Rethinking the Role of Recourse in the Sale of Financial Assets

By Peter V. Pantaleo (Reporter), Herbert S. Edelman, Frederick L. Feldkamp, Jason Kravitt, Walter McNeill, Thomas E. Plank, Kenneth P. Morrison, Steven L. Schwarcz, Paul Shupack, and Barry Zaretsky*

INTRODUCTION

What does it mean to "sell" a financial asset? The answer has confounded courts and commentators for some time. The question has taken on increased importance with the rise of the securitization industry. A financial asset is a right to payment of money. Examples include trade receivables (rights to payment for goods sold or services rendered), lease rentals, mortgage and other loans, license and franchise fees, and any other legal or contractual right to payment.1

Transfers of financial assets in which the parties state that they intend a sale, and in which all the benefits and risks commonly associated with ownership are transferred for fair value in an arm's-length transaction, are easily identifiable as sales. The issue becomes complicated if the buyer retains recourse to the seller such that less than all of the risks of ownership are transferred. In that case, an issue can arise over whether to view the transaction as a sale or a secured loan. But why?

Under contract law, parties generally are free to enter into and enforce any contract that is not illegal or against public policy; there is nothing

*Peter V. Pantaleo (Reporter) is a member of O'Melveny & Myers LLP. Herbert S. Edelman is a member of Kaye, Scholer, Fierman, Hayes & Handler, LLP. Frederick L. Feldkamp is a member of Foley & Lardner. Jason Kravitt is a partner of Mayer, Brown & Platt and an adjunct professor of law at Northwestern University Law School. Walter McNeill is a member of Weil, Gotshal & Manges. Kenneth P. Morrison is a partner of Kirkland & Ellis and an adjunct professor of law at Northwestern University Law School. Thomas E. Plank, formerly a member of Kutak Rock, is a professor of law at University of Tennessee School of Law. Steven L. Schwarcz, formerly a member of Kaye, Scholer, Fierman, Hays & Handler, is a professor of law at Duke University School of Law. Paul Shupack is a professor of law at Benjamin N. Cardozo School of Law. Barry Zaretsky is a professor of law at Brooklyn Law School. The authors gratefully acknowledge the research assistance of J. Russell McNanahan, an associate with White & Case.

1. This Article does not address the sale of financial assets associated with the transfer of other assets essential to the seller's business, such as the assignment of tradenames and trademarks to support the sale of future payments under franchise agreements.
about recourse, for example, that either is illegal or in violation of public policy. Common law favors the free transfer of rights to receive money where there are no significant externalities that have consequences to third parties. There is no legal or public policy which precludes a transferor from improving the value of an asset sold by adding its own guarantee. When a financial asset represented by a check or other draft is transferred, recourse is the common, accepted, and sometimes mandatory consequence of transfer. Indorsement with recourse has never been viewed as precluding the existence of a sale.

A seller might agree to some kind of recourse because it wants the benefits of the sale and is prepared to incur recourse in order to induce someone to buy the asset. The most common example is the sale of goods backed by warranties. The Official Comments to the U.C.C. recognize that "there may be a true sale of accounts, [or] chattel paper . . . although recourse exists." The complication arises most often when a buyer of a financial asset attempts to enforce or has to defend its ownership rights to an asset in the seller's subsequent bankruptcy case. In bankruptcy, for example, if the sale were treated as a sale, the buyer would enjoy greater rights and privileges than if the sale were treated as a loan. The asset would belong to the buyer. It would not be part of the seller's bankruptcy estate, and the buyer would not have to worry about the automatic stay, turnover, or any interference with its property rights. This result is good for the buyer, but some might argue that it damages the debtor's chances for rehabilitation and creditors' expectations of equal treatment. Because of this tension between the buyer's interest and those of the debtor and its creditors, recharacterization issues often arise in bankruptcy cases. When they do, they appear largely to turn on whether the existence of recourse turns a "sale" into a "loan."

But if, as the U.C.C. comment states, there may be a true sale even with recourse, then under what circumstances should a bankruptcy court recharacterize a sale as a loan? Furthermore, is it a question of state law, federal law, or both?

2. The Uniform Commercial Code (U.C.C.) declares "ineffective" any contract term that "prohibits assignment of an account." U.C.C. § 9-318(4) (1995); see U.C.C. § 9-318 cmt. 4 (1995), which notes that this provision states a rule of law which is widely recognized in the cases and which corresponds to current business practices. It can be regarded as a revolutionary departure only by those who still cherish the hope that we may yet return to the views entertained some two hundred years ago by the Court of King's Bench.


The authors of this Article try to answer these questions by rethinking the role of recourse in the sale of financial assets. The concept of "true sale" is profoundly significant in today's commercial world. Defining true sale is the holy grail of the securitization market, a market in which hundreds of billions of dollars flow in transactions structured around constantly evolving ideas of what true sale means. In structuring true sale transactions, tension often arises between the desire for a certain amount of recourse and the belief that "too much" recourse will prevent true sale treatment.

There is no single case that presents a comprehensive theory of the effect of recourse in a true sale. Little thought has been given, for example, to the competing policy issues of balancing the need for clarity, fairness, and simplicity in commercial transactions with those bankruptcy law policies that may be affected by treating a transfer with recourse as a sale rather than a loan. Yet, sale characterization has important consequences.

If the transfer of the future payment stream from the originator to the third party fails to constitute a true sale under § 541 of the Bankruptcy Code, the transfer would be deemed an advance of funds by the third party to the originator secured by the payment stream, i.e., a secured loan. The third party would then be a creditor of the originator and have a security interest, but not an ownership interest, in the payment stream. In such a case, the originator’s bankruptcy would, under § 362 of the Bankruptcy Code, automatically result in a stay of all actions by creditors to foreclose on or otherwise obtain property of the originator. The third party may not be able to obtain payments collected on the payment stream until the stay is modified. Further, under § 363 of the Bankruptcy Code, a court, after notice to creditors and the opportunity of a hearing, could order the cash collections of the payment stream to be used by the originator in its business as working capital if the originator or its trustee in bankruptcy provides adequate protection for the interest of the third party in the payment stream. "Adequate protection," though, does not always translate into an alternative cash source.

5. See Thomas E. Plank, The True Sale of Loans and the Role of Recourse, 14 GEO. MASON L. REV. 287, 306-07 (1991). Concerns over recourse and its effect on true sale treatment have caused one rating agency to say that in certain structured financings there "should be no recourse against the seller for defaulted receivables beyond a reasonably anticipated default rate based upon historical analysis." STANDARD & POOR'S CORPORATION, STRUCTURED FINANCE CRITERIA 69 (1988). When the authors refer to "recourse," they mean not only contractual recourse but also any type of credit support the seller may provide to the buyer. For example, a seller that retains a subordinated interest in the financial asset it sells as part of the consideration it receives in the sale provides the buyer with recourse to the extent of the subordinated interest. Any loss suffered, if the asset fails to collect, is suffered first by the seller to the extent of its retained subordinated interest.

In addition, § 364 of the Bankruptcy Code also would permit the originator, if credit is not otherwise available to it and if adequate protection is given to the third party, to raise cash by granting to new lenders a lien that is either pari passu with that of the third party, or if a pari passu lien cannot attract new financing, a lien having priority over the third party’s lien.7

Because the law fails to define clearly the effect of recourse in a sale, virtually all of the securitization transactions that involve noninvestment grade originators or the issuance of publicly traded securities require a two-tier structure to avoid the risk that recourse might disqualify true sale treatment for a transfer.8

In this Article, the authors analyze the caselaw and define, in their view, the consequences of the presence of recourse in sales of financial assets. The analysis in this Article assumes an arm’s-length transaction in which the buyer has taken all requisite steps to perfect its interest in the asset it buys.9 The authors conclude that:

(i) A distinction in law can be made between two types of recourse,


8. A two-tier structure is a way of resolving the conflict between the high recourse level, or overcollateralization, desired by investors and the economic goal that excess collections be returned to the seller:

If the originator is not investment grade, a sale for bankruptcy purposes will be required to protect investors from the risks associated with the originator's possible bankruptcy. This bankruptcy risk can be avoided, while minimizing the cost of overcollateralization, by structuring the securitization transaction with two SPVs [special purpose vehicles] in a two tier structure, also known as “FINCO” (finance company) structure. Under this method, the originator first sells receivables to a wholly owned SPV in a transaction that constitutes a true sale for bankruptcy purposes and thus achieves bankruptcy protection. The wholly owned SPV then transfers its receivables to an independent SPV in a transaction that constitutes a sale for accounting purposes but not necessarily for bankruptcy purposes. The independent SPV issues securities in the capital markets to fund the transfer. After the independent SPV pays off the securities, it can reconvey the remaining receivables and collections to the wholly owned SPV without impairing the accounting characterization as a sale. The wholly owned SPV is then merged into the originator, or alternatively, the remaining receivables and collections are transferred back to the originator, as dividends. This structure thus allows the originator to realize the value of any excess receivables and collections created by the original overcollateralization.


9. In addition to the perfection rules of U.C.C. Article 9, which generally apply to sales of accounts and chattel paper; other state perfection laws might apply to sales of other kinds of personal property. See Thomas E. Plank, Sacred Cows and Workhorses: The Sale of Accounts and Chattel Paper Under the U.C.C. and the Effects of Violating a Fundamental Drafting Principle, 26 CONN. L. REV. 397 (1994); see also infra note 66.
which are identified by this Article as recourse for collectibility and economic recourse. Recourse for collectibility is the equivalent of warranting that the asset will perform in accordance with its terms. Economic recourse is the equivalent of warranting a return to the buyer of its investment plus an agreed upon yield unrelated to the asset’s payment terms. As a matter of state law, the transfer of a financial asset in an arm’s-length transaction should be treated as a sale if the parties so state, even if the buyer retains partial or full recourse for collectibility against the seller. If the buyer retains economic recourse against the seller, however, the transaction is susceptible to recharacterization as a loan. The rationale underlying the case law is that when recourse relates only to the quality of the asset being sold, that type of recourse is consistent with a sale (similar to a warranty on sale); but when the recourse goes beyond the quality of the asset and ensures an economic rate of return to the purported buyer that is unrelated to the payment terms of the underlying asset, the asset serves merely as collateral and the transaction is susceptible to being recharacterized as a loan.

(ii) A sale under state law should be treated as a sale in bankruptcy, even if the buyer has partial or full recourse for collectibility against the seller. Although bankruptcy policies may require a bankruptcy court to determine independently whether recharacterization is appropriate, state law principles of recharacterization must govern the analysis. The U.S. Supreme Court has specifically found that following state contract law is necessary to reduce uncertainty by treating interests uniformly within a state and to prevent a party from receiving a windfall by the happenstance of bankruptcy.10 State law is determinative of contractual rights when the contract for the sale of financial assets is formed, and to preempt state law by reason of the occurrence of a bankruptcy upsets the economic bargain reached between the parties.

This Article then applies these principles to a variety of transaction structures that are used, or potentially useful, in the marketplace. It illustrates that, in many cases involving the sale of financial assets, a true sale determination can be made even if the buyer were to have full or partial recourse to the seller for collectibility.

DISCUSSION

THE ROLE OF RECOURSE IN TRUE SALES

Although the cases involving sales of financial assets with recourse are not uniform, a significant number of them support the hypothesis that the

difference between sale and loan characterization is the difference between recourse for collectibility and economic recourse.

Reconciling the Role of Recourse in True Sales

Recharacterization cases are centuries old. They illustrate that the law may not treat a transaction as a sale just because the buyer and seller labeled it a sale. If the buyer later attempts to enforce its rights as a buyer and someone (usually the seller or its creditors) then challenges the sale as a loan, a court, under certain circumstances, could recharacterize the sale as a loan.

Generally, the party seeking recharacterization had to prove two things in order to prevail. First, it had to prove that recharacterization was necessary to avoid a result that would otherwise be illegal or violate public policy. Usury was a favorite charge of those seeking recharacterization. Grant Gilmore also suggests that recharacterization was used most often against transactions that were called sales in order to evade state or local recording requirements or compliance with "long-drawn-out, expensive and uncertain foreclosure proceedings." On occasion, a transferor would seek to recharacterize a sale as a loan in order to recover the surplus above the purchase price plus interest that the transferee of the asset had collected.

