TRUE SALE OF RECEIVABLES: A PURPOSIVE ANALYSIS[*]

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INTRODUCTION

True sale, like true love, is much pursued but sadly elusive. Since the 1980s, an enormous market has developed in receivables-backed debt that has an attribute prized by financiers: it is designed to be insulated from any future bankruptcy of the beneficiary of the financing, through a transaction structure called "securitization." Securitization entails the conveyance of the receivables by the beneficiary to another entity formed for the purpose of the financing. For the structure to achieve its purpose it is essential that this conveyance be a "true sale" of the receivables—that is, it is essential that a court treat the conveyance as a sale, in accordance with its form, and not recharacterize it as a loan secured by the receivables. In consequence, as one commentary put it, "defining true sale is the holy grail of the securitization market."[1]

 In this paper, unless otherwise indicated, citations to the Bankruptcy Code, title 11 of the United States Code, are to the version as amended through the end of 2007. Citations to the Uniform Commercial Code ("UCC") are given by date. References to the "original version" of the UCC are to the 1962 Official Text, which was the version first widely enacted.

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[1] Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 161 (1996). For a brief account of the structure of a prototypical securitization transaction, see *infra* Part IV. For a fuller account, see Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1556–80 (2008).

Grails, too, are elusive. Securitization has been criticized on a various grounds during its existence (most recently for its role in fostering a vast market in subprime mortgage loans, the collapse of which has caused much distress in the financial markets since late 2006).[2] But its legal structure has lived a charmed life. Only one contested ruling on the true sale issue in a securitization transaction has been reported to date, and while that ruling was against true sale treatment, the procedural posture of the ruling deprives it of much heft as precedent.[3] Outside the securitization setting, cases involving the true sale issue have been thin on the ground for decades. And that body of case law is remarkable for its incoherence, to the degree that some judges have thrown up their hands and declared that the state of precedent is such that they might as well toss a coin to decide such cases.[4]

This paper analyzes the doctrine of true sale as it relates to sales of receivables—or, to say the same thing in another way, the doctrine that calls for a court in some circumstances to recharacterize a sale of receivables as a loan secured by those receivables. Part I.A begins by summarizing the generally-applicable law on the subject. Part I.B reviews related law revision efforts, some successfully enacted by states, others proposed but not enacted by the federal government.

Part II addresses the circumstances in which a sale of receivables should be recharacterized as a secured loan under nonbankruptcy law. The chaotic state of the case law is the consequence of courts trying to divine similarities and differences between a sale and a secured loan on an intuitive basis, without reference to the purpose of recharacterization. Yet the purpose of the doctrine is apparent from well known history, and a reasonably coherent standard for exercising recharacterization follows from that purpose. Part II also demonstrates that nothing in Article 9 of the UCC alters the historical purpose of recharacterization, and offers an explanation of why the cases have drifted away from the orthodox understanding of the doctrine.

Part III surveys the fragile normative justifications for the recharacterization doctrine. It also notes certain instances in which the doctrine has been renounced, either by statute or case law. The most significant of those renunciations were, in a

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[2] For evidence that securitization encouraged the lax mortgage lending that led to massive defaults and the ensuing credit crisis, see Atif Mian & Amir Sufi, *The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis* (May 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1072304, and Benjamin J. Keys et al., *Did Securitization Lead to Lax Screening? Evidence from Subprime Loans* (Apr. 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1093137.

[3] The ruling, *In re* LTV Steel Co., 274 B.R. 278 (Bankr. N.D. Ohio 2001), was made by the court overseeing the bankruptcy of the beneficiary of a securitization financing; the court declined to vacate its earlier interim order allowing the beneficiary to use the cash proceeds of the securitized assets. The bankruptcy court never had occasion to issue any further contested order on the subject as the matter settled. For further discussion of *LTV Steel*, see Kettering, *supra* note 1, at 1655–56, 1717–20.

[4] *See In re* Commercial Loan Corp., 316 B.R. 690, 700 (Bankr. N.D. Ill. 2004) ("With no discernible rule of law or analytical approach evident from the decisions, a court could flip a coin and find support in the case law for a decision either way.") (internal quotation marks omitted); Elmer v. Comm'r, 65 F.2d 568, 570 (2d Cir. 1933) (L. Hand, J.) ("It is possible, as we have suggested, to construe these transactions in either way.").

sense, accidental, in that they were made for reasons that have nothing to do with the purpose of the doctrine.

Finally, Part IV turns to the heart of the matter so far as securitization is concerned: namely, recharacterization under bankruptcy law. It shows that there are excellent reasons why a court so inclined could conclude that a sale of receivables in a securitization transaction is not a true sale for bankruptcy purposes even though it is a true sale under nonbankruptcy law. For reasons that have nothing to do with legal doctrine, however, that threat to securitization is more theoretical than real.

This paper is concerned only with the recharacterization of a sale of receivables as a loan secured by the receivables—or, in other words, the distinction between a sale and a secured loan. The broader question of what constitutes a "sale" of a receivable for purposes of Article 9 of the UCC has other aspects that do not enter into this discussion.[5] Furthermore, this paper is directed at the recharacterization doctrine as applied to sales of receivables (as more precisely defined below), and not to other assets.

I. THE STATE OF THE ART

A. Generally

Since its inception Article 9 of the UCC has governed the outright sale of a broad class of rights to payment, as well as the grant of an interest in personal property of any kind to secure an obligation. The 1998 revision broadened significantly the class of rights to payment the sale of which is governed by Article 9.[6] That rectified the inadvertently narrow reach of the original version, and

[5] For example, the critical conveyance of receivables in a securitization transaction is often a capital contribution by a parent corporation to its subsidiary, and it is not clear that such a transaction is governed by Article 9. Article 9 generally governs the "sale" of receivables. *See* U.C.C. § 9-109(a)(3) (2007). But neither the term "sale," nor the correlative term "buyer" used in *id.* § 1-201(b)(35), is defined for this purpose. In common parlance, "sale" does not include every absolute conveyance, but only one made in exchange for a price in money paid or promised to be paid. *See* BLACK'S LAW DICTIONARY 1364 (8th ed. 2004). Hence a respectable argument can be made that a conveyance of receivables as a capital contribution, or in a barter transaction, is not a "sale" and hence is not governed by Article 9. (Article 9 does define "sale," by reference to the definition in U.C.C. § 2-106 (2007). *See id.* § 9-102(b). That definition, however, is best read as applying only to goods. That reading follows from, *e.g.*, the definition's reference to *id.* § 2-401, which is limited to goods, and from the fact that the definition of the correlative term "seller" in *id.* § 2-103(1)(d) is limited to goods. Even if the section 2-106 definition were applied by analogy to receivables it would not clearly cover a capital contribution, as it defines a sale to be the passage of title "for a price." The section 2-106 definition would cover a barter transaction, as Article 2 contemplates that the price can be paid other than in money. *See id.* § 2-304.) This issue is not new. *See* U.C.C. §§ 9-102(1)(b), 9-105(3) (1962).

[6] Article 9 originally governed "any sale of accounts, contracts rights or chattel paper." U.C.C. § 9-102(1)(b) (1962). The 1972 revision deleted the concept of "contract rights" from Article 9, its content being picked up by the definitions of "account" and "general intangible." As thus revised Article 9 governed "any sale of accounts or chattel paper." U.C.C. § 9-102(1)(b) (1972). As revised in 1998, Article 9 applies to

was agreeable to the securitization industry, which preferred the certainties of Article 9 to the vagaries of the common law.[7] For brevity, this paper refers to rights to payment the sale of which is governed by Article 9 as "receivables."

The official comments to the UCC justify the decision to include sales of receivables within Article 9 by reference to the difficulty of distinguishing a sale of a receivable from its transfer as security for an obligation.[8] As with some other comments that purport to explain decisions about the scope of Article 9, that explanation is, at best, only part of the truth.[9] Grant Gilmore, co-drafter of Article 9, later explained its coverage of sales of receivables as simply tracking pre-UCC statutes on assignment of accounts receivable, which applied to sales as well as security transfers. Those pre-UCC statutes, in turn, almost all had been enacted shortly before the UCC was drafted, in reaction to an ephemeral problem arising from the Supreme Court's unexpected construction of an amendment to the Bankruptcy Act in a way that could have disastrous consequences for a receivables financier who took either a sale or a security transfer.[10] According to Gilmore's

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"a sale of accounts, chattel paper, payment intangibles, or promissory notes." U.C.C. § 9-109(a)(3) (2007). The broadening of scope in 1998 extended beyond the inclusion of payment intangibles and promissory notes, because the definition of "accounts" was substantially broadened. *See infra* text accompanying notes 107–11.

[7] As to the inadvertently narrow reach of original Article 9 as applied to sales of receivables, see PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, PEB STUDY GROUP UNIF. COMMERCIAL CODE ARTICLE 9 REPORT 43–49 (Dec. 1, 1992), and Homer Kripke, *Suggestions for Clarifying Article 9: Intangibles, Proceeds, and Priorities*, 41 N.Y.U. L. REV. 687, 690–93 (1966). As to the agreeability of the change to the securitization industry, see Paul M. Shupack, *Making Revised Article 9 Safe for Securitizations: A Brief History*, 73 AM. BANKR. L.J. 167 (1999).

[8] This thought was belatedly added by the 1972 revision, where it appeared in the comments to U.C.C. § 9-102 in both the unnumbered introductory paragraph and comment 2. It now appears in U.C.C. § 9-109 cmt. 4 (2007).

[9] An example of the disingenuousness of the comments on matters of scope relates to the exclusion from Article 9 of interests in insurance policies set forth in U.C.C. § 9-104(g) (1962) and carried forward to U.C.C. § 9-109(d)(8) (2007). The comments justified the exclusion with doubletalk, see U.C.C. § 9-104 cmt. 7 (1962), but the real reason was the drafters' fear that political opposition from the insurance industry would derail enactment otherwise. *See* 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 10.7, at 315 (1965).

[10] For Gilmore's explanation of the inclusion of receivables sales within Article 9, see 1 GILMORE, *supra* note 9, § 10.5, at 308; see also 2 *id*. § 44.4, at 1229; for his explanation of why the pre-UCC accounts receivable statutes included sales, see 1 *id*. § 8.7, at 275–76. These pre-UCC statutes were a reaction to *Corn Exchange National Bank v. Klauder*, 318 U.S. 434 (1943). *Klauder* construed section 60 of the then-Bankruptcy Act, as amended in 1938, so as to permit avoidance as a voidable preference of any assignment of accounts receivable in which the account debtor was not notified of the assignment in a state whose law permitted a subsequent assignee to obtain priority over the non-notifying assignee. Most states in which this priority issue was in any degree uncertain speedily enacted a statute to resolve it in a way that would avert the *Klauder* result. While *Klauder* involved a security transfer, its theory could apply to an outright buyer of receivables, so the curative statutes were drafted to cover sales. Section 60 was amended to undo *Klauder* in 1950, but by that time the curative statutes had already done their work. For fuller discussions of *Klauder*, see 1 GILMORE, *supra* note 9, §§ 8.6, 8.7, and Kettering, *supra* note 1, at 1659–61. *See also* 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, 436–40 (1994) (further discussing the motivations for including sales of receivables within Article 9).

account, therefore, the UCC's coverage of sales of receivables was the result of an historical accident that had nothing to do with difficulty in distinguishing a sale from a security transfer.

In any event, Article 9 is drafted on the premise that the sale of a receivable and its transfer to secure an obligation are disjoint categories. On casual inspection that point is obscured by the definition of fundamental terms of Article 9 to do double duty, for reasons of drafting efficiency. Thus, "debtor" means, as the occasion may require, either a seller of receivables or the grantor of an interest in personal property that secures an obligation; "secured party" means either a buyer of receivables or the grantee of an interest in personal property that secures an obligation; "security interest" means either the ownership interest of a buyer of receivables or an interest in personal property that secures an obligation; and "collateral" means either receivables that have been sold or personal property that secures an obligation.[11] But Article 9 does make important consequences turn on the category into which a given transaction falls, as detailed in Part II.B of this paper.

Article 9, however, declines to state any rule on whether a given conveyance of a receivable should be classified as a sale or as a security transfer. The comments flag this omission and note that the subject is, as a result, left entirely to the courts—an observation that the original drafters made once and that the revisers, chivvied perhaps by anxious securitization practitioners, repeated thrice.[12] The closest Article 9 comes to giving explicit guidance on the subject are comments to the effect that a conveyance with recourse to the seller is not necessarily inconsistent with a true sale. Moreover, the statutory text has always included provisions that assume that a true sale can exist notwithstanding recourse to the seller.[13]

The courts thus have been on their own in true sale analysis, and they have not fared well. The tenor of the opinions is reminiscent of the cases addressing the distinction between a true lease of equipment and its sale with a retained security interest in the bad old days, early in the post-World War II boom in equipment leasing, when courts generally had no idea how to analyze such cases. When courts facing a characterization issue do not know what to do, they often speak in terms of giving effect to the parties' intent: so it was in the early days of true lease adjudication,[14] and so it is with true sale.[15] But deferring to the parties' stated intent

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[11] U.C.C. § 1-201(b)(35) (2007) ("security interest"); *id*. § 9-102(a)(12) ("collateral"); *id*. § 9-102(a)(28) ("debtor"); *id.* § 9-102(a)(72) ("secured party"). The same drafting technique was used in the original version. *See* U.C.C. §§ 1-201(37); 9-105(1)(c), (d), (i) (1962).

[12] In the original version, see U.C.C. § 9-502 cmt. 4 (1962); in the revision, see U.C.C. § 9-109 cmt. 4 (2007); *id*. § 9-109 cmt. 5; *id*. § 9-318 cmt. 2.

[13] *See infra* note 124 and accompanying text.

[14] *See* Kettering, *supra* note 1, at 1618–19.

[15] *See, e.g.*, Bear v. Coben (*In re* Golden Plan of Cal., Inc.), 829 F.2d 705, 708–09 (9th Cir. 1987); Am. Home Mtg. Inv. Corp. v. Lehman Bros. Inc. (*In re* Am. Home Mtg. Holdings, Inc.), 388 B.R. 69, 88–92 (Bankr. D. Del. 2008) (evaluating recharacterization of a sale of a subordinated note in the context of repurchase agreement).

as to the character of a transaction is merely a long-winded way of abolishing the recharacterization doctrine, and courts do not really mean to do that—though it is, naturally, a notion much caressed by practitioners who have a stake in avoiding recharacterization of the transactions they structure.[16] Such rhetoric aside, courts generally proceed as they did in the early days of true lease adjudication: namely, they make an intuitive judgment about the similarity of the transaction in question to the court's notion of an ideal sale (lease) or ideal secured loan (sale with retained security interest), based on an ad hoc selection of factors that strike the court as relevant in the particular case.[17] Despite the contrary intimations to be found in Article 9, the factor that has struck the most courts as the most significant in favor of recharacterization is the buyer having recourse to the seller on the sold receivable—though, as with other factors mentioned by courts, the significance of recourse by no means commands unanimous assent.[18] Many miscellaneous factors have been mentioned by the courts, among them such matters as use of a pricing mechanism that strikes the court as being reminiscent of the pricing of a loan transaction,[19] a right in the seller to any surplus collections after the buyer has collected a predetermined amount,[20] retention of collection and servicing duties by the seller,[21] and lack of notice to the account debtor or others of the purported sale.[22]

The courts obviously are in want of a guiding principle, and to date commentators have not supplied one. Few have even made the attempt, and those have offered little more than their own intuitive notions of sale and secured loan.[23]

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[16] Thus, for example, the useful compilation of cases in SECURITIZATION OF FINANCIAL ASSETS § 5.03 (Jason H.P. Kravitt ed., 2d ed. 1995 & Supp. 2007), is prefaced with a discussion optimistically captioned, "The Intent of the Parties as the Primary Determinant."

[17] For discussion of true lease cases up to the promulgation of Article 2A of the UCC, see Corinne Cooper, *Identifying a Personal Property Lease Under the UCC*, 49 OHIO ST. L.J. 195, 201 (1988) ("The current 'test' is in fact only the enumeration of an arbitrary set of factors, ostensibly based upon indicia of ownership, identified by the courts on an ad hoc basis.").

[18] Thus, the most recent substantial case on point, NetBank v. Kipperman (*In re* Commercial Money Ctr., Inc.), 350 B.R. 465, 481–85 (B.A.P. 9th Cir. 2006), recharacterized a sale of receivables, emphasizing that the buyer had indirect recourse to the seller (via direct recourse on a surety bond, the surety having a right to indemnity from the seller). *See also, e.g.*, Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979) (discussed *infra* Part II.C); Ratto v. Sims (*In re* Lendvest Mortgage, Inc.), 119 B.R. 199, 200 (B.A.P. 9th Cir. 1990). *But see, e.g.*, Carter v. Four Seasons Funding Corp., 97 S.W.3d 387, 397–98 (Ark. 2003) (explicitly dismissing recourse).

[19] *See, e.g.*, Home Bond Co. v. McChesney, 239 U.S. 568, 575 (1916).

[20] *See, e.g.*, *id.*; *In re* Evergreen Valley Resort, Inc., 23 B.R. 659, 661 (Bankr. D. Me. 1982).

[21] *See, e.g.*, *McChesney*, 239 U.S. at 575; *NetBank*, 350 B.R. at 483.

[22] *See, e.g.*, Petron Trading Co. v. Hydrocarbon Trading & Transport Co., 663 F. Supp. 1153, 1159 (E.D. Pa. 1986); *In re* Alda Commercial Corp., 327 F. Supp. 1315, 1317 (S.D.N.Y. 1971).

[23] *See* Pantaleo et al., *supra* note 1; Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON. L. REV. 287 (1991); 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 (1991).

B. Statutory Revision Efforts Pertaining to Recharacterization

Efforts both to unleash and to rein in securitization through statutory revision to date have revolved around the true sale issue. Almost none of those efforts, however, has aimed simply at clarifying the circumstances in which a sale should be recharacterized. After the promulgation of Revised Article 9, a lonely call by a member of the drafting committee for development of a uniform state law on the subject went nowhere.[24] Revision efforts by the securitization industry instead have aimed at abolishing altogether the possibility of recharacterization, at least in securitization transactions. The premier revision effort of that sort was an attempt to amend the Bankruptcy Code to render recharacterization irrelevant in securitization transactions, by declaring assets securitized by a debtor to be outside the debtor's subsequent bankruptcy estate if certain modest conditions are met. That proposed amendment was first introduced in 1998 and appeared in several successor bills before being killed off in 2002 as a fortuitous by-product of the bankruptcy of Enron Corporation, which had manipulated its financial reports through use of securitization-like structures.[25]

The securitization industry has had greater success in the state legislatures. Nine states have enacted statutes of broad applicability that preclude recharacterization of a sale. These enactments fall into two patterns. The earliest, first enacted by Texas in 1997 and promptly mirrored by Louisiana, is an amendment to the state's UCC that precludes recharacterization of a sale of receivables, whether or not made in connection with a securitization transaction, absent "fraud or intentional misrepresentation."[26] The seven enactments of the other pattern, the earliest by Ohio in 2001 but of which Delaware's is commonly taken as the exemplar, are stand-alone statutes, each of which precludes recharacterization of a sale of property of any kind (not just receivables, as in the Texas pattern), but only if made in a securitization transaction.[27] Two of the Delaware-pattern statutes are further limited to sales made by insured depositary institutions.[28]

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[24] *See* Edwin E. Smith, *Proposal for a Uniform State Law on What Constitutes a True Sale of a Right to Payment*, in AMERICAN LAW INST. & AMERICAN BAR ASS'N, THE EMERGED AND EMERGING NEW UNIFORM COMMERCIAL CODE (2002).

