

**Title:** **SECURITIZATION IS ILLEGAL.**

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#### Abstract

**Under US laws, securitization is illegal, primarily because its fraudulent and causes specific violations of RICO, usury, and antitrust laws.** Securitization of many types of assets (loans, credit cards, auto receivables, intellectual property, etc.) has become more prevalent, particularly for financially distressed companies and companies with low or mid-tier credit ratings. This article focuses on securitization as it pertains to asset-backed securities and mortgage-backed securities, and analyzes critical legal and corporate governance issues.

#### Keywords:

Securitization; antitrust; RICO; constitutional law; capital markets; complexity; fraud.

#### Introduction

Under US laws, securitization is illegal. Indeed many authors have illustrated the deficiencies in securitization.<sup>1</sup> This article focuses on securitization as it pertains to asset-backed securities and mortgage-backed securities<sup>2,3</sup>. The existing literature on legal

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<sup>1</sup> **See:** Yamazaki Kenji, What makes Asset Securitization Inefficient ? (2005); Berkeley Electronic Press, Working paper #603.

**See:** Steven Schwarcz, Enron And The Use And Abuse Of Special Purpose Entities In Corporate Structures, 70 U. Cin. L. Rev. 1309 (2002).

**See:** Carlson D. (1998). The Rotten Foundations of Securitization. William & Mary Law Review, 39:\_\_\_\_\_.

**See:** Lupica L (2000). Circumvention Of The Bankruptcy Process: The Statutory Institutionalization Of Securitization. Connecticut Law Review, 33: 199-210.

**See:** Thomas Plank, 2004, The Security of Securitization And The Future Of Security, 25 Cardozo L. Rev. 1655 (2004).

<sup>2</sup> **On securitization, see:** *Eastgroup Properties v. Southern Motel Association, Ltd.*, 935 F.2d 245 (11th Cir. 1991); *Union Savings Bank v. Augie/Restivo Baking Co.* (In Re Augie/Restivo Baking Co.), 860 F.2d 515 (2d Cir. 1988); In Re Bonham, 229 F.3d 750 (9th Cir. 2000); In Re Central

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*European Industrial Development Company LLC*, 288 B.R. 572 (Bankr. N.D. Cal. 2003); Special Report by the TriBar Opinion Committee, Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions, 46 Business Lawyer 717 (1991);

**See:** Sargent, Bankruptcy Remote Finance Subsidiaries: The Substantive Consolidation Issue, 44 Business Lawyer 1223 (1989).

**See:** *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

On "True-sale" and "assignment" distinctions, **see:** *Major's Furniture Mart, Inc. v. Castle Credit Corporation, Inc.*, 602 F.2d 538 (3rd Cir. 1979); *In re Major Funding Corporation*, 82 B.R. 443 (Bankr. S.D. Tex. 1987); *Fox v. Peck Iron and Metal Company, Inc.*, 25 B.R. 674 (Bankr. S.D. Cal. 1982); *Carter v. Four Seasons Funding Corporation*, 97 S.W.3d 387 (Ark. 2003); *A.B. Lewis Co. v. Nat'l Investment Co. of Houston*, 421 S.W.2d 723 (Tex. Civ. App. - 14th Dist. 1967); *Resolution Trust Corp. v. Aetna Casualty and Surety Co. of Illinois*, 25 F.3d 570, 578 (7th Cir. 1994); *In re Royal Crown Bottlers of North Alabama, Inc.*, 23 B.R. 28 (Bankr. N.D. Ala. 1982) (addressing 'reasonably equivalent value' in transfer by parent to subsidiary); *Butner v. United States*, 440 U.S. 48 (U.S. 1979); *In re Schick*, 246 B.R. 41, 44 (Bankr. S.D.N.Y. 2000); (state law determines the extent of the debtor's interest; bankruptcy law determines whether that interest is "property of the estate").

**See:** Homburger & Andre, Real Estate Sale and Leaseback Transactions and the Risk of Recharacterization in Bankruptcy, 24 Real Property, Probate and Trust Journal 95, (1989).

**See:** *In re Integrated Health Services, Inc.*, 260 B.R. 71 (Bankr. Del. 2001).

**See:** *HSBC Bank v. United Air Lines, Inc.*, 317 B.R. 335 (N.D. Ill. 2004).

**See:** Jonathan C. Lipson, Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?, 11 J. Bankr. L. & Prac. 1 (2002).

**See:** Peter J. Lahny IV, Asset Securitization: A Discussion of the Traditional Bankrupt Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation, 9 Am. Bankr. Inst. L. Rev. 815 (2001).

**See:** Lois R. Lupica, Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic, 9 Am. Bankr. Inst. L. Rev. 287 (2001).

**See:** Lois R. Lupica, Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization, 33 Conn. L. Rev. 199 (2000).

**See:** Lois R. Lupica, Asset Securitization: The Unsecured Creditors Perspective, 76 Tex. L. Rev. 595 (1998)

**See:** Stephen I. Glover, Structured Finance Goes Chapter 11: Asset Securitization by the Reorganizing Companies, 47 Bus. Law 611, 627 (1992).

**See:** Thomas J. Gordon, Securitization of Executory Future Flows as Bankruptcy-Remote True Sales, 67 U. Chi. L. Rev. 1317, 1322-23 (2000).

**See:** *In Re Kingston Square Assocs.*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997)(creditors brought an involuntary petition against an SPV).

<sup>3</sup> On Corporate governance issues pertaining to SPVs and securitization see the following materials:

**See:** *In Re Buckhead America Corp.*, #s 91-978 through 91-986 (Bankr. D. Del, Aug. 13, 1992); *In Re Minor Emergency Center Of Tamarac Inc.*, 45 BR 310 (Bankr. SD.FL., 1985); *Revlon Inc. v. Mac Andrews & Forbes Holdings*, 506 A2d 173 (Del. 1986); *In Re Kingston Square Associates*, 214 BR 713 (Bankr. SDNY 197).

**See:** Sheryl Gussset, A Not-So-Independent Director In A Bankruptcy Remote Structure, 17 Am. Bankr. Inst. J. 24 (1998).

and corporate governance issues pertaining to securitization is extensive, but has several gaps that have not been addressed at all or sufficiently:

- Whether securitization is legal.
- Whether securitization causes usury.
- The standards for usurious loans/forbearance.
- The specific components of cost-of-capital, for purposes of assessing usury violations.
- Antitrust liability in securitization transactions.
- Federal/state RICO liability in securitization transactions.
- The constitutionality of securitization transactions.
- The validity of contracts used in effecting securitization transactions.
- Whether securitization usurps the purposes of the US bankruptcy code.

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**See:** Roberg Dean Ellis, Securitization, Fiduciary Duties And Bondholders Rights, 24 J. Corp. L. 295 (1999).

**See:** Richard Graf, Use Of LLCs As Bankruptcy Proof Entities Widens, National L. J. , April 10, 1995 at B16.

**See:** Schwarcz Steven, Enron And The Use And Abuse Of Special Purpose Entities In Corporate Structures, 70 U. Cin. L. Rev. 1309 (2002).

**See:** Schwarcz, Steven, Securitization Post-Enron, 25 Cardozo L. Rev. 1539 (2004).

**See:** Thomas Plank, 2004 Symposium: The Security Of Securitization And The Future Of Security, 25 Cardozo L. Rev. 1655 (2004).

**See:** Thomas H, Effects Of Asset Securitization On Seller Claimants, Journal Of financial Intermediation, 10: 306-330.

**See:** Nolan, Anthony, Synthetic Securitizations And Derivatives Transactions BY Banks: Selected Regulatory Issues, Journal of Structured Finance, Fall 2006, pp. 40-46.

**See:** American Securitization Forum, ASF Securitization Institute: The Securitization Legal And Regulatory Framework, 2006.

**See:** Yamazaki, Kenji, What makes Asset Securitization “Inefficient” ? Working Paper # 603, Berkeley Electronic Press.

This article seeks to fill these significant gaps in the literature. Although the following analysis is supported with US case law, the principles derived are applicable to securitization transactions in common-law countries and civil-law countries.

In analyzing the legality of securitization, the following criteria are relevant:

- Origins and history of securitization – legislative history, evolution of securitization processes, and current practices. Carlson (1998), Janger (2002) and Lupica (2000)<sup>4</sup> traces the history of securitization to direct and specific efforts/collaborations to avoid the impact of US bankruptcy laws. Klee & Butler (\_\_\_\_\_) and other authors have traced the history of securitization to attempts to handle the problem of non-performing debt.
- Types of contracts used in securitization. The key criteria for enforceability.

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<sup>4</sup> **See:** Schwarcz S. (1999). Rethinking Freedom Of Contract: A Bankruptcy Paradigm. *Texas Law Review*, 77: 515-599.

**See:** Klee K & Butler B (\_\_\_\_). Asset-Backed Securitization, Special Purpose Vehicles And Other Securitization Issues. *Uniform Commercial Code Law Journal*, 35(2):.

**See:** Carlson D (1998). The Rotten Foundations Of Securitization. *William & Mary Law Review*, 39:

**See:** Janger, Edward J, Muddy Rules For Securitizations, *Fordham Journal of Corporate & Financial Law*, 2002.

**See:** Lois R. Lupica, Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization, 33 *CONN. L. REV.* 199 (2000).

**See:** Steven L. Schwarcz, The Inherent Irrationality of Judgment Proofing, 52 *STAN. L. REV.* 1 (1999).

**See:** S. 420, 107th Cong. 912 (2001); H.R. 333, 107th Cong. 912 (2001)

**See:** Steven L. Schwarcz, The Impact on Securitization of Revised UCC Article 9, 74 *CM. - KENT L. REV.* 947 (1999) ("Revised Article 9 attempts to broaden its coverage to virtually all securitized assets.").

**See:** Claire A. Hill, Securitization: A Low-Cost Sweetener for Lemons, 74 *WASH. U. L.Q.* 1061 (1996).

**See:** Yamazaki Kenji, What makes Asset Securitization Inefficient ? (2005); Berkeley Electronic Press, Working paper #603.

**See:** Saayman, Andrea, Securitization And Bank Liquidity In South Africa, Working Paper, Potchefstroom University, South Africa.

**See:** Sargent Patrick, Structural and Legal Issues in Commercial Mortgage Securitization Transactions, November 1, 2004.

- Purposes, wording and scope of applicable laws – state contract laws, state trusts laws, US bankruptcy code, and state/federal securities laws. The legislative intent of the US Congress in drafting and revising the US Bankruptcy Code.
- How the applicable laws are applied in securitization processes – by market participants, regulators and lawyers that represent investors.
- The people, markets, and entities/organizations affected by securitization.
- The usefulness of existing (if any), possible and proposed (if any) deterrence measures designed to reduce fraud/crime/misconduct.
- Transaction costs.
- The results and consequences of application of relevant laws.

#### A. Securitization Violates State Usury Laws.

Securitization violates usury laws, because the resulting effective interest rate typically exceeds legally allowable rates (set by state usury laws).<sup>5</sup> There is substantial disagreement (conflicts in case-law holdings) among various US court jurisdictions, and also within some judicial jurisdictions, about some issues and these conflicts have not been resolved by the US Supreme Court<sup>6</sup>. On these issues, even the cases for which the

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<sup>5</sup> See: Schwarcz S (2004). Is Securitization Legitimate? *International Financial Law Review*, 2004 Guide To Structured Finance, pp.115.

See: Schwarcz S (2002).. The Universal Language Of International Securitization. *Duke Journal Of Comparative And International Law*, 12:285-300.

See: Frankel T (\_\_\_\_). Cross-Border Securitization: Without Law But Not Lawless. *Duke Journal Of Comparative And International Law*, 8: 255-265.

See: Kanda H (\_\_\_\_). Securitization In Japan. *Duke Journal Of Comparative And International Law*, 12: 359-370.

See: Klee K & Butler B (\_\_\_\_). Asset-Backed Scuritization, Special Purpose Vehicles And Other Securitization Issues. *Uniform Commercial Code Law Review*, 35(3):23-33.

See: Higgin E & Mason J(2004). What Is The Value Of Recourse To ABS ? A Study Of The Credit Card Bank ABS Rescue. *Journal Of Banking & Finance*, 28(4):857-874.

US Supreme Court denied certiorari, vary substantially in their holdings. The issues are as follows:

1. What constitutes usury.
2. What costs should be included when calculating the effective cost-of-funds.

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See: Carlson D (1998). The Rotten Foundations Of Securitization. *William & Mary Law Review*, 39:

See: Elmer P (\_\_\_\_\_) Conduits: Their Structure And Risk. *FDIC Banking Review*, pp. 27-40.

See: Dawson P (\_\_\_\_\_) Ratings Games With Contingent Transfer: A Structured Finance Illusion. *Duke Journal Of Comparative & International Law*, 8: 381-391.

