simply the burdens that Congress placed on all secured lenders when it enacted the Bankruptcy Code. These burdens may be thought of as a kind of tax that Congress placed on secured lenders to contribute to the attempt to rehabilitate the bankrupt company – a tax that inures to the benefit of the other constituencies of the company who will benefit from its rehabilitation, such as its creditors, employees, suppliers and equity holders. If a company is legally permitted, through securitization, to insulate a pool of assets from the creditworthiness of the company as a whole, the investors in that pool of assets are in effect allowed to evade that “bankruptcy tax.” And the other constituencies of the company, if and when it goes bankrupt, will bear the cost of that “tax evasion,” because they will be forced to accept the resulting diminution in the likelihood that the company will be able to be rehabilitated.

To license evasion, through securitization, of the “bankruptcy tax” that the Bankruptcy Code imposes on secured lenders has nothing to do with “efficiency.” It is merely a forced shifting of costs by a group of the company’s financiers onto other constituencies of the company, constituencies that were not parties to the securitization transaction and that Congress intended to protect.

It is precisely because the result sought by the securitization industry impairs the interests of third parties that little weight should be given to the industry’s oft-repeated plea that Congress and the courts should not look behind the label applied to the transaction by the immediate parties thereto. And a thoughtful legislator, who might otherwise be inclined to give great weight to the endorsement of section 912 by the “major federal financial regulatory bodies” (BMA Letter, p. 2), should reflect that the mission of those regulatory bodies is to consider the interests of the parties to the securitization transaction and the investors who invest in the resulting securities, all of whom are gainers by securitization. The third parties who are the losers by securitization – the creditors, employees, suppliers and other constituencies of the securitizing company in a future bankruptcy proceeding, who will suffer the consequences if the company is unable to be reorganized – are looked after only by Congress.

Should the securitization industry be saved from a serious legal risk that has been well known in the industry since its inception, on the plea that the industry became too big to fail in the meantime? A close reader of the BMA Letter (p. 3) will note an interesting paradox. In one paragraph it states:

“The basic problem ... is that there is a lack of controlling judicial precedent by which the precise contours of [the distinction between a sale of financial assets and a loan secured by financial assets] may reliably be defined and applied

in the securitization context.”

That is a half-truth. For centuries it has been a fundamental principle that a transaction (or set of related transactions) that is in economic substance a secured transaction will be treated by courts as a secured transaction, no matter what label the parties to the transaction applied to it. The shelves of law libraries groan under the weight of cases and commentaries applying and analyzing this principle in innumerable factual settings. It is precisely this centuries-old principle that industry fears to have securitization transactions tested against. And it is precisely for that reason that industry desires to enact section 912, which simply abolishes the principle as to securitization and securitization alone. It is, however, quite true that to date no case has been litigated to conclusion involving the application of this principle to a securitization transaction, and so there is indeed no “controlling legal precedent” on the application of the principle to industry’s product *du jour*.

In the next paragraph, however, the BMA Letter states that securitization transactions will qualify for the blessings of section 912 only if they “possess structural features that are common in other securitization transactions that have routinely been determined to involve a ‘true sale’ of underlying assets.” The letter’s use of the passive voice disguises the natural question: just who is doing the “determining” – “routinely” at that – if there are no controlling judicial opinions?

The answer is that the lawyers for the parties engaged in a securitization transaction “routinely” give a legal opinion that the asset transfers involved in the transaction would be treated by a bankruptcy court as a “true sale” rather than a secured loan. These “true sale” opinions, however, are *sui generis* legal artifacts quite unlike ordinary legal opinions. No competent lawyer ever gave a simple flat opinion that the asset transfers involved in a securitization transaction constitute a “true sale.” Indeed given the absence of controlling case law a lawyer could not responsibly do so. These opinions therefore typically go on for a great many pages, emphasizing the lack of controlling authority, analyzing analogous case law, and concluding, with a great many qualifications, that, in the opinion of the lawyer, the issue is not free from doubt but that a “properly decided case” would conclude that the asset transfer is a “true sale.” It is all but impossible to imagine a lawyer ever incurring liability on an opinion so extravagantly hedged. These all-but-liability-proof legal opinions underline the fact that the parties to a securitization transactions are knowingly assuming a serious legal risk.

The securitization industry owes its existence to the rating agencies’ willingness to issue credit ratings on the securities issued in securitization transactions on the basis of these virtually liability-proof legal opinions. It is impossible for an outsider to say for sure why the rating agencies choose to do that, but one may speculate that the facts mentioned in the January 28 Professors’ Letter played a role in the rating agencies’ calculus, namely: (a) the rating agencies get their compensation from the companies who issue the rated securities, not from the investors who rely on the ratings awarded by the rating agencies, (b) the rating agencies are virtually unregulated, and (c) the rating agencies historically have proven almost invulnerable to suits by investors asserting that they were misled by faulty ratings.

Who, then, bears the legal risk that a bankruptcy court would hold that securitized assets have not been insulated from the bankruptcy estate of the sponsoring company? The investors who purchase the securities issued. Investors are abundantly warned of that legal risk. For example, a typical prospectus very recently filed with the Securities and Exchange Commission in respect of a securitization transaction warns the investor, under the bold heading “RISK FACTORS,” as follows:¹²¹

If Credco, TRS, or any of their affiliates were to become a debtor in a bankruptcy case, the court could exercise control over the receivables on an interim or a permanent basis. Although steps have been taken to minimize this risk, Credco, TRS, or any of their affiliates as debtor-in-possession or another interested party could argue that --

* Credco did not sell the receivables to RFC II but instead borrowed money from RFC II and granted a security interest in the receivables;

* RFC II and its assets (including the receivables) should be substantively consolidated with the bankruptcy estate of

Credco, TRS, or any of their affiliates; or

- * The receivables are necessary for Credco, TRS, or any of their affiliates to reorganize.

