Asset Class, Solvency, and Efficiency of Asset Securitization
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17 April 2005

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I. INTRODUCTION

Despite the damage caused by the recent Enron scandal[1], the asset securitization market has been vibrant and has become a popular financing alternative[2]. A number of academics emphasize its merits and suggest that it is a more favorable way of financing, and Congress's proposal to make sales of asset in securitization immune from characterization as secured transactions under the Bankruptcy Reform Act of 2001[3] (the "Reform Act") almost materialized when the Enron scandal hit the scene. Conversely, there have been accusations that securitization is not a legitimate way of financing because, for example, it fosters fraudulent transactions.

Why are there such divergent views? This divergence may derive from the all-encompassing definition of "securitization." Securitization transactions, while possessing certain common characteristics, cover a wide variety of asset classes and structures[4], and confusion arises when addressing the subject without attention to nuances.[5] This paper attempts to show that securitization is not necessarily "efficient" when the originator becomes financially distressed and the securitized asset was a type of asset the unsecured creditors do not expect to be subject to securitization.

Section II defines the term "efficient." Section III talks about a debtor's financial status at the time of securitization transaction. Financially distressed companies have a tendency to overinvest[6] and this could cause "inefficiency." Section IV discusses the impact of asset classes on securitization, focusing on the difference between traditional and non-traditional securitization assets. "Inefficiency" with respect to the former asset class may eventually fade out but it will persist for the latter. Section V discusses the implications of securitization not always being "efficient."

a. <u>Defining Securitization</u>

Securitization is a structure in which a special purpose vehicle (SPV) is created and securities collateralized by the SPV's asset are issued to the investors.[7] The SPV may take a form of a regular corporation, partnership, or a trust. Depending on the form of the SPV, the securities may be bonds or certificate of beneficial interest. Unlike corporate bonds where investors look to the creditworthiness of the entire company asset back securities (ABS) investors rely primarily on the creditworthiness of the SPV's assets to secure their investments.[8]

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[1] *See In Re* Enron, 235 F.Supp2d 549. *See also* Steven L. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. Cin. L. Rev. 1309 (2002) [hereinafter Schwarcz, *Enron & SPV*]; Steven L. Schwarcz, *Securitization Post-Enron*, 25 Cardozo L. Rev. 1539 (2004) [hereinafter Schwarcz, *Post-Enron*].

[2] *Big Rise in ABS Issuance*, Fin. Times, Feb. 17, 2005.

[3] Bankruptcy Reform Act of 2001, S. 220, 107th Cong. § 912 (2001); H.R. 333, 107th Cong. § 912 (2001).

[4] *See* STANDARD & POOR'S, LEGAL CRITERIA FOR STRUCTURED FINANCE TRANSACTIONS, April, 2002.

[5] *See* Lois R. Lupica, *Asset Securitization: the Unsecured Creditor's Perspective*, 76 Tex. L. Rev. 595 (1998); Schwarcz, *Post-Enron*, *supra* note 1.

[6] *See id.*, 1555-1563; Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure,* 3 Journal of Fin Econ. 305-360 (1976).

[7] STEVEN L. SCHWARCZ, STRUCTURED FINANCE, §1 (Adam D. Ford ed., Practising Law Institute 2003) [hereinafter SCHWARCZ].

[8] *Id.*

The securitization process starts with the sale of the asset, typically mortgages, credit card receivables, auto loans, equipment purchase loans, or student loans from the originator to the SPV.[9] The SPV funds this sale via non-recourse loan and equity investment.[10] The sale is carefully structured to be a "true sale,"[11] ensuring that the originator does not retain the asset's risk-return excessively and that fair value is received by the SPV in exchange for the asset.[12] If the "true sale" threshold is not met with the result that the sale is recharacterized as disguised secured lending, the asset enters the originator's estate and causes automatic stay to apply in the event of the originator's bankruptcy.

The SPV is structured to be "bankruptcy remote."[13] In other words, measures are taken to prevent the SPV from going into voluntary or involuntary proceedings. The articles of incorporation for the SPV specify the scope of its operation. The articles typically specify that the operation's scope is limited to an administrative function and that nothing more can be undertaken by the SPV.[14] Typically the SPV limits itself to collecting the receivables, keeping the non-asset-related risk of its bankruptcy to minimal. This also limits the number of trade creditors and thereby reduces the chances of involuntary bankruptcy.[15] The articles may also specify that the SPV require a vote from at least one independent director of the board in order to file a voluntary bankruptcy. Measures are taken to prevent "substantive consolidation" of the SPV and the originator as well.[16] Courts substantively consolidate two entities if they find that the two entities' structures and operations suggest they are actually one.[17] If the SPV is consolidated into the originator when the originator goes into bankruptcy, the SPV's assets enter the originator's estate. Therefore, typical SPV transactions are structured to provide separate bookkeeping for the activities of the originator and the SPV, to avoid any duplicative service, violation of the SPV corporate form, an overlap in the board of directors of both entities, and to strictly limit the originator's involvement with the transferred asset.

