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STRUCTURED FINANCE: THE NEW WAY TO SECURITIZE ASSETS

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I. INTRODUCTION

Traditionally, a company will raise money by issuing securities that represent equity in the company or, in the case of debt securities, entitle the holders to claims for repayment. Sometimes payment of these claims is secured by a lien on certain of the company’s properties. In each case, the securityholder looks primarily to the company for repayment. If the company becomes financially troubled, or bankrupt, payment of the securities may be jeopardized, or at least delayed.

Structured finance can change the securityholder’s dependence on the company for payment, by separating the source of payment from the company itself. In a typical structured financing, a company that seeks to raise cash may sell certain of its assets to a special purpose vehicle or trust (hereinafter called the “SPV”) that is organized in such a way that the likelihood of its bankruptcy is remote. The “sale” is accomplished in a manner that removes, to the extent practicable, these assets from the estate of the selling company in the event of its bankruptcy. The result is that the assets are no longer owned by the selling company, but by the bankruptcy remote vehicle or trust. The assets themselves are typically payment obligations, such as accounts or other amounts receivable, owing to the company from creditworthy third parties. (In this article, these payment obligations are generically referred to as “receivables.”)

The SPV, and not the selling company, will issue securities to raise cash. These securities are intended to be payable from collec-
tions on the receivables purchased by the SPV. A potential buyer of the securities therefore looks to the cash flow from the purchased receivables, and not necessarily to the credit of the selling company, for repayment.

This separation of the selling company (hereinafter called the “originator,” because it usually originates the receivables) from the receivables themselves can enable the originator to raise funds less expensively, through securities issued by the SPV, than it would cost to raise funds through securities issued directly by the originator. In addition, as illustrated in the attached chart, the cash that is raised will not require an offsetting liability to be shown on the originator’s balance sheet; from the standpoint of the originator, the cash represents proceeds of the sale of receivables to the SPV.

If the originator is a bank or similar financial institution that is required to maintain risk based capital under the recent capital adequacy guidelines, securitization also could permit the originator to sell assets (for example, loans reflected as assets on the bank’s financial statements) for which it would otherwise be required to maintain capital. This reduces the bank’s effective cost of funds.

Furthermore, an originator may be restricted by its indenture covenants from incurring or securing debt beyond a specified level. A structured financing may enable the originator to raise cash in compliance with such covenants, because the originator may be selling assets and not incurring or securing debt. (Whether a structured financing would violate particular covenants requires a case-by-case inquiry.)

II. HISTORY

The first structured financings, identified as such, started in the early seventies with the securitization of pools of mortgages. Initially, mortgages were originated by savings and loan associations. These institutions depended heavily on core deposit flows for funds to finance local housing demand. When the housing credit market collapsed during the Depression, Congress reacted by passing the National Housing Act of 1934, intended in part to create a secondary market in mortgages. To this end, the Federal National Mortgage Association (“FNMA” or “Fannie Mae”) was established in 1938 to provide liquidity for mortgage investment by purchasing mortgages when funds are in short supply, and selling mortgages when funds are plentiful. As the nation’s demand for housing increased after World

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1 See Appendix.

War II, a capital shortage developed, and alternative capital streams were needed to finance the growing housing industry. In 1957, the Federal Home Loan Bank Board created a credit reserve system for savings and loan associations by permitting the purchase and sale of participations in interests in mortgage loans.

The first structured financing came in 1970 when the newly created Government National Mortgage Association ("GNMA" or "Ginnie Mae") began publicly trading "pass-through" securities. In a mortgage pass-through security, the investor purchases a fractional undivided interest in a pool of mortgage loans, and is entitled to share in the interest income and principal payments generated by the underlying mortgages. Mortgage lenders originate pools of mortgages with similar characteristics as to quality, term and interest rate. The pool is then placed in a trust. Then, either through a government agency, a private conduit or direct placement, certificates of ownership are sold to investors. Income from the mortgage pool passes through to the investors.

In recent years, many different types of assets have been the subject of securitization. Where the securities issued by the SPV are publicly issued, and where rating agencies—such as Standard & Poors and Moody’s—rate these securities, the assets purchased by the SPV tend to be payment streams that have proven histories of past payment and predictable expectations of future payment. Examples would include pools of mortgage loans, trade receivables and credit card receivables.

On the other hand, where the securities are privately placed, and in some recent transactions as the rating agencies become more comfortable with the credit issues involved with securitization, the assets purchased by the SPV are becoming more creative. For example, recent deals have included payment streams consisting of franchise fees, leases, subrogation claims and even utility surcharges.

III. DEFINING THE SOURCE OF REPAYMENT

As can be seen, the common thread is that the receivables purchased consist of a payment stream as to which there is a reasonable predictability of payment. Collections on the receivables would be applied to pay principal and interest on the securities issued by the SPV.

Predictability of payment is affected by the nature and identity of both the obligors on the receivables and the originator, and also by the nature of the receivables themselves. From the standpoint of the obligors, there are two risks: delay in payment (sometimes referred to
as "slow pay"), and default in payment (sometimes referred to as "no pay").

The "slow pay" risk is that the obligors on the receivables may delay in making their payments. A holder of securities issued by the SPV would not be pleased to learn that his monthly or quarterly interest payment was not made because an obligor delayed his payment. For this reason, the number of obligors on the receivables should be large enough to maintain statistical assurance that, even if a reasonably expected number of obligors delay in making their payments, the securities issued by the SPV will be paid on time.\(^3\)

The "no pay" risk is that the obligors on the receivables may default in making their payments. This risk in turn depends upon several factors. The obvious factor is the financial ability of the obligors to pay the receivables: an obligor might not pay because it is bankrupt or otherwise having financial problems. An obligor also may have a defense to payment.\(^4\) Therefore, the number of obligors on the receivables again must be large enough so that the risk of default can be statistically determined.

There are, however, certain factors that can impair the validity of a statistical analysis. It may be that a relatively small number of the obligors (counting, for this purpose, affiliated obligors as a single obligor, because default by any given obligor may signify financial trouble for the affiliates of that obligor) account for a disproportionately large amount of payments under the receivables. Default by these obligors might impair the ability of the securityholders to be repaid. This risk of high concentrations of payments by a relatively small number of obligors is called, naturally enough, the obligor concentration risk.

The default risk therefore can be managed by the SPV buying receivables having a statistically large number of obligors, and by analyzing the obligor concentrations. The financial ability of the obligors to pay, and the possibility that the obligors may be able to assert defenses to payment, also would be considered. The default risk then may be addressed by the originator's adjusting the sale price of the receivables to take into account anticipated defaults.\(^5\) Alternatively,

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\(^3\) Even payment streams that are uncertain as to precise timing of collections may be able to be securitized if a credit facility (referred to as a liquidity facility) is provided to advance funds to the SPV to pay debt service if collections are temporarily delayed. While the security holders obtain comfort as to timing of collection, a liquidity facility does not necessarily protect the securityholders in the case of larger than anticipated defaults.

\(^4\) The rights of a transferee of receivables may be subject to obligor defenses. See U.C.C. § 9-318(1) (1989).

\(^5\) There are various ways to compute the purchase price. The most straightforward is to discount the outstanding balance of the receivables to be purchased, taking into account antici-
or in addition, the default risk may be addressed by credit enhancement. This can take various forms, such as a guaranty, a letter of credit, an irrevocable credit line, or third party purchasing a tranche of subordinated securities from the SPV. The goal is that a creditworthy third party assures payment of all or a portion of the securities issued by the SPV.6

Predictability of payment also depends on the nature and identity of the originator. A financially troubled originator is more likely to go bankrupt, thereby raising the question whether the transfer of its receivables is a sale for bankruptcy purposes. If a court holds the transfer not to be a sale, the ability of the SPV to receive collections on the receivables will be delayed and may be seriously impaired. This is discussed in greater detail in Part IV(B).

Finally, predictability of payment may depend on the nature of the receivables themselves. For example, where the receivables constitute obligations owing for goods sold or services rendered (the standard trade receivables), there are few defenses to payment. Perhaps some of the goods sold will turn out to be defective, or some of the obligors will turn out to be minors. But in general a buyer of the receivables can anticipate the delinquency and default risks based on past collection patterns.

