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DETRIMENTAL LEGAL IMPLICATIONS OF OFF-BALANCE SHEET SPECIAL PURPOSE VEHICLES IN LIGHT OF IMPLICIT GUARANTEES

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In the face of financial institutions’ spiraling asset prices, large write-offs, and excessive risk exposure firms are being forced to guarantee their SPVs and VIEs. In light of current accounting standards, financial firms’ efforts to preserve their institutional reputation by maintaining implicit guarantees on off-balance sheet SPVs have rendered the SPV moot as a viable vehicle of off-balance sheet asset transfers. The fundamental problem with these implicit guarantees is that they appear to violate the “true sale” element of the ABS process under FAS 140 and cause the sponsor to be designated a “primary beneficiary” under FIN 46(R). Under FAS 140, if a true sale does not occur, then assets should not be removed from the sponsoring firm’s balance sheet. If assets still are transferred from the sponsor to the SPV, the SPV would lose its bankruptcy remote status and the SPV would be susceptible to a “claw back” of its assets in the event the sponsoring firm enters bankruptcy. In addition, under FIN 46(R) the sponsor would also be considered the primary beneficiary of its VIEs. As the primary beneficiary the firm must consolidate its VIEs or fully disclose it’s VIE relationship. Most financial firms are not acting in accordance with these standards and have also failed in their duty to adequately disclose the risk of exposure to their SPVs. This presents what this paper calls the fundamental flaw in the system of off-balance sheet debt transfers, which could potentially spell the industry’s downfall. Even more importantly, given the magnitude of these originating sponsors’ off-balance sheet obligations and the fact financial that sponsors’ stock price have declined dramatically after a complete picture of their SPV holdings were revealed, it appears that the failure to adequately disclose sponsors’ off balance sheet obligations amounts to a material misrepresentation and a violation of SEC disclosure rules. Thus, the ultimate result of sponsors’ implicit guarantees is to subject the financial industry to significant legal liability to its investors.

1. INTRODUCTION

The financial press has squawked incessantly with headlines warning of impending financial doom and gloom. The conversation often swirls around the sub-prime meltdown, multi-billion dollar writedowns, and the precarious financial position of previously stable banks prompting
takeovers and government bailouts. As a result, investors are facing massive losses. At the center of this turmoil lies a serious problem worthy of attention: in the midst of financial difficulty, financial institutions are consolidating the off-balance sheet debt from their failing special purpose vehicles (“SPVs”). This action begs the question: Can firms legally do this without suffering negative consequences? In other words, if firms move risky assets and debt off of their balance sheets are they, under current accounting, bankruptcy, and SEC rules, able to move those assets and debt back onto their balance sheets when those vehicles face financial hiccups?

Financial firms face a profound dilemma: many of their SPVs, especially those containing collateralized debt obligations (“CDOs”) filled with mortgage backed securities or leveraged buyout debt, are suffering heavy losses. On one hand, financial firms feel the desire to leave those risky securities in their off-balance sheet vehicles avoiding massive writedowns and risking a lower credit rating. On the other hand, these firms face significant institutional pressure to maintain their credible reputation, which often forces them to implicitly guarantee their SPVs’ securities to the market. This implicit guarantee requires firms to support their SPVs in a financial crisis. Unfortunately, current accounting rules governing the formation of SPVs and their cousins, the variable interest entities (“VIEs”)—FAS 140 and FIN 46(R)—do not allow firms to guarantee their off-balance sheet assets and debt.

Under the Financial Accounting Standards Board (“FASB”) structure, if an originating sponsor is either explicitly or implicitly obligated to consolidate their off-balance sheet assets or debt in its VIE, the sponsor is deemed the entity's “primary beneficiary” and must consolidate the entity onto its balance sheet. In fact, a “true sale” of the sponsor’s debt to the SPV must take place in order for the debt to be deemed “off-balance sheet.” If no true sale occurs, the SPV will not be considered bankruptcy remote and its debt and assets cannot be consolidated onto the sponsoring firm’s balance sheet. The implicit guarantee violates the premise of a true sale as well FAS 140 and
Fin 46(R) because it fundamentally shifts the expected risk of loss from the SPVs’ investors to the sponsoring firm.¹

Furthermore, violation of accounting rules FAS 140 and FIN 46(R) have profound consequences for complying with SEC disclosure rules and Rule 10b-5. Simply put, if the firm’s implicit guarantee requires it to consolidate its SPVs and VIEs then that firm must fully disclose the amount of its off-balance sheet holdings as well as its risk exposure to its SPVs. Failing to do so may amount to a material misrepresentation of that firm’s financial information resulting in massive legal liability.

This paper proceeds as follows: Part 2 describes the recent cases of bringing off-balance sheet vehicles onto the balance sheet and the results of doing so. Part 3 describes the fundamental flaw in the off-balance sheet transfer system. Part 4 describes the structure and functionality of SPVs and VIEs. Part 5 describes the governing accounting rules for SPV off-balance sheet debt. Part 6 discusses regulatory bankruptcy rules of SPV off-balance sheet debt. Part 7 more fully discusses the implicit guarantee and the evidence for its existence. Part 8 discusses why failure to disclose liabilities for the implicit guarantee violates FASB rules. Part 9 provides a discussion and analysis of why, if failure to disclose liabilities for the implicit guarantee violates FASB accounting rules, as well as Rule 10b-5 and SEC disclosure rules. Part 10 provides a conclusion.

2. RECENT CASES OF BRINGING OFF-BALANCE SHEET VEHICLES ONTO THE BALANCE SHEET AND THE RESULTS OF DOING SO

In December 2008, the Bloomberg News Service ran a story about a suit filed against Citigroup in Manhattan Federal Court alleging Citigroup fraudulently managed its structured

¹ For a more thorough discussion about this assertion the reader is referred to pages 9-12, 20-23 of this paper.
CDOs. “Citigroup also misrepresented and concealed its exposure to SIVs,” or structured-investment vehicles, the complaint alleges, referring to the funds as “ticking time bombs that eventually exploded back onto Citigroup’s balance sheet.”

This suit, which will probably be the first of many, stems from action occurring over a prolonged time period. It was not until the first wave of financial collapse that occurred at the end of 2007 did the extent of firms’ exposure to their SPVs become apparent. On November 27, 2007, HSBC, then Europe’s largest bank by market value, bailed out its two structured investment vehicles (“SIVs”). The London-based company took on $45 billion of assets from their SPVs, SIVs, and VIEs and swapped HSBC-backed debt for their investors’ holdings. The decision to bring their SPVs—holding bonds backed by sub-prime loans and other high-yielding debt securities—back onto its balance sheet provided HSBC with an alternative to dumping their holdings at fire-sale prices.

