

THE PARTS ARE GREATER THAN THE WHOLE: HOW SECURITIZATION OF DIVISIBLE INTERESTS CAN REVOLUTIONIZE STRUCTURED FINANCE AND OPEN THE CAPITAL MARKETS TO MIDDLE-MARKET COMPANIES

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I. INTRODUCTION

Structured finance, although only a recent innovation, nonetheless is "becoming one of the dominant means of capital formation in the United States."¹ Also known as asset securitization, structured finance refers to an approach used to raise capital

whereby income-producing [financial] assets . . . are pooled and converted into capital market instruments. In a typical [structured] financing, a sponsor transfers a pool of [financial] assets to a limited purpose entity, which in turn issues [in the capital markets] non-redeemable debt obligations or equity securities with debt-like characteristics . . . Payment on the securities depends primarily on the cash flows generated by the pooled assets.²

Structured finance offers a company important advantages over other approaches to raising capital. Transactions are arranged so that investors make their investment decisions by focusing on the quality of specific financial assets³ of a company instead of looking to the company's overall financial strength. Thus, businesses that could not easily raise funds through traditional sources may be able to use securitization to

¹ Investment Company Act Release No. 19105, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,062, at 83,500 (Nov. 19, 1992) (provided in connection with the recent issuance of Rule 3a-7 under the Investment Company Act of 1940) [hereinafter SEC Release].

² *Id.* For an introduction to the principles underlying structured finance and asset securitization, see STEVEN L. SCHWARCZ, *STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* (Practicing Law Institute, 2d ed. 1993).

For an example of a large but fairly typical structured finance transaction, see the discussion of the recent Sears credit card securitization in Asset Sales Report, Feb. 8, 1993, at 1. Sears, Roebuck & Co. sold its credit card accounts receivable (that is, Sears' right to payment from customers who charged their purchases on a Sears' credit card) to a newly created master trust, which in turn sold interests in these receivables to several newly-created limited purpose corporations. The limited purpose corporations funded their purchase of the interests by issuing up to \$1.5 billion in commercial paper to investors in the capital markets.

³ "Financial assets" are assets that by their terms are expected to convert into cash within a finite period of time. Examples of financial assets include leases, loans, mortgages, and trade accounts receivable.

gain access to the capital markets.⁴ Companies that already could raise funds through traditional sources may be able to use securitization to obtain funding on more advantageous terms through lower interest rates⁵ or off-balance sheet structures.⁶

Structured finance is expected to continue to grow in importance as a source of capital for companies.⁷ There is, however, a practical limitation to structured finance. Companies below investment grade,⁸ and even investment grade companies engaged in publicly marketed transactions, must structure their securitization transactions in a manner that protects investors in the event of a subsequent bankruptcy. Perhaps the most essential element of such a "bankruptcy-remote" structure is a

⁴ The capital markets are "markets where capital funds — debt and equity — are traded. Included are private placement sources of debt and equity as well as organized markets and exchanges." JOHN DOWNES & JORDAN GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* 54 (3d ed. 1991).

⁵ Debt securities issued in the capital markets typically bear a lower interest rate than a bank financing. This is due partly to ratings by rating agencies, see *infra* note 8, partly to the source of funds being a mix of institutional and other investors, and partly to the ability of an investor in the capital markets to freely trade the debt securities. Debt securities issued pursuant to a structured finance transaction further benefit from the source of payment being separated from possible credit risks associated with the company.

⁶ An off-balance sheet structure refers to a company raising financing by selling assets to a third party, which in turn issues debt securities in the capital markets. Thus, the company's balance sheet will reflect an asset sale and not the issuance of debt. Accordingly, the company's leverage (ratio of debt to equity) will not be affected.

⁷ See, e.g., *You Can Securitize Virtually Everything*, *BUS. WK.*, July 20, 1992, at 78. The SEC also recently adopted Rule 3a-7 under the Investment Company Act of 1940 to relax an inadvertent restriction on the growth of these transactions: "Rule 3a-7 [adopted by the SEC under the Investment Company Act of 1940] removes an unnecessary and unintended barrier to the use of structured financings in all sectors of the economy . . ." SEC Release, *supra* note 1, at 83,499.

⁸ The term "investment grade" technically refers to the rating on a company's long-term debt securities given by independent rating agencies. An investment grade rating reflects a rating agency's prediction that the debt securities will be paid on a timely basis. At the end of 1992, most medium-sized, or "middle-market," companies either did not have ratings or were not rated investment grade. At that time, even some larger companies, including virtually all airlines and department stores, did not have investment grade ratings. See, e.g., *S. & P. Lowers Bond Ratings of the 3 Big Airlines to Junk*, *N.Y. TIMES*, Mar. 12, 1993, at D1.

"true sale" of financial assets from the company to the limited purpose entity.⁹ Structuring an economically viable transaction as a true sale, however, has not always seemed feasible. For this reason, structured financing has not expanded in any meaningful way to the significant middle-market.

This article introduces the concept of a "divisible interest," a type of partial interest in financial assets, and explains how this innovation can expand the structured finance market significantly while maintaining the true sale nature so critical in structured financing. The divisible interest approach also can be applied to pool financial assets from multiple companies into a single securitization transaction, thereby catalyzing an expansion of the capital markets to now-excluded middle-market companies.

This article will first discuss the legal basis underlying structured finance, focusing on the importance of a "true sale" and its determining criteria. The article will then introduce the "divisible interest" concept and apply the true sale criteria to divisible interests. In that analysis, the article will dispel the unfounded perception that the transfer of only a partial interest in a future payment stream cannot be a true sale for bankruptcy purposes. The article then analyzes the commercial applicability of a divisible interest in structuring a securitization transaction. Finally, the article examines Section 363 of the Bankruptcy Code¹⁰ and Section 9-306 of the Uniform Commercial Code and concludes that their cash collateral provisions are not applicable to divisible interests.

To help the reader focus more concretely on the issues, this article will use the example of a "future payment stream" as a representative type of financial asset. Nonetheless, the conclusions reached will have general applicability to all types of financial assets.¹¹

⁹ See *infra* notes 12 to 18 and accompanying text. A "true sale" is one which will prevent the property being sold from becoming part of the seller's bankruptcy estate in a bankruptcy subsequent to the sale.

¹⁰ 11 U.S.C. § 363 [hereinafter 11 U.S.C. *et seq.* may be referred to as the "Bankruptcy Code"].

¹¹ To the extent the future payment stream in which an interest is being sold is a general intangible under the U.C.C., it raises issues of general application that are beyond the scope of this article. Such issues include how to perfect the sale, and whether the filing of U.C.C.-1 financing statements is sufficient in

II. ANALYSIS

A. Importance of a True Sale

Before discussing the legal and economic consequences of selling a divisible interest in a future payment stream, it is necessary to explain the meaning of a "true sale." In many structured financing transactions, a future payment stream is legally separated from the company originating a right to receive payment for goods or services (known as the "originator"). That way, if the originator later becomes bankrupt, creditors of the originator are unable to reach the future payment stream. The future payment stream, in turn, is dedicated to payment of the securities issued to investors in the capital markets.