This type of predictability may not be obtained if the receivables represent payment for future performance obligations of the originator. A good example is franchise fees. These are amounts payable

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7 A rating agency that rates the SPV’s securities would want the third party to be at least as creditworthy as the rating on the securities. The third party providing the credit support would want to be comfortable, as a business matter, with the ability to be repaid from the originator or its assets. If the third party has a claim for repayment that is enforceable against the originator or its general assets (as opposed, for example, to a subrogation claim limited to the receivables sold), the transaction may appear to provide a form of indirect recourse against the originator. Cf. supra note 5 and Part IV(B)(1).
from obligors, called franchisees, to a franchisor (the originator) in return for the license to run a business using a special tradename or trademark and selling designated products or services.\textsuperscript{8}

Franchise fees may not be payment obligations at all but merely expectations of payment. These fees may be calculated, for example, by a percentage (or other formula) of the franchisee's monthly or other periodic revenues or profits. If there are no revenues or profits, no franchise fee is payable. Also, if the franchisor (originator) fails to perform the contractually agreed upon franchise services, the franchisee may have a legal defense against payment of franchise fees.

In addition, in the case of bankruptcy of the originator, the originator (or its trustee in bankruptcy) may have the right, under section 365 of the Federal Bankruptcy Code,\textsuperscript{9} to reject, or terminate, the franchise agreement as an executory contract. An executory contract is any contract where substantial performance remains due on both sides, such that breach by one party of its performance obligations would excuse the other side's obligation to perform.\textsuperscript{10} A franchise agreement may well be this type of a contract.\textsuperscript{11} Accordingly, an originator that becomes the subject of a bankruptcy case may be able to terminate the contract if it has business reasons to do so.\textsuperscript{12}

The rejection of an executory contract by an originator in bankruptcy would subject the originator to a claim for damages for breach of contract. This damage claim, however, has no priority and ranks on a parity with the originator's general unsecured claims. Presumably the claim would be worth less (perhaps far less) than 100 cents on

\textsuperscript{8} See, e.g., Black's Law Dictionary 592 (5th ed. 1979) (definition of franchise). It is typical for franchise agreements, and indeed many other types of long-term contracts, to contain prohibitions on assignment. This should not, however, prohibit the assignment of the right to payments made thereunder. Even if the contract purports to prohibit the assignment of rights thereunder, such prohibition should be ineffective as a matter of law in most cases. See U.C.C. § 9-318(4) (1989) and Official Comment No. 4 thereunder.


\textsuperscript{10} See H. R. No. 595, 95th Cong., 1st Sess., at 347 (1977); In re Streets & Beard Farm Partnership, 882 F.2d 233 (7th Cir. 1989); In re Grayson-Robinson Stores, Inc., 321 F.2d 500 (2d Cir. 1963); 2 Collier on Bankruptcy ¶¶ 365-01, 365-02, 365-05, 365-06, 365-08 (15th ed. 1989).

\textsuperscript{11} See, e.g., Rosenthal Paper Co. v. National Folding Box & Paper Co., 226 N.Y. 313, 123 N.E. 766 (1919); Isquith v. New York State Thruway Auth., 27 Misc. 2d 539, 542, 215 N.Y.S.2d 393, 397 (N.Y.Ct. Cl. 1961) (thruway toll ticket as executory contract); Gerry v. Johnston, 85 Idaho 226, 378 P.2d 198 (1963). Many contracts have been held to be executory, even where the performance obligation has not been obvious. For example, a lease has been held to be an executory contract because of the lessor's obligation not to interfere with the lessee's right of quiet enjoyment. See, e.g., In re O.P.M. Leasing Servs., Inc., 23 Bankr. 104, 117 (Bankr. S.D.N.Y. 1982).

\textsuperscript{12} For example, the franchisor may be unable to provide the products or perform the training or other services, if any, required under the franchise contract.
the dollar.\textsuperscript{13} The foregoing analysis of risks was illustrated by reference to a payment stream represented by a franchise contract. The same legal conclusions would obtain, however, for other types of future payment streams—such as leases, licenses, etc.—where a contract breach by the originator could raise a defense to payment by the obligors; or where the contract is an executory contract.\textsuperscript{14}

IV. \textbf{Separating the Source of Payment from the Originator}

We have previously discussed the "source" of payment. The source of payment must be \textit{separated} from the originator in the event the originator becomes troubled or bankrupt. It is therefore necessary, first, to ensure that whatever happens to the originator cannot affect the SPV (often referred to as making the SPV "bankruptcy remote") and, second, to ensure that the transfer of the receivables from the originator to the SPV cannot be interfered with (often referred to as creating a "true sale" of the receivables).

A. \textit{Making the SPV "Bankruptcy Remote"}

The SPV itself must be insulated, to the extent practicable, from a possible bankruptcy of the originator. There are several ways the

\textsuperscript{13} See Bankruptcy Code, 11 U.S.C. § 365(g). There is a further question that could arise in bankruptcy. Section 552(a) of the Bankruptcy Code provides, in part, that property acquired by a company after the commencement of a bankruptcy case is not subject to a lien resulting from a pre-bankruptcy security agreement. 11 U.S.C. § 552(a). Section 552(b) provides that proceeds of pre-bankruptcy property may be exempt from this restriction. 11 U.S.C. § 552(b). Where the SPV pays for a future payment stream, such as lease rentals, would the SPV be entitled to rentals paid after the originator goes bankrupt? At least one court has said yes. In United Virginia Bank v. Slab Fork Coal Co. (\textit{In re Slab Fork Coal Co.}), 784 F.2d 1188 (4th Cir. 1986), cert. denied, 477 U.S. 905 (1986), the court held that payments made post-bankruptcy under a coal supply contract were proceeds subject to a pre-bankruptcy lien, even where the bankrupt company would have to continue to supply the coal in order to be paid. Id. at 1190-91 (following \textit{In re Sunberg}, 729 F.2d 561 (8th Cir. 1984)). Because § 552(b) allows a court to weigh the equities of each case, however, there is no assurance that a similar result will obtain in each case. See, e.g., \textit{In re Colonial Realty Investment Co.}, 516 F.2d 154 (1st Cir. 1975); \textit{In re Photo Promotion Associates, Inc.}, 61 Bankr. 936, 939-40 (Bankr. S.D.N.Y. 1986) (bankruptcy courts have considerable latitude under § 522(b)).

\textsuperscript{14} The nature of the receivable also can affect predictability of payment where the receivable is prepayable. If, for example, the receivables consisted of mortgage loans, and interest rates declined, the obligors might prepay the loans. Although the collections should then be sufficient to prepay the principal amount of the debt securities issued by the SPV, the holders of these securities may have bargained to have their securities outstanding for a longer period of time at a fixed interest rate. The problems associated with prepayments are beyond the scope of this article.
originator's bankruptcy could affect the SPV, and each must be protected against.

If the SPV is owned or controlled by the originator, the originator may have the power to cause the SPV to file a voluntary petition for bankruptcy under section 303 of the Federal Bankruptcy Code. There are no legal standards that must be met for a voluntary petition to be filed. It is therefore important to limit, by design, the ability of the originator to cause the SPV to file a voluntary bankruptcy.

This limitation normally is accomplished by drafting the SPV's charter or articles of incorporation or other organizational documents to restrict the circumstances under which it may place itself in voluntary bankruptcy. Charters of SPVs sometimes provide that the SPV may not place itself into bankruptcy unless the SPV is insolvent and a requisite percentage of independent board members votes for bankruptcy. Some SPVs are organized with at least two classes of stock; and both classes must vote affirmatively for bankruptcy in order for the SPV to file a voluntary petition. One class of stock then is pledged to, or otherwise controlled by, the holders of the SPV's securities.

These methods are not infallible. Whether they are enforceable will depend upon the law of the particular jurisdiction of the SPV's

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15 Sometimes, for example, the SPV is a limited purpose subsidiary of the originator.


