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, antitrust and constitutional 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. This article focuses on securitization as it pertains to asset-backed securities and mortgage-backed securities. The existing literature on legal 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.

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) traces the history of securitization to direct and specific efforts/collaborations to avoid the impact of US bankruptcy laws.[1]
- Types of contracts used in securitization. The key criteria for enforceability.
- Purposes, wording and scope of applicable laws – state contract laws, state trusts laws, US bankruptcy code, and state/federal securities laws.
- 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.

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[1] 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:

- 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).[2] 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 [3]. On these issues, even the cases for which the

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[2] 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*, 8: 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.

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.

[3] 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.,

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.

3. What types of forebearance qualify for applicability of usury laws.

4. Conditions for pre-emption of state usury laws.

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 Asssociation*, 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)(r*eversed*) 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.

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 higher of the company's annual cost-of-equity or the percentage annual yield from the collateral (in a situation where the SPV 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 Yield From The Collateral, minus the interest paid to investors, minus the Servicing Expense (paid to the servicer), minus Charge-offs (impaired collateral).
- 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 equity 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 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.
- The amortized periodic transaction cost (amortized over the life of the ABS) expressed as a percentage of the value of the pledged collateral; and amortized at a rate equal to the interest rate on an equivalent-term US treasury bond. The 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.). Note that SPV-specific costs such as servicing fees and charge-off expenses are also included in transaction costs in this scenario.

- 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.

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:

- The higher of the company's annual weighted-average-cost-of-capital, or the percentage annual yield from the collateral.
- The amortized periodic transaction costs paid by the sponsor/originator and directly attributable to the offering (and amortized over the life of the ABS) expressed as a percentage of the market value of the collateral, and amortized at a rate equal to the interest rate on an equivalent term US treasury bond. The 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.). Note that SPV-specific costs such as servicing fees and charge-off expenses are not included in transaction costs in this scenario.

- The difference between the market value of the collateral, and the amount raised from the ABS offering (before bankers' fees), and such difference is amortized over the average life of the ABS bonds and 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.
- Any unrealized loss in the carrying amount of the collateral; expressed as a percentage of the book value of the collateral. Most collateral are recorded at the lower-of-cost-or-market.
- 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.

B. 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 [4] - the origins of

[4] *See*: Schwarcz (2002), supra. 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: Abreu D (1988). On The Theory Of Infinitely Repeated Games With Discounting. *Econometrica*, 56: 383-396.
See: Rotemberg J & Saloner G (1986). A Supergame-Theoretic Model Of Price Wars During Booms. *American Economic Review*, 76:390-407.
See: David A (1997). Controlling Information Premia By Repackaging Asset Backed Securities. *Journal Of Risk & Insurance*, 64(4):619-648.

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 confirms that securitization contravenes most bankruptcy policies [5]. The underlying issues are that:

- Insolvency often occurs before management decides to file for bankruptcy. Many firms that are technically insolvent continue to operate as if they are normal companies.
- Securitization is often a major strategic choice for financially distressed companies. [6] Under the US Internal Revenue Tax Code, securitization qualifies as a reorganization.

See: DeMarzo P (2005).. The Pooling And Tranching Of Securities: A Model Of Informed Intermediation. *Review Of Financial Studies*, 18(1):1-35.
See: Menard C (1998). Mal-Adaptation Of Regulation To Hybrid Organizational Forms. *International Review Of Law & Economics*, 18:403-417.
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 Stricture And Risk. FDIC Banking Review, pp.27-40. Available at http://www.lebow.drexel.edu/mason/fin650.elmer.pdf.

[5] **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.

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

- Securitization involves an implicit (and often express) waiver of the debtor/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. [7],[8] Securitization involves an implicit (and sometime express) waiver of the

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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.

[7] 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 c*ontrast*: *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 proceedings is in the best interests of parties and all other creditors, is binding*); In Re Little Creek Development*, 779 F2d 1068 (CA5, 1986).

