THE ROLE OF RECEIVABLES FINANCING IN THE CONTEXT OF ABS SECURITIZATION – COMPARATIVE VIEW ON ROMANIAN AND U.S. LAW

By
Florentin Cătălin Giurgea

LL.M. SHORT THESIS
COURSE: Comparative Secured Transactions
PROFESSOR: Tibor Tajti, SJD
Central European University
1051 Budapest, Nador utca 9
Hungary

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ABSTRACT

Securitization began to be used as structured finance technique in the United States in 1970, when there were issued the first securities backed by mortgages; the securities may be also backed by receivables.

Securitization is a modality of financing against receivables used by companies in order to allow them to raise liquidities from lenders otherwise inaccessible and to rates of interest which are lower than those imposed by banks or other credit institutions. The originator transfers receivables, by means of assignment, to a special created entity that will issue and sell notes to interested investors. The main characteristic of securitization is that the notes are backed by receivables, which are the only assets of the special entity. Issued notes may be sold directly to so-called sophisticated investors or on the secondary market.

In the Unites States securitization is a contractual transaction that is not regulated through specific laws; this is more a characteristic for civil law systems and the lately enactment of such laws regulating securitization of receivables or of mortgage bonds in countries like Romania, Ukraine, Poland, Russia supports this idea.

LIST OF ABBREVIATIONS

ABS	=	asset backed securities
MBS	=	mortgage backed securities
SPV	=	special purpose vehicle
SPE	=	special purpose entity
UCC	=	Uniform Commercial Code
i.e.	=	(*id est*) that is
no.	=	number
SCJ	=	Supreme Court of Justice of Romania
CC	=	Civil Code (*Codul civil*)
CPC	=	Civil Procedure Code
art.	=	article
GO	=	government ordinance
OG	=	Official Gazette

CHAPTER 1 - INTRODUCTION

Receivables financing, in general, gives the companies the possibility to finance their activities for short and medium term. Securitization, project finance, sale of receivables, creation of security interest on receivables, factoring, forfeiting are modalities of financing against receivables. Securitization is a form of structured finance and by mean of which the assets are repackaged in such way that permits the issuance of securities, sold on the secondary market or directly to sophisticated investors, in order to allow the originator to raise money at a lower rate of interest and from lenders otherwise considered as being inaccessible.

Securitization is used in the U.S. from 1970 and during nearly forty years evolved and became a refined financing technique involving assignment of receivables, creation of security interest, pooling of receivables, issuance of securities, servicing and administering the special created entities, various modalities to reduce the operational risks. ABS securitization is just a type of securitization whose specific element is given by the fact that the issued notes (securities) are backed by receivables.

It was regulated in Romania for the first time in 2006 and despite the fact that almost two years passed from the moment when the Law on securitization of receivables was enacted the market does not gives a positive feed-back in what concern a potential transaction. One possible reason may be the insufficient understanding of how the mechanisms of securitization work and what the final results after involving in such transactions are. Thus the American experience in securitization may be useful.

Authors like Gilmore (*Security Interest in Personal Property, 1965*), Oditah (*The Future for the Global Securities Market – Legal and Regulatory Aspects, 1996)*, Schwarcz (*Securitization, Structured Finance and Capital Market, 2004*), Bonsal (*Securitisation,*

1990), just to name a few scholars who deal with this subject brought important contribution to this field. It must also be said that reports issued by rating agencies, by law firms and companies specialized with this kind of industry are useful instruments in order to comprehend how the securitization functions and to choose the best solution so as to attain its scope, namely to raise liquidities.

The analysis using comparison is meant to determine to what extent the solutions proposed by Romanian laws respond to the actual level of development of industry, what improvements should be made if any and also to what extent the regulations allow the development of securitization into an industry.

The questions which arise are: a) whether financing against receivables was/is/will be useful to companies; b) what are the main differences between various types of financing techniques; c) what is the influence of the legal system over receivables financing; d) whether securitization is a viable method of financing; e) what may be learnt from US experience.

The thesis will develop and will present the main futures of the concept of accounts receivable according to US and Romanian law; secondly it will deal with financing against receivables techniques, presenting their advantages and disadvantages in connection with American and Romanian markets and also specific legal requirements (attachment, assignment, filing, perfection, priorities); further it will focus on securitization as financing against receivables method and will envisage its main characteristics. The comparison between the two analyzed systems should allow foreseeing main recommendations to Romanian specialists. The research will analyze scholars' works, reports issued by rating agencies, by law firms, by companies, and also statistical data, national statutes and official comments. There will be referred not only American and English sources, but also sources from Romania.

This thesis will analyze the main techniques of financing receivables, focusing on securitization's main advantages and disadvantages as financing method. It will be shown that ABS securitization represents a viable option of financing receivables for a country with economy in transition like Romania using as example one with functional market economy as the US. However, securitization is just an option to raise liquidities and its utility is to be determined taken consideration more factors, like: the necessary amount of liquidity, the past performance of the originator, the predicted performance of the assets intended to be securitized through comparison to past evolution of similar assets, special entity's administrator experience, the risk level envisaged by rating agencies through specific rating. The U.S. level of expertise in this domain cannot is beyond any doubt, that's why it is necessary to use a working model so as to realize the way the securitization functions and to avoid possible misunderstandings.

CHAPTER 2 - RECEIVABLE FINANCING IN THE CONTEXT OF ABS SECURITIZATION IN THE UNITED STATES

Financing against receivables is used in the U.S. for more than two centuries in various forms. The continuing need of liquidities manifested by the companies, so as to improve the offered goods and services and to provide new goods and services, in order to satisfy the market demands led to a necessary development of financing techniques. And developing a financing mechanism without offering specific security to the lender would affect this tendency because the lenders might refuse to imply themselves in financing projects as unsecured creditors. The inaction of Uniform Commercial Code[1] in 1951 offered to both parties (debtor and creditor) the possibility to expand the existing financing methods and also imagine and put in practice new financial schemes. Article 9 of the UCC named "Secured Transactions"[2] provides a complete statutory framework of secured transactions in personal property[3]; this article was revised once in 1971 and more recently in 1999 with the intention of improving some of its provisions, to regulate new aspects and to better respond to the industry demands.

Securitization is such a new device whose origins can be found even before UCC in 1934, when as a reaction to the 1929-1933[4] Great Depression, the Congress of the United States passed the National Housing Act[5] which created the Federal Housing Administration

[1] Uniform Commercial Code (hereinafter referred to as the UCC) was "a joint project of the National Conference of Commissioners on Uniform State Law and the American Law Institute"; UCC is adopted on a local basis, so the "states have adopted numerous local variations"; DAVID G. EPSTEIN, JAMES A. MARTIN, WILLIAM H. HENNING & STEVE H. NICKELS, BASIC UNIFORM COMMERCIAL CODE – TEACHING MATERIALS 1, 5 (West Publishing Co Saint Paul, Minn., 3rd ed. 1988)

[2] *See* UCC Section 9-101; in this paper, when citing provisions of UCC or referring to Official Comment of Articles reference should be made to text of UCC provided in Commercial and Debtor-Creditor Law-Selected Statutes (2007 Edition, Foundation Press Thomson West, compiled by Douglas G. Baird et al.)

[3] *See* DOUGLAS J. WHALEY, SECURED TRANSACTIONS 9 (The BarBri Group, 2002)

[4] In some countries the beginning year was 1928

[5] Available at: http://fraser.stlouisfed.org/docs/historical/martin/54_01_19340627.pdf

and a "secondary market in mortgages"[6]. Further, in 1938 was created Federal National Mortgage Association[7] in the context of existence of millions of families in danger to loose their homes "for lack of a consistent supply of mortgage funds across the United States"[8]. Fannie Mae had to buy mortgages in order to offer liquidities when investments needed finance[9] and in this way the problem of short capital was solved.

In 1968 the Congress established the Government National Mortgage Association[10] whose main purpose was to finance house purchases. Ginnie Mae issued in 1970 the first mortgage backed securities, beginning their trade on the market[11].

The securitization process implies pooling assets by a special purpose entity in a way that allows the issuance of securities backed by these assets, which are sold directly to sophisticated investors or on the secondary market. During time the concept of securitization evolved and despite the fact that it may seem a simple concept one, it must be said the problems involved are very complex and a successful securitization transaction request the intervention of lawyers, accountants, bankruptcy and tax specialists. In a usual scenario the originator (assignor) assigns its receivables to a special created entity whose only activities are: to take on the transferred assets, to repay the originator, to pool the receivables together in a favorable manner in order to permit the issuance of securities; the securities are sold to investors; the investors are secured creditors of the special entity, whose only assets are the receivables; the investors receive an interest for investment. Securitization is a financing

[6] *See* STEVEN L. SCHWARCZ, BRUCE A. MARKELL & LISSA LAMKIN BROOME, SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS 2 (Lexis Nexis 2004)
[7] Known as "Fannie Mae"
[8] Fannie Mae; see An Introduction to Fannie Mae, p. 3, available at: http://www.fanniemae.com/media/pdf/fannie_mae_introduction.pdf (last visited 1 February 2008)
[9] In 1968 Fannie Mae became a fully private owned company
[10] Ginnie Mae
[11] *See* SCHWARCZ, *supra note* 6 at 2; this was the first structured financing, Ginnie Mae beginning to trade publicly "pass through securities"; Id.; over the years Ginnie Mae got involved in many transactions and the numbers provided are impressive: more than $2.6 trillion in mortgage-backed securities, more than 34 million households were using this program; informations available at: http://www.ginniemae.gov/about/history.asp?subTitle=About (last visited: 28 March 2008)

against receivables method which may be used for raising capital from sources otherwise considered inaccessible for the originator.

2.1. Receivables Financing in the U.S.

UCC Article 9 does not provide a definition for "receivable" within the Section 9-102; however, it is defined the "account" as "meaning the right to payment of monetary obligation whether or not earned by performance"[12]. Black's Law Dictionary indicates that account receivable is "an account reflecting a balance owed by a debtor; a debt owed by a customer to an enterprise for goods or services"[13]. The United Nation Convention on the Assignment of Receivables[14] provides a similar definition of receivables: "assignor's contractual right to payment of a monetary sum from a third person". All these definitions contain the following features: assignor's right to claim payment, the duty of account debtor to pay for a good or a service, the obligation that should be provided is a monetary one, the temporary existence of receivables between the arising moment and that of payment. Accounts receivable[15] fall within the category of pure intangibles[16]; these intangibles are not

[12] The UCC Article 9' definition of account, in Section 9-102 (a) (2) reads as follows: the account is "a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of, (ii) for services rendered or to be rendered, (iii) for a policy of insurance issued or to be issued, (iv) for a secondary obligation incurred or to be incurred, (v) for energy provided or to be provided, (vi) for the use or hire of a vessel under a charter or other contract, (vii) arising out of the use of a credit or charge card or information contained on or for use with the card"

[13] BLACK'S LAW DICTIONARY 17 (7th ed. 1999)

[14] United Nation Convention on the Assignment of Receivables in International Trade, available at: http://untreaty.un.org/English/notpubl/10-17_E.doc (last visited 15 January 2008)

[15] For the scope of this paper the term accounts receivable and accounts have the meaning provided by UCC 9-102, except as otherwise indicated; in this paper these terms and receivables will have the same meaning as accounts receivable

[16] Personal property includes goods and intangibles; goods are "all things that are movable when a security interest attaches" (UCC 9-102 (44)), intangibles are excludes from the meaning of this term: further, intangibles include two subcategories: pledgeable intangibles (instruments, document, chattel paper) and non-pledgeable intangibles (accounts, general intangibles, payment intangibles); TIBOR TAJTI, COMPARATIVE SECURED TRANSACTIONS LAW, 44-48 (Akademiai Kiado, Budapest 2002); according to 9-102 (61) payment intangible is "general intangible under which the account debtor's principal obligation is a monetary obligation"; it should also be noted that payment intangibles does not represent an independent non-pledgeable intangibles because it is a subcategory of general intangible

pledgeable because they are not necessary evidenced by a document. From this point of view receivables[17] differ in comparison to instrument (9-102 (47)[18]), chattel paper (9-102 (11)[19]), or document (9-102 (30)[20]). The document, the instrument and the chattel paper are in writing and evidence a right to payment of a monetary obligation. The revision of UCC Article 9 "expanded and reformulated" the definition of accounts and a consequence of this fact is that more rights considered as general intangibles[21] before revision fall now within the definition of account[22].

Fidelis Oditah identifies four types of receivables[23]: present, potential, future and contingent[24]. Potential receivables are unearned but their origin is in present contracts which will give rise to them. Present receivables are those earned by the promise and enforceable too; future receivables are vested from the moment the contract is made though they are unearned by the promise but they are enforceable at some time in the future[25]. Future receivables are potential debts because their existence it is not certain.

[17] The English literature uses receivables and accounts receivable as interchangeable terms; see Tibor Tajti, *supra note*, p. 99, at footnote 288

[18] UCC 9-102 (47) defines instrument as a "negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation"

[19] Chattel paper means a "record or records that evidence both a monetary obligation and a security interest in specific goods, a security interest in specific goods and software used in the goods, a security interest in specific goods and license of software used in the goods, a lease of specific goods, or a lease of specific goods and license of software used in the goods."

[20] *Document* is a "document of title or a receipt of the type described in Section 7-201(2)"

[21] According to the Official Comment 9-102(5)(d), general intangible is "the residual category of personal property, including things in action, that is not included in other defined types of collateral"; so, general intangible include all other rights or goods (intangibles) that do not fall within account

[22] Official Comment 9-102 (5)(a) at 644; health care insurance receivables are considered accounts and this is an important feature of Article 9 in the context of securitization, because the same procedure as for the other accounts in case of assignment will be followed; the most securitized assets are considered to be: accounts, chattel paper, instruments, general intangibles; see Tibor Tajti, supra note 16 at 79 footnote 204

[23] This distinction's goal is to determine the specific regime applicable to different types of debts and also their specific occurrence conditions

[24] *See* FIDELIS ODITAH, LEGAL ASPECTS OF RECEIVABLES FINANCING, 27 (Sweet & Maxwell, London 1991); this differentiation may present interest for knowing, at a certain point in time, what is the status of a given receivable; the delineation proposed by the author seems to have more theoretical purposes than practical

[25] *See id.* at 28

Distinguishing between future and contingent receivables is considered to be more difficult. Future receivables "are neither earned nor payable"[26], their existence in the future are just potential; however, they are used in a financing strategy "to support advances of money"[27]. Contingent debt is "a debt that is not presently fixed but that may become fixed in the future with the occurrence of some event"[28].

Receivables financing is a way of ensuring working capital not only for short term, but also for medium and long term. Financing against receivables may be used for small amounts of debts' selling and also for collecting important amounts. Receivables financing was considered a method for "the recycling or utilization of corporate debts"[29]. It is to say that financing is used to provide capital at a given moment and otherwise the obligations would have been paid to the creditor at a different moment in time. It is a useful financing method if the creditor needs capital in order to get involved in other projects or to sustain the running business. Fidelis Oditah names three modalities of financing against receivables: outright assignment, discounting receivables and assignment of receivables or charge on receivables. The receivables financing related problems will be addressed in Section 2.1.3.

2.1.1. The evolution of receivables financing

Receivables financing is known in the U.S. for more than two centuries[30] even though in some "incipient" forms. Grant Gilmore names two types of such financing methods[31] having their origins in the 19th century: i) the first, used mainly in the building and

[26] *See id.* at 30
[27] *See id.* at 30
[28] BLACK'S LAW DICTIONARY 410 (7th ed. 1999); the existence of such debt is related to the occurrence of a specified event at some time in the future
[29] *See* Tibor Tajti, *supra note* 16 at 99
[30] This approximation refers only to the more recent period because financing was well known and used even before 1800
[31] GRANT GILMORE, SECURITY INTEREST IN PERSONAL PROPERTY at 250-251 (Little & Brown, Boston &Toronto 1965, reprinted in 1999 by The Lawbook Exchange, Ltd. New Jersey, 1st volume)

construction industry consisted in use of "monies due and to become due" to secure loans in industries above mentioned; ii) the second was the factoring, having its origins in "inventory financing".

The notification of account debtor may be considered as the matter that divided receivables financing evolution in two main pre-UCC periods: before Benedict v. Ratner case and the period following this case. It should be mentioned that Corn Exchange v. Klauder case prepared the inaction of UCC. Because of their importance and of their influence over the evolution of receivables financing both of these cases will be shortly presented in this subsection.

a) Ratner v. Benedict[32]

Hub Carpet Company, a mercantile concern doing business in N.Y. City borrowed $ 15,000 on May 23 and $ 15,000 on July 1, 1921, from Ratner. The company assigned all accounts receivable present and future accumulated in the ordinary course of business in order to secure the loan. A list of outstanding accounts had to be delivered to Ratner on 23rd day of each succeeding month. From May to September, the outstanding accounts aggregated between $100,000 and $120,000. The receivables were to be collected by Hub Carpet, but Ratner had at any time the right to ask that all amounts collected be used in payment of its loans. However, the company enjoyed entire freedom to dispose and use the proceeds of all accounts. The outstanding accounts aggregated $ 90,000, on September 23, according to the delivered list, while the company collected from assigned accounts before September 17, $ 150,000. On September 26 began the proceedings of declaring the company's bankruptcy.

Benedict was appointed receiver and later trustee. Ratner filed a petition sustaining that the amounts collected by Benedict should be paid to him because he was a secured creditor. Benedict defended himself on the ground that the original assignment was

[32] Benedict v. Ratner 268 U.S. 353 (1925); the case is available at: http://caselaw.lp.findlaw.com/scripts/getcase.pl?court=us&vol=268&invol=353 (last visited 18 January 2008)

fraudulent conveyance and as cross-petition he claimed Ratner to be ordered to return all proceeds paid by the company after September, 17.

The District Court and the Second Circuit Court of Appeals ruled in Ratner's favor. The Supreme Court of Justice granted a writ of certiorari and reversed previous orders. For ruling so, the Supreme Court upheld following facts: the applicable law is the law of N.Y., under which "a transfer of property as security which reserves to the transferor the right to dispose of the same, or to apply the proceeds thereof, for his own uses, is, as to creditors, fraudulent in law and void"[33]. The May 23 assignment was fraudulent conveyance and Ratner was not a secured creditor who may claimed the right to be paid from the proceeds; further, the payment between 17 and 26 September "constituted a preference voidable under section 60 of the Bankruptcy Act"[34].

As a consequence of this, the non-notification of debtors was not the reason for which the Supreme Court reversed previous orders. The real reason was that "the reservation of dominion is inconsistent with the effective disposition of title and creation of a lien"[35]. The court did not rest on ostensible ownership doctrine but on lack of "ownership because of dominion reserved"[36].

Grant Gilmore considers that Benedict rule according to which the lender (assignee) is required to exercise dominion over the receivables, to receive daily informations about collected proceeds, to re-send the proceeds to the assignor and to police the assignor's

[33] The Court mentioned also that: "whether the collateral consists of chattels or of accounts, reservation of dominion inconsistent with the effective disposition of title must render the transaction void"
[34] *See* Grant Gilmore, *supra note* 31 at 257
[35] The Supreme Court of Justice repealed the Second Circuit decision which was stating that the doctrine of ostensible ownership does not apply to intangibles and decided that the real reason for non-applying this doctrine is that of retained possession; this leads to the conclusion that the ostensible ownership doctrine is applicable in case of intangibles; in this sense see Grant Gilmore, *supra note* 31 at 256
[36] UCC 9-205 repealed the Benedict v. Ratner rule of non-notification; the arrangement between the parties was held void "as a matter of law because the debtor was given unfettered dominion or control over collateral", Official Comment 9-205 (2), p. 673; moreover, section 9-205 does not retain that a security interest is void "by reason of the debtor's liberty to dispose of the collateral without being required to account to the secured party for proceeds or substitute new collateral"; *Id.*; *per a contrario*, the validity on a security interest may be affected only by non-compliance with other required formalities (i.e. perfection, filing); but if possession is a prerequisite for attachment, perfection or enforcement of a security interest then the creditor should posses the collateral; *See* UCC 9-205 (b)

business was just a factor of making thing working better in the industry; the conclusion is that the industry would have arrived to the same result at some time later because this was the following step.[37]

b) Corn Exchange v. Klauder[38]

In 1938 Quaker City Sheet Metal Company (hereinafter referred to as the Company) needed working capital; a part of the existing creditors accepted to subordinate their claims to those which might be incurred for new working capital. At the time of bankruptcy filing the Company was indebted to the Bank for loans made between January and April 1940. The assignments were registered in the Company's books. The issue raised was that the debtors were not given notice about the assignment of obligations. The trustee challenged on this ground creditors right to the benefits of their security.

The Court engages in a discussion over the scope of assigning receivables and over the necessity of secrecy of such operation. Further, the Court envisages that the borrower wants to keep secret the lending arrangement with the intention of not allowing his customers to learn about it. But, as long as the transaction is not notified to the debtor, the real economic status of the borrower is unknown and this may induce others to contract with it, "where they would not do so if informed".