17 The Federal Bankruptcy Code does not require any special procedures for a company to file a voluntary bankruptcy petition. A company would make this decision like any other significant decision. Unless restricted in its charter or bylaws, a corporation, for example, normally would make this decision by a vote of its board of directors.

18 It appears to be against public policy to remove entirely a company's power to place itself in voluntary bankruptcy. Cf. Fallick v. Kehr, 369 F.2d 899, 904-05 (2d Cir. 1966); In re Tru Block Concrete Prods., Inc., 27 Bankr. 486, 492 (Bankr. S.D. Cal. 1983) (prepetition agreement to avoid bankruptcy proceedings void as against public policy); In re Weitzen, 3 F. Supp. 698, 698-99 (S.D.N.Y. 1933) (agreement to waive benefits of bankruptcy unenforceable).

19 If the holders of the SPV's securities control, by pledge or otherwise, a class of the SPV's voting stock, there is a question whether these holders may be exposed to liability claims for "controlling" the SPV. See, e.g., In re Sea-Land Corporation Shareholders Litigation, Fed. Sec. L. Rep. (CCH) ¶ 93,923 (Del. Ch. 1988); Aronson v. Lewis, 473 A.2d 805, 815-17 (Del. 1984); Gilbert v. El Paso Co., 490 A.2d 1050 (Del. Ch. 1984) for a discussion by the Delaware courts of what constitutes shareholder control and the type of liability which might accompany such control. Related to this is the issue of whether the holders of the SPV's securities may vote against a bankruptcy proceeding for the SPV when such proceeding might be in the best interests of the equity owner of the SPV (i.e., the originator). Courts have held that when a creditor is able to exercise control of a corporation by voting pledged securities, it has a duty to use reasonable care to maintain the value of the collateral. See, e.g., Citibank, N.A. v. Data Lease Fin. Corp., 828 F.2d 686, 694 (11th Cir. 1987); cert. denied, 108 S. Ct. 1019 (1988); Empire Life Ins. Co. of Am. v. Valdak Corp., 468 F.2d 330, 335 (5th Cir. 1972). But the creditor nonetheless has the right to protect its legitimate self-interest and need not fall back upon its debtor's recommendations in order to satisfy the duty of reasonable care. Bankers Trust Co. v. J.V. Dowler & Co., 47 N.Y.2d 128, 390 N.E.2d 766, 417 N.Y.S.2d 47 (1979).
formation. Delaware law presently appears to offer flexibility in approaches. 20

Another approach is for the SPV to be neither owned nor controlled by the originator. The SPV may, for example, be owned by an independent third party, such as a charitable institution. If the SPV continued to collect the receivables and pay on its securities even after the originator went bankrupt, the charity (or other third party) would have no incentive to place the SPV in bankruptcy. The SPV also could be structured as an entity that cannot become the subject of a federal bankruptcy case. One such entity is a trust, although “business trusts” 21 may be the subject of federal bankruptcy cases. 22

Once the SPV’s power to file a voluntary bankruptcy petition is restricted, the next step is to limit the circumstances under which creditors can force the SPV into involuntary bankruptcy. Unlike voluntary bankruptcy, a creditor may not force an SPV into involuntary bankruptcy unless the SPV meets the criteria required for filing. 23 These criteria are that the SPV is either generally not paying its debts as they become due, or that a custodian, other than a trustee, receiver, or agent, appointed or authorized to take charge of less than substantially all of the property of the SPV for the purpose of enforcing a lien against such property, has been appointed or has taken possession. 24 One therefore may attempt to protect against involuntary bankruptcy by limiting both the debt that the SPV can issue and the number of trade creditors. (The number of trade creditors can be effectively limited by limiting the business in which the SPV can engage.) These limitations could be included, for example, in the SPV’s charter or other organizational documents. Furthermore, any third parties that deal with the SPV contractually could be required to waive their respective rights to file an involuntary bankruptcy petition against the SPV.

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20 See, e.g., Del. Code Ann. tit. 8 §§ 102(b)(1), 121 (1988). If a majority of the voting shares of the SPV is owned by the originator, the SPV and the originator may have to be consolidated for accounting purposes. See Statement of Financial Accounting Standards No. 94.

21 A business trust is a trust that carries on a business for profit, as opposed to a non-business trust which is created to hold and preserve the trust property. See Hecht v. Malley, 265 U.S. 144, 159-62 (1924); W. Fletcher, 16A Fletcher Cyclopedia of the Law of Private Corporations § 8267 (D. Nelson & M. Wasiunec rev. ed. 1988).

22 See Bankruptcy Code, 11 U.S.C. § 101(8)(A)(v) (1988). If the originator is an entity, such as a bank, that cannot become the subject of a federal bankruptcy case, the requirements for an SPV may be more lenient. See Bankruptcy Code, 11 U.S.C. § 109 (1988).

23 Section 303(b) of the Bankruptcy Code also has requirements for the number of creditors and the types of claims necessary for filing an involuntary petition. 11 U.S.C. § 303(b) (1988).

Eliminating creditors does not guaranty that the SPV will be protected from the originator's bankruptcy. An equitable doctrine of law, known as substantive consolidation, may allow a court under appropriate circumstances to consolidate the assets and liabilities of the originator and the SPV. Although substantive consolidation usually arises in the context of a bankruptcy both of the originator and the SPV, a court could order a substantive consolidation even where the SPV is not in bankruptcy, or, in the alternative, place restrictions on the operations of the SPV notwithstanding that the SPV is not in bankruptcy.25

Courts do not order substantive consolidation lightly. The determination that two entities should be substantively consolidated must be made on a case-by-case basis, after consideration of the relevant facts of each case. Courts will take into consideration both the nature of the relationship between the entities to be consolidated and the effect of the consolidation on the creditors of each entity. Among the factors to be considered for this purpose, the courts have identified the following:

1. the degree of difficulty in segregating and ascertaining individual liabilities and assets;
2. the presence or absence of consolidated financial statements;
3. the commingling of assets and business functions;
4. the unity of ownership and interests between the corporate entities;
5. the guaranteeing by the parent of loans of the subsidiary; and
6. the transfer of assets without formal observance of corporate formalities.26

The presence of some or even many of these factors does not, however, necessarily mean that a court will order a substantive consolidation. Recently, courts have held that because substantive consolidation is an equitable remedy, it should not be used to harm innocent holders of securities of the company (in our case, the SPV) that is the target of consolidation.27

It therefore would not appear likely that a court would substan-

25 See, e.g., Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215 (1941) (consolidating the assets of corporation with those of its stockholders); 5 Collier on Bankruptcy ¶ 1100.06 [3], at 1100-44 to 1100-46 (15th ed. 1989).
27 See, e.g., In re Augie/Restivo Baking Co., 860 F.2d 515 (2d Cir. 1988) (denying consolidation where one creditor would suffer unfairly); In re Snider Bros., Inc., 18 Bankr. 230, 239 (Bankr. D. Mass. 1982) (court's power arises out of equity and should be used sparingly).
tively consolidate the assets and liabilities of an SPV and a bankrupt originator in a typical transaction. Nonetheless, substantive consolidation is an equitable remedy and is highly dependent on the facts.

The foregoing discussion has focused on limiting the circumstances under which the SPV, or its assets, could become subject to a federal bankruptcy case. Certain types of governmental claims, however, that arise against the originator may also be asserted against the SPV, regardless of whether the SPV is in bankruptcy. Under the United States Internal Revenue Code, for example, a claim can be asserted against any member of a consolidated tax group. If the SPV is a member of the originator's consolidated tax group, as would be likely if the SPV is a subsidiary of the originator, the Internal Revenue Service would be able to assert a claim that it has against the originator directly against the SPV.

