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A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs

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A TRANSACTIONAL GENEALOGY OF SCANDAL: FROM MICHAEL MILKEN TO ENRON TO GOLDMAN SACHS

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ABSTRACT

Three scandals have reshaped business regulation over the past thirty years: the securities fraud prosecution of Michael Milken in 1988, the Enron implosion of 2001, and the Goldman Sachs “ABACUS” enforcement action of 2010. The scandals have always been seen as unrelated. This Article highlights a previously unnoticed transactional affinity tying these scandals together—a deal structure known as the synthetic collateralized debt obligation involving the use of a special purpose entity (“SPE”). The SPE is a new and widely used form of corporate alter ego designed to undertake transactions for its creator’s accounting and regulatory benefit.

The SPE remains mysterious and poorly understood despite its use in framing transactions involving trillions of dollars and its prominence in foundational scandals. The traditional corporate alter ego was a subsidiary or affiliate with equity control. The SPE eschews equity control in favor of control through preset instructions emanating from transactional documents. In theory, these instructions are complete or very close thereto, making SPEs a real-world manifestation of the “nexus of

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contracts” firm of economic and legal theory. In practice, however, formal designations of separateness do not always stand up under the strain of economic reality.

When coupled with financial disaster, the use of an SPE alter ego can turn even a minor compliance problem into a scandal because of the mismatch between the traditional legal model of the firm and the SPE’s economic reality. The standard legal model looks to equity ownership to determine the boundaries of the firm: equity is inside the firm, while contract is outside. Regulatory regimes make inter-firm connections by tracking equity ownership. SPEs escape regulation by funneling inter-firm connections through contracts, rather than equity ownership.

The integration of SPEs into regulatory systems requires a ground-up rethinking of traditional legal models of the firm. A theory is emerging, not from corporate law or financial economics, but from accounting principles. Accounting has responded to these scandals by abandoning the equity touchstone in favor of an analysis in which contractual allocations of risk, reward, and control operate as functional equivalents of equity ownership—an approach that redraws the boundaries of the firm. Unfortunately, corporate and securities law hold out no prospects for similar responsiveness. Accordingly, we await the next alter-ego-based innovation from Wall Street’s transaction engineers with an incomplete menu of defensive responses.

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I. INTRODUCTION

Three scandals fundamentally reshaped the structure of business regulation over the past thirty years. First came the 1988 securities fraud prosecution of Michael Milken and his firm, Drexel Burnham Lambert,¹ which generated the junk bonds that financed the takeover wars of the 1980s.² The prosecution marked the end of the takeover wars,³ but not before Milken's junk bonds had poisoned the balance sheets of many savings and loans, leading to their failures.⁴ The takeover wars reshaped Delaware corporate law,⁵ while the savings and loan debacle resulted in

1. JAMES B. STEWART, *DEN OF THIEVES* 461, 478–510 (1992) (providing the details of the prosecutions of Drexel, Milken, and others).

2. *See infra* Part II.A.

3. ROBERT B. THOMPSON, *MERGERS AND ACQUISITIONS: LAW AND FINANCE* 235 (2010) (detailing how the prosecution of Milken may have prevented the appeal to the Delaware Supreme Court of *City Capital Assocs. Ltd. P'ship v. Interco Inc.*, 551 A.2d 787 (Del. Ch. 1988), in which the Delaware Chancery Court had ordered a poison pill withdrawn).

4. BENJAMIN J. STEIN, *A LICENSE TO STEAL: THE UNTOLD STORY OF MICHAEL MILKEN AND THE CONSPIRACY TO BILK THE NATION* 1–2 (1992).

5. *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (requiring directors to maximize short-term value once they have decided to dismantle a company);

major banking law reforms, culminating in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989⁶ and the Federal Deposit Insurance Corporation Improvement Act of 1991.⁷

The second scandal was Enron's accounting and securities fraud in 2001, which quickly led to the enactment of the Sarbanes-Oxley Act ("SOX").⁸ More recently, the securities fraud scandal surrounding Goldman Sachs ("Goldman") and its ABACUS 2007-AC1 transaction provided needed momentum to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act.⁹

Each of these scandals provided an impetus for major changes in business regulation, but the scandals have always been seen as unrelated. This Article highlights a previously unnoticed transactional tie that binds the Milken, Enron, and Goldman affairs—a transaction structure known as the synthetic collateralized debt obligation developed at J.P. Morgan & Co., Inc., ("Morgan") in 1997 under the name "Broad Index Secured Trust Offering" or "Bistro."¹⁰

Bistro built on the regular or cash collateralized debt obligation ("CDO"), a security produced through a transaction structure invented by Milken in 1987.¹¹ The CDO applied the techniques of private-label mortgage securitization, in its infancy during the 1980s, to corporate bonds and loans. Bistro combined the CDO with a second financial invention, the credit default swap ("CDS"), a derivative that Morgan had pioneered

Smith v. Van Gorkom, 448 A.2d 858, 881 (Del. 1985) (requiring directors to make decisions related to takeovers based on an informed understanding of the "intrinsic" value of the corporation, rather than the market value); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955–56 (Del. 1985) (accepting the appropriateness of takeover defenses and changing the standard for evaluating directors' response to unsolicited takeover bids from a business judgment rule to a more demanding, objective "reasonable in relation to the threat posed" test); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) (permitting Delaware boards to adopt a poison pill, which would be evaluated under the *Unocal* standard rather than the business judgment rule). Although the takeover era ended badly, it is credited for the emergence of corporate governance as we now know it. See William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 677–81 (2010) (describing the prevalence of shareholder-oriented economic assumptions after the takeover era).

6. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183.

7. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236.

8. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

9. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

10. See *infra* Part III.B.

11. The term CDO refers both to securities and to the entity that issues the securities.

during the early 1990s.¹² The result was a “synthetic” CDO, which amounted to a securitization of a CDS. Goldman’s ABACUS deal was also a synthetic CDO, a direct descendant of Bistro. The transactions that lay at the core of the Enron scandal also descended from Bistro, albeit along a crooked, collateral line with transactional affinities to Milken-era machinations.

Our transactional lens highlights commonalities between the scandals that have significant implications for understanding firms, markets, and risk taking. All three cases involved compliance problems, bad bets, and copious red ink. All three scandals involved companies in the vanguard of financial innovation, populated with swaggering, sharp-elbowed traders. All three involved companies that loomed large in the public eye as exemplars of free market capitalism. All three involved transaction structures designed to facilitate risk management, but which also opened doors to new modes of market speculation. All three involved the creation of markets where none had formerly existed—markets that were supposed to import pricing accuracy and management discipline, but often failed to do so.

All three also involved misuse of special purpose entities (“SPEs”).¹³ SPEs are legally distinct entities that companies use to facilitate transactions that yield regulatory and accounting benefits. In particular, SPEs enable companies to become “asset light,” meaning that they move assets and liabilities off their balance sheets without necessarily making a concomitant sacrifice of earnings power. Becoming “asset light” enhances return on assets and shareholder value by arbitraging accounting rules and, in the case of banks and insurers, regulatory capital requirements. The transactions, however, can lack ancillary business motivations and fall well short of the arm’s-length transactional ideal. Therefore, when SPE structures produce red ink, scandal can quickly arise.

The SPEs embody these scandals’ lessons for lawyers and regulators.¹⁴ It is often said that corporations are “artificial entities.”¹⁵ With

12. GILLIAN TETT, *FOOL’S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE* 46–56 (2009) (describing the creation of Bistro and CDS and Morgan’s combined use of the two).

13. SPEs are also known as “special purpose vehicles” or “SPVs.”

14. See Milton C. Regan, Jr., *Teaching Enron*, 74 *FORDHAM L. REV.* 1139, 1182–83, 1238–39 (2005) (describing Enron’s relationship with outside entities including Nahanni and CHEWCO).

15. See, e.g., *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. 518, 636 (1819) (“A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law.”); Samuel J. Alito, Jr., *Documents and the Privilege Against Self-Incrimination*, 48 *U. PITT. L. REV.* 27, 30 (1986) (referring to “artificial entities, such as corporations”); Ralph Nader, *Legislating Corporate Ethics*, 30 *J.*

conventional corporations, the artifice contains assets, agents, and equity owners, all of which coalesce together as an interest that can negotiate an arm's-length contract. Corporations are also said to be nexuses of contracts.¹⁶ The characterization is apt, but only with a qualification. With conventional operating companies, the contracts are incomplete, and the omitted terms are filled in over time by agents operating subject to governance constraints. Control is critical at this point, and the traditional legal model allocates it to the holders of the residual economic, or "equity," interest.

