Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?

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The Bankruptcy Reform Act of 2001 (the ''Reform Act'')[1] has been called many names — but until recently, ''dead'' was not among them.[2] True, several recent attempts to revise the Bankruptcy Code had floundered for one reason or another. However, with George W. Bush in the White House, and bipartisan support in Congress, the Reform Act was as sure as a thing could be in Washington.

And then came Enron.

Enron has not, it appears, killed the Reform Act entirely. Indeed, it seems likely that it will become law.[3] It has, however, been weakened in at least one important respect: Section 912 of the Reform Act —the provision that would have insulated asset securitization transactions from almost any judicial scrutiny —is gone, at least for the moment.[4]

Section 912 —which was billed as a ''technical'' fix to the Bankruptcy Code — would have had two principal effects. First, it would have foreclosed bankruptcy courts from recharacterizing asset securitizations as loans,

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

[2] The events of September 11, 2001 left some questioning the merits of the Reform Act. *See, e.g., Bill to Alter Bankruptcy Law Remains Stalled*, ABI WORLD (Oct. 19, 2001), http://www.abiworld.org/headlines/01oct19.html (observing that, due to the terrorist attacks, ''lawmakers' enthusiasm for the legislation may have dimmed [because] no one in Washington wants to be perceived as anti-consumer''). As noted below, the Reform Act would appear to be alive and well.

[3] Congressman F. James Sensenbrenner, Jr., the leader of the House delegation of the conference to reconcile the House and Senate versions of the Reform Act, recently said: ''I feel a bit like Mark Twain[,] who observed that reports of his death were exaggerated. Contrary to [recent] prognostications of gloom and doom, the [Bankruptcy Reform Act] is alive and well, and its future has never been healthier.'' F. James Sensenbrenner, Chairman, House Judiciary Committee, Remarks to Credit Union National Association, February 27, 2002 (available at http://www.house.gov/judiciary/sensenbrenner022702.htm) (hereinafter, ''Sensenbrenner Speech''). Of course other political issues — *e.g.,*, homestead exemptions, abortion clinic damage claims — could also derail the Reform Act.

[4] A copy of Section 912 is attached as Appendix A.

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regardless of the true economics of the transaction. Under Section 912, any transaction in which certain financial assets (e.g., accounts receivable) were ''sold . . . with the intention of removing them from the estate of the debtor'' would, as a matter of law, be excluded from the bankruptcy estate of the debtor that originated the financial assets (e.g., the initial creditor of the account receivable). Even if the debtor/originator retained the obligation to make up the difference in the event the account debtor defaulted —classic indicia of a loan, rather than a sale —bankruptcy courts would have to treat the transaction as a ''true sale'' of the financial assets —which could, in many cases, leave debtors without the resources to reorganize. Courts could not follow the recent, controversial decision in *LTV*, where the debtor was permitted to use securitized assets under a cash collateral order.[5]

But Section 912 would not simply have forced courts to accept the parties' ''sale'' characterization of securitizations. Section 912's second, and perhaps more insidious, effect would have been to gut a number of important and long-standing avoidance powers, in the Bankruptcy Code and at state law, where a transaction is denominated an asset securitization. These avoidance powers can and should be available to deter and undo transactions that are harmful to debtors like Enron, even if they are asset securitizations.

What is the connection between Enron and Section 912? To be fair, so far it is only circumstantial. According to the *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* (the ''Enron Report''), Enron used hundreds of special purpose entities to hide assets and liabilities from public scrutiny. Because special purpose entities are also central to asset securitizations, it is reasonable to infer that Section 912 would encourage the use of these somewhat controversial financing vehicles, and would deprive courts of a remedy when they were misused.

Thus, the timing of Section 912 was inconvenient, to say the least. On the one hand, members of Congress have wasted no time in trumpeting their outrage about Enron. United States Senator Peter Fitzgerald, for example, recently denounced Enron's former CEO Kenneth Lay as a ''carnival barker'' and ''confidence man.''[6] Similarly, Orrin Hatch observed at a recent hearing that Enron represents a ''failure of the transparent system meant to protect investors and our securities markets . . . it's a national shame.''[7] On the other hand, Section 912 would appear to promote transactions with features similar to those in issue in Enron. Worse, as discussed below, there

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[5] 2001 Bankr. Lexis 131 (February 5, 2001).

[6] *Lawmakers scold Lay; Enron Chief pleads 5th*, THE SUN (BALTIMORE), Feb. 13, 2002.

[7] *Committee Hearing*, Feb. 6, 2002, (available at http://web.lexis-nexis.com/congcomp/document).

is an argument that Section 912 would even apply to the Enron partnership transactions themselves.

This irony was simply too rich to be ignored. In January 2002, 35 law professors pointed some of this out in a lengthy letter to Congress.[8] The Bond Market Association, a chief proponent of Section 912, responded, criticizing the law professors as undifferentiated enemies of economic efficiency, and noting that something like Section 912 was in every recent version of bankruptcy reform legislation. Thereafter, for reasons lost to the mysteries of the legislative process, it was announced that Section 912 would, in fact, be removed from the Reform Act.[9]

This Article briefly describes asset securitization transactions and Section 912. It then reviews several significant problems with Section 912 and explains how, if it became law, Section 912 would apply to transactions like those in Enron —and may even apply to immunize Enron and its questionable partnership transactions. Notwithstanding the Enron connection, the pressures that gave rise to Section 912 are considerable. It is supported by a powerful, wealthy and articulate lobby. As discussed below, Section 912 may be dead. It may, however, just be dormant.