Second, the challenging party had to establish that the transaction was, in substance, intended to be a loan even if it took the form of a sale. Although the courts considered a number of factors to determine the parties' true intentions and whether to recharacterize, the underlying reason for loan recharacterization was that the buyer's interest in the transaction did not sufficiently reflect the characteristics of ownership. Often courts would recharacterize because the transferee's interest in the asset was limited to its investment plus a predetermined rate of return, with all surplus

13. Gilmore, supra note 11, § 2.6, at 49.
14. Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979); Isaak v. Journey, 15 F.2d 1069 (Idaho 1932). The issue at stake in these kinds of cases is reflected in U.C.C. § 9-502(2) (1995), which mandates that if a transfer is for security, as opposed to an outright sale, the transferee "must account to the debtor for any surplus." Id.
going to the transferor.\textsuperscript{15} This arrangement obviously indicated something other than a true sale of the benefits of ownership.

For instance, in \textit{Home Bond Co. v. McChesney},\textsuperscript{16} the Supreme Court affirmed a decision to recharacterize a sale of accounts as a loan. The Supreme Court emphasized the fact that the ownership in the accounts was not transferred because the buyer only acquired the right to recover from the proceeds of the accounts the amount it had advanced plus a pre-determined rate of interest.\textsuperscript{17} The buyer had recourse to the seller if an account debtor defaulted, but recourse was limited to the amount paid for the account plus interest, and not the face amount of the account.\textsuperscript{18} On the other hand, in \textit{Chase \& Baker Co. v. National Trust \& Credit Co.},\textsuperscript{19} the fact that the seller was obligated to repurchase defaulted accounts at their face value, and not just for the amount paid by the buyer plus interest, indicated to the court that the parties intended a sale.\textsuperscript{20}

In virtually all of the recharacterization cases, including those in which the fight was over which party was entitled to the surplus, the nature of the buyer's recourse to the seller became the key issue in the debate over whether the transfer was a sale or a loan.\textsuperscript{21}

An example is in \textit{In re Grand Union Co.},\textsuperscript{22} in which a company "sold" certain leases with recourse to a credit company. The court acknowledged "[t]he fact that the bankrupt guaranteed payment of principal and interest

\textsuperscript{15} Typically, the rate of return was also unrelated to the return implied by the payment terms of the transferred asset. As discussed below, this also was relevant to the issue of whether the presence of recourse prevented true sale treatment. \textit{See infra} text accompanying notes 38-40.

\textsuperscript{16} \text{239 U.S. 568 (1916).}

\textsuperscript{17} \textit{Id.} at 575; \textit{see} \textit{Sponge Exch. Bank v. Commercial Credit Co.}, 263 F. 20 (5th Cir. 1920). The court stated:

\textit{When by the terms of a transaction by which an indorsee acquires a note he is required to pay, or account to the indorser for, so much of what is collected on it as is in excess of an amount advanced and agreed interest thereon, the transaction is not a sale of the note, and the indorsee is not the buyer of it.}

\textit{Id. at 25; Commercial Sec. Co.}, 262 F. at 661 (entitling debtor to collections on sold accounts in excess of buyer's stipulated rate of return); \textit{Dorothy}, 116 N.E. at 149 ("[I]f an account . . . discounted for four months or for a year was paid in one month, it was treated as a one-month account, and adjusted accordingly in the settlement between the two companies."); \textit{Keller}, 160 A. at 130 ("On profitable contracts a balance was paid by the so-called 'buyer' of the contract to the alleged 'seller.'"); \textit{see also} \textit{Annotation, When Transfer of Accounts or Other Choses in Action Is Deemed a Sale Rather Than a Pledge as Security for a Loan and Vice Versa}, 95 A.L.R. 1197 (1935), and cases cited therein.

\textsuperscript{18} \textit{Home Bond}, \text{239 U.S. at 575; see National Discount Co. v. Evans, 272 F. 570, 573-74 (6th Cir. 1921) (holding repurchase obligation limited to amount advanced by buyer, plus interest).}

\textsuperscript{19} \text{215 F. 633 (N.D. Ill. 1914).}

\textsuperscript{20} \textit{Id.} at 638-39.

\textsuperscript{21} \textit{See supra} note 12, and cases cited therein.

\textsuperscript{22} \text{219 F. 353 (2d Cir. 1914).}
as well as leases ‘purchased’ . . . does not, standing alone, convert the sale . . . into a loan.”

The court nevertheless recharacterized the sale as a loan because the seller, among other things, not only guaranteed collectibility, but “made itself responsible for every conceivable loss” and guaranteed the buyer’s rate of return regardless of what payments either were called for or collected under the lease. The Third Circuit, more than sixty years later, had a similar reaction in Major’s Furniture Mart, Inc. v. Castle Credit Corp.: Castle required Major’s to retain all conceivable risks of uncollectibility of these accounts. It required . . . that Major’s warrant that the accounts were . . . “fully and timely collectible” [and there was an obligation to repurchase any account sixty days overdue]. Guaranties of quality alone, or even guarantees of collectibility alone, might be consistent with a true sale, but Castle attempted to shift all risks to Major’s, and incur none of the risks or obligations of ownership.

Although recharacterization cases, like Major’s Furniture Mart and Grand Union, acknowledged that there could be a true sale with recourse, they failed to address the circumstances under which recourse would not jeopardize true sale treatment. In other cases, courts have held sales with recourse to the seller to be true sales. In those cases, however, the seller typically guarantees that the asset will perform (i.e., collect) as warranted and remains contingently liable for collection risk if it does not.

For example, in Coast Finance Corp. v. Ira F. Powers Furniture Co., the court upheld a sale in which the plaintiff, Coast, paid the defendant, Powers, $100 in exchange for “the first $109.91 of a certain conditional sales contract.” At the time of sale, a balance of $282.63, payable in ten monthly installments, remained unpaid. Powers, the seller, warranted that the contract was “genuine and that the balance represented is unpaid and not subject to offset or counterclaim,” and also guaranteed payment of the outstanding amount in accordance with the contract. When Powers later refused to remit collections to Coast, Coast sued. Powers claimed that the

23. Id. at 361.
24. Id. at 361-62.
25. 602 F.2d 538 (3d Cir. 1979).
26. Id. at 545 (emphasis added). The Third Circuit, in affirming the lower court’s decision to recharacterize, also emphasized the fact that if Major’s defaulted under its agreement with the “buyer” or went out of business, “Major’s was required to repurchase all outstanding accounts immediately” without regard to performance by the account debtors. Id. at 541; see In re Lendvest Mortgage, Inc., 119 B.R. 199, 200-01 (B.A.P. 9th Cir. 1990) (stating that the assignor “guaranteed that the [assignee] would have no loss at all” and applying state law).
29. 209 P. 614 (Or. 1922).
30. Id. at 614.
31. Id. at 615.
transaction was a loan, not a sale, and argued that the payment to Coast of $109.91 for a $100 loan would be usurious. The court refused to recharacterize the sale as a loan stating:

When the holder of an instrument, such as the conditional sales contract held by defendant, transfers the instrument at a discount and is required to indorse or otherwise guarantee it so that the vendor becomes liable contingently to pay the purchaser at a future day a sum greater than that received with legal interest, the authorities present different views. The great weight of authority is that such a transaction should be regarded as a valid sale of a chattel with a warranty of soundness and the purchaser is allowed to enforce the obligation to its full extent against his own indorser and all prior parties.

It appears that plaintiff was in the business of discounting contracts and commercial paper. From the facts stated in defendant's answer quoted above, and the stipulation as to the position of the plaintiff and the defendant, the court was warranted in finding that the assignment of the conditional sales contract, in consideration of the sum of $100, was a bona fide sale of an interest in the contract. Any contrary holding would clog the wheels of commerce. As far as the record shows, the transaction did not constitute a loan; there was no understanding between the parties that defendant should return the money to plaintiff, except in the contingency that the original promise should make default in payment; and it was a pure bargain and sale of an interest in the contract, and no rate of interest was agreed upon. As far as shown, the sale was made in entire good faith, and there was no corrupt intent to exact a usurious rate of interest.32

Other courts have likewise ruled that a sale with recourse solely for collectibility to the seller is still a sale.33 The difference between cases like

32. Id. at 615-16 (citations omitted) (emphasis added).
33. See General Motors Acceptance Corp. v. Mid-West Chevrolet Co., 66 F.2d 1 (10th Cir. 1933). The court stated that

[b]efore there can be usury, there must be a loan. A loan of money involves an absolute agreement to return the sum borrowed at a future time. No usury can attach to a bona fide sale of property, tangible or intangible, even though it is accompanied by an agreement of the seller to indemnify the buyer against loss.

Id. at 4-5; see also Investors Thrift v. AMA Corp., 255 Cal. App. 2d 205, 208 (Cal. Ct. App. 1967) (citing case law to the effect that "a guarantee of the validity of accounts implemented by an agreement to repurchase 'uncollectible or disputed accounts' did not, per se, render the transaction a loan"); Advance Indus. Fin. Co. v. Western Equities, Inc., 343 P.2d 408, 413 (Cal. Ct. App. 1959) (holding accounts sold with recourse "w[ere] a real purchase, not a loan"); Refinance Corp. v. Northern Lumber Sales, 329 P.2d 109, 113 (Cal. Ct. App. 1958) (same); Indian Lake Estates, Inc. v. Special Invs., Inc., 154 So. 2d 883, 891 (Fla. Dist. Ct. App. 1963) (citing several cases, including Coast, in concluding that an assignment of "installment sales contracts . . . is regarded as a sale, not a loan, despite a provision for recourse
Grand Union and Major's Furniture Mart on the one hand, and Coast Finance on the other hand, seems to be the nature of the recourse involved. Most of the cases in which the courts recharacterized a purported sale as a loan involved the sale of accounts not represented by instruments or chattel paper. In a typical transaction, the “buyer” would purchase receivables at a discount from face value and hold back some portion of the purchase price as a “reserve.” Although the discount might vary with the age of the or guaranty”); State Bank v. Northwestern Sec. Co., 199 N.W. 240 (Minn. 1924) (note sold at a discount with guaranty of “payment when due of each and every installment . . . [of] each and every note” deemed a sale, not a loan); General Motors Acceptance Corp. v. Weinrich, 262 S.W. 425 (Mo. Ct. App. 1924) (commercial payer sold at a discount with guaranty of “payment when due of each and every installment . . . [of] each and every note” deemed a sale, not a loan); A.B. Lewis Co. v. National Inv. Corp., 421 S.W.2d 723 (Tex. Civ. App. 1967), where the court explained that:

[the fact is, however, that the language . . . ‘with full recourse’ was to impose a contingent obligation on appellant to pay the amount of the sales contract if the buyer of the automobile did not do so. Such an obligation is not inconsistent with a sale of the contract rather than a pledge to secure a loan.]

Id. at 728; Starker v. Heckart, 267 P.2d 219 (Or. 1954) (following Coast Finance); Martin v. McAvoy, 228 P. 694 (Wash. 1924); see infra note 45 and cases cited therein.

34. Some courts have gone so far as to try to reconcile cases that differ on whether recourse affects true sale by creating a distinction between sales of ordinary accounts receivable (loan) and sales of installment paper or other instruments (sale). See, e.g., Indian Lake Estates, 154 So. 2d at 891 (“It should be emphasized that the agreements here do not involve ordinary accounts receivable, but the sale of lot purchase installment contracts. A transfer at a discount of installment sales contracts . . . is regarded as a sale, not a loan, despite a provision for recourse or guaranty.”). Apart from whether this distinction makes sense as a matter of law, it does not exist as a matter of fact. Although most cases in which sales have been recharacterized as loans involved accounts, assignments with recourse of installment contracts have been recharacterized as loans. See, e.g., Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979); In re Grand Union Co., 219 F. 353 (2d Cir. 1914); Dorothy v. Commonwealth Commercial Co., 116 N.E. 143 (Ill. 1917). Sales of ordinary accounts with recourse also have been treated as true sales. See, e.g., Chase & Baker Co. v. National Trust & Co., 215 F. 633 (N.D. Ill. 1914); Investors Thrift v. AMA Corp., 255 Cal. App. 2d 205 (Cal. Ct. App. 1967); Advance Indus. Fin. Co. v. Western Equities, Inc., 343 P.2d 408 (Cal. Ct. App. 1959). Moreover, the reason most of the cases involved accounts was not because of any particular law or policy about recharacterization that was unique to accounts. A major reason most of the cases involved ordinary accounts receivable was because many of the cases were decided before the promulgation of the U.C.C. Under the U.C.C., procedures were established which generally assured that perfection of a transfer of interests in ordinary accounts receivable would survive a challenge under the “strong-arm” power found in § 70(c) of the Bankruptcy Act of 1898 (§ 544(a) of the Bankruptcy Code). Under laws which predated the U.C.C., it was problematic whether a creditor could sufficiently perfect its interest in undocumented receivables so as to obtain priority in the event the debtor filed for bankruptcy. As a result, the effect of recharacterizing a sale of an account as a loan was significant. The transferee went from having ownership of the account to mere standing as a general unsecured creditor. These high stakes encouraged litigation and gave rise to the large number of reported decisions concerning sales of accounts. Today, the consequences of recharacterization to a buyer who has properly perfected its interest in the sold accounts is not nearly as dramatic. See infra text accompanying note 103.
account to reflect risk, often the discount did not attempt to compensate the buyer completely for the time value of money. Additional compensation for the time value of money—the buyer's yield—was determined in advance and paid as interest either directly or disguised as a "service charge" in order to avoid usury laws. More important, however, recourse for the buyer's return was fixed, calculated in advance, at a rate unrelated to the payment terms of the underlying asset.