<sup>6</sup> See: *Fogie v. Thorn*, 95 F3d 645 (CA8, 1996)(cert. den.) 520 US 1166; *Pollice v. Nationa;l Tax Funding LP*, 225 F3d 379 (CA3, 2000); *Najarro v. SASI Intern. Ltd*, 904 F2d 1002 (CA5, 1990)(cert. den.) 498 US 1048; *Video Trax v. Nationsbank NA*, 33 Fsupp2d 1041 (S.D.Fla., 1998)(affirmed) 205 F3d 1358(cert. den.) 531 US 822; *In Re Tammy Jewels*, 116 BR 290 (M.D.Fla., 1990); *ECE technologies v. Cherrington Corp.*, 168 F3d 201 (CA5, 1999); *Colony Creek Ltd. v. RTC*, 941 F2d 1323 (CA5, 1991)(rehearing denied); *Sterling Property Management v. Texas Commerce Bank*, 32 F3d 964 (CA5, 1994); *Pearcy Marinev. Acadian Offshore Services*, 832 Fsupp 192 (S.D.TX, 1993); *In Re Venture Mortgage Fund LP*, 245 BR 460 (SDNY, 2000); *In Re Donnay*, 184 BR 767 (D.Minn, 1995); *Johnson v. Telecash Inc.*, 82 FSupp2d 264 (D.Del., 1999)(reversed in part) 225 F2d 366 (cert. denied) 531 US 1145; *Shelton v. Mutual Savings & Loan Association*, 738 FSupp 50 (E.D.Mich., 1990); *S.E.C. v. Elmas Trading Corporation*, 638 FSupp 743 (D.Nevada, 1987)(affirmed) 865 F2d 265; contrast: *J2 Smoke Shop Inc. v. American Commercial Capital Corp.*, 709 FSupp 422 (SDNY 1989)(cost of funds); *In Re Powderburst Corp.*, 154 BR 307 (E.D.Cal. 1993)(original issue discount); *In Re Wright*, 256 BR 626 (D.Mont., 2000)(difference between face amount and amount actually recovered or owed by debtor); *In Re MCCorhill Pub. Inc.*, 86 BR 283 (SDNY 1988); *In Re Marill Alarm Systems*, 81 BR 119 (S.D.Fla., 1987)(affirmed) 861 F2d 725; *In Re Dent*, 130 BR 623 (S.D.GA, 1991); *In Re Evans*, 130 BR 357 (S.D.GA, 1991); contrast: *In Re Cadillac Wildwood Development*, 138 BR 854 (W.D.Mich., 1992)(closing costs are interest costs); *In Re Brummer*, 147 BR 552 (D.Mont., 1992); *In Re Sunde*, 149 BR 552 (D.Minn., 1992); *Matter Of Worldwide Trucks*, 948 F2d 976 (CA5,1991)(agreement about applicable interest rate maybe established by course of conduct); *Lovick v. Ritemoney Ltd*, 378 F3d 433 (CA5, 2004); *In Re Shulman Transport*, 744 F2d 293 (CA2, 1984); *Torelli v. Esposito*, 461 NYS2d 299 (1983)(reversed) 483 NYS2d 204; *Reschke v. Eadi*, 447 NYS2d 59 (NYAD4, 1981); *Elghanian v. Elghanian*, 717 NYS2d 54( NYAD1, 2000)(leave to appeal denied) 729 NYS2d 410 (there was no consideration in exchange for loan, and transaction violated usury laws); *Karas v. Shur*, 592 NYS2d 779 (NYAD2, 1993); *Simsbury Fund v. New St. Louis Associates*, 611 NYS2d 557 (NYAD1, 1994); *Rhee v. Dahan*, 454 NYS2d 371 (NY.Sup., 1982); *Hamilton v. HLT Check Exchange, LLP*, 987 F. Supp. 953 (E.D. Ky. 1997); *Turner v. E-Z Check Cashing of Cookeville, TN, Inc.*, 35 F.Supp.2d 1042 (M.D. Tenn. 1999); *Hurt v. Crystal Ice & Cold Storage Co.*, 286 S.W. 1055, 1056-57 (Ky. 1926); *Phanco v. Dollar Financial Group.*, Case No. CV99-1281 DDP (C.D. Cal., filed Feb. 8, 1999).  
See: Van Voris, B. (May 17, 1999) "'Payday' Loans Under Scrutiny," *The National Law Journal*, page B1.

3. What types of forbearance qualify for applicability of usury laws.
4. Conditions for pre-emption of state usury laws.

Where the securitization is deemed an assignment of collateral, the effective cost-of-funds for the securitization transaction is not the advertised interest cost (investor's coupon rate) of the ABS securities but the sum of the following:

- The greater of the sponsor's/originator's annual cost-of-equity (in percentages) or the percentage annual cash yield from the collateral (in a situation where the SPV's corporate documents expressly state that the Excess Spread should be paid to the sponsor, the Excess Spread should be subtracted from the resulting percentage). The Excess Spread is defined as the Gross Cash Yield From The Collateral, minus the interest paid to investors, minus the Servicing Expense (paid to the servicer), minus Charge-offs (impaired collateral).
- **The Amortized Value Difference.** The difference between the Market Value of the collateral, and the amount raised from the ABS offering (before bankers' fees), which is then amortized over the average life of the ABS bonds (at a discount rate equal to the US Treasury Bond rate of same maturity) and then expressed as percentage of the market value of the collateral. This difference can range from 10-30% of the Market Value of the collateral, and is highest where there is a senior/junior structure, and the junior/first-loss piece serves only as credit enhancement.
- **Amortized Total Periodic Transaction Cost.** The *Pre-offering Transaction Costs* are amortized over the average life of the ABS, at a rate equal to the interest

rate on an equivalent-term US treasury bond. The *Periodic Transaction Costs* are then added to the Amortized Pre-Offering Transaction Costs to obtain *Total Periodic Transaction Cost* which is expressed as a percentage of the value of the pledged collateral. The *Pre-offering Transaction Costs* include external costs (underwriters' commissions/fees, filing fees, administrative costs (escrow, transfer agent, etc.), marketing costs, accountant's fees, legal fees, etc.) and internal costs incurred solely because of the securitization transaction (costs incurred internally by the sponsor/originator - direct administrative costs, printing, etc.). The *Periodic Transaction Costs* include administrative costs, servicing fees, charge-off expenses and escrow costs.

- **Foregone Capital Appreciation.** The foregone average annual appreciation/depreciation of the value of the collateral minus the interest rate on demand deposits, with the difference expressed as a percentage of the Market Value of the collateral.

The sum of these four elements is typically greater than state-law usury benchmark rates.

Where the securitization is deemed a 'true-sale', there is an implicit financing cost which is typically usurious, because it is equal to the sum of the following:

- **Base Cost of Capital.** The greater of the sponsor's/originator's annual weighted-average-cost-of-capital, or the annual percentage yield from the collateral.



- **The Amortized Total Periodic Transaction Cost.** The *Pre-Securitization Transaction Costs* paid by the sponsor/originator and directly attributable to the offering is amortized over the life of the ABS, at a rate equal to the interest rate on an equivalent term US treasury bond, and the result (the *Amortized Pre-Securitization Costs*) is added to the *Periodic Transaction Costs* for only one period to obtain the *Total Periodic Transaction Cost*, which is then expressed as a percentage of the market value of the collateral is the *Amortized Total Periodic Transaction Cost*. The *Pre-Securitization Transaction Costs* include external costs (underwriters' commissions/fees, filing fees, administrative costs (escrow, transfer agent, etc.), marketing costs, accountant's fees, legal fees, etc.) and internal costs incurred solely because of the securitization transaction (costs incurred internally by the sponsor/originator - direct administrative costs, printing, etc.). The *Periodic Transaction Costs* include servicing fees, administrative fees, and charge-off expenses.
- **The Value Difference.** The difference between the Market Value of the collateral, and the amount raised from the ABS offering (before bankers' fees), is amortized over the average life of the ABS bonds and the result is then expressed as percentage of the Market Value of the collateral. This difference can range from 10-30%, and is highest where the senior/junior structure is used and the junior piece serves only as credit enhancement.
- **Amortized Unrealized Losses.** Any unrealized loss in the carrying amount of the collateral, is amortized over the estimated average life of the ABS, and the result for one period is expressed as a percentage of the book value of the

collateral. Most ABS collateral are recorded in financial statements at the lower-of-cost-or-market.

- **Foregone Capital Appreciation.** The foregone appreciation/depreciation of the value of the collateral minus the interest rate on demand deposits, with the difference expressed as a percentage of the market value of the collateral.

The sum of these five elements is typically greater than the state-law usury benchmark interest rates.

### **B. All “True-Sale”, “Disguised Loan” And “Assignment” Securitizations Are Essentially Tax-Evasion Schemes.**

In the US, the applicable tax evasion statute is the US Internal Revenue Code Section 7201<sup>7</sup> which reads as follows: “.....Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution.....”.

Under this statute and related case law, prosecutors must prove three elements beyond a reasonable doubt:

- 1) the “actus reus” (the guilty conduct) — which consists of an affirmative act (and not merely an omission or failure to act) that constitutes evasion or an attempt to evade either: a) the assessment of a tax or b) the payment of a tax.
- 2) the “mens rea” or “mental” element of willfulness — the specific intent to violate an actually known legal duty.

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<sup>7</sup> See: [26 U.S.C. § 7201](#). 26 USC Subtitle F, Chapter 75. See: *Cheek v. United States*, 498 U.S. 192 (1991).

3) the “attendant circumstance” of the existence of a tax deficiency — an unpaid tax liability.

In the case of ‘true sale’ transactions, the tax evasion<sup>8</sup> occurs because: **a)** the sponsor determines the price at which the collateral is transferred to the SPV, and hence, can arbitrarily lower/increase the price to avoid capital gains taxes – its assumed that the sponsor is a profit-maximizing entity and will always act to minimize its tax liability and to avoid any tax assessment; **b)** the sponsor typically retains a ‘residual’ interest in the SPV in the form of IOs, POs and “junior piece”, which are typically taxed differently and at different tax-basis compared to the original collateral - hence the sponsor can lower the price of the collateral upon transfer to the SPV, and convert what would have been capital gains, into non-taxable basis (for tax purposes) in the SPV “residual”; **c)** there is typically the requisite “intent” by the sponsor – evidenced by the arrangement of the transaction and the transfer of assets to the SPV; **d)** before securitization, collateral is typically reported in the sponsors’ financial statements at book value (lower-of-cost-or-market - under both US and international accounting standards, loans and accounts receivables are typically not re-valued to market-value unless there has been some major impairment in value) which does not reflect true Market Values. and results in effective tax evasion upon transfer of the collateral to the SPV because any unrealized gain is not taxed; **e)** the Actus Reus is manifested by the execution of the securitization transaction and transfer of assets to the SPV; **f)** the Mens Rea or specific intent is manifested by the elaborate arrangements implicit in securitization transactions, the method of determination of the price of the collateral to be transferred to the SPV, the objectives of securitization, and the sponsor’s transfer of assets to the SPV; **g)** the unpaid tax liability consists of foregone tax on the capital gains from the collateral (transaction is structured to avoid recognition of capital gains), and tax on any income from the collateral which is ‘converted’ into basis or other non-taxable forms; **h)** income (from the collateral) that would have been taxable in the sponsor’s financial statements, is converted

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<sup>8</sup> *SEC v. Towers Financial Corp. et al.*, 93 Civ. 744 (WK) (S.D.N.Y.)

into non-taxable basis in the form of the SPV's interest-only (IO) and principal-only (PO) securities - part of the Interest-Spread (the difference between the SPV's income and what it pays as interest and operating costs) is paid out to PO-holders and this transforms interest into return-of-capital or just capital repayment, with no tax consequences.

In the case of 'disguised loan' or 'assignment' securitization transactions, the tax evasion occurs because: **a)** the sponsor determines the price at which the collateral is transferred to the SPV, and hence can lower/increase the price of the collateral to avoid capital gains taxes; **b)** the sponsor typically retains a 'residual' interest in the SPV which is typically taxed differently and at different tax-basis compared to the original collateral - hence the sponsor can lower the price upon transfer to the SPV, and covert what would have been capital gains, into non-taxable basis for tax purposes; **c)** the transfer of collateral to the SPV and the creation of interest-only and principal-only securities essentially converts what would have been taxable capital gains into non-taxable basis; **d)** any gain in the value of the collateral is not recognized for tax purposes, because there has not been any 'sale'; **e)** where the ABS is partly amortizing, any capital gains are converted into interest payments; **f)** the Actus Reus is manifested by the execution of the securitization transaction and transfer of assets to the SPV; **g)** the Mens Rea or specific intent is manifested by the elaborate arrangements implicit in securitization transactions, the objectives of securitization and the sponsor's transfer of assets to the SPV; **h)** the unpaid tax liability consists of tax on the capital gains from the transfer of the collateral (the transaction is structured to avoid recognition of a sale, whereas the transfer to the SPV is effectively a sale), and tax on any income from the collateral which is 'converted' into basis or other non-taxable forms (IOs and POs) , by securitization.

**C. In All “True-Sale”, “Disguised Loan” And “Assignment” Securitizations, The Conflict Of Interest Inherent In The Sponsor Also Serving As The Servicer, Constitutes Fraud And Conversion.**

In most securitization transactions, the sponsor eventually serves as the servicer of the SPV asset pool. As servicer, the sponsor: a) determines when there has been impairment of collateral, and b) selects collateral for replacement; c) monitors collateral performance.

To prove fraud, prosecutors must prove several elements beyond a reasonable doubt:

1) **The “actus reus” (the guilty conduct)** — which consists of an affirmative act (and not merely an omission or failure to act) of misrepresentation of material facts. In securitizations, the sponsor typically makes material misrepresentations: a) the sponsor/servicer selects the assets to be transferred to the SPV, and the terms of the Offering Prospectus typically misrepresents the level of objectivity and fairness of the servicer/sponsor; b) the sponsor/servicer selects collateral for substitution where there are problems – the past and present disclosure statements and ABS offering documents materially misrepresent the sponsor/servicers objectivity/fairness.

