ARTICLES

RE: DEFINING SECURITIZATION

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ABSTRACT

This Article fills a gap in commercial finance law. Despite the fact that "securitization" has become enormously important to capital markets—and is sometimes blamed for the financial crisis—we have no agreed understanding of the term. Various regulators and commentators have generated a wide range of definitions, but many are vague or omit crucial elements. Perhaps more surprising, the Dodd-Frank financial services reform—the most aggressive attempt yet to regulate securitization—does not define it at all. How can we regulate something without a shared conception of what it is?

In order to develop a more fully considered definition of the term, this Article assesses data on the performance of securitizations, as well as the transaction form's essential elements (its inputs, structure, and outputs). The definition offered here distinguishes "true" securitizations from other transactions, such as collateralized debt obligations and Enron's structured financings. While the latter transactions may satisfy many current definitions of (or associated with) securitization, they in fact lack

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one or more essential elements of true securitizations. Not surprisingly, such transactions largely failed to advance the legitimate social and economic goals of securitization, the most basic of which is to connect the buyers and sellers of capital more effectively than traditional financing methods, such as bank lending or issuing shares of stock.

After (re)defining securitization, this Article concludes by summarizing the benefits of a better definition of securitization.

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I. INTRODUCTION

Although securitization is widely discussed in the legal and financial literature, no uniform definition has emerged that satisfactorily describes it. There is no particular legal meaning for securitization and, like many new financial terms, it is often used to mean a variety of things.

—Joseph C. Shenker & Anthony Colletta[1]

A decade and a half ago securitization was not even a real word, and today we hold seminars on the concept.

—Lewis S. Ranieri[2]

During the financial crisis, securitization displayed significant vulnerabilities to informational and incentive problems among various parties involved in the process.

—Credit Risk Retention[3]

Show me the money.

—Quote from Jerry Maguire[4]

At the heart of the financial crisis was a particular type of transaction, known loosely as asset securitization. At the heart of asset securitization lies a series of basic questions: What is it, exactly? What distinguishes it from other, similar transactions that go by different names, such as collateralized debt obligations ("CDOs") or structured financings? Do differences in nomenclature signal anything important about the law, economics, or social consequences of any of these transactions? This Article explores these questions, and explains why the answers matter.

One reason the answers matter is money: Since the early 1990s, securitization has been one of the dominant means of capital formation in

1. Joseph C. Shenker & Anthony Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1373 (1991).

2. Lewis S. Ranieri, *The Origins of Securitization, Sources of Its Growth, and Its Future Potential*, *in* A PRIMER ON SECURITIZATION 31, 31 (Leon T. Kendall & Michael J. Fishman eds., 2000) [hereinafter, SECURITIZATION PRIMER].

3. Credit Risk Retention, 76 Fed. Reg. 24,089 (Apr. 29, 2011).

4. JERRY MAGUIRE (TriStar Pictures 1996).

the United States.[5] Several trillion dollars in securitizations were outstanding at its peak before the financial crisis, and it remains an important source of financing.[6]

So, it is not surprising that there are scores of different definitions of the term (or terms associated with it) in statutes, regulations, and commentary.[7] Yet, these definitions tend to be vague and omit one or more crucial elements of what this Article defines as a "true" securitization. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[8]—the most aggressive attempt to "fix" securitization[9]—does not even purport to define it, and neither do other important sources of law and guidance.[10]

Dodd-Frank and related proposed changes have led long-time participants in the securitization market to exclaim that "[t]here has never been a time when so many pillars of the securitization process have been tossed up in the air without an indication as to how they will land."[11] It is

5. *See* Exclusions from Investment Company Definition, Investment Company Act Release No. 18736, 51 SEC Docket 940 (May 29, 1992); U.S. SECURITIES AND EXCHANGE COMMISSION, DIVISION OF INVESTMENT MANAGEMENT, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 1–25 (1992) (surveying development of ABS market).

6. For a discussion regarding data on the securitization market see *infra* Part III.C.

7. For a discussion on patterns in these definitions, and problems with them, see *infra* Part IV.

8. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (codified in scattered sections of U.S.C.). As discussed *infra* in Part IV, Dodd-Frank uses the terms "securitizer" and "asset-backed securities" without actually defining a "securitization."

9. According to Sheila Bair, then Chairwoman of the Federal Deposit Insurance Corporation, Dodd-Frank was enacted in the wake of the financial crisis with a variety of goals, including "reforming the 'originate-to-distribute' model for securitization and realigning the interests in structured finance." Press Release, Fed. Ins. Deposit Corp., Chairman Bair's Statement on Credit Risk Retention Notice of Proposed Rulemaking (Mar. 29, 2011), http://www.fdic.gov/news/news/press/2011/statement03292011.html.

10. In the case of private ordering guidance, the Financial Accounting Standards Board ("FASB") has attempted to wipe clean the slate on which we have historically accounted for securitization. In June of 2009, the FASB issued two statements, neither of which define a securitization. *See* FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 166: ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS—AN AMENDMENT TO STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 140 (2009); FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 167: AMENDMENTS TO FASB INTERPRETATION NO. 46(R) (2009). Perhaps the most prominent relevant law, besides Dodd-Frank, that regulates, but does not define, "securitization" is Delaware's Asset-Backed Securitization Facilitation Act. DEL. CODE ANN. tit. 6, §§ 2701A–2703A (2004). As discussed in Part VI below, this statute, like others enacted by several other states, purports to insulate securitizations from recharacterization as secured loans.

11. MARTY ROSENBLATT, JIM MOUNTAIN & ANN KENYON, SECURITIZATION ACCOUNTING: THE INS AND OUTS (AND SOME DO'S AND DON'TS) OF FAS 166, 167, AND COUNTING . . . 3 (8th ed. 2010), *available at* http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/AERS/us_deloittte_securitization_accounting_Jan2010.pdf.

hard to know where the "pillars" should land if we do not agree on the nature and meaning of the structure that would rest on them.

Thus, a more basic reason the answers matter is that we do not yet have a shared conception of what the term securitization connotes. It apparently means different things to different people. These differences increase the likelihood of confusion, mistakes, and even fraud in dealing with complex commercial financial transactions that are (or purport to be) securitizations.

This Article focuses the discussion by developing a normative and stipulative definition of a "true" securitization.[12] For purposes of this paper, true securitization is defined as a purchase of primary payment rights by a special purpose entity that (1) legally isolates such payment rights from a bankruptcy (or similar insolvency) estate of the originator, and (2) results, directly or indirectly, in the issuance of securities whose value is determined by the payment rights so purchased.

While this definition will be unpacked in Part V, the basic point is that it describes the essential elements of a securitization, its inputs (payment rights), structure (bankruptcy-proof legal isolation), and outputs (securities). It also embeds its legitimate social and economic functions: if it works, securitization links the buyers and sellers of capital more efficiently than traditional methods of financing, such as bank lending or issuing shares of stock.

This Article distinguishes true securitizations from other transactions that may satisfy existing definitions and understandings, but which flunk the definition advanced here. For example, CDOs and Enron's structured financings often have relied not on "primary payment rights"—a key input

12. The definition advanced here is "normative" because it makes value claims about the functions of securitization. It is "stipulative" because it is a designation for the use of a term of the form "let x designate y." As such, it cannot be epistemically true or false. It simply constitutes a basis for discussion. A stipulative definition is one in which a new or currently existing term is given a specific meaning for the purposes of argument or discussion in a given context. *See, e.g.*, Michael T. Ghiselin, *The Nomenclature of Correspondence: A New Look at "Homology" and "Analogy*," *in* EVOLUTION, BRAIN, AND BEHAVIOR: PERSISTENT PROBLEMS 129, 129–42 (R. B. Masterton et al. eds., 1976); CHARLES L. STEVENSON, ETHICS AND LANGUAGE (1944). The leading use of stipulative definitions in commercial law appears in Julian B. McDonnell, *Definition and Dialogue in Commercial Law*, 89 NW. U. L. REV. 623 (1995).

This Article focuses largely on securitizations created by private originators rather than those created by government-sponsored entities, such as the Federal Home Loan Mortgage Corporation. As discussed *infra* in Part III.A., transactions involving government-sponsored entities are a special case that may deviate structurally from those involving private parties, although they would nevertheless constitute "securitizations" in the minds of most observers.

in a true securitization—but instead on more opaque "financial assets" that may have masked the weaknesses of these transactions.[13] While there may be legitimate uses of CDOs and structured financings, their inputs are often not primary payment rights, but instead synthetic or derivative rights, which may be contingent and illiquid. Transactions of these forms generally involved greater complexity, and performed worse in the financial crisis, than did "true" securitizations, even those involving subprime mortgages. It is thus not analytically helpful to call them (and treat them as) "securitizations."[14]

There are two important caveats: First, this Article does not seek to excuse the many serious problems exhibited by securitization leading up to (and through) the financial crisis. Poorly conceived and executed securitizations—even "true" ones—doubtless contributed to the crisis, and

13. For a more comprehensive discussion of CDOs and Enron's transactions see *infra* Parts III.C.2 and IV.B. CDOs, which were viewed as especially problematic in connection with the financial crisis, are a specific and notorious example of the broader phenomenon of "synthetic" securitization. According to the Securities and Exchange Commission,

> Synthetic securitizations are designed to create exposure to an asset that is not transferred to or otherwise part of the asset pool. These synthetic transactions are generally effectuated through the use of derivatives such as a credit default swap or total return swap. The assets that are to constitute the actual "pool" under which the return on the [asset-backed security] is primarily based are only referenced through the credit derivative.

Asset-Backed Securities, Securities Act & Exchange Act Release No. 33-8518, Release No.34-50905, 84 SEC Docket 1624, 2004 WL 2964659, at *15 (December 22, 2004) [hereinafter Regulation AB].

14. Nevertheless, even sophisticated observers frequently do so. As Steven Schwarcz, one of the nation's leading authorities on the mechanics of securitization, explained in 2009,

> Subprime mortgage securitization, the type of securitization whose failure initially triggered the chain of failures that became the subprime crisis, is a subset of mortgage securitization. In the most basic form of mortgage securitization, mortgage-backed securities (MBS) are issued by a special-purpose vehicle (SPV), and payment on the securities is derived directly from collections on mortgage loans owned by the SPV. More complex forms of mortgage-backed securities include collateralized debt obligation (CDO) securities in which payment derives directly from a mixed pool of mortgage loans and sometimes, also, from other financial assets owned by the SPV; and "ABS CDO" securities in which payment derives from MBS and CDO securities owned by the SPV (and thus indirectly from the mortgage loans and other financial assets underlying those owned securities). *Subprime mortgage securitization can mean any of these types of mortgage securitization where all or a portion of the underlying financial assets consists of subprime mortgage loans*.

Steven L. Schwarcz, *The Future of Securitization* 41 CONN. L. REV. 1313, 1316 (2009) (emphasis added) (footnotes omitted). Some writers get the definitional exercise backwards, branding a transaction as something other than a securitization (for example, a CDO) when it appears in fact to be a securitization. *See, e.g.*, Charles W. Murdock, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: What Caused the Financial Crisis and Will Dodd-Frank Succeed in Preventing Future Crises?*, at 47–48 (February 2011), *available at* http://works.bepress.com/cgi/viewcontent.cgi?article=1015&context=charles_murdock ("CDOs typically involved residential mortgage loans made by a non-bank lender with no relationship to the borrower, who cared less about the underlying safety of the loan, and who sold it to get rid of the risk."). Murdock is not describing a CDO, but is instead describing a securitization.

may have impeded its resolution.[15] Thus, this Article does not claim that a better definition of securitization, by itself, would have altered this history. Rather, as discussed in Part VI, securitization can be seen as a "disruptive technology" that is now maturing. As such, it has become ripe for a richer normative definition. This Article is a step in that larger process.[16]

Second, this Article does not claim that the definition developed here is the best or only way to redefine securitization. For example, it is not expected that this Article will result in bank or securities regulators, who have generated the bulk of definitions regarding securitization, replacing their jargon with that enunciated here. Rather, the definition offered here should be understood as a tool to organize the process of thinking about what securitization means, normatively. This linguistic exercise can have a clarifying effect that helps to map better regulatory and market boundaries through a more coherent use of terminology. If successful, this effort will not be the last word on (re)defining securitization, but the first.

This Article has six parts. Part II introduces a grounded methodology for defining terms in commercial finance law. Part III uses the methodology to describe securitization's key elements and social and economic functions. Part IV describes patterns in existing definitions and their weaknesses. Part V develops a stipulative definition of securitization and explains why it is better than existing definitions. Part VI shows why a better definition of securitization should matter to legal and market systems. Part VII concludes.

II. CREATING MEANING IN COMMERCIAL FINANCE LAW

The process of creating meaning—and by inference, defining terms—in law is no small undertaking. At its most serious, it recruits deep thinkers such as Wittgenstein,[17] Raz,[18] and Putnam,[19] all of whom have made

15. For example, it appears that the complexity of securitization structures made renegotiating a mortgage—typically the first move when a borrower encounters financial distress—more difficult than it would be in a traditional nonsecuritized loan. *See* Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1093–98. (2009); Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 9–10 (2011).

16. Thus, this paper's title: It is about ("re:") defining securitization and is an attempt to redefine the term.

17. *See* LUDWIG WITTGENSTEIN, PHILOSOPHICAL INVESTIGATIONS 21 (G.E.M. Anscombe trans., 3d ed. 1968); Dennis M. Patterson, *Good Faith, Lender Liability, and Discretionary Acceleration: Of Llewellyn, Wittgenstein, and the Uniform Commercial Code*, 68 TEX. L. REV. 169 (1989).

18. *See* Joseph Raz, *Intention in Interpretation*, *in* THE AUTONOMY OF LAW: ESSAYS ON LEGAL POSITIVISM 249, 258 (Robert P. George ed., 1996).

important contributions to the epistemic project that gives content to the language of the law. For more pragmatic purposes, however, we need recognize only two basic points, both associated with Karl Llewellyn, chief architect of the Uniform Commercial Code ("U.C.C."), about how meaning is and should be created in the world of commercial law.

First, Llewellyn was a "realist."[20] As such, and at the risk of oversimplification, he believed that law should presumptively reflect the norms, practices, and language of those in the trade. For example, Llewellyn apparently wanted terms such as "good faith" to be defined broadly in the U.C.C., subject to the proviso that "merchant juries"—comprised of those in the trade—would determine how to apply the terms to particular facts.[21] Although merchant juries did not become part of the U.C.C. template, "[w]hat is essential," Llewellyn wrote, "is the provision of some adequate tribunal to determine competently and reckonably all questions of fact which rest in special knowledge of the trade."[22]

Llewellyn recognized that experts might have normative conflicts with one another.[23] For example, those in a given industry might have greater confidence in market solutions than academics. Thus, for Llewellyn, "expertise" in defining terms should come not solely from those in the industry, but also from others who facilitate and observe the industry, such as lawyers, regulators, and academics. Dennis Patterson has thus observed that "[p]erhaps more than any other modern theorist of commercial law, Llewellyn was aware that commercial practices are inseparable from the social critique of those practices."[24] Legal terminology should reflect the social context in which it is used, guided by a fuller understanding of that context.[25]

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19. *See* 2 HILARY PUTNAM, *The Meaning of 'Meaning,' in* PHILOSOPHICAL PAPERS: MIND, LANGUAGE AND REALITY 215, 215 (1975). *See generally* Robert Ware, *The Division of Linguistic Labor and Speaker Competence*, 34 PHIL. STUDIES 37 (1978) (discussing Putnam's work).

20. *See* Zipporah Batshaw Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rule*s, 100 HARV. L. REV. 465, 466 (1987) ("Llewellyn was a central figure in American legal realism."); WILLIAM TWINING, KARL LLEWELLYN AND THE REALIST MOVEMENT 278–300 (1973).

