Commercial Trusts as Business Organizations: Unraveling the Mystery

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Although the law focuses almost exclusively on gratuitous trusts, the increasingly dominant use of trusts is for securitization and other distinctly non-gratuitous commercial transactions. This shift has occurred without a systematic understanding of whether commercial trusts are a better form of business organization than traditional alternatives, such as corporations. Furthermore, few have even considered whether existing trust law is adequate to govern commercial trusts. This Article builds an analytical framework in which to attempt to examine these issues. In that context, it argues that commercial trusts and corporations can be viewed as mirror-image entities that respond to different investor needs.

INTRODUCTION

In a seeming incongruity, trusts have come to dominate certain types of modern business and financial transactions. For example, “[a] large fraction of all mortgage, credit card, automobile, and student loan debt,”¹ perhaps “number[ing] in the trillions of dollars,”² is financed through asset securitization trusts.³ Trusts also

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1. John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 172 (1997).

2. *Id.* (describing asset securitization as “one of the most important commercial uses of the trust”).

3. *Id.* For an introduction to asset securitization, see STEVEN L. SCHWARCZ, *STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* (3d ed. 2002). See also Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994). Financial accounting principles contemplate, for example, that the entity through which securitization transactions are conducted be a “trust or other legal vehicle” that meets specified requirements. ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140, app. A, ¶ 35, at 24 (Financial Accounting Standards Bd. Sept. 2000).

have become a primary tool for investing pension moneys⁴ as well as the preferred form for structuring mutual funds.⁵ This contrasts sharply with the traditional view of trusts⁶ as facilitating gratuitous transfers:

In the culture of Anglo-American law, we think of the trust as a branch of the law of gratuitous transfers. That is where we teach trusts in the law school curriculum, that is where we locate trusts in the statute books, and that is where American lawyers typically encounter the trust in their practice . . . in truth, *most of the wealth that is held in trust in the United States is placed there incident to business deals*, and not in connection with gratuitous transfers.⁷

These new, and now widespread, business uses of trusts have created economic pressures that have profoundly transformed the fundamental character of trusts, forever changing how they are viewed.⁸ There is, however, relatively little scholarly or systematic understanding of this change. There are not even clear answers to the fundamental question of whether trusts are a better form of business organization than corporations⁹ or partnerships.¹⁰

4. "American pension trusts have attained stupendous size and importance," and "[a]s of year-end 1996 . . . own more than a quarter of American equities and about half of all corporate debt." Langbein, *supra* note 1, at 168–69.

5. "As of May 1997, American mutual funds held nearly \$4 trillion in assets . . . [and] about half or more of American mutual funds take the trust form." *Id.* at 170–71 (footnotes omitted). See also Jeffrey M. Laderman, *Your Guide to Mutual Funds*, Bus. Wk., Feb. 3, 1997, at 62 ("In 1996, some \$223 billion was handed over to equity-[mutual] fund managers . . . It's almost as much as the gross domestic product of Sweden."). In order to achieve more suitable forms for professional management of invested funds, civil law countries are also increasingly "adopt[ing] trust-like institutions, and important efforts are underway to promote recognition by nontrust jurisdictions of trusts formed in other countries." Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. REV. 434, 435–36 (1998) (citations omitted).

6. For example, even the American Law Institute's *Restatement of Trusts* focuses exclusively on gratuitous trusts, noting "[a] statement of the rules of law relating to the employment of a trust as a device for carrying on business is not within the scope of the Restatement of this Subject." RESTATEMENT (SECOND) OF TRUSTS § 1, cmt. b (1959).

7. Langbein, *supra* note 1, at 165–66 (emphasis in original). Professor Langbein estimates that "well over 90% of the money held in trust in the United States is in commercial trusts as opposed to personal trusts." *Id.* at 166, 178. See Hansmann & Mattei, *supra* note 5, at 436 (observing that "[i]n the United States, academic commentary and law school curricula continue to focus on the private trust in its historical role as a device for intrafamily wealth transfers. Today, however, that role is relatively trivial. Vastly more important is the enormous—though commonly neglected—role that private trusts have come to play in the American capital markets").

8. "[T]he American legal intellectual tradition, which characterizes the trust as a branch of the law of gratuitous transfers, is at odds with the reality of American trust practice." Langbein, *supra* note 1, at 166.

9. For an interesting comparison of trusts and corporations, see Hansmann & Mattei, *supra* note 5, at 472–78. Hansmann and Mattei conclude, however, that "[w]e are left . . . with the question whether the differences between these two forms are in any way fundamental . . ." *Id.* at 479. My Article argues that the differences are indeed quite fundamental.

10. Although partnerships also are a significant form of business organization, this Article focuses on corporations because they dominate partnerships as a form of business organization. This Article's purpose is to place the discussion of commercial trusts in perspective rather than to systematically compare trusts with all other forms of business organization.

This Article inquires into the very nature of this ongoing transformation. Part I distinguishes traditional gratuitous trusts from business, or "commercial," trusts. Part II catalogs the varieties of commercial trusts that have evolved, showing how business requirements have shaped their evolution. Part III derives an analytical framework in which to compare commercial trusts with other forms of business organization, and then applies that framework to comparing trusts and corporations.

The comparison shows that commercial trusts and corporations can be thought of as mirror-image entities that respond to different investor needs. The essential distinction between these entities turns on the degree to which assets need to be placed at risk in order to satisfy the expectations of residual claimants.¹¹ In a corporation, the residual claims are sold to third-party investors (shareholders) who expect management to use corporate assets to obtain a profitable return on their investments.¹² But that creates a risk that the corporation will become insolvent, jeopardizing repayment of the senior claimants (creditors). The conflicting expectations of the corporation's senior and residual claimants are resolved by allowing a solvent corporation's managers (its board of directors) to undertake certain risky business ventures in order to raise shareholder value.

In contrast, a commercial trust's residual claimant is typically the settlor of the trust,¹³ who (it will be shown) does not expect a risk-weighted return. The expectations of the trust's senior and residual claimants are therefore the same: to preserve the value of the trust assets. These expectations are satisfied by trust law, which requires the trust's manager (its trustee) to deal impartially with claimants.

Where, however, commercial trusts sell residual claims to third parties, such trusts should have much in common with corporations because of the conflict between the expectations of senior and residual claimants. If a robust market in residual-trust claims were to develop, trust law may be forced to evolve in order to address these conflicting expectations, thereby triggering unification of certain aspects of corporate and trust law.¹⁴

Although this Article's focus is on trust law in the United States, comparative-law scholars may well also find it useful for its paring away of centuries of encrusted trust-law verbiage to reveal the more fundamental realities. Thus, especially in civil law countries where trusts are only now beginning to be recognized, scholars will better appreciate why trusts have become important forms of business organization and will better understand how their own legal systems might benefit by adoption of trust-like structures.¹⁵

11. I refer to residual and senior claims and claimants in the economic sense. Senior claimants have the right to repayment of their claims prior to repayment of residual claims. Residual claimants, however, have the right, traditionally associated with ownership, to all remaining value once the senior claims have been paid in full. See, e.g., Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 666–67 (1996).

12. *Id.*

13. See *infra* note 23 and accompanying text (explaining how trusts are settled).

14. See *infra* notes 124–34 and accompanying text (suggesting that courts then might impose on trustees a duty to residual claimants similar to the duty of corporate directors to shareholders).

15. Comparative-law scholars also might be interested in my forthcoming essay *Commercial Trusts*

PART I: COMPARISON OF COMMERCIAL AND GRATUITOUS TRUSTS

Traditionally viewed, "[t]rusts are gifts."¹⁶ The donor of the gift, called the settlor, conveys the assets to a trustee to hold for the benefit of a beneficiary.¹⁷ There are, however, critical differences between so-called gratuitous trusts and trusts used in commercial, financial, and other business transactions (referred to in this Article as "commercial trusts").¹⁸

The most obvious difference is that the settlor in a gratuitous trust receives no compensation for the conveyance¹⁹ whereas the settlor in a commercial trust—typically a corporation or financial institution—always receives payment for the assets conveyed to the trust. One therefore can view a commercial trust as a trust in which there is a bargained-for exchange rather than a gift.²⁰ A more subtle difference is that the settlor in a gratuitous trust may or may not retain a residual interest²¹ in the trust assets,²² whereas the settlor in a commercial trust almost always retains a residual interest in trust assets that remain once the business transaction is concluded.²³ Commercial trusts are therefore economic deals where resort to the trust form serves a distinct commercial advantage.

The deal nature of a commercial trust can be illustrated by a typical example from structured finance.²⁴ A company settles a trust by transferring financial assets to the trust in return for payment in the form of trust certificates and a bargained-

as *Business Organizations: An Invitation to Comparatists*, DUKE J. COMP. & INT'L L. (forthcoming 2003), which attempts to redact to fundamental principles, shorn of any U.S.-specific considerations, the analytical framework developed in this article.

16. John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 632 (1995). That article, seminal for its treatment of trusts as contracts, "excludes commercial trusts." *Id.* at 630.

17. *Id.* at 632.

18. This Article uses the term commercial trust rather than "business trust" because business trusts are narrowly defined in law. See, e.g., *In re Secured Equip. Trust of E. Air Lines, Inc.*, 38 F.3d 86 (2d Cir. 1994) (holding that a trust used in an equipment finance transaction is not a business trust under New York law).

19. Hence the conveyance of trust is gratuitous.

20. See Langbein, *supra* note 1, at 167. The settlor bargains for the consideration it receives in exchange for the assets it transfers to the trust. Thus, so-called "offshore asset protection trusts," which are irrevocable trusts created offshore in order to shield assets from future creditors, are not commercial trusts because they are not bargained for exchanges. Elena Marty-Nelson, *Offshore Asset Protection Trusts: Having Your Cake and Eating It Too*, 47 RUTGERS L. REV. 11, 12 (1994).

21. A residual interest is a right of the settlor to retain assets remaining in the trust once the beneficiaries are paid. The settlor retains a reversion to the extent he transfers away less than he owns, or provides for a reversion on condition subsequent. In private trust practice, equitable reversions arise when there is a failure of beneficial interests.

22. Prior to the promulgation of Pub. L. No. 99-514, 100 Stat. 2712 (1986), codified at 26 U.S.C. §§ 676-677 (2000), settlors often retained residual interests. For example, a parent may have held a reversionary or other form of residual interest in assets of a trust created for the benefit of a child. After the tax law change, however, assets no longer were recognized as having been transferred to a trust if the settlor held the residual interest. Because gratuitous trusts normally are intended as gifts, settlors often preferred to give up these residual interests in order to ensure that tax law recognizes the transfer of assets to the trust.