Assignments made without knowledge of debtors, though many of them were aware about the assignment "does not cure the failure to meet the requirements of notice". The consequence was that the Bank as assignee, failing to give notice to debtors, had not a perfected interest at the time of bankruptcy. Grant Gilmore refers to the position of the Court which considered that the assignment of receivables is postponed until the moment of debtors' notification; and in this case a notification was not given so a second assignee has

[37] *See* Grant Gilmore, *supra note* 31 at 260-261

[38] Corn Exchange Nat. Bank & Trust Co., Philadelphia v. Klauder, 318 U.S. 434 (1943), available at: http://caselaw.lp.findlaw.com/scripts/getcase.pl?court=us&vol=318&invol=434 (last visited 1 February 2008)

the possibility (who notifies the account debtors) to defeat the first assignee[39]. The effect of this decision was that the states enacted statutes which provided that the rule of Dearle v. Hall "was no longer in force" and which gave "non-notifying assignees complete Klauder insurance"[40]. UCC Article 9 repealed the Benedict rule as well as the statues enacted after Klauder decision and the Klauder rule where it was still in force.

2.1.2. Modalities of receivables financing

Fidelis Oditah names three ways of financing against receivables: outright assignment, discounting receivables, creation of security interest in receivables. This is only one possibility of structuring the methods of receivables financing; for the scope of this paper, there may be identified as modalities of financing against receivables: sale of receivables[41] (which includes outright sale, factoring, discounting receivables, true sale, forfeiting), creation of security interest on receivables, securitization of receivables and project finance[42]. All these techniques have at least a common feature: they provide working capital to the assignor[43] from a source – the debts – otherwise not used as such. It was expressed the opinion that securitization "is not a distinct method of financing against receivables since it involves a sale of a stream of receivables or a sale with a sub-charge by

[39] *See* Grant Gilmore, *supra note* 31 at 273

[40] *See id*. at 274; the author talks also about the fact that statutes enacted immediately after Klauder decision promoted the idea that "assignment should receive statutory protection without either notification or filing"; so, the first assignee would have had all assigned rights and a second assignee's claims were to be subordinated to those of the first in time assignee notwithstanding he notified the account debtor or filed the assignment

[41] The reason for including all these methods under the sale of receivables is that all imply a transfer of ownership from assignor to assignee

[42] For large projects there are used as financiers two or more lenders in form of loan syndications and sub-participation. Given the amount needed it might be very difficult for a single lender to insure all the funds; at the same time lenders may want to spread the risk. In loan syndication a leading party (bank) negotiates the agreement with other parties; "each syndicate member holds legal and beneficial title to its individual loan". In "funded sub-participation" each participant places a deposit with or makes an advance to the lead bank "in return for a specified share of the benefit of the loan". P.A.U. ALI, THE LAW OF SECURED FINANCE at 3-4 (Oxford University Press, 2002)

[43] Assignor should be understood not just as a natural person but also as a legal person or as an association of natural or/and legal persons, because some of above mentioned techniques require important resources (financial, logistic) to be involved in

the purchaser"[44]. Reducing securitization to the sale of receivables may be considered a very simplistic way of seeing this transaction; securitization is more than a simple sale of receivables and implies also creation of security interest, structuring of assets, enhancement techniques, post-sale servicing, protection against bankruptcy, interconnection with many external providers.

2.1.2.1. Sale of receivables

2.1.2.1.1. Outright assignment

The outright assignment in discharge or reduction of an existing indebtedness is used in order to allow the assignor to extinguish an existing debt or to reduce this debt up to the value of assigned accounts receivable.

This transaction involves three parties: the assignor, the assignee and the account debtor. The assignor assigns a debt due to him by an account debtor to the assignee to satisfy his claim. This financing technique represents basically replacement of a debt with another one. Reasons for accepting an outright assignment may be: a) "substituted debtor is more creditworthy"[45]; b) the term when this second assignment become due is shorter; c) assignee wants to avoid an indebtedness of the assignor; d) the assignor does not have the possibility to pay the debt.

A possible graphical representation of this transaction may be the following:

[44] *See* Fidelis Oditah, *supra note* 24 at 34
[45] *See* Fidelis Oditah, *supra note* 24 at 33

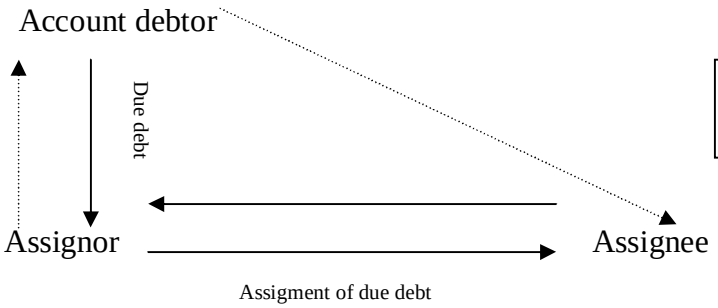


Figure 1 (the outright assignment)

Source: author's diagram

Taking into consideration the difference between the existing indebtedness and the assigned accounts receivables, more hypothetical situations may be envisaged:

i) if the existing indebtedness amount is higher than the value of assigned accounts receivable the former will be reduced up to the value of the latter; remaining debt will be due on the same day as the initial indebtedness; the reduction has no effect over the remaining part of the debt;

ii) if the assigned accounts receivable covers the entire indebtedness the debt is entirely extinguished;

iii) if the assigned debts have a higher value than advanced amount, the latter is extinguish and for the difference the assignor becomes creditor of the assignee or if between the assignor and the assignee there are established commercial relations the difference may be considered as an advance for a future transaction[46]. To some extent a similar situation may be when the assignee is a bank[47] and accepts an assignment of debts in change of money advances. In this case, Oditah considers that collected debts reduce the paid advance and this works like a revolving credit.

Using this method of financing the assignor does not obtain liquidities but only a reduction or the extinction of a existing debt.

[46] In case of a sale of accounts the debtor may be entitled to any surplus only if the agreement so provides, while in case of security assignments "the secured party must account to the debtor for any surplus"; Tibor Tajti, *supra note* 16 at 99 (footnote 289)
[47] *See id.* at 74-75

2.1.2.1.2. Factoring

The UNIDROIT Convention on International Factoring[48] considers factoring being the contract that involve an assignment of receivables to the factor, under the condition that the factor performs at least two of the following actions: finance for the supplier, maintenance of accounts, collection of receivables, protection against default in payment by debtors; another required element is that of noticing the debtors about the assignment of receivables.

In his book, Salinger[49] offers a "restricted definition of factoring" generally accepted in the United States, pursuant to which factoring is " a continuing arrangement between a factoring concern and the seller of goods or services on open account, pursuant to which the factor performs the following services with respect to the accounts receivable arising from sale of such goods: purchases all accounts receivable for immediate cash; maintains the ledger and performs other book-keeping duties; collects the accounts receivables; assumes the losses"[50].

Fidelis Oditah[51] uses 'discounting receivables' to generally refer to this financing technique which includes: block discounting, factoring, invoice discounting[52]. By way of factoring the assignor assigns to the factor (financier) accounts receivable due to him by a debtor[53]. Using the strength of accounts receivables receivable the assignor raises liquidities in order to insure short and medium term capital.

Factoring involves three parties: the assignor, the factor (assignee, financier) and the debtor. It is possible to assign at the same time account belonging not only to one debtor but

[48] UNIDROIT Convention on International Factoring, Ottawa, 28 May 1988, available at: http://www.unidoit.org/english/coventions/1988factoring/1988factoring-e.htm (last visited 1 February 2008)
[49] FREDDY SALINGER, FACTORING - LAW & PRACTICE at 1 (Sweet & Maxwell, 2nd ed. 1995)
[50] *See id.* at 1
[51] *See* Fidelis Oditah, *supra note* 24 at 33-34
[52] Each of these methods is specific for different industries
[53] *See* Fidelis Oditah, *supra note* 24 at 34

to more debtors. The transfer may involve only one receivable[54] or a stream of receivables, which may or not be due at the moment of the transfer. It is possible that an insurance company intervene to insure against the risk of indebtedness of the debtor or that of the assignor.

a) In case of non-recourse factoring, the assignor transfers the accounts receivables to the factor in change of finance. The price paid by the factor is below the total amount of transferred accounts receivables. The factor becomes creditor of the account debtor and he is not granted recourse against the assignor for any unpaid accounts or for the insolvency of the debtor.

Source: author's diagram

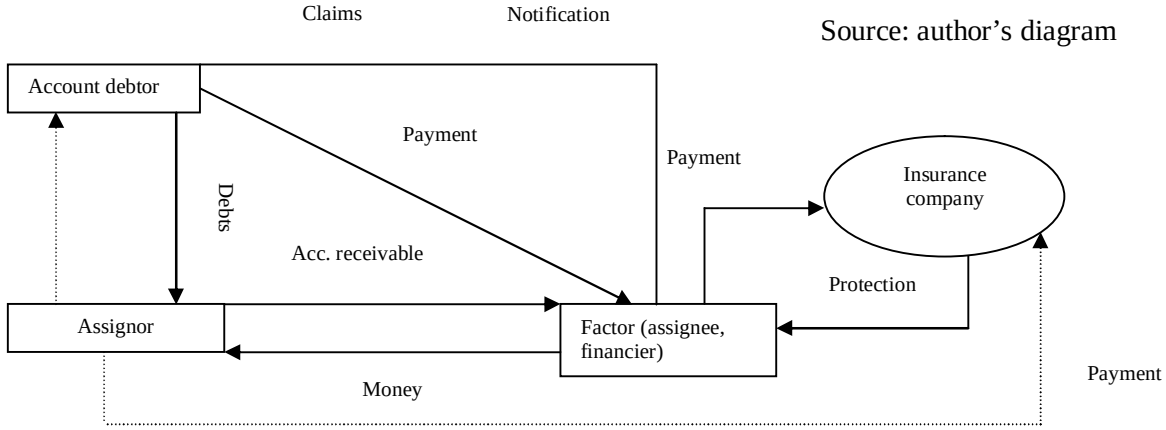


Figure no. 2 (non-recourse factoring)

Subsection 9-406 (a)[55] indicates that an account debtor may "discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee. After receipt of the notification, the account debtor may discharge its obligation by paying the assignee and may not discharge the obligation by paying the assignor". The payment of the debt to the assignee is conditioned by the reception of the transfer's notification.

[54] *See id.* at 44; this is the case when the amount is very large
[55] UCC Article 9

Subsection 9-405 (a) allows the modification or substitution of an assigned contract between the account debtor and the assignor and these are effective against the assignee under the condition of being made in good faith. 9-405 (b) introduces two limitations to this rule: the right to payment "has not been fully earned by performance" and if the right to payment has been fully earned by performance the account debtor was not notified about the assignment. Upon assignment the assignee's rights are subject to "any defense or claim in recoupment arising from the transaction that gave rise to the contract" (9-404 (a) (1))[56].

In non-recourse factoring the factor acquires not only good (solvable) debts but also bad debts and the risk of not get paid. Thus, it is possible to introduce in factoring mechanism an insurance company which will undertake the risk of unpaid debts and of debtor's insolvency. Salinger envisage two insurance possibilities[57]: i) assignor may have prior insurance policy and transfers it to the assignee by way of selling of receivables; in this situation the factor has to pay a value that is equal to the value of the entire stream; ii) the assignee has also the possibility to conclude an insurance policy after acquiring rights through factoring. In this case the sum paid by the assignor is smaller or the assignor may be asked to pay for the insurance policy.

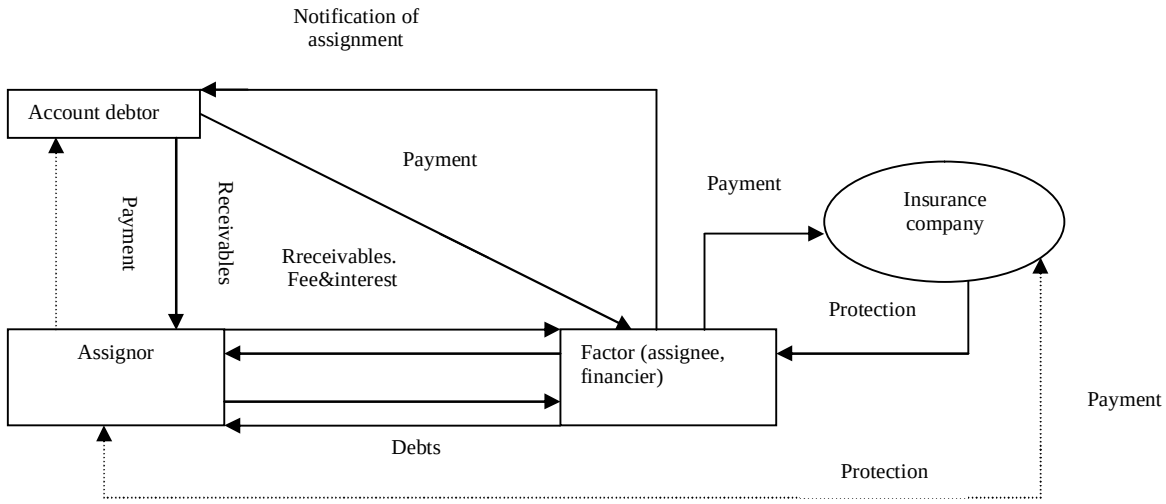
Non-recourse factoring may be considered a true-sale of accounts receivable because the debts are removed from the books of the assignor and transferred to those of the factor. The assignor is paid on the spot and he does not have to deal with the risk of non-payment of the debts afterwards; this is so because the factor accepts to bear the entire risk of the transaction.

According to 9-608 (b) in case of sale of accounts the debtor is not "entitled to any surplus and the obligor is not liable for any deficiency". However, the Official Comment offers the parties the possibility to derogate from the rule and as a consequence: i) the obligor

[56] The claim of an account debtor against an assignor may be asserted against an assignee only to reduce the amount the account debtor owes. (9-404 (b))
[57] *See* Freddy Salinger, *supra note* 49 at 20-21

may not be held responsible even if the collateral is offered as security; ii) in a true sale receivables transaction the obligor is liable for a deficiency[58]. This provision should be read together with 9-615.

b) In recourse factoring, after advancing a sum as price for an account the factor (assignee, financier) has the possibility to claim payment from assignor in case the account debtor does not fulfill his obligation on due date. The assignor repurchases the debt and the amount paid back to the factor includes fee and interest.



Source: author's diagram

Figure no. 3 (recourse factoring)

If the account debtor pays in due period to assignee there is no obligation for assignor to repurchase the debt; but if the factor does not receive its payment in due time he has not a claim against account debtor, his only claim is against the assignor. By recourse factoring the factor "provides finance and carries out the functions of sales ledger administration and collections"[59].

It is possible a combination of recourse factoring with credit insurance in order to create a favorable position for both assignor and assignee.

[58] Official Comment 9-608 (3) at 830
[59] *See* Freddy Salinger, *supra note* 49 at 17

Factoring as financing method depend on the strength of receivables used. It depends on the quality of account debtor, assignor, of the industry because a financier's willingness to involve is such transaction is influenced by these elements and greater risk taken, lesser price paid by factor.

Factoring is a quick method to ensure liquidities for companies that are short of working capital, non-recourse form offers the assignor protection against bad debts. However, using factoring the assignor will not obtain the entire payment of the debts because it has to pay fees, taxes, instrument; some debtors may prefer to have a direct contractual relation with the assignor and not to a third party; factoring may also be a 'trap' for the assignor in case the debtor does not pay in due time or become insolvent – if this the situation, assignor is directly liable to the factor. In recourse factoring the factor may ask the right to influence assignor's business in order to avoid non-payment.

It is quite difficult for a factoring company to finance projects whose amount exceeds $100 million[60]; this is so because the debts involved may be complex, concerning big volume of information to deal with, having their origins in different industries. Accepting to finance such projects may be burdensome for factoring companies.

2.1.2.2. Creation of Security Interest on Receivables

Receivables may be used as security in exchange of liquidities and security interest is created over owed receivables. "Security presupposes a repayment obligation and a right to redeem the security by repayment"[61]. Security in receivables creates: i) for the assignor the obligation to repay the debt and the right of regaining upon repayment; ii) for the assignee

[60] *See infra* 2.2.
[61] *See* Tibor Tajti, *supra* note 16 at 98

the right to be repaid for the credit and to ask repayment and an obligation to transfer receivables back to the assignor upon repayment.

In case of creating a security interest in receivables they are not removed from the balance sheet of the assignor because, *de jure* does not operate a transfer of ownership over receivables. As a consequence, the assignor and the assignee are not obliged to comply with Sections 9-406, 9-407, 9-405 of Article 9 and it is not necessary to give notice to the account debtor, but it is needed to register the transfer for security. UCC excludes from the scope of Article 9 the use as collateral. The assignee does not have a direct claim against the account debtor before assignor's default.

The secured creditor (assignee) may ask to be paid upon default of assignor; if the total amount rose from account debtor does not cover the debt, he has the possibility to claim the payment of difference from assignor[62]. In this sense, 9-607 (c) reads: "A secured party shall proceed in a commercially reasonable manner if: (1) undertakes to collect from or enforce an obligation of an account debtor or other person obligated on collateral; (2) is entitled to charge back uncollected collateral or otherwise to full or limited recourse against the debtor or a secondary obligor." The Official Comment of Section 9-601 referring to the "buyers of accounts" shows that "they own the entire interest in the property sold and may enforce their rights without regard to the seller (debtor) or the seller's creditors"[63].

Subsection 9-607 (c) imposes to the secured party the requirement of acting in a commercial reasonable manner. If the assignee has no right of recourse against the assignor 9-607 (c) does not apply; however, the Official Comment extends the condition of commercial reasonableness to a true sale of accounts because "the collection process affects

[62] According to Official Comment 9-607 (2) "collateral consisting of rights to payment is most liquid" asset and is a kind of "property that may be collected without any interruption of the debtor's business" at 827; "the assignee has the right to liquidate the collateral whether or not the collection method was direct or indirect" at 827-828

[63] Official Comments 9-601 (9) at 823

the extent of the seller's recourse liability"[64]. It is possible upon debtor's agreement to collect and enforce assignee's rights even before default[65].

It is possible to use as collateral not only existing receivables but also future receivables[66]; it will be created a floating charge over the debts, which means the assignee does not earn a right over a specific debt but the collateral is given in all assignor's receivables. "The fund retains its identity although its constituents may change from time to time"[67]. That means the assets of a company are fluctuating, they are not the same for the entire period and from time to time they are replaced with other assets. The main element of the floating lien is given by the independence of the assignor's management over the assets[68].

Receivables may refer not only to existing rights to receive payment and include existing rights to ask payment at some time in the future and also future rights to receive payment in the future. The last category is that of future receivables and the assignee takes them into account when a secured interest is created based on the normal course of assignor's business[69].

Oditah refers to the impossibility of transferring something that has not a present existence[70], but it is possible that a present agreement express the intention to transfer future receivables.

Creating security in receivables in order to raise liquidities necessary in the normal course of business or to finance projects may depend on the assignee's capacity of financing, on the strength and the total amount of receivables, on the assignor's business and

[64] Official Comment at 829
[65] Official Comment 9-607 (4) at 828
[66] ROY GOODE, LEGAL PROBLEMS OF CREDIT AND SECURITY at 93 (Thomson Sweet & Maxwell, 3rd ed., 2003)
[67] *See* Fidelis Oditah, *supra note* 24 at 110
[68] *See id.* at 111
[69] *See* Fidelis Oditah, *supra note* 24 at -34; the author speaks about the 'sustainability' of receivables for revolving credit; the normal course of business includes the history of commercial relations, the past cash-flows, the predictions
[70] *See* Fidelis Oditah, *supra note* 24 at 106; this express the rule according to which *nemo ad alium transfere potest quam ipse habet*

management (including former financial results). The amount offered by assignee is lesser than the total value of collateral; the assignee may express his intention of influencing the management of the assignor to be sure that its rights are well protected.

2.1.2.3. Forfaiting

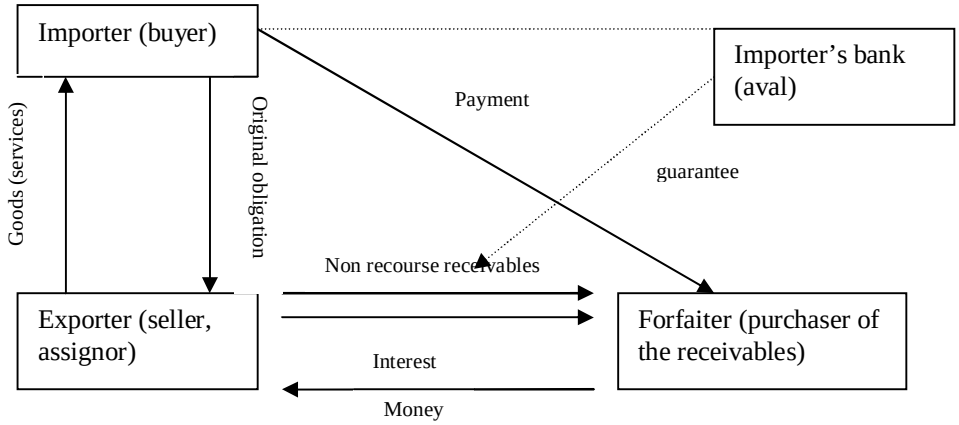
Forfaiting is a financing technique, similar as concept to factoring, used in international commercial relations. The exporter sells on non-recourse basis the receivables (debts owed to him by importer) to the forfeiter; the latter will receive interest from the exporter or from the importer because "forfaiters will insure that the buyer not the seller incurs changes involved in a forfait transaction"[71].