21. DENNIS M. PATTERSON, GOOD FAITH AND LENDER LIABILITY: TOWARD A UNIFIED THEORY 36 (1990) (in designing the Uniform Commercial Code, "Llewellyn advocated a central role for merchant juries," not lay juries, "in judging the merits of commercial disputes").

22. *Id.* at 40–41 (quoting 1941 Revised Act (2d Draft), at Comment on Secs. 59-59-D, at 253, *in* 1 U.C.C. Drafts 533).

23. *See* Wiseman, *supra* note 20, at 480 (discussing Llewellyn's complex relationship with the New York Merchant's Association in promoting enactment of a federal Uniform Sales Act).

24. *See* Patterson, *supra* note 17, at 204.

25. "No language stands alone," Llewellyn explained in the law school classic *The Bramble Bush*, "[i]t draws life from its background." KARL N. LLEWELLYN, THE BRAMBLE BUSH: ON OUR LAW AND ITS STUDIES 79 (1960).

Second, by inference, legal terminology should be functional. As Patterson has noted "Llewellyn relentlessly emphasize[d] the importance of context and the role of seeing the meaning of the language and conduct of participants in commercial practice against the background of practice."[26] Subject to normative constraints, what participants in the legal system and the market actually do should influence, if not determine, how the law works and speaks. Patterson argued,

> The meaning of a practice—commercial, social, or otherwise—is not readily apparent. Like any other text, a commercial practice must be interpreted; its meaning is not self-evident from the behavior of the participants in the practice. Instead, the participants offer constructive accounts of the meaning and significance of what they do.[27]

Strictly speaking, Llewellyn was concerned with the ex post judicial interpretation of terms, not the ex ante process of defining them.[28] Nevertheless, we can extrapolate from Llewellyn's approach a grounded method of finding meaning in commercial finance law. We should look to the social construction of legal meaning as mediated by experts and the actual functions of transactions and terms. If we wish to advance the law, we must look closely and critically at what actually happens in the real world.

It is important to recognize, however, that any attempt to do so must acknowledge the institutional complexities that affect the social construction of meaning.[29] Market actors, for example, may conclude that it is "functional" to define securitization in a particular way, or in multiple, inconsistent ways (as has, in fact, been the case). Such definitions may, in turn, be at variance with the understandings of judges, regulators, legislators, academics, or other institutional actors. There is no reason that

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26. PATTERSON, *supra* note 21, at 25.

27. Patterson, *supra* note 17, at 204.

28. Yet, we find a similar approach in Robert Cover's seminal work on meaning in constitutional law, Nomos *and Narrative*. *See* Robert M. Cover, Nomos *and Narrative*, 97 HARV. L. REV. 4, 11–19 (1983) ("[T]he creation of legal meaning—'jurisgenesis'—takes place always through an essentially cultural medium. Although the state is not necessarily the creator of legal meaning, the creative process is collective or social.").

29. I use the term "institutional" here after Neil Komesar, who—as indicated by the titles of his work—identifies various institutional actors as potential sources of solutions to social problems, including courts, political actors, markets, and communities. NEIL K. KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY (1994); NEIL K. KOMESAR, LAW'S LIMITS: THE RULE OF LAW AND THE SUPPLY AND DEMAND OF RIGHTS (2001); Neil K. Komesar, *Exploring the Darkness: Law, Economics, and Institutional Choice*, 1997 WIS. L. REV. 465; Neil K. Komesar, *In Search of a General Approach to Legal Analysis: A Comparative Institutional Alternative*, 79 MICH. L. REV. 1350 (1981).

a single institution's approach to defining securitization should apply in all cases. Nevertheless, it would appear that, while markets have given us the term "securitization,"[30] it falls to public actors—in particular, legislatures and regulators—and academics to help explain what is and is not a securitization for a variety of important social and legal purposes, including whether (and how) they are regulated, whether they are enforced, and so on.

Thus, the development of the definition of securitization, even if functional, has been (and will remain) a dialectical process. One institution (like markets) may coin the term only to see other institutions, such as regulators or legislatures, offer a different version. Market actors may respond by adding their own gloss. Academics may then pile on with their own interpretation, and so on.

There is nothing inherently problematic in this process, except that it can result in a proliferation of varying connotations of the same term. When a term has unintentionally taken on different or vague meanings due to differing institutional imperatives or orientations, confusion can ensue. Such confusion can, in turn, lead to mistakes in interpretation, judgment, execution, and more, all of which seem to characterize errors leading up to and through the financial crisis. To help avoid such mistakes in the future, the next two parts of this Article assess the functions and performance of securitization in order to build a more socially grounded definition of the term.

III. DESCRIBING SECURITIZATION: HOW DOES A SECURITIZATION MEAN?[31]

If the key to defining terms in commercial finance law is understanding social context and function, it becomes important to understand the essential elements of securitization, its actual usage, and the context in which it has developed. This part briefly discusses all three.

30. I briefly sketch the history of the development of the term "securitization" and its market roots in Part IV.A, below.

31. Apologies to John Ciardi, who doubtless spent little time thinking about the answer to the question posed by this heading. *See generally* JOHN CIARDI & MILLER WILLIAMS, HOW DOES A POEM MEAN? (2d ed. 1975).

A. THE ELEMENTS OF A SECURITIZATION

Although there are many variations, a securitization has three essential elements: (1) inputs, (2) a particular structure, and (3) outputs.

Inputs. In most securitizations, the inputs will be payment rights, such as those arising under mortgages, car loans, or student loans owing to the initial payee who made the loan (and who is thus typically referred to as an "originator"). As discussed in Part IV, however, under many common definitions, assets that do not necessarily involve payment rights (at least not directly), such as other securities (in the case of collateralized debt obligations), inventory,[32] or whole businesses,[33] can technically be inputs in a securitization. A central contribution of the definition of securitization advanced in Part V of this Article is to focus on a particular type of input—primary payment rights.[34]

Structure. For private originators the key structural feature in a securitization is typically thought to be the legal isolation of the inputs (payment rights) from the credit risk of the originator. This is often accomplished by a "true sale" of the input assets from the originator to a "special purpose entity" ("SPE") that is legally "remote" from the originator should the originator go into bankruptcy or a similar insolvency proceeding.[35] If a securitization does not involve a "true sale" of these

32. *See In re* LTV Steel Co., 274 B.R. 278, 286 (N.D. Ohio 2001) (declining to modify an interim order giving the sponsor of a "securitization" control over the accounts and inventory transferred in the securitization pending a full determination of whether there had been a "true sale" of such accounts and inventory); Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1686–98 (2004) (discussing how the presence of the "inventory securitization" enabled the debtor in possession to attack the trade receivables securitization, which had been structured as a true sale).

33. Claire Hill, *Whole Business Securitization in Emerging Markets*, 12 DUKE J. COMP. & INT'L L. 521, 521 (2002) (explaining how placing a whole business, including all of its assets, into a securitization structure adds value).

34. Of course, this does not mean that primary payment rights must be liquidated and noncontingent. Future payment rights are often central to securitizations. Moreover, this is not to suggest that the securitization itself might not legitimately be supported by various forms of credit support which, in themselves, would not be primary payment rights, for example, insurance, guarantees, and so forth. The important question is whether the sale of primary payment rights is the central economic goal of the transaction.

35. *See, e.g.*, 11 U.S.C. § 362(a) (2006) (bankruptcy stay halts collection of assets owned by debtor in bankruptcy). An insured depositary (like a bank) that originated a securitization and failed would not be subject to a bankruptcy court's jurisdiction. *Id.* § 109(b)(2). Instead, the Federal Deposit Insurance Corporation ("FDIC") would most likely take the bank over. In that process, the question would arise whether payment rights sold by the bank could be recaptured by the FDIC as receiver. Federal regulations set forth the structural criteria governing transactions that the FDIC will not challenge. *See* 12 C.F.R. § 360.6(b)(1) (2009) (providing that the FDIC "shall not, by exercise of its

assets, it may be characterized instead as a loan secured by those assets. This, in turn, might expose the assets to the originator's bankruptcy (or similar insolvency) process, which could impair the assets' value.[36] As discussed further below, legal academics have debated whether securitizations should or should not be treated as "true sales."[37] Although it would appear that the need to achieve legal isolation was driven largely by the requirements of the rating agencies (who would not assign a desired rating absent a true sale opinion or effective substitute)[38], it has come more generally to be considered the "holy grail" of securitization.[39]

Outputs. The output of a securitization is, as the name suggests, supposed to be "securities." While the term "securities" is itself sometimes disputed,[40] in general, securitizations are financed, directly or indirectly, by

authority to disaffirm or repudiate contracts under 12 U.S.C. 1821(e), reclaim, recover, or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution in connection with a securitization or participation, provided that such transfer meets all conditions for sale accounting treatment under generally accepted accounting principles, other than the 'legal isolation' condition as it applies to institutions for which the FDIC may be appointed as conservator or receiver, which is addressed by this section."). Although a bank receivership presents few of the procedural impediments to realization on assets seen in a bankruptcy case, by regulation and practice the FDIC (and other regulators) have established mechanisms by which a bank-originated transaction will effectively function as a "true sale" for legal purposes. *See* STANDARD & POOR'S, LEGAL CRITERIA FOR U.S. STRUCTURED FINANCE TRANSACTIONS 32–36 (2004) [hereinafter S&P CRITERIA] (discussing criteria for rating bank-originated securitizations).

36. *See, e.g.*, Plank, *supra* note 32, at 1669–71.

37. For example, Kenneth Kettering and Thomas Plank have traded jabs over how courts should treat the structural characterization of securitizations. *Compare* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1562 (2008) [hereinafter Kettering, *Discontents*]; *and* Kenneth C. Kettering, *True Sale of Receivables: A Purposive Analysis*, 16 AM. BANKR. INST. L. REV. 511 (2008); *and* Kenneth C. Kettering, *Pride and Prejudice in Securitization: A Reply to Professor Plank*, 30 CARDOZO L. REV. 1977 (2009) [hereinafter Kettering, *Pride*]; *with* Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON. L. Rev. 287 (1991) [hereinafter Plank, *True Sale*]; *and* Plank, *supra* note 32; *and* Thomas E. Plank, *Sense and Sensibility in Securitization: A Prudent Legal Structure and a Fanciful Critique*, 30 CARDOZO L. REV. 617 (2008). My own somewhat more agnostic accounts of these and related issues appear in Jonathan C. Lipson, *Secrets and Liens: The End of Notice in Commercial Finance Law*, 21 EMORY BANKR. DEV. J. 421 (2005) [hereinafter Lipson, *Liens*]; Jonathan C. Lipson, *Enron, Securitization and Bankruptcy Reform: Dead or Dormant?*, 11 WEST J. BANKR. L. & PRAC. 1 (2002).

38. *See, e.g.*, S&P CRITERIA, *supra* note 35, at 15 ("To obtain legal comfort that each transfer of assets through the chain of transfers from any [transferor subject to a case under the Bankruptcy Code] constitutes a true sale, Standard & Poor's will, as a general matter, request a 'true sale opinion' on each transfer.").

39. Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 161 (1996) ("Defining true sale is the holy grail of the securitization market . . . .").

40. As the Supreme Court stated in *Marine Bank v. Weaver*, 455 U.S. 551, 555 (1982), the definition of the term "security" is "quite broad" and meant to include "'the many types of instruments that in our commercial world fall within the ordinary concept of a security,'" including "stocks and bonds, along with the 'countless and variable schemes devised by those who seek the use of the money

the issuance of bonds, trust certificates, shares, or other instruments designated to have secondary market value. The optical value of the output will, in important part, be that it takes a form recognizable to the capital markets. Thus, these securities are often rated by rating agencies, such as Moody's and Standard & Poor's. The purchase price paid for the securities, less transaction costs, is then remitted to the originator.[41]

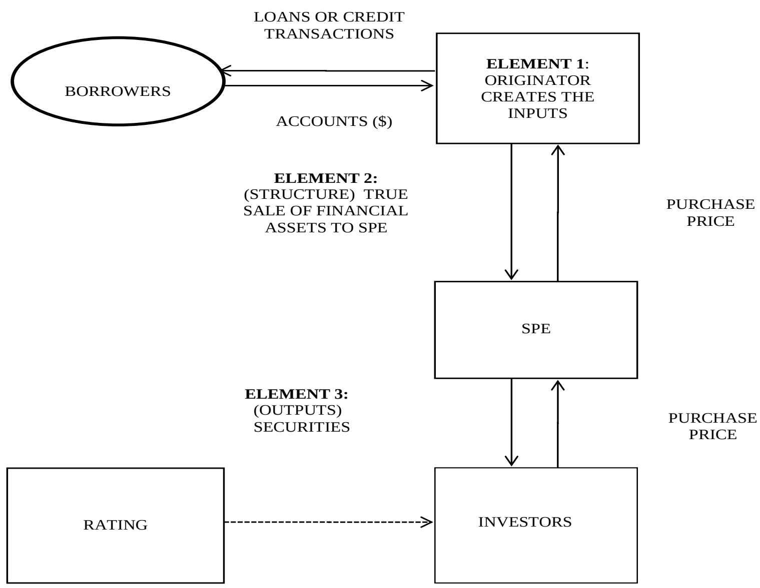
These basic elements are depicted graphically in figure 1.[42]

of others on the promise of profits . . . .'" (citations omitted). Thus, the Supreme Court has held that interests in a citrus grove were investment contracts and "securities" for purposes of the securities laws because they were purchased by investors with (1) an expectation of profits arising from (2) a common enterprise that (3) depends "solely" for its success on the efforts of others. SEC v. W.J. Howey Co., 328 U.S. 293, 300–01 (1946).

41. Strictly speaking, the timing may work in either direction. The transaction may first be structured by an investment bank, which raises funds (issues securities) based on the expectation that the originator will have assets to sell, the structure will be implemented, and the assets sold to the SPE. The timing, however, does not strongly determine the core question explored here: What essential elements distinguish a "securitization" from other similar transactions?

42. Note that this depiction contemplates private parties, and not government-sponsored entities, such as Fannie Mae, which might produce different structures, but whose transactions involve many of the same elements. In some cases, for example, government-sponsored entities may have created trusts that acquired mortgages in transactions that were not legally true sales by originating banks. *See, e.g.*, PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP, REPORT TO THE SPECIAL REVIEW COMMITTEE OF THE BOARD OF DIRECTORS OF FANNIE MAE (RUDMAN REPORT), Feb. 23, 2006, http://www.sec.gov/Archives/edgar/data/310522/000095013306000889/w17889exv99w2.txt.

FIGURE 1. Basic Securitization Elements



B. THE FUNCTIONS OF SECURITIZATION

Like any complex, important social phenomenon, securitization is more than a summary of its elements. In order to develop a better understanding and definition of the term, it is important to assess its functions. Why, in short, do we have securitization at all?

Securitization appears to serve one or more of three principal ends. First, it is thought to be more economically efficient than traditional financing, such as lending or issuing shares.[43] This is because the structure of a securitization is said to assure that those who purchase the securities need not worry about the credit risk of the originator.[44]

43. James A. Rosenthal & Juan M. Ocampo, *Analyzing the Economic Benefits of Securitized Credit*, 1 J. APPLIED CORP. FIN. 32, 42–43 (1988) (discussing economic efficiencies of securitization).