23. In contrast to gratuitous trusts, settlors of commercial trusts are not making gifts. The taxonomy, *infra* Part II, shows that the residual interest is a valuable property right which the settlor is unlikely to give up without receiving equivalent value in return.

24. See Part II, *infra*, describing structured finance.

for residual interest in the trust.²⁵ The company then raises funds by selling the trust certificates to capital market investors,²⁶ who buy the certificates expecting that the trust assets will generate sufficient cash to repay their investment plus the contractual rate of return specified in the certificates.²⁷ The residual interest entitles the company to any assets remaining in the trust once the certificates are paid in full. In this way, the company does not give up more value than needed to make the deal work.

The deal is thus an arm's-length, negotiated bargain in which all parties benefit. The investors, as senior claimants of the trust, get their money back with interest. The company, as residual claimant, receives payment for the financial assets sold to the trust and is entitled to any residual value of those assets once the investors are paid in full. In economic terms, the deal is similar to a secured loan—the quintessential commercial transaction—in which surplus collateral is returned to the debtor once lenders receive principal and interest.²⁸

Because commercial trusts are business deals, business requirements naturally shape their evolution. This is next illustrated by examining the most common varieties of commercial trusts that have developed.²⁹

PART II: TAXONOMY OF COMMERCIAL TRUSTS

Commercial trusts can be categorized in two ways: by the “type” of trust, where labels have been given to commercial trusts, and by the business use to which

25. A trust certificate is simply a writing that evidences the holder's undivided interest, to the extent specified in the writing, in the trust assets. See Thomas S. Harman, *Emerging Alternatives to Mutual Funds: Unit Investment Trusts and Other Fixed Portfolio Investment Vehicles*, 1987 DUKE L.J. 1045, 1053.

26. Capital market investors are investors in “markets where capital funds—debt and equity—are traded. Included [in these markets] are private placement sources of debt and equity as well as organized markets and exchanges.” JOHN DOWNES & JORDAN GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 59 (3d ed. 1991) (definition of capital markets).

27. Sometimes the trust issues senior trust certificates or debt instruments *directly* to investors and, as a purchase price for the financial assets sold by the company to the trust, pays the proceeds along with a residual trust certificate to the company. This Article's analysis, however, would be the same in either case.

28. See U.C.C. §§ 9-608, 9-615 (2002) (returning any surplus collateral to debtor once secured loan is paid in full). One may ask why, if this transaction looks like a loan, the company does not simply borrow the funds directly from a bank, thereby saving the transaction costs associated with creating the trust structure, such as documenting the trust and selecting and paying the trustee? One answer is that a trust structure can save the company money by providing *direct* access to low-cost capital market funding, thereby bypassing the more expensive bank-credit markets. See Schwarcz, *Alchemy*, *supra* note 3, at 149–50. Bank credit is more expensive because much of the money that a bank lends to customers is raised by the bank in the capital markets and, to make a profit on the loan, the bank must charge a higher rate of interest than it pays the capital market investors: in effect, a markup. By avoiding bank credit, the company avoids paying that mark-up. See also Langbein, *supra* note 1, at 173 (arguing that asset securitization trusts have two major advantages over conventional financing: lowering the costs of some credit by separating less risky financial assets into a trust that is distinct from the rest of the liabilities of the bank and thereby making it easier for investors to evaluate, and additionally by being “bankruptcy remote” so that the investor is effectively an owner of a beneficial interest in a distinct pool of trust assets).

29. The discussion below omits pension trusts, pursuant to which deferred compensation is paid to retired employees as required by the Employee Retirement Income Security Act, 29 U.S.C. § 1103 (2000). Such trusts “commonly give[] rise to a gratuitous transfer,” and have “been much assimilated to conventional trust law.” Langbein, *supra* note 1, at 169–70. For a general discussion of pension trusts, see *id.* at 168–70.

the trust has been placed. Both ways are needed because there is sometimes an imprecise correlation between labels and functions: certain entities called trusts are not trusts, and other entities may be trusts even though they do not go by that name.

TRUSTS USED AS SPECIAL PURPOSE VEHICLES

One of the most widespread uses of commercial trusts is as special purpose vehicles, or SPVs, in structured finance transactions. In these transactions, companies transfer certain assets to SPVs that are specifically protected from the company's business risks, including its risk of bankruptcy.³⁰ The SPV obtains funding to pay for the assets by issuing securities in the capital markets or by borrowing.³¹ Trusts frequently serve as the SPV, in which case the securities typically issued would be trust certificates.³²

Trusts used as SPVs in structured financings³³ usually have three common descriptive features.³⁴ The first is that they are relatively static entities. They usually do not operate an ongoing business but rather issue trust certificates with debt-like characteristics, repayable from cash generated by the assets acquired by the SPV or from leases of those assets. The second feature is that any residual value of the trust assets³⁵ is returned to the company once the business transaction is consummated. The company normally preserves this residual value by retaining a residual trust certificate.³⁶ In this way, the company gives up no more economic value than is needed to make the deal work.

30. Different terms have come to be associated with different structured financing approaches. If the company transfers financial assets to an SPV which funds its purchase price by issuing securities in the capital markets, the transaction is usually referred to as an asset securitization. If the company uses an SPV to acquire equipment, all or a portion of whose purchase price is borrowed and then repaid from lease rentals of such equipment, the transaction is usually referred to as a leveraged lease or an equipment trust. If the company uses an SPV to construct a real estate project all or a portion of whose construction cost is borrowed and then repaid from lease rentals of the project, the transaction is often referred to as a synthetic lease. This Article generally will refer to these and similar types of transactions as structured financings.

31. Schwarcz, *Alchemy*, *supra* note 3, at 136–38.

32. See *supra* text accompanying notes 24–27 (describing trust certificates).

33. Other entities also can be used as SPVs in structured financings. See Schwarcz, *Alchemy*, *supra* note 3, at 135.

34. Some may argue there is a fourth common descriptive feature, investor preference for trust certificates. Investors sometimes favor trust certificates as a form of investment security. Investors, however, presumably are motivated by the substantive rights attached to the security—rights which arise out of the inherent nature of the trust form—and not by the fact that the security they hold is called a “trust certificate.”

35. The residual value of the trust assets may be considerable either because of “overcollateralization” or, less frequently, because a “core” asset, such as trademarks and trade names relating to licenses or franchises, are transferred to the trust. Overcollateralization exists where the SPV’s “level of receivables [is] well in excess of the amount necessary to pay the securities issued by the SPV.” Schwarcz, *Alchemy*, *supra* note 3, at 141.

36. Giving the company a right to the return of those assets sometimes may appear inconsistent with the assertion that the company effectively has transferred title to the assets, creating a tension between business and bankruptcy requirements. See *infra* note 113 (discussing whether retention by the settlor of a residual interest could impair the separate legal existence of a trust).

The third descriptive feature is avoidance of the so-called "entity-level tax." Separate legal entities are generally subject to taxes on their earnings.³⁷ If, however, an SPV were subject to a separate tax, the transaction in which it is involved may become too costly. Trusts created pursuant to contracts, however, would not be subject to entity-level taxes if their separate existence is not recognized under tax law.³⁸ Accordingly, the trust-form is sometimes used for SPVs that must avoid paying an entity-level tax.³⁹ In recent years, this third feature has become less important because federal tax law has been changed, by the adoption of "check-the-box" rules⁴⁰ and financial asset securitization investment trust (FASIT) legislation,⁴¹ to minimize the circumstances when an entity-level tax is imposed.⁴²

TRUSTS USED FOR DIVERSIFYING LENDING RISK

Commercial trusts also use the trust form to diversify lending risk. Lenders such as banks traditionally diversified their risk of lending too much money to a single borrower by selling to other banks participations, or undivided interests, in their loans.⁴³ Often, however, a bank will want to diversify its lending risk with respect to a large number of its loans. A bank that issues credit cards to consumers also may want to diversify its credit advances made under the cards. It would be

37. Sometimes trusts and other non-corporate entities are able to be structured as "partnerships" for tax purposes, thereby avoiding an entity-level tax. See Treas. Reg. § 301.7701-4(b), (c) (as amended in 1996) (certain business or investment trusts not viewed as trusts for tax purposes will be classified as corporations or partnerships by reference to rules on partnership classification in Treas. Reg. § 301.7701-2 (as amended in 1999)). Certain types of passive trusts (grantor trusts) also are specifically recognized as "pass-throughs" for tax purposes, thereby avoiding an entity-level tax. But many trusts do not qualify as grantor trusts because the trustee, for business reasons, has power to vary the investment of certificate-holders, such as by substituting trust assets. Treas. Reg. § 301.7701-4(c) (as amended in 1996). Recently, however, tax law changes have made it easier for state law trusts to avoid entity-level taxation. See *infra* notes 40–42 and accompanying text.

38. See *infra* Part III.

39. The contracts by which the trust relationship is created are sometimes called trust agreements or pooling and servicing agreements.

40. In December 1996, the Internal Revenue Service issued final regulations replacing the existing test under federal tax law to distinguish between unincorporated business entities that must be treated as corporations and are subject to an entity-level tax, and partnerships that are not. These new "check-the-box" regulations permit a state law trust and many other non-corporate entities to simply elect to avoid an entity-level tax by choosing to be taxed as a partnership (or, in the case of an entity with a single owner, simply to be ignored). Treas. Reg. §§ 301.7701-2, -3 (as amended in 1999, 2001). "The theory behind check the box is that entity classification is already largely elective for the well-advised, and that resources currently spent by taxpayers and the IRS dealing with classification issues are better spent elsewhere." Donald G. Carden, *Tax Legislation and Proposed Treasury Regulations Offer New Structuring Options*, NEW DEVELOPMENTS IN SECURITIZATION 1996, at 77, 81–82 (Practising Law Institute 1996).

41. Discussed *infra* Part II. The Small Business Job Protection Act of 1996 includes provisions allowing an entity, including a trust or corporation, that qualifies for special treatment as a financial asset securitization investment trust, or "FASIT," to avoid an entity-level tax. I.R.C. §§ 860H–860L (2002).

42. Cf. Langbein, *supra* note 1, at 189 (concluding prior to these changes in tax law that part of the reason "the trust appears so attractive as a commercial form" is that it "facilitates pass-through [i.e., non-entity-level] taxation").

43. Steven L. Schwarcz, *Intermediary Risk in a Global Economy*, 50 DUKE L.J. 1541, 1557–58 (2001). Selling loan participations also may allow the selling bank to reduce its risk-based capital charges.

costly and administratively burdensome to sell participations in each individual loan or credit card advance to different banks.

