When Is a Dog’s Tail Not a Leg?: A Property-Based Methodology for Distinguishing Sales of Receivables from Security Interests That Secure an Obligation

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I. INTRODUCTION

A firm that is owed money payable in the future may need the money now. There are two principal ways in which the firm might use its rights to payment (receivables) to accomplish that result: It might sell its
receivables, or it might borrow and use the receivables as collateral to secure a loan. Either transaction creates a “security interest” under Uniform Commercial Code Article 9. However, different legal consequences follow depending on whether the transaction is a sale (or, as it commonly is called, a true sale) or is a security interest that secures an obligation (a SISO). These legal consequences are particularly salient when the firm enters bankruptcy. If the transaction is a sale, then the receivables do not become part of the firm’s bankruptcy estate, and the buyer can collect them as if no bankruptcy had ensued. If, however, the transaction is a SISO, then the receivables do become property of the firm’s bankruptcy estate. As such, they may be used by the firm during the bankruptcy and cannot be collected by the secured party unless the bankruptcy court orders otherwise. The bankruptcy consequences of the distinction between a true sale and a SISO form the cornerstone of securitization, or “structured finance,” transactions. In these transactions, a firm obtains needed cash by selling its receivables to an entity whose sole purpose is to buy the receivables and issue securities (often, publicly traded debt securities). The value of the securities depends solely on the value of the receivables. Unlike the firm’s secured debt, the value of the securities issued by the buyer is not affected by the financial condition of the firm.

If the firm enters bankruptcy, creditors have an incentive to argue that a transaction that is structured and documented as a true sale creates a SISO in substance and so should be treated as a SISO in the bankruptcy. Such a recharacterization poses a great risk to the holders of securities issued by the buyer in a securitization. Unless the bankruptcy court treats a securitization transaction as a true sale of the receivables, the

2. “‘Security interest’ means an interest in personal property or fixtures which secures payment or performance of an obligation. ‘Security interest’ includes any interest of a...buyer of accounts, chattel paper, a payment intangible, or a promissory note in a transaction that is subject to Article 9.” U.C.C. § 1-201(b)(35) (2008). Article 9 generally applies to transactions, regardless of their form, that create a security interest by contract, as well as to sales of accounts, chattel paper, payment intangibles, and promissory notes. U.C.C. § 9-109(a)(1), (3) (2010).

3. See infra Part III. SISOs also are known as “collateral assignments” and “transfers for security.”

4. See id. U.S.C. § 541(a)(1) (2012) (providing that the estate includes “all legal or equitable interests of the debtor in property as of the commencement of the case”).

5. See id. More precisely, the firm’s interest in the receivables becomes property of the bankruptcy estate.

6. See id. § 363(c)(1)–(2) (providing that the trustee in bankruptcy generally “may use property of the estate in the ordinary course of business” and specifying the conditions under which the trustee may use cash collateral); id. § 362(a)(3) (prohibiting the taking of “any act to obtain possession of property of the estate... or to exercise control over property of the estate”); id. § 362(a)(4) (prohibiting the taking of “any act to... enforce any lien against property of the estate”).

7. Typical securitization transactions are described in greater detail infra Part III.
transaction will not accomplish its intended purpose. If the court recharacterizes a purported sale as a SISO, the receivables will become property of the firm's bankruptcy estate, thereby reducing the value of the securities to the security holders.8

Because a true sale and a SISO share many attributes, both courts and scholars have found it difficult to distinguish between them in securitization and other complex transactions. Article 9 includes important provisions whose application depends on whether a transaction is a true sale or a SISO, yet the Uniform Commercial Code (UCC) provides virtually no guidance for characterizing a transaction, leaving that task to the courts.9 The existing case law is confused and confusing, and the resulting uncertainty increases the costs (and thereby reduces the value) of securitizations.10 Commentators have suggested a variety of approaches to characterization, but none has been wholly successful. Most rely on a balancing of specific factors that by necessity results in uncertainty.11 Professor Kenneth Kettering's approach, which would recharacterize a purported sale as a SISO only when necessary to promote the purpose of recharacterization, gives more guidance. But by ignoring the economic differences between the two transactions, it too falls short.12

We offer in this Article our own methodology for determining whether a purported true sale is a SISO. First, one must identify the specific allocation of rights between the purported buyer and seller and determine whether the seller has retained any meaningful economic interest in the receivables. Second, even if the seller has retained some economic interest in the receivables, one must determine whether that interest secures an obligation of the seller. The requisite obligation need

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8. A court that applies nonbankruptcy law to determine whether a purported sale is a SISO looks to the nature of the transaction at the time it is entered into. In that sense, the court "characterizes," rather than "recharacterizes" the transaction. We refer to a court as "recharacterizing" to contrast the court's later characterization of the transaction with the parties' earlier characterization.

9. U.C.C. § 9-109 cmts. 3, 4 (2010). Article 9 does indicate, however, that a transaction may be a true sale even if the buyer is entitled to charge back uncollected collateral or to full or limited recourse against the seller. See id. § 9-207(d)(1). On the relevance of recourse, see infra Part V.A–B.

10. As one court explained:

The extensive case law is almost no help, ...

The absence of any set legal analysis, along with the annoying tendency of decisions to turn on their facts, makes predicting the outcome of a loan/true sale dispute nearly impossible. See Hearing on Bankruptcy Reform Act of 1999 (H.R. 833) (Statement of S. Grosshandler, Partner, Cleary, Gottlieb, Steen & Hamilton) (available at www.house.gov/judiciary/106–gros.htm) (observing that the legal analysis is "highly subjective" and that issuing "true sale opinions" in connection with some transactions is therefore "extremely difficult, costly, and in a few cases, impossible").


11. See infra Part IV.B.1 (discussing the principal approaches taken by commentators).

12. See infra Part IV.B.2 (discussing Kettering's approach).
not be a binding contractual obligation. It may be implied when the
terms of the transaction, as viewed from the outset, are such that, to
avoid losing its interest in the receivables, the seller would be
economically compelled to make a payment to the buyer. This property-
based approach builds on the analysis of the characterization issue by
others and borrows directly from the existing learning, literature, case
law, and codification concerning an analogous determination: whether a
true lease of goods should be recharacterized as a SISO. By focusing on
the essential attributes of a SISO, we provide a workable way in which
to give effect to the policy underlying recharacterization. 13

Because the true sale–SISO distinction is so crucial to securitization
transactions, we focus on the distinction as it arises in that context. We
begin in Part II with a brief description of a typical securitization
transaction and a summary of various critiques and defenses of
securitization presented in the legal literature. Part III explains what is
at stake if a purported true sale is recharacterized outside bankruptcy.
Part IV first reviews and criticizes the approach toward the
recharacterization issue that characterizes the case law and then
addresses the efforts at rationalizing the case law that others have taken.
In Part V we develop our own methodology, which we illustrate with
specific examples.

II. OVERVIEW OF SECURITIZATION

A securitization typically entails a sale of receivables by an originator
to a separate entity, which sale is accompanied by the buying entity’s
issuance of securities. 14 For commercial law and bankruptcy purposes,
the core concept is that the originator has transferred ownership of the
receivables to the buyer and no longer has any interest in them. 15 The
buyer in many cases will be a special purpose entity (SPE) formed
solely to participate in the securitization transaction and whose activities
are limited to such participation. In many cases the SPE is a wholly-
owned subsidiary of the originator. 16 Funds received from the SPE’s

13. We offer our methodology for use in the commercial law and bankruptcy settings. The
distinction between a true sale and a SISO may affect a transaction’s tax and accounting treatment;
however, those settings may implicate different policies and so may dictate a different methodology.

14. The following overview is based in large part on Kenneth C. Kettering, Securitization and its
(2008) [henceforth Kettering, Discontents]

15. Some transactions (for accounting reasons) employ a “two-tier” structure in which the buyer
transfers the receivables to a second buyer, which then issues the securities and pays over the proceeds
to the first buyer. The key point for the securitization’s effectiveness is that the sale to the first buyer be
a true sale.

16. The receivables typically would be of a value in excess of that needed to pay the debt
securities issued by the SPE. The originator would indirectly retain the benefit of the excess value
issuance of securities are used to pay the originator the purchase price for the receivables. Various arrangements attempt to ensure that the SPE will be “bankruptcy remote,” i.e., that the SPE will not itself become subject to a bankruptcy proceeding and that, if the originator enters bankruptcy, the SPE and the originator will not be substantively consolidated and treated as a single entity. The goal is that a future bankruptcy of the originator will have no effect on the SPE’s right and ability to collect the receivables.

To date, this goal has been achieved. During the past twenty-five years the volume of securitization transactions in the United States has grown exponentially. A setback occurred in 2008, when new securitizations virtually came to a halt as a result of the financial crisis, but the product has rebounded since then and can be expected to be an important method of financing in the future.

Several legal scholars have criticized securitization transactions on both doctrinal and normative grounds. The legal academic literature through its equity interest in the SPE. In an alternative structure, the originator sells the receivables to a trust that holds legal title for the benefit of the holders of pass-through certificates representing the beneficial interest in the receivables. See Thomas E. Plank, Sense and Sensibility in Securitization: A Prudent Legal Structure and a Fanciful Critique, 30 CARDOZO L. REV. 617, 641–42 (2008) [hereinafter Plank, Sense].

17. Alternatively, proceeds of the issuance may be paid to the originator as a return on its equity interest in the SPE.

18. Of course, if the SPE has credit recourse against the originator (e.g., the originator has agreed to repurchase defaulted receivables or has guaranteed payment of the receivables), the originator’s bankruptcy would impair the SPE’s ability to enforce the recourse obligation. But the bankruptcy would not impair its rights in respect of the receivables themselves.


20. In its press release announcing the creation of the Term Asset-Backed Securities Loan Facility (TALF), the Federal Reserve Board observed: “New issuance of ABS [asset-backed securities] declined precipitously in September and came to a halt in October.” Press Release, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Nov. 25, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081125a.htm. TALF was “a facility that will help market participants meet the credit needs of households and small businesses by supporting the issuance of asset-backed securities (ABS) collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration (SBA).” Id.


also includes strong appreciation for the benefits of securitization as well as robust support for its doctrinal and normative soundness.\textsuperscript{23} Regardless of whether this support is warranted (we generally think it is), securitization is here to stay.\textsuperscript{24} Accordingly, in this Article we avoid that debate. We take as given that the commercial law distinction between true sales and SISOs applies to securitization transactions, and we provide a methodology for drawing the distinction that is both practical and theoretically sound.

III. CHARACTERIZATION UNDER ARTICLE 9 AND NONBANKRUPTCY LAW: WHAT ARE THE STAKES OUTSIDE OF BANKRUPTCY?

Although the need to characterize a securitization transaction as a true sale or SISO typically arises in the originator’s bankruptcy, we begin with nonbankruptcy law. As the Supreme Court explained, “[p]roperty interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.”\textsuperscript{25} Proceeding on the widely shared understanding that the nonbankruptcy standard for characterizing a transfer of property also applies in bankruptcy, we focus on the characterization of a transaction as a true sale of receivables or as a SISO for purposes of UCC Article 9.\textsuperscript{26}


\textsuperscript{24} Kettering, who thinks “the doctrinal foundations of the prototypical securitization transaction are shaky,” Kettering, \textit{Discontents}, supra note 14, at 1632, acknowledges this point:

\begin{quote}
If... a court holds authoritatively that the legal doctrines on which the edifice of securitization was constructed do not achieve the hoped-for result... the result would be cataclysmic... 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.
\end{quote}

\textit{Id.} at 1632–33.


\textsuperscript{26} The prevailing view, which we share, is that nonbankruptcy law determines whether a transaction is a sale or a SISO for bankruptcy purposes. However, Kenneth Kettering has suggested otherwise. Kenneth C. Kettering, \textit{True Sale of Receivables: A Purposive Analysis}, 16 AM. BANKR.
The original UCC Article 9 covered sales of certain receivables: accounts and chattel paper. By expanding the definition of "account" and by including sales of payment intangibles and promissory notes, revised Article 9 expanded the scope of the article to cover sales of virtually all types of receivables. The principal effect of covering sales of receivables in Article 9 is to subject them to the perfection and priority rules applicable to SISO transactions (subject to an important exception, discussed below). Because Article 9 now covers most sales of receivables, in many circumstances the true sale versus SISO issue will have no relevance for commercial law purposes. However, there are some important aspects of Article 9 that do turn on the true sale-SISO dichotomy.

In a true sale of receivables, the debtor (seller) would not be entitled to a surplus or liable for a deficiency following a default because there is...

27. The 1962 official text of Article 9 applied "to any sale of accounts, contract rights or chattel paper." U.C.C. § 9-102(1)(b) (1962). The 1972 revisions expanded the definition of "accounts" to include receivables that previously had been classified as "contract rights," compare id. § 9-106 (1972), with id. § 9-106 (1962), and eliminated all references to the latter, compare id. § 9-102(1) (1972), with id. § 9-102(1) (1962).

28. "Revised Article 9" refers to the revision of Article 9 approved by the UCC's sponsors (The American Law Institute and the National Conference of Commissioners on Uniform State Laws) in 1998. The categories of receivables that were added to the definition of "account" and those that were included in the definition of "payment intangibles" were classified as general intangibles under Former Article 9. See U.C.C. § 9-106 (1962) (defining "general intangibles"). Former Article 9 did not apply to sales of general intangibles of any category. The drafting history of the current definitions of "account" and "payment intangible" appears in Paul M. Shupack, Making Revised Article 9 Safe for Securitizations: A Brief History, 73 AM. BANKR. L.J. 167 (1999), and Steven L. Harris & Charles W. Mooney, Jr., How Successful Was the Revision of UCC Article 9?: Reflections of the Reporters, 74 CHI.-KENT L. REV. 1357, 1369-74 (1999).

Our references to "receivables" include the four types of receivables defined in Article 9: account (defined in § 9-102(a)(2)), chattel paper (defined in § 9-102(a)(11)), payment intangible (defined in § 9-102(a)(61)), and promissory note (defined in § 9-102(a)(65)).


30. For a more detailed description and analysis of these aspects of Article 9, see Kettering, True Sale, supra note 26, at 532-39.