35. This is evident from the fact that the buyer would often charge the same discount for accounts that could be expected to collect at different times. For instance, in *Grand Union*, the buyer applied the same discount to receivables that were expected to collect at different times. See *Grand Union*, 219 F. at 360.

36. See id. at 360 (interest payable by seller at six percent per annum).

37. See *Merchants' Transfer & Storage Co. v. Rafferty* (In re Gotham Can Co.), 48 F.2d 540 (2d Cir. 1931) (noting seller paid "service charge" of one percent per day upon outstanding balance of accounts); Brierley v. Commercial Credit Co., 43 F.2d 724 (E.D. Pa. 1929), aff'd, 43 F.2d 730 (3d Cir. 1930) (same); see also *National Discount Co. v. Evans*, 272 F. 570, 573 (6th Cir. 1921) (noting charge of one percent per month on face value of purchased accounts for "services rendered").

38. In many cases, the absence of a relationship between recourse for the buyer's return and the return implied by the asset's terms was obvious. See *Commercial Sec. v. Holcombe*, 262 F. 657, 661-62 (5th Cir. 1920), stating that:

a transfer of paper evidencing indebtedness payable after the date of the transfer, and which does not include any interest, is not a sale, is quite obvious, when the transferor is required to pay to the transferee interest on the amount owing on such paper before anything is payable by the maker, and the transferor has the right to reacquire the paper by paying to the transferee the sum it calls for with interest thereon.

See also *Major's Furniture Mart*, 602 F.2d at 546 (unilateral imposition of floating interest rate on price term of the agreement "treated the transaction as . . . a loan situation"); *Grand Union*, 219 F. at 360 (Grand Union was "paying interest to the Hamilton Investment Company at the rate of 6 percent per annum, although the leases themselves bore no interest"); *Ryan v. Zinker* (In re *Sprint Mortgage Bankers Corp.*), 164 B.R. 224 (Bankr. E.D.N.Y. 1994), aff'd, 177 B.R. 4, 25 U.C.C. Rep. Serv. 2d 1267 (Bankr. E.D.N.Y. 1995). The court noted that:

a guaranteed rate of return was promised, as well as a specific date of return of all funds one (1) year from the date of the investment. The one year maturity date was often in advance of the maturity date of the mortgage, and was not the same date as the last due date on the mortgage.

*Id.* at 226; *European Am. Bank v. Sackman Mortgage Corp.* (In re *Sackman Mortgage Corp.*), 158 B.R. 926, 935 (Bankr. S.D.N.Y. 1993) (interest rate guaranteed to participant by assignor calculated differently than rate payable by underlying obligor); *Ables v. Major Funding Corp.* (In re *Major Funding Corp.*), 82 B.R. 443, 448 (Bankr. S.D. Tex. 1987) ("The investors were promised a set return on their investment regardless of the rate on the 'assigned note.'"); *Castle Rock Indus. Bank v. S.O.A.W. Enter., Inc.* (In re *S.O.A.W. Enter., Inc.*), 32 B.R. 279, 282-83 (Bankr. W.D. Tex. 1983) (holding 30% "participation" in debtor/assignor's real property sales contracts deemed a loan where rate of return to the participant was unrelated to the return under the contract and where the debtor and its president "personally guaranteed the return to [the participant] of its investment and guaranteed the interest to be generated by [its] investment").

Evidence that the recourse for buyer's return was unrelated to the payment terms of the underlying asset was obvious from the fact that the discounted purchase price for the pur-
Recourse for the buyer's return in these cases was unrelated to the payment terms of the underlying asset. The buyer's recourse to the seller, therefore, had nothing to do with collectibility. Recourse for collectibility creates a contingent obligation to pay only if the underlying obligor defaults.\textsuperscript{39} In most of the recharacterization cases, the buyer's recourse for its return was not conditioned upon default, but upon the mere passage of time. The buyer's return was predetermined, unrelated to the return earned on the underlying asset, and usually not affected by an increase in the value of the asset that might arise were the asset to collect sooner than expected. The obvious consequence of all of this was made clear in the following illustration by the court in \textit{Dorothy v. Commonwealth Commercial:}\textsuperscript{40}

For instance, if an account or piano contract which was discounted for four months or for a year was paid in one month, it was treated as a one-month account, and adjusted accordingly in the settlement between the two companies. On the other hand, if a four-months account ran over four months, it was adjusted on the advanced basis, thus indicating that it was the intention that the [seller] should be charged for the money loaned to it for the time it used the money.\textsuperscript{41}

In cases like \textit{Coast Financial,} recourse was only for collectibility. The buyer purchased the asset at a discount calculated to reflect the buyer's return based upon the payment terms of the asset. If the asset failed to perform as warranted, the seller paid. If the payment occurred sooner than expected, the buyer realized the upside. The economics of the buyer's re-chased account could not be calculated until the account actually collected. The later the account collected, the greater the discount (whether expressed as a straight discount reflected in the purchase price or as the seller's obligation to pay a rate of return from a retained interest in the sold accounts). If an account was collected sooner than expected, the discount would be less. The discount, however, was not fixed at the outset of the sale based upon anticipated collections. Therefore, recourse was not to warrant that the account would collect when expected, but simply to insure that whatever the collections were the buyer would receive an agreed-upon return, with the surplus going to the seller. \textit{See Union Sec., Inc. v. Merchants' Trust & Sav. Co., 185 N.E. 150 (Ind. 1933); cases cited supra note 17; see also In re Carolina Util. Supply Co., 118 B.R. 412, 416 (Bankr. D.S.C. 1990) (holding sale of accounts deemed a loan where purchaser received a stipulated return of two percent above prime on funds advanced until accounts collected).} In the seminal article on the sale of divisible interests and bankruptcy, Schwarcz refers to this type of recourse as “adjustable recourse” because the recourse adjusts retroactively to the actual collection rate to reflect the time value of money. Schwarcz, \textit{supra} note 7, at 158. It is not fixed at the time of purchase and tied to the payment terms of the underlying asset.

Finally, the fact that a seller has an obligation to repurchase accounts under circumstances unrelated to the account debtor's failure to perform suggested that recourse, and thus the economics of the buyer's bargain, was unrelated to the collectibility of the asset sold. \textit{Major's Furniture Mart, 602 F.2d at 541; Blackford v. Commercial Credit Corp., 263 F.2d 97, 105-06 (5th Cir. 1959).}

\textsuperscript{40} Id. at 143 (Ill. 1917)
course against the seller were tied directly to the collectibility of the underlying asset. The seller's recourse exposure was not that of a borrower, but that of a seller who, by accepting recourse, agrees to a "plain contract of bargain and sale, with a warranty of soundness of the property." 42

Recourse to a seller who warrants performance of the asset it sells (i.e., collectibility) should not turn a sale into a loan. Under the case law, however, an absolute promise by the seller to repay the purchase price, with an agreed upon rate of return unrelated to the payment terms of the underlying asset, clearly risks turning a sale into a loan. In recognizing this principle, it is important to understand that the difference between recourse for collectibility and economic recourse is not the difference between a buyer accepting significant financial risk and one who accepts none. In fact, in some situations, the economic bargain between a true buyer of a financial asset who has recourse for collectibility and a lender with economic recourse can be roughly equal. 43 On the one hand, a true buyer, unlike a lender, cannot adjust its return after the purchase to ensure a market return at all times. 44 A buyer, however, would enjoy the upside in value if, for instance, the asset was collected earlier than the parties expected. And so long as the buyer has recourse for collectibility, it could protect itself against the underlying obligor's default.

The real difference between recourse for collectibility and economic recourse is what each says about the type of transaction the parties intended. Recourse for collectibility merely improves the quality of the asset transferred. The purchaser with recourse cannot do better economically than the purchaser without recourse if the asset performs in accordance with its terms. The economic terms of the transaction are defined by the cash flows of the asset itself and collectibility recourse is defined solely by the failure of the asset to perform. On the other hand, economic recourse in some fashion guarantees the return to the purchaser without regard to the economic characteristics of the transferred asset. In the truest sense of the word, the transferred asset serves merely as collateral, as its own financial characteristics do not serve to define the economic terms of the transaction. Transfers with economic recourse look and smell like loans, and because enforcing important state law policies—like prohibiting usury—turned on determining the appropriate characterization of trans-

42. Nichols v. Pearson, 32 U.S. 103, 111 (1833) (finding that the sale of a note at discount with recourse to the indorser was a sale not a loan).
43. See infra text accompanying notes 81-86.
44. See, e.g., Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 546 (3d Cir. 1979) (interpreting sale agreement to allow retroactive changes in the discount for prior purchases to track movements in the prime rate). Although a fixed rate lender may not be able to adjust its return after its loan is made, it still may be able to protect itself against market value erosion in ways that a buyer cannot. See infra note 85.
actions, courts historically have had little hesitation recharacterizing such transfers as loans.\textsuperscript{45}

45. Economic recourse does not mean that the buyer's return on the asset sold has to equal what the seller's return would have been absent the sale. Obviously, a buyer who buys receivables at a discount would earn an overall rate of return on the receivables greater than that which would have been earned by the seller had no sale occurred. The buyer's return would be a function of the purchase price discount and the subsequent cash flows generated by the receivables. Even if the buyer has recourse to the seller, so long as recourse was limited to collectibility, it would not alter the return the buyer would otherwise earn if the receivables were to collect in accordance with their terms. This type of recourse should not turn the sale into a loan.

Economic recourse also does not mean that the buyer and the seller could not agree to an arrangement, such as an interest rate swap, structured to pay the buyer a floating rate return from a fixed rate investment or vice-versa. For instance, if the buyer of a pool of fixed rate receivables thinks interest rates will rise, it may wish to structure the purchase so that it earns a floating rate of interest instead of a fixed rate. One way to do this would be to purchase a swap from a third party and thus trade a fixed rate for a floating rate. This third-party arrangement, of course, should have no effect on the true sale nature of the underlying transaction.

Similarly, the buyer could also purchase a swap from the seller. Superficially this might look like economic recourse because the seller would be liable for a rate of return that differs from the return implied from the terms of the receivables sold. It should not, however, constitute economic recourse if the swap, in substance, is a separate buy/sell transaction in which the seller of the receivable is compensated at a market rate for providing the swap. It should also make little difference whether the seller satisfies its obligations under the swap directly from its own pocket or, instead, out of any interest it otherwise might have retained in the receivables sold.

Finally, consider a different scenario—one in which the buyer and seller agree to make payments to each other not as a result of interest rate changes (as in the case of the swap) but instead as a result of differences in the timing of collections on sold receivables from that which was anticipated at the time of sale. A more expansive theory of true sale than that set forth in this Article would permit the buyer and seller to make these kinds of payments to each other so long as the payments were from the cash flows generated from the sale of the receivables or the proceeds of collection.

For instance, under this expansive theory, if a pool of receivables performs more slowly than anticipated, the seller may make compensating payments to the purchaser so long as the payments are from the proceeds received by the seller from the purchaser in payment of the purchase price. In parallel fashion, if the pool of transferred receivables pays more quickly than anticipated, the purchaser may make compensating payments to the seller from collections received by the purchaser on account of the transferred receivables. In either situation, the parties are merely reallocating cash flows of a particular transaction to adjust for differences between what had been anticipated by the parties and what had actually occurred. On the other hand, if the seller makes payments in excess of the purchase price, or the purchaser makes payments in excess of collections (or payments received on account of collections), the adjustments go beyond merely allocating cash flows. Instead, they suggest a level of recourse that goes beyond that which would be appropriate in a true sale.