Less than two weeks later, Citigroup, then the United States’ largest bank by assets, also made the decision to consolidate its SPVs, SIVs, and VIEs back onto its balance sheet, representing $49 Billion in value. Although it appeared to the public like alphabet soup run amuck, in a released statement, both Citigroup and HSBC did not expect material amounts of losses to result from bringing their SPVs onto their balance sheets because they claimed that the SPVs’ equity holders would bear the brunt of any potential write-downs. Citigroup, however, lost over 45% of its shareholder value as investors in Citigroup learned Citigroup’s capital base had been comprised of

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3 Id.
4 See David Wilson, HSBC’s Example, Citigroup’s About-Face, Dubai’s Losses, BUSINESS WEEK, Nov. 27, 2007.
massive holdings in off-balance sheet investment entities, primarily SPVs, SIVs, VIEs and CDOs. Similar problems occurred at numerous financial institutions throughout the industry.

Until the third quarter 2007 earnings release, investors did not know that Citigroup’s capital structure was compromised by heavy involvement in asset-backed securities (“ABS”), CDOs, SPVs, SIVs, and VIEs. Until that time, Citigroup’s earnings releases and SEC filings provided practically no details with respect to the firm's CDO exposure, or it’s financing obligations for its off-balance sheet instruments. This practice of limited disclosure concerning firms’ off-balance sheet exposure was typical of the industry. In fact, Citigroup, like numerous other financial institutions (Merrill Lynch, Morgan Stanley, Lehman, etc), publicized its supposed success and competency in managing their SPV risks. On July 20, 2007, CFO Gary Crittenden claimed that Citigroup’s “risk team did a nice job of anticipating [their off balance sheet exposure] and so set about in a pretty concentrated effort to reduce [that] exposure.” Citigroup claimed that its exposure at the end of the second quarter of 2007 was contained to $13 billion. Citigroup never disclosed the details (or even confirmed the existence) of their $49 Billion in SPV exposure until November 2007.


7 From mid-October 2007 through November 2, 2007, Merrill Lynch lost over $17 billion in shareholder equity after investors learned the tragic consequences of its gamble with SPVs, SIVs and sub-prime lending in CDOs. While Merrill Lynch investors have long known that the company was involved in CDOs and sub-prime lending, the company concealed the true extent of its risk from shareholders. As the declines in the housing and credit markets worsened, Merrill Lynch redoubled its concealment efforts. In mid-July, the company stated that its risk management and hedging “have proven to be effective in mitigating the impact [of dislocation of credit markets] on our results.” CFO Jeff Edwards said that the company had implemented “proactive aggressive risk management” that put it “in an exceptionally good position.” In fact, the company had increased its exposure to sub-prime and CDOs, and would face disaster unless these markets abruptly turned around. On October 24, 2007, investors learned the true amount of Merrill Lynch’s third quarter writedown. It was not $4.5 billion, as the company had stated nineteen days earlier, but an even more whopping $7.9 billion; and the company admitted that its previously-touted risk management and hedging
According to a February, 2008 filing, Citigroup had $320 billion in unconsolidated VIEs. Merrill Lynch, which recorded $24.5 billion in subprime writedowns, had $22.6 billion in VIEs, and Lehman, which wrote down the net value of subprime securities by $1.5 billion, later committed to guarantying $6.1 billion of its VIEs.  

Concerned about the banking industry’s lack of disclosure, the Security and Exchange Commission (“SEC”) sent a letter to industry officers, recommending companies disclose the types of securities and the credit ratings of assets held in off-balance sheet entities. The SEC also recommended that financial firms provide “detailed disclosure” regarding any “triggers associated with obligations” to SPVs and SIVs. On November 2, 2007, the Wall Street Journal ran a front page story revealing that the SEC had opened an informal inquiry into the industry’s disclosure and valuation of its mortgage securities.

3. THE FUNDAMENTAL FLAW OF THE OFF-BALANCE SHEET TRANSFER SYSTEM

Given the turbulent state of the financial markets, and more specifically, the banking and credit industries, it is important to understand the ABS process and how previous ABS deals were structured. In general, firms employ SPVs or SIVs (defined basically as managed SPVs) as the conduit of the ABS structure. An SPV is a legal entity created by a certain sponsor or originator by transferring assets to the entity to carry out some specific previously outlined purpose. The ABS activities had been totally ineffective. As a result of these ballooning losses and his lack of candor with investors, CEO Stanley O’Neal was forced to resign. See Id.


11 Although numerous derivative suits have been filed against Citigroup, Merrill Lynch, etc. most of these suits are based on claims of failure of good faith wherein these companies failed to prudently monitor their assets, etc. The author has failed to find suits alleging specific violation of the 1934 Act for a failure to properly disclose financial information.
process transfers assets to the SPV, which then sells securities to investors based on the future cash flows of those assets. Seldom are the underlying assets specifically transferred to the SPV. Rather, rights to the underlying cash flows from the assets dedicated to the SPV are assigned to the SPV, while the assets themselves are held in a trust and are only transferred to the SPV if needed.  

SPVs are critical to the ABS process because they are considered to be “bankruptcy remote.” Indeed, most of the value received by a sponsoring firm in an ABS transaction is derived from the elimination of bankruptcy costs associated with risky balance sheet receivables (i.e. credit card receivables or mortgage-backed securities). SPVs are used to move those risky receivables off-balance sheet. These assets can be removed off-balance sheet if they are appropriately transferred through a “true sale” of those assets. Lack of disclosure relating to these assets can occur because the assets are no longer reported on the sponsoring firm’s balance sheet.  

More specifically, Citigroup classified its SIVs under a specific subgroup called VIEs. VIEs are special purpose vehicles in which the sponsor or investor holds a controlling interest, not based on the majority of voting rights, and where the sponsor must consolidate such entities if it is deemed the primary beneficiary of the VIE. VIEs are governed through a 2003 set of rules laid out by the Financial Accounting Standards Board, FASB Interpretation No. 46(R), as well as the interpretive 2005 FASB paper on “implicit variable interests.”