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

[8] 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 in that the following characteristics/conditions existed: a) they involve single-asset entities, b) 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) no or few unsecured non-insider creditors (those existing have small claims); e) no realistic chance of rehabilitation or reorganization, f) no cash flow.

creditor/ABS-investor's right to file for involuntary bankruptcy[9]. In the absence of securitization, this same investor/creditor 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.[10]

- 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 [11] – 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.
- There are special 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).
- Hence under these foregoing circumstances/conditions, bankruptcy laws and associated principles are implicated and apply where the firm has not filed for bankruptcy.

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[9] See cases cited in Notes 5 & 6.

[10] 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:

[11] See notes 5 and 6, *supra*.

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.

Securitization can increase the bankruptcy risk of a company, 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 securitization cash proceeds in projects that yield returns that are less than what the collateral would have yielded or less than the company's cost of debt.

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

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). [12] 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[13]**.** Securitization can also result in illegal wealth 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.).

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[12] *See*: Shakespeare C (20030. *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.

[13] *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').

The Priorty-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.

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. [14] 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.

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 mis-construed by stock-market investors as evidence of good prospects for the originator-company. To the extent that all securities offerings have relevant

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

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 makes it more difficult to efficiently form consensus on a plan of reorganization once the bankruptcy petition is filed. In this realm, investor/creditor expectations are critical and have utility value and typically form the basis 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. [15]

Avoidance Theory - To the extent that securitzation 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 federal bankruptcy laws. [16] Deprivation of, or interference with this property right is a violation of the US constitution. Securitization can defer or eliminate this property right, and hence violate the 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) member of a potential class of creditors that can file an involuntary bankruptcy petition.

C. Securitization Renders The SPV Automatically Insolvent, And Hence Is Illegal.

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[15] *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').

[16] *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 wining bids).

In securitization, cash from investors is used to purchase the underlying collateral. However, because: 1) the cash has to be obtained from investors first, and 2) the ABS involves a promise to pay interest on debt and or preferred securities; then the ABS is technically insolvent once the 'investment' is done; and the subsequent purchase of the underlying collateral does not cure the initial technical default, which is sufficient to invalidate the entire securitization.

Even if the ABS is structured (and disclosed in the offering prospectus) as an ownership interest in, or participation in the underlying collateral, it can be construed as debt because there are express and implied promises to pay interest and principal (sometimes with some conditions, such as availability of cash flow from the collateral).

D. ***Securitization Constitutes A Violation Of The Commerce Clause Of The US Constitution, The Free-Speech Clause And The Right-To- Contract Clause Of The US Constitution, And Hence, Is Illegal*** [17]

[17] On constitutionality of statutes and processes in general, see the following articles.
See: Chemerinsky E (2005). Constitutional Issues Posed In The Bankruptcy Abuse Prevention And Consumer Protection Act Of 2005. *American Bankruptcy Law Journal*, ____.
See: Alexander F S (2002). Constitutional Questions About Tax Lien Foreclosures. *Government Finance Review*,
See: Povel P(1999). Optimal "Soft" OR 'Tough" Bankruptcy Procedures. *Journal Of Law, Economics & Organization*, 15(3):659-669.
See: Alexander F S (2002). Constitutional Questions About Tax Lien Foreclosures. *Government Finance Review*, _____.
See: Hirsch W (1994). An Economic Analysis Of The Constitutionality Of State Preference Laws. *International Review OF Law & Economics*, 14:299-306.
See: Cotlar A (Jan. 2003). Say Cheese: The Constitutionality Of State-Mandated Free Airtime On Public Broadcasting Stations. *Federal Communications Law Journal*, .
See: Nimmer M B (1958). The Constitutionality Of Official Censorship Of Motion Pictures. *University Of Chicago Law Review*, .
See: Dunbar W (Feb. 1901). The Constitutionality Of The US Inheritance Tax. *Quarterly Journal Of Economics*, 15(2):292-298.

Securitization constitutes violations of the US Constitution – the Free-Speech Clause, the Right-To-Contract Clause, and The Commerce Clause. For purposes of constitutional law analysis, the relevant 'state-action' consists of: a) the US Congress's omission in failing to create a uniform set of laws for securitization given the sheer magnitude of securitization transactions in the US, and its pervasive effect on the overall US economy; b) the sponsor's selection of collateral for securitization – which is essentially a governmental regulatory role.