To effect a sale of a future payment stream, the originator normally transfers all its right, title, and interest in the future payment stream to a bankruptcy-remote third party. This transfer should fully separate the future payment stream from the originator entity. Sales that are effective against creditors and the estate of a bankrupt originator, in that the property is no longer "property of the debtor's estate" under Section 541 of the Bankruptcy Code,¹² are generally referred to as "true sales."¹³ For originators that are below investment grade, or that do not have investment grade ratings (which include most middle-market companies, as well as hospitals),¹⁴ it is critical

light of U.C.C. § 9-102 and Official Comment No. 2; whether contractual prohibitions on the sale of future payment streams are valid under U.C.C. § 9-318 and Official Comment No. 4; and the issues relating to the sale of future intangibles described in note 36, *infra*. But see Permanent Editorial Study Board Study Group, Uniform Commercial Code Article 9 Report Vol. I, part III.A.1, at 43 (Dec. 1, 1992) which recommended that "Article 9 [of the U.C.C.] should be revised to include within its scope sales of general intangibles for the payment of money." Other issues of general application to the sale of a future payment stream, such as tax treatment, also are beyond the scope of this article.

¹² 11 U.S.C. § 541 (property of a debtor's estate). For a sale to be effective against creditors as well, the sale must not constitute a fraudulent conveyance under § 548 of the Bankruptcy Code or applicable state fraudulent transfer laws. See SCHWARCZ, *supra* note 2, at 35-36.

¹³ The term "true sale" will have a different definition depending on the field of law for which it is operative. The three principal areas of applicability are accounting, tax, and bankruptcy. A given transfer of receivables may well be a sale for certain purposes but not others. See SCHWARCZ, *supra* note 2, at 28-29.

¹⁴ Because investment grade companies are regarded by the rating agencies

to the success of a structured financing transaction that the transfer of the relevant future payment stream to the third party constitutes a true sale.¹⁵

The third party to whom the future payment stream is sold would be a bankruptcy-remote, limited purpose entity (referred to as a special purpose vehicle or SPV¹⁶). The SPV raises funds to pay the purchase price for the future payment stream to the originator by issuing debt securities (or securities having debt-like characteristics) to investors in the capital markets. Since these securities usually are rated as investment grade or higher by nationally recognized rating agencies because of the quality of the underlying financial assets, they can be traded in the capital markets.¹⁷ Their ability to be traded not only attracts investors but also means that the mix of investors in a given structured finance transaction may well change during the life of the transaction.

as highly unlikely to go bankrupt, it is sometimes less critical in structuring a securitization transaction to protect against the possibility of bankruptcy.

¹⁵ If the transfer of the future payment stream from the originator to the third party fails to constitute a true sale under § 541 of the Bankruptcy Code, the transfer would be deemed an advance of funds by the third party to the originator secured by the payment stream, i.e., a secured loan. The third party would then be a creditor of the originator and have a security interest, but not an ownership interest, in the payment stream. In such a case, the originator's bankruptcy would, under § 362 of the Bankruptcy Code, automatically result in a stay of all actions by creditors to foreclose on or otherwise obtain property of the originator. The third party may not be able to obtain payments collected on the payment stream until the stay is modified. Further, under § 363 of the Bankruptcy Code, a court, after notice to creditors and the opportunity of a hearing, could order the cash collections of the payment stream to be used by the originator in its business as working capital if the originator or its trustee in bankruptcy provides adequate protection for the interest of the third party in the payment stream. "Adequate protection," though, does not always translate into an alternative cash source.

In addition, § 364 of the Bankruptcy Code also would permit the originator, if credit is not otherwise available to it and if adequate protection is given to the third party, to raise cash by granting to new lenders a lien that is either *pari passu* with that of the third party or, if a *pari passu* lien cannot attract new financing, a lien having priority over the third party's lien. See SCHWARCZ, *supra* note 2, at 30.

¹⁶ Special purpose vehicles can be structured in many forms such as corporations, trusts, or partnerships. For a more complete discussion of the types of SPV's, the reasons for each type, and the importance of making the SPV "bankruptcy remote," see SCHWARCZ, *supra* note 2, at 16-27.

¹⁷ Such securities are known as "asset-backed securities."

Whether the transfer of a future payment stream constitutes a true sale under Section 541 of the Bankruptcy Code requires case-by-case analysis.¹⁸ Although various courts have considered whether transfers of payment streams constitute a true sale for bankruptcy purposes, the facts of the decided cases have not been representative for the most part of modern structured finance transactions. Accordingly, the cases are not easily harmonized, and readers can differ as to which factors are relevant and which are entitled to greater weight. Nonetheless, a cluster of factors can be identified that are relevant in most determinations of whether a given transfer of payment streams is a sale or a secured loan. Each of these factors is indicative of whether the originator truly parted with the future economic risks and benefits of ownership of the payment stream purported to be sold, and whether the purported buyer has taken on the risks and benefits of ownership.

1. Recourse

The most significant factor in determining whether a transaction is a true sale or a secured loan appears to be the extent and nature of the recourse that the transferee of the payment stream has against the transferor.¹⁹ The existence of some recourse in a sale agreement does not by itself preclude characterization of the transaction as a true sale.²⁰ If recourse is present, the issue is "whether the nature of the recourse, and the true nature of the transaction, are such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction [a secured loan] or to a sale."²¹

¹⁸ Portions of the following discussion of true sale criteria have been based on SCHWARCZ, *supra* note 2, at 31-35, with permission of the author and publisher.

¹⁹ See, e.g., *Major's Furniture Mart v. Castle Credit Corp.*, 602 F.2d 538, 545 n.12 (3d Cir. 1979) (stating that Grant Gilmore "place[s] almost controlling significance on the one factor of recourse"); see also 2 GRANT GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* § 44.4, at 1230 (1965).

²⁰ *Major's Furniture Mart*, 602 F.2d at 544 (relying on U.C.C. § 9-502 cmt. 4); see also PETER F. COOGAN ET AL., 1C *SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* § 28.03[4] (1992).

²¹ *Major's Furniture Mart*, 602 F.2d at 544 (footnote omitted).

In the leading case of *Major's Furniture Mart v. Castle Credit Corp.*,²² the court analyzed the recourse provisions in an accounts receivable financing agreement to determine whether the transaction should be considered a sale or a secured loan. In holding the transaction to be a secured loan, the court considered the risks that each party assumed as well as the guaranties given by Major's as to the quality and the collectibility of its accounts.²³ Major's was required to give the following warranties: that its customers "meet the criteria set forth by Castle, that Major's perform the credit check to verify that these criteria were satisfied, and that Major's warrant that the accounts were fully enforceable legally and were 'fully and timely collectible.'"²⁴ Major's was also required to indemnify Castle for any losses that resulted from "a customer's failure to pay, or for any breach of warranty, and an obligation to repurchase any account after the customer was in default for more than 60 days."²⁵ The court concluded that "[g]uaranties of quality alone, or even guarantees of collectibility alone, might be consistent with a true sale, but Castle attempted to shift all risks to Major's, and incur none of the risks or obligations of ownership."²⁶ This case is illustrative of the approach courts take in determining the nature of the recourse in a particular transaction.²⁷

2. Retained Rights and Right to Surplus

Perhaps the second most important factor indicating the existence of a secured transaction rather than a sale is the originator's right to redeem or repurchase a transferred payment stream. For example, Section 9-506 of the Uniform Commercial

²² 449 F. Supp. 538 (E.D.P.A. 1978), *aff'd*, 602 F.2d 538 (3d Cir. 1979),

²³ *Id.* at 543.