Upon transfer operation, the forfaiter has the right to claim payment from importer or its bank. The purchaser of receivables has the possibility to transfer the debts to another investor, also on a non-recourse basis[72] or to sell them otherwise on the secondary market[73].

It is recommended to use forfaiting in transactions whose total amount does not exceed $ 100,000; this method may be used for a period from six months to five years[74].

First the exporter approaches a forfaiter before finalizing a transaction and after obtaining forfaiter's agreement the exporter will transfer the goods to the importer[75]. The interest rate owed to forfaiter may be included in selling price; afterwards the forfaiter pays according to previous agreement.

[71] *See* John F. Moran, Jr., Forfaiting. *A User's Guide. What It Is Who Uses It and Why*? at 4, available at: www.crfonline.org/orc/pdf/forfaiting.pdf (last visited 1 March 2008)
[72] See *id*. at 1
[73] www.investopedia.com/terms/f/forfaiting.asp (last visited 5 March 2008)
[74] *See* John F. Moran, Jr., *supra note* 71 at 1
[75] *See id* at 4



Source: author's diagram

Figure no. 4 (Forfaiting)

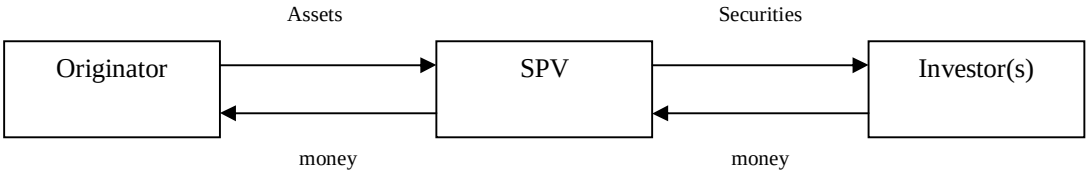
2.1.2.4. Securitization of receivables

Securitization is a complex financial transaction which allows a company to raise liquidities using a different technique than usually (i.e. factoring, sale of receivables, creation of security interest). Through securitization certain assets "with predictable cash flow are pooled and sold to a specially created third party that has borrowed money to finance the purchase"[76]. This means that company's assets are transferred by way of sale to a SPV (special purpose vehicle)[77] which is an independent entity, in order to allow, for bankruptcy purposes, a separation of original assets from the company; the SPV groups these financial assets and issues bonds (securities), selling them on the secondary market or directly to institutional buyers (i.e. banks, investment funds, mutual funds, insurance companies). "Those securities are intended to be payable ultimately and over time from collections on the

[76] Cristian Chetran, Adrian Sacalschi, *Credit Risk Transfer of Loan Portfolio*, at 5 (University of Konstanz, 2004, unpublished)
[77] It is used also "special purpose entity" to denominate the same entity

receivables purchased by the SPV"[78]. Using securitization a company is able to raise capital at a lower interest rate than it would pay in case of issuing securities directly[79], if the SPV gets a superior rating than the initiator.

The basic structure of a securitization transaction looks as follows[80]:



Source: author's diagram

Figure no. 5 (Securitization-basic structure)

All kinds of assets may be, at least at a conceptual level, eligible to be securitized; the limits are imposed by the assets' ability to ensure the buyers of the "future stream of revenues" or of "reasonably ascertainable value"[81]. Securities issued by the SPV may be traded in the market as pass-through securities (the interest and capital are paid to the holders in the received amount and form) or pay-through securities (the notes' holders are paid not in the same amount and form as received; nevertheless the interest and capital are paid from the cash flow generated by the receivables)[82].

The main advantages of securitization are: i) the possibility to raise funds from lenders that otherwise would be inaccessible; ii) the lower rate of interest which has to be paid in comparison with other financing methods; iii) the receivables are erased from the balance sheet of the originator and moved to that of the SPV; thus, the SPV's creditors are not creditors of the seller and the SPV takes over the entire or only part of transaction's risk;

[78] *See* Steven L. Schwarcz, *supra note* 6 at 7
[79] *See id*. at 8; JAMES J. WHITE, SECURED TRANSACTIONS. TEACHING MATERIALS, at 161 (Thomson West, 2nd ed.)
[80] More details will be offered in Section 2.2. of this paper
[81] *See* Cristian Chetran, Adrian Sacalschi, *supra note* 76 at 5
[82] *See* James J. White, *supra note* 79 at 161

iv) "asset/liability management is improved"[83]; v) if the originator is a financial institution, securitization allows it to meet the capital adequacy standards[84].

The following comparison of securitization with other financing techniques, previously presented in this paper, will envisage their main advantages and disadvantages:

i) Outright assignment v. securitization

The outright assignment of receivables imposes as a necessary condition the preexistence of contractual relations between the parties, which is not the case of securitization. It reduces the amount of debts owed to a creditor, but it does not bring capital in form of liquidities to the company. The "collected funds" may be used only to extinguish a certain debt, which again is not the case of securitization.

ii) Non-recourse factoring (sale of receivables) v. securitization

In non-recourse factoring as well as in securitization the assets are erased from the books of the assignor (seller, originator) and the risk is taken over by the buyer who becomes the owner of receivables. The "flows from securitized assets" and those from factoring may be reinvested in "short term investments or in additional loans of similar type"[85].

iii) Recourse factoring v. securitization

The buyer (i.e. factor) has recourse against the seller in case of non-payment or of debtor's insolvency. The buyers of ABS have recourse against the SPV and not against the originator. Both methods provide liquidities for the company. In case of securitization it is also possible the originator not to transfer the entire risk to the SPV; the assignee in factoring may want to get involved and to influence the daily activity of the assignor (debtor).

iv) Secured lending v. securitization

In a securitization transaction the issued securities "rely not on the entire fund of assets of the company or its payment ability, but only on the cash-flow generated by the

[83] *See id.*
[84] *See id.* at 162
[85] Cristian Chetran, Adrian Sacalschi, *supra note* 76 at 7

pooled assets"[86]. Creditors do not have recourse against the originator because the assets are the property of SPV.

2.1.3. Statutory provisions on receivables (financing)

2.1.3.1. Attachment and perfection

Attachment is considered the first step in creation of security interest. "A security interest attaches to collateral when it becomes enforceable against the debtor"[87]. It should be said that attachment regards only the parties involved and the security agreement is not considered a notification opposable *erga omnes.*

For a security interest to be enforceable against the debtor and against third parties it is needed that: i) value has been given; ii) the debtor has rights in the collateral; iii) an agreement was reached.

The agreement has to be in writing as a consequence of the fact that "the formal requisite of writing is in the nature of a Statute of Fraud"[88]. The Official Comment states another reason, namely the prevention of future possible disputes related to the terms of the security agreement[89].

"The debtor must have rights in the collateral" or at least "the power to transfer the rights in the collateral to a secured party". The first part of this prerequisite involves the full ownership of the debtor over the collateral, while the second leads to the conclusion that even the debtor has only limited rights in the collateral is enough in the fulfillment of the second condition. The security interest attaches limited by the principle of *nemo dat quod non*

[86] *Id*. at 8
[87] Section 9-203 (a); upon agreement of the parties this moment may be postponed
[88] See Tibor Tajti, *supra note* 16 at 31, (footnote 41)
[89] Official Comment 9-203 (5) at 670

habet[90]. However, the Official Comments promotes the idea that the second part of this condition should be read *in extenso*; that means not literally, but in a way that allows the debtor to transfer greater rights than he owns[91].

After-acquired property and future advances clauses are valid when the transaction creates a security interest and also a sale of account, chattel paper, payment intangibles, and promissory notes[92]. If the assignment represents a sale of receivables the rules regarding the attachment are not applicable, maintaining within the scope of this section only the creation of security interest.

Attachment to collateral without perfection is not opposable to third parties and is "unenforceable even between the parties"[93] of the transaction.

A security interest perfects under the condition of prior attachment and of satisfying the requirements of Sections 9-310 through 9-316 of UCC. It is also possible a security interest to perfect when attaches if all the prerequisites are fulfilled before the attachment[94]. At the moment of attachment a security interest may be either perfected or unperfected[95]. Perfection does not guarantee to the secure party an absolute protection against other interests because "may become or be subordinated to other interests"[96].

Attachment is a prerequisite for perfection; however, the accomplishment of perfection conditions before attachment is not forbidden and upon attachment the security interest becomes perfected. Section 9-309 enumerates the security interests that are perfected upon attachment without being necessary to fulfill other conditions.

[90] Official Comment 9-203 (6); for the exception from these rule *see infra* 2.1.4.3.
[91] Official Comment 9-203 (6) at 670-671; sometimes debtor's power to transfer rights is limited (i.e. security interest may be given in after-acquired collateral by way of security agreement)
[92] 9-209 (c) excludes from the application of this section the assignment that represents a sale of receivables
[93] See Tibor Tajti, *supra note* 16 at 39
[94] Section 9-308 (a)
[95] Official Comment 9-308 (2) at 694
[96] Official Comment 9-308 (2) at 694

An assignment of accounts or payment intangibles perfects upon attachment, but the text refers only to casual or isolated assignment. The Official Comment excludes from the application of this provision "the person who regularly takes assignments of debtor's accounts or payment intangibles" and indicates further as being mandatory the filing procedure[97]. So, if the assignment involves a "significant part of the assignors' outstanding accounts or payment intangibles"[98] it is needed a filing procedure. Filing is mandatory to perfect a security interest in a beneficial interest in a trust[99].

The rationale for excluding these transactions from the statutory requirement is that "these assignments are not engage in further credit transactions"[100].

Under Section 9-310 (a) is stated the general rule, namely filing is required to perfect a security interest. A perfected[101] security interest that is attached subsequently does not need to be filed in order to maintain its status. According to 9-312 a security interest in chattel paper, instrument and negotiable documents may be perfected by filing. Section 9-312 (e) states the conditions for automatic temporary perfection in certificated securities, negotiable documents and instrument; the security interest in these instruments is perfected without filing or taking possession for a period of 20 days[102].

[97] A sale of payment intangibles and of a promissory note are perfected without fulfill other conditions, 9-309 (3), (4); the same treatment is applied to health care receivables, (9-309 (5)), to a security interest arising in the delivery of a financial asset (9-309 (9)), to a security interest in investment property created by a broker or securities intermediary (9-309 (10)), to an assignment for the benefit of all creditors of the transferor and subsequent transfers by the assignee thereunder (9-309(12))

[98] Section 9-309 (2)

[99] This provision is important in case of SPVs in securitization

[100] *See* Official Comment 9-309 (8) at 698

[101] By filing, by control or by possession, Official Comment, 9-310 (4) at 699

[102] "A security interest in certificated securities, negotiable documents, or instruments is perfected without filing or the taking of possession or control for a period of 20 days from the time it attaches to the extent that it arises for new value given under an authenticated security agreement"; certificated securities are important in the context of securitization

In what concerns the proceeds, 9-315 (c) follows the rule *accesorium sequitur principale* according to which the security interest in proceeds is perfected if the "security interest in the original collateral was perfected"[103].

In Corn Exchange v. Klauder case the court decided that notification of account debtors was a prerequisite in order to permit the assignee to have a perfected interest in receivables; otherwise, a second assignee who notified the debtor would defeat the first assignee. However this rule and the following statutes were repealed by UCC Article 9.

The Official Comment[104] states very clear that the security interest in accounts and intangible payment may be perfected only by filing; therefore perfection by possession or delivery is available only when the collateral is goods, tangible chattel paper, instruments, negotiable documents; perfection by control is available for electronic chattel paper, deposit accounts.

2.1.3.2. Filing

One of the major achievements of UCC Article 9 is the requirement of filing. Before UCC it was not established a necessary filing procedure and Benedict v. Ratner case showed this. It was sufficient an agreement between the parties in order to conclude a valid contract; it should also be noted that the court retained the arrangement as being void because of "unfettered dominion"[105] given to the debtor over the collateral and not because of non-notification.

[103] 9-315 (a)(2) reads: "a security interest attaches to any identifiable proceeds of the collateral"; security interest in proceeds perfects automatically for a period of 20 days; form the 21st day after the security interest attached to proceeds, the security interest becomes unperfected unless legal requirements are fulfilled with (Subsection 9-315 (d))
[104] *See* Official Comment 9-313 (2) at 707
[105] Official Comment 9-205 (2) at 673

Under former version of Article 9 there were set up three alternatives for filing compliance: central filing, local filing or both, "depending on the extent to which the State desires"[106]. In a securitization transaction it could be difficult and costly to satisfy the requirement of local filing for at least two reasons: i) the uncertainty increases; ii) the originator, the SPV and the investors may be situated in different states, so various filing procedures must be fulfilled; further checks on former filings need to be done[107].

As a consequence, Article 9 imposes a central filing for perfection of security interest. The exceptions are limited to minerals and timber, fixtures and transmitting utilities[108].

It is not needed to file the entire security agreement as pre-UCC formalities required; it is sufficient, for the scope of Article 9 that a financial statement contains: the name of the debtor; the name of secured party and an indication of collateral[109].

If the debtor is a trust or a trustee[110], the financing statement should provide "the name specified for the trust in its organic documents or, if no name is specified, the name of the settlor and additional information sufficient to distinguish the debtor from other trusts having one or more of the same settlors"[111]. If the debtor is a registered organization[112] the notice should indicate the name of the debtor[113].

When a representative's capacity of a secured party is not indicated or when the representative of the secured party is not shown in the financing statement, this does not

[106] Official Comment 9-501 (2) at 782
[107] The conclusion of Official Comment expresses a reality: "any benefit that local filing may have had in he 1950's is now insubstantial" at 782
[108] Subsection 9-501 (a)(2)(b)
[109] Subsection 9-502 (a)
[110] This is an indispensable entity for a securitization
[111] Subsection 9-503 (a)(3)(A)
[112] According to 9-102 (a)(70) (70) registered organization "means an organization organized solely under the law of a single State or the United States and as to which the State or the United States must maintain a public record showing the organization to have been organized"
[113] The debtor's trade name is not sufficient to comply with legal requirements; in this sense subsection 9-503 (c) reads: "A financing statement that provides only the debtor's trade name does not sufficiently provide the name of the debtor"

affect the sufficiency of statement. Indication of collateral should provide a description according to 9-108 (a)[114].

A financing statement may be filed before the attachment of security interest and this constitutes a prerequisite for perfection upon attachment.

In a transaction that involves continuing arrangements and a change in collateral (account, chattel paper) notice filing is useful[115]. According to 9-210 (c) the debtor may ask and obtain from secured party further informations about the collateral and the secured obligation; the secured party (not the buyer of receivables) has to comply within 14 days after its reception.

Under former version of Article 9 it was required the debtor's signature to appear on a financing statement; this implied a form of notification of debtor about the assignment and also his agreement to sign; the 1972' amendments eliminated the requirement that a financial statement contain secured party's signature[116].

A financing statement needs to be filed by an authorized person in order to be effective. If a secured party files a statement which covers more than debtor authorized, then the filing is ineffective for what is not included in debtor's authorization[117].

Communication of a record to a filing office and the acceptance of the filing office represent filing[118] of a record[119].

[114] "a description of personal or real property is sufficient, whether or not it is specific, if it reasonably identifies what is described"
[115] Official Comment 9-502 (2) at 784
[116] Official Comment 9-509 (2) at 793
[117] Official Comment 9-510 (2) at 795
[118] Subsection 9-516 (a)
[119] Official Comment 9-516 (2) indicates that record includes: the initial financing statement, assignments, continuation statements, termination statement; at 803

2.1.3.3. Priorities[120]

From a historical point of view the two priority rules of importance were: the majority rule and the minority rule. The first was exposed as "first in time, first in right" rule[121], because the assignor had nothing left to assign to a second assignee[122]. The minority rule offered protection to the first assignee under the condition of giving notice of the assignment to the account debtor; and it protected also the second assignee if he was acting in good-faith and he notified the account debtor before the first assignee, which means he was the first in time as notification giver, despite second as assignee[123].

A buyer of accounts, chattel paper, general intangibles or investment property takes them free of security interest if he gives value in good faith[124] and before the perfection. The Official Comment offers the explanation that a seller of accounts or chattel paper has rights in collateral which a lien creditor may reach as long as the buyer did not perfect the security interest[125].

[120] When engaging in a discussion about priorities in such complex system which regulates the secured transaction, a problem that may arise is that of circular priority; in order to address this problem the courts "have invented ad hoc solutions", the prevailing one granting "distribution in the same way that would be ordered if the circularity has arisen from a contractual subordination"; s*ee* Tibor Tajti, *supra note* 16 at 48-49

[121] In civil law systems this rule is known as *prior temporis potior jure*

[122] *See* Douglas J. Whaley, *supra note* 3 at 7-8; in Salem Trust Co. v. Manufacturers' Finance Co. (264 U.S. 182) (1924), the Supreme Court decided that priority should be granted to the first assignee even if notice was not given to the account debtor; in the court's wording: "mere priority of notice to the debtor by a second assignee, who lent his money to the assignor without making any inquiry of the debtor, is not sufficient to subordinate the first assignment to the second"; in case of accounts receivable "it is not accurate to say that notice is necessary to perfect title in the assignee of a chose in action"; further the curt considered that failure of noticing cannot be considered as necessary or even an element of in the title's assignment; it was also stated that the first assignment passed all rights to the assignee and a "subsequent assignee takes nothing by his assignment", because the assignor is not the owner of those rights anymore; the case is available at: http://supreme.justia.com/us/264/182/case.html (last visited 20 March 2008)

[123] Grant Gilmore refers to this rule as *Dearle v. Hall* rule under which „as between succesive assignees of the same claim, the one who first notifies the debtor of his assignment prevails, even though his assignment is the later in time"; *see* Grant Gilmore, *supra note* 31 at 273

[124] Good faith means without knowing about the security interest; in this sense, Subsection 9-317 (c) reads: "a lessee of goods takes free of a security interest or agricultural lien if the lessee gives value and receives delivery of the collateral without knowledge of the security interest or agricultural lien and before it is perfected."

[125] See Official Comment 9-317 (5) at 718

One should also bear in mind that a security interest arising from sales of payment intangibles notes (9-309) perfects upon attachment[126]. This provision should be read jointly with 9-318 which provides that a "debtor is deemed to have right and title to the account or chattel paper identical to those the debtor sold"[127], only as long as the former buyer does not perfect his security interest. This is the case when a second debtor sells receivables to a first buyer who does not file; subsequently, the same receivables are sold to a second buyer who files. Before perfection of first buyer's interest in receivables the debtor, according to 9-318 (b) has the right and title, therefore second buyer has a senior right[128]. Upon perfection of first buyer the rights of the debtor ceases to exist and the second sale would be ineffective against him. The rule is settled in paragraph (a) of Section 9-318: a seller of receivables cannot retain a legal equitable interest in sold collateral[129].

Another feature of this Section is that there is no delineation between sale transaction and creation of security interest, which means the provisions are applicable equally for sale scope[130].

The general rule of determining priorities is given in 9-322 (a): i) if there are two or more competing perfected security interests, priority shall have first right in time perfected; ii) if a perfected and an unperfected security interest are competing, priority is given to the perfected one; iii) if there are more unperfected competing security interests, priority will have the first attached right.

[126] For securitization this may be a possible problem because it cannot be verified the financial statement
[127] Section 9-318 (b)
[128] Official Comment 9-318 (2) at 719
[129] 9-318 (a) applies to account, chattel paper, payment intangibles and promissory notes, while 9-318 (b) covers only accounts and chattel paper because the other two are perfected upon attachment; 9-318 (a) reads: "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 sold."; this provision is very important in a true-sale securitization because the main objective of the originator is to transfer the assets to the SPV in such that the investors or other SPV's creditor cannot have any recourse against it (originator)
[130] The courts have been left the possibility to decide (considering all given facts) whether a transaction falls within sale or security interest creation

The text refers to filing and perfection because as shown above, in 9-308 and 9-309, it is possible to perfect upon attachment, without being necessary to file, and the filing procedure involves the filing of a financial statement to perfect[131] a security interest[132].

If the debtor and the secured party agree to prohibit a subsequent transfer of the rights to a second secured party, and if the debtor transfers the rights in collateral despite this prohibition, the transfer is valid[133].

If the accounts are proceeds of inventory then 9-324 (b) applies. The Official Comment offers an example to better explain this situation[134]: a debtor creates a security interest in its present and after acquired inventory in favor of a creditor who files a statement covering inventory; a second creditor takes a purchase money security interest in certain inventory and it will have priority in this inventory. If the inventory is sold, the accounts are not subject of PMSI priority and the first filing in time will prevail[135].

Section 9-331 allows a party whose interest is secured with a junior security interest in receivables to have priority over the proceeds of these receivables in front of a senior security interest under the condition the junior creditor is "a holder in due course of the proceeds"[136].

[131] Official Comment 9-322 (4) at 725

[132] This raises another discussion because 9-322 (d) says that "conflicting perfected security interests in proceeds of the collateral (if the security interest was given in chattel paper, deposit accounts, negotiable documents, instruments) and was perfected using other method than filing, have priority according to the moment of filing."

[133] 9-323 (a) and (b) do not apply to the buyer of receivables

[134] Official Comments 9-324 (10) at 735-736

[135] 9-315 applies; the purchaser of chattel paper will have priority according to 9-330 (a) which reads: "A purchaser of chattel paper has priority over a security interest in the chattel paper which is claimed merely as proceeds of inventory subject to a security interest if: (1) in good faith and in the ordinary course of the purchaser's business, the purchaser gives new value and takes possession of the chattel paper or obtains control of the chattel paper under Section 9-105; (2) the chattel paper does not indicate that it has been assigned to an identified assignee other than the purchaser; for an instrument purchaser 9-330 (d) applies: "a purchaser of an instrument has priority over a security interest in the instrument perfected by a method other than possession if the purchaser gives value and takes possession of the instrument in good faith and without knowledge that the purchase violates the rights of the secured party".