44. Kettering, *Discontents*, *supra* note 37, at 1563 ("The reason why Originators obtain financing by doing a securitization transaction, instead of simple secured borrowing, is because the debt issued in a securitization will be rated solely on the basis of the quality and quantity of asset pool that backs it. As a result, securitized debt typically will be rated higher than the Originator's own rating, which means that investors will demand a lower yield on the securitized debt than they would for debt issued by the Originator. The rating agencies' willingness to rate securitized debt on the assumption that the

Take a hypothetical example. Through securitization, an originator with an overall credit rating of AA may be able to issue bonds that are rated AAA. Generally speaking, this signals to the market that the bonds pose less credit risk than does the credit of the originator itself. Carrying this logic forward, investors would then pay more for the AAA-rated bonds issued in the securitization than they would if the AA-rated originator had borrowed the money directly. This is because the securities themselves were a safer bet than the originator. In effect, this means that the originator's cost of capital should be lower in a securitization than in a secured loan because it receives a discount based on the quality of the payment rights it sold, unburdened by its own credit condition.

This analysis focuses chiefly on the structural element of a securitization, and asks whether the structure resulted in a "true sale" of the input assets. This question has a long, complex, and venerable history. It well predates securitization, with roots in such classic cases as *Benedict v. Ratner*.[45] In *Benedict*, Justice Brandeis, writing for a unanimous Supreme Court, negated a sale of future accounts receivable by holding that it was a fraudulent conveyance void against the assignor's bankruptcy trustee.[46]

Legal academics have debated whether, or under what conditions, a securitization should be treated as a true sale. Some, such as Thomas Plank, believe that in most cases, a true sale will be obvious if the parties properly document and structure their transactions.[47] Others, such as Lois Lupica,

securitization structure achieves its purpose of isolating the securitized assets from the future bankruptcy estate of the Originator is what drives securitization.").

45. Benedict v. Ratner, 268 U.S. 353 (1925).

46. *Id.* at 361–63 (holding the assignment was fraudulent "because of dominion reserved. It does not raise a presumption of fraud. It imputes fraud conclusively because of the reservation of dominion inconsistent with the effective disposition of title and creation of a lien"). Indeed, it goes back further to the less famous case of *Home Bond Co. v. McChesney*, 239 U.S. 568 (1916), which held that transactions purporting to be purchases of accounts receivable from a debtor were really loans with the accounts transferred as collateral security.

47. According to Plank,

> The elements of a true sale are relatively straightforward. First, the terms of the transaction should describe it as a sale and not a transfer for security. In other words, the form of the transfer must be a sale. Form alone, however, is not enough. The substance of the transaction also must constitute a sale. Hence, the transferor should transfer most of the benefits and burdens of ownership. In the case of the transfer of receivables, this requires that the buyer receive most of the risk of loss from default by the obligors and most of the opportunity for gain or loss in the market value of the receivables. Finally, the seller must receive fair market value for the transfer of benefits and burdens of ownership and for retention of any of those risks.

Plank, *supra* note 32, at 1675. *See also infra* nn.79–82 and accompanying text; Plank, *True Sale*, *supra* note 37, at 328–29 (suggesting a rule for determining a true sale that "if the documents evidencing the transaction and the actions of the parties unambiguously characterize a particular transaction as a sale, a court should not disregard this characterization if the buyer paid fair value for the property, unless the have argued on normative and doctrinal grounds that courts should be wary of deferring to the parties' sale characterization, and instead should recharacterize some such transactions as secured loans.[48] Recharacterization would presumably impair the credit-enhancing effect of the sale to the SPE, but increase the pool of assets available for sharing by an originator's creditors.

Still others, notably Kenneth Kettering, argue that regardless of the legal characteristics of the transaction, securitization as a capital markets' phenomenon is now "too big to fail," and thus courts will be cowed into respecting the parties' characterization regardless of the real economics of the deal.[49] As noted above, rating agencies have required true sale legal opinions in order to provide ratings. This may mean that, in essence, their determination of the legal criteria informed that of the larger marketplace. Given the socially constructed nature of the question, therefore, legal academics will not likely resolve the debate, even though it would appear to be conventional wisdom among commercial finance lawyers that the structural heart of a securitization requires a true sale.[50]

Second, securitization gives originators access to the capital markets, which they might not otherwise have. This, in turn, is thought to reduce the cost of capital or make possible financing that would not otherwise have existed. Traditional bank loans were made by depositary institutions, which were fairly heavily regulated in order to protect customers' deposits. Although this glosses over a great deal of complexity, regulation inhibited the nature and amount of risk a bank could take.[51] By contrast, investors in the broader capital markets, who would purchase the securities in a

seller retains substantially all of the benefits and burdens of ownership").

48. "Securitization's structure is designed to divert value away from the originator," Lupica has argued, "in the absence of any compensating controls on either the consideration received in exchange for the asset sale, or the debtor's behavior. The originator enjoys the benefits of this distributional inefficiency, at the expense of its unsecured creditors." Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595, 598 (1998). *See also* Lois R. Lupica, *Revised Article 9, The Proposed Bankruptcy Code Amendments and Securitizing Debtors and Their Creditors*, 7 FORDHAM J. CORP. & FIN. L. 321, 321–28 (2002); Lois R. Lupica, *Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic*, 9 AM. BANKR. INST. L. REV. 287, 287–91 (2001); Lois R. Lupica, *Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization*, 33 CONN. L. REV. 199, 199–202 (2000).

49. *See* Kettering, *Discontents*, *supra* note 37, at 1633 ("It seems improbable that a court that is fully aware of these consequences would be willing to accept the responsibility of causing them by ruling that the legal doctrines relied upon to support securitization do not do their job. In other words, the product has simply become too big to fail.").

50. *See* Panteleo et al., *supra* note 39 and accompanying text.

51. *See* 12 U.S.C. § 24 (2008); 12 C.F.R. § 1.3 (2011) (governing investment and lending limits on regulated depositaries).

securitization, were generally subject to fewer such constraints. In theory, this means they can provide financing that regulated banks cannot.

Reduced regulation also means that securities could vary in the degree of risk associated with the underlying payment streams. Investors with an appetite for a higher risk-adjusted rate of return might purchase one "tranche" of securities linked to a more speculative stream of payments. In exchange, they would receive a higher rate of interest. More conservative investors, by contrast, might purchase a different tranche linked to more or better quality payment rights. They would receive a lower rate of interest in exchange for an investment structured to be safer.

Third, and perhaps more controversially, firms sometimes choose securitization because it may result in certain accounting benefits. For example, a leasing company might improve its accounting appearance by engaging in a securitization because it would effectively remove from its balance sheet long-term assets (payment streams from lessees) as well as liabilities associated with the leased equipment, and replace them with the cash received from the purchasers of the securities. Although the details are complex—and the rules recently changed in ways that may reduce the accounting benefits of securitization[52]—securitization sometimes has been motivated by a desire to improve an originator's accounting position.[53] As discussed below, Enron's fraudulent transactions, which were viewed as securitizations, were apparently designed to achieve this result.

In addition to these three functions, securitization has also had important collateral consequences for those involved in structuring and implementing them, such as lawyers, rating agencies, and investment banks. While not part of the function of securitization per se, these social factors doubtless contributed to its rise and development.

Securitization has, for example, been lucrative. The complexity of these transactions, among other things, requires significant amounts of time and analysis, which are not cheap. At least until the financial crisis of 2008, securitization was highly profitable for the lawyers,[54] rating agencies,[55] and

52. *See supra* note 10 and accompanying text.

53. *See, e.g.*, Patricia M. Dechow, Linda A. Myers & Catherine Shakespeare, *Fair Value Accounting and Gains from Asset Securitizations: A Convenient Earnings Management Tool with Compensation Side-Benefits*, 49 J. ACCT. & ECON. 2, 4 (2010) (discussing the use of securitization to "manage" earnings reporting).

54. The Linklaters firm, for example, published a brochure in 2004 arguing that "for those securitization lawyers willing to think outside the box, to paraphrase Creedence Clearwater, the securitization gravy train may just keep on chooglin', and that big wheel may just keep on turning, for one more year." *See* Adam W. Glass, LINKLATERS, *Securitization: In Search of the Next Big Thing*,

investment banks (among others) involved in structuring and marketing these transactions.[56]

It is also likely that the appeal of securitization to market facilitators goes beyond money, and includes the caché associated with working on novel, complex, and innovative transactions. Observers often characterize securitization as a new kind of "technology."[57] New technologies tend to have inherent allure, and tend to develop and diffuse in fairly predictable ways, with "early adopters" being key exponents of the success or failure of an innovation.[58] Lawyers, rating agencies, and investment bankers can thus be thought of as early adopters of this comparatively new financing technique. Securitization may, in other words, have developed not only to serve the buyers and sellers of capital, but also those who serve them.

C. A SHORT HISTORY OF THE DEVELOPMENT AND SIGNIFICANCE OF SECURITIZATION

In order to understand what the term securitization does—and should—connote, it is also helpful to understand how the transactions developed, why they have been important to the capital markets, and the role they played in the financial crisis.

July 2004, at 6, *available at* www.linklaters.com/pdfs/publications/us/securitization2004.pdf.

55. For a discussion of the enormous profits earned by rating agencies, see, e.g., Elizabeth Devine, Note, *The Collapse of an Empire? Rating Agency Reform in the Wake of the 2007 Financial Crisis*, 16 FORDHAM J. CORP. & FIN. LAW 177 (2011). Devine explains that

> nearly every company that publicly traded bonds began paying the rating agencies directly for [rating agency] services. The average cost of these services ranged between $30,000 and $100,000. In some instances, Wall Street paid as much as $1 million for ratings. With the new millennium, both Moody's and S&P went public and a push for even greater revenue growth resulted. In 2000, when Moody's went public, mid-level executives at the company were given stock options. These executives therefore had incentive to consider not just the accuracy of their ratings but also the effect those ratings would have on Moody's as a business. An investment bank might be willing to pay a higher fee for an AAA rating than a BB rating. Not surprisingly, when Moody's went public, its profits increased by 900%. By 2002, Moody's was worth more than Bear Stearns, which, at the time, was a prominent investment bank. Revenues that were $800.7 million in 2001 soon topped $1.73 billion in 2005 and reached $2.03 billion in 2006.

Id. at 184 (footnotes omitted).

56. *See* Jonathan C. Lipson, *Enron Rerun: The Credit Crisis in Three Easy Pieces*, *in* LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES AND OUR ECONOMIC FUTURE 43 (Robert W. Kolb ed., 2010) (discussing fees of transaction facilitators).

57. *See* Rosenthal & Ocampo, *supra* note 43, at 32 ("In our view, credit securitization represents . . . a technological advance—and, we will argue, a very sizeable advance.").

58. The term "early adopter" comes from Everett Rogers. *See* EVERETT M ROGERS, DIFFUSION OF INNOVATIONS (1983). For discussions about the rate of adoption of innovation, see Barbara Wejnert, *Integrating Models of Diffusion of Innovations: A Conceptual Framework*, 28 ANN. REV. SOC. 297, 297–306 (2002). As discussed in Part VI.B, below, the novelty of securitization means it can be seen as a "disruptive technology."

1. Securitization Prior to the Financial Crisis

Although there are somewhat exaggerated claims that securitization-like transactions have existed for hundreds of years,[59] they more realistically trace their origin to the development of a secondary market for real estate mortgages in the 1970s. More specifically, they likely developed when Congress created the Federal Home Loan Mortgage Corporation and broadened the authority of the Federal National Mortgage Association to purchase conventional and variable-rate loans, the original form of "input" in a securitization.[60]

As a general matter, securitization remained the province of residential real property mortgages until the mid-1980s, when commercial property mortgages became the subject of securitization transactions.[61] Soon, other payment rights—for example those arising under auto loans and credit cards—were being sold into securitizations. In 1986, General Motors Acceptance Corporation sold about $4.2 billion in auto loan receivables into a securitization that observers believed showed the economic efficiency of securitization as compared to other forms of financing, such as traditional, asset-based lending.[62]

59. As Shenker & Colletta observed,

> Even before the turn of the century, however, mortgage-backed bonds were sold to the public, and mortgage participation certificates, which were very similar to modern mortgage-backed securities, had been issued by mortgage bankers. In the 1920s, private title and mortgage insurance companies in New York State sold "guaranteed mortgage participation certificates" secured by single mortgage loans or pools of mortgage loans. Purchasers of these certificates received a pro rata share of the cash flow from the underlying loans, and the mortgage insurance companies guaranteed payment of principal and interest. These certificates were very popular among investors and were actively traded until the 1930s, when the real estate market collapsed with the Depression, leading to widespread defaults on the underlying mortgages.

Shenker & Colletta, *supra* note 1, at 1380–81 (footnotes omitted). A more credible claim may be that the current institutional framework was created in the late 1960s, when the U.S. government first developed a mortgage-pass-through financing mechanism during the Johnson administration. *See* Sarah Quinn, *'Things of Shreds and Patches': Credit Aid, the Budget, and Securitization in the Postwar Era* 30 (Working Paper draft of Oct. 2010), *available at* http://www.hbs.edu/units/ob/pdf/Quinn_ShredsandPatches_OCT2010.pdf (discussing Housing and Urban Development Act of 1968 and the creation of "Pass-Through Certificates").

60. Federal Home Loan Mortgage Corporation Act, Pub. L. No. 91-351, 84 Stat. 450 (1970) (codified as amended in scattered sections of 12 U.S.C.). *See also* Thomas E. Plank, *Regulation and Reform of the Mortgage Market and the Nature of Mortgage Loans: Lessons from Fannie Mae and Freddie Mac*, 60 S.C. L. REV. 779, 796 (2009) (describing the history of this development).

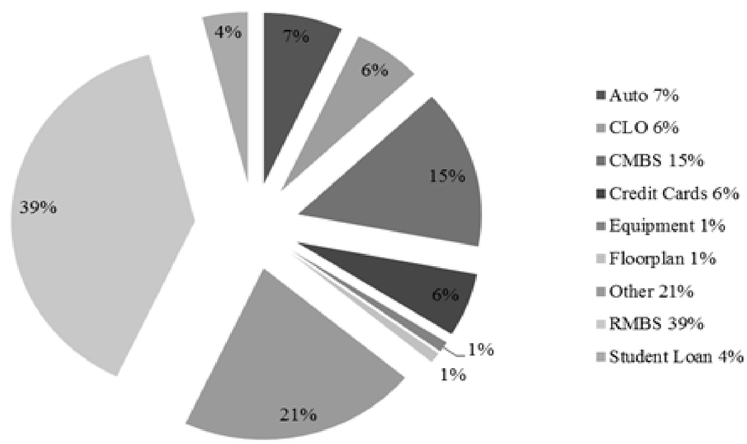
61. *See* Shenker & Colletta, *supra* note 1, at 1401 ("With respect to securities backed by mortgages on commercial real estate, it was not until 1985 that a single-property commercial financing was rated, and not until 1987 that a security backed by a pool of commercial mortgages was rated.").

62. *See* Rosenthal & Ocampo, *supra* note 43, at 40 ("[W]e estimate that, on an annual basis, GMAC may have saved as much as 1.30 percent annually over the cost of match-funded traditional finance."). Rosenthal & Ocampo had to acknowledge the speculative nature of this conclusion: "Not

2. Securitization's Performance: The Financial Crisis

By the time of the 2008 financial crisis, well over $2 trillion in securitization transactions (broadly construed) were outstanding. Although residential real property remained an important part of the story, as indicated in figure 2, by the early 2000s, other types of payment rights (like auto loans, credit cards, and student loans) had in the aggregate overtaken residential real property as the input element of new securitization transactions.

FIGURE 2. Securitization Market Share by Asset Class, 2005–2009



Source: Credit Risk Retention, 76 Fed. Reg. 24,089, 24,094 tbl.B (Apr. 29, 2011).

Observers frequently claim that securitization was one of the causes of the financial crisis. Although "[s]ecuritization is an important source of credit formation to the economy," Treasury Secretary Timothy Geithner has commented, "certain risks of securitization contributed to the financial crisis and macroeconomic instability."[63] Kurt Eggert, a vocal critic of securitization, has argued that "[w]hile there were multiple causes of the subprime boom and collapse, securitization itself was a significant cause of

being privy to the particular nonpublic financial details of the transaction, however, we have been forced to make reasonable approximations where necessary." *Id.* at 40.