1. *Commerce Clause*

Securitization constitutes a violation of the Commerce Clause of the US Constitution. For purposes of constitutional law analysis, the 'state-action'[18] implicit in

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See: Thomas S A (2003). Re-Examining The Constitutionality Of The Remitittur Under The Seventh Amendment. *Ohio State Law Journal*, ___.
See: Huhn W (2004). Assessing The Constitutionality Of Laws That Are Bother Content-Based And Content Neutral: The Emerging Constitutional Calculus. *Indiana Law Journal*, 79:801-810.
See: White D B (1939). Unfair Competition: The Constitutionality Of California Unfair Practices Act. *California Law Review*, __ .

[18] **See**: *Evans v. Newton*, ____US____ (1966).
See: *Evans v. Abney*, ___ US ____ (1970).
See: *Burton v. Wilmington*, ___ US ____(1971).
See: *Moose Lodge v. Irvis*, ___ US ____(1972).
See: *Edmonson v Leesville Concrete*, ____ US ___(1991).
See: Tushnet M (2003). The Issue Of State Action/Horizontal Effect In Comparative Constitutional Law. *International Journal Of Constitutional Law*, 1(1):79-98.
See*: Marsh v. Alabama*, ___*US* ___ (1946).
See: *Screws v. US*, 325 US 91 (___).
See: Stephen Ellman, "Constitutional Confluence: American "State Action; Law And The Application Of South Africa's Socio Economic Rights Guarantees To Private Actors", 45 New York law School Law Review ____ (2001).
See: Stephen Gardbaum, *The "Horizontal Effect" of Constitutional Rights*, Michigan Law Review, 102: 387-398 (2003).
See: Stephen Gardbaum, Where The (State) Action Is, *Int. J. Constitutional Law*, 4:760-779.

violation of the Commerce Clause in securitization consists of: a) the sponsor's selection of collateral located in various states – ie. in the absence of state laws that specify criteria for selection of collateral, this function is essentially regulatory and the sponsor performs the role of the government; b) the government's omission in failing to create uniform laws for securitizations – the government has an affirmative duty to create and enforce laws that govern activities that have significant effects on its citizens and institutions.

Securitization transactions are typically governed by a combination of state laws (trust laws, corporations laws, securities laws and contract laws) and federal securities laws. Securitization typically involves interstate commerce, because the collateral is typically located in more than one state, the investors are located in more than one state and the trustees/board-members and servicing agent maybe located in different states. Such interstate activities implicates the Commerce Clause. Hence, securitization contravenes the Commerce Clause of the US Constitution because there are no federal contract laws, federal trust laws or special laws that directly regulate the terms and processes of securitizations (apart from federal securities laws which are not sufficiently specific) [19].

See: Currie D (1986). Positive And Negative Constitutional Rights. *University Of Chicago Law Review*, 53(3): 864-890.
See: Goldberg J (2005). The Constitutional Status Of Tort Law: Due Process And The Right To A Law For The Redress Of Wrongs. *Yale Law Journal*, 115:524-534.

[19] **See**: Merrill T (2000). The landscape of constitutional property. *Virginia Law Review*, 86(5):885-999);

See: Anonymous (1982), supra;
See: Edelstein R, Urosevic B & Wonder N (2005). Ownership Dynamics of REITs. *Journal of Real Estate Finance and Economics*, 30(4):447- 466;
See: Anonymous (1979). Securities Law and the Constitution: State Tender Offer Statutes Reconsidered. *The Yale Law Journal*, 88(3): 510-520.

Furthermore, securitization imposes substantial burdens on interstate commerce because: **a)** due diligence costs are higher for out-of-state collateral, than for in-state collateral, and hence, securitization impliedly or directly discourages the use of geographically dispersed assets as collateral; **b)** the geographical location of the servicer is critical to the profitability of the securitization process, and hence securitization encourages specific geographical preferences; **c)** compliance costs and processing costs per transaction increases drastically with the number of store locations; d) under the present legal regime, securitization introduces conflicts of laws – arising from non-uniform laws; e) .