[136] Official Comment 9-331(5) at 753

2.1.3.4. Rights of third parties

The fourth part of UCC Article 9 focuses on the rights of third parties of a sale or security interest transactions; even if these persons were not directly involved they may be affected by the transactions. The account debtor is not part of the agreement between assignor and assignee; the assignee is not part of the contract concluded between debtor and assignor; however, both of them rest with rights and obligations from the contracts they were not part of.

The assignee's rights[137] are subject to all terms of the agreement between account debtor and assignor, including any defense or claim of account debtor[138] arising from the said agreement and any defense effective as against the assignor before the account debtor being notified about the assignment[139].

If the account debtor had a claim against the assignor it is possible to assert it against the assignee only to reduce the amount he owes to the assignee[140].

A modification of an assigned contract is permitted and is effective against the assignee if made in good faith; subsequently, assignee acquires corresponding rights under the new contractual clauses[141]. In order to be effective against the assignee, the modification has to comply with two rules: a) the right to payment has not been fully earned; b) the right to payment has been fully earned but the account debtor did not receive the notification of assignment[142]. The modification may be a breach of the assignor's agreement with assignee.

[137] It should also be underlined in the context of securitization that the assignment of health-care receivables is excluded from the application of 9-404, due to the nature and the scope of this type of receivables
[138] This term includes the account debtors on a collateral that is proceeds; See Official Comment 9-404 (5) at 771
[139] Section 9-404 (a); Section 9-403 (b) reads: "an agreement between an account debtor and an assignor not to assert against an assignee any claim or defense that the account debtor may have against the assignor is enforceable by an assignee that takes an assignment: (1) for value; (2) in good faith; (3) without notice of a claim of a property or possessory right to the property assigned; (4) without notice of a defense or claim in recoupment of the type that may be asserted against a person entitled to enforce a negotiable instrument under Section 3-305(a)"
[140] Subsection 9-404 (b)
[141] Subsection 9-405 (a); these provisions are not applicable in case of health-care receivables
[142] Subsection 9-405 (b)

Upon reception of assignment's notification, authenticated by the assignor or by the assignee, the account debtor may discharge its obligation by paying the assignee[143]. The notification must reasonably identify the assigned rights.

The debtor may request the assignee to give "reasonable proof" of the assignment. If the assignee fails to comply, payment made by the assignor is valid, because it was the assignee's duty to present in good time the requested proof. But if assignee offers the debtor "reasonable proof" of the assignment then valid payment should be made to assignee. Anti-assignment clauses are ineffective to the extent that they: i) prohibit, restrict or require the consent of account debtor to the assignment of a security interest in receivables[144]; or ii) provide that the assignment of a security interest may give rise to default, claim, defense[145].

This "infectivity" applies to the sale of accounts and chattel paper[146] as well as to the creation of security interest over chattel paper, receivables, payment intangibles, promissory notes.

Subsection 9-406 (d) may be considered as a natural consequence of business environment enhanced after UCC inaction, because it prevents imposing artificial prohibition to the freedom of contracts and to financial commercial relations in particular.

From the point of view of securitization, the Official Comment address the question of multiple assignments, more specific that of subsequent assignments[147] when the assignee assigns the receivables to a second assignee and so forth. This is not specifically regulated, being left to the common-law rules.

[143] Subsection 9-406 (a)
[144] This subsection covers the accounts, chattel paper, payment intangibles and promissory notes; health care receivables are excluded, according to 9-406 (i)
[145] Subsection 9-406 (d)
[146] Under a *per a contrario* interpretation of 9-406 (e)
[147] Official Comment 9-406 (7) at 775

2.2. Securitization of receivables in the U.S.

Securitization is based on repackaging the asset cash-flows and on issuance of securities[148] which are sold on capital and money markets, in order to allow the originator to raise money at a lower rate of interest than through other methods.

Securitization may have different meanings and it was defined like: i) describing the transmutation of liquid assets into tradable securities[149]; ii) describing any sale of financial assets whether or not involving the creation of securities[150]; iii) describing the process of issuing tradable debts whether or not are backed by receivables[151]; iv) a financing technique "whereby a company transfers rights in receivables or other financial assets to a special purpose vehicle (SPV)[152], which in turn issues securities to capital market investors and uses the proceeds of the issuance to pay for the financial assets"[153]; v) consisting of isolation a pool of receivables and packaging them into securities sold on capital market[154]. Given these definitions it can be said that securitization is a form of structured finance by using of which: i) a company spreads the risk of the collateral among different classes of investors using a special purpose vehicle and the issuance of securities; ii) a company may raise liquidities in capital markets using its receivables for an interest rate below banks' interest rate; it is also a secondary way of financing future projects if banks loan may be considered as a primary modality to finance investments.

[148] See WALID A CHAMMAH, AN OVERVIEW OF SECURITISATION, at 2 (ASSET SECURITISATION, Joseph Norton, Paul R. Spellman (editors), Blackwell Finance, 1991)
[149] See FIDELIS ODITAH, THE FUTURE FOR THE GLOBAL SECURITIES MARKET – LEGAL AND REGULATORY ASPECTS, at 84 (Clarendon Press, Oxford 1996)
[150] *See id.*
[151] *See id.*
[152] Entity with or without legal personality having as object of activity exclusively the issue of asset-backed securities on the basis of a pool of receivables
[153] Steven L. Schwarcz, *THE UNIVERSAL LANGUAGE OF CROSS-BORDER FINANCE*, available at http://www.law.duke.edu/journals/djcil/articles/djcil8p235.htm (last visited 10 February 2008)
[154] *See* James J. White, *supra note* 79 at 158

Receivable financing is used in the U. S. for more than two centuries, contributing to the development of an industry; the law had its important role regulating sale of receivables and creation of security interest over receivables and imposing filing requirements on both.

UCC Article 9 plays a major role in a securitization transaction and its revision[155] was necessary given: i) the fundamental changes in business practices and the development of faster methods of communication[156]; ii) the globalization[157]. Steven Schwarcz points, in one of his articles[158], the importance of Article 9' modifications over securitization: i) the revised Article 9 bring the sale of most of financial assets within its scope because and govern the perfection of financial assets and the priority of SPV against creditors and trustee in bankruptcy, by establishing "clear and pragmatic rules"; ii) revised Article 9 addresses the problem of perfection in two ways: a) by determining the jurisdiction and the applicable law of perfection using the debtor's location; b) by showing clearly where a debtor is deemed to be located; iii) Article 9 clarifies the effect of a negative pledge covenant used in a context of securitization by originators who make negative pledges covenants in favor of SPV; a negative pledge does not prohibit the transfer but constitutes a default by originator[159]; iv) Article 9 "promotes assignability notwithstanding contractual restriction"; anti-assignment clauses are treated different depending on whether the transfer is a sale or a transfer for security.

[155] UCC is not law "as such"; "the Code is adopted on a state-by-state basis; states are free to make changes and this may lead to non-uniform regulations and as a consequence to different courts interpretations, making more difficult to have uniform interpretation of law"
[156] *See* Tibor Tajti, *supra note* 16 at 140
[157] *See id.*
[158] Steven Scwarcz, *The Impact on Securitization of Revised UCC Article 9*, available at http://www.law.duke.edu/globalmark/research/imp_sec_txt.html (last visited 15 February 2008)
[159] a corporation organized under the law of one state is deemed to be located in that state; the new system permits perfection by filing which is different system than the former

UCC Article 9 covers not only the creation of security interest over receivables but also the sale[160] of receivables. In an off-balance sheet securitization the originator sales the receivables to a trust; this transfer falls within the scope of Article 9. This type of securitization is used also to gain high rating for the ABS (asset-backed securities) and this may be better achieved if the sold assets are isolated from the originator in case of bankruptcy. There is a double way protection: originator's creditors cannot reach the ABS and the SPV's creditors cannot claim against the originator.

On-balance sheet securitization may be chosen by financial and credit institution in order to comply with capital adequacy requirement; this originators create a security interest in receivables in favor of a trust (secured party). The assets are not removed from the books of the originators and they are considered debts[161]. Securitization was considered as a method to reduce the loss reserves and the capitalization and to increase the lending capacity through own means of the company, without appeal to external sources[162].

It was stressed the idea that securitization became a used financing method because it allows organizations to raise capital in a manner similar to factoring[163]; the commentary does not stop here and continues saying that "securitization is more cost-effective and requires the companies to continue servicing the paper"[164].

[160] According to 2-106 (1) a sale "consists in the passing of title from the seller to the buyer for a price" and a contract for sale "includes both a present sale of goods and a contract to sale goods at a future time" ; however, before revision of Article 9 in Octagon Gas System v. Rimmer, 995 F.2d 948 (10th Cir, 1993) the court decided that under Article 9 sale of accounts and of chattel paper would give to the buyer only a security interest because these receivables are treated as secured transactions; this was just an isolated way of seeing the assignments of receivables and the revised version repealed this interpretation; Ray Warner, *Lien on Me: Secured Transactions*, available at: http://findarticles.com/p/articles/mi_qa5370/is_200009/ai_n21460203 (last visited: 28 March 2008)

[161] See Walid A Chammah, *supra note* 148 at 7

[162] *See id* at 9

[163] Joel Kurtzman, *Cashing in on Receivables*, available at: http://www.encyclopedia.com/doc/1G1-17776279.html (last visited 5 March 2008)

[164] *See id.*; the pointed elements are correct; however, it may be said that these two techniques target different types of beneficiaries; the continuation of "servicing the paper" is just a possibility for the originator and not an obligation

As a proof of the fact that securitization becomes more common place, Kurtzman[165] gives the example of a bank which takes receivables from large and medium sized companies, pools them together and sells them to investors afterwards. "A number of investment banks can take a pile of messy receivables - $50 million to $100 million or even more, and turn them in a tidy security in under a week"[166]. And just to make an idea about how the system works, it should also be said that buyers of securities may be companies with excess of liquidities, "which swap some of that cash for the receivables of a cash-strapped company"[167].

2.2.1. Forms of securitization

Asset-backed securities (ABS)[168] are "securities collateralized by the cash-flow of a variety of receivables or loans"[169]. For the scope of this paper the term ABS will refer strictly to ABS backed by non-mortgage securities. Receivables that may be used in a non-mortgage backed securitization are:[170] "credit cards, auto loans, boat loans, marine loans, furniture loans, home equity loans, non-performing loans, unsecured consumer loans, manufactured housing loans, auto leases, truck leases, utility leases, computer leases, municipal equipment leases, trade receivables, healthcare receivables, junk bonds, insurance premiums, recreational vehicle loans, political subdivision bonds, political subdivision bonds, utility debt, common stock". Only the imagination of originators and of SPVs may be

[165] *See id.*
[166] *See id.*; this is a good and simple description of how the process works
[167] *See id.*;it is to some extent illogically to consider that a company that has liquidities would like to raise more cash, instead of investing the existing resources to earn a profit
[168] The term ABS may include not only ABS backed by non-mortgage assets, but also mortgage backed securities (MBS)
[169] MARY E. KANE, AN INTRODUCTION TO THE ASSET-BACKED SECURITIES MARKET, at 69 (Lakbir Hayre (editor), *Salomon Smith Barney Guide to Mortgage-Backed and Asset-Backed Securities*, John Wiley & Sons Inc, 2001)
[170] JOSEPH D. SMALLMAN & MICHAEL J.P. SELBY, ASSET-BACKED SECURITISATION, at 242-242 (Davis C. Bonsal (editor)l, *Securitisation*, Butterworth, London, 1990); this is a non-limitative enumeration

the limit in securitize assets. As securities, the ABS credit worthiness is somehow atypical because it has its origin in other sources than the originators or debtors ability to pay[171].

All these assets have a common characteristic: they produce a higher or lower level of cash-flow, element taken into account by investors when deciding to buy bonds backed by this kind of assets. Usually, an ABS transaction involves five main steps: transfer of receivables to the SPV, conversion of receivables into securities, payment of the originator, securities' transfer to investors, payment of investors.

There are two main types of securitization: off-balance sheet ("traditional method") and on-balance-sheet ("synthetic securitization").

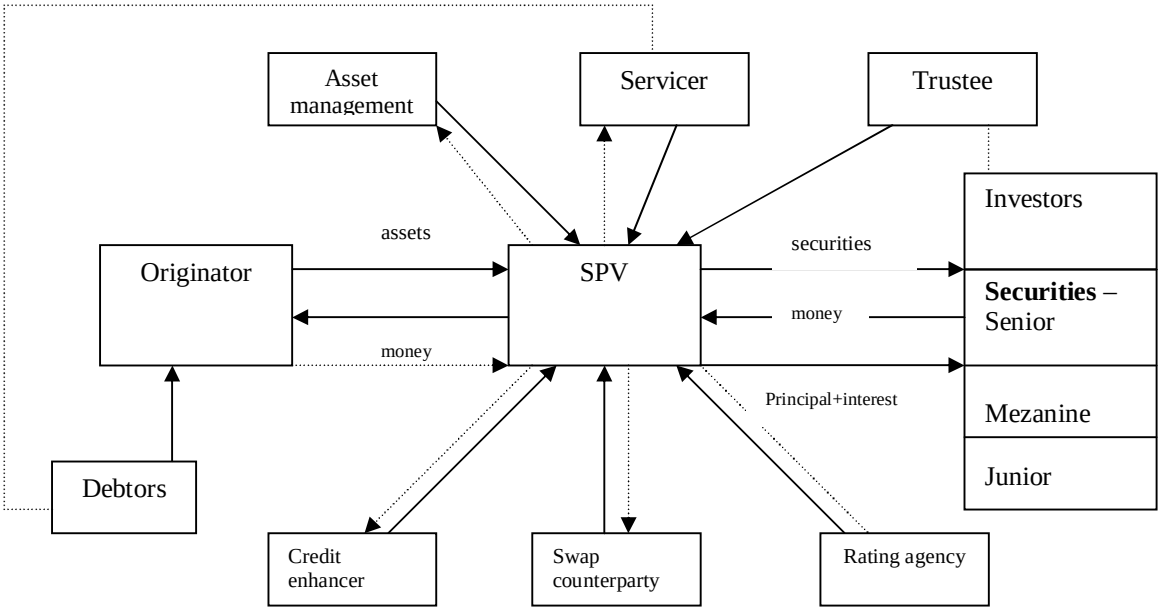
a) Off-balance sheet securitization[172]

Receivables are pooled and the result is a homogenous structure; the assets are selected depending on their performance, on their creditworthiness, on the ability to repay the investors. These assets are transferred to a special entity, SPV; the transfer that involves a sell of receivables leads to a removal of the assets from the balance-sheet of the seller and as a consequence they are registered on the balance sheet of the SPV. It is possible that the originator may continue to act as a servicer, even it is not anymore the owner of the receivables.

[171] Cristian Chetran, Adrian Sacalschi, *supra note* 76 at 12

[172] Delaware is known as a favorite location for SPVs in securitization transactions due to its favorable regulations regarding the securitization; the inaction of Delaware Asset-Backed Securities Facilitation Act (6 Del. C. §§ 2701A-2703A) had the declared scope of construing broadly the term "securitization transaction"; the rules are clearly stating the delimitation between the assets transferred for securitization scope to an entity an the remaining assets in transferor (originator) portfolio; the text reads: "any property, assets or rights purported to be transferred, in whole or in part, in the securitization transaction shall be deemed to no longer be the property, assets or rights of the transferor" (2703A(a)(1)); "in the event of bankruptcy or other insolvency proceeding with respect to the transferor or the transferor's property, to the extent the issue is governed by Delaware law, such property, assets and rights shall not be deemed to be part of the transferor's property, assets, rights or estate" (2703A(a)(3)); in a securitization it is of vital importance for the originator to separate remaining assets from those transferred to the SPV, in order not to allow its creditors to reach the SPVs assets and not to permit the SPV's creditors a recourse against the originator; this separation is important also in rating process because one of the facts assessed by rating agencies is remote bankruptcy; the investors do not want that the that the originator's creditor have any possibility to claim against the SPV; in two of the three examples provided in this paper the trust was set up in Delaware: in Citibank credit card receivables securitization and in Honda Motors auto loan receivables securitization

The bankruptcy of the originator will not affect the SPV; originator's creditors cannot claim against the SPV that is organized as a bankruptcy remote company engaging in activities related only to the scope of securitization: buying assets and issuance of securities. If the SPV is a trust, the transaction is called pass-through and if it is a corporation then we deal with a pay-through transaction[173]. "Most vehicles used in securitization are thinly capitalized, established specifically for the purpose of acquiring the assets to be securitized, the acquisition of which is financed by the issue of loan notes"[174].



Source: www.securitisation .ro

Figure no. 6 (Off-balance sheet securitization)

A grantor trust is established in such way that enables to acquire non-taxable status under U.S. Department of Treasury regulations[175]. In order to attain this scope the trust

[173] Calvin Reis Roy, An Analysis of the Law and Practice of Securitisation, at 18 (PhD thesis, 2003), available at: wlv.openrepository.com/wlv/bitstream/2436/14405/3/ReisRoyPhd%202007.pdf (last visited 25 March 2008)
[174] Fidelis Oditah, *supra note* 149 at 42; author's assertion is not complete because the SPV may have to pay the originator before the issuance of securities and if so it needs to borrow money; only after selling the securities to investors it will be able to repay its own creditors from the "issue of notes"
[175] Calvin Reis Roy, *supra note* 173 at 18

must comply with three prerequisites: "a) must not engage in profitable business: b) must not be empowered to vary the terms of the investment; c) must issue only ownership interest based on a single class of securities."[176] If the trust fails to respect any of these conditions it will be treated as a regular company. In case of grantor trust the income (principal and interest from receivables will pass through to the investors on a pro-rata basis. Credit risk in ABS issued by grantor trust "is mitigated mainly by senior/subordinate security structure and third party insurance"[177].

Master trust is a SPV used to permit the issuer's access to more markets at the same time[178] and to issue/sell securities in consecutive transactions 'backed by the same underlying receivables pool"[179]. This structure allows the use of diverse types of receivables, the issuance of more tranches of securities as consequence of the fact that after each securitization new assets (underlying) are added to the portfolio.

The owner trust is used as a pay-through structure that involves the creation of multiples classes of securities due at different moment in time. While in a pass-through structure it is not allowed to the SPV to reinvest the principal received as payment for the securities, the owner trust has the possibility to increase the collateral (overcollateralisation) offered to the investors and also to maintain the pooled receivables at a constant level.

In an off-balance securitization the SPV will pay for the pooled receivables on the basis of securities sold to the investors or it may pay before issuance of securities from external sources[180].

The servicer[181] transfers to the SPV the principal and the interest paid by originator's debtors[182]. If the debtors do not pay in due time their obligations it might appear

[176] *See id.*
[177] Cristian Chetran , Adrian Sacalschi, *supra note* 76 at 16
[178] Calvin Reis Roy, *supra note* 173 at 19
[179] *See* Cristian Chetran , Adrian Sacalschi, *supra note* 76 at 16
[180] On the balance sheet of the SPV the portfolio appears as assets, while the securities are liabilities
[181] May be the originator or another entity

a delay on the payment of investors. Investors are not granted recourse against the originator. In case of debtors' default or delay in payment it may be used a bank that will cover the short term misuse of liquidities. In order to prevent the currency risk or the floating interest rate it is used swap counterparty[183].

The indenture trustee (agent) has the duty to oversee the entire transaction, to make sure that all involved parties are acting accordingly; it represents and protects the rights of investors. It is possible that the trustee resigns or to be removed if it become insolvent or does not comply with the eligibility conditions; under these circumstances the appointment of a new trustee becomes effective upon its acceptance.

The SPV is a secured party (assignee) of the originator and an assignor for the investors. The SPV has to follow the steps prescribed by UCC Article 9 in order to become a secured creditor. So it has to attach to perfect and to file when so required. It should be kept in mind that the only assets of the SPV are the receivables and it can offer security interest in its only assets. According to sections 9-301 and 9-501 the filing procedure must be completed according to the law of the state where the debtor is located.[184] It was expressed the opinion "the parties have great flexibility in deciding where the trust's place of business is"[185] and by doing this they may decide the applicable law.

The SPV has to file at the originator location and the investors file where the SPV has its place of business. Subsection 9-607 (a)(1) says that after default the secured party "may notify the account debtors to make payments or otherwise render performance to or for

[182] The servicer has a recourse right aganst defaulting debtors
[183] *See* Cristian Chetran , Adrian Sacalschi, *supra note* 76 at 18; swap agreement consists in "an exchange of streams of payments over time according to specified terms"; in an interest rate swap one party agrees to pay a fixed interest rate in return for receiving an adjustable rate from another party"; information available at: http://www.investorwords.com/4838/swap.html (last visited 15 March 2008)
[184] Subsection 9-307 (b)(2) establishes that a "debtor that is an organization and has only one place of business is located at its place of business"
[185] Steven L. Schwarcz, *supra note* 6 at 33

the benefit of the secured party"[186]. In a securitization transaction, default may be any interruption in payment to originator/servicer and further to investors. UCC Article 9 does not define what 'default' means, leaving room for the parties to establish the meaning of this term.

