PRIDE AND PREJUDICE IN SECURITIZATION: A REPLY TO PROFESSOR PLANK[*]

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Introduction. My article *Securitization and Its Discontents: The Dynamics of Financial Product Development*[1] is primarily a study in legal sociology. It is devoted to exploring the processes by which new financial products, having legal underpinnings that suffer from the uncertainties that commonly attach to innovation, come to take root and shape the law to accommodate their existence. The product that is the main reference point for that discussion is securitization, and so a secondary theme of the article is examination of the weaknesses in that product's doctrinal underpinnings, in order to study how the product came to flourish in their despite. Professor Thomas Plank, who is actively engaged in securitization practice, has written a response[2] that

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1 29 CARDOZO L. REV. 1553 (2008).

2 Thomas E. Plank, *Sense and Sensibility in Securitization: A Prudent Legal Structure and a Fanciful Critique*, 30 CARDOZO L. REV. 617 (2008). As to Plank's active engagement in securitization practice, see *id.* at 617 n.*.

gives only a brief nod to the primary theme of the article. Instead, his response is devoted almost exclusively to defending securitization's doctrinal underpinnings.

I use the word "defending" advisedly, for Plank introduces my article as a "criticism of securitization"[3] and proceeds to treat it as an attack on the product. A reader only of Plank's response therefore is likely to be surprised to learn of the similarity of our normative views about the product. We agree that securitization of receivables is desirable.[4] We also agree that the product is here to stay. Moreover, we have each made much the same legislative recommendation about the product: namely, that Congress should amend the Bankruptcy Code to lift the burdens that it imposes (for short, the "Bankruptcy Tax") on loans secured by receivables, so as to permit financing to be done on the same terms that securitization aims at achieving without the costly hocus-pocus of special purpose entities that securitization entails.[5] The limits of our concord are not clear with respect to securitization of assets other than receivables, for Plank did not address the subject—a notable omission, discussed later in this paper. Nevertheless, at least as far as receivables securitization is concerned, our views of the appropriate attitude of the bankruptcy system are quite similar.

What separates us is merely doctrine. It is all but axiomatic (and Plank does not deny) that a debtor's prebankruptcy waiver of rights the debtor would have under the Bankruptcy Code is unenforceable. In particular, if an Originator undertakes a prebankruptcy financing against assets that it owns, and the terms of the financing include a waiver by the Originator of the Bankruptcy Tax that will apply in the event of the Originator's subsequent bankruptcy, that waiver would be unenforceable. The prototypical securitization transaction is nothing but a structural substitute for such an unenforceable waiver, in that the structure has no purpose and no significant effect other than to evade the Bankruptcy Tax on the financed assets in the event of the Originator's subsequent bankruptcy. That structural contrivance is in obvious tension with the rule of nonwaivability. A plausible basis in bankruptcy policy therefore exists for a bankrupt Originator in need of cash to collapse its prepetition securitization for the purpose of undoing this evasion of the Bankruptcy Tax (and, in particular, enabling the Originator to use the cash proceeds of the securitized assets). All that such an Originator requires is a doctrinal tool with which to collapse the securitization in the name of vindicating that policy. My article

[3] *Id.* at 620.

[4] *See* Kettering, *supra* note 1, at 1716-27.

[5] *See id.* at 1722 n.556 and accompanying text. For elaboration of the burdens imposed by the Bankruptcy Code on secured loans, which both Plank and I refer to as the "Bankruptcy Tax," see *id.* at 1566-68 and Plank, *supra* note 2, at 621-22.

discussed two doctrines—fraudulent transfer and substantive consolidation—that a court so inclined could use to that end.

To say that a court could so use those doctrines is not the same as saying that a court inevitably would so use them, of course. Both doctrines are elastic by nature; neither is sufficiently algorithmic to allow confident prediction about how a court would react to its invocation in a novel setting. But securitization has depended upon this legal risk being assessed as virtually nil, to justify the AAA ratings routinely awarded to securitized debt. For the purpose of my article, it is not necessary to be convinced that a court inevitably would apply these doctrines adversely to the product, still less that a court should do so. It is enough to be convinced that this risk is substantially higher than the negligible level implicit in the AAA rating, particularly in the case of litigation arising during the early years of the product's use. Much of my article is devoted to exploring how the product pulled itself up by its bootstraps to its present status, in which it is so widely used that successful challenge to its doctrinal foundations is now almost unthinkable, as contrasted with the days of its youth, when it lacked the shield of widespread use.

Plank has no use for that exploration, for he will not abide the notion that there is or ever has been any plausible basis in legal doctrine for collapsing a prototypical securitization in the bankruptcy of its Originator. He claims that the legal risk is "extremely low"[6] for this "very conservative"[7] structure, and that dissent is "fanciful."[8] His response is effectively a brief for the defense in a hypothetical future case in which a bankrupt Originator attempts to collapse its securitization. As such, it makes no pretense of balance, and twists facts to the limits of what might pass in a brief.

Two examples of such fact-twisting can be selected from Plank's discussion of *In re LTV Steel Co*.[9] That case is an embarrassment to Plank's contention that the legal risk is "extremely low," for it is the only reported opinion to date adjudicating a bankrupt Originator's attempt to collapse its securitization, and in it the court ruled against the securitization structure, allowing LTV Steel, the Originator of the securitizations involved in that case, to use the cash proceeds of the securitized assets. The decision might be shrugged off because of its meager precedential weight: it was but a decision by a single bankruptcy judge declining to vacate his earlier interim order allowing the Originator to use that cash, and the litigation never progressed even

[6] Plank, *supra* note 2, at 638.

[7] *Id.* at 637.

[8] *Id.* at 617, 623, 626, 627, 634. Better yet is "romantic fantasy," *id.* at 642, though the romantic element is obscure.

[9] 274 B.R. 278 (Bankr. N.D. Ohio 2001).

as far as a final order.[10] Plank, however, portrays the case as though it were a triumph for securitization, asserting that "the challenge to the trade receivables securitization resulted in an order finding that there had been a true sale of the receivables to the receivables' SPE."[11] He omits to disclose that the "finding" to which he refers was in a later consent order ratifying a settlement among the parties to the securitization transactions (a settlement that, moreover, gave the Originator $100,000,000 in additional financing).[12] Being uncontested, that later finding has no stare decisis effect and means nothing (except, of course, between the parties who agreed to it).[13]

In the same discussion, Plank says: "Kettering attributes the ultimate vindication of the inventory and trade receivables securitization in *LTV Steel* as the product of the 'shaky but too big to fail' phenomenon."[14] Quite apart from the fact that *LTV Steel* was anything but a "vindication" of the securitization transactions involved in that case, Plank here attributes to me views that are the opposite of those set forth in my article. There I observed that *LTV Steel* is a counterexample

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[10] For a nonpolemical description of the litigation and its background, see Robert Stark, *Viewing the LTV Steel ABS Opinion in its Proper Context*, 27 J. CORP. L. 211, 219-23 (2002). Plank's effort to minimize the embarrassment of *LTV Steel* extends to asserting that my description of the opinion as ruling against the product is "inaccurate." Plank, *supra* note 2, at 640. It is quite accurate. The court denied a securitization financier's motion to vacate the interim order allowing LTV Steel to use the proceeds of the securitized assets, and one of the reasons for the ruling was rejection of the "true sale" argument that is essential to the success of that and every other securitization:

> [T]here 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 order. Debtor's business requires it to purchase, melt, mold and cast various metal products. 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. Accordingly, the Court concludes that Debtor has at least some equitable interest in the inventory and receivables, and that this interest is property of the Debtor's estate. This equitable interest is sufficient to support the entry of the interim cash collateral order.

274 B.R. at 285.

[11] Plank, *supra* note 2, at 640.