Banks more easily can diversify their risk by transferring all of the loans or credit card advances to a newly created trust. The trust in turn issues one or more classes of trust certificates. These classes may include a senior class sold to capital market investors, a subordinate class either sold to investors or retained by the bank, and a residual class retained by the bank.⁴⁴ As before, the residual class enables the bank to recoup the value of any trust assets that remain after the senior investors are paid in full. The residual and, if applicable, subordinate classes also overcollateralize⁴⁵ the senior class of certificates. Furthermore, the retention of the residual interest provides financial motivation to the bank to monitor the debtor's financial condition and compliance with loan covenants, which presumably benefits investors. Trusts used by banks to diversify risk are thus similar to the trusts used by companies in structured financing transactions⁴⁶ because both facilitate shifting the risk of owning financial assets from the settlor to the investors.⁴⁷

MASTER TRUSTS

Master trusts are related to trusts used for diversifying lending risk.⁴⁸ Whereas the latter facilitates the sale to investors of interests in loans, master trusts enable an originator of financial assets generally to sell interests therein to the broadest investor base, thereby diversifying the originator's risk associated with holding such financial assets as well as the investors' risk in investing in such assets.

Master trusts often are used by companies engaged in structured financing that have significantly more assets than the amount of financing needed.⁴⁹ The simplest solution would be to allocate a portion of the assets to the financing. In practice, however, companies rarely can segregate the assets to dedicate to the financing

44. A bank also may retain a "seller interest," which is a relatively small undivided interest in the trust that is *pari passu* in priority with the senior certificates. The percentage represented by the seller interest fluctuates based on a formula equal to one hundred percent minus the percentages represented by the senior and subordinate certificates. Upon the occurrence of certain events of default, however, the percentage represented by the seller interest becomes fixed. The seller interest is therefore effectively a type of residual interest because it reduces as needed to cover any increases in the senior and subordinate certificate interests.

45. Recall, *supra* note 35, that overcollateralization means that the SPV's level of receivables is well in excess of the amount necessary to pay the securities issued by the SPV. These subordinate classes of certificates overcollateralize the senior certificates by providing funds that are used to purchase additional receivables against which the holders of the senior certificates have a priority claim. Schwarcz, *Alchemy*, *supra* note 3, at 144.

46. See, e.g., *Sec. Indus. Ass'n v. Clarke*, 703 F. Supp. 256 (S.D.N.Y. 1988), *vacated by* 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990).

47. Some institutional investors, such as insurance companies, may prefer a trust structure for investing in even single loans because they believe that trust certificates are a safer investment than loan participations. Interview with Frederic P. Vigneron, Senior Securities Analyst, National Association of Insurance Commissioners Securities Valuation Office, in New York City (Apr. 16, 1996).

48. See *supra* discussion in Part II.

49. For example, a company with \$50 million of trade receivables may only need \$20 million of financing.

on a cost-effective basis.⁵⁰ They usually keep records and reporting requirements on categories of assets, and it is difficult to obtain separate reporting for assets within a category. Some companies also may have seasonal fluctuations in financing needs so that the assets dedicated to the financing may fluctuate over time, or they may want to diversify their funding sources based on a single pool of assets.

A master trust responds to these needs.⁵¹ In the business transaction underlying a master trust, a company transfers specified financial assets to the trust in return for which the trust will issue, at the outset, at least one class of trust certificates plus a residual interest in the trust. The company will sell the certificates to investors and retain the residual interest.⁵² If the dollar value of the certificates is small compared to the amount of assets transferred to the trust, the amount of the residual interest may be quite substantial.

So far, this is no different than a trust created by contract. The magic to a master trust, however, is its flexibility: a master trust allows more than one class of beneficial interests to be issued.⁵³ If, in the future, the company wishes to raise additional financing, it can notify the trustee to issue additional classes of trust certificates.⁵⁴ Each class of certificates can have its own interest rate, events of default, covenants, maturities, and other rights, obligations and remedies.⁵⁵ Furthermore, one or more classes of certificates can be subordinated to repayment of other classes in order to achieve an overall lower financing rate for the trust.⁵⁶ The only limitation on the characteristics of future classes of trust certificates are contractual restrictions in the trust agreement intended to protect previously-issued certificates. This flexibility in fashioning different substantive rights and obligations for diversified classes of certificates greatly expands the range of investors who may be interested in investing,⁵⁷ thereby increasing the total amount of financing that can be raised from the assets.

From a technical standpoint, master trusts combine the trust form with what are sometimes called "intercreditor agreements." Intercreditor agreements are simply contracts among multiple creditors of a debtor that allocate the re-

50. The company in note 49 with \$50 million of receivables that only needs \$20 million of financing may be unable to designate which of the receivables should be used as collateral.

51. See, e.g., Circuit City Credit Card Master Trust, Fitch Research (Structured Finance) (Apr. 29, 1996) (discussing how a master trust works).

52. *Id.*

53. Typically, a company creates a master trust pursuant to a contract called a "pooling and servicing agreement." *Id.* at 3. The contract, of course, could equally well be called a trust agreement. While the term "pooling and servicing agreement" is descriptive of the settlor transferring a pool of assets to the trust and then agreeing to perform ongoing monitoring services regarding the assets, it fails to describe the issuance by the trust of multiple classes of beneficial interests.

54. The only limit to the classes of trust certificates issued is that the assets in the trust must be sufficient to repay the certificates.

55. Circuit City Credit Card Master Trust, *supra* note 51, at 5.

56. *Id.*; see also Schwarcz, *Alchemy*, *supra* note 3, at 136, 143-44.

57. Different classes of trust certificates can be sold to investors in different markets. Circuit City Credit Card Master Trust, *supra* note 51, at 6 (discussing certificate classes sold publicly, sold privately, and retained by the settlor).

spective rights, obligations, and remedies of the creditors with respect to the debtor's assets. A master trust effectively serves as an intercreditor agreement by specifying in advance many of the fundamental characteristics of the trust certificates. By defining investor rights in advance, the [company] controls those rights and also avoids the difficulty and expense of trying to negotiate with multiple classes of investors after trust certificates have been issued.⁵⁸

Ultimately, therefore, master trusts are successful because they are an efficient way to (again) diversify investor risk by permitting securities to be sold not only to multiple individual investors *but also to multiple classes of investors*.⁵⁹

BUSINESS TRUSTS

A business trust is a separate legal entity, created under a state's business trust law, in which property is conveyed to a trustee and managed for the benefit of holders of certificates.⁶⁰ This is illustrated, for example, by Delaware Business Trust law: Under the Delaware Business Trust Act, which was enacted in 1988, Delaware trust law applies to a business trust "[e]xcept to the extent otherwise provided in the governing instrument."⁶¹ The statute specifically states that the "duties (including fiduciary duties)" of a trustee to a trust or its beneficial owner may be "restricted" by the governing instrument and any trustee "acting under a governing instrument shall not be liable to the business trust or to any such beneficial owner" for relying in good faith on the governing instrument.⁶² The statute also grants a business trust broad powers to indemnify and "hold harmless" any person "from and against any and all claims and demands whatsoever."⁶³ Presumably this would include protection against claims arising in respect of duties that, under the governing instrument, a trustee has no obligation to perform.⁶⁴

A business trust, at least under Delaware law, is therefore a state law trust that is modified by contract as is necessary to reallocate the trustee's rights and obligations in order to meet business requirements.⁶⁵

Unlike the other commercial trusts discussed above, a business trust is not a "type" of trust that satisfies a specific business purpose. Rather, the term includes any trust that is created pursuant to a state's business trust law. Business trusts,

58. SCHWARCZ, *STRUCTURED FINANCE*, *supra* note 3, § 3:2.4, at 3-20.

59. In effect, the master trust has diversified risk not only by dividing interests in assets but also by allocating risks and returns among different classes of divided interests.

60. *Betts v. Hackathorn*, 252 S.W. 602, 604 (Ark. 1923); *Enochs & Flowers, Ltd. v. Roell*, 154 So. 299, 301 (Miss. 1934). See generally Tamar Frankel, *The Delaware Business Trust Act Failure as the New Corporate Law*, 23 CARDOZO L. REV. 325 (2001).

61. DEL. CODE ANN. tit. 12, § 3809 (1974 & Supp. 1994).

62. *Id.* § 3806(c).

63. *Id.* § 3817(a).

64. Comm. on Bankr. & Corp. Reorganization of the Ass'n of the Bar of the City of N.Y., *Structured Financing Techniques*, 50 BUS. LAW. 527, 556 n.88 (1995).

65. For a discussion of the contractual basis of trusts generally, see generally Langbein, *supra* note 16. For a history of business trusts, see also Hansmann & Mattei, *supra* note 5, at 473-75.

therefore, can be created as SPVs, or to diversify lending risk, or to comply with regulatory restrictions, or for any of the other purposes that commercial trusts are created. The descriptive characteristics of business trusts would be those of the type of trust created.

TRUST INDENTURES

Trust indentures are among the oldest forms of commercial trusts. A trust indenture is a contractual arrangement by which a trustee, usually a financial institution, acts as agent for one or more investors whose money is advanced as a loan to a debtor.⁶⁶ Many trust indentures are entered into pursuant to the Trust Indenture Act of 1939,⁶⁷ which requires independent trustees to protect the interests of investors in public offerings⁶⁸ of debt securities. Other trust indentures are private arrangements bargained among sophisticated lenders, such as insurance companies, wherein one lender acts as agent for the others.

Although trust indentures create a fiduciary relationship based on agency, some may argue they are not actual trusts because no property is held in trust for beneficiaries.⁶⁹ Instead, the transaction between the investors and the debtor is merely a loan,⁷⁰ and the investors' claims against the debtor for repayment are monitored and enforced by the trustee as agent for the ratable benefit of the investors.⁷¹ Should trust indentures be included as a type of commercial trust? The answer is unclear because there is an ambiguity whether the trustee of a trust indenture actually holds trust property.⁷² Although trust property may include

66. RICHARD T. McDERMOTT, *LEGAL ASPECTS OF CORPORATE FINANCE* 144–45, 154–56 (3d ed. 2000).

67. 15 U.S.C. § 77aaa (2000).

68. A public offering is a technical term, but it means essentially the issuance of securities to investors without limitations on re-sale or transferability. *See generally* Randolph P. Beatty & Ivo Welch, *Issuer Expenses and Legal Liability in Initial Public Offerings*, 39 J.L. & ECON. 545 (1996).

69. *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 2, cmt. f (Tentative Draft No. 1, 1996).

A trust involves three elements: (1) a trustee, who holds the trust property and is subject to duties to deal with it for the benefit of one or more others; (2) one or more beneficiaries, to whom and for whose benefit the trustee owes the duties with respect to the trust property; and (3) *trust property, which is held by the trustee for the beneficiaries.*

Id. (emphasis added).