Another type of governmental claim that may be asserted in this way is a pension claim. Certain governmental claims relating to defined benefit pension plans can be asserted under the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA), as amended, against any trade or business under common control with the sponsor of the plan (a "controlled group"). For example, if there are unfunded benefits payable upon the termination of a defined benefit pension plan, the sponsoring employer and each member of its controlled group, which could include the SPV, would be liable to the Pension Benefit Guaranty Corporation (PBGC), the agency responsible for administering the ERISA plan termination rules, for 100% of the unfunded benefits. In addition, the PBGC has a lien for its claim against the property of each member of the

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29 Treas. Reg. § 1.1502-6 states that the common parent corporation and each subsidiary that was a member of the group during any part of the consolidated return year shall be severally liable for the tax for such year unless the subsidiary has ceased to be a part of the group as the result of a bona fide sale or exchange for fair value prior to the date upon which the deficiency was assessed, in which case such liability may be limited. No agreement entered into by one or more members of the group with any other member or other person can eliminate or reduce this liability. 26 C.F.R. § 1.1502-6 (1989).
31 In general, a controlled group includes parent-subsidiary and brother-sister groups that are under 80% common ownership, and therefore may include an 80% owned SPV. I.R.C. § 414(b), (c) (1988); Treas. Reg. § 1.414(b), (c), 26 C.F.R. §§ 1 & 602, 53 F.R. 6603 (1989); ERISA § 4001(b), Pub. L. No. 93-406, 88 Stat. 829, 1004 (codified as amended at 26 U.S.C. § 401 (1982)).
group, up to 30% of the collective net worth of the group.33 The lien generally has the same status as a tax lien.34 In addition, liability for unpaid contributions to an ongoing defined benefit pension plan extends to all members of the controlled group, and a lien on their property (with the same status as a tax lien) will be imposed in favor of the PBGC if the unpaid contributions exceed a certain level.35 These governmental claims normally would have priority to claims of general security holders.

It is possible, however, for the claims of holders of securities of the SPY to gain priority over governmental claims by the SPY's pledging its receivables to secure repayment of the securityholders. Such a pledge would come ahead of the governmental claims in most instances.36

B. Creating a “True Sale” of the Receivables

Having accomplished a separation of the originator and the SPV, it is important to ensure that ownership of the receivables is effectively transferred to the SPV. This transfer is typically referred to as

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33 ERISA § 4068(a), 88 Stat. 829, 1032 (codified as amended at 29 U.S.C. § 1368 (a) (Supp. V 1987)). The PBGC generally has great latitude in determining net worth, and ERISA was recently amended to specifically provide that negative net worths of group members are not offset against positive net worths for these purposes. 29 U.S.C. § 1362(d)(1) (Supp. V 1987)).

34 ERISA § 4068(c), 88 Stat. 829, 1032-33 (codified as amended at 26 U.S.C. § 6323 (1982)).


36 See, e.g., In re National Fin. Alternatives, Inc., 96 Bankr. 844, 853-54 (Bankr. N.D. Ill. 1989) (holding that receivables acquired by the debtor after a tax lien filed by the IRS had become effective were nevertheless “qualified property,” i.e., property covered by the creditor’s prior security interest, so long as they were the identifiable proceeds of a contract right acquired prior to the effective date of the tax lien and had not been commingled with other monies or expended to acquire other properties after that date). Cf. U.C.C. §§ 9-301(4), 9-312 (1989).

Another issue that should be considered in connection with the establishment of the SPV is the extent to which it may be subject to income tax. Although a detailed discussion of tax issues is beyond the scope of this Article, a few key points should be noted. If the SPV is a corporation wholly-owned by a corporate originator, then it can be consolidated with the originator, at least for federal income tax purposes, eliminating a separate tax at the SPV level. (It may or may not, however, be possible to consolidate or combine for state or local income tax purposes.) Similarly, if the SPV is a trust with respect to which the originator retains a sufficient economic interest or control such that the SPV is treated as a so-called grantor-trust, there will be no tax at the SPV level, and any income of the SPV would simply be passed through to the originator, as grantor. Alternatively, it may be possible to structure an SPV that is a trust in such a way as to assure that it will be treated as a partnership, in which case it also would generally not be subject to a separate level of tax. In other cases the SPV may be subject to tax in its own right; it may in fact have little taxable income, however, because of offsetting deductions for interest paid on debt securities issued by it.
a "true sale." The term "true sale" is misleading, however, because a
given transfer of receivables may well be a sale for certain purposes
but not others. For example, the criteria for establishing an account-
ing sale under generally accepted accounting principles (GAAP), gov-
erned by Statement of Financial Accounting Standards No. 77 (FAS
77), are less stringent\(^\text{37}\) than the criteria for establishing a sale under
bankruptcy law.

The originator transferring its receivables to the SPV presumably
would want the transfer to constitute a sale for accounting purposes.
That way the financing is reflected on its balance sheet as a sale of
assets and not as a secured loan (which would increase leverage). The
originator also may want the transfer to be a sale for purposes of its
indenture covenants, if such covenants restrict the originator's ability
to incur debt or pledge its assets. In many cases, particularly where
the indenture itself states that its interpretation is to be governed by
GAAP, it may well be the case that a transfer which is an accounting
sale also will be viewed as a sale under the indenture.\(^\text{38}\) Whether a
given transfer of receivables violates one or more indenture or other
contractual covenants, however, is a legal question that turns closely
on the precise contractual language and usually would be best inter-
preted by the originator's own counsel.

The term "true sale" most often is used in analyzing whether the
transfer of receivables effectively has removed the receivables from the
originator for bankruptcy purposes. If the originator goes bankrupt
and the receivables are no longer owned by the originator but instead
are owned by the SPV, then the SPV would own the collections on the
receivables. Assuming the receivables were paid, the SPV then would
have sufficient cash to pay its securities without defaulting. But if the
transfer is held not to be a sale for bankruptcy purposes, it will be

\(^{37}\) On February 23, 1989, at a meeting of the Financial Accounting Standard Board's
Emerging Issues Task Force (EITF), the SEC observer stated that the SEC is becoming in-
creasingly concerned about certain receivables, leasing and other transactions involving special
purpose vehicles. The SEC observer suggested, for the EITF's consideration, certain require-
ments that the SEC felt should be met in order for the transfers of receivables to be recognized
as sales and to avoid consolidation of the SPV and the originator of the receivables. These
requirements included that the majority owner of the SPV be an independent third party who
has made a substantive capital investment in the SPV, has control of the SPV, and has substan-
tive risks and rewards of ownership of the receivables or other assets purchased by the SPV
(including residuals). Although the SEC staff is said to be considering the issuance of a Staff
Accounting Bulletin setting forth guidelines on the accounting for transactions involving
SPVs, no such Bulletin has yet been issued. See EITF Abstracts, Issue No. 84-30.

\(^{38}\) For example, the indenture covenant may restrict liens securing debt, although the term
"debt" may not be defined in the indenture. Indentures often state that accounting terms used
therein are to be construed in accordance with GAAP. A court therefore may use the GAAP
definition of "debt," which is governed by FAS 77.
deemed an advance of funds by the SPV to the originator secured by the receivables. The SPV would have a security interest, but not an ownership interest, in the receivables. In such a case, the originator's bankruptcy would, under section 362 of the Federal Bankruptcy Code, automatically result in a stay of all actions by creditors to foreclose on or otherwise obtain property of the originator.

If the transfer of the receivables from the originator to the SPV is recharacterized by the bankruptcy court as a secured loan rather than as a sale, the SPV may not be able to obtain payments collected on the receivables until the stay is modified. Furthermore, under section 363 of the Federal Bankruptcy Code, a court, after notice to creditors and the opportunity of a hearing, could order the cash collections of the receivables to be used by the originator in its business as working capital if adequate protection of the interest of the SPV in the receivables is provided by the originator or its trustee.

In addition, section 364 of the Federal Bankruptcy Code also would permit the originator, if credit is not otherwise available to it and if adequate protection is given to the SPV, to raise cash by granting to new lenders a lien that is either pari passu with that of the SPV or, if a pari passu lien cannot attract new financing, having priority over the SPV's lien.

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A related issue is whether a true sale of receivables can be avoided as a "fraudulent conveyance" if the SPV pays a purchase price that is less than the reasonably equivalent value of the receivables. This risk is minimal, however, in the typical structured financing because the purchase price for the receivables normally will be determined on an arm's length basis (although the fairness of the purchase price may be subject to greater scrutiny if the originator is a troubled company). For a discussion of fraudulent conveyance laws, see Schwarcz, The Impact of Fraudulent Conveyance Law on Future Advances Supported by Upstream Guarantees and Security Interests, 9 Cardozo L. Rev. 729 (1987).