[12] The consent order is Final Order Authorizing Debtors Pursuant to 11 U.S.C. §§105, 361, 362, 363, 364(c)(1) and 364(c)(3) to (A) Obtain Post-Petition Financing and (B) Repurchase Certain Inventory, Accounts Receivable and Adequate Protection Claims, *In re* LTV Steel Co., 274 B.R. 278 (Bankr. N.D. Ohio 2001) (No. 00-43866) (docket no. 734, filed Mar. 20, 2001). That Plank is referring to this later settlement can be discovered only by reading the source cited in Plank, *supra* note 2, at 640 n.98. That consent order provided for a debtor-in-possession credit facility to refinance the prepetition securitizations; a simultaneous consent order provided for an additional credit facility for an additional $100,000,000. The latter is Order (I) Approving Debtors' Motion for Order Approving Post-Petition Financing and Related Relief, and (II) Granting Security Interests and Superpriority Claims Pursuant to Sections 105(a) and 364(a) of the Bankruptcy Code and Bankruptcy Rules 2002, 4001 and 9014, *id.* (docket no. 735, filed Mar. 20, 2001). Both facilities were secured by substantially all of the debtor's property. The docket and pleadings in *LTV Steel*, including these two consent orders, are available at http://ltv.williamslea.net/search.asp.

[13] *See* Kettering, *supra* note 1, at 1720 n.550.

[14] Plank, *supra* note 2, at 639.

to the "too big to fail" dynamic, in that the court ruled against the securitizations even though the "too big to fail" dynamic weighed heavily in their favor. Indeed I used *LTV Steel* as a primary example of the limits of "too big to fail."[15] Financiers seeking to uphold the securitization beat the "too big to fail" drum in the briefs they filed in *LTV Steel*, and Plank misattributes those financiers' argument to me.[16]

Having given these examples I will leave the reader of Plank's advocacy with a *caveat lector*.

On the topic of the strength of the doctrinal foundations of securitization, Plank maintains that the only issue that merits serious consideration is the one that the securitization industry has most emphasized: namely, that the conveyance of the securitized assets from Originator to the special purpose entity ("SPE") established as a conduit for the financing constitutes a "true sale" of those assets that removes them from any future bankruptcy estate of the Originator.[17] My article does no more than mention that issue, though I have since published an analysis of it.[18] But analysis is not required to demonstrate the uncertainty of the result counted on by the securitization industry even on that issue, for the industry and its allies have acknowledged that uncertainty when necessary.

A prominent instance is the abortive effort in the late 1990s and early 2000s to amend the Bankruptcy Code to validate the industry-desired position on the true sale issue.[19] The proposed amendment originated with a trade association of bond insurers, most of whom insure or reinsure securitized debt. The association unsuccessfully lobbied the National Bankruptcy Review Commission to propose that amendment to Congress, candidly asserting its desirability on the ground that the uncertainty of the present law leaves securitization transactions open to challenge.[20] The eventual Congressional sponsor

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[15] Kettering, *supra* note 1, at 1655-56.

[16] As authority for his statement quoted *supra* at note 14, Plank cites my article, *supra* note 1, at 1635 & n.270. There the financiers' "too big to fail" arguments, fully attributed to their briefs, are quoted. Those briefs were filed in regard to an anticipated final order on the Originator's right to use cash proceeds of the securitized assets, after the published opinion referred to *supra* note 9 that refused to vacate the interim order allowing such use. The settlement referred to *supra* note 12 mooted the contest.

[17] *See* Plank, *supra* note 2, at 621 ("[Kettering] does not directly attack the analytical foundations of securitization—the true sale of assets to a separate legal entity—except by innuendo."). To be fair, Plank elsewhere clarifies that he also takes seriously the possibility of substantive consolidation of the Originator and the SPE. But that issue plainly does not bulk as large as the true sale issue to him or to the securitization industry at large.

[18] The mention in Kettering, *supra* note 1, is at 1581-85; the later analysis is Kenneth C. Kettering, *True Sale of Receivables: A Purposive Analysis*, 16 AM. BANKR. INST. L. REV. 511 (2008).

[19] For the history of this episode, see Kettering, *supra* note 1, at 1653-54, 1721-22.

[20] Letter from Martin J. Bienenstock, Weil, Gotshal & Manges LLP, for Financial Security Assurance on behalf of the Association of Financial Guaranty Insurers, to Elizabeth Warren,

of legislation to enact that proposal introduced it to Congress with a statement likewise emphasizing the need to correct the uncertainty of the result under current law.[21] Practitioners friendly to the proposal made the same observation in their testimony to Congress.[22]

The securitization industry's recognition that its probability of success on the true sale issue is a good deal less than certain is evident from other signs as well. One is the enactment by some states of statutes that aim at assuring true sale status for the critical conveyance in a securitization transaction.[23] Another is the fact that in

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Executive Director, National Bankruptcy Review Commission (Feb. 19, 1997, accompanied by proposed amendment and explanation, each dated Feb. 21, 1997) (on file with the library of American University Washington College of Law). Page 1 of the explanation, for instance, states as follows:

> The purpose of the proposed amendments to the Bankruptcy Code is to provide certainty and uniformity of treatment for asset securitizations under the Bankruptcy Code. . . .
>
> The lack of either clear judicial precedent or statutory provisions respecting the availability of cash-flows and proceeds from the underlying assets for payment of the asset-backed securities leave those arrangements open to challenge, with potentially disastrous consequences for the multi-billion dollar market.

[21] The proposed amendments first appeared in S. 1914, 105th Cong. § 215 (1998) and H.R. 4393, 105th Cong. § 12 (1998). Senator Grassley, sponsor of the Senate bill (a wide-ranging set of changes to business bankruptcy law), explained this provision as follows:

> I would call my colleagues' attention to one provision in particular. . . . One factor in keeping mortgage interest rates very low is the existence of a robust secondary market where mortgage lenders can spread the risk by issuing securities backed up by home mortgages. With the risk spread by a securities market, mortgage bankers can make loans at lower interest rates.
>
> Unfortunately, a provision of the bankruptcy code threatens to undermine the viability of this important secondary market. And if the secondary market dries up, then lenders will have to raise interest rates. Under current law, it isn't clear that the income stream going to the purchaser of the mortgage-backed securities will continue if the lender declares bankruptcy. In my bill, we expressly say that the income stream belongs to the securities purchaser and not the bankrupt lender. This change will help ensure that the secondary market stays strong by providing much-needed certainty to purchasers of mortgage-backed and other asset-backed securities.

144 CONG. REC. S3129 (daily ed. Apr. 2, 1998).

[22] Thus, Seth Grosshandler, a partner at the law firm of Cleary Gottlieb Steen & Hamilton LLP, testified as follows:

> Unfortunately, there is a lack of guiding judicial precedent regarding what constitutes [a] true sale of assets. The considerations in the analysis are highly subjective and depend on a qualitative assessment of a wide variety of facts and circumstances. For these and other reasons, any true sale opinion will generally be a reasoned one, with various assumptions as to factual matters and conclusions that introduce an unnecessary degree of legal uncertainty in the asset-backed market. . . .
>
> These changes would not only reduce transaction costs for future mortgage- and asset-backed securitizations, they would minimize the likelihood that an insolvent debtor could attempt to reclaim already-securitized assets in a proceeding under the Bankruptcy Code, notwithstanding the structural safeguards to avoid such a result.

Bankruptcy Reform Act of 1999 (Part III): Hearing on H.R. 833 Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary, 106th Cong. 395-96 (1999).