2. Free Speech Rights.

Securitization is a violation of the Free-Speech Clause of the US Constitution. Typically, the sponsor of the securitization transaction and the trustees (or members of the board of directors) of the Special Purpose Vehicle ('SPV"), negotiate and determine the applicable dividend rates (where the trust issues preferred securities or other equity securities) and interest rates (on bonds issued by the trust) prior to the offering, and the

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See: Warren M (1997), Federalism And Investor Protection: Constitutional Restraints On Preemption Of State Remedies For Securities Fraud. *Law and Contemporary Problems*, 60(3-4):169-201.
See: Landrum D (2003). Governance of limited liability companies - Contrasting California and Delaware models. *The Real Estate Finance Journal*, 19(1);.

See: Larbalestier P (1990). Australian Corporations Act Held to Be Unconstitutional. *International Financial Law Review*, 9(4): 11-12;

See: Williams T & Lundeen W (2002). Taxation And The Business Of The Internet, Part II: The Shaky Ground Of The Commerce Clause. *Corporate Business Taxation*, 4(3):11-15;

established terms are not changed during the life of the ABS. The sponsor and the intermediary bank typically appoint the SPV's trustees. The key issues are:

- The SPV's dividend policy and debt policy are essentially set by the sponsor and the intermediary investment bank.
- The SPV is typically organized as a state-law trust, LLP, LLC or a c-corporation, and hence should be free to establish its own debt policy and dividend policy which should change over time.

These conditions constitutes violations of the free speech rights of the SPV (and the SPV trustees), and holders of the SPV's beneficial interests, because:

1. Corporate Dividend policy and debt policy are constitutionally-protected free speech and hence cannot be dictated by third-parties [20] – the SPV has protected property interests in determining and implementing its dividend policy and debt policy. The property interests arises from custom, state corporations/trusts laws, state constitutional laws and expectations. Dividend policy and debt policy are forms of communication to capital markets and investors. Numerous empirical finance studies have identified information content in dividend policy. Dividend policy and debt policy involve recurring decisions and announcements. Dividend policy and debt policy

[20] **See**: *City Of Boerne v. Flores*, 521 US 507 (1997); **See**: *Bartnicki v. Vopper*, 532 US 514 (2001); **See**: *National Endowment Of The Arts v. Finley*, 524 US 569 (1998); **See**: *Rosenberger v. University Of Virginia*, 515 US 819 (1995); **See**: *Rust v. Sullivan*, 5001 US 173 (1991); **See**: *44 Liquormart*, ___ US ____(1996); See: *Buckley v. Valeo*, ____ US ____ (1976); **See:** *First National Bank Of Boston v. Belotti*, 435 US 765 (___). **See**: *Austin v. Michigan Chamber of Commerce*, ___ US ____(___). **See:** *FEC v. Masssachussetts Citizens For Life Inc.*, ___ US ____ (____). **See:** *Buckley v. American Constitutional Law Foundation*, ___ US ____ (___); *Nixon v. Shrink Missouri Government PAC*, ___US ____(_____); *Pacific Gas & Electric v. Public Utilities Commission*, 475 US 1 (1986); *Lorillard Tobacco v. Reilly*, ___US ____(2001); *Nike Inc. v. Kasky*, _____ US _____(2003); *BASF Corp v. Peterson*, ____ US ____ (2005); *Virginia Board of Pharmacy v. Virginia Citizen's Consumer Council Inc.*, 425 US 748 (1976).
See: Greenwood D (1998), Essential Speech: Why Corporate Speech Is Not Free, *Iowa Law Review*, 83: 995-1010.

represent expressions of the entity's condition and prospects, and typically dont violate any civil or criminal laws, and don't harm other parties.

There is the required "compulsion" by the sponsor and the intermediary bank – they elect/select the trustees, and the trustees don't get compensated and the deal will not be executed unless the trustees agree with the sponsor and the intermediary bank. There is actual and implied compulsion because the sponsor retains substantial and almost complete control of the SPV before the securities offering, and during this pre-offering period, the sponsor effectively compels the SPV to adopt specific dividend policies and debt policies.