63. TIMOTHY F. GEITHNER, FIN. STABILITY OVERSIGHT COUNCIL, MACROECONOMIC EFFECTS OF RISK RETENTION REQUIREMENTS 2 (2011), *available at* http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20%28FINAL%29.pdf.

both."[64] Even those who are not hostile to securitization would now seem to support this view. The Federal Reserve System, generally supportive of securitization, has observed that "during the financial crisis securitization also displayed significant vulnerabilities to informational and incentive problems among various parties involved in the process. The ramifications of these problems have had and continue to have profound effects on many American households."[65] Another market cheerleader, Henry Paulson—the former treasury secretary and chairman of investment bank Goldman Sachs—admitted that securitization contributed to the overleveraging that led to the crisis because it "separated originators from the risk of the products they originated."[66]

While it is true that securitizations, and transactions such as CDOs (which this Article argues are not properly understood as securitizations), contributed to the growth of the credit bubble and its rapid collapse in 2008, it is important to recognize that not all transactions performed the same. In significant part, it appears that variation in performance correlates to the input element, the type of assets sold into the front end of the transaction.

The Federal Reserve's Risk Retention Report, for example, explains that "[w]idespread defaults, in which contractual payments were not made

64. Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257, 1262 (2008) ("This Article, however, focuses on one causative aspect: how a prime element of the subprime meltdown is the flawed structure of securitization itself and how, because of the securitization of subprime and other non-prime mortgages, as well as the resecuritization of some of the resulting subprime-backed securities, many of the villains of the story were acting based on incentives generated by that structure.").

65. BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO THE CONGRESS ON RISK RETENTION 8 (2010) [hereinafter FRB RISK RETENTION REPORT], *available at* http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf. *See also* Kenneth E. Kohler, *ABA Webinar: Securitization Reform: Dodd-Frank Changes the Rules* (Apr. 27, 2012, 1:00 PM), http://www.mofo.com/aba-webinar-securitization-reform-dodd-frank-changes-the-rules-04-27-2011/ ("Securitization has been blamed for parts of the financial crisis, including for facilitating the making of poor quality loans by lenders who sold the risk of those loans into the capital markets."); Benjamin J. Keys et al., Did Securitization Lead to Lax Screening? Evidence from Subprime Loans 2–3 (2008) (unpublished manuscript) (on file with author); Taylor D. Nadauld & Shane M. Sherlund, *The Role of the Securitization Process in the Expansion of Subprime Credit* 2 (Fin. and Econs. Discussion Series & J. Econ. Literature Working Paper Classification Nos. G21 & G24, 2009) *available at* www.federalreserve.gov/pubs/feds/2009/200928/200928pap.pdf (last visited July 27, 2011) ("It is widely believed that a misallocation of resources to the real estate sector, facilitated by the practice of securitization, is one of the causes of the current financial crisis.").

66. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 142 (2011) [hereinafter FCIC REPORT], *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (quoting Henry Paulson, chairman of Goldman Sachs from 1999 until 2006, when he became treasury secretary) (internal quotation marks omitted).

to bondholders, were largely concentrated in [securitizations] backed by real estate [mortgages]. . . . driven primarily by the large drop in nominal house prices and its effect on loans made to borrowers with weak credit histories, unverified income or with nontraditional amortization structures."[67] It appears that securitizations involving other types of payment rights performed better.

This is curious. In a significant and general economic downturn, one might expect that all or most types of securitizations would suffer more or less commensurate types of losses. If homeowners encounter financial distress, they most likely are not only going to default on their home mortgage, but also on car payments, credit card payments, student loans, and other obligations. Yet, as indicated in the table below, that was not the case.

TABLE. Percentage of Securities Rated CCC+ or Lower (Likely to Default) by Standard & Poor's as of January of the Year Indicated

Year	*Prime RMBS*	*Alt-A and subprime RMBS*	*CMBS*	*Credit Card*	*Auto loans and leases*	*Student loans*	*Equipment*
2006	0.2%	0.2%	1.8%	0.7%	0.0%	0.0%	0.0%
2007	0.2%	0.3%	1.8%	0.8%	0.0%	0.0%	0.0%
2008	0.2%	3.0%	2.0%	0.2%	0.0%	0.0%	0.0%
2009	3.6%	26.3%	4.9%	0.0%	0.0%	0.0%	0.0%
2010	28.3%	66.5%	16.0%	2.2%	0.0%	0.3%	0.0%

Source: FRB RISK RETENTION REPORT, *supra* note 65, at 50 tbl.4 (citing Standard & Poor's).

The input element appears to be related to the transactions' performance. Nearly two-thirds of nonprime real-estate mortgage-backed securities ("RMBS") were rated likely to default by 2010. In contrast, only 2.2 percent of credit-card securitizations had this low rating by the same time, and securitizations based on auto loans and equipment loans or leases were not downgraded at all.

67. *See* FRB RISK RETENTION REPORT, *supra* note 65, at 2.

Perhaps the transaction form that performed worst in the financial crisis was the "collateralized debt obligation" ("CDO"), which performed so badly, this Article argues, that it should not be characterized as a securitization. The Treasury Department defines a CDO as a "financial instrument that entitles the purchaser to some portion of the cash flows from a portfolio of assets, which may include bonds, loans, mortgage-backed securities, or other CDOs."[68] The key to a CDO seems to be that it is not itself backed directly by primary payment rights, such as credit card receivables. Instead, it typically has been composed of other securities, like bonds, or derivative rights, such as credit default swaps.[69] The use of CDOs expanded rapidly during the run up to the financial crisis, increasing from $20 billion to almost $2 trillion between 2004 and 2007.[70]

Although the CDO market in the 2000s grew rapidly, it collapsed just as quickly.[71] While traditional securitizations (especially RMBSs) also suffered from declines in home prices, the CDO market radically underperformed even the RMBS market. According to the Financial Crisis Inquiry Commission,

> By the end of 2008 more than 90% of all tranches of CDOs had been downgraded. Moody's downgraded nearly all of the 2006 Aaa and all of the Baa CDO tranches. And, again, the downgrades were large—more than 80% of Aaa CDO bonds and more than 90% of Baa CDO bonds were eventually downgraded to junk.[72]

68. "*Collateralized Debt Obligation (CDO)*" *Glossary Definition*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/financial-stability/glossary/Pages/Default.aspx (follow "C" hyperlink) (last visited August 24, 2012).

69. *See* Paul Mizen, *The Credit Crunch of 2007–2008: A Discussion of the Background, Market Reactions, and Policy Responses*, 90 FED. RESERVE BANK ST. LOUIS REV. 531, 537-38 (2008), *available at* http:// research.stlouisfed.org/publications/review/08/09/Mizen.pdf; Regulation AB, *supra* note 13, at *15 (describing "synthetic" securitization).

70. *See* Yongheng Deng, Stuart A. Gabriel & Anthony B. Saunders, *CDO Market Implosion and the Pricing of Subprime Mortgage-Backed Securities* 3 (Working Paper No. 1356630, 2010).

71. As the *Financial Times* reported in 2008,

> [T]he way in which CDOs of ABS react drastically to systemic risk and the widespread nature of the problems in the US mortgage markets have led to rapid and substantial losses right through the structure of these deals. Those deals created from mortgage-backed bonds structured in 2006 and 2007 account for about 90 per cent of all downgrades seen in the CDO market since problems have really begun to work their way through. According to Morgan Stanley research, this year alone has seen 4,485 downgrades to all kinds of CDOs. 4,008 of these downgrades were on CDOs of ABS, or structured finance CDOs as they are also called.

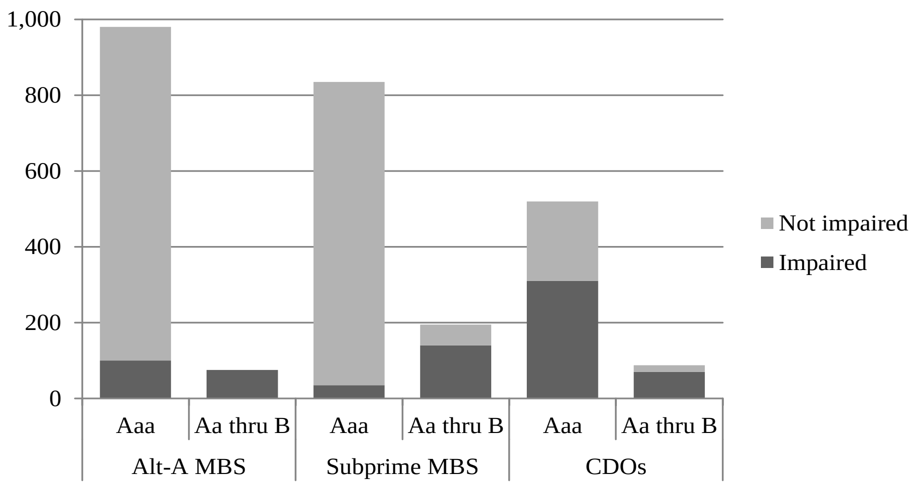
Michael Mackenzie, *'Super-Senior' CDO Investors Begin to Flex Their Muscles*, FIN. TIMES (April 15, 2008), http://www.ft.com/intl/cms/s/0/8473466c-0a85-11dd-b5b1-0000779fd2ac.html#axzz24VQQgPHe. Tranches with AAA ratings account for 1000 of these downgrades, more than any other ratings class. *Id.*

72. FCIC REPORT, *supra* note 66, at 224. One report indicated that "among high-yield CBOs, 82% of tranches rated in 1997, 69% of those rated in 1998, and 72% of those rated in 1999 have been

According to a paper prepared for the Harvard Economics department, as of 2008 CDOs were responsible for over half of the losses experienced in the market for asset-backed securities.[73]

Figure 3 shows that CDOs performed worse, absolutely and relatively, than traditional, primary-payment securitizations involving residential real-property mortgages.

FIGURE 3. MBS and CDO Performance 1993–2009 (billions)



Source: FCIC REPORT, *supra* note 66, at 229 (citing MOODY'S INVESTORS SERV., SPECIAL COMMENT: DEFAULT & LOSS RATES OF STRUCTURED FINANCE SECURITIES 1993-2009 (2010)).

According to the several federal agencies responsible for assessing securitization and the financial crisis, CDOs may have performed poorly because they were especially vulnerable to manipulation.[74] Congress also believed that the complexity and opacity of CDOs "created the conditions

downgraded." Daniel Newman et al., *Empirical Evidence on CDO Performance*, 18 J. FIXED INCOME 32, 35 (2008). "The percentages for 2005-2007 vintage ABS CDO tranche downgrades are even more disastrous, at 73% for 2005, 90% for 2006, and 91% for 2007." *Id.*

73. Anna Katherine Barnett-Hart, The Story of the CDO Market Meltdown: An Empirical Analysis 3 (March 19, 2009) (unpublished B.A. thesis, Harvard College), *available at* www.hks.harvard.edu/m-rcbg/students/dunlop/2009-CDOmeltdown.pdf ("Collateralized debt obligations (CDOs), once a money making machine on Wall Street, have been responsible for $542 billion of the nearly trillion dollars in losses suffered by financial institutions since 2007.").

74. Credit Risk Retention, 76 Fed. Reg. 24,089, 24,095–06 (Apr. 29, 2011) ("In addition, participants in the securitization chain may be able to affect the value of the ABS in opaque ways, both before and after the sale of the securities, particularly if those assets are resecuritized into complex instruments such as collateralized debt obligations (CDOs) and CDOs-squared.").

that allowed the financial shock from the subprime mortgage sector to spread into a global financial crisis."[75]

There are many reasons CDOs performed worse than traditional securitizations.[76] The mathematical models on which they were based failed to account for the possibility of a drop in housing prices. The ratings (based on the mathematical models) failed to signal the true risks inherent in these transactions. They concentrated and magnified—and did not diversify—risk. As author Michael Lewis has colorfully explained,

> A CDO in [the view of Cornwall Capital, a hedge fund Lewis examined] was essentially just a pile of triple-B-rated bonds. Wall Street firms had conspired with the rating agencies to represent the pile as a diversified collection of assets, but anyone with eyes could see that if one triple-B subprime mortgage went bad, most would go bad, as they were all vulnerable to the same economic forces. Subprime mortgage loans in Florida would default for the same reasons, and at the same time, as subprime mortgage loans in California. And yet fully 80 percent of the CDO composed of nothing but triple-B bonds was rated higher than triple-B: triple-A, double-A, or A. To wipe out any triple-B bond—the ground floor of the building—all that was needed was a 7 percent loss in the underlying pool of home loans. That same 7 percent loss would thus wipe out, entirely, any CDO made up of triple-B bonds, no matter what rating was assigned it. "It took us weeks to really grasp it because it was so weird," said Charlie [Ledley, of Cornwall]. "But the more we looked at what a CDO really was, the more we were like, *Holy sh*[*]*t, that's just f*[*]*cking crazy. That's fraud*. Maybe you can't prove it in a court of law. But it's fraud."[77]

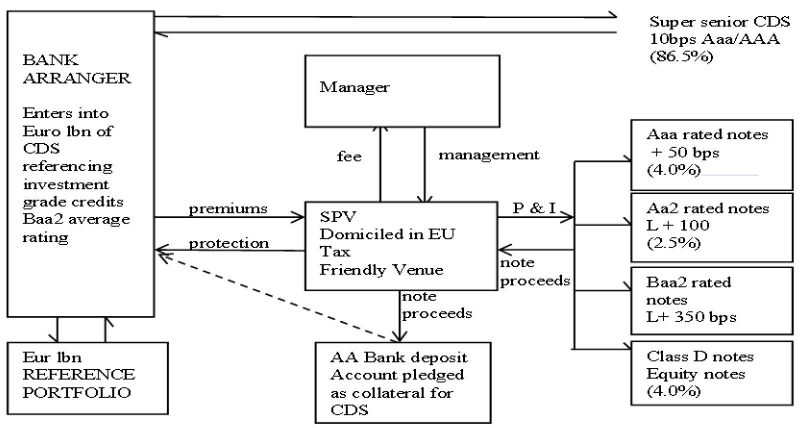
75. S. REP. NO. 111-176, at 128 (2010).

76. Despite their prominent role in causing and exacerbating the financial crisis, regulators have generally been unwilling to study CDOs, even as they have been commanded by Dodd-Frank to explain the financial crisis. *See, e.g.*, FRB RISK RETENTION REPORT, *supra* note 65, at 7 ("The study does not explicitly address resecuritizations, such as collateralized debt obligations (CDOs) backed by ABS or re-REMICs (resecuritizations of real estate mortgage investment conduits). Given that the credit risk retention provisions of [Dodd-Frank] are intended to influence the quality of assets being securitized, it is appropriate for the study to focus on primary securitizations though further analysis of re-securitizations in the context of final rulemaking would be worthwhile.").

77. MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 129 (2010). CDOs have been associated with some of the higher-profile allegations of misconduct by financial institutions in the financial crisis, including the so-called "Magnetar trade," in which a hedge fund bet against bonds contained in CDOs it sold to investors and the Goldman Sachs "Abacus" transaction, where Goldman Sachs allegedly failed to disclose certain conflicts of interest involving participants in a CDO transaction. *See also* Jesse Eisinger & Jake Bernstein, *The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going*, PROPUBLICA (April 9, 2010 2:00 PM), http://www.propublica.org/article/the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble-going; Press Release, SEC, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges

An important contributing factor must have been the complexity of CDOs. Unlike the three basic elements of a securitization noted in figure 1 above, CDOs (figure 4) can have many elements, each adding dense layers of legal, financial, and regulatory contingency and nuance. These complexities doubtless introduce or exacerbate problems of cognitive overload:[78] the deals were too difficult to digest in any meaningful way in real time by those ultimately affected by or responsible for them, in particular investors and regulators. It is thus no surprise that it took the sophisticated investors Lewis interviewed "weeks to really grasp because it was so weird."[79]

FIGURE 4. CDO Schematic



Source: Sam Jones, *The CDO Unwind Waiting to Happen*, FIN. TIMES (Oct. 23, 2008), http://ftalphaville.ft.com/blog/2008/10/23/17365/the-cdo-unwind-waiting-to-happen/.