[23] These state "true sale" statutes are briefly mentioned in Kettering, *supra* note 1, at 1582; for a fuller discussion, see Kettering, *supra* note 18, at 517-26.

securitizations in which the financiers' investment is subject to the disclosure requirements of the federal securities laws, the offering documents typically (if not invariably) contain prominent warnings of the risk that the Originator's future bankruptcy court may deny true sale status to the critical conveyance, and of the unhappy consequences to the financiers that would follow.[24] Furthermore, the legal opinions rendered on the true sale issue at the closing of securitization transactions are typically lengthy reasoned opinions that, by the nature of a reasoned opinion, are designed to communicate uncertainty, and are extravagantly qualified.[25] (Plank contests this description of the legal opinions, asserting that, to the contrary, "the opinion language is quite conclusive."[26] It is sufficient to observe that the single true sale opinion he cites is anything but conclusive: it is, as usual, a reasoned opinion, and among its many qualifications is a warning that "the opinion expressed below is not based on controlling precedent and we do not purport to predict the conclusion that would be reached by a particular court considering the question."[27])

These signs of uncertainty are not surprising, for the incoherence of the cases addressing the true sale issue is so complete that courts in search of precedent have declared that they might as well decide such cases by tossing a coin.[28] Indeed, Plank himself wrote an article devoted to the subject in order "to promote greater certainty" in light of

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[24] For example, in a search for prospectuses for securitized debt filed today (December 4, 2008) in the Securities and Exchange Commission's Edgar database, the first to appear relates to $600,000,000 in securitized debt issued by Nissan Auto Receivables 2008-C Owner Trust (prospectus supplement dated December 2, 2008, prospectus dated December 1, 2008). Page 10 of the prospectus is almost entirely devoted to disclosing, as a "Risk Factor," that "if . . . [the Originator or one of certain affiliates] becomes subject to a bankruptcy proceeding, the court in the bankruptcy proceeding could conclude that . . . [the Originator or affiliate] still owns the receivables by concluding that the sale to the [affiliate] or the issuing entity was not a 'true sale,'" and warning of the adverse consequences to investors that would follow. Similar disclosure also appears in the body of the prospectus at pp. 68-69. The disclosure is prominent: the covers of both the prospectus and the prospectus supplement contain the usual bold-faced warning to investors to review carefully the "Risk Factors."

[25] On opinion practice in securitization transactions, see Kettering, *supra* note 1, at 1683-85.

[26] *See* Plank, *supra* note 2, at 633-37; the quoted language is at 634.

[27] The opinion in question, cited by Plank, *supra* note 2, at 634 n.69, was rendered in connection with the closing of one of the securitization transactions involved in *LTV Steel*. The opinion is Exhibit J to, and the quoted language is at page 494 of, Emergency Motion for (1) Order Granting Interim Authority to Use Cash Collateral and (2) Scheduling and Establishing Deadlines Relating to a Final Hearing; Memorandum of Points and Authorities and Affidavits of John Delmore and James W. Croll in Support Thereof, *In re* LTV Steel Company, Inc., No. 0043866 (Bankr. N.D. Ohio 2000) (docket no. 28, filed Dec. 29, 2000), *available at* http://ltv.williamslea.net/search.asp.

[28] *In re* Commercial Loan Corp., 316 B.R. 690, 700 (Bankr. N.D. Ill. 2004) ("With 'no discernible rule of law or analytical approach' evident from the decisions, a court 'could flip a coin and find support in the case law for a decision either way.'"); Elmer v. Comm'r, 65 F.2d 568, 570 (2d Cir. 1933) (L. Hand, J.) ("It is possible, as we have suggested, to construe these transactions in either way."). These cases are noted in Kettering, *supra* note 1, at 1583 n.87; for a fuller discussion, see Kettering, *supra* note 18.

the "absence of a consistent analysis" by the courts.[29]

Thus, even on the true sale issue—the securitization industry's own preferred doctrinal playing field—the uncertainty of the result necessary to support the product is amply shown by the words and deeds of the industry and its allies. That alone suffices to refute Plank. As to the different doctrinal issues on which my article focused, much of Plank's response is empty rhetoric.[30] But his response does include some points that warrant reply.

Fraudulent Transfer: Financial Distress is Not a Necessary Element. My article included an extended analysis of the use by courts of the primordial rule of fraudulent transfer law, which declares avoidable any transfer of property by a debtor made to "hinder, delay or defraud" its present or future creditors, as a regulatory tool to enforce policies of debtor-creditor law that the courts consider sufficiently important.[31] Historically prominent, this use of fraudulent transfer law is less familiar today, when specific statutory responses to perceived abuses are more common than in former times. My article noted many examples of courts wielding fraudulent transfer law to proscribe undesirable debtor behavior that is not fraudulent in any ordinary sense. That doctrine is available to a court that attaches sufficient importance to preventing securitization's evasion of the Congressionally-mandated Bankruptcy Tax, and to enforcing the long-established policy denying enforcement to a debtor's prebankruptcy waiver of rights granted to it by the Bankruptcy Code. Moreover, the precedents include a group of cases, headed by *Shapiro v. Wilgus*,[32] that are analogous to securitization, in that the debtor behavior the courts deemed impermissible were transfers aimed at manipulating the applicability of insolvency law to the debtor's future insolvency proceeding in a way that the courts considered undesirable.

Plank raises two objections to this analysis. First, he denies that cases support the use of fraudulent transfer law as a regulatory tool as

[29] Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON. L. REV. 287, 291 (1991).

[30] For example, most of a subsection of Plank's response aims at detracting from the fact that the prototypical securitization is economically equivalent to a direct nonrecourse loan secured by the securitized assets. *See* Plank, *supra* note 2, at 640-41. That fact is obvious from the structure of the prototypical securitization, and has been widely acknowledged. *See* Kettering, *supra* note 1, at 1570-74. Plank does not clearly deny the fact, but asserts its irrelevance on the ground that direct nonrecourse loans secured by receivables are not made in any substantial number. But the point, obviously, is that the purpose of the prototypical securitization is to evade the Bankruptcy Tax that would apply to that economically equivalent product. The extent to which lenders choose to make such "taxable" loans is immaterial.

[31] Kettering, *supra* note 1, at 1585-1622.

[32] 287 U.S. 348 (1932). For discussion of these cases, see Kettering, *supra* note 1, at 1601-08.

thus described.[33] His central argument on this point derives from the fact that in some of the cases I cited, including *Wilgus*, the debtor was in a state of financial distress at the time of the challenged transfers.[34] From that he summarily infers that the debtor's financial distress at the time of the transfer is a necessary element of the primordial rule of fraudulent transfer law. Hence, according to Plank, a securitization can be vulnerable to challenge under the primordial rule only in the unusual case in which the securitization is effected by an Originator that is insolvent or nearly so.

This objection is far-reaching, as it would radically confine the application of the primordial rule. It is also quite wrong. It confuses the constructive fraud rules of fraudulent transfer law, under which the debtor's financial distress at the time of the transfer is a necessary element, with the primordial rule, which contains no such element. The debtor's insolvency is traditionally considered to be one of the many "badges of fraud" that may be indicative of a violation of the primordial rule, but as with any "badge of fraud," the existence of this one is not a necessary element.[35] That the debtor's insolvency at the time of the transfer is not a necessary element of the primordial rule is black-letter law, and has been stated by innumerable cases.[36]

Indeed, cases applying the primordial rule as a regulatory tool, and doing so independently of the debtor's financial condition at the time of the transfer, include some of the best known in fraudulent transfer law.

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[33] Plank, *supra* note 2, at 623-27.