Hence, for purposes of constitutional law analysis, the "state-action"[21] consists of **a)** the afore-mentioned 'compulsion' - the conduct of the sponsor and the intermediary bank who are in effect performing the regulatory role of the government, and are "standing the government's shoes"; or **b**) the sponsor's determination and implementation of dividend policy and debt policy for the SPV; c) failure of the

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[21] **See**: *Evans v. Newton*, ____US____ (1966).
See: *Evans v. Abney*, ___ US ____ (1970).
See: *Burton v. Wilmington*, ___ US ____(1971).
See: *Moose Lodge v. Irvis*, ___ US ____(1972).
See: *Edmonson v Leesville Concrete*, ____ US ___(1991).
See: Tushnet M (2003). The Issue Of State Action/Horizontal Effect In Comparative Constitutional Law. *International J. Of Constitutional Law*, 1(1):79-98.
See*: Marsh v. Alabama*, ___*US* ___ (1946).
See: *Screws v. US*, 325 US 91 (___).
See: Stephen Ellman, "Constitutional Confluence: American "State Action; Law And The Application Of South Africa's Socio Economic Rights Guarantees To Private Actors", 45 New York law School Law Review ____ (2001).
See: Stephen Gardbaum, *The "Horizontal Effect" of Constitutional Rights*, Michigan Law Review, 102: 387-398 (2003).
See: Stephen Gardbaum, Where The (State) Action Is, *Int. J. Constitutional Law*, 4:760-779.
See: Currie D (1986). Positive And Negative Constitutional Rights. *University Of Chicago Law Review*, 53(3): 864-890.
See: Goldberg J (2005). The Constitutional Status Of Tort Law: Due Process And The Right To A Law For The Redress Of Wrongs. *Yale Law Journal*, 115:524-534.

government to enact and implement rules that govern SPV dividend policies in securitizations (which are different from dividend policies of normal corporate entities).

3. *Right-To-Contract*

Securitization constitutes a deprivation of the SPV's, and the SPV shareholders' and the SPV trustees' constitutionally protected right to contract [22] because: **1)** the sponsor has almost complete control of the SPV in the pre-offering period, and determines terms of the ABS issuance/offering; **2)** the SPV shareholders/bondholders and the SPV trustees cannot change the terms of the ABS.

The SPV shareholders' and the SPV trustees have constitutionally protected property interests in negotiating and entering into contracts that are not illegal or otherwise offensive to others. These property rights arise from state constitutional law, state contract law, expectations and norms.

However, the government's legitimate property interest in promulgating laws that enhance efficiency of the capital markets (such as usury laws) is far outweighed by the property interests of the SPV shareholders/bondholders/trustees – **a**) there are no sufficient public policy concerns that justify upholding the government's property interests; **b**) the contract at issues has far reaching effects on other parties and significant economic effects on the parties.

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[22] See: *Nollan v. California Coastal Commission*, 483 US 825 (1987);
See: *Dolan v. City OF Tigard*, 512 US 374 (1994);
See: *Lochner v. New York*, 198 US 45 (1905).
See: *Keystone Bituminous Coal Ass'n v. DeBenedictis*, 480 U.S. 470, 505 (1987).
See: *Boys Scout Of America v. Dale*, 530 US 640 (2000).
See: *Regan v. Taxation With Representation*, 461 US 540 (1983)(affirming IRS denial of tax exemption status to a nonprofit organization due to the organization's attempts to influence legislation); *Healey v. James*, 408 US 169 (1972)(freedom of association); *Brotherhood Of Railroad Trainmen v. Virginia*, 377 US 1 (1964)(right of association).

The 'state action' [23] consists of any of the following: **a**) the sponsor's act of specifying/controlling the terms of the ABS offering, because by doing so, the sponsor is essentially acting in the regulatory capacity of the government; **b**) the government's omission which consists of not promulgating laws that will govern terms of ABS; **c)** the failure (omission) of certain industry participants such as the NYSE, NASD and SEC to enact specific laws that govern the ABS terms – these entities are effect acting in the same role as the government.