31. Article 9 defines "debtor" and "secured party" to include, respectively, a seller and buyer of receivables. U.C.C. § 9-102(a)(28) (defining "debtor"); id. § 9-102(a)(73) (defining "secured party").
no secured obligation and consequently there could be no “default” as contemplated by Article 9. 32 For the same reason, the debtor (seller) in a sale transaction has no right to redeem the collateral. 33 Moreover, a number of duties imposed on a secured party in a SISO transaction are not imposed on the secured party (buyer) in a sale transaction. 34 These distinctions generally reflect the fact that a secured party (buyer) has acquired the entire interest of the debtor (seller) in the receivables sold. 35

Revised Article 9 emphatically makes this point by providing that “[a] debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral.” 36

The most significant example of Article 9 treating a true sale differently from a SISO does not follow from the inherent economic differences between the two transactions. Under the “automatic perfection” rule for sales of payment intangibles and promissory notes, the security interest of a buyer of either type of receivable is perfected upon attachment. 37

If a purported sale of such receivables were

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32. U.C.C. § 9-608(b) (application of proceeds of collection or enforcement); id. § 9-615(e) (application of proceeds of a disposition). Both of the cited subsections provide that if the underlying transaction is a sale of receivables, “the obligor is not liable for any deficiency.” However, in sale transactions there is no “obligor” because there is no secured obligation. Id. § 9-102(a)(59) defines “obligor” as:

a person that, with respect to an obligation secured by a security interest in . . . the collateral, (i) owes payment or other performance of the obligation, (ii) has provided property other than the collateral to secure payment or other performance of the obligation, or (iii) is otherwise accountable in whole or in part for payment or other performance of the obligation.

Reading these provisions charitably, the reference in each should be understood as a reference to the debtor (seller), not to an obligor.

33. Id. § 9-623.

34. See, e.g., id. § 9-209(c) (duty to release account debtor not applicable to buyer of receivables); id. § 9-210(b) (duty to respond to requests for accounting, list of collateral, and statement of account); id. § 9-608(a) (duties with respect to application of proceeds and surplus); id. §§ 9-620, 9-621, 9-622 (duties with respect to acceptance of collateral in satisfaction of obligation). In addition, certain duties apply in a sale of receivables transaction only if there is a right of chargeback or full or limited recourse exists. Id. § 9-207(d) (duty of care as to collateral under secured party’s possession or control); id. § 9-607(c) (duty to collect or enforce in commercially reasonable manner).

35. Two exceptions to the priority rules relating to future advances also reflect the idea that those rules, which turn on the timing of “advances,” do not make sense in the case of a buyer of receivables. Id. § 9-323(a), (b); see also Kettering, True Sale, supra note 26, at 535–36, 536 n.105.

36. U.C.C. § 9-318(a). For purposes of priority, however, if a security interest held by a buyer of an account or chattel paper is unperfected, then the debtor (seller) is deemed to have the rights and title that was sold. Id. § 9-318(b). This puts the priority of an unperfected security interest in sold receivables on a par with the priority of a SISO. Section 9-318(a) was intended to reject the holding of Octagon Gas Sys., Inc. v. Rimmer, 995 F.2d 948 (10th Cir. 1993): because a buyer of a receivable acquires a security interest, the debtor (seller) necessarily retains some legal or equitable interest.

37. U.C.C. § 9-309(a)(3) (payment intangible); id. § (a)(4) (promissory note). This rule represents an accommodation to entrenched practices in the bank loan participation market and recognizes that filing and searching in that market would be impracticable. For the background of this rule, see Shupack, supra note 28; Harris & Mooney, supra note 28, at 1369–74.
recharacterized as a SISO, however, the security interest held by the purported buyer would be unperfected unless a financing statement had been filed.\textsuperscript{38} In that posture, the battle over recharacterization would have high stakes indeed. But in securitization and other transactions outside of the loan participation and mortgage loan markets, precautionary filing of financing statements is the norm, even when true sale treatment is perceived as highly likely, so for most transactions the stakes for recharacterization are not so high.\textsuperscript{39}

Practitioners and commentators alike have assumed that in typical securitization transactions the relevant “sale” may qualify as a “sale” within the meaning of section 9-109(a)(3) so as to be within the scope of Article 9.\textsuperscript{40} Kettering suggests, however, that “a respectable argument can be made” that one such typical transaction—a capital contribution of receivables by the originator to an SPE in exchange for stock issued by the SPE—is not a “sale” and so is excluded from Article 9.\textsuperscript{41} He notes that Article 9 does not define “sale” or “buyer” with respect to receivables and observes that, “[i]n common parlance, ‘sale’ does not include every absolute conveyance, but only one made in exchange for a price in money paid or promised to be paid.”\textsuperscript{42} It follows, the argument goes, that a “sale” does not include capital contributions or barter transactions.\textsuperscript{43}

Excluding non-SISO capital contributions of receivables from the scope of Article 9 would not affect the need to determine, and the basis for determining, whether any given contribution was a SISO or an outright assignment. Although Article 9 distinguishes between SISOs and true sales, it does not itself provide a method for distinguishing between the two. Thus the common law governs the characterization issue, regardless of whether the assignment transaction is covered by Article 9.\textsuperscript{44} Nevertheless, the stakes for securitizers and their investors would be substantial if Article 9 did not apply to non-SISO capital

\textsuperscript{38} U.C.C. § 9-310(a). The purported buyer’s security interest in promissory notes also could be perfected by the secured party’s taking possession, id. § 9-313(a), or temporarily without filing or the taking of possession, id. § 9-312(c).

\textsuperscript{39} Of course, for the secured party who fails to file or perfect its security interest by another method, recharacterization can be fatal. This proved to be the case in the Commercial Money Center bankruptcy. See \textit{In re Commercial Money Ctr., Inc.}, 350 B.R. 465, 473–79 (B.A.P. 9th Cir. 2006) (holding that a purported true sale of payment intangibles was a SISO); \textit{In re Commercial Money Ctr., Inc.}, 392 B.R. 814 (B.A.P. 9th Cir. 2008) (holding that the SISO was unperfected and so avoidable by the trustee in bankruptcy).

\textsuperscript{40} U.C.C. § 9-109(a)(3).

\textsuperscript{41} Kettering, \textit{True Sale, supra} note 26, at 513 n.5.

\textsuperscript{42} Id. (citing BLACK’S LAW DICTIONARY 1364 (8th ed. 2004)).

\textsuperscript{43} Id.

\textsuperscript{44} “[N]either this Article [9] nor the definition of ‘security interest’...delineates how a particular transaction is to be classified. That issue is left to the courts.” U.C.C. § 9-109 cmt. 4.
Article 9 specifies the steps that are necessary to create an enforceable sale of receivables, resolves competing claims to receivables that have been sold, repeals the rule of *Benedict v. Ratner*, details the obligations of persons obligated on these receivables, and to a considerable extent overrides legal and contractual restrictions on assignment. If non-SISO capital contributions are excluded from Article 9, resolution of these issues would be left to nonuniform—and considerably less certain—common law.

Indeed, the UCC sponsors’ predominant motivation for bringing sales of virtually all types of receivables into Revised Article 9—by expanding the definition of “accounts” and adding sales of payment intangibles and promissory notes—was to provide for the first time a coherent, accessible, and uniform body of law to govern these transfers as well as to subject most of them to Article 9’s public-notice regime. These reforms were thought to be important in particular because of the prominence of receivables sales in securitizations. It would be an unfortunate and surprising result were Article 9 construed so as not to embrace transfers of receivables in connection with a typical securitization structure.

This statutory construction issue is unlikely to arise with any frequency. Although in many securitization transactions some of the value of the receivables transferred to the buyer is treated as a capital contribution, only rarely is the entire value of the receivables so treated. That is, in the vast proportion of transactions in which the buyer makes a capital contribution, the buyer also pays money to the seller in exchange for the receivables.

45. *Id.* § 9-203(b) (conditions to creation of an enforceable sale); *id.* § 9-317(a) (priority as against lien creditor); *id.* § 9-322(a) (priority as against competing secured party); *id.* § 9-205 (repeal of *Benedict v. Ratner*); *id.* § 9-406 (discharge of account debtor); *id.* § 9-408 (effect of legal and contractual restrictions on assignment). *Benedict v. Ratner* held that an assignment of accounts receivable that reserves to the assignor “dominion inconsistent with the effective disposition of title and creation of a lien” is a fraudulent transfer. *Benedict v. Ratner*, 268 U.S. 353, 363 (1925) (applying New York law).

46. Shupack, *supra* note 28; Harris & Mooney, *supra* note 28, at 1372-73. Note, however, that the application of Article 9 to sales of payment intangibles and promissory notes does not implicate the issue of public notice. The common law contains no public notice or perfection requirement, and sales of payment intangibles and promissory notes are automatically perfected under Revised Article 9. U.C.C. § 9-309(3). (4). However, a buyer of these types of receivables may improve its priority by filing a financing statement covering them. Steven L. Harris & Charles W. Mooney, Jr., *Using First Principles of UCC Article 9 to Solve Statutory Puzzles in Receivables Financing*, 46 GONZ. L. REV. 297, 309-11 (2011). Contra Thomas E. Plank, *Article 9 of the UCC: Reconciling Fundamental Property Principles and Plain Language*, 68 BUS. LAW. 439 (2013).


48. Although his article expresses no view on the statutory construction issue, Kettering “agree[s] that it would be a bad thing for Article 9 not to apply to such transactions.” Memorandum from Ken Kettering to Steve Harris and Chuck Mooney 9 (July 29, 2013) [hereinafter Kettering Memorandum] (on file with authors).
for the receivables. There is no reason why these transactions, in which the capital contribution is only one component of the price, would not qualify as sales.

In addition, we see no reason why the word “sale” in Article 9 should be limited to transactions in which the price is paid in money. If, for example, the buyer (say, an SPE) is newly formed for the purpose of the transaction and the seller receives newly issued equity in exchange for the receivables, we would understand the transaction to be a sale and the equity to be the price of receivables. Even where the seller already owns equity in the buyer and the capital contribution has the effect of increasing the value of the buyer’s equity holdings, the seller has received this increased value in exchange for the receivables. It follows that this increased value should be the price of the receivables and that the transaction should be considered a sale.49

The interpretation of the scope of Article 9 in this context—what is a “sale”?—is illuminated by the explicit transactional exclusions provided in section 9-109(d). Certain sales and assignments of receivables are excluded from Article 9 because they do not relate to commercial financing transactions.50 No one disputes that securitizations are commercial financing transactions.51 The application of Article 9 to securitization transactions was a focus of the revision effort, yet Revised Article 9 does not exclude outright transfers (sales) of interests in receivables as a contribution of capital in exchange for stock or as barter. Indeed, as far as we know, the participants in the revision process assumed that these transactions were “sales” within the meaning of Article 9. This suggests that “sale” should not be restricted to outright transfers in exchange for money paid or promised to be paid.52

49. We also think that such a capital contribution constitutes “value” for purposes of § 9-203(b)(1). A seller that transfers receivables in a securitization transaction and receives credit for a capital contribution is not making a gift of the receivables. See U.C.C. § 1-204(4) (explaining that a person gives “value” for rights if the person “acquires them in return for any consideration sufficient to support a simple contract”). Cf. In re Fairchild Aircraft Corp., 6 F.3d 1119, 1129 (5th Cir. 1993) (holding that indirect benefits to a corporation for making payments owed by an affiliate was “value” within the meaning of the fraudulent transfer provisions of the Bankruptcy Code); Rubin v. Mfrs. Hanover Trust Co., 661 F.2d 979, 991-92 (2d Cir. 1981) (discussing the indirect economic benefit to a transferee as “value”).

50. See U.C.C. § 9-104(f) (1962), U.C.C. § 9-109(d)(4), (5), (6), (7) (2010); U.C.C. § 9-109 cmt. 12 (“Paragraphs (4), (5), (6), and (7) of subsection (d) exclude from the Article certain sales and assignments of receivables that, by their nature, do not concern commercial financing transactions.”).

51. Indeed, Kettering claims that “[t]he financing obtained by an Originator through the use of the prototypical securitization structure is economically equivalent to a nonrecourse loan by the financiers to the Originator that is secured by the assets used to support the financing.” Kettering, Discontents, supra note 14, at 1570.

52. Drawing negative implications from statutory language is not a preferred method of statutory interpretation. It may be risky and may lead to erroneous conclusions. In this situation, however, the argument is one that an advocate likely would make in any litigation on the issue, and it is plausible that...
Indeed, one might read section 1-103 as compelling courts to reject such a restriction.  

To sum up on the stakes of recharacterization outside of bankruptcy, the true sale–SISO determination can be quite significant under Article 9 when a purported buyer of payment intangibles or promissory notes is relying on automatic perfection. In other contexts, however, two alternative generalizations apply: either Article 9 treats sales in essentially the same fashion as SISO transactions, or its differing treatment coherently reflects the inherent economic differences between the two types of transactions.

IV. TRUE SALE VERSUS SISO: CASE LAW AND COMMENTARY

A. Case Law

We agree with most earlier observers that the case law addressing the proper characterization of a self-styled “sale” of receivables is confusing, inconsistent, and often incoherent, even though many reported decisions may have reached the correct results. Many of the opinions identify “factors” that represent either the “benefits” or “burdens” of ownership and then determine which of the benefits and burdens have been allocated to the purported seller and which have been allocated to the purported buyer.  

The number of factors to which courts have referred is quite large, and although the courts take some factors into account more frequently than others, no standard list has developed.

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53. U.C.C. § 1-103(a) provides as follows:

(a) [The Uniform Commercial Code] must be liberally construed and applied to promote its underlying purposes and policies, which are:

(1) to simplify, clarify, and modernize the law governing commercial transactions;

(2) to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties; and

(3) to make uniform the law among the various jurisdictions.


55. John Hilson provides a nonexhaustive list of fifteen factors that “have turned up in cases as bearing on the ‘true sale’ question in the context of ascertaining whether the accounts form part of the bankruptcy estate of the seller . . . .” JOHN FRANCES HILSON, ASSET-BASED LENDING: A PRACTICAL GUIDE TO SECURED FINANCING § 2:5.3 (2013). He identifies the following as perhaps the most important: the level of any recourse the buyer may have against the seller with respect to the
The opinions suffer from two serious deficiencies. First, the factors to which courts refer are in fact consistent with both a true sale and a SISO. Standing alone, these factors cannot be outcome-determinative, and the fact that they are not necessary attributes of either a sale or a SISO makes them, at best, unreliable indicators of the economic substance of a transaction. Second, although several commentators have offered approaches to deal with the not unusual situation in which some of the perceived benefits and burdens are assigned to the purported buyer and others remain with the purported seller, none of the approaches has found favor with the courts.

Judicial opinions that rely on factors to determine the characterization of a transaction often are based on the following false syllogism:

Premise 1: Factor X is a typical attribute of ownership of receivables.
Premise 2: Factor X is an attribute of purported seller A's relationship to the receivables.

Conclusion: Purported seller A remains the owner of the receivables, and purported buyer B holds only a SISO.

Alternatively, the following false syllogism sometimes applies:

Premise 1: Factor Y is an attribute of ownership of receivables.
Premise 2: Factor Y is not an attribute of purported buyer B's relationship to the receivables.

Conclusion: Purported buyer B is not the owner of the receivables and holds only a SISO.