I. Asset Securitization and its Agonists

''Asset securitizations'' are generally defined as ''the sale of equity or debt instruments, representing ownership interests in [an], . . . income-producing asset or pool of assets. . . structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets.''[10]

A securitization typically involves at least two parties:

1. The ''originator'' is typically the original owner (and creator) of the financial assets (such as accounts receivable, lease payments, credit card receivables or mortgage receivables) that are the subject of the securitization transaction. The originator might, for example, be an equipment leasing company which is owed lease payments from its lessees. The lessee's payment obligations are an asset of the originator. These assets are defined in Section 912(2) as ''eligible assets.''

2. The ''special purpose entity'' is the initial purchaser of these eligible

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[8] I was a signatory to the letter (the ''Professors' Letter''), and even went on to write a second, more technical letter about some of the implications of Section 912. Both letters can be viewed at http://www.abiworld.org/research.

[9] *See* Sensenbrenner Speech, *supra* note 3

[10] Tamar Frankel, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES (1991 & Supp. 1995). *See also* Lois R. Lupica, *Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic*, 9 Am. Bankr. L. Rev. 287, 288 (2001); SECURITIZATION OF FINANCIAL ASSETS (Jason H.P. Kravitt ed., 2d ed. 1997 & Supp. 2000).

assets and is often called an ''SPE.'' In Section 912, the SPE is defined as an ''eligible entity.''[11]

The heart of a securitization is a transfer of financial assets from the originator to the SPE that has the legal force of a ''true sale.'' If the transfer of these assets is a true sale, then the assets should be insulated from the originator's economic troubles.[12] If, instead, the transfer is not a true sale —but is, for example, a transfer for security (e.g., a disguised financing) —the originator's bankruptcy estate would retain an interest in the assets. The assets would then be subject to, among other things, the automatic stay, rules on the debtor's use of cash collateral and cram-down under Bankruptcy Code Section 1129. Indeed, it is generally understood that the ''efficiency'' of securitization derives, in part, from separating the debtor permanently from these assets.[13]

Even proponents of asset securitizations would appear to have some anxiety about the true sale character of these transactions. Thus, they typically have counsel to the originator issue what is known as a ''true sale'' opinion, declaring that the transaction will, probably, be treated as a true sale (and not a loan or other kind of transaction whereby the securitized assets would remain part of the originator's bankruptcy estate). In general terms, the true sale opinion is an elaboration on the more common enforceability opinion —the lawyer's letter that says that the transaction is what it purports to be, and is enforceable according to its terms. The problem, of course, is that legal opinions are important only where one or more parties is unsure of how a court would treat the transactions in hindsight.

Uncertainty about ''true sale'' — the distinction between sales and financings — has a long and venerable history. The problem goes back at least as far as 1925, when the Supreme Court decided *Benedict v. Ratner*.[14] There, Justice Brandeis, writing for a unanimous court, held that a sale of future accounts receivable was really a disguised loan, and therefore a fraud-

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[11] Securitizations may also involve a third entity, defined in Section 912 as the ''Issuer.'' This is the entity that purchases the eligible assets from the SPE and issues the securities backed by the income stream they produce.

[12] Thomas J. Gordon, *Securitization of Executory Future Flows as Bankruptcy-Remote True Sales*, 67 U. Chi. L. Rev. 1317, 1318 (2000) (securitization eliminates risk of regular unsecured and secured arrangements).

[13] *See generally* Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 Wash. U.L.Q. 1061 (1996); Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STANFORD J. L., BUS. & FIN. 133 (1994); STEVEN L. SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION Appendix A (*Is Securitization a Zero-Sum Game?*) (3d ed. 2002). *See also* Lynn M. LoPucki, *The Death of Liability*, 106 Yale L.J. 1, 24 (1996) (discussing benefits of asset securitization where company keeps valuable assets separate from entities at risk).

[14] Benedict v. Ratner, 268 U.S. 353, 45 S. Ct. 566, 69 L. Ed. 991 (1925).

ulent conveyance void against the assignor's bankruptcy trustee.[15] *Benedict* has generally been viewed as a ''mistake''[16] because ''instead of looking to the New York assignment cases (which were [] in point), [Brandeis] looked to the New York cases on inventory . . . chattel mortgages (which were not in point at all).''[17] Had Justice Brandeis viewed the accounts as subject to the rule on the sales of accounts, he would likely have concluded that the nonpossessory security interest was perfected, and not avoidable as a fraudulent conveyance.[18] Having instead viewed the assignment of accounts through the (''wrong'') lens of the inventory finance cases,[19] Justice Brandeis held that the secured party's failure to exercise ''dominion and control'' over the accounts was a fraud on the debtor's creditors.[20]

Benedict may be seen as but one salvo in the war over the true sale problem. The most effective response came in the UCC, which undertook to overturn *Benedict* legislatively.[21] UCC § 9-205 provides that ''[a] security interest is not invalid or fraudulent against creditors solely because . . . the

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[15] *Benedict*, 268 U.S. at 360 (''Under the law of New York a transfer of property as security which reserves to the transferor the right to dispose of the same, or to apply the proceeds thereof, for his own uses is, as to creditors, fraudulent in law and void.'').

[16] 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 622-23 (1965).

[17] *Id.* at 622.

[18] *See, e.g.*, Stackhouse v. Holden, 66 A.D. 423, 73 N.Y.S. 203 (4th Dep't 1901). In *Stackhouse*, the court held that an assignment of accounts to secure an overdraft was not a fraudulent conveyance. *Id.* at 205. Although this would appear to have been the controlling decision, *Benedict* adopted the reasoning of the *Stackhouse* dissent. *Benedict*, 268 U.S. at 365 (citing *Stackhouse*, 73 N.Y.S. at 209 (Spring, J., dissenting) (''[T]he vice here is that there was in fact no real transfer-no real vesting-of title in the assignee.'')).