2) **The “mens rea” or “mental” element of willfulness** — the specific intent to misrepresent the sponsor/servicer’s acts, truthfulness and objectivity/fairness is manifested by the dual role of sponsor/servicer which constitutes a conflict-of-interest. Mens Rea is also clearly inferable from the facts and circumstances - the sponsor/servicer clearly has significant economic, psychological and legal incentives to maximize its profits by: **a)** delaying substitution of collateral for as long as possible, **b)** delaying recognition of collateral impairment, and **c)** substituting impaired collateral with sub-standard collateral; all of which make the sponsor very un-suitable for the role of servicer.

3) **The reliance element.** ABS investors rely heavily on the structure/arrangements, contracts and disclosure statements in securitizations, which are relatively complex. These form the primary source of knowledge and valuation terms for the investor.

4) **The victim(s) suffers loss as a result of the misrepresentations** (direct or proximate causation). Investors suffer losses because of the sponsor's/servicer's misrepresentations of its obligations, fairness, objectivity and fiduciary duties – **a)** investors' estimates of the values of ABS are inaccurate and too high due to the servicer's/sponsor's misrepresentations, **b)** investors incur unnecessary trading costs to re-balance their portfolios as the ABS becomes riskier, **c)** investors and the sponsor/servicer incurs additional monitoring costs whenever there is any report of impairment of collateral or substitution. Furthermore, in the ABS sales process, the underwriter makes certain representations concerning the effectiveness and predictability of the collection process. Under certain conditions, investors relying on such representations may have a securities fraud claim if the servicer fails to perform, such as in bankruptcy.

**C. In All “True-Sale”, “Disguised Loan” And “Assignment” Securitizations Where The SPV Is A Trust, The Declaration of Trust Is Void Because Its For An Illegal Purpose.**

The declaration of trust relating to the SPV is void because the intent and purpose of the SPV is illegal and unconstitutional as described in this article and in Nwogugu (2006).

**D. Off-Balance-Sheet Treatment Of ABS (Both True-Sale And Assignment Transactions) Constitutes Fraud.**

Under present accounting rules in the US and most countries, if certain criteria were met, the debt raised by the SPV in securitization can be treated as off-balance sheet debt — but this requires compliance with three criteria:

- (i) The SPV should be truly independent from the sponsor and of the directors, fiduciary administrative duties notwithstanding.
- (ii) The sponsor's transfer of the assets to the SPV should be a "true sale" and the sponsor should not have any ongoing economic interest in the assets.
- (iii) The form and substance should transparently be identical, and the structure should not appear to be illusory or deceptive.

However, this off-balance-sheet treatment criteria has been recently reformed by changes in accounting standards. The UK-based International Accounting Standards Board and the US FASB are moving towards stricter reporting standards:

- FIN 46 (FASB): Effective in 2003, FIN 46 applies only to companies subject to regulation by FASB. Its goal is to substantially tighten the criteria necessary to obtain off-balance-sheet treatment for SPVs, and its main thrust is capital adequacy. FIN 46 also imposes an obligation on originators to consolidate the accounts of an SPV (denying off-balance-sheet treatment) unless the total equity at risk is regarded as sufficient to enable the SPV to finance its own activities.
- IAS 32, IAS 39, and IFRS 7: International Accounting Standards (IAS) 32 covers the disclosure and presentation of financial instruments, but from 2007 onwards the disclosure aspects will be replaced by the introduction of International Financial Reporting Standard (IFRS) 7. IAS 39 deals with the recognition and measurement of financial instruments, and has been challenged in two aspects: introducing the concept of "fair value" accounting for financial instruments and whether SPVs should be consolidated back into the balance sheet of the originator. Like Fin 46, IAS 32 is likely to result in consolidation of most SPVs on-balance-sheet of the sponsors.
- Basel II: The proposals are aimed at the global banking industry and call for a more scientific measurement of risk and of capital requirements for banks in order to support that risk. Since the general expectation has been that, in overall terms, the proposals could require the banking industry to maintain a higher rather than lower capital base, the proposals have met resistance by many banks. The Basel Committee's rules/codes are not binding because the committee is not a regulator.

The off-balance sheet treatment of ABS debt in securitizations, constitutes fraud because:

1) **The “mens rea’ or "mental" element of willfulness** — the specific intent to misrepresent the true “Trust” nature of the SPV debt is manifested by the elaborate arrangements and structure of the securitization transaction.

2) **The “actus reus” (the guilty conduct).** This consists of the affirmative act of misrepresentation of material facts by not consolidating the SPV on the sponsor’s Balance Sheet. In Securitization, consolidation of the SPV in the Sponsor’s financial statements is warranted because the sponsor: **a)** typically retains a residual economic interest in the SPV; **b)** functions as servicer of the SPV asset pool – which grants the sponsor significant control over the assets and the SPV’s operations, **c)** determines recognition of impairment of collateral, and selects and provides assets for ‘substitution’ of collateral, **d)** typically misrepresents the level of objectivity and fairness of the servicer/sponsor in disclosure statements. Taken together, these factors and the aforementioned new/proposed accounting standards constitute sufficient Actus Reus.

3) **The reliance element.** The sponsor’s current and prospective shareholders and other investors rely heavily on the structure/arrangements of securitizations, associated disclosure statements and assurances of off-balance sheet treatment of SPV debt in securitizations, which are relatively complex. These form the primary source of knowledge and valuation terms for the investor.

4) **The victim suffers loss as a result of the misrepresentation** (direct or proximate causation). Investors suffer loss because of the sponsor/servicer’ misrepresentations of its obligations – a) investors’ estimates of the values of the sponsor’s equity are inaccurate and too high due to the servicer’s/sponsor’s misrepresentations of the SPV debt, b) investors incur unnecessary trading costs to re-balance their portfolios as the sponsor is deemed more risky, c) the investor and the sponsor/servicer incurs additional monitoring costs whenever there is any report of impairment of collateral or substitution.



## **E. All “True-Sale”, “Disguised Loan” And “Assignment” Securitizations Involve**

### **Fraudulent Conveyances.**

Any transfer/conveyance of a debtor's assets that is deemed to be made for the purposes of hindering, delaying or defrauding actual or potential creditors may be determined to be a fraudulent conveyance.<sup>9</sup> In the US, three sets of laws cover potential fraudulent conveyances:

a) Section 548 of the US Bankruptcy Code (the Code); or

b) Most states have adopted the Uniform Fraudulent Transfer Act (UFTA)<sup>10</sup> or the older Uniform Fraudulent Conveyance Act (UFCA); or

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<sup>9</sup> **See:** Schwarcz Steven, Enron And The Use And Abuse Of Special Purpose Entities In Corporate Structures, 70 U. Cin. L. Rev. 1309 (2002).

**See:** Schwarcz, Steven, Securitization Post-Enron, 25 Cardozo L. Rev. 1539 (2004).

**See:** Thomas Plank, 2004 Symposium: The Security Of Securitization And The Future Of Security, 25 Cardozo L. Rev. 1655 (2004).

**See:** Thomas H, Effects Of Asset Securitization On Seller Claimants, Journal Of financial Intermediation, 10: 306-330.

**See:** Yamazaki, Kenji, What Makes Asset Securitization “Inefficient” ? Working Paper # 603, Berkeley Electronic Press.

<sup>10</sup> The Uniform Fraudulent Transfer Act reads as follows:

#### **SECTION 4. TRANSFERS FRAUDULENT AS TO PRESENT AND FUTURE CREDITORS:**

**(a)** A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the

- (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or
- (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor: (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; Or (ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.

**(b)** In determining actual intent under subsection (a)(1), consideration may be given, among other factors, to whether:

- (1) the transfer or obligation was to an insider;
- (2) the debtor retained possession or control of the property transferred after the transfer;
- (3) the transfer or obligation was disclosed or concealed;
- (4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
- (5) the transfer was of substantially all the debtor's assets;
- (6) the debtor absconded;
- (7) the debtor removed or concealed assets;

c) Fraudulent Transfers claims can also be made under a theory of constructive fraud, in which circumstantial evidence may warrant a finding that fraudulent transfers were made with the primary purpose of shielding assets from current or future creditors. Although each state has its own laws regarding the appropriate elements of proof of constructive fraud, Section 548(a)(2) of the US Bankruptcy Code permits an inference of constructive fraud if the following factors exist: 1) the debtor received less than reasonably equivalent value for the property transferred; and 2) the debtor either: was insolvent or became insolvent as a result of the transfer, retained unreasonably small capital after the transfer, or made the transfer with the intent or belief that it would incur debts beyond its ability to pay.

The following are various theories of fraudulent conveyance within the context of securitization.

#### E1. Sponsor/Originator Receives Insufficient Value For Assets Transferred.

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(8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

(9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;

(10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and

(11) the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

Under both the US Bankruptcy Code and UFTA (Section 544 of the US Bankruptcy Code also allows unsecured creditors to sue in Federal Bankruptcy Court using applicable state), judges must determine whether there has been fraudulent conveyance. Courts have developed a series of factors as criteria for proving the requisite intent. The factors to be considered (“badges of fraud”) in determining where there has been fraudulent conveyance include:

- Whether the transfer represented substantially all of the debtor's assets.
- Whether the transfer was made around the time a substantial debt was incurred.
- Whether the debtor received reasonable consideration equivalent to the value of the assets conveyed or the obligation incurred.
- Whether the debtor became insolvent soon after the transfer.
- Whether the transfer was made to insiders or family members.
- Whether the transfer or the assets were concealed

All ‘true sale’ and ‘assignment’ securitizations involve fraudulent conveyances (as defined in the US Bankruptcy Code and the Uniform Fraudulent Transfer Act ) because the originator typically receives insufficient value for assets that it transfers to the SPV<sup>11, 12</sup>:

i) horizon mismatch – in the case of receivables and fixed income assets, since the originator/sponsor sells these assets before their maturities, their effective yields and values are much lower than their stated yields, and hence, the originator receives less-than-normal value for assets transferred.

ii) the Originator always incurs substantial cash and non-cash transaction costs in such transfers, which reduces the net-value it receives from the transfer to the SPV – these costs include legal fees, accounting fees, underwriting fees, monitoring costs, administrative costs, regulatory compliance costs, capital-budgeting costs (the decision to

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<sup>11</sup> **See:** Roman Dan, Sarlito M & Mukhtiar A (Winter 2007). Risks to Consider When Purchasing Technology-based IP for Securitization. Working Paper.

**See:** Nolan Anthony, Synthetic Securitizations and Derivatives Transactions by Banks: Selected Regulatory Issues. *The Journal of Structured Finance*, Fall 2006.

**See:** Lucas Douglas, Goodman Laurie & Fabozzi Frank, Hybrid Assets in an ABS CDO: Structural Advantages and Cash Flow Mechanics, *Journal Of Structured Finance* (Fall 2006).

**See:** Prince, Jeffrey, A General Review of CDO Valuation Methods. *Journal Of Structured And Project Finance* (Summer 2006).

<sup>12</sup> **See:** Peter V. Pantaleo et al., Rethinking the Role of Recourse in the Sale of Financial Assets, 52 *Bus. Law.* 159, 159-63 (1996)(discussing types of permissible and impermissible recourse for sale treatment).

**See:** Thomas E. Plank, The True Sale of Loans and the Role of Recourse, 14 *GEO. MASON L. Rev.* 287 (1991).

**See:** Gordon T (2000). Securitization Of Executory Future Flows As bankruptcy-Remote True Sales. *University Of Chicago Law Review*, 67:1317-1322.

**See:** Higgin E & Mason J (2004). What Is The value of Recourse To Asset-Backed Securities ? A Study Of Credit Card Bank ABS Rescues. *Journal Of Banking & Finance*, 28(4); 857-874.

securitize has inherent negotiation costs, conflict costs and resource allocation costs), etc.;

**iii)** in these asset transfers, the Originator loses all the future appreciation of the transferred assets – the transfers are done at book values or stated adjusted costs – the asset valuation for the transfers don't consider future increases in asset value, and hence are an implicit undervaluation.

**iv)** where the assets transferred have residual values (as in computer leases and equipment leases), the originator often cannot accurately calculate such residual values accurately and does not incorporate them in asset valuation, and loses such residual value, and hence, receives less than normal value for the assets transferred; **v)** in some securitizations, the Originator's transfer of assets to the SPV is backed by recourse (to the originator's assets) and such recourse has economic value that reduces the net-value that the Originator receives from the transfer – Higgin & Mason (2004), Pantaleo et al (1996) and Plank (1991)<sup>13</sup> describe the basis for the value of such recourse.

**vi)** Where the Originator/sponsor is financially distressed, securitization is often the chosen form of financing, and under fraudulent conveyance laws, securitizations are illegal because, 1) securitizations increase the bankruptcy risk of the Originator/sponsor,

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<sup>13</sup> **See:** Peter V. Pantaleo et al., Rethinking the Role of Recourse in the Sale of Financial Assets, 52 Bus. Law. 159, 159-63 (1996)(discussing types of permissible and impermissible recourse for sale treatment);

**See:** Thomas E. Plank, The True Sale of Loans and the Role of Recourse, 14 GEO. MASON L. Rev. 287 (1991).

**See:** Higgin E & Mason J (2004). What Is The value of Recourse To Asset-Backed Securities ? A Study Of Credit Card Bank ABS Rescues. *Journal Of Banking & Finance*, 28(4); 857-874.