Admittedly, one could argue that this expansive theory of true sale is ahead of where the case law generally is today. A number of the authors, however, believe that it would be appropriate and logical for any practical theory of true sale to allow the parties to a sale of a financial asset to allocate cash flows between themselves to reflect the economics that had been mutually anticipated at the time of sale. Securitization now involves the elaborate reconfiguration of cash flows to accommodate the economic needs of sellers and investors. See
Admittedly, not all of the recharacterization cases involving recourse can be catalogued into recourse for collectibility (sale) and economic recourse (loan). This distinction between recourse for collectibility and economic recourse, however, holds true for a significant number of recharacterization cases, and continues to appear in case law today.

For instance, in *Goldstein v. Madison National Bank*, the debtor could not pay $201,000 it owed to Madison National Bank. The debtor, however, did have an asset—an approximately $1 million receivable owed by one of its customers. The bank and the debtor entered into an agreement under which the debtor “absolutely assigned” (i.e., sold) $200,000 of the receivable to the bank. Once the assignment had been agreed to, the bank stopped accruing interest on the debt, and the parties treated the debt as extinguished by the transfer.

The customer paid the receivable. Within one week of this payment, but more than ninety days after the original assignment of the receivable, the debtor filed for bankruptcy. The district court affirmed the bankruptcy court, ruling that the payment was not preferential because the assignment constituted an absolute assignment and not a secured transaction.

It is noteworthy that the court was not troubled that only part of the receivable—the right to the first $200,000 of collections of a $1 million

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46. According to some cases, recourse, even if just for collectibility, suggests a loan. In other cases, a sale with full economic recourse was nonetheless treated as a sale. Compare West Pico Furniture Co. v. Pacific Furniture Loans, 2 Cal. 3d 594, 604-06 (1970) (holding assignment of conditional sales contract with recourse was a loan, not a sale because “at all times the risk of nonpayment” was borne by the assignee) with Hatoff v. Leons & Assoc., Inc. (In re Leons & Assoc., Inc.), 67 B.R. 198, 201 (Bankr. D. Nev. 1986) (holding assignment of mortgage notes treated as a sale notwithstanding court’s acknowledgement that purchasers were “guaranteed a rate of interest . . . regardless of the terms, maturity date or performance history of their particular note”).

47. This distinction even appears in most “risk of loss” cases. See infra text accompanying note 65. In emphasizing this distinction, the authors do not mean to suggest that the presence of any amount of economic recourse should automatically turn a sale into a loan. A number of the authors believe that if economic recourse exists in a particular sale transaction, but is not material or is qualified in a material fashion, and if there are other indicia of sale, then the transaction should qualify as a sale.


49. *Id.* at 277.
receivable—had been sold. Instead, as part of its analysis, it referred to the case of Lyon v. Ty-Wood Corp.,\(^{50}\) in which the same question was at issue: whether the right to receive the first $25,000 of a $30,000 receivable was an absolute assignment or a secured transaction.\(^{51}\)

The Lyon court also found the transaction to be an absolute assignment (i.e., a sale).\(^{52}\) The sale of part of a receivable necessarily raises questions concerning recourse. So long as the buyer receives the right to the first dollars paid with respect to the receivable, the seller retains, as a practical matter, some of the risk concerning the value of the receivables. In Goldstein, the court specifically recognized and reaffirmed the holding of Major's Furniture Mart: the presence of recourse in a sale transaction will not, without more, automatically convert a sale into a secured loan transaction.\(^{53}\) Moreover, the recourse in Goldstein was purely for collectibility, and not for economic recourse. The bank stopped accruing interest upon the sale, the account did not bear interest, and the seller did not warrant any particular rate of return.

Similarly, the Supreme Court's recent decision in Nebraska Department of Revenue v. Loewenstein\(^{54}\) also supports the concept of true sale with recourse for collectibility. Loewenstein concerned federal debt securities purchased for cash by certain mutual funds under repurchase agreements which later obligated the funds to resell the securities to the original owner. Upon resale, the funds received an amount equal to the price paid by them for the securities "plus interest at an agreed-upon rate that bears no relation to the yield on the underlying securities."\(^{55}\) The issue was whether the interest paid to the funds was interest on federal government obligations, and thus not subject to state income tax, or interest on loans.\(^{56}\)

The funds argued that the transaction was a true purchase and sale, and the interest paid should be treated as interest from the securities purchased by the funds. Although the Court specifically declined to address whether the securities were actually purchased by the funds,\(^{57}\) it gave several reasons for treating the interest paid to the seller as interest on loans. First, the interest paid to the buyer bore no relation to the interest paid or accrued in the underlying security. Second, upon the seller's default, the

\(^{51}\) Id. at 821.
\(^{52}\) Id. at 822.
\(^{53}\) Both Goldstein and Lyon involved transactions in which the receivable was sold in exchange for canceling an antecedent debt. Assignments of a single receivable in satisfaction of an antecedent debt are expressly excluded from Article 9 by U.C.C. §9-104(f) (1995). Nonetheless, in determining whether a transaction is a true sale or a secured transaction, there should be no meaningful distinction drawn between a transfer for antecedent debt and a transfer for new value.
\(^{54}\) 115 S. Ct. 557 (1994).
\(^{55}\) Id. at 559.
\(^{56}\) Id. at 561.
\(^{57}\) Id. at 564.
buyer's interest in proceeds would be limited to a return of its investment plus its predetermined yield. Third, the seller bore the risk and received the upside benefit of change in the market value of the underlying asset. Fourth, the seller could "substitute" equivalent securities for the ones initially purchased by the buyer.\textsuperscript{58}

The Court's reasoning is directly in line with the theory of this Article as to the distinction between recourse for collectibility and economic recourse. A sale of a financial asset with recourse for collectibility only, and not economic recourse, would bear none of the above characteristics; a sale with economic recourse would often bear them all. In a typical case of receivables sold with recourse for collectibility\textsuperscript{59} (i) the buyer's return is tied directly to the payment terms of the underlying asset; (ii) upon liquidation, the buyer's interest in proceeds is not limited to this investment plus a predetermined rate of return that is unrelated to the underlying asset; (iii) only the buyer's interest, not the seller's, is affected by post purchase changes in the asset's market value; and (iv) normally, the seller would not have a right to substitute the asset purchased with a new asset.\textsuperscript{60}

\textbf{Recourse and "Risk of Loss" Cases}

Several recent cases hold, mistakenly in the authors' view, that a sale does not occur unless the buyer assumes the "risk of loss" associated with the asset. Even though in most of these cases recharacterization was appropriate because the "buyer" had economic recourse, the rationale of these cases, if correct, would preclude true sale treatment for any transfer sold with recourse for collectibility.

\textit{In re Executive Growth Investments, Inc.}\textsuperscript{61} is typical of these kinds of cases. The dispute involved an assignment of a fractional interest in a secured promissory note. The note was payable to the debtor, Executive Growth Investments (EGI), and EGI had assigned its interest in the note with

\textsuperscript{58} Id.
\textsuperscript{59} See infra text accompanying notes 77-81.
\textsuperscript{60} The Supreme Court in \textit{Loewenstein} noted that the seller was liable for any deficiency upon foreclosure. \textit{Loewenstein}, 115 S. Ct. at 562. A seller who accepts recourse for collectibility may also be so liable. The securities in \textit{Loewenstein}, however, were risk-free federal securities. Thus, any loss that the funds might suffer upon foreclosure would be a loss in market value due to interest rate changes, not a loss due to a default under the securities themselves. Recourse in \textit{Loewenstein}, therefore, was economic recourse, not recourse for collectibility.
recourse to various investors, including a Mrs. Feldman who held an 8.2% interest in the note. EGI kept possession of the note.

After EGI filed bankruptcy, the maker paid the note. The Chapter 7 trustee argued that the assignment was a loan, not a sale, and that because Mrs. Feldman failed to perfect her interest in the note under state law, her claim to her share of the proceeds of the note was voidable.

In order to decide the issue, the court had to decide the parties' intentions. According to the court, this meant looking "past the expressed intention of the parties . . . [to] some purer intention behind the form." Although the court began its analysis with the U.C.C., it noted the absence of "any express guidance from the U.C.C." and formulated its own test. The court asked the question: "[W]ho bears the risk of loss in the event of non-payment?"

Applying that analysis to the A & W note, I can reframe the question in this way: absent bankruptcy, as between the transferor EGI and the transferee Mrs. Feldman, who would have borne the loss if the note had gone unpaid? And on this issue, I think the record is beyond dispute. The agreement specifically provides that the transfer is "with recourse." I take that to mean that if the note had proven uncollectible, then the transferee Mrs. Feldman would have recourse against the transferor EGI. By express agreement then, EGI bore the risk of loss. On the analysis set forth above, I find that EGI made something less than an absolute transfer. I thus conclude that Mrs. Feldman can have at best no more than a security interest.

Although there may have been other reasons to call the sale a loan, the court relied on a risk of loss analysis to get to this answer. This was

62. Executive Growth Inv., 40 B.R. at 422. U.C.C. Article 9, and its rules of perfection, apply "to any transaction (regardless of its form) which is intended to create a security interest." U.C.C. § 9-102 (1995).
63. Executive Growth Inv., 40 B.R. at 422.
64. Id.
65. Id.
66. Id. The court's conclusion was dicta. Under California law, which applied to the transaction, a sale of personal property not accompanied by delivery to and possession by the buyer is "conclusively presumed fraudulent and void as against the transferor's creditors." CAL. CIV. CODE § 3440 (1970 & West Supp. 1996). Therefore, as the Executive Growth Investments court recognized, Mrs. Feldman's interest in the note was voidable under the "strong-arm" provisions of 11 U.S.C. § 544(a) (1994), irrespective of whether the transfer was a sale. Executive Growth Inv., 40 B.R. at 420.
67. The court specifically noted, for example, that Mrs. Feldman bargained for a 12% annual return and a return of principal at the end of one year. Id. at 422. Although the terms of the note in which Mrs. Feldman claimed an interest were not detailed in the opinion, it seems that the return to Mrs. Feldman may have had nothing to do with the terms of the note and was thus a form of economic recourse. Economic recourse also existed in most other "risk of loss" cases. See Ryan v. Zinker (In re Sprint Mortgage Brokers Corp.), 164 B.R. 224 (Bankr. E.D.N.Y. 1994); European Am. Bank v. Sackman Mortgage Corp. (In re Sackman
wrong. Prior case law has recognized that one could have a true sale with recourse for collectibility. Moreover, the U.C.C., the starting point in the court's analysis, makes it clear that "there may be a true sale of accounts or chattel paper . . . although recourse exists."69

Finally, consider the result had EGI not assigned undivided interests in the note to several investors with recourse, but simply assigned all of its interest with recourse to one investor. The transfer of a negotiable instrument (a check, a note, or a draft) in the ordinary course of commerce is customarily accomplished by indorsement and delivery.70 As a general rule, when a seller indorses a negotiable instrument over to a buyer, it does so with full recourse.71 The nature of recourse that arises upon indorsement is similar to the liability of a guarantor and to that of one who sells

68. See Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979).
69. U.C.C. § 9-502 cmt. 4 (1995) ("The last sentence of subsection (2) therefore preserves freedom of contract, and the subsection recognizes that there may be a true sale of accounts, or chattel paper, or contract rights although recourse exists."). The fact that the Executive Growth Investments court was dealing with a negotiable instrument instead of an account or chattel paper is irrelevant. The transfer of negotiable instruments under the U.C.C. is routinely done with recourse.
70. "Unless otherwise agreed, if an instrument is transferred for value . . . the transferee has a specifically enforceable right to the unqualified indorsement of the transferor . . . ." U.C.C. § 3-203(c) (1995).
71. Lake Hiwassee Dev. Co. v. Pioneer Bank, 535 S.W.2d 323, 326 (Tenn. 1976) (noting that when chattel paper or other negotiable instruments are sold, "endorsement with recourse is standard procedure in . . . state[s] . . . that have adopted the [U.C.C.]").
any type of receivable with recourse. The liability is contingent and secondary: “The term ‘with recourse’ . . . implies the . . . result—that the drawer, or indorser, or transferor of the document will be liable if the document is not honored by the primary obligor.”

Starting over 160 years ago with the Supreme Court, courts have made it clear that having recourse against an indorser does not mean that a sale is a loan. This is so even though a seller’s indorsement “may well be regarded in the light of a guarantee against the insolvency of the promisor.”