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12 Notes on Funding Investments lecture from Gary B. Gorton, Professor, Wharton School of Business (Fall 2007) (on file with author).
13 Id.
14 Financial insurers have also played a significant part in this story. Beginning in February, 2008, the financial industry realized insurers of the industry’s SPVs, such as Ambac Financial Group Inc. and other guarantors, could no longer justify their AAA financial-strength ratings due to writedowns stemming from the surge in mortgage delinquencies among homeowners with the riskiest subprime-credit histories. As of February, 2008, the industry’s VIEs have had $784 billion in commercial paper outstanding, according to Moody’s Investors Service and the Federal Reserve. As a result, financial firms have been forced to return their VIE assets to their books, recording the declining value as losses. MBIA Inc., the biggest insurer, said it plans to separate its municipal and asset-backed businesses, a move that would likely result in a lower credit rating for the types of assets owned by VIEs. See Mark Pittman, Goldman, Lehman May Not Have Dodged Credit Crisis, BLOOMBERG, Feb. 26, 2008, available at http://www.bloomberg.com/apps/news?pid=20601109&sid=alExwdst38cQ&refer=home.
Under the FASB structure, if an originating sponsor is either explicitly or implicitly obligated to consolidate its off-balance sheet assets in its VIE in the event the VIE experiences economic difficulties, the sponsor is deemed the entity's “primary beneficiary” and must immediately consolidate the entity onto its balance sheet. Interpreting FIN 46(R), FASB Chairman Robert Herz said, “[this rule] requires a company and the auditors to understand all the arrangements in the structures, both explicit and implicit, and also understand the design and intent behind those structures…. And if there's a party at risk for a majority of the expected losses, then that party has to consolidate.”\(^\text{15}\) FASB member Tom Linsmeier added, “If a bank sponsor in deteriorating credit markets feels it is necessary in order to protect its reputation to provide an implicit guarantee of additional support to a VIE, and that additional support would make it the party that is expected to absorb the majority of losses, then the bank sponsor should be consolidating the VIE.”\(^\text{16}\)

Furthermore, recent studies have shown that due to the problems of moral hazard and adverse selection investors have historically been reluctant to purchase SPV-issued debt. To overcome this problem, studies have shown sponsors have implemented a form of trigger strategies to provide implicit guarantees to investors. Because sponsors will need to reissue SPV debt in the future, they are inclined to guarantee SPV debt in the event of financial difficulties.\(^\text{17}\) The aforementioned examples of HSBC and Citigroup affirm the existence of this practice.

The fundamental problem with these implicit guarantees is that they appear to violate the “true sale” element under FAS 140 and render the sponsor a primary beneficiary under FIN 46(R).


\(^{16}\) See Id.

\(^{17}\) Notes on Funding Investments lecture from Gary B. Gorton, Professor, Wharton School of Business (Fall 2007) (on file with author).
If there is no true sale, the assets should never be removed from the sponsoring firm’s balance sheet causing the SPVs to lose their bankruptcy remote status. This problem presents what this paper terms the fundamental flaw in the system of transferring of off-balance sheet debt.

4. SPVs & VIEs: DESCRIPTION AND FUNCTIONALITY

An SPV is a legal entity created by a sponsor or originator where the sponsor transfers assets to the entity to carry out some specific purpose or circumscribed activity. SPVs have no purpose other than the transactions for which they were created and they can make no substantive decisions; their governance is contracted in advance and carefully circumscribes their activities. Indeed, an SPV has no physical location. The legal form of the SPV may be a limited partnership, a limited liability company, a trust, or a corporation. In short, SPVs are essentially “robot firms” that make no substantive economic decisions, have no physical location, and cannot go bankrupt. Generally, the assets of SPVs are moved to the SPV through a legal sale. Thus, in theory, the originator moves these assets off of its own balance sheet and onto that of the SPV.

Typically, off-balance sheet SPVs have the following characteristics: (1) they are thinly capitalized, (2) they have no independent management or employees, (3) their administrative functions are performed by a trustee who follows prespecified rules with regard to the receipt and distribution of cash, (4) assets held by the SPV are serviced via a servicing arrangement, and (5) they are structured so that they cannot practically become bankrupt.

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18 Notes on Funding Investments lecture from Gary B. Gorton, Professor, Wharton School of Business (Fall 2007) (on file with author).
An essential feature of an SPV is that it be bankruptcy remote, that is, that the SPV is never be able to legally default. The simplest method of achieving bankruptcy remote status is to cause the SPV to waive its right to file a voluntary bankruptcy petition, but this is legally unenforceable. To eliminate the risk of either voluntary or involuntary bankruptcy, the SPV must be structured in a legal form that is ineligible to be a debtor under the U.S. Bankruptcy Code. SPVs are structured to achieve this result. To make the SPV as bankruptcy remote as possible, its activities are restricted. For instance, it can be forbidden from issuing debt beyond a stated limit.

One important way in which bankruptcy is avoided is early amortization. Typically, ABS securities have a stated maturity, but they may end their lives earlier. If the pool of assets within the SPV is not generating enough cash to make the coupon payments on its ABS bonds, then the cash that is available is used to make early principal payments, rather than coupon payments. This is called early amortization, that is, the principal is paid back before it is legally required. Early amortization is not an event of default, but risk faced by investors in ABS bonds, especially those issued by SPVs.

Early amortization is an event that is triggered by losses, problems with the seller or servicer, or legal problems. Examples include: (1) the failure or inability to make required deposits or payments, (2) the failure or inability to transfer receivables to the trust when necessary, (3) false representations or warranties that remain without remedy, or (4) the three-month excess spread falls below zero. Early amortization is one of the most widely used methods of insulating the SPV from credit risk and achieving bankruptcy remote status.

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21 See generally id.
23Notes on Funding Investments lecture from Gary B. Gorton, Professor, Wharton School of Business (Fall 2007) (on file with author).
24 The yield on the underlying loans that is paid into the trust should be high enough to cover the payment of interest on the asset-backed securities (ABS) tranches in addition to the servicing fees. Excess spread is generally defined as finance charges collections (i.e., the gross yield on the underlying receivables) minus certificate interest (paid to the
5. GOVERNING ACCOUNTING RULES FOR TRANSERING OFF-BALANCE SHEET DEBT TO THE SPV

The accounting rules treat the movement of a sponsoring firm’s debt off its balance sheet as a “true sale” such as one entity purchasing the assets of another entity. The accounting rules regard this sale as a commitment by the issuing firm to not support its SPV should the SPV experience an event of default or financial difficulties that could reasonably be foreseen as potentially leading to an event of default.