To summarize, data on securitization performance up to and through the financial crisis offer two important lessons. First, the type of input matters. Transactions that used primary payment rights appear to have had a better chance of better performance than those that did not (like CDOs). Transactions whose primary payment rights were subject to more stringent

Related to Subprime Mortgage CDO (July 15, 2010), *available at* http://www.sec.gov/news/press/2010/2010-123.htm.

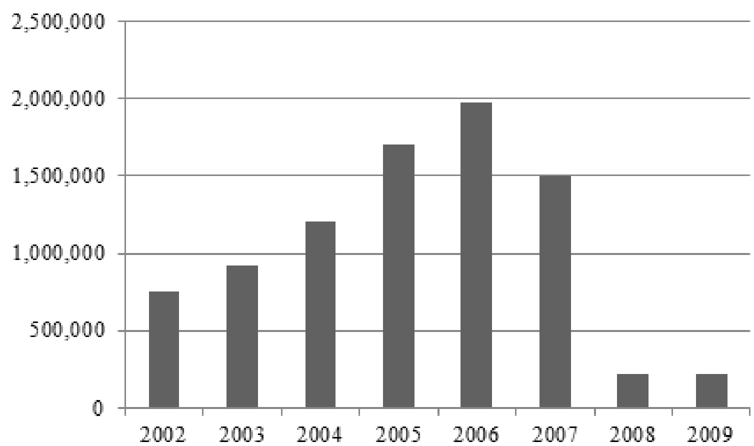
78. I do not mean this in a technical sense, although it may map onto the spirit of the cognitive work of, for example, George Miller or Herbert Simon. *See* George A. Miller, *The Magical Number Seven, Plus or Minus Two: Some Limits on Our Capacity for Processing Information*, 63 PSYCHOL. REV. 81 (1956); William G. Chase & Herbert A. Simon, *Perception in Chess*, 4 COGNITIVE PSYCHOL. 55 (1973); Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 STAN. L. REV. 657 (2012).

79. LEWIS, *supra* note 77, at 129.

underwriting standards (like car loans) performed better than those that did not (like residential real-property mortgages). Transactions in which primary payment rights derived from assets that were themselves not subject to rapid inflation in value (like real estate) appear to have performed better, too.[80] In short, although legal academics frequently focus on the structural element of securitization (in other words, the "true sale" question), it may be that the input element is actually more important to understanding the effect and effectiveness of these transactions.

Second, the financial crisis injured, but did not kill, securitization. As figure 5 indicates, even after 2007, new securitization transactions were being originated, although obviously at a far lower level than the 2006 peak. Thus, securitization is likely here to stay. The important question will then be how to regulate it. In order to regulate it, one important question will be how to define it.

FIGURE 5. Outstanding Securitization Amounts 2002-2009 ($000s)



Source: Credit Risk Retention, 76 Fed. Reg. 24,089, 24,094 tbl.A (Apr. 29, 2011).

The foregoing describes securitization's elements, functions, historical

80. We tend to assume that securitization contributed to the rise in home prices. Mary L. Shapiro, SEC Chairman, Remarks Before the American Securitization Forum 2011 Annual Meeting (June 22, 2011), *available at* http://www.sec.gov/news/speech/2011/spch062211mls.htm ("In conjunction with low interest rates and rising home prices, securitization helped fuel the real estate boom of the last decade."); Atif Mian & Amir Sufi, Finance and Macroeconomics: The Role of Household Leverage, NBER Reporter 2011 No. 3: Research Summary, *available at* http://www.nber.org/reporter/2011number3/sufi.html (last visited Aug. 24, 2012) ("We argue that the primary explanation behind the dramatic increase in mortgage debt was a securitization-driven shift in the supply of mortgage credit."). An interesting empirical question to consider is why securitization appears to have contributed to inflation of home prices, but not of other assets like cars.

context, and performance. It provides a basis for developing a definition of securitization grounded in context and practice, the normative aspirations offered in the Introduction. Before unpacking that definition in Part V, however, it is important to understand why existing definitions are inadequate, which I do in Part IV.

IV. EXISTING DEFINITIONS: VAGUENESS AND VOIDS

A. UN(DER)-DEFINING SECURITIZATION

Although securitization transactions initially emanated from public innovation (like Fannie Mae), the neologism itself comes from market actors, in particular Lewis Ranieri. Often considered one of the creators of securitization,[81] Rainieri claims to have coined the term during a 1977 interview with the *Wall Street Journal*.[82] Yet, as one would expect with a new and developing transactional form, there was little precision at the time. This would come later, as legislatures and regulators attempted to define this new form of financing. And come it did, in scores of definitions in statutes, regulations, and commentary.

Yet, these definitions often share two types of problems. First, they frequently embed terms that are themselves vague, making it easier to use inputs (assets) of sometimes opaque and speculative value. Second, they tend to omit one or more of the essential elements of a securitization described above. They thus suffer from vagueness and omissions that

81. *See* Mike McNamee, *Lewis S. Ranieri: Your Mortgage Was His Bond*, BLOOMBERG BUSINESSWEEK, Nov. 29, 2004, *available at* http://www.businessweek.com/magazine/content/04_48/b3910023_mz072.htm.

82. *See* Ranieri, *supra* note 2, at 31–43. Ranieri's story about the roots of the term would appear to have special significance in trying to understand today how to differentiate "true" securitizations from other transactions. "The term *securitization* has an interesting origin," he has explained—

> It first appeared in a "Heard on the Street" column of the *Wall Street Journal* in 1977. Ann Monroe, the reporter responsible for writing the column, called me to discuss the underwriting by Salomon Brothers of the first conventional mortgage pass-through security, the landmark Bank of America issue. She asked what I called the process and, for want of a better term, I said securitization. *Wall Street Journal* editors are sticklers for good English, and when the reporter's column reached her editor, he said there was no such word as securitization. He complained that Ms. Monroe was using improper English and needed to find a better term. Late one night, I received another call from Ann Monroe asking for a real word. I said, "But I don't know any other word to describe what we are doing. You'll have to use it." The *Wall Street Journal* did so in protest, noting that securitization was a term concocted by Wall Street and was not a real word.

Id. at 31. "Securitization" is, in short, a neologism that characterizes an important development in commercial financing. I note that Merriam-Webster Dictionary quibbles with the timing, opining that the term was first used in 1981. *Securitize Definition*, MERRIAM-WEBSTER.COM, http://www.merriam-webster.com/dictionary/securitization?show=0&t=1310130267 (last visited Aug. 24, 2012).

undermine their effectiveness by, among other things, treating as securitizations things that are not. For convenience, this Article discusses the legal definitions first, then those developed in commentary.

1. Legal Definitions

There are over two dozen regulatory and statutory definitions of the word "securitization."[83] For example, according to U.S. bank regulators, "securitization" means "the pooling and repackaging by a special purpose entity of assets or other credit exposures that can be sold to investors."[84]

At least on its own terms, this definition is vague. Many things besides payment rights could be "assets." Nor does the regulation tell us what a "credit exposure" is. The term is used in federal regulations in connection with definitions of certain types of derivative contracts for purposes of establishing minimum bank capital requirements.[85] It would appear therefore to have a fairly technical, industry-specific meaning—it applies to banks that hold derivative contracts. Yet, the core term, "credit exposure," is not defined; so perhaps it refers to broader types of obligations. Intuitively, contingent liabilities under insurance policies, fixed and liquidated liabilities embodied in final judgments, and binding oral promises could all reasonably be construed to be a "credit exposure."

It also omits two of the three essential elements of securitization: structure and output. Although it speaks of "special purpose entities" it says nothing about the structural key to a securitization, namely that it be a "true sale" of the "assets" in question. Nor does it discuss the output, securities.

83. Among federal regulations, securitization is defined in 12 C.F.R. app.A § 3 (2012); *id.* app.A § 208; *id.* app.A § 225; *id.* § 360.6; *id.* § 567.1; *id.* § 615.5201; *id.* § 627.2726; *id.* § 704.2; *id.* § 709.10; 13 C.F.R. § 120.420; *id.* § 307.8. Among states, it is defined in HAW. REV. STAT. § 431:19-203 (2010) (Hawaii); ME. REV. STAT. tit. 24-A § 781 (2011) (Maine); MASS. GEN. LAWS ch. 164, § 1 (2010) (Massachusetts); NEV. REV. STAT. § 100.210 (2010) (Nevada); N.C. GEN. STAT. § 53-425 (2010) (North Carolina); OHIO REV. CODE ANN. § 5751.01 (LexisNexis 2011) (Ohio); S.C. CODE ANN. § 38-90-420 (2010) (South Carolina); S.D. CODIFIED LAWS § 54-1-9 (2010) (South Dakota); UTAH CODE ANN. § 31A-37a-102 (2011) (Utah); VT. STAT. ANN. tit. 8, § 6048c (2010) (Vermont); V.I. CODE ANN. tit. 22, § 6652 (2011) (Virgin Islands); VA. CODE ANN. § 6.2-2400 (2010) (Virginia).

84. 12 C.F.R. app.A § 3 sec. 4(a)(14).

85. *Id.* § 3 secs. 3(b)(7)(A) to (B) define "current credit exposure" and "potential future credit exposure" respectively. The former is defined as

> The current credit exposure for a single derivative contract is determined by the mark-to-market value of the derivative contract. If the mark-to-market value is positive, then the current credit exposure equals that mark-to-market value. If the mark-to-market is zero or negative, then the current credit exposure is zero. The current credit exposure for multiple derivative contracts executed with a single counterparty and subject to a qualifying bilateral netting contract is determined as provided by section 3(b)(5)(ii)(A) of this appendix A.

Id. § 3 sec. 3(b)(7)(A).

Instead, it provides that whatever has been "pooled and repackaged" can be "sold" to investors, without indicating the medium through which that sale is to occur.

Dodd-Frank—the most ambitious attempt to regulate capital markets since the Depression—is equally problematic, for, strictly speaking, it does not even attempt to define securitization.[86] Instead, Dodd-Frank effectively resorts to two different definitions of the term "asset-backed security": the first in the legislation itself, as it amends the Securities Exchange Act of 1934 ("Exchange Act ABS");[87] and the second in Regulation AB, an SEC disclosure exemption regime created in 2004 ("Reg AB-ABS").[88]

Consider first the statutory definition, Exchange Act ABS. The Securities Exchange Act of 1934 ("Exchange Act") defines an "asset-backed security" as

> a fixed-income or other security collateralized by any type of *self-liquidating financial asset* (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including . . . a *collateralized debt obligation* [and] *a collateralized debt obligation of collateralized debt obligations*.[89]

This definition is vague because, among other things, the terms "self-liquidating" and "financial asset" could describe a wide range of things not likely to be inputs in a securitization. The term "self-liquidating," for example, could be used to describe funds or securities held by money-market mutual funds, but no one thinks they are securitizations.[90]

86. Dodd-Frank does define a "securitizer" but only by reference to "asset-backed securities." Dodd-Frank Wall Street Reform and Consumer Protections Act, Pub. L. No. 111–203 § 15G(a)(3), 124 Stat. 1376, 1891–96 (2010) (codified at 15 U.S.C. § 78o-11(a)(3)).

87. *See* Dodd-Frank § 941(a), 124 Stat. at 1841-42 (codified at 15 U.S.C. § 78c(a)(77)).

88. *See* Regulation AB, *supra* note 13.

89. 15 U.S.C. § 78c(a)(79)(A)(1)–(6) (emphasis added). For convenience, I have italicized and numbered in brackets problematic language.

90. A fact confirmed by an exemption under the Investment Company Act of 1940. *See* 17 C.F.R. § 270.3a-7 (2011); Exclusion from the Definition of Investment Company for Structured Financings, Investment Company Act, Release No. IC–19105, 57 Fed. Reg. 56,248, 56,255 (proposed Nov. 27, 1992) (codified at 15 C.F.R. § 270). Practitioners have noted that the breadth of the Exchange Act definition may create other problems as well. *See* Subcomm. on Annual Review, Comm. on Fed. Regulation of Securities, *Regulatory Developments 2010 Survey—Federal Regulation of Securities*, 66 BUS. LAW. 665, 710 n.366 (2011) ("The scope of the definition of Exchange Act-ABS raises a number of concerns, including the possibility that it could be read to include common financial instruments, such as structured notes, covered bonds, hybrid capital securities, and pooled investment vehicles, not previously considered to be (or treated as) ABS, thereby subjecting such instruments to Dodd-Frank's securitization reforms or Regulation AB.").

The term "financial asset" is not defined in the Exchange Act, but is defined very broadly in Article 8 of the Uniform Commercial Code to include an "interest in . . . property . . . which is recognized in any area in which it is issued or dealt in as a medium for investment."[91] Not surprisingly, some aficionados have joked that even a ham sandwich could be a "financial asset" under the right circumstances, although that is not likely what the drafters had in mind.[92]

The term "collateralized debt obligation" is problematic because it appears to conflict with the requirement that an ABS be backed by "self-liquidating" assets. As explained in Part III, commercial finance lawyers generally understand CDOs (and other "synthetic" transactions) to be structured like securitizations and produce securities, but to involve a different input. The asset sold into the transaction is not a primary payment right, but instead may be derivative securities such as credit default swaps or bonds issued in other securitizations. Derivative rights will liquidate, however, only if the asset from which the security is derived actually produces cash (for example, when a "credit event" triggers counterparty liability on the swap). Moreover, CDOs appeared susceptible to "recycling" cash flows from the original obligors, which means there may not be much cash to "self-liquidate." This inconsistency makes the Exchange Act ABS definition unclear and, to that end, less effective than it might otherwise be.

The Exchange Act ABS definition is also incomplete. It focuses largely on the inputs and the output; a "fixed income or other security." But it omits entirely the structural element, the step lawyers seem to think is most important. It speaks neither of "sales" of the financial assets nor "special purpose entities," both of which are thought to be central to the legal efficacy of securitization.

The Regulation AB ABS presents other problems. Under Regulation AB, an ABS means "a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time

91. U.C.C. § 8-102(a)(9) (2010).

92. *See* e-mail from Richard L. Goldfarb, Partner, Stoel Rives, to ucclaw-l@lists.washlaw.edu, (October 11, 2006 16:40 EST) (on file with author) ("My question is whether there is any limitation on the scope of this definition (other than, presumably, the express statement in 8-103(f) that a commodity contract is not a financial asset). In other words, if the securities intermediary and the holder of a securities entitlement agree, may any form of property, up to and including a ham sandwich, be a financial asset?"). The answer, according to aficionados, "is supposed to be a resounding yes." *See, e.g.*, e-mail from Sandra M. Rocks, Counsel, Cleary Gottlieb Steen & Hamilton, to ucclaw-l@lists.washlaw.edu, (October 12, 2006 8:57 EST) (on file with author).

period . . . ."[93] This definition ties more closely to the essential elements of a securitization set forth in Part III. It explicitly recognizes that the input should "primarily" be "cash flows." Although it, too, includes the potentially vague term "financial assets," the uncertainty is mitigated by the requirement that the assets must "convert to cash within a finite period of time." While it omits any reference to the structural element (true sale), it is the closest we come to a definition that captures the important input and output elements of securitization set forth in Part III.