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.* To the extent that the seller of a payment stream makes representations and warranties that are not continuing representations and warranties of collectibility, but rather ones limited to the condition and characteristics of the payment streams at the time they are sold, such warranties should be no different than warranties ordinarily given by a seller of a product. See U.C.C. §§ 2-312 to 2-315. Accordingly, such limited representations and warranties should not be inconsistent with treatment of the transaction as a sale.

²⁷ See, e.g., *In re Joseph Kanner Hat Co.*, 482 F.2d 937 (2d Cir. 1973).

Code and various state mortgage statutes allow a debtor to redeem property before a secured party ultimately disposes of it.²⁸ The absence of a right of redemption or repurchase would be a factor in favor of characterization of the structured finance transaction as a true sale.

Several courts also have considered the existence of a transferor's right to any surplus collections, once the transferee has collected its investment plus an agreed yield, as indicative of a secured loan.²⁹ The right of the SPV to retain collections for its own account, even after the SPV has collected its investment plus yield, therefore would be a factor in favor of characterization of the structured finance transaction as a true sale.

3. Pricing Mechanism

Pricing based upon a fluctuating interest index of the type found in commercial loan agreements, such as the prime or base rate, may be indicative of a secured loan. The pricing mechanism also may be indicative of a secured loan to the extent the purchase price is retroactively adjusted to reflect actual rather than expected collections on payment streams.³⁰

In the closest approach to a true sale, the SPV would purchase a future payment stream on a discounted basis. The discount would be calculated or negotiated prior to each purchase, in part based on the SPV's then net current cost of funds and the anticipated collection and loss experience of the payment stream then to be purchased. Once a discount has been negotiated for each purchase, it could not thereafter be adjusted for that purchase, regardless of differences between the actual and anticipated costs of funds and of collection experience. Such fixed pricing would be a factor in favor of characterization of the structured finance transaction as a true sale.

²⁸ See, e.g., DEL. CODE ANN. tit. 6, § 9-506 (Supp. 1992).

²⁹ See, e.g., *In re Nixon Mach. Co.*, 6 B.R. 847, 854 (Bankr. E.D. Tenn. 1980); *Evergreen Valley Resort, Inc.*, 23 B.R. 659, 661-62 (Bankr. D. Me. 1982); *In re Hurricane Elkhorn Coal Corp.*, 19 B.R. 609, 617 (Bankr. W.D. Ky. 1982), *rev'd on other grounds*, 763 F.2d 188 (6th Cir. 1985).

³⁰ See *Home Bond Co. v. McChesney*, 239 U.S. 568 (1916); *Dorothy v. Commonwealth Commercial Co.*, 116 N.E. 143 (Ill. 1917).

4. Administration and Collection of Accounts

The administration of and control over the collection of the payment stream are factors courts sometime cite in resolving the sale/secured loan issue.³¹ In the strongest example of a true sale of a payment stream, the SPV should have the authority to control collection of the payments.³² Examples of such authority would include: (1) the SPV's ownership of all books, records, and computer tapes relating to the payment stream, and (2) the SPV's having the right (a) to control the activities of the collection agent for the payment stream and at any time to appoint another collection agent, (b) to establish a credit and collection policy for the payment stream, and (c) at any time to notify the persons obligated to make the payments that the payment stream has been sold.

In practice, the originator often is appointed as the collection agent. That is not necessarily inconsistent with characterization as a sale if: (1) the originator will be acting as an agent for the SPV pursuant to established standards, much like any other collection agent; (2) the originator will receive a collection agent fee that represents an arm's-length fee for those services; and (3) the SPV has the right at any time to appoint itself or another person as collection agent in place of the originator.³³

Sometimes collections of the payment stream are paid to the originator as collection agent and commingled, or mixed, with the originator's general funds. This frequently occurs when the originator receives collections from the payment stream each day, but remits the collections periodically (*e.g.*, monthly) to the SPV. Besides raising a potential perfection question under the UCC,³⁴ commingling might raise a question whether a sale was intended if the originator is permitted to use collections that belong to the SPV. That inconsistency often can be addressed by the originator's segregating and holding the collections in trust pending remittance to the SPV or periodic reinvestment.

³¹ One interesting discussion of this question occurs in the British case, *Lloyds & Scottish Fin. Ltd. v. Cyril Lord Carpets Sales Ltd.*, House of Lords, 29 Mar. 1979 (LEXIS, English General Library, Cases File).

³² *People v. Service Inst., Inc.*, 421 N.Y.S.2d 325 (N.Y. Sup. Ct. 1979).

³³ See SCHWARCZ, *supra* note 2, at 34.

³⁴ See discussion *infra* part II.C.

There are also a variety of miscellaneous factors that do not fall within the categories discussed above, but that may be indicative of a secured loan.³⁵

B. Applying the True Sale Criteria to Divisible Interests

In order to apply the foregoing true sale criteria to the sale of a divisible interest in a future payment stream, it is necessary to define a "divisible interest." A divisible interest is any interest in a future payment stream that (1) is less than all of the originator's right, title, and interest in the payment stream and (2) can be measured clearly so that the originator and the SPV will have no valid basis to dispute how collections (once received) are to be divided. References to the sale of a divisible interest in a future payment stream are intended to mean the sale of a divisible interest in an existing right to future payment as well as the sale of a divisible interest in collections. It is important to sell the right to an intangible asset and not only the proceeds of such asset once such proceeds are later collected.³⁶

³⁵ These factors are: (1) the originator of the payment stream is a debtor of the SPV on or before the purchase date; (2) the SPV's rights in the payment stream can be extinguished by payments or repurchases by the originator or by payments from sources other than collections on the payment stream; (3) the originator is obligated to pay the SPV's costs (including attorney fees) incurred in collecting delinquent or uncollectible payments; (4) the language of the documentation contains references to the transfer being "security for" a debt; and (5) the parties' intent, as evidenced by the documentation and their actions, suggests that the parties view the transaction as a security device. Also of importance is how the parties account for the transactions on their books, records, and tax returns. See SCHWARCZ, *supra* note 2, at 34-35.

³⁶ There are two reasons why it may not be feasible to sell an interest in future payments under a contract not yet in existence. First, the common law governing the sale of intangibles is ambiguous as to the effectiveness of the sale of an intangible asset that does not exist on the date of its purported sale. Compare *New York Security and Trust Co. v. Saratoga Gas and Electric Co.*, 53 N.E. 758 (N.Y. 1899) (purchaser of accounts must ensure that the subject matter of accounts involves a right existing at the time of assignment in order to protect its interest from general creditors) with *Rockmore v. Lehman*, 128 F.2d 564 (2d Cir.) *rev'd on reh'g*, 129 F.2d 892, *cert. denied*, 317 U.S. 700 (1942) (assignment of account which arose from contract already in existence was a legal assignment with priority over prior or subsequent equitable claims and over subsequent lien creditors in a court of law). Second, under § 552 of the Bankruptcy Code, assets that are acquired by a debtor after a bankruptcy

The particular example of a divisible interest discussed in this article is an interest in the future payment stream equal to 100 percent of collections up to a negotiated amount (the "trigger point") and a fixed percentage (the "fixed percentage") of collections above the trigger point. This is not necessarily the only way a divisible interest can be structured, but merely the author's suggestion of a potentially useful structure.