[25] The final incarnation of this proposed legislation was in Bankruptcy Reform Act of 2001, S. 420, 107th Cong. § 912 (2001) and Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, H.R. 333, 107th Cong. § 912 (2001). For discussion of this episode, see Kettering, *supra* note 1, at 1652–53, 1721–22.

[26] LA. REV. STAT. ANN. § 10:9-109(e) (2002) (reenactment of provision originally enacted in 1997); TEX. BUS. & COM. CODE ANN. § 9.109(e) (Vernon 2002) (reenactment of provision originally enacted in 1997).

[27] ALA. CODE §§ 35-10A-1–35-10A-3 (LexisNexis Supp. 2007) (enacted 2001); DEL. CODE ANN. tit. 6, §§ 2701A–2703A (2005) (enacted 2002); NEV. REV. STAT. §§ 100.200–100.230 (2007) (enacted 2005); N.C. GEN. STAT. §§ 53-425–53-426 (2007) (enacted 2002); OHIO REV. CODE ANN. § 1109.75 (LexisNexis Supp. 2008) (enacted 2001); S.D. CODIFIED LAWS §§ 54-1-9–54-1-10 (Supp. 2003) (enacted 2003); VA. CODE ANN. §§ 6.1-472–6.1-473 (Supp. 2007) (enacted 2004).

[28] These are the North Carolina and Ohio statutes cited in the preceding footnote. As the insolvency of an insured depositary institution is not governed by the Bankruptcy Code, those enactments are not bankruptcy

These broad enactments are reasonably well known. By contrast, a plethora of state anti-recharacterization statutes of narrow applicability have gone almost unmarked outside the securitization industry. The earliest of these appears to have been a 1994 Washington statute pertaining to conservation-related investments by public utilities, the costs of which state regulators might allow a utility to recover over time through an increase in its rates; the utility might accelerate its recovery by securitizing the revenue stream comprised of those additional charges, and the statute awarded indefeasible true sale status to the utility's transfer of the right to collect those additional charges to the utility's securitization vehicle.[29] Other states followed with similar statutes in aid of utilities' financing of environmental control costs, with similar anti-recharacterization provisions.[30] The floodgates opened in the late 1990s, when the deregulation of the electrical industry left many electrical utilities saddled with so-called "stranded costs": that is, previous capital expenditures the cost of which could not be expected to be recovered under the new order of competitively priced electricity rates. At least eleven states responded by enacting statutes allowing utilities to recover their stranded costs through an additional charge to customers and, like the prototypical Washington statute, further allowing the utilities to securitize that revenue stream, with the transfer by the utility to its securitization vehicle of the right to collect those additional charges being awarded indefeasible true sale status.[31] Having tasted this fruit and found it good, states have since enacted a variety of similar statutes with anti-recharacterization provisions to facilitate securitization of other types of utility charges.[32] Such narrowly-tailored anti-recharacterization statutes to date have been

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driven. Their evident purpose is to assure off-balance-sheet treatment to securitization transactions by such institutions under current accounting standards. For background, see Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1734 n.371, 1739–40 (2004).

[29] WASH. REV. CODE ANN. § 80.28.306 (West 2001) (enacted 1994).

[30] OR. REV. STAT. § 757.460 (2007) (enacted 1995); W. VA. CODE ANN. § 24-2-4e(m) (LexisNexis Supp. 2008) (enacted 2005); WIS. STAT. ANN. § 196.027(5)(c) (West Supp. 2007) (enacted 2003).

[31] The first of these "stranded cost" securitization statutes was enacted in 1996. CAL. PUB. UTIL. CODE § 844(a) (West 2004) (enacted 1996); CONN. GEN. STAT. ANN. § 16-245k(h) (West 2007) (enacted 1998); 220 ILL. COMP. STAT. ANN. 5/18-108 (West 2007) (enacted 1997); MASS. GEN. LAWS ANN. ch.164, § 1H(f) (West 2003) (enacted 1997); MICH. COMP. LAWS SERV. § 460.10l (LexisNexis 2001) (enacted 2000); MONT. CODE ANN. § 69-8-503 (2007) (enacted 1997); N.H. REV. STAT. ANN. § 369-B:6 (Supp. 2007) (enacted 2000); N.J. STAT. ANN. § 48:3-72 (West 2008) (enacted 1999); 66 PA. CONS. STAT. ANN. § 2812(e) (West 2000) (enacted 1996); R.I. GEN. LAWS § 39-1-59 (2006) (enacted 1997); TEX. UTIL. CODE ANN. § 39.308 (Vernon 2007) (enacted 1999).

[32] The latest vogue in such statutes allows utilities to securitize tariffs they are allowed to charge to recover for the costs of prevention and remediation of hurricane damage. FLA. STAT. ANN. § 366.8260(c) (West 2008) (enacted 2005); LA. REV. STAT. ANN. § 45:1230 (Supp. 2008) (enacted 2006); LA. REV. STAT. ANN. § 45:1320 (Supp. 2008) (enacted 2007). For other uses, see CAL. PUB. UTIL. CODE § 848.4 (West 2004) (enacted 2004) (securitization of tariffs allowed to be charged by Pacific Gas & Electric Co. to amortize a multibillion-dollar "regulatory asset" it was permitted to book in order to finance its emergence from bankruptcy); IDAHO CODE ANN. § 61-1506 (2002) (enacted 2001) (securitization by public utilities of tariffs charged for certain energy cost adjustments); IDAHO CODE ANN. § 61-1606 (Supp. 2008) (enacted 2005) (similar); IND. CODE ANN. § 8-1-8.9-15 (West Supp. 2007) (enacted 2007) (securitization by public utilities of tariffs charged to recover for the costs of purchasing natural gas produced by coal gasification); MD.

mostly confined to utilities, but at least one state has enacted such a statute to facilitate the securitization of municipal tax liens.[33]

In addition, many states have enacted statutes that allow the state itself to securitize particular revenue streams to which the state is entitled, with anti-recharacterization provisions applicable to the transfer of the revenue stream by the state to its securitization vehicle. At least a dozen states have enacted statutes of that type applicable to securitization of the state's share of revenues from the master settlement agreement entered into in 1998 by the four major U.S. tobacco companies.[34] Finding this acceleration of revenue appealing, at least two states later enacted other statutes allowing the securitization of state revenues of other kinds, complete with anti-recharacterization provisions.[35] As a state is not eligible to be a debtor under the Bankruptcy Code, however, an anti-recharacterization statute applicable to a transfer by a state stands on a footing different from the other anti-recharacterization statutes previously mentioned.

Parenthetically, few of the foregoing anti-recharacterization statutes are cross-referenced in the enacting state's UCC. Absent such a cross-reference, such a provision is concealed in the thicket of the state's statutory code. The result is a gradual hidden subversion of the recharacterization doctrine. Whether that concealment was consciously intended by the drafters of these statutes is an interesting subject for speculation. Mundane explanations for the absent cross-references are not lacking.[36] But similar hidden subversion has occurred previously in the form of widespread state enactment of two groups of statutes, not commonly cross-referenced in the enacting state's UCC, that prohibit the recharacterization as security interests of two kinds of personal property leases: so-called TRAC leases,[37]

CODE ANN., PUB. UTIL. COS. § 7-539 (LexisNexis 2008) (enacted 2006) (securitization by electric utilities of tariffs charged to smooth a sharp increase of rates following the end of a regulatory freeze).

[33] N.J. STAT ANN. § 52:27BBB-70 (West Supp. 2008) (enacted 2003).

[34] CAL. GOV'T CODE § 63049.3 (West Supp. 2008) (enacted 2002); D.C. CODE § 7-1831.04 (2004) (enacted 2000); FLA. STAT. ANN. § 17.41 (West 2003) (enacted 2003); IOWA CODE ANN. § 12E.9 (West 2005) (enacted 2005); LA. REV. STAT. ANN. § 39:99.12 (2005) (enacted 2001); MICH. COMP. LAWS SERV. § 129.268 (LexisNexis 2007) (enacted 2005); MO. ANN. STAT. § 8.535 (West Supp. 2008) (enacted 2002); N.J. STAT. ANN. § 52:18B-5 (LexisNexis Supp. 2008) (enacted 2002); OHIO REV. CODE ANN. § 183.51 (LexisNexis 2007) (enacted 2007); R.I. GEN. LAWS § 42-133-7 (2006) (enacted 2002); S.D. CODIFIED LAWS § 5-12-49 (Supp. 2003) (enacted 2001); W. VA. CODE ANN. § 4-11A-12 (LexisNexis Supp. 2007) (enacted 2007); WIS. STAT. ANN. § 16.63 (West 2007) (enacted 2005).

[35] CAL. GOV'T CODE § 63048.75 (West Supp. 2008) (enacted 2004) (sale by California of its share of revenues under tribal compacts relating to gambling); LA. REV. STAT. ANN. § 39:99.36 (Supp. 2008) (enacted 2007) (sale by Louisiana of its share of revenues allocated by the federal government from certain offshore oil and gas leases).

[36] Aside from oversight or indifference, it may be that in some states an anti-recharacterization provision enacted as an addition to the state's public utility code (for instance) would have to clear only the legislative committee in each house with jurisdiction over public utilities, while adding to such a bill an amendment to the state's UCC would require reference to an additional committee.

[37] In a TRAC ("terminal rental adjustment clause") lease, the rent is retroactively adjusted based on the proceeds received from disposition of the leased property at the end of the lease term. Corinne Cooper has recounted how the motor vehicle leasing industry tried and failed to induce the Article 2A drafting

and rent-to-own transactions.[38] The recurrence justifies at least the raising of a quizzical eyebrow.

For a number of reasons, a financier structuring a securitization transaction would be ill-advised to put much reliance in these state anti-recharacterization statutes. In the first place, the drafting of the anti-recharacterization statutes of general applicability, at least, leaves them full of holes. The statutes of the Texas pattern, for instance, do not apply in the event of "intentional misrepresentation," and a court might easily conclude that if a given transaction denominated a sale should be recharacterized absent this statute, then the denomination of the transaction as a sale is a misrepresentation, thus rendering the statute inapplicable. Likewise, the statutes of the Texas pattern instruct the court that the applicability of Texas Article 9 to a sale of accounts, chattel paper, payment intangibles or promissory notes is not for the purpose of requiring such sales to be recharacterized, "but to protect purchasers of those assets by providing a notice filing system." That is nonsensical, because sales of payment intangibles and promissory notes are automatically perfected without filing or other public notice.[39]

The statutes of the Delaware pattern have their own crotchets. For instance, they apply only to sales in connection with a "securitization" transaction, but they define that term with varying scope and coherence, and Delaware does not define it at all (aside from an optimistic exhortation that it be "construed broadly").[40] More exotically, two scholars have independently asserted that the language of the Delaware-pattern statutes not only precludes recharacterization of a sale, but goes radically beyond that to abolish, under the relevant state's law, the Article 9

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committee to bless TRAC leases as true leases. Failing that, the industry promptly began to procure enactment by states of anti-recharacterization legislation, generally outside the state's UCC and not cross-referenced therein. These widespread enactments came as a surprise even to Professor Cooper when she came to learn of them, despite her earlier extensive writing on the subject of lease recharacterization. *See* Corinne Cooper, *The Madonnas Play Tug of War with the Whores or Who is Saving the UCC?*, 26 LOY. L.A. L. REV. 563, 574–76 (1993). As of 2004, forty eight states had enacted such legislation, only five as part of the state's UCC. *See* Memorandum from Edwin E. Huddleson, General Counsel, Am. Auto. Leasing Ass'n, for the Am. Auto. Leasing Ass'n (Apr. 21, 2004), *available at* http://www.elfaonline.org/pub/advocacy/state/PDFs/TRAC-2004.pdf (compiling such statutes). For a current discussion of characterization of TRAC leases, see Robert W. Ihne, *Seeking a Meaning for "Meaningful Residual Value" and the Reality of "Economic Realities"—An Alternative Roadmap for Distinguishing True Leases from Security Interests*, 62 BUS. LAW. 1439, 1458–64 (2007).

[38] A "rent to own" transaction is a close substitute for a credit sale of a consumer durable, structured as a lease in order to avoid the application of consumer protection laws that would apply to a credit sale. Nearly every state has enacted an industry-backed statute on such transactions, and such statutes typically exempt such transactions from recharacterization as security interests. *See* ELIZABETH RENUART & KATHLEEN E. KEEST, THE COST OF CREDIT § 7.5.3.5 (3d ed. 2005).

[39] U.C.C. § 9-309(3), (4) (2007). This aspect of the Texas-pattern statutes made more sense before the adoption of Revised Article 9, as before then Article 9 did not apply to the sale of a payment intangible or promissory note, and then as now, a security interest constituting an ownership interest of an account or chattel paper typically did have to be perfected by filing in order to be of practical value—though even then not always. *See* U.C.C. § 9-302(1)(e) (1995) (providing that a de minimis assignment of accounts is automatically perfected).

[40] DEL. CODE ANN. tit. 6, § 2702A (2005). The Alabama enactment is similar.

requirement that a financing statement be filed to perfect a sale of accounts or chattel paper that is subject to the statute.[41] The Delaware-pattern statutes need not and should not be interpreted so radically, but the fact that this argument can be made at all is telling.[42]

These rickety state anti-recharacterization statutes have not been fortified by cases. To date there does not appear to have been a reported opinion significantly interpreting any of them. And, discouragingly for securitizers, in the most notable judicial engagement with any of these statutes to date the Fifth Circuit gave the statute the back of its hand. That occurred outside the securitization context, in a 2003 case[43] in which an unpaid credit seller of produce to a failed wholesaler sought recovery from the wholesaler's financier pursuant to the federal Perishable Agricultural Commodities Act ("PACA"), based on the interest the wholesaler had granted the financier in receivables arising from the wholesaler's resales of the produce. The transfer of the receivables to the financier had been denominated a sale, and that characterization would have given the financier a defense under PACA, but the court recharacterized the transfer as a loan secured by the

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[41] Jonathan C. Lipson, *Secrets and Liens: The End of Notice in Commercial Finance Law*, 21 EMORY BANKR. DEV. J. 421, 472–74 (2005) (advancing this interpretation without qualification); Edward J. Janger, *The Death of Secured Lending*, 25 CARDOZO L. REV. 1759, 1772 n.74 (2004) (advancing this interpretation "merely as a possibility").

[42] The core language of the Delaware anti-recharacterization statute states that "[n]otwithstanding any other provision of law, . . . to the extent set forth in the transaction documents relating to a securitization transaction," any property purported to be transferred in the securitization transaction "shall be deemed to no longer be the property, assets or rights of the transferor." DEL. CODE ANN. tit. 6, § 2703A(a) (2005). Professor Lipson in effect contends that this language overrides any other state law that may operate to undo or limit the effect of a sale that is subject to the statute, including the priority rules of Article 9. That this is not so can be seen by observing that Article 9 itself has always provided by implication, and since the 1999 revision has provided expressly, that property sold is no longer the seller's property. *See* U.C.C. § 9-318(a) & cmt. 2 (2007). But the Article 9 priority rules nevertheless apply, and so place the buyer at risk if the buyer does not perfect its interest and take other necessary steps to preserve its ownership interest against third parties. *See id.* § 9-317 cmt. 6; *id*. § 9-318 cmt. 4. In the same way, the quoted language of the Delaware anti-recharacterization statute says that if a transfer in a securitization is denominated a sale, then the same result prescribed by the UCC applies—namely, that the property sold is no longer the seller's. But that does not preclude application of the Article 9 priority rules. If the Delaware anti-recharacterization statute were interpreted as per Professor Lipson's argument, the consequences would be even more drastic than negation of the Article 9 filing requirement as to sales of accounts and chattel paper subject to that statute. Under that interpretation, the Delaware anti-recharacterization statute also would override, among other things, the protection given to a holder in due course of a negotiable instrument by *id.* § 3-306, the protection given to a protected purchaser of a security by *id.* § 8-303, and (as Lipson himself noted) fraudulent transfer law. Moreover, that interpretation would take such a large bite out of the requirement to file under Article 9 in order to have priority over a lien creditor as to raise the question of whether Delaware any longer "generally requires" such filing; if not, then all filings in all transactions, whether or not subject to the Delaware anti-recharacterization statute, made in Delaware pursuant to the general rule of *id.* § 9-307(b) would be ineffective and would have to be made instead in the District of Columbia. *Id*. § 9-307(c).

[43] Reaves Brokerage Co. v. Sunbelt Fruit & Veg. Co., 336 F.3d 410 (5th Cir. 2003). "[T]he back of its collective hand" is the characterization accurately given in Elizabeth Warren & Jay L. Westbrook, *A Little Peripheral Vision*, 23 AM. BANKR. INST. J. 26 (Feb. 2004).

receivables, under which the financier had no defense to liability under PACA. This despite the fact, vigorously urged by the financier's counsel, that the law of Texas (conceded by all parties to be the only relevant state) included an anti-recharacterization statute.[44] The court ignored that statute completely and said nothing whatever about it, implicitly choosing to apply a federal standard for determining what constitutes a "sale" under PACA.

The utility of these state anti-recharacterization statutes to securitizers is further vitiated by the rules pertaining to the choice of law governing the characterization of a transaction, which are radically unsettled and Byzantine. That the parties to a securitization agree that the sale of receivables in that transaction is governed by the law of state X, which has an applicable anti-recharacterization statute, means nothing if the character of the transaction is litigated in a forum that determines the issue to be governed by the law of state Y, which has no such statute. The UCC does not set forth a clear rule on which jurisdiction's law governs the character of a transaction. At first blush the issue therefore might seem to be governed by the UCC's general rule of party autonomy, under which, absent a specific contrary command in the UCC, the parties to a transaction governed by the UCC may choose which jurisdiction's law applies to the transaction, so long as that jurisdiction bears a reasonable relationship to the transaction.[45] An official comment added by Revised Article 9 indeed states that the law governing characterization of a transaction is to be determined pursuant to this rule of deference to the parties' contractual choice.[46] Some courts have so held.[47] As a practical matter, however, the characterization of a transaction is commonly litigated by a third person who was not a party to the original transaction (such as the bankruptcy trustee of one of the parties). Other courts deciding such characterization cases have concluded that it is neither fair nor reasonable to bind a third person to a contractually-designated law to which it never agreed.[48] There is good support in other UCC comments for that

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[44] Brief of Appellant at 20–24, *Reaves*, 336 F.3d 410 (No. 02-10321).

[45] U.C.C. § 1-105(1) (1995). The 2001 revision of Article 1 would have altered this rule, see U.C.C. § 1-301 (2001), but the unanimous rejection of the revised provision by the states that enacted Revised Article 1 induced the UCC's sponsors in 2008 to amend Revised § 1-301 to continue the language of former § 1-105.

[46] U.C.C. § 9-301 cmt. 2 (2007) (discussing the limited scope of the mandatory choice of law rule set forth in § 9-301: "For example, the law applicable to issues such as attachment, validity, characterization (e.g., true lease or security interest), and enforcement is governed by the rules in Section 1-105 . . . .").

[47] *See, e.g.*, Pac. Express, Inc. v. Teknekron Infoswitch Corp. (*In re* Pac. Express, Inc.), 780 F.2d 1482, 1485 (9th Cir. 1986) (pertaining to law governing whether a lease should be recharacterized as a security interest); Coode v. M & J Fin. Corp. (*In re* Boling), 13 B.R. 39, 42 (Bankr. E.D. Tenn. 1981) (similar).