SPEs, like corporations, begin with artificial legal form. But they never fully coalesce as independent organizations that take actions in pursuit of business goals. Nor does control lie with the holder of the equity interest. Instead, SPEs operate pursuant to instructions emanating from complex transactional documents. In theory, the instructions are complete or very close thereto—set in advance in immutable contractual stone. The SPE is intended to be the firm robotic.

In practice, however, opportunities arise for the exercise of influence by the transactions' real parties in interest. When financial disaster follows such a moment of influence, scandal is invited. Meanwhile, a critical regulatory question is posed: Should the real parties in interest be treated as if they are traditional equity holders even though their ties to the SPE are entirely in contractual form?

The transactional affinities among these scandals point to a new legal model of the firm, one based not on equity ownership, but on functional control. In traditional corporate law and financial economics models of the firm, everything follows from a line of separation between the equity interest and the interests of contract counterparties. In the traditional model, equity "owns" the firm, which in turn makes contracts with third parties: equity is inside the firm, contract is outside, and regulatory regimes make inter-firm connections by tracking equity ownership.

The SPE scandals all involved the use of third-party contracts, rather than equity, to exercise control, thereby escaping traditional equity-based regulation. The SPE scandals show that control can be exercised by contract as well as by ownership, a transactional development that

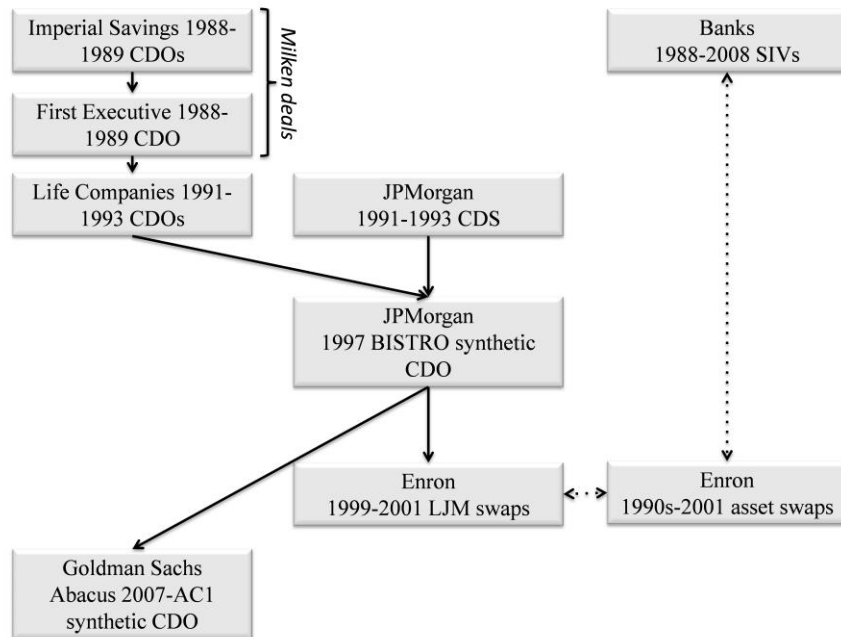
LEGIS. 193, 202 (2004) (explaining that "[corporations] are artificial entities"); John C. Coates IV, Note, *State Takeover Statutes and Corporate Theory: The Revival of an Old Debate*, 64 N.Y.U. L. REV. 806, 810–15 (1989) (discussing the artificial entity theory of the corporation).

16. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976).

accounting principles have begun to recognize, but neither law nor finance. The new accounting approach rejects the formalism that enabled transactional arbitrage via SPEs, drawing the line between the firm's insiders and outsiders on a case-by-case basis based on allocations of risk and directive power. This functional conception of the firm may also point to expanded liability: traditional fiduciary duties may apply to contractual relationships in addition to equity relations, as Goldman learned with ABACUS.

This Article tells a five-part story of the development of SPEs and the related scandals that point to a more refined, functional model of the firm. Figure 1 presents the genealogy of these scandals.

FIGURE 1. The Genealogy of Scandal



The story begins in Part II with the origins of the collateralized debt obligation (“CDO”), the brainchild of Michael Milken. The CDO was a new type of security issued by SPEs that purchased junk bonds from Milken clients, thereby cleaning up the clients’ balance sheets. The CDO never realized its potential under Milken; he was convicted of securities fraud before it could take off. But even from its first days, the CDO transaction structure was a vehicle for regulatory arbitrage, entwined in the

failure of one of the nation's largest life insurers—and the world's largest investor in junk bonds—First Executive Corporation. First Executive tried to use a CDO transaction to get regulatory capital relief for its plunging junk bond portfolio. It failed.

In Part III we show how Morgan succeeded where First Executive did not. In a breathtaking regulatory arbitrage, Morgan combined the CDO with the credit default swap to bring forth Bistro. Bistro posed a question: Is a swap with an alter ego SPE truly a swap? That is, is there any economic substance to a party's contract with itself?

Amazingly, Morgan got a “yes” answer from the Federal Reserve Board—a “yes” based on the Bistro SPE's financial contents. The structure, unlike the one pioneered by First Executive, involved third-party investors, whose capital commitment was deemed to make the SPE financially viable. The Bistro structure also magnified the SPE's capital base, permitting Morgan to remove billions of dollars of loans from its regulatory balance sheet by hedging them with swaps with the SPE. These hedges allowed Morgan to reduce significantly the amount of regulatory capital it was required to hold, effecting an “asset light” increase in its return on invested capital.

Bistro was a moment of genius, but there was also something diabolical about it. Part IV pursues the diabolical possibilities, following Bistro to Enron, where the Smartest Guys in the Room invented an SPE and swap variant that protected its earnings statement from \$1 billion of investment portfolio losses. The Enron variation missed Bistro's central point, however. Where Morgan infused its SPE with financial wherewithal in the form of hard money from outside investors, Enron funded its SPEs with its own common stock. The stock lost value, causing Enron's self-constructed swap counterparties to become insolvent and forcing a massive downward restatement of Enron's earnings reports. Enron filed for bankruptcy within two months. Enron had propped up its earnings by booking revenue from swaps with itself, subverting capitalism's most basic norm—it takes two to transact. Scandal followed.

Part V takes a regulatory digression, following Enron rather than Bistro to the Structured Investment Vehicles (“SIVs”) sponsored by the big banks in the run up to the financial crisis of 2008. The banks used the SIVs to follow a different transactional trail blazed by Enron. Enron used SPEs not only to engage in faux swaps to bolster earnings, but also as off-balance sheet dumping grounds for underperforming assets and associated indebtedness. The arrangements were conditional—Enron was back on the

hook if its stock price fell below stated levels. It received its final kick into bankruptcy when those off-balance-sheet obligations came due.

The Enron scandal resulted in revised accounting principles. After Enron, contractual ties to the sponsoring company could prevent the use of leveraged SPEs to move assets off of balance sheets.¹⁷ But the banks constructed the SIVs to fly in under the radar of the new principles and used the SIVs to expand their portfolios of securitized subprime mortgage debt, parking the assets off-balance sheet and funding them with borrowing.

The off-balance-sheet treatment allowed the banks to increase return on equity without increasing their assets and debt and, hence, their regulatory capital. But, as with Enron, there turned out to be a catch. When the quality of the SIVs' investments deteriorated in 2007, the banks honored "implicit" guaranties and brought the SIVs' assets and debt back to their own balance sheets. But there was no scandal, for, unlike Enron, the banks internalized the losses and appeared to have followed the rules. A regulatory Enron repeat did occur, however. Once again, accounting standards were revised after the fact in 2010 to prohibit the off-balance-sheet treatment employed. With this revision, the accountants provide us with the basis for a new model of the firm tailored to the SPE, an approach that abandons the traditional distinction between contract and equity participations and looks for control where the parties vest it, ignoring the form their arrangements take.

The SIVs proved to be the canary in the coal mine. The banks would follow the SIVs into collapse in 2008, along with the rest of the economy. They would honor their obligations then too, but in many cases only with federal bailout money. In the end, the risks the banks ran as the SIVs took advantage of off-balance-sheet treatment were externalized on the economy as a whole. The fact that the SIVs collapsed without a scandal should now give us pause.