41 Section 362(d) provides criteria for the judge to determine whether to lift the stay. Whether the stay will be lifted depends on the facts of the given case. See, e.g., In re Comcoach Corp., 698 F.2d 571, 573-74 (2d Cir. 1983); In re Sweetwater, 11 Bankr. Ct. Dec. (CRR) 1220, 1227 (Bankr. D. Utah 1984), aff'd, 57 Bankr. 748 (D. Utah 1985).


43 Adequate protection is not defined in the Federal Bankruptcy Code. Instead, the Bankruptcy Code, 11 U.S.C. § 361, gives several examples of what may constitute adequate protection, such as making periodic cash payments to the creditor (§ 361(1)) or giving a lien on other unencumbered property in the debtor's estate (§ 361(2)), and leaves it for the courts to decide on a case by case basis what constitutes "adequate protection" in the circumstances. See, e.g., In re AIC Indus., 83 Bankr. 774, 777 (Bankr. D. Colo. 1988) ("adequate protection" pursuant to § 363); In re O.P. Held, Inc., 74 Bankr. 777, 782-84 (Bankr. N.D.N.Y. 1987).

44 For a thorough discussion of the issue of "adequate protection," see In re Timbers of Inwood Forest Assoc., 808 F.2d 363 (5th Cir. 1987), aff'd, 484 U.S. 365 (1989).

45 Bankruptcy Code § 364(d)(1) provides as follows:
Although various courts have considered whether a given transfer of receivables constitutes a sale or a secured loan for bankruptcy purposes, the facts of the decided cases have not been representative for the most part of modern asset securitized transactions. Accordingly, the cases are not easily harmonized, and different readers may argue as to which factors are relevant and which are entitled to greater weight. Nonetheless, a cluster of factors can be identified that are relevant in most determinations of whether a given receivables transfer is a sale or a secured loan.46

1. Recourse

The most significant factor appears to be the extent of recourse the transferee of the receivables has against the transferor. As the degree of recourse increases, the likelihood that a court will find a true sale decreases. The existence of some recourse does not by itself preclude characterization of the transaction as a true sale. If recourse is present, the issue is "whether the nature of the recourse, and the true nature of the transaction, are such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction [that is, a secured loan] or to a sale."47

Sometimes the seller represents and warrants that all receivables sold meet certain eligibility criteria, and the seller will provide an indemnity for breach of these representations and warranties. To the extent these representations and warranties are not general representations and warranties of collectibility, but rather are limited to the condition of the receivables at the time the receivables are sold, this

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46 Each of these factors is indicative of whether the originator truly has parted with the future economic risks and benefits of ownership of the receivables purported to be sold, and whether the SPV has taken on these risks and benefits.

47 Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 544 (3d Cir. 1979) (emphasis in original; footnotes omitted).
should be no different from a warranty ordinarily given by a seller of a product. Accordingly, such limited representations and warranties and indemnity should not be inconsistent with sale treatment.

2. Retained Rights and Right to Surplus

Perhaps the second most important factor indicating a secured transaction is the transferor's right to redeem or repurchase transferred receivables. For example, section 9-506 of the UCC and various state mortgage statutes allow a debtor to redeem property before it is ultimately disposed of by a secured party. The absence of a right of redemption or repurchase would be a factor in favor of characterization of the receivables transaction as a true sale.

Several courts also have considered the existence of a transferor's right to any surplus collections, once the transferee has collected its investment plus an agreed yield, as indicative of a secured loan. The right of the transferee of the receivables to retain all collections of transferred receivables for its own account, even after the transferee has collected its investment plus yield, would therefore be a factor in favor of characterization of the receivables transaction as a true sale.

3. Pricing Mechanism

Pricing based upon a fluctuating interest index of the type found in commercial loan agreements, such as the prime or base rate, may be indicative of a secured loan. The pricing mechanism also may be indicative of a secured loan to the extent the purchase price is retroactively adjusted to reflect actual rather than expected collections on receivables.

In the closest approach to a true sale, the SPV would purchase receivables at a discount calculated to cover the SPV's funding cost (as well as risk of loss). The discount would be fixed for each sale,
and would not be retroactively adjusted to cover the actual funding cost.

4. Administration and Collection of Accounts

The administration of and control over the collection of accounts receivable are factors sometimes cited by courts in resolving the sale/secured loan issue. To be a true purchase, the transferee should have the authority to control the collection of the accounts. Examples of such authority would include (1) ownership by the transferee of all the books, records and computer tapes relating to the purchased receivables, and (2) the transferee’s having the right to (a) control the activities of any collection agent with respect to purchased receivables and at any time to appoint itself or another person as collection agent, (b) establish credit and collection policy with respect to purchased receivables, and (c) at any time notify the obligors of the purchased receivables of the sale.

In practice, the seller often is appointed as the collection agent initially. This is not necessarily inconsistent with sale characterization if (1) the seller, as collection agent, will be acting as an agent for the purchaser pursuant to established standards, much like any other agent, (2) the seller will receive a collection agent fee that represents an arm’s length fee for these services, and (3) the purchaser has the right at any time to appoint itself or another person as collection agent in place of the seller.

Sometimes collections of the purchased receivables are paid to the originator and commingled, or mixed, with the originator’s general funds. This frequently occurs where the originator collects the receivables each day, but only remits the collections periodically (such as monthly) to the SPV. Besides raising a potential perfection question under the UCC, commingling would, if permitted by the SPV, appear to be inconsistent with the concept of a sale: the originator would be using collections that belong to the SPV. This inconsistency often can be addressed by the originator’s segregating and holding the collections in trust, pending remittance to the SPV.

52 One interesting discussion of this question occurs in the British case, Lloyds & Scottish Finance Ltd. v. Cyril Lord Carpets Sales Ltd., House of Lords, 29 March 1979 (transcript available on LEXIS).


54 See text accompanying footnotes 58-69.

55 Alternatively, the SPV may be able to lend proceeds to the originator, although this approach has limited precedent.
5. Additional Factors

The courts have identified a variety of other factors that do not fall within the categories discussed above but which may be indicative of a secured loan. Among the more significant of these factors are the following:

(a) the originator of receivables is a debtor of the SPV on or before the purchase date;
(b) the SPV’s rights in the receivables can be extinguished by payments or repurchases by the originator or by payments from sources other than collections on receivables;
(c) the originator is obligated to pay the SPV’s costs (including attorneys’ fees) incurred in collecting delinquent or uncollectible receivables;
(d) the language of the documentation contains references to the transfer being “security for” a debt; and
(e) the parties’ intent, as evidenced by the documentation and their actions, suggests that the parties view the transaction as a security device. Also of importance is how the parties account for the transaction on their books, records, and tax returns.

It is rare in modern commercial transactions for all the factors favoring a true bankruptcy sale to be met. There is inevitably a balance. Some recourse is needed to give a reasonable assurance to holders of the SPV’s securities that they will be paid. It may be uneconomic for an originator to agree that the SPV obtains the entire surplus of collections once holders of the SPV’s securities are paid. In each case the parties structuring the transaction will have to balance how important it is that the transaction be a bankruptcy sale with the other commercial desires of the investors and the originator. This balance will depend, in large part, on the credit quality of the originator. It may be less important to investors to insist on a true sale where the originator has an investment grade rating than where the originator is troubled or in a workout.

C. Additional Steps Required Under the UCC to Protect the Transfer

Once the SPV has been created and the transaction structured, it

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56 See P. Weil, supra note 39, at 23-37.
57 A company sometimes may require that the receivables transfer be a loan for tax purposes so as, for example, to avoid recognition of a taxable gain that would be triggered if the transfer is treated as a tax sale. Because the bankruptcy and tax sale criteria, although not identical, are similar—and the bankruptcy cases may apply even closer scrutiny than the IRS—structuring a receivables transfer as a bankruptcy sale may well make it also a tax sale.
still will be necessary to take certain steps to protect the transfer of receivables against claims of third parties and in bankruptcy. The Uniform Commercial Code (UCC), adopted (with only minor variation) in every state of the United States, provides in section 9-102 that each transfer of an interest in "accounts" and "chattel paper," whether or not intended as a transfer for security or a transfer of actual ownership, must be perfected by one of the procedures set forth in the UCC (usually accomplished by the filing of UCC-1 financing statements). The commentary to this section (Official Comment No. 2) explains that the draftsmen had difficulty trying to set guidelines on whether a given transfer was a sale or a secured loan, and therefore established the same filing requirement in both cases. The purpose of the filing is to place third parties on notice of the transfer of the interest in the receivables, so they will not be misled when extending credit to or otherwise dealing with the originator.