[48] *See, e.g.*, Carlson v. Tandy Comp. Leasing, 803 F.2d 391 (8th Cir. 1986) (pertaining to law governing whether lease should be recharacterized as a security interest); *In re* Eagle Enters., Inc., 223 B.R. 290 (Bankr. E.D. Pa. 1998), *aff'd*, 237 B.R. 269 (E.D. Pa. 1999) (similar); Hong Kong & Shanghai Banking Corp. v. HFH USA Corp., 805 F. Supp. 133 (W.D.N.Y. 1992) (pertaining to law governing whether a title retention agreement should be recharacterized as a security interest); *see also* J.C. Rozendaal, Note, *Choice of Law in Distinguishing Leases from Security Interests under the Uniform Commercial Code*, 75 TEX. L. REV. 375 (1996).

position,[49] and it is consonant with the general policy embodied in the UCC's express choice of law provisions, which allow parties to a transaction to choose the law governing a transaction as between themselves but not insofar as the choice would affect third parties.[50] If the contractually-chosen law is dismissed, however, the UCC gives no clear guidance on how the law that governs characterization should be selected: perhaps by reference to the ultimate fallback rule, which directs the court to choose the law of the state bearing "an appropriate relation" to the transaction (whatever that may mean),[51] perhaps by reference to some supplementary principle of law outside the UCC,[52] or perhaps by reference to the choice of law rules pertaining to perfection and priority,[53] which govern third party rights intimately bound up with the outcome of a characterization dispute. The uncertainty is heightened because the forum in which the issue is litigated may well conclude that the law of the forum state is the most reasonable choice, and that forum state is in all likelihood unpredictable by the financier that originally structures the transaction.

For such reasons as the foregoing, one may suppose, the Delaware bar procured the enactment of a nonuniform addition to the Delaware UCC declaring that if an agreement is governed by Delaware law, then the characterization of the transaction subject to that agreement is also subject to Delaware law—and, thus, the Delaware anti-recharacterization statute.[54] The Delaware bar is renowned for its diligence in causing Delaware law to be shaped to maximize the demand for their services, but in this instance they might have outsmarted themselves, for the effect of this nonuniform provision will be to induce a troubled business debtor to file its bankruptcy petitions outside of Delaware, if the debtor wishes to challenge a securitization of its receivables for the purpose of accessing the cash flow from those receivables.

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[49] U.C.C. § 1-302 cmt. 1 (2007) (stating, in the context of the UCC provision that generally validates variation by agreement of the terms of the UCC, that "the effect of an agreement on the rights of third parties is left to specific provisions of the Uniform Commercial Code and to supplementary principles applicable under Section 1-103"); *id*. § 9-401 cmt. 3 (stating that the law chosen to govern a secured transaction by the debtor and the secured party is not necessarily the law that should govern rights of a third party, such as an account debtor on collateral, notwithstanding U.C.C. § 1-105 (1995)).

[50] *See* U.C.C. § 1-105(2) (1995) (listing mandatory UCC choice of law rules); *see also* 1 WILLIAM D. HAWKLAND & FREDERICK H. MILLER, 1 UNIFORM COMMERCIAL CODE SERIES § 1-105:5 (2007) [hereinafter HAWKLAND] ("Choice of law is mandated in [the circumstances specified in § 1-105(2)], obviously, because all of them involve third parties who should not, on principle, be bound by the agreement between the original parties to which they were not privy.").

[51] U.C.C. § 1-105(1) (1995).

[52] U.C.C. § 1-103(b) (2007).

[53] U.C.C. §§ 9-301–9-307 (2007). *But cf*. HAWKLAND, *supra* note 50 (declaring it a "close question," but offering no conclusion, as to whether the law governing recharacterization should be that of the forum state or that specified by the mandatory rules identified in U.C.C. § 1-105(2) (1995), which in this context presumably would be §§ 9-301–9-307).

[54] DEL. CODE ANN. tit. 6, § 9-111(b) (2005) (enacted 2005); Del. Bill Summ., 2005 Reg. Sess. (143rd Gen. Ass.), H.B. 238 (June 28, 2005) (stating that the bill enacting this provision is "a product of the Commercial Law Section of the Delaware State Bar Association").

A further layer of indeterminacy is added to the choice of law analysis if the characterization issue is litigated in the bankruptcy of one of the parties to the transaction. Assuming that the bankruptcy court does not simply decide (as discussed in Part IV of this paper) that federal interests justify determining as a matter of federal substantive law whether a purported sale of receivables should be recharacterized for the purpose of determining whether the receivables remain part of the debtor's estate, the bankruptcy court must first decide what choice of law rule to apply in order to select the state substantive law that governs recharacterization. The Supreme Court, however, has never laid down a rule on how bankruptcy courts are to select which state's substantive law to apply to issues governed by nonbankruptcy law, and courts are much divided on the subject. Some hold that, just as a federal court adjudicating a case under diversity jurisdiction must apply the choice of law rules of the state in which it sits, a bankruptcy court must apply the choice of law rules of the state in which it sits.[55] Others hold that choice of nonbankruptcy law is governed by a uniform federal rule, typically looking to the state with the "most significant contacts."[56] Still others buy some of each, treating choice of law in bankruptcy as a federal question, but looking to the choice of law rules of the forum state absent some more or less strong federal interest that would justify adopting a different choice of law rule.[57] When one adds to this mélange the fact that a corporate debtor can easily manipulate the venue rules to select the bankruptcy court in which it files its petition,[58] it is evident that choice of law considerations alone typically should prevent a financier structuring a securitization transaction from being able to rely upon the applicability of a given state's anti-recharacterization statute in a future bankruptcy of the beneficiary of the financing, even if characterization is held to be governed by state law in the first place.

Most damning of all, there is a powerful argument that these state anti-recharacterization statutes would be preempted by the Bankruptcy Code in any adjudication of what constitutes property of the debtor's estate. The fullest analysis of the subject, by Ronald Mann, concludes from the Supreme Court's past treatment of bankruptcy-directed state laws that "a state statute that has a substantial effect *only* in bankruptcy is preempted whether or not it directly conflicts with some

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[55] *See, e.g.*, Amtech Lighting Servs. Co. v. Payless Cashways, Inc. (*In re* Payless Cashways), 203 F.3d 1081, 1084 (8th Cir. 2000). *Klaxon Co. v. Stentor Electric Mfg. Co.*, 313 U.S. 487 (1941), held that a federal court in a diversity case must apply the choice of law rules of the forum state, and dictum in *Vanston Bondholder Protective Comm. v. Green,* 329 U.S. 156 (1946), has been interpreted by some as mandating the same result in a bankruptcy case. *See generally* Jackie Gardina, *The Perfect Storm: Bankruptcy, Choice of Law, and Same-Sex Marriage,* 86 B.U. L. REV. 881, 906–22 (2006).

[56] *See, e.g.*, Lindsay v. Beneficial Reins. Co. (*In re* Lindsay), 59 F.3d 942, 948 (9th Cir. 1995).

[57] *See, e.g.*, Bianco v. Erkins (*In re* Gaston & Snow), 243 F.3d 599, 605 (2d Cir. 2001); Compliance Marine, Inc. v. Campbell (*In re* Merritt Dredging Co.), 839 F.2d 203, 206 (4th Cir. 1988); FDIC v. Lattimore Land Corp., 656 F.2d 139, 146 (5th Cir. 1981).

[58] *See generally* LYNN M. LOPUCKI, COURTING FAILURE (2005); Symposium, *Venue Choice: Where the Action Is*, 54 BUFF. L. REV. 321 (2006).

specific provision of the Bankruptcy Code."[59] Preemption of these state anti-recharacterization statutes easily follows, as "[o]nly in the most hypothetical of transactions would those statutes have any application outside of bankruptcy—indeed several of them display their intended substantive range by making specific references to the intended bankruptcy effect."[60] Hence, if a transaction "is not a sale under conventional principles, the assets that the transaction purported to sell should remain in the estate of the bankrupt originator."[61] The force of the preemption argument is such that even long-time scholarly defenders of securitization have all but written off these state anti-recharacterization statutes as reliable tools for securitizers,[62] and practitioners have been able to muster only half-hearted defenses.[63]

Securitization skeptics were sufficiently perturbed by these state anti-recharacterization statutes to make an abortive attempt in 2002 to amend the Bankruptcy Code to confer upon bankruptcy courts an explicit power to recharacterize a sale as a secured loan as a matter of federal law—though the proposal continued the tradition of intellectual vacuity as to true sale by declining to state any meaningful standard.[64] But so far, at least, these state anti-recharacterization statutes do not seem to have been taken very seriously in the securitization setting for which they were primarily designed. For instance, the legal opinion on bankruptcy matters rendered in the pioneer securitization transaction under the pioneer state anti-recharacterization statute is of public record, and though its authors were happy to mention the statute, the opinion nevertheless undertook essentially the same true sale analysis that is characteristic of opinions

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[59] Ronald J. Mann, *The Rise of State Bankruptcy-Directed Legislation*, 25 CARDOZO L. REV. 1805, 1824 (2004); *see also* Janger, *supra* note 41, at 1784–87 (arguing similarly).

[60] Mann, *supra* note 59, at 1825. This is an overstatement as applied to the statutes of the Texas pattern, which it is quite possible to imagine applying outside of bankruptcy. Nevertheless, the drafters of the Texas statute acknowledged that it was directed at defense of securitization transactions in bankruptcy. *See infra* at note 170.

[61] Mann, *supra* note 59, at 1825.

[62] *See* Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1547–48 (2004); Plank, *supra* note 28, at 1727, 1733–34.

[63] *See* Jeffrey M. Carbino & William H. Schorling, *Delaware's Asset-Backed Securities Facilitation Act: Will the Act Prevent the Recharacterization of a Sale of Receivables in a Seller's Bankruptcy?*, 6 DEL. L. REV. 367, 400 (2003); Eugene F. Cowell III, *Texas Article 9 Amendments Provide "True Sale" Safe Harbor*, 115 BANKING L.J. 699, 706 (1998).

[64] Employee Abuse Prevention Act of 2002, S. 2798, 107th Cong. (2002); H.R. 5221, 107th Cong. (2002). Section 102 of these bills would have added a new subsection (e) to Bankruptcy Code section 105, paragraph (1) of which would have conferred power on a bankruptcy court to "recharacterize as a secured loan, a sale, lease or transaction if material characteristics of the sale, lease, or transaction are substantially similar to the characteristics of a secured loan." Paragraph (2) would have stated that paragraph (1) is not to be construed to impair "any other authority the court has to recharacterize a sale, lease, or transaction," which would have preserved the power to recharacterize under the *Butner* reservation discussed *infra* in Part IV. For a critique, see the report appended to Steven L. Harris & Charles W. Mooney, Jr., *The Unfortunate Life and Merciful Death of the Avoidance Powers Under Section 103 of the Durbin-Delahunt Bill: What Were They Thinking?*, 25 CARDOZO L. REV. 1829, 1866, 1888–90 (2004).

rendered in transactions without the benefit of such a statute.[65] It is doubtful that these state anti-recharacterization statutes have made much difference in securitization practice, in the sense of deals being done in reliance upon these statutes that would not have been done without them.

II. RECHARACTERIZATION UNDER NONBANKRUPTCY LAW

A. Its Purpose and Orthodox Application

The incoherence of the cases addressing the circumstances in which a sale of receivables is properly recharacterized as a secured loan is the result of two perennial failures by the courts. The more fundamental is failure to consider the purpose to be served by such an override of the parties' contractual autonomy. As noted earlier, courts deciding such cases instead commonly do what courts often do when they have no clear idea of what they should do: they enumerate all facts that strike them as possibly relevant (in this case, real or fancied similarities and differences between the transaction in issue and the court's notion of the Platonic ideal of a sale and of a secured loan), and then announce a result based on intuition (usually put more impressively as "weighing the factors"). One need not be an unconditional adherent of the Legal Process school to see that this methodology—or lack of methodology—promotes neither predictability nor rationality.[66] Analysis should begin by asking the purpose of recharacterization, and that purpose should determine the circumstances in which recharacterization is appropriate.

The other failure is the courts' habit of addressing recharacterization of receivables sales as an isolated subject, ignoring the rich body of authority addressing recharacterization of sales as secured loans in the larger setting of secured transactions law. The two failures are closely related, for the purpose of recharacterizing a sale as a secured loan is evident when the subject is considered in that larger setting. Briefly put, recharacterization is an antiforfeiture doctrine. It is a manifestation in property law of the same judicial abhorrence of enforcing a penalty for failure of a contemplated performance that denies enforcement to agreed penalties for breach of contract. Taking that purpose seriously leads to a reasonably coherent approach to recharacterization of sales of receivables. It also solves one of the perennial mysteries of the subject: namely, the extent, if any, to which the seller's assumption of recourse for the sold receivables should affect the characterization of a purported sale.

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[65] That securitization involved the issuance of $202,300,000 of pass-through certificates for the benefit of Puget Sound Power & Light Company in 1995 pursuant to the Washington anti-recharacterization statute referred to *supra* note 29. The legal opinion on bankruptcy was filed with the Securities and Exchange Commission as Exhibit 99.1 to the registration statement for those securities (No. 33-87784), as part of Amendment No. 3 (filed May 16, 1995), and is available online in the SEC's Edgar database.

[66] *See* HENRY M. HART, JR. & ALBERT M. SACKS, THE LEGAL PROCESS 1374 (William N. Eskridge, Jr. & Philip P. Frickey eds., 1994) (1958) (famously insisting upon purposive statutory interpretation).

The origin of the recharacterization doctrine is intimately bound up with the origin of the real estate mortgage.[67] In medieval England, before the concept of the mortgage had evolved, if the owner of Blackacre wished to raise money on the security of Blackacre (as we would say today), he would deed Blackacre outright to a buyer in exchange for an agreed sum, the grant being subject to the condition that if on an agreed "law day" the seller paid a stipulated sum to the buyer, title would revert to the seller. As a consequence, if for any reason the seller (who we may anachronistically refer to as the "debtor") did not make the required payment on the law day, he lost all interest in Blackacre. The law courts enforced the parties' bargain in accordance with its terms, but the equity courts began to step in to ameliorate the punitive consequences to the debtor. That equitable intervention became progressively more extensive over time, and the eventual result was to turn this deed on a condition subsequent into a mortgage. Initially equitable intervention took the form of allowing the debtor to pay late only if he had a good excuse for his default. By the end of the sixteenth century, however, the debtor was permitted as a matter of right to redeem the land by paying his debt, with interest, within a reasonable time after the law date. This right became known as the debtor's "equity of redemption," and in time that right came to mean not only a personal right to pay late, but a continuing estate in the land on the part of the seller, amounting to an ownership interest, until his right to redeem was terminated ("foreclosed").

As with most matters of legal evolution, there is more than one reason why this equitable override of the parties' agreement came to pass. Particularly in the early stages, judicial tenderness for landowners' security of tenure in their titles no doubt played a role. A leading study reached the unedifying conclusion that the original driving force was the desire of the equity chancellors to enhance their case flow (and thus also their fees) by extending their jurisdiction at the expense of the law courts.[68] But there is general agreement that the reason why the doctrine had the staying power to persist and extend itself for centuries is the deeply engrained unwillingness of the equity courts to abide a forfeiture that penalizes a party who fails to perform as contemplated. In this setting a forfeiture, or potential forfeiture, would result from enforcement of a transaction that allowed the financier to retain the whole value of a property whose value may exceed that of the underlying debt,

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[67] The origins and evolution of the mortgage have been recounted many times. A frequently cited and crisp treatment is GEORGE E. OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES (West 2d ed. 1970) (1951); a full and careful study is R.W. TURNER, THE EQUITY OF REDEMPTION (Wm. W. Gaunt & Sons, Inc. 1986) (1931). Citations to other and more recent discussions are gathered in RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 3.1, Reporters' Note (1997) [hereinafter RESTATEMENT] and Andrew R. Berman, *"Once a Mortgage, Always a Mortgage"—The Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments*, 11 STAN. J.L. BUS. & FIN. 76, 81–90 (2005).

[68] TURNER, *supra* note 67, at 30–42. Some things never change. *Cf.* LOPUCKI, *supra* note 58 (asserting that bankruptcy judges have been competing to induce large reorganization cases to be placed in their respective courts, and have warped bankruptcy doctrine as a result).

when the parties' agreement contemplated that the debtor could recover that property by paying the stipulated sum on the agreed law day.

This doctrine grew from the same root as the doctrine of modern contract law that holds unenforceable an agreed-to remedy for breach of contract that amounts to a penalty, rather than a sum adequate to compensate the nonbreaching party for its loss. The unenforceability of contractual penalties has its origin in the history of the penal bond in medieval England, when the bond was the basic device available to render a promise legally enforceable.[69] A promise by X to pay Y £100, for example, might be rendered enforceable by a bond entered into by X binding X to pay Y £200 on a stated date, subject to the condition that the bond would be void if X paid £100 to Y before that date. The same technique could be used to penalize the nonperformance by X of any promise, not just a promise to pay money. Just as with the conditional deed, the law courts enforced such penal bonds in accordance with their terms, but the equity courts gradually stepped in to enjoin their collection, remitting the promisee to an action at law to collect his actual loss. This equitable intervention, and the rise of the action of assumpsit in the law courts, eventually led to the decline of the penal bond, but the antiforfeiture principle thus evolved came to be applied to contractual penalties of all kinds. Relief against forfeiture under a penal bond was granted by the same equity courts that, through the doctrine that came to be labeled "equity of redemption," were granting the relief from the forfeiture implicit in a conditional deed, and in their origins the two doctrines were two sides of the same coin. As one scholar observed, "undoubtedly the two were scarcely differentiated by the lawyers of that day."[70]

The degree of protection that the doctrine of the equity of redemption afforded a debtor varied with time and the particular jurisdiction. Early in the evolution of the doctrine, equitable intervention entailed no more than an extension of the time during which the debtor might redeem the land by paying the debt. The debtor might redeem until the end of a period fixed by decree of the equity court in a proceeding brought for the purpose by the financier. Absent redemption, such a foreclosure decree had the effect of confirming the financier as owner of the land, free of the debtor's right to redeem, with no provision for a deficiency against the debtor in the event that the land was worth less than the debt or for return to the debtor of any value the land might have in excess of the debt—a result referred to today as a "strict foreclosure." Strict foreclosure of real estate mortgages survives today in a few American jurisdictions, but in most jurisdictions equity or statute has

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[69] For the rise and fall of the penal bond and the origins of the antipenalty doctrine in contract law, see the brief discussion in 1 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS §§ 1.5–1.6 (3d ed. 2004); 3 *id.* § 12.18, and the much fuller discussion in A.W.B. SIMPSON, A HISTORY OF THE COMMON LAW OF CONTRACT: THE RISE OF THE ACTION OF ASSUMPSIT 53–136 (1975), especially pp. 88–99. For discussions noting the continuity between the equitable intervention that gave rise to the equity of redemption and the equitable intervention against enforcement of penal bonds, see *id.* at 118–25 and TURNER, *supra* note 67, at 22–36.