There has been an unfounded perception that the transfer of only a partial interest in a future payment stream (as opposed to transfer of the entire payment stream) cannot be a true sale for bankruptcy purposes. Part of the confusion may be semantic. The transfer of all of a person's right, title, and interest in an asset to another person is the very definition of a sale of such asset.³⁷ Yet a divisible interest has been defined as *less than* all of the originator's right, title and interest in the relevant payment stream! This apparent dilemma is resolved by recognizing that what is being sold is *all* of the originator's right, title, and interest in a divisible interest in the payment stream, as opposed to all of the originator's right, title, and interest in the entire payment stream.

At least one court has held that the assignment of a partial interest in a future payment transfers full legal title in that interest to the assignee. In *Angeles Real Estate Co. v. Kerxton*,³⁸ one-half of the proceeds of a note was assigned by a construction company as payment for a prior debt.³⁹ When the construction company was adjudicated bankrupt, the assignee sued the trustee of the bankruptcy estate for one-half of the

petition is filed may not be subject to a pre-bankruptcy security interest except to the extent that such assets are proceeds of property pledged prior to bankruptcy.

It would be feasible to sell an interest (divisible or otherwise) in the right to future payments arising from existing trade accounts receivable or even consisting of the right to payments that are expected to come due in the future under an existing contract (indeed, there is authority that one may assign a future right to payment under an existing contract even if services giving rise to the payment obligation under such contract have not yet been performed) *United Va. Bank v. Slab Fork Coal Co. (In re Slab Fork Coal Co.)*, 784 F.2d 1188 (4th Cir.), *cert. denied*, 477 U.S. 905 (1986); *See SCHWARCZ, supra* note 2, at 9 n.9 & 37-39; *cf.* U.C.C. § 9-204 (security interests in after-acquired property).

³⁷ *See supra* text accompanying note 13.

³⁸ 737 F.2d 416 (4th Cir. 1984).

³⁹ *Id.* at 418.

proceeds that had been collected on the note. The Fourth Circuit held that the assignee had a superior claim to half of the proceeds since the partial assignment transferred legal title to the assignee. In rejecting the trustee's contention that "a partial assignment does not create a legal interest in the assignee unless the debtor [i.e., the person obligated to make the payment] consents to the assignment," the court reasoned first, that "[h]ere there is no question of prejudicing the obligor on the note," and second, that Section 326 of the Restatement Second of Contracts provides that an "assignment of a part of a right [, whether the part is specified as a fraction, as an amount, or otherwise,] is operative as to that part to the same extent and in the same manner as if the part had been a separate right."⁴⁰ Under the logic of the *Angeles Real Estate Co.* case, an originator's sale of a divisible interest in a future payment stream will effectively separate that interest from the originator entity in the event of a subsequent bankruptcy.⁴¹

⁴⁰ *Id.* at 419 (quoting Restatement Second of Contracts § 326(1) (1981); bracketed language appears in § 326(1) but was omitted from the quotation cited by the court).

⁴¹ The law arising from the sale of loan participations is also instructive. A loan participation is an undivided interest in a loan. The bank that made the loan sells the participation to another bank, thereby diversifying the lending bank's credit risk. See, e.g., Reade H. Ryan, Jr., *Participations in Loans under New York Law*, INT'L FIN. L. REV., Oct. 1984 at 40.

In the leading case on the characterization of a loan participation as a true sale, *FDIC v. Mademoiselle of California*, 379 F.2d 660 (9th Cir. 1967), San Francisco National Bank ("SFNB") sold to Union Bank an 80% interest in a loan. SFNB subsequently was declared insolvent and taken over by the Federal Deposit Insurance Corporation, as Receiver. After SFNB's takeover, SFNB received a substantial payment on its loan through a set-off. Union Bank asserted a preferred claim to 80% of that payment. 379 F.2d at 664. The court would have given Union Bank a preferred claim, as opposed to merely a distribution of SFNB's assets pro rata with other creditors, if "the property is not that of [SFNB] but that of the claimant [Union Bank]." 379 F.2d at 664.

The court acknowledged the general rule that "[a]n assignment of payments to be made *in futuro* . . . is held to pass legal title in the proceeds to the assignee." 379 F.2d at 665. The court further stated that "[i]f Mademoiselle [the borrower] had made a specific payment on the note in the amount now claimed by Union [Bank], this case would come within [the foregoing] rule," thereby recognizing that the sale of an undivided interest in a loan can constitute a true sale. *Id.* Nonetheless, the court held that Union Bank did not have a preferred claim based on the narrow (and this author believes, archaic) ground that the payment occurred through a set-off and a set-off does not augment the assets of SFNB or its receiver. *Id.* *Mademoiselle* nevertheless establishes the

1. Commercial Application

Selling a divisible interest in a future payment stream can have significant commercial importance. The right to receive future payments from obligors is an intangible that may not be easily divisible until cash collections actually are received. Therefore, the ability to sell a divisible interest, prior to collections being received, would afford significant flexibility to originators. This is evident, by way of example, where the future payment stream is due from a limited number of obligors, such as lessees on a few long-term leases. Even where the future payment stream is due from a large number of obligors, such

rule that a participation can create a true sale. See, e.g., *In re Drexel Burnham Lambert Group Inc.*, 113 B.R. 830, 842 n.15 (Bankr. S.D.N.Y. 1990) ("In *Mademoiselle*, the Ninth Circuit acknowledged with approbation the general rule that a loan participation passes legal title in the proceeds of the fund to the participant.")

The *Mademoiselle* case can be contrasted with another leading case on the sale of loan participations, *In re Yale Express System, Inc.*, 245 F. Supp. 790 (S.D.N.Y. 1965). First National City Bank ("FNCB") made a loan to Yale Express, and then sold a 40% participation in that loan to Marine Midland Trust Company of New York ("Marine"). Yale Express subsequently went bankrupt. The issue before the court was whether Marine was a creditor of Yale Express and therefore could have set off against a bank account of Yale Express. If the sale of the participation made Marine an owner of 40% of the loan, the set-off would have been permitted.

The court ruled, however, that "Marine was not and is not a creditor entitled to set off the bank account." 245 F. Supp. at 792. Although the court does not discuss its reasoning, it is apparent from the facts specifically noted by the court that the true sale determination was based on the type of general factors discussed in part II.A of this article and not on the undivided nature of the participation *per se*:

[Marine's] right to repayment would arise only upon the receipt by FNCB of payment from Yale [Express]. All rights to extend or amend the substantial terms of the credit agreement were lodged solely with FNCB. Upon any default by Yale, FNCB alone had the power to act respecting such default or defaults. In addition, FNCB had the option to repurchase Marine's stipulated participation interest.

245 F. Supp. at 792.

If the participation agreement in the *Yale Express* case did not give FNCB the option to repurchase Marine's interest, if it did not provide that Marine's right to repayment would arise only upon FNCB's receipt of payment from Yale Express, and if Marine had some degree of control over amendments to and enforcement of remedies under the credit agreement, this writer believes the court would have held the participation to be a true sale and therefore permitted the set-off.

as buyers of goods who are obligated to pay trade receivables, an originator's ability to sell a divisible interest still would afford significant flexibility over more traditional pooling. The originator may have operational difficulties, for example, in segregating smaller pools of receivables and tracing proceeds of their collections. Selling a divisible interest can obviate the originator's need to do that and a host of similar problems.