Once the asset is transferred to the SPV, the SPV (or another SPV created by that SPV) issues new securities backed by the asset as collateral. These securities are called ABS and purchasers of these securities are ABS investors.

b. Enron's Use of the Special Purpose Vehicle

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[9] *See* STANDARD & POOR'S, STRUCTURED FINANCE: RATINGS TRANSACTIONS 2002, Jan. 31, 2003.
[10] *See* OKAUCHI KOUSAKU, SHOUKEN-KA NYUMON [Introduction to Securitization], §2 (Nippon Keizai Shinbun Sha 2003 (1997).
[11] SCHWARCZ, *supra* note 5, §4.
[12] *Id.*
[13] *Id.*§3.
[14] *See id. §3:2.1.*
[15] *See id. §3.3.*
[16] I will hereinafter call the legal risk of the SPV pertaining to the originator's bankruptcy, namely the risk of true sale recharacterization, the voluntary/involuntary bankruptcy filing risk of the SPV, and the substantive consolidation risk collectively as the "weak link" risk.
[17] *See id. §3.4.* The author lists factors typically given weight by the court in a substantive consolidation case.

Enron used the SPV for purposes of double-dealing and hiding debt.[18] Basically, Enron transferred its debts to SPVs and solicited investors by committing to pledge its own shares sufficient for repayment.[19] This constituted self-dealings because Enron treated the SPVs as separate entities for accounting purposes, while they did not have legally required 3% third-party equity investment. Although the structure has an SPV as a component, the transactions here are not securitization because the investors' risk-return exposure was not only to the SPV's assets but also to the guarantee by the originator in the form of share pledging. This paper does not address Enron-style non-securitization SPV transactions.

II. DEFINITION OF "EFFICIENT" SECURITIZATION

This paper adopts Kaldor-Hicks efficiency standard. Kaldor-Hicks efficiency is found in the context of securitization when "the aggregate benefit to the parties to the securitization exceeds any net harm to other parties."[20] As the only "parties susceptible to being made worse off are the originator's unsecured creditors",[21] a securitization transaction is "efficient" under this theory if the benefit to the originator and the ABS investors exceeds net harm to the originator's unsecured creditors.[22] This is the definition used in Professor Schwarcz's *Securitization Post-Enron*,[23] which will be discussed in the following sections.

III. SOLVENCY

The financial status of the originator <u>at the time of the securitization transaction</u> impacts the nature of the transaction immensely. Some commentator dismisses this nuance by arguing it is unlikely that financially distressed companies engage in securitization.[24] But there is evidence that suggest the contrary. I would like to discuss this evidence first and then examine how the financial status of the originator could be a distinguishing factor of "efficient" and "inefficient" securitization.

a. <u>Use of Securitization by Financially Distressed Companies</u>

There are three reasons to believe that financially distressed companies would use securitization: (1) an increase in low-rated ABS;(2) an emergence of ways to hedge the risk of ABS; and (3) a diversified portfolio of ABS investors.

<u>(1) Increase in Low-Rated ABS</u>

The ABS market as a whole has experienced rapid growth over the past decade or so.[25] But the growth has been more prominent among ABS with low rating (*see* Figure

[18] *See In Re* Enron, *supra* note 1; Schwarcz, *Enron & SPV*, *supra* note 1.
[19] In re *Enron, supra,* note 1.
[20] Schwarcz, *Post-Enron, supra* note 1, at 1553.
[21] *Id.* at 1553.
[22] *See Id.*
[23] *Id.*
[24] *See* Schwarcz, *Post-Enron*, *supra* note 1, at 1558; Steven L. Schwarcz, , *The Alchemy of Asset Securitiztion*, 1 Stan. J.L. Bus. & Fin. 133 (1994) [hereinafter Schwarcz, *The Alchemy*].
[25] *Compare Big Rise in ABS Issuance, supra* note 2, *and* Phillip L. Zweig, *Asset-Backed Securities*, THE CONCISE ENCYCLOPEDIA OF ECONOMICS (David R. Henderson ed., Library of Economics and Liberty), *available at* http://www.econlib.org/library/Enc/AssetBackedSecurities.html. The total issuance in 2004 was $896.6 billion while in 1991 it was just $50.6 billion.