The principal goal in crafting this narrower definition in 2004 was to create disclosure exemptions for securitizations that most likely had the strongest inputs (or payment rights). Thus, the SEC explained that "synthetic" securitizations—which would include CDOs—would have to include greater disclosure to investors than securitizations involving inputs with primary payment rights.[94] Payments in a synthetic securitization, the SEC explained, "can primarily or entirely comprise or include payments based on the value of a reference asset which is unrelated to the value of or payments on any actual assets in the pool."[95] As previously discussed, this bifurcation, between the payments on the "reference asset," and "payments" or "actual assets" in the pool, foreshadowed an important distinction in the poor performance of CDOs.[96]

Many aspects of proposals to implement Dodd-Frank under Regulation AB would advance the definition of a "true securitization" proposed here, by requiring greater focus on the quality of the inputs.[97] For example, the SEC seeks to eliminate the "investment grade securities" condition for "shelf registration" (reduced disclosure) of asset-backed securities. It replaces this with four eligibility criteria, including, a requirement that the originator (or sponsor) retain a 5 percent interest in each class of offered asset-backed securities or, in common terms, keep "skin in the game."[98] In principle, these regulations should align originators' and investors' interests in the performance of the transaction. Regulation AB would also be amended to enhance "pool-level" (asset) disclosure. For example, with respect to potential defaults by the

93. Regulation AB, *supra* note 13, at *18 (citations omitted) (internal quotation marks omitted).

94. Specifically "shelf registration" of securities on Form S-3. For General Instructions to Form S-3 see 17 C.F.R. § 239.13 (2010), and 17 C.F.R. § 229.1100 (2010).

95. Regulation AB, *supra* note 13, at *16.

96. *See supra* Part III.C.2.

97. *See* Asset-Backed Securities, Securities Act Release No. 33-9117, 75 Fed. Reg. 23,328 (proposed May 3, 2010) (to be codified in scattered section of 17 C.F.R.) [hereinafter Reg AB Amendments Proposing Release].

98. *Id.*

underlying obligations, rights that investors may have against the originator if the assets do not perform as promised, and so forth.

There are, however, two major problems with these and related proposals to amend Regulation AB. First, it is not clear when or under what conditions these regulatory changes would be implemented. Dodd-Frank rulemaking is materially delayed,[99] and there have been significant efforts to dilute Dodd-Frank's reforms. Second, and more fundamentally, future administrations may have little interest in fully implementing Dodd-Frank. Because the Exchange Act definition of ABS is so much broader than the Regulation AB definition, the rules may eventually be relaxed to tolerate reduced disclosure of transactions unlike true securitizations.

2. "Nonlegal" Definitions

If we care about how language is used on the ground then legal definitions alone are not enough. We must also look to "nonlegal" definitions developed in reports and commentary. Yet, here too, we find the same pattern: definitions will nest vague terms and fail to include one or more essential elements of securitization.

Regulators, for example, sometimes step out of their regulatory role and offer definitions of securitizations in capacities that are not, strictly speaking, laws or rules. Instead, the Federal Reserve Board and the Treasury Department have issued reports that purport to define securitization in connection with various studies. For example, § 941(b) of Dodd–Frank requires bank regulators and the SEC, among others, to jointly prescribe "risk-retention" regulations that would require those who create securitizations (namely, a "securitizer," in Dodd-Frank parlance) to keep "skin in the game" (for example, 5 percent of the credit risk in the deal, as noted above).[100]

In its report, the Federal Reserve offered two somewhat different definitions of securitization:

> First, a financial institution is said to have securitized a pool of financial assets (for example, loans) when it creates securities backed by the cash

99. *See* DAVIS POLK & WARDWELL, LLP, DODD-FRANK PROGRESS REPORT 2, (July 18, 2012), *available at* http://www.davispolk.com/dodd-frank-rulemaking-progress-report ("As of July 18, 2012, a total of 221 Dodd-Frank rulemaking requirement deadlines have passed. . . . [o]f these 221 passed deadlines, 136 (61.5%) have been missed and 85 (38.5%) have been met with finalized rules. . . . [o]f the 398 total rulemaking requirements, 123 (30.9%) have been met with finalized rules and rules have been proposed that would meet 134 (33.7%) more. Rules have not yet been proposed to meet 141 (35.4%) rulemaking requirements.").

100. 15 U.S.C. § 78o-11(b)-(c).

> flows from those assets and sells some or all of these securities to investors. . . . Second, securitization may also refer, more narrowly, to the process of creating multiple securities with different payment priorities from a pool of underlying loans. For example, a pool of loans may be transformed into a senior tranche that is first in line to receive cash flows and a junior tranche that is last in line to receive cash flows.[101]

As with the legal definitions, the first of these is vague in that it contemplates inputs of "financial assets" which may not be payment rights. It also omits any reference to the structural element, a "true sale" to an SPE. The second is unusual. "[T]he process of creating multiple securities with different payment priorities from a pool of underlying loans"[102] might refer to a securitization. But it might also refer to a mutual fund, a hedge fund or a limited purpose joint venture. Moreover, the fact of priority among the securities would seem at most incidental to the core functions of securitization: a special purpose entity could issue a single class of bonds from a pool of payment rights, and most would acknowledge that to be a securitization. Most interesting of all is the fact that the Federal Reserve seems to believe it acceptable for a term of art such as "securitization" to have (at least) two quite different definitions.

Other market participants, in particular the rating agencies, might have had a greater influence in the development of securitization (and the meaning of the term) than the government. Yet, here we find definitions that are similarly vague and incomplete. Moody's, for example, has defined a securitization as

> the process through which a variety of financial and non-financial assets are packaged into securities that are then sold to investors. The cash flows generated by the underlying assets are used to pay principal and interest on the securities in addition to transaction expenses. The securities themselves are "backed" or supported by the assets and are known as asset-backed securities (ABS).[103]

This definition of securitization suffers from the same flaws found in the statutory and regulatory definitions discussed above. The inputs are vague (what are "nonfinancial assets" for this purpose?). It also omits important

101. FRB RISK RETENTION REPORT, *supra* note 65, at 8.

102. *Id.*

103. MOODY'S INVESTORS SERVICE, DEMYSTIFYING SECURITIZATION FOR UNSECURED CREDITORS 1, (2003) *available at* http://www.moodys.com/sites/products/AboutMoodysRatingsAttachments/2001700000415918.pdf.

structural features (nowhere is "true sale" mentioned, although we know the rating agencies themselves purported to care a great deal about it).

But at least Moody's tried. Standard & Poor's 2004 glossary of terms pertinent to the legal criteria involved in rating securitizations contains no definition of the term at all.[104]

Trade associations, such as the Securities Industry and Financial Markets Association ("SIFMA"), are another source of nonlegal definitions. These organizations appear to represent chiefly the interests of those involved in the structuring and implementation of securitizations. According to SIFMA,

> The term securitization refers to the process of converting assets with predictable cash flows into securities that can be bought and sold in financial markets. In other words, securitization allows financial institutions to bundle and convert illiquid income-producing assets held on their balance sheets, such as individual mortgage loans or credit card receivables, into liquid securities.[105]

As noted above, it would appear that certain transactions that otherwise fit this definition (in particular CDOs) may not have involved "predictable cash flows." Moreover, strictly speaking, "assets" in a securitization are not "converted" into securities: securities are issued in connection with a series of discrete legal steps, in particular the "true sale" of payment rights to an SPE. And, as we already know, when the financial crisis hit, securities issued in securitizations—like most securities—were at least temporarily illiquid.

In 1991, two prominent practitioners, Joseph Shenker and Anthony Colletta, offered one of the first serious attempts to define securitization in a rigorous way. "[A] serviceable definition" of securitization, they argued, is

> the sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets.[106]

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104. *See* S&P CRITERIA *supra* note 38, at 229–247.
105. SIFMA, HOUSING FINANCE AND SECURITIZATION RES. CTR., *Overview*, http://www.sifma.org/Issues/Capital-Markets/Securitization/Housing-Finance-and-Securitization/Overview/ (last visited Aug. 24, 2012).
106. Shenker & Colletta, *supra* note 1, at 1374–75.

Although perhaps serviceable at the time, this definition is today problematic for the same basic reasons. Consider first the suggestion that debt or equity instruments represent "ownership interests" in "income producing assets." As noted above, many assets could be income producing. Indeed, that is the likely expectation of any investor who purchases a share of common stock: if all goes as hoped, she will receive some sort of income (like a dividend) from the assets of the entity that issued the share of stock. A more technical grouse goes to the use of the term "ownership." As sophisticated observers have long understood, securities issued by an entity, whether debt or equity, do not represent "ownership" interests in either the entity itself or its assets. Rather, they represent a type of claim against the entity, which may or may not be fulfilled depending on a variety of factors, including the contractual rights of the security holders as well as various statutory and common law benefits and debilities they may experience.

Consider next the suggestion that a securitization is "structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets."[107] This is doubtless what the marketing departments of the investment banks that structured securitizations wanted investors to believe. But, at least so far as real-property mortgage-backed securities were concerned, once subprime (or "nonprime") loans became the assets behind a securitization, risk was not reduced or reallocated, but increased and concentrated.[108] CDOs, which simply repackaged existing securities, made the problem even worse.

Finally, note the claim that securitizations are designed "to ensure that such interests [securities issued in a securitization] are more readily marketable."[109] This might be true in the sense that securities are generally thought to be more readily susceptible to serial trading than other bundles of payment rights, such as promissory notes or loans. The securities markets typically exist in a state of supercharged negotiability. It is equally true that the assets put into a securitization are often not themselves readily marketable, and that securitization takes advantage of the negotiability

107. *Id.*

108. To be sure, the securitization of real property mortgages from around the nation created the potential for geographic diversity, and pools of mortgages were likely more diverse in that dimension (and perhaps others) than would have been the case if originated and held by a traditional lender, such as a bank. Yet, it would seem that securitization does not always diversify risk. In any case, risk diversification may be a consequence of a well-structured securitization, just as the payment of principal and interest on securities issued in the transaction would be a consequence of the transaction.

109. Shenker & Colletta, *supra* note 1, at 1374–75.

found in the securities system. But this simply means that securitization, as a discrete transaction form, does not promote marketability. This is something that securities markets do, generally. Securitization, in other words, takes advantage of the liquidity and high trading volumes offered by advanced securities markets. But it does not create those conditions.

Perhaps more to the point, because more ironic, there is some reason to doubt that securitizations in the end did promote marketability. While the freezing of the credit markets in 2008 had many causes, we know that one was the misuse of certain types of bonds issued in securitizations, like RMBS. These bonds, like virtually all other credit instruments, stopped trading almost entirely around the time Lehman Brothers declared bankruptcy. It is unrealistic to say that securitization alone caused this seizure in the credit markets. But it is equally implausible to claim that a defining feature of securitization is its trading resiliency.

In sum, definitions both "legal" and "nonlegal" tend toward vagueness and omissions that are inconsistent with a better understanding of a "true" securitization.

B. WHY BAD DEFINITIONS MATTER

One may nevertheless shrug this off. Who cares if definitions of securitization are vague or incomplete? Arguably, the market did not. Until the financial crisis of 2008, trillions of dollars were tied up in securitizations, regardless of how the term was defined.

The answer is that flawed definitions can permit or promote bad transactions, transactions that may satisfy definitions of securitization (or allied terms, such as ABS), yet differ in materially harmful ways from "true" securitizations. The proliferation of varying definitions, many with omissions or ambiguities, helped to create conditions under which even sophisticated investors and regulators were fooled into trusting transaction designs that, in retrospect, proved unreliable.

Consider two notorious examples: CDOs and Enron's "structured financings." In both cases, the transactions' central problem involved the inputs (Enron also presented the structural problem that its transactions may not have been true sales). Rather than selling primary payment rights, these transactions appear to have involved a kind of recycling that masked the true economics of the transactions, and thus harmed investors and the larger economy.

1. CDOs

Modern CDOs were, in essence, predicated on a kind of recycling.[110] As one observer explained before the financial crisis, and apparently without irony,

> Understanding of securitization can be enhanced by differentiating natural securities from synthetic securities. Natural securities may be defined as debt instruments based on the direct payment of interest and principal by the obligor—home owner, auto buyer, business corporation—to the investor. *Synthetic securities, or derivatives, involve the recycling or bifurcation of the cash flows or credit risk from the natural securities to create multiple securities with revised bundles of rights and unique characteristics*.[111]

The recycling became even more pronounced in the run up to the financial crisis, as investment banks cross-sold CDOs in order to create the appearance of demand. This was because the "real money"—that is to say, outside investors—realized that CDOs may not have been a good investment.[112] As the Financial Crisis Inquiry Commission ("FCIC") Report explained, "Merrill [Lynch] and other investment banks simply created demand for CDOs by manufacturing new ones to buy the harder-to-sell portions of the old ones."[113] This was apparently confirmed by SEC attorneys, who told the FCIC, that

110. CDOs were apparently first created in 1987, were composed of high-yield bonds, and were referred to as collateralized bond obligations. Newman et al., *supra* note 72, at 32.

111. Leon T. Kendall, *Securitization: A New Era in American Finance*, *in* SECURITIZATION PRIMER, *supra* note 2, at 1, 8–9 (emphasis added).

112. FCIC REPORT, *supra* note 66, at 203. As the FCIC Report further explains,

> It had long been standard practice for CDO underwriters to sell some mezzanine tranches to other CDO managers. . . . But reliance on them became heavier as the demand from traditional investors waned, as it had for the riskier tranches of mortgage-backed securities. The market came to call traditional investors the "real money," to distinguish them from CDO managers who were buying tranches just to put them into their CDOs. Between 2005 and 2007, the typical amount a CDO could include of the tranches of other CDOs and still maintain its ratings grew from 5% to 30%, according to the CDO manager Wing Chau. According to data compiled by the FCIC, tranches from CDOs rose from an average of 7% of the collateral in mortgage-backed CDOs in 2003 to 14% by 2007. CDO-squared deals—those engineered primarily from the tranches of other CDOs—grew from 36 marketwide in 2005 to 48 in 2006 and 41 in 2007. . . . [F]or the 44 ABS CDOs that Merrill [Lynch] created and sold from the fourth quarter of 2006 through August 2007, nearly 80% of the mezzanine tranches were purchased by CDO managers. The pattern was similar for Chau: an FCIC analysis determined that 88% of the mezzanine tranches sold by the 13 CDOs managed by Chau were sold for inclusion into other CDOs. An estimated 10 different CDO managers purchased tranches in Merrill's Norma CDO. In the most extreme case found by the FCIC, CDO managers were the only purchasers of Merrill's Neo CDO.

Id.

113. *Id.*

> heading into 2007 there was a Streetwide gentleman's agreement: you buy my BBB tranche and I'll buy yours. Merrill and its CDO managers were the biggest buyers of their own products. Merrill created and sold 142 CDOs from 2003 to 2007. All but 8 [Merrill deals] . . . sold at least one tranche into another Merrill CDO. In Merrill's deals, on average, 10% of the collateral packed into the CDOs consisted of tranches of other CDOs that Merrill itself had created and sold. This was a relatively high percentage, but not the highest: for Citigroup, another big player in this market, the figure was 13%.[114]

Why is recycling cash flows attractive to those who create CDOs? In part, the answer appears to include transaction costs—that is, fees for bankers, lawyers, rating agencies and others involved in the process of structuring and managing these transactions. As a 2002 article from *Pensions & Investments* explained,

> For a $500 million CDO, a manager might need to raise, say, $25 million, to invest in the "equity" tranche of the deal. An outside investment bank will leverage that investment to $500 million, packaging the securities into several tranches and selling the senior notes and mezzanine debt to institutional investors. The underlying assets will be invested in some combination of high-yield debt, bank loans, investment-grade debt, mezzanine debt or emerging market debt for the life of the fund, generally seven to 10 years. . . . The kicker is that the manager will rake in fees on the entire $500 million issue, even though the collateral might be just 5% of assets. And those assets won't disappear, regardless of performance; the manager will pick up fees for the life of the issue.[115]

Although there are yet no systematic studies of the transaction costs associated with securitizations and resecuritizations, it appears these fees may have bled the cash flow out of the transactions, so that these structures really presented three related input problems: (1) to the extent they were boom-vintage mortgages, the inputs reflected inflated values; (2) to the extent they were credit-default swaps or other derivatives, they may have had no payoff at all absent a triggering credit event; and (3) transaction

114. *Id.* (footnotes omitted).