The failure to perfect, in accordance with the requirements of the UCC, can have serious consequences. The secured party or purchaser may not be able to enforce its rights as against later secured creditors who file financing statements covering the same receivables or as against the originator's trustee in bankruptcy. Curiously, although section 9-102 of the UCC refers to transfers of "accounts" and "chattel paper," it does not refer to, and therefore by its terms does not apply to, sales of other types of payment streams. "Account" is defined in UCC section 9-106 as "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance." "Chattel paper" is defined in UCC section 9-105(1)(b) as follows:

"Chattel paper" means a writing or writings which evidence both a

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58 Louisiana has not adopted the Uniform Commercial Code as such. However, Articles 1, 3, 4, 5, 7, and 8 of the UCC have been adopted in substance as title 10, Commercial Laws, of the Louisiana Revised Statutes, chapters 1, 3, 4 and 5 (Act No. 92 of 1974, effective January 1, 1975), Acts No. 164, 165 of 1978 (effective January 1, 1979); Article 9 was adopted by Act No. 528 of 1988, effective July 1, 1989, effective date extended to January 1, 1990 by No. 12 of the 1989 Extraordinary Session. U.C.C. Rep. Serv. (Callaghan), State Correlation Tables, Louisiana (1989).

59 Chattel paper, however, also can be perfected by the secured party or buyer taking possession of the collateral. U.C.C. § 9-305 (1989).

60 Any argument that the filing of UCC-1 financing statements indicates the parties' intention that the transaction constitutes a secured loan and not a sale can be obviated by stating on the financing statement that the intention is to create a sale and that the filing is being made because the UCC requires it.

monetary obligation and a security interest in or a lease of specific goods, but a charter or other contract involving the use or hire of a vessel is not chattel paper. When a transaction is evidenced both by such a security agreement or a lease and by an instrument or a series of instruments, the group of writings taken together constitutes chattel paper.

Many common types of payment streams, such as fees payable under a franchise contract, may not fall into either of these categories. Indeed the UCC has other categories, including a catch-all category of "general intangibles," into which any payment stream falls that is not included in a specific category.62

Does the failure of UCC section 9-102 to refer to the sale of general intangibles mean that the draftsmen intended that no legal steps need be taken under the UCC to perfect such sale, or does this failure mean that the UCC was not intended to vary whatever common law requirements were applicable to sales of intangibles? The UCC offers no clue.

The answer to this question, however, can have practical consequences. Prior to enactment of the UCC, different states had varying requirements as to how to protect the interest of a purchaser of accounts receivable and other intangibles. One line of cases, followed in New York and various other states, provided that a sale is not perfected where the transferor retains "unfettered" dominion over collections.63 A minority line of cases, following the English rule,64 required notice to be given to the obligors on the receivables in order to perfect.

It is unclear, as a matter of law, whether these pre-UCC perfection requirements continue to apply to sales of intangibles that are neither accounts nor chattel paper under the UCC.65 Such a result would create commercial confusion because of the varying and conflicting state requirements. Perhaps a better approach is to recognize that it is the universally followed procedure for anyone who extends secured credit or is concerned about collateral to search the UCC records. For example, if a company were merely to pledge, as opposed to selling, its intangibles, there is no question that the UCC, which by its terms covers the granting of a security interest in "gen-

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62 U.C.C. § 9-106.
65 U.C.C. § 1-103 states that principles of common law not inconsistent with the UCC will continue to apply. This is the so-called "Swiss Cheese" principle, because the common law fills the holes in the UCC-cheese.
eral intangibles," would apply. It therefore would appear illogical and inequitable for a buyer that has filed UCC-I financing statements to be penalized because it did not also follow common law perfection procedures that may be commercially impracticable in today's world. There are, however, no decided cases offering further guidance.

Sometimes the payment stream sold will be evidenced by a promissory note or other negotiable writing evidencing an obligation to pay money. Under the UCC, these are classified as "instruments" and, because they are negotiable, can only be perfected by the buyer taking possession.

A further concern arises under the UCC where the collections from the purchased receivables are not paid directly to the SPV but instead are paid to the originator and commingled, or mixed, with the originator's general funds. UCC section 9-306(4) provides that, in the event of the originator's "insolvency proceeding" (presumably meaning bankruptcy), collections of the receivables that are commingled may lose their perfected status and be subject to claims of other creditors and the trustee-in-bankruptcy. In appropriate cases, particularly with financially weak originators, collections of receivables purchased by the SPV may be required to be paid by obligors directly to lockboxes at banks that do not contain the originator's general funds or to lockboxes owned by the SPV. The SPV could enter into agreements giving it the right to take over lockboxes under appropriate circumstances. Alternatively, if adequate lockbox arrangements cannot be established, an SPV may obtain the right to notify obligors to make payments directly to the SPV.

V. REGULATORY REQUIREMENTS

Structuring an asset securitized financing frequently impacts on a number of federal and state regulatory schemes. The issuance of securities by the SPV, as well as an originator's transfer of receivables to the SPV, may raise the issue of whether registration under the Securities Act of 1933 (the "1933 Act") and state "blue sky" laws is required and whether, as a result of such issuance and transfer, the SPV

66 See U.C.C. § 9-102(1)(a).
68 U.C.C. § 9-306(4).
69 An SPV may be reluctant, however, to give such a notice, and an obligor receiving such a notice may choose to ignore it until the obligor receives reasonable proof that the receivables have been sold. See U.C.C. § 9-318(3).
inadvertently has become an "investment company" within the meaning of the Investment Company Act of 1940 (the "1940 Act"). Moreover, there may be special concerns (discussed below) if the originator is itself a regulated industry or financial institution.

A. Investment Company Act of 1940

Beginning first with the investment company issue, the 1940 Act provides that any entity principally engaged in owning or holding "securities" must, subject to certain exemptions, register with the United States Securities and Exchange Commission ("SEC") as an investment company. The 1940 Act was promulgated as part of the comprehensive federal securities legislation enacted in the 1930s to curb a number of perceived abuses in the United States securities markets, to protect the public from being defrauded, and to ensure adequate controls and information. Unlike the 1933 Act and the non-broker/dealer sections of the Securities Exchange Act of 1934 (the "1934 Act"), which focus principally on the adequacy of disclosure in connection with the issuance, sale, and trading of securities, the 1940 Act is a comprehensive, substantive regulatory scheme. Compliance with the 1940 Act is generally very costly and burdensome. Accordingly, registration of an SPV as an investment company is generally considered economically infeasible, and transactions are structured so as to fall within various statutory exemptions from 1940 Act registration.


72 One can perhaps intuitively understand the purpose behind the 1940 Act if one views a company that is principally engaged in owning or holding securities as a miniature stock exchange, and investors in the company as investors in stock traded on the exchange.