To report a transfer of assets as a sale, a sponsor or financial institution must satisfy the requirements of generally accepted accounting principles (“GAAP”) regarding sales of assets. The Statement of Financial Accounting Standards No. 140 (“FAS 140”) specifies circumstances under which transactions that purport to be sales of receivables should be accounted for as a financing. FAS 140 has a three-part test to determine whether a transfer of assets in a securitization transaction will be accounted for as a sale:  

1. the transferred assets have been isolated from the transferor; that is put presumptively beyond the reach of the transferor and its creditors, even in the bankruptcy of the transferor,
2. the transferee or, if the transferee is a trust, corporation or other legal entity that holds title to the transferred assets, each holder of its beneficial or debt interests, has the right to pledge or exchange the assets, beneficial or debt interests it received, and no condition constrains holders of the SPV debt), servicing fees (paid to the servicer of the receivables, usually the sponsor), and charge-offs (due to default by the underlying borrowers) allocated to the series. Depending on the structure of the SPV, available excess spread may be shared with other series in the Master Trust, used to pay credit enhancers, deposited into a reserve account to be used to cover charge-offs, or released to the sponsor.

It is important to note that as of earlier this year FASB has decided to “eliminate the concept of the QSPE” in the revised financial-accounting standard, FAS 140, and also will “remove the related scope exemption from FIN 46R,” says FASB director of technical activities Russ Goldin. FASB is still studying actual implementation and disclosure issues, but it seems pretty clear those QSPEs must eventually be consolidated onto the balance sheet. However, this will concern future implementation of off-balance sheet debt and not govern previous misuse of former FASB rules governing off-balance sheet debt transfers. See Bigpicture.typepad.com, http://bigpicture.typepad.com/comments/2008/06/fasb-bombshell.html (last visited Jan. 29, 2009).
the transferee or holder from taking advantage of its right to pledge or exchange and provides more
than trivial benefit to the transferor, and (3) the transferor does not maintain effective control over
the transferred assets through an agreement that entitles the transferor to repurchase the assets
before their maturity or to repurchase or redeem assets that are not readily obtainable.\textsuperscript{26} The basic
idea of FAS 140 is that to achieve a “true sale” characterization, the transferor must surrender
control of the transferred assets or, in other words, structure the transaction so that the transferred
assets are separated from the transferor.

Specifically concerning VIEs, FASB issued FIN 46(R) laying out the test for whether a
sponsor’s off-balance sheet VIEs are subject to consolidation. Basically, when the holder of a
variable interest shares in the majority of the economic risks and rewards (measured using the
expected losses and returns of the VIE) that holder becomes the “Primary Beneficiary” of the VIE
and must consolidate. Also, the exposure to a risk of loss will trump potential gains in this analysis.
If the sponsor is subject to the majority of the expected losses it must consolidate regardless of who
bares a majority of the expected gains.

FIN 46(R) is also a three parts of the rule (if the conditions in \textit{a}, \textit{b}, or \textit{c} exist a sponsor must consolidate): 1) the total equity investment at risk is not sufficient to permit the entity to finance its
activities without additional subordinated financial support provided by any parties, including
equity holders, 2) as a group the holders of the equity investment at risk lack any one of the
following three characteristics of a controlling financial interest: (i) the direct or indirect ability
through voting rights or similar rights to make decisions about an entity’s activities that have a
significant effect on the success of the entity, (ii) the obligation to absorb the expected losses of the
entity, and (iii) the right to receive the expected residual returns of the entity, or 3) the equity
investors as a group also are considered to lack characteristic (b)(1) if (i) the voting rights of some

investors are not proportional to their obligations to absorb the expected losses of the entity, their rights to receive the expected residual returns of the entity, or both, and (ii) substantially all of the entity’s activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights. For purposes of applying this requirement, a sponsor considers each party’s obligation to absorb expected losses and to receive expected residual returns related to all of that party’s interests in the entity and not only to its equity investment at risk. Ultimately, if an entity is deemed a VIE under FIN 46(R) the consolidation decision turns more on who bares the risk or reward for the entity’s expected losses or gains.

Even if the sponsor is not deemed the “Primary Beneficiary” of the VIE the sponsor still must disclose its relationship with the VIE. FIN 46(R) states that the sponsor must disclose: 1) the nature of its involvement with the VIE and when that involvement began, 2) the nature, purpose, size, and activities of the VIE, and 3) the enterprise’s maximum exposure to loss as a result of its involvement with the VIE.

It is important, however, to keep separate the different consolidation requirements for an SPV under FAS 140 and a VIE under FIN 46(R). As a specified exception to FIN 46(R), transferors to qualifying SPVs and “grandfathered” qualifying SPVs are only subject to the reporting requirements of FAS 140 and should not be analyzed under FIN 46(R). A firm is not required to consolidate a qualifying SPV or a “grandfathered” qualifying SPV unless the firm has the unilateral ability to cause the entity to liquidate or to change the entity in such a way that it no longer meets the requirements to be a qualifying SPV or “grandfathered” qualifying SPV.

FASB issued FSP FIN 46(R)-5 to interpret FIN 46(R) and to address whether a sponsor holds an implicit interest in a VIE. FASB defined whether a sponsor had an implicit variable interest, defined as an implied pecuniary interest in an entity that changes with changes in the fair value of the entity’s net assets exclusive of the variable interests. Implicit variable interests may arise from transactions with related parties, as well as from transactions with unrelated parties. Paragraph B10 of Interpretation 46(R) provides a perfect example of an implicit variable interest; that is, an implicit agreement to replace impaired assets held by a variable interest entity that protects holders of other interests in the entity from suffering losses.

Ultimately, the determination of whether an implicit variable interest exists is a matter of judgment that depends on the relevant facts and circumstances. An implicit variable interest may exist if the reporting enterprise can be required to protect variable interest holders in an entity from absorbing losses incurred by the entity.\(^{30}\) Fundamentally, that scenario occurs when a firm maintains an implicit guarantee of its SPVs, SIVs, or VIEs.

6. **BANKRUPTCY REGULATORY RULES ON SPV OFF-BALANCE SHEET DEBT**

As previously discussed, one of the sponsor’s primary benefits of an ABS transaction is that if the transfer to the SPV is a “true sale” the corresponding assets and liabilities may be removed from that sponsor’s balance sheet.\(^{31}\) Conversely, in a secured financing the sponsor’s assets remain on its balance sheet along with the additional liability in an amount equal to the secured financing.\(^{32}\) This additional liability will undoubtedly affect the sponsor’s credit rating, which essentially is an assessment of the credit risk of its assets. An effective “true sale” will also more properly allocate

\(^{30}\) See Financial Accounting Standards Board, FASB Staff Position on Interpretation 46(R) (FSP FIN 46(R)-5), 1-3 (2005).