For example, some courts have considered the purported seller's continued servicing (collecting and enforcing) of the transferred receivables to be an indication that the transaction was not a true sale. It is a truism that some owners of receivables service their own receivables, especially if they have not sold them. But it is also true that some owners of receivables engage third parties to perform this function. Allowing the seller to continue servicing the receivables as the buyer's agent may well be the buyer's most efficient means of collecting them. The physical transfer of the servicing function is not without its costs. And especially when the seller originated the receivables, the seller's continuing relationship with the account debtors (obligors) may increase the likelihood of payment. The mere absence of a factor commonly associated with ownership does not compel the conclusion that the purported owner is not the true owner. Indeed, the allocation of the servicing function per se is irrelevant to the characterization of the transaction.\footnote{\textsuperscript{56}}

\begin{itemize}
\item receivables; whether the seller collects the receivables and, if so, whether the seller is allowed to hold the proceeds and commingle them with its own funds; the purchase price; whether the parties' books reflect the transaction as a sale; and whether the buyer's return from the receivables is limited. \textit{id.}
\item Some cases have concluded that continued servicing combined with the seller-servicer's
\end{itemize}
Some factors relied upon by the courts appear to address the parties' intentions or motivations as inferred from the terms of the transaction or the behavior of the purported buyer. The intuition underlying these factors is that if a purported buyer were really the owner under a true sale, it never would have agreed to such terms or behaved in such a manner. For example, terms that permit the purported seller to modify or compromise the receivables postsale fall into this category. But these facts do not aid the recharacterization analysis. Particularly when the buyer and seller have a continuing relationship and the seller has a stake in maintaining its reputation, it may make good sense for the buyer to delegate such discretion to the seller. Or, it may be that the buyer agreed to improvident terms. In a similar vein, there is some case law support for the notion that a buyer's failure to independently investigate the creditworthiness of account debtors on transferred receivables suggests that the parties intended a secured loan rather than a sale. But a buyer might properly rely on a seller's representations and warranties or on recourse against the seller instead of on an independent investigation. At most these types of factors might raise a suspicion warranting further analysis of the transaction. They should not, however, carry any weight in the analysis itself.

The recharacterization case law not only relies on factors that, if not altogether irrelevant, are unreliable proxies for the economic substance of the transaction, it also lacks a method for resolving cases in which some of the factors appear to point in one direction and some in another. Over the past twenty-five years, several commentators have offered

commingling of collections with its own funds is a strong indication that the purported seller remained the owner. See, e.g., People v. Serv. Inst., Inc., 421 N.Y.S.2d 325, 327 (N.Y. Sup. Ct. 1979) (nonnotification, collections, and commingling). While such commingling might prevent the buyer from identifying the collected funds and so deprive the buyer of any property interest in them, the fact of commingling should not of itself determine that the buyer is not the owner of the uncollected receivables. Owners sometimes enable third parties to deprive them of their property. See, e.g., U.C.C. § 2-403(2) (“Any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in ordinary course of business.”).


59. Aicher and Fellerhoff accurately portray another "factor": Where other factors are present, the courts will often discuss the language that the parties have used in the document or agreement governing the transaction. Courts focus on terms such as "security" or "collateral" where the other factors indicate a loan, and on terms such as "sale" or "absolutely convey" where other factors support (or do not preclude) sale treatment. For one court, the language in an agreement and conduct of the parties triumphed over full recourse provisions, and the court found a sale. Most courts, however, de-emphasize the language used in a document, and consider intent and actual conduct more relevant.

Aicher & Fellerhoff, supra note 54, at 194 (footnotes omitted). As we explain below, we think the parties' expressed intention concerning the legal characterization of the transaction is by and large irrelevant.
narrowly focused factors-based methodologies for bringing some order to the true sale analysis. Chief among these are Robert Aicher and William Fellerhoff, Thomas Plank, and Peter Pantaleo. Their methodologies have their substantive shortcomings, which we discuss below. For present purposes, however, it is sufficient to observe that although judicial discussions of the recharacterization issue refer to the articles in which these methodologies appear, no court has relied on any of these methodologies to resolve the issue. In 2008, Kenneth Kettering advocated rejecting the factors-based approach entirely, arguing that a purported true sale should be recharacterized only when necessary to promote the purpose of recharacterization, the prevention of forfeiture. Thus far, Kettering’s proposal has met the same judicial fate as his predecessors: It has been cited by the courts but not adopted.

Thus the courts’ continue to rely on a recharacterization approach that ultimately is based on their intuitive judgments about whether a given transaction seems more like a sale than like a SISO. This impressionistic approach, with its inherent uncertainty, has proven costly to parties both in and out of the securitization industry. The state of play in the case law on the true sale–SISO issue is similar to early case law on the lease versus security interest issue. We are hopeful that the property-based approach that we explain in Part V and that proved successful in rationalizing the case law on recharacterization of leases of goods will succeed likewise with respect to the recharacterization of true sales of receivables.

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60. Aicher & Fellerhoff, supra note 54.
61. Plank, True Sale, supra note 54.
62. Peter V. Pantaleo et al., Redefining the Role of Recourse in the Sale of Financial Assets, 52 Bus. Law. 159 (1996). Pantaleo is identified as the “Reporter” and nine other coauthors are listed (including Thomas Plank, some of whose work we address in this paper). For convenience our discussion refers to Pantaleo as the author. We discuss in more detail our views on the role of recourse against a seller as well as the views of other observers infra.
63. See infra Part IV.B.1.
64. Kettering, True Sale, supra note 26. As we explain infra Part IV.B.2, Kettering’s methodology is a clear improvement over the factors-based approaches but still has some substantive difficulties.
65. “[C]ourts generally proceed [on the true sale issue] as they did in the early days of true lease adjudication: namely, they make an intuitive judgment about the similarity of the transaction in question to the court’s notion of an ideal sale (lease) or ideal secured loan (sale with retained security interest), based on an ad hoc selection of factors that strike the court as relevant in the particular case.” Kettering, True Sale, supra note 26, at 516 (citing Corinne Cooper, Identifying a Personal Property Lease Under the UCC, 49 OHIO ST. L.J. 195, 201 (1988)).
66. We are quick to acknowledge that success of this approach in the lease context was due in no small part to the fact that it was codified in U.C.C. § 1-203. However, the approach was beginning to take hold in the case law even before codification.
B. Commentary

Resolving the uncertainty prevailing in the case law would be a notable accomplishment for any methodology. We offer our approach not only with that desideratum in mind but also with the goal of providing a method for distinguishing true sales from SISOSs on the basis of their economic substance. To fully appreciate the substantive merits of our approach, it will be useful to understand how it differs from the factors-based and purposive approaches referred to above. To this end, we describe those approaches briefly in this Part before presenting the details of our own approach in Part V.

1. The “Factors” or “Benefits and Burdens” Approaches

Aicher and Fellerhoff’s approach turns on a factor with a more venerable past than the factors discussed above (e.g., servicing and compromising the receivables): a material disparity between the sale price and the value of the property purportedly sold. They described their “reasoned analytical approach to the recourse issue” as follows:

What would an informed and willing buyer pay a willing seller for a transfer of the entire bundle of risks and benefits embodied in the cash flow represented by the receivables? If the ultimate price that the transferee pays, taking into account the presence of any direct and indirect recourse provisions, is notably less than this amount, a court should conclude that the transaction is a secured loan.

The doctrinal hook on which Aicher and Fellerhoff rely is the line of cases holding that a deed absolute to real property nonetheless can be recharacterized as a mortgage securing an obligation, thus permitting the transferor to claim a right of redemption. "As a general rule
courts have found that a purchase price significantly less than the market value of the property is highly suggestive of a mortgage. Although many cases contain statements indicating that a disparity between the price and the value of the property conveyed is not dispositive, it appears that such a disparity actually was dispositive in many cases.

Aicher and Fellerhoff recognized that no court had adopted an approach like the one they proposed, and consequently they recommended that transacting parties place most or all of the benefits and burdens of ownership with the buyer (i.e., play the “factors” game). Thomas Plank’s “analytical methodology” seeks to provide more flexibility to the parties than Aicher and Fellerhoff’s play-it-safe approach. Like Aicher and Fellerhoff, Plank focuses on the relationship between the value of the receivables and the price paid for them. A court applying Plank’s approach would allow true sale treatment if (i) the documents and conduct of the parties clearly indicate that the transaction is a sale, (ii) the buyer assumes some of the burdens of ownership or an allocation of burdens is difficult to determine, and (iii) the buyer pays “fair value” for the receivables.

While Plank’s methodology seems relatively straightforward, he appreciates the inherent complexity of the analysis. For example, as Plank explains:

There is a corollary to this rule: If the documents and the actions are ambiguous on the characterization of the transaction, then the courts should weigh the price paid for the property against the allocation of burdens and benefits. If the buyer pays an amount that is in the higher range of fair value for the property, the transaction should be characterized as a sale if the buyer assumes a substantial portion of the benefits and burdens, but not necessarily a preponderance. If the buyer pays a price in the lower range, then he would need to assume a preponderance of those benefits and burdens. If the transferee paid less than fair value for the property, the transaction should be characterized as a secured loan unless he had substantially all of the benefits and

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1. Aicher & Fellerhoff, supra note 54, at 209 (citing Annotation, Value of Property as Factor in Determining Whether Deed Was Intended as Mortgage, 89 A.L.R.2d 1040, 1042 (1963) (supplementing Annotation, Value of Property as Factor in Determining Whether Deed Intended as Mortgage, 90 A.L.R. 953, 954 (1934))).
2. Id.
3. NELSON & WHITMAN, supra note 69, § 3.8 n.9. We explain below that even a significant disparity between the purchase price of receivables and their value is not inconsistent with a true sale and so should not ipso facto compel the conclusion that the transaction is a SISO. See infra Part V.B (Example 5).
4. Id. at 211.
5. Plunk, True Sale, supra note 54, at 328.
6. Id. at 334–37.
7. Id.
burdens. 77

Whether or not such ambiguity in the parties' documents and actions exists, Plank's impressionistic approach necessarily involves the identification, and allocation to one party or the other, of various burdens and benefits that seem to correlate with ownership. Moreover, he suggests giving weight to such noneconomic factors as the parties' accounting treatment and any descriptions of a transaction given to third parties. 78 And, as we explain below, the relationship between the price of receivables and their value does not deserve the prominent (even if not determinative) role that it plays in Plank's analysis. 79

Whereas Aicher and Fellerhoff and Plank emphasize the value that a purported buyer of receivables gives to the purported seller (i.e., the purported price), Peter Pantaleo focuses principally on the nature of the seller's obligation to the buyer (i.e., the secured obligation, if the transaction were recharacterized). 80 Pantaleo is not the first to focus on the seller's obligation to the buyer, which is nothing more or less than the buyer's right of recourse against the seller. The buyer's right of recourse against the seller has been treated as a powerful, if not conclusive, indication that the transaction is not a true sale. 81 Such recourse may take various forms, including the seller's guaranty of the obligations of the account debtors on the receivables or its agreement to repurchase a receivable upon the account debtor's default. Some recourse arrangements contemplate that the buyer will hold back a percentage of the sale price to be applied against defaulted receivables. The thinking behind this emphasis on recourse against the seller seems to be that the chief burden in respect of a receivable is the risk of the account debtor's default and nonpayment. If the purported seller has retained that risk, the argument goes, then the purported buyer has not taken on an important attribute of ownership. 82

Pantaleo emphasizes the question whether the seller's obligation has the attributes of a borrower's obligation to repay a loan. He draws a

77. Id. at 329 n.152.
78. Id. at 333.
79. See infra Part V.B (Example 5).
80. Pantaleo et al., supra note 62.
81. See, e.g., STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION § 4:2 (Adam D. Ford ed., 2010) ("The most significant factor in the true sale determination appears to be the nature and extent of recourse that the transferor of the receivables has against the transferor."). We discuss in more detail our views on the role of recourse against a seller as well as the views of other observers elsewhere in this paper. See infra Part V.B.
82. As explained elsewhere, however, we are not alone in our view that the right to receive payments from the account debtors is an even more significant attribute of ownership. See infra pp. 30, 41–42. And if the purported buyer has acquired those rights to the exclusion of the purported seller, the buyer must have become the owner regardless of its recourse against the seller. See id.
sharp distinction between two different types of seller recourse obligations in this respect. The first type is “[r]ecourse for collectibility,” which he describes as “the equivalent of warranting that the asset will perform in accordance with its terms.”\(^83\) Collectibility recourse could take forms such as a guaranty of the assigned receivables or an obligation to repurchase a receivable in the case of default. Because this recourse derives from the qualities of the assets being sold, it is akin to warranties of quality that typically accompany sales of other types of property, such as goods.\(^84\) According to Pantaleo, such recourse is consistent with true sale treatment and not indicative of a loan.\(^85\)

Pantaleo identifies a second type of recourse as “economic recourse.” He explains that “[e]conomic recourse is the equivalent of warranting a return to the buyer of its investment [the putative sales price] plus an agreed upon yield unrelated to the asset’s payment terms.”\(^86\) Economic recourse “goes beyond the quality of the asset and ensures an economic rate of return to the purported buyer that is unrelated to the payment terms of the underlying asset . . . .”\(^87\) Pantaleo argues that economic recourse demonstrates that the “underlying asset . . . serves merely as collateral and the transaction is susceptible to being recharacterized as a loan.”\(^88\) We are skeptical of this approach.\(^89\)

Aicher and Fellerhoff, Plank, and Pantaleo sought to bring some order from chaos, but none adequately identifies exactly what it is that distinguishes a true sale from a SISO. Rather, each adopts the conventional approach of analyzing whether and to what extent the purported buyer has succeeded to and assumed the “benefits and burdens” of ownership. Each also denounces the approach of many courts looking to various “factors” and assessing whether overall the transaction “seems” more like a sale than a secured loan. Instead, each claims to have discovered a more coherent approach for the characterization puzzle. But each ultimately embraces some form of the “factors” approach, even if implicitly and grudgingly.\(^90\)

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83. Pantaleo et al., supra note 62, at 163.
84. E.g., U.C.C. § 2-314(a) (providing that a warranty that goods are merchantable is ordinarily implied in a contract for their sale).
85. Pantaleo et al., supra note 62, at 171. We agree, as do others such as Kettering. Kettering, True Sale, supra note 26, at 542–43.
86. Pantaleo et al., supra note 62, at 163.
87. Id.
88. Id.
89. See infra Part V.
2. Kettering’s “Purposive Analysis”

Kettering rejects the factors-based approaches of Aicher and Fellerhoff, Plank, and Pantaleo as “offering little more than their own intuitive notions of sale and secured loan.” He offers instead a “purposive analysis.” Recharacterization, he claims, is an antiforfeiture doctrine. The sole purpose of recharacterizing a sale of receivables as a SISO is to protect the purported seller from suffering a forfeiture in the event the seller fails to perform as contemplated by the parties. One should recharacterize a purported sale of receivables as a SISO only when recharacterization is necessary to accomplish this purpose.