74 For example, the 1940 Act imposes the following general requirements on registered investment companies: (i) restrictions on capital structure (e.g., prohibitions or restrictions on the issuance of debt securities), § 18, as amended, 15 U.S.C. § 80a-18 (1988); (ii) restrictions on the composition of the Board of Directors or other governing body (e.g., limits on the number of "interested persons" appointed), §§ 10 and 16, as amended, 15 U.S.C. §§ 80a-10, 16; (iii) restrictions on investment activities (e.g., limits on investments in other investment companies), §§ 12(d), (e), as amended, 15 U.S.C. §§ 80a-12(d), (e); (iv) regulation of advertising (e.g., filing of sales literature with the Securities and Exchange Commission), § 24(b), as amended, 15 U.S.C. § 80a-24(b); (v) required shareholder votes on a number of issues (e.g., approval of advisor contracts, changes in investment policies and appointment of auditors), § 13, 15(d), 31, as amended, 15 U.S.C. §§ 80a-13, 15(d), 31; (vi) ongoing reporting and disclosure requirements, §§ 29, 30, as amended, 15 U.S.C. §§ 80a-29, 30; and (vii) extensive and complicated controls on pricing of investment company shares, § 22, as amended, 15 U.S.C. § 80a-22.
Under section 3(a) of the 1940 Act, an investment company is defined in relevant part as (1) an entity which is "engaged primarily ... in the business of investing, reinvesting, or trading in securities" or (2) an entity "engaged" in such business, which "owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such [entity's] total assets (exclusive of Government securities and cash items) on an unconsolidated basis." The term "security" is defined broadly under section 2(a)(36) to include notes, stocks, bonds, evidences of indebtedness, transferable shares, investment contracts, and "any interest or instrument commonly known as a 'security.'"

Most receivables and payment streams appear to fall within the definition of the term "security" under the 1940 Act because they are "evidences of indebtedness." Nevertheless, several effective exemptions from registration as an investment company may be available to an SPV. The most frequently used is section 3(c)(5)(A) of the 1940 Act, which excludes from the definition of "investment company" entities that are "primarily engaged" in acquiring or holding receivables that constitute "notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services."

Many, but not all, types of receivables will fall under the section 3(c)(5)(A) exclusion. These will generally include the most commonplace type of receivable—trade accounts receivable—since they clearly represent the purchase price of merchandise. Other types of receivables may not, however, come clearly within the section

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75 § 3(a), as amended, 15 U.S.C. § 80a-3(a).
78 § 2(a)(36), as amended, 15 U.S.C. § 80a-2(a)(36) (originally at § 2(a)(35), 54 Stat. 789, 795). Under § 3(a), the term "investment securities" is defined to include all securities except Government securities, securities issued by employees' securities companies, and securities issued by majority-held subsidiaries (provided the owner is not itself an investment company).
81 Id. Section 3(c)(5)(B) similarly exempts entities primarily engaged in making loans to manufacturers, wholesalers, retailers, and prospective purchasers of "specified merchandise, insurance, and services." § 3(c)(5)(B), as amended, 15 U.S.C. § 80a-3(c)(5)(B) (1988). Under § 3(c)(5)(C), entities primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" are also excluded from the definition of investment company under the 1940 Act. § 3(c)(5)(C), as amended, 15 U.S.C. § 80a-3(c)(5)(C). It is this latter exemptive provision which originally was used in securitizing mortgage loans.
82 § 3(c)(5)(A), as amended, 15 U.S.C. § 3(c)(5)(A) (sales price of merchandise).
3(c)(5)(A) exclusion. In some of these instances, however, it may be possible to obtain a "no-action" letter from the SEC, which will in practice have basically the same effect as an exemption from investment company registration.

In *Days Inn of America, Inc.*, for example, the SEC staff stated that it would not recommend enforcement action under section 3(c)(5)(A) if a wholly-owned subsidiary of Days Inn acquired certain franchise fee receivables from Days Inn (through another subsidiary), privately issued and sold notes secured by those receivables, and loaned the net proceeds from the note sales to Days Inn to refinance certain indebtedness of the parent company. The receivables were characterized as obligations representing part or all of the sales price of various services rendered by Days Inn to its franchisees and on that basis were found to fall within the scope of section 3(c)(5)(A).

Where section 3(c)(5)(A) does not cover the receivables in question, other exemptions may be available. Under section 3(c)(1) of the 1940 Act, for example, "[a]ny issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities" is excluded from the definition of investment company. This so-called "private investment company" exemption is frequently used in conjunction...
with the private offering exemption under the 1933 Act (discussed below) to place interests in an SPV with a limited number of institutional investors and other holders. 89

If no statutory exemption is clearly available, sections 3(b)(2) 90 and 6(c) 91 of the 1940 Act permit an SPV to petition the SEC to issue an order exempting the SPV from registration on the grounds that either (1) the SPV is primarily engaged in a business other than that of investing, owning, or trading in securities (under section 3(b)(2) 92) or (2) an exemption is necessary or appropriate in the public interest and is consistent with the protection of investors and the other purposes of the 1940 Act (under section 6(c) 93). Obtaining a decision on such an application may take several months, and certainly there is no guaranty that an exemptive order will ultimately be issued by the SEC. Nevertheless, sometimes there is no alternative if investment company registration is not cost-effective.

B. Securities Act of 1933 and Securities Exchange Act of 1934

Even if an SPV establishes an exemption from registration under the 1940 Act, it will still be subject to the 1934 Act and the 1933 Act to the extent that it issues non-exempt securities. The 1934 Act imposes standards of disclosure and liability for certain types of fraudulent statements or omissions, as well as registration and on-going reporting requirements for certain publicly-held issuers. The 1933 Act also imposes standards of disclosure 94 and requires the filing of a registration statement with the SEC in connection with any public offering of non-exempt securities. 95

In weighing methods of compliance with the 1933 Act, an SPV will often choose to file a registration statement with the SEC and issue its securities as part of a public offering. Although such registra-

89 In placing interests with institutional investors and other entities under the 100 person or less exemption set forth in § 3(c)(1), care must be taken to comply with the rule for determining beneficial ownership under § 3(c)(1)(A). Pursuant to that subsection, beneficial ownership by a company is generally deemed to be ownership by only one person. In an important exception to that general rule, however, it is necessary to look through the investing company and count its ultimate security holders if the company owns 10% or more of the outstanding securities of the SPV unless the value of all securities owned by such company in all issuers exempted under § 3(c)(1), together with all securities in issuers which would be exempt thereunder were it not for the beneficial ownership rules, does not exceed 10% of the investing company's total assets.

91 § 6(c), as amended, 15 U.S.C. § 80a-6(c).
93 § 6(c), as amended, 15 U.S.C. § 80a-6(c).
94 §§ 7, 10, as amended, 15 U.S.C §§ 77g, 77h (1985).
95 § 5(c), as amended, 15 U.S.C. § 77e(c).
tion may take several months and is therefore somewhat time-con-
suming, as well as costly, registered securities issued by an SPV have
the advantage of being freely issuable to and traded by the public.

If a public market is not necessary or if a public offering would
preclude a necessary “private investment company” exemption under
the 1940 Act, the SPV may choose instead to issue its securities in a
private placement under section 4(2) of the 1933 Act,96 which ex-
empts “transactions by an issuer not involving any public offering.”97
If the private placement is made to a relatively few large institutional
investors, such as pension funds and banks, relatively little in the way
of specialized disclosure documents may be required; such investors
are generally presumed to have the sophistication and bargaining
power to elicit from the issuer and its sponsors the financial and other
information necessary to make an informed investment decision.

If the private placement is to a larger number of investors, and
particularly if non-institutional investors are involved, the SPV may
find it prudent to comply with the “safe harbor” provisions of Regula-
tion D promulgated by the SEC.98 Under that rule, the SPV may, in
general, sell its securities to up to 35 “non-accredited” investors and
an unlimited number of “accredited” investors.99 If “non-accredited”
investors are included, it will generally be necessary to prepare and
circulate a private offering memorandum setting forth certain finan-
cial and other information required to be furnished under Regulation
D.