**See:** Lois R. Lupica, Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic, 9 AM. BANKR. INST. L. REV. 287, 291-92 (2001).

**See:** Carol M. Rose, Crystals and Mud in Property Law, 40 STAN. L. REV. 577, 600 (1988).

**See:** Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 DuKE L.J. 557 (1992).

2) the distressed company's assets are typically valued at higher interest rates (which yield lower asset values) and hence, the originator loses value in the transfers.

vii) the originator's/sponsor's net-cash proceeds from the securitization transaction is often significantly less than either the pre-transaction carrying value of the collateral, or the net realizable value of the collateral (liquidation value in a supervised open auction) – primarily because of transaction costs, over-collateralization, etc..

### E2. “Intent To Hinder, Delay Or Defraud Creditors”– Implicit Pre-Petition Waiver Of Right To File For Bankruptcy.

All ‘true-sale’, ‘Disguised Loan’ and ‘Assignment’ securitizations involve fraudulent conveyances (as defined in the US Bankruptcy Code and the Uniform Fraudulent Transfer Act ) because as described in this article, such securitizations are the equivalent of illegal pre-petition waivers of the right to file bankruptcy, and the waiver of the bankruptcy stay – all of which are sufficient evidence of ‘intent to hinder, delay, or defraud any creditor of the debtor’, which is the major element of fraudulent conveyance under the UFTA and the US Bankruptcy Code.

### E3. “Intent To Hinder, Delay Or Defraud Creditors” – Originator’s Transfer Of Assets To SPV.

All ‘true-sale’, ‘Disguised Loan’ and ‘Assignment’ securitizations are fraudulent conveyances (as defined in the US Bankruptcy Code and the Uniform Fraudulent Transfer Act ) because the originator's/sponsor's mere act of transferring assets to an SPV reduces the values of any of its un-secured creditor's claims – ie. trade creditors, holders of unsecured loans, holders of certain preferred stock, etc..<sup>14</sup> Without such

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<sup>14</sup> See: Yamazaki, Kenichi, What makes Asset Securitization “Inefficient” ?,2005. Working Paper #603, Berkeley Electronic Press.

transfers, un-secured creditors would have had access to such assets. This is sufficient evidence of “intent to hinder, delay or defraud” existing creditors.

E4. “Intent To Hinder, Delay Or Defraud” Creditors – Originator’s Transfer Of Assets To SPV Is Not Done In Arms-Length Transactions.

The originator’s transfer of assets to the SPV via a “true sale” or “assignment” is typically not done in arms-length transactions. Most originators have substantial influence/control over the valuation of collateral, the selection of the appraiser/valuers, the choice of appraised collateral, the corporate form and life of the SPV, and the selection of the officers/trustees of the SPV. Hence, the originator can manipulate the values of collateral for accounting and economic purposes. The originator typically creates, funds and staffs the SPV – hires the SPV’s officers and directors and determines the SPV’s corporate governance policies. The combination of such excessive control, and the originator’s transfer of assets to the SPV is prima facie evidence of ‘intent to hinder, delay or defraud’ the originator’s existing and future creditors.

E5. Securitization Increases The Originator’s Bankruptcy Risk

Securitization can increase the bankruptcy risk of an originator<sup>15</sup>, where: **a)** the cash proceeds from the securitization transaction are significantly less than either the carrying value of the collateral, or the net realizable value of the collateral (liquidation value in a supervised auction); or **b)** management reinvests the cash proceeds of securitization in projects that yield returns that are less than what the collateral would have yielded or less than the company’s cost of debt.

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<sup>15</sup> See: Yamazaki (2005), supra.

Securitization via assignments or ‘disguised loans’ increases the risk of the originator/sponsor, and also increases its post-transaction cost of capital primarily because: **a)** the amount raised is less than the assets pledged, **b)** the pledge of assets to the SPV reduces the originator’s borrowing capacity and financial flexibility, **c)** the pledge of assets to the SPV reduces the originator’s ability to repay other debt. Hence, the originator/sponsor loses value in the transfer of assets to the SPV.

#### **F. Securitization Usurps US Bankruptcy Laws And Hence, Is Illegal.**

Securitization undermines US federal bankruptcy policy, because its used (in lieu of secured financing) as a means of avoiding certain bankruptcy-law restrictions<sup>16</sup> - the origins of

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<sup>16</sup> **See:** Schwarcz (2002), supra.

**See:** Schwarcz (2004), supra.

**See:** Klee & Butler, supra.

**See:** Lipson J C (2002). Enron, Asset Securitization And Bankruptcy Reform: Dead or Dormant ? *Journal Of Bankruptcy Law & Practice*, 11: 1-15.

**See:** Lupica L (2001). Revised Articles Nine, Securitization Transactions And The Bankruptcy Dynamic. *American Bankruptcy Institute Law Review*, 9:287-299.

**See:** Garmaise M (2001). Rational Beliefs And Security Design. *Review Of Financial Studies*, 14(4):1183-1213.

**See:** David A (1997). Controlling Information Premia By Repackaging Asset Backed Securities. *Journal Of Risk & Insurance*, 64(4):619-648.

**See:** DeMarzo P (2005).. The Pooling And Tranching Of Securities: A Model Of Informed Intermediation. *Review Of Financial Studies*, 18(1):1-35.

**See:** Report By The Committee On Bankruptcy And Corporate Reorganization Of The Association Of The Bar Of The City Of New York (2000). New Developments In Structured Finance. *The Business Lawyer*, 56: 95-105.

**See:** Lupica L (2000). Circumvention Of The Bankruptcy Process: The Statutory Institutionalization Of Securitization. *Connecticut Law Review*, 33:199-209.

**See:** Glover S (1992). Structured Finance Goes Chapter Eleven: Asset Securitization By The Reorganizing Companies. *The Business Lawyer*, 47:611-621.

**See:** Gordon T (2000). Securitization Of Executory Future Flows As bankruptcy-Remote True Sales. *University Of Chicago Law Review*, 67:1317-1322.

**See:** Elmer P (\_\_\_\_) Conduits: Their Structure And Risk. *FDIC Banking Review*, pp.27-40. Available at <http://www.lebow.drexel.edu/mason/fin650.elmer.pdf>.

**See:** Lois R. Lupica, Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic, 9 AM. BANKR. INST. L. REV. 287, 291-92 (2001).

**See:** Steven L. Schwarcz, The Inherent Irrationality of Judgment Proofing, 52 STAN. L. REV. 1 (1999).

securitization in the US can be traced directly to efforts by banks and financial institutions to avoid bankruptcy law restrictions.

An analysis of the legislative intent of the US Congress with regard to the US Bankruptcy Code confirms that securitization contravenes most policies of the US Bankruptcy Code<sup>17</sup>. These policies include: **a)** recognition of financial distress, **b)** stay of bankruptcy proceedings, **c)** determination of claims and priorities of security interests; **d)** fair division of value; **e)** the continuance or liquidation decision, **f)** efficient reorganization.

In most cases, Insolvency often occurs before management decides to file for bankruptcy. Many firms that are either financially distressed and or technically insolvent continue to operate as if they are normal companies, and enter into securitization transactions – often securitization enables them to reduce the effect of actual and or perceived low credit ratings.

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**See:** Lynn M. LoPucki, *The Irrefutable Logic of Judgment Proofing: A Reply to Professor Schwarcz*, 52 STAN. L. REV. 55 (1999).

**See:** Steven L. Schwarcz, *The Impact on Securitization of Revised UCC Article 9*, 74 Cm. - KENT L. REV. 947 (1999) ("Revised Article 9 attempts to broaden its coverage to virtually all securitized assets.").

**See:** Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TuL. L. REV. 101 (1997);

**See:** Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061 (1996).

**See:** Steven L. Schwarcz, *Judgment Proofing: A Rejoinder*, 52 STAN. L. REV. 77 (1999).

<sup>17</sup> **See:** Reams B & Manz W (eds.), *FEDERAL BANKRUPTCY LAW: A LEGISLATIVE HISTORY OF THE BANKRUPTCY REFORM ACT OF 1994*.

**See:** *The Legislative History of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*; ([FRB Leg. Hist](#)); ([S. 256 -LoC](#)); Pub. L. 109-8, April 20, 2005, 119 Stat, 23. <http://www.llsdc.org/sourcebook/leg-hist.htm>

**See:** *Bankruptcy Reform Act of 1978: A Legislative History*, Hein.

**See:** *Federal Bankruptcy Law: A Legislative History of The Bankruptcy Act of 1994*; Pub. L. No. 103-394, 108 Stat. 4106, including the National Bankruptcy Commission Act and Bankruptcy Amendments (1987-1993).

**See:** Ahern, Lawrence (Spring 2001). "Workouts" Under Revised Article Nine: A Review Of Changes And Proposal For Study. *American Bankruptcy Institute Law Review*, 9:115-125.

**See:** Ribstein, Larry & Kobayashi, Bruce (1996). An Economic Analysis Of Uniform State Laws. *Journal Of Legal Studies*, 25(1):131-199.



Securitization is often a major strategic choice for financially distressed companies.<sup>18</sup> Under the US Internal Revenue Tax Code, securitization qualifies as a reorganization. The underlying issues are as follows.

#### F1. Implicit Waiver Of Right To File For Bankruptcy And Or Stay.

Securitization involves an implicit (and often express) waiver of the debtor's/Originator's/sponsor's right to file for voluntary bankruptcy. This is achieved by using a bankruptcy-remote SPV and segregating the assets that otherwise would have been part of the bankruptcy estate.<sup>19,20</sup> Securitization involves an implicit (and sometime express) waiver of the

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<sup>18</sup> **See:** Ashta A & Tolle L (200). Criteria For Selecting Restructuring Strategies For Distressed Or Declining Enterprises. *Cahners Du Ceren*, 6:1-20.

**See:** Carlson D (1998). The Rotten Foundations Of Securitization. *William & Mary Law Review*, 39: .

**See:** Higgin E & Mason J (2004). What Is The value of Recourse To Asset-Backed Securities ? A Study Of Credit Card Bank ABS Rescues. *Journal Of Banking & Finance*, 28(4); 857-874.

**See:** *Albany Insurance v. Esses*, 831 F2d 41 (CA2, 1987)(making false statements about value of asset was a "predicate act"); *Howell Hydrocarbons v. Adams*, 897 F2d 183 (CA5 1990)(under federal RICO statutes, making a company look solvent when its not, constitutes a 'predicate act'); *Matter of Lewisville Properties*, 849 F2d 946 (CA5, 1988)(under federal RICO, false pretenses constitutes 'predicate acts').

**See:** Bens D & Monahan S (Feb. 2005). *Altering Investment Decisions To Management Financial Reporting Outcomes: Asset Backed Commercial Paper Conduits And FIN 46*. Working Paper.

<sup>19</sup> In the following cases, courts held that pre-petition waivers of the right to file for voluntary/involuntary bankruptcy, were unenforceable. *See: In Re Huang*, 275 F3d 1177 (CA9, 2002)(its is against public policy for a debtor to waive the pre-petition protection of the Bankruptcy Code); *In Re South East Financial Associates*, 21 BR 1003 (M.D.Fla, 1997); *In Re Tru Block Concrete Products Ins*, 27 BR 486 (E.D.Pa., 1995)(advance agreement to waive the benefits of bankruptcy law is void as against public policy); *In Re Madison*, 184 BR 686, 690 (E.D.Pa, 1995)(even bargained-for and knowing waivers of the right to seek bankruptcy protection must be deemed void); *In Re Club Tower LP*, 138 BR 307 at 312 (N.D.Ga, 1991); *In Re Graves*, 212 BR 692 (BAP, CA1, 1997); *In Re pease*, 195 BR 431 (D.Neb., 1996); *In Re Jenkins Court Associates Ltd. Partnership*, 181 BR 33 (E.D.Pa., 1995); *In Re Sky Group International Inc.*, 108 BR 86 (W.D.Pa., 1989); *Association of St.Croix Condominium Owners v. St. Croix Hotel Corp.*, 692 F2d 446 (CA3, 1982). But contrast: *In Re University Commons LP*, 200 BR 255 (M.D.Fla.)(debtors agreement that in the event debtor enters bankruptcy proceedings, the secured lender shall be entitled to court order dismissing the case as 'bad faith' filing an determining that: (i) no rehabilitation or reorganization is possible, and ii) dismissing all

creditor/ABS-investor's right to file for involuntary bankruptcy<sup>21</sup>, <sup>22</sup> – US courts have repeatedly

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proceedings is in the best interests of parties and all other creditors, is binding); *In Re Little Creek Development*, 779 F.2d 1068 (CA5, 1986).

**See:** 124 Congr. Record H 32, 401 (1978).

<sup>20</sup> There are several cases that hold that pre-petition waivers of the right to file for voluntary/involuntary bankruptcy, are enforceable: *In Re Shady Grove Tech Center Associates Limited Partnership*, 216 BR 386 (D.Md., 1998)(waiver of the right to file for bankruptcy is unenforceable)(*opinion supplemented*) 227 BR 422 (D.Md., 1998); *In Re Atrium High Point Ltd. partnership*, 189 BR 599 (MDNC 1995); *In Re Darrell Creek Associates*, 187 BR 908 (DSc, 1995); *In Re Cheeks*, 167 BR 817 (D.Sc, 1997); *In Re McBride Estates*, 154 BR 339 (N.D.Fla., 1993); *In Re citadel Properties*, 86 BR 275, MD.Fla., 1988); *In Re Gulf Beach Development Corp.*, 48 BR 40 (M.D.Fla., 1985). However, these cases are very distinguishable from standard securitization transactions because the following characteristics/conditions existed in these cases: a) they involve only single-asset entities, b) these entities had no employees, c) the timing of filing of bankruptcy petition indicates an intent to delay or frustrate creditors' proper efforts to enforce their rights after a workout had failed, d) there were no or few unsecured non-insider creditors (those existing had small claims); e) there was no realistic chance of rehabilitation or reorganization; f) the assets did not produce any cash flow.