Given that millions of dollars of negotiable instruments are indorsed and sold every day with recourse, it is hard to see the wisdom (not to mention the consequences) of a per se rule of law that would treat all of these sales as loans. Sales of negotiable instruments with recourse is how many operate day to day. It would be a shock to all who regularly indorse checks if their unrestricted indorsement were to produce a “loan” from


73. Sticka v. Bestline, Inc. (In re Attaway, Inc.), 180 B.R. 274, 278 (Bankr. D. Or. 1995). The liability of an indorser of a negotiable instrument is explained in § 3-415(a) of the U.C.C.:

Subject to subsections (b), (c), (d), and (e) and to § 3-419(d), if an instrument is dishonored, an indorser is obliged to pay the amount due on the instrument (i) according to the terms of the instrument at the time it was indorsed, or (ii) if the indorser indorsed an incomplete instrument, according to its terms when completed, to the extent stated in Sections 3-115 and 3-407. The obligation of the indorser is owed to a person entitled to enforce the instrument or to a subsequent indorser who paid the instrument under this section.


74. Nichols v. Pearson, 32 U.S. 103, 110 (1833); see Lake Hiwassee Dev. Co. v. Pioneer Bank, 535 S.W.2d 323 (Tenn. 1976); Val Zimmermann Corp. v. Leffingwell, 318 N.W.2d 781 (Wis. 1982). Moreover, even “[t]he presence of a reserve fund is not determinative of the question of whether the transaction constituted a loan or sale.” Lake Hiwassee, 535 S.W.2d at 326. “The establishment of a reserve fund was a valid method whereby the bank insured that it would receive payment on the notes endorsed by Lake Hiwassee, and is not sufficient to convert an otherwise valid sale into a loan.” Id. at 326-27. Some states have enacted laws which deem recourse transfers of instruments to be loans for usury purposes. Baxter v. Stevens, 773 P.2d 890 (Wash. 1989). Even in those states, however, business-related transfers are generally exempt, and such statutes are recognized as contrary to common law. Cases from North Carolina apply usury laws to sales of instruments with recourse, but recognize that this position is contrary to usury decisions in other states. See Western Auto Supply Co. v. Vick, 277 S.E.2d 360 (N.C.), reh'g granted, 283 S.E.2d 101 (N.C. 1981); see also 6 SAMUEL WILLISTON & GEORGE J. THOMPSON, A TREATISE ON THE LAW OF CONTRACTS § 1689, at 4782 (1938) (stating the general rule that “a sale . . . though accompanied with a guaranty of the value of the article sold . . . should not be regarded as within the purview of statutes against usury, unless the parties are in fact intending a loan rather than a sale”). Moreover, these cases recharacterize sales of negotiable instruments with recourse as loans in order to vindicate a policy against usury. They do not stand for the proposition that the sale of every note with recourse per se constitutes a loan.
Recharacterization is appropriate only if there is economic recourse

Recourse per se cannot be the controlling issue in determining true sale; indeed, many courts have found true sales to exist despite the presence of recourse. Rather, as the court in Major's Furniture Mart framed it: "The question 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 or to a sale."76

The court’s emphasis on the “nature” of the recourse and its statement that “[g]uaranties of . . . collectibility alone, might be consistent with true sale” place the proper focus on the question of recourse and true sale.77 So, too, does the emphasis on “the nature of the transaction” and whether the buyer’s rights and interests bear “a greater similarity” to a loan than a sale.

A sale with recourse for collectibility is consistent with the concept of sale and certainly does not bear a greater similarity to a loan than a sale. Sellers of many different types of assets, financial and otherwise, routinely

75. The law has an interest in encouraging the free transferability of negotiable instruments, and the presumption that an indorser warrants the terms of a negotiable instrument serves that purpose. The law, however, also favors the free transferability of accounts. See U.C.C. § 9-318(4) (1995). While at some level there may be a difference between a negotiable instrument and an account, a rule of law that would promote sales of negotiable instruments with recourse but effectively prohibit such sales of other assets by applying a “risk of loss” standard would make little sense. The funding efficiencies achieved in today's multi-billion dollar securitization market suggest that the law should have a compelling interest in encouraging the free transferability of all kinds of financial assets.

76. Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 544 (3d Cir. 1979) (footnote omitted). In a footnote, the court noted that Gilmore “would place almost controlling significance on the one factor of recourse.” Id. at 545 n.12. The court's statement was based upon the following Gilmore quote:

If there is no right of charge-back or recourse with respect to uncollectible accounts and no right to claim for a deficiency, then the transaction should be held to be a sale, entirely outside the scope of Part 5. If there is a right to charge back uncollectible accounts (a right, as § 9-502 puts it, of “full or limited recourse”) or a right to claim a deficiency, then the transaction should be held to be for security and thus subject to Part 5 as well as the other Parts of the Article.

2 Gilmore, supra note 11, § 44.4, at 1230. For a good discussion of the Gilmore quote and why it does not mean what it seems to say, see Plank, supra note 5, at 320-22.

warrant the future performance of the asset sold.\textsuperscript{78} Moreover, in some situations, a buyer with recourse for collectibility only and not economic recourse assumes risks that a lender would not.

Take the simple case of a buyer of a pool of noninterest-bearing trade receivables. Assume the buyer purchases the pool at a discount which contemplates an average collection rate of thirty-five days. If, on average, the receivables actually collect in full in forty days, the buyer’s yield would be less than expected, although the assets would have performed as promised (i.e., the receivables collected ultimately in full). A buyer with recourse for collectibility would have no claim against the seller. A buyer with economic recourse, however, would. In that situation, even though the obligor paid in full, the buyer would have the right to recover without limit the rest of its expected yield from the seller and the transaction would be economically indistinguishable from a loan. Economic recourse not only protects the buyer’s interest in the asset (which would be consistent with a sale) but also the buyer’s interest in receiving a predetermined rate of return which bears no direct relationship to the asset itself.\textsuperscript{79} The buyer’s risk in the transaction is reduced to that of a lender.\textsuperscript{80}

\textsuperscript{78} For a discussion of the role of recourse in the sale of other property, see Plank, \textit{supra} note 5, at 339-43; see also U.C.C. § 3-414 (1995) (stating indorser’s liability upon sale of a negotiable instrument). The fact that recourse for collectibility may be consistent with \textit{both} the concept of loan and sale does not mean that its presence mandates the treatment of a transaction as a loan. \textit{See} A.B. Lewis Co. v. National Invs. Corp. of Houston, 421 S.W.2d. 723, 728 (Tex. Ct. App. 1967); cf. Cohen v. Army Moral Support Fund \textit{(In re Bevill)}, 67 B.R. 557 (Bankr. D.N.J. 1986). The court noted:

The mere presence of secured loan characteristics in repo and reverse repo agreements is not enough to negate the parties’ voluntary decision to structure the transaction as purchases and sales. There is nothing in Article 2 of the U.C.C. governing sales which would preclude parties from incorporating terms which are common features of collateralized loans into agreements which otherwise have legitimate attributes of a purchase and sale.

\textit{Id.} at 598.

\textsuperscript{79} Interest in a situation like the one described above would be set at a rate that reflects two things: the risk that the asset would not perform as promised (default risk) and risk of loss associated with the time value of money (arising as a result of lost opportunity and inflation). \textit{See} Peter V. Pantaleo & Barry W. Ridings, \textit{Reorganization Value}, 51 BUS. LAW. 419, 430 n.41 (1996). Default risk is directly related to the quality of the asset sold because it can be eliminated if the asset collects in full. The risk of loss for the time value of money, however, is not necessarily eliminated if the asset collects in full and thus is a risk that reflects a potential loss that is unrelated to the quality of the asset sold. A buyer of noninterest-bearing receivables with recourse for collectibility tries to eliminate default risk by assuring itself of the quality of the asset it buys. A buyer with economic recourse goes beyond this by trying to eliminate risk not associated with the asset but with the time value of money—an investment risk real buyers often assume and lenders never do.

\textsuperscript{80} As discussed above, often courts recharacterize sales as loans if, in addition to recourse that eliminates all risk to the buyer (including economic risk), the seller also retains the right to any surplus collections, a right also typically associated with a loan and not a true sale. \textit{See} Major’s Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979); \textit{In re Grand
If the terms of the receivables were such that the obligors were contractually bound to pay, on average, within thirty-five days, a buyer might attempt to lock in its return because, in that instance, a warranty of collectibility arguably would mean collectibility in full and on a timely basis. In such a case, the discount applied to the purchase can be calculated to assure a return based upon collections within thirty-five days, or payment in lieu of such collections by the seller. Of course, in many situations involving trade receivables, a warranty like this could not be given because there is often no fixed payment date for a trade receivable. Instead, payment within a broader time period may be all that is required, based upon the course of dealing between the parties or the custom in the industry. If the account party was clearly obligated to pay by a certain date, however, or if finance charges accrued on the account, a warranty of collectibility would insure payment of principal on a timely basis and thus a rate of return to the buyer.

This scenario obviously presents a more difficult question of true sale than the earlier illustration involving the pool of receivables that collect five days late. In the earlier illustration, the buyer suffers real economic loss, even with recourse, that a lender never does, and so a true sale determination clearly seems appropriate. In this scenario, the buyer might suffer no loss, yet the transfer would be a true sale because (i) recourse for the buyer's return is contingent upon, and not independent of, the collectibility of the asset purchased; (ii) there is still a potential for loss in

Union Co. 219 F. 353 (2d Cir. 1914). In nearly all of those cases, however, economic recourse was an element of the transaction. Surplus is effectively defined as whatever is collected by the buyer above a predetermined rate of return unrelated to the payment characteristics of the asset sold. Transactions in which the buyer did not have economic recourse have been treated as sales despite the fact that the seller was entitled to collections after a specified amount was received by the buyer. See generally Goldstein v. Madison Nat'l Bank, 89 B.R. 274 (Bankr. D.D.C. 1988); Coast Fin. Corp. v. Ira F. Powers Furniture Co., 209 P. 614 (Or. 1922); see also Steven Schwarcz, A New Theory of Recourse, ASSET SALE REP., Feb. 14, 1994, at 8.

81. See Milana v. Credit Discount Co., 163 P.2d 869 (1945) (finding no sale when, among other things, seller of accounts guaranteed payments within specified periods not corresponding to the maturity dates of the accounts).

82. See Frank Novak & Sons, Inc. v. Sommer & MACA Indus., 538 N.E.2d 700 (Ill. 1989) (time of payment for goods delivered may be determined by parties' agreement as reflected in "course of dealing or usage of trade or course of performance"); cf. Brownie's Army & Navy Store, Inc. v. E.J. Burke, Jr., Inc., 424 N.Y.S.2d 800, 803, 28 U.C.C. Rep. Serv. (Callaghan) 90, 93 (Sup. Ct. 1980) ("The custom and practice of the parties can affect the imposition of interest. The evidence here is that plaintiff never expected his customer to pay interest unless the account was very 'late'.")

83. This assumes, of course, that the market value of the obligation purchased did not deteriorate as a result of a change in interest rates or the credit-worthiness of the seller or the underlying obligor.

84. In Major's Furniture Mart, for example, the Third Circuit stressed that the buyer had recourse to compel the seller to repurchase accounts under certain circumstances regardless of whether the obligor defaulted. Major's Furniture Mart, 602 F.2d at 545.
market value to the buyer if interest rates rise after the purchase or if the credit-worthiness of the underlying obligor or the seller deteriorates; and (iii) the buyer would still enjoy the upside of ownership were the account to collect early.

A SALE THAT WOULD NOT BE RECHARACTERIZED UNDER STATE LAW SHOULD BE ENFORCED UNDER BANKRUPTCY LAW

Property Rights in Bankruptcy Are Governed By State Law

Two fundamental policies underlie bankruptcy law: equality of treatment for creditors and rehabilitation for the debtor. Whether a transfer of assets is a true sale is often an issue in bankruptcy cases because the answer can impact these policies. If a debtor’s prepetition sale of property is a true sale, then the property is no longer part of the debtor’s estate in bankruptcy and the buyer’s rights in the property are not subject to the automatic stay. As a result, the property cannot be used by the debtor either for reorganization or as a source of value for paying its creditors.

These bankruptcy policies often compel a court to examine issues of true sale, and compel courts to do so independently of concerns about usury, fraud, or other matters of state law (although a bankruptcy court will be concerned about those issues as well). But while bankruptcy policies lead bankruptcy courts to examine whether a sale is in fact a true sale, bankruptcy courts must apply state law in order to come to the answer. Questions in bankruptcy over ownership of property can only be answered by applying state law, even if the answer yields an unfortunate result for a debtor and its creditors. In Butner v. United States, a unanimous U.S. Supreme Court adopted the view, already held by the Second, Fourth, Sixth, Eighth, and

85. In Major’s Furniture Mart, the court interpreted the transaction to conclude that the “buyer,” Castle, was able to protect itself against “any conceivable loss” by unilaterally adjusting the interest rate payable by the seller in respect of purchased loans. Making this kind of adjustment would help to assure a market return for the buyer. Major’s Furniture Mart, 602 F.2d at 546. The court’s interpretation, however, was wrong. The buyer did announce unilaterally that the discount rate for loans purchased after a certain date would float based on the prime rate; the court’s own review of a typical transaction reveals, however, that the discount was applied only at the purchase of a loan; after the loan was purchased, there was no floating or fluctuating interest charged with respect to that loan. Id. at 540-41. Moreover, the seller acquiesced in the pricing change since it continued to sell loans to Castle. A more significant indication of a secured loan transaction was the fact that Castle was also able to force Major’s Furniture Mart to repurchase accounts if Major’s defaulted upon its agreement with Castle or went out of business even if the accounts were not in default. Castle was therefore able to protect the market value of its investment much like any lender who relies on financial or otherwise covenant protection to compel immediate repayment if the borrower’s condition or the collateral deteriorates.