[34] Though peripheral to his central argument, Plank also misstates the facts of *Wilgus*, incorrectly asserting that the transfer successfully challenged in that case, which had been made for the purpose of establishing a receivership otherwise unavailable to the debtor, "would have required that [the dissenting creditor] accept less than full payment." *Id.* at 626. The dissenting creditor never claimed to be at risk of receiving less than full payment from the debtor (who was solvent, a finding embraced by the dissenting creditor). Rather, the dissenting creditor asserted only the harm of the delay imposed by the receivership. Petitioner's Brief Upon the Merits at 7, 19-25, 30-31, *Wilgus*, 287 U.S. 348 (No. 40). The Court's opinion likewise never alluded to any risk of less than full payment.

[35] This point is stated in the indicative listing of "badges of fraud" in UNIF. FRAUDULENT TRANSFER ACT § 4(b), which codifies the consensus view of courts construing the primordial rule in other enactments of fraudulent transfer law.

[36] Thus, the discussion of the Bankruptcy Code's enactment of the primordial rule in the standard treatise on bankruptcy includes a section captioned "Insolvency Irrelevant." 5 COLLIER ON BANKRUPTCY ¶ 548.04[3] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2007) (citing many cases). For additional cases declaring the irrelevance of the debtor's solvency to application of the primordial rule, in settings involving fraudulent transfers of familiar types, see, e.g., *United States v. Green*, 201 F.3d 251 (3rd Cir. 2000) (interspousal transfer by husband for inadequate consideration violated the primordial rule, regardless of whether husband was solvent at time of transfer; applying Pennsylvania enactment of the Uniform Fraudulent Conveyance Act); *Pashaian v. Eccelston Properties, Ltd.*, 88 F.3d 77, 86 (2d Cir. 1996) (transfers by judgment debtor to affiliated entities violated the primordial rule, applying New York enactment of the Uniform Fraudulent Conveyance Act; a cause of action under the primordial rule "'may lie even where fair consideration was paid and where the debtor remains solvent'").

An example is *Benedict v. Ratner*[37] and the many cases that followed it. These cases proscribed the collateral assignment of receivables if the debtor has the right to retain for its own benefit collections on the assigned receivables. The rule thus laid down was completely independent of the debtor's financial condition at the time of the assignment, so much so that in *Benedict* itself the Supreme Court did not even mention the point. Another example are the cases holding nonpossessory security interests to be fraudulent transfers, in the days before statutory introduction of chattel mortgages and other security devices altered that result. Such cases, too, attached no significance to the debtor's financial condition at the time of the transaction.[38] A third example is the "vendor in possession" doctrine, which holds that if a seller of goods retains possession of them rather than delivering them to the buyer, then the sale is, or can be, a fraudulent transfer. In some jurisdictions such a sale is considered to be a fraudulent transfer per se; in other jurisdictions, such a transaction may be only presumptively a fraudulent transfer, or not even that. Again, the point for present purposes is that courts have applied such rules without regard to the seller's financial condition at the time of the transfer.[39]

A fourth example is the rule that a self-settled spendthrift trust is unenforceable against creditors of the settlor. A "spendthrift trust" is a trust with a restraint on voluntary or involuntary alienation of the beneficiary's interest. Such a restraint, if enforced, shields the beneficiary's interest from the beneficiary's creditors. The spendthrift trust is a child of Pennsylvania law, and so Pennsylvania courts were the first to be faced with a situation in which a person conveys property to a

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[37] 268 U.S. 353 (1925). For a discussion of *Benedict* and its progeny, see Kettering, *supra* note 1, at 1593-96. In a footnote, Plank, *supra* note 2, at 627 n.41, dismisses *Benedict* on the ground that the drafters of the Uniform Commercial Code came to disapprove the result it prescribed and superseded it by statute for transactions subject to Article 9. *See* U.C.C. § 9-205 (2007). That does not affect the standing of *Benedict* as an interpretation of fraudulent transfer law: it was never overruled, and indeed was followed enthusiastically by other courts.

[38] A classic example is *Clow v. Woods*, 5 Serg. & Rawle 275 (Pa. 1819). *See* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 2.1 (1965) (stating this to be the general rule prevailing in the era before nonpossessory security interests began to be statutorily validated). It has been argued that, contrary to Gilmore, many courts did uphold nonpossessory security interests during that era. *See* George Lee Flint, Jr., *Secured Transactions History: The Fraudulent Myth*, 29 N.M. L. REV. 363 (1999). Even if the cases were more diverse than Gilmore's account would have it, judicial skepticism of such nonpossessory security interests, independent of the debtor's financial condition, was at a minimum a strong presence in the cases.

[39] Pennsylvania, for instance, has long held that a vendor's retention of possession is fraud per se (though the cases recognize that delivery may be made "constructively" in appropriate cases). *See* Shipler v. New Castle Paper Prod. Corp., 293 Pa. 412, 420 (1928); Proyectos Electronicos, S.A. v. Alper, 37 B.R. 931, 933-34 (E.D. Pa. 1983). The vendor-in-possession doctrine has been overridden in limited circumstances by U.C.C. §§ 2-402(2), 2A-308(1), (3) (2007). *See generally* 2 SAMUEL WILLISTON, THE LAW GOVERNING SALES OF GOODS §§ 351-404 (rev. ed. 1948); 1 GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES §§ 341-63 (rev. ed. 1940).

spendthrift trust of which he himself is the beneficiary.[40] The courts declined to allow the settlor's creditors to be thwarted by such an arrangement, and they based that holding on the primordial rule of fraudulent transfer law.[41] The solvency of the settlor at the time of the conveyance is irrelevant.[42] As spendthrift trusts became accepted in other states, courts elsewhere uniformly followed that rule, so it achieved the status of a staple from the beginning.[43] As with other well-settled rules that originated as applications of fraudulent transfer law, the origin of this rule has largely faded from current memory—but that, of course, does not alter the fact.[44]

Hence if a court is inclined to view securitization's evasion of the Bankruptcy Tax as a violation of bankruptcy policy, the primordial rule of fraudulent transfer law is available to remedy the violation, and there is nothing, either in the language of the usual enactments or in its historical application, that limits its application to a transfer by a debtor that is in a state of financial distress.

As a pendant, it is worth noting that the rule against self-settled spendthrift trusts is of topical interest, as it has recently been reversed by statute in several states as part of a broad effort to permit the wealthy to shield assets from their creditors through self-settled trusts. The roots of the current vogue are in the mid-1980s, when many offshore asset havens began to attract business by modifying their laws to improve asset protection for beneficiaries of locally-sited trusts. Envious of the trust business thus attracted, at least ten states, beginning with Alaska in 1997, have enacted statutes validating self-settled asset protection

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[40] On the Pennsylvania origins of the spendthrift trust, see ERWIN N. GRISWOLD, SPENDTHRIFT TRUSTS §§ 25-33, at 21-33 (2d ed. 1947).

[41] The root case is *Mackason's Appeal*, 42 Pa. 330, 338-39 (1862), which held that the arrangement violates the primordial rule as embodied in the original Statute of 13 Elizabeth. *See also* Ghormley v. Smith, 139 Pa. 584, 591 (1891) (arrangement is "against the public policy, as well as the statute of Elizabeth"); Patrick v. Smith, 2 Pa. Super. 113, 119 (1896) ("The prohibition of conveyances with intent to delay, hinder or defraud creditors, would be of little use if the debtor may put his estate beyond the reach of creditors and still get a living from it.").

[42] *See In re* Mogridge's Estate, 342 Pa. 308, 309 (1941); State v. Nashville Trust Co., 28 Tenn. App. 388, 401 (1945) (quoting the first edition of SCOTT ON TRUSTS. Substantially the same language appears in the current edition at 3 AUSTIN WAKEMAN SCOTT ET AL., SCOTT AND ASCHER ON TRUSTS § 15.4, at 953 (5th ed. 2007)).