<sup>21</sup> See cases cited in Notes 5, 6, 19 and 20.

<sup>22</sup> On pre-petition waivers of right to file for bankruptcy and waivers of bankruptcy stays, **see:** *In re Huang*, 275 F.3d 1173, 1177 (9th Cir. 2002) (“It is against public policy for a debtor to waive the pre-petition protection of the Bankruptcy Code.”); *In re Shady Grove Tech Center Assocs. Limited Partnership*, 216 B.R. 386, 389 (Bankr. D. Md. 1998) (“The courts have uniformly held that a waiver of the right to file a bankruptcy case is unenforceable.”); *In re Tru Block Concrete Prods., Ins.*, 27 B.R. 486, 492 (Bankr. E.D. Pa. 1995) (advance agreement to waive the benefits conferred by bankruptcy law is void as against public policy); *In re Madison*, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995)(even bargained-for and knowing waivers of the right to seek bankruptcy protection must be deemed void); *In re Club Tower L.P.*, 138 B.R. 307, 312 (Bankr. N.D. Ga. 1991); *In re Orange Park S. Partnership*, 79 B.R. 79, 82 (Bankr. M.D. Fla. 1987); *In re Aurora Invs.*, 134 B.R. 982, 985 (Bankr. M.D. Fla. 1991)(debtor's agreement that petition, if filed, would be in “bad faith” if its primary purpose is to delay foreclosure sale, is binding); *In re University Commons, L.P.*, 200 B.R. 255, 259 (Bankr. M.D. Fla. 1996) (debtor's agreement that in the event debtor becomes subject of bankruptcy case secured lender shall be entitled to order dismissing case as “bad faith” filing and determining that (i) no rehabilitation or reorganization is possible, and (ii) dismissing all proceedings is in the best interest of parties and all other creditors, is binding); *In Re Little Creek Dev. Co.*, 779 F.2d 1068, 1073 (5th Cir. 1986). 47212 B.R. 1003, 1005 (Bankr. M.D. Fla. 1997).

**See:** 124 Cong. Rec. H 32, 401 (1978) (“The explicit reference in Title-11 forbidding the waiver of certain rights is not intended to imply that other rights, such as the right to file a voluntary bankruptcy case under section 301, maybe waived.”).

**See:** Klee, Kenneth & Butler, Brendt ( ), *Asset-backed Securitization, Special Purpose Vehicles And Other Securitization*. Working Paper. Cases that enforced pre-petition waivers of the automatic stay focus upon: (i) the financial sophistication of the borrower; (ii) the creditor's demonstration that significant consideration was given for the pre-petition waiver; (iii) the effect

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of the enforcement of the pre-petition waiver upon other parties having legitimate interests in the outcome; (iv) circumstances of the parties at the time enforcement of the pre-petition waiver is sought; (v) the enforcement of the pre-petition waiver being consistent with public policy of encouraging out of court restructurings and settlements with creditors; and (vi) other indicia which support granting relief from stay, such as “bad faith” criteria (i.e. single-asset case, two-party dispute, long history of pre-petition workouts, newly formed entity, filing on eve of foreclosure, no ongoing business to reorganize, few employees, no unencumbered funds, etc.). Cases that held that pre-petition stay waivers were enforceable include: *In Re Shady Grove Tech Ctr. Assocs., L.P.*, 216 B.R.386, 390 (Bankr. D. Md. 1998); *In Re Atrium High Point L.P.*, 189 B.R. 599, 607 (Bankr. M.D.N.C. 1995); *In Re Darrell Creek Assocs., L.P.*, 187 B.R. 908, 910 (Bankr. D.S.C. 1995); *In Re Cheeks*, 167 B.R. 817, 818 (Bankr. D.S.C. 1994); *In Re Powers*, 170 B.R. 480, 483 (Bankr. D. Mass. 1994); *In Re McBride Estates, Ltd.*, 154 B.R. 339, 343 (Bankr. N.D. Fla. 1993); *In Re Citadel Properties, Inc.*, 86 B.R. 275, 276 (Bankr. M.D. Fla. 1988); *In Re Gulf Beach Development Corp.*, 48 B.R. 40, 43 (Bankr. M.D. Fla. 1985). Several courts, however, have refused to enforce pre-petition waivers for any of the following reasons: (i) the pre-petition waiver is the equivalent to an ipso facto clause; (ii) such clause is void as against public policy by depriving the debtor of the use and benefit of property upon the filing of a bankruptcy case; (iii) the borrower lacks the capacity to act on behalf of the debtor in possession; (iv) the debtor has a business with a reasonable chance at reorganization and enforcement of the waiver would otherwise prejudice third-party creditors; (v) the automatic stay is designed to protect all creditors and may not be waived by the debtor unilaterally to the detriment of creditors; and (vi) the waiver was obtained by coercion, fraud or mutual mistake of facts. Courts that have refused to enforce pre-petition waivers of the automatic stay have reasoned that the automatic stay protects not only debtors but also other creditors. US Courts disagree sharply about the utility, benefits and desirability of the enforcement of pre-petition waivers, and relevant criteria. Some courts have held that a pre-petition automatic stay waiver may be considered as a factor in determining whether cause exists for relief from the stay. See: *In Re Darrell Creek Assocs., L.P.*, 187 B.R. 908, 913 (Bankr. D.S.C. 1995) (“out of court workouts are to be encouraged and are often effective”); *In Re Cheeks*, 167 B.R. 817, 819 (Bankr. D.S.C. 1994) (“the most compelling reason for enforcement of the forbearance agreement is to further the public policy in favor of encouraging out of court restructuring and settlements”); *In Re Club Tower L.P.*, 138 B.R. 307, 312 (Bankr. N.D. Ga. 1991) (“enforcing pre-petition settlement agreements furthers the legitimate public policy of encouraging out of court restructurings and settlements”). Cases holding pre-petition automatic stay waivers unenforceable include: *In Re Southeast Financial Assocs., Inc.*, 212 B.R. 1003, 1005 (Bankr. M.D. Fla. 1997); *In Re Graves*, 212 B.R. 692, 694 (B.A.P. 1st Cir. 1997); *In Re Pease*, 195 B.R. 431, 433 (Bankr. D. Neb. 1996); *In Re Jenkins Court Assocs. L.P.*, 181 B.R. 33, 37 (Bankr. E.D. Pa. 1995); *Farm Credit of Cent. Fla., ACA v. Polk*, 160 B.R. 870, 873-74 (M.D. Fla. 1993); *Farm Credit of Cent. Fla., ACA v. Polk*, 160 B.R. 870, 873-74 (M.D. Fla. 1993) (“The policy behind the automatic stay is to protect the debtor’s estate from being depleted by creditor’s lawsuits and seizures of property before the debtor has had a chance to marshal the estate’s assets and distribute them equitably among creditors.”); *In Re Sky Group Int’l, Inc.*, 108 B.R. 86, 89 (Bankr. W.D. Pa. 1989) (“To grant a creditor relief from stay simply because the debtor elected to waive the protection afforded the debtor by the automatic stay ignores the fact that it also is designed to protect all creditors and to treat them equally”) (citing *Assoc. of St. Croix Condominium Owners v. St. Croix Hotel Corp.*, 682 F.2d 446 (3d Cir. 1982)). **Also see:** *In re Shady Grove Tech Ctr. Assocs., L.P.*, 216 B.R. 386, 393-94 (Bankr. D. Md. 1998); *In re S.E. Fin. Assocs., Inc.*, 212 B.R. 1003, 1005 (Bankr. M.D. Fla. 1997); *In re Darrell Creek Assocs., L.P.*, 187 B.R. 908, 910 (Bankr. D.S.C. 1995); *In re Powers*, 170 B.R.

held that such waivers are void as against public policy. In the absence of securitization, this same investors/creditors would have been a creditor/lender to the sponsor/originator. This implicit waiver is achieved by using an SPV and segregating the assets that otherwise would have been part of the bankruptcy estate; and by various forms of credit enhancement. Without the automatic stay of the bankruptcy code, the debtor/sponsor would not need to transfer assets to an SPV – Carlson (1998) traces the history of securitization to direct and specific efforts/collaborations to avoid the impact of US bankruptcy laws.<sup>23</sup>

Furthermore, there is a distinct difference of opinions among US courts about the enforceability of pre-petition waivers (of rights to file for voluntary or involuntary bankruptcy) which has not been resolved by the US Supreme Court<sup>24</sup> – however, the standard securitization processes differ substantially from the conditions in cases where the courts held that pre-petition waivers (or rights to file for bankruptcy) were un-enforceable.

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480, 483 (Bankr. D. Mass. 1994); *In re Cheeks*, 167 B.R. 817, 819 (Bankr. D.S.C. 1994); *In Re Shady Grove Tech Ctr. Assocs., L.P.*, 216 B.R. 386, 393-94 (Bankr. D. Md. 1998) (granting stay relief for cause based upon finding which included debtor's pre-petition agreement not to contest request for stay relief given as part of pre-petition restructuring in which debtor was afforded substantial consideration).

**See:** Steven L. Schwarcz, Rethinking Freedom of Contract: A Bankruptcy Paradigm, 77 Tex. L. Rev. 515 (1999).

**See:** *In Re Club Tower L.P.*, 138 B.R. 307, 311-12 (Bankr. N.D. Ga. 1991).

<sup>23</sup> See: Schwarcz S. (1999). Rethinking Freedom Of Contract: A Bankruptcy Paradigm. *Texas Law Review*, 77: 515-599.

See: Klee K & Butler B ( ). Asset-Backed Securitization, Special Purpose Vehicles And Other Securitization Issues. *Uniform Commercial Code Law Journal*, 35(2):.

**See:** Carlson D (1998). The Rotten Foundations Of Securitization. *William & Mary Law Review*, 39:

<sup>24</sup> See notes 5, 6, 19 and 20, *supra*.

## F2. The US Bankruptcy Code Expressly Invalidates Certain Pre-filing Transfers

Sections of the US bankruptcy code that expressly invalidate certain types of pre-filing transfers, payments and transactions (that occur within a specific time period before the filing of bankruptcy). Most securitizations fall under the classes of voidable pre-filing transfers. Hence under these foregoing circumstances/conditions, bankruptcy laws and associated principles are implicated and apply where the firm has not filed for bankruptcy. Therefore, any pre-bankruptcy-filing transactions that invalidate or contravene the principles of bankruptcy codes are illegal. The bankruptcy-remoteness characteristic of securitizations prevents the efficient functioning of bankruptcy law.

## G. New Theories Of The Effects Of Securitization On Bankruptcy Efficiency

The following are new theories that explain how securitization contravenes the principles of US bankruptcy laws.

### G1. The *Illegal Wealth-Transfer Theory*

Securitization can result in fraudulent conveyance and illegal wealth transfer where the transaction effectively renders the originator/issuer company technically insolvent; or fraudulently transfers value to the SPV (in the form of low collateral values) and then to the ABS/MBS bond holders (in the form of low bond prices, and or high interest rates).<sup>25</sup> Courts have held that stripping a company of the ability to pay judgment claims is a ‘predicate act’ that is actionable under federal RICO statutes<sup>26</sup>. Securitization can also result in illegal wealth

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<sup>25</sup> See: Shakespeare C (2003). *Do Managers Use Securitization Volume And Fair Value Estimates To Hit Earning Targets ?* Working Paper, University Of Michigan (School Of Business)

See: Shakespeare C (2001). *Accounting For Asset Securitizations: Complex Fair Values And Earnings Management.* Working Paper, University Of Michigan.

<sup>26</sup> *Wooten v. Loshbough*, 649 Fsupp 531 (N.D.Ind. 1986)(on reconsideration) 738 Fsupp 314 (affirmed) 951 F2d 768 (under federal RICO statutes, stripping of company’s ability to pay judgment claim was ‘predicate act’).

transfers to the intermediary bank where it retains a residual interest in the Trust/SPV (residual securities) or is over-compensated (excessive cash fees, trustee positions, underwriter is granted a percentage of securities offered, etc.).

*G2. The Priority-Changing Theory –*

To the extent that bankruptcy laws are designed to facilitate rehabilitation of troubled companies, and increase efficient allocation of debtor assets to creditors, securitization enables the debtor to defeat the Absolute-Priority principle; and to effectively re-arrange priorities of claims, particularly where the debtor/originator does not have any secured claims (but has only un-secured claims). This is achieved by securitizing un-encumbered assets and using credit enhancement to provide higher-quality securities (the equivalent of higher priority) to other creditors.

*G3. The Facilitation Of Inefficient-Continuance Theory:*

Securitization enables the debtor/originator to change the progression of financial distress, by supplying cash that typically lasts for short periods of time, and often at a high effective cost of funds. This implicates the principles of ‘inefficient continuance’ (where an otherwise non-viable company that should be liquidated, sold/merged or substantially reorganized, continues to operate solely as a result of short-term solutions and or bankruptcy court orders), and hence, the sections of the Sarbanes-Oxley Act (“SOX”) - which require certification of solvency of the company and adequacy of internal controls, and also carry criminal penalties for non-compliance.<sup>27</sup> The question of whether ‘inefficient continuance’ has occurred is a matter of law that should be decided by judges. Thus, all else remaining constant, where the necessary elements occur, (a securitization and ‘inefficient continuance’ and management’s certification of solvency and adequate internal controls), management and the company become criminally liable.