[70] TURNER, *supra* note 67, at 22.

supplemented the debtor's right of redemption by displacing strict foreclosure in favor of foreclosure by sale: that is, the foreclosure decree requires the land to be sold, with the proceeds paid first to the financier for application to the underlying debt and any surplus paid over to the debtor.[71] The debtor's right to redeem, and the debtor's right to have the value of the property credited to the debt and any surplus paid over, are different but complementary methods of protecting the debtor against the potential forfeiture implicit in enforcement of the conditional deed in accordance with its terms in the event that the debtor fails to comply with those terms. The right of redemption offers this protection only temporarily, and only if the debtor can produce the payoff amount before he is foreclosed. Foreclosure by sale offers a permanent and unconditional protection against that contingency. But both serve the same purpose.

Just as courts created the antiforfeiture principle embodied in the debtor's right to redeem and foreclosure by sale, so courts defended that principle against circumvention by financiers. A mortgagor's direct waiver of those rights (at least before default) in a mortgage transaction was simply not enforced by the courts; this came to be referred to as the principle that "a clog on the equity of redemption" is unenforceable. Recharacterization of a sale of property as a mortgage loan emerged to defeat less straightforward attempts at circumvention. One paradigmatic setting is the relatively crude attempt to hide a mortgage relationship by way of a conveyance of property by deed absolute, accompanied by an informal side agreement between grantor and grantee to the effect that the transaction is really a mortgage, in that the grantee will reconvey the property if the grantor pays a specified amount (the equivalent of the purchase price and interest). Courts have never had any difficulty recharacterizing such arrangements, and have not let the parol evidence rule stand in their way.[72]

A more sophisticated recharacterization issue arises in a different paradigmatic setting, in which nothing is hidden, and the grantor conveys property to the grantee under a formal agreement that gives the grantor a right (or perhaps a duty) to later repurchase the property. It is easy to see that such an arrangement may serve as a mortgage substitute, but where to draw the line? Courts that are unable to state an appropriate rule in a given setting are very apt to speak in terms of the "parties' intent," a readily manipulable phrase, and the *Restatement of Mortgages*, bowing to centuries of judicial pronouncements of that sort, states that the ultimate rule in this setting is whether the parties intended the arrangement to secure an obligation.[73] But the *Restatement* glosses that rule in a way that implements the antiforfeiture principle described earlier. That is, the sale will be recharacterized if the

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[71] *See* RESTATEMENT, *supra* note 67, § 3.1 cmt. a; OSBORNE, *supra* note 67, §§ 6–10; 1 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW §§ 1.3–1.4, 7.9–7.10 (4th ed. 2002).

[72] *See* RESTATEMENT, *supra* note 67, § 3.2; 1 NELSON & WHITMAN, *supra* note 71, at §§ 3.4–3.16.

[73] RESTATEMENT, *supra* note 67, § 3.3; *see also* 1 NELSON & WHITMAN, *supra* note 71, at §§ 3.17–3.18. On the manipulability of "intent" in recharacterization, *see* Kettering, *supra* note 1, at 1613–20, 1643–44.

transaction amounts to imposition of a forfeiture upon the grantor in the event that the grantor fails in a contemplated performance. Specifically, if the economic terms of the transaction are such as to make it clear at the outset that the grantor will repurchase the property if he is able to do so, then the sale will be recharacterized, for the grantor suffers the economic equivalent of strict foreclosure by not carrying out the contemplated repurchase.[74] The *Restatement* illustrates the point as follows:

> 3. Grantor conveys Blackacre to Grantee by a deed that contains no language of defeasance. Grantee pays Grantor $50,000 in cash, but receives no promissory note from Grantor. Grantee delivers to Grantor a two-year written lease on Blackacre with rent payable at $300 monthly. The lease also confers on Grantor the right at the end of that two-year period to purchase Blackacre for $60,000. Grantor retains possession of Blackacre and continues to pay real estate taxes on it. At the time of the conveyance, the fair market value of Blackacre is $125,000. Grantor fails to exercise the option in a timely fashion. The facts justify the conclusion that the parties intended a security transaction. Grantor will be permitted to redeem by paying to Grantee $60,000 less a credit for the rent paid or to compel Grantee to foreclose on Blackacre for that amount.[75]

A later illustration states that if the fair market value of Blackacre at the time of conveyance instead had been in the range of $60,000 to $65,000, the sale should not be recharacterized.[76] Given the difficulty of determining market value with precision and personal exigencies that might force some sellers to sell for less than others would be willing to accept, this conveyance by Grantor for about 75%–80% of fair market value "may reflect an arm's length sale rather than a mortgage transaction" (as the *Restatement* says).[77] In other words, the expectation at the outset that Grantor will exercise the option is not so clear that Grantor's failure to do so means that he is suffering a forfeiture on account of his failure to perform a plainly contemplated act.

The foregoing illustrates the nub of recharacterization's historical function as an antiforfeiture device. Just as the widely accepted principle for characterizing an equipment lease as a true lease rather than a sale with retained security interest—

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[74] *See* RESTATEMENT, *supra* note 67, § 3.3 cmt. c ("[T]he single most important indication of mortgage intent is the presence of a substantial disparity between the value received by the grantor and the fair market value of the real estate at the time of the conveyance. It is axiomatic that a rational owner of real estate normally will not sell it without receiving a purchase price that at least roughly approximates its fair market value."); *see also* 1 NELSON & WHITMAN, *supra* note 71, § 3.19, at 80–81.

[75] RESTATEMENT, *supra* note 67, § 3.3, illus. 3.

[76] *Id.* § 3.3, illus. 5.

[77] *Id.* § 3.3 cmt. c.

namely, the lessor having a meaningful residual interest in the leased equipment[78]—calls for judgments of probability and estimates of value, so does the principle that a sale should be recharacterized as a secured loan if the result otherwise would be an arrangement in which the seller is at risk of suffering a forfeiture in the event that he fails to perform a contemplated act. But the principle is reasonably coherent, and to members of a legal culture imbued with the unenforceability of contracted-for penalties, its purpose is familiar.

Cases on the debtor's equity of redemption in mortgage law have accreted for centuries, and it would be possible to pick out a few to support the proposition that there is something more at stake in courts' defense of the equity of redemption than implementation of the antiforfeiture principle. This is particularly so with respect to the notion that a "clog" on the equity of redemption is unenforceable, for different courts have had different ideas of what constitutes a "clog." That has let to uncertainty as to whether an "equity kicker" given to a real estate mortgagee, such as an option to buy the mortgaged property, or the right to receive a payment equal to a portion of the appreciation in value of the mortgage property (a so-called "shared appreciation mortgage"), might be deemed an invalid "clog." The *Restatement* validates equity kickers, on the ground that the rule against "clogs" should be construed as being limited to implementation of the antiforfeiture principle from which it sprang.[79] Thus, the *Restatement* explicitly validates a mortgagee's option to purchase the mortgaged property, so long as the option is not one exercisable only on the mortgagor's default.[80] Likewise, the *Restatement* declares the amorphous doctrine that a mortgagee cannot have a "collateral advantage" in addition to his entitlement to interest on his loan, a doctrine in tension with any equity kicker, to be an English import that is not part of American law.[81] Insofar as the logic of the rule against "clogs" is relevant to the related subject of recharacterization, therefore, the *Restatement*, which may be taken as the highest common denominator of American legal thought on the subject, gives no warrant to view the doctrine as having drifted substantially from implementation of the antiforfeiture principle.[82]

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[78] *See* Charles W. Mooney, Jr., *The Mystery and Myth of "Ostensible Ownership" and Article 9 Filing: A Critique of Proposals to Extend Filing Requirements to Leases*, 39 ALA. L. REV. 683, 689–96 (1988).

[79] Thus, Professor Whitman, co-reporter for the *Restatement of Mortgages* and writing in explication of it, stated as follows: "Equity kickers are quite different from the traditional clog on the equity of redemption because they are not designed as remedies for default by the borrower, but rather as additional compensation to the lender when the real estate venture is successful and increases in value." Dale A. Whitman, *Mortgage Drafting: Lessons from the Restatement of Mortgages*, 33 REAL PROP. PROB. & TR. J. 415, 427 (1998).

[80] RESTATEMENT, *supra* note 67, § 3.1(c).

[81] *Id.* § 3.1 cmt. g.

[82] The treatment of the anti-clogging rule in the *Restatement of Mortgages* has had its critics, notably Morris G. Shanker, *Will Mortgage Law Survive?*, 54 CASE W. RES. L. REV. 69 (2003). Professor Shanker's criticism did not extend to the *Restatement*'s treatment of the rules pertaining to recharacterization, however.

B. Implementation of the Distinction Between Sale and Secured Loan in Article 9

Article 9 has the same features as real estate mortgage law that inspired recharacterization of sales as secured loans. Specifically, Article 9 bestows upon a debtor who owes a secured obligation two benefits that are essentially the same as the two benefits that comprise the equity of redemption under the classic principles of mortgage law discussed earlier. First, under Article 9 a debtor who owes a secured obligation has the right, not waivable before default, to redeem the collateral by paying the obligation before that right is foreclosed (which, under Article 9, generally occurs upon collection or sale of the collateral).[83] Second, under Article 9 a debtor who owes a secured obligation has the right, entirely nonwaivable, to have the proceeds of the collateral applied to the secured obligation and to receive any surplus.[84] These two rights amount to a codification of the mortgage law principle recognizing a debtor's equity of redemption that may not be "clogged" by any waiver. Mortgage law applies that anti-clogging principle to invalidate only arrangements entered into contemporaneously with the mortgage, and not to post-default arrangements such as a deed in lieu of foreclosure.[85] Article 9 implements the anti-clogging principle in a similar way, by allowing the debtor after default to waive its right to redeem, and to consent to strict foreclosure (that is, the secured party's retention of the collateral in satisfaction of the debt).[86]

If it is appropriate to defend the antiforfeiture principle established by this cluster of provisions by recharacterizing a sale as a secured loan when necessary to prevent circumvention, there is no reason to distinguish between real estate mortgages and Article 9 security interests in so doing. Courts transplanted the notion of recharacterization, seemingly without question, from the real estate mortgage to the chattel mortgage when the latter device was introduced.[87]

The question then arises whether other features of Article 9 call for modification of the foregoing justification for recharacterization, and hence different standards for recharacterization. Before investigating that subject, it is useful to establish some terminology.

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[83] U.C.C. § 9-623 (2007); *see also id.* §§ 9-602(11), 9-624(c) (nonwaivability before default). These provisions carry forward rules originally set forth in U.C.C. § 9-506 (1962).

[84] U.C.C. §§ 9-608(a)(4), 9-615(d) (2007); *see also id.* § 9-602(5) (nonwaivability of the foregoing provisions). These provisions carry forward rules originally set forth in U.C.C. §§ 9-502(2), 9-504(2) (1962), with nonwaivability addressed at *id*. § 9-501(3)(a).

[85] *See* RESTATEMENT, *supra* note 67, § 3.1(b) & cmt. f.

[86] U.C.C. §§ 9-620(a)(1), (c), 9-624(c) (2007); *see also id*. § 9-602(10), (12) (nonwaivability of the foregoing provisions). These provisions carry forward rules originally set forth in U.C.C. §§ 9-505(2), 9-506 (1962), with nonwaivability addressed at *id.* § 9-501(3)(c), (d). These rules are more restrictive as to consumer goods.

[87] *See, e.g.*, Cabrera v. Am. Colonial Bank, 214 U.S. 224, 230–31 (1909). *See generally* 1 GILMORE, *supra* note 9, § 2.6; 1 LEONARD A. JONES, THE LAW OF CHATTEL MORTGAGES AND CONDITIONAL SALES §§ 21-33b (Renzo D. Bowers 6th ed. 1933 & Supp. 1956).

Because Article 9 uses the term "security interest" to mean both the limited interest of a secured lender and the ownership interest of a buyer of receivables, a provision of Article 9 applicable to a "security interest" will apply identically to interests of both kinds, absent special verbiage providing otherwise. Some provisions of Article 9 do afford different treatment to the interest of a secured lender than to the interest of a buyer of receivables. Article 9 uses several different phrasings to distinguish the two kinds of interests.[88] It is convenient to define the term "sale-distinguishing" to mean a provision that by its terms applies differently to a sale (or the ownership interest resulting therefrom) than to a security transfer (or the limited interest resulting therefrom). The cluster of provisions just mentioned that establish the debtor's nonwaivable equity of redemption—that is, the debtor's right of redemption, the debtor's right to surplus, and the unenforceability of a debtor's pre-default agreement to strict foreclosure—are sale-distinguishing, as they apply to the debtor in a secured loan but not to the debtor who sells receivables. The recharacterization doctrine is a defense of the antiforfeiture benefit that these provisions confer upon the debtor in a secured loan. The other sale-distinguishing provisions of Article 9 should be examined to consider their relevance to recharacterization.

The sale-distinguishing provisions of Article 9 can be grouped into five categories. The first consists of this cluster of provisions that establish the debtor's nonwaivable equity of redemption. The other four categories will be considered in turn.

The second category implements the principle that when the parties to a conveyance of a receivable refer to it as a "sale," they normally intend that the seller is transferring to the buyer all of the seller's rights in the receivable and is retaining none. The primordial rules in this category, present in Article 9 from the beginning, are those providing that, absent contrary agreement, the seller of a receivable has no right to any surplus from collection or disposition of the receivable (and "surplus" in the context of a sold receivable, where there is no secured obligation owing, necessarily means any proceeds at all).[89] Article 9 imposes a number of duties on the secured party for the benefit of the debtor that make sense in a transaction in which a receivable secures a loan, where the debtor has at least a potential right to collections from the receivable, but do not make sense in a transaction in which a receivable is sold, where the debtor has no such right. Before the 1998 revision, Article 9 was lax about distinguishing the applicability of such provisions to sale transactions, evidently due partly to simple oversight by the original drafters and

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[88] For example, U.C.C. § 9-207(d)(4) (2007) applies "[i]f the secured party is a buyer of accounts, chattel paper, payment intangibles, or promissory notes"; *id*. § 9-309(3), (4) provides that a security interest in "a sale of" a payment intangible or promissory note is automatically perfected; and *id*. § 9-608(a), (b) refer respectively to "a security interest [that] secures payment or performance of an obligation" as distinguished from "a sale of" a receivable.

[89] U.C.C. §§ 9-608(b), 9-615(e) (2007). These provisions carry forward rules originally set forth in U.C.C. §§ 9-502(2), 9-504(2) (1962).

partly to their implicit confidence that judges would understand the elementary meaning of a "sale" and would apply such provisions appropriately in light of that meaning. The drafters of the 1998 revision, shocked by the *Octagon Gas* case,[90] had no confidence whatever in judicial competence on that score, and so added a number of provisions to spell out the intended results.[91] One such provision states that a "sale" of a receivable leaves the seller with no rights in the receivable.[92] Substantively that is no more than a restatement in different words of the primordial rules just mentioned, but it directly corrects the terminological confusion of *Octagon Gas*.[93] Another provision corrects an oversight acknowledged by the drafters of original Article 9, by providing that the rules of Article 9 pertaining to default and enforcement impose no duties upon a buyer of receivables.[94] Furthermore, the revisers qualified a number of other provisions that impose duties upon the secured party for the benefit of the debtor by adding explicit exceptions, where appropriate, for a secured party who is a buyer of receivables. These include the secured party's duty to care for collateral in its possession or control[95] and to provide the debtor on request with a list of collateral and statement of account;[96] and the secured party's duty after payment of the secured obligation to undo any control arrangement previously made,[97] to cancel any direction previously given to an account debtor to make payment to the secured party,[98] and to file a termination statement.[99]

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[90] *Octagon Gas Systems Inc. v. Rimmer* (*In re* Meridian Reserve, Inc.), 995 F.2d 948 (10th Cir. 1993), held in effect that there can be no such thing as a sale of a receivable, at least for bankruptcy purposes. That muddled opinion stemmed from confusion arising from Article 9's dual-use definitions, referred to *supra* note 11. For further discussion of the case, see Kettering, *supra* note 1, at 1584, 1657–58.

[91] Many of the laxities of original Article 9 on this score had been identified in Plank, *supra* note 10. *See also* Thomas E. Plank, *Assignment of Receivables Under Article 9: Structural Incoherence and Wasteful Filing*, 68 OHIO ST. L.J. 231, 240–42 (2007).

[92] U.C.C. § 9-318(a) (2007).

[93] *See* Steven L. Harris & Charles W. Mooney, Jr., *Revised Article 9 Meets the Bankruptcy Code: Policy and Impact*, 9 AM. BANKR. INST. L. REV. 85, 107 n.121 (2001) (similarly describing the purpose of section 9-318(a)).

[94] U.C.C. § 9-601(g) (2007). By way of exception, section 9-601(g) does not relieve a buyer of receivables from the duty imposed by *id.* § 9-607(c). Subsection 9-607(c), which is nonwaivable under *id*. § 9-602(3), provides that a secured party having a security interest in a payment obligation has a duty to act in a commercially reasonable manner in enforcing the obligation if the secured party has recourse on the obligation to the debtor or a secondary obligor. This exception has nothing to do with the distinction between sale and secured loan; it is rather a codification of the duties of an obligee to a secondary obligor that is broadly analogous to, though much less elaborate than, those set forth in RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY §§ 37–51 (1996). For Grant Gilmore's rueful acknowledgement that the original version of Article 9 should have included a provision having the characteristics eventually added by U.C.C. § 9-601(g) (2007), see 2 GILMORE, *supra* note 9, § 44.4, at 1229–30.

[95] U.C.C. § 9-207(d) (2007).

[96] *Id.* § 9-210(b).

[97] *Id.* § 9-208(b)(3).

[98] *Id.* § 9-209(c).

[99] *Id.* § 9-513(c)(1).

Nothing in this second category of sale-distinguishing provisions suggests any reason to recharacterize as a security transfer a conveyance that the parties have denominated a sale. To the contrary, the provisions of this second category all give effect to the parties' characterization of a transfer as a sale. If preservation of the debtor's equity of redemption is considered to require a purported sale to be recharacterized as a security transfer, the transaction must be treated as a security transfer for purposes of the provisions of this category. But in themselves these provisions supply no reason to recharacterize any purported sale.

The third category of sale-distinguishing provisions in Article 9 pertain to the priority of a security interest in a receivable as against an interest claimed by a third party. The reason adduced by the comments for covering sales of receivables in Article 9 in the first place was the potential difficulty of determining whether a given conveyance constitutes a sale or a secured loan, and (by implication) the undesirability of having different priority rules apply to the conveyance depending upon that doubtful classification.[100] It follows that Article 9 should not award different priority status to a security interest in a receivable depending upon whether it is the ownership interest of a buyer or the limited interest of a secured lender.[101] In general, Article 9 follows that norm. A few priority rules single out sales of receivables for special treatment, but the effect of that singling-out almost invariably is not to create a difference between the priority status of a security interest depending upon whether it results from a sale or a security transfer, but rather to prevent such a difference from arising. For example, the general rules governing a priority conflict between an unperfected security interest and the interest of buyer X are written so as not to apply if X is a buyer of receivables. The reason for singling out buyers in that way is to make the outcome of the priority conflict the same regardless of whether X's interest is that of a buyer or is instead that of a secured lender.[102] Similarly, a clarifying provision added in the 1998 revision singles out buyers by stating, in effect, that a buyer of receivables who does not perfect its interest leaves its debtor with power to convey an interest in the receivables to a third person.[103] That provides further assurance that the priority rules apply identically to an unperfected ownership interest in receivables as to an unperfected security transfer of them.

Article 9 does not always provide the same priority status to a security interest in a receivable that arises from a sale instead of a security transfer. A unique provision in which differing priority status clearly was intended by the drafters was added in the 1998 revision, to declare inapplicable to a sale of receivables and consignment transactions two rules that effectively provide for partial subordination

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[100] *See supra* note 8 and accompanying text.