[19] *Benedict*, 268 U.S. at 362-63; *see also* Russell v. Winne, 37 N.Y. 591, 4 Abb. Pr. N.S. 384, 1868 WL 6145 (1868).

[20] *Benedict*, 268 U.S. at 363 (holding that the assignment was fraudulent ''because of dominion reserved. It does not raise a presumption of fraud. It imputes fraud conclusively because of the reservation of dominion inconsistent with the effective disposition of title and creation of a lien''). For a thoughtful rehabilitation of *Benedict*, *see* Edward J. Janger, *Brandeis, Progessivism, and Commercial Law: Rethinking* Benedict v. Ratner, 37 Brand L. J. 63, 74 (1998) arguing that *Benedict* reflected Brandeis' '''progressive' passion for financial accountability'').

In one sense, *Benedict* represents the opposite problem from that posed by asset securitization. In *Benedict*, Justice Brandeis was troubled by the secured party's absence of ''dominion and control'' over financial assets (which absence suggested fraud). In asset securitizations, by contrast, the purchaser usually has (or purports to have) complete dominion and control over the purchased assets. The true sale problem posed by securitization is not one of purchaser control, but rather one of the risk retained by the debtor in the obligation to repurchase the financial asset in the event the account debtor defaults. Nevertheless, both *Benedict* and asset securitization confront the same general problem: How to characterize a transfer that shares attributes of both a sale and a loan?

[21] Gilmore, *supra* note 14, at 625 (citing F. § 9-205).

secured party fails to require the debtor to account for proceeds or replace collateral.''[22] The Official Comment explains that ''this section repeals the rule of *Benedict v. Ratner*.''[23]

UCC § 9-205 has not, however, stopped more recent courts from construing purported sales to be disguised financings. In 1993, the United States Court of Appeals for the Tenth Circuit, in *Octagon Gas Systems v. Rimmer (In re Meridian Reserve, Inc.)*,[24] held that financial assets sold by the debtor prior to its bankruptcy should, in fact, be included in the debtor's bankruptcy estate. Relying upon the Supreme Court's expansive interpretation of ''estate'' in *United States v. Whiting Pools, Inc.*,[25] the *Octagon* court reasoned that, because property of the estate includes property subject to a security interest, and because the sales of accounts are governed by the law governing transfers of security interests, the accounts remained property of the debtor's bankruptcy estate.[26]

In the wake of *Octagon*, the drafters of Revised Article 9 of the UCC —which went into effect virtually everywhere in the nation July 1, 2001 —included UCC § 9-318(a). This section was intended to clarify that financial assets that were sold prior to bankruptcy, and in which a security interest was perfected, were to be treated as fully alienated by the debtor.[27] Under § 9-318(a) ''[a] debtor that has sold an account, chattel paper, pay-

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[22] UCC. § 9-205(a) (2001).

[23] UCC § 9-205 cmt. 2.

[24] *See* Octagon Gas Systems, Inc. v. Rimmer, 995 F.2d 948, 957 n.9, Bankr. L. Rep. (CCH) ¶ 75288, 20 U.C.C. Rep. Serv. 2d 1330 (10th Cir. 1993) (rejecting view that sale of asset removes it from transferor's bankruptcy estate).

[25] 462 U.S. 198, 203-205 (1994). The use of *Whiting Pools* is curious. In that case, the U.S. Supreme Court concluded that the automatic stay was effective to stop the Internal Revenue Service from consummating a tax sale of assets seized before commencement of the bankruptcy case. The IRS had argued that the assets seized were not property of the debtor's estate; the Court held that they were, and required the IRS to turn them over to the estate pursuant to § 542(a) of the Bankruptcy Code. *Id.* at 203, 205. Citing both the legislative history and the language of Bankruptcy Code § 541(a)(1), the Court observed that § 541 is ''intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code'' (*id.* at 204), and that in order to ''facilitate the rehabilitation of the debtor's business, all of the debtor's property must be included in the reorganization estate, including property in which a creditor has a security interest.'' *Id.* at 203. Whether this also permits a court to recover assets conveyed in a true sale, however, is another matter. If the sale is a true sale, it is not clear what property interest the debtor retains. In a foreclosure, whether by the IRS or otherwise, the debtor would appear to retain its equity in the property and a right of redemption. Absent grounds for avoidance (e.g., fraudulent conveyance, preference), no such rights should remain where the debtor sells its property.

[26] *See Octagon*, 995 F.2d at 955.

[27] UCC § 9-318 (2001). *See also* Lupica, *supra* note 10, at 301; Steven L. Harris & Charles W. Mooney, Jr., *How Successful Was the Revision Of UCC Article 9?: Reflections of the Reporters*, 74 Chi-Kent L. Rev. 1357, 1398 n.178 (1999) (''Revised section 9-318 rejects *Octagon Gas* insofar as the opinion interpreted Article 9.''); G. Ray Warner, *Asset Securitiza-*

ment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold.''[28]

UCC § 9-318(a) is intended to ''make[] explicit what was implicit, but perfectly obvious, under former Article 9: The fact that a sale of an account or chattel paper gives rise to a ''security interest'' does not imply that the seller retains an interest in the property that has been sold.''[29] To the contrary, the official comment explains that ''a seller of an account or chattel paper retains no interest whatsoever in the property to the extent that it has been sold.''[30]