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<sup>27</sup> See: Kulzick R (2004). *Sarbanes-Oxley: Effects on Financial Transparency. S.A.M. Advanced Management Journal*, 69(1): 43-49.

#### G4. *The Information-Content Effect Theory* –

Securitization changes and distorts the perceived financial position of the originator/sponsor, because various forms of credit enhancement (senior/junior pieces, loan insurance, etc.) are used to achieve a high credit rating for the SPV – which may be misconstrued by stock-market investors as evidence of good prospects for the originator-company. To the extent that all securities offerings have relevant information content and associated signaling, then securitization by financially distressed companies effectively conveys the wrong signals to capital markets and hence, changes the expectations of creditors and shareholders (and in the case of bankruptcy, makes it more difficult to efficiently form consensus on a plan of reorganization once the bankruptcy petition is filed). In this realm, investor and creditor expectations are critical and have utility value and typically form the basis for investment/disinvestment and for negotiations about restructuring or plan of reorganization. Courts have held that persons that create false impressions about the financial condition of a company are potentially liable under federal RICO statutes.<sup>28</sup>

#### G5. *Avoidance Theory* –

To the extent that securitization defers or eliminates a potential creditor's rights to file for involuntary bankruptcy, then securitization can be deemed to be fraudulent, and gives rise to criminal causes of action such as deceit, conversion, etc. The creditor's right to file for a debtor's involuntary bankruptcy is a valid property right that arises from state property law, state contract law, state constitutional laws, and federal bankruptcy laws.<sup>29</sup> Deprivation of, or interference with this property right is a violation of the US constitution. Securitization can defer or eliminate this

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<sup>28</sup> See: *Albany Insurance v. Esses*, 831 F2d 41 (CA2, 1987)(under federal RICO statutes, making false statements about the value of asset was a 'predicate act'); *Howell Hydrocarbons v. Adams*, 897 F2d 183 (CA5 1990)(under federal RICO statutes, making a company look solvent when its not, constitutes a 'predicate act').

<sup>29</sup> See: *Lockheed Martin v. Boeing*, 357 Fsupp2d 1350 (M.D.Fla., 2005)(bidder violated competitor's property rights to proprietary information by using that information to produce winning bids).

property right, and hence violate the US constitution where the transaction: **a)** effectively re-arranges priority of claims; or **b)** reduces the debtor-company's borrowing capacity (value of un-encumbered/un-pledged collateral) to the detriment of secured and or un-secured creditors; or **c)** uses the proceeds of the transaction to pay-off some (but not all) members of a potential class of creditors that can file an involuntary bankruptcy petition.

#### **H. Securitization Constitutes A Violation Of Federal RICO Statutes**

In 'true-sale', 'disguised loan' or 'assignment' securitizations, there are fraudulent transactions which serve as 'predicate acts' under federal RICO statutes<sup>30</sup>. The specific RICO sections implicated are:

- Section 1341 (mail fraud)
- Section 1343 (wire fraud)
- Section 1344 (financial institution fraud)
- Section 1957 (engaging in monetary transactions in property derived from specified unlawful activity).
- Section 1952 (racketeering).

The prices of the collateral are determined in negotiations between the sponsor/issuer and the intermediary bank and on occasion, the SPV's trustees. This presents opportunities for "predicate acts" (ie. fraud, conversion, etc.) because:

1. The collateral could be under-valued or over-valued. There are no state or federal laws that require independent valuation of collateral or appointment of

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<sup>30</sup> See: Colloff M (2005). The Role of the Trustee in Mitigating Fraud in Structured Financings. *Journal of Structured Finance*, 10(4):73-85.



independent/certified trustees in securitization transactions. The parties involved are often business acquaintances. The originator/sponsor controls the entire process.

2. The trustees can be, and are influenced by the sponsor/originator and or intermediary investment-bank.

3. The required disclosure of collateral is sometimes insufficient – a) does not include historical performance of collateral pools, b) does not include criteria for selection of collateral and for substitution of collateral, c) criteria for replacement of impaired collateral is sometimes not reasonable.

4. Mail and wire are used extensively in communications with investors and participants in the transaction.

5. There is compulsion – because the intermediary/investment bank has very substantial incentives to under-price the securities, and to inflate/deflate the value of the collateral in order to consummate the transaction and earn fees.

The entire securitization process constitutes violations of federal RICO <sup>31</sup> statutes because:

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*See: Shakespeare C (2003). Do Managers Use Securitization Volume And Fair Value Estimates To Hit Earning Targets ? Working Paper, University Of Michigan (School Of Business)*

*See: Shakespeare C (2001). Accounting For Asset Securitizations: Complex Fair Values And Earnings Management. Working Paper, University Of Michigan.*

*See: Katyal K (2003). Conspiracy theory. The Yale Law Journal, 112(6):1307-1398.*

*See: Geary W (2002). The legislative recreation of RICO: Reinforcing The "myth" of organized Crime. Crime, Law & Social Change, 38(4):311-315.*

*See: Kulzick R (2004). Sarbanes-Oxley: Effects On Financial Transparency. S.A.M. Advanced Management Journal, 69(1): 43-49.*

*See: Painter R (2004). Convergence And Competition In Rules Governing Lawyers and Auditors. Journal of Corporation Law, 29(2):397-426.*

*See: Jordans R (2003). The legal approach to investment advisers in different jurisdictions. Journal of Financial Regulation and Compliance, 11(2):169-171.*

*See: Blanque P (2003). Crisis and fraud. Journal of Financial Regulation & Compliance, 11(1):60-70.*

1. There is the requisite criminal or civil “enterprise” – consisting of the sponsor/issuer, the trustees and the intermediary bank. These three parties work closely together to effect the securitization transaction.

2. There are “predicate acts”<sup>32</sup> of:
- a) Mail fraud - using the mails for sending out materials among themselves and to investors.
  - b) Wire fraud – using wires to engage in fraud by communicating with investors.
  - c) Conversion – where there isn’t proper title to collateral.
  - d) Deceit- mis-representation of issues and facts pertaining to the securitization transaction.

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*See: Pickholz M & Pickholz J (2001). Manipulation. Journal of Financial Crime, 9(2):117-133.*

*See: Zey M(1999). The subsidiarization of the securities industry and the organization of securities fraud networks to return profits in the 1980s. Work and Occupations, 26(1):50-76.*

*See: Aicher R, Cotton D & Khan T (2004). Credit Enhancement: Letters of Credit, Guaranties, Insurance and Swaps. The Business Lawyer, 59(3):897-973.*

*See: Brief T & MsSweeney T (2003). Corporate Criminal Liability. The American Criminal Review, 40(2): 337-366.*

*See: Landrum D (2003). Governance of limited liability companies - Contrasting California and Delaware models. The Real Estate Finance Journal, 19(1):*

<sup>31</sup> See: 18 USC 1961-1968.

<sup>32</sup> See: *Alexander v. Thornbough*, 713 FSupp 1271 (D.Minn. 1989)(*appeal dismissed*) 881 F2d 1081; *Mira v. Nuclear Measurements Corp.*, 107 F3d 466 (CA7, 1997); *US v. Manzella*, 782 F2d 533 (CA5, 1986)(*cert. Denied.*) 476 US 1123; *Cadle Co v. Flanagan*, 271 Fsupp2d 379 (D.Conn., 2003); *Seale v. Miller*, 698 Fsupp 883 (N.D.G.A., 1988); *Georgia Gulf Corp. v. Ward*, 701 Fsupp 1556 (NDGA 1988); *Wooten v. Loshbough*, 649 FSupp. 531 (N.D.Ind. 1986)(*on reconsideration*) 738 Fsupp 314 (*affirmed*) 951 F2d 768 (stripping of company’s ability to pay judgment claim was ‘predicate act’ under RICO statutes); *Formax v. Hostert*, 841 F2d 388 (CAFed, 1988); *Abell v. Potomac Insurance*, 858 F2d 1104 (CA5, 1988) (*appeal after remand*) 946 F2d 1160 (*cert. denied*) 492 US 918; *Aetna Ca. Ins. Co. v. P & B Autobody*, 43 F3d 1546 (CA1, 1994); *Albany Insurance v. Esses*, 831 F2d 41 (CA2, 1987)(making false statements about value of asset was a “predicate act”); *Alfadda v. Fenn*, 935 F2d 475 (CA2, 1991)(*certiorari denied*) 502 US 1005; *Laird v. Integrated Resources*, 897 F2d 826 (CA5, 1990); *Shearin v. E F Hutton*, 885 F2d 1162 (CA3, 1989); *Bank One Of Cleveland v. Abbe*, 916 F2d 1067 (CA6, 1990); *BancOklahoma Mortgage Corp. v. Capital Title Co.*, 194 F3d 1089 (CA10, 1999); *Howell Hydrocarbons v. Adams*, 897 F2d 183 (CA5 1990)(under federal RICO statutes, making a company look solvent when its not, constitutes a ‘predicate act’); *Matter of Lewisville Properties*, 849 F2d 946 (CA5, 1988)(false pretenses constitutes ‘predicate acts’).

- e) Securities fraud – disclosure issues.
- f) Loss of profit opportunity.
- g) Making false statements and or misleading representations about the value of the collateral.
- h) Stripping the originator/issuer of the ability to pay debt claims or judgment claims in bankruptcy court – this may apply where the sponsor is financially distressed and the cash proceeds of the transaction are significantly less than the value of the collateral.

3. There is typically the requisite ‘intent’ by members of the enterprise – evident in knowledge (actual and inferable), acts, omissions, purpose (actual and inferable) and results. Intent can be reasonably inferred from: a) existence of a sponsor that seeks to raise capital – and obviously cannot raise such capital on better terms using other means, b) existence of an investment bank that has very strong incentives to consummate the transaction on any agreeable (but not necessarily reasonable) terms,

### **I. Securitization Constitutes Violations Of US Antitrust Laws**

The various processes in securitization constitute violations of the US Antitrust statutes.<sup>33, 34, 35</sup> These violations are described as follows.

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Also See: *Securities Investor Protection Corp. v. Vigman*, 908 F2d 1461 (CA9, 1990); *International Data Bank v. Zepkin*, 812 F2d 149 (CA4, 1987); *Warner v. Alexander Grant & Co.*, 828 F2d 14528 (CA11, 1987); *Mauriber v. Shearson/American Express*, 546 FSupp 391 (SDNY, 1982); *Farmers Bank F Delaware v. Bell Mortgage Corp.*, 452 FSupp 1278 (D.Del, 1978); *Moss v. Morgan Stanley Inc.*, 719 F2d 5 (CA2, 1983); *USACO Coal v. Carbomin Energy Inc.*, 689 F2d 94 (CA6, 1982); *Binkley v. Shaeffer*, 609 FSupp 601 (E.D.Pa., 1985); *Sedima v. Imrex Co.*, 473 US 479 (1985); .

I1. Market Concentration: The US ABS and MBS markets are dominated by relatively few large entities such as FNMA, Freddie Mac, the top-five investment banks (all of which have conduit programs), the top-five credit card issuers (MBNA, AMEX, Citigroup, etc.), etc.. Hence the top-five ABS/MBS issuers control more than 50% of the US ABS/MBS market. This constitutes illegal market concentration under US Antitrust laws.

I2. Market Integration: The ABS and MBS markets are essentially national and international (geographically-diverse entities/individuals participate in each transaction). Each ABS transaction/offering typically involves a ‘roadshow’ which consist of presentations to investors in various cities – the cost of the roadshow is often paid by the underwriter(s) before its fees are paid by the sponsor. In addition, there are printing, mailing, traveling and administrative costs that increase with the greater geographical

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See: Glanz M (1983). RICO And Securities Fraud: A Workable Limitation. *Columbia Law Review*, 6:1513-1543.

See: Masella J (1991). Standing TO Sue In A Civil RICO Suit Predicated On Violation OF SEC Rule 10b-5: The Purchase Or Sale Requirement. *Columbia Law Review*, 91(7):1793-1812.

See: Coffey P (1990). The Selection, Analysis And Approval OF Federal RICO Prosecutions. *Notre Dame Law Review*, 65: 1035-1055.

See: Matthews A (1990). Shifting The Burden Of Loses In The Securities Markets: The Role OF Civil RICO In Securities Litigation. *Notre Dame Law Review*, 65: 896-906.

<sup>33</sup> See: *Bradford National Clearing Corp. v. SEC*, 590 F2d 1085 (DCCir, 1978); *In Re Stock Exchanges Options Trading Antitrust Litigation*, 317 F3d 134 (CA2, 2003); *Gordon v. NYSE*, 422 US 659 (1975); *National Gerimedical Hospital v. Blue Cross Of Kansas City*, 452 US 378 (1981); *Silver v. NYSE*, 373 US 341 (1963)(no antitrust immunity); *Strobl v. NY Mercantile Exchange*, 768 F2d 22 (CA2, 1985).

dispersion of investors. This has two main effects: a) it reduces competitive pressure on dominant investment banks and groups of investment banks (to the detriment of smaller investment banks); and b) it raises market-entry barriers by making it more expensive to conduct 'road-shows' for new offerings. Hence, the market integration created by the industry practices of securities underwriters is anti-competitive and violates the Sherman Act, and the FTC Antitrust statutes.