[101] *See* U.C.C. § 9-109 cmt. 5 (2007) ("The principal effect of [Article 9's application to sales of receivables] is to apply this Article's perfection and priority rules to these sales transactions.").

[102] *Id.* § 9-317(b), (d). The final paragraph of *id.* § 9-317 cmt. 6 notes this purpose.

[103] *Id.* § 9-318(b).

of certain future advances.[104] One of these rules subordinates the priority of a perfected security interest to the interest of a lien creditor to the extent of certain advances made by the secured creditor after the lien creditor's interest arises; the other rule has analogous effect with respect to future advances made by the holder of a security interest that is temporarily or automatically perfected in a priority contest with a competing perfected security interest. The revisers did not gloss this provision in the comments or in any of the publicly-available drafts, but it can be viewed as less an exception to the norm of equivalent priority status for sales and security transfers than a recognition that it is not clear what these rules of partial subordination would mean if applied to non-security transactions such as sales and consignments.[105] Furthermore, some commentators have argued that Article 9 might be interpreted to provide for other mismatches between the priority status of sales and security transfers of receivables.[106] But those other mismatches, if they are held

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[104] The two future advance rules in question are subsections (a) and (b) of *id.* § 9-323, and subsection (c) provides that those rules do not apply to receivables sales or consignments.

[105] For instance, a key term in subsections (a) and (b) of *id.* § 9-323 is "advance," and it is not clear that the term has any meaning as applied to a sale. Even if payment of a portion of the purchase price in a sale transaction is treated as an "advance," it is not clear that subsection (b) could ever plausibly apply to such an advance, given the inapplicability of subsection (b) to committed advances. "Publicly-available drafts" refers only to the drafts posted at the University of Pennsylvania archive at www.law.upenn.edu/bll/archives/ulc/ulc.htm. I have not examined other archival materials.

[106] One such argument, noted in Plank, *supra* note 91, at 242–47, centers on the following situation: (i) at T1, SP-1 files a financing statement covering D's accounts, (ii) at T2, D grants to SP-2 a security interest in then-existing account X, with requisites for attachment satisfied, and SP-2 files against it, (iii) at T3, D grants to SP-1 a security interest in X (either a sale or a security transfer), with requisites for attachment satisfied. It is indisputable that if the grant to SP-2 at T2 is a security transfer, then at T3 SP-1 has priority over SP-2 in X under the baseline "first to file or perfect" rule of U.C.C. § 9-322(a)(1) (2007). Some commentators (including Plank) contend that the result changes if the grant to SP-2 at T2 is a sale, on the theory that the effect of the sale is to leave D with no rights in X, per *id.* § 9-318(a), so that SP-1's later security interest cannot attach to it. That argument definitely misreads Article 9. D has no rights in X after the sale, but D still has power to convey rights in X, and that is all that is required for SP-2's interest to attach under *id.* § 9-203(b)(2). D's power to convey rights in X derives from the priority rules of Article 9 themselves, including the "first to file or perfect" rule. Section 9-318(a) is not a priority rule. In particular, it does not impose a priority rule of *nemo dat* in sale transactions that displaces Article 9's ordinary priority rules. To the contrary, several comments to Article 9 note the applicability of the ordinary priority rules to sale transactions. *See, e.g.*, *id.* § 9-317 cmt. 6; *id*. § 9-318 cmt. 4.
A more difficult argument, noted in Plank, *supra* note 91, at 259–60, derives from ambiguity as to whether a security interest that is a buyer's interest in a payment intangible or promissory note, which is perfected automatically by *id*. § 9-309(3), (4), can be perfected redundantly by filing a financing statement. If that is not the case, then the prefiling of a financing statement would give a priority benefit to a secured lender against a payment intangible or promissory note that would not be available to a buyer of the same item. For example: (i) at T1, SP-3 files against D's promissory notes, (ii) at T2, D grants SP-4 a security interest securing an obligation in then-existing promissory note Y, with requisites for attachment satisfied, and SP-4 files a financing statement covering Y, (iii) at T3, D grants SP-3 a security interest in Y, with requisites for attachment satisfied. If the security interest in Y granted to SP-3 at T3 secures an obligation, SP-3 indisputably has priority over SP-4 in Y under the "first to file or perfect" rule of *id.* § 9-322(a)(1). If, however, SP-3's security interest in Y is an ownership interest, and if SP-3's financing statement is not effective to perfect that security interest (due to the automatic perfection afforded to buyers of promissory notes by *id.* § 9-309(4)), then SP-3's filing is meaningless and SP-4 will have priority over SP-3 under the "first to file or perfect" rule. Article 9 (specifically *id.* § 9-308(a)) can and, I believe, should be read to

to exist, are drafting glitches, for there has been no serious contention that those mismatches are desirable. So again, none of the sale-distinguishing provisions in this third category suggests any reason to change the principles of recharacterization historically imposed to defend the debtor's equity of redemption.

The fourth category of sale-distinguishing provisions in Article 9 constitutes the peace treaty between the 1998 revisers and the banking industry in respect of loan participations.[107] From the beginning the revisers had determined to correct the original version's inadvertently narrow coverage of sales of receivables. Before the revision, Article 9 applied only to sales of accounts and chattel paper. Due to the relatively narrow definitions of those terms, pre-revision Article 9 governed sales of only a limited class of rights to payment. The rationale for including sales of rights to payment within Article 9—or at least the "difficulty of distinguishing sale from security transfer" rationale—applies to any right to payment. The revisers thus early determined to spread Article 9 to govern sales of payment intangibles and, eventually, sales of promissory notes as well. That, however, created problems for the loan participation market, which deals in rights to payment of those kinds and the practices of which would be upset by application of the ordinary principles of Article 9 (such as would occur if, for example, a buyer of a loan participation had to file a financing statement against its seller in order to perfect its interest). The revisers addressed the problem by doing their best to confine the definition of "payment intangible" to the right to repayment of a loan, which they did by expanding the definition of "account" to include virtually every other imaginable payment stream not already captured by a more specialized Article 9 category.[108] The revisers then added a few rules applicable to a sale (but not a security transfer) of a payment intangible or promissory note, in order to prevent disturbance of established practices in the loan participation market. The most important of those sale-distinguishing rules is automatic perfection of a sale of a payment intangible or promissory note.[109] Likewise, while Revised Article 9 generally overrides contractual restrictions imposed by an obligor on the obligee's sale or security transfer of a receivable,[110] as an exception it gives substantial effect to restrictions imposed by an obligor on the obligee's sale of a payment intangible or promissory

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provide that SP-3's filing is effective, redundantly, to perfect its security interest, which would prevent this mismatch between the priority status of SP-3 as secured lender against payment intangibles or promissory notes and SP-3 as their buyer. However, it must be admitted that the relevant language is unclear, and *id.* §§ 9-505(a), 9-513(c)(1) can be read to support the contrary interpretation.

[107] For the background and drafting history of these provisions, see *supra* notes 6–7 and Steven L. Harris & Charles W. Mooney, Jr., *How Successful Was the Revision of UCC Article 9?: Reflections of the Reporters*, 74 CHI.-KENT L. REV. 1357, 1369–74 (1999).

[108] U.C.C. § 9-102(a)(2) (2007) ("account"); *id.* § 9-102(a)(42) ("general intangible"); *id.* § 9-102(a)(61) ("payment intangible"). "Payment intangible" is a subset of "general intangible," which is the residual category of property rights that do not fit within any other Article 9 category, so expansion of the meaning of "account" correspondingly shrinks the meaning of "general intangible" and hence of "payment intangible."

[109] *Id.* § 9-309(3), (4).

[110] *Id.* § 9-406(d).

note. This exception was intended to preserve restrictions in a loan agreement on the lender's sale of loan participations.[111]

It would be specious to contend that recharacterization analysis should be altered as a result of the rule affording automatic perfection to sales of payment intangibles and promissory notes, on the theory that the public notice afforded by compliance with the ordinary perfection requirements of Article 9, required in the case of a secured loan, is so desirable as to weigh in favor of a low standard for recharacterizing such sales as secured loans. The automatic perfection provided by Revised Article 9 is nothing new. Notice of a sale of a payment intangible or promissory note never had to be filed in the Article 9 filing system in order for the sale to be effective against a lien creditor, before sales of such property were made subject to Article 9.[112] Even if the public notice afforded by filing were thought desirable, lowering the standard for recharacterization would be a terrible way to induce more filings, for no standard for recharacterization follows from such a purpose; the result would be arbitrary and unpredictable. Moreover, recharacterization of a sale would change the economics of the transaction, by awarding the seller a right to potential surplus collections on the sold receivables that was not part of the bargain between the seller and the buyer. It is one thing for the law to change the agreed economics of the deal to avert a forfeiture, as in the orthodox standard for recharacterization; it is quite a different thing, and not justifiable, for the law to change the agreed economics merely to promote the filing of a financing statement.

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[111] This exception follows from subsection (e) of *id.* § 9-406, which renders the general override of contractual restrictions on assignment set forth in subsection (d) inapplicable to a sale of a payment intangible or promissory note. Such a sale is instead subject to the limited override set forth in subsections (a) and (d) of *id.* § 9-408. Those provisions override such a restriction on assignment to the extent the restriction would preclude the sale, but give effect to the restriction (to the extent the restriction is enforceable under other law) by providing that the obligor on the payment intangible or promissory note has no duties to the buyer, and the buyer may not enforce the payment intangible or promissory note against the obligor. *See* Harris & Mooney, *supra* note 107, at 1373 n.65 (noting the purpose of this exception as a sop to the loan participation market). Essentially the same rule is restated in *id.* § 9-406(b)(2), which provides in effect that the obligor on a payment intangible that has been sold need not pay the buyer, notwithstanding receipt of notice to do so, if the agreement governing the payment intangible contains an otherwise-enforceable provision that limits the obligor's duty to pay a person other than the seller.

[112] Although a buyer of receivables of these types was not subject to the public notice requirements of Article 9 before Revised Article 9, a buyer might have been well advised to take some action to protect itself against adverse claims to the receivable by a third party. Generalization is difficult, as each state's law on the matter was typically obscure, with no uniformity. For example, in some states a later buyer (though not a lien creditor) might prevail over an earlier buyer unless the earlier notified the obligor on the receivable of his assignment. *See* 3 FARNSWORTH, *supra* note 69, § 11.9. Likewise, in some states a buyer of receivables of these types might be subject to the doctrine of *Benedict v. Ratner*, 268 U.S. 353 (1925) (which was abolished for transactions subject to Article 9 by U.C.C. § 9-205 (1962), carried forward to U.C.C. § 9-205 (2007)), and so find its interest subject to avoidance unless it obtained sufficient dominion over the assigned receivables. The dominion requirement has nothing to do with public notice of the assignment, however. *See* Kettering, *supra* note 1, at 1594–95.

The fact that a financing statement must be filed, or other perfection step taken, to perfect a security transfer of a payment intangible or promissory note, but not a sale, will be a standing inducement for bankruptcy trustees and others with a stake in defeating perfection to argue for recharacterization of sales of such items.[113] Prudent buyers should take that into account in judging whether to make precautionary filings. But that does not justify changing the orthodox recharacterization standard.

The last and least category of sale-distinguishing provisions in Article 9 are exclusions of various assignments of receivables from Article 9.[114] These exclusions relate to transactions that are not financing operations and which, for that reason, according to Grant Gilmore, no one would ever think of filing.[115] Fifty years of life under Article 9 have changed the legal culture, and one might question whether that justification is still valid, but there has been no outcry for modification of these exceptions and the revisers quite reasonably did not do so. To change recharacterization doctrine for the purpose of accommodating any of these minor provisions would let the tail wag the dog.

Hence there is nothing in the structure of Article 9 that provides a good reason for recharacterization of a sale of receivables to be governed by a standard different from the antiforfeiture principle from which the doctrine evolved.

C. The Irrelevance of Recourse to Recharacterization

If recharacterization of sales of receivables as secured loans is understood to implement the antiforfeiture principle, as previously discussed, the doctrine's proper application is much narrower than the application it has been given in many modern cases. Among other things, this understanding of the purpose of recharacterization punctures the notion that the seller's assumption of recourse on sold receivables is a reason for recharacterization. Recourse to the seller is irrelevant to recharacterization, for the existence of recourse has nothing to do with the existence of a potential forfeiture to the seller in the event of the seller's failure to perform as contemplated, and it is the latter that is the concern of the recharacterization doctrine.

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[113] For a notorious recent example, see NetBank v. Kipperman (*In re* Commercial Money Center, Inc.), 350 B.R. 465 (B.A.P. 9th Cir. 2006).

[114] These exceptions comprise the following paragraphs of U.C.C. § 9-109(d) (2007): paragraph (4) (sale of receivables as part of a sale of the business out of which they arose), paragraph (5) (assignment of receivables for the purpose of collection only), paragraph (6) (assignment of a right to payment under a contract to an assignee that is obligated to perform under the contract), and paragraph (7) (assignment of a single receivable in full or partial satisfaction of a preexisting indebtedness).

[115] 1 GILMORE, *supra* note 9, § 10.5, at 309. Gilmore was referring to the predecessor of these provisions as set forth in U.C.C. § 9-104(f) (1962); they were revised slightly in 1972 to essentially the form carried forward today, but Gilmore's observations remain applicable to the provisions as revised.

It follows that (for example) *Major's Furniture Mart, Inc. v. Castle Credit Corp.*,[116] which is regularly cited as a leading case on recharacterization of sales of receivables, was wrongly decided. In that case the court recharacterized a sale of receivables based all but exclusively on the existence of recourse to the seller, and the facts of the case did not implicate the antiforfeiture principle.

Major's Furniture Mart involved a furniture retailer, Major's, which sold to financier Castle a series of receivables consisting of installment sale agreements owed to Major by its retail customers. Each receivable was sold to Castle for its unpaid face amount, minus unearned interest, a discount of 15% (later increased), and a further 10% held by Castle, without interest, in a reserve account. Castle was not obliged to purchase any receivable unless it chose to do so. The sales were with full recourse to Major's, and that recourse was implemented by several overlapping terms of the purchase agreement: Major's warranted the timely collectibility of each receivable; Castle had the right to charge the reserve account for amounts not paid by an account debtor; and Major's was obliged to repurchase each defaulted receivable at a price equal to the balance due from the customer plus expenses, minus unearned interest. Major's was also required to repurchase the receivables in the event of a default in its part under the agreement. The receivables bore interest at rates higher than the discount, but the agreement between Major's and Castle did not provide for any rebate to Major's of any collections made by Castle in excess of the discount; absent repurchase, all collections on the receivables were Castle's. After two years of monthly sales under this arrangement, Major's ceased selling receivables to Castle and instead pursued the more profitable strategy of suing Castle, on the theory that each sale should be recharacterized as a loan by Castle to Major's secured by the receivables, in principal amount equal to the purchase price paid by Castle for the receivable, with interest, and that Major's was therefore entitled to collections received by Castle in excess of that amount.

The Third Circuit affirmed the trial court's summary judgment in favor of Major's, holding that the sales should be recharacterized as secured loans. Following the trial court, it based its conclusion all but exclusively on the recourse that Major's assumed on the receivables.[117] True to tradition, however, the court offered no theory of how to distinguish sale from secured transaction, and its opinion lacks coherence correspondingly: according to the court, recourse "without more will not automatically convert a sale into a security interest";[118] on the other hand, recourse is "the extremely relevant factor,"[119] upon which Grant Gilmore

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[116] 602 F.2d 538 (3d Cir. 1979), *aff'g* 449 F. Supp. 538 (E.D. Pa. 1978).

[117] 602 F.2d at 545–46 (quoting *Major's Furniture Mart, Inc.*, 449 F. Supp. at 543).

[118] 602 F.2d at 544. The court here suffered from the same linguistic confusion that later led to disaster in the *Octagon Gas* case, see *supra* note 90, in that the court erroneously treated the term "security interest" as a synonym for an interest that secures an obligation, overlooking the fact that Article 9 defines the term also to include the ownership interest in a receivable resulting from its sale. *See supra* note 11. However, in *Major's Furniture Mart*, unlike *Octagon Gas*, this linguistic confusion was merely incidental.

[119] 602 F.2d at 545.

"would place almost controlling significance."[120] Recourse was in fact dispositive, for the court cited no fact before it other than recourse as justifying recharacterization, aside from endorsing the trial court's very odd mention that at one point Castle had notified Major's that Castle would increase the discount for receivables sold in following months.[121] Neither the Third Circuit nor the trial court offered any suggestion as to why Castle's insistence on sweetening the pricing of future dealings in this way was more indicative of a secured loan than a sale, and of course it is not. In any event the court's sympathies plainly were with Major's, as the court's indignation at the severity of the terms of the deal to Major's is unmistakable.[122]

The court's holding was unjustified. The nonwaivable equity of redemption embedded in Article 9, and the recharacterization doctrine that defends it, overrides freedom of contract to the extent of preventing a party from enforceably agreeing to the economic equivalent of a strict foreclosure in the event that the party fails to carry out a contemplated performance. It is not a general warrant for relieving a party from the consequences of selling on hard terms. If, for example, the agreement between the parties required Castle, absent default by Major's in a specified performance, to pay over to Major's any collections in excess of the initial purchase price paid by Castle plus an agreed return, the transaction would have entailed a conditional forfeiture that would have justified recharacterization. But the facts of the case contained no hint of any such arrangement. When Major's conveyed a receivable to Castle, Major's parted with all interest in collections on the receivable, and Major's did not forfeit any interest in those collections as a result of any default-like event on its part.

The notion that recourse to the seller is a reason to recharacterize a sale of receivables as a secured loan dominated the thinking of the court in *Major's Furniture Mart* to the exclusion of virtually all else. The notion is by no means unique to that case. As previously noted, it is the most important single factor that can be drawn from the hodge-podge of the cases.[123] Even without the full-fledged theory of recharacterization advanced in this paper, however, there are good reasons to be suspicious of recourse as a basis for recharacterization. One is that Article 9 indicates that recourse, or at least some recourse, is not inconsistent with a true sale.

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[120] *Id.* at 545 n.12 (citing 2 GILMORE, *supra* note 9, § 44.4, at 1230).

[121] 602 F.2d at 546 (quoting 449 F. Supp. at 543). Castle was under no obligation to purchase any receivable, so it certainly had the right to cease to buy absent sweetening of the pricing if it chose. The agreement contained a clause prohibiting modification except in writing signed by all parties, but Major's chose not to argue that the sweetened pricing was unenforceable due to noncompliance with that clause, 602 F.2d at 541 (probably wisely, as the usual rule is that such clauses are unenforceable, at least when a party has relied on the oral modification, as Castle obviously did. *See* 2 FARNSWORTH, *supra* note 69, § 7.6.)

[122] This is particularly manifest in the numerical example the court worked out in 602 F.2d at 540–41.

[123] *See supra* note 18; *see also* STEVEN L. SCHWARCZ, STRUCTURED FINANCE § 4.2 (3d ed. 2002 & Supp. 2007) (recourse is "the most significant factor" in judicial analysis of recharacterization). Pantaleo et al., *supra* note 1, is exclusively devoted to analyzing the role of recourse in recharacterization (and, specifically, to denying that recourse, as ordinarily understood, should play any role).