One or more rating agencies[187] will assess "the strength of receivables, the designed mechanism for full and timely payment, credit and liquidity support provided, the relevant legal framework"[188]. This rating is important for investors because it shows to what extent buying securities is a good investment; it should also bear in mind the investors take over the risk of default and their recourse is limited to the issuer, which usually does not have any other assets except the receivables. Rating agencies' role of "market watchdogs" is accomplished by looking at three main areas of risk: a) credit risk of the collateral – this includes an overview of originator's risk and the strength of receivables; b) legal issues – including the "true sale' and its capacity to insulate the originator from the SPV and secondly perfection of the assets; c) cash flow risks - includes the principal and the interest to be paid[189].

In case a class of bond has subclasses it is necessary that the subclasses earn the same rating as the class it is part of[190]. If subsequent securities are issued the rating is subject to possible variations during a securitization and if it deems to be necessary the rating may be improved through credit enhancement. Obtaining triple A rating for the entire issuance or at

[186] Subsection 9-607 (c) reads: "A secured party shall proceed in a commercially reasonable manner if undertakes to collect from or enforce an obligation of an account debtor or other person obligated on collateral"; Subsection 9-607 (a)(2) provides that in case of default the secured party "may take any proceeds to which the secured party is entitled"

[187] For a brief discussion over the liability of rating agencies see Fidelis Oditah, *supra note* 149 at 86

[188] Calvin Reis Roy, *supra note* 173 at 23

[189] Joseph D. Smallman, Michael J.P. Selby, *supra note* 170 at 250

[190] Citibank Credit Card Issuance Trust, Prospectus, 14 February 2001, p. 14; this issue will be detailed below in Section 2.2.3.

least for the superior class of securities is a prerequisite; without this rating is improbable the investors will buy[191].

In a securitization that involves more classes of notes the transaction is structured in such way that superior class gets triple A rating or equivalent, the mezzanine class acquires A or triple B or B or equivalent; the junior (equity)[192] class may be rated, but it includes the most risky assets and the losses of the transaction are firstly supported by this class. The higher rating gets a class, the lower the interest paid, but more stringent conditions imposed by agencies; the higher rated class is the most attractive for investment fund, pension funds and it is based on the volume of transaction. A mezzanine class returns to buyers a higher rate of interest and a higher risk.

b) Synthetic securitization

In a synthetic securitization the main idea is that the originator buys protection for its debts in case of debtors' default. The assets remain on the buyer's balance sheet, only the risk being transferred to SPV and CDS (credit default swap)[193]. The originator/buyer pays a rate of interest to CDS that takes on the risks[194]; the CDS has to pay the buyer if the risk occurs. The originator an the seller establish by agreement which risks will be covered by the transaction. SPV is a CDS junior partner so it has to cover losses up to a certain amount after which the seller has to cover all losses[195].

The SPV issues securities and sells them to investors; with the income, the SPV buys bonds or securities issued by other entities. Main income sources for a SPV are given

[191] Obtaining triple A rating by a company in Romania may be very difficult if not impossible given the general economic relative stability and the fact that the country rating will affect negatively any attempt to obtain triple A or equivalent rating

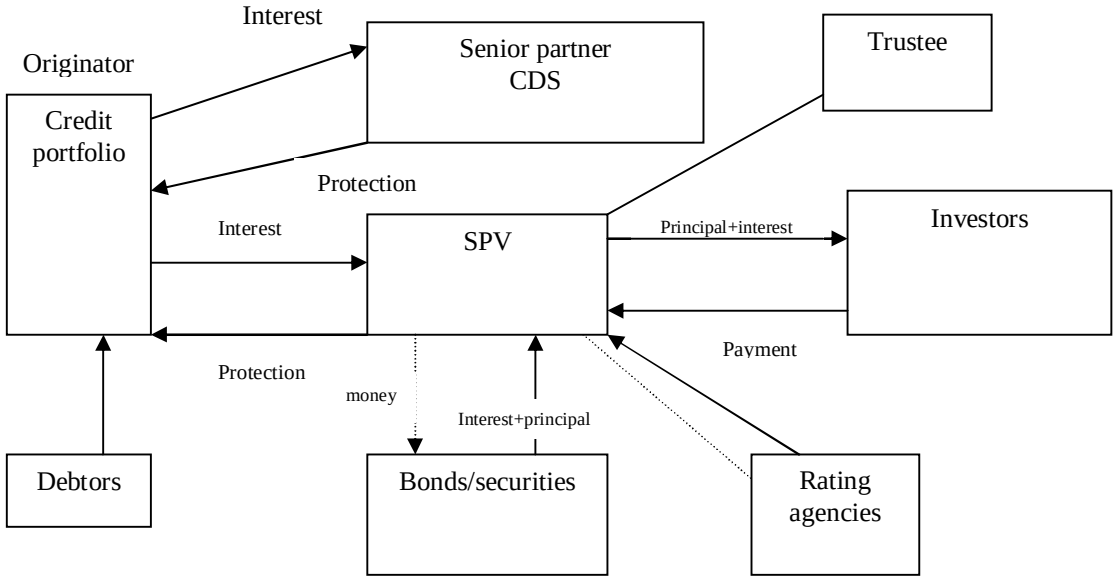
[192] The originator may keep on its balance sheet the junior class of securities; any excess of cash remained after reimbursement of investors will be distributed to the lower class

[193] There are three possibilities: i) if the risk is taken on by the CDS the transaction is totally non-financed; ii) if the risk is taken on by SPV, the transaction is totally financed; iii) if the risk is shared between CDS and SPV the transaction is partially financed; information available at: http://www.securitisation.ro/mechanisms.asp?lang=2

[194] Default or other risks

[195] http://www.securitisation.ro/mechanisms.asp?lang=2

by the interest paid by the originator and the interest paid by bought bond and securities. The SPV has to pay the investors (principal and interest) and also the buyer in case default occurs[196].



Source: www.securitisation.ro

Figure 7 (Synthetic securititzation)

Through credit enhancement the securities may obtain a better rating, which usually has to be higher than that of the originator[197]; a good rating represents a guarantee for investors but may also be a prerequisite because investment funds, insurance companies, pension funds may be required to invest only in triple A rated or equivalent securities.

"The amount of credit enhancement is determined by exposing the pool of receivables to various stress tests"[198]. The scope of these tests is to insure it will be enough liquidity in receivables to permit investors' payment in case of default[199]. Overcollateralisation means

[196] Id.
[197] One of the reasons to securitize is the possibility to acquire superior rating for the securities than the originator itself
[198] Joseph D. Smallman, Michael J.P. Selby, *supra note* 170 at 252
[199] *See id.*

that the total amount of assets placed in securities exceeds their par value. The letter of credit offers to investors and to rating agencies guarantees that in case of default repayment will not be a problem. Through a repurchase agreement the originator agrees to buy back assets at face value[200].

To determine the aggregate cost of the capital in a securitization one should note that in traditional financing methods equity is needed when such calculation is made; however, the SPV, in an off-balance sheet securitization is an independent entity and the equity cost involved in an ABS transaction is less than in traditional methods[201]. Risky assets can be transferred off-balance sheet and this may improve the overall standing of a company[202].

cost of capital = (percentage of equity) x (cost of equity) + (percentage of debt) x (cost of debt)

If the cost of equity[203] exceeds a certain threshold established for a securitization transaction, then this method is less expensive than a so called a traditional one.

2.2.2. Examples of securitization

For the scope of this paper more examples of securitization of two main types of receivables (credit cards and auto loans) there will be presented. Even though credit card and auto loans had encountered high delinquencies in 2007 which led to a change in Fitch's asset performance overview for 2008[204] to declining, these kinds of receivables are two of the most securitized assets[205].

[200] *See id.*
[201] Joseph D. Smallman, Michael J.P. Selby, *supra note* 170 at 244-246
[202] *See id.* at 247; it is offered the example of Credit Commercial de France that removed $ 500 million in risky assets by way of securitization
[203] This formula is availabe in Walid A Chammah, *supra note* 148 at 12
[204] Fitch Ratings, *2008 Global Structured Finance Outlook – Economic an Sector by Sector Analysis* at 2
[205] See Mary E. Kane, *supra note* 169 at 73; in 1999 ABS issuance of credit card had an amount of $ 38 billion, auto loans $ 43.3 billion from a total of 196.2 billion; in 2000: auto loans reached $42 billion, credit card $28.2 billion, from a total issuance ABS amount of $135.6 billion

In 1987 were issued the first securities backed by credit cards and from that moment the growing trend in the industry was obvious. Only a year later took place eighteen public offerings, involving a total amount of issued securities of $ 7.4 billion.

The pool of credit card assets is a revolving pool, which means "repayment may be replaced by new changes and the credit limit may continually be utilized to the maximum limit"[206]. Paid receivables are replaced with new assets which enable the issuers to maintain a more or less constant level of underlying assets; it should also be mentioned that prior reaching the maturity of the transaction the replacement of pooled receivables stops.

A1) Spiegel Inc. Credit Card Receivable Securitization

In a 1988 securitization Spiegel Inc., a retail merchant, securitized $150 million in investor certificate. The scheme[207] of the transaction was as follows:

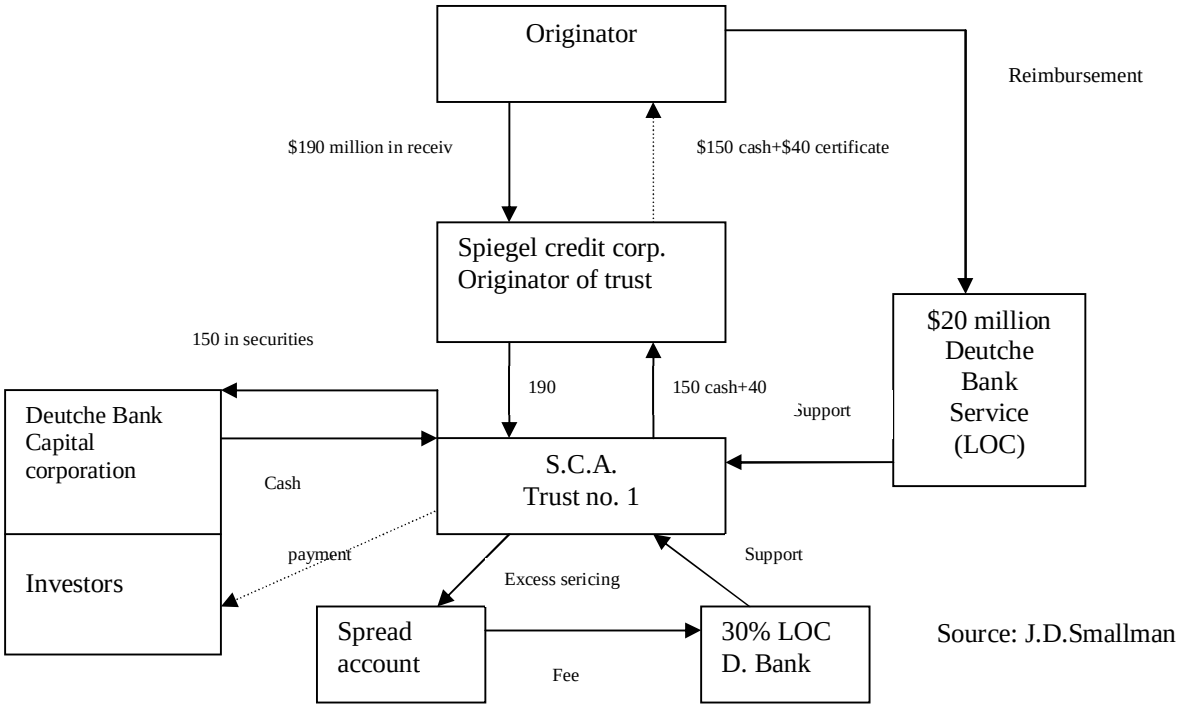


Figure no. 8 (Spiegel Inc. - credit card securitization)

[206] *See id.* at 99
[207] Joseph D. Smallman, Michael J.P. Selby, *supra note* 256

The originator[208], Spiegel Inc. sold credit card receivables with a total amount of $190 million[209] to an originator of trust to insulate the receivables from the reach of originator's creditors. Secondly, the originator of trust sold the pooled assets to Trust no. 1; the latter issues securities[210] of $ 150 million worth to DBCC; in turn DBCC transfers cash to the Trust no. 1, which subsequently transfers this amount with a seller certificate of $40 million to the originator.

The originator continues to transfer through the structure to Trust no. 1 the payments received from its debtors. The excess servicing is paid to Deutsche Bank through a spread account for the 30% letter of credit that protects the Trust's cash flow in case of default[211]. The role of additional letter of credit of $20 million is to insure at least for a short period that the trust will not be affected (more precisely its payments to the investors) in case of servicer (originator)'s default.

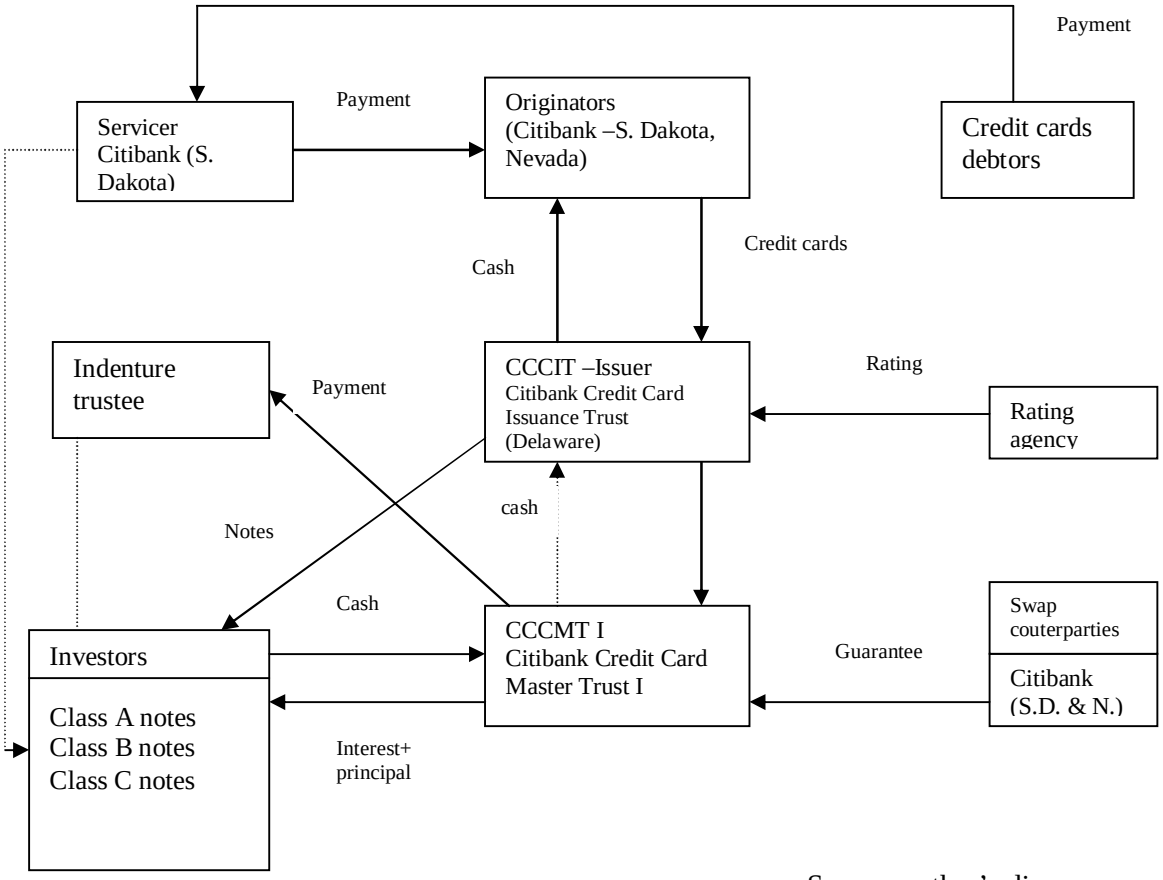
This securitization is interesting because the payment of investors is structured on two stages: the first one of 36 months when only interest (principal not) is paid and the second of 12 months when interest is paid and also one twelfth of the principal each month

A2) Citibank Credit Card Issuance[212]

In February 2001 Citibank Credit Card Issuance Trust released the Prospectus which contained major part of details of issuance of three classes of securities through securitization of credit card receivables belonging to Citibank (South Dakota) N. A. and to Citibank (Nevada) National Association.

[208] The originator is used as servicer in this securitization
[209] Due to this sale the transaction was treated as off-balance sheet, for tax purposes
[210] Standard & Poor's and Moody's rated the issue of securities with triple A, this while Spiegel Inc. was an unrated company.
[211] In case of default or of delinquent receivables the trust has to cover 30% x $150 million + $40 million=$85 million, before the investor be affected
[212] All data used under this subsection are provided by the Prospectus from February 2, 2001, Citibank Credit Card Issuance Trust

The notes will be issued in single issuance series or multiple issuance series; the former consists of a series including class A to C notes. The subordinated classes have the maturity date later or at the same time as the senior class. The latter consists of three classes A to C and each of this class may have multiple subclasses and a multiple issuance of notes of B class will be subordinated to those of A class even to the lowest issued notes classified under A class.



Source: author's diagram

Figure no. 9 (Citibank – credit card securitization)

The originators are the Citibank (South Dakota) and Citibank (Nevada) and according to the Prospectus they are the sole owners of the beneficial interests in the issuer[213].

Citibank Card Issuance Trust is the issuer of the notes and is operating as trustee; its manager is Citibank (South Dakota). Issuer will not have to pay federal income tax[214].The proceeds from the sale of a class of notes are paid to the originators[215].

Superior class notes cannot be issued as long as junior class (C or D) were not previously issued in a sufficient amount. Interest is paid on a "interest period" basis which means investors will receive the interest from time to time; the principal will be paid on the spot on the note's expected principal payment date; this date is two years before its legal maturity date[216]. Interest payment on class B notes and class C notes is subordinated to payment on class A notes of the same issuance series.

Citibank Credit Card Master Trust I (CCCMT I)'s only activity is to acquire and to hold trust assets, the proceeds of those assets, to issue certificates and to make distribution of proceeds[217].

The originators are compensated for the transfer of credit card receivables from the cash proceeds received in exchange of issued notes and also from the increased originators' interest in receivables retained and not sold to investors[218]. Given the type of securitized assets on revolving basis, the originator may determine additional receivables to be sold and assigned to the CCCMT I. In case the ratio of principal receivables in the Master trust is

[213] Citibank Prospectus at 29
[214] *See id.* at 100
[215] *See id.* at 29
[216] *See id.* at 3 and 32
[217] *See id.* at 90; its assets are credit card receivables which arise in a portfolio of revolving credit card accounts
[218] *See id.* at 91

lower than required by rating agencies, the originators have the obligation to make a "lump addition"[219].

The notes are secured by shared security interest in the collateral certificate and the collection account[220] and also by security interest in the applicable principal and interest funding subaccounts, in any derivative agreement for a specific class, any supplemental account.

Servicer of the transaction is Citibank (South Dakota) and has to deposit collection on receivables into a collection account maintained on behalf of master trust and to calculate the amounts to be allocated to different classes of notes[221]. The servicer is paid from finance charge collections allocated to each series of master trust certificates before the sum allocation to collateral certificate. Is servicer's responsibility to pay the expenses of the master trust. Issuance trust has to indemnify the Indenture trustee for its activity under the indenture.

Notes' issuance is related to the rating agencies report; the Prospectus imposes a rating no lower than triple A or equivalent fro class A notes, A rating or equivalent for B class notes and triple B or equivalent for class C notes. If needed, the originators may take into consideration the possibility of credit enhancement.

B. Auto loans receivables

Auto loans[222] are the oldest asset used in ABS securitization. Major part of auto loans ABS is supported by prime loans[223]; some are collateralized by loans to sub-prime borrowers[224].

[219] *See id.* at 92
[220] *See id.* at 8
[221] *See id.* at 95
[222] Security interest in motor vehicle have to be noted on the title certificates or to be shown in specific vehicle records; see James J. White, *supra note* 79 at 166
[223] "Debtors with strong credit history"

Honda decided to securitize the auto loan receivables and for this scope selected 104014 financing contracts. The mechanism for a potential client to buy a new Honda or Accura was the following: the client goes to a Honda dealer, where, if it does not pay the entire amount, enters into a financing contract for a period up to five years with Honda Motors. The buyers offer a security interest in the car, the seller offers the car[225].