Ninth Circuits, that property rights are determined by state law even in a bankruptcy proceeding:

Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. . . . The justifications for application of state law are not limited to ownership interests; they apply with equal force to security interests. . . .

In Butner, the Court reasoned that “[u]niform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving ‘a windfall merely by reason of the happenstance of bankruptcy.’”

According to Butner, state property rights can be overridden only by a federal statute or interest. The Court, however, did not define what constitutes a federal interest that would allow a bankruptcy court to override state law and to modify property rights. Courts, when using the federal interest exception in Butner, often rely on the congressional goal of encouraging reorganizations in conjunction with a specific Bankruptcy Code section which plainly demonstrates a federal interest that overrides state law rights. For instance, in In re Hudson Shipbuilders, Inc., the bankruptcy court determined that a specific Bankruptcy Code provision, section 506(b), manifested a sufficient federal interest to supersede state law rights in connection with a mortgage provision. In that case, a junior secured creditor sought to purchase the senior secured creditor’s mortgage. A dispute arose over the amount of attorneys’ fees the senior creditor would be entitled to receive based upon the debtor’s default. Although the note in question provided for fifteen percent of the outstanding principal balance as the amount of attorneys’ fees, the court determined the amount of attorneys’ fees under section 506(b) and did not regard the fifteen percent provision as determinative. The court awarded $30,000 as reasonable attorneys’ fees rather than fifteen percent of the balance due on the note, which would have been $190,000.

88. Id. at 55 (citation omitted).
89. Id. (citing Lewis v. Manufacturers Nat’l Bank, 365 U.S. 603 (1961)).
92. Id. at 1055.
93. Id. at 1058-59
ingly, the holding in *Butner* is not applicable. Here, a paramount federal interest dictates that federal law shall govern.\(^{94}\)

Admittedly, notwithstanding illustrative cases like *Hudson Shipbuilders*, there is no ready rule of law that enables one to determine whether, in a given dispute in a bankruptcy proceeding, a "paramount federal interest" is implicated such that federal law, and not state law, governs the parties' rights. Nonetheless, it seems clear that if the "federal interest" exception is not to swallow the rule, a bankruptcy court's perception of equity, standing alone, should not constitute an identifiable federal interest that would override state law rights, even for the sake of promoting reorganization or fostering equality among creditors. In *Butner*, for instance, the Court made it clear that generalized notions of equity cannot replace state law rights:

> The minority of courts which have rejected state law have not done so because of any congressional command or because their approach serves any identifiable federal interest. Rather, they have adopted a uniform federal approach to the question of the mortgagee's interest in rents and profits because of their perception of the demands of equity. The equity powers of the bankruptcy court play an important part in the administration of bankrupt estates in countless situations in which the judge is required to deal with particular, individualized problems. But undefined considerations of equity provide no basis for adoption of a uniform federal rule affording mortgagees an automatic interest in the rents as soon as the mortgagor is declared bankrupt.\(^{95}\)

Indeed, prior to *Butner*, the Seventh Circuit, contrary to the overwhelming majority of circuits, had established a doctrine that allowed bankruptcy courts to alter entitlements in order to achieve more equitable treatment of creditors.\(^{96}\) *Butner*, however, "expressly rejected [this] doctrine."\(^{97}\)

94. *Id.* at 1058.
96. *See Boston and Maine Corp. v. Chicago Pac. Corp.*, 785 F.2d 562, 566 (7th Cir. 1986).
97. *Id.* at 566; *see also Union Pac. R.R. v. Moritz (In re Iowa R.R.*), 840 F.2d 535, 536-37 (7th Cir. 1988) ("[P]roperty rights are defined in most cases by state law. When they are so defined, the bankruptcy court must implement rather than alter them."); *In re Chicago, Milwaukee, St. Paul and Pac. R.R.*, 791 F.2d 524, 532 (7th Cir. 1986) ("Bankruptcy law provides a federal machinery for enforcing creditors' rights but the rights themselves are created by state law."); *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1361 (7th Cir. 1990) ("[B]ankruptcy judges no longer have equitable powers to modify contracts to achieve 'fair' distributions. Bankruptcy judges enforce entitlement created under state law."); *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988); *Official Comm. of Equity Sec. Holders v. Mabey*, 832 F.2d 299 (4th Cir. 1987); *see also In re Contractors Equip. Supply Co.*, 861 F.2d 241, 244 (9th Cir. 1988) (stating in a dispute over whether the debtor had an interest in the receivable, "whether a debtor-in-possession has an interest in property is determined by state law").
Applying state law principles (e.g., the right to purchase or sell an asset with recourse for collectibility) to decide true sale issues in bankruptcy cases makes sense. As noted, equal treatment for creditors and debtor rehabilitation are the two major bankruptcy goals. Neither goal, however, is so threatened by the concept of a true sale with recourse for collectibility as to require courts to create federal common law and ignore state law rights. For example, a sale of financial assets, with or without recourse for collectibility, does not offend the policy of equitable distribution. There is no preference issue in a sale of financial assets because no debtor-creditor relationship exists. There is no debt and therefore no possibility of a preference. Even if the sale were treated as a loan there would be no preference issue. The sale of financial assets is typically a contemporaneous exchange in which the buyer buys the assets for cash. As a contemporaneous transaction, the transfer of financial assets would not be a preference, even if characterized as a loan, because there is no antecedent debt. The payment on those assets also would not be preferential (assuming, again, that the transferor took the required steps to perfect its interest in the assets) because the buyer receives no more when the assets collect than it would receive in a liquidation of the debtor, regardless of whether one calls the transfer a sale or a secured loan.

Similarly, in an arm's-length transaction, a sale of financial assets, with or without recourse, should not be a fraudulent conveyance. There rarely will be a basis for asserting actual fraud in a typical structured finance transaction. If anything, the transaction is intended to benefit the debtor and its creditors by enabling the debtor to liquidate assets in a highly efficient manner. Also, there rarely will be a basis for asserting constructive fraud because the buyer of financial assets normally will have paid reasonably equivalent value for the assets. The mere conversion of longer term assets into cash, at a reasonably equivalent value without any indicia of fraud or wrongful dealing, is not a fraudulent transfer. Even if it

98. See Thomas E. Plank, The Constitutional Limits of Bankruptcy, 63 TENN. L. REV. 487, 559-81 (1996) (noting that, although Congress's power under the Constitution to enact bankruptcy laws allows it to adjust the state law rights of insolvent debtors and their creditors, a bankruptcy law may not constitutionally impair the state law rights of third parties, that is, those who are neither insolvent debtors nor their creditors—including the property rights of those who buy property from the insolvent debtor).

99. Generally speaking, a preference is a transfer to or for the benefit of a creditor made by an insolvent debtor within 90 days prior to bankruptcy in reduction of an antecedent debt that enables a creditor to receive more on its debt than it would have received in a Chapter 7 liquidation absent the transfer. 11 U.S.C. § 547(b) (1994).

100. Of course, if the sale is with recourse and, as a result, the seller has to pay the buyer for a shortfall in collection, the payment might be preferential. Whether the payment is or is not preferential does not turn on whether the sale is a true sale (with recourse) or a secured loan (with recourse).

101. Generally speaking, a fraudulent conveyance is a transfer by an insolvent debtor for less than reasonably equivalent value or by a debtor with the intent to hinder, delay, or defraud its creditors. 11 U.S.C. § 548(a) (1994).
were, the voidability of the transfer would not depend on its characteriza-
tion as either a sale or a loan. 102

Finally, as a practical matter, recharacterizing a sale with recourse for collectibility (or even economic recourse) as a loan will not result in any significant increased distribution to unsecured creditors. In most cases, the buyer would have filed U.C.C. financing statements and would be entitled to the cash flow from the asset ahead of unsecured creditors, to pay back its investment plus interest. 103 In cases like Executive Growth Investments, in which recharacterization turned a sale into an unsecured loan, recharacterization vindicated no independent bankruptcy policy. It simply reflected the court's belief that Mrs. Feldman intended a loan and underscored the significance of Mrs. Feldman's failure to protect herself by taking the necessary steps that state law, not bankruptcy law, required her to take in order to perfect her interest in the note assigned to her. Had Mrs. Feldman perfected her interest under state law, then, regardless of what the bankruptcy court thought of the parties' true intentions, the trustee probably would have been required to pay Mrs. Feldman her share of the note proceeds, just as if she had owned them outright.

Of course, in a reorganization case, the financial assets of a business are often a prime source of collateral for debtor-in-possession financing. A trustee or debtor in possession might wish to undo a structured finance deal entered into prior to the commencement of the case in order to have available those assets to secure debtor-in-possession financing. Recharacterization of a sale transaction as a loan may permit the debtor to use the cash collections to assist in its reorganization if it gives adequate protection. 104 Furthermore, because the automatic stay applies to loan collateral but not to sold assets, recharacterization would suspend enforcement rights and might result in a negotiated compromise of the secured claim. 105 Therefore, in some cases, even if a trustee or debtor cannot entirely avoid

102. Admittedly, it is easier for a debtor to dissipate or divert cash than it is to dispose of financial assets. One might argue that the conversion of financial assets into the more easily disposable cash itself represents a fraudulent transfer if the debtor tries to defraud its creditors by then hiding the cash. Such an approach, however, could as easily be applied to a broad range of transactions, including tangible asset sales and secured financings. This would make it virtually impossible for financially troubled debtors ever to obtain financing for continuing operations. So long as a buyer or creditor pays fair value for the assets transferred, and there is no clear separate indicia of fraud (or, to be precise, fraud of which the transferee is or should be aware), the mere conversion of longer term financial assets into cash should not be viewed as a basis for fraudulent transfer attack. Moreover, whether the transfer is a sale or a loan is irrelevant to this issue.

103. Interest would include post-petition interest to the extent proceeds exceed the principal amount of the buyer's investment plus accrued interest or of the bankruptcy, 11 U.S.C. § 506(a) (1994). In most securitizations, proceeds would be expected to cover postpetition interest in the event of recharacterization.


Rethinking the Role of Recourse

an interest in an asset, the estate might benefit from simply recharacterizing that interest as a secured claim rather than an ownership interest.

Nonetheless, the fact that recharacterization may assist the debtor's rehabilitation does not mean that a bankruptcy court can reform a bona fide state law sales contract, particularly in cases in which the proceeds of the sale of financial assets may have provided liquidity to help a debtor stave off an earlier bankruptcy filing (and where the impact of such reformation may be to inhibit other companies from undertaking transactions that could allow sufficient liquidity to avoid bankruptcy altogether). Courts historically have recharacterized transactions under state law that were structured as sales to evade laws or frustrate public policy. In a Chapter 11 case, recharacterizing a sale as a loan may, to some degree, enhance a debtor's prospects for rehabilitation. Indeed, this would be true regardless of whether the buyer had recourse to the seller. The fact that it would be better for a debtor to turn a sale into a loan, however, is not, by itself, enough to override the state law rights of the buyer.

For instance, in *In re CIS Corp.*, a trustee in bankruptcy argued that a bankruptcy court had the power to recharacterize a lease as a secured financing under section 105 of the Bankruptcy Code. The district court rejected the trustee's argument, specifically noting that a recharacterization case "generally involves application of principles of contract interpretation" that turn on state law causes of action. According to the court, section 105 of the Bankruptcy Code did not provide an independent basis to recharacterize the lease. "That provision merely provides the court with equitable powers to further the substantive provisions of the code, it does not empower the court to create a cause of action otherwise unavailable under the bankruptcy code."