1).[26] In 1985, 87.5 percent of the ABS issuance was rated AAA.[27] No ABS had been rated below A up to 1987. Starting in 1993, the percentage of ABS below A rating grew quickly. In 1995, AAA-rated ABS declined to 56 percent, and 8.2 percent of all was rated below A. The proportion of AAA-rated ABS further declined to 42.6 percent in 2002, while the proportion of ABS rated below A rose to 20.7%. Standard & Poor's reports that this trend indicates that the ABS market is not strictly a "AAA" and "AA" market any longer, offering investors lower-rated investments with various risk-and-return options."[28]

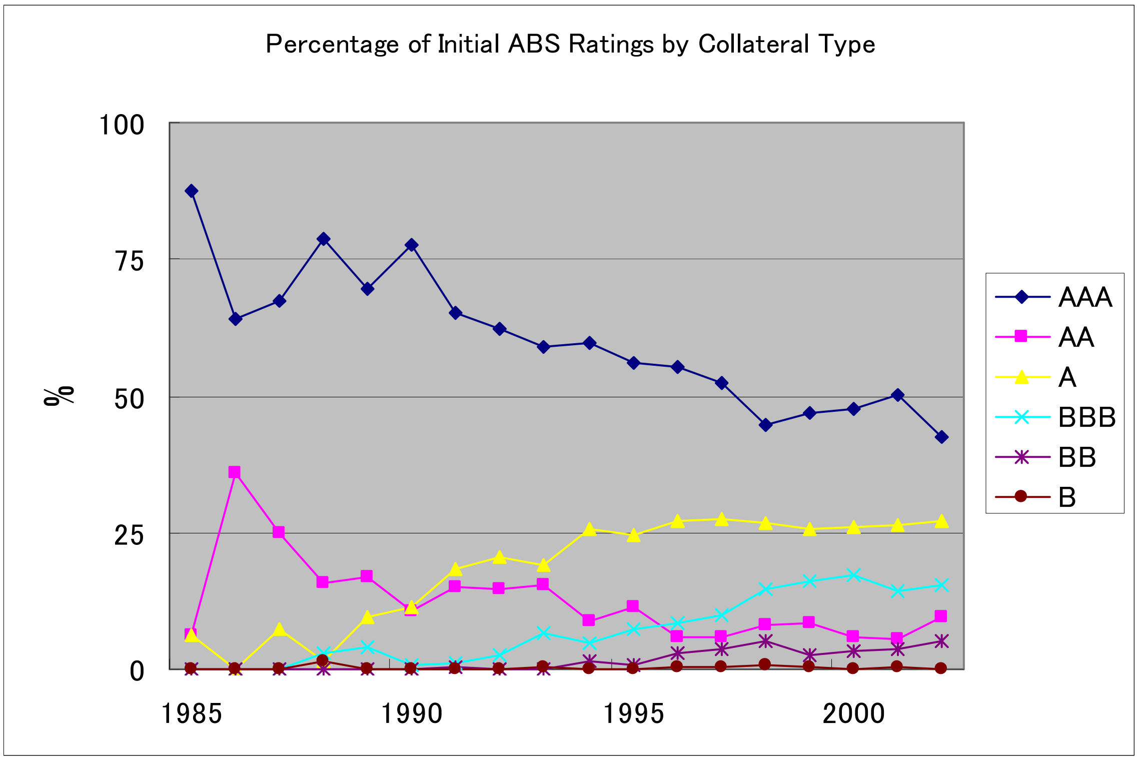

Figure 1

This trend suggests some investors are interested in ABS with relatively returns for taking higher risk. The risk of the ABS could derive from various sources including the quality of the securitized assets and the soundness of the legal structure. The transaction between LTV Steel and Abbey National is an example of investors' interest in low-rated ABS.[29] Abbey National purchased ABS of the LTV Steel's inventory, which received a rating of BBB from Fitch Rating Services, Inc. The low rating was due to the uncertainty surrounding the assets' cash flow generating capabilities and legally risky structure.[30] Successful engagement by the originator was necessary in order for the asset to successfully generate cash flow. The originator would need to process the ore, market

[26] *See*, STANDARD & POOR'S, *supra* note 7.
[27] For the purpose of this section, I assume ABS rated by Standard & Poor's as representing the whole ABS industry.
[28] *Id.*, at 10.
[29] *In re* LTV Steel Co., 274 B.R. 278, 285 (Bankr. N.D. Ohio 2001). The debtor and investor tried to securitize the debtor's inventory, legitimacy of which the court seemed to doubt.
[30] Thomas E. Plank, *2004 Symposium: The Security of Securitization and the Future of Security,* 25 Cardozo L. Rev. 1655, 1688 (2004).

the finished product, and consummate the sale before cash would be generated. The structure was legally risky because the extent of the originator's involvement affects the court's willingness to bring in the SPV into the estate of the originator upon bankruptcy on the theory that the SPV is simply a conduit for the originator (substantive consolidation). Another obvious risk is the court avoiding the asset transfer in bankruptcy.

LTV Steel emerged from its first bankruptcy on June 28, 1993. The business performed reasonably well for several years, with a net income of $127.1 million in 1994. However, its performance deteriorated in 1997, its net income plunging to $30 million, as international competition intensified. Soon after, in 1998, Abbey National purchased the ABS from the SPV in the amount of $30 million. Anyone who receives payments 90 days before the debtor's bankruptcy petition is subject to a court's decision to avoid such transfer. In this case, Abbey National was aware of the debtor's unfavorable financial state, the risk of avoidance concerning the transfer of the inventory to the SPV, the risk of substantive consolidation, and the uncertainty of the asset's cash flow generating capability. It nevertheless decided to take exposure to the said investment given the return the investment provided.[31] These days' investors are not necessarily looking for safe investments. They are looking for investments that fit their risk-return profile. As sophisticated investors strive to flexibly construct their portfolios and as they focus more and more on yields, the appetite for low-rated ABS continues to grow.