Since its inception, Article 9 has contained provisions that assume that a true sale can exist notwithstanding the existence of recourse to the seller. Comments explicitly state the point as well.[124] In keeping with Article 9's reticence about true sale, the comments do not go so far as to say that recourse is irrelevant to recharacterization, but these are at least strong reasons for skepticism.

A second reason is the sheer prevalence of sales of receivables with full recourse. Every time a negotiable instrument is assigned, with the assignor indorsing the instrument (as would typically be necessary except in the case of a bearer instrument), by default the assignor is deemed to have guaranteed payment of the instrument.[125] So if recourse to the seller is a basis for recharacterizing a sale, then every routine assignment of a negotiable instrument by indorsement should be recharacterized—a wildly counterintuitive result.

Furthermore, the seller's assumption of recourse on a sold receivable is nothing more than a warranty about the performance of the item sold. The seller's assumption of recourse has powerful intuitive appeal as a basis for recharacterization at first blush, for by assuming recourse the seller bears the risk of nonperformance of the receivable, which is also the case for a borrower who borrows on the security of the receivable.[126] But that analogy is specious, for there is nothing unusual about a seller of property retaining the risk of nonperformance of the item sold. Any time that a seller sells an item, tangible or intangible, extending a warranty as to the item's performance, the seller is assuming the risk of the item's nonperformance. As a general matter the seller's extension of a warranty about the

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[124] The original version of Article 9 explicitly stated that in a sale of receivables, the seller-debtor would be liable for a deficiency if the security agreement so provided. U.C.C. §§ 9-502(2), 9-504(2) (1962). That explicit statement was not carried forward in the successor provisions of the current version, U.C.C. §§ 9-608(b), 9-615(e) (2007), but the drafters took care to state in the comments that no substantive change was intended because a sale with recourse can still be effected on the basis of the UCC's general allowance of variation by agreement (now codified in *id.* § 1-302). *Id.* § 9-608 cmt. 3 ("The parties are always free to agree that . . . an obligor is liable for a deficiency, even if the transaction is a sale of receivables."). The text of Revised Article 9 includes other provisions that make no sense if a sale with recourse cannot be a true sale. *See id.* § 9-207(d); *id.* §§ 9-601(g), 9-607(c). In the comments to the original version of the Article 9, the clearest statement that recourse is not inconsistent with a true sale was in U.C.C. § 9-502 cmt. 4 (1962) ("[Section 9-502(2)] recognizes that there may be a true sale of accounts, chattel paper, or contract rights although recourse exists."). In the current version, see U.C.C. § 9-607 cmt. 9 (2007) ("[I]f the secured party does have a right of recourse, the commercial-reasonableness standard applies to collection and enforcement even though the assignment to the secured party was a 'true' sale.").

[125] U.C.C. § 3-415 (2007) (indorser of negotiable instrument that has been dishonored is obligated to pay amount due on the instrument, unless the indorsement states it is made without recourse). A similar point was made by Pantaleo et al., *supra* note 1, at 160.

[126] That, in a loan secured by receivables, the credit risk of the receivables is borne by the borrower is true if the loan is with recourse to the borrower. If the loan is nonrecourse, the credit risk of the receivables may be borne in part or in full by the lender, depending upon the amount of the receivables, the amount of the credit loss thereon, and the amount of the loan. That the borrower does not necessarily bear the credit risk of receivables in every secured loan transaction is a further signal that there is something wrong with looking to which of seller or buyer bears the credit risk in a purported sale of receivables as a benchmark for recharacterization of the sale.

performance of the item sold has never been thought inconsistent with the nature of a transaction as a sale. Indeed, such warranties are often implied by law.[127] If a buyer buys an industrial motor, for instance, no one would dream of saying that the character of the transaction as a sale would change if the buyer, instead of buying "as is," obtains from the seller a warranty that the motor will perform to certain specifications for a stated period (perhaps equal to its useful life). A buyer of a receivable who obtains from the seller a warranty of its timely collectibility is in the same position as the buyer of the motor.[128]

Finally, commentators universally assume that a seller may sell a receivable with non-forward-looking warranties about the receivable's qualities, without upsetting sale characterization.[129] Most such warranties are extended because they bear on the likelihood that the receivable will be duly and timely collected, such as warranties that the receivable arises out of a transaction that has been fully performed by the seller, that the obligor on the receivable has no potential offsets against the seller, and that the obligor has a good credit history. There is no sensible reason to distinguish the ultimate warranty that the receivable will be paid in accordance with its terms from other warranties that tiptoe up to the point.

Why has the notion that recourse to the seller is a reason to recharacterize gotten such a grip on thinking on the subject? Part of the blame might be laid at the feet of Grant Gilmore, whose great treatise (which as we saw was quoted on this point by the court in *Major's Furniture Mart* and is similarly cited by other courts), repeatedly assumes without discussion that a sale with full recourse should be recharacterized as a secured loan.[130] But Gilmore was not alone among commentators of his day in making such an assumption.[131] And there was substantial support in the case law for that position at the time Gilmore wrote.

In 1959, shortly before Gilmore wrote and while the UCC was in the throes of enactment, Homer Kripke wrote an article addressing the distinction between a sale of receivables and secured lending against them.[132] Most then-current cases on the subject arose in the context of usury. Usury statutes commonly are written to apply to a "loan or forbearance" of money, and so do not apply to a sale of a receivable or other property, but do apply if the sale is recharacterized as a secured loan. Kripke observed that on the subject of recharacterizing a sale of receivables with recourse, two irreconcilable lines of cases had emerged that did not recognize each others'

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[127] *See, e.g.*, U.C.C. § 2-314 (2007) (warranty of merchantability implied in merchant's sale of goods).

[128] A similar point was made in Plank, *supra* note 23, at 339–43.

[129] *See, e.g.*, STANDARD & POOR'S, LEGAL CRITERIA FOR U.S. STRUCTURED FINANCE TRANSACTIONS 158 (2006); SCHWARCZ, *supra* note 123, § 4.2; Plank, *supra* note 23, at 306.

[130] 1 GILMORE, *supra* note 9, § 8.7, at 276; 2 *id.* § 44.4, at 1230. Plank, *supra* note 23, at 320–22, argues that the latter passage should not be so understood, but the passage, though unreasoned, is clear.

[131] *See* Marion Benfield, *Money, Mortgages, and Migraine—The Usury Headache*, 19 CASE W. RES. L. REV. 819, 870–71 (1968) (criticizing cases that hold usury laws inapplicable to recourse purchases of receivables and asserting that "recourse financing is indistinguishable from a loan").

[132] Homer Kripke, *Conceptual Obsolescence in Law and Accounting—Finance Relations Between Retailer and Assignee of Retail Receivables*, 1 B.C. INDUS. & COMP. L. REV. 55 (1959).

existence. One line involved recourse sale of short-term trade receivables, in which the account debtor is not notified of the sales. Led by the Supreme Court's 1916 decision in *Home Bond Co. v. McChesney*,[133] courts for decades steadily held that for usury purposes such sales should be recharacterized as secured loans. By contrast, recourse sales of receivables of other kinds, such as what we would today refer to as chattel paper and notes evidencing bank loans, were not recharacterized. Kripke could find no distinction between cases of the two kinds, aside from the nature of the underlying receivable.[134] The former line of cases obviously supports the notion that recourse is a substantial, and perhaps controlling, reason for recharacterization, at least if the other line of cases is ignored.

Kripke was content to describe these cases. We can go a step further and try to explain them. The reason why these cases drift from the theory of recharacterization set forth earlier in this paper is that they involve usury, and there is nothing in the policies underlying usury law that calls for distinguishing between a sale of a receivable and a loan secured by the receivable. Insofar as a usury statute is written to apply only to a loan of money, and hence not to a sale, that limitation is completely arbitrary. Usury is a paternalistic prohibition on the purchase of financing at a sufficiently bad price. If one accepts its premise, there is no reason why it should be limited to a bad price for financing in the form of a loan against a receivable and not also applied to a bad price for financing in the form of a sale of the receivable. The arbitrariness of the distinction is illustrated by the fact that some usury statutes are explicitly written to limit the yield that a buyer may receive from purchasing a receivable.[135] Given the arbitrariness of the limitation in the usury setting, and courts' evident difficulty in getting a firm grasp on the orthodox justification for recharacterization, it would be natural for courts in sympathy with the purpose of the usury statutes to recharacterize more liberally than is called for by the orthodox understanding. Candid courts have indeed

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[133] 239 U.S. 568 (1916).

[134] *See* Kripke, *supra* note 132, at 60–62. There are older cases, not mentioned by Kripke and by no means unanimous, holding that a transfer of a negotiable instrument by indorsement (and hence with recourse) for less than the legal rate of discount is usurious. *See* 2 JOHN W. DANIEL, A TREATISE ON THE LAW OF NEGOTIABLE INSTRUMENTS §§ 873–81 (Thomas H. Calvert ed., 7th ed. 1933). *See generally* H.D. Warren, Annotation, *Usury as Predicable upon Transaction in Form a Sale or Exchange of Commercial Paper or Other Choses in Action*, 165 A.L.R. 626 (1946); 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).

[135] The usury statute applicable to national banks has long been construed to limit the yield a national bank may receive from purchasing a receivable, even though the purchase is not a loan and does not violate applicable state usury laws. *See* National Bank v. Johnson, 104 U.S. 271 (1881) (construing Rev. Stat. sections 5197, now codified, with language unchanged in relevant part, at 12 U.S.C. § 85 (2006)); Daniel v. First National Bank, 227 F.2d 353, 357 (5th Cir. 1956), *reh'g denied*, 228 F.2d 803 (5th Cir. 1956). According to Kripke, writing in 1959, banks in most states were subject to comparable usury statutes applicable not only to "loans" but also to "discounts" and which therefore applied to sales of receivables. Homer Kripke, *Secured Transactions Financing the Seller*, 76 BANKING. L.J. 185, 192 (1959).

acknowledged the force of this dynamic in recharacterization cases.[136] And there certainly is no doubt that a seller's assumption of recourse on sold receivables makes the deal a harder one for the seller than would be the case otherwise.

Acceptance of the theory of recharacterization set forth in this paper does not necessarily compel the conclusion that cases of the *McChesney* line, which recharacterize sales of receivables for usury purposes largely on the basis of recourse, are simply wrong. The point may be more theoretical than practical, for usury statutes today are (as James White put it) a *trompe l'oeil*: an elaborate set of rules that have been so hollowed out by exceptions and preemptions as to be of small account even as to consumer credit, and as to business credit practically vestigial.[137] Insofar as the question remains a live one, a court could plausibly take the position that it might recharacterize the sale of a receivable for usury purposes only, even though the sale does not qualify for recharacterization under the orthodox standard embedded in Article 9. There is a long tradition in usury law of manipulating definitional concepts in order to render the usury statute applicable to transactions in which the courts perceive debtors to be in need of protection, and inapplicable to transactions in which the courts do not perceive such need. An example is the time-price doctrine, which holds that a sale of goods on credit is not a "loan or forbearance" to which an ordinarily-drafted usury law applies. Even critics have acknowledged that the time-price doctrine, though economically unreal, makes practical sense insofar as usury laws are conceived of as aimed at protecting a person who is in need of money from the dire consequences that may follow from his desperation to borrow, for few buyers of goods on credit are under a genuine compulsion to buy.[138] The same factor also plausibly explains the two irreconcilable lines of usury cases discussed by Kripke. The cases of the *McChesney* line, which did recharacterize, involved financing against trade receivables, and in the era when *McChesney* was decided such financing was widely perceived to be a last-ditch resource symptomatic of financial distress.[139] The users of that financing would be apt to be perceived as correspondingly in need of protection.

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[136] Thus, in *Reaves Brokerage Co. v. Sunbelt Fruit & Veg. Co.*, 336 F.3d 410 (5th Cir. 2003), discussed *supra* at notes 43–44, the court recharacterized a sale of receivables as a secured loan, and thereby deprived the financier who bought the receivables of a defense to which it otherwise would have had in a suit under the federal Perishable Agricultural Commodities Act by an unpaid seller of produce the resale of which had given rise to the receivables. The court took care to "emphasize that the distinction between purchase and lending transactions can be blurred . . . . We also stress that our decision is guided by the policies behind PACA, which mandate protection of suppliers of fresh fruit and other perishable commodities." *Id.* at 416 (internal quotation marks omitted).

[137] James J. White, *The Usury Trompe l'Oeil*, 51 S.C. L. REV. 445 (2000); *see also* Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 MINN. L. REV. 1110 (2008).

[138] *See* RENUART & KEEST, *supra* note 38, § 2.3.2.2, at 22; *see also* Benfield, *supra* note 131, at 846.

[139] *See* Kettering, *supra* note 1, at 1659–61 & nn.354–355.

Tax law has parted ways with commercial law in regard to characterization of a transaction as a sale or secured loan.[140] It would not be a surprise for usury law also to part ways with Article 9 on the subject. For courts to do so openly would be a healthier development than pretending that the characterization rulings in the usury realm have anything to do with the antiforfeiture principle upon which recharacterization was founded and that is embedded in the structure of Article 9.

III. NORMATIVE EVALUATION OF THE RECHARACTERIZATION DOCTRINE

Recharacterization of a sale as a secured loan is properly understood as a way of defending the principle of the debtor's nonwaivable equity of redemption in a secured loan. To ask whether the recharacterization doctrine is normatively justified is therefore equivalent to asking whether the nonwaivability of the debtor's equity of redemption in a secured loan is normatively justified.

For example, suppose that Borrower sells to Financier item P of property, worth $120, at a price of $100, with Borrower having an option to repurchase item P in a month's time for $101 (equal to $100 plus a month's interest), time being of the essence. If recharacterization were precluded, a court would enforce that transaction in accordance with its terms, with the result that Borrower would suffer the loss of the whole $120 value of item P if Borrower were unable to pay the exercise price of the repurchase option on the agreed date. Almost exactly the same substantive result would transpire if a court would enforce a secured debtor's agreement at the outset to strict foreclosure in the event of default. That is, Borrower would borrow from Financier $100 for a month on the security of item P, with Borrower agreeing at the outset that in the event of Borrower's default, Financier may retain item P in satisfaction of the debt, without accounting for any surplus. The two transactions are not identical, for the first but not the second puts Borrower at risk in the event of Financier's insolvency, but that risk can be minimized by having the Financier grant the Borrower a security interest in item P to secure the Financier's obligation under the repurchase option.

Because of the nonwaivability of the debtor's equity of redemption and the recharacterization doctrine that follows from it, neither of these transactions is enforceable if item P is personal property, so that Article 9 is the governing law; and neither is enforceable if item P is real estate, assuming that the general

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[140] For instance, a standard repo transaction, in which A sells a debt security to B and agrees to buy it back at a fixed price and time is treated as a loan from B to A for federal income tax purposes, see JAMES M. PEASLEE & DAVID Z. NIRENBERG, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS 72 (3d ed. 2001), but has been held consistently to be a true sale for bankruptcy purposes (at least among players in the capital markets). *See infra* note 163. The divergence between tax law and commercial law on characterization issues is by no means limited to true sale. On the subject of what constitutes a true lease, for instance, tax law has gone its own separate way to varying degrees over time, diverging greatly from commercial law in the 1980s when tax law recognized so-called "safe harbor leases" and "finance leases." For a brief history, see PETER K. NEVITT & FRANK J. FABOZZI, EQUIPMENT LEASING 32–41 (4th ed. 2000).

principles of mortgage law embodied in the *Restatement of Mortgages* are not displaced by anomalous quirks of a given state's law.[141] But why shouldn't a borrower—at least if a sophisticated business entity that knows what it is getting into—be allowed to contract on those terms if it is willing to do so?

Given its origin as an empire-building, fee-enhancing weapon wielded by medieval English equity chancellors in their low intensity war with the common law courts, it is not surprising that the nonwaivable equity of redemption lacks a justification that is obviously compelling. Traditionally two justifications have been offered: first, that it counterbalances the superior bargaining power of lenders against "impecunious landowners," and second, that it protects borrowers against their own misplaced optimism about their ability to satisfy their future obligations, which may lead them too lightly to accept the potential forfeiture.[142] Both have obvious weaknesses. As to the argument from bargaining power, the borrower has nothing to complain about so long as there is a competitive market in lending. A demand by one potential lender that the borrower waive the equity of redemption as a condition of lending can be met by the borrower opening negotiations with a less demanding competitor; and if the borrower's position is so weak that all potential lenders make the same demand, the borrower's position is not clearly improved by a bar on waiver of the equity of redemption, as lenders will extract their pound of flesh in other ways not legally restricted, such as a very high interest rate or a very low loan-to-value ratio.[143] The second justification, protection of borrowers against their own undue optimism, may have intuitive appeal as applied to consumers and other small fry, but it is hard to see why a sophisticated commercial entity should be considered to be in need of such paternalistic solicitude. Moreover, some empirical investigations cast doubt on the intuition that cognitive shortcomings justify nonenforcement of penalties even for parties that are not commercial sophisticates.[144]

Scholars who focus narrowly upon the equity of redemption, therefore, may be apt to write it off as an historical accident that is justified weakly or not at all. Grant Gilmore, for one, was of that opinion.[145] His observation that "a power of

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[141] In the real estate setting, some states may allow the equivalent of forfeiture of the debtor's equity of redemption in some circumstances through various devices. For example, some states give effect to an installment land sale contract used as a mortgage substitute, including a forfeiture clause therein allowing the vendor, upon the purchaser's default, to declare the contract terminated, retain possession of the land, and retain all of the purchaser's prior payments. *See* Grant S. Nelson, *The Contract for Deed as a Mortgage: The Case for the Restatement Approach*, 1998 B.Y.U. L. REV 1111, 1113; *cf.* RESTATEMENT, *supra* note 67, § 3.4 (precluding this device by declaring such contract to be mortgage). Likewise, strict foreclosure of mortgages may still be available in a few states. *See* 1 NELSON & WHITMAN, *supra* note 71, § 7.10.

[142] *See* RESTATEMENT, *supra* note 67, § 3.1 cmt. a; 1 NELSON & WHITMAN, *supra* note 71, § 3.1, at 34–37.

[143] *See* Marshall E. Tracht, *Renegotiation and Secured Credit: Explaining the Equity of Redemption*, 53 VAND. L. REV. 599, 612–13 (1999).

[144] *See* Larry A. DiMatteo, *Penalties as Rational Response to Bargaining Irrationality*, 2006 MICH. ST. L. REV. 883 (2006); Paul Bennett Marrow, *The Unconscionability of a Liquidated Damage Clause: A Practical Application of Behavioral Decision Theory*, 22 PACE L. REV. 27 (2001).

[145] *See* 2 GILMORE, *supra* note 9, § 43.2.

sale, coupled with a right to a deficiency judgment, can be harder on the debtor than strict foreclosure ever was"[146] indeed finds some confirmation in some early mortgage cases in which the debtor complained that foreclosure by sale benefited mortgagees and sought to have their financiers limited to a decree of strict foreclosure.[147]

Justification of the nonwaivable equity of redemption can be viewed as a special case of a broader question: is there a sound justification for the law's unwillingness to enforce an agreed-to penalty for breach of contract? The linkage between the two doctrines is not only functional but, as we have seen, historically rooted. There are differences between the forfeiture involved in enforcing a right of strict foreclosure in collateral and enforcement of a penalty clause in a contract. Among other things, enforcement of a penalty clause in a contract typically would involve a lawsuit, whereas a right of strict foreclosure against personal property (for instance) might be enforced by self-help. Furthermore, the secured transaction setting entails issues of priority as against other creditors that do not exist in the contractual setting. But those differences are sufficiently secondary that it is plausible to ignore them. So it is notable that system-building scholars have not succeeded in producing a justification of the doctrine against enforcement of contractual penalties that is markedly stronger than the traditional justifications specific to the equity of redemption.