Selling a divisible interest also can provide a simplified and less cumbersome transactional structure. At present, many middle-market companies, because they lack an investment grade rating, cannot gain direct access to the capital markets. In order to gain access to the capital markets through securitization, these companies presently would have to engage in a somewhat cumbersome structure, involving a true sale to a newly created bankruptcy-remote subsidiary and a second sale transaction between the subsidiary and an SPV that would issue securities in the capital markets.⁴² The costs involved in creating a two-step structure prevent it, however, from being economically viable for the relatively small level of future payment streams originated by a typical middle-market company.

Although it would be desirable to avoid the need for a two-step structure, an economically viable true sale from the originator to the SPV is difficult to achieve. There is a tension between the originator — which wants to maximize the purchase price it receives for selling the future payment stream — and the SPV — which wants to minimize the purchase price. The excess of the amount of the future payment stream over the purchase price is referred to as “over-collateralization.” The higher the over-collateralization, the more the SPV (and investors in its securities) are protected from losses but the less attractive the transaction is to the originator.⁴³ A two-step

⁴² This structure is known as a “FINCO” or “two-tier” structure. The future payment stream is partly sold and partly transferred as a capital contribution to a newly created, bankruptcy-remote subsidiary of the originator. When the capital market securities eventually are paid, the originator regains the benefit of any excess collections remaining in the subsidiary by causing the subsidiary to dividend the excess to the originator or by merging the subsidiary into the originator. For a general discussion of the FINCO structure, see SCHWARCZ, *supra* note 2, at 21-22.

⁴³ Consider, for example, a true sale of a one million dollar future payment stream to an SPV. The originator would want to be paid one million dollars upon the sale of the future payment stream, discounted only for the SPV's cost

structure (*see supra* note 42) could permit the originator to regain the benefit of excess collections, but it is a cumbersome and expensive solution.

By selling a divisible interest in a future payment stream, however, the two-step structure is rendered unnecessary. As will be shown in an example below, the amount paid by an SPV to purchase a divisible interest would equal only a portion of the future payment stream. The divisible interest is structured, however, so the SPV will receive all collections of the payment stream up to the trigger point (and perhaps a fixed percentage of collections thereafter). The practical effect is that the SPV (and its investors) will have a high degree of protection from loss while the originator retains all or most of the benefit of collections above the trigger point.

Perhaps of even greater commercial importance is the potential for multiple companies to sell divisible interests in their future payment streams as part of a single securitization transaction. At present, the level of future payment streams generated by a single middle-market company rarely would be sufficient to justify the underwriting and related costs in selling an SPV's securities to investors in the capital markets. A possible solution would be to pool multiple originators in a single financing, and thereby achieve an economy of scale. Present "true sale" structures, however, do not easily accommodate themselves to the pooling of multiple originators. In the two-tier structure, for example, the originator sells the future payment stream to a wholly owned, bankruptcy-remote SPV. If there are multiple originators, each originator would have to own shares or other interests in the SPV and agree how the SPV's assets and income are to be divided.

By using the concept of a divisible interest, however, multiple originators could join together to sell their future payment streams to a single SPV, which would issue securities to inves-

of funds until the future payments are expected to be collected, suggesting, say, 980,000 dollars as a purchase price. The SPV, however, also would want to guard against possible losses (as well as the risk that payments may be delayed — *see infra* note 55) and may counter-offer with 900,000 dollars as a proposed purchase price. If the originator believes that future payments will be made without losses, it may well regard 900,000 dollars as too low a price because the SPV would become the owner of the entire payment stream, including all collections above 900,000 dollars.

tors in the capital markets based on the combined pool of future payments. Because each originator's sale would stand on its own, the complexities of a joint venture are avoided. The costs of underwriting and selling the SPV's securities thereby can be made economically viable.

2. Example of a True Sale of a Divisible Interest

It may be useful to illustrate a sale of a divisible interest in a future payment stream. In considering how to structure the following example, an attempt has been made to balance, in a manner that will be consistent both with a true sale and commercial acceptability, the SPV's desire to minimize the collection risk associated with each purchase and the originator's competing desire that the interest in the payment streams sold does not give the SPV a windfall.

The example chosen is a structured financing for a company that originates payment streams in the form of receivables owing from third parties for goods sold and services rendered,⁴⁴ and from time to time sells divisible interests in these receivables to an SPV. The question is whether the transfer of these divisible interests can be structured as a true sale.

Assume for a given batch of receivables in which an interest is to be sold that the net outstanding balance at the time of sale is \$1,000,000. Also assume that the SPV agrees to buy a divisible interest in the receivables, measured as follows, for a purchase price of \$700,000:⁴⁵

⁴⁴ Virtually any type of originator could have been used as an example. For example, the originator could be a hospital that originates payment streams in the form of receivables for healthcare services rendered (owing from patients and related governmental and private insurers).

⁴⁵ The purchase price of \$700,000 used in the example could well have been \$600,000, or \$900,000, or even \$500,000. It and the trigger point are arms' length negotiated numbers. If, for example, the purchase price were negotiated to be \$500,000, the trigger point might be expected to be negotiated in the order of magnitude of \$515,000. The lower the purchase price compared to the amount of the future payment stream, the less is the SPV's risk of collections not reaching the trigger point. While theoretically any negotiated purchase price and trigger point would be consistent with a true sale for the reasons discussed in the text accompanying notes 48-49, at some point the purchase price may be so low compared to the amount of the payment stream that it would violate the "smell test" and be considered a secured loan rather than a true sale.

- (i) 100 percent of all collections up to a "trigger point," and
- (ii) a fixed percentage of all collections above the trigger point.

The trigger point and the fixed percentage would be negotiated at the time of the purchase, and thereafter would remain fixed. In negotiating the trigger point, the SPV will want to select a number that reflects its best estimate of the minimum collections that will ensure repayment of its purchase price and a desirable return on the investment represented by its purchase price. The originator, by contrast, will want the trigger point to be as low as possible. In negotiating the fixed percentage, the SPV will want a number that provides an extra source of compensation for taking a risk on fixing the amount of the trigger point and the collection risk.⁴⁶ The originator, again, will prefer the percentage to be as low as possible.

Assume that the negotiated trigger point was \$720,000 and the negotiated fixed percentage was three percent. Further assume that the collections on the receivables later turn out to be \$980,000.⁴⁷ One then would compute the following numbers:

⁴⁶ The divisible interest equally well could have been structured without a fixed percentage. The SPV, in that case, only buys an interest in the receivables measured by 100% of all collections up to the trigger point.

⁴⁷ Collections on each batch of receivables sold would be separately tracked. From the standpoint of a true sale, each transfer of a divisible interest in a batch would be independent of each other such transfer. This sometimes is referred to as the transfers not being "cross-collateralized." Nonetheless, to the extent the originator makes limited representations and warranties consistent with a true sale, see *supra* note 26 and accompanying text, there is no logical reason why the originator could not cross-collateralize an indemnification obligation for breach of such representations and warranties by pledging all of its assets, which would include the originator's retained interest in each batch of receivables. For example, in a securitization of a middle-market company that, perhaps, might not have completely reliable records as to its future payment streams, the SPV could be indemnified for reliance on inaccurate records, and this indemnity could (if desirable) be secured by all of the company's assets.

Trigger Point	= \$720,000.
Collections above Trig- ger Point	= \$980,000 - \$720,000. = \$260,000.
Fixed Percent- tage x Col- lections above Trigger Point	= 3% x \$260,000 = \$7,800.

Therefore, for a purchase price of \$700,000, the SPV would receive a return of \$727,800.