106. See supra text accompanying notes 11-14. In some cases, the issue may be over who gets to keep the surplus proceeds (i.e., the proceeds in excess of the transferee's investment plus yield). Ordinarily, if the transfer were a sale, the transferee would keep them; if it were a loan, the surplus proceeds would be paid to the transferor. U.C.C. § 9-502(2); see supra text accompanying note 15. Therefore, if the amount of surplus is significant, the outcome of a recharacterization dispute could have real economic consequences to a transferor in bankruptcy. Even so, it still seems that the fundamental question of whether a transfer is a sale or a loan should be governed by state law, especially where the point of the question is to decide a state law entitlement to surplus.


108. Id. at 756.

109. Id. at 757. In support of its holding, the court noted the following cases:

*Southern Ry. Co. v. Johnson Bronze Co.*, 758 F.2d 137, 141 (3d Cir. 1985) (holding that § 105 did not give bankruptcy court authority to create a lien to secure payment of environmental cleanup costs when the contract obligating the debtor to pay such costs did not provide for such a lien); *United States v. Sutton*, 786 F.2d 1305, 1308 (5th Cir. 1986) (holding that bankruptcy court did not have power under § 105 to authorize monthly allowance for support of debtor's spouse who did not have a matured claim for support when
The Third Circuit reached a similar conclusion in *In re Jason Realty*, a case that determined whether an assignment of rents to a mortgagor constituted an absolute assignment or a security interest. Citing *Butner*, the Third Circuit viewed the issue as one solely of New Jersey state law, unaffected by the bankruptcy court's equitable powers. Indeed, the court so stated in recognition of the potentially harmful consequences to the debtor under state law:

> Although our decision here may create serious obstacles for debtors whose sole income stream is rents, *Butner* mandates that we interpret the assignment as New Jersey courts would construe it outside the bankruptcy context.

> . . . It is important in interpreting New Jersey law that the otherwise worthy desire for achieving a reorganization under Chapter 11 should not trump the rights of an assignee of a lease under a pre-petition assignment.

petition was filed; court noted that § 105 does not "constitute a roving commission to do equity"); *In re Charles & Lillian Brown's Hotel, Inc.*, 93 B.R. 49, 54 (Bankr. S.D.N.Y. 1988) ("§ 105(a) does not create substantive rights otherwise unavailable or grant the bankruptcy court an unrestricted license to do equity").

Id. Not all of the cases involving whether a lease is a true lease or a secured loan view the issue as one of state law. *See*, e.g., *Olathe, Kansas v. KAR Dev. Assocs. L.P. (In re KAR Dev. Assocs. L.P.)*, 180 B.R. 629 (Bankr. D. Kan. 1995), and cases cited therein. Whether state or federal law should determine whether, in bankruptcy, a lease of real or personal property is a true lease is beyond the scope of this Article. It is worth noting an important difference, however, between a lease of property and a sale of a financial asset with recourse. If the lease transaction is truly a secured loan, then the lessee's bankruptcy payments to the transferee would be limited to the value of the collateral. *See* 11 U.S.C. §§ 506(a), 1129(b) (1994). If the lease is treated as a true lease, the lease itself, if assumed, would dictate the amount, timing, and other terms of the payments regardless of the value of leased property. *See id.* §§ 365(a), (b), 1123(b)(2). This difference in treatment could create a windfall for a transferee clever enough to disguise a loan as a lease. The recourse claim of the transferee of a financial asset, on the other hand, would be entitled to full payment only if fully collateralized. Moreover, the payment terms, unlike the terms of an assumed lease, could be restructured under a plan. *See id.* § 1129(b).


111. *Id.* at 427.

112. *Id.* at 429-30; *see* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) ("[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."); *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1361 (7th Cir. 1990) ("[B]ankruptcy judges no longer have equitable powers to modify contracts to achieve 'fair' distributions. Bankruptcy judges [now must] enforce entitlements created under state law." (citing *Butner* v. United States, 400 U.S. 48 (1979)); *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186 (7th Cir. 1989); *Union Pac. R.R. v. Moritz (In re Iowa R.R.)*, 840 F.2d 535 (7th Cir. 1988).
In *Jason Realty*, the issue was whether, in an assignment of rents, the assignee owned the rents or merely had a security interest in them.\(^{113}\) Similar issues are raised in true sale cases involving financial assets. Although in those cases, too, bankruptcy courts might be tempted to rely upon equity and ignore state law principles, whether a sale is a true sale can only be answered by looking ultimately at state law and respecting state law rights. To ignore state law rights and create a separate body of federal common law instead would increase uncertainty—a consequence of bad, not good, bankruptcy law.\(^{114}\) It also would undermine the law's interest in preserving reasonable commercial expectations that insure efficiency and predictability in the marketplace.\(^{115}\)

**Recognizing Sales with Recourse for Collectibility Promotes Efficiency and Predictability**

Recognizing that one can have a true sale of financial assets even with recourse for collectibility creates both transactional efficiency and predictability in the credit markets, and, as a result, lowers the cost of credit. Transactions are more efficient because a seller is better able to assess the risk of assets it originates and, as a result, can minimize the extent to which it discounts the asset’s sale price and thus maximize sale proceeds.

The reason why the seller will provide credit recourse is to maximize her sale proceeds. As an example, suppose that an originator holds a pool of loans with a face amount of $1,000,000. She knows the credit quality of the loans, and therefore she can predict a probable 1% loss on this pool over the life of the loans. A potential buyer is not as confident about the credit quality of the loans, and may be willing to pay only 97% of the face amount of the loans without any recourse. He may, however, be willing to pay 100% if the seller guarantees that he will suffer no losses from default. By providing this recourse, the seller can receive $30,000 more in sale proceeds in exchange for a contingent liability that she estimates will be 1%, or $10,000, over

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114. *See Butner*, 440 U.S. at 55.
115. This does not mean that, unless a transaction actually violated state law, a bankruptcy court could not recharacterize a sale as a loan. Obviously a “sale” with significant economic recourse and no other material characteristics of a sale, even if not usurious or otherwise illegal under state law, should nonetheless be recharacterized in bankruptcy. There is no reason to respect the transaction as a sale in bankruptcy if recharacterizing it as a loan would in any way facilitate a debtor's rehabilitation, so long as state law principles that generally apply in recharacterization cases are applied in bankruptcy. This means recognizing that, under state law, a buyer has the right to bargain for a sale with recourse for collectibility, and it means enforcing his bargain in bankruptcy.
the life of the loans. For accounting purposes, she will treat this transaction as a sale, and her sale proceeds will equal $990,000.\textsuperscript{116}

Transactions would become more predictable because buyers would not have to wonder how much recourse is "too much" recourse and wed themselves in every transaction to potentially more complicated and expensive two-tiered structures in order to accomplish a true sale.\textsuperscript{117}

Creating efficiencies is good legal policy.\textsuperscript{118} In fact, the efficiency created by permitting a sale of a financial asset with recourse for collectibility is no different than that created when a seller gives a warranty of quality in the sale of any asset. Virtually every type of asset sale is accompanied by representations and warranties as to origin, quality, condition, and similar attributes. Such warranties serve not only to assure the buyer that it will receive what was bargained for, but also as a mechanism for allocating risk when it is difficult or impossible for the buyer to ascertain certain facts. For a transaction to be economically feasible, often the seller must allocate these risks to itself.

Each material term of a contract maximizes the expected value of the contract by sharing risk, reducing risk, or allocating risk.\ldots

\ldots\ [{O}]ne party may rationally accept all risk related to an event if that party is in a position to prevent the risk and if the costs of shifting the risk to the other party render further negotiation inefficient.\textsuperscript{119}

For example, the seller of real property previously used as a gas station may represent and warrant to the buyer that the property is free and clear of all environmental risks. It is a risk that the seller, who may have knowledge of the property's prior use over many years, is comfortable in assuming or, at least, is in a better position than the buyer to assess. Unless the seller makes such warranty, the buyer may decide not to proceed.

Certain warranties of quality relating to accounts deal with the probability of default by third-party obligors. These types of warranties, which allocate risk to the seller, are commonly accepted in securitized transactions and, to some extent, are surrogates for warranties of collectibility. Take, for example, a seller that warrants to the buyer that all third-party obligors on certain consumer receivables have met specified screening criteria. Typically, the seller would warrant that the underlying obligors will satisfy certain underwriting standards, that the receivables do not exceed

\begin{itemize}
\item \textsuperscript{116} Plank, supra note 5, at 305; see Robert D. Aicher & William J. Fellerhoff, Characterization of a Transfer of Receivables as a Sale or a Secured Loan Upon Bankruptcy of the Transferor, 65 AM. BANKR. L.J. 181, 209 (1991).
\item \textsuperscript{117} See infra text accompanying notes 126-28.
\item \textsuperscript{118} See generally RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (2d ed. 1977).
\item \textsuperscript{119} Laurie Fisher Humphrey, Default Rules in the Guaranty Context, 42 CASE W. RES. L. REV. 1229, 1249-50 (1992).
\end{itemize}
certain concentration limits, that the receivables are not subject to disputes, setoffs, or other noncredit-related reductions, that the obligor has not previously defaulted on any receivable owing to the seller, and that other eligibility criteria have been met.\textsuperscript{120} If, however, the seller has not maintained uniform origination standards such that this warranty cannot be given, will a warranty of collectibility automatically jeopardize the characterization of the transaction as a sale? The seller is in a much better position than the buyer to assess risk and may be confident that risk will be minimal. If the purchaser is not convinced, however, it may be unwilling to proceed unless it receives a warranty of collectibility for all losses—or, alternatively, unless the seller discounts the purchase price. The economic effect and the necessity for the giving of a warranty of collectibility in that situation would often be indistinguishable from a warranty of quality that a seller of any asset would give and would permit the transaction and encourage economic efficiency. It should not, \textit{per se}, change the parties' characterization of a transaction from a sale to a pledge.\textsuperscript{121} To do so would be to preclude otherwise economically efficient transactions from occurring.

Affording true sale treatment to a sale with recourse for collectibility also promotes predictability. The law, including bankruptcy law, values commercial predictability, encourages the free transferability of assets, and recognizes the direct relationship between predictability and the cost of credit. “[L]enders’ expectations are central to the calculation of interest rates and other terms of loans, and fulfilling those expectations is therefore important to the efficiency of credit markets.”\textsuperscript{122}

Commercial law requires legal certainty. Benjamin N. Cardozo’s recognition of “the overmastering need of certainty in the transactions of commercial life” is as apt today as it was over fifty years ago.\textsuperscript{123} The need for certainty is especially strong when it comes to the sale of financial assets. These transactions occur as the result of planning, usually with the assistance of legal counsel. Risks accompanying the transactions are carefully evaluated and are reflected in the price of the transaction. Any risk, including legal risk, will reduce the value of the asset to either party to the

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  \item 120. Some try to distinguish these types of warranties from warranties of collectibility on the theory that the former deals with risk arising from circumstances that existed prior to sale, the latter with the future risk that the obligor will default. In many transactions that are treated unquestionably as a sale, however, the seller warrants against certain types of future risk. \textit{See} Plank, \textit{supra} note 5, at 339-43.
  \item 121. \textit{Id.} at 343-46; Aicher \& Fellerhoff, \textit{supra} note 116, at 210. (“If the effective price paid (accounting for all recourse, purchase price holdbacks, overcollateralization with a retained seller interest and similar devices) reasonably approximates what a willing buyer would pay a willing seller, the court should not decide that such recourse devices require characterization of the transactions as a loan.”).
  \item 123. \textit{Benjamin N. Cardozo, Growth of the Law} 110 (1924).
\end{itemize}
transaction. Although some legal uncertainty is, in all probability, un­
avoidable, unnecessary risk created by unnecessary uncertainty about the
law is simply an avoidable dead-weight loss to both sides of the deal.
“[T]he policies of both contract and property law include creating cer­
tainty and predictability to reduce the parties’ planning and transaction
costs.”

The uncertainty caused by In re Twist Cap\textsuperscript{125} illustrates this problem. There, the bankruptcy court temporarily enjoined payment under a letter of credit issued prepetition to an unsecured creditor because the issuing bank’s contingent reimbursement obligation was secured, and, upon draw­
ing, would have become fixed. This result was contrary to the understand­
ing of most lawyers who had contemplated the matter, and almost all of them thought that the implication in the case, that a payment under the letter of credit might constitute a preference, was wrong. That belief could not, however, counteract the doubt the case caused, and the uncertainty it created has had substantial effects.