\(^{31}\) See Structured Financing Techniques at 550.

\(^{32}\) See Structured Finance Goes Chapter 11 at 617.
risk, and substantively determine whether or not the SPV will be bankruptcy remote. Therefore, properly obtaining a “true sale” is imperative to effectuating an asset securitization.33

A “true sale” of assets to the SPV isolates those assets from the general financial risk of the sponsor, including bankruptcy. This isolation allows the investors in the SPV to purchase the SPV’s commercial paper or debt at a rate that takes into account only the risk inherent in the SPV and the securitized assets. Thus, the isolation for the sponsor reduces the risk of the SPV’s securitized assets.

No bankruptcy court has expressly laid out the test of when an asset securitization is a “true sale,” but bankruptcy courts have considered asset securitization transactions in the “true sale” context, as well as how it applies to other legal doctrines.34 To determine whether an asset securitization transaction is a “true sale” bankruptcy courts generally look to state law. In this context, a “true sale” usually involves the transfer by the sponsor of all of its right, title and interest in its assets to be securitized by the SPV. Thus, a “true sale” can been defined as a transfer of financial assets in which the parties state that they intend a sale, and in which all of the benefits and risks commonly associated with ownership are transferred for fair value in an arm’s length transaction.35

There are many factors to determine whether a transfer of assets should be treated as a “true sale.” In determining whether a particular transaction is a true sale courts frequently refer to the intent of the parties. Courts will ignore the labels used by the parties and conduct an investigation

34 See, e.g., In re LTV Steel Co., Inc., 274 B.R. 278 (Bankr. N.D. Ohio 2001) (discussing how the court analyzed asset securitization in the true sale context, but did not hold whether it was a disguised loan or a true sale); In re Kingston Square Associates, 214 B.R. 713 (Bankr. S.D.N.Y. 1997) (examining asset securitization in the context of whether to uphold the claim of bad faith for the involuntary bankruptcy by a SPV’s creditors).
35 Steven L Schwarcz & Peter V. Pantaleo (Reporter) et al., Rethinking the Role of Recourse in the Sale of Financial Assets, 52 BUS. LAW. 159 (1996).
of the true nature of the transaction by examining all of the factual circumstances. Under this analysis, it appears that the most important factor has been the extent to which the risks and benefits associated with ownership have either been retained by the sponsor or transferred to the SPV.\(^{36}\) One of the risks of ownership that it is always examined is whether the SPV and its investors, as opposed to the sponsor, bear the risk of loss with respect to the transferred assets. If the SPV or its investors fail to retain most of the risks or obligations of ownership, a court is likely to consider the transaction to not be a true sale.\(^{37}\)

For example, in *Major’s Furniture Mart, Inc. v. Castle Credit Corp.*, the sales contract placed all risk of account uncollectibility upon the seller, limiting the buyer’s risk to the possibility that the seller could not fulfill its obligations.\(^{38}\) Conceding that guarantees of quality or collectibility alone “might be consistent with a true sale,” the Third Circuit still held that a shifting of risk from the buyer to the seller never occurred.\(^{39}\) Therefore, the Court ruled that no “true sale” took place.\(^{40}\) In the SPV context, courts will probably follow the reasoning that if the risk of loss is not transferred from the sponsor to the SPV, due to the sponsor’s implicit guarantee of the SPV, then no “true sale” occurred between the sponsor and the SPV.

7. **THE ECONOMIC REALITY: THE IMPLICIT GUARANTEE AND EVIDENCE FOR THE EXISTENCE OF AN IMPLICIT GUARANTEE**

There are several motivations that exist for firms to engage in off-balance sheet transactions through the use of SPVs. These motivations are mainly to avoid bankruptcy costs by reducing the

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\(^{36}\) *See* Structured Financing Techniques at 543.


\(^{38}\) *See*, *Major's Furniture Mart, Inc. v. Castle Credit Corp.*, Inc., 602 F.2d 538 (3d Cir. 1979).

\(^{39}\) *Id.* at 543.

\(^{40}\) *Id.*
debt to equity ratios of the originators, and to gain access to lower costs of debt by moving risky
debt off of the originator’s balance sheet and raising their bond ratings. Also, off-balance sheet
financing allows firms to gain immediate access to periodic account receivables, which gives firms
the ability to finance new projects using these cash flows as collateral. These cash flows would
otherwise be unavailable.

There have been several studies that have attempted to explain why a firm should securitize
its assets. One study, by Jure Skarabot showed that securitization is a preferred choice for overall
firm capitalization because it avoids the costs associated with the standard bankruptcy procedure for
the firm.\footnote{Gorton and Souleles also found that empirical results are consistent with the theory that an implicit contractual
relationship between SPV sponsors and capital markets investors reduces bankruptcy costs. Consistent with the
prediction that in the Implicit Recourse Equilibrium investors would price the risk of the sponsor defaulting, and hence
being unable to subsidize the SPV, we found that the risk of the sponsor (as measured by the sponsor’s bond rating) was
consistently significant. The prediction of the model that firms with high expected bankruptcy costs would be the largest
users of off-balance sheet financing was also generally confirmed.} The essential feature, if sponsors are to avoid bankruptcy costs, is that SPVs cannot go
bankrupt. Indeed, Standard & Poor’s defines an SPV as “a bankruptcy-remote, special-purpose
entity that satisfies Standard & Poor’s SPV Criteria.”\footnote{See StandardandPoors.com,
http://www2.standardandpoors.com/portal/site/sp/en/us/page.siteselection/site_selection/0,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0,0.html (last visited Jan. 29, 2009).}

In the U.S. it is not possible to waive the
right to have access to the government’s bankruptcy procedure, but it is possible to structure an SPV
so that there cannot be “an event of default” which would throw the SPV into bankruptcy. This
means that debt issued by the SPV should not include a premium reflecting expected bankruptcy
costs, as there never will be any such costs.\footnote{The debt could, however, be repaid early due to early amortization. This is a kind or prepayment risk is born by the
investors.} Thus, one benefit to sponsors of securitization is that
the off-balance sheet debt should be cheaper than equivalent debt left on the sponsor’s balance
sheet. There are costs, however, to off-balance sheet debt. Legal and banking fees to structure
SPVs are costly. The SPV sponsor also does not receive tax advantages for its off-balance sheet
debt, a critically important element of highly leveraged firms.\textsuperscript{44} Depending on the structure of the SPV, the interest expense of off-balance sheet debt may not be tax deductible.\textsuperscript{45}