4. Equal Protection

Securitization constitutes violation of the Equal Protection Clause of the US Constitution. There is no one uniform set of laws for securitization; rather, securitization typically uses state corporation laws, federal bankruptcy laws, state mortgage laws and state UCC laws. The relevant state-action is the government's failure to provide uniform laws for securitization.

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[23] **See**: *Evans v. Newton*, ____US____ (1966).
See: *Evans v. Abney*, ___ US ____ (1970).
See: *Burton v. Wilmington*, ___ US ____(1971).
See: *Moose Lodge v. Irvis*, ___ US ____(1972).
See: *Edmonson v Leesville Concrete*, ____ US ___(1991).
See: Tushnet M (2003). The Issue Of State Action/Horizontal Effect In Comparative Constitutional Law. *International J. Of Constitutional Law*, 1(1):79-98.
See*: Marsh v. Alabama*, ___*US* ___ (1946).
See: *Screws v. US*, 325 US 91 (___).
See: Stephen Ellman, "Constitutional Confluence: American "State Action; Law And The Application Of South Africa's Socio Economic Rights Guarantees To Private Actors", 45 New York law School Law Review ____ (2001).
See: Stephen Gardbaum, *The "Horizontal Effect" of Constitutional Rights*, Michigan Law Review, 102: 387-398 (2003).
See: Stephen Gardbaum, Where The (State) Action Is, *Int. J. Constitutional Law*, 4:760-779.
See: Currie D (1986). Positive And Negative Constitutional Rights. *University Of Chicago Law Review*, 53(3): 864-890.
See: Goldberg J (2005). The Constitutional Status Of Tort Law: Due Process And The Right To A Law For The Redress Of Wrongs. *Yale Law Journal*, 115:524-534.

Securitization violates the Equal Protection Doctrine because the 'specific combination of application of different laws/rules and circumvention of requirements of laws/rules": **a**) unfairly discriminates between those who have the knowledge to structure bankruptcy-remote entities/transactions and those who do not have the knowledge; **b**) unfairly discriminates between parties who can afford to hire skilled lawyers and accountants to circumvent relevant bankruptcy law statutes, and those who cannot afford to hire skilled advisors; **c)** unfairly discriminates between different securitization transactions done using various combinations of state corporation laws, federal bankruptcy laws, state mortgage laws and state UCC laws – the final result is the same but the legal protections/remedies provided to various parties differ; **d)** unfairly discriminates between SPVs that are different entities – ie. trusts vs. LLPs vs. LLC vs. C-Corporation.

Furthermore, the magnitude of legal protection for the mortgagee/borrower and the investor significantly depends on ABS tranche and the associated protections.

The foregoing challenged classifications do not serve any compelling government interest, and the classifications are not substantially related to serving any legitimate government interest [24].

5. *Separation Of Powers.*

[24] **See**: *Railway Express v. New York* , __US___(1949). **See**: *Kotch v. Bd. of River Port Pilot Commissioners,* ___ US ___(1947). **See**: *Skinner v. Oklahoma,* ___ US ___(1942). **See**: *Korematsu v. United States,* ___ US ___(1944). **See:** *Loving v. Virginia,* ___US ____(1967). **See**: *Washington v. Davis,* ____ US ___ (1976). **See:** *Arlington Heights v. MHDC,* ___US ____ (1977).

Securitization constitute a violation of the Separation-Of-Powers doctrine. [25] **T**he main disputes in securitizations pertain to default, replacement/substitution of collateral and trustees duties. When there are problems with securitization using SPV's, the usual venues for resolution are:

a) The bankruptcy court – however, the bankruptcy laws governing securitizations and SPVs consists of both federal bankruptcy statutes and bankruptcy judge-made law (such as stays). The judge-made law arises partly from the significant discretion grated to bankruptcy judges, and the substantial flexibility in subsequent interpretations of such man-made laws. Hence, the US bankruptcy court's combined role of enactment and enforcement of laws pertaining to SPVs in securitization, constitutes violations of the separation-of-powers doctrine.