70. Most trust indentures today evidence unsecured loans. Even secured trust indentures appear to be loans and not actual trusts. Some confusion originally may come from the term “trust indenture” having referred to a mortgage, deed of trust or other lien on property that was granted by the debtor to the trustee to secure repayment of the investors. That would be closer to a traditional trust, involving the transfer of assets (i.e., collateral) to a fiduciary. Article 9 of the Uniform Commercial Code, however, now provides for the creation of a security interest by the debtor’s signing a simple security agreement describing the collateral. U.C.C. § 9-203(1) (2001). A trust, in the traditional sense of an *actual* transfer of property to a fiduciary, is no longer needed to create a security interest. *See* U.C.C. § 9-203(1)(a) (providing that physical possession of collateral by the secured party or his agent or trustee is not necessary for creating a security interest).

71. FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 24 (1991). Prior to a default, however, the trustee’s responsibilities are purely ministerial. Trust Indenture Act of 1939, 15 U.S.C. § 77000 (2002).

72. As required by RESTATEMENT (THIRD) OF TRUSTS § 2, cmt. f (Tentative Draft No. 1, 1996).

chooses in action such as investors' claims for repayment,⁷³ the investors (and generally not the trustee) are deemed to be the holders of the loan claims that would constitute the trust assets.⁷⁴ Nonetheless, the trustee monitors and often maintains records to register ownership of the loan claims,⁷⁵ and, for administrative convenience, payments are generally made to the trustee for the benefit of the investors. While held by the trustee, those payments constitute trust property; and while payments are owed on the loan claims but not yet paid to the trustee, the trust indenture might be characterized as an instrument of trust or a promise to create a trust.⁷⁶ A trust indenture therefore appears to be a hybrid form of a trust.

A trust indenture also facilitates the diversification of risk—in this case, the risk of investing in a single loan. A single investor may not, for example, want to take the risk of making a \$1,000,000 loan to a single borrower; but if two hundred investors under a trust indenture each invests \$5000, the borrower will receive the \$1,000,000 and the investors can apply their excess funds to other, diversified investments.

DEEDS OF TRUST

Deeds of trust are "transfer[s] of legal title to property from the trustor [settlor] to the trustee, for the purpose of placing the legal title with the trustee as security for the performance of . . . [loan] obligations."⁷⁷ Thus a deed of trust appears to be a trust in form because a trustee holds property for beneficiaries.⁷⁸

Differences between a deed of trust and a traditional trust, however, suggest the former is a trust *only in form* and not in substance. The transfer of legal title under a deed of trust is conditional. If the debtor repays the loan, the trustee must return the property to the debtor; if the debtor defaults on the loan, the trustee may turn over the property to the lender. Bankruptcy and commercial law also impose limitations on this turnover right. For example, if the debtor is bankrupt at the time the turnover would take place, the automatic stay in bankruptcy would prevent such turnover.⁷⁹ Furthermore, the trustee must account to the debtor for any surplus property value once the loan is repaid.⁸⁰ These restrictions

73. *Id.* § 2, cmt. i clarifies that "the rights under an enforceable promise constitute 'property' (a *chose in action*) so that, if intended, they may be held immediately in trust" (emphasis in original).

74. See 15 U.S.C. § 77ppp(b) (restricting the trustee from impairing an indenture security-holder's right to payment or right to institute suit for payment).

75. *Id.* § 77lll(a).

76. "In the absence of trust property, there is at most an instrument of trust, or a plan or a promise to create a trust." RESTATEMENT (THIRD) OF TRUSTS § 2, cmt. i (Tentative Draft No. 1, 1996). This provision, however, is controversial. Interview with John H. Langbein, Professor of Law, Yale Law School, New Haven, Connecticut (Mar. 18, 1997).

77. STEVEN H. GIFFS, LAW DICTIONARY 55 (1975). Unlike the other commercial trusts discussed above, a deed of trust does not diversify risk. Rather, its function is to *shift* risk from the lender to the debtor by securing the repayment of the lender's loan.

78. RESTATEMENT (THIRD) OF TRUSTS § 2, cmt. f (Tentative Draft No. 1, 1996).

79. 11 U.S.C. § 362 (2002).

80. U.C.C. §§ 9-608, 9-615 (2000).

effectively make a deed of trust the functional equivalent of a security device for the granting of collateral.⁸¹

MUTUAL FUNDS

Mutual funds are vehicles for pooling investor money and using the money to invest in securities. In this way, a small investor is able to achieve a diversified investment portfolio that is professionally managed by a trustee and investment experts hired by the trustee. Investors place great reliance on the rate of return these managers are able to achieve.⁸² Approximately half of American mutual funds are organized as trusts, as opposed to corporations.⁸³ Although the reason for this dichotomy is not obvious, it would appear to derive from the fact that returns on mutual funds that invest aggressively for high returns are like equity returns and require the manager to take risks. This suggests the corporate form. On the other hand, where all of the fund's beneficiaries want the manager to take these risks, there would be no real conflicting interests, and the trust form is sufficient.

REAL ESTATE INVESTMENT TRUSTS (REITS)⁸⁴

A real estate investment trust, or REIT, is a legal construct that may or may not use the trust form. REITs in their modern form were created in 1960 under a provision of the Internal Revenue Code that allows a corporation, trust, or association whose primary business is the ownership of real estate to pass income through to investors without incurring an entity-level tax.⁸⁵ REITs therefore are a type of special purpose vehicle and could have been included in Part II.⁸⁶ Because

81. See Langbein, *supra* note 1, at 168.

82. See, e.g., Gene Koretz & Dean Foust, *Brainy Young Fund Managers, Their Mutual Funds Yield More*, Bus. Wk., Mar. 10, 1997, at 22 ("Shopping for a mutual fund? . . . You might be better off choosing funds based on their manager's age and academic pedigree The researchers found that [these managers] tended to invest in high-risk, high-return stocks—a strategy that has paid off handsomely during the current bull market."). As a practical matter, of course, investors rarely rely on individuals but instead look to mutual fund performance. See, e.g., Jeffrey M. Laderman, *The Best Mutual Funds: The Top Performers*, Bus. Wk., Feb. 3, 1997, at 66 (ranking top performers in mutual funds based on average annual total return compared to risk).

83. Langbein, *supra* note 1, at 171.

84. This section was prepared with the assistance of Tilman T. Gates.

85. See generally I.R.C. § 856 (1996, Supp. 2002). Prior to 1960, real estate owners and developers used partnerships and sole proprietorships in order to avoid the entity-level tax. Those structures, however, often were too cumbersome to attract funding from large numbers of unrelated small investors who wished to pool their funds in a tax neutral way. The REIT was designed to encourage small investors to pool their funds. The legislative history indicates that Congress wanted to eliminate individual investor size as a factor in determining the relative size of investments in real estate, thus encouraging the flow of small-investor private capital into such investments. Conduit treatment of REITs was justified because of their comparability to mutual funds. Marvin Kahn, *Taxation of Real Estate Investment Trusts*, 48 VA. L. REV. 1011, 1012–13 (1962).

86. See *supra* Part II (discussing trusts used as special purpose vehicles).

of their prominence,⁸⁷ this Article discusses them separately with the understanding that, other than their non-entity tax status, REITs used as special purpose vehicles would be analyzed the same as other SPVs discussed in Part II.⁸⁸

By electing REIT status, an entity submits to extensive regulation by the U.S. Internal Revenue Service (IRS). The regulations limit the REIT to passive activities in order to ensure that operating businesses are not established as REITs, thereby avoiding entity-level taxes and undermining the integrity of the corporate income tax.⁸⁹ For example, a REIT has no control over the timing of income dispersion to investors and must contract out any services active in nature, such as the actual management and operations of a property.⁹⁰ It also must meet detailed income, asset, and distribution tests, all intended to ensure that the REIT is a passive real estate conduit and not an active business.⁹¹ REITs therefore appear as static entities⁹² that avoid entity-level taxes,⁹³ characteristics associated with commercial trusts.⁹⁴

87. After a period of over-aggressive mortgage lending in the early 1970s, many REITs went bankrupt, causing the structure to fall out of favor with investors. However, when bank and other private real estate financing declined in the 1980s, developers and owners turned to the REIT structure to finance their developments in the public securities markets. Since then, REITs have enjoyed strong growth and heavy investor interest. See Richard J. Gannon, The London Group Realty Advisors, Inc., *Wall Street's Role in the Commercial Real Estate Recovery*, at <http://www.londongroup.com/finance1.html> (last visited Dec. 23, 2002).

88. The history of the REIT mirrors to some extent the history of commercial trusts. The REIT, created in the mid-1800s in response to a prohibition of corporate ownership of real estate, grew out of the "Massachusetts trust." Mortimer M. Caplin, *Foreword to Virginia Law Review Symposium on Real Estate Investment Trusts*, 48 VA. L. REV. 1007, 1007-08 (1962); see also WILLIAM B. BREUGGEMAN & JEFFREY D. FISHER, *REAL ESTATE FINANCE AND INVESTMENTS* 696 (9th ed. 1993). Early REITs avoided the prohibition on corporate ownership of real estate while being treated as a trust and thereby avoiding an entity-level tax. REIT income distributed to beneficial shareholders was not taxed at the corporate level. *Id.*; Crocker v. Malley, 249 U.S. 223, 232-33 (1919); BREUGGEMAN & FISHER, *supra*, at 696. However, in 1935 the Supreme Court held that the corporate characteristics of REITs were "sufficient to classify the trust as an 'association' taxable as a corporation." Caplin, *supra*, at 1008; Morrissey v. Comm'r, 296 U.S. 344, 360 (1935); Swanson v. Comm'r, 296 U.S. 362, 365 (1935); Helvering v. Combs, 296 U.S. 365, 368-69 (1935); Helvering v. Coleman-Gilbert Assocs., 296 U.S. 369, 372 (1935). Although mutual funds (or "regulated investment companies"), which also were affected by the ruling, quickly obtained legislation exempting themselves from the entity-level tax, REITs were not able to achieve that until 1960. See I.R.C. §§ 851(a), 852(b), 857(b) (2002). The decline in the use of REITs after the 1935 Supreme Court decision and their proliferation since the 1960 legislation confirm that the main attraction of the REIT is its non-entity tax status.

89. Cf. *supra* note 88 (discussing whether trusts and corporations that are functionally identical ought to be taxed alike).

90. Contracting out services can create a potential conflict of interest. In addition to the fact that the REIT will many times be formed to purchase property from the sponsors themselves, these services will in all likelihood be contracted out to associated organizations and individuals. For this reason, state law generally requires that a majority of a REIT's trustees not be affiliated with the sponsors of the REIT. BREUGGEMAN & FISHER, *supra* note 88, at 701-02.