I3. Syndicate Collusion: the syndicates (of investment banks) used in distributing ABS/MBS essentially collude to determine: a) the price at which each ABS tranche is sold, b) which investors can purchase different tranches.

Collusion occurs because:

a) In the typical ABS offering, the price determination process is not transparent or democratic because the lead underwriters typically negotiate the offering price with the originator/sponsor and the prospective investors (but some underwriters use auctions). The lead underwriters purchase most of the new-issue ABS, and the balance is typically sold to 'junior' syndicate members (who presumably can arrange to buy more ABS from the lead underwriters than allocated to them). In essence, the true price-demand characteristics and negotiability of junior underwriting-syndicate members are very much hidden simply because of the structure of the underwriting/bidding process. Hence, the existing syndicate-based ABS distribution system for new issue ABS distorts the true demand for ABS, reduces competition, and facilitates and results in collusion, and constitutes violations of the Sherman Act and the FTC Antitrust statutes.

b) Similarly, the ABS allocation process is not transparent. The lead underwriter and junior underwriters allocate new-issue ABS to investors based on subjectively determined “suitability” and “in-house criteria”. There are no established or generally accepted major guidelines for such ‘in-house’ criteria and associated allocation. The lead and junior underwriters can typically collude to determine that only certain investors deemed appropriate are allocated ABS. Hence, the antitrust violation (collusion) occurs solely by the underwriters’ discretionary choice of investors to whom ABS are allocated – this is more evident where the investor pool consists of mostly institutional investors, and thus, final offering prices are more sensitive to choice of investors, and prices can change significantly simply by changes in allocation to investors. In such circumstances, the collusion is reasonably inferable, so long as there are no statutory or generally accepted allocation criteria that have been approved by the NASD or other trade associations.

I4. Price Formation: The price of ABS securities is often linked to the price/yields of US treasury bonds – the credit risk of ABS/MBS is priced relative to risk of US Treasury bonds. This system distorts the true demand/supply balance for ABS/MBS, and erroneously incorporates the demand/supply relationships of the US Treasury Bond market, into the ABS/MBS markets. The key question then, is whether there are conditions under which the US Treasury Bond market is completely de-coupled from the ABS market, or phrased differently, whether there is sufficient justification for actual or perceived de-coupling of the US Treasury Bond market and the US ABS market. These conditions are as follows:

1. The credit fundamentals of the US treasury market differ substantially from those of the ABS market. The treasury market is much more sensitive to US Federal Reserve actions, currency fluctuations, consumer spending, federal/state fiscal policies, etc.). The ABS market tends to be more sensitive to industry-specific and sometimes company-specific risks/factors.

2. The use of various credit enhancement techniques/products further exacerbates the differences in the credit trends/quality in the US treasury and ABS markets. In ABS transactions, most forms of credit enhancement creates a floor, but does not limit or affect other industry-exposure or company-exposure. In the US treasury market, investors are subject to more variety of risks.

3. The investor objectives in the US treasury bond markets differ from those of investors in ABS markets. Hence, investors are very likely to view these two markets and the underlying risks differently, and should value the securities differently.

I5. Vertical Foreclosure: In the ABS/MBS markets some investment banks and commercial banks are active in almost all phases of the securitization process – origination (through their in-house conduits), due diligence, disclosure and pricing, new-issue securities offerings, and secondary-market trading. Similarly, non-bank entities can use their own asset portfolios (origination of credit card receivables or mortgage receivables), shelf-registration procedures and or Regulation-D/Rule 144A procedures (pricing and new-issue offerings) and in-house trading desks (secondary-market trading) to participate in almost all aspects of securitization processes. Hence, these companies have almost no incentive to, and are not required to make their infrastructure and

relationships available to competitors. Such vertical foreclosure constitutes violation of antitrust laws.



I6. Tying<sup>36</sup>: a) the sponsor is sometimes formally or informally required to

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**§ 1 Sherman Act, 15 U.S.C. § 1**

Trusts, etc., in restraint of trade illegal; penalty

Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. Every person who shall make any contract or engage in any combination or conspiracy hereby declared to be illegal shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding \$10,000,000 if a corporation, or, if any other person, \$350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

**§ 2 Sherman Act, 15 U.S.C. § 2**

Monopolizing trade a felony; penalty

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding \$10,000,000 if a corporation, or, if any other person, \$350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

**§ 3 Sherman Act, 15 U.S.C. § 3**

Trusts in Territories or District of Columbia illegal; combination a felony

Every contract, combination in form of trust or otherwise, or conspiracy, in restraint of trade or commerce in any Territory of the United States or of the District of Columbia, or in restraint of trade or commerce between any such Territory and another, or between any such Territory or Territories and any State or States or the District of Columbia, or with foreign nations, or between the District of Columbia and any State or States or foreign nations, is declared illegal. Every person who shall make any such contract or engage in any such combination or conspiracy, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by fine not exceeding \$10,000,000 if a corporation, or, if any other person, \$350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

3. **CLAYTON ACT, 15 U.S.C. §§ 12-27, 29 U.S.C. §§ 52-53**

**§ 1 Clayton Act, 15 U.S.C. § 12**

Definitions; short title

(a) "Antitrust laws," as used herein, includes the Act entitled "An Act to protect trade and commerce against unlawful restraints and monopolies," approved July second, eighteen hundred and ninety; sections seventy-three to seventy-seven, inclusive, of an Act entitled "An Act to reduce taxation, to provide revenue for the Government, and for other purposes," of August

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twenty- seventh, eighteen hundred and ninety-four; an Act entitled "An Act to amend sections seventy-three and seventy-six of the Act of August twenty-seventh, eighteen hundred and ninety-four, entitled 'An Act to reduce taxation, to provide revenue for the Government, and for other purposes,' " approved February twelfth, nineteen hundred and thirteen; and also this Act.

"Commerce," as used herein, means trade or commerce among the several States and with foreign nations, or between the District of Columbia or any Territory of the United States and any State, Territory, or foreign nation, or between any insular possessions or other places under the jurisdiction of the United States, or between any such possession or place and any State or Territory of the United States or the District of Columbia or any foreign nation, or within the District of Columbia or any Territory or any insular possession or other place under the jurisdiction of the United States: Provided, That nothing in this Act contained shall apply to the Philippine Islands.

The word "person" or "persons" wherever used in this Act shall be deemed to include corporations and associations existing under or authorized by the laws of either the United States, the laws of any of the Territories, the laws of any State, or the laws of any foreign country.

(b) This Act may be cited as the "Clayton Act".

**§ 2 Clayton Act, 15 U.S.C. §§ 13<sup>(2)</sup>**

**Discrimination in price, services, or facilities**

**(a) Price; selection of customers**

It shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them: Provided, That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered: Provided, however, That the Federal Trade Commission may, after due investigation and hearing to all interested parties, fix and establish quantity limits, and revise the same as it finds necessary, as to particular commodities or classes of commodities, where it finds that available purchasers in greater quantities are so few as to render differentials on account thereof unjustly discriminatory or promotive of monopoly in any line of commerce; and the foregoing shall then not be construed to permit differentials based on differences in quantities greater than those so fixed and established: And provided further, That nothing herein contained shall prevent persons engaged in selling goods, wares, or merchandise in commerce from selecting their own customers in bona fide transactions and not in restraint of trade: And provided further, That nothing herein contained shall prevent price changes from time to time where in response to changing conditions affecting the market for or the marketability of the goods concerned, such as but not limited to actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the goods concerned.

**(b) Burden of rebutting prima-facie case of discrimination**

Upon proof being made, at any hearing on a complaint under this section, that there has been discrimination in price or services or facilities furnished, the burden of rebutting the prima-facie case thus made by showing justification shall be upon the person charged with a violation of this section, and unless justification shall be affirmatively shown, the Commission is authorized to issue an order terminating the discrimination: Provided, however, That nothing herein contained

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shall prevent a seller rebutting the prima-facie case thus made by showing that his lower price or the furnishing of services or facilities to any purchaser or purchasers was made in good faith to meet an equally low price of a competitor, or the services or facilities furnished by a competitor.

(c) Payment or acceptance of commission, brokerage, or other compensation

It shall be unlawful for any person engaged in commerce, in the course of such commerce, to pay or grant, or to receive or accept, anything of value as a commission, brokerage, or other compensation, or any allowance or discount in lieu thereof, except for services rendered in connection with the sale or purchase of goods, wares, or merchandise, either to the other party to such transaction or to an agent, representative, or other intermediary therein where such intermediary is acting in fact for or in behalf, or is subject to the direct or indirect control, of any party to such transaction other than the person by whom such compensation is so granted or paid.

(d) Payment for services or facilities for processing or sale

It shall be unlawful for any person engaged in commerce to pay or contract for the payment of anything of value to or for the benefit of a customer of such person in the course of such commerce as compensation or in consideration for any services or facilities furnished by or through such customer in connection with the processing, handling, sale, or offering for sale of any products or commodities manufactured, sold, or offered for sale by such person, unless such payment or consideration is available on proportionally equal terms to all other customers competing in the distribution of such products or commodities.

(e) Furnishing services or facilities for processing, handling, etc.

It shall be unlawful for any person to discriminate in favor of one purchaser against another purchaser or purchasers of a commodity bought for resale, with or without processing, by contracting to furnish or furnishing, or by contributing to the furnishing of, any services or facilities connected with the processing, handling, sale, or offering for sale of such commodity so purchased upon terms not accorded to all purchasers on proportionally equal terms.

(f) Knowingly inducing or receiving discriminatory price

It shall be unlawful for any person engaged in commerce, in the course of such commerce, knowingly to induce or receive a discrimination in price which is prohibited by this section.

Discrimination in rebates, discounts, or advertising service charges; underselling in particular localities; penalties, 15 U.S.C. § 13a

It shall be unlawful for any person engaged in commerce, in the course of such commerce, to be a party to, or assist in, any transaction of sale, or contract to sell, which discriminates to his knowledge against competitors of the purchaser, in that, any discount, rebate, allowance, or advertising service charge is granted to the purchaser over and above any discount, rebate, allowance, or advertising service charge available at the time of such transaction to said competitors in respect of a sale of goods of like grade, quality, and quantity; to sell, or contract to sell, goods in any part of the United States at prices lower than those exacted by said person elsewhere in the United States for the purpose of destroying competition, or eliminating a competitor in such part of the United States; or, to sell, or contract to sell, goods at unreasonably low prices for the purpose of destroying competition or eliminating a competitor.

Any person violating any of the provisions of this section shall, upon conviction thereof, be fined not more than \$5,000 or imprisoned not more than one year, or both.

Cooperative association; return of net earnings or surplus, 15 U.S.C. § 13b

Nothing in sections 13 to 13b and 21a of this title shall prevent a cooperative association from returning to its members, producers, or consumers the whole, or any part of, the net earnings or surplus resulting from its trading operations, in proportion to their purchases or sales from, to, or through the association.

**§ 3 Clayton Act, 15 U.S.C. § 14**

purchase other financial services (loans, letters of credit, custody services, etc.) from the investment bank, in order to effect the securitization transaction, **b)** the investors are sometimes required to simultaneously purchase two or more tranches of an ABS offering, or to promise to buy the same or similar ABS/MBS securities in order to be allocated ABS in new offerings; **c)** the sponsor and or investment may formally or informally require investors to purchase minimum dollar volume of ABS in specific offerings in order to get 'allocations' in future offerings. These acts constitute tying which is anti-competitive.

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Sale, etc., on agreement not to use goods of competitor

It shall be unlawful for any person engaged in commerce, in the course of such commerce, to lease or make a sale or contract for sale of goods, wares, merchandise, machinery, supplies, or other commodities, whether patented or unpatented, for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, or fix a price charged therefor, or discount from, or rebate upon, such price, on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the goods, wares, merchandise, machinery, supplies, or other commodities of a competitor or competitors of the lessor or seller, where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce.

FTC Regulations

Section 5 of the Federal Trade Commission Act outlaws "unfair methods of competition" but does not define unfair. The Supreme Court has ruled that violations of the Sherman Act also are violations of Section 5, but Section 5 covers some practices that are beyond the scope of the Sherman Act. It is the FTC's job to enforce Section 5.

<sup>36</sup> See: *Eastman Kodak Co v. Image technical Services*, 504 US 451 (1992); *Jefferson parish Hospital v. Hyde*, 466 US 2 (1984); *Zenith Radio Corp. v. Hazeltine Research*, 395 US 100 (1969).

17. Price-Fixing<sup>37</sup> – The *Locus-shifting Theory* is introduced here. Locus-shifting occurs when a potential and obvious party to a price-fixing scheme is effectively replaced (in pricing negotiations) by a third party that has the resources and willingness to dramatically alter the pricing of goods/services in either the transaction, or a series of transactions or in the sector/industry as a whole. Normally, price-fixing would occur between two sponsors or two intermediary banks. Since the intermediary-investment bank is central to ABS offerings, and associated pricing and negotiations, the price fixing should be deemed to occur between the sponsor/originator and the investment bank (or between two sponsors). Since each active investment bank typically underwrites many offerings simultaneously, and essentially controls the pricing of each new-issue ABS, the investment banks are the locus of said price fixing and are potentially liable for the associated antitrust violations. Further evidence of price fixing maybe obtained by analyzing: **a)** the yield differentials of various ABS offerings in various asset classes (ie. autos, home equity, mortgages, etc.) by different sponsors within a specific block of time, **b)** the price differentials of various ABS offerings in various asset classes (autos, home equity, credit cards, mortgages, etc.) with the same rating, within a specific block of time.