In Part VI, the story returns to Bistro, the synthetic CDO, and its role in the Goldman affair. After 2000, Bistro became the template for a "naked" synthetic securitization—a securitization of a credit default swap that made a naked bet rather than a hedge. Such naked synthetic CDOs became a favorite vehicle for betting on the performance of U.S. mortgages, and as such, facilitated a magnification of risk taking far beyond direct investments in mortgages and mortgage-backed securities.

17. See *infra* text accompanying notes 208–14.

The new template changed the economic profile of the Bistro structure. Bistro was a transaction used to obtain regulatory capital relief from a portfolio of loans owned by a bank. Banks like Goldman repurposed the structure to enable a party (the “short”) to make a naked wager against the SPE (the “long”) about the performance of a portfolio of obligations in which neither party had any credit exposure.

Goldman’s ABACUS 2007-AC1 SPE was one of many such synthetic CDOs. Like ABACUS, many of them ended up in default. ABACUS attracted attention because Goldman led the buyers of the CDOs’ debt securities to believe that an actor who helped select the assets for the bet was also making a long bet when the actor was in fact going short. Goldman, in other words, marketed assets selected by a party betting that the assets would decline in value without disclosing the nature and extent of that party’s participation.¹⁸ Not that Goldman lacked a defense: the deal’s structure presupposed a short and a long and their mutual agreement on the assets for the wager.¹⁹ Even so, Goldman soon cut its losses and settled with the SEC for \$550 million, then the largest settlement in the agency’s history.²⁰

Part of Goldman’s problem lay in the toxic characterization applied to bankers and bailouts after 2008. ABACUS was a small-scale compliance problem that underwent magnification in a particular political context.²¹ It all might have gone unnoticed at another time, but in 2010 the economy was still recovering from externalities inflicted by large financial institutions. Goldman had the least attractive public profile in the group. It

18. Consent of Defendant Goldman, Sachs & Co. ¶3, *SEC v. Goldman, Sachs & Co.*, 790 F. Supp. 2d 147 (S.D.N.Y. 2011) (No. 10-CV-3229(BSJ)), 2010 WL 2779309.

19. Goldman mooted a two-part defense: (1) any omission was immaterial, and (2) no actor at Goldman acted with scienter. Submission on Behalf of Goldman, Sachs & Co. at 4–6, *In re ABACUS CDO*, No. HO-10911 (S.D.N.Y. Sept. 10, 2009), available at <http://av.r.ftdata.co.uk/files/2010/04/Goldman-defence-doc-Part-I.pdf>.

20. Press Release, SEC, Goldman Sachs to Pay Record \$550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), available at <http://www.sec.gov/news/press/2010/2010-123.htm>.

21. As such, it bears comparison to the 1970s foreign payments scandal. The payments in question there were bribes made to corrupt actors abroad to facilitate the sale of big-ticket products. They were termed “questionable” because they were not exactly illegal and had been in pursuit of profits for American shareholders. But the payments were not exactly appropriate either. The companies covered them up only to see them uncovered in the course of the Watergate investigation. The public, reeling from revelations of government corruption, found corporate corruption unacceptable as well, even corruption abroad in pursuit of shareholder value at home. DONALD R. CRUVER, *COMPLYING WITH THE FOREIGN CORRUPT PRACTICES ACT 5* (2d ed. 1999); GEORGE C. GREANIAS & DUANE WINDSOR, *THE FOREIGN CORRUPT PRACTICES ACT 59* (1982).

was the arrogant “Vampire Squid”²² that contributed to the financial meltdown by promoting risky transactions, even as its CEO proclaimed that Goldman was “doing God’s work.”²³ It thereafter benefitted from federal bailouts of contract counterparties²⁴ and promptly returned to rapacious profit making as if nothing had happened.²⁵ ABACUS thus loomed large because it fed public demands for rectitude on the part of powerful corporate actors in the wake of the financial crisis of 2008.²⁶ In such circumstances, even borderline fraud more than sufficed to bring the wrath of the enforcers, the politicians, and the press.

We think Goldman’s problem also stemmed from the nature of the securities offered by the ABACUS SPE. A formal entity such as an SPE that lacks both assets and actors can neither make investments nor representations about itself, for there is “no there there.”²⁷ It follows that the eyes of the world turn to the entity’s promoter when things go wrong, transforming the promoter into the de facto issuer of the securities as well as their marketer. As such, what ordinarily might be viewed as an arm’s-length relationship takes on a fiduciary coloration and invites the imposition of heightened disclosure duties. Unfortunately, our characterization better explains the scandal than it maps onto federal securities law, which is increasingly respectful of formal entities. The Goldman scandal accordingly heralds no change on the law of SPEs.

Part VII concludes, focusing on the SPE, the central character in each phase of our story, and how it presents a challenge to traditional equity-based models of the firm. The SPE is a new form of corporate alter ego that breaks the historical mold by posing as a wholly separate, independent entity for accounting and regulatory purposes. Unsurprisingly, new questions follow concerning the responsibilities of those who create and benefit from it. The cases discussed in this Article show that formal

22. Matt Taibbi, *The Great American Bubble Machine*, ROLLING STONE (July 9, 2009), <http://www.rollingstone.com/politics/news/the-great-american-bubble-machine-20100405>.

23. John Arlidge, *I’m Doing “God’s Work.” Meet Mr. Goldman Sachs*, SUNDAY TIMES (Nov. 8, 2009), www.thesundaytimes.co.uk/sto/news/world_news/article189615.ece.

24. CONG. OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT’S EXIT STRATEGY 3–4 (2010), available at <http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT56698/pdf/CPRT-111JPRT56698.pdf>.

25. See *id.* at 85 (after the bailout, “AIG’s normal course of business, such as putting up cash collateral for new or existing contracts (including both CDSs that would eventually be placed into ML3 and CDSs that AIG still covers)” continued).

26. TETT, *supra* note 12, at 243–49 (discussing the rapid shift in public sentiment toward Morgan and other major banking institutions).

27. GERTRUDE STEIN, EVERYBODY’S AUTOBIOGRAPHY 289 (1937). The use of the term “CDO” to refer to both an issuer and its securities is perhaps indicative of the lack of entity substance.

designations of separation constructed by transaction engineers—lawyers, accountants, and investment bankers—do not always stand up under the strain of economic reality. The accounting and regulatory authorities have responded in fits and starts. But, now, after a succession of scandals and financial disasters, a workable approach is emerging, not from Congress, corporate lawyers, or bank regulators, but from the Financial Accounting Standards Board, the private body that promulgates generally accepted accounting principles (“GAAP”). The new GAAP follows from a functional model that looks to actual control and economic returns, rather than formal indicia of ownership, to determine firm boundaries and legal duties.

It is said that bad law results when lawmakers respond to scandals,²⁸ and there is something to the point. But we reach a contrasting conclusion. SPE usage in recent years vastly outstripped the ability of regulators to consider systemic implications. Financial institutions possess the political wherewithal to retard regulatory catch-up even in the wake of catastrophic losses. So, even when an arguable compliance problem ripens into a full-blown scandal, it does so as a part of a wider political economic process of adjustment. This metastasis of peccadilloes into major scandals is a natural consequence of finance capitalism and its cycle of scandal, regulation, and transactional end-runs on regulation. Those who push the limit in transaction structuring have only themselves to blame when scandal ensues. Even so, regulatory catch up in the case of SPEs remains incomplete, covering appearances through new accounting standards but not sponsor liability under corporate and securities law.