Section 9-318 does not, however, tell a court whether a particular transfer is a true sale.[31] Comment 2 makes this clear in noting that, ''[n]either this Article nor the definition of 'security interest' in Section 1-201 provides rules for distinguishing sales transactions from those that create a security interest securing an obligation.''[32] Thus, as Professor Lupica has observed ''this remains a determination to be made by courts on a case by case basis.''[33]

The most recent published decision on true sale suggests that, at least in the Northern District of Ohio, the bankruptcy estate of the originator does retain an equitable interest in financial assets sold in a securitization. In *In re LTV Steel Company*,[34] LTV, a large manufacturer of steel products, had entered into two securitization facilities prior to the commencement of its chapter 11 case, pursuant to which it agreed to sell accounts receivable and inventory to wholly subsidiaries (SPEs) which, in turn, borrowed money secured by these assets. Neither of the SPEs was a debtor in bankruptcy.[35]

Early in the case, the bankruptcy court entered an interim cash collateral order permitting the debtor to use cash collateral, including the receivables allegedly sold in the securitizations. The court determined that the cash collateral was ''necessary to permit Debtor to continue business operations''

tion Under Revised Art. 9, AM. BANKR. INST. J., Sept. 2000, at 16 (''Revised § 9-318(a) is designed to overrule *Octagon* by providing that a debtor who has sold an income-producing asset does not retain a legal or equitable interest in the collateral sold'').

[28] UCC § 9-318(a).

[29] UCC § 9-318, cmt. 2.

[30] *Id.*

[31] Lupica, *supra* note 10, at 301-302.

[32] Rev. UCC § 9-318 cmt. 2.

[33] Lupica, *supra* note 10, at 302.

[34] 2001 Bankr. Lexis 131 (February 5, 2001).

[35] *Id.* at *4.

and that the interests of the securitization providers were ''adequately protected.''[36]

One of these securitization providers, Abbey National Treasury Services, PLC (''Abbey''), soon sought to modify the cash collateral order.[37] Among other things, Abbey claimed that the receivables sold in the securitizations were not property of LTV's bankruptcy estate under Section 541.[38] Thus, the bankruptcy court had no power to subject the receivables to the cash collateral order.

The Bankruptcy Court rejected Abbey's position. Like *Octagon*, the *LTV* court began its analysis by citing *Whiting Pools* and emphasizing the breadth of the estate: ''The estate created by the filing of a Chapter 11 petition is very broad, and property may be included in Debtor's estate even if Debtor does not have a possessory interest in that property.''[39] For reasons that are not entirely clear, Abbey conceded that ''whether Debtor actually sold the receivables to [the SPE] is a fact-intensive issue that cannot be resolved without extensive discovery and an evidentiary hearing.''[40]

In any case, the court reasoned that ''there seems to be an element of sophistry to suggest that Debtor does not retain at least an equitable interest in the property that is subject to the interim [cash collateral] order. . . . To suggest that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept.''[41] This ''equitable interest'' in the securitized assets, coupled with the debtor's need for the funds, were, to the court's view sufficient to support the interim order.

The implications of *LTV* are unclear. Perhaps it means that a debtor retains a residual interest in financial assets, even if sold in a securitization. Perhaps it means that the court believed —but did not say —that the securitizations were, like those in *Ratner*, disguised financings, a kind of fraud. Perhaps it was simply what it purported to be — an interim cash collateral order neces-

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[36] *Id* at * 6.

[37] Abbey did not consent to the cash collateral order. *Id.* at *4-5.

[38] Abbey also argued that the entry of the cash collateral order deprived it of due process and failed to provide adequate protection.

[39] *Id.* at *18 (citing U.S. v. Whiting Pools, Inc., 462 U.S. 198, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 10 Bankr. Ct. Dec. (CRR) 705, 8 Collier Bankr. Cas. 2d (MB) 710, Bankr. L. Rep. (CCH) ¶ 69207, 83-1 U.S. Tax Cas. (CCH) ¶ 9394, 52 A.F.T.R.2d 83-5121 (1983).

[40] *Id.* at *18-19. One could have argued that the agreements were clear on their face, and required no further evidence whatsoever.

[41] *Id.* at *19 —20.

sary to save a desperate company, and as such should not be taken as strong precedent on true sale, or securitizations, generally.[42]

II. Section 912

Whatever the meaning of *LTV*, it provided renewed vigor to proponents of Section 912, who understandably point to the case as the kind of judicial interference that increases the risks (and therefore costs) of asset securitizations. Section 912 would prevent decisions like *LTV* in the future by excluding securitized assets from the bankruptcy estate of the originator, if two things were true: (i) the transaction was one where financial assets (e.g., accounts receivable) were ''sold . . . with the intention of removing them from the estate of the debtor,''[43] and (ii) at least one tranche or class of securities to be issued in the securitization (by the SPE or the securitization provider) were rated ''investment grade'' by one or more nationally recognized statistical rating organizations (''NRSRO''), when the securities were initially issued.[44]

Although promoted as a ''technical'' amendment to the Bankruptcy Code, Section 912 would have two principal effects: (i) it would force courts to accept the ''true sale'' character of an asset securitization, regardless of the economics of the transaction; and (ii) it would prevent a bankruptcy court from recovering assets conveyed in an asset securitization except under the fairly narrow, one-year avoidance power of Bankruptcy Code Section 548. All other avoidance actions would be eliminated by Section 912.