If these or similar arguments were made, whether successfully or not, payments to you could be delayed or reduced.

If Credco, TRS, or any of their affiliates were to enter bankruptcy, moreover, the trustee and the certificateholders could be prohibited from taking any action to enforce the RFC II receivables purchase agreement or the pooling and servicing agreement against Credco, TRS, or those affiliates without the permission of the bankruptcy court. Certificateholders also may be required to return payments already received if Credco were to become a debtor in a bankruptcy case.

Investors can hardly say that they were not warned.

The BMA Letter (p. 6) warns of “grave market consequences” if the legal uncertainty is not resolved in the way that industry desires, citing a memorandum it filed in an inconclusive litigation in which the issue was raised. The principal consequence cited by the memorandum, however, is simply that investors will suffer exactly the consequences that flow from adverse resolution of the very legal issue that they were warned about^[3] That is, rating agencies will cease to rate securitization transactions on the assumption that they insulate the securitized assets from the creditworthiness of the sponsoring company, hence ratings on securities that were issued in securitization transactions will be reduced or withdrawn, the securities thus downgraded will drop in value, and the investors who hold those securities will have to absorb those losses.

To anyone familiar with the history of other financial products, such as over-the-counter derivative contracts and hold-in-custody repurchase agreements, industry’s warning of the dire consequences that will follow if industry is not bailed out from the consequences of its aggressive reading of bankruptcy law has a familiar ring. The cycle has become all too familiar. A financial product is developed that is profitable for the immediate parties thereto but entails serious legal risk in the event one of the parties goes bankrupt. Market participants are induced to accept the product notwithstanding the legal risk. By happenstance, no bankruptcy case adjudicating the legal risk occurs early in the product cycle. The market for the product grows explosively. Industry then points to the huge size of the market either by way of imploring Congress for statutory relief from the risk it assumed or by way of putting moral pressure on the unlucky bankruptcy court in which the issue is finally adjudicated. Resolution of the issue in favor of industry keeps industry happy, but at the cost of depriving third parties of rights to which they would otherwise be entitled in an eventual bankruptcy proceeding. So the interests of the financial community (or selected components of it) steadily erode the protections afforded by the Bankruptcy Code to other constituencies. And the financial community is encouraged to found other products upon highly aggressive readings of bankruptcy law, confident that if the product can be grown quickly enough Congress will bail it out.

Congress should be wary of repeating this cycle yet again, and may well find it the better part of wisdom to allow the parties to a transaction that entails legal risk in the event of bankruptcy to bear the consequences of having assumed that risk.

Legal disclosure. The BMA Letter, pp. 6-8, argues vigorously that the financial statements and SEC filings (if any) of a company engaged in a securitization transaction provide adequate disclosure of the fact to the company’s creditors and other third parties. Recent notorious developments give some grounds for skepticism as to whether current financial accounting standards provide for adequate disclosure of off-balance-sheet transactions. But I shall not re-argue the point. Rather, I simply note that section 912 may deprive third parties of a fundamental form of *legal* disclosure to which they have historically been entitled. For broad classes of financial assets, long-established rules of commercial and bankruptcy law require a public notice called a “financing statement” to be filed in a public filing office whenever a company sells or grants a lien on those assets. If a financing statement is not properly filed and the company later goes bankrupt, the purported sale or lien is effectively void. Because failure to have filed a financing statement has swift and certain adverse consequences for the buyer in a purported sale in the event of the seller’s later bankruptcy, this is a self-enforcing way of mandating public disclosure of the a purported sale of financial assets that are subject to these rules.

Section 912 changes that result for securitization transactions, and securitization transactions only. Failure to file a financing statement will no longer invalidate a purported sale of financial assets in the event of the seller’s later

bankruptcy. The BMA Letter does not attempt to justify this change.

If I can be helpful as you evaluate section 912, please feel free to call.

Very truly yours,

Kenneth C. Kettering
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cc: Members of the Conference Committee

^[1] “It is precisely this feature of securitization that creates substantial financing efficiencies, and corresponding benefits, for the wide range of companies that rely upon it. By legally isolating a discrete and defined pool of assets as the principal source of payment on related securities, a company can issue securities that carry a higher credit rating (and a corresponding lower rate of interest) than the credit ratings assigned to its general short- and long-term debt obligations.” BMA Letter, at 5.

^[2] Registration Statement on Form S-3, American Express Credit Account Master Trust et al. (filed January 3, 2002) (available on the SEC’s EDGAR website, <http://www.sec.gov/>), p. 11. Similar disclosure is repeated on pp. 71-72 of the prospectus.

^[3] The Memorandum cited in note 6 of the BMA Letter, at pp. 18-19, states: “The consequences of [a ruling adverse to industry’s position] could be grave. First, investors large and small risk immediate losses... Billions of dollars in asset-backed securities have been issued on the assumption that two-tier securitization structures, comparable to those used by [the company in that litigation] successfully isolate assets of a special purpose subsidiary from the financial troubles of its parent. If these assumptions are called into question, many ratings could be withdrawn or dramatically reduced. The impact on the market value of the securities would be immediate.”