That case caused chaos in the markets where the parties depend upon letters of credit. For example, the credit rating of bond issues some­times depends upon a letter of credit backing those bonds from a bank with stronger credit standing than the issuer. After Twist Cap, issuers had difficulty getting a favorable rating for fear that a bank­ruptcy court might enjoin the bank from paying. . . . Elements of that problem have persisted despite the fact that nearly every court that has since considered the issue has held there is no preference. . . .\textsuperscript{126}

This confusion concerning the potential consequences in bankruptcy of secured letters of credit resulted from a single decision by one trial judge. Twist Cap illustrates the economic cost of unpredictable laws. In the secur­itization market, uncertainty over how much recourse is “too much” re­course and the concern that one cannot have a true sale with recourse for collectibility creates unnecessary cost and uncertainty. Cardozo’s lesson still needs to be taught. In commercial matters, uncertainty is costly and courts must do their utmost to minimize both its amount and degree.

\textit{MARKET APPLICATIONS}

Many securitized transaction structures rely, to some extent, on recourse to lower risk and thus lower the cost of credit. Unfortunately, because of the existing confusion over recourse and true sale, the amount of recourse

Rethinking the Role of Recourse

in these structures is often unnecessarily limited and is often the cause of extensive, and unnecessary, debate and negotiation. The following are examples of actual or potentially useful market structures that, to varying degrees, rely on collectibility recourse to lower credit cost. Although some of these structures may go beyond where the market generally is today because of existing concerns about recourse and true sale, they are all, in the view of the authors, true sales despite the presence of collectibility recourse.

**Trade Receivables; Divisible Interest Structure**

A company wishes to raise money by periodically selling its receivables to an independent SPV. Assume in a given transaction that the company will sell a batch of non-interest bearing receivables with an aggregate face amount of $1,000,000. Assume also that the company has the ability to make discrete sales of the receivables and identify and track collections on them (in order to avoid commingling concerns), and that the discounts are negotiated at arms’ length and are not subject to adjustments after the purchase occurs. Such a sale might look like this:

| Outstanding balance of receivables in batch | $1,000,000 |
| Yield discount (negotiated and fixed for each purchase) [assume based on a 10% \(^{127}\) per annum purchaser return, and a 60 day average maturity] | $ 16,667 |
| Servicer discount [payable to servicer] [assume based on a 0.50% \(^{127}\) per annum] | $ 833 |
| Purchase Price = outstanding balance minus discounts | $ 982,500 |

Reserves/holdbacks for:

- defaults (greater of 3 times historical losses and 3 times concentrations) [assume 9%] | $ 90,000
- Dilution [assume 15%] | $ 150,000

Cash Purchase Price = Purchase Price minus reserves/holdbacks | $ 742,500

This transaction would be a true sale under the theory of this Article. The purchaser, by accepting a fixed yield discount for each purchase, is taking the economic risk that the receivables may collect more slowly than anticipated, and also is getting the potential upside in the event the payback is faster. The reserves taken for default and dilution will give the buyer protection only for collection risk. They would not mitigate the economic risk the buyer accepts as a result of the fixed discount.\(^{128}\)

\(^{127}\) This includes a profit factor. If the SPV funds itself in the capital markets, the yield discount may well be lower.  
\(^{128}\) See generally Schwarcz, supra note 7 (describing this structure in detail).
This transaction structure would also dispense with the need for a two-tier structure, reducing cost and complexity and therefore making it even easier, in certain cases, to bring capital market-priced funding to companies—especially middle market companies.

**Credit Card Receivables; Master Trust**

In a second example, a bank\(^\text{129}\) may wish to manage its financial ratios or match fund its credit card receivables portfolio with liabilities with similar terms. The selling bank will identify a pool of credit card accounts, pursuant to which receivables have been and will be generated. It will transfer to a master trust all receivables generated and to be generated by the identified accounts, which, in this example, at the time of transfer equal approximately $1 million in principal amount. The purchasing trust will pay cash equal to the face amount of the receivables for a portion of the pool and will issue to the selling bank an undivided, minority interest in the pool for the remainder of the pool. It will obtain the cash by selling A, B, and C interests in the trust to third parties. A interests will be senior to B and C interests, and B interests will be senior to C interests. The A interests will equal 85% of the original pool, the B interests 5%, and the C interests 10%, respectively. As old receivables collect, the collections will be invested in newly generated receivables. If new receivables in excess of available collections are generated, the seller’s undivided interest in the pool will increase to accommodate this fluctuation in the pool’s size during the reinvestment or "revolving" period. Similarly, the seller’s interest will decrease if collections exceed new receivables. The seller’s interest will be

\(^{129}\) One might initially question whether the concept of a true sale is relevant for a commercial bank. In rated securitizations, commercial banks, thrifts, and other depository institutions are not required to effect true sales of their receivables; as a result, the typical securitization by such an originator is a one-step sale of the receivables to a trust in which the major focus is on the proper perfection of the trust’s security interests in the receivables. These types of sellers are granted this latitude because the Federal Deposit Insurance Corporation (FDIC), which is the receiver for insolvent depository institutions and has the statutory power to delay foreclosures on property by secured creditors, 12 U.S.C. § 1821 (1994) (roughly analogous to the automatic stay powers granted to a bankruptcy court), has indicated that it will not use this power as a receiver to stay foreclosure on assets in which a creditor has a properly perfected security interest, provided that certain additional conditions are met. Federal Deposit Ins. Corp., Statement of Policy on Foreclosure and Redemption Rights, 57 Fed. Reg. 29,491 (1992). The FDIC’s right, however, to repudiate “burdensome” contracts to which a failed depository institution is a party, 12 U.S.C. § 1821(e)(1) (1994), gives the FDIC the right to, in effect, prepay the obligations secured by the receivables and retake possession of the receivables. Such an action would prove harmful to investors in an environment in which interest rates had fallen since the issuance of the securities in question because the investors might not be able to reinvest their prepaid principal in comparably yielding investments. Many lawyers, however, are of the opinion that the requirements of § 1821(e)(1) do not apply to true sales. Id. A transaction structure that constituted a one-step true sale, therefore, could provide greater certainty to investors (and result in a savings to the selling bank) by reducing the likelihood of prepayment upon an insolvency of the seller.
on par with A's interest, but will not be entitled to bad debt protection from the B or C interests. Because of the reinvestment of collections, the seller will retain all collections on account of principal during the revolving period. After the revolving period ends, the seller and other investors in the trust will receive ratable portions of principal collections based on their then respective individual interests in the trust. Liquidation of the portfolio normally takes about ten months.

To protect against bad debts, holders of the C interests will make the A and B interests whole to the extent of the C interests, and the B interests will make the A interests whole to the extent of the B interests. Bad debts will first, however, be covered by "excess spread."

Excess spread will be obtained from interest collections on transferred receivables. The receivables will bear interest at a rate specified in the charge account agreements, the rate of which will have a floor of not less than 6% per annum. The actual return on the receivables pool will fluctuate based upon a variety of factors (such as the rate of charge-offs, delinquencies, and payment rate). For purposes of this example, the return will be assumed to be 20% per annum. Yield will be distributed between holders of A, B, and C interests based on the outstanding principal amount of their respective investments and will only be paid to the extent interest collections are actually received. The A interests will earn 5% per annum, the B interests 5.5% per annum and the C interests 6% per annum. The bank, as servicer, will earn 2% per annum, and other fees and expenses will be about 1% per annum. Bad debts have been running at 4% per annum.

Excess spread constitutes interest collections not otherwise allocated to the A, B, and C interests or servicing fees or other expenses. The bank, as seller, will be entitled to retain all interest collections not allocated to the contracted—for return on the A, B, or C interests, servicing and other fees, or to cover bad debts.

Finally it is assumed that $100,000 of principal collections will be obtained each month (and, by definition, $16,666.66 of interest collections (1/12 of $200,000) (20% of $1,000,000 = $200,000)). For simplicity's sake, these calculations ignore the effects of compounding interest periods.

A monthly settlement prior to liquidation might look like this:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Cash flow:</td>
<td>$116,666.66</td>
</tr>
<tr>
<td>Total Principal cash flow:</td>
<td>100,000.00</td>
</tr>
<tr>
<td>Total Interest cash flow:</td>
<td>16,666.66</td>
</tr>
<tr>
<td>Total Defaulted Receivables</td>
<td>3,333.33</td>
</tr>
<tr>
<td>A's share of interest (85%)</td>
<td>$14,166.66</td>
</tr>
<tr>
<td>A's share of defaults</td>
<td>2,833.33</td>
</tr>
<tr>
<td>A's net share of interest</td>
<td>11,333.33</td>
</tr>
<tr>
<td>A's share of servicing and other fees</td>
<td>2,124.92</td>
</tr>
<tr>
<td>A's accrued interest</td>
<td>3,541.66</td>
</tr>
<tr>
<td>A's excess interest</td>
<td>5,666.75</td>
</tr>
</tbody>
</table>
In this example, even though the protection for bad debts given to the investors in the most senior interests equals a multiple of seven times historical experience and, to the most junior interests, three times historical experience, the transfer should constitute a true sale. Bad debt protection constitutes only credit recourse, and the investors depend for their return entirely on yield accruing on the transferred assets, which yield is based upon an interest rate which must, under the terms of the charge account agreements, equal or exceed the return promised to investors.

**Retail Automobile Receivables; One-tier Structure**

In this example, a captive finance subsidiary of an automobile manufacturer wishes, for balance sheet purposes, to securitize $1,000,000 of auto

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131. In this example, available spread after deducting accrued interest and other expenses equals $9,520.84, or about three times loss experience (per month of $3,333.33), and the B and C interests of $150,000 equal about four times loss experience (annualized of $40,000).

132. An interesting question would arise if the investors received a floating interest rate not tied to the rate earned by the receivables, but payable solely from a cash flow generated by the receivables (and thus, by definition, subject to a cap). As the return to the buyers derive from the cash flow generated by the receivables, the floating rate return, one might argue, should not constitute an impermissible amount of economic recourse and the transfer should be a true sale. See supra notes 45, 47.
retail installment contracts that bear a fixed rate of return equal to 9% per annum. The investors, however, in the trust that is to purchase the receivables, wish to obtain a floating rate of return equal to the London Interbank offered rate or "Libor" plus 0.50% per annum on the notes to be issued by the trust and Libor plus 0.75% per annum on the certificates to be issued by the trust (which on the proposed date of closing, equals 5.5% and 5.75% per annum, respectively). Historical loss experience equals 1% per annum of total collections and the pool has an expected weighted average maturity of one and a half years.

The finance company seller wishes to sell the receivables to an owner trust which will issue a senior class of notes with a principal amount equal to 97% of the face amount of the pool and a subordinated class of certificates with a principal amount equal to the remaining 3% of the face amount of the pool. The finance company will also enhance the certificates and the notes by pledging a cash collateral account equal to 5% of the face amount of the pool. The interest collections on the receivables will, as in the credit card example, be applied to pay the rate of return on the trust notes and certificates, the servicing fee, and to cover bad debts; the excess spread, if any remains, will be returned to the finance company. The amount of bad debt protection, as discussed above, should not disqualify the transfer from being a true sale. But what of the floating interest rate, which does not match the yield on the underlying receivables, and, if rates rise, may need to be paid out of the cash collateral account? Although this appears to be economic recourse, it would seem that so long as the economics of the transaction are in substance the same as sale of a fixed rate investment together with a separate, arm's-length sale of a swap, the transaction should not be disqualified as a true sale.

**Retail Automobile Receivables; Two-Tier Structure**

Assume that the parties to the above transaction wished to structure the transaction using a two-tier structure. The seller would transfer the receivables from itself to a wholly owned SPV and the SPV would transfer them to an owner trust. The transfer to the SPV, which would constitute a true sale, would be extremely simple:

- Outstanding auto receivables $1,000,000
- Contribution of receivables to SPV 70,000
- Sale of receivables to SPV for purchase price equal to face amount of receivables 930,000

The SPV would earn whatever return the receivables themselves earned and the transfer would therefore clearly be a true sale (even if the receivables were to earn a floating rate of interest). The SPV could then sell the receivables to the owner trust for $1,000,000 and pledge a portion of the $70,000 obtained from the trust (which it will not need to pay the finance
company seller as purchase price) in the cash collateral account to cover bad debt and interest rate risk.

According to this Article, this transaction could be enhanced with one additional feature: full collectibility recourse against the seller for all defaulted receivables. This right of recourse would be assigned by the SPV to the owner trust as additional credit support for the sold receivables. Under the theory of this Article, full collectibility recourse would be completely consistent with the concept of true sale.

CONCLUSION

To analyze whether the recourse that a seller of financial assets gives to a buyer converts a sale into a loan, one must distinguish between collectibility recourse and economic recourse. This Article shows that the question of sale versus loan is one of state law, even in bankruptcy, and so long as recourse is limited to collectibility, there should be no legal reason why the recourse should convert the sale into a loan.