115. *See* Dave Kovaleski & Joel Chernoff, *Bond Managers Quietly Raking in the Cash from CDOs*, PENSIONS & INVESTMENTS, January 7, 2002, at 1. Even when the market began to slow, managing CDOs presented attractive opportunities to extract fees from the assets (bonds) backing the CDO securities. "In an effort to counteract beleaguered volume and maintain cash flow," the *Asset Securitization Report* explained in 2008, "the market has refocused its efforts to monitoring portfolio risk. Increasingly, however, some managers are earning new fees by taking on the management responsibility of existing [CDO] deals directly from their competitors." *CDO Management Changes Help Earn Fees in Slow Market*, 23 ASSET SECURITIZATION REP. 9, 20 (2008).

costs would have consumed some important portion of the cash flow generated.

2. Enron's Structured Financings

Cash-flow recycling predates the financial crisis in transactions sometimes characterized as securitizations. It was, for example, apparently central to Enron's fraudulent structured financings. As Enron's bankruptcy examiner explained, Enron misled investors in transactions such as those nicknamed "Hawaii" by using structured financing techniques to book the sales of cash flows from certain SPEs, and then selling and reselling interests in the SPEs, even though it appears the underlying cash flows could not have supported the purchase prices.[116] Between March 2000 and October 2001, Enron engaged in at least twenty-two Hawaii transactions,[117] raising approximately $353 million in cash.[118]

Although the details are complex, in essence, Enron would contribute cash flow or some other "financial asset" to a subsidiary known as an "Asset LLC." Enron retained control of the Asset LLC, but purportedly sold almost all of the economic value to an SPE in the form of "Class B" membership interests. The SPE would then borrow from a bank, the loan secured by the interest in the Asset LLC.

The key to the economics of these transactions was Enron's commitment to enter into a "Total Return Swap." Under this arrangement, Enron agreed to make payments to the SPE or the lender in an amount equal to the SPE's obligation to the lender, which was usually 97 percent of the purchase price of the asset that had been transferred to the Asset LLC. The effect of this was to guarantee the SPE's loan from the bank.

The examiner found that in five of the six structured financing transactions he reviewed, the assets that ostensibly were the source of payment by the SPE to the security holders could not produce sufficient

116. The discussion of Enron's transactions is drawn from various reports of the court-appointed examiner as well as my own work as a consulting expert employed by Enron's Official Committee of Unsecured Creditors. First Interim Report of Neal Batson, Court-Appointed Examiner at 9–10, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2002) [hereinafter Examiner's First Report].

117. *Id.* at 101.

118. *Id.* at 103. The Hawaii transactions resulted in an aggregate reported cash flow from "operations" or "investing" of $523.3 million and "gains on sales" of $237.7 million. In the Examiner's Second Report, the Examiner opined that Enron's debt would rise $436.5 million if the transactions were recharacterized as loans. Second Interim Report of Neal Batson, Court-Appointed Examiner app. M (FAS 125 Transactions), Annex 3 (Hawaii Transaction) at 1–2, *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2003) at 1–2.

cash flow to repay the bank loan. Enron's guarantee under the Total Return Swap thus "played what appears to be a substantial—if not the decisive—role" in convincing the lenders to advance funds to the SPE.[119]

Moreover, in certain transactions, the examiner reported, Enron or an affiliate prepaid the obligations associated with an existing series of Class B membership interests, and Enron then transferred the interest to another SPE.[120] The asset that had previously been contributed to an Asset LLC would thus remain with that entity, and only the Class B membership interest associated with that Asset LLC would be transferred.[121] When fully described, it appears that Enron's structured financing transactions depended heavily on cash flow recycling. The resale of Class B membership interests, coupled with the reality that the underlying assets would not have been sufficient to repay investors, meant that cash flow was being recycled by Enron to manipulate its earnings. Investors apparently either did not fully understand this, or did not care because they relied on the Total Return Swap.

In 2003, the U.S. Senate Permanent Subcommittee on Investigations issued its own report on a series of Enron transactions (Subcommittee Report).[122] The Subcommittee Report found that transactions it reviewed "involved the transfer of assets at inflated values from Enron to special purpose entities ("SPEs") or joint ventures that Enron orchestrated and, among other problems, established with sham outside investments that did not have the required independence or did not truly place funds at risk."[123]

In assessing this, Steven Schwarcz, one of the leading authorities on securitization, argued in 2004 that "none of these [Enron] transactions was actually a securitization"[124] for two basic reasons. First, he argued, was the purpose of securitization. "[S]ecuritization is normally used by an originator to obtain lower-cost financing through disintermediation, or removal of intermediaries such as bank lenders between the originator and the ultimate source of funds, the capital markets," he argued.[125] This was

119. Examiner's First Report, *supra* note 116, at *16.

120. *See id.* at *114.

121. *See id.* The details of the recycling of the Hawaii assets are set forth in the Examiner's First Report. *Id.* at *24–35 (discussing "New Power Warrants").

122. *See generally* S. REP. NO. 107-82, at 5 (2003) (recommending increased regulation and government oversight of structured transactions, after consulting with "key federal agencies including . . . the Government of Canada").

123. *Id.* at 3.

124. *See* Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1550 (2004).

125. *Id.* at 1551.

"markedly different from Enron's use of SP[E]s for mere financial-statement manipulation."[126]

Second, he argued that "in certain ways [the] most fundamental difference between securitization and Enron's use of SP[E]s results not from any particular deal structure but, rather, from the conflicts of interest in Enron. Significant conflicts of interest pervaded the Enron deals."[127] In typical securitizations, however, Schwarcz argued such conflicts were unlikely. "In contrast to Enron, management in securitization transactions would be expected to be free of material conflicts."[128]

Schwarcz is correct that Enron's structured financings should not be understood as securitizations, but for the wrong reasons. Arguing with the benefit of hindsight, Schwarcz is, in essence, saying that transactions that are manipulative or conflicted could not have been securitizations. Therefore, he concludes, Enron's transactions were not securitizations.

But, of course, we know empirically that originators often have used securitization in the past to gain one form of accounting treatment or another.[129] While this may not always have been fraudulent, it was manipulation sufficiently troubling to lead to changes in accounting rules.[130] Moreover, conflicts pervade all sorts of transactions. We would not say that a director who purchases a corporation's assets for less than fair value did not engage in an asset sale, we would say that it was a conflicted asset sale. Indeed, to take Schwarcz's approach—"securitizations" do not suffer from conflicts of interest—is to view every transaction in which an originator paid a rating agency for a rating as something other than a securitization.[131] Not surprisingly, Schwarcz himself, among many others, has (rightly) criticized such conflicts of interest.[132]

To be sure, CDOs and Enron's structured financings would appear to have satisfied certain definitions of securitization. As a matter of legal terminology, these transactions involved the "pooling and repackaging" of "financial assets" in transactions that may have resulted in the issuance of

126. *Id.*

127. *Id.* at 1552.

128. *Id.*

129. Dechow, Myers & Shakespeare, *supra* note 53, at 4.

130. *See supra* note 10 and accompanying text.

131. To say nothing of CDOs and other transactions involving even greater apparent conflicts. *See, e.g.*, *supra*, note 77 and accompanying text.

132. Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 379 n.35 (2008).

"securities." Moreover, many observers characterized Enron's transactions as securitizations. The CPA Journal, for example, worried that "Enron was . . . the most visible abuse in the history of securitization."[133] Even before Enron's collapse, sophisticated writers lauded Enron's "energy securitizations."[134] Now, few who value securitization as a financing technique would use the term in the same sentence as Enron. But this simply tells us that something is wrong with existing definitions of securitization.

V. REDEFINING SECURITIZATION

What, then, would a better definition of securitization look like? It would have to capture the transaction's essential elements, its inputs, structure and outputs, as well as its social functions, its capacity to connect the buyers and sellers of capital more efficiently than other methods of financing. To this end, I believe that a true securitization would satisfy the definition offered in the Introduction, and repeated here for convenience:

> A purchase of [1] primary payment rights by [2] a special purpose entity that (i) [3] legally isolates such payment rights from a bankruptcy (or similar insolvency) estate of the originator, and (ii) results, directly or indirectly, in [4] the issuance of securities [5] whose value is determined by the payment rights so purchased.[135]

(1) "*Primary payment rights.*" This is perhaps the key input element of a "true" securitization. A "primary payment right" will be the account debtor's regular obligation to repay a loan or for goods or services received on credit, such as a monthly mortgage, auto loan, student loan or credit card payment. These rights may be in existence at the time of the transfer; or they may be expected to arise in the future (as in the sale of accounts). Of course, securitizations may also be supported by "secondary" rights, such as guarantees, insurance or similar forms of credit support. Indeed, such mechanisms would tend to bolster the quality of the transaction. Nevertheless, the important point is that if securitization's legitimate social function is to link payment rights to the larger capital markets, then the central asset involved in the transaction must be payment rights, and those

133. Kyle Richard & Melissa Kosiba, *Securitization: A Platform to Debate Accounting*, CPA J. ONLINE (Oct. 2005), http://www.nysscpa.org/cpajournal/2005/1005/perspectives/p10.htm.

134. *See, e.g.*, Charles E. Harrell, James L. Rice III & Robert Shearer, *Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques*, 52 BUS. LAW. 885, 890, 893, 906–08 (1997).

135. To aid exposition, I have numbered in brackets certain important phrases.

payment rights should derive from reasonably transparent obligations owing initially to the originator.

In contrast, it is now apparent that a key failure of CDOs and Enron's structured financing was the recycling of cash flows or other noncash assets, meaning a failure to structure the transactions around primary payment rights.

(2) and (3) "*A special purpose entity*" that "*legally isolates such payment rights.*" As explained in Part III, legal isolation of an originator's credit risk from the input assets is thought to be the central structural element of a securitization. If the transaction legally isolates the primary payment rights from the credit attributes of the originator, then the only important question for investors will involve the input: What were the underwriting standards associated with the assets sold?

True sale—the structural element often used to achieve this isolation in securitization—has been the subject of debate among academics, in significant part because it has important social policy implications.[136] True sale treatment may have economic benefits on the front end, in that it results in a lower cost of capital for originators. But, on the back end, some academics worry that it undermines the collectivizing aspirations of the Bankruptcy Code. Given the fact that "true sale" is essentially a legal conclusion that reflects policy choices about the role of contract and sharing in the presence of financial distress, it seems unlikely we can develop a definitive list of factors that would predict accurately in all cases whether or not a given transaction was a true sale.

It is worth observing that whether true sale has economic value is a difficult question to answer and depends in large part on one's frame of reference. If one focuses only on the parties to the transaction, it would appear that a properly structured securitization is more likely to be wealth creating than is a secured loan given the alleged differences in the cost of capital associated with loans versus securitizations.[137] If, instead, one expands the focus to include third parties—so-called "involuntary" creditors of an originator, or shareholders of firms that structured or invested in securitizations—it is somewhat less clear. In some cases, legal isolation may still produce net benefits for all; in other cases, it might not. And, while economic efficiency is an important value in considering the desirability of a legal rule, it is not the only value with which one might be

136. *See* discussion, *supra* notes 34–36 and accompanying text; Lynn M. Lopucki, *The Death of Liability*, 106 YALE L.J. 1, 23–30 (1996).

137. *See* Rosenthal & Ocampo, *supra* note 43, at 42–43.

concerned. Institutional integrity (for example, of bankruptcy courts and the Bankruptcy Code) may also matter, regardless of how dollars are distributed.

It is not necessary to resolve the questions raised by the true sale problem to recognize that legal isolation of the input assets from the originator has become deeply embedded in thinking about the function of securitization. Some securitizations (for example, those involving government sponsored entities such as Fannie Mae) may not have technically involved legal true sales. However, it would seem that a strong argument has been made across social institutions, including markets and political branches, that true sale matters, even if we may debate which elements produce a transaction that a court will respect as a sale. Thus, if social context and function influence the construction and meaning of terms in commercial finance law, it would seem relatively easy to conclude that "true sale" should be part of a definition of securitization. It is, as Llewellyn might say, part of the usage of trade.

(4) "*The issuance of securities.*" This captures the output element of a true securitization: As the term implies—and as its history suggests—legitimate securitizations connect consumers of capital (borrowers) to the sellers of capital (the larger capital markets), thus displacing traditional lenders. Because the capital markets typically invest through "securities," a securitization should result in the issuance of that type of instrument and not, for example, interests in entities such as Enron's LLCs or other financial assets that are not generally viewed as securities. While the term security is itself sometimes vague, the key functional point is that securitization (and the securities thereby issued) must connect those who seek capital to the capital markets, for it is there that legitimate efficiencies (if any) will likely be found.

(5) "*Whose value is determined by the payment rights.*" This output element recognizes that the securities issued should have value independent of the credit quality of the originator, or others with whom the originator has contractual relations. Thus, the value of a bond issued in a securitization should be determined chiefly by the value of the primary payment rights sold, and not "credit enhancements" that may in small doses be appropriate, but which should not be the driving feature of the transaction. This is not to suggest that a true securitization could not use credit-enhancement devices, such as letters of credit, interest-rate swaps, and so on. Properly structured and executed, such devices can enhance the quality of a transaction. But they are nothing more than that—

enhancements. They should not be the driving force behind the transaction, as happened with Enron's Total Return Swaps.

VI. WHY (RE)DEFINE SECURITIZATION?

Even if the foregoing is a better definition of securitization than is currently in use, this Article must still address a final, but critical, question: Why does the definition matter? We misuse terms all the time. What value would a better definition of securitization add? This part addresses these questions, and in the process applies the better definition of securitization developed above.

Any justification for (re)defining securitization must rest in part on general observations about why we define terms in law at all. At some level, the answer is obvious: law cannot have effect if it does not define its subject matter. This, however, is an instrumental definition of law—law as a device that uses force to produce particular social ends. A second, related reason to define terms (and the term securitization) involves the expressive function that law can perform. Even when law lacks instrumental force, how the law speaks, and what it speaks of, have larger, if more diffuse, social consequences. This subpart explores both reasons for defining (and redefining) securitization.

A. INSTRUMENTAL ("HARD") LAW

The principal, traditional reason to define any term from a legal perspective is to give law the capacity to act with instrumental force with respect to the defined term. Julian McDonnell has developed a list of six, inter-related reasons why defining terms is so important, especially in commercial law: (1) it helps to systemize the subjects of the law;[138] (2) it helps to conceptualize new terms and ideas;[139] (3) defining terms is part of the larger ritual of legal process;[140] (4) it can empower judges to make boundary distinctions;[141] (5) it can provide contrast guidance, enabling

138. McDonnell, *supra* note 12, at 649 ("Stipulative definitions assist the drafters in the systematic presentation of technical doctrinal material. Establishing defined terms such as 'negotiable instrument' or 'purchase money security interest' permits them to later abbreviate reference to a complex category.").

139. *Id.* ("Stipulative definitions allow the drafters to introduce new terms that have not been generally recognized by either the general language community or the legal profession.").