b) *The Securities And Exchange Commission* – The SEC adjudicates disputes related to disclosure by SPVs, sponsors, rating agencies and investors. The SEC enacts and implements its own rules pertain to disclosure, which the SPV must comply with. Hence, the SEC's combined role of enactment and enforcement of laws pertaining to SPVs in securitization, constitutes violations of the separation-of-powers doctrine.

c) *US Internal Revenue Service* - The US IRS adjudicates disputes related to taxation of SPVs, sponsors, rating agencies and investors. The IRS implements both its own rules and the US Internal Revenue Code (created by Congress), which the SPV must comply with. Hence, the IRS's combined role of enactment and enforcement of laws pertaining to SPVs, constitutes violations of the separation-of-powers doctrine.

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[25] [25] **See:** Katyal N (2006). Internal Separation of Powers: Checking Today's Most Dangerous Branch From Within. *Yale Law Journal*, 115:2314-2320.

6. *Right Of Association.*

The requirements that:

a) The SPV's use of pre-specified _____ constitutes a violation of the SPV's right-of-association.

b) The requirement that the SPV

c) The requirement that the SPV

F. *Securitization Constitutes A Violation Of Federal RICO Statutes*

In 'true-sale' or 'assignment' securitizations, there are fraudulent transactions which serve as 'predicate acts' under federal RICO statutes[26]. 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).

[26] *See*: Colloff M (2005). The Role of the Trustee in Mitigating Fraud in Structured Financings. *Journal of Structured Finance*, 10(4):73-85.

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 present s opportunities for 'predicate acts" (ie. fraud, conversion, etc.) because:

1. The collateral could be over-valued. There are no state or federal laws that require independent valuation of collateral or appointment of independent/certified trustees in securitization transactions. The parties involved are often business acquaintances.

2. The trustees can be, and are influenced by the sponsor/originator and or intermediary-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 a strong 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 [27] statutes because:

See: Shakespeare C (20030. *Do Managers Use Securitization Volume And Fair Value Estimates To Hit Earning Targets* ? Working Paper, University Of Michigan (School Of Business)

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"[28] of:

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.
See: Pickhjolz 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):

[27] See: 18 USC 1961-1968.
[28] 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").

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.

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,

G. Securitization Constitutes Violations Of US Antitrust Laws

The various processes in securitization constitute violations of the US Antitrust statutes. [29]. These violations are described as follows.

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..

Market Integration: The ABS and MBS markets are essentially national (geographically-diverse entities/individuals participate in each transaction) and this has two main effects: a) it reduces competitive pressure on dominant companies/groups, b) it

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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); .

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.

[29] 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).

raises market-entry barriers by making it more expensive to conduct ‘road-shows’ for new offerings.

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

Collusion occurs because:

a) The price determination process is not transparent or democratic. The lead underwriters typically negotiate the offering price with the sponsor and the investors. 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 syndicate members are hidden. 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.

b) The lead and junior underwriters allocate new-issue ABS to investors based on suitability and in-house criteria. There are no established major guidelines for such allocation. The lead and junior underwriters will typically collude to determine that only investors deemed appropriate are allocated ABS. Hence, the antitrust violation (collusion) occurs solely by the underwriters’ 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.

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 errornously incorporates the demand/supply relationships of the US treasury market, into the ABS/MBS markets. The key question then, is whether there are conditions under which the US treasury 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 market and the US ABS market:

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 Fed 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 further execerbates 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 securities differ from those of investors in ABS markets. Hence, investors are very likely to view these two markets and the underlying risks differently.

Vertical Foreclosure: In the ABS and MBS markets some investment 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 make their infrastructure and relationships available to competitors. Such vertical foreclosure consitutes antitrust.

Tying[30]: a) the sponsor is sometimes formally or informally required to 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, 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, d) the investor maybe required .
These acts constitute tying.

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[30] 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).

Price-Fixing[31] – 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 good/services in either the transaction, or a series of transactions or in the sector/industry as a whole. Since the intermediary-investment bank is central to ABS offerings, and associated pricing and negotiations, the price collusion 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 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.