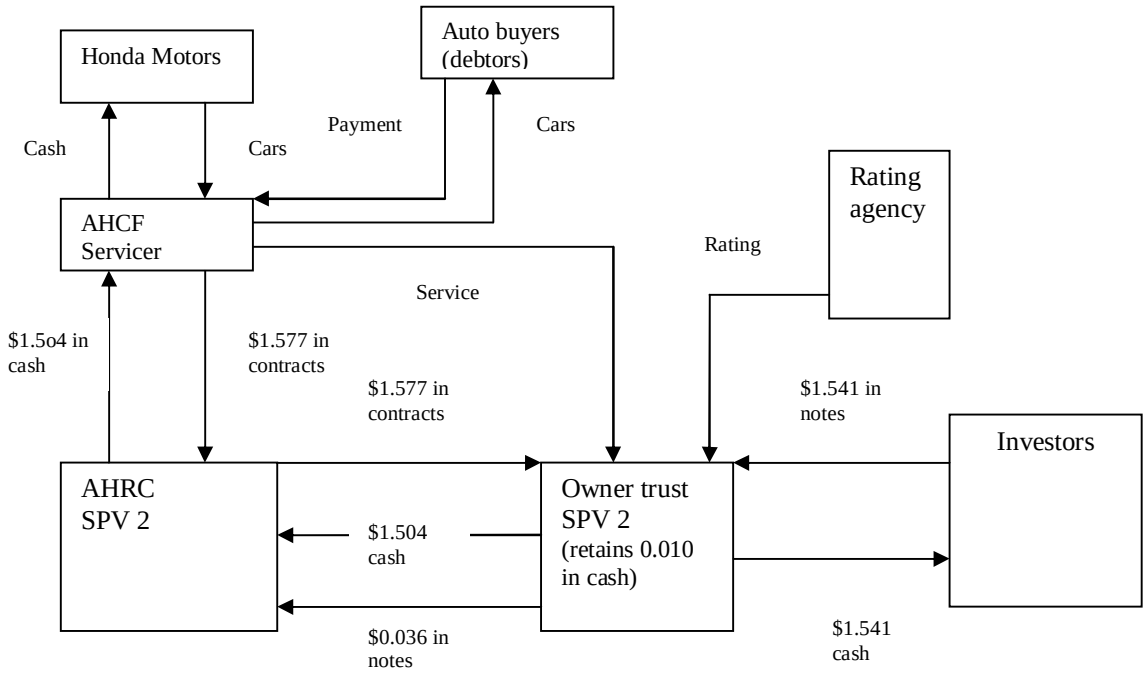
By securitizing this contracts Honda acquires liquidities that allow it to build new cars and at the same time offers the opportunity to borrow for less.

Honda Motors has A- company rating, which is not bad but for its pooled assets has the possibility to get triple A, so to pay less for the same amount[226].

Motor Honda transferred all selected contracts to American Honda Finance Corporation (herein after referred to as AHFC), which is originator and within which Motor Honda has important participation. AHFC sells the contracts to a SPV (American Honda Receivables Corporation – hereinafter referred to as AHRC), that pays $1.54 billion in cash and $0.036 billion in subordinated notes[227]. AHRC transfers $1.577 in contracts to Honda Receivable Owner Trust (herein after referred to as HROT) and receives $1.54 in cash and $ 0.036 in subordinated notes.

As one can see on the diagram, further AHRC Owner Trust (SPV2) issues securities, rated by the rating agencies with triple A to investors; the total amount of issued notes[228] and the received payment in cash from investors is $1.5141 billion. The subordinated notes with a value of $0.036 billion were established considering past records in selecting customers by AHFC. This subordinated are used as subordinated collateral. Other $0.01 billion are returned by HROT as collateral under indenture document.

[224] Cristian Chetran, Adrian Sacalschi, *supra note* 76 at 13
[225] Steven L. Schwarcz, *supra note* 6 at 8
[226] *See id.* at 8-9
[227] *See id.* at 10; AHRC owns the notes but this company is a wholly owned subsidiary of AHFC, so upon the termination of seuritization this amount goes to AMFC
[228] Secured by 104014 financing contracts



Source: Steven L. Schwarcz, *supra note* 6 at 9

Figure no. 10 (Honda auto loans securitization)

AHFC is the servicer for this transaction and transfers the payments from the car buyers (debtors) to the Owner Trust that has to repay investors and also to "manage the consumer contracts"[229]. The notes were structured in four tranches with different maturity dates and different rates of interest to be paid[230]. AHRC is the residual beneficiary of the Owner Trust so all its assets will be taken on by this company upon trust's liquidation.

Honda had the possibility to engage in this securitization due to the fact that AHFC is one of its subsidiaries; in another scenario when the financing contract is concluded with an independent financier the latter has the possibility to securitize the said contracts; this is so because the car seller receives its payment from the financier.

[229] Steven L. Schwarcz, *supra note* 6 at 15; the servicer receives a fee equal to 0.08% of the collected value
[230] *See id. a*t 15

2.2.3. Bankruptcy related matters in the context of securitization

One of the most important features in an off-balance sheet securitization is to insure the SPV's isolation for bankruptcy purposes. This is double way remoteness because on the one hand it provides the impossibility for the originator's creditors to reach the assets transferred to the special purpose vehicle[231] and to satisfy their claims against the originator by recourse to these assets; the investors are concerned about the isolation's existence because they are SPV's secured creditors and they have priority in its assets and the intervention of other creditors claiming rights in the same assets may affect their prevailing position; on the other hand SPV's creditors cannot bring a suit against the originator, claiming rights in its assets.

With the intention of verifying, for bankruptcy purposes, whether the sale was true or not more tests were proposed: i) one of them refers to the necessity that the originator (seller) retains no control in the transferred assets[232], which means, upon sale, it has not the possibility to make any further transaction that involves transferred assets; as a consequence the receivables should be removed from its books; ii) the accounting and tax treatment of the transaction may be an indicator of whether the transfer was a sale or the receivables were transferred for other purposes[233]; iii) in case the investors are not paid according to the prospectus the only part against whom they may raise claims is the SPV[234]; iv) the SPV and the originator should be two distinct entities with different directors, separate business offices, different balance sheets[235]; v) the selling price is another element which may be taken into account, because a too low transaction's value may lead to the conclusion that the

[231] If the transaction is a true-sale this appears like a normal state of facts as long as the transferred assets have been replaced by the payment received from the special entity
[232] See James J. White, *supra note* 79 at 164
[233] *See id.*
[234] Credit enhancement has the role to provide money sources in case the SPV has no resources at a given moment to repay the investors; however, this is a temporary and an emergency solution to facilitate the continuance of the transaction
[235] *See* James J. White, *supra note* 79 at 165

transfer was not a true sale[236]; vi) the separation of the account debtors from the originator (assignor)[237] and consequently of the cash flow generated by payments from the transferor.

Section 301 of the Bankruptcy Code[238] refers to the voluntary petition in bankruptcy, "commenced by the filing with the bankruptcy court" of such petition by the debtor[239]; so, this provision offers the originator or the SPV the possibility to obtain an order for relief if they voluntary file. The other possibility of commencing a bankruptcy procedure is the involuntary petition[240] that may be introduced against a person that is not a farmer or a charity[241]. Upon filing such petition automatic stay operates *de jure*; this means that after complying with sections 301, 302 or 303 of the Bankruptcy Code the commencement or the continuation of judicial or administrative procedures against the debtor, the enforcement against the debtor or against the estate property, the creation, perfection or enforcement of any lien against the estate property, setting off any debt are stopped[242].

[236] Usually the companies are transferring the assets to raise capital so as to continue their activity, but there may be exceptions and the real intention could be of depriving the creditors of their collateral; "a trustee in bankruptcy may recover, as fraudulent conveyance, any amount transferred for less than a reasonably equivalent value if the debtor was insolvent or rendered insolvent at the time of the transfer"; See id., p. 165; Section 548(a)(1) of the Bankruptcy Code offers a description of circumstances under which the trustee may avoid the transfer "of an interest of the debtor in property, or any obligation incurred by the debtor that was made or incurred on or within two years before the date of the filing of the petition": i) the transferor had the intention to deprive its creditors existing or potential; ii) the received amount worth less than "reasonably equivalent"; iii) the transferor was insolvent at the time of the transfer; iv) the transferor became insolvent due to this transfer; v) the transferor involved in another transaction and the remaining capital was too small to allow it to perform properly its contractual obligations; vi) the real beneficiary of the transfer was an insider.

[237] *See* Steven L. Schwarcz, *supra note* 6 at 6; in some transactions the originators remain servicers for the transaction; nevertheless, their rights and duties are strictly provided in the prospectus and they act on behalf of the SPV; this rule is not without importance because the servicer may decide when to make payments, the amount of that payments; and is important to state very clear before the beginning of the securitization that any misconduct will signify breach of contract and will lead to servicer's removal; in fact, the prospectus refer these problems and if the servicer does not perform accordingly it might be held liable

[238] Bankruptcy Code and Related Provisions in *Commercial and Debtor-Creditor Law* (Selected Statutes, 2007 Edition, Thomson West)

[239] The text refers to "entity", which is defined in Section 101(15) as including "person, estate, trust, governmental unit and United States trustee'

[240] Section 303(a) of the Bankruptcy Code

[241] Section 101(41) shows that "individual, partnership and corporation" fall within the meaning of the "person" and the involuntary filing procedure will apply to any other person that is not a farmer or organized as charity; according to section 303(b) an involuntary action has to be filed by "three or more entities" (creditors) if the total number of the creditors exceeds twelve and the "undisputed claims aggregate at least $13,475 more than the value" of any collateral securing the creditors' claims; if there are less than twelve creditor any of them may file the petition under the condition "that holds in the aggregate at least $13,475 of such claims"

[242] See Section 362(a)(1) to (8)

In order to avoid any interference or claim of the originator's creditor against the transferred assets the sale for securitization purposes firstly must be a true sale and secondly there must be observed all the elements which could affect considering the transfer as a true sale (i.e. accounting and tax treatment of the transaction, the selling price, the contractual relation between originator and trust).

CHAPTER 3 - RECEIVABLE FINANCING IN THE CONTEXT OF ABS SECURITIZATION IN ROMANIA

3.1. Receivable financing in Romania

Romanian Civil Code enacted in 1864, that followed the model of Napoleon Code Civil and that of the Belgian Law of 1851, is still in force and contains norms which regulate the legal regime of suretyship, of possessory pledge and of cession[243] of receivables. The legal framework concerning creation of security interest and receivable financing also include the Commercial Code and more specific regulations[244]. However, all these regulations did not create a working coherent mechanism the result being that the access to credit was very limited for individuals and for small and medium sized businesses, situation which led to "lower rates of economic growth"[245]. It was also stated that "limited access to credit has been generally recognized as constraining growth and aggravating poverty"[246]. Given the new dynamic of economic relations, the pressure of internal market and the pressure put on the internal market by external factors, the interdependence and interference of Romanian commercial relations with the world wide economic network, the growth of financial and capital markets, the demands for an improved legal framework increased and became more stringent than ever before. As a consequence in 1999 was enacted the Law no. 99[247], which in Title VI regulated the security interest regime[248]. This law followed the model

[243] The language used by the Civil Code is different form that used in Common-Law system; this language is specific for a civil law system; its equivalent is attachment and this term will be used in this paper when refer to cession of receivables

[244] Laws, emergency government ordinances, government ordinances, government decisions

[245] Nuria de la Pena, Heywood W. Fleisig, *Romania: Law on Security Interests in Personal Property and Commentaries*, No. 2, Review of Central and East European Law, 2004 at 133; real estate was considered the only viable kind of collateral because the filing and publicity system concerning this type of property was a functional one and the law offered protection to the creditor's rights (the creditor was secured); before enacting the Law no. 99/1999 collateral in movable property was possible only in form of possessory pledge

[246] *See id.* at 133

[247] The Law no. 99 of 1999, Title VI of the law regulates the regime of Security interest in personal property (*Regimul juridic al garantiilor reale mobiliare*); the Law was published in Official Gazette no. 236 of 27 May 1999, and was modified by the Government Ordinance no. 89 of 2000 and by the Law no. 161 of 2003

of the Uniform Commercial Code – Article 9 and it was considered that "the intellectual challenges in adapting a law to different national circumstances"[249] were formidable. The result was a very actual law, connected with the latest achievements in this field which enabled it to create also an unusual compatibility for a civil law system to the common-law system.

This part of the paper will present the main techniques of financing against receivables in Romania taking into consideration their impact over the industry.

3.1.1. Sale of receivables

a) Cession of receivables[250]

Articles 1391 to 1404 of the Civil Code regulate the transfer of receivables from an assignor to an assignee. The assignor has the obligation to hand over to the assignee the document that embodies his rights (proof of debt[251]) and also to guarantee, at the sale moment, the valid existence of the debt. It is obvious that this rule is not very easy to handle for financiers involved in transactions with more assignors. In order to make opposable as against third parties the transaction, the new creditor has to notify the account debtor about the sale[252]. From this moment the debtor has to pay to the new creditor (assignee); if he had already paid to the assignor before receiving the notification of the transaction the payment is deemed to be valid.

[248] During first three years after its enaction there have been more than 400000 filings; see de la Pena, *supra note* 245 at 146

[249] Rodrigo Chavez, Nuria de la Pena, Heywood Fleisig, *Secured Transactions Reform: Early Results from Romania*, CEAL Issues Brief, September 2004

[250] These provisions were in force before the enactment of Law 99/1999 and are still in force; the cession of receivables refers to the assignment of receivables (sale of receivables), being from this point of view different from the assignment whose scope is to create security interest; Art. 1687 of CC regulates the pledge in receivables

[251] This is the moment when the security debt attaches

[252] The Code gives an alternative to perfection : the account debtor acceptance of the transaction through a notarized document

This ruling does not mention the necessity of a filing register[253] that could permit the assignee to check if the debt was previously assigned or perfected; the effective remittance of the proof of debt (debt security) replaced the necessity of a filing register; for a company involved in thousands of assignments it was money and time consuming to keep a good evidence of each transaction. Another disadvantage of this regulation was that it could not offer public notice to third parties about the sale, only the involved parties knowing the creditor has been replaced[254]. Future receivables may be assigned under the following circumstances: i) the assignor and the assignee agree expressly that the object of their contract is future receivables and these receivables are sufficiently identified at the time of the assignment; or ii) the future receivables are at least identifiable at the agreement moment and they will be able to be identified at the time of arising; iii) the agreement concluded between the parties has to be embodied in a document[255].

It should also be mentioned that the text speaks only about transfer for the scope of selling receivables and does not mention the possibility of creating a security interest in assignor's receivables[256]. From this point of view it is quite a limited and unfavorable method of raising liquidities for a company for at least two reasons: i) when selling receivables the received price may be lower than the difference between the amount of receivables and the interest rate paid to a creditor[257] in case of a loan; ii) it affects the assignor's relations with its clients because some of them are not willing to pay to another creditor.

b) Outright assignment

[253] Under the Law no. 99 of 1999 this inconvenience was removed, because the rules on priority, perfection and enforcement are applicable to assignment of receivables as well
[254] Under the Law no. 99 of 1999 this uncertainty was removed
[255] *See* Mayer Brown, *Securitisation in Romania: Some Legal Issues*, released in January 2008, available at: http://www.securitization.net/pdf/AtAGlance/Romania_Jan08.pdf (last visited 15 March 2008)
[256] However, this problem was solved by the enactment of the Law no. 99 of 1999, *see infra* 3.1.2.
[257] If the assignor would have the possibility to offer a security interest in receivables

The outright assignment[258] regulated by the Articles 1143 to 1153 of Civil Code is used to discharge or to reduce an existing indebtedness in such way to allow two parties which are in the same time creditor and debtor to extinguish existing debts or to reduce these debts. In order for a legal outright assignment to take place it is needed the existence of two reciprocal monetary outstanding debts[259]. When these conditions are not fulfilled the parties may engage in a contractual relation whose scope is to compensate the reciprocal debts each party owes the other[260]. The compensation is different from the US outright assignment in that it cannot be transferred by the assignor to the assignee a debt of a third party (account debtor) and from this point of view the result of using compensation as a method of financing against receivables is limited to the amount a party owes to the other.

c) Novation

Articles 1128 to 1131 of Civil Code refer to novation[261] as being the substitution of the creditor (transferor) with a third party to the initial contract becoming through this agreement the new creditor (transferee). The agreement between the creditor and the third party needs to be concluded in written form; the debtor has to pay its debt to the new creditor because the transferor becomes third party to the initial contract upon agreement. The Supreme Court of Justice ruled that it is not needed a notification to be given to the account debtor[262]; this is one element that differentiate the novation from cession of receivables and through which the legal provision that impose the notification of the account debtor may be avoided. Another type of novation involves the substitution of the old debtor with a new one; this substitution is valid even if the former debtor has not been notified or if he does not

[258] The Code's language refers to compensation
[259] This are the conditions imposed for a legal compensation
[260] Mariana Rudareanu, The Obligations – Responsibility at 117 (*Obligații – Responsabilitatea*, Fundația România de Mâine, București, 2007)
[261] This operation is known in common-law system too: "A novation is the substitution of a third party as lender under the loan agreement, the original lender giving up his rights and being relieved of his obligations. This requires the assent of the borrower unless provided for in the loan agreement", Roy Goode, supra note 66 at 57
[262] SCJ, Commercial Section, Decision no. 1472 of March 21, 2000; information available at: http://www.capital.ro/articole/cesiunea-de-creanta-se-face-cu-o-clauza-in-contractul-de-leasing/101901 (last visited 1 March 2008)

express his acceptance or denial of this operation. The novation as new contract has to contain a new element not mentioned in the former contract, the expressed intention of the party to conclude a novation, the replacement of the old contractual duty with a new one[263]. Novation as financing against receivables technique did not have a substantial impact over the industry.

d) Factoring

The factoring contract is not regulated "as such", despite the fact it became one of the most utilized financing instruments[264] by the Romanian financiers, with a predicted increasing rate of total volume of transactions for 2008 of at least 40% than in 2007[265]. The Law no. 469/2002[266] describes the factoring as a contract concluded between the adherent (assignor) which is a provider of services or a goods' seller and the factor (assignee) which may be a bank or another authorized non-banking financial institution; the assignee has the duty to finance the assignor, to collect the debts and to protect against non-payment risks, while the assignee sells the account receivables and the claims he has against account debtors. This definition comprises the main elements contained by the UNIDROIT Convention on International Factoring (1988) and by that generally accepted in the U.S.[267]

[263] Maria Rudareanu, *supra note* 260 at. 113

[264] According to some unofficial statistics the factoring market in Romania reached in 2007 an amount of 1 to 1.2 billion euro; in this sense: Dan Popa, *Factoring-ul in Romania, de 400 de ori mai mic decat in UE*, available at: http://www.gandul.info/economic/factoring-ul-romania-400-ori-mic-ue.html?3936;271668; Adina Vlad, *Fortis aduce servicii de factoring în România*, available at: http://www.curierulnational.ro/Finante%20Banci/2007-09-05/Fortis+aduce+servicii+de+factoring+in+Romania and *Piata romaneasca de factoring are un potential anual de crestere de 40%*, available at: http://www.banknews.ro/stire/14276_piata_romaneasca_de_factoring_are_un_potential_anual_de_crestere_de_40p.html; EU factoring market was estimated as having a value of 400 billion Euro in 2006

[265] The estimated volume for 2008 is 1.8 billion Euro; the predicted increasing rate is the highest in Romania in comparison with other countries of the region: for the Czech Republic the factoring increasing rate for the first semester in 2007 reported to the same interval of 2006 was 17%, for Hungary was 6%, and for Slovakia was 5%; informations available at: http://www.banknews.ro/stire/14276_piata_romaneasca_de_factoring_are_un_potential_anual_de_crestere_de_40p.html (last visited 4 March 2008)

[266] The Law no. 469 of 2002 for the adoption of measures to strengthen the contractual discipline, modified by the Emergency Government Ordinance no. 112 of 2002

[267] See Freddy Salinger, *supra note* 49 at 1

Factoring implies a cession of receivables (assignment of receivables) from the assignor to the assignee; the latest developments of the industry are related to the inaction of the law regarding the secured transactions because Art. 2 of the above mentioned law states that it (the Law no. 99/1999) applies to the assignments of receivables.

A characteristic of the local market is given by the fact that large businesses prefer to choose a package of services that include not only receivables financing but also risks allocation management and income and debt management; factoring is a useful financing instrument for the suppliers of big retailers with national distribution networks[268].

Factoring is considered an adhesion contract which gives little or no room to negotiate for small and medium sized companies. Usually the factor pays 80% of the total amount of the discounted receivables immediately after conclusion of the contract; the rest of 20% will be paid to the assignor when the account debtor pays entirely the debt; the factor may offer protection against default in payment (for the rest of 20%); factor's services are reimbursed as follows: for the 80% the assignor has to pay a rate of interest (EURIBOR or BUBOR are the main alternatives but it may used LIBOR or other reference interbank interest rate), a variation margin and if the case, a tax for the protection against debtor's default or other non-payment risks; separately the assignor negotiate with the factor the handling charge[269].

The late statistics show an increasing factoring market in Romania[270] as a consequence of the growing demand for liquidities. It may be said that the Romanian businessmen began to discover the facilities of this financing method. In this context it may

[268] http://www.banknews.ro/stire/14276_piata_romaneasca_de_factoring_are_un_potential_anual_de_crestere_de_40p.html
[269] http://www.gandul.info/economic/factoring-ul-romania-400-ori-mic-ue.html?3936;271668 (last visited 4 March 2008)
[270] The improved legal framework has to be taken into consideration as one of the factors that contributed to this result

seem that securitization is a too evolved financing method and the market development level is not the one required by such mechanisms[271].

3.1.2. The new legal framework on security interest

Before enacting the Title VI of Law no. 99 of 1999 the Romanian juridical system offered more possibilities to create a security interest but these regulations were not interconnected with each other having as result a non-functional system[272]. Even though possessory pledge was permitted this did not constitute a viable option for borrowers as long as they cannot use the pledged goods; it is not very convenient for lender either, because it involves supplementary actions like deposit of goods; and the finality of the loan could not be achieved as long as the borrower had not the possibility to use the good(s) to produce value. Another difficulty encountered by the borrowers was that the banks were the main lenders imposing high interest rates, adhesion financing contracts, because they were acting in quasi oligopolistic market. To some extent this problem was solved by using the leasing contracts, but the legal framework still was not very permissive. However, without an effective security interest in movable property the access to credit for individuals as natural persons and for small and medium sized businesses was considerably limited.