II. MYTHIC ORIGINS: MICHAEL MILKEN AND JUNK BONDS

Our story begins with Michael Milken, Drexel Burnham Lambert (“Drexel”), and the drama they acted out with junk bonds during the 1980s. Our interest lies in a particular Milken transaction structure, the

28. See, e.g., STEPHEN M. BAINBRIDGE, *CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS* 268–69 (2012) (“[F]ederal intervention in corporate governance tends to be ill-conceived” in part because such laws “tend to be enacted in a climate of political pressure that does not facilitate careful analysis of costs and benefits.”); Roberta Romano, *Regulating in the Dark*, in *REGULATORY BREAKDOWN: THE CRISIS OF CONFIDENCE IN U.S. REGULATION* 88 (Cary Coglianese ed., 2012) (explaining that legislation adopted in response to financial crises is bound to be “off the mark”); Larry E. Ribstein, Commentary, *Bubble Laws*, 40 *HOUS. L. REV.* 77, 82 (2003) (“[L]awmakers regulating in a crash are likely to ignore or minimize regulatory costs.”); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 *YALE L.J.* 1521, 1528 (2005) (“The healthy ventilation of issues that occurs in the usual give-and-take negotiations . . . did not occur” when Sarbanes-Oxley was enacted).

collateralized debt obligation (“CDO”), which only made its appearance in his drama’s last act. Even so, the CDO stood at the intersection of the era’s highest profile compliance scandal and the Savings and Loans debacle. More importantly, we here witness the genesis of central pieces of later scandals: the securitization of dodgy financial assets; desperate attempts to clean up corporate balance sheets either for market or regulatory capital purposes; and companies swapping with themselves.

A. JUNK BONDS AND S&LS

Michael Milken’s contribution to corporate finance was the original issue, non-investment-grade (“junk”) bond. Before Milken, the bond market accepted only new issues of investment grade paper. The pre-Milken junk bond market was comprised only of “fallen angels”—bonds that had been investment grade at issue but had been subsequently downgraded.²⁹ Milken argued that junk bonds were irrationally stigmatized and therefore underpriced by the market; they represented a good value, particularly as the benefits of portfolio diversification nullified the risk on individual bonds.³⁰

Milken established a trading operation in junk bonds at Drexel in the early 1970s and succeeded in marketing new issues of junk bonds in large amounts by 1977.³¹ The new market grew rapidly in the 1980s when junk bonds became the preferred tool for financing (or defending against) corporate takeovers. Issuers found the junk bond market an attractive alternative to bank borrowing for mobilizing large sums of capital quickly. Junk bond buyers sought high yields, relying on misleading reports of low junk bond default rates in early academic research.³² Here at last was the

29. Robert A. Taggart, Jr., *The Growth of the “Junk” Bond Market and Its Role in Financing Takeovers*, in *MERGERS AND ACQUISITIONS* 5, 8 (Alan J. Auerbach ed., 1988). See also George A. Akerlof & Paul M. Romer, *Looting: The Economic Underworld of Bankruptcy for Profit* 45 (Nat’l Bureau of Econ. Research, Working Paper No. R1869, 1994), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=227162 (observing that the market for sub-investment grade bonds was “trivially small” prior to Milken).

30. These were notably self-serving assertions from one seeking to make a market in junk bonds.

31. Taggart, *supra* note 29, at 8.

32. The first published research on junk bond default rates was Edward I. Altman & Scott A. Nammacher, *The Default Rate Experience on High-Yield Corporate Debt*, 41 *FIN. ANALYSTS J.* 25, 27–35 (1985). Altman and Nammacher found a very low default rate on junk bonds, but their measurement had several flaws. *Id.* at 29. First, it failed to distinguish between bonds that were junk at issuance and “fallen angels”—bonds that had been originally investment grade and were subsequently downgraded. *Id.* at 30–31. Instead, Altman and Nammacher looked at all high-yield debt. If the fallen angels performed better than the true-born junk, it would mask the real performance of the junk. Second, it defined default somewhat formally and narrowly, excluding restructurings where there were payments in kind of securities instead of cash. See *id.* at 26 (“The appropriate base for calculating the default rate

portfolio manager's holy grail: high return for low risk.

Milken built a network of junk bond issuers and investors, leveraging Drexel's trading operation into a secondary junk bond market.³³ This secondary market provided liquidity that added appeal to new junk bond issues. It was a proprietary operation: sitting at his X-shaped trading desk in Beverly Hills, Milken matched buyers and sellers, taking fees on every deal.³⁴ He alone was the node that connected the market's sell-side issuers, corporate raiders prominent among them, and buy-side institutional investors.

A handful³⁵ of high-flying, federally-insured savings and loans figured

for corporate debt seems to us to be the low-rated straight debt market.”). Exchanges were not included in their definition of default. *See* Akerlof & Romer, *supra* note 29, at 51–52 (explaining that such exchanges “were not taken into account in the junk bond market’s halcyon years”). This had the effect of reducing the numerator in the default rate.

The greater flaw, however, was that Altman and Nammacher presented the default rate as a percentage of total debt outstanding: their 1.53 percent annual default rate from 1974–1985 was the quotient of high-yield debt defaulted in a year over high-yield debt outstanding in a year. EDWARD I. ALTMAN & SCOTT A. NAMMACHER, *INVESTING IN JUNK BONDS: INSIDE THE HIGH YIELD DEBT MARKET* 103–04 (1987). The problem with this approach was that it would necessarily understate the riskiness of high-yield debt if the market were expanding and conversely overstate it if the market were contracting. To wit, imagine that over ten years the volume of high-yield debt began at one hundred and doubled annually. Also assume that there is a 100 percent default rate on all high yield debt, but that the default does not occur until year five. Thus, in years one through four, the default rate is zero. In year five, by Altman and Nammacher’s calculation, the default rate is 3.2 percent ($=100/(100+200+400+800+1600)$). And by year ten, the default rate is 3.1 percent ($=3200/102300$). As it happens, the market was rapidly expanding, so Altman and Nammacher’s methodology understated the real risk on junk bonds.

Altman’s later work recognized the flaws in this approach, but this recognition came after his initial work was used to promote the safety of a diversified junk bond portfolio. *See* Edward I. Altman, *Revisiting the High-Yield Bond Market*, 21 *FIN. MGMT.* 78, 85 (1992) (acknowledging criticisms of the traditional method for calculating default rates); Edward I. Altman, *Measuring Corporate Bond Mortality and Performance*, 44 *J. FIN.* 909, 912 (1989) (adopting human mortality calculation methods for calculating investment risks); Paul Asquith, David W. Mullins, Jr. & Eric D. Wolff, *Original Issue High Yield Bonds: Aging Analysis of Defaults, Exchanges and Calls*, 44 *J. FIN.* 923, 924–25 (1989) (arguing that prior default calculations underestimated actual high-yield bond default rates).

33. Akerlof & Romer, *supra* note 29, at 46.

34. *X Marked the Spot* . . . , *L.A. TIMES* (May 28, 1990), http://articles.latimes.com/1990-05-28/business/fi-148_1_michael-milken.

35. While by the late 1980s S&Ls as a whole held only around 7 percent of the junk bonds in the market, Taggart, *supra* note 29, at 11, this 7 percent was highly concentrated among a handful of S&Ls closely associated with Milken. Akerlof & Romer, *supra* note 29, at 53. By 1989, S&Ls held over \$13.5 billion in junk bonds or 6.5 percent of a \$205 billion market. Harry DeAngelo, Linda DeAngelo & Stuart C. Gilson, *The Collapse of First Executive Corporation: Junk Bonds, Adverse Publicity, and the “Run on the Bank” Phenomenon*, 36 *J. FIN. ECON.* 287, 290 (1994) (market size); Anise C. Wallace, *Savings Units Trim “Junk” Holdings*, *N.Y. TIMES*, Apr. 2, 1990, at D7, available at <http://www.nytimes.com/1990/04/02/business/savings-units-trim-junk-holdings.html> (S&L holding size). A single S&L, Columbia Savings & Loan Association of Beverly Hills, California, held over \$4.36 billion in junk bonds by 1989, accounting for more than 2 percent of the entire junk bond market.

prominently on both the buy and the sell sides. For example, Charles Keating used Drexel junk bonds to finance his takeover of an S&L, Lincoln Savings & Loan, and then caused Lincoln to figure prominently as a junk bond customer.³⁶ The implicit rule was pay to play: if you wanted Drexel to underwrite your junk bonds, it was understood that you would be a buyer for Drexel's future issues.³⁷ And the players were willing. Keating was not the only junk bond investor who took over an S&L in a Drexel-financed acquisition.³⁸ The S&Ls, with their federally-insured deposit bases,³⁹ in turn provided ready buyers for new issues.⁴⁰

It has been alleged, credibly in our view, that the S&Ls took part in a "daisy chain" scheme masterminded by Milken to inflate junk bond prices artificially and make the market appear more liquid than it was, enhancing

Richard W. Stevenson, "Junk Bond" Shift Hurts Columbia Savings, N.Y. TIMES, Oct. 26, 1989, at D19, available at <http://www.nytimes.com/1989/10/26/business/junk-bond-shift-hurts-columbia-savings.html>. See also James Bates & Greg Johnson, *For Sale: Used S&Ls, Including Lincoln*, L.A. TIMES, Nov. 3, 1990, at D1, available at http://articles.latimes.com/1990-11-03/business/fi-3357_1_drexel-junk-bond (describing the forced sale of several Saving & Loans which invested heavily in junk bonds, including Lincoln and Imperial).