Exclusive Contracts [32] – Exclusive contracts facilitate and enhance anti-competitive behavior by contractually restricting conduct - these include: a) contracts that prevent the intermediary bank from providing financial services to other sponsor-

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[31] 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. Ticor Title Insurance Company*, 504 US 621 (1992); *Allied Tube & Conduit Corp. v. Indian head Inc*., 486 US 492 (1988).

[32] See: *Standard Oil Co v. US*, 337 US 293 (1949); *US v. Griffith*, 334 US 100 (1948).

companies in the same industry/sector, b) contracts that prevent or limit the formation of a syndicate of securities dealers.

Price Discrimination[33] – there are three classes of ABS: a) IO – interest only securities; PO – principal only securities and c) traditional ABS that pay both interest and principal. In many cases, 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, such stratified offerings within each class (IO, or PO or ordinary) constitutes price discrimination because the underlying asset and risk is essentially the same, although different securities are being offered in the same transaction (series of tranactions), at different prices to investors, based on the same asset.

Predatory Pricing[34] - 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:

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.

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[33] 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).

[34] 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).

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.

Lack of Transparency: The ABS market often lacks transparency in terms of name/size/types of investors, actual pool performance, determination of offering prices, quality/effectiveness of contracts, availability of investor capital that can be used to purchase ABS, etc..

H. *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.

1. The sponsor agrees to transfer the collateral to the SPV, and the SPV in return pays cash to the sponsor. In true-sale transactions
2. The SPV investors purchase beneficial interests in the SPV. 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 in exchange for the purchase amount, is promises to purchase the collateral, and to make payments from the SPV assets. Hence, a present asset is being exchanged for a future asset that does not exist as of the contract. This contract is void and illegal for the following reasons:

1. Lack Of Consideration [35] – there is no consideration in many of the contracts used in effecting securitizations. There are three main issues:

a) Unilateral Executory Promise [36]– 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 promise (agreement) - where the sponsor agrees to substitute impaired collateral.

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[35] 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 Lavorro*, 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. FPl 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).

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

- Assignment of future collateral (not yet existing) may be deemed a unilateral executory promise by the assignor.

b) *Illusory Promises*[37] – An illusory promise is not a valid consideration for a contract. The following are some illusory promises inherent in securitization transactions:

- 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 other corporate documents. In most cases, the offering prospectuses don't state the exact steps in the SPV's purchase of the collateral.

- Furthermore, all securitization offerings are done pursuant to 'Subscription Agreements' and Investor Questionnaires – the two documents have to be signed by the 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 exists is an implied agreement to subject the investor to the SPV's articles of incorporation and board of directors' (or Board of Trustee's) decisions.

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[37] *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.

- 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.

c) *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. [38]. In some securitizations, the process of setting offering prices for new issues does not afford all parties the opportunity to negotiate terms, especially individual investors. Furthermore, some

2. *No mutuality* [39] – in this context, for there to be mutuality, each party must have firm control of the subject matters of the contract and the underlying assets (consideration), and there should be a direct contractual relationship between the parties. At time of contract, the SPV typically does not own or have rights to the collateral. 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, and in exchange a loan to the sponsor.
- The sponsor typically controls the SPV before the offering and determines (or substantially influences) the SPV's post-offering operating characteristics.
- The sponsor influences the appointment of the SPV's trustees or board of directors.

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[38] *Prudential Insurance v. Sipula*, 776 F2d 157 (CA7, 1985)(no consideration where party to contract could not bargain for alleged agreement).
[39] See: *Tampa Pipeline Transport v. Chase Manhattan Service Corp*., 928 Fsupp 1568 (MD.Fla., 1995)(*affirmed*) 87 F3d 1329.

Thus, the use of the SPV effectively removes any mutuality between the two main contracting parties.

3. *Illegal subject matter And Contravention Of Public Policy* [40] – as explained in preceding sections, securitizations result in violations of antitrust statues and federal RICO statutes, and hence, the contracts used to effect securitizations are void and illegal.

Conclusion

Under US laws, Securitization is clearly illegal. Thus, the legal system should be changed: a) enactment of special federal securitization statutes, b) changes in law enforcement patterns and practices.

[40] 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).