The impact of the new regulation was significant over the industry: at the end of 2003 the Archive reported 426,000 security interests (65,000 filings were reported in 2001, and 236,000 in 2002) filed while the bank system reported 73,357 debtors[273]. These statistics lead to at least two conclusions: i) the overall amount of borrowers increased significantly; ii) the non-banking financing institutions began to be an "actor" on the financing market.

[271] *See infra* Section 3.2.
[272] Livia Mocanu, Security interest in movable property, at 16-17 (*Garantiile reale mobiliare*, All Beck, 2004)
[273] Rodrigo Chavez, *supra note 249*; it should also be noted that in 2000 the banks has redistered 18672 debtors, in 2001- 24240 debtors, and in 2002 – 37562 debtors; this are debtros regitered only in banking system

The law covers almost all kinds of receivables; in order to obtain priority it is needed to register the security interest in the Electronic Archive of Security Interest[274]. The security interest constitutes an *in rem* right that secures the performance of any obligations. The security interest grants to secured creditor the right to satisfy the secured obligation with the collateral before any unsecured creditor and before other creditor whose security interest or rights in the collateral have a lower ranking of priority as provided in the law. The security interest may be created with or without dispossession of the collateral from the debtor. Given the American pattern the law permits the creditor, without court intervention, to repossess and sell the collateral if borrower defaults. It authorizes the secured creditor to use self-help[275] in repossessing collateral so long as repossession occurs without breaching the peace[276]. The secured creditor may sell the collateral; if the creditor does not respect the law then penalties shall be applied against him[277].

This subsection of the paper will focus on the main features of the Law no. 99 of 1999 due to its importance as financing against receivables technique and to its direct application in an ABS securitization.

a) Scope

According to Article 1 of the Law no. 99/1999, Title VI[278] this Law "governs the legal framework of security interest aimed at securing the performance of civil or commercial obligations arising from any contract agreed among individuals" or legal entities.

[274] "The rules permit the credit rights in portfolio to change without executing a new security agreement or filing a new notice of the security interest every time the debtor, in course of his business, creates new credits"; dela Pena, *supra note* 245 at 173. "The borrower does not need to change the location at which the payment is made and the lender does not need to notify the debtors. Given the fact that the security interest floats the borrower may replace individual credit rights in the portfolio"; *see id*.

[275] It is a total new element for a civil law judicial system

[276] Without using violence or force

[277] Under these provisions the secured creditors may repossess and sale the collateral in few days; under the normal judicial procedure the shortest term may be a few months

[278] In the article of Nuria de la Pena and Heywood W. Fleisig, *supra note* 245, it is published the translation into English of the above mentioned law (pages 168 to 217); the quotations from the text of the law used in its English version within this paper is using this source, except as otherwise indicated; when references are made

The debtor is "the person obligated to perform the obligation secured by a security interest"[279]; the lessee, the assignor of receivables, and the consignee are covered by this definition. The creditor (secured party) is the person in "whose favor the security interest is created"[280].

The provisions on priority, publicity and enforcement shall apply to: a) all assignment of credit rights; b) conditional sales, trusts and any other legal acts that are intended to guarantee the performance of an obligation with property; c) all forms of rentals; d) the consignment contract; e) warrants and warehouse receipts.(Art. 20) It should be noted that the necessary conditions to comply with for engage in such contracts and the form of the contracts are not covered by this law[281]. The difference between cession of receivables, regulated by Civil Code and the assignment of receivables regulated by the Law 99/1999 is that the latter is a security interest in the cession of receivables[282]; both of them are covered by the priority, publicity and enforcement rules as indicated by the Law no. 99[283]. The Law covers also both type of leasing contracts (financial and operational) and all forms of rentals of movable property (as defined by the Law in Art. 6) concluded for more than one year period.

"All personal property, corporeal and incorporeal, falls within the scope of application of this law"[284]. Further, the Law mentions the goods which fall within its scope; among them, very important from an ABS securitization, there are: shares in public companies and in limited liability companies; "credit balances in deposit accounts, savings accounts, or time deposits"; rights arising from patents, trademarks and other intellectual

to the Law no. 99/1999 it will be understood that they envisage Title VI of the Law which regulates the Security interest in personal property, except as otherwise indicated

[279] Art. 4 (1) (a)

[280] Art. 4 (1) (b)

[281] Radu Rizoiu, *Garanțiile reale mobiliare* at 24 (Security interest in movable property, Universul Juridic, Bucharest, 2006)

[282] *See id.*at 26

[283] In this sense the SCJ, the Commercial section, ruled in Decision no. 2617 of 15 April 2005 that the cession of receivables has to be registered within the Electronic Archive; Radu Rizoiu, *supra note* 281 at 32

[284] Art. 6 (1)

property rights; secured receivables[285]; negotiable instruments; insurance policies; leased or rented movable property. The mention in Article 6 (5) of the goods covered by the law is not limitative having the role to show examples of such goods. The collateral includes the good object of a security interest and its proceeds. The security interest secures any type of present or future obligation to give, to do or to refrain from doing something[286].

b) Creation of security interest

The security agreement is the only legal basis to create a security interest and it has to be done in written form[287] either notarized or not and the debtor must sign it[288]. It was raised the question whether an electronic agreement sighed through digital (electronic) signature may satisfy the requirements of the legal text; the answer was affirmative because the law extends the classic notion of written assignment[289]. This provision may have important impact over the securitization transaction because it allows creation of security agreement even between absent parties[290].

Another very important provision gives the security agreement[291] the power of a writ of execution[292]. This means that in case of debtor's default the secured creditor may proceed to the enforcement of the agreement without having to follow the normal procedure through ordinary courts of justice. In line with this provision, the SCJ ruled in one decision[293] that a security agreement in receivables represents a writ of execution.

"A security agreement may provide for a security interest in future property. The priority against third parties of a security interest in future property ranks from the time of

[285] Before modification the text included unsecured receivables, too
[286] Art. 10 (1)
[287] SCJ, Commercial Section, ruled in Decision no. 2119 of 15 March 2005 that the written form of the security agreement is mandatory, in Radu Rizoiu, *supra note* 281 at 120
[288] Art. 13 (1) and Art. 14 (2)
[289] Radu Rizoiu, *supra note* 281 at 119-120
[290] This kind of agreement is interesting and might be deemed useful for its features when a SPV intends to create a security agreement over receivables in favor of investors
[291] The security agreement must contain the collateral's description, as well as "the creditor' right to collect, on the account of the debt, the fruits and the products of the collateral"; Art. 16 (1), (2)
[292] The language of the law refers to 'executory title'; Art. 17
[293] SCJ, Commercial Section, Decision no. 5117 of 28 October 2005, in Radu Rizoiu, *supra note* 281 at 134

publicity of the security interest (…) even though it may rank from before the debtors acquires a property interest in the collateral"[294]. This disposal has some practical applications in a securitization if we take into consideration the creation of a security interest in credit card receivables and the necessity of priority ranking.

Any agreement which forbids the assignment of receivables or condition their assignment only on the debtor's consent or creates an automatic default upon assignment, is null and void[295].

c) Priority rules and public notice

"The security interest grants to the secured creditor the right to satisfy the secured obligation with the collateral before any unsecured creditor, and before creditors whose security interest or rights in the collateral have a lower ranking of priority"[296]. After a financial statement is filed with the Electronic Archive[297] public notice is given about the creation of a security interest over the collateral. The consequence is that a subsequent creditor filing a financial statement regarding the same collateral is deemed to know his secured right is second in time. In case of securities, the Law provides a derogatory regime establishing that a security interest in securities is valid and offers public notice upon registration in clearing agency's registers.

The assignee who filed the assignment with the archive shall prevail in case another assignee who notified the account debtor or whose assignment was accepted by the account debtor[298] will have a competing claim. It should be noted that Art. 57 (2) requires that the Archive database assign "beyond any doubt" the filing moment, including the day, hour,

[294] Art. 18 (1), (2)
[295] Art. 22 (2)
[296] Art. 9 (2)
[297] The exact denomination is Electronic Archive of Security Interest in Personal Property
[298] Art. 99 (1); "In case of successively assignments, the assignee who has filed first the assignment in the archive, acquires a public ranking of priority against third parties" (Art. 99 (2))

minute and the second of that entry; this may be considered as a supplementary guaranty for the priority in time of filing.

The Law introduces the requirement of filing even for State's privilege for taxes due, in order to gain priority over a secured party's secured interest in collateral; upon filling State's privilege is considered to have priority[299]. However, the filing with the Electronic Archive cannot give validity to a security interest that is void[300]. More court rulings[301] are in line with this provision and consider that a security interest which is not validly created before filing cannot achieve validity through filing; the financing statement creates priority for the valid created security interest; at the filing moment the archive operator does not verify the legality of the security agreement. Art. 49 (2) reads very clear that the "archive must accept financing statements and other records without exercising judgments as to legal sufficiency and other matters. (…) the archive personnel have no right and are not expected to take steps to insure the accuracy of the information contained in the archive".

According to Art. 59 (1) the notice of the financing statement should contain: the names, the residence of both the debtor and the creditor, the collateral, description of the collateral, the period for public notice and if parties decide so, the maximum amount of the secured obligation. Within 40 days after termination of secured obligation the creditor has the obligation to request the archive operator to mention this fact in the Archive[302].

The scope of the Law was to create a single interoperable national system, readily available; the databases should be linked in such way that permits the search or electronic registration of new records at any time from any authorized office.

[299] Art. 36 (1)
[300] Art. 29 (2)
[301] Cluj Court of Appeal, Commercial Section, Decision no. 1178 of 27 November 2001, Decision no. 3999 of 4 May 2004, in Radu Rizoiu, *supra note* 281 at 197
[302] In fact this request's finality is to erase the secured obligation and to show the third parties the goods are free of charge

From the point of view of a securitization transaction, the Law brings a series of necessary 'tools': i) the Electronic Archive permits access to the information through phone and Internet even after the working hours; the public is granted access to the Archive and the possibility to copy necessary information[303]; ii) the person that intends to file a document to give public notice about a possible security interest agreement should send through any means a suitable for filing document; the filing of intention to create a security interest is free of charge and is limited in time to two months; if within this period a security interest is created it will be deemed to have priority from the moment the intention has been filed[304].

d) Enforcement

If the collateral in receivables is assigned, the assignee has to notify in writing the account debtor about the assignment. The notification may be made through a notarized or a simple document[305]; this document must mention the assigned contract, the payable amount, the name of assignee, the method and place of payment. After receiving notification the account debtor has to make valid payment to the assignee. However, the account debtor has the possibility to ask the assignee to present a proof[306] of the assignment; if within 15 days the assignee does not comply with this requirement, the account debtor may continue to pay to the assignor[307].

The SCJ ruled[308] that the assignment of receivables filed through a financing statement with the Electronic Archive cannot be enforced against the assigned debtor as long as notice of the assignment has not been given. The consequence is that non-notified account debtor cannot be obligated by the assignee to make payment to him, but he has to pay to the

[303] Art. 54 (2)
[304] "Within 24 hours of recording a financing statement, every secured party is obligated to send to the debtor a copy of the information sent to the archive" (Art. 58)
[305] For the protection against future claims of the account debtor it is recommended to use at least a recommended letter
[306] The proof of the assignment may be a copy of the assignment contract, or of security agreement, or of filing with the archive
[307] Art. 87 (1), (2), (3)
[308] SCJ, Commercial Section, Decision no. 2868 of 13 May 2005, in Radu Rizoiu, *supra note* 281 at 429

assignor; the problem is that the assignor assigned the receivables to the assignee and given the situation he has no right to ask payment from account debtor; after notification of assignment the assignee may claim payment from debtor. The notification has the role to inform the debtor about the assignment and is not requiring his consent to the assignment; its absence (of the notification) does not affect the validity of the assignment. It should be also pointed out the notification has no effect over the priority rules; the assignment gained the priority upon filing of financial statement.

In case of debtor default the secured creditor has the right to take peaceful possession of the collateral or of its proceeds, "titles or instruments representing these", "without the need for court notice, judicial assistance, or need to pay a fee, tariff, or any tax"[309]. Self-help[310] is an innovation for a civil law system; the required conditions are that this action does not breach the peace, neither physical force or intimidation or any other coercion methods are used against the debtor. When repossess the collateral the creditor may not demand the help of a public official or of a police officer.

Repossession is only an alternative for the secured creditor because he may sell the collateral even the debtor has its possession. The buyer will have the same rights as the seller over the collateral which means the may use self-help in order to gain collateral's possession.

If peaceful repossession is not possible, the creditor may ask a bailiff to enforce his right over the collateral[311].

The security agreement may envisage in case of debtor's default how the creditor may sell the collateral. If such agreement is not concluded the creditor has to sell the collateral in a "commercially reasonable manner that maximizes the net proceeds of the

[309] Art. 63 (1)
[310] Repossession is allowed if the security agreement contains the following statement: "IN CASE OF DEFAULT THE CREDITOR MAY USE SELF-HELP IN TAKING POSSESSION OF THE COLLATERAL", Art. 63 (4)
[311] Art. 67 (1)

sale"[312]. The buyer acquires the ownership of the collateral free of any charge or security interest or encumbrances[313].

3.2. Romanian Law on Securitization of Receivables[314]

The improvement of legal framework undertook by the authorities between 2005 and 2006 included "the securitization package" which comprises the Law no. 31/2006 regarding securitization of receivables[315], the Law no. 32/2006 regarding mortgage bonds and the Law no. 33/2006 regarding mortgage banks. By means of these laws the capital market gets more chances to become more competitive, the development of new financial instruments is encouraged and new financing resources for investors are created.

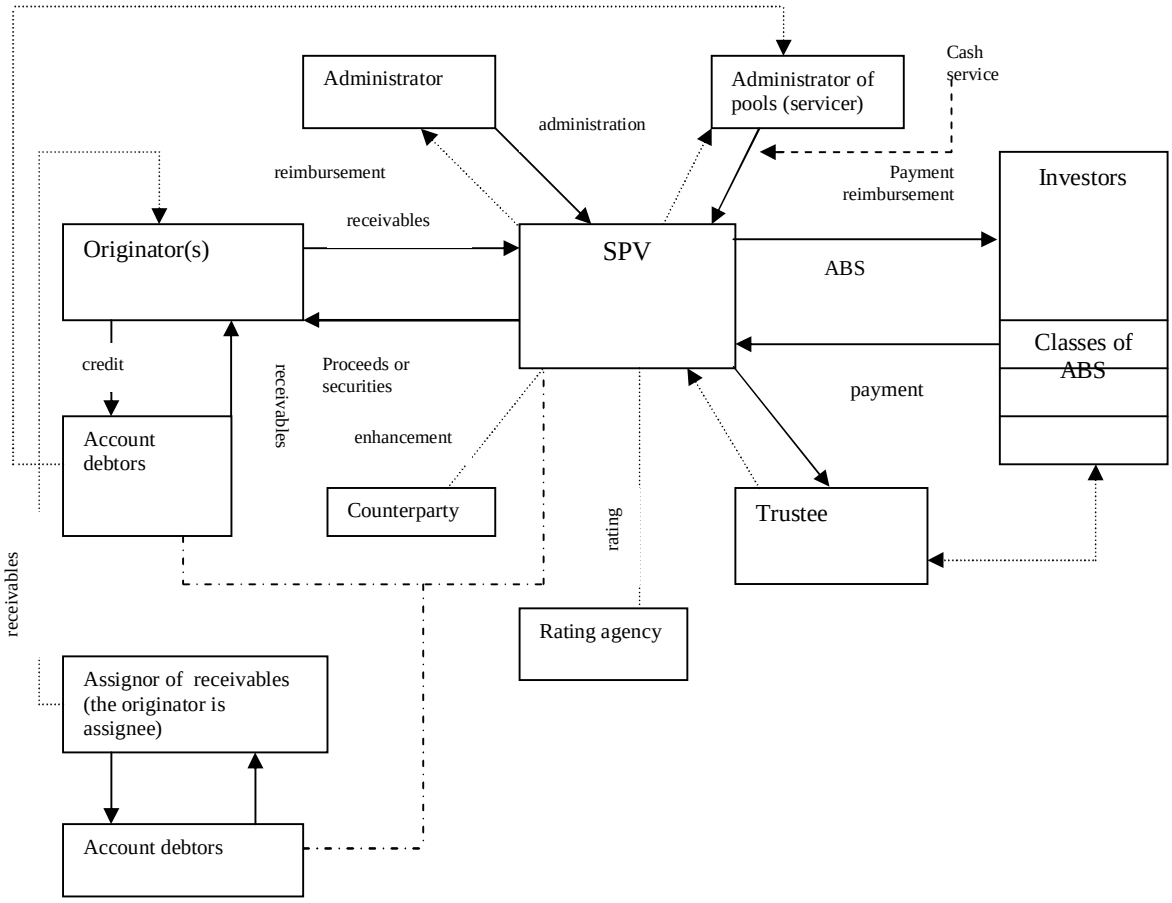
Despite the fact that nearly two years have been passed from the moment of securitization law enforcement, there has not been any such transaction on the local market. One reason may be that this market is not enough developed in order to perform such transaction; another possible reason is that the potential originators have other sources of liquidities or their need of such financing is not critical; a third hypothetical motivation may be related to the possible legal inconsistencies; securitization may still have "secrets" for the addressees of the law due to the fact it is a complex transaction which involves the compliance with specific requirements; the lack of scholars activity in this domain is a sign that at least for the moment securitization of receivables is not a priority on the agenda of possible originators; another factor that leads to such a situation may be the volatility of the financial system and macroeconomic instability[316]. The quality of assets is directly related to the latter reason because in an ABS securitization after underlying assets are sold to the SPV,

[312] Art. 69 (2); the notion of "commercially reasonable manner" is borough from UCC; usually it is based on the creditor's good-faith
[313] Art. 70 (1)
[314] Securities legal regime falls outside the scope of this paper
[315] The Law no. 31 on the securitization of receivables (*Legea privind securitizarea creanțelor*), published in the Official Gazette no. 225 of 13 March 2006, in force from 12 April 2006
[316] Nick Eisinger, Greg Kabance, *Legal Uncertainty in Emerging Market Transactions*, Fitch Ratings, released on 27 February 2007

the transaction has to be rated independently and for emerging economies this is not quite a good news because here the important financiers are banks and they have usually best rating so it will be difficult for a SPV to obtain a better rating for the issue of securities[317].

a) The originator

The Romanian Law on Securitization of Receivables follows the pattern of true-sale securitization which implies a transfer of receivables from the originator or from the creditor to the SPV using cession of receivables. As discussed above[318] the cession of receivables is the term used to designate the assignment[319] with the meaning of selling receivables.



Source: author's diagram

Figure no. 11 (Securitization diagram according to Romanain Law)

[317] Rating is just one possible issue in securitization but is directly related to the quality of assets which at their turn are connected to the general economic situation

[318] *See supra* Section 3.1.

[319] with the sense of sale of receivables not for the scope of creating a security interest

The Law defines the assignor ("creditor") as the owner of present and future receivables which are assigned for securitization to a special purpose vehicle[320]. Assignor may be natural or juridical person because the law does not indicate any limitation. Within the legal text meaning, receivables include: loan contracts, including mortgage loans, auto loans, credit card receivables, leasing contracts, on term sale agreements, installment sale agreements, and equity or debt financial instruments issued in compliance with this law; this are just examples of receivables that may be assigned for securitization because the law considers as falling within this definition any other assignable receivable.

The contract between the originator and the SPV being a sale has to comply with the rules provided by the Civil Code in articles 1391 to 1404, therefore the SPV through its servicer has to give notice about the assignment to the account debtor and also to comply with the rules established by the Law no. 99/1999, because the provisions on priority, publicity and enforcement are applicable to the assignment of receivables. The assignor transfers to the assignee upon assignment all his claims against the account debtor. The assignor has to transfer to the assignee the proof of debt (instrument).

In exchange to the assigned receivables the assignor may receive securities[321]. In case the payment will be made under the condition of issuance of asset-backed securities, *pendente conditione* the assignor will not be reimbursed.

The law does not refer to only one assignor, using the plural form of the noun, "assignors", which lead to the conclusion that in one securitization may be involved more natural or/and legal persons as originators.

b) Special Purpose Vehicle (SPV)

For the scope of defining the SPV the drafters used not less than four different notions. The "issuer"[322] is the SPV authorized by the National Securities Commission to

[320] Art. 3 (4) and Art. 4 (1) of the Law on securitization of receivables; hereinafter this regulation will be referred to as the Law
[321] Art. 11

issue asset-backed bonds and asset-backed units. The "securitization fund"[323] is the SPV without legal personality created on the basis of a civil partnership contract under the terms and conditions of the Law. The "securitization company"[324] is the SPV created as a joint stock company under the terms and conditions of the Law. "Special Purpose Vehicle"[325] is an entity with or without legal personality, whose only activity consists in the issue of asset-backed securities on the basis of a pool of receivables.