[43] "[T]he cases are uniform in holding that . . . a person cannot create a spendthrift trust for himself which shall be effective against the rights of his subsequent creditors." GRISWOLD, *supra* note 40, § 474 at 543. The rule is laid down in each of RESTATEMENT (THIRD) OF TRUSTS § 58(2) (2003), RESTATEMENT (SECOND) OF TRUSTS § 156(1) (1959), and RESTATEMENT OF TRUSTS § 156(1) (1935).

[44] For example, the comments to the current Restatement state that the rule "does not depend on the settler having made a transfer in fraud of creditors." RESTATEMENT (THIRD) OF TRUSTS § 58 cmt. 3 (2003). That overlooks the fact that the rule was based on the conclusion that any such transfer is by definition "in fraud of creditors." On the tendency to forget the origin of legal rules founded on fraudulent transfer law, see Kettering, *supra* note 1, at 1608-10.

trusts.[45] Comparison of the march of these domestic asset protection trusts with the growth of securitization shows similarities and differences that may warrant a full study. Neither product faced litigation (or at least reported litigation) challenging its foundations soon after its establishment.[46] The vast bulk of the early literature on each product was written by practitioners with an interest in the product's success.[47] On the other hand, the domestic asset protection trust, unlike securitization, is wholly a creature of statute, and owes its existence largely to a race to the bottom among the states. Legislatures have not been ashamed to admit that these enactments are designed to draw trust business to the enacting states; and as the enacting states (at least to date) have been of low population, the frustrated creditors who bear the costs of the legislation will be largely out of state, thus neatly internalizing benefits and externalizing costs to the enacting states.[48] No similar dynamic drove the growth of securitization.

Any product that realigns creditors' rights is potentially at risk from fraudulent transfer law, and that is as true for the asset protection trust as it is for securitization. An asset protection trust loses its utility to the extent that a transfer to the trust is avoidable as a fraudulent transfer. The fraudulent transfer law of a state that has validated asset protection trusts could not reasonably be construed to make a transfer to such a trust a fraudulent transfer per se, but such a transfer might be subject to other fraudulent transfer laws (including the Bankruptcy Code's integral provision) that could be so construed. Commentators with a stake in the product therefore have written to oppose such construction of fraudulent transfer law, arguing (like Plank) that application of the primordial rule must depend upon the financial condition of the debtor at the time of transfer. Their argument typically

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[45] *See* David G. Shaftel, *A Comparison of the Various State Domestic Asset Protection Trust Statutes*, 35 EST. PLAN. 3, 14 (2008). On the offshore roots of the domestic product, see Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 CORNELL L. REV. 1035, 1047-51 (2000).

[46] *See* Richard W. Nenno & John E. Sullivan, III, *Planning and Defending Domestic Asset-Protection Trusts*, *in* AMERICAN LAW INST. & AMERICAN BAR ASS'N, PLANNING TECHNIQUES FOR LARGE ESTATES 894 (2008) ("No court has adjudicated whether a creditor may reach the assets of a properly designed and implemented domestic APT.").

[47] On the domination of the early literature by interested parties in the case of asset protection trusts, see Henry J. Lischer, Jr., *Professional Responsibility Issues Associated with Asset Protection Trusts*, 39 REAL PROP. PROB. & TR. J. 561, 584-86 (2004); in the case of securitization, see Kettering, *supra* note 1, at 1558-61.

[48] *See* Adam J. Hirsch, *Fear Not the Asset Protection Trust*, 27 CARDOZO L. REV. 2685, 2687 (2006); John K. Eason, *Policy, Logic, and Persuasion in the Evolving Realm of Trust Asset Protection*, 27 CARDOZO L. REV. 2621, 2654-57 (2006); Sterk, *supra* note 45, at 1066-74. Congress has intervened in this race for the bottom to the extent of amending the Bankruptcy Code in 2005 to provide a ten year limitations period for the Bankruptcy Code's integral fraudulent transfer provision in the case of a transfer by a debtor to "a self-settled trust or similar device" made with "actual intent to hinder, delay, or defraud" creditors. Bankruptcy Code § 548(e)(1). For a discussion, see Eason, *supra* note 48, at 2667-77.

runs that the primordial rule cannot be violated by a transfer if the transferor has made provision to pay all of his present and reasonably foreseeable creditors, and so a transfer to shield assets from creditors is not avoidable if the shielded assets are only those in excess of the amount reasonably estimated to be necessary to satisfy his present and reasonably foreseeable creditors.[49] That argument directly conflicts with the cases that laid down the original rule against self-settled spendthrift trusts, which held that a transfer by a debtor to shield assets whose benefit the debtor continues to enjoy violates the primordial rule per se.

Fraudulent Transfer: Evasion of the Bankruptcy Tax Plausibly Works to "Hinder, Delay or Defraud" the Originator's Creditors. Plank's second objection to the fraudulent transfer analysis boils down to the assertion that securitization of receivables should not be viewed as violating the primordial rule because its consequences are benign, and are not adverse (or at least not adverse to any substantial extent) to the interests of unsecured creditors of a bankrupt Originator.[50] This argument is essentially the same as my article makes in support of legislative validation of receivables securitization.[51] Briefly restated, the argument begins with the observation that escape from the Bankruptcy Tax is highly prized by asset-based financiers, who are willing to accept materially lower interest rates in financings that purportedly escape it. The price to the Originator of obtaining that benefit through securitization is that in the event of the Originator's later bankruptcy, the Originator will not have the right to use the cash proceeds of the financed assets. Inability to use that cash conceivably might thwart a reorganization of the Originator, which would certainly prejudice the Originator's unsecured creditors. But the situation is not as simple as that, for even if the transaction were characterized as a secured financing and the Bankruptcy Tax imposed, the Originator would have the right to use the cash only to the extent the financiers are adequately protected. In principle, an Originator might obtain better net financing terms by fighting to collapse the securitization if the bankruptcy court interprets "adequate protection" in a way markedly more generous to the Originator than the Originator could obtain in a negotiated debtor-in-possession financing. In practice, almost no

[49] *See* Nenno & Sullivan, *supra* note 46, at 828; Duncan E. Osborne & Jack E. Owen, Jr., *Planning for Asset Protection*, *in* AMERICAN LAW INST. & AMERICAN BAR ASS'N, ESTATE PLANNING IN DEPTH 913-17 (2008); John E. Sullivan III, *Future Creditors and Fraudulent Transfers: When a Claimant Doesn't Have a Claim, When a Transfer Isn't a Transfer, When Fraud Doesn't Stay Fraudulent, and Other Important Limits to Fraudulent Transfers Law for the Asset Protection Planner*, 22 DEL. J. CORP. L. 955, 988-95 (1997).

[50] Plank, *supra* note 2, at 628-32 (with a preliminary mention at 625-26).

[51] Kettering, *supra* note 1, at 1716-21, 1723-25.

Originators have found that course of action appealing (and the only publicly reported exception, LTV Steel, seemingly resorted to it only because a last minute falling out among its securitization financiers rendered impossible a peaceful debtor-in-possession financing, which was its preferred course of action).[52] Better, therefore, to allow the Bankruptcy Tax to be evaded, and allow all Originators to reap the certain benefit of lower interest rates, than to preserve a right available only to bankrupt Originators and that they have in practice found to be of little use.

The problem with this argument is that, whatever its normative appeal, it is not bound to persuade a court. The argument amounts to saying that Congress made a mistake when it imposed the Bankruptcy Tax on financings against receivables. That may be so (and indeed I believe that it is), but it is not an argument that a court would, or should, necessarily consider to be within its institutional competence. Congress imposed the Bankruptcy Tax on all secured financings, and it did so in a legal environment that took for granted the unenforceability of a debtor's prepetition waiver of rights it has under bankruptcy law. A court very plausibly would view itself as being in the business of enforcing that Congressional policy rather than allowing it to be thwarted. Plank himself acknowledges that receivables securitization amounts to circumventing a questionable policy judgment by Congress.[53] It cannot be supposed that a court necessarily would be, or even should be, receptive to that. That is especially so when one considers that in all probability the issue would be put before the court by an Originator that, like LTV Steel, is the odd case whose reorganization would die for lack of cash otherwise.

