Asset Partitioning and Financial Innovation

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Date : March 6, 2019

Ofer Eldar & Andrew Verstein, *The Enduring Distinction between Business Entities and Security Interests*, 92 **S. Cal. L. Rev.** __ (forthcoming 2019), available at SSRN.

While business entities have existed for centuries, their essential nature and forms of utility remain contested matters today. Over recent years, the asset partitioning theory of business entities has become highly influential, yet even for those inclined to accept it, fundamental questions remain unresolved. As Ofer Eldar and Andrew Verstein observe in the paper cited above, security interests likewise function to partition assets for the benefit of particular creditors, yet we lack a nuanced account of when one approach might be preferable to the other. In their paper, Eldar and Verstein develop a compelling foundation for such an account, analyzing these differing modes of asset partitioning and providing a fresh perspective on legal and market dynamics prompting financial innovations that, at least at first glance, appear to "blur the distinction between security interests and entities."

Eldar and Verstein argue that, while business entities and security interests alike possess capacity to order creditors' claims in a manner unachievable through contracts, a critical distinction remains. Whereas business entities create a "floating" priority scheme in the sense that an entity "can always update it to undermine the priority of existing creditors by pledging the assets to additional creditors," security interests create a "fixed" priority scheme favoring "the first perfected secured interest over other claims in the assets." This, they conclude, is why both forms of asset partitioning persist. "Security interests and entities coexist in the world and in particular structures because they offer different and irreplaceable priority schemes for creditors."

So when might one be preferable to the other? Eldar and Verstein style the choice as a trade-off between "evaluation costs" and "managerial discretion." The floating priority associated with business entities will generally appear preferable where one anticipates requiring "flexibility to respond to changing circumstances"—notably, capacity to continue borrowing in the future. The fixed priority associated with security interests, on the other hand, will correlatively appear preferable "when the value of managerial discretion is limited," and "when debt liquidity is critical"—home mortgages being a straightforward example, reducing evaluation costs and facilitating a secondary market by fixing creditors' priority.

After examining and rejecting various other potential distinctions, Eldar and Verstein deploy their floating-versus-fixed framework as a means of understanding "three areas of financial innovation" where this distinction might appear to have substantially blurred. In securitization, captive insurance, and mutual funds alike, the predominant U.S. approach involves heavy reliance on "numerous entities," even though the asset pools are generally constructed "to ensure low evaluation costs and low managerial discretion." Eldar and Verstein argue that, "in all these financial products, the key structural element is actually a security interest or other law that essentially fixes the priority of the creditors," and that entities have become critical solely because, in the United States, "security interests are not bankruptcy remote." In these fields, the proliferation of entities reflects the benefit of insulating the pooled assets they contain from the bankruptcy of a distinct management company, not the need for managerial discretion that would ordinarily render distinct entities attractive.

This insight prompts fascinating comparative points and leads Eldar and Verstein to raise important normative questions that one hopes they will continue to explore in future work. Observing, for example, that a bankruptcy-remote form of security interest under English law has facilitated a form of securitization "without meaningful use of an entity," they reason that similar availability of a bankruptcy-remote security interest would render distinct entities largely superfluous in U.S. securitization, captive insurance, and mutual fund structures alike, eliminating substantial associated transaction costs. In this light, they further argue that the emergence of "protected cell companies" and the like—permitting more granular partitioning of assets within a single entity—reflects demand for more efficient U.S. structures combining fixed priority with bankruptcy remoteness.

"The law would be improved," they conclude, "if it respected the bankruptcy remoteness of security interests in such contexts without requiring the interposition of an entity"—at least "where entity-based bankruptcy remoteness is already feasible." In the meantime, Eldar and Verstein's analysis sheds new light on a range of complex structures and highlights dynamics that will likely continue to drive financial innovation.

Cite as: Christopher M. Bruner, *Asset Partitioning and Financial Innovation*, JOTWELL (March 6, 2019) (reviewing Ofer Eldar & Andrew Verstein, *The Enduring Distinction between Business Entities and Security Interests*, 92 **S. Cal. L. Rev.** __ (forthcoming 2019), available at SSRN), https://corp.jotwell.com/asset-partitioning-and-financial-innovation/.