Under Kettering’s purposive approach, the decision whether to recharacterize is based on the consequences of the decision rather than an intuitive sense of whether the transaction seems more like a sale or more like a SISO. Such an approach may yield more predictable results than the factors-based approaches it rejects. We think the results that Kettering reaches are for the most part correct. We also agree that the purposes and policies underlying Article 9 have some bearing on the recharacterization decision and that these purposes and policies may differ from those applicable in other settings where the distinction must be drawn, such as when construing the tax and usury laws.

Nevertheless, our approach is fundamentally different from Kettering’s. Kettering argues that the “purpose” of recharacterization “should determine the circumstances in which recharacterization is appropriate.” According to Kettering, “a sale should be recharacterized as a secured loan if the result otherwise would be an arrangement in which the seller is at risk of suffering a forfeiture in the

Pantaleo’s focus on the nature of recourse—collectibility or economic—appears to invoke the idea that economic recourse possesses the characteristics typical of a loan. Pantaleo et al., supra note 62, at 171.

91. Kettering, True Sale, supra note 26, at 516.
92. Id. at 531.
93. Id. at 512 (“[N]othing in Article 9 of the UCC alters the historical purpose of recharacterization . . . .”); id. at 539 (discussing other possible purposes for recharacterization and concluding that “nothing in the structure of Article 9 . . . provides a good reason for recharacterization of a sale of receivables to be governed by a standard different from the antiforfeiture principle from which the doctrine evolved”).
94. Id. at 526 (“Analysis should begin by asking the purpose of recharacterization, and that purpose should determine the circumstances in which recharacterization is appropriate.”).
95. This is not to suggest that the approach does not require the exercise of judgment; it does. Id. at 530–31 (explaining that the principle for recharacterizing calls for judgments of probability and estimates of value).
96. See infra Part V.
97. See U.C.C. § 1-103(a) (providing that “[The Uniform Commercial Code] must be liberally construed and applied to promote its underlying purposes and policies . . . .”).
98. See Kettering, True Sale, supra note 26, at 546.
99. Id.
event that he fails to perform a contemplated act." We think that Kettering has it backwards. The reason a sale must be recharacterized as a SISO is because the "seller" retained an interest in the receivables that secures an obligation, and consequently the transaction is the functional and economic equivalent of a SISO. Protection against forfeiture is a consequence of—and not the reason for—the recharacterization. And recharacterization of a purported sale may be appropriate even when the terms of the transaction would not result in a forfeiture.

Consider, for example, the simplest sale of a receivable imaginable: a nonrecourse sale for an up-front cash price and with the seller retaining no rights, control, or interest in the receivable and no direct or indirect benefits of, or other connection with, the receivable after the sale. Then consider an explicit SISO transaction involving a debtor's grant of a security interest to secure its debt to a secured party (which implicitly incorporates the concept imposed by law that the security interest vanishes upon satisfaction of the debt). Is the former a true sale and the latter a SISO because it is necessary to protect the debtor's equity of redemption in the latter and not in the former? Certainly not. Article 9 treats them differently because of the economic substance of the transactions are different. The debtor's equity of redemption is protected in the latter because it is a SISO. It is not a SISO because it is necessary to protect the debtor's equity of redemption. The application of Article 9 turns on the characterization of the transaction.

V. A PROPERTY-BASED APPROACH TO DISTINGUISHING A TRUE SALE FROM A SISO

A. Building on the Lease Versus SISO Analysis

As we have noted, Article 9 does not define the terms "sale" and "security interest that secures an obligation," even though it draws important distinctions between them. To a considerable extent, Kettering's approach to recharacterization of a purported true sale of receivables, under which a transaction is recharacterized only when necessary to achieve a desired result (prevention of forfeiture), eliminates any need to define these terms or otherwise imbue them with content outside the forfeiture context. We think that these terms,

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100. Id. at 531.
101. See infra notes 106–116 and accompanying text.
102. See infra Part V.D (Example 1).
103. See supra notes 40–43.
104. Kettering's approach requires one to recharacterize a transaction in order to protect the
although undefined, have content, that their content reflects the functional and economic substance of the transactions they encompass, and that Article 9 distinguishes between the two concepts on the basis of their substance. The substance of the transactions, in turn, depends on the functional and economic attributes of the property interests that the purported buyer and purported seller enjoy after the purported sale occurs. In our view, a transaction should be recharacterized as a SISO if the interest transferred to the purported buyer is in fact not the functional and economic equivalent of ownership but rather the functional and economic equivalent of a security interest that secures an obligation.

How, then, can one determine whether a transferee of receivables acquires an interest that is the functional and economic equivalent of ownership, in which case the purported sale would not be recharacterized, or of a SISO, in which case recharacterization would be dictated? Fortunately, we need not reinvent the wheel. Courts must make the same determination, i.e., whether a transferee acquires an interest that is the functional and economic equivalent of ownership, when distinguishing a true lease of goods from a purported lease that creates a SISO. The proper characterization of a purported lease of goods has been the subject of a considerable amount of thoughtful analysis, the best of which was incorporated into UCC Article 1. By bringing to bear the experience and learning with respect to the characterization of purported leases, one can “solve” the recharacterization problem with respect to purported sales of receivables.

When the parties enter into a purported lease of goods, the purported lessor is the owner of the goods. If the transaction is a true lease, the

purported seller from the risk of suffering a forfeiture for failing to make a contemplated performance. But, in our view, before one can protect the seller from this risk, one must determine whether the seller has retained an interest in the receivables, whether the parties contemplate a future performance, and whether the seller’s interest would be forfeited if performance is not forthcoming.

105. See U.C.C. § 9-109(a)(1) (Article 9 applies to “a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract”). See also id. § 1-203 cmt. 2 (explaining that subsection (b), which sets forth circumstances where a transaction in the form of a lease creates a security interest, “focus[es] on economics”).

106. Kettering has noted that the state of play in the case law on the true sale issue is similar to early case law on the lease versus security interest issue. “[C]ourts generally proceed [on the true sale issue] as they did in the early days of true lease adjudication: namely, they make an intuitive judgment about the similarity of the transaction in question to the court’s notion of an ideal sale (lease) or ideal secured loan (sale with retained security interest), based on an ad hoc selection of factors that strike the court as relevant in the particular case.” Kettering, True Sale, supra note 26, at 516 (citing Cooper, supra note 65, at 201).

107. U.C.C. § 1-203 (distinguishing a lease from a security interest). For an overview of these provisions as they appeared in former Article 1, see Steven L. Harris, The Interface Between Articles 2A and 9 Under the Official Text and the California Amendments, 22 UCC L.J. 99, 101-110 (1989).
lease contract affords to each party a leasehold interest in the goods. The lessee acquires the right to possession and use of the goods for the term of the lease, subject to the right of the lessor to recover the goods in the event that the lessee defaults on rental or other obligations. In addition, the lessor retains a residual interest in the goods, i.e., an “interest in the goods after expiration, termination, or cancellation of the lease contract.” Put otherwise, the lessor remains the owner of the goods, subject to the lessee’s leasehold interest.

The legal issue surrounding characterization usually is cast as follows: should the interest retained by the purported lessor be recharacterized as a security interest? Because the right to recover the goods upon default is consistent with both a true lease and a SISO, the answer turns in large part on whether the transaction is structured so that, at the end of the lease term, the purported lessor will enjoy a “meaningful” residual interest. If the transaction is structured in such a way that, when the parties enter into it, the lessor reasonably expects to recover the goods and that the goods will have economic value in excess of scrap, the lease will not be recharacterized. Rather, the law will give effect to the parties’ characterization and treat the lessor, who is expected to retain a meaningful residual interest in the goods, as the owner; the lessee will hold only a leasehold interest. Article 2A, and not Article 9, will govern the rights of the parties on the lessee’s default. Its remedial scheme allocates to the owner—lessor any unexpected increase or decrease in the residual value of the goods.

On the other hand, if the transaction is structured in such a way that, when the parties enter into it, the lessor does not reasonably expect to recover the goods unless the lessee fails to pay the purchase price (rent), then the “lessee” can be expected to enjoy the functional and economic equivalent of ownership. Under these circumstances, the “lessor”—as an economic, and therefore as a legal, matter—holds a security interest in the goods and not a residual ownership interest. Regardless of whether the parties subjectively intended to enter into a lease and not a secured transaction, and regardless of the label they applied to the transaction, the “lessor” is an Article 9 secured party and the “lessee” is

108. U.C.C. § 2A-103(1)(m) (defining “leasehold interest”).
109. Id. § 2A-103(1)(q) (defining “lessor’s residual interest”).
110. This is the upshot of the tests provided in U.C.C. § 1-203(b).
111. See U.C.C. § 2A-527(2); id. § 2A-528(1). Stripped to their essentials, these sections limit a defaulting lessee’s liability for damages to (i) past due rent, (ii) the difference between the present value of the lessee’s rental obligation for the remainder of the lease term and the present value of the market rent for that term, and (iii) incidental damages less expenses saved by the lessor in consequence of the default. So if, for example, the lessee defaults and the lessor reposesses and sells the goods, the lessee’s liability is unaffected by the amount of the purchase price.
the owner and an Article 9 debtor. Article 9’s remedial scheme applies, not Article 2A’s. Article 9 protects the “lessee’s” (debtor’s) ownership by affording the “lessee” a nonwaivable right to redeem the collateral (the “leased” goods) and a nonwaivable right to recover any surplus proceeds of a foreclosure sale or other disposition.

The analysis of a purported true sale of receivables is the mirror image of the true lease analysis. In the case of a purported sale of receivables, when the parties enter into the transaction the seller is the owner of the receivables. The parties agree that ownership is conveyed to the buyer. If in fact the buyer acquires the functional and economic equivalent of ownership, then the sale is a true sale and Article 9 affords no redemption rights to the seller. But if the buyer acquires only a limited interest, i.e., if the seller has not transferred all of its interest in the “sold” receivables, then the transaction should be recharacterized.

To summarize, in a recharacterized sale of receivables, the initial owner of the collateral is the seller-debtor that is transferring a security interest to the buyer-secured party. In a recharacterized lease of goods, the initial owner of the goods is the lessor-secured party that is selling the goods to the lessee-debtor and retaining a security interest. In the former context, the exercise is to determine whether the “seller” transferred all of its interest to the “buyer” or whether it transferred only a security interest and retained some interest. In the latter context, the goal is to determine whether the “lessor” transferred all of its interest in the goods to the “lessee,” retaining only a security interest, or whether the lessor retained a residual interest in the goods upon termination or completion of the lease term.

Consider another perspective: one might address the characterization issue with respect to both leases of goods and sales of receivables by focusing on whether the original owner (lessor or seller) has conveyed to the transferee (lessee or buyer)—and whether the transferee has acquired—the functional and economic equivalent of ownership. If the answer is “yes,” then the lease will be recharacterized as a secured sale.

112. As the official comments explain:
When a security interest is created, this Article applies regardless of the form of the transaction or the name that parties have given to it. Likewise, the subjective intention of the parties with respect to the legal characterization of their transaction is irrelevant to whether this Article applies....

113. See id. § 9-623 (affording a debtor the right to redeem collateral); id. § 9-615(d) (affording a debtor a right to payment of any surplus); id. § 9-602(4), (11) (providing that a debtor may not waive or vary the rules stated in §§ 9-623 and 9-615(d)).

114. Cf. Kettering, True Sale, supra note 26, at 533 (“[W]hen the parties to a conveyance of a receivable refer to it as a ‘sale,’ they normally intend that the seller is transferring to the buyer all of the seller’s rights in the receivable....”).
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(SISO) but the sale of receivables will not be recharacterized. If the answer is "no," then the lease of goods will not be recharacterized but the sale of receivables will be. Alternatively, one might conduct the equivalent analysis by focusing on what the transferor retained. If the lessor retained the functional and economic equivalent of ownership, then the transaction is a true lease. If the seller of receivables retained such an interest, then the transaction is not a true sale. This analysis is reflected in Table 1.

Table 1

<table>
<thead>
<tr>
<th>True Lease of Goods</th>
<th>True Sale of Receivables</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lessor retains ownership</td>
<td>Seller retains no interest</td>
</tr>
<tr>
<td>Lessee acquires limited interest (leasehold)</td>
<td>Buyer acquires ownership</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Lease Recharacterization as SISO</th>
<th>Sale of Receivables Recharacterized as SISO</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;Lessor&quot; retains limited interest (SISO)</td>
<td>&quot;Seller&quot; retains ownership</td>
</tr>
<tr>
<td>&quot;Lessee&quot; acquires ownership</td>
<td>&quot;Buyer&quot; acquires limited interest (SISO)</td>
</tr>
</tbody>
</table>

As the foregoing suggests, the purported seller’s retention of an interest in receivables that have been “sold” is an essential component of a SISO. Stated otherwise, for a SISO to arise, the “seller” must *not* have transferred all of its interest in the receivables. Of course, not every interest retained by a “seller” of receivables is a SISO. By definition, for a SISO to arise there must also be an obligation that is secured by the transferred receivables. In the present context, this normally would mean that there must be an obligation of the purported seller to the purported buyer of the receivables that is secured by the receivables. The transfer of receivables from the seller to the buyer cannot be a SISO unless such a secured obligation can be identified.

115. U.C.C. § 1-201(b)(35) ("‘Security interest’ means an interest in personal property or fixtures which secures payment or performance of an obligation.").

116. The existence of a secured obligation also plays an important role in distinguishing leases from security interests. It has long been understood that a lease with a nominal purchase option may be a true lease nevertheless if the lease is terminable by the lessee. In that case there may be no meaningful obligation sufficient to support a SISO characterization. This is the point of a problem in our casebook based on the infamous case of *In re Royer's Bakery, Inc.*, 1 UCC Rep. Serv. 342 (Bankr. E.D. Pa. 1963). STEVEN L. HARRIS & CHARLES W. MOONEY, JR., SECURITY INTERESTS IN PERSONAL PROPERTY 318–19 (Problem 5.1.2), 324 (Note 3) on The Importance of the Lessee’s Contractual Obligation) (5th ed. 2011); see also Peter F. Coogan, Leases of Equipment and Some Other Unconventional Security...
Of course, the lease–SISO and the true sale–SISO analyses are not identical, and we do not claim that they are or should be. Rather, our claim is that various components of the lease–SISO analysis are applicable and instructive in the true sale–SISO analysis. In each case, the goal—to ascertain the economic substance of the transaction—is the same. So are many of the consequences of recharacterization. Just as when a purported lease is recharacterized as a SISO the ownership interest of the purported lessee is entitled to the benefits of Article 9’s antiforfeiture provisions, so when a purported sale of receivables is recharacterized the ownership interest of the purported seller is entitled to those same protections.117 And just as when a purported lease is recharacterized the resulting security interest is at risk unless it is perfected, the same consequences follow when a purported sale is recharacterized and the resulting security interest is unperfected.118 Inasmuch as the purpose and effect of each recharacterization is to determine whether the provisions of Article 9 governing SISOs apply to the transaction in question, we think it makes perfect sense in the sale-of-receivables context to use the economic-substance analysis that has proven so successful in the leasing context.