91. I.R.C. §§ 856(c), (d), 857(a)(1)(A)-(B) (2002). Organizationally, the REIT must have beneficial ownership by one hundred or more stockholders whose interests are evidenced by transferable shares, or by transferable certificates of beneficial interest. I.R.C. § 856(a); Treas. Reg. § 1.856-1(a)-(b) (2002).

92. Cf. text accompanying *infra* notes 128-31 (arguing that trustees of REITs that have senior and residual claimants should be judged by corporate and not trust standards of governance).

93. See discussion accompanying *supra* notes 85-91.

94. REITs also are like mutual funds to the extent they use the proceeds of securities offerings to invest in a real estate portfolio intended to diversify investor and market risk. See *supra* Part II. Indeed,

FINANCIAL ASSET SECURITIZATION INVESTMENT TRUSTS (FASITs)⁹⁵

Provisions of the Small Business Job Protection Act of 1996 allow an entity, including a trust or corporation, that elects to qualify for special treatment as a financial asset investment securitization trust, or "FASIT,"⁹⁶ to avoid an entity-level tax.⁹⁷ FASITs are used exclusively as special purpose vehicles in securitization transactions.⁹⁸ Like a REIT, a FASIT is a legal construct that may use the trust form.

The concept of a FASIT was inspired by the so-called real estate mortgage investment conduit, or REMIC, an exclusive method under tax law for securitizing mortgage loans.⁹⁹ FASITs are similar but not identical to REMICs. For example, FASITs can be applied to any class of assets that qualify as debt for federal income tax purposes¹⁰⁰ and, unlike REMICs, they are *not* an exclusive method for securitizing those assets classes.¹⁰¹

PART III: ANALYSIS

A FRAMEWORK FOR ANALYSIS

The taxonomy shows that commercial trusts tend to be static entities that diversify risk and often avoid an entity-level tax. This Article now attempts to use these descriptive features to derive an analytical framework in which to compare commercial trusts with other forms of business organization.¹⁰² These features, however, are insufficient by themselves to create an analytical framework because

REITs have been described as "mutual funds that invest in real estate." Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211, 248 (1991).

95. This section was prepared with the assistance of Willys H. Schneider, partner, Kaye Scholer LLP.

96. I.R.C. §§ 860H(a), 860L.

97. See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1621, 110 Stat. 1755 (codified at 26 U.S.C. §§ 860H-860L).

98. See William A. Wurch, *The FASITnating Facets of FASITs*, 11 PROB. & PROP. 21, 22 (1997).

99. [An] SPV is not subject to taxation if it qualifies as a REMIC. The SPV can be a corporation, trust, partnership, or simply a pool of assets that has elected REMIC status. To qualify as a REMIC, however, the SPV must . . . fulfill certain . . . requirements [including those] relating to the types of assets it holds [primarily limiting such assets to qualified mortgage loans].

STEVEN L. SCHWARCZ, *STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* 51 (2d ed. 1993) (citations omitted); see also SCHWARCZ, *STRUCTURED FINANCE*, *supra* note 3, §§ 5:1, 5:3, 5:3:1, at 5-3 to -4, 5-21, 5-25.

100. I.R.C. § 860L(c)(1)(B) (2002) ("permitted" FASIT assets include any debt instruments as long as certain requirements regarding interest rates are met).

101. Cf. *id.* § 7701(i) ("taxable mortgage pools" subject to corporate tax, defined to include certain entities substantially all of the assets of which are mortgages and which are *not* REMICs or FASITs). FASITs differ from REMICs in other ways, including that assets may be added, substituted, or withdrawn without impairing the non-entity tax status. Cf. *id.* § 860G(d) (tax on contributions to REMIC after starting up with limited exceptions).

102. This use of descriptive features is inspired by philosophical attempts to define things that "have no one thing in common which makes us use the same word for all,—but that they are *related* to one another in many different ways." LUDWIG WITTGENSTEIN, *PHILOSOPHICAL INVESTIGATIONS* pt. I, § 65 (G.E.M. Anscombe trans., MacMillan Co. 3d ed. 1971) (1953).

they are not necessarily unique to commercial trusts.¹⁰³ For example, nothing prevents corporations from restricting their charters to become static entities. Corporations certainly can diversify risk by issuing different classes of shares;¹⁰⁴ and most non-publicly traded entities with the functional attributes of corporations can now avoid entity-level taxes.¹⁰⁵

The Article therefore adds to the framework by next examining commercial trusts from the perspective of the three fundamental ways that one can think about a business entity: for what purposes does the entity exist (hereinafter, "legal existence"); how is the entity governed (hereinafter, "governance"); and what effect does the entity have on its surroundings and vice versa (hereinafter, "exogenous effects").¹⁰⁶ In that context, the Article asks what makes commercial trusts different from corporations, their chief business competitor.

Legal Existence. Commercial trusts are not all recognized as having separate legal existence, and some commercial trusts are recognized under certain laws but not others.¹⁰⁷ In contrast, a corporation almost always is recognized as having a separate existence at law.¹⁰⁸ Although recent check-the-box rules allow entities that resemble corporations to sometimes avoid an entity-level tax,¹⁰⁹ business planners may favor trusts where such rules do not apply and non-entity status is still needed to avoid the tax.¹¹⁰

103. Moreover, the taxonomy only describes existing commercial trusts. Business needs change, and it is possible that commercial trusts in the future may evolve in other directions and have different descriptive characteristics. For example, the trend of mutual funds to incorporate riskier investments and more sophisticated managers is making those types of commercial trusts less static and more dynamic. *See supra* Part II. Also, changes in tax law are narrowing the entity-level tax distinction between commercial trusts and other forms of business organization. *See supra* Part II.

104. For example, corporations can issue common and preferred shares and can subdivide rights and priorities even within those classes. *See, e.g.*, DEL. CODE ANN. tit. 8, § 151(a) (2001).

105. *See supra* note 40 (discussing the IRS's check-the-box regulations). This Article's definition of a "commercial trust" as a trust in which there is a bargained-for-exchange rather than a gift is also insufficient to create an analytical framework because it fails to address the business elements associated with commercial trusts. It would be like using the technical definition of a bird, "a warm-blooded vertebrate having a body covered with feathers and forelimbs modified into wings," to try to understand what birds are like. Definition of "bird," at http://www.nps.gov/tuma/Bird_List.html (last visited Dec. 23, 2002). The definition says nothing about which birds can fly and which cannot. Indeed, it does not even state that any birds can fly.

106. *Cf.* Steven L. Schwarcz, *A Fundamental Inquiry Into the Statutory Rulemaking Process of Private Legislatures*, 29 GA. L. REV. 909, 931 (1995) ("One of the strengths of Article 9 [of the Uniform Commercial Code] is that it approaches secured transactions from a conceptual standpoint and does not (as did [earlier] statutes) use the transactions themselves or their forms as the organizing principle.").

107. *See supra* Part II (discussing that trusts created by contract do not always have separate legal existence).

108. Exceptions include certain mutual funds formed as corporations but acting solely as conduits and situations where the corporation so fails to maintain a separate identity that its corporate veil is pierced or, in bankruptcy, it is substantively consolidated with an affiliate. *See supra* Part II and text accompanying *infra* notes 112–15.

109. *See supra* text accompanying notes 40–42 (discussing the check-the-box rules).

110. The check-the-box rules have certain restrictions, including that such rules neither change the need for securities that purport to be debt under tax law to be supported by a significant equity investment in the entity nor override provisions that independently classify entities (for reasons such as the entity having a publicly traded equity interest) as corporations for tax purposes. Treas. Reg. § 301.7701-2(a) (2002) (check-the-box rules apply to business entities not subject to special treatment under the Internal Revenue Code).

On the other hand, a trust's lack of legal existence could be troublesome if its beneficiaries are concerned that the company transferring assets to the trust might go bankrupt. If bankruptcy law did not recognize the trust, the assets thought to be conveyed to the trust would still belong to the bankrupt company. Therefore, where bankruptcy is a realistic risk, a commercial trust often is created under state trust law,¹¹¹ and not merely by contract, in order to increase the likelihood that its existence is kept legally separate from that of the company, an attribute often referred to as "bankruptcy remoteness."¹¹²

The legal flexibility of forming a trust either by contract or by state trust law, coupled with recent tax law changes, therefore offer business planners significant flexibility to avoid entity-level taxes and obtain bankruptcy protection.¹¹³

Governance. The taxonomy has shown that commercial trusts tend to be static entities, and that their managers (the trustees) often are perceived as passive. This contrasts sharply with business corporations, whose managers tend to be aggressive and opportunistic to take advantage of business opportunities. Although this distinction is superficial, it reflects on a fundamental underlying distinction between trusts and corporations.

In a corporation, the residual claims, evidenced by shares of stock in the corporation, are sold to *third-party* investors (shareholders) who expect a rate of return that compensates them for the money they voluntarily put at risk. If that rate of return is not forthcoming, they will not invest and the system of shareholder corporate finance would collapse. It therefore is essential that corporations engage in business ventures that are likely to increase their profitability. In contrast, a corporation's senior claimants (its creditors) will be paid principal and interest (the latter being their contractual rate of return) so long as the corporation is solvent. From their standpoint, allowing an already-solvent corporation to engage in business ventures to increase profitability brings no benefit but, if the venture fails, brings a risk of insolvency and loss. The fundamental goals of a corporation's shareholders (residual claimants) and creditors (senior claimants) are thus *inconsistent*: "[T]ension between the interests of shareholders and creditors is inherent in every decision that increases a corporation's risk in order to make it more profitable."¹¹⁴

111. Such a trust may be created, for example, as a Delaware business trust. See *supra* Part II.

112. A necessary requirement for "bankruptcy remoteness" is that the SPV itself is not subject to bankruptcy. Trusts are not generally the types of entities that may become debtors in a federal bankruptcy case because, with one exception, trusts are not "person[s]" within the meaning of the Federal Bankruptcy Code. 11 U.S.C. § 101(41) (2000). However, business trusts are persons within the meaning of the Code. Compare 11 U.S.C. § 101(41) (defining "person" to include a corporation) with *id.* § 101(9)(A)(v) (definition of "corporation" includes a business trust). Analysis of this issue can be confusing because the Code does not define a "business trust" and the state law definitions are conflicting. *In re Secured Equip. Trust of E. Air Lines, Inc.*, 38 F.3d 86, 87, 91 (2d Cir. 1994) (holding that a trust used in an equipment finance transaction is not a business trust under New York law).

113. That discretion, however, is not unlimited. Companies that settle trusts often wish to retain a right to the residual trust assets in order to benefit from their surplus value, and such retention might appear inconsistent with the argument that the company effectively has transferred title to the assets to the trust. See *infra* notes 128, 161–62 and accompanying text.