Plank thus stands the situation on its head when he says that my fraudulent transfer analysis "relies substantially on an empirical question: Does the Bankruptcy Tax in fact benefit the unsecured creditors of a debtor? Further, to what extent do the costs to the secured

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[52] *See* Moody's Investors Service, *Special Report: True Sale Assailed: Implications of* In re LTV Steel *for Structured Transactions*, at 5 (Apr. 27, 2001), *available at* http://www.moodys.com/.

[53] *See* Plank, *supra* note 2, at 629 ("[T]he Bankruptcy Tax as applied to receivables simply reflects poor regulatory design . . . . In this light, securitization does not thwart a purposeful Congressional policy. It is a private law means of curing a defect in the statutory scheme.").

Elsewhere, Plank asserts that "contrary to Kettering's characterization of the Bankruptcy Tax as a deliberate Congressional policy, it is more likely an unintended consequence." *Id.* at 628. That is nonsense. The exact extent of the Bankruptcy Tax can be debated (as Plank proceeds to do in discussing *United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365 (1988)), but there is no question that such basic features of the Bankruptcy Tax as the automatic stay, and the debtor's right to use cash proceeds subject to the bankruptcy court's notion of adequate protection, apply to debt secured by receivables. They are in no sense "unintended." Those basic features would block payment as and when due on a debt secured by receivables owned by a bankrupt debtor, and thus preclude a rating of such debt significantly higher than the rating of the debtor, no matter how *Timbers* had been decided.

creditor (and to society as a whole through the addition of the bankruptcy premium [to interest rates]) outweigh the putative benefits to the unsecured creditors of the bankruptcy estate?"[54] The threat to securitization derives precisely from the fact that a court need not undertake any such analysis in order to conclude that a securitization involves a fraudulent transfer. All the court need do is observe that Congress has already made the judgment to impose the Bankruptcy Tax, for good or for ill, and that prepetition waivers of rights granted to debtors by the Bankruptcy Code are unenforceable, and so enforce that Congressional judgment. It is the defenders of the securitization who are faced with persuading the court of the empirical argument, a la Plank, that this Congressional judgment was a bad one (and that, moreover, courts should allow it to be circumvented).

Furthermore, the crucial time for evaluating the strength of the product's legal foundations was during the early years of its use.[55] Elastic legal judgments are much less likely to be resolved adversely to the product today than would have been the case in its early years. That is so partly because the "too big to fail" dynamic would discourage an adverse ruling today, and partly because the twenty years of use have demonstrated that bankrupt Originators rarely wish to invoke the Bankruptcy Tax in such financings. The argument in favor of receivables securitization would have been much less persuasive during the product's early years, before those factors came into play.

Finally, as discussed in my article, if the Bankruptcy Tax against financed receivables can be evaded through use of the securitization structure, there is no obvious reason why such evasion could not be procured as to financed assets of any kind.[56] But evasion of the Bankruptcy Tax is, or can be, repugnant to core bankruptcy policy in the case of a financing against assets other than receivables in a way that does not apply to a financing against receivables. A fundamental aim of business bankruptcy—arguably *the* fundamental aim—is to prevent the loss of going concern value that may result if creditors are allowed to dismember a debtor's assets piecemeal. The Bankruptcy Tax (and, in particular, its automatic stay element) is the means for achieving that aim. Any exemption from the Bankruptcy Tax creates an opportunity for such a loss of value. It is intuitively plausible to suppose that the value of a receivable is not significantly dependent upon its owner, and so no significant value is lost by allowing the Bankruptcy Tax to be evaded as to receivables.[57] But the same

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[54] Plank, *supra* note 2, at 629.

[55] For further discussion of this point, see *infra* text at notes 64-70.

[56] *See* Kettering, *supra* note 1, at 1723-27.

[57] Moreover, Congress has repeatedly expanded the definition of "repurchase agreement." A "repurchase agreement" is effectively a loan secured by a financial asset of a permitted type, and

supposition cannot plausibly be made as to assets of other kinds—e.g., inventory, equipment, or core intellectual property assets. If a court respects the securitization structure as to receivables, it opens the way to securitization of any assets. That would rip the heart out of the bankruptcy system. Plank alludes tangentially to the problem,[58] but he offers no solution, for he does not discuss securitization of assets other than receivables.

In short, a court inclined to redress securitization's evasion of the Bankruptcy Tax could do so by applying fraudulent transfer law, consistently with established use of that doctrine. To repeat, for the purpose of my article it is not necessary to be convinced that a court would do so (still less that it should do so). It is enough that the risk be evaluated—particularly in the early years of the product's use, before it became "too big to fail"—as a serious one, well above the negligible level reflected in the AAA credit ratings that the product has received.

Substantive Consolidation. My article addressed a second doctrinal tool, in addition to fraudulent transfer, that a court so inclined could use to redress the evasion of the Bankruptcy Tax that is the purpose of securitization. That is substantive consolidation of a bankrupt Originator with the SPE that is used as the conduit for the securitization.[59] Substantive consolidation is typically invoked in situations in which two entities have disregarded their formal separateness in a substantial way, or have so scrambled their assets that unscrambling is impossible or impracticable. But the doctrine is based on implied equitable powers of the bankruptcy court, and so its application need not be confined to such situations. The point is illustrated by the fountainhead case on the subject, *Sampsell v. Imperial Paper & Color Corp.*,[60] which applied substantive consolidation for a reason having nothing to do with disregard of formal separateness or asset scrambling (specifically, remediation of a fraudulent transfer from the debtor to another entity). Power to invoke substantive consolidation exists where appropriate to further bankruptcy policy, and a court quite reasonably could view the policing of attempted evasion of the Bankruptcy Tax as such a policy. The hard question presented by a

is expressly exempted from the Bankruptcy Tax. *See* Kettering, *supra* note 1, at 1640-42, 1645-46. The existence and steady growth of this exemption suggests the absence of a fundamental need for the Bankruptcy Tax to apply to a loan secured by a financial asset of any type.

58 Thus, in arguing that the Bankruptcy Tax is bad policy as applied to receivables, Plank emphasizes the difference between a bankrupt trucking company's trucks and its receivables. Plank, *supra* note 2, at 629. On the other hand, Plank has also stated, with seeming approval, that in his opinion the challenge to the inventory securitization in *LTV Steel* would not have prevailed had it been pursued. *See* Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1698 n.176 (2004).

59 Kettering, *supra* note 1, at 1622-32.

60 313 U.S. 215 (1941).

typical substantive consolidation case is how far a court is justified in invoking substantive consolidation when that might inflict an adverse redistribution upon an innocent creditor, especially one who relied upon the separateness of the two entities in making its credit judgment. That question does not arise in the securitization setting, for the securitization financiers seeking to evade the Bankruptcy Tax are not innocents.

Plank makes two arguments in opposition, and both are devoid of substance. First, he asserts that such an application of substantive consolidation "would require a repudiation of a large body of case law."[61] But he cites no cases that would be overruled by such a holding. There is an excellent reason for that omission: there are no such cases. The securitization industry fondly imagines that the only grounds for substantive consolidation are disregard of formal separateness or asset scrambling.[62] It isn't so. The doctrine's basis does not so limit the doctrine's application, and there is no body of case law that depends upon on the doctrine's application being so limited.