A. True Sale

As discussed above, the true sale problem has vexed courts for many years. When, under what circumstances, and to what effect, should a transaction denominated by the parties as a ''sale'' be treated as something else? These questions animated decisions such as *Benedict, Octagon* and *LTV*, where the courts held that assets that were allegedly sold nevertheless remained part of the debtors' bankruptcy estates. Section 912 would fore-

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[42] On March 20th, 2001, a final order was entered in the U.S. Bankruptcy Court for the Northern District of Ohio authorizing debtor-in-possession financing for LTV Steel Company. As part of this order, the court entered stipulated findings stating that ''the Debtors admit and the Court finds that the transactions contemplated by and entered into pursuant to [the relevant inventory and trade receivable securitization documentation] constitute ''true sales'' of, respectively, the inventory and accounts receivable conveyed to [LTV's securitization SPVs].'' *See* http://www.bondmarkets.com/r-updates/2001/040301.shtml

[43] Section 912(2)(f)(5) (defining ''transfer''). *See also* § 912(2)(f)(2) (defining ''eligible assets'').

[44] Section 912(2)(f)(1). Section 912 calls these organizations ''nationally recognized *securities* rating organizations.'' This would appear to be a misnomer. *See* Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1.

close such decisions in the future, requiring bankruptcy courts to accept the parties' characterization of the transaction so long as it satisfied the basic statutory criteria set forth above.

There are good reasons to be concerned about Section 912's solution to the true sale problem. The Professors' Letter mentioned in the introduction to this article argued that stripping courts of this power would seriously impair the ability of many debtors to reorganize.[45] It would permit parties to place assets beyond the reach of unsecured creditors, such as employees and tort claimants. It may also place too much power in the hands of the NRSROs, such as Moody's. These organizations work for the parties, and do not have the interests of the originator's other creditors in mind.

Perhaps the most disquieting aspect of Section 912's treatment of the true sale problem was the so-called ''put'' feature: A transaction would qualify as a statutory securitization even if the originator retained the obligation to repurchase defaulted assets from the SPE. Specifically, the term ''transferred'' would be defined to mean a sale of financial assets ''irrespective and without limitation of . . . (B) whether the debtor had an obligation to repurchase . . . such eligible assets.''[46] In other words, Section 912 would treat a securitization as a ''true sale'' even if the SPE could ''put'' defaulted assets back to the originator.

This is troubling at two levels. First, it defies economic reality. Retention of risk is classic indicia of ownership, not sale. If I lease you my car, or grant you a security interest in it, I retain the risk that it may break down or otherwise lose value. I, as the owner, remain responsible for making up the difference (''deficiency'') owed to you. If, instead, I sell you the car, you assume these risks, absent fraud or breach of warranty on my part. Section 912, however, would permit us to characterize what is, economically, a lease as a sale.

Defying reality (economic otherwise) is not, however, necessarily a problem. Our law is generally indifferent to a contract where you and I agree to call my cat a dog. There is, in other words, no rule that says that contracts must be objectively ''true'' to be enforceable.[47] Rather, the second, and more troubling, aspect of the ''put'' would flow from the fact that third parties would undoubtedly rely on the (misleading) contractual characterization rendered by the parties. Under Section 912, an originator could book the revenue of an asset securitization as if it were a sale, without necessarily disclosing the fact that the originator retained the obligation to repurchase the assets

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[45] *See* Professors' Letter, *supra* note 8.

[46] Section 912(2)(f)(5).

[47] Putting securities laws to one side.

purportedly sold in the event the assets did not perform.[48] This, of course, smacks of Enron, which according to the Enron Report apparently made a business out of booking revenue without disclosing liabilities concealed in special purpose entities.

B. Avoidance Powers

Section 912 would not simply force courts to ignore the economic reality of an asset securitization. Its second, perhaps more insidious feature, would eliminate virtually all judicial powers to avoid (that is, undo) asset securitizations as, e.g., fraudulent or preferential transfers. By eliminating these avoidance powers, Section 912 would scuttle important checks and balances in the financial system, and would thereby permit —perhaps even encourage —all kinds of financial misconduct.

Section 912 does not expressly say that it is eliminating avoidance powers. Rather, it 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, would therefore eliminate every other judicial power under the Bankruptcy Code and at state law to return these assets to the originator's bankruptcy estate.

1. Strong Arm Power

Consider first the effect of Section 912 on the ''strong arm'' power of Bankruptcy Code § 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. A principal purpose of the strong arm power is to prevent or undo ''secret'' transfers.[49] Secret transfers avoidable by Section 544(a) include unperfected (that is, undisclosed) security interests and unperfected sales of financial assets. In the *Octagon* case, discussed above

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[48] Statement of Financial Accounting Standards No. 140 (''FAS 140'') governs ''off-book'' accounting for asset securitizations. To enjoy off-book accounting, FAS 140 generally requires that (a) the transferred assets be presumptively beyond the reach of the transferor and its creditors; (b) where the transferee is an SPE, each holder of its beneficial interests (i.e., its securities) has the right to pledge or exchange those interests; and (c) the transferor does not have the ability to unilaterally cause the holder to return specific assets. FAS 140 ¶ 9. FAS 140 does not appear to preclude off-book treatment where the transferor (i.e., the originator) retains the obligation to repurchase the transferred assets..

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

for example, the purchaser of accounts had not filed a financing statement to perfect its interest in the debtor's accounts.[50]

In the case of asset securitizations, this notice is typically provided by filing a ''UCC-1'' financing statement in the office of the secretary of state where the debtor (the originator) is incorporated.[51] Other creditors of an originator —trade creditors, service providers, even other lenders —probably rely heavily on these filings to determine the creditworthiness of the originator. By removing the threat of the strong arm power, however, Section 912 would significantly reduce the impetus to file UCC-1 financing statements. What incentive would the securitization provider have to file a financing statement if there were no meaningful sanction —e.g., transfer avoidance — for failing to do so?[52]

2. State Law Avoidance Powers —Section 544(b)

Section 912 would also eliminate 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.[53]

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.[54] State fraudulent transfer law, by contrast, provides much longer statutes of limitations — from four to six years.