114. Schwarcz, *supra* note 11, at 650.

Corporate law resolves these competing goals by allowing managers—the corporation's board of directors—to take risks in order to maximize corporate profitability (and thus shareholder return) so long as the corporation is not insolvent. This essentially makes the board of directors responsible, absent insolvency, only to shareholders and not to creditors.¹¹⁵

Trust law, on the other hand, developed historically from gratuitous trusts. The extent of conflict between senior and residual claimants that was seen with corporations is unlikely to arise in a gratuitous trust because the expectations of its claimants tend to be *consistent*: to preserve the value of the trust assets.¹¹⁶ A trust with no residual claimants, for example, avoids conflict by having only senior claims. A trust where the settlor is the only residual claimant—as in settlor transferring a life-estate in assets for the benefit of third party, residual to settlor—rarely creates a significant conflict because the settlor, unlike a corporate shareholder, normally would not expect a risk-weighted return on its claim. Even a trust where the residual claimants are third parties—as in husband transferring a life-estate in assets for the benefit of his wife, residual to his children—does not create the degree of conflict¹¹⁷ that occurs between a corporation's creditors and shareholders: the children, receiving a gift for which they gave nothing in return, could not reasonably expect the trustee to jeopardize the wife's life-estate solely in order to maximize the children's residual return. Although the children will

115. At least one court has found that a board of directors is responsible to creditors as well as shareholders where the corporation is in the "vicinity of insolvency." *Id.* at 669–72 (discussing *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. Civ. A. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991)). This author has argued that a board of directors also should be responsible to both creditors and shareholders where the board's contemplated action would be reasonably expected to give rise to insolvency. Schwarcz, *supra* note 11, at 673. The rationale in either case is that insolvency reduces the value of a shareholder's claim to zero and jeopardizes creditor repayment. *Id.* at 667–68 n.97 (citations omitted).

116. See, e.g., IIA AUSTIN W. SCOTT & WILLIAM F. FRATCHER, *THE LAW OF TRUSTS* § 176, at 482 (4th ed. 1987) ("It is the duty of the trustee to use care and skill to preserve the trust property."); see also *id.* § 174, at 468 ("In making investments the trustee is under a duty not only to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property, but he must use the caution of one who has primarily in view the preservation of the estate entrusted to him, a caution that may be greater than that of a prudent man who is dealing with his own property."); *id.* § 181, at 544 (even where a trustee is "authorized to make . . . land productive by managing it, he is not under a duty to lease it."); RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227, cmt. e (1990) ("Normally, in investing the funds of a trust, the trustee's strategy must make preservation of the trust estate (including its purchasing power) a significant consideration."); GEORGE T. BOGERT, *TRUSTS* § 106, at 387 (6th ed. 1987) ("[A trustee] has no duty to make investments for the purpose of increasing the [real] value of the trust assets. He is not permitted to speculate with the trust principal.").

117. I am not claiming there is no conflict; rather, I focus on the degree of conflict. Cf. E-mail from John H. Langbein, Sterling Professor of Law and Legal History, to author (Aug. 10, 2002) (on file with *The Business Lawyer*, University of Maryland School of Law) (observing that there is "an imbedded conflict of interest in every trust that has multiple interests, especially the common successive (life and remainder) estates"); see also Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1159 (1988) (noting that the duty of impartiality "does not assume . . . that all participants and their beneficiaries will always have the same interests. Conventional trust law recognizes the problem of conflicts among beneficiaries").

want the trustee to ensure that the trust assets preserve their value,¹¹⁸ that goal does not allow the trustee to “endanger the safety of principal in order to produce a large income.”¹¹⁹ Instead, trust law imposes a duty of impartiality: where “there are two or more beneficiaries of a trust, the trustee is under a duty to deal impartially with them.”¹²⁰

To understand how the duty of impartiality works, assume that the foregoing trust has \$500,000 of assets—a life-estate with which the wife is satisfied—and the opportunity to invest in a business transaction with a ninety percent chance of successfully doubling the assets but a ten percent chance of losing all the assets. A trustee considering this investment would have to weigh the ten percent chance that the wife will lose her entire life-estate against the ninety percent chance that the children’s residual estate will be significantly increased. Even though the investment has a significantly positive expected value,¹²¹ it may well constitute excessive risk.¹²² If so, the trustee’s duty of impartiality would prevent it from making the investment.¹²³

Commercial trusts follow the same pattern. The taxonomy revealed that most commercial trusts have residual interests that are held by the settlor.¹²⁴ Viewed from a purely technical standpoint, the settlor-residual claimant’s interest is precisely the inverse of the senior-claimant interests: every dollar that goes to pay the senior claimants reduces *pro tanto* the amount available to return to the re-

118. Trust law imposes on the trustee “a duty to the remainder beneficiaries [i.e., the residual claimant] to exercise reasonable care in an effort to preserve the trust property, and this duty ordinarily includes a goal of protecting the property’s purchasing power.” RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 232, cmt. c (1990).

119. *Id.*; see also *id.* § 227, cmt. e (observing that while trust law today recognizes that “[a]ll investments . . . and all investment strategies involve some risk in the comprehensive sense of possible loss of real, inflation-adjusted value, the duty of caution still calls for the prudent management of risk”). The duty of caution is reflected in “[c]ase law and prior Restatements [of the Law of Trusts which] have condemned ‘speculation’ and excessive risk.” *Id.*, Introduction, at 6. Although, for those states that enact it, the Uniform Prudent Investor Act is substituting a requirement of sensitivity to risk in place of the directive to avoid speculation, that change is not expected to materially change “the outer reaches of the risk/return distribution.” John H. Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 IOWA L. REV. 641, 650 (1996).

120. RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 183 (1990). The duty of impartiality applies “whether the beneficiaries’ interests in the trust property are concurrent or successive.” *Id.* § 183, cmt. a. Because trust duties can be varied by agreement, it is theoretically possible to create a trust in which the trustee, like the board of directors of a corporation, owes a primary duty to residual claimants. But that is not the default rule.

121. The expected value of this investment = $0.9 (\$1,000,000) + 0.1 (0) = \$900,000$. For an introduction to expected-value analysis, see RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 15.1 (5th ed. 1998).

122. Professor Langbein clarifies this example by noting that “[t]he prudent investor rule says all risk is relative to[] [t]he risk profile of the investor. The destitute widow . . . cannot take the 10% risk of loss, but many an affluent beneficiary can.” E-mail from John H. Langbein, *supra* note 117.

123. The trustee’s duty to diversify investments also may prevent it from making this investment. See RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227(b) (1990) (“In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust . . .”).

124. See *supra* Part II; see also *infra* note 126 (explaining why the settlor almost always holds the residual claim of a commercial trust).

sidual claimant.¹²⁵ As with gratuitous trusts, however, that technical conflict rarely is problematic because the settlor-residual claimant, unlike a corporate shareholder, normally does not expect a risk-weighted return on its claim. Rather, its business goal is simply to retain any surplus value in the trust's assets.¹²⁶ Settlers of SPVs derive their primary value from selling the senior certificates; they retain a residual claim solely to preserve any excess value that remains once the senior certificate-holders are paid. Commercial trusts without third-party residual investors simply do not have the economic constraints that corporations have to be profitable.¹²⁷ Moreover, because the settlor itself is the residual claimant in a commercial trust context, any given settlor could, if it wished a higher return, contractually specify the trustee's investment duties.

*The degree to which assets need to be placed at risk in order to satisfy the expectations of residual claimants thus provides a key to distinguishing commercial trusts from corporations.*¹²⁸ Although the interests of senior and residual claimants of a trust are technically inconsistent, the expectations of all such claimants would be satisfied merely by preserving the value of the trust assets. And preserving such value usually requires relatively ministerial effort on the part of a trustee. It therefore is feasible to operate under a duty of impartiality. In contrast, the expectations of senior and residual claimants of a corporation are much more divergent. Shareholders expect and demand increased profitability; merely preserving corporate value would be insufficient.¹²⁹ This has two consequences. First, because it is harder to increase than to merely preserve value, corporate managers must devote far more than ministerial effort to the task; and that requires that such managers generally be better trained and more sophisticated than trustees. Second, the divergence in expectations would make a corporate duty of impartiality difficult to apply.¹³⁰ Instead,

125. This computation assumes a fixed trust estate.

126. To understand why the settlor almost always holds the residual claim, recall how that claim arises. Commercial trusts issue trust certificates that give investors senior claims against the trust assets. Those investors have no obligation to invest; they will do so only if they believe that making the investment is in their rational self-interest. Investors therefore want to be assured of the safety of their investment. In practice, this usually requires that the amount of assets conveyed to the trust be well in excess of the minimum amount required to repay the investors. The settlor effectively "buys" this residual interest by overcollateralizing the trust, relying on its greater knowledge of its own assets to take this residual investment risk. The overcollateralization protects third-party investors against the possibility of losses or delays in payment. Schwarcz, *Alchemy*, *supra* note 3, at 141. Excess trust assets, perhaps significant in amount, are likely to remain once the investors are repaid their senior claims. The residual claim to these assets therefore is a valuable property right which the settlor is economically unwilling to give up without receiving equivalent value in return. See *supra* Part I and *supra* note 23.

127. Of course, if all the beneficiaries want a trust to be profitable, as in a mutual fund, there is no conflict at all and the trustee's obligation to achieve profitability merely reflects the duty "to administer the trust solely in the interest of the beneficiary." RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1957); cf. *supra* Part II.

128. There might be a "chicken and egg" nature to this inquiry: does the distinction derive from differences in governance or do differences in governance derive from the distinction? This Article's analysis, however, does not depend on which came first. The biases created by the transaction costs of changing legal default rules then lock in the relationship.

129. Cf. *supra* note 127.

130. See, e.g., Schwarcz, *supra* note 11, at 672–77 (explaining the difficulties of trying to determine how directors of an insolvent corporation can balance their duties to shareholders and creditors); see

absent insolvency, corporate law requires that managers have a duty solely to the residual claimants, that is, the shareholders.¹³¹ One therefore should consider using the trust form of business organization where residual claimants do not expect management to favor their class of claims over senior claimants.¹³²

In this context, it is interesting to note that commercial trusts whose residual interests are sold to third parties would have much in common with corporations. Residual claimants of the trust (like shareholders in a corporation) may well expect a rate of return that compensates them for the money they voluntarily put at risk, thereby creating a conflict with the trust's senior claimants. The trust law duty of impartiality has not yet needed to address this conflict because third-party investment in residual trust claims is rare.¹³³ If, however, a significant market in residual trust claims were to develop, it is not inconceivable that the law would evolve to impose on trustees a duty to such residual claimants similar to the duty of corporate directors to shareholders.¹³⁴

Trusts and corporations are also linked by the happenstance of insolvency. This Article previously noted that a corporation's creditors (senior claimants) will be paid so long as the corporation is solvent. The governance rules of corporation and trust law begin to converge, however, in insolvency because the value of a residual claimant's claim then approaches zero while the senior claimants face a risk of nonpayment.¹³⁵ Directors of an insolvent corporation have obligations to creditors (senior claimants) as well as to shareholders (residual claimants).¹³⁶ Indeed, some have referred to this reversal of the primary fiduciary duty as the "trust fund doctrine": "The courts have reasoned that, upon insolvency, the di-

also id. at 676 (likening such balancing to "the dilemma of comparing apples and oranges"); *id.* at 673 (observing that "[c]urrent law . . . does not provide any hard and fast rules" on how to achieve the balance).