On the positive side, firms can create value through raising their bond rating by moving risky debt off-balance sheet. This allows sponsors to obtain less expensive financing and benefit from a lower cost of capital. This action also directly reduces balance sheet leverage. Enron, which created over 3,000 off-balance sheet SPVs, is the leading example of creating perceived value through by reducing its balance sheet leverage.\textsuperscript{46} But many argue that Enron was only able to obtain a lower cost of capital because it prevented its off-balance sheet debt from being observed by investors. The issue then arises: If market participants are aware of firms’ off-balance sheet vehicles, and assuming that these vehicles truly satisfy the legal and accounting requirements to be off-balance sheet, then how does this lower the cost of capital for the sponsor? The solution, however, is that rarely are the extent of off-balance sheet assets adequately disclosed by the originator or the sponsor to their shareholders.\textsuperscript{47} When off-balance sheet debt is disclosed, it is often opaque and difficult to understand by the average investor. In some contexts though, operating leases for example, Lim, Mann, and Mihov (2003) find that bond yields reflect off-balance sheet debt.\textsuperscript{48}

\textsuperscript{44} One of the principle positive aspects of high leverage in companies are tax shields. Companies can generally deduct interest payments on their corporate debt from their tax liabilities. Therefore, Ceretis Paribas, the present value of these tax shields increases overall firm value, granted the firm has sufficient cash flows to service the excess debt.


\textsuperscript{48} There are other reasons for setting up off-balance sheet SPVs. See, e.g. Cathy Shakespeare, Do Managers Use Securitization Volume and Fair Value Estimates to Hit Earning Targets? (working paper, University of Michigan School of Business, 2003); Cathy Shakespeare, Accounting for Asset Securitizations: Complex Fair Values and Earnings Management (working paper, University Of Michigan Business School, 2001). Shakespeare argues that managers frequently take the gains their firms receive from securitization to meet earnings targets and forecasts. Managers are able to do this, argues Shakespeare, because of how the “gain on sale” is booked; but see Charles W. Calomiris & Joseph R. Mason, Credit Card Securitization and Regulatory Arbitrage, 26 J. FIN. SERV. RES. 5 (2004).
In order for securitization through SPVs to function properly there must be both supply and demand for the securities issued by the SPVs. At first glance, the SPV appears to create more risk because its assets are off the balance sheet of its sponsor and thus removed through a “true sale” from the safe harbor of the sponsor’s backing. This additional risk exists because investors in SPV debt face not only a moral hazard problem (uncertainty about the quality of the individual assets allocated to the SPV) but an adverse selection problem with regard to which projects are allocated to the SPV.

Gorton and Souleles call this problem the “strategic adverse selection problem.” In this scenario, investors will not buy the SPV debt because they cannot overcome the strategic adverse selection problem. In short, because of the adverse selection problem the price investors are willing to pay would be rendered too low to make the transaction sufficiently attractive for sponsors to do the deal. If the sponsor can commit to subsidize the SPV, however, then the SPV is viable and can economically sell its debt. In particular, if the sponsor can commit to subsidize the SPV, then the profitability of the sponsor is the same as it would be when projects were allocated between the bank and the SPV prior to their realizations, i.e., when there was no strategic adverse selection.

Since the sponsor does not have any legal responsibility to back the assets of the SPV, investors will invest in SPVs only when they become sustainable. As has been seen recently with the current sub-prime mortgage devaluation, SPVs will only become sustainable in a repeated scenario when sponsors can implicitly “commit” to subsidize or “bail out” their SPVs when the SPV would otherwise default on its debt commitments.

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They argue in favor of the “efficient contracting view,” where firms use securitization to optimally use capital relative to risk in a manner consistent with market demands.

51 See id.
There exist formal requirements for determining the dealings between sponsors and their SPVs, including when the SPVs are consolidated and when the SPVs’ debts are off-balance sheet. There are, however, other, implicit dealings. Implicit dealings concern sponsors’ support of their SPVs and investors’ reliance on this support even though sponsors are not legally bound to support their SPVs—and in fact under accounting and regulatory rules are required not to support their SPVs.

Under the current legal structure, sponsors cannot verifiably commit to SPV subsidies because the courts would view such recourse as evidence the assets were never sold to the SPV in the first place. If this were to occur, the SPV would not be “bankruptcy remote.” Creditors of the sponsoring firm would then have the ability to “claw back” SPV assets in a bankruptcy proceeding of the sponsor. Gorton and Souleles argue that instead sponsors implement a set of trigger strategies to incentivize investors over time to follow an implicit arrangement rather than an explicit one. Firms sponsoring SPVs “collude” with the investors in the SPVs by agreeing to the subsidization of the SPV—recourse that is prohibited by accounting and regulatory rules. In this sense SPVs are a kind of “regulatory arbitrage.”

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52 See id.
54 This result is based on the familiar use of trigger strategies, see e.g. James W. Friedman, A Non-Cooperative Equilibrium for Supergames, 28 REV. ECON. STUD. 1 (1971); Edward J. Green & Robert H. Porter, Noncooperative Collusion under Imperfect Price Information, 52 ECONOMETRICA 87 (1984). Trigger strategies incentivize the originator or sponsor to maintain the implicit guarantee. Trigger strategies have previously been used to describe oligopolistic competition. In the oligopoly case incentives to collude are followed because of punishment periods that are triggered if one side deviates from the implicit agreement. Gary B. Gorton & Nicholas S. Souleles, Special Purpose Vehicles and Securitization (FRB Philadelphia Working Paper, No. 05-21, 2005), available at http://ssrn.com/abstract=713782.
55 Id.
In testing their position empirically, Gorton and Souleles show that because the value in using SPVs is derived in large part from avoiding bankruptcy costs, riskier firms should be more likely to engage in off-balance sheet financing, and indeed are.\textsuperscript{56}

Also, Gorton and Souleles find that investors do require significantly higher yields for credit card ABS issued by riskier sponsors, as measured by the sponsors’ credit ratings.\textsuperscript{57} This implies that investors in the debt of the SPVs incorporate expectations about the risk of the sponsor because the sponsor must exist in order to subsidize the SPV if problems arise. As Moody’s puts it:

Part of the reason for the favorable pricing of the [SPVs’] securities is the perception on the part of many investors that originators (i.e., the ‘sponsors’ of the securitizations) will voluntarily support—beyond that for which they are contractually obligated—transactions in which asset performance deteriorates significantly in the future. Many originators have, in fact, taken such actions in the past.\textsuperscript{58}

Beyond affecting prices, why would sponsors generally agree to make this implicit guarantee on their SPVs? One reason is so that sponsors can preserve their credibility in the market. Indeed, sponsors play a repeated game in which they will need to, over time, continue to go to the trough of ABS securitization. Agreeing with this principle, Fitch-IBCA stated:

“Although not legally required, [sponsors] may feel compelled to support a securitization and absorb credit risk beyond the residual exposure. In effect, there is

\textsuperscript{56}See, Lillian F. Mills & Kaye J. Newberry, Firms’ Off-Balance Sheet and Hybrid Debt Financing: Evidence from Their Book-Tax Reporting Differences, 43 J. ACCT. RES. 251 (2004) (finding that “firms use more structured financing arrangements when they enter into contractual loan agreements that provide incentives to manage debt ratings” and that firms with more debt and higher leverage, thus riskier, use more off-balance sheet debt); see also Moody’s (September, 1997).


\textsuperscript{58}Moody’s, 40 (September, 1997).
moral recourse since failure to support the securitization may impair future access to the capital markets.”

There have been numerous instances of voluntary support for SPVs. In addition to the recent examples cited above, in May 1989, Chrysler increased the amount of the letter of credit supporting CFC-2 Grantor Trust, from 7% to 9.5%, to offset weaker than expected performance of the trust’s underlying automobile loans. In November 1991, Sears added higher quality accounts to dilute the weak performance of existing receivables in a number of series of securitized credit card pools. There are at least fifteen other such examples.

By supporting its SPV, an originator presumably expects to benefit in the long-run. But, supporting its SPV means that the firm failed to originally transfer the risk off its balance sheet. The possibility, or perhaps likelihood, of implicit support means that there may be a difference between the accounting treatment of securitization and the economic impact of securitization.

8. WHY FAILURE TO DISCLOSE LIABILITIES FOR THE IMPLICIT GUARANTEE VIOLATES FASB RULES

From a bankruptcy point of view the most important factor in the true sale analysis has been the extent to which the risks associated with ownership in the ABS process have either been retained by the sponsor or transferred to the SPV. This is a difficult question to analyze. From the sponsor’s point of view, although not legally obligated, the sponsor maintains the option to support or bailout their SPVs to ensure they maintain their market reputation and have future access to the securitization markets. The sponsor could argue that a theory tantamount to the business judgment rule in corporate law should apply in these cases. The theory would support the view that the sponsor has the power to make a business decision it believes to be in its best interests. Absent

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60 Notes on Funding Investments lecture from Gary B. Gorton, Professor, Wharton School of Business (Fall 2007) (on file with author).
impropriety, the theory would suggest that this decision should be respected by the courts. Viewed through such a lens, the inherent risks in ABS transactions are initially transferred to the SPV and remain there indefinitely. Investors have no legal reason to believe sponsors are obligated to bailout their SPVs, and simply because investors expect a bailout does not mean the default risk is actually transferred from the SPV to the sponsor. Investors constantly price expectations into asset valuations, but that does not mean their expectation will automatically occur or that their expectation compels the sponsor to guarantee their SPVs. An implicit guarantee is not an explicit guarantee and should not be treated as such for “true sale” analysis purposes, or so the argument goes.

An implicit guarantee, however, although implicit, is still a guarantee. Sponsors accept a market price for the securities issued by their SPVs that would incorporate a premium based on the expectation that they will support their SPVs in the case of financial difficulty. Additionally, given the economics of the transaction, the necessity facing sponsors to continuously access the securitization markets, and how indispensable a sponsor’s reputation becomes in its ability to access that market, obligates sponsors to support and bailout their SPVs if necessary. Sponsors cannot, in a sense, have their cake and eat it too. If sponsors are, for all extent and purposes, required to support their SPVs, then sponsors are ultimately bearing the default risk of the SPVs’ assets. If SPVs becomes financially distressed, then it is the sponsor and not the SPV wherein lies associated default risk. Thus, it is probable that with an implicit guarantee, the “true sale” doctrine would be declared violated.

From an accounting point of view, under FAS 140, the accounting rules treat the securitization as a commitment by the issuing firm not to support their SPV should there be any financial difficulties in the SPV. The controlling language here arises from FAS 140 quoted above that states that in order for the off-balance sheet debt to be considered truly removed off of the
balance sheet the “transferred assets [must be] isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.”

This analysis is directly related to the argument above. If a true sale is violated, resulting in the SPVs failure as a bankruptcy remote entity, its transferred assets are no longer isolated from the sponsor. In short, when sponsors consolidate SPV assets onto their balance sheet they are per se supporting their SPV. By definition, this violates FAS 140. It then follows that if it is the intention, ex ante, of the sponsoring firm through an implicit guarantee to consolidate SPV assets pending financial difficulty, then the accounting rules would probably not treat the ABS process as an actual off-balance sheet transfer of the sponsor’s assets to the SPV in the first place.

In the VIE world, to determine whether a sponsor is deemed the primary beneficiary of the VIE, resulting in consolidation of the VIE, the same above analysis would apply. By maintaining an implicit ex ante guarantee on the obligations of their VIEs the sponsors are ultimately bearing the expected risk of the entity. An implicit relationship is specifically mentioned in FSP FIN 46(R)-5 as a sufficient element in determining primary beneficiary status. The rule comes with the implicating on-point example that a sponsor will be recognized as the primary beneficiary if there exists “an implicit agreement to replace impaired assets held by a variable interest entity that protects holders of other interests in the entity from suffering losses.” This example is the exact occurrence mentioned by Gorton above. Since liability for the expected risk of the entity is the main test in determining primary beneficiary status, it is likely that originating sponsors will be considered primary beneficiaries in regards to their VIEs. Thus, these sponsors should have consolidated their VIEs before they were forced to act on their guarantees. In other words, VIEs with implicit guarantees should not have existed as off-balance sheet vehicles in the first place.


\[62\] See supra note 55.
Even if originating sponsors, such as Citigroup or Lehman, are eventually not held to be primary beneficiaries of their VIEs their implicit guarantees would still require them to disclose their relationship with their VIEs in their financial statements, including the extent to which they are exposed to potential VIE losses. These firms are currently not adequately disclosing this exposure.