This longer period of coverage is an important check on harmful transactions. Those who engage in such transactions under current law usually 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

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[50] 995 F.2d 948 (10th Cir. 1993)

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

[52] Securitization providers might, under Section 912, choose to file financing statements because, for example, other parties at state law might attempt to seize the securitized assets subject to the unperfected security interest. This may, however, encourage originators to file for bankruptcy, in order to obtain the protections of Section 912.

[53] 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).

[54] 11 U.S.C. § 546.

by Bankruptcy Code Section 544(b). By enacting Section 912, Congress would eliminate this important check.

3. Other Judicial Powers.

By eliminating all avoidance powers except Section 548(a) of the Bankruptcy Code, Section 912 would also limit a host of other well-established judicial powers to scrutinize and avoid suspect transactions. These include the turnover power under Section 542,[55] the power to avoid preferential transfers under Section 547,[56] the power to avoid post-petition transfers under Section 549,[57] and other equitable powers that bankruptcy courts have historically had to scrutinize and undo transactions that may harm debtors and their creditors.

Supporters of Section 912 would respond that the foregoing makes much ado about nothing. Section 912 would still subject securitizations to the fraudulent transfer provisions of Section 548(a). Moreover, asset securitizations remain subject to a number of non-judicial checks and balances. Most important, these proponents would argue, is that an asset securitization cannot qualify for treatment under Section 912 unless at least one tranche or series of securities issued is rated investment grade by a ''nationally recognized statistical rating organization'' (i.e., Moody's).

The problem is that the NRSRO's do not serve the same functions or constituencies as bankruptcy courts. They are generally hired and paid by the parties to the transaction. The NRSROs therefore have an incentive to rate the securities favorably. Moreover, they do not generally appear to have the interests of the originator's other creditors in mind, nor the power to do anything affirmative for them. NRSROs cannot, for example, avoid transfers in an asset securitization if they turn out to be fraudulent.

C. Yes, But What Does This Have To Do With Enron?

The title of this article suggests a connection between Section 912 and Enron. There is one, both by analogy and, perhaps, in fact.

As indicated above, Enron was apparently able to mislead investors, em-

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[55] Interestingly, the cash collateral order in LTV contained a provision requiring the ''secured creditors'' (presumably the SPEs or those who lent to the SPEs) to turn over securitized assets to be used as working capital for the debtor.

[56] *See* 11 U.S.C. § 547(b) (1994). This section provides that the trustee may avoid any transfer of an interest of the debtor in property (1) to or for the benefit of a creditor, (2) for or on account of an antecedent debt, (3) made while the debtor was insolvent (a fact which is presumed for the ninety-day period prior to commencement of the case under § 547(f)), (4) on or within 90 days of the commencement of the case (or one year, if the creditor was an ''insider'' of the debtor), and (5) that enabled the creditor to receive more than the creditor would have received if the transfer had not been made and the debtor were liquidated under Chapter 7. *Id.*

[57] 11 U.S.C. § 549.

ployees and regulators by manipulating special purpose entities, and the assets and liabilities they held. A recent article in the New York Times explained the problem concisely: ''The same financial tools used to create asset-backed securities [securitizations] were also used to construct the elaborately camouflaged and booby-trapped partnerships that have been blamed for Enron's collapse.''[58] Enron demonstrates the ease with which —even under current law — SPEs can be manipulated. To expand the power to use —or misuse — SPEs, and concomitantly to limit judicial oversight of them, seems imprudent.[59] Nevertheless, this is what Section 912 would do.

But the application of Section 912 to Enron may be more than analogical. It is unclear how many, if any, of the hundreds of Enron partnership transactions would qualify as statutory securitizations under Section 912. It is, however, easy to imagine that at least some would. The Chewco, JEDI and LJM partnerships all appeared to involve SPEs and appear to have involved financial transfers or sales of Enron financial assets in what were characterized as ''true sales'' by Vinson & Elkins, Enron's law firm.[60] What is unknown is whether any of these transactions involved the issuance of one or more tranches or series of securities that were rated investment grade by an NRSRO. A recent story in the New York Times suggested that some may have been.[61]

If these transactions were statutory securitizations, consider the effect that Section 912 would have on just one of them. According to Enron's Form 10-Q, filed as of September 30, 2001, in 1999, Enron entered into a series of transactions involving a third party and a partnership known as LJM1:

> The effect of the transactions was (i) Enron and the third party amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron having forward contracts to purchase Enron common shares at the market price on that day, (ii) LJM1 received 6.8 million shares of Enron common stock subject to certain restrictions, 3.1 million shares of which it contributed to the LJM1 subsidiary and (iii) Enron received a note receivable from LJM1, which was repaid in

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[58] Diana B. Henriques, *The Brick Stood Up Before. But Now?*, N.Y. TIMES, (Mar. 10, 2002).

[59] Obviously, existing judicial powers were not a perfect deterrent; they did not for example, stop Enron from engaging in the transactions that led to the current crisis.

[60] The Enron Report, for example, suggests that the partnerships were involved in securitizations. According to Enron's proxy statement for 2000, ''LJM2 paid 12.9 million for an equity interest in an Enron securitization vehicle (that owned approximately $300 million of merchant assets) and loaned $19.6 million to such vehicle.'' Enron Report at 185.