<u>(2) Hedging the SPV's Credit Risk</u>

Not long ago, an instrument called credit default swap emerged. Credit default swap is a transaction where the parties are able to buy/sell the protection against a specified credit event occurring to a specified entity (a "reference entity"). In general, purchasers of the protection in a variation of credit default swap, credit default swap on ABS, are able to flexibly hedge the ABS' risk. Because the ABS purchasers will become better at controlling exposure to the instrument, the investors are expected to be more open to low-rated ABS.[32]

The credit default swap market went through an even more dramatic jump than the ABS counterpart. The total of credit derivatives, a large portion of which is credit default swaps, rose from $180 billion in 1997 to $5,000 billion at the end of 2004.[33] The most typical transaction is the corporate debt credit default swap.[34] In the corporate debt credit default swap, the agreement specifies that the seller of the protection would pay the buyer a certain amount upon a default by the issuer of a certain corporate debt and that the seller receives from the buyer the premium for providing a protection against this contingent default. Parties to the corporate debt credit default swap have a variety of reasons for their participation: "to hedge the risk on its balance sheet"; "to hedge counterparty risk"; "as an alternative to buying or selling a bond or loan"; "as a directional play on credit (as an arbitrage trade, for example)"; or "for market-making purposes."

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[31] *Id.*
[32] Paul Watterson, Craig Stein, and Kristin Boggiano, *Credit default swaps on asset-backed securities*, *CREDIT MAGAZINE*, Nov. 2002, at 2.
[33] *UK Warning on Credit Derivatives*, Fin. Times, Feb. 23, 2005.
[34] *See* Watterson et al., *supra* note 29.

A credit default swap on ABS is a variation of the aforementioned credit default swap. The only difference is that the reference entity is an SPV created for purposes of structured finance. Such SPV differs from regular companies in that it usually does not have a significant business operation. Therefore, the SPV's credit risk is the risk pertaining to the asset itself and to the legal aspect of the structured finance, notably a "weak link." A weak link is the risk of the originator's bankruptcy affecting the SPV's solvency. It comprises avoidance and substantive consolidation where the transferred asset is brought into the originator's estate for distribution to the originator's creditors. ABS investors with large exposure to a certain ABS are able to use the credit default swap on ABS to hedge against the SPV's bankruptcy. The availability of such hedging instrument is expected to lessen the investors' anxiety in purchasing ABS from the financially distressed originator.

(3) Diversified Portfolio of ABS Investors

Flexibility and liquidity are two appealing aspects of ABS for investors. Secured lenders are subject to the credit risk of the originator (delay in payments in the case of fully secured creditors). Secured lenders' commitments are typically large, although they could form syndication in order to lessen the extent of each participant's commitment. In the securitization, by contrast, the risk-return exposure is limited to the asset's risk. The small denominations in which ABS are available also reduces the risk return exposure into smallerportions . Exit from such investments is usually easier because there is often a secondary market.[35] Consequently, the ABS investors are likely to have more diversified portfolios with relatively smaller commitments to each investment than secured lenders. This implies that the ABS investors are likely to be less concerned with the risk of each ABS they own. The cost of research would be greater than its benefit, and the investors may be willing to take a greater risk for some components of their portfolios when the exposure to each investment is small. Thus, ABS investors are expected to have become less averse to ABS issued by financially distressed companies.

b. Impact of Originator's Financial Status

The securitization technique is becoming popular among originators of different financial statuses. But what are the implications of this expansion of the originator class? If the originator is financially distressed, it is more likely to embark upon overinvestment or risk-shifting behavior.[36] The originator receives cash from the securitization transaction, and as the ABS investors provide no supervision on the use of the cash, the financially distressed originator is likely to take on projects whose net value may be positive to the shareholder but negative to the unsecured creditors.[37]

When the company has positive equity, its shareholders oversee the company and prevent it from engaging in a project with net negative present value. This is not the case when the company has no positive equity. In that case, the shareholders prefer the company to engage in a risky project with a high expected return in the hopes of realizing any potential return. For example, assume there is a project that hasa five percent chance

[35] *See* http://www.absnet.net. This is a website dedicated to following more than 10,000 structured transactions in the secondary market, evidencing the existence of an active ABS secondary market.
[36] *Contrast* Schwarcz, *Post-Enron*, *supra,* note 1, 1557-1562. arguing that harms from the overinvestment is offset by the ABS's lower interest rate and the prolonged life of the company.
[37] *See* Jensen et al., *supra,* note 6. *See also* Lupica, *supra* note 5, at 629-630.