Applying the factors discussed above, the transfer of the divisible interest in this illustration constitutes a true sale under Section 541 of the Bankruptcy Code. The SPV has assumed the benefits and burdens of ownership of the divisible interest it has purchased. If the amount of the divisible interest, calculated by applying the negotiated trigger point and fixed percentage to actual collections, is insufficient to repay the SPV's purchase price plus its applicable cost of capital, the SPV suffers a loss. The SPV, however, will benefit to the extent that collections received exceed its investment and cost of funds.⁴⁸ The pricing formula is, effectively, a discount and has no semblance of loan-type pricing. Also, because the trigger point and the fixed percentage are negotiated prior to each sale of a divisible interest, there is no retroactive adjustment of the purchase price based on the amount of actual collections or the timing of collections.⁴⁹

⁴⁸ The SPV will receive the amount, if any, by which the trigger point is in excess of its purchase price and return on investment. The SPV also will receive its negotiated fixed percentage of all collections above the trigger point, although a transaction structured without entitling the SPV to collections above the trigger point would still have enough potential benefit to constitute a true sale. See *infra* note 55.

⁴⁹ The foregoing example might be contrasted with an approach, sometimes seen, of the originator selling the entire payment stream to a buyer in return for which the buyer pays its purchase price partly in cash and partly by giving the originator an undivided interest (or "participation") in future collections of the payment stream. At least where the buyer is a wholly-owned subsidiary of

Consequently, the only true sale issue that can be raised in the foregoing transaction is whether, because the SPV is receiving 100 percent of the first dollars collected up to the trigger point, there may be excessive recourse. This is not, however, the type of recourse that is inconsistent with a true sale. The nature of the recourse in this transaction is such that the legal rights and economic consequences are those of a true sale and not a secured loan.

The type of transaction that is inconsistent with a true sale occurs where the SPV's recourse against the originator (or its assets) is subject to adjustment to ensure that the SPV receives its original investment plus an agreed upon return on the investment.⁵⁰ The originator then would receive all collections in excess of the foregoing amounts.⁵¹ Recourse of this nature will be referred to as "adjustable recourse."

Adjustable recourse is inconsistent with a sale because the adjustment changes the benefits and burdens of a sale to those of a secured loan. The benefits and burdens of a sale are that the buyer enjoys the benefit of any increase in value of the asset purchased and bears the burden of any loss in value.⁵² The benefits and burdens of a secured loan are that the lender is entitled only to repayment of the amount of its loan plus interest at an agreed upon rate; and the borrower is entitled, as a matter of law,⁵³ to the return of any remaining collateral.

the originator in a FINCO structure, this raises an issue whether the originator is truly entering into an arms' length negotiated sale. To achieve a sale, the probability that the originator will be repaid on its participation must be sufficiently high to induce an independent seller of the payment stream in an arms' length market transaction to take the participation as partial payment.

⁵⁰ In *Major's Furniture Mart v. Castle Credit Corp.*, 602 F.2d 538, 546 (3d Cir. 1979), the purported purchaser of the receivables, unilaterally changed the discount from time to time to reflect the prime rate. Due to such changes, coupled with full recourse against Major's, the court held that transaction to be a secured loan. See *supra* notes 22-26 and accompanying text.

⁵¹ Compare U.C.C. § 9-504(2) (secured party's right to dispose of collateral after default) ("If the security interest secures an indebtedness, the secured party must account to the debtor for any surplus, and, unless agreed, the debtor is liable for any deficiency. But if the underlying transaction was a sale of accounts or chattel paper, the debtor is entitled to any surplus or is liable for any deficiency only if the security agreement so provides.").

⁵² *Rexnord, Inc. v. U.S.*, 940 F.2d 1094, 1098 (7th Cir. 1991).

⁵³ See *supra* note 51.

Even if the SPV in this example were virtually assured of receiving collections up to the trigger point (because it receives 100 percent of the first dollars collected),⁵⁴ its benefits and burdens are still those of a buyer. The SPV takes the risk that collections may be slower than originally anticipated and the trigger point therefore may be too low to give the SPV a satisfactory return on its investment, as well as the risk that collections are insufficient even to reach the trigger point. But because the SPV is entitled to receive all collections up to the trigger point (and is not limited to an agreed upon rate of return), if the actual rate of collection turns out to be higher than originally anticipated the SPV will benefit from a greater return on its investment.⁵⁵ It is this potential for both gain and loss on its investment, due to the fixed nature of the divisible interest, that makes the SPV's recourse consistent with a

⁵⁴ As previously discussed, however, the trigger point would be fixed by negotiation between the SPV and the originator prior to the sale of the divisible interest. A rational originator would not be expected under ordinary circumstances to agree to too high a trigger point because the SPV benefits from all collections up to the trigger point.

⁵⁵ A numerical example perhaps would be helpful. If the \$720,000 trigger point in the example discussed in the text accompanying notes 45-48 is collected in an average of six months, the SPV's effective rate of return, assuming simple interest, on its \$700,000 investment would be:

$$\frac{\$20,000}{\$700,000} \quad 6/12 = 5.7\%.$$

\$20,000

\$700,000

If, however, the \$720,000 trigger point were collected in an average of two months, the SPV's effective rate of return would be

$$\frac{\$20,000}{\$700,000} \quad 2/12 = 17.1\%.$$

\$20,000

\$700,000

On the other hand, if the originator becomes troubled and collections are delayed to an average of, say, nine months, the SPV's effective rate of return would be as little as

$$\frac{\$20,000}{\$700,000} \quad 9/12 = 3.8\%.$$

\$20,000

\$700,000

The SPV therefore is subject to significant variation of its return on investment. Because a significant disparity between the anticipated and the actual collection rate can significantly affect the economics of the transaction, the sale of a divisible interest would appear to have its greatest practical application to short term payment streams, such as trade receivables, retail credit card receivables and the like, where the collection rate can be predicted with greater accuracy. Certain items relating to the unique characteristics of the payment stream, such as dilution, may (in appropriate cases) be able to be covered by a specific indemnity without impairing true sale treatment. *Cf.* notes 26 and 47, *supra*.

true sale.⁵⁶

C. After a True Sale, Could the SPV's Divisible Interest in Commingled Cash Collections be Impaired?

Two theories threaten to impair an SPV's divisible interest in cash collections that have been commingled with cash collections of the originator's retained interest in the future payment stream. The first theory is that, in the event of the originator's bankruptcy, cash collections of the divisible interest would constitute "cash collateral" and therefore be subject to Section 363 of the Bankruptcy Code.⁵⁷ The second theory is that to the extent cash collections are commingled with the originator's interest in the same payment stream, Section 9-306 of the U.C.C. limits the SPV's interest in the collections.⁵⁸ Neither theory should apply to cash collections of a divisible interest.

⁵⁶ A similar analysis is used to determine the status of a production payment in the oil and gas and mineral industries. A production payment is the right to share (normally a specified percentage) minerals produced from described property, free of the costs of production and terminating when a specified quantity or dollar amount has been realized. *See* *Alamo Nat'l Bank of San Antonio v. Hurd*, 485 S.W.2d 335 (Tex. Civ. App. 1972); *see also* 2 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 422 (1992). If the owner of the property on which the oil, gas or minerals are located files for bankruptcy, it becomes important to characterize the interest held by the recipient of the production payment in the bankruptcy proceeding.