The issuers of securities secured with a pool of receivables may be SPVs created either as security funds upon a civil partnership agreement or as securitization companies[326] in form of joint stock companies. In case of securitization fund the civil partnership contract needs to be concluded between at least five founding members, foreign or Romanian natural persons or legal entities; the initial minimum working capital of the fund is 25,000 Euro. The securitization fund is established for the scope of a single transaction[327].

For a SPV to legal involve in a securitization it is needed a National Securities Commission agreement; any subsequent modification to the documents shall be notified to the Commission within five days; if such modifications are contrary to the legal provisions in force and the SPV does not cure such situation within the term established, the Commission may amend, suspend or withdraw the authorization[328].

If the SPV is established as a joint stock company it will need to get the Commission's authorization twice: one before registration and second before engaging in

[322] Art. 3 (8)
[323] Art. 3 (9); the securitization fund issues asset-backed units that are dematerialized equity title tradable on the regulated market
[324] Art. 3 (19); the securitization company issues asset-backed bonds that are dematerialized bonds, tradable on the regulated market
[325] Art. 3 (25)
[326] The registration of securitization company with the trade registry is subject to prior authorization by National Securities Commission, Art. 20; under the Law no. 31 of 1990 on Commercial partnerships a joint stock company is established by the agreement of at least five founding members and the working capital is at least 25,000 Euro or its equivalent in Romanian currency
[327] Art. 17 (1), (2); The SPV cannot have any employees, Art. 13
[328] Art. 16 (1), (2), (3)

securitization; the second authorization seems to be unnecessary and imposing such difficult mechanism will affect the entire process.

c) Assignment of receivables

For the scope of securitization the SPV may acquire individual receivables or pooled receivables from one or more assignors to issue asset-backed bonds or asset-backed units. The assignment of receivables to a SPV without charge shall be deemed null and void[329]. The only purpose of receivables' assignment shall be the issue of securities.

Upon assignment: i) the SPV acquires all claims the assignor had against the account debtor and the security agreement (concluded between assignor and account debtor) maintains its quality as a writ of execution in case of debtor' default; ii) the SPV becomes secured creditor and acquires the right to satisfy the secured obligation with the collateral before any unsecured creditor, and before creditors whose security interest or rights in the collateral have a lower ranking of priority"[330].

The assignment of receivables shall be filed[331] with Electronic Archive prior to the issuance of prospectus. There are established some derogatory rules from the regime imposed by the Law no. 99/1999 and by the Civil Code: i) the assignor (and not the assignee) has the obligation to notify through registered letter the account debtor about assignment[332]; ii) the assignor has to notify its creditors about the assignment, indicating the selling price and the assignee[333]. These provisions are intended to reduce the risk of claiming of assignor's creditors against the transferred assets. The law does not indicate what the sanctions against the assignor in case of non-compliance are, but the agreement between the assignor and

[329] Art. 5 (1), (2)
[330] Art. 9 (2) of the Law no. 99 of 1999
[331] In absence of specific derogatory provisions, the notice of the financing statement should contain: the names, the residence of both the debtor and the creditor, the collateral, description of the collateral, the period for public notice and if parties decide so, the maximum amount of the secured obligation.
[332] It is at least questionable what the drafters' intention was because usually the assignee is the interested party to notify the assignment to the account debtor as long as the courts ruled that not notified assignment cannot be enforced
[333] Art. 8 (1)

assignee may rule this aspect. The assignor has to comply with these requirements even if he receives securities in exchange to assigned receivables. The financing statement creates priority for the valid created security interest so the SPV has the duty to verify the validity of security interest prior to attachment; otherwise it risks a dilution of investors' collateral and a possible non-compliance with its duties.

The assignment of receivables in scope of securitization is a VAT free operation[334].

Each issue of ABS[335] is secured with the cover pool described in the internal cover register of the servicer. Based on such security, the ABS holders shall have the right to satisfy their claims against the issuer by means of enforcing the pool with priority before any other creditor, irrespective of the nature of another's creditor's claims and regardless of whether such creditor would have a security interest or a privilege over the pool or over any component of the pool, if such security interest or privilege has not been registered with the Electronic Archive prior to the perfection of the security interest over the cover pool on behalf of the ABS holders[336].

Asset backed units holders are *de jure* members of the issuing securitization fund.

d) SPV's administrator

The administration of an SPV may be realized only by a joint stock company who's only purposed activity is to administer SPVs, has at least 125,000 Euro working capital, at least two of its major shareholders are financial or credit institutions.

Administrator's main tasks include: SPV's registration with relevant authorities; render administrative services to the SPV; assignment of receivables on behalf of the special purpose vehicle; preparing the document for the issue of securities; compliance with publicity of security interest requirements according to the prospectus; keeping a register to reflect the names of investors (ABS holders); representing the SPV in relation with

[334] Art. 10
[335] ABS includes both the asset-backed bonds and the asset-backed units
[336] Art. 38 (1)

authorities and with third parties; sending periodical reports regarding the transaction to the Securities Commission and to the trustee. The administrator has the possibility to engage on behalf of SPV in agreements with consultancy or financial investments entities, but it cannot devolve all or part of its duties to a third party[337].

e) Cover pool servicer

The servicer of a cover pool has to be organized as a financial or credit institution within the meaning of Emergency Government Ordinance no. 99 of 2006[338]. In case the assignor complies with this requirement it may render services specific to administration of pools[339]. Giving the assignor the possibility to service the pool of receivables the law identifies possible originators: the credit or financial institutions.

The servicer shall be held liable before the special purpose vehicle and the ABS holders for any loss incurred by such persons due to the failure of the servicing company to perform its obligations or to delayed or un-proper performance[340].

The administrator may enter on behalf of the SPV into legal arrangements with one or more servicer, in accordance with the prospectus.

Servicing activities include[341]: i) enforcement of receivables in the cover pool, including the notification of the assigned debtors, calculation and collection of interest and delay penalties, of commission fees and of other dues, as well as collection of the amounts deriving from receivables; ii) custody of the documents evidencing the receivables; iii) monitoring performance of payment obligations of the assigned debtors and restructuring the

[337] Art. 22 (1), (3)
[338] The Emergency Government Ordinance no. 99 of 2006 regarding the credit institutions and the capital adequacy (*Ordonanța privind instituțiile de credit și adecvarea capitalului*), published in the Official Gazette no. 1027 of 29 December 2006, approved by the Law no. 227 of 2007
[339] Art. 23 (1), (3); it should be noted the drafters' intention to allow only institution organized according to the Ordinance no. 99 of 2006 to render pool's administration services, so this may be a supplementary guaranty given to the investors that only professional entities are involved in the securitization
[340] Art. 25
[341] This are just mandatory activities for a servicer; it may engage in other activities related to its scope as well

receivables that no longer fulfill eligibility criteria or have become non-performing[342]; iv) declaration of anticipated enforceability of the claims and enforcement of such claims; v) renewal or deregistration of *in rem* rights created to secure the receivables in the pool; vi) payment of the amounts due to ABS holders out of the collected dues I the pool securing a particular issue. The servicer acts in own name but on behalf of the special purpose vehicle[343].

The servicing company shall keep and maintain for each issue of ABS an internal cover register to reflect the structure and the dynamics of the cover pool it service. The register should contain at least following data in respect to each receivable in the cover pool: identification and specification of category of the document from which the receivable is derived; identification of the assigned debtors; identification of the collateral offered as security; the drawback value, the nominal value and the market value of the receivables. The servicing company shall communicate to the trustee, on monthly basis, a copy of the register, as well as written information regarding the portfolio[344].

All these provisions have the role to offer good information of investors during the entire period of transaction and also to avoid possible wrong conduct of the servicer; investor's interests are promoted and protected by the trustee.

f) Trustee[345]

The collective rights of the investors may be promoted by a trustee. The SPV has the duty to appoint an authorized trustee to verify the correct maintenance of the internal cover register by the servicer; the trustee may not be an affiliated person or the financial auditor of either the servicing company or of the administrator. Trustee services shall be performed by

[342] This is credit enhancement
[343] Art. 28 (1), (2)
[344] Art. 30 (1), (2)
[345] According to the Article 37 the legal provisions of the Law no. 32 of 2006 (on Mortgage Bonds) regarding trustee services for the benefit of mortgage bondholders, with respect to appointment, revocation, its rights, obligations, duties and liability towards investors shall apply accordingly

financial audit companies, credit institutions, financial investment companies, individual or associated law offices, law firms, public notary offices. Some of the trustee's main duties are: to call the general meeting of the investors upon the occurrence and persistence of a breach by the issuer of any obligation undertaken towards the investors; to publish the decision taken by the general meeting of the investors and to ensure enforcement thereof; to represent the ABS holders in front of the SPV, of the public authorities and third parties. The trustee shall exercise its duties using the same degree of care and diligence as for its own affairs[346].

It is very unusual the solution of the drafters: the trustee is appointed and paid by the issuer but its main duties involve the verification of issuer's compliance with the law and with the prospectus; maybe a better solution would have been that of giving the investors the possibility to appoint the trustee as long as it represents their interests; it may be emphasized that the trustee helps the servicing company and the SPV to comply with all requirements but this duty should be seen as related to the principal one, that to protect ABS holders interests.

Art. 42 of the law sets up a special derogatory regime in case of SPV's insolvency giving the general meeting of investors the right to decide upon the vote of 75% of the issued securities value either: i) to sell the portfolios through an auction or through other legal means; or ii) to compensate their debts owed to the special purpose vehicle, without giving notice to third parties about the compensation[347].

The Romanian law on securitization of receivables establishes quite complicated prerequisites for the SPV, and for the SPV's administrator, too; moreover, the SPV is not the beneficiary of a derogatory tax regime[348], therefore it is possible the Romanian originators try

[346] Art. 15 (1) and 16 (1) of the Law no. 32 of 2006

[347] "The insolvency administrator may challenge fraudulent transactions concluded within a general suspect period of three years prior to the commencement of the insolvency proceedings in respect of the assignor"; See Mayer Brown, *Securitisation in Romania: Some Legal Issues*, released in January 2008, available at: http://www.securitization.net/pdf/AtAGlance/Romania_Jan08.pdf, last visited: 15 March 2008

[348] As already explained the transfer of receivables from the originator to the SPV is exempted from the application of VAT

to find and use as special purpose vehicle entities registered under other jurisdictions[349], in a so-called off-shore securitization[350].

[349] Luxembourg may be an example for its permissive legislation concerning the SPV; the Law of 22 March 2004 on Securitization in Luxembourg "introduces the most attractive, regulatory, and tax framework for securitization vehicles in Europe"; see PriceWaterhouseCoopers, *Structuring Securitisation Transactions in Luxembourg*, p. 10

[350] *See* also Mayer Brown Report, *supra note* 347

CHAPTER 4 – CONCLUSIONS

4.1. Comparison between the two systems (Main differences and similarities)

The usage of financing mechanisms as refined processes has longer history in the U.S. than in Romania. Even though not very accurately and disregarding to some extent the obvious difference between a common law system and a civil legal system it could be said that the enactment of the Law no. 99 of 1999 on Security Interest in Personal Property had a significant impact over the industry in Romania as the enactment of Uniform Commercial Code had in United States. And the similarities as between the Law no. 99 of 1999 and the UCC Article 9 are stronger than one could imagine at first sight. However, between the enactments of the two statutory rules there is a difference in time of almost half century; and this difference is transposed in inevitable distinctions between i) the creditors and debtors views over the market and over the financing process as a whole; ii) the maturity of the markets themselves; iii) the existence of a so called "culture of credit" and its absence; iv) the existing contractual relations involving interested parties in financing transactions; v) the willingness of the creditors (i.e. banks, credit institutions) to negotiate contractual terms; vi) the readiness to promote and to get involved in new financing devices as securitization. One step in learning from the American experience was the usage as a model for the secured transaction law of the UCC Article 9; as the drafters of the Romanian law noted, transposing common law provisions in a civil law legal system was not an easy job because many factors had to be taken into consideration (i.e. the necessary coordination with existing provisions, creation of a filing and notice system in accordance with the local custom, enforcement procedure in compliance with the civil law system specificity). The result was one of the most modern secured transaction regulation which promoted totally new devices for a civil law country (i.e. fully electronic filing procedure, self help repossession provisions). In the same time the new Law managed to create a unified system concerning perfection, notice and

enforcement, bringing within its scope creation of security interest as well as the assignment of receivables[351].

From another point of view it might be said that while the American financing market has reached a certain maturity which allow to the investors and to the borrowers to best choose among different services, the Romanian financiers and borrowers are reluctant in using new financing techniques or even in using financing at all. As shown previously in this paper[352] the statistics and the previsions for the factoring market for this year show a boom of the market in this area; in U.S. factoring is considered "an age-old financing technique"[353], whilst Romanian businessmen seem just to discover its benefits.

It should also be noted that for involving in a securitization transaction the originator must have an important amount of receivables and a need of capital in form of liquidities so as to permit it to continue the production process or in case of banks to continue providing credits to new lenders. In the U.S. given the market dimension even medium companies are taking into consideration securitization as a financing method; in Romania it may be inferred that only few major non-banking players (i.e. Petrom, Rompetrol, Transgas) may consider securitizing assets; for Romania, most probably the first originators will be the banks[354] and they will consider securitization because as already shown[355] the demand of the population for credit increased significantly after enactment of the Law no. 99 of 1999.

In the U.S. securitization is created on a contractual basis and therefore the parties have the possibility to best define their rights and their duties; in Romania, as in most civil law systems from the region (i.e. Ukraine, Poland, Russia), securitization is regulated

[351] Following the American pattern, the sale of receivables and creation of security interest in receivables were brought within the scope of the law; the difference from the American model is given by the fact that the Law apply the same regime to assignment and to security interest creation only in what concerns filing, notice and enforcement
[352] *See supra* 3.1.1.
[353] *See* Steven L. Schwarcz, *supra note* 6 at 8
[354] Especially retail banks, specialized in consumer loans
[355] *See supra* 3.1.

through a specific law; this fact causes some limitation of contractual freedom of the parties because they have to comply with the rules settled by the law. The Romanian law on securitization of receivables refers strictly to the true sale securitization.

The concept is identical with that used in a U.S. securitization and includes specific "actors": originator, special purpose vehicle, servicer, trustee, investors, account debtors, SPV's administrator, rating agencies, swap counterparties[356]. Usually, when a company or a bank takes into consideration the possibility to securitize assets it must firstly realize a feasibility study in order to acknowledge the main objectives and constraints of the transaction, to review the historic performance of the assets[357] and to predict the potential cash flow[358].

The originator may transfer to the SPV its own receivables or receivables bought from other different assignors; these methods of constituting the pool of receivables are valid in both systems, American and Romanian. According to the Romanian Law the originator has to be the owner of receivables and the same situation is met in the U.S. in a true sale securitization because the scope, upon assets transfer to the SPV, is to isolate the receivables from the originator; and this is so not only for bankruptcy purposes, but also for tax and accounting scopes. The analysis of portfolio data may include a review of last years of assets performance and for the scope of simulating the possible "conduct" of a given pool of assets, some assets are isolated and their passed performance is studied for a period of three to five years[359]. All these proceedings have the scope of identifying possible misconducts of receivables in order to avoid default and delinquent assets.

[356] Even though the Romanian Law is silent in indicating the rating agencies or the swap counterparties as parties of securitization mechanism, it may be inferred that their presence is not mandatory from a legal perspective but is necessary for convincing the investors to buy securities issued by the SPV
[357] As shown above in Section 2.2.3. in Honda securitization the past performance of the assets was of vital importance in determining the rating of securities and of the necessary guarantees
[358] Price Waterhouse Coopers, *Structuring Securitisation Transactions in Luxembourg*, p. 8
[359] *See id.*

With the intention of making effective the transfer of assets from the originator to the SPV further procedures (i.e. filing, notice) must be complied with in both systems; these requirements have to be fulfilled because in this way the assignment becomes opposable as against third parties and the SPV secures its interest in receivables gaining priority in front of other creditors; in the context of securities issuance compliance with filing and noticing procedures is of utmost importance because the securities are backed by assigned receivables and they represent the only assets of the SPV; in other words, the investors have at their own turn a security interest in receivables created upon securities assignments; and if the SPV does not gain priority or does not file the financing statement it cannot transfer valid created security interests to the investors.

The intervention of rating agencies in a securitization became indispensable in U.S. and it may be said that it will be a necessary element in a securitization in Romania as well. The agencies will rate the issuance of securities taking into consideration multiple and complex factors which may influence the transaction (i.e. the solvability of account debtors, the strength of receivables, past commercial records of the originator, originator's ability to repay debts, strength of security interest over the collateral, the order of priority, SPV' s potential creditors, credit enhancement). Usually, securitization is used when the pooled receivables are in position of gaining a better rating than the originator; this fact leads to a lower rate of interest to be paid by the originator than if borrowing from other sources (e.g. factoring, loans). But securitization may be used by an originator who is collecting receivables through assignment and transfers them to a SPV in order to make some profit; the surplus is given by the difference between the paid sum to the assignors and the amount paid to notes' investors. The rating is also a useful instrument for the investors because it indicates the SPV's ability to repay the loan. A better rating (i.e. AAA) leads to a lower rate of interest paid to the investors but it is related to an improved capacity of repaying the loan. Securities

issue under a lower rating (i.e. B) gives the note holders the possibility to get a superior rate of interest but this is associated to a grater risk of non-payment. It is possible to structure the issue in such way that permits senior and junior rights; in this case the junior rights holders accept to subordinate their claim against the SPV; in this case a higher rate of interest repays also this risk undertook by investors. If there are issued more classes of securities, in case of delinquent receivables or of default, the first affected will be the junior class and the mezzanine class.

Both systems provide that the rights of investors should be protected and promoted by a trustee. In an U.S. securitization the trustee is appointed by the investors, solution that seems to be very logical as long as its main duty regards investors' rights; however, the Romanian legislator imposed that the appointment of the trustee be done by the issuer[360].

Romanian law imposes high requirements for the SPV's administrator[361] and this aspect is not able to determine interested parties to use securitization as financing technique but rather to use another financing method or to use off-shore securitization.

4.2. What should be learnt from the American experience?

The American securitization market began its development in 1970 when the first issue of mortgage backed securities occurred. In 2003 the non-US securitization reached 20% of the overall market volume[362]; this expresses the idea that the leading securitization market is the American one.

[360] The investors have the possibility to remove the trustee and to appoint another one in case of misconduct

[361] Administrator of an SPV may be only a joint stock company who's only purposed activity is to administer SPVs and has at least 125,000 Euro working capital and at least two of its major shareholders are financial or credit institutions; See also Mayer Brown, *Securitisation in Romania: Some Legal Issues*, released in January 2008, available at: http://www.securitization.net/pdf/AtAGlance/Romania_Jan08.pdf, last visited: 15 March 2008

[362] PriceWaterhouseCoopers, *Structuring Securitisation Transactions in Luxembourg*, p. 4

ABS Securitization is just a method of financing against receivables that it should be considered by companies willing to raise money in order to permit them to finance future or on going projects; it is usually utilized by consumer loans banks and manufacturing companies. It was considered that the minimum amount of securitized assets should be situated between $50 and $100 million[363]; for receivables whose amount is under this level other financing processes should be taken into consideration (i.e. factoring, outright assignment, creation of security interest).

An on-going ABS securitization process offers also the possibility to see which are the best types of credit enhancement and to what extent it is possible to use them in a domestic transaction. Lately, the issue of sub-prime lending affected the securities market in the US and a possible lesson may be learnt from this situation; namely, to avoid granting loans based primarily on the prediction of the general status of the economy; if not sufficient guarantees are taken it is possible to encounter a domino effect as happened in the US[364]. And in this case "people are searching for liquidity wherever they can, instead of where they like"[365].

However, securitization showed that it is a viable method of raising liquidities from lenders otherwise considered inaccessible. In a securitization it is important that the pooled assets are independent from the originator and from its commercial history and the SPV may earn a superior rating than that of the originator or even than that of the country.

Securitization, if all necessary steps are followed accordingly, may be an engine for developing economies in countries like Romania. The necessity of funding is the result of

[363] *See* Joel Kurtzman, *supra note* 163

[364] The most important buyers in the market became sellers, trying to get rid of all their owned receivables, and they were not replaced by another buyers; the only buyer in the market are those who have cash but their purchasing power is limited; at the beginning of March 2008 the Carlyle Capital Fund crashed because it could not meet the demands of repayment of lenders; the immediate effect was that the main creditor began to sell its assets u to an amount of $10 billion from a total of $21 billion; See *Fund Blowups Clobbering Secondary Market*, released on 14 March 2008, available at: http://www.securitization.net/article.asp?id=1&aid=8038 (last visited on 14 March 2008)

[365] *See id*.

increasing demand of consumers and as long as the demand does not reach a certain threshold it cannot be inferred that exist a pressing necessity of liquidities. If the banks and the credit institutions have liquidities they will not use securitization so as to raise more money from the market; when the lending entities (including banks) will confront themselves with important demand for credit then they will consider securitization as a possible option.

In the US first issue of securitized securities was backed by mortgage; it is plausible that the first securitization in Romania will be one involving mortgage backed securities instead of asset backed securities. This is so because the volatility of the market affects the investors' willingness to buy notes backed by assets and not by mortgages.

In the US it took nearly 15 years from the first issue of mortgage backed securities until asset backed securities were issued; the issuance of ABS may involve the necessity of a definite level of maturity of the market. On the other hand, in Romania, at least until now, securitization was not seen a viable alternative of financing.

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