It is true that the principal nonbankruptcy effect of recharacterizing a purported lease as a SISO is to subject it to the Article 9 filing rules, whereas in most cases sales of receivables are already subject to the filing rules.119 But it does not follow from the differences in principal effects that differing methodologies are appropriate for determining whether a transaction is a SISO. The effects of the recharacterization of sales of receivables and leases flow from the terms of Article 9. The purpose and effect of either recharacterization is to apply to the transaction the rules of Article 9 applicable to a SISO.

In determining whether those rules would apply to a purported lease,

117. See, e.g., U.C.C. § 9-615(d)(1) (providing for a nonwaivable right to any surplus of a disposition after default). There is, of course, a difference in the applicable remedial scheme if these transactions are not recharacterized. The true lessor of goods will enjoy the remedies under Article 2A if the lessee breaches the terms of the lease, see supra note 111, whereas the true buyer may have no statutory remedy against the seller because the buyer may have no obligation to the seller. See U.C.C. § 9-615(e) (providing that if the underlying transaction is the sale of receivables, there is no liability for a deficiency); see also supra note 32 (explaining that “obligor” should read “seller”).

118. See, e.g., U.C.C. § 9-317(a) (providing that an unperfected security interest generally is subordinate to a subsequent judicial lien creditor). Recharacterization would affect perfection with respect to payment intangibles and promissory notes but not accounts and chattel paper. See also infra note 152.

119. Exceptions are sales of payment intangibles and promissory notes.
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Section 1-203 follows the case law that focused on the economic realities of the transaction, i.e., whether the “lessee” agreed to acquire and pay for, and whether the “lessor” agreed to part with, essentially the entire economic value of the goods. The recharacterization methodology was not developed by examining a transaction, asking whether public notice by way of an Article 9 filing should be required for the transaction, and recharacterizing the transaction in the case of an affirmative answer. The filing requirement for leases recharacterized as SISOs was simply one of several results, albeit a very important one, that followed from the recharacterization.

Our methodology is not only sound but also useful. For example, lessons from the leasing cases and literature are instructive in identifying the relevance, if any, of recourse to the proper characterization of a...

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120. Of course, the applicability of the filing rules is not the only material nonbankruptcy effect of recharacterizing a lease as a SISO. Consider a nonterminable lease of equipment valued at $1,000, with an anticipated economic life of ten years, for an initial term of three years at an annual rental of $350, payable monthly. The anticipated fair market value of the equipment at the end of the initial term will be $700. Following the initial term, Lessee has an option to renew annually, for an additional seven years, for an annual rental of $5. Assume that Lessee defaults after making the first 18 monthly rental payments and Lessor takes possession of the equipment. Lessor claims damages in the amount of the present value of the remaining (initial-term) rental payments ($525) less the present value of the market rent for the remaining portion of the initial term.

If the lease is not recharacterized as a SISO, then Article 2A would apply. Lessor would be entitled to retain the equipment and recover the damages claimed. See U.C.C. § 2A-528(1). If, however, the lease is recharacterized (as it should be, given the nominal renewal options that extend through the remaining economic life of the equipment, see id. § 1-203(b)(3)), then Article 9, Part 6 would apply. In the normal case, Lessor (as a secured party, in the role of either a seller of goods or a lender of funds) would not be entitled to retain the equipment but would be obliged to dispose of the collateral in a commercially reasonable manner, credit the net proceeds of disposition against Lessee’s obligation, and pay any surplus to Lessee. Id. §§ 9-610, 9-615. In effect, the failure to recharacterize would cause Lessee to forfeit the residual value, for which it bargained.

It is inconceivable to us that a court astute enough to recognize that Lessor is not entitled to any meaningful residual value (i.e., would give Lessee the benefit of its bargain and limit Lessor’s recovery to lost rent), perhaps relying on U.C.C. § 1-305(a), nevertheless would fail to recharacterize the lease as a SISO. The only plausible explanation for a court’s failure to recharacterize the lease as a SISO would be that the court failed to recognize the basis for recharacterization (the nominal renewal options). Having failed to recharacterize, the lease, the court should apply Article 2A to the breach that occurred during the initial three-year term of the true lease.

Recharacterization also may have material economic consequences even in the simple case in which the initial term (say, ten years) of a nonterminable lease is equal to the anticipated economic life of the goods. The actual useful life of the goods may turn out to exceed expectations, and the fair rental value of the goods at the time of Lessee’s default may exceed the rent due under the lease. Suppose that Lessee repudiates at the end of year three and returns the equipment to Lessor. Lessor then enters into a substitute lease of the goods for the remaining seven years at a higher rent than Lessee had agreed to pay. The economic substance of the transaction is that Lessee bargained to become the owner of the goods. As such, Lessee should be entitled to credit for the entire value of the goods (as reflected by the present value of the rent payable under the substitute lease and the value, if any, of the residual), less the obligation deemed secured by the goods. Because this transaction must be recharacterized as a SISO, under Article 9 Lessee would be entitled to the present value of the rentals, to the extent that they exceed the secured obligation and related expenses and attorney’s fees. See id. § 9-615(d)(1).
transaction in receivables. As we have explained, the overarching role of recourse in the case law and literature on the true sale issue may be understood best from the perspective of the courts' attempt to allocate and measure the benefits and burdens of ownership.\(^{121}\) Seen from that narrow perspective alone, the seller's retention of the credit risk of account debtor nonperformance seems significant, if not determinative. The risk of nonpayment is the principal risk of owning a receivable.

In the lease context, however, commentators and courts have come to accept that a factors-type "benefits and burdens" focus on what may seem to be owner-type responsibilities or risks sheds little, if any, light on the analysis.\(^{122}\) For example, placing contractual responsibility on a lessee for the payment of taxes, insurance, and other obligations and expenses relating to the leased goods has little or nothing to do with whether a purported lease should be recharacterized as a SISO.\(^{123}\) Much of the case law on recharacterizing purported leases as secured transactions, during the 1960s and 1970s in particular, took a factors approach. By the 1980s, much of the case law was appropriately focusing on the economic realities of the transaction and whether a purported lessor had effectively retained a meaningful residual interest at the expiration of the lease term.\(^{124}\) If so, true lease treatment was appropriate. The more rigorous analysis in these cases was inspired in part by a growing and more sophisticated academic literature.\(^{125}\) The resulting analytical structure was codified in a revised definition of "security interest" promulgated in 1987 along with Article 2A.\(^{126}\)

The analogous case law and literature on the true sale–SISO issue,
however, has failed to mature analytically. It generally focuses on the existence of recourse against the seller coupled with other factors claimed to represent indicia of ownership, such as whether a purported seller or buyer has responsibility for servicing and collecting the receivables. This approach fails to appreciate and rigorously analyze the actual economic relationships. These “factors” generally should be discounted and disregarded except in respect of their actual economic impact or as they may be useful for determining the terms of the relevant agreement.

Thus we see two very different alternative approaches to comparing the terms of a purported sale of receivables to the characteristics of a SISO, particularly as regards the role of recourse. One approach, advocated by Pantaleo, focuses primarily on the question whether a seller’s recourse has the attributes of a borrower’s obligation to repay a loan. If economic recourse (as opposed to collectibility recourse) exists, Pantaleo would find a SISO transaction. But this emphasis on the “loan-like” terms of a seller’s recourse obligation appears to give great significance to the parties’ subjective intentions with respect to the legal characterization of the transaction. Moreover, the seller’s economic recourse, its guaranty of the buyer’s yield, is offset by the price paid or to be paid by the buyer. Taken together, the guarantee and the price determine the net value that the seller will receive in exchange for the receivables. In our view, the nature and calculation of the net sales price do not provide an adequate basis for recharacterization.

We favor a second general approach to comparing the terms of a purported sale transaction with the characteristics of a SISO. This approach recognizes that in a SISO transaction the purported seller will retain some economic interest in the receivables to secure an obligation of the purported buyer. Stated otherwise, it recognizes that in a true sale the buyer will have captured all of the value of the receivables, leaving none for the seller. But these conclusory descriptions do not alone provide sufficient guidance. For that reason Part V.B provides examples that illustrate these concepts of a retained interest and a secured obligation.

As to a putative buyer’s secured obligation, once again, the leasing cases and literature are instructive. As we explained above, a purported lessee’s obligation is an essential element of recharacterizing a lease as a SISO transaction. But the law on lease recharacterization, now codified, recognizes that such an obligation (as in a “full-payout” lease) is of itself an insufficient basis for recharacterization if the lessor in fact

[27. See supra Part IV.A-B.]
retains a meaningful residual interest.\textsuperscript{128} The lessee’s obligation may have all the earmarks of an installment purchase price, but if the lessee does not acquire all of the lessor’s interest, the transaction is a true lease. The same holds true in the receivables context. As we shall see in the examples that follow, a seller’s recourse obligation may be an important, indeed necessary, element of a recharacterization, but it is not a sufficient basis on which to conclude that a transaction is a SISO.\textsuperscript{129} This is so even if a recourse obligation is accompanied in the transaction by various other “indicia of ownership” thought to be probative “factors” in the true sale analysis. This analysis reveals the flaw in Pantaleo’s argument that a loan repayment-like recourse obligation—economic recourse—dictates SISO treatment. A seller’s recourse obligation in an amount equivalent to repayment of the sales price with interest should not dictate SISO treatment if the seller has not retained a meaningful economic interest in the receivables.\textsuperscript{130}

The features of a SISO are commonly known and understood. Holding up a purported sale transaction against the SISO template is more likely to yield an appropriate result than using what one imagines are the characteristics of a sale as a template. Virtually all of the commentary on the subject recognizes that attempts to sort out whether, and the extent to which, the benefits and burdens of ownership have passed to a purported buyer are problematic at best.\textsuperscript{131}

Even with the approach we advocate, distinguishing a true sale of receivables from a SISO may not be easy. Indeed, determining whether the purported seller of receivables has retained some interest in the receivables after sale often is more difficult than determining whether the purported lessor of goods has retained an interest. In lease transactions, the terms of the transaction documents invariably provide that the purported lessor retains a leasehold interest and a residual interest in the leased goods. The legal question is whether the economic nature of the retained interests is such that the law should recharacterize them as a security interest. In receivables transactions, however, an interest retained by the seller may not be expressly reflected by the contractual terms of the transaction documents. That is to say, the documentation may provide in its form and terminology for the transfer of all of the seller’s interest and may not provide—by its terms—for the seller to retain any residual, reversion, or other beneficial “equity”

\textsuperscript{128.} U.C.C. § 1-203(c)(1); id. § 1-203 cmt. 2.
\textsuperscript{129.} See infra Part V.B.
\textsuperscript{130.} Of course, one can’t help but wonder why a sophisticated seller would agree to be liable for an amount equivalent to the sales price plus interest without also retaining some interest in the sold receivables. We discuss this apparently implausible situation infra.
\textsuperscript{131.} See, e.g., Kettering, True Sale, supra note 26, at 516.
interest. But if the transfer is functionally and economically a SISO, then the "seller" is an Article 9 debtor who enjoys a right to redeem the collateral (the "sold" receivables), even if the transfer by its terms purports to be absolute.

In attempting to fashion a method for distinguishing a true sale of receivables from a SISO, some commentators have sought guidance from the large body of case law that addresses the same issue with respect to real property, i.e., whether a deed absolute on its face should be recharacterized as a conveyance for security (in effect, a mortgage). Although real property recharacterization law is not completely consistent, section 3.2 of the Restatement Third, Property (Mortgages) is sufficient for present purposes. In setting out what the Reporters describe as "the majority view that the intent of the parties, and not the form of the transaction, controls," that section provides, in pertinent part:

§ 3.2 The Absolute Deed Intended as Security
(a) Parol evidence is admissible to establish that a deed purporting to be an absolute conveyance of real estate was intended to serve as security for an obligation, and should therefore be deemed a mortgage. The obligation may have been created prior to or contemporaneous with the conveyance and need not be the personal liability of any person.
(b) Intent that the deed serve as security must be proved by clear and convincing evidence. Such intent may be inferred from the totality of the circumstances, including the following factors:
(1) statements of the parties;
(2) the presence of a substantial disparity between the value received by the grantor and the fair market value of the real estate at the time of the conveyance;
(3) the fact that the grantor retained possession of the real estate;
(4) the fact that the grantor continued to pay real estate taxes;
(5) the fact that the grantor made post-conveyance improvements to the real estate; and
(6) the nature of the parties and their relationship prior to and after the

132. Aicher and Fellerhoff relied on that case law to buttress their argument that the touchstone of the analysis should be the existence of a material disparity between the value of the receivables and the price paid for them. Aicher & Fellerhoff, supra note 54, at 207-09. Plank pointed out that the recharacterization law was well settled in the real property context, but other than giving central significance to a material disparity between the sales price and the value, his analysis does not apply real property doctrine directly. Plank, True Sale, supra note 54, at 288-89. Kettering argued that courts should be paying more attention to that law, which directly addresses the policy that recharacterization seeks to promote: insuring that the mortgagor does not forfeit any equity it may enjoy in the real property. Kettering, True Sale, supra note 26, at 526-31.

133. RESTATEMENT THIRD, PROPERTY (MORTGAGES) § 3.2 reporters' note (1997).
Couched in terms of what a conveyance was "intended" to achieve and listing "factors" from which "intent may be inferred," section 3.2 seems to embody the very attributes that were rejected in the UCC's reformed approach toward the lease–security interest dichotomy. Properly understood, however, there is no contradiction. The *Restatement* rule faithfully reflects the language used by courts over many years. But the comments suggest that the point of the exercise is to ascertain the terms of the agreement between the parties, i.e., what the parties intended the deal between them to be. Recharacterization requires terms that amount to a mortgage securing an obligation. For example, was it the deal that the recipient of the conveyance would reconvey the property to the transferor upon satisfaction of an obligation owed by the transferor? Or, was the agreement the economic equivalent of such a deal? In either case the transaction is for security and should be recharacterized as a mortgage. If not, then the absolute conveyance should stand.