of generating a thousand dollars and a ninety five percent chance of losing a hundred dollars. A hundred dollars, principal and interest, is owed to the unsecured creditors. When there is one hundred dollars in equity, the project would be rejected by the shareholders because the net value of the project is (1000x0.05-100x0.95=-45) and because they risk their equity being wiped out. The creditors would not like the project either, because the project has a negative present value. On the other hand, if there is no equity, the shareholders have nothing to lose and the only way they can possibly get something is to take on this very risky project. This is the risk-shifting problem for the creditors of financially distressed companies.[38]

The risk shifting problem is universal and courts have been unsuccessful in curbing this problem.[39] Recently, a Delaware chancery court held that the board directors of the financially distressed company owe a fiduciary duty not only to its shareholders but also to its creditors.[40] The ruling cautioned the managers and directors not to yield to the pressure by the shareholders. However, it is not a powerful tool because it is limited to the state of Delaware and a breach of fiduciary duty action takes too much time to timely cope with the fast decline of a financially distressed company. The risk-shifting behavior translates into overinvestment because the risk-shifting projects are projects with net negative present value. I argue here that the risk-shifting problem is likely to be more pronounced in the case of securitization than secured lending because: (1) no one monitors the investment activities of the originator/debtor while in secured lending secured creditors do so[41]: and (2) the cash consideration received in a securitization transaction is typically a lump sum payment subject to no restriction while encumbrance on the collateral usually restricts its use by the debtor in a wasteful manner. These two reasons are similar in that the originator/debtor is under looser control in the case of securitization.

<u>(1) Lack of Monitoring</u>

Secured creditors take the debtor's credit risk. Even if they are fully or overly secured, a bankruptcy petition leads to uncertainties, including the timing of the payment and the use of the collateral for reorganization. Thus, secured creditors usually examine the debtor carefully before extending the loan and oversee the debtor's business activities after the loan and debt covenants have been made. This examination and monitoring helps mitigate the risk shifting and overinvestment problem. It is unlikely that the lender would extend a loan if the examination reveals that the company may go into bankruptcy in the near future. This is true of securitization transaction as well but the ABS investors tend to rely on rating agencies because their commitments are usually smaller. The secured creditors are also unlikely to allow the debtor to gamble on the loaned money by

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[38] *See* Jensen et al., *supra*, note 6.

[39] *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986).

[40] Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. Civ. A. 12150, 1991 WL 277613 (Del. Ch. Dec 30,1991). *See also In re* Kingston Square Assocs., 214 B.R. 713, (Bankr. S.D.N.Y. 1997).

[41] Lupica, *supra* note 5, at 628-629. *But see* Edward M. Iacobucci & Ralph A. Winter, *Asset Securitization and Asymmetric Information*, 34 Journal of Legal Studies 161, 180 (2005). Iacobucci et al. argues that the monitoring by the equity holders may force the managers to "commit not to waste free cash flow by securitizing assets and promising to pay out the proceeds to investors". This argument does not hold in the case of a financially distressed originator because the originator does not have much equity left and the equity holders therein are not entitled to such cash distribution.

investing on a very risky project even though such investment does not violate covenants discussed in the following section. The unsecured creditors would be able to count somewhat on such monitoring.[42]

In contrast, there is no incentive on the part of the ABS investors to monitor the activities of the originator once the asset has been transferred into the SPV.[43] The ABS investors would probably examine the originator for fear of a weak link, but they usually rely on the ratings by the rating agencies because their investment in a certain ABS is not large enough to make any independent research monetarily worthwhile. Once the asset is transferred to the SPV, the title passes to the SPV, so there is no reason for the ABS investors to be concerned about the business activities of the originator. Also, there is usually a lump sum payment of cash consideration to the originator in securitization, which enables the originator to engage in a large project, while secured loans in many cases are revolving credit facilities where cash is requested whenever needed. Therefore, the originator/debtor in the securitization transaction is at greater liberty to engage in overinvestment.

(2) Restriction on Activities of Origintor/Debtor

In addition to the aforementioned informal supervision on the debtor, a loan agreement and a security agreement contain covenants restricting the originator/debtor in many ways and have a stringent definition of an event of default. There is typically a restriction on the ways in which the obtained cash may be spent and the collateral may be used. The covenant could take a variety of forms. For example, such covenant may require the debtor to get the lender's consent before spending the obtained cash on any projects other than those in the ordinary course of business. It could also limit the debtor to use the obtained cash for a specific project only.

Typically, there is also a covenant restricting the debtor from further encumbering any of its assets including the collateral. Breach of these covenants is usually an event of default. Going beyond a certain threshold such as falling below the specified capital adequacy ratio may also be an event of default. Because all loans usually contain cross-default provisions, events of default would accelerate all of the debtors' loans. Consequently, debtors should be very careful in keeping their activities within the framework set out by the covenants and other provisions. In this way, the secured lending agreement limits the debtor's ability to over invest and waste the collateral.