Thus, for example, one school of contracts scholars justifies the enforcement of promises on moral grounds, specifically a Kantian vindication of individual autonomy: a person who is not able to bind himself by a promise is not wholly free. A leading exponent of that school, Charles Fried, claimed that this theory supports the award of expectation damages for breach.[148] But while vindication of a promisor's ability to bind himself calls for application of some remedy for breach, that principle does not determine what particular remedy is appropriate.[149] That must depend upon other values. If one gives great weight to the morality of promise-keeping, Fried's principle would support enforcement of penalties.

The most influential school of contract scholarship in the last three decades is based on economic analysis, and scholars of that school have generated a sizable literature exploring whether mandatory and nonwaivable rules of contract law in general, and the rule against enforcement of agreed penalties for breach in particular, is economically efficient. Most economically-influenced scholars today are of the view that the rule against enforcement of penalties is not economically

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[146] *Id.* § 43.2, at 1188.

[147] *See* Sheldon Tefft, *The Myth of Strict Foreclosure*, 4 U. CHI. L. REV. 575, 589 (1937), *quoted in* Tracht, *supra* note 143, at 607 n.25.

[148] CHARLES FRIED, CONTRACT AS PROMISE 17–21 (1981).

[149] *See* Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH. L. REV. 489, 514–20 (1989).

justified, at least as between reasonably sophisticated contracting parties.[150] That conclusion follows from basic principles of welfare economics: in a well-functioning market, a voluntary transaction that does not produce negative externalities increases efficiency because it makes the contracting parties better off and nobody else worse off, and a contractual penalty does not impose any obvious negative externalities. Discourse on the subject for the most part has taken the form of exploring progressively more refined possibilities of market failure that might negate this simple conclusion. Moreover, strictly speaking the question is not whether contractual penalties are efficient, but rather whether it is efficient to preclude parties from contracting into them. It is thus not sufficient to show that compensatory damages are efficient most of the time; one must explain why parties would choose to contract for an inefficient penalty if allowed to do so.[151]

Early literature sometimes took a different tack, tending to skepticism about penalties on the grounds that such a remedy may undesirably deter an "efficient breach"—that is, a breach that increases net social welfare. It was soon realized, however, that if renegotiation is possible, the efficient result would be reached by negotiation regardless of the damage rule, so such arguments had force only where high transaction costs preclude renegotiation.[152] In any case, arguments based on efficient breach are only doubtfully applicable to debts and other promises to pay money. Efficient breach assumes a situation in which welfare is increased by a promisor's redeployment of resources and payment of damages to the promisee in lieu of tendering the promised performance, and when the promised performance is

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[150] See, for example, Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 616–18 (2003), which builds on Aaron S. Edlin & Alan Schwartz, *Optimal Penalties in Contracts*, 78 CHI-KENT L. REV. 33 (2003) and Charles J. Goetz and Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977); and see Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428 (2004); Larry A. DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633 (2001). For a formal demonstration that if parties are symmetrically informed, courts cannot increase welfare by refusing to enforce contract terms, see Benjamin E. Hermalin & Michael L. Katz, *Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach*, 9 J.L. ECON. & ORG. 230 (1993). For an international perspective, see Aristides N. Hatzis, *Having the Cake and Eating it Too: Efficient Penalty Clauses and Civil Contract Law*, 22 INT'L REV. L. & ECON. 381 (2002) (arguing that civil law, which enforces penalty clauses when not grossly excessive, is more consonant with economic efficiency than the common law rule against penalties).

[151] *But cf.* Matthew J. Baker et al., *An Economic Theory of Mortgage Redemption Laws*, 36 REAL EST. ECON. 31 (2008) (explaining the right of redemption as a means of protecting landowners against loss of nontransferable values associated with their land, but not attempting to explain why the redemption right is legally mandatory).

[152] For a discussion of early literature on this subject, see Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 630 (1988).

itself the payment of money no such welfare-increasing redeployment is possible (except perhaps to the extent arising from a different time of performance).[153]

Market failures of various kinds have been postulated as a basis for declining to enforce agreed-to penalties.[154] A sophisticated argument advanced by Philippe Aghion and Benjamin Hermalin in 1990 forms the basis of the most sustained effort yet to justify economically the nonwaivability of the equity of redemption.[155] The Aghion-Hermalin analysis builds on the work of other economists who have shown that information asymmetries between the parties to a contract at the time it is negotiated (such as differing knowledge about the likelihood that a given party will default) can result in negotiation of a contract that is less efficient than would be negotiated if both had symmetric information. Aghion and Hermalin demonstrated that limitations on the enforceability of contract terms, including nonenforcement of agreed-to penalties, might improve efficiency in some circumstances in a world of asymmetrical information. Their demonstration centers on the role a penalty clause can play as a signaling device in such a world. The basic idea is as follows.

Suppose that party X is in the market to contract for a given performance. Potential promisors fall into two categories, high quality promisors who have a low risk of defaulting in the promised performance, and low quality promisors who have a high risk of default. Each promisor, but not X, knows the category to which the promisor belongs. In such a world, if penalties are enforceable, a high quality promisor may agree to pay a penalty upon default, in order to signal that it is of high quality. However, a low quality promisor, unwilling to be shut out, may be willing to mimic that signal. That in turn may induce the high quality promisor to offer to

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[153] This quite apart from other criticisms of condonation of efficient breach. *See, e.g.*, Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEG. STUD. 1 (1989) (arguing that condonation of "efficient breach" implies condonation of "efficient theft").

[154] *See, e.g.*, Craswell, *supra* note 149 (arguing that the economic case for overcompensatory remedies is problematic); Paul H. Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. LEG. STUD. 237 (1981) (arguing that penalty clauses create negative externalities, in that they create incentives to induce breach, thereby breeding litigation); Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WISC. L. REV. 351 (1978) (arguing that nonenforcement of penalties promotes efficiency if either party has the opportunity and incentive to induce the other party to breach). While it is unlikely that many people require a justification for nonenforcement of penalties against consumers, an ingenious economic justification is in Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEG. STUD. 283 (1995) (arguing that the social commitment to ameliorate poverty results in socialization of contractual losses incurred by individuals, and that contract law doctrines that preclude undue risk-taking by individuals are an appropriate way to limit such behavior).

[155] Philippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J.L. ECON. & ORG. 381 (1990). For a discussion placing the Aghion-Hermalin result in context with related results, see Benjamin E. Hermalin et al., *Contract Law, in* 1 HANDBOOK OF LAW AND ECONOMICS § 2.3.2, at 34–39 (A. Mitchell Polinsky & Steven Shavell eds., 2007). A simplified presentation of the Aghion-Hermalin model, written for readers who may have difficulty with the mathematical sophistication of the original, is at David Gamage & Allon Kedem, *Commodification and Contract Formation: Placing the Consideration Doctrine on Stronger Foundations*, 73 U. CHI. L. REV. 1299, 1368–79 (2006).

be subject to an even steeper penalty, and so on. The end result of this vicious spiral may find the high quality promisors undertaking to be subject to ruinous penalties upon default, for the purpose of distinguishing themselves from the low quality promisors (who might or might not still mimic their betters). Aghion and Hermalin demonstrated that the result that would follow from a legal regime that precludes such ruinous signaling, by not enforcing penalties in the first place, could be more efficient than the result would occur otherwise. Marshall Tracht later put this argument forward as a justification for the nonwaivability of the equity of redemption in real estate mortgages.[156]

Interesting though it is, the Aghion-Hermalin result does not justify nonenforcement of penalties. Even in the world of asymmetrical information to which it applies, it is only a possibility proof: it shows that there exists a set of factual parameters for which nonenforcement of penalties will increase welfare. Under the same model, for other sets of parameters, nonenforcement of penalties will reduce welfare.[157] Furthermore, the argument applies not just to remedial terms, but to all terms of a contract. Professor Tracht has argued that special focus on remedial terms makes sense because they are especially suitable for signaling, in that their cost is strongly correlated with the probability of default.[158] But many other contract terms are strongly correlated with probability of default, such as pricing and, in secured transactions, such matters as the loan-to-value ratio. Taking the Aghion-Hermalin argument seriously thus would imply enhanced judicial scrutiny for inefficiency of many important contract terms, not just remedial terms.[159]

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[156] Tracht, *supra* note 143, at 636–41. A similar argument is formalized in Lynn M. Fischer & Abdullah Yavas, *The Value of Equitable Redemption in Commercial Mortgage Contracting*, 35 J. REAL EST. FIN & ECON. 411 (2007).

In his article Professor Tracht asserted that late drafts of Revised Article 9 of the UCC, including the draft of April 6, 1998, would have allowed "commercial debtors" to waive the core protections of Article 9, including the equity of redemption. Tracht, *supra* note 143, at 604 & n.18. That is incorrect. Section 9-602(b) of the April 6, 1998 draft would have permitted waiver of the core protections of Article 9 only by an obligor (other than a consumer obligor). It did not permit waiver by the debtor—*i.e.*, the person who owns the collateral. The nonwaivability of the core protections of Article 9 by the debtor was explicit in section 9-602(a) of the April 6, 1998 draft and was noted in the reporters' notes to other drafts of Revised Article 9 containing this provision, such as the draft dated July 25–August 1, 1997. The drafters' brief flirtation with allowing commercial obligors to waive the core protections of Article 9 was aimed at guarantors and other secondary obligors. While not insignificant, it does not approach the far more radical notion of allowing the debtor to waive those protections. Drafts of Revised Article 9 referred to in this footnote are available at the University of Pennsylvania archive, *supra* note 105.

[157] *See* Eric A. Posner, *Economic Analysis of Contract Law after Three Decades: Success or Failure?*, 112 YALE L.J. 829, 860–61 (2003). Posner indeed sees this point as supporting a broad indictment of the ineffectuality of the economic approach to analysis of contract law. Even scholars who disagree with that indictment acknowledge his point about the indeterminacy of the Aghion-Hermalin result. *See* Hermalin et al., *supra* note 155, at 36–37.

[158] Tracht, *supra* note 143, at 640.

[159] *See* Posner, *supra* note 157, at 860–61.

The inertia of centuries of judicial unwillingness to enforce contractual penalties in general, and judicial zeal in defending the debtor's equity of redemption in particular, is not to be lightly overcome, even if the demonstration of the intellectual fragility of those doctrines were more definitive than it stands today. Renunciation of the equity of redemption has nonetheless manifested itself in some settings involving security interests in personal property, both by statute and by judicial action.

An example is pawnbrokerage. By ancient tradition, a pawn of goods is a nonrecourse loan by the pawnbroker to the customer, with strict foreclosure on the maturity date if the pledge has not been redeemed. The provisions of Article 9 previously discussed preclude that traditional practice. Under Article 9 a pawnbroker cannot compel strict foreclosure; the customer has the right to force a foreclosure sale.[160] Many states have enacted statutes for the benefit of pawnbrokers (some surprisingly recent) that trump Article 9 and divest the customer of its ownership interest in the pawned goods at the end of the redemption period.[161]

At the other end of the economic spectrum is the repurchase agreement, or "repo," in securities. In a typical repo transaction, repo seller S sells to repo buyer B a marketable security, commonly a U.S. Treasury or federal agency security, for cash, with the parties simultaneously agreeing that B will sell to S, and S will purchase from B, an equivalent security on an agreed future date and for an agreed price, typically equal to the price received by S in the initial sale, plus an amount equal to interest on that price from the date of the initial sale to the date of repurchase. Standard forms for such transactions typically provide that if repo seller S defaults, repo buyer B may sell the repo securities or retain them, applying the price received or their value as a credit against S's obligation to pay the repurchase price; and the forms typically do not require B to pay over to S any excess.[162] Such a transaction is the economic equivalent of a loan from B to S secured by the repo securities, and indeed a secured loan in which the secured party is in effect allowed to strictly foreclose on the collateral. Yet courts have been

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[160] *See* U.C.C. § 9-620(a)(1) (2007). *See also In re* Schwalb, 347 B.R. 726 (Bankr. D. Nev. 2006) (holding a pawnbroker liable for the substantial civil penalty provided for creditor misbehavior in consumer transactions by U.C.C. § 9-625(c) (2007) when the pawnbroker applied strict foreclosure in the traditional way, as warned on the pawn ticket, because Nevada law did not except pawn transactions from the ordinary rules of Article 9).

[161] ALA. CODE § 5-19A-6 (LexisNexis 1996); ARIZ. REV. STAT. ANN. § 44-1623 (2003); CAL. FIN. CODE § 21201 (West 1999); FLA. STAT. ANN. § 539.001 (West 2007); GA. CODE ANN. § 44-14-403 (2002); HAW. REV. STAT. § 445-134.15 (1993); KAN. STAT. ANN. § 16-714 (2007); LA. REV. STAT. ANN. § 37:1800 (2007); MINN. STAT. ANN. § 325J.06 (West 2004); MISS. CODE. ANN. § 75-67-311 (1972); MO. ANN. STAT. § 367.040 (West 1997); N.C. GEN. STAT. § 91A-9 (2007); OHIO REV. CODE ANN. § 4727.11 (LexisNexis 2006); OKLA. STAT. ANN. tit. 59, § 1511 (West 2000); OR. REV. STAT. § 726.400 (2007); S.C. CODE ANN. § 40-39-110 (1976); TENN. CODE ANN. § 45-6-211 (2007); TEX. FIN. CODE ANN. § 371.169 (Vernon 2006); WASH. REV. CODE ANN. § 19.60.061 (West 1999).

[162] The standard repo agreement form in the United States is the Master Repurchase Agreement (September 1996) prepared by the then Bond Market Association (now the Securities Industry and Financial Markets Association), of which Paragraph 11(d) deals with default.

remarkably willing to uphold parties' characterizations of such transactions as sales.[163]

Finding a coherent justification for that result has been a perennial issue since repos came to prominence. Jeanne Schroeder, who has written the fullest academic commentaries on the subject, advanced a justification based upon the metaphysical underpinnings of Article 9. She argued that Article 9 requires that a secured transaction have an identifiable *res* that constitutes collateral, that it is inconsistent with that principle for a secured party to have unbridled power to dispose of the collateral, and that, because standard forms of repo agreement typically give the repo buyer the power to dispose of the repo securities and return fungible securities, such repo agreements cannot qualify as secured transactions.[164] As I have noted elsewhere, however, that appealing argument fails to take into account the long and steady judicial position, strengthened still further by Revised Article 9, that a secured party's effective disposition of pledged securities by repledging them does not cause the transaction to cease to be a secured transaction.[165]

The cases rely on a simpler justification. Judge Debevoise, who in 1986 decided the leading case on characterization of repos, deferred to the characterization adopted by the parties because of the vast market that had evolved in the product in reliance upon that characterization.[166] Professor Schroeder, though approving Judge Debevoise's conclusion, spurned his reasoning, noting that it flouts long-established law to ignore substance and defer to form in characterization analysis.[167] That is quite true, but a principled case can be made for rejecting the traditional analysis in the repo setting, even if Judge Debevoise did not make that case in his opinion. The traditional characterization analysis is not a law of nature. It stems from the paternalistic decision that a debtor should not be allowed to contract into the potential forfeiture that would result if he gave his creditor an enforceable right of strict foreclosure. Recharacterization prevents that policy decision from being circumvented by the use of a different transactional structure. It is at least plausible to view participants in the wholesale repo market as being sophisticated enough to be in no need of that bit of state paternalism.

At least in the realm of personal property, it is not clear that financiers have much interest in imposing the forfeitures that would be permitted if the recharacterization doctrine were abandoned. For example, industry's preference for

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[163] For a summary of the authorities on the subject, see Kettering, *supra* note 1, at 1640–45. *See also In re* Am. Home Mtg. Holdings, Inc., 388 B.R. 69, 88–92 (Bankr. D. Del. 2008).

[164] Jeanne L. Schroeder, *Repo Madness: The Characterization of Repurchase Agreements Under the Bankruptcy Code and the U.C.C.*, 46 SYRACUSE L. REV. 999 (1996) [hereinafter *Repo Madness*] and Jeanne L. Schroeder, *A Repo Opera: How Criimi Mae Got Repos Backwards*, 76 AM. BANKR. L.J. 565 (2002) [hereinafter *Repo Opera*].

[165] Kenneth C. Kettering, *Repledge Deconstructed*, 61 U. PITT. L. REV. 45, 192–206 (1999).

[166] Cohen v. Army Moral Support Fund (*In re* Bevill, Bresler & Schulman Asset Mgmt. Corp.), 67 B.R. 557, 598 (Bankr. D.N.J. 1986). For a discussion of the case, see Kettering, *supra* note 1, at 1642–45.

[167] *See* Schroeder, *Repo Madness, supra* note 164, at 1010–16; *Repo Opera, supra* note 164, at 566, 569.

the repo structure over secured lending lies not in obtaining that forfeiture, but rather in avoiding the adverse consequences to a secured lender of the debtor's bankruptcy, such as inability to close out the transaction due to the automatic stay. Safe-harbor provisions of the Bankruptcy Code exempt broad categories of repos from the usual consequences of a bankruptcy proceeding, including the automatic stay, whether or not the repo qualifies as a true sale.[168] Those provisions undo the forfeiture, because they require a repo buyer who wishes to take advantage of them to remit to the bankrupt repo seller any excess of the value of the repo securities over the agreed repurchase price.[169]

The state anti-recharacterization statutes discussed in Part I.B of this paper likewise illustrate financiers' lack of interest in overthrowing the prohibition on contracting into a forfeiture. The anti-recharacterization statutes of the Delaware pattern, which are limited to sales of receivables in a securitization transaction, patently were not motivated by any desire to do transactions that impose a forfeiture for nonperformance; they are aimed solely at facilitating the bankruptcy and accounting treatment that is desired for securitization transactions. By contrast, the anti-recharacterization statutes of the Texas pattern, which are not limited to securitization transactions, do permit circumvention of the equity of redemption. But the comments of the statute's drafters show that such circumvention was no part of their purpose. Their stated purposes rather were to facilitate securitization and to avoid the usury risk that would arise from recharacterization.[170] The relationship of those purposes to circumvention of the equity of redemption is accidental: as we saw in Part II.C, courts have departed from an orthodox understanding of recharacterization in the usury setting; and as we will see in Part IV, it is doubtful that the determination that a sale is a true sale for nonbankruptcy purposes is conclusive for bankruptcy purposes in the securitization setting, for reasons of bankruptcy policy that have nothing to do with the policies underlying the equity of redemption. So, ironically, while the one thing that the Texas-pattern statutes clearly enable is the doing of deals that are economically equivalent to secured loans that circumvent the equity of redemption and permit the debtor to suffer the resulting forfeiture, it is by no means clear that financiers have any interest in doing such deals.

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[168] *See* Bankruptcy Code § 101(47) (defining "repurchase agreement"); *id*. § 362(b)(7) (exempting setoff and remedies against collateral from the automatic stay); *id.* § 546(f) (insulating most pre-petition transfers from avoidance); *id*. § 559 (enabling close-out in bankruptcy). Not all repos will qualify for the protection of these provisions, although the 2005 amendments expanded their reach considerably (so much so that, for example, mortgage warehouse lenders have taken to redocumenting their loan agreements as repurchase agreements because the 2005 amendments extended the reach of these provisions to repos of mortgage loans).

[169] *See id*. § 559.