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134. *Id.* For Kettering's discussion of recharacterization in this setting, including under the *Restatement*, see Kettering, *True Sale, supra* note 26, at 527–31. *Restatement* section 3.3 is substantially similar. As explained in comment a:

Section 3.2 deals with situations in which parol evidence is used to establish that an absolute deed was intended as security for an obligation, or in which the security intent is reflected in a separate writing. The present section deals with absolute deed transactions in which there is a second written document that purports to confer on the grantor either the option (Illustrations 1-3 and 5-6) or the contractual obligation (Illustration 4) to purchase the property described in the deed. This type of transaction is often referred to as a conditional sale.

*RESTATEMENT THIRD, PROPERTY (MORTGAGES)* § 3.3 cmt. a.

135. Recall that, until the promulgation of Article 2A, the UCC used the phrase "intended as security" with respect to the recharacterization of a true lease. *See supra* note 125. The phrase also appeared in Former Article 9. U.C.C. §§ 9-102(2), 9-408 (1962).

136. Kettering's perspective is consistent with this characterization:

"[T]he *Restatement* glosses [the rule in section 3.3, which contemplates recharacterization when an absolute conveyance was intended by the parties as security] in a way that implements the antiforeclosure principle . . . . That is, the sale will be recharacterized if the transaction amounts to imposition of a foreclosure upon the grantor in the event that the grantor fails in a contemplated performance. Specifically, if the economic terms of the transaction are such as to make it clear at the outset that the grantor will repurchase the property if he is able to do so, then the sale will be recharacterized, for the grantor suffers the economic equivalent of strict foreclosure by not carrying out the contemplated repurchase."

Kettering, *True Sale, supra* note 26, at 529–30. These observations apply equally to the rule in section 3.2.

We recognize that not everyone agrees with the *Restatement's* gloss. *See, e.g.*, Marshall E. Tracht, *Leasehold Recharacterization in Bankruptcy: A Review and Critique* (N.Y. Law Sch. Legal Stud. Res. Paper No. 12/13 #42), available at http://ssrn.com/abstract=2097105 (finding merit in the cases that characterize a transaction in accordance with the subjective intent of the parties as to the legal effect or form of their transaction and criticizing those that adopt the "economic reality" approach). Under the UCC, however, ""[t]he subjective intention of the parties with respect to the legal characterization of their transaction is irrelevant"" to whether a transaction gives rise to a ""security interest"" governed by Article 9. U.C.C. § 9-109 cmt. 2.
The factors usefully come into play when the evidence is conflicting as to the terms of the parties’ agreement. Consider section 3.2, illustration 3:

3. Grantor conveys Blackacre to Grantee by a deed that contains no language of defeasance. Grantee pays Grantor $25,000 in cash, but Grantor does not deliver a promissory note to Grantee. Grantor testifies that Grantee promised orally to reconvey Blackacre to grantor upon the latter’s payment of $35,000 to Grantee two years thereafter. Grantee denies making such an oral promise and contends that the transaction constitutes a sale of Blackacre to Grantee. Grantor has retained possession and has continued to pay the real estate taxes on Blackacre. At the time of the conveyance the fair market value of Blackacre is $50,000. The facts justify the conclusion that the parties intended a security transaction.

The factors in illustration 3—the disparity between the consideration paid and value of the property conveyed and the grantor’s continued possession and payment of real estate taxes—provide cogent evidence of whose testimony should be believed. In illustration 3, these factors make the grantor’s story credible, and when the grantee’s obligation to reconvey becomes a term of the parties’ agreement, the economic substance of the transaction becomes a SISO.

Now suppose that the grantor is deceased and the only direct evidence of the parties’ agreement is the grantee’s testimony that the parties agreed to a sale with no promise of reconveyance. Consider Restatement section 3.2, illustration 5:

5. Grantor conveys Blackacre to Grantee by a deed that contains no language of defeasance. Grantee pays Grantor $25,000 in cash, but Grantor does not deliver a promissory note to Grantee. Grantor retains possession, pays the real estate taxes and builds a garage on the premises. The fair market value of Blackacre at the time of the conveyance is $50,000. Grantor dies a year after the conveyance and, other than Grantee, no one else can testify as to what was said at the time the deed was delivered. Grantee testifies that the parties intended an absolute sale of Blackacre. Nevertheless, the facts justify the conclusion that the parties intended a security transaction.

In addition to the factors specified in illustration 3 (Grantor’s retention of possession and payment of real estate taxes), in illustration 5 the deceased grantor had built a garage on the property following the conveyance. Inasmuch as there can be no mortgage without an obligation that is secured, the fact that there is no direct evidence that

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137. Restatement Third, Property (Mortgages) § 3.2 cmt. e, illus. 3.
138. Id. § 3.2 cmt. e, illus. 5.
(deceased) Grantor was entitled to a reconveyance upon discharge of a specified obligation is problematic. The comments indicate, however, that “it is unnecessary to establish either the existence of a promissory note or similar written evidence of the debt or that the grantor is personally liable to repay it. Rather a court may impute the existence of the debt where the totality of the facts indicate that a security transaction was intended.” 139 In illustration 5, the factors strongly suggest the transaction was for security and appear sufficient to permit the trier of fact to disbelieve Grantee’s testimony. After all, why else would Grantor have conveyed property in exchange for half its fair market value, remained in possession rent-free, paid real estate taxes, and built a garage? 140

For the most part the types of “factors” that attend a purported sale of receivables, including any recourse against the seller, lack the meaningful economic impact of the factors involved in illustration 5, such as rent-free retention of possession, payment of taxes, and construction of a new building on the property. Absent express terms providing that the “seller” will share in the value of the “sold” receivables, the most significant factor that may be seen in a receivables transaction is a disparity between the price paid and the value of the receivables. In connection with Example 5, below, we address the question whether such a price-value disparity alone could be an adequate basis for recharacterization of a purported sale of receivables. 141 We conclude that it should not be.

B. Illustrative Examples

The following examples illustrate how our approach to recharacterization might be applied. Example 1 is a transaction facially structured as (i.e., using the terminology of) a sale of receivables, but its terms mirror as closely as possible a SISO transaction.

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139. Id. § 3.2 cmt. e.
140. As comment e suggests, had Grantor and Grantee been party to a long-term lease of the property in question, the inference that the absolute deed was in fact for security would have been significantly weaker. Id. Regardless, inferring an obligation gives rise to a host of operational problems. What would be the amount of the secured obligation and when would it be due? Presumably a court would conclude that the implicit (or explicit) agreement must have been that the $25,000 paid by Grantee was the principal amount, that Grantor would pay interest at a “reasonable” rate (such as a statutory rate of interest), and that the principal and interest would be due at a “reasonable” time. Cf. U.C.C. § 2-305 (if the price is an open term in a contract for sale of goods then the price will be a “reasonable price”); id. § 2-309 (if the time for shipment or delivery is not specified in a contract for sale of goods then the time will be a “reasonable time”). And assuming a judicial determination consistent with the result in illustration 5, what would Grantee then be required to plead and prove in order to foreclose its “mortgage”? 141. See infra Part V.B (Example 5).
Example 1:
Seller (S) agrees to sell and Buyer (B) agrees to buy specified receivables for a purchase price equal to ninety percent of the present value of the receivables (assuming payment by the account debtors when due). The present value is calculated at a market discount rate, which takes into account the time value of money and the risk of account debtor default, so that the price roughly equals ninety percent of the fair market value of the receivables. B has full recourse against S arising out of an account debtor’s default: If any receivable is not paid when due, S is obligated to repurchase the receivable for an amount equal to the account debtor’s payment obligation. If S fails to pay any repurchase obligation, S is obligated to pay interest on the amount due at a specified rate per annum.

Notwithstanding S’s full recourse repurchase obligation, B’s aggregate recovery from the receivables and S’s repurchase payments (S’s maximum obligation) is capped at ninety percent of the face amount of the receivables (the original purchase price plus imputed interest). B is obligated to remit to S the amount of any recovery exceeding this cap. In addition, S has an option to repurchase the receivables at any time for the repurchase price of ninety percent of the face amount of the receivables (adjusted to present value if the repurchase occurs before the receivable due date).

As a matter of economic substance and legal obligation, Example 1 is equivalent to a loan. B’s interest in the receivables is a SISO, and Article 9 applies as it would to any loan secured by receivables. The principal amount of the loan is equal to the purchase price of the receivables advanced by B to S (ninety percent of the present value of the receivables). The principal becomes due, along with imputed interest, as the receivables become due. The principal (the purchase price) bears interest in an amount equal to the difference between the principal amount and ninety percent of the face amount of the receivables. S’s recourse obligation, as limited by the ninety percent cap, constitutes the obligation secured by the security interest in the receivables. To the extent that S’s obligation to repay the principal and interest is not satisfied by collection of the receivables, S is liable for the difference. If S fails to make a required principal payment (the repurchase price due on an account debtor default), that payment bears interest at an agreed default rate. In effect, the parties have agreed that the manner of repayment in the ordinary course will be B’s receipt of collections on receivables when due, but this feature does not affect the

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142. The risk premium reflects the risk that the receivable may not be collected in full from the account debtor or from S under the full recourse arrangement and consequently that the receivables may be less valuable than the present value of the amounts payable. In the real world there could be a further haircut or “holdback” so that B would pay less up front and thereby maintain a greater cushion of receivables value over the amount advanced to S.
nature of the payments to B as repayments of principal and payments of interest.

Note the significance of the cap on S’s obligation (and B’s recoveries) and of S’s repurchase option: because B will not be entitled to collect and retain the full face amount of the receivables, S has retained an economic interest in them. By analogy to a leasing transaction, S has a meaningful residual interest in the receivables, just as a true lessor has a residual interest in leased goods, and B has not captured the entire economic value of the receivables, just as a true lessee has only a leasehold interest in leased goods. It follows that the transaction is not a true sale to B. And because S has the right to recover the interest transferred by paying a noncancellable obligation, the transaction is a SISO.\(^{143}\) Note that the interest in the receivables retained by S sufficient to obviate true sale treatment need not be based on an explicit contractual retention of an in rem right or interest but may be the economic equivalent.

In Kettering’s view, the law should respect the true-sale characterization chosen by the parties unless recharacterization is necessary to prevent the purported seller from suffering a forfeiture for failing to make a contemplated performance.\(^{144}\) In Example 1, however, the terms of the parties’ agreement appear to afford the “seller” the antiforeclosure protection afforded to a debtor under a SISO. Resort to Article 9’s antiforeclosure provisions would not be necessary. Under Kettering’s purposive approach, then, the transaction in Example 1 would stand as a true sale.\(^{145}\) If the law were to treat Example 1 as a true sale, however, then any typical loan secured by receivables could be structured as a true sale without there being any meaningful difference in the economic substance of the transaction or the contractual obligations of the parties. Kettering acknowledges that the recharacterization of a true sale of receivables may bring about consequences unrelated to the risk of forfeiture, but he deems them insufficient to warrant a standard for recharacterization other than the prevention of forfeiture.\(^{146}\) We think the stakes are higher.

Suppose that the receivables in Example 1 were payment intangibles and that B did not file a financing statement covering them. If the form of the transaction is respected, then B’s security interest would be perfected; recharacterization, however, would result in B’s security

\(^{143}\) This aspect of the transaction is explored again in connection with Example 3, infra.

\(^{144}\) Kettering, *True Sale*, supra note 26, at 539 (“[T]here is nothing in the structure of Article 9 that provides a good reason for recharacterization of a sale of receivables to be governed by a standard different from the antiforeclosure principle from which the doctrine evolved.”).

\(^{145}\) U.C.C. § 9-607(c).

interest being unperfected and thus vulnerable to the claims of competing creditors and subsequent buyers.\textsuperscript{147} This is because a true sale of payment intangibles is perfected automatically, but perfection of a SISO in payment intangibles requires the giving of public notice by filing a financing statement.\textsuperscript{148}

Kettering would allow the parties to a transaction that is the economic equivalent of a SISO in payment intangibles to avoid the consequences of the failure to give public notice of the resulting security interest by structuring the transaction as a true sale. In his view, the Article 9 policy of requiring public notice of SISOs is not an appropriate basis on which to recharacterize what the parties have documented as a true sale. He writes:

It would be specious to contend that recharacterization analysis should be altered as a result of the rule affording automatic perfection to sales of payment intangibles and promissory notes, on the theory that the public notice afforded by compliance with the ordinary perfection requirements of Article 9, required in the case of a secured loan, is so desirable as to weigh in favor of a low standard for recharacterizing such sales as secured loans.\textsuperscript{149}

Note that Kettering’s claim follows directly from his own proposed analysis but would make no sense under our analysis, the analyses in the case law, or those offered by earlier commentators. Kettering’s analysis tailors the recharacterization doctrine as may be necessary to promote a specific purpose. If there is more than one purpose to be served by recharacterization, then different standards for recharacterization may arise with respect to a single transaction. Having identified one purpose that justifies recharacterization, i.e., to prevent forfeiture, the identification of a second purpose, i.e., to promote Article 9’s policy of requiring public notice of SISOs, would require that the standard for recharacterization be “altered” and, at least in the case under discussion, “lower[ed].”\textsuperscript{150} Such an alteration apparently would be justified only if

\textsuperscript{147} An unperfected security interest generally is junior to the rights of lien creditors and holders of perfected security interests. U.C.C. § 9-317(a) (lien creditors); id. § 9-322(a)(2) (security interests).

\textsuperscript{148} See U.C.C. § 9-310(a) (providing the general rule that a financing statement must be filed to perfect a security interest); id. § 9-310(b)(2) (providing that a security interest that is perfected when it attaches is an exception to the general rule); id. § 9-309(3) (providing that a sale of a payment intangible is perfected when it attaches). Likewise, a sale of promissory notes is perfected automatically but a SISO is not. See id. § 9-309(4) (providing that a sale of a promissory note is perfected when it attaches). But see id. § 9-312(e) (providing for temporary perfection of a security interest in instruments that arises for new value under an authenticated security agreement). For convenience, the discussion in the text refers only to payment intangibles.

\textsuperscript{149} Kettering, \textit{True Sale}, supra note 26, at 538.

\textsuperscript{150} Id. at 538.
it yielded an outcome that is particularly “desirable.”

Article 9’s perfection policy, at least in this case, does not meet that test. Moreover, “[e]ven if the public notice afforded by filing were thought desirable, lowering the standard for recharacterization would be a terrible way to induce more filings, for no standard for recharacterization follows from such a purpose; the result would be arbitrary and unpredictable.” Finally, recharacterization of a transaction in order to promote the perfection policy might result in application of the antiforefeiture provisions, even when the seller retained no otherwise protectable interest in the receivables.