36. 1 FDIC, MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 282 (1998), available at <http://www.fdic.gov/bank/historical/managing/history1-11.pdf>. Keating bought Lincoln Savings & Loan with the proceeds of a Drexel underwriting. *Id.* Keating then turned Lincoln into a leading junk bond purchaser. 3 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM (1970-2001) 170 (2002). Similarly, in 1983 corporate raider Victor Goulet, already a major junk bond investor, purchased a controlling interest in the stock of Imperial Corporation of America (ICA), the parent of Imperial Savings and Loan Association of California. Goulet's acquisition was funded by Executive Life, a major life insurance company closely affiliated with Milken, which will be discussed below for its own CDO. Amended Complaint Class Action at 140, FDIC v. Milken, 781 F. Supp. 226 (S.D.N.Y. 1991) (No. 91-0433) [hereinafter FDIC Complaint]. Executive Life later acquired a 9.9 percent share in ICA, and Columbia, another Milken-dominated S&L, purchased an 8 percent share. *Id.* at 143. Later, in 1988, MDC, a Denver-based homebuilder financed by Milken, purchased 9.5 percent of Imperial's stock, apparently in an attempt to prop up its stock price. Stephen P. Pizzo, *Congress to Investigate "Daisy Chain" of Thrifts*, NAT'L MORTGAGE NEWS, Dec. 18, 1989, at 1.

37. FDIC Complaint, *supra* note 36, at 158; Richard Stengel, *Free Mike Milken*, SPY, Feb. 1990, at 45, 48. Milken may also have rewarded cooperative conspirators with insider information on deals to facilitate insider trading.

38. In some cases, these investors used the banks as personal piggy-banks, looting them. See WILLIAM K. BLACK, THE BEST WAY TO ROB A BANK IS TO OWN ONE: HOW CORPORATE EXECUTIVES AND POLITICIANS LOOTED THE S&L INDUSTRY 38 (2005) (describing the S&L acquisition process); KATHLEEN DAY, S&L HELL: THE PEOPLE AND THE POLITICS BEHIND THE \$1 TRILLION SAVINGS AND LOAN SCANDAL 387-90 (1993) (discussing the involvement of numerous top officials in the S&L scandal).

39. FDIC Complaint, *supra* note 36, at 140.

40. Dan Morain & James Granelli, *Lincoln S&L Backed Boesky Takeover Bids: Irvine-Based Thrift Invested \$100 Million, Apparently Profited*, L.A. TIMES, Aug. 30, 1989, § 4, at 1, available at http://articles.latimes.com/1989-08-30/business/fi-1423_1_risky-investments. When it looked like an issue was headed for default, Milken engineered for its refinancing, thereby maintaining the junk bond market's performance record. Stengel, *supra* note 37, at 49.

its appeal to investors and further encouraging its growth.⁴¹ A “daisy chain” is a Ponzi scheme variant that inflates the value of an asset not because of any change in fundamentals, but through constant “flipping”: an asset is sold back and forth among the chain’s members who book “profits” on each sale even as the fundamental value of the asset does not appreciate.⁴²

Thus did the handful of Milken-associated S&Ls sell each other junk bonds at inflated prices set by Milken, using their phony “gains” to mask their real financial results (and in some cases to disguise looting by their owners), at least for a while. They also provided a market for Milken to place more and more junk bonds and take more underwriting fees.

B. THE FIRST COLLATERALIZED BOND OBLIGATIONS

There were implicit limits on the liquidity Milken could gin up at the X-shaped trading desk. After all, in a daisy chain, each bond seller is also a bond buyer. Within the chain, the pool of new cash for purchases expands only to the extent the members expand their businesses or new members join up (as in a Ponzi scheme). Meanwhile, there were limits on the class of potential new members. Pension funds, for example, were required to invest only in investment-grade bonds and so stayed out of the junk market. Other institutions’ junk bond portfolios were subject to regulatory caps. For example, federally chartered S&Ls were limited to holding 11 percent of their assets in junk bonds.⁴³ Thus did Drexel and its S&L clients share a

41. See FDIC Complaint, *supra* note 36, at 5–7 (describing the Milken Group’s manipulation of the junk bond market). Numerous Milken affiliated partnerships were also part of the daisy chain. Akerlof & Romer, *supra* note 29, at 47–48. *But see* DANIEL FISCHER, PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION 285 (1995) (“The daisy chain variant of the high-yield bond market as a Ponzi scheme claim was ludicrous.”). While we think the charge credible, we note that it would have been extremely hard to prove: given an artificially inflated price, chain members would have had every incentive to cheat by shorting, much like members of a cartel.

42. Pizzo, *supra* note 36.

43. The 11 percent figure is never actually stated in federal statutory or regulatory materials, but was widely understood within the S&L industry. *E.g.*, Taggart, *supra* note 29, at 18. Prior to 1980, Federal savings and loans lacked authority to invest in corporate debt securities. The Depository Institutions Deregulation and Monetary Control Act of 1980 authorized investment in corporate debt securities, but limited the investment authority for corporate debt securities and consumer loans together to 20 percent of an S&L’s assets. Pub. L. No. 96-221, § 401, 94 Stat. 132, 153 (1980). This 20 percent cap was removed by the Garn-St. Germain Depository Institutions Act of 1982. Pub. L. No. 97-320, § 329, 96 Stat. 1469, 1502 (1982) (codified at 12 U.S.C. § 1464(c)(2) (1982)), and replaced with a 30 percent cap on consumer loans, but no explicit cap on corporate debt securities, which were “as defined and approved by the [Federal Home Loan Bank] Board. *Id.* Confusingly, the section heading in the United States Code was never amended, so it still reads “Loans or investments limited to 20 per centum of assets,” despite statutory language stating that the limits are set forth in subparagraphs,

high-powered incentive to innovate. They needed a way to package junk bonds so as to end-run the regulatory barriers.

A potential packaging template had been invented only recently, namely securitization. Securitization was first pioneered in the mortgage market, starting in 1970, but developments in the 1980s made it a much more sophisticated transaction form. In a mortgage securitization, a bank takes a bundle of residential mortgages out of its portfolio and sells them to an SPE that it itself creates.⁴⁴ The SPE in turn goes to the public securities

including the higher limit for consumer loans.

The Federal Home Loan Bank Board (“FHLBB”) implementing regulations stated that investments in corporate debt securities had to be in securities “rated in one of the four highest grades by at least two nationally recognized investment rating services at their respective most recent published rating before the date of purchase of the security,” meaning that the corporate debt securities had to be investment grade. 12 C.F.R. § 545.75(b)(2) (1984). However, the rule making permitted S&Ls to invest up to 1 percent of their assets in corporate debt securities irrespective of their rating “if in the exercise of its prudent business judgment it determines that there is adequate evidence that the obligor will be able to perform all that it undertakes to perform in connection with such securities, including all debt service requirements.” *Id.* § 545.75(d). In other words, on their face, the regulations permitted up to 1 percent of S&Ls’ assets to be invested in junk bonds if the S&L believed that the bonds would not default.

In its Federal Register release publishing the regulations, however—but not in the regulation itself—the FHLBB stated that “the Board wishes to clarify that an investment in notes, paper, or debt securities may be treated as a commercial loan to the issuer whether or not they satisfy the rating, marketability, and other requirements of § 545.75.” 48 Fed. Reg. 23032, 23045 (May 23, 1983). This meant that S&Ls could purchase junk bonds and treat them as “commercial loans” for the purposes of investment regulation. Accordingly, the applicable limit for S&L junk bond purchases was the 10 percent of assets limit set for commercial loans. 12 C.F.R. § 545.46(a) (1984). This 10 percent limit could then be added to the 1 percent facially permitted junk bond limit, as S&Ls were permitted to elect the “classification of loans or investments,” namely that the S&L could choose which limit would apply to a particular loan or investment if multiple limits could apply. *Id.* § 545.31. This should not be confused with regulatory classification of loans for Allowance of Loan and Lease Losses (ALLL) purposes.