140. *Id.* at 650 ("Formally naming and giving the identifying marks of a legal category makes the category seem real.").

141. *Id.* ("Stipulative definitions can be means of empowering the judges to draw boundary lines between contrasting categories.").

judges to distinguish complex concepts and transactions;[142] and (6) it can enhance predictability in decisionmaking.[143]

Of these, the most important from an instrumental standpoint involves empowerment. A normatively derived, stipulative definition

> can be [a] means of empowering . . . judges to draw boundary lines between contrasting categories. The abstract, general definitions of core terms such as "sale," "security interest," or "goods" illustrate this function. Empowerment definitions are employed when the drafters are concerned that the transactional types will attempt to evade regulatory measures. Giving the judges great freedom in shaping the category allows them to block evasion.[144]

Definitions, especially stipulative ones, are central to the functioning of the legal system's positive aspects. Law lacks force if it does not first define what it purports to govern, and this seems to be especially true of commercial finance law and practice. As McDonnell has explained of the process of creating and using definitions under the Uniform Commercial Code, "the drafters [of the U.C.C.] seek through their definitions to control the categorization of particulars by the judges,"[145] among other things.

In the case of securitization, it is now time for a more thorough, thoughtful definition than we currently use. The most obvious instrumental reason involves Dodd-Frank and the hundreds of rulemakings under it, which either do not define the term at all, or do so inadequately. As discussed in Part IV, the lexical proxy often chosen—"asset-backed security"—is vague and contains omissions that make it problematic. While there may be other, better definitions of securitization than the one generated here, legislatures, regulators, and judges will increasingly be called on to make important legal and social decisions about the permissible scope of securitization. Understanding what a securitization is—through the definitional process—will be an important aspect of any effective attempt to regulate it.

More pragmatically, a definition that distinguishes true securitizations from those that appear to be more harmful provides a grounded way for regulators to distinguish between transactions that appear relatively benign,

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142. *Id.* ("The definitions can provide contrast attributes that may assist the judges with more difficult categorization decisions.").

143. *Id.* at 651 ("Stipulative definitions can be a means of reducing the uncertainty of categorizing particulars that occur regularly in commercial transactions. By its nature, definition reduces ambiguity.").

144. *Id.* at 650.

145. *Id.* at 649.

and those that are not. For example, we may wish to create a range of regulatory exemptions for true securitizations, but not for transactions such as CDOs and structured financings. True securitizations might be subject to relaxed risk retention and disclosure rules, while CDOs and structured financings would be subject to heightened regulation. Although the SEC's Regulation AB has recognized a distinction of this sort, Dodd-Frank itself makes no such distinction. The latter lumps all asset-backed securities together, whether they involve only primary payment rights, or are CDOs of CDOs—apparently the worst of the worst.

This also matters to state laws that purport to facilitate the use of securitization. These laws are designed to avoid the true sale problem (described in Part III.B) simply by declaring that in a "securitization," the documented intentions of the parties will govern the treatment of the transaction, regardless of its economic reality.[146] Yet, in some cases (as in Delaware), these statutes do not define a securitization at all.[147] If they do, it will be with the same sorts of problems seen in definitional attempts thus far.[148] These statutes have less force than state legislators would like, because they are preempted by federal law (for example, federal banking regulations or the Bankruptcy Code). If they do matter, however, judges will need to decide their scope. Since they purport to apply to securitization, courts will need to decide what that term means. This paper offers them a way to do so.

B. NONINSTRUMENTAL ("SOFT") LAW

There is more to law than imposing rules and expecting outcomes. Law often has a noninstrumental, or expressive, function.[149] The expressive theory of law holds that "the expression of social values is an important function of the courts or, possibly, the most important function of

146. *See* Lipson, *Liens*, *supra* note 37, at 472–474.

147. DEL. CODE ANN. tit. 6, §§ 2701A-2703A (2004).

148. States other than Delaware have facilitation statutes. *See, e.g.*, ALA. CODE § 35-10A-2(a)(1) (2004) (Alabama); LA. REV. STAT. ANN. § 10:9-109(e) (2002) (Louisiana); N.C. GEN. STAT. § 25-9A-102 (2002) (North Carolina); OHIO REV. CODE ANN. § 1109.75 (LexisNexis 2002) (Ohio); TEX. BUS. & COM. CODE ANN. § 9.109(e) (West 2002) (Texas). The statutes in Alabama, North Carolina, and Ohio are substantially similar to Delaware's, with all but Ohio's statute entitled "Asset-Backed Securities Facilitation Act." ALA. CODE § 35-10A-2(a)(1); N.C. GEN. STAT. § 25-9A-102; OHIO REV. CODE ANN. § 1109.75. Texas and Louisiana, by contrast, simply added a new subsection to Article 9 of the Uniform Commercial Code that left it up to the parties involved in securitization transactions to classify the nature of transfers. LA. REV. STAT. ANN. § 10:9-109(e); TEX. BUS. & COM. § 9.109(e). Neither Delaware nor Alabama define a securitization.

149. Jonathan C. Lipson, *The Expressive Function of Directors' Duties to Creditors*, 12 STAN. J.L. BUS. & FIN. 224 (2007).

courts."[150] Expressive theories view law as being more important for what it says than what it does.[151] This account of law is fuzzier, more nuanced than traditional explanations, and thus inherently easier to criticize.[152] Yet, a better definition of securitization will express values about the role that this particular type of transaction plays in the legal system, and about the legal system's commitment to adequately defining the transactions that it permits, promotes, and regulates.

First, and perhaps most obvious, a more accurate definition of securitization has the expressive capacity to clarify a field that has become needlessly murky. As discussed above, securitization has been confused with other transaction forms such as structured financing and CDOs. These other transactions, as we learned a decade ago with Enron, and relearned in the current financial crisis, may be misunderstood or abused, and may well cloak fraud. Not surprisingly, lumping comparatively benign securitization with more malign pretenders has led to confusion. As discussed above, the complexity of CDOs, resecuritizations and Enron's transactions appears to have contributed to complacency which, in turn, permitted conflicts of interest to go undetected or unchecked. Markets should not tolerate confusion, but will not necessarily know better if beguiled by novel and elaborate technologies. While markets, themselves, can create meaning, the legal system can be a countervailing source of definition. As such, it has a responsibility to define terms in ways that market actors find both useful and socially relevant, subject to the need to achieve normative goals beyond the realistic reach of private ordering.

Second, confusion about what constitutes securitization has contributed, at least in part, to giving securitization a bad name. This has deterred foreign regulators from permitting the transaction form, even where some argue it may have benefits, such as in East Asia[153] and

150. *Id.* at 262 (internal quotations omitted) (quoting Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL. STUD. 585, 586 (1998)).

151. *See, e.g.*, JOSEPH R. GUSFIELD, SYMBOLIC CRUSADE: STATUS POLITICS AND THE AMERICAN TEMPERANCE MOVEMENT 177 n.83 (Ellini Books ed. 1986) (1963); Dan M. Kahan & Donald Braman, *More Statistics, Less Persuasion: A Cultural Theory of Gun-Risk Perceptions*, 151 U. PA. L. REV. 1291, 1318 n.25 (2003); Dan M. Kahan, *The Secret Ambition of Deterrence*, 113 HARV. L. REV. 413, 416 n.18 (1999).

152. For a critique of such theories and an exchange, see Matthew D. Adler, *Linguistic Meaning, Nonlinguistic 'Expression,' and the Multiple Variants of Expressivism: A Reply Response to Professors Anderson and Pildes*, 148 U. PA. L. REV. 1577 (2000), and Elizabeth S. Anderson & Richard H. Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. PA. L. REV. 1503 (2000).

153. *See* Paul Lejot, Douglas Arner & Lotte Schou-Zibell, *Securitization in East Asia* 1 (Asian Dev. Bank Working Paper Series on Regional Economic Integration No. 12, 2008), *available at* http://www.adb.org/documents/papers/regional-economic-integration/WP12-Securitization-East-

India.[154] By redefining securitization we clarify its meaning. In so doing, we can distinguish transaction elements and forms more likely to be more productive economically and socially, and thus redeem the transaction form more generally. A sound definition of true securitization can help to rehabilitate securitization.

Third, the definition advanced here recognizes that the most important features of a securitization will be the inputs (primary payment rights) and outputs (securities). By inference, it tells lawyers and market participants that they should focus on the nature and quality of the assets (payment rights) sold into the securitization. It is apparent that a failure to take underwriting standards seriously contributed to excesses in real-property lending, which impaired securitization structures. A definition of securitization that emphasizes the inputs should lead market actors and their lawyers to do the same.

Fourth, it is simply time to take the process of defining securitization more seriously. As an innovation, securitization might be viewed as a "disruptive technology," one that has significantly altered the ways that networks value and perform certain types of transactions.[155] In this case, the disruptions resulted from replacing traditional lending pathways—banks and borrowers—with more complex chains of relationships, including originators, SPEs, underwriters, rating agencies, and so forth.[156]

Asia.pdf ("The credit and liquidity crisis that began in the United States (US) and spread to other developed financial systems in mid-2007 exposed the danger associated with securitization in excessive risk-taking or regulatory capital arbitrage, rather than as a tool to assist a more conventional or conservative approach to funding, risk management, or investment.").

154. Jonathan Rosenthal, *Reregulation: A Dangerous Embrace*, THE ECONOMIST, May 14, 2011, at 3, 3. By being restrictive, Indian regulators

> are also keeping out some rather useful financial innovations that got themselves a bad name. India, for instance, could make good use of securitisation to help it channel the vast sums of money it needs to spend on building ports, roads and railroads. But now regulators are inclined to ban first and ask questions later.

Id.

155. The term "disruptive technology" is associated with Harvard Business School Professors Joseph Bower and Clay Christensen. *See* CLAYTON M. CHRISTENSEN, THE INNOVATOR'S DILEMMA: WHEN NEW TECHNOLOGIES CAUSE GREAT FIRMS TO FAIL 61–97 (1997) [hereinafter DILEMMA]; Joseph L. Bower & Clayton M. Christensen, *Disruptive Technologies: Catching the Wave*, 73 HARV. BUS. REV. 43 (1995). Strictly speaking, the term "disruptive technology" refers not to a more sophisticated innovation but one which, according to Christensen, may result in "*worse* product performance, at least in the near term." DILEMMA *supra*, at xv. Such technologies nevertheless have the capacity to displace older technologies because "they have other features that . . . customers value. Products based on disruptive technologies are typically cheaper, simpler, smaller, and, frequently more convenient to use." *Id.* So far as we can tell, none of those things can be said of securitization. Nevertheless, it was seen as a new technology, one that certainly disrupted the allocation of capital. To this extent, therefore, it is a disruptive technology.

156. *See* Giovanni Dell'Ariccia, Deniz Igan & Luc Laeven, *Credit Booms and Lending Standards:*

Disruptive technologies tend to follow fairly predictable patterns. The new technology starts, perhaps quietly, outside the mainstream (as agency-based mortgage securitization did in the 1970s). It then rapidly overtakes and displaces existing technologies, which struggle to keep pace. As with securitization, there is a suggestion that isolating the novel, value-creating components—new technologies or payment rights, as the case may be—in separate entities is important to the success of the new technology.[157] As with securitization, disruptive technologies often fail in early application.[158]

In this process of "creative destruction,"[159] new nomenclature emerges. While there is no reason to believe that the naming of the technology, alone, should determine its legal effect, at some point the new technology becomes an industry norm. Thus, it must bring with it language that distinguishes the new from the old in terms that are reliable to those responsible for both public governance (legislators, regulators, and judges) and private ordering (market participants and facilitators). Neologisms arise to describe something new. As Llewellyn would say, what matters is that the terminology makes sense of the new data in a socially constructive way.

Securitization is over thirty years old by most conventional measures. It has, in certain respects, followed the arc of a disruptive technology by displacing old methods (bank intermediation), sometimes successfully and sometimes unsuccessfully. Yet, there is little question that many believe it can have socially productive value. To that extent, it is important that it be properly identified to distinguish the better variants from the worse. Even properly understood, securitization may not be a perfect market innovation.

Evidence from the Subprime Mortgage Market 17 (Int'l Monetary Fund, IMF Working Paper No. WP/08/106, 2008), *available at* http://www.imf.org/external/pubs/ft/wp/2008/wp08106.pdf. ("This evidence partially supports the view that disintermediation through securitization provides lenders with incentives to extend riskier loans."); Ian Bell & Petrina Dawson, *Synthetic Securitization: Use of Derivative Technology for Credit Transfer*, 12 DUKE J. COMP. & INT'L L. 541, 561 (2002) ("[T]he synthetic securitization market is the second great leap forward in the road to a totally disintermediated financial world.").

157. Bower & Christenson, *supra* note 155, at 56 ("For example, isolating a team of engineers so that it can develop a radically new sustaining technology just because that technology is radically different is a fundamental misapplication of the skunk-works approach.").

158. *Id.* at 45 ("In the history of the hard-disk-drive industry, the leaders stumbled at each point of disruptive technological change: when the diameter of disk drives shrank from the original 14 inches to 12 inches, then to 5.25 inches, and finally to 3.5 inches. Each of these new architectures initially offered the market substantially less storage capacity than the typical user in the established market required.").

159. The term "creative destruction," Marxist in origins, has since the 1950s been a way to describe the process of innovation in a market system. *See* JOSEPH A. SCHUMPETER, *The Historical Approach to the Analysis of Business Cycles*, *in* ESSAYS ON ENTREPRENEURS, INNOVATIONS, BUSINESS CYCLES, AND THE EVOLUTION OF CAPITALISM 322 (Richard V. Clemence ed., 11th ed. 2009).

But failing to develop a shared conception of what the signifier connotes is surely problematic.

VII. CONCLUSION

In 1964, Justice Potter Stewart, in perhaps the most notorious semantic maneuver of the past hundred years, threw up his hands when asked to define the word "pornography." He could not do so, he confessed, but stated, "I know it when I see it."[160]

Do we know securitization when we see it? We may think so, but thus far, we have often been wrong. Securitization is not just any transaction involving a sale of financial assets, or the issuance of asset-backed securities, or the use of special purpose entities, or (more obliquely) a wealth-maximizing transaction leveraging the value of financial assets as distinct from the good will of the originator of those assets. Instead, like all innovative forms of commercial financial practice, it is a specific way of deploying capital, which may have certain benefits, but which is not without costs. A better definition of securitization can help to identify and promote its benefits while delimiting (and perhaps reducing) its costs.

Defining terms in law is rarely easy. In 1965 Grant Gilmore, co-reporter for the original Article 9 of the Uniform Commercial Code, explained the difficulties in defining the important term "security interest":

> This, like most definitions of basic terms, is essentially a declaration of faith. Who can meaningfully define the number "one" or the verb "to be"? . . . It is not suggested that anything useful could have been done to explain the phrase "an interest . . . which secures . . . an obligation": the draftsman's art does not go so far.[161]

We may complement Gilmore's cadre of decisionmakers affected by the definitional exercise (judges) with legislators, regulators, lawyers and market actors. But that merely serves to emphasize the importance of taking seriously the definitional project. Defined terms—especially stipulative neologisms such as securitization—matter, and it does no good to dismiss vagueness or gaps in the articulation of the concept and the transaction form associated with that concept.

160. Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring) (acknowledging difficulty of defining hardcore pornography for purposes of First Amendment restrictions but declaring, "I know it when I see it").

161. 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 11.1 (1965).

Any serious attempt to redefine securitization must, therefore, reflect not only the social context from which it grows, but also particular methodological choices about how terms come to take on socio-legal significance. The work of redefining securitization, and therefore this Article, is to better understand and identify this transaction form so that we can make more intelligent social, political, and market judgments about it. If we do not define it, we may not understand it. And if we do not understand it, we will continue to fall victim to those who think that they do.