131. See *supra* note 127 and accompanying text.

132. Hansmann & Mattei, *supra* note 5, at 473 (arguing that trust law helps to balance conflicting interests among a trust's claimants by "[m]aking the [trustee] a pure fiduciary, not subject to control by any of the" residual claimants); see also E-mail from Henry Hansmann, Professor of Law, Yale Law School, to the author (Feb. 9, 1998) (on file with *The Business Lawyer*, University of Maryland School of Law) (arguing that "the natural distinction [between corporations and trusts is that] one uses a trust when the organization's managers must necessarily have discretion in trading off the interests of conflicting claimants, since that's a situation in which one wants a relatively disinterested fiduciary in charge who's bound by strict fiduciary duties that constrain favoritism").

133. Third-party investment in residual trust claims may well be rare precisely because the trust law duty of impartiality does not adequately clarify the rights associated with those claims.

134. Cf. *Terrydale Liquidating Trust v. Barness*, 611 F. Supp. 1006, 1016 (S.D.N.Y. 1984) (demonstrating the court's struggle as to whether trustees of a REIT who were alleged to have breached their fiduciary duty should be judged by the corporate business judgment rule or by stricter trust law standards). The decision was that "it is appropriate to judge the conduct of REIT trustees by the standards generally applied to corporate fiduciaries." *Id.* at 1017. The court's rationale was that "the trustees of a REIT are functionally more similar to corporate directors than to ordinary trustees." *Id.* at 1016 (citing 16A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8249, at 619 (R. Eickhoff rev. ed. 1979)); *Terrydale*, 611 F. Supp. at 1016 ("The functional similarity and shared characteristics of business trusts and corporations centralized management, transferable ownership in the form of shares, continuity of life, separate and distinct legal existence, a charter-like declaration of rights and obligations, and a profit-making purpose has been recognized.").

135. See Schwarcz, *supra* note 11, at 667-68.

136. *Id.* at 665-68, 668 n.100.

rectors become 'trustees' for the creditors and hold corporate assets as a 'trust fund' for the benefit of these investors."¹³⁷

The trust fund doctrine, however, is an artificial label¹³⁸ for the more fundamental recognition that, de facto, creditors of an insolvent corporation become third-party residual claimants to the extent of the insolvency.¹³⁹ As such, they (like shareholders) should be owed a fiduciary duty by the corporation's directors.¹⁴⁰

Exogenous Effects. In business, perhaps the most common exogenous effect is the cost of taxes. Taxes are generally imposed on the income of each entity that is recognized under tax law as having separate existence. Prior to recent tax law changes,¹⁴¹ virtually all corporations¹⁴² incurred entity-level taxes whereas some trusts did not. As a result of these changes, non-publicly traded entities with the functional attributes of corporations now can usually avoid entity-level taxes.¹⁴³ Therefore, this exogenous factor remains important, but less so than before.

Trusts also can affect third parties, such as by diversifying their risk. Furthermore, investors in trust certificates are not liable for the debts and other obligations of the trust.¹⁴⁴ Because this immunity is the same as that of a corporate shareholder,¹⁴⁵ this exogenous factor is neutral.

137. Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1513 n.92 (1993); see also HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 235, at 626 (3d ed. 1983).

138. Professor Langbein of Yale Law School observes, for example, that the word "trust" in the trust fund doctrine loses meaning; the doctrine is merely a remedy system by analogy to a trust. Telephone Interview with John H. Langbein, Professor of Law, Yale Law School (Mar. 19, 1997).

139. To illustrate this, consider a corporation with assets of \$100 and debt claims of \$125. The \$125 senior claim can be viewed as a \$100 senior claim payable from the \$100 in assets and a \$25 claim that will be payable only if the residual value of the corporation is increased. The \$25 claim therefore is, de facto, a residual claim, although it remains senior to the shareholders' residual claim to any value remaining after the \$125 debt claim is paid in full.

140. Schwarcz, *supra* note 11, at 667-68. Similarly, the trustee's fiduciary duty to senior trust claimants is subject to a duty of impartiality to residual trust claimants to preserve the value of the trust assets, in order to ensure that both classes of claimants—senior and residual—have a reasonable chance of being paid, whereas a corporate director's fiduciary duty to residual corporate claimants may be subject, in the event of a corporation's actual or contingent insolvency, to a fiduciary duty to senior corporate claimants again to ensure that both classes of claimants have a reasonable chance of being paid. See generally *id.* In each case, the duty to claimants who have dominated investment in such entity—shareholders in the case of corporations, and senior claimants in the case of trusts—is subject to a duty to protect the rights of other claimants. This balance addresses the dilemma that a manager cannot simultaneously maximize conflicting claims.

141. See *supra* note 40 and accompanying text (discussing the check-the-box rules).

142. Other than Subchapter S corporations.

143. For example, limited liability companies, or LLCs, "combine the owner-limited liability benefits of incorporation with the tax benefits of non-incorporation." SCHWARCZ, *STRUCTURED FINANCE*, *supra* note 3, § 3:2.4, at 3-20 (citations omitted) (discussing the ability of LLCs to avoid entity-level taxation). Furthermore, LLCs can be structured on the corporate governance model without jeopardizing their non-entity tax status. *Id.* at 3-21 n.59.

144. James M. Ginocchi & Kimberly A. Taylor, Comment, *How "Limited" Is Pennsylvania's Limited Liability Company Act?*, 33 DUQ. L. REV. 613, 649 (1995).

145. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(6) (2001) (providing the default rule that "the stockholders or members of a corporation shall not be personally liable for the payment of the corporation's debts except as they may be liable by reason of their own conduct or acts"). The rationale is that an investor exposed to liability would not rationally choose to invest unless the likely return on the investment offsets the risk, but such a return would be so expensive as to be impractical in most circumstances.

Framework for Analysis. The foregoing examination suggests the following framework for analysis:

Commercial trusts are not all recognized as having separate legal existence. This can allow a trust to avoid entity-level taxes, whereas corporations are more likely to be subject to such taxes. Separate legal existence may be important, however, where bankruptcy remoteness is a goal. Trustees need only preserve the value of the trust's assets for claimants, which requires minimal managerial discretion and cost. In contrast, corporate managers must actively manage assets to achieve a profitable return for residual claimants. Finally, trusts are efficient vehicles by which to diversify risk, thereby attracting funding from investors.

This Article next applies the framework to the use of commercial trusts and corporations in securitization transactions, analyzing why and under what circumstances the trust form would be used over the corporate form.

APPLICATION OF THE FRAMEWORK

Securitization transactions exemplify the seemingly interchangeable use of trusts and corporations as forms of business organization. Viewing these transactions from the standpoint of the framework, however, reveals that the trust and corporate forms are not always interchangeable but tied to the transaction's underlying business purpose.

A primary business goal is to minimize or altogether avoid entity-level taxes on the SPV.¹⁴⁶ Until the recent tax law changes,¹⁴⁷ trusts were somewhat favored as SPVs because they could be organized to avoid these taxes, whereas most corporations could not.¹⁴⁸ Those changes, however, have made it less important *from a tax standpoint* how the SPV is organized.

Once organized, the SPV uses the funds raised from investors to purchase financial assets from a company. The company, however, almost always retains a residual interest in those assets.¹⁴⁹ The retention of that interest might raise a question as to who actually owns the financial assets if the company later goes

146. SCHWARCZ, *STRUCTURED FINANCE*, *supra* note 3, § 5:2.3, at 5-11.

147. *See supra* notes 40-41 and accompanying text (discussing check-the-box and FASIT rules).

148. An SPV's issuance of corporate debt securities could, however, at least minimize the entity-level tax problem by providing an offsetting tax deduction. From the standpoint of characterizing the investment as debt or trust certificates, the corporate versus trust distinction is irrelevant, however. Securitization investors are typically major financial institutions and pension funds that want to treat their investments as debt for tax purposes. Thomas A. Humphreys et al., *Tax Treatment of Structured Finance Transactions*, 15 *TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS, & RESTRUCTURINGS* 1013, 1025-26 (Practicing Law Institute 2000) But trust certificates can also be characterized as debt for tax purposes. *See* Am. Bar Ass'n Section of Taxation Comm. on Fin. Transactions Subcomm. on Asset Securitization, *Legislative Proposal to Expand the REMIC Provisions of the Code to Include Nonmortgage Assets*, 46 *TAX L. REV.* 299, 321 (1991).

149. *See* Schwarcz, *Alchemy*, *supra* note 3; SCHWARCZ, *STRUCTURED FINANCE*, *supra* note 3, § 3:2.3, at 3-17.

bankrupt.¹⁵⁰ Even in states such as Delaware that have legislation specifically permitting a settlor to retain a residual interest without undermining the integrity of the trust, there is little authority—given that federal bankruptcy law policy disfavors bankruptcy remoteness where the seller of assets retains a residual interest¹⁵¹—as to whether a federal bankruptcy judge would uphold this legislation.

In some transactions, parties are prepared to live with this ambiguity. But where bankruptcy remoteness—in the form of a “true sale” of the financial assets from the company to the SPV—is critical to the transaction’s success,¹⁵² parties often look to corporate law in order to avoid ambiguity.¹⁵³ Corporate law simply provides a more developed legal framework than trust law. Because corporations have long been recognized under bankruptcy law as having separate legal existence, securitizations often can achieve bankruptcy remoteness by being structured as “two-tier” transactions in which the first tier is a sale of financial assets to a corporate-SPV.¹⁵⁴ In securitization transactions, the corporate form is thus favored over the trust form in order to address bankruptcy remoteness.