Securitization transfers the asset to the SPV in exchange for cash but neither the SPV nor the ABS investors impose restriction on the use of the cash consideration. A large lump sum payment invites a financially distressed originator to overinvest as its shareholders urge it to do so.

c. "Efficiency" of Securitization and Originator's Financial Status

Securitization provides net negative value to the unsecured creditors because (1) liquidity at this stage is susceptible to overinvestment and because (2) the benefit of the ABS's lower interest rate is not going to be sufficient to offset the harm. Using professor Schwarcz's example, assume an originator "faced with a 10% risk of bankruptcy unless it obtains liquidity, with $1 million of assets [whose bankruptcy valuation is 75%] and $1

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[42] *See Id.*
[43] *See Id.*

million of unsecured claims."[44] Also assume that the liquidity reduces the chance of bankruptcy by 10% to 9%. The expected value without liquidity is (0.1 x $750,000) + (0.9 x $1,000,000) = $975,000. Under professor Schwarcz's analysis, the expected value with liquidity would rise to (0.09 x $750,000) + (0.91 x $1,000,000) = $977,500. The previous part of this section showed that financially distressed companies which securitized their assets have more opportunities to overinvest than those which obtained their financing through secured lending. Say, the originator with enhanced liquidity takes a project that has 10% chance of yielding $500,000 at the cost of $100,000. This project is worth (0.1 x $500,000) + (0.9 x (-$100,000)) =- $40,000, reducing the expected value of the claim to $937,500. The originator with no enhanced liquidity or which obtained financing through secured loan would not be able to embark on such project, because the former has no cash and the latter is monitored by the secured lender. The benefit of the ABS's lower interest is usually minimal in the case of financially distressed companies because the enhanced liquidity only slightly prolongs the originator's solvency. Here, securitization transaction reduces the unsecured creditor's claim without increasing the benefit to the originator or the ABS investors. Therefore, securitization in this particular case is "inefficient."

IV. ASSET CLASS

The securitization technique was invented in the 1970s to apply to mortgage receivables.[45] The Government National Mortgage Association, or GNMA (Ginnie Mae), was the first to use the technique to enhance the liquidity among mortgage finance companies.[46] The Federal National Mortgage Association, or FNMA (Fannie Mae), and Freddie Mac shortly followed suit. Beginning in 1975, the securitization technique was used to securitize computer lease receivables by Sperry Corporation.[47] The securitization asset class has since expanded, and a category like credit card receivables has now surpassed the securitization of mortgage payments in amount.[48] In the 1990s, the securitization technique expanded into new types of asset classes including equipment payment receivables and intellectual property receivables.[49] In 1997, David Bowie issued what are called "Bowie Bonds," which are ABS on his music royalty receivables, and made a headline.[50] The proliferation of asset classes subject to securitzation is definitely the continuing trend (*see* Figure 2). But what is the impact of expanding asset classes in the securitization technique?

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[44] Schwarcz, *Post-Enron*, *supra* note 1, at 1560.
[45] *See* OKAUCHI, *supra* note 8, at 209; SCHWARCZ, *supra* note 5, §1:2.
[46] *Id.* at 1-7; OKAUCHI, *supra* note 8, at 209.
[47] Zweig, *supra* note 22.
[48] *See* STANDARD & POOR's, *supra* note 7.
[49] *See id.*
[50] Kim Clark, *On the Frontier of Creative Finance: How Wall Street can Securitize Anything*, FORTUNE, Apr. 28, 1997, at 50.