Second, Plank states that "the facts and holding in *Sampsell* do not support Kettering's argument."[63] He notes that the debtor in *Sampsell* was insolvent at the time he transferred assets to the entity with which his estate was later consolidated, and that the injury to the debtor's creditors resulting from that transfer (lessening their distributions) differs from the injury posed by evasion of the Bankruptcy Tax in a securitization transaction (inability of the debtor-Originator to use the cash flow from collections on the securitized assets). That objection misses the point. The main significance of *Sampsell* to the present discussion is simply that it illustrates that equity may impose substantive consolidation for reasons quite apart from disregard of separateness or asset scrambling. Of secondary significance is the encouraging coincidence that *Sampsell* invoked the doctrine to remedy a fraudulent transfer, and the asset transfer from Originator to SPE in a securitization transaction is likewise susceptible to characterization as a fraudulent transfer. Naturally the facts of *Sampsell* differ from those of a securitization, but the factual differences are irrelevant to the two points just mentioned. In particular, Plank's emphasis on the insolvency of the debtor in *Sampsell* at the time of transfer is pointless. The insolvency at any time of one or both of the entities to be consolidated has never been held to be a necessary element of substantive consolidation.

That Was Then, This Is Now. Arthur Schlesinger, Jr. was fond of quoting the great English legal historian Frederic William Maitland as

[61] Plank, *supra* note 2, at 627.
[62] *See* Kettering, *supra* note 1, at 1628-29 & n.253.
[63] Plank, *supra* note 2, at 627-28; the quoted language is at 627.

saying that "it is very difficult to remember that events now in the past were once far in the future."[64] A thought near to the hearts of two such eminent professional historians merits close attention by amateurs; and as with other truths, the importance and subtlety of this one should not be concealed by its surface triteness. In my original article I would have been wise to emphasize that thought. The main theme of the article is to explore how securitization thrived despite its questionable doctrinal foundations, and grew so large and widely used that doctrine in all probability will adapt to accommodate it. For that exploration the critical time is early in the product cycle, before the product became "too big to fail." Assessment of the likely result of a challenge to the product's legal foundation, therefore, should be made from the perspective of market actors in the 1980s, when the early deals were being done. Those actors did not have the comfort of an enormous existing market and a twenty-year history of bankrupt Originators all but unanimously declining to seek to collapse their securitizations (or at least not doing so in a way that gave rise to reported judicial opinions).

Strictly speaking, therefore, analysis of the doctrinal weaknesses of securitization for that purpose should have been confined to doctrine prevailing during that early period. I made no attempt to comply with such a stipulation, however, because there has been no major change in the meantime in the three bodies of doctrine—fraudulent transfer, substantive consolidation, and true sale—that are most directly relevant to the analysis, nor to the basic contours of the Bankruptcy Tax that securitization is designed to evade. Doctrinal weaknesses arguable today were equally arguable in the mid-1980s.

But in evaluating the persuasiveness of those doctrinal arguments, it is essential to keep in mind that a court faced with a legal challenge to the product by a bankrupt Originator could not help but be more skeptical of the product during that early period than would be the case today, after the product has been in use for decades. Even Plank cites as a source of comfort about the product's legal foundation the almost complete absence of reported challenges to those foundations since the product came into use.[65] In assessing the strength of the doctrinal arguments, the important question is how they would have been weighed by a court before that track record developed.

It is equally essential to keep in mind that the critical time for evaluation is the early period of the product's history when evaluating

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[64] *E.g.*, Arthur Schlesinger, Jr., *Camelot Revisited*, THE NEW YORKER, June 5, 1995, at 33, 33; ARTHUR M. SCHLESINGER, JR., THE CYCLES OF AMERICAN HISTORY 216 (1986). Maitland's actual words are less brisk to the modern ear: "It is hard to think away out of our heads a history which has long lain in a remote past but which once lay in the future. . . ." FREDERIC WILLIAM MAITLAND, *Introduction to Memorandum de Parliamento, 1305*, *in* SELECTED HISTORICAL ESSAYS OF F.W. MAITLAND 52, 91 (Helen M. Cam ed., 1957).

[65] Plank, *supra* note 2, at 638-39.

nondoctrinal factors germane to securitization's success in overcoming its shaky legal foundations. The significance of such nondoctrinal factors may change over time. Thus, in evaluating why securitization has been the subject of so few legal challenges despite its questionable underpinnings, I noted, but did not pursue, two possible contributing factors.[66] The first is strategic settlements by financiers made for the purpose of avoiding the possible creation of adverse legal precedent. The second is systemic conflicts of interest on the part of law firms. A given firm may have rendered (or may wish to be engaged to render) the legal opinions on bankruptcy matters required to close a securitization transaction, and also may be engaged as counsel for a bankrupt Originator, and so be disinclined to challenge the correctness of such opinions by seeking to collapse that Originator's securitization.[67]

Plank dismisses the possibility of conflicts of interest by law firms, on the ground that, in his experience, "[m]any securitizations have been done for large and small companies by law firms that would not be the counsel in the future bankruptcy of the originator."[68] Plank here overlooks the timing point just mentioned. His observation is certainly true today. But conflicts of interest today are irrelevant to explaining securitization's growth to its present "too big to fail" status, for that has already happened. The meaningful question is the extent to which conflicts of interest may have been a factor in suppressing challenges to securitization transactions during the product's early years. In the product's early years, small companies were not issuing securitized debt, and legal work on such transactions was the province of elite law firms, partly as possessors of expertise now widely shared, and partly because the employment of such a firm was a selling point for a relatively new and relatively untried product.[69] Moreover, it is not necessary for such conflicts of interest to exist in all cases; any instance during the early years in which such a conflict of interest resulted in suppression of a challenge to securitization that might otherwise have been brought would be significant. In such an environment, conflicts of interest of the sort described are a plausible hypothesis.

"Plausible hypothesis" is the most that can be said, however, for I have not attempted to gather data on the extent, if any, to which conflicts of interest or strategic settlements played a role in suppressing

[66] Kettering, *supra* note 1, at 1671-73.

[67] The conflict of interest point is here stated in the baldest way, limited to law firms, but variations on the theme should not be neglected. For instance, a lender approached to provide debtor-in-possession financing for a soon-to-be-bankrupt Originator might be in a position to induce the Originator not to seek to collapse its prepetition securitizations, if such lender is, or wishes to be, an arranger of (or even a mere investor in) other securitization transactions.

[68] Plank, *supra* note 2, at 639 n.87.

[69] This observation is merely a personal impression, albeit one based on a transactional practice that included work on securitizations as early as the 1980s.

litigation relating to the efficacy of securitization. I am skeptical that it is possible to gather trustworthy data on those subjects. Scraps of news, rumors and gossip on analogous matters are familiar to anyone who has had a sophisticated transactional practice, but accumulation of reliable information is another matter. No one market player is apt to have inside knowledge of more than a small number of relevant transactions. More important, market players having knowledge adverse to the product (or to their law firm or client) would have every incentive (and possibly even an ethical obligation) to suppress it. Factors similar to the foregoing may be of significance to the introduction of any new financial product, and the difficulty in gathering reliable information about them may be part of the reason why there has been so little scholarship exploring the methods by which new products come to take root.[70]

Conclusion: A Lesson from the Subprime Mortgage Debacle. A court inclined to collapse a securitization of the prototypical type in the event of the Originator's bankruptcy has plausible doctrinal tools with which to do so. The likelihood of a court actually so holding would have been substantially higher during the product's early years, before it became "too big to fail." The broader inquiry to which my article was chiefly devoted—exploration of the mechanisms by which the product thrived despite its questionable doctrinal foundations—is therefore meaningful and, I believe, worthwhile. Plank's contrary advocacy is without merit.