As in the sale of a divisible interest, a production payment "imposes no personal obligation to pay the sum of money specified in the instrument creating it and no duty to deliver the agreed number of units of production apart from actual production from the described premises." *Id.* § 422.2 at 373. The right to receive payment does not arise until the oil, gas or minerals are produced. *Id.* The recipient of the production payment therefore has assumed all the risks and benefits of ownership. "If, however, the payment is required to be made whether or not the production is obtained or is sufficient for the purpose, there is no true [production] payment; instead there is a debtor-creditor relationship and a lien or other security interest in production" because there is no indicia of ownership. *Id.* § 422.2 at 374 (footnote omitted).

⁵⁷ 11 U.S.C. § 363.

⁵⁸ For a detailed discussion of commingling under U.C.C. § 9-306, *see* SCHWARCZ, *supra* note 2, at 40-41.

1. Cash Collateral under Bankruptcy Law

Section 363 of the Bankruptcy Code defines procedures for allocating cash and cash equivalents in which both the debtor (*i.e.*, the originator) and a third party (*i.e.*, the SPV) share an interest. If cash collections of a divisible interest constitute "cash collateral," the procedures of Section 363 would have to be followed in allocating the collections. These procedures, if applicable, could hinder the SPV's distribution of cash collections to its security holders.⁵⁹

Cash collateral is defined as

cash, . . . deposit accounts, or other cash equivalents . . . in which the [debtor's] estate and an entity other than the [debtor's] estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of [the Bankruptcy Code], whether existing before or after the commencement of a [bankruptcy] case.⁶⁰

Cash collateral therefore would include cash collections of property owned by a debtor in which a third party has a security interest. The debtor's ownership interest and the third party's security interest constitute overlapping and competing interests in the same property.⁶¹

Does the term "cash collateral" also include cash collections of a divisible interest in a payment stream sold to an SPV? Resolution of this question turns on whether an originator, in bankruptcy, and an SPV both "*have an interest*" in these collections. The following analysis will consider, first, the divisible interest to the extent it constitutes an interest in 100 percent

⁵⁹ Even if collections of the divisible interest are required to be paid to the SPV, a delay might result in the investors in the SPV's securities not being paid principal or interest on a timely basis, which could impair the investment grade rating of the securities.

⁶⁰ 11 U.S.C. § 363(a).

⁶¹ Section 363 of the Bankruptcy Code prevents the debtor from using cash collections without affording the third party a court hearing at which the third party's security interest would be adequately protected. "Adequate protection," however, may be inadequate from the standpoint of the third party to the extent non-cash collateral is substituted for cash and cash equivalents. 11 U.S.C. §§ 363(c)(2), 363(e), 361.

of collections of the future payment stream up to the trigger point; and, second, the divisible interest to the extent it constitutes a fractional undivided interest (represented by the fixed percentage) in collections above the trigger point.

The sale of the divisible interest to the SPV has been shown to be a true sale under Section 541 of the Bankruptcy Code.⁶² The originator therefore cannot have an ownership interest in cash collections of the divisible interest up to the trigger point because the SPV owns 100 percent of such collections (and the SPV has not granted to the originator a security interest or any other type of interest in the collections). Because the originator has no interest in these collections, the term "cash collateral" should not include cash collections of a divisible interest up to the trigger point. Accordingly, such collections should not be subject to the procedures set forth in Section 363 of the Bankruptcy Code.

The analysis of whether the term "cash collateral" includes cash collections of a divisible interest above the trigger point is more complicated because both the originator and the SPV own a fractional undivided interest in the collections. If, for example, the SPV's fixed percentage is three percent and the amount of collections above the trigger point is \$260,000, the SPV would be entitled to \$7,800, and the originator would be entitled to \$252,200. Even though the SPV's interest is an ownership and not a security interest, the definition of "cash collateral" refers to "an interest"⁶³ and therefore could be interpreted broadly to include both types of interests.

If the SPV's ownership interest in collections above the trigger point did constitute "cash collateral" under Section 363(a), a court nonetheless should be required to allocate cash collections to the SPV and not permit the originator to use the cash.⁶⁴ Subsections 363(h) and (j) contemplate a debtor and a third party having co-ownership undivided interests in property represented by a tenancy in common, joint tenancy, or tenancy by the entirety.⁶⁵ The debtor is permitted, in these limited circumstances,⁶⁶ to sell the third party's co-ownership interest,

⁶² See *supra* notes 44 to 56 and accompanying text.

⁶³ See *supra* text accompanying note 60.

⁶⁴ Cf. *supra* note 61 (regarding a debtor's right to use cash collateral by providing "adequate protection").

⁶⁵ 11 U.S.C. § 363(h).

⁶⁶ Because courts have wanted to limit the right of debtors to sell co-owner-

but "the proceeds of such sale" are required to be "distribute[d] to the . . . co-owners of such property . . . and to the [debtor] . . . according to the interests of such . . . co-owners and of the [debtor]."⁶⁷ Therefore, when a co-ownership interest is reduced to cash, there appears to be a legislative intent to distribute the cash to the co-owners (*i.e.*, the SPV and the originator) according to their respective interests.⁶⁸

It is also possible that a divisible interest itself may constitute a tenancy in common under state law. A tenancy in common can exist in relation to every type of property, including personal property such as a future payment stream.⁶⁹ The originator need not intend the sale of the divisible interest to constitute a tenancy in common; the sale of an interest that is undivided, in and of itself, may create the tenancy in common.⁷⁰ If the divisible interest were to constitute a tenancy in common under state law, Section 363(j) explicitly would require the cash collections of the divisible interest to be distributed to the originator and the SPV according to their respective interests.⁷¹

2. Commingling under Commercial Law

If the originator goes bankrupt when cash collections of the divisible interest and the originator's retained interest are commingled, could Section 9-306 of the Uniform Commercial Code limit the SPV's perfected interest in these collections? Where an originator sells a divisible interest in a future payment stream

ship interests held by third parties, they have construed § 363(h) narrowly. *See, e.g., In re Livingston*, 804 F.2d 1219, 1222-23 (11th Cir. 1986).

⁶⁷ 11 U.S.C. § 363(j).

⁶⁸ Because even a delay in the distribution of collections could impair the investment grade rating on the SPV's securities (see *supra* note 59), a party seeking to avoid any risk of delay could structure the transaction so that the cash collections up to the trigger point are sufficient to pay the SPV's securities or simply eliminate the SPV's right to a fixed percentage of collections above the trigger point.

⁶⁹ *See, e.g., Kellum v. Williams*, 39 So.2d 573 (Ala. 1949); 20 AM. JUR. 2D *Cotenancy and Joint Ownership* § 25 (1965).

⁷⁰ *See, e.g., Dressler v. Mulhern*, 136 N.Y.S. 1049 (1912); *Lutz v. Dutmer*, 282 N.W. 431 (Mich. 1938); *Green v. Cannady*, 57 S.E. 832 (S.C. 1907); 20 AM. JUR. 2D *Cotenancy and Joint Ownership* § 28 (1965).

⁷¹ *See supra* text accompanying notes 65-68.

to an SPV, commingling could result either from the originator's interest in collections above the trigger point being deposited into a deposit account containing collections of the divisible interest, or from the originator's and the SPV's respective interests in collections above the trigger point being deposited into the same deposit account. For the reasons set forth below, Section 9-306 should be interpreted not to apply to commingled cash collections of a divisible interest.