[170] *See* TEX. BUS. & COM. CODE ANN. § 9.109, State Bar Committee Comment 2 (Vernon 2002).

IV. RECHARACTERIZATION IN BANKRUPTCY IN THE SECURITIZATION SETTING

Recharacterization of sales of receivables is important today because avoidance of recharacterization is critical to the success of the securitization structures widely used to obtain financing against receivables. The issue that matters to securitization is not the primal question of recharacterization under state law discussed in Part II, however. Rather, it is the question of recharacterization for purposes of the Bankruptcy Code. The securitization industry has relied upon the equivalence of the legal standard for recharacterization in those two settings. That reliance is dubious. A court so inclined has powerful reasons to conclude that a receivables sale in a securitization ought to be recharacterized for bankruptcy purposes even though the sale does not qualify for recharacterization under state law.

Consider the elements of a prototypical securitization transaction.[171] Such a transaction begins with an Originator that wishes to procure financing against assets that it owns, commonly receivables (of which it usually is the originator, hence the nickname). The Originator forms a subsidiary, conventionally referred to as a "special purpose entity" or "SPE," whose operations are limited to those required in connection with the financing. This SPE is "bankruptcy remote," in the sense that it is created subject to an array of constraints designed to eliminate, to the extent possible, any risk that the SPE might become subject to a proceeding under the Bankruptcy Code.[172] After the SPE is formed, the Originator conveys the receivables that it wishes to securitize to the SPE. The SPE then either borrows directly (commonly by issuance of debt securities), or transfers the receivables to a trust to borrow on behalf of the SPE. The proceeds of the borrowing are returned by the SPE to the Originator as payment for the receivables transferred to the SPE (insofar as the transfer was a sale) or as dividends (insofar as the transfer was a capital contribution).

The result is economically the same as a nonrecourse loan by the financiers to the Originator on the security of the receivables. But the securitization structure frees the financiers from the burdens—usefully denoted by the shorthand "Bankruptcy Tax"—that the Bankruptcy Code would place upon a direct secured

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[171] For further elaboration on this prototypical structure, see Kettering, *supra* note 1, at 1564–66.

[172] A direct waiver by the SPE of its right to file a bankruptcy petition would be unenforceable (and in any case would be of no avail against other means of entering bankruptcy, such as an involuntary petition). The possibility of the SPE entering bankruptcy is instead countered by a combination of stratagems, typically along the lines of the following: (a) voluntary bankruptcy is countered by provisions in the SPE's organic documents requiring unanimous vote of the SPE's board of directors to authorize a bankruptcy filing, and requiring one or more members of the board to be independent of the Originator; (b) involuntary bankruptcy is countered by provisions in the SPE's organic documents authorizing it to engage only in activities necessary to the securitization transaction and by obtaining waivers of the right to file an involuntary petition from third parties who deal with the SPE; (c) substantive consolidation with the Originator is countered by covenants requiring the SPE to comply with proper corporate formalities, to avoid commingling its assets with those of the Originator, and otherwise to avoid actions that would permit the invocation of any of the usual grounds for substantive consolidation.

lender to the Originator if the Originator later goes bankrupt. Those burdens would include (i) the cessation of post-petition payment of the financiers' debt,[173] (ii) the stay of any remedies the financiers otherwise would be entitled to exercise against the receivables,[174] and (iii) sufferance of the power of the Originator, as debtor in possession, to use the proceeds of the receivables so long as the financiers' interest in the receivables is adequately protected.[175] If the Originator has financed its receivables through securitization, and later goes bankrupt, the securitization financiers will be unaffected by the event if the structure of the financing is respected by the bankruptcy court. Relieving the financiers of the Bankruptcy Tax is the purpose of the securitization structure.[176]

For the structure to achieve its purpose, the conveyance of the receivables from Originator to the SPE must remove the receivables from the estate of the Originator in the event of the Originator's subsequent bankruptcy.[177] If a contest on the subject arises, the challenger in all likelihood would be the Originator, as debtor in possession, whose goal it would be to have the receivables be declared to be property of its estate, thereby entitling it to use cash collected from the receivables so long as the interest of the financiers (through the SPE) is adequately protected. As with any contest over use of cash collateral, the Originator's failure to obtain use of the cash conceivably might spell the difference between a successful reorganization and a failed one.

Property is subject to the Bankruptcy Tax if it constitutes property of the debtor's bankruptcy estate, and the black-letter rules that the Supreme Court has laid down in interpreting that concept reflect a certain ambivalence about the respective roles of federal and state law. On one hand, what constitutes property of the estate is ultimately a federal question, at least in the sense that state-law labels do not govern whether a particular interest is "property."[178] On the other hand, the substantive attributes of property rights are defined by state law, unless a federal

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[173] This follows from the rules on when and how distributions are made under the different chapter proceedings, *e.g.*, Bankruptcy Code §§ 726, 1123, and from *id*. § 549, which provides for avoidance of unauthorized post-petition transfers.

[174] *Id*. § 362.

[175] *Id*. § 363.

[176] For a more detailed discussion of the Bankruptcy Tax and securitization's purpose as a device through which financiers may evade it, see KETTERING, *supra* note 1, at 1564–80. The useful shorthand "Bankruptcy Tax" was coined in David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055, 1064 (1998).

[177] "Property of the estate" is defined in Bankruptcy Code § 541, the core provision of which, § 541(a)(1), states that, in general, the term includes "all legal or equitable interests of the debtor in property as of the commencement of the case."

[178] *See* Bd. of Trade of Chi. v. Johnson, 264 U.S. 1 (1924) (holding debtor's membership on the Chicago Board of Trade to be property of the debtor's bankruptcy estate, even though not to be considered property under applicable state law; further holding that the estate took the membership subject to restrictions on further transfer that were valid under state law).

interest requires otherwise. The latter point is commonly associated with *Butner v. United States,*[179] which offered the following much-cited passage in justification:

> 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. Uniform 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."[180]

The essence of this is discouragement of what the court refers to as "forum shopping"—that is, awarding different property entitlements in bankruptcy than outside of bankruptcy. "Prevention of a windfall" is merely a different way of stating the same point. "Reduction of uncertainty" also amounts to the same point if interpreted as referring to the component of uncertainty that would be added to commercial relationships if property entitlements might change depending upon whether evaluated inside or outside a bankruptcy proceeding. "Reduction of uncertainty" makes little sense if interpreted otherwise, for application of a uniform federal rule to allocate a given property entitlement in bankruptcy would make for less uncertainty of result than application of the differing laws of each applicable state.

Conventional wisdom in the securitization industry interprets this as meaning that the rules for recharacterization of a receivable sale for bankruptcy purposes are the same as the rules for recharacterization under state law.[181] That is, a receivable that an Originator has sold to an SPE before the Originator's bankruptcy should not be treated as part of the Originator's bankruptcy estate unless the sale should be recharacterized as a secured loan under state law. *Butner*'s reservation that a different result would be warranted if "some federal interest" so requires is dismissed as irrelevant, for lack of any federal interest. The critical question in this regard, according to the conventional wisdom, is whether promotion of the Originator's reorganization—a reorganization that conceivably might fail if the

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[179] 440 U.S. 48 (1979) (holding that a mortgagee of North Carolina real estate did not have a right to post-petition rents because mortgagee failed to comply with the conditions of North Carolina law for establishment of such a right, and rejecting the view that such a right should be imposed as an independently-created federal rule of equity).

[180] *Butner*, 440 U.S. at 55 (citation omitted). In the interests of brevity and conformity to the Court's usage in *Butner*, I generally will use the phrase "state law" rather than "nonbankruptcy law" when referring to the law that allocates a property right outside of bankruptcy. The latter phrase is more accurate, as federal law or foreign law might sometimes govern.

[181] A cogent statement of the conventional wisdom in the securitization industry on the application of *Butner* to securitization is in Pantaleo et al., *supra* note 1, at 182–89.

Originator is denied the use of the cash collateral that would result from recharacterization—should be considered a federal interest sufficient to warrant the creation and application of a federal rule of recharacterization, more favorable to the Originator than the state law rule. The conventional wisdom holds that promotion of the Originator's reorganization does not qualify as such a federal interest.

This touches one of the principal fault lines of bankruptcy policy. Douglas Baird has observed that scholars of business bankruptcy generally fall into two categories, which he dubbed the "proceduralists" and the "traditionalists."[182] For a proceduralist, the baseline principle of adherence to state law set forth in *Butner* is not just a rule that defines property of the debtor's estate, but is the central organizing principle of bankruptcy law. To the proceduralist, the purpose of bankruptcy law is no more and no less than to solve the collective action problem that would arise if creditors were allowed to pursue a distressed debtor's assets separately, destroying the valuable synergies that may exist when particular assets are held and operated together, and multiplying collection expense. As such, bankruptcy law should be viewed as a procedural mechanism that, by alleviating this collective action problem, provides a comparatively efficient method of debt collection. Substantive entitlements need not and should not be altered in bankruptcy, unless some specific policy of bankruptcy law requires such alteration. Preservation of a bankrupt firm, in particular, is not an independent good that justifies altering state-law entitlements.

Traditionalists are defined less by adherence to any single clearly-defined competing paradigm than by contrast to proceduralists. In general, traditionalists are much more willing than proceduralists to override state-law entitlements in bankruptcy, being more concerned with the interests of the parties before the bankruptcy court than the adverse effect such shifting of entitlements would have on parties' incentives to deal with each other before bankruptcy. Traditionalists believe that preservation of distressed firms (and the jobs and other community effects associated with such preservation) is an important goal of bankruptcy law, independent of collection of creditors' claims, and as such justifies more or less extensive modification of state-law entitlements.

A traditionalist may require little encouragement to conclude that furtherance of an Originator's reorganization is a federal interest sufficient to justify the creation

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[182] *See* Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573 (1998). Proceduralism had its inception in the "creditors' bargain" theory of bankruptcy, originated in Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982), which posits that bankruptcy is the system to which creditors would have mutually agreed had they been in a position to bargain on the matter before extending credit. Proceduralist principles are not, however, necessarily linked to acceptance of the creditors' bargain theory. For a proceduralist account founded upon the incoherence of other perspectives and explicit linkage to civil procedure, see Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931 (2004).

and application of a federal rule of recharacterization to the sale of receivables by the Originator to the SPE. A proceduralist would reject that conclusion and endorse the conventional wisdom of the securitization industry, holding that furtherance of the Originator's reorganization does not amount to a federal interest that justifies trampling on the property rights in the receivables established by state law. And as a matter of positive law, the Bankruptcy Code generally does afford, and where unclear generally has been interpreted to afford, great respect to legal entitlements under state law.[183]

The problem for the securitization industry is that, even if one agrees with the proceduralists that furtherance of the Originator's reorganization does not in itself justify recharacterization of a receivables sale that state law would not recharacterize, a strong proceduralist case nevertheless exists for recharacterization. *Butner*, like the proceduralist program as a whole, contemplates respect for state-law entitlements unless a specific bankruptcy policy justifies departure from it. The bankruptcy policies that would justify recharacterization of the receivables sales in a securitization transaction are the Bankruptcy Tax and the strongly rooted policy that a debtor's pre-petition waiver of the benefits of bankruptcy law is unenforceable. Congress explicitly imposed the Bankruptcy Tax on secured financing to assure, among other things, that the debtor would have the right to use cash proceeds of the collateral, overriding the financier's state-law entitlement to the contrary, so long as the financier's interest is adequately protected. Congress did so in a legal environment that took for granted that a debtor's pre-petition waiver of the rights given to debtors by bankruptcy law is unenforceable. The securitization structure has no purpose and no substantial effect other than to effect a waiver of the Bankruptcy Tax that would be unenforceable if effected directly. If the pre-petition nonwaivability of a debtor's rights under bankruptcy law is an important bankruptcy policy, it would be incoherent to respect a transaction structure that has no purpose or substantial effect other than to implement such a waiver. Hence recharacterization can be justified as preventing circumvention of the nonwaivable Bankruptcy Tax. Moreover, recharacterization is by no means inequitable to the SPE against which the recharacterization is asserted, for the SPE is no ignorant innocent; the whole object of the SPE's existence is to effect this evasion of the

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[183] *See, e.g.*, Travelers Cas. & Sur. Co. v. Pac. Gas & Elec. Co., 549 U.S. 443 (2007) (creditor not precluded from filing unsecured claim for contractual attorney fees recoverable under state law, notwithstanding that the fees were incurred in litigating issues of bankruptcy law); BFP v. Resolution Trust Corp., 511 U.S. 531 (1994) (low-price pre-petition foreclosure sale of debtor's property cannot be avoided under Bankruptcy Code's integral fraudulent transfer provision, so long as all requirements of state foreclosure law were complied with); Nobelman v. Am. Sav. Bank, 508 U.S. 324 (1993) (Bankruptcy Code does not give individual debtor the power to reduce undersecured homestead mortgage to the value of mortgaged residence, in contravention of state law). In a similar vein, for a powerful proceduralist defense of Revised Article 9 against traditionalist attack, see Harris & Mooney, *supra* note 93, at 86–97.

Bankruptcy Tax.[184] Nor would recharacterization expropriate the SPE, for it would be entitled to adequate protection of its interest in the recharacterized receivable.

Securitization's structural waiver of the Bankruptcy Tax is a conflict with bankruptcy policy that could be policed by several different doctrines. I have noted elsewhere the potential applicability of fraudulent transfer law and substantive consolidation; recharacterization of the Originator's sale of the receivables to the SPE is one more alternative.[185] Functionally, recharacterization would operate like an avoiding power, but it would have procedural advantages over fraudulent transfer law for a bankrupt Originator that seeks to collapse a securitization to which it was party, such as not being limited by a statute of limitations.[186]

The volume of transactions involving securitization of receivables has grown to vast figures since the product was developed in the 1980s. I have argued that the product has shown itself to be desirable and should be congressionally validated.[187] The very small number of reported cases in which a bankrupt Originator has sought to collapse a pre-petition receivables securitization to which it is party strongly suggests that the Bankruptcy Tax is of minimal value to bankrupt Originators as applied to securitized receivables. By contrast, escape from the Bankruptcy Tax is highly valued by financiers, for such escape (which the market assumes is possible through securitization structures, as rating agencies rate securitized debt on that assumption) means that payments on the securitized debt will not be interrupted by the Originator's bankruptcy, resulting in a rating of the securitized debt that is independent of and commonly much better than the Originator's own credit rating. Allowing debtors to offer that much-valued benefit to financiers, and thereby reap the benefit of commensurately lower interest rates, in exchange for yielding a little-valued potential Bankruptcy Tax in a hypothetical future bankruptcy, is good policy.

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[184] For further elaboration of these points, see Kettering, *supra* note 1, at 1564–80.

[185] *See id.* at 1581–1632.

[186] Professor Plank has argued that it would be outside federal power under the Bankruptcy Clause to recharacterize a sale of receivables if it would not be recharacterized under nonbankruptcy law. *See* Plank, *supra* note 28, at 1727. I disagree. His own theory that a "non-expropriation" principle would be violated by such recharacterization contemplates an exception permitting federal adjustment of third-party entitlements that interfere with the bankruptcy process. *See id*. at 1727–28. The point of the securitization structure is to free the financiers of the Bankruptcy Tax to which they would be subject in the Originator's bankruptcy had the financing been done as a direct secured loan to the Originator. Furthermore, as he acknowledges, his "non-expropriation" principle would imply the unconstitutionality of, among other things, the federal law permitting avoidance of fraudulent transfers in bankruptcy, which has been part of federal bankruptcy law since 1898. *See* Thomas E. Plank, *Bankruptcy and Federalism*, 71 FORDHAM L. REV. 1063, 1103–04 & n.152 (2002). (Plank would allow a federal power to avoid a constructively fraudulent transfer, on the ground that the recipient of such a transfer is or should be on notice that he is giving less than reasonably equivalent value for what he is receiving. But by the same token, the SPE is on notice that the object of the securitization structure is to avoid the Bankruptcy Tax.) *See also* Mann, *supra* note 59, at 1825 n.112 (noting his disagreement with Plank on this point on other grounds).

[187] *See* Kettering, *supra* note 1, at 1716–27.

Even if a court is sympathetic to these arguments about the normative desirability of receivables securitization, however, it is by no means clear that they would persuade the court not to collapse the securitization. Such arguments are doubtfully within the institutional competence of a court. They amount to saying that the Bankruptcy Tax is a bad idea as applied to receivables. But rightly or wrongly Congress imposed it; and the pre-petition nonwaivability of a debtor's rights under the Bankruptcy Code is so deeply engrained as to be all but axiomatic.

Furthermore, the same structural evasion of the Bankruptcy Tax that is applied to receivables might be applied to any asset, but the normative desirability of thus securitizing assets other than receivables is doubtful. An important purpose—to a proceduralist, the only purpose—of bankruptcy is to avoid the loss of value consequent to the disruption of synergies that may occur if creditors are allowed to dismember a debtor's assets piecemeal. Allowing the Bankruptcy Tax to be evaded as to an asset, whether by direct waiver or by a structural substitute as in securitization, by definition allows just such dismemberment to the extent of that asset. It is plausible to suppose that the value of a receivable is not significantly dependent upon its owner, and so no significant value is lost by allowing the Bankruptcy Tax to be evaded as to receivables. But the same supposition cannot plausibly be made as to other assets. Yet if the securitization structure works for receivables, it would work for any other assets, thereby allowing a debtor to offer any of its assets to dismemberment by creditors without hindrance by a bankruptcy court. Non-receivables securitization transactions are occurring and advocates of securitization have indeed gloried in the applicability of the structure to assets of any kind.[188] Even if a court is persuaded that receivables securitization is normatively desirable, a court should have grave reservations about embracing a legal theory that would allow such a complete evisceration of bankruptcy's purpose. Congress can amend the Bankruptcy Code to relieve receivables financings of the burdens of the Bankruptcy Tax, but under the Bankruptcy Code as it currently stands it is hard to see how a court could validate a receivables securitization without also validating the financing, free of the burdens of the Bankruptcy Tax, of inventory, equipment, intellectual property, or indeed any or all of a debtor's assets.

Nevertheless, a lawyer obliged to write a reasoned opinion of the kind required by rating agencies in securitization transactions, to the effect that the Originator's sale of receivables would be respected as a true sale by the Originator's hypothetical future bankruptcy court, can sleep soundly. That is because the lawyer can be reasonably confident that, if the Originator does go bankrupt, in all probability it will not elect to go to war with its securitization financiers, but instead will employ less contentious ways to obtain cash, such as debtor-in-possession financing. And in the unlikely event that the Originator does seek to collapse its securitization, in all probability its bankruptcy court will decline to accept the responsibility for the

[188] For further elaboration on the applicability of securitization to assets of any kind, and the consequences of that fact, see Kettering, *supra* note 1, at 1723–27.

downgrades of trillions of dollars of outstanding securitized debt that would follow a definitive holding that the securitization structure does not work. These are not legal arguments, but it is always better to have the facts on one's side than the law.

CONCLUSION

True sale, unlike true love, does not justify itself. The reason for recharacterizing a sale of receivables for purposes of Article 9 differs from the reasons that apply for the purpose of determining the applicability of a usury statute, and both differ from the reasons that apply for the purpose of determining whether the receivables should be treated as part of the seller's subsequent bankruptcy estate. It is not surprising that when the purpose of recharacterization in a given setting is forgotten or ignored and a court instead relies on intuition to decide whether a sale should be recharacterized, the result is the incoherence that now prevails. The course of true sale never did run smooth.