As I write in December 2008, the financial markets continue to be roiled by turbulence that began in mid-2007, when massive defaults on loans originated as low-quality ("subprime") home mortgages became obvious. The turbulence has been enhanced by cascading failures in the interim, but there is no doubt that it was triggered by the collapse in value of vast quantities of securitized debt backed by subprime mortgages, which securitized debt had been grossly mispriced when originated. That mispricing had nothing to do with the legal issue—evasion of the Bankruptcy Tax—that lies as the foundation of securitization. Rather, it resulted from a factual misjudgment: namely, grossly overoptimistic estimates of the likely performance of the subprime mortgages that backed that securitized debt.[71]

[70] On the dearth of such scholarship, see Kettering, *supra* note 1, at 1554-56.

[71] For succinct reviews, see PRESIDENT'S WORKING GROUP ON FIN. MKTS., POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS 8-10 (Mar. 2008) [hereinafter PWG POLICY STATEMENT]; FINANCIAL STABILITY FORUM, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE 5-9 (Apr. 7, 2008) [hereinafter FSF REPORT]. *See also The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight & Govt. Reform*, 110th Cong. (2008) (written

This episode supports indirectly one of the major points made in my article: rating agencies have acted as de facto lawmakers with respect to the legal foundations of securitization. The willingness of investors to rely upon the legal judgments implicit in the ratings of securitized debt was essential to the product growing to its present size, in which it is so widely used that its legal foundations are now in all likelihood impervious to challenge.[72]

Much finger-pointing over the subprime debacle has been directed at the willingness of consumer borrowers to undertake mortgage loans that they could not hope to satisfy absent a continuing rise in housing prices, the willingness of loan originators to make such loans in anticipation of speedily reselling them to a financial intermediary, and the readiness of financial intermediaries to buy them for packaging into speedily-resold securitized debt. Those actions, however, are unsurprising; they were merely manifestations of the eternal drive to maximize profit at someone else's expense. The surprising feature of the debacle was the willingness of sophisticated investors to buy the mispriced securities that were so generated. The subprime market could not have developed to substantial size absent a massive supply of willing buyers of the mispriced end-product. That widespread failure of credit judgment by investors is the proximate cause of the debacle. Detailed analysis of that failure has not yet appeared, but it is generally agreed that overreliance by investors on the rating agencies' overoptimistic ratings of the resulting securities was a principal element.[73]

In public, sophisticated investors have been apt to pooh-pooh credit ratings, asserting loftily that the rating is only one element in their assessment of a security's risk, dwarfed by their own independent analyses.[74] The subprime debacle shows that, whatever they might say,

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testimony of Alan Greenspan, former chairman of the Federal Reserve Board) [hereinafter Greenspan Testimony]. For a study of the role of credit ratings in the turmoil, see Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36,212, 36,213-36,218 (June 25, 2008) [hereinafter Proposed Rules], which draws on UNITED STATES SECURITIES AND EXCHANGE COMMISSION, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT AGENCIES (July 2008).

72 *See* Kettering, *supra* note 1, at 1671-1701.

73 *See* TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONERS, FINAL REPORT: THE ROLE OF CREDIT RATING AGENCIES IN STRUCTURED FINANCE MARKETS 2, 7-9 (May 2008) [hereinafter IOSCO REPORT]; PWG POLICY STATEMENT, *supra* note 71, at 8; FSF REPORT, *supra* note 71, at 8; Greenspan Testimony, *supra* note 71.

74 Thus, a survey conducted shortly before the deluge concluded that "investors do not appear to be overly reliant on ratings in making structured finance investment decisions. In fact, the Working Group's interviews with investors and other market participants suggest that, in general, investors are well aware of the risk of basing their investment decisions solely on ratings." COMM. ON THE GLOBAL FIN. SYS., BANK FOR INT'L SETTLEMENTS, THE ROLE OF RATINGS IN STRUCTURED FINANCE: ISSUES AND IMPLICATIONS 22 (2005). By contrast, a report after the deluge concluded that "many investors and market participants effectively outsourced their own

many sophisticated investors in securities backed by subprime mortgages in fact looked little, if at all, beyond the rating. Moreover, that failure of judgment went to the core of any sensible risk assessment, for in evaluating the riskiness of an asset-backed security, nothing is more basic or more obvious than evaluating the probable cash flows to be generated by the underlying assets. Yet sophisticated investors were widely prone to rely on the rating agencies' assessments of that core risk, without adequate independent assessment. How much more would investors be prone to rely on the rating agencies' assessment of the comparatively secondary risk associated with successful evasion of the Bankruptcy Tax?[75]

The regulatory response to the debacle, so far as rating agencies are concerned, is in flux. In December 2008 the Securities and Exchange Commission ("SEC") issued some regulations, and proposed others, to require additional disclosures from rating agencies and to prohibit certain practices as impermissible conflicts of interest.[76] But the SEC has not proposed to displace the issuer-pays business model followed by the major rating agencies, which creates a standing inducement to the agencies to make overoptimistic assessment of legal risks associated with a sophisticated financial product. Some commentators have suggested that the rating agencies are now so discredited that their ratings are irrelevant. Quite aside from the question of how long the current sharp lesson will remain fresh in investors' minds, however, investors cannot be indifferent to ratings so long as rating-dependent regulation continues to exist. Several official or quasi-official bodies that have reported on the debacle have made lukewarm recommendations to the effect that rating-dependent statutes and regulations should be studied with a view to mitigating their tendency to induce investors to rely upon ratings.[77] But the only visible action on

valuations and risk analyses of RMBSs [residential mortgage-backed securities] and RMBS-backed CDOs [collateralized debt obligations] to the CRAs [credit rating agencies] . . . ." IOSCO REPORT, *supra* note 73, at 2.

75 For further discussion of investor reliance upon ratings, including with respect to legal matters, see Kettering, *supra* note 1, at 1694-1700.

76 The regulations in question were proposed in Proposed Rules, *supra* note 71. On December 3, 2008 the SEC voted to adopt portions of those regulations (in modified form) and to re-propose other portions in modified form for comment. *See* Press Release, Securities and Exchange Commission, SEC Approves Measures to Strengthen Oversight of Credit Rating Agencies (Dec. 3, 2008), *available at* http://www.sec.gov/news/press/2008/2008-284.htm.

77 Thus, the Financial Stability Forum, a consortium of world financial regulators and central banks, recommended that authorities "check that the roles that they have assigned to ratings . . . are consistent with the objectives of having investors make independent judgment of risks . . . and that they do not induce uncritical reliance on credit ratings as a substitute for that independent evaluation." FSF REPORT, *supra* note 71, at 38 (emphasis omitted). But any rating-dependent regulation must be taken into account by an investor "uncritically"; the only way to prevent that would be to eliminate rating-dependent regulation root and branch, which the Forum pointedly did not recommend. A similar recommendation appears in PWG POLICY STATEMENT, *supra* note

the subject in this country to date has not risen to that less-than-ringing call: in the summer of 2008 the SEC issued a proposal to root out of its own regulations many rating-dependent features, but after six months put off action pending further study.[78]

It is a truth universally acknowledged, that an investor in possession of a debt security must be in want of a credit rating. So long as that is the case, the power of the rating agencies to shape fuzzy law applicable to the securities they rate, through their ratings and the "too big to fail" dynamic, will remain.

71, at 6, 18. Academics have recommended eliminating rating-dependent regulation with less ambivalence. *See* Kettering, *supra* note 1, at 1694 n.465.

[78] The proposal was in three concurrent releases, each entitled References to Ratings of Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 40,088, 40,106, 40,124 (July 11, 2008). Although the SEC took action on December 3, 2008 on contemporaneously-proposed regulations on rating agencies as referred to *supra* in note 76, it took no action on this proposal and gave no timetable for action.