Thus, an S&L could opt for the 10 percent limit plus the 1 percent limit to get up to 11 percent of its assets in junk bonds. *See* 52 Fed. Reg. 25870, 25876 (July 9, 1987) (referring to the 11 percent limit); Taggart, *supra* note 29, at 18. This 11 percent limit was somewhat mitigated by the fact that junk bonds were competing with other financing products for the 11 percent cap—true unsecured commercial loans, commercial paper, financing leasing, overdraft loans on demand accounts, unsecured loans made by S&L service corporation subsidiaries, and inventory and floor plan loans to consumer goods dealers.

44. Here we describe a private-label mortgage securitization, not a securitization guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae. The first private-label mortgage-securitization deal is often dated to 1977, with credit being awarded to a \$100 million Bank of America deal issued on September 21, 1977. *See* Bank of Am. Nat’l Trust & Sav. Ass’n, SEC No-Action Letter, 1977 SEC No-Act. LEXIS 1343 at *5–7 (May 19, 1977) (describing Bank of America MBS transaction); Michael D. Grace, *Alternative Mortgages and the Secondary Market*, AM. BANKER, Oct. 13, 1982, at 5 (describing the integration of mortgage and bond markets in the 1970s as well as the Bank of America deal). It appears that this was in fact the third mortgage securitization, but the first true private pass-through securitization. The first modern private mortgage bond appears to have been the California Federal Savings and Loan’s September 25, 1975, a \$50 million bond issuance secured by FHA-insured / VA-

markets and sells long-term notes. The SPE uses the cash proceeds of the sale of its notes to pay the bank the purchase price of the pool of mortgages. The mortgages in the SPE's pool secure the notes, generating a stream of cash that pays the notes' principal and interest.

Early mortgage securitizations were pass-through certificates, representing a pro rata claim on the cash flows from the pool of mortgages. But between 1983 and 1986 mortgage securitizations began to appear that featured "tranching"—the slicing of cash flows into various unequal strips. At first, tranching was done solely to ameliorate interest rate risk, but by 1986, tax rules permitted tranching for credit risk as well.⁴⁵ This meant that SPEs could issue notes in different series, dividing the claims on the "waterfall" of cash generated by the mortgages into tranches: junior, mezzanine, and senior. The juniors bear the first-loss risk on the mortgages in the pool, the mezzanine holders the next level of risk, and the seniors the residual risk.

The greater the risk, the higher the interest rate on the notes in the tranche. Thus, a pool of mortgages bearing an average 7 percent coupon could be divided into bonds a third of which (seniormost) would have 6 percent coupons, a third (mezzanine) 7 percent coupons, and a third (juniormost) 8 percent coupons. In practice, most notes in securitizations are in the senior tranches—as a rule of thumb, 80–90 percent.⁴⁶ Thus, for a pool of 7 percent mortgages, we might have 90 percent of the notes be senior with a coupon of 6.5 percent, 8 percent be mezzanine with a coupon of 10 percent, and 2 percent be junior with a coupon of 17.5 percent. The

guaranteed mortgages. *Mortgage Bonds*, U.S. NEWS & WORLD REP., Oct. 13, 1975, at 86. The second private-label deal was a \$200 million bond issuance by the Home Savings and Loan Association (Los Angeles, California) on June 23, 1977, secured by conventional mortgages. Grace, *supra*. The Bank of America deal was a true pass-through; the prior deals appear to have been secured bonds, meaning that the revenue to pay the bondholders was not necessarily from the mortgages in the first instance. The private-label mortgage securitization market remained small until 2004–2008.

45. In early 1986, an Internal Revenue Service Private Letter Ruling enabled securitizers to retain a credit-enhancing junior tranche of up to 10 percent. I.R.S. Priv. Ltr. Rul. 86-20-014 (Feb. 7, 1986). In October of 1986, the Real Estate Mortgage Investment Conduit provisions of the Internal Revenue Code, 26 U.S.C. § 860A–G, were enacted. These provisions enabled the sale of junior tranches as well as senior. See Mark Basch, *Salomon Offers Two-Class Mortgage Security; Lending Institution Retains Subordinate Class of Pass-Through Certificate*, AM. BANKER, Feb. 26, 1987, at 3 (discussing the first use of the senior/subordinated structure for commercial mortgages after the 1986 tax code changes); Richard Chang, *Coast Holds Risk on Commercial MBS*, NAT'L MORTGAGE NEWS, Mar. 9, 1987, at 14 (discussing issue of \$53 million of commercial mortgage backed securities whose risks are "largely held by the originator in a subordinated class"); Jed Horowitz, *Salomon Sells Junior Portion of Remic Security*, AM. BANKER, June 18, 1987, at 15 (discussing first Real Estate Mortgage Investment Conduit ("REMIC") with junior tranche sold for Residential Funding Corp).

46. See, e.g., Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 82 (2011) (noting that many mortgage-backed securities received AAA credit ratings because of tranches).

average coupon rate is constant, but the distribution among tranches can be tailored to match investors' preferences for risk and reward. This sort of structured security enables issuers to cater to idiosyncrasies in market demand.

Securitization lets the bank transform illiquid assets (there is no trading market for individual residential mortgages) into liquid assets traded on the bond market. But why would the bond market accept debt securities issued by a shell entity like an SPE? The market looks through the entity to the value of the assets inside it. So long as the transfer to the SPE is deemed a "true sale" and the SPE is constructed to be "bankruptcy remote" from the bank, the market deems the mortgages to be locked into the SPE.⁴⁷ In addition, the mortgages in the SPE's pool are geographically diverse, and the SPE's notes are rated by credit rating agencies. Add it up, and the return on the SPE's notes is higher than would be obtainable on a corporate bond with the same rating. The bank emerges free to make new loans from the principal returned upon the transfer to the SPE, transactions that generate new fees. Finally, for accounting and bank capital purposes the mortgages are deemed removed from the bank's balance sheet. (In future years, the widespread availability of securitization would stoke the mortgage markets, leading to a surfeit of subprime lending and ultimately the financial crisis. But that is not our story.)

The securitization model enhanced liquidity. There was nothing, however, that limited securitization to mortgages. Other types of assets, such as junk bonds, could potentially be securitized just like mortgages. Experimentation proceeded at two intertwined Drexel clients, Imperial Savings and an insurance company named First Executive Life, which was also the largest shareholder of Imperial Saving's parent corporation.⁴⁸

1. Imperial Savings

Imperial Savings Association, a California S&L run by the former head of Freddie Mac, joined Drexel to apply the securitization technique to

47. See William McInerney, *From Bankruptcy Remote to Risk Remote*, N.Y.L.J. (Aug. 23, 2010), <http://www.law.com/jsp/article.jsp?id=120247072324> (describing the primary features of bankruptcy-remoteness as restricted ability to file for bankruptcy and single purpose). Here, bankruptcy remote means that the assets of the SPE will not be consolidated with those of the bank in the event the bank is put into receivership. Bankruptcy remote also has a separate, distinct meaning, namely that the SPE itself will not or cannot file for bankruptcy.

48. Susan Burkhardt, *Partner of Target in SEC Probe Owns Nearly 10% of Imperial*, SAN DIEGO UNION, Sept. 19, 1987, at C1. Other Milken-associated entities also owned large stakes in Imperial. Susan Burkhardt, *Denver Firm Buys 6.9% of ICA Stock*, SAN DIEGO UNION, Nov. 6, 1987, at C1.

junk bonds.⁴⁹ Imperial was the sixteenth largest S&L in the country when it was seized by the FDIC on February 23, 1990.⁵⁰ Between 1986 and 1989, Imperial purchased more than \$1.6 billion in Drexel-underwritten junk bonds,⁵¹ and its \$1.5 billion junk bond portfolio⁵²—10 percent of its assets⁵³—was the second largest of any thrift.⁵⁴

In 1987, Imperial, together with Drexel as underwriter, issued the first collateralized debt obligation.⁵⁵ Imperial transferred \$200 million of junk bonds to an SPE called “Long Run Bond Corp.” The bonds were priced at 99.73 (virtually at par);⁵⁶ they were diversified by industry; and they carried ratings greater than or equal to B- or BBB (low investment grade).⁵⁷ The SPE then issued \$100 million in collateralized notes with a three-year maturity.⁵⁸ Between the two-to-one overcollateralization⁵⁹ and the diversification of the bonds by issuer and industry, Imperial and Drexel were able to convince Moody’s and Standard and Poor’s to award the CDO an AAA-rating.⁶⁰ There does not appear to have been senior-subordinate tranching for credit support. It seems likely that Imperial retained the

49. The Chairman of the Board of Imperial’s parent, Imperial Corporation of America, was Victor Goulet, a Milken-financed raider. IMPERIAL CORP. OF AM. ANNUAL REPORTS (1986–1988).