150. Compare, e.g., *Vanderbilt Credit Corp. v. Chase Manhattan Bank*, 473 N.Y.S. 2d 242, 245 (N.Y. App. Div. 1984) (stating that if a settlor holds a beneficial interest in a trust, the settlor’s creditors can reach the full amount of the settlor’s interest even though the conveyance was not a fraudulent conveyance) with *In re Ocana*, 151 B.R. 670, 673 (S.D.N.Y. 1993) (stating that only the debtor’s reversionary interest is property of the bankruptcy estate). Although Delaware Business Trust Act provides that “[n]o creditor of the beneficial owner [of a Delaware business trust] shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the business trust,” there is ambiguity whether federal bankruptcy law would override state law to more broadly define the settlor’s bankruptcy estate. DEL. CODE ANN. tit. 12, § 3805(b) (2001); see also *infra* note 154. This conflict between state and federal law is complicated by the U.S. Supreme Court’s decision in *Butner v. United States*, 440 U.S. 48, 55 (1978), holding that federal bankruptcy courts must recognize state law entitlements unless there is a contrary federal interest. It is ambiguous whether the bankruptcy law policy of broadly defining the bankruptcy estate would qualify as a federal interest that is sufficient to override the beneficiaries’ state law entitlement to trust property.

151. See *supra* Part III.

152. Schwarcz, *Alchemy*, *supra* note 3, at 135 (noting that investors may not want to take the risk of the company’s bankruptcy).

153. As a technical matter, it would be relatively easy to amend federal bankruptcy law to resolve this ambiguity. The ambiguity, however, appears to be a subset of a broader, unresolved policy issue in bankruptcy law: If party X transfers assets to party Y but retains a residual interest in the assets, who owns the assets in the event of party X’s bankruptcy? Commercial trusts would be most useful if the answer were party Y. Some courts, however, have ruled that party X owns the assets, in effect re-characterizing the transaction as a loan by party Y to party X secured by the assets. See Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 186–87 (1996); Steven L. Schwarcz, *The Parts Are Greater Than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies*, 1993 COLUM. BUS. L. REV. 139, 145–47 (arguing that it is not the transferor’s retention of a residual interest that should govern characterization of the transfer as a sale or a secured loan but rather whether the residual interest adjusts to ensure that the transferee receives an economically bargained rate of return). Until that controversy is resolved, the two-tier structure may be a costly and second-best solution. See *infra* note 154 and accompanying text (describing the two-tier structure).

154. [E]ven in a structured financing in which a . . . trust is used to issue the asset-backed securities, an intermediary corporate SPV is often used as the initial transferee of assets from the originator (which SPV in turn transfers such assets to the trust) and is the bankruptcy remote SPV for which legal opinions are delivered. This is in part because of the uncertain status that a . . . trust might have under applicable commercial law principles.

Structured Financing Techniques, *supra* note 64, at 571 n.130; see also Schwarcz, *Alchemy* *supra* note 3, at 142 (discussion of two-tier structure); ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL

On the other hand, the governance criteria may favor a trust over a corporate form for certain securitization transactions where bankruptcy remoteness is unimportant. For example, securitizations involving banks, which are exempt from the federal bankruptcy laws,¹⁵⁵ often use the trust form. Investment-grade non-bank originators sometimes also structure securitization transactions using the trust form because their high credit rating means that bankruptcy remoteness may not be an important business concern.¹⁵⁶ The governance rationale is that directors of a *corporate*-SPV would owe their primary fiduciary duty to residual claimants (shareholders) and not to the creditors who invest in the SPV.¹⁵⁷ Where the SPV is a trust, however, the trustee cannot (under the duty of impartiality) favor the residual claimant (settlor) over investors, absent explicit agreement to that effect.

Finally, master trusts sometimes are used—directly in the case of a transaction where bankruptcy remoteness is unimportant, and as the second SPV in a two-tier structure where bankruptcy remoteness is desirable—in order to efficiently diversify risk by issuing a variety of securities having different returns and risk levels, thereby maximizing funding from investors.¹⁵⁸

The framework is also useful to shed light on when business planners should use trusts.

WHEN SHOULD BUSINESS PLANNERS USE TRUSTS?

Business planners should consider using trusts wherever an entity-level tax must be avoided, although recent tax law changes make it relatively easy to avoid this tax by other means. Absent tax concerns, however, the main criterion that business planners should consider in choosing between a corporate and trust form is governance. A trustee's duty of impartiality limits the utility of the trust form for business entities that have third-party residual claimants. Whereas trustees cannot generally take risks in order to make the trust profitable for residual claimants at the expense of senior claimants, corporate boards owe their primary fiduciary duty to the residual claimants and therefore may engage in positive expected-value ventures even if there is a possibility of loss.¹⁵⁹

Governance demonstrates that the decision to form a business entity as a trust

ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140, app. A, ¶ 83, at 46–47 (Financial Accounting Standards Bd. Sept. 2000). (describing two-tier structure).

155. 11 U.S.C. § 109 (2000).

156. Schwarcz, *Alchemy*, *supra* note 3, at 140.

157. Directors of a solvent corporation generally owe their fiduciary obligations solely to shareholders. See *Pepper v. Litton*, 308 U.S. 295, 307 (1939). If, for example, the shareholder goes bankrupt, the directors might be obligated to put the SPV into bankruptcy, thereby protecting the shareholder's equity interest in the SPV but "significantly impair[ing] [the SPV's investors] by suspending their right to payment and possibly compromising their claims." Schwarcz, *supra* note 11, at 684. There are arguments, based on a theory of "contingent insolvency," that "[b]ecause the benefit to shareholders does not appear to outweigh the harm to creditors, directors are likely to vote against a bankruptcy filing." *Id.* There are, however, no cases on point.

158. A true sale to the corporate SPV achieves bankruptcy remoteness; the master trust then efficiently diversifies the risk. See *supra* Part II (describing master trusts).

159. Cf. *supra* note 121 (illustrating a positive expected value venture).

or a corporation may depend on the nature of the business's assets. Say, for example, that the business will have only financial assets and wants to raise money from investors to purchase such assets. Because one can usually calculate the value of financial assets, the business can predict with some accuracy how much will need to be invested. Also, because investors generally require overcollateralization of their investment, there should be some residual value left after the investors are repaid. Selling subordinated interests (i.e., residual claims) in this residual value to other investors would contribute little because financial assets ordinarily do not increase in value.¹⁶⁰ Moreover, the business's management may well have superior ability to value the residual. It then makes sense to sell only senior claims to investors, retaining the residual interest. Forming the business as a trust would facilitate this capital structure because the trustee's duty to preserve the value of the estate, and the duty of impartiality to senior and residual claimants, would effectively and cheaply protect investor interests.

If, on the other hand, the business will have non-financial assets, the asset values may be difficult to calculate precisely. To avoid loss, potential senior investors would demand greater overcollateralization, which would increase the residual value. Furthermore, the value of non-financial assets may well be able to be increased by taking appropriate business strategies. The residual interest is therefore potentially more valuable than in the prior (financial assets) example, and the business may wish to sell it in order to increase the money raised from investors.¹⁶¹ Absent explicit agreement to the contrary among all parties, however, a trust structure would limit the ability to use the non-financial assets in positive expected-value ventures that include a risk of loss,¹⁶² thereby minimizing the value of the residual interest. But in a corporate structure, the board would have a duty to maximize the value of the residual claims, thereby making such claims more attractive to investors.¹⁶³

CONCLUSION

This Article has inquired into the nature of commercial trusts, comparing them with their chief business competitor, corporations. Where entity-level taxation is

160. The expected amount of the residual will remain small compared to the face value of the financial assets, other than relatively minor fluctuations in value based on changing market conditions, such as changes between the interest rate on the financial assets and the market interest rate. Also, because of the risk in buying a subordinated residual interest, investors would not be expected to pay more than a fraction of that small expected amount. The amount of overcollateralization, in the author's experience, is typically five to fifteen percent. Say a company has \$1000 face amount of financial assets, such as receivables. Senior investors might invest \$900 leaving a residual value of no more than \$100. An investor in the residual value cannot gain more than \$100 but, if collections on the receivables are poor, could lose her entire investment. How much, therefore, would that investor offer for the residual? The answer is more than zero but much less than \$100. The investment in the residual, therefore, would contribute little compared to the \$900 senior investment in the financial assets.

161. Investors who want a high return and are willing to accept high risk then would invest in the residual claims, and investors who want low risk and are willing to accept a low return would invest in the senior claims. Issuing both classes of claims enlarges the number of potential investors.

162. See *supra* note 121 and accompanying text (discussing the ninety percent/ten percent venture).

163. For illustrative purposes, the above analysis does not take dilution of ownership into account.

not at issue, the essential distinction between these entities turns on the degree to which assets need to be placed at risk in order to satisfy the expectations of residual claimants. In a corporation, the residual claims are sold to third-party investors (shareholders) who expect management to place corporate assets at risk in order to obtain a profitable return on their investments. But that also creates a risk that the corporation will become insolvent, thereby jeopardizing repayment of the senior claimants (creditors). The expectations of the corporation's senior and residual claimants are thus inconsistent. These expectations are resolved by allowing a solvent corporation's board of directors to engage in business ventures that are likely to maximize shareholder value even if there is a possibility of insolvency and loss.

In contrast, a commercial trust's residual claimant is typically the settlor, who does not expect a risk-weighted return. The expectations of a trust's senior and residual claimants therefore tend to be consistent: to preserve the value of the trust assets. These expectations are satisfied by trust law, which merely requires the trustee to deal impartially with claimants.

Commercial trusts, however, that sell residual claims to third parties who expect a high return for the money they put at risk may have much in common with corporations. In both cases, the residual claimants' expectations of a high return would conflict with the expectations of the senior claimants. If the existence of third-party residual claimants eventually becomes the norm, trust law may have to evolve in order to address these conflicts, such as by imposing on trustees a duty to residual claimants similar to the duty of corporate directors to shareholders.

This analysis shows that commercial trusts and corporations are mirror-image entities that respond to different investor needs. It also may help to explain why trusts, commonly used as a form of business enterprise in the nineteenth century,¹⁶⁴ are less frequently used today for that purpose. One explanation is that "[w]ith the routinization of the corporate form, the trust fell from scholarly attention among business lawyers."¹⁶⁵ Perhaps another explanation is that businesses were not then as heavily leveraged and aggressive as now, and thus there was less risk that the failure of a new business venture would cause insolvency. Absent insolvency, the trust would have sufficient assets to pay both senior and residual claimants. Now, however, as companies facing increased competition have become more aggressive and resilient to the stigma of insolvency,¹⁶⁶ they are more likely to take business risks that, though likely to succeed, *might* result in insolvency. The duties of caution and impartiality under trust law would hinder the ability of a trust to take these risks. The corporate form, however, allows it.

164. Langbein, *supra* note 1, at 188–89.

165. *Id.* at 189.

166. Until this century and even until recent decades, many thought that a business that operated when insolvent was committing a fraud. Compare U.C.C. § 2-702 cmt. 2 (1998) ("any receipt of goods on credit by an insolvent buyer amounts to a tacit business misrepresentation of solvency and therefore is fraudulent as against the particular seller") with 11 U.S.C. § 301 (2000) (insolvency is not a criterion of a bankruptcy case).