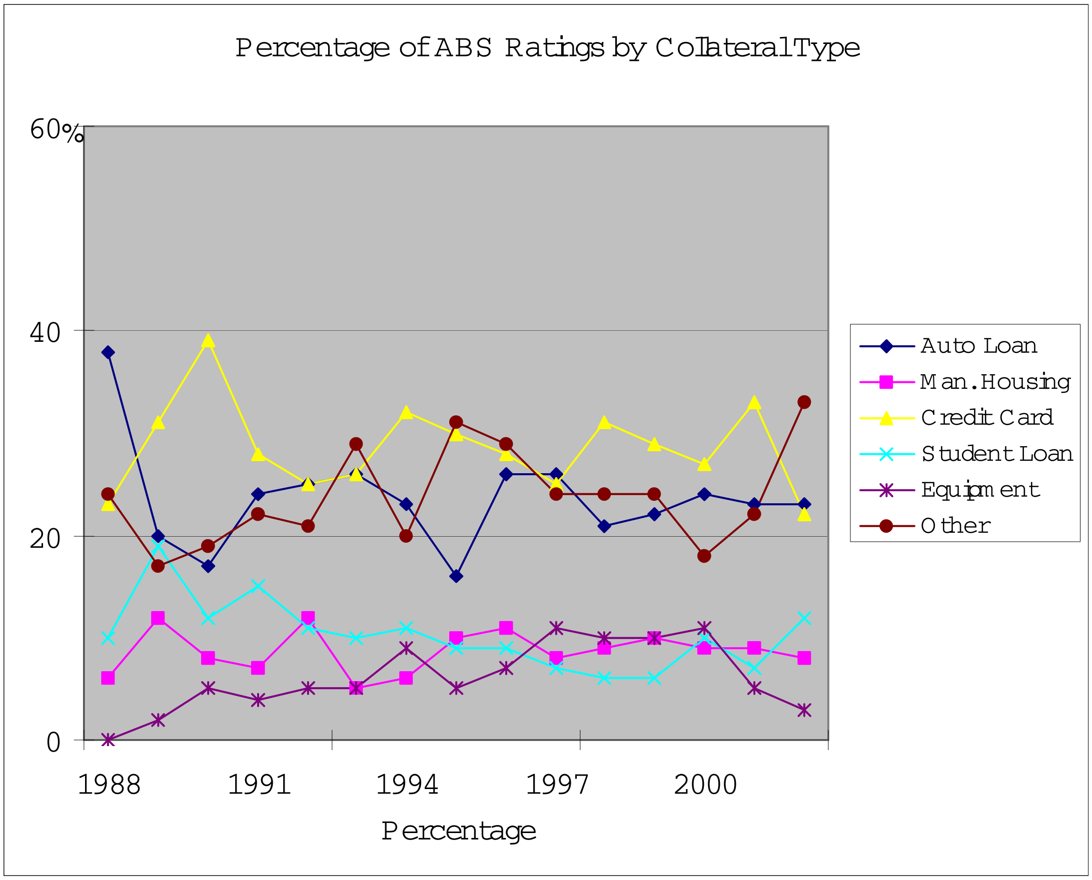

Figure 2[51]

a. Asset Characteristics

Mortgage loans were the first asset to be securitized in the early 1980s.[52] This quickly expended to include accounts receivable, credit card receivables, corporate loan receivables, and real estate receivables. Initially, assets were limited to those that generated cash flows without involvement on the part of the originator after the asset had been transferred (traditional securitization assets). In the case of mortgage loan payments, the originator screens candidates and gives approvals, but these are all pre-securitization activities. The originator's post-securitization involvement or servicing is confined to administrative functions such as collecting payments. Real estate receivables require more servicing because the originator usually takes on the marketing and maintains the buildings and insurance thereon in addition to collecting payments. In this instance, the quality of servicing affects the cash flow prospect somewhat.

As the market for ABS expanded dramatically, so did the asset class. The asset class now includes music royalties[53] and inventories[54] (non-traditional securitization assets). The common feature among thee assets is the fact that the cash flows are substantially dependent on the servicer/originator's effort.[55] For instance, raw inventories

[51] *See* STANDARD & POOR'S, *supra* note 7. The chart was made from the data therein.
[52] *See* OKAUCHI, *supra* note 8, at 209; SCHWARCZ, *supra* note 5, §1:2.
[53] *See* CLARK, *supra* note 26.
[54] *See In re* LTV Steel, *supra* note 26.
[55] *But see* Iacobucci et al., *supra*, note 41.

need to be processed, marketed, and distributed in order to generate cash. This is a significant involvement on the part of the servicer/originator, and the servicer/originator's effectiveness impacts the capability of the asset to generate the cash flow.

b. "Efficiency" of Seuritization and Asset Class

Section III showed that in the event the originator-debtor securitizes its asset the unsecured creditors to the financially distressed companies suffer a detriment and that such transaction is "inefficient." Theoretically, the unsecured creditors may insert covenants to prevent securitization altogether or to let them adjust their terms when the originator-debtor becomes financially distressed, thus avoiding detriment to themselves and "inefficient" transaction. But they fail to do so[56] because securitization is a relatively new invention and because particularly securitization with respect to non-traditional asset is out of their expectation. Securitization technique has been in existence for just three decades or so,[57] and it was not until 1985 when the Sperry Lease Finance Corporation securitized its computer receivables that the technique was used outside of mortgage context.[58] The unsecured creditors are probably aware that the originator-debtor's traditional securitization assets maybe securitized later on, but they may not fully appreciate the impact of a securitization transaction on their recovery prospect. As the unsecured creditors become more educated and insert such covenants, "inefficiency" pertaining to the use of the securitization technique on the traditional securitization asset will diminish.