50. Greg Johnson, *Imperial S&L’s Parent Files for Chapter 11 Thrifts: The Action, Which Was Expected, Won’t Affect Depositors*, L.A. TIMES, Mar. 1, 1990, at D4, available at http://articles.latimes.com/1990-03-01/business/fi-2401_1_imperial-savings.

51. FDIC Complaint, *supra* note 36, at 169.

52. Bates & Johnson, *supra* note 35.

53. Susan Burkhardt, *Junk-Bond Based Imperial Offering Wins Triple-A Rate*, SAN DIEGO UNION, Sept. 25, 1987, at E1.

54. Bates & Johnson, *supra* note 35. The largest cache was the more than \$4 billion holding of Columbia Savings and Loan of Beverly Hills, California (located conveniently near the Drexel junk bond desk). Richard W. Stevenson, *California Saving Unit Seized*, N.Y. TIMES, Feb. 24, 1990, at 33, available at <http://www.nytimes.com/1990/02/24/business/california-saving-unit-is-seized.html>.

55. *Major Debt and Equity Offerings by Financial Companies; In September (Dollar Amounts in Millions)*, AM. BANKER, Oct. 13, 1987, at 6. Technically, the collateralized debt obligation was a collateralized bond obligation or CBO. A CBO would be distinguished from a collateralized loan obligation or CLO—one contains bonds, the other loans. We are eliding the difference in this paper, using CDO as a term encompassing both.

56. Press Release, Bus. Wire, Imperial Savings Offers \$100 Million in Notes Backed by High-Yield Bonds (Sept. 24, 1987).

57. Burkhardt, *supra* note 53.

58. *Major Debt and Equity Offerings by Financial Companies; In September (Dollar Amounts in Millions)*, *supra* note 55.

59. See Leslie Gifford, *Drexel Prices First Issue Ever Backed by Corporate Junk Bonds; Prices Down*, BOND BUYER, Sept. 25, 1987, at 5 (noting that Moody’s rating criteria were 165–250 percent overcollateralization, diversification, marked-to-market collateral monthly, updated every two weeks for price volatility, market price, and credit rating). Implied in this is that Imperial had an obligation to top off the collateral pool if its value declined.

60. Richard Chang, *Imperial Securities to Be Backed by Junk Bond Collateral*, NAT’L MORTGAGE NEWS, Aug. 31, 1987, at 10.

residual equity interest in the SPE.

The effect was to enable institutional investors prohibited from holding non-investment-grade investments to invest in junk bonds, thereby expanding the market. The terms of the CDO made them quite attractive—the bonds were AAA-rated, but with a yield eighty-five basis points above comparable duration Treasuries.⁶¹ A third of the bonds were sold to S&Ls (presumably including some Milken daisy chain participants), the rest to pension and investment funds.⁶²

The deal gave Imperial immediate liquidity⁶³—instant cash instead of bonds that would pay out over years. Presumably, retention of the equity interest in the SPE precluded off-balance-sheet accounting treatment, but there was a give back. Retaining the SPE equity meant that Imperial could benefit from SPE's overcollateralization and the spread between the high coupons on the junk bonds and the lower rates on the notes issued by the SPE,⁶⁴ as the SPE's revenue, beyond what was needed to pay the CDO notes and the CDO trustee, would presumably go back to Imperial.

The possibilities held out by the Imperial CDO were not lost on the investment banking world. As one observer noted, "Investment bankers clearly see a gold mine in this product. The total volume of corporate bonds currently outstanding is about \$600 billion, and securitization offers investors the opportunity to transform their holdings into cash."⁶⁵

Even so, Imperial seems to have had second thoughts about the two-to-one ratio of junk bonds to collateralized notes. So when Imperial packaged a second CDO in late 1988⁶⁶ it more closely followed the

61. Gifford, *supra* note 59.

62. Burkhardt, *supra* note 53.

63. We detect no additional or alternative motivation for the Imperial deals. There does not appear to have been a regulatory capital arbitrage. While federally chartered S&Ls were limited to holding 11 percent of their assets in junk bonds, see *supra* text accompanying note 43, Imperial was a California chartered thrift, and California removed all limits on S&L junk bond investment. PAUL TESKE, REGULATION IN THE STATES 109, 113 (2004). The Federal Savings & Loan Insurance Corporation (FSLIC), which insured Imperial, had no restrictions on junk bond investment. See *id.* at 111–15 (discussing the FSLIC's permissive regulatory policies). The motivation for the CDOs might simply have been to enable Imperial to raise funds against its junk bond holdings, rather than against its overall asset base. We also cannot rule out Milken / Drexel as the driving force in the transaction, as the creation of the CDOs effectively expanded the market of junk bond purchasers, a development that benefitted Milken and Drexel.

64. Gifford, *supra* note 59.

65. *Id.*

66. *Imperial Offering "Junk Bond" CMO*, NAT'L MORTGAGE NEWS, Aug. 8, 1988, at 25 (discussing a planned offering). See also R. RUSSELL HURST, FIRST UNION SECURITIES, INC., CDO QUARTERLY REVIEW app. A (May 2000), available at http://www.securitization.net/pdf/cdo_0500.pdf (listing a \$126 million rated portion of a CDO issued by Long Run Bond Corp, with Imperial S&L and

residential mortgage securitization model, using a senior-subordinate structure. The second deal featured three tranches. The first (and presumably largest) was AAA-rated and sold to investors.⁶⁷ The second tranche was lower rated and held in portfolio by Imperial's parent company.⁶⁸ The third, unrated tranche was given to a pair of San Diego charities (following a model developed in other securitizations).⁶⁹ This apparently enabled Imperial to get off-balance-sheet treatment for the CDO⁷⁰ even as it retained a slice of the risk and return on the junk bonds by retaining the SPE's second tranche. Figure 2, below, presents a summary version of the transaction.

Capwood Christian as managers and Drexel as agent with an issuance date of 11/1/1988). The second deal seems to have been considerably larger than the first, although we have not been able to identify a precise figure. See Eric Homer, *Phoenix Lights Up Murky World of CDOs*, PRIVATE PLACEMENT LETTER, June 18, 2001, at 1 (noting that the two Imperial deals totaled \$606 million).

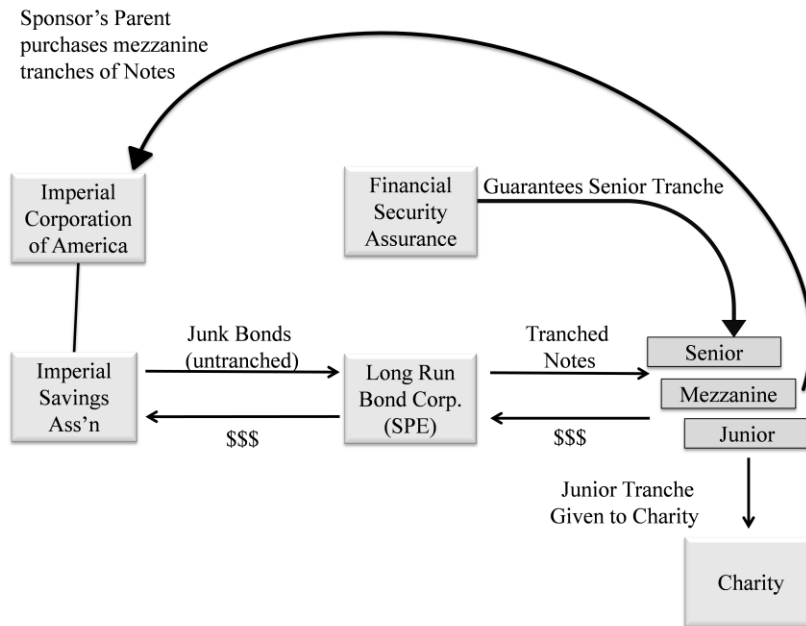
67. *Imperial Offering "Junk Bond" CMO*, *supra* note 66. It was insured by Financial Security Assurance, a monoline bond insurer, which had the ability to veto the sale or purchase of bonds by the CDO. Telephone Interview with Thomas Saake, Administrator, Long Run Bond Corp., (Aug. 6, 2012). Mr. Saake worked at Imperial and then at Capwood-Christian, the Long Run Bond Corp.'s manager, in which Imperial had purchased a controlling stake. According to Mr. Saake, FSA only approved sales of the bonds in Long Run Bond Corp.'s portfolio, in keeping with its interest as a senior creditor in liquidating assets. *Id.* After Imperial's failure, the Resolution Trust Corp. took over Imperial's interest in the mezzanine bonds. *Id.*

68. *Imperial Offering "Junk Bond" CMO*, *supra* note 66.