Regardless of whether the Regulation D safe harbor is used, se-
curities issued in a private placement will generally be deemed to be
“restricted securities” and may not be resold except in compliance
with SEC Rule 144.100 In general, that rule imposes a two-year hold-
ing period unless the securities are resold in another private transac-
tion (in which case the securities will generally continue to be
“restricted” in the hands of the buyer).101

77 (1933)).
97 Id.
99 In addition to banks, insurance companies, and other institutional investors, the cate-
gories of accredited investors under Regulation D include individuals with a net worth of $1
million or more and partnerships and corporations with total assets in excess of $5 million. 17
101 The SEC has proposed Rule 144A, which would, in general, provide an additional “safe
harbor” exemption for resales of restricted securities (with certain exceptions) to “qualified
institutional buyers,” including banks, insurance companies, and broker-dealers, provided that
such buyers had more than $100 million in securities purchased for their own account during
Certain other exemptions may be available under the 1933 Act to an SPV that wishes to issue its securities in the public market but wants to avoid the time and cost of filing a registration statement. If the securities are supported by a bank letter of credit, for example, the securities would be exempt from registration under section 3(a)(2) of the 1933 Act. If the securities are supported by a bank letter of credit, for example, the securities would be exempt from registration under section 3(a)(2) of the 1933 Act. Under the more frequently used section 3(a)(3) "commercial paper exemption," securities having a maturity of no longer than nine months, the proceeds of which are to be used for "current transactions," are also free from the registration requirements of the 1933 Act.

The only difficulty with the section 3(a)(3) exemption is that the central requirement of a "current transaction" is not defined anywhere in the 1933 Act. It is therefore necessary to turn to various SEC no-action letters interpreting what is and is not a current transaction under various circumstances. In general, those letters indicate that a "current transaction" is a transaction which is undertaken by an issuer in the ordinary course of its business operations and which has a relatively short duration.

102 § 3(a)(2), as amended, 15 U.S.C. § 77c(a)(2) (1988). Unlike § 4(2), as amended, 15 U.S.C. § 77d(2), which is a "transactional" exemption applicable to all types of securities, § 3 of the 1933 Act exempts entire specified classes of securities from the registration requirements of that act. § 3, as amended, 15 U.S.C. § 77c. Section 3(a)(2) includes among those classes "securities ... guaranteed by any bank," with the term "bank" defined to mean "any national bank, or banking institution organized under the laws of any State, territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official." § 3(a)(2), as amended, 15 U.S.C. § 77c(a)(2). This exemption is not often used in structured financings because the letter of credit typically covers only a portion of the securities.

103 I.e., 270 days.

104 Specifically, § 3(a)(3) exempts "[a]ny note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." § 3(a)(3), as amended, 15 U.S.C. § 77c(a)(3) (1988). Commercial paper may also be privately placed without registration under § 4(2) of the 1933 Act, as amended, 15 U.S.C. § 77d(2) (discussed supra note 100), but this approach is less common.


It also should be noted that, regardless of whether an SPV issues exempt securities or issues non-exempt securities in an exempt transaction or a registered public offering, the anti-fraud provisions of section 10(b) of the 1934 Act and Rule 10b-5 promulgated by the SEC thereunder will apply. Accordingly, an SPV would be liable if, in connection with the issuance and sale of its securities, it employed "any device, scheme, or artifice to defraud" or if it made "any untrue statement of a material fact or [omitted] to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading." 109

C. Other Regulatory Requirements

If the originator transferring its receivables to the SPV is in a regulated industry or is a financial institution, the laws, rules, and regulations applicable to it also may apply. In the case of a bank, for example, transferring its own assets to an SPV, or underwriting asset securitization for a third party, the Glass-Steagall Act may restrict the bank's actions. Indeed, the power of a bank to underwrite the sale of interests in securitized assets is an issue of current controversy. In 1987, the Comptroller of the Currency had determined that the sale by Security Pacific National Bank of mortgage pass-through certificates, representing fractional undivided interests in a pool of Security Pacific's own mortgage loans, was not in violation of the prohibitions on bank underwriting contained in the Glass-Steagall Act.110 The Glass-Steagall Act was a response to widespread bank failures after the stock market crash of 1929 and was intended to protect banks from the risks of investment banking activities, such as underwriting. The Act applies to all national banks and state banks that are members of the Federal Reserve System. The Comptroller's rationale, however, was that the sale by a bank of its own assets was not "underwriting" of the type prohibited by Glass-Steagall; and the fact that the assets were being sold through the mechanism of pooling did not change this essential nature.

The Comptroller's determination subsequently was challenged by the Securities Industry Association. In 1988, a federal district

loans with commitments for permanent takeouts in three years constitute current transactions, but development mortgage loans maturing in five years or less do not.

109 Id.
111 See Securities Indus. Ass'n v. Clarke, 885 F.2d 1034, 1036 (2d Cir. 1989).
court judge rejected the Comptroller's position.\textsuperscript{112} In September, 1989, however, the Second Circuit Court of Appeals reversed the district court's decision and decided in favor of the Comptroller's position.\textsuperscript{113} The court reasoned that banking activities that are explicitly authorized by statute, and the exercise of "all such incidental powers as shall be necessary to carry on the business of banking,"\textsuperscript{114} are permitted to banks notwithstanding that such activities may constitute underwriting or other investment banking activities.\textsuperscript{115} The court followed another circuit court of appeals in including in a bank's "incidental powers" any activity that is "convenient [and] useful in connection with the performance of one of the bank's established activities pursuant to its express powers."\textsuperscript{116} The court held that Security Pacific's use of mortgage pass-through certificates was indeed "convenient [and] useful" in connection with its express power to sell its own mortgage loans.\textsuperscript{117}

There has been speculation over how broadly the Second Circuit's opinion can be read and whether it may have application to bank underwriting of pooled assets originated by third parties.\textsuperscript{118} The Securities Industry Association, after originally announcing its intention to appeal the case to the Supreme Court, decided to drop the appeal and to focus instead on lobbying for limitations on bank underwriting powers.\textsuperscript{119} The Federal Reserve Board, however, recently has expanded the ability of a bank to underwrite, through non-bank subsidiaries (known as "section 20 subsidiaries," because they are created pursuant to powers found in section 20 of the Glass-Steagall Act\textsuperscript{120}), certain types of securities (including securities backed by mortgage and consumer receivables).\textsuperscript{121} And so the saga continues.

\textsuperscript{113} Clarke, 885 F.2d at 1034.
\textsuperscript{114} Clarke, 885 F.2d at 1043 (quoting § 16 of the Glass-Steagall Act, codified at 12 U.S.C. § 24 (1988)).
\textsuperscript{115} Id. at 1043.
\textsuperscript{116} Id. at 1044 (quoting Arnold Tours, Inc. v. Camp, 472 F.2d 427, 432 (1st Cir. 1972)).
\textsuperscript{117} Id. at 1049.
\textsuperscript{118} For example, because a bank has explicit power to buy a mortgage loan from a third party and subsequently sell it, could the bank buy mortgage loans with the intention of pooling them for securitization?
\textsuperscript{120} § 20, 48 Stat. 162, 188 (codified as amended at 12 U.S.C. § 377 (1988)).
\textsuperscript{121} The Federal Reserve Board originally had given section 20 subsidiaries the power to underwrite these types of securities backed by receivables originated by third parties. The recent (September 1989) expansion of these powers allows section 20 subsidiaries to underwrite these types of securities backed by receivables originated by the bank or its affiliates.
VI. CONCLUSION

In summary, asset securitization has significant potential for enabling companies to obtain economically advantageous financing without necessarily increasing leverage. Parties wishing to take advantage of asset securitization, however, may encounter many complex legal pitfalls. A well designed structured financing will minimize and avoid these pitfalls.
**Balance Sheet Impact of Securitizing Assets**

**XYZ Company**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables  $100</td>
<td>Debt $100</td>
<td>Equity $100</td>
</tr>
<tr>
<td>Equipment     $100</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. If XYZ Company borrows $100, secured by its receivables:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash $100</td>
<td>Debt $200</td>
<td>Equity $100</td>
</tr>
<tr>
<td>Receivables $100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment $100</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

   **Ratios worsen**

   Debt/Equity = 2

2. But if XYZ Company sells $100 of its receivables:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash $100</td>
<td>Debt $100</td>
<td>Equity $100</td>
</tr>
<tr>
<td>Equipment $100</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

   **Ratios unchanged**

   Debt/Equity = 1

3. And if XYZ Company then uses $90, for example, of the cash to pay off debt, its ratio of debt to equity dramatically improves:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash $10</td>
<td>Debt $10</td>
<td>Equity $100</td>
</tr>
<tr>
<td>Equipment $100</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

   **Ratios improve**

   Debt/Equity = 1/10