[61] *Enron's Deals Were Marketed to Companies By Wall Street*, N.Y. TIMES, C1, C9, February 14, 2002 (discussing ratings of Marlin partnerships; suggesting bonds issued were rated by Standard & Poor's).

> December 1999, and certain financial instruments hedging Enron's investment in the stock of Rhythms NetConnections, Inc. . . . . In March 2000, Enron and LJM1 entered into an agreement to terminate the financial instruments. In connection with this agreement, Enron received the 3.1 million shares of Enron common stock held by the LJM1 subsidiary. A put option, which was originally entered into in the first quarter of 2000 and gave LJM1 the right to sell shares of Enron common stock to Enron at a strike price of $71.31 per share, was terminated under this agreement. In return, Enron paid approximately $26.8 million to LJM1.[62]

Would this $26.8 million payment be an avoidable fraudulent transfer? Absent Section 912, it would if it were made with the requisite intent, or while Enron was insolvent or inadequately capitalized and if, as appears to be the case, Enron received inadequate consideration for the payment. If, however, Section 912 were enacted, this payment would *not* be avoidable. It could not be challenged under Section 548(a), because it occurred more than one year before commencement of Enron's bankruptcy. Nor would it be vulnerable under Section 544, because Section 912 would expressly disable avoidance actions arising at state law, with longer limitations periods.[63]

Assuming that the partnership transactions qualify as statutory securitizations under Section 912, the next question is whether the new provision would apply to Enron, itself.

Here, too, the answer is not clear. Section 913 of the Reform Act provides that it will be effective on enactment, ''but shall not apply with respect to cases commenced or appointments made under any Federal or State law before the date of enactment of this Act.''[64] A careful reader will immediately recognize that avoidance actions are not ''cases'' —they are ''adversary proceedings'' —a different species of judicial action. An adversary proceeding has many of the features of a civil litigation commenced under the Federal Rules of Civil Procedure.[65] Governed by Part VII of the Federal Rules of Bankruptcy Procedure, an adversary proceeding is commenced by the filing of a complaint with the court and the service of a summons on the defendant. A ''case,'' by contrast, is the entire bankruptcy case, commenced by the filing of a petition under Section 301 of the Bankruptcy Code. While Enron's bankruptcy case preceded the effective date, the argument would go,

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[62] Enron 10-Q, at 16.

[63] Which limitations period applies turns on which state's fraudulent transfer law applies. This, in turn, is a complex question involving the underlying contracts, their choices of law and a variety of other factors, beyond the scope of this article.

[64] Section 913(a) & (b). The text of Section 913 is set out at the end of this article as Appendix B.

[65] FED. R. BANKR. P. 7003, 7004.

the adversary proceeding would be commenced after the Reform Act's effective date.[66] Thus, while Section 912 would not apply to the Enron *case*, it would apply to adversary proceedings commenced after its effective date.

For whom would this matter? For any of the participants in the partnerships who received Enron property in asset securitizations that fit within the statutory criteria of Section 912 and the timing of Section 913. They may include people like Andrew Fastow, who appears to have acted as the managing member of the general partner of certain of the partnerships, as well as financial institutions like J.P. Morgan Chase and Citigroup, who are investors in the limited partnerships, and direct creditors of Enron.[67]

III. Conclusion

At the heart of Section 912 is a paradox. On the one hand, cases like *LTV* make plausible the concerns that animate Section 912. Proponents of Section 912 are understandably anxious about the costs of legal uncertainty. On the other hand, it is well known that the securitization market is quite robust, accounting for several trillion dollars in assets.[68] Uncertainty has not, it would appear, dampened enthusiasm for securitization.

But this is not to say that uncertainty is without cost. Legal uncertainty does create costs, in terms of due diligence, legal opinions, transactional complexity, and so on. The important question is whether these costs are accompanied by meaningful benefits. Enron would suggest that they are. For example, these uncertainties usually lead parties to a securitization to dis-

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[66] The distinction between ''adversary proceedings,'' on the one hand, and non-adversary proceedings has been exploited by the Fourth Circuit of Appeals in the sovereign immunity context. *Compare* In re NVR, LP, 189 F.3d 442, 452, 42 Collier Bankr. Cas. 2d (MB) 750 (4th Cir. 1999), *cert. denied*, 528 U.S. 1117, 120 S. Ct. 936, 145 L. Ed. 2d 815 (2000) (state immune from adversary proceeding to avoid and recover certain taxes) *with* State of Maryland v. Antonelli Creditors' Liquidating Trust, 123 F.3d 777, 31 Bankr. Ct. Dec. (CRR) 475 (4th Cir. 1997)(state not immune to discharge of certain taxes under plan of liquidation). I have criticized this distinction as incoherent. *See* Jonathan C. Lipson, *Fighting Fiction with Fiction: The New Federalism in (a Tobacco Company) Bankruptcy*, 78 Wash. U.L.Q. 1271 (2000). Nevertheless, the distinction may provide support for the view that adversary proceedings are different from other aspects of a bankruptcy case. Ergo, the effective date of Section 912 for cases may be prospective, but the effective date for adversary proceedings is when the Reform Act goes into effect. Whether or not coherent, the distinction has been recognized for jurisdictional purposes, among other. *See, e.g.*, In re Porges, 44 F.3d 159, 163, n.2, 32 Collier Bankr. Cas. 2d (MB) 1354, Bankr. L. Rep. (CCH) ¶ 76342 (2d Cir. 1995) (''an adversary proceeding and the companion bankruptcy case constitute two distinct proceedings'').