Unlike Kettering, we think the transaction in Example 1 should be recharacterized as a SISO for purposes of Article 9, even if the only legal consequence of recharacterization would be the loss of perfection. We recognize that the “automatic perfection” rule for sales of payment intangibles does not follow from the inherent economic differences between the two transactions. But we think it would be a mistake to construe the reference in section 9-309(3) to “a sale of a payment intangible” to include a transaction, like Example 1, that is the economic equivalent of a SISO. When it comes to characterizing a transaction as a SISO, the UCC elevates substance over form. Even though the courts have not adopted a clear rule for distinguishing true sales from SISOS, the “sale-distinguishing” rules of Revised Article 9 were written on the understanding that there is a real economic difference between the two transactions. We think that all the sale-related provisions of Article 9—not just the antiforefeiture provisions—should be construed to reflect that difference. We do not advocate for an “altered” recharacterization test but seek to identify and justify what is and should be the appropriate test.

Under our analysis, one need not inquire into the strength of the policy requiring public notice for security transfers (SISOS) of payment intangibles. Regardless of whether the original decision to subject true sales of certain receivables to the perfection and priority rules of Article 9 (including the general rule that a financing statement must be filed in order to perfect) reflects the difficulty of distinguishing a true sale from

151. Id.
152. Kettering supports his claim that promotion of the perfection policy is not “so desirable” in the setting under consideration by observing that even before Revised Article 9 introduced the “automatic perfection” rule, a buyer of payment intangibles may have needed to take steps to protect itself against the claims of third parties. Id.
153. Id.
154. Id.
155. But there are other consequences outside of bankruptcy. See supra Part III.
156. Id.
157. Id.
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a SISO\textsuperscript{158} or was “the result of an historical accident that had nothing to do” with the difficulty of drawing such a distinction,\textsuperscript{159} and regardless of whether one thinks the policy is beneficial\textsuperscript{160} or is of “questionable utility,”\textsuperscript{161} the sponsors reaffirmed this decision when they expanded the application of the general rule to sales of receivables that were previously outside the scope of Article 9.\textsuperscript{162} The fact that the drafters advertently applied the ordinary perfection rules to SISOs in payment intangibles is reason enough for courts to determine—as they must do when considering a purported lease of goods—whether a purported sale should be recharacterized as a SISO.

The failure to recharacterize the putative sale in Example 1 also would deprive the seller (debtor) of the benefit of nonwaivable rights and duties provided by Article 9.\textsuperscript{163} Moreover, the rights of third parties also would be compromised. True sale treatment would mean that future creditors, secured and unsecured, could not reach the receivables that otherwise would be available to them were the transaction recharacterized as a SISO.\textsuperscript{164} Although these consequences have nothing to do with the antiforfeiture principle, that fact would not ameliorate the adverse impact for those who would be aggrieved by the failure to recharacterize the transaction in Example 1.

Finally, recharacterization of a putative sale as a SISO under

\begin{footnotes}
\footnotetext{158}{See U.C.C. § 9-102 cmt. (1972) (“[C]ertain sales of accounts and chattel paper are brought within this Article to avoid difficult problems of distinguishing between transactions intended for security and those not so intended.”).}

\footnotetext{159}{Kettering, True Sale, supra note 26, at 515. For a detailed description of the historical background leading to the inclusion of true sales of receivables in the Article 9 filing system, see Thomas E. Plank, Sacred Cows and Workhorses: The Sale of Accounts and Chattel Paper Under the U.C.C. and the Effects of Violating a Fundamental Drafting Principle, 26 CONN. L. REV. 397, 413-25, 436-39 (1994).}

\footnotetext{160}{This is Professor Shupack’s view.}

\footnotetext{161}{Plank, supra note 46, at 471 (citing Plank, Assignment of Receivables Under Article 9: Structural Incoherence and Wasteful Filing, 68 OHIO ST. L.J. 231, 249-62 (2007)).}

\footnotetext{162}{See supra notes 27–30.}

\footnotetext{163}{U.C.C. § 9-210(b) (rights to receive a response to requests for an accounting, regarding a list of collateral, and regarding a statement of account); id. § 9-608(a) (application of proceeds of collection and enforcement). Because the buyer (secured party) in Example 1 is entitled to recourse against the seller (debtor), however, the buyer would be required to collect and enforce the receivables in a commercially reasonable manner even if the transaction were characterized as a true sale. Id. §§ 9-601(g), 9-607(c).}

\footnotetext{164}{U.C.C. § 9-318(a) (seller of receivables retains no legal or equitable interest in the collateral sold).}
\end{footnotes}
nonbankruptcy law would have significant consequences in the bankruptcy proceeding of the seller (debtor). Specifically, the seller’s interest in the receivables would become property of the estate, and the buyer would be stayed from collecting the receivables.\(^{165}\) As we have already observed, unless a federal interest requires a different result, bankruptcy law respects nonbankruptcy property interests that are defined by state law.\(^{166}\) We see no federal interest that would justify recharacterizing in bankruptcy a transaction that is a SISO under nonbankruptcy law, and we are not aware of anyone who has taken the position that a SISO under nonbankruptcy law would not or should not be treated as such in bankruptcy.\(^{167}\) In our view this demonstrates why the transaction in Example 1 should be recharacterized under nonbankruptcy law even though the antiforfeiture principle is not compromised.

Adoption of the single standard for recharacterization we advocate, i.e., whether a transaction is the functional and economic equivalent of a SISO, would render irrelevant Kettering’s concerns about the risk of multiple recharacterization standards and about the uncertainty that might follow from a standard designed solely to promote Article 9’s notice-filing policy. Our property-based standard also would eliminate any risk of imposing the antiforfeiture rules inappropriately. The antiforfeiture rules would apply only when the “seller” retains an interest in the “sold” receivables that is the functional and economic equivalent of a SISO, as is the case in Example 1. We turn now to Example 2, which significantly alters the facts of Example 1.

Example 2:
Example 2 differs from Example 1 in four respects. First, the purchase price is a fraction of the face amount of the receivables that approximates the fair market value of the receivables. Second, S has no recourse obligation to repurchase receivables in the event of account debtor defaults, i.e., B has assumed the entire credit risk of account debtor nonpayment. Third, S does not have an option to repurchase receivables at ninety percent of the face amount. Finally, B’s recoveries from the receivables are not capped at ninety percent of the face value.

\(^{165}\) See 11 U.S.C. § 541(a)(1) (2012) (providing that the estate includes “all legal or equitable interests of the debtor in property as of the commencement of the case”); id. § 362(a)(3) (prohibiting the taking of “any act to obtain possession of property of the estate . . . or to exercise control over property of the estate”); id. § 362(a)(4) (prohibiting the taking of “any act to . . . enforce any lien against property of the estate”).

\(^{166}\) See supra note 25 and accompanying text.

\(^{167}\) Kettering has argued the converse, i.e., that “there are excellent reasons why a court so inclined could conclude that a sale of receivables in a securitization transaction is not a true sale for bankruptcy purposes even though it is a true sale under nonbankruptcy law.” Kettering, True Sale, supra note 26, at 513 (emphasis added). We reserve for another day our response in opposition to his argument.
We see no basis for recharacterizing the Example 2 transaction as a SISO. By definition, a secured obligation is an essential element of a SISO.\textsuperscript{168} That element, which is present in Example 1, is completely lacking in Example 2.\textsuperscript{169} Moreover, the absence of S’s repurchase option and the absence of the cap on B’s recoveries underscore the fact that S has retained no meaningful interest in the receivables sold to B and that B has captured the entire economic value of the receivables.

Examples 1 and 2 make clear that the presence of a purported seller’s recourse obligation may be a key element in recharacterizing a purported sale as a SISO. To be sure, the absence of a conventional recourse obligation may not ensure true sale treatment.\textsuperscript{170} Likewise, the existence of recourse does not always dictate SISO treatment.\textsuperscript{171} But Kettering’s claim that the existence of a seller-recourse obligation is irrelevant to the true sale issue and that such recourse is like any other form of warranty of quality cannot stand.\textsuperscript{172} We do not disagree that an element of credit recourse is analogous to a warranty of quality, but in a purported sale of receivables transaction it may have additional significance.

Next consider Example 3.

Example 3:
Like Example 1 (a SISO), but unlike Example 2 (a true sale), S has a full recourse repurchase obligation in case of account debtor defaults. However, unlike Example 1 but like Example 2, S does not have an option to repurchase receivables at ninety percent of the face amount, and S’s maximum obligation (i.e., B’s aggregate recovery from the receivables and S’s repurchase payments) is not capped at ninety percent of the face amount of the receivables.

Does the elimination of S’s option to repurchase and the elimination of the cap on S’s obligation affect the characterization of the transaction as a SISO? Because Example 3 retains Example 1’s full recourse repurchase obligation on S but eliminates the cap on S’s liability, S has

\textsuperscript{168} U.C.C. § 1-201(b)(35) (“‘Security interest’ means an interest in personal property or fixtures which secures payment or performance of an obligation.”).

\textsuperscript{169} Return again to the leasing analogy and recall the importance of identifying the obligation secured as an essential element of a SISO. See supra note 116. The familiar Article 9 concepts of default and calculation of surplus and deficiency simply do not fit the transaction in Example 2.

\textsuperscript{170} See the discussion of Example 4 infra.

\textsuperscript{171} See the discussion of Example 3 infra.

\textsuperscript{172} See Kettering, True Sale, supra note 26, at 539 (“Recourse to the seller is irrelevant to recharacterization, for the existence of recourse has nothing to do with the existence of a potential forfeiture to the seller in the event of the seller’s failure to perform as contemplated, and it is the latter that is the concern of the recharacterization doctrine.”); id. at 543 (“A buyer of a receivable who obtains from the seller a warranty of its timely collectibility is in the same position as the buyer of the motor.”). As discussed in connection with Example 3, however, we agree with Kettering’s principal argument, our differences with his “irrelevance” claim notwithstanding.
assumed even greater responsibility for account debtor performance. By the conventional wisdom of measuring and weighing benefits and burdens of ownership, S’s greater responsibility makes Example 3 seem even less like a true sale (and more like a SISO) than Example 1. But we believe that the transaction in Example 3 should be afforded true sale treatment notwithstanding S’s full recourse obligation.

Both Example 1 and Example 3 allow B to collect from the account debtors and from S. As we discussed, in Example 1 B is not entitled to retain the full face amount of the receivables. Once B collects an amount equal to the cap on B’s recovery, S is entitled to any excess value of the receivables. Moreover, S can realize any excess value by exercising the option to repurchase a receivable for an amount less than its face amount and then collecting the entire face amount from the account debtor. Because S retained an interest in the receivables, the transaction in Example 1 was not a true sale. In Example 3, however, B’s recovery is not capped. B is entitled to collect the full face amount from the account debtors or, if they default, from S. S’s position is also different in the two examples. In each, S may become entitled to collect from the account debtors, but S’s recovery in Example 3 is limited to the amount of the repurchase price that S paid to B. Thus S will obtain from the transaction no more than the purchase price that B paid S. And because S has no option to repurchase, S has no right to reacquire any receivables that become more valuable than the repurchase price. In short, unlike in Example 1, S has retained no economic interest in the receivables. Thus, one of the essential characteristics of a SISO is missing in Example 3.

Of course, in one sense S does have an economic stake in the receivables in Example 3: collections by B from the account debtors reduce the exposure of S under its recourse repurchase obligations. But this stake arises from the fact that S is a surety on the receivables; it is not the economic (typically, ownership) interest of a debtor in a SISO. Any relevant duties in this respect owed to S, as surety, by B, as creditor, would be governed by the law of suretyship and not by Article 9.

Example 3 is a simplified version of the full recourse transactions addressed in Major’s Furniture Mart, Inc. v. Castle Credit Corp., perhaps the most commonly cited authority for recharacterizing a purported sale as a SISO based on recourse against the seller for account

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173. Changes in market interest rates might make it advantageous for S to borrow elsewhere at a lower cost and use the funds to exercise its repurchase option (i.e., to prepay the secured loan). In the economic and pricing structure of Examples 1 and 2 it is unlikely that a receivable would have a value materially greater than the repurchase obligation, but in other structures a greater disparity might exist. In circumstances in which it makes economic sense for S to repurchase, presumably S would repurchase all of the receivables.

174. 602 F.2d 538 (3d Cir. 1979).
debtor defaults. We think that Major's was wrongly decided—full recourse against the seller notwithstanding—because the buyer was entitled to all collections of the receivables (albeit supported by the seller's recourse obligations) and the seller retained no interest. We believe that Kettering's analysis is correct. The only value associated with the receivables arises from collections from the account debtors. In Example 3, B is entitled to all of the collections with none of that value being retained by or returned to S. B is entitled to the entire value; consequently, the transaction is a true sale.

We suspect that some may find our conclusion to be counterintuitive. One arguably problematic aspect of the analysis relates to the fact that, in a SISO (such as in Example 1), the debtor's predefault waiver of its right to redeem the receivables would not be enforceable. It might seem ironic that simply striking out the contract provisions that give rise to that right—the repurchase option and the cap on liability—effectively eliminates the otherwise nonwaivable right. On reflection, however, the irony must give way. The exercise here is to fathom whether the purported seller has sold everything; an agreement that results in the seller retaining nothing demonstrates that the seller has in fact done so.

Given that in a SISO transaction the right of redemption is statutory and need not be preserved or provided for by contract, it may seem odd that the contractual provisions present in Example 1 but missing in Example 3 play such a pivotal role. But all one can glean from this is that the absence of an express redemption right does not preclude recharacterization of a purported true sale as a SISO. Indeed, a typical secured loan (not dressed in a sale's clothing) does not expressly provide for a right of redemption, yet normally the question would not even arise as to whether the transaction was a SISO or whether the debtor had a redemption right. Thus, although the presence of an express redemption right is relevant to characterization, its absence is not. When in substance a seller conveys its entire interest in a receivable, the seller retains no interest that can be foreclosed and so enjoys no right to redeem.

175. Kettering reaches the same conclusion, but his analysis differs somewhat. We think the transaction in Major's is a true sale because the seller retained no interest in the receivables. Kettering thinks that the transaction is a true sale because there is no risk that the seller would forfeit any interest in the collections as a result of any default-like event on its part. See Kettering, True Sale, supra note 26, at 541 (criticizing the holding in Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979)). Of course, the reason the seller would not forfeit an interest in the collections is that the seller retained no such interest.

176. U.C.C. § 9-602(11).

177. Id. § 9-623.

178. As Kettering noted:

The nonwaivable equity of redemption embedded in Article 9, and the recharacterization...
We concluded that S retained no interest in the receivables because B was entitled to all of the collections on the receivables. Because of S's recourse obligation, however, B does have an economic stake in B’s collections on the receivables: every dollar collected reduces B’s contingent, secondary obligation. But the question is whether the interest transferred to B is a SISO, with the result that B would have obtained only a security interest instead of full ownership and S would have retained an interest. That S has a recourse obligation cannot determine whether S has retained an interest. An obligation on a receivable, including a secondary obligation, does not constitute or evidence a property interest in the receivable itself. A surety for an obligation acquires no interest in the obligation until and unless it acquires such an interest such as by assignment or through subrogation.