Section 9-306 of the U.C.C. governs a secured party's rights on disposition of collateral. A central concept in Section 9-306 is "proceeds" which is defined as "whatever is received upon the . . . collection . . . of collateral."⁷² Cash collections of a divisible interest therefore may constitute proceeds. The general rule of Section 9-306 is that "a security interest continues in collateral . . . and also continues in any identifiable proceeds including collections" that are received by the originator instead of the SPV.⁷³ However, in the event of an "insolvency proceeding," such as a bankruptcy,⁷⁴ a more restrictive rule applies under Section 9-306(4). The SPV's divisible interest in cash collections of the future payment stream would continue *only* in specified categories of proceeds.⁷⁵

Upon an originator's bankruptcy, an SPV's divisible interest in cash collections continues to the extent such collections are deposited to a bank account of the originator containing only collections of the divisible interest.⁷⁶ Likewise, an SPV's divisible interest in cash collections continues to the extent such collections are deposited into a deposit account owned and controlled by the SPV and not by the originator.⁷⁷

⁷² U.C.C. § 9-306(1). The term "collateral" is defined in U.C.C. § 9-105(1)(c) to include "accounts and chattel paper which have been sold." Therefore, proceeds would appear to include collections of a divisible interest in a future payment stream consisting of "accounts" or "chattel paper." See *id.* § 9-106 and § 9-105(1)(b)). Cf. *supra* note 11.

⁷³ U.C.C. § 9-306(2). The term "security interest" used therein includes "any interest of a buyer of accounts and chattel paper which is subject to Article 9." U.C.C. § 1-201(37). Cf. *id.*

⁷⁴ U.C.C. § 1-201(22).

⁷⁵ *Id.* § 9-306(4).

⁷⁶ *Id.* § 9-306(4)(a).

⁷⁷ *Id.* § 9-105(1)(e) ("deposit account"). The commingling rule of U.C.C. § 9-306(4) is intended to account for "proceeds received by a debtor." *Id.* § 9-306, Official Comment No. 1. Collections received in the SPV's deposit account are

Analysis becomes more difficult, however, if collections of the SPV's divisible interest are deposited into an originator's bank account containing funds of the originator. In that case, Section 9-306(4), by its terms, suggests that the SPV's interest would be limited to an amount determined by a formula. Under this formula, an SPV's divisible interest in commingled cash collections is limited to collections received by the originator within 10 days before the bankruptcy case is instituted less the sum of payments made to the SPV on account of such collections. The SPV would lose its interest in cash collections received by the originator prior to such 10-day-period and not paid over to the SPV before the originator's bankruptcy.⁷⁸

Where cash collections of the SPV's divisible interest in a payment stream are commingled with general funds of the originator, the limitation in Section 9-306(4) would apply. However, where cash collections of the SPV's divisible interest in a payment stream are commingled only with cash collections of the originator's interest in the same payment stream, the limitation in Section 9-306(4) should not apply.⁷⁹

The purpose of the formula in Section 9-306(4) is to "substitute specific rules of identification for general principles of tracing" in situations where "*proceeds have been commingled with other funds.*"⁸⁰ Would collections from the originator's retained

not proceeds received by the debtor. Therefore a practical solution to the commingling issue is to cause all collections of the future payment stream to be deposited directly into the SPV's deposit account.

⁷⁸ Therefore another practical solution would be to "sweep" collections at least every 10 days from the originator to the SPV or to require all collections to be deposited to an account of the SPV (instead of the originator's account). An additional practical solution to the commingling issue can be referred to as the "bootstrap approach." In note 47, *supra*, it was suggested that the originator could cross-collateralize its indemnification obligations by pledging other assets, perhaps including the originator's retained interest in the future payment stream. Such cross-collateralization would give the SPV a security interest in the originator's retained interest, thereby preventing commingling under U.C.C. § 9-306(4). See *infra* text accompanying notes 80-82.

⁷⁹ Such commingling may occur, for example, where the trigger point has been reached and each additional dollar of collections is allocated to the SPV according to its negotiated fixed percentage and to the originator according to its retained interest.

⁸⁰ See U.C.C. § 9-306, Official Comment No. 2(a), and U.C.C. § 9-306(4)(d) (emphasis added). To the extent that the U.C.C. does not apply to the sale because the payment stream sold is neither accounts nor chattel paper (*supra*

interest in a payment stream in which the SPV has a divisible interest constitute "*other funds*," or would they constitute proceeds? As discussed above, the term proceeds includes whatever is received upon the collection of collateral. The term "collateral" means "the property subject to a security interest."⁸¹ Because a divisible interest creates an undivided interest in the entire future payment stream, all of the cash collections of the future payment stream should constitute proceeds. Accordingly, cash collections of an SPV's divisible interest in a payment stream that are commingled with cash collections of the originator's interest in the same payment stream are not commingled "*with other funds*" within the meaning of U.C.C. Section 9-306(4).⁸²

It also should be noted that the risk of commingling discussed above applies only to cash collections of the divisible interest that are commingled with the originator's funds at the time the originator first becomes subject to a bankruptcy case. Cash collections received by the originator thereafter are not subject to U.C.C. Section 9-306(4), which by its terms provides that an interest continues in "identifiable cash proceeds in the form of money which is neither commingled with other money nor deposited in a deposit account *prior to*" an originator's bankruptcy,⁸³ and also continues in "identifiable cash proceeds in the form of checks and the like which are not deposited in a deposit account *prior to*" such bankruptcy.⁸⁴

note 72), the common law general principles of tracing would appear to apply in lieu of the formula in U.C.C. § 9-306(4). In addition, the Article 9 Study Committee of the Permanent Editorial Board for the Uniform Commercial Code recently recommended to the National Conference of Commissioners on Uniform State Laws and the American Law Institute that subsection (4) of U.C.C. § 9-306, including the formula and other special rules that apply to proceeds only in the event of a debtor's insolvency proceedings, should be eliminated. Permanent Editorial Board Study Group, Uniform Commercial Code Article 9 Report, Vol. 1, part III.C.15, at 122 (Dec. 1, 1992).

⁸¹ U.C.C. § 9-105(1)(c) (including "accounts and chattel paper which have been sold.").

⁸² If, of course, such collections are commingled with general funds of the originator, that would raise a separate commingling concern under U.C.C. § 9-306(4). In that case, the "bootstrap approach" discussed in *supra* note 78 could be used.

⁸³ U.C.C. § 9-306(4)(b) (emphasis added).

⁸⁴ *Id.* § 9-306(4)(c) (emphasis added); *accord*, In re Bumper Sales, Inc. (Unsec. Cred. Comm. v. Marecon Fin. Corp.), 20 B.C.D. 1212, 1216 (4th Cir.

III. CONCLUSIONS

The sale of a divisible interest in a future payment stream can be structured in an economically viable manner as a true sale. After the sale, the SPV's divisible interest in commingled cash collections would not be impaired under bankruptcy or commercial law.

Selling a divisible interest in a future payment stream can revolutionize the development of structured finance and asset securitization as means of raising capital. Not only will it allow for a less cumbersome transactional structure than that which is currently used, but the reduced transaction costs as well as the economies of scale that can be achieved by multiple originators joining together in a single securitization transaction promise to expand the capital markets to now-excluded middle-market companies.⁸⁵

1990).

⁸⁵ To the extent small businesses and hospitals generate future payment streams, they could benefit like middle-market companies. Application of structured finance to the small business sector of the economy is an important governmental policy goal. See SEC Release, *supra* note 1, at 4.