In short, what is referred to as the “fundamental flaw” in the current ABS system occurs because when sponsor firms implicitly guarantee their SPVs they violate the “true sale” doctrine rendering their SPVs vulnerable to a “claw back” of their assets in the potential bankruptcy proceeding of the sponsor. These SPV structures also fail to meet FASB accounting standards under both FAS 140 and FIN 46(R). This violation should also presumably place the previously transferred assets back onto the balance sheet of the sponsoring firm because essentially with out a “true sale” the assets were never legally transferred in the first place. In other words, if the SPVs are no longer bankruptcy remote from the sponsor, which is necessary in justifying the existence of securitization through SPVs, then the whole system is fundamentally flawed. If securitization through SPVs fails to transfer risk, and fails to lower bankruptcy costs of the sponsor, then the primary justification for engaging in asset securitization through SPVs fades away.

9. WHY, IF FAILURE TO DISCLOSE LIABILITIES FOR THE IMPLICIT GUARANTEE VIOLATES FASB, IT ALSO VIOLATES SEC RULE 10B-5 AND SEC DISCLOSURE RULES

The SEC intends on maintaining its role as “gatekeeper” to the U.S. capital markets and favors consistency in applying accounting standards to protect U.S. investors. Any right of action against an originating sponsor will probably be maintained through an assertion of a disclosure violation under the 1934 Act. Specifically, Rule 10b-5 and Section 18A. If the implicit guarantee renders the SPV moot to the sponsor and the off-balance sheet obligations of those SPVs are
consolidated with the originating sponsor, those obligations should have been originally disclosed on the sponsor’s mandatory periodic financial statements.

The relevant section of Rule 10b-5 states that “It shall be unlawful for any person, directly or indirectly….to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made.” Rule 10b-5 has been applied when a corporation issues misleading information to the public, or keeps silent when it has a duty to disclose. To be subject to Rule 10b-5 in this case, the conduct must be “in connection with the purchase or sale of a security…. in a medium upon which an investor would presumably rely,” which the courts have held may be satisfied by a showing of materiality. In cases that involve public dissemination on mandated periodic financial statements the outcome literally hinges on whether there existed a material misrepresentation on the company’s financial statements and whether those misstatements were relied upon by the investor. Reliance can be shown by what the courts call the “fraud on the market theory” where a purchaser at an exchange relies on the supposition that the market price is validly set by incorporating correct and truthful information. Under that theory a “presumption of reliance” arises without proof the investor individually relied on a particular misstatement.

The substantial likelihood standard of materiality, as applied to 10b-5 by Basic Inc. v. Levinson, states that a fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making a decision to buy or sell a security. In explaining this test the court said, “[T]here must be a substantial likelihood that the disclosure of [the] omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of

\[64\] Larry D. Soderquist & Theresa A. Galbaldon, SECURITIES LAW 149 (Foundation Press 3d ed.) (2007).
\[65\] See, e.g., Semerenko v. Cendant Corp., 223 F.3d 165 (3d Cir. 2000).
\[67\] See supra note 58, 154.
\[68\] Id., 164.
information made available.”69 The Court further stated in Levinson that when dealing with a speculative outcome or a probability that an event would occur, materiality depends “upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.”70

In applying these standards of Rule 10b-5 to the factual situation at hand, the amount of off-balance sheet debt and the risk of exposure inherent in carrying an implicit guarantee would have been sufficiently material to warrant disclosure. Using the substantial likelihood standard of materiality and given the magnitude of these originating sponsors’ off-balance sheet obligations (Citigroup’s $320 billion in VIEs and $49 billion in recently consolidated SPVs) and the fact that the financial sponsors’ stock price declined dramatically after a complete picture of their SPV holdings were revealed, it appears that a reasonable investor would have believed the information would have altered the “total mix” of information.71 Any corporation, regardless of its size, would have its financial outlook fundamentally altered by an influx of risky assets onto its books. There are estimates that the securities in the VIEs may be worth as little as 27 cents on the dollar once they’re put back on balance sheets.72 A court will probably hold that information concerning the consolidation of sponsors’ SPVs amount to material information that should have been disclosed in the firms’ financial statements.

Additionally, sponsors face a duty to disclose their relationship with their SPVs. The SEC explicit disclosure rules are now quite broad. In addition to the periodic and mandatory disclosure reports, which would probably now demand disclosure of the material information concerning SPVs, new Section 13(l) of the Exchange Act, added by the Sarbanes-Oxley Act, imposes a

70 Supra note 60.
71 Id.
continuous duty to disclose information concerning material changes in the sponsor’s financial condition or operations. Section 13(l) has resulted in a substantial increase in the types of items required to be reported on form 8-K. This is a significant disclosure duty and would apply to firms acting upon the implicit guarantee to their SPVs.

10. CONCLUSION

In the face of downward spiraling asset prices, large write-offs, and excessive risk exposure sponsors are being forced to guarantee their SPVs and VIEs and their investors are facing enormous losses as a result.

In light of current accounting standards, financial sponsors’ efforts to maintain institutional reputation through implicitly guarantying off-balance sheet SPVs have rendered the SPV moot as a viable vehicle of off-balance sheet asset transfers. The fundamental problem with these implicit guarantees is that they appear to violate the “true sale” element of the ABS process under FAS 140 and designate the sponsor a “primary beneficiary” under FIN 46(R). Under FAS 140, if a true sale does not occur, then assets should not be removed from the sponsoring firm’s balance sheet. If assets are transferred to the SPV, the SPV would lose its bankruptcy remote status because the sponsor would be considered the primary beneficiary Under FIN 46(R), the primary beneficiary must consolidate their VIEs or fully disclose their VIE relationship. This presents what this paper calls the fundamental flaw in the system of off-balance sheet debt transfers, which could potentially spell the industry’s downfall.

Most originating sponsors also failed in their duty to adequately disclose the risk of exposure from their SPVs. Given the magnitude of these originating sponsors’ off-balance sheet obligations and the fact that the financial sponsors’ stock price declined dramatically after a

73 See supra note 58, 162.
complete picture of their SPV holdings were revealed, it appears that the failure to adequately
disclose sponsors’ off balance sheet obligations amounts to a material misrepresentation and a
violation of SEC disclosure rules. Thus, the ultimate result of sponsors’ implicit guarantees is to
subject the financial industry to significant liability to their investors.