[67] J.P. Morgan Chase and Citigroup are members of the Official Committee of Unsecured Creditors and appear to have been investors in LJM2.

[68] *See, e.g., Securitization 101*, at http://www.securitization.net/pdf/sec101.pdf.

close their transactions publicly (that is, to perfect the security interests)[69] and, one hopes, to make a clear-headed fraudulent transfer assessment.[70] They also compel the parties to seek true sale opinions, which should result in a greater level of independent scrutiny than would otherwise be the case. In other words, uncertainty inspires a certain amount of discipline among the parties which, in turn, leads them to consider the effect the transaction will have on third parties (e.g., other creditors of the originator). In a roundabout way, uncertainty begets financial prudence and integrity —considerations apparently lacking in many of Enron's dealings.

Obviously, even these safeguards were inadequate to prevent what appears to have been significant wrongdoing at Enron. Nevertheless, it is easy to see why Congress appears to have jettisoned Section 912. Eliminating uncertainty has a generic charm, until the consequences of doing so are considered. Here, the consequences would be manifest: Does any elected official really want to be known for legislation that, with only slight exaggeration, could be characterized as the ''Enron Immunity Act of 2002?''

But do not assume that Section 912 is dead. Like Lazarus, it may yet rise from the grave. While members of Congress vent their spleens at and about Enron in public, watch what actually happens with Section 912, or similar future provisions. For example, although he may view Enron as a ''national shame,'' Senator Hatch — a cosponsor of the Reform Act and Section 912 — also used recent Enron hearings to defend Section 912, claiming that it ''would not encourage the kinds of abuses that occurred in Enron.''[71] Section 912 may be dead — or it may just be dormant.

Appendix A: Complete Text of § 912 of S. 420

SEC. 912. ASSET-BACKED SECURITIZATIONS.

Section 541 of title 11, United States Code, is amended—

(1) in subsection (b), by inserting after paragraph (7), as added by this Act, the following:

(8) any eligible asset (or proceeds thereof), to the extent that such eligible asset was transferred by the debtor, before the date of

[69] Perfection will not always correlate to public notice, as security interests in certain kinds of collateral —uncertificated securities and electronic chattel paper —may (or, in the case of electronic chattel paper, must) be perfected by ''control.'' See UCC §§ 9-106, 9-104, 9-105, 9-107 & 9-314(a). Perfection by ''control'' does not turn on any public filing.

[70] There are some opponents of asset securitization who might actually view Section 912 as a good thing, on the theory that it would likely force bankruptcy trustees to articulate what may be the most compelling argument against the worst abuses of securitization: Asset securitizations are, as a matter of law, intentional fraudulent conveyances because they are intended to hinder and delay creditors of the originator.

[71] *Committee Hearing*, Feb. 6, 2002, (available at http://web.lexis-nexis.com/congcomp/document).

commencement of the case, to an eligible entity in connection with an asset-backed securitization, except to the extent such asset (or proceeds or value thereof) may be recovered by the trustee under section 550 by virtue of avoidance under section 548(a); and

(2) by adding at the end the following new subsection:

(f) For purposes of this section—

(1) the term 'asset-backed securitization' means a transaction in which eligible assets transferred to an eligible entity are used as the source of payment on securities, including, without limitation, all securities issued by governmental units, at least one class or tranche of which was rated investment grade by one or more nationally recognized [securities][72] rating organizations, when the securities were initially issued by an issuer;

(2) the term 'eligible asset' means—

(A) financial assets (including interests therein and proceeds thereof), either fixed or revolving, whether or not the same are in existence as of the date of the transfer, including residential and commercial mortgage loans, consumer receivables, trade receivables, assets of governmental units, including payment obligations relating to taxes, receipts, fines, tickets, and other sources of revenue, and lease receivables, that, by their terms, convert into cash within a finite time period, plus any residual interest in property subject to receivables included in such financial assets plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders;

(B) cash; and

(C) securities, including without limitation, all securities issued by governmental units;

(3) the term 'eligible entity' means—

(A) an issuer; or

(B) a trust, corporation, partnership, governmental unit, limited liability company (including a single member limited liability company), or other entity engaged exclusively in the business of acquiring and transferring eligible assets directly or indirectly to

[72] Should probably be ''statistical.'' See discussion *supra* note 44.

an issuer and taking actions ancillary thereto;

(4) the term 'issuer' means a trust, corporation, partnership, or other entity engaged exclusively in the business of acquiring and holding eligible assets, issuing securities backed by eligible assets, and taking actions ancillary thereto; and

(5) the term 'transferred' means the debtor, under a written agreement, represented and warranted that eligible assets were sold, contributed, or otherwise conveyed with the intention of removing them from the estate of the debtor pursuant to subsection (b)(8) (whether or not reference is made to this title or any section hereof), irrespective and without limitation of—

  (A) whether the debtor directly or indirectly obtained or held an interest in the issuer or in any securities issued by the issuer;

  (B) whether the debtor had an obligation to repurchase or to service or supervise the servicing of all or any portion of such eligible assets; or

  (C) the characterization of such sale, contribution, or other conveyance for tax, accounting, regulatory reporting,

Appendix B: Complete Text of § 913 of S. 420

SEC. 913. EFFECTIVE DATE; APPLICATION OF AMENDMENTS.

(a) Effective Date. This title shall take effect on the date of enactment of this Act.

(b) Application of Amendments. The amendments made by this title shall apply with respect to cases commenced or appointments made under any Federal or State law on or after the date of enactment of this Act, but shall not apply with respect to cases commenced or appointments made under any Federal or State law before the date of enactment of this Act.