As we have acknowledged above, we are mindful that the analysis of a transaction against the template of a SISO will not always be straightforward or easy. More complicated transactional structures may yield less clear conclusions than the simple examples discussed here. But when the facts are messy, it is particularly useful to know what one is looking for. The object of the investigation should be the existence, or not, of an obligation of the purported seller that is secured by the receivables transferred to the buyer, as evidenced by an economic interest or benefit that is retained by the purported seller. The specific terms of the parties' agreement are relevant only insofar as they relate to the existence, or not, of such an interest and such an obligation. But a putative seller’s recourse obligation does not reflect a property interest in the assigned receivables.

Next consider Example 4.

Example 4:
Example 4 includes several significant variations from Example 1. The purchase price paid by B to S is about half of the fair market value of the receivables. S’s repurchase-option price is equal to the original purchase price paid by B with two adjustments: a downward adjustment to take account of amounts collected from account debtors and paid to B and an upward adjustment to compensate B for the time value of money (imputed interest) to the extent not reflected in the purchase price. S’s doctrine that defends it, overrides freedom of contract to the extent of preventing a party from enforceably agreeing to the economic equivalent of a strict foreclosure in the event that the party fails to carry out a contemplated performance. It is not a general warrant for relieving a party from the consequences of selling on hard terms.

Kettering, True Sale, supra note 26, at 541 (emphasis added).

179. See supra Part IV.A–B.

180. However, in a proper case (such as in Example 1) a recourse obligation may constitute the obligation secured by the assigned receivables.
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The repurchase option expires six months after the transaction date. The receivables are payable by account debtors in monthly installments over a period of years. As in Example 2, $S$ has no recourse obligation.

One might conclude that the transaction in Example 4 cannot be a SISO because there is no obligation secured. The purchase option is just that, an option. $S$ has no enforceable contractual obligation to repurchase the receivables. Yet Example 4 is a classic example of a sale that is absolute in form but which would be recharacterized as a secured loan. By failing to exercise the option, $S$ would forfeit half the value of the receivables. For this reason, one can be confident that $S$ is just as likely to exercise the option as $S$ would be to fulfill a contractual obligation to repurchase. Thus the repurchase-option price in Example 4 is a secured obligation, even though it is an obligation based on economic compulsion and not on a contractual undertaking. As $S$ is the debtor in a SISO transaction, Article 9 will protect $S$’s economic interest in the receivables, including its equity of redemption, if $S$ is unable to pay the repurchase-option price before the option expires by its terms (i.e., if $S$ is unable to satisfy the secured obligation when due).

The analysis here is essentially the same as with a bargain or nominal purchase option in favor of a lessee of goods upon expiration of the lease term: the bargain option economically compels the lessee to exercise it.

It is fundamental that the identification of a secured obligation is a necessary and useful analytical approach to the true sale versus SISO dichotomy. The bargain option price also demonstrates that $S$ has retained a meaningful economic interest in the receivables (i.e., that $B$ has not acquired their entire value) and that, accordingly, true sale treatment would not be appropriate. This is true even though, as in Example 4, the parties’ agreement does not expressly provide $B$ with a right of redemption or a residual interest. The bargain repurchase option is the practical economic surrogate for such an express provision and so constitutes the secured obligation.

1. See supra note 137 and accompanying text.
2. We make this point with a problem in our casebook involving a recharacterized lease under which a purchase option price is properly treated as a part of the secured obligation. Harris & Mooney, supra note 116, at 319 (Problem 5.1.3). A third party might attack the sale as a constructive fraudulent transfer. Assuming that $B$ acted in good faith, $B$ would be entitled to a credit or lien for the value it advanced. See, e.g., UNIF. FRAUDULENT TRANSFER ACT § 8(d) (1984). Avoidance and recharacterization thus would yield the same result, or at least a similar one. Kettering claims that our position—that a secured obligation is necessary for recharacterization—is circular because "recharacterization itself can create the secured obligation" and he points to our analysis of Example 4 as a case in point. Kettering Memorandum, supra note 48, at 6. But he misconstrues our position, which is that the terms of a transaction must provide a basis for determining that there is an obligation secured. As stated in the text, it need not be an explicit and enforceable contractual obligation.
3. See U.C.C. § 1-203(b)(4) (purchase option for no or nominal consideration).
Consider next Example 5.

Example 5:
Example 5 makes only one variation from Example 4. It eliminates S’s option to repurchase the receivables.

In Example 4 S’s bargain repurchase option was the linchpin of the SISO analysis. It provided the obligation that was secured and the means by which S retained an interest in the receivables. Because Example 5 removes this repurchase option, we believe that the transfer of receivables is a true sale.

Contrary to the position of Aicher and Fellerhoff, in our view a disparity between the sales price and the value of the receivables being sold should not be sufficient of itself for recharacterization of the transaction as a SISO. Nor do we believe that such a disparity should be given a prominent role, as Plank proposed. The attention to disparity between price and value is grounded on the idea that rational actors normally do not sell property for much less than its value, while borrowers that provide collateral typically provide collateral of a value in excess of their secured obligation. A substantial disparity arguably indicates that even though neither the transaction documents nor the testimony proves that there was a bargain purchase option, the parties must have agreed that the purported seller enjoyed a right to repurchase the transferred receivables at a bargain price.

This thinking seems to underlie the approach of the Restatement. As we have seen, the Restatement includes "the presence of a substantial disparity between the value received by the grantor and the fair market value of the real estate at the time of the conveyance" among the circumstances from which the trier of fact may infer that a deed absolute was intended to serve as security. Where, as in illustration 3 of Restatement section 3.2, the grantor and grantee offer conflicting testimony concerning the terms of the parties’ agreement, the fact of a substantial disparity may assist the trier of fact in determining whom to believe. Thus, in illustration 3, the disparity between the amount advanced by Grantee ($25,000) and the value of Blackacre at the time of the conveyance ($50,000), together with the fact that Grantor retained possession of Blackacre and continued to pay real estate taxes, gives credence to Grantor’s testimony that Grantee promised to reconvey Blackacre upon Grantor’s payment of $35,000. In other words, in illustration 3, the determinative fact is Grantor’s option to obtain a

184. See supra Part III.B.
185. See id.
186. RESTATEMENT THIRD, PROPERTY (MORTGAGES) § 3.2(b)(2).
187. See id.
reconveyance of Blackacre at a bargain price, not the substantial disparity between the value of Blackacre and the amount Grantor received for it.

We return to the broader point: The terms of the transaction dictate its characterization. Unless the terms have the effect of providing for the transferor to retain an interest in the property transferred (which would be the case, for example, if the term include a mechanism by which the transferor can compel reconveyance of the property), the transaction is not a SISO. In the mortgage context, a person seeking to recharacterize a deed absolute as a mortgage is given considerable leeway to prove the terms of the transaction. But we doubt that, as an evidentiary matter, the disparity between the value of the transferred property and the value given to the transferor should be sufficient to prove that a transaction is a SISO, particularly in the context of securitization of receivables. The large disparity between price and value in Example 5 does suggest that the parties may not have entered into a true sale, inasmuch as one must wonder why $S$ would fully divest itself of receivables for only about half of their value. But if disparity alone supported recharacterization, the terms of the SISO transaction would not be apparent. As we noted in connection with illustration 5 to Restatement section 3.2, presumably the deemed loan would have been in the amount of the price paid by $B$ to $S$ in Example 5, and perhaps it would be due at a “reasonable time” and bear a “reasonable” interest rate.\(^{188}\) In the real world of receivables transactions, in which sophisticated parties and well drafted documents predominate, it is extremely unlikely that there would occur great disparities in price and value in the absence of other terms supporting SISO treatment.\(^{189}\) It follows that the question whether such a disparity alone would be sufficient to support recharacterization of a purported sale of receivables is not of practical importance.\(^{190}\)

Finally, consider Example 6.\(^{191}\)

\(^{188}\) See supra note 140.

\(^{189}\) It is hard to imagine that $S$ would be arguing that the transaction is a SISO unless $S$ offered evidence that there were other agreed terms to support recharacterization. And, of course, if $S$ does not oppose true sale treatment then no dispute would exist. In theory, a creditor or insolvency representative would raise the recharacterization issue even in the absence of such parol evidence from $S$, thus squarely raising the issue of whether the price-value disparity would be sufficient for recharacterization. But third parties would not need to rely on recharacterization based on a price-value disparity. The disparity would permit them to rely on the law of constructive fraudulent transfer. See, e.g., UNIF. FRAUDULENT TRANSFER ACT § 4(a)(2) (1984) (providing that certain transfers are fraudulent as to a creditor "if the debtor made the transfer . . . without receiving a reasonably equivalent value in exchange for the transfer").

\(^{190}\) Of course, as the preceding footnote indicates, such a disparity may be relevant to other legal issues implicating the rights of creditors.

\(^{191}\) Example 6 is based on a hypothetical transaction suggested to us by Kettering. Kettering Memorandum, supra note 48, at 6–7.
Example 6:
S agrees to sell and B agrees to buy specified receivables for a purchase price of $1,000. The parties expect that the aggregate collections on the receivables will be $900. B agrees to pay an up-front purchase price equal to the agreed present value (based on the parties' expectations as to the timing of future collections) of the $900 anticipated collections. B further agrees to pay a deferred purchase price equal to fifty percent of collections on the receivables in excess of $900.

We do not believe that the transaction in Example 6 should be recharacterized as a SISO. It is true that following the sale S stands to benefit if B recovers more than the $900 that the parties expect to be collected and in that respect S retains a future economic stake in the future collections of the receivables. The fact that the parties characterized this stake as a contingent readjustment of the purchase price does not preclude the possibility that, in a proper case, the stake could represent an interest retained by S that could support recharacterization as a SISO. However, recharacterization would not be appropriate in Example 6 for want of an obligation that would be secured by the receivables were the transaction to be recharacterized. On what obligation could S possibly default in order to trigger B's remedies as a secured party? The absence of a secured obligation conclusively demonstrates that the transaction is not a SISO.

On another view, arguably S has not sold one hundred percent of its interest in the receivables and has retained an undivided interest represented by its contingent right to be paid fifty percent of the collections in excess of $900. But because the interest acquired by B is not a SISO (for want of a secured obligation), even if S had retained such a contingent future interest in the receivables the transaction would reflect a true sale to B of the interest in the receivables over and above the interest retained by S.

As a variation on Example 6, assume that B is entitled to recourse against S to the extent that B recovers less than $900 from the receivables. As we noted in connection with Example 3, such recourse does provide S with a stake in the future connections. But also as explained in that connection, in the setting of Example 3 we view such recourse as a suretyship obligation of S that does not reflect a retained interest in the receivables. Should this variation change the appropriate result in Example 6? One might argue that S's contingent recourse obligation (up to $900) is the obligation secured (as in Example 1) and that the receivables secure that obligation because S has retained an interest in the receivables (represented by the contingent future

192. See supra Part V.B (Example 3).
193. Id.
interest in collections in excess of $900). We would reject that analysis, however, because S’s right to receive payments on its retained future interest would ripen only when collections had exceeded $900 and the contingent recourse obligation had ceased to exist. That is to say, S’s recourse obligation cannot ripen if the receivables have value. S’s asset (the putative collateral) and S’s ripened recourse obligation (the putative secured obligation) cannot coexist.

Example 6 illustrates the inherent difficulties of rules that require resolution of a dichotomy (lease or SISO, true sale or SISO) based on terms of transactions that reflect gradations and matters of degree. There will be hard cases whose proper outcome is disputed. This is not an exact science.

This discussion also implicates another, less obvious point. Both commentary and case law implicitly take as given that, when a purported sale of a receivable does not qualify for true sale treatment of the purported seller’s entire interest, the transaction must be a SISO. In our view, however, that conclusion is not inevitable. To be more precise, a transfer that does not constitute a true sale of the transferor’s entire interest in a receivable nonetheless may also not constitute a SISO because, for example, there may be no secured obligation (as in Example 6). Although the transferor retains an interest in the relevant receivables, the transaction may be a true sale of the portion of the seller’s interest that it purported to transfer. Consider the sale of an undivided fractional interest in a receivable. Cases involving sales of participation interests in loans generally have recognized that such a fractional interest can be the subject of a true sale even though the seller has itself retained a fractional interest.\footnote{See, e.g., Fed. Deposit Ins. Corp. v. Mademoiselle of Cal., 379 F.2d 660 (9th Cir. 1967). We acknowledge that there are important aspects of the law relating to loan participations that remain unsettled. See, e.g., Steven L. Schwartz, \textit{Intermediary Risk in a Global Economy}, 50 DUKE L.J. 1541, 1558–60 (2001). The point to be made for present purposes is that it is possible to have a true sale of a receivable as to which the seller remains the owner of the unsold fractional interest and no SISO is created.} Similarly, one might have a true sale of rights to discrete and specific payments of principal and interest (e.g., a sale of the right to payment of principal and interest due on a specified date).\footnote{We can imagine a transfer of less precise and less identifiable rights and interests resulting in a shared ownership in a receivable, but in a transaction that would not create a SISO for want of an identifiable secured obligation. While such transactions may be of conceptual interest, we are uncertain whether they are common. Transactions in which the seller retains a security interest in the transferred receivables to secure the buyer’s obligations to the seller are more common. Of course, the fact that the seller retained a security interest in the receivables is not at all inconsistent with the buyer becoming the owner and the transaction being a true sale.}
VI. CONCLUSION

In this Article we have advanced a more coherent approach to the exercise of distinguishing a true sale of receivables from a SISO. In particular, we have drawn on the experience and learning from the analogous process of distinguishing a true lease from a SISO. The central feature of the lease–SISO dichotomy is whether the purported lessor has retained a meaningful residual interest. If it has, then true lease characterization, not SISO treatment, is appropriate. In the receivables context, the central questions are whether a purported seller has retained a meaningful interest in the receivables that are subject to a sale to a purported buyer and, if so, whether the interest transferred to the purported buyer secures an obligation of the seller. Affirmative answers to these questions should result in SISO characterization. The existence of a buyer’s recourse obligation to a seller may be a significant factor inasmuch as SISO characterization requires the existence of a secured obligation and a buyer’s recourse may satisfy that requirement. But such a recourse obligation is not, alone, sufficient to justify recharacterizing a sale transaction as a SISO. In our view a functional analysis based on the application of economic realities to the terms of a transaction offers a more coherent and predictable approach than the “factors” approach reflected in much of the case law. That approach has long been rejected by case law and codification in the true lease versus SISO context, and we believe the same is warranted in the true sale of receivables versus SISO analysis.