The more serious concern is regarding securitization of non-traditional securitization assets. In these cases, the unsecured creditors presumably do not even know that the assets could be securitized. Furthermore, it is hard to restrict the activities on some of these assets by inserting a covenant.[59] For instance, assume an originator with a perfume making operation. Because the perfume making does not require an extravagant facility and it does not retail the products themselves, its only substantial assets are accounts receivables and its inventory. Here, the unsecured creditors to the perfume manufacturer probably know that the accounts receivable are securitizable, while they probably do not know that the inventory is. Even if they suspected of such possibility and tried to prevent it, the unsecured creditors would have hard time crafting an appropriate covenant to restrict the originator-debtor's dealings with its inventory, its only working capital, and convincing the originator-debtor to adopt it. Moreover, should the unsecured creditors decide to monitor the originator-debtor's business closely (monitoring of the inventory and the working capital), the cost would be prohibitive.[60] The result that (1) it will be sometime before the unsecured creditors became aware of the assets' securitizability and its impact on their claims; that (2) even when they become aware of (1), they would have difficulty addressing such concern because of the nature of the asset; and that "inefficient" transactions continue, unless the unsecured creditors stop lending altogether.[61]

[56] *See* Schwarcz, *Post-Enron*, *supra* note 1, at 1564.
[57] *See* OKAUCHI, *supra* note 8, at 209; SCHWARCZ, *supra* note 5, §1:2.
[58] THE CONCISE ENCYCLOPEDIA OF ECONOMICS, *supra* note 24.
[59] *See* Harry DeAngelo & Karen H. Wruck, *Asset Liquidity, Debt Covenants, and Managerial Discretion in Financial Distress: The Collapse of L.A. Gear*, 64 Journal of Fin. Econ. 3-34 (2002).
[60] *See* Lupica, *supra* note 5, 628-629.
[61] *See id.*

V. IMPLICATION

Previous sections have demonstrated that an originator may be in a financial distress when it securitizes its asset. A financially distressed company is susceptible to engaging in overinvestment and jeopardizing the prospect of the unsecured creditors' recovery. Under the said circumstances, an overinvestment will make the transaction "inefficient" because the harm it creates exceeds the benefit from the ABS's low interest rate and the reduced chance of bankruptcy. Soon the unsecured creditors will realize this risk and try to curb it by including covenants to allow an adjustment in the loan terms to compensate for the heightened risk should the originator-debtor decide to securitize, or by monitoring the originator, reducing the chance of an overinvestment, both of which scenarios prevent "inefficiency." However, the said covenants and monitoring are not always available. In the case of non-traditional securitization assets, creation/implementation of covenants can be difficult and the monitoring be prohibitively expensive. The prominent example of the non-traditional securitization asset is inventory. For some company, putting restrictions on the inventory could be disruptive of its operation and monitoring its handling of inventory requires close eyes on the business' day-to-day operation. In this scenario, "inefficiency" of the securitization could be avoided only when the unsecured creditors stop lending. In short, securitization transactions are "efficient" only when the investment of the received cash is under control through monitoring and/or restrictions.

As one can easily see, securitization has many dimensions and it is dangerous to make a sweeping statement on the subject. For instance, the proposed section 912 of Bankruptcy Reform Act of 2001 intended to make the securitized asset immune from recharacterization by bankruptcy courts. Though the provision requires the transferred asset to be "eligible asset" and the ABS be investment-grade, theses are no stringent requirements. The definition of "eligible asset" is broader than it looks at the first glance. "Financial Assets" under Section 912 (2) includes "residential and commercial mortgage loans, consumer receivables, trade receivables . . . plus any residential interest in property subject to receivables included in such financial assets plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders." This list is not exclusive. Because the non-traditional securitization asset can be characterized as a type of receivables – cash flow from the disposition of the inventory, it could easily fit into the definition of "financial asset" and thus of "eligible asset." Being an investment grade is not a high threshold either. Fitch Ratings Services says BBB ratings (lowest investment-grade category) "indicate that there is currently a low expectation of credit risk" and that "the capacity for timely payment of financial commitments is considered adequate, but adverse chances in circumstances and in economic conditions are more likely to impair this capacity."[62] The ABS on LTV Steel's inventory was rated BBB.[63] As aforementioned, LTV Steel was not in the perfect financial state and had just emerged from bankruptcy when these securities were issued. The potential problem with the proposed legislation did not attempt to make a distinction between the traditional and non-traditional securitization asset, which could promote

[62] Fitch Ratings Services, *Fitch Ratings Definitions*, *available at* http://www.fitchratings/corporate/fitchResources.cfm?detail=1&rd_file=ltr

[63] *See* Plank, *supra* note 30, at 1688.

free-handedly "inefficient" securitization transactions. As the foregoing example shows, promoting "efficient" form of financing requires the legislator to dissect the broad category of securitization and pay great attention to the nuances such as the financial status of the originator-debtor and the asset class of the securitization. The expansion of the asset class may have impact on rationale for asset securitization. Iacobucci et al. based it on "information asymmetries."[64] One of the asymmetry is between the insider-manager and the outsider-investor. They propose the situation where the outsider-investor has good information on the value of some assets and only the insider-manager knows the value of the other underlies securitization.[65] This explanation does not hold true if the originator securitize its inventory. Here, there is no asymmetry because the outsider-investor is ignorant of the value of such asset as they are of the value of the unsecuritized asset.

[64] Iacobucci et al., *supra*, note 41.
[65] *Id.*, at 180-182.