18. Exclusive Contracts<sup>38</sup>

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<sup>37</sup> See: *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 US 717 (1988); *Copperweld Corp. v. Independence Tube*, 467 US 752 (1984); *Monsanto Co. v. Spray-Rite Service Corp.*, 465 US 752 (1984); *US v. Arnold, Schwin et al*, 388 US 365 (1967); *USPS v. Flamingo Industries*, #02-1290 (2004); *Brown v. Pro Football*, 518 US 213 (1996); *FTC v. Tigor Title Insurance Company*, 504 US 621 (1992); *Allied Tube & Conduit Corp. v. Indian head Inc.*, 486 US 492 (1988).

<sup>38</sup> See: *Standard Oil Co v. US*, 337 US 293 (1949);  
See: *US v. Griffith*, 334 US 100 (1948).  
See: *Brooke Group Ltd. V. Brown & Williamson Tobacco*, 509 US 209 (1993).

Exclusive contracts facilitate and enhance anti-competitive behavior by contractually restricting conduct by and trade among participants in the market. In the US ABS/MBS markets, existing illegal exclusive contracts include: **a)** contracts that prevent the intermediary investment bank from providing financial services to other prospective securitization sponsor-companies in the same industry/sector, **b)** contracts (by the sponsor, underwriter(s) or third parties) that prevent or limit the formation of a syndicate of securities dealers; **c)** contracts that prevent the sponsor from selling securities through other underwriters, other than an appointed intermediary investment bank. These types of contracts constitute direct violations of US antitrust statutes.

#### I9. Price Discrimination<sup>39</sup>

There are several classes of ABS:

1) Securities that involve pure “pass-through” of cash flows, and hence rights to payment of cash from the SPV pool, but no ownership interest in the pool to: a) IO – interest only securities; b) PO – principal only securities; and c) traditional ABS that pay both interest and principal.

2) Securities that confer ownership interests in the underlying pool to: a) IO – interest only securities; b) PO – principal only securities; and c) traditional ABS that pay both interest and principal.

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<sup>39</sup> See: *Texaco v. Hasbrouck*, 496 US 543 (1990); *J Truet Payne Co v. Chrysler Motors*, 451 US 557 (1981); *Great Atlantic & Pacific Tea Co. v. Federal Trade Commission*, 440 US 69 (1979); *US v. United States Gypsum*, 438 US 422 (1978); *FTC v. Sun Oil Co.*, 371 US 505 (1963).

3) Debt-type securities that involve a security interest in the underlying collateral - a) IO – interest only securities; b) PO – principal only securities; and c) traditional ABS that pay both interest and principal.

In many instances, the SPV offers many tranches in each of the above-mentioned classes of ABS. The tranches within each class typically vary by term, interest rate, duration, and bond-rating/risk-rating. Hence, in any situation where the tranches don't have any priority as to security interests or rights-to-payment of cash flows from the pool, such stratified offerings within each class (IO, or PO or ordinary; or pass-through, collateral-type or equity-interest) constitutes price discrimination because the underlying asset and risk is essentially the same, although different securities are being offered in the same transaction (or series of transactions), at different prices to investors, based on the same underlying pool of assets. The distinguishing and critical element is that there is no contractually agreed-upon priority of claims as to security interests or right-to-payment of cash from the pool of assets.

#### 110. Predatory Pricing<sup>40</sup>

This occurs when investment banks under-price ABS offerings in order to obtain more investors, and to build name recognition for a particular issuer (that does or intends to come to the ABS market regularly). Evidence of predatory pricing may be inferred or established by:

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<sup>40</sup> See: *Brooke Group Ltd. V. Brown & Williamson Tobacco*, 509 US 209 (1993); *Matsushita Electric v. Zenith Radio*, 475 US 574 (1986); *Utah Pie Co. v. Continental Baking Co. et al*, 386 US 685 (1967).

a) Comparing the offering prices of various new-issue ABS bonds sold by one sponsor/originator, in the same asset class (auto loans, home equity, credit cards, etc.), but at different times of the year, to offering prices of similar ABS bonds sold by other regular ABS sponsors/originators in the same time periods.

b) Running regressions to identify any statistically significant relationship between: 1) the difference in the yield of company XYZ's ABS bond and the yields of other similar ABS bonds, and 2) various independent variables such as yield, price, asset type, bond rating, duration, industry, amount of offering, frequency of ABS offerings, types of investors, etc..

c) Comparing the offering prices of various new-issue ABS bonds underwritten by one investment bank (in the same asset class, but at different times of the year) to offering prices of similar ABS bonds underwritten by other investment banks in the same time periods.

### I11. Rigging Of Allocations

Most ABS offerings are done via allocations of securities by investment banks to their brokerage customers.

1. Most sponsors issue ABS/MBS through bids by investment banks. Most bids for ABS securities are won by a few investment banking firms. This may suggest that customers have been "allocated" among investment banks. This is also an indication of collusion.
2. On occasion, the primary underwriters subcontract work (re-sell securities) to secondary underwriters.



## **J. Securitization Involves Void Contracts**

The process of securitization involves several contracts that are either signed simultaneously or are all signed within a short time frame. Many of these contracts are void and illegal for the following reasons:

a) Lack Of Consideration <sup>41</sup> – there is no consideration in many of the contracts used in effecting securitizations. Many of these contracts are unilateral executory promises and contain illusory promises. There are three main issues:

i) Unilateral Executory Promise <sup>42</sup> – A unilateral executory promise is not consideration. The following are some unilateral executory contracts in securitizations:

- The promise made by the SPV to payout periodic interest, whether contingent or non-contingent on whether the collateral pays cash interest.
- Collateral-substitution Agreement contains a promise in which the sponsor agrees to substitute impaired collateral.
- Assignment Agreement - Assignment of future collateral (not yet existing) may be deemed a unilateral executory promise by the assignor.

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<sup>41</sup> See: *Parmenter v. FDIC*, 925 F2d 1088 (CA8,1991); *Ace-Federal Reporters v. Barram*, 226 F3d 1329 (Ca.Fed., 2000)(on remand) 2002 WL 1292032; *Workman v. UPS*, 234 F3d 998 (CA7, 2000); *Dibrell Brothers v. Banca Nazionale Del Lavoro*, 383 F3d 1571 (CA11, 1999); *Gibson v. Neighborhood Health Clinics*, 121 F3d 1126 (CA7, 1997); *Floss v. Ryans Family Steakhouses*, 211 F3d 306 (CA6, 2000)(cert. denied) 531 US 1072; *Heinig Furs*, 811 Fsupp 1546 (M.D.Ala., 1993); *Flanders Medeiros v. Bogosian*, 88 Fsupp 412 (DRI, 1994)(affirmed in part) 65 F3d 198; *Johnson Enterprises v. FPI Group*, 162 F3d 1290 (CA2, 1998); *Hoffman v. Bankers Trust*, 925 Fsupp 315 (M.D.Pa, 1995); *Prudential Insurance v. Sipula*, 776 F2d 157 (CA7, 1985); *In Re Sulakshma*, 207 BR 422 (E.D.Pa, 1997).

<sup>42</sup> See: Gordon T (2000). Securitization Of Executory Future Flows As bankruptcy-Remote True Sales. *University Of Chicago Law Review*, 67:1317-1322.

- Transfer Agreement. The sponsor agrees to transfer the collateral to the SPV, and the SPV in return pays cash to the sponsor.

ii) *Illusory Promises*<sup>43</sup> – An illusory promise is not a valid consideration for a contract. The following are some illusory promises inherent in securitization transactions:

- The Subscription/purchase Agreement. The SPV's promises to acquire the collateral with the cash raised from investors are essentially illusory promises. These promises are embedded in the offering Prospectus, but are typically not included in other corporate documents. In most cases, the offering prospectuses don't state the exact steps in the SPV's promised purchase of the collateral. Purchase/Subscription Agreement. The SPV's investors purchase beneficial interests in the SPV or the SPV's debt. These beneficial interest evidence: **a)** right to payments from the SPV, or **b)** an ownership interest in the underlying collateral, or **c)** a 'participation' in the underlying collateral. However, at the time of executing this agreement, the only consideration that the SPV can grant to investors in exchange for the purchase amount, consist of promises to purchase the collateral in the future, and to make payments from the SPV's assets. Hence, an existing asset is being exchanged for a future asset that does not exist as of the date of the purchase/subscription agreement.

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<sup>43</sup> See: *Valdiviezo v. Phelps Dodge*, 995 Fsupp 1060 (D.Ariz., 1997). *Johnson enterprises v. FPL Group*, 162 F3d 1290 (CA2, 1998). *Ryan v. Upchurch*, 474 Fsupp 211 (SND, 1979)(reversed) 627 F2d 836.

See: Rose J & Dawson P (Sept. 1997). Contingent Transfer - The Illusory Promise Of Structured Finance. *S&P Structured Finance*, page 10.

- Furthermore, all securitization offerings are done pursuant to ‘Subscription Agreements’ and Investor Questionnaires – the two documents have to be signed by the prospective investor. None of the agreements signed by the investor as part of his/her purchase of the SPV’s ABS expressly incorporates the promises embodied in the Offering Prospectus. What typically exists is an implied agreement to subject the investor to the SPV’s articles of incorporation, Trust Indenture, and or Trustees’/board of directors’ (or Board of Trustee’s) decisions.
- The SPV’s promise to pay interest/dividends on ABS IOs, Preferreds and POs are essentially illusory promises because the underlying collateral may not produce any cash flows, in which case there wont be any interest or dividend payments.

iii) *No Bargain* – some courts have held that there is no consideration (and hence, the contract is void) where one party was not allowed to bargain for the alleged agreement.<sup>44</sup> In some securitizations, the process of setting offering prices for new ABS issues does not afford all parties the opportunity to negotiate terms of the offering, especially individual investors, because the price of the ABS is typically determined primarily by the sponsor and the lead-underwriters. Furthermore, in securitizations, the originator sets the terms of the SPV (trust documents, articles of incorporation, Bylaws, etc.).

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<sup>44</sup> *Prudential Insurance v. Sipula*, 776 F2d 157 (CA7, 1985)(no consideration where party to contract could not bargain for alleged agreement).

2. *No mutuality*<sup>45</sup> – in the securitization context, for there to be mutuality: a) each party must have firm control of the subject matters of the contract and the underlying assets (consideration), and b) there should be a direct contractual relationship between the parties. At time of the Subscription Agreement, the SPV typically does not own or have rights to the collateral, and hence, there is not mutuality. Furthermore, the concept of ‘piercing the SPV veil’ is introduced here (and is similar to piercing the corporate veil) and applies since the following conditions exist:

- The economics of the transaction is an asset transfer from the sponsor/originator to the SPV investors, in exchange for a loan to the sponsor. However, there is no direct contractual relationship
- The sponsor typically controls the SPV before the ABS offering and determines (or substantially influences) the SPV’s post-offering operating characteristics. Since prospective ABS investors don’t have firm pre-offering control of the SPV and cannot influence its post-offering policies, there is no mutuality between the SPV and the ABS investors; and securitization is void.
- The sponsor influences the appointment of the SPV’s trustees or board of directors.

Thus, under contract law, the use of the SPV in securitization effectively eliminates any mutuality between the two main contracting parties - the sponsor and the investors. Secondly, there is no mutuality between the SPV and the investors: a) the SPV corporate documents (trust indentures or bylaws or articles of incorporation) typically limits the rights of each ABS investors and the group of ABS investors. Thirdly, there is no

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<sup>45</sup> See: *Tampa Pipeline Transport v. Chase Manhattan Service Corp.*, 928 Fsupp 1568 (MD.Fla., 1995)(*affirmed*) 87 F3d 1329.

mutuality between the SPV and the sponsor/originality because both entities are essentially the same, and are controlled by the sponsor before and after the securitization.

3. *Illegal subject matter And Contravention Of Public Policy*<sup>46</sup> – as explained in preceding sections of this article, securitization constitutes violations of antitrust statutes and federal RICO statutes, and hence, the contracts used to effect securitizations are void and illegal.

### **Conclusion**

Under US laws, Securitization is clearly illegal. This requires the enactment of special federal securitization statutes; and changes in law enforcement patterns and practices.

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<sup>46</sup> See: *Imel v. laborer's Pension Fund Trust*, 904 F2d 1327 (CA9, 1990)(*cert. den.*) 498 US 939 (contract should not alter statutory duties); *Truck Ins. Exchange v. Ashland Oil*, 951 F2d 787 (CA7, 1992); *Cramer v. Consolidated Freightways*, 255 F3d 806 (CA9, 2001)(*cert. denied*) 122 SCt 806; *Lake James Community v. Burke County NC*, 149 F3d 277 (CA4, 198) (*cert. denied*) 525 US 1106; *Davis v. Parker*, 58 F3d 183 (CA5, 1995); *In Re NWFx*, 881 F2d 530 (*on rehearing*) 904 F2d 469 (*cert. denied*) 498 US 941; *Biomedical Systems v. GE Marquette*, 287 F3d 707 (CA8, 2002)(*cert. denied*) 123 SCt 636 (post-contract formation failure to obtain statutorily required license invalidated agreement).