69. Saake Interview, *supra* note 67.

70. *Imperial Offering "Junk Bond" CMO*, *supra* note 66.

FIGURE 2. The Imperial Savings Association CDO



These Imperial deals did not beget a scandal. Instead, they slightly inflated the junk bond bubble and in the end were no more than a minor footnote at the juncture of the Milken / Drexel compliance scandal and the S&L debacle.⁷¹ The third CDO, however, had a closer tie to scandal as part and parcel of the “largest insurance company failure in U.S. history.”⁷²

2. First Executive

First Executive (“FE”) was a life insurance company run by CEO Fred Carr, a close personal acquaintance of Milken, and “Milken’s biggest and

71. The FDIC and RTC settled all of their civil claims with Milken, other Drexel executives, and their insurers for \$1.3 billion. Alison Leigh Cowan, *F.D.I.C. Backs Deal by Milken*, N.Y. TIMES, Mar. 10, 1992, at D1, available at <http://www.nytimes.com/1992/03/10/business/fdic-backs-deal-by-milken.html>. This was on top of a \$400 million settlement Milken reached with the SEC. *Id.* It was followed in April 1990 by a criminal plea by Milken. Kurt Eichenwald, *Milken Defends “Junk Bonds” As He Enters His Guilty Plea*, N.Y. TIMES, Apr. 25, 1990, available at www.nytimes.com/1990/04/25/business/milken-defends-junk-bonds-as-he-enters-his-guilty-plea.html?pagewanted=all&src=pm. In 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (“FIRREA”), Pub. L. No. 101-73, 103 Stat. 183, which eliminated S&Ls’ ability to invest in junk bonds and required divestment of existing holdings over a five-year period.

72. DeAngelo, DeAngelo & Gilson, *supra* note 35, at 288.

best customer.”⁷³ FE was a “controversial upstart in an otherwise mostly staid life insurance industry.”⁷⁴ Under Carr’s management, FE had experienced dramatic growth,⁷⁵ famously marketing a new insurance product, the single-premium deferred annuity.⁷⁶ This promised a hefty payment in the future in exchange for a small amount today, a return only possible because FE in turn earned high returns on a junk bond portfolio.⁷⁷ Indeed, FE held the largest junk bond portfolio in the world,⁷⁸ totaling nearly \$11 billion in 1989, when the entire junk bond market’s value was around \$205 billion.⁷⁹ Carr accorded Milken trading discretion over the bonds in FE’s account,⁸⁰ and Milken held an equity stake in FE.⁸¹ Milken exercised his discretion copiously, turning over \$40 billion in FE trades between 1982 and 1987.⁸²

FE was in financial distress by 1988.⁸³ It had an unpleasant choice:

73. FISCHER, *supra* note 41, at 284.

74. DeAngelo, DeAngelo & Gilson, *supra* note 35, at 289.

75. Kathy M. Kristof, *Behind Executive Life’s Fall: Regulators Are Taking the Heat for Letting the Insurer’s Problems Go on, Entrapping Thousands of Its Policyholders*, L.A. TIMES, Sept. 1, 1991, at D1, available at http://articles.latimes.com/1991-09-01/business/fi-2535_1_executive-life. Its insurance in force increased from \$700 million in 1974 to nearly \$60 billion in 1989.

76. *Id.*

77. *Id.*

78. GARY SCHULTE, *THE FALL OF FIRST EXECUTIVE: THE HOUSE THAT FRED CARR BUILT* 190 (1991).

79. DeAngelo, DeAngelo & Gilson, *supra* note 35, at 290.

80. See STEIN, *supra* note 4, at 88–94 (discussing Milken’s influence and power within FE); STEWART, *supra* note 1, at 67 (1992) (explaining that Milken would “freely trade” with Carr’s portfolio without consulting Carr).

81. CONNIE BRUCK, *THE PREDATORS’ BALL: THE INSIDE STORY OF DREXEL BURNHAM AND THE RISE OF THE JUNK BOND RAIDERS* 276 (1988).

82. SCHULTE, *supra* note 78, at 190.

83. First Executive started running into trouble in 1986, when New York insurance regulators forced it to restate its financials by \$180 million, leaving it with less than \$90 million in equity value. Kristof, *supra* note 75. From then on, First Executive bounced from one set back to another until its final collapse in 1989. By 1987, default rates on junk bonds had gone up and Milken and Drexel were under investigation in connection with the Ivan Boesky insider trading scandal. Associated Press, *Milken Said to Be Subpoenaed by House Panel*, L.A. TIMES (Apr. 22, 1988), http://articles.latimes.com/1988-04-22/business/fi-1740_1_house-panel. Given First Executive’s large junk bond holdings and CEO Carr’s close personal affiliation with Milken, investors and policyholders began to exhibit jitters. In 1987, New York insurance regulators found the First Executive’s New York insurance subsidiary had taken millions of dollars in credits for phony or backdated reinsurance from First Stratford Life Co. of Delaware, a joint venture between First Executive and a holding company owned 49 percent by Milken and some of his Drexel affiliates, and issued a record fine. Scot J. Paltrow, *Enigmatic Fred Carr*, L.A. TIMES, Apr. 8, 1990, at D1, available at http://articles.latimes.com/1990-04-08/business/fi-1602_1_junk-bond (backdating); Sabin Russell, *State Probing Deal by Insurer to Cut Its Debts*, S.F. CHRON., Apr. 4, 1990, at C1 (discussing First Stratford Life Co.); Scot J. Paltrow, *Wheel of Fortune Turns Against First Executive*, L.A. TIMES (Jan. 26, 1990), http://articles.latimes.com/1990-01-26/business/fi-657_1_junk-bonds (discussing negative press and “nervous” investors). First Stratford

either raise new equity capital or stop writing new business and go into wind down.⁸⁴ This set the stage for the third CDO. It was not an underwritten product, and so we found no direct evidence of participation by Milken and Drexel. We associate them by proximity, confident that we are fair in so doing.

FE's California insurance subsidiary Executive Life Insurance Company ("ELIC") set up six SPEs,⁸⁵ formally distancing itself from them, but in fact enjoying very close proximity. The SPE corporations were wholly owned by limited partnerships, in which ELIC had a 99 percent limited partnership stake.⁸⁶ The SPEs were managed by an ELIC consultant, formerly ELIC's second most highly compensated employee.⁸⁷ The SPEs were based in ELIC's former headquarters building, in a suite occupied by a four-person securities firm formerly known as First Executive Securities Company.⁸⁸ FE's general counsel was the entities' agent for service of process.⁸⁹

ELIC transferred \$789 million in junk bonds to the SPEs in exchange for six tranching CDOs.⁹⁰ The CDOs, taken together, were FE's second-largest investment position.⁹¹ The exchange of the debt for the bonds appears to have been done at par rather than at fair market value; the six-

had 69 percent of its own assets in junk bonds, the highest percentage for any life insurer. Sabin Russell, *Junk-Bond Woes Snare Insurers*, S.F. CHRON., Jan. 22, 1990, at C1. Reinsurance from First Stratford supported \$558 million of Executive Life of New York's reserves. *Id.* The New York insurance regulation action forced Executive Life of New York to raise its capital. Kristof, *supra* note 75. The California subsidiary, ELIC, was permitted to give its New York sister \$151 million to meet New York regulators' capital demands. *Id.* But the California Department of Insurance then wanted ELIC to boost capital. ELIC received \$175 million in cash and \$170 million in a (backdated) note from its parent—raising its net worth to \$204 million in 1987. *Id.*

84. Kristof, *supra* note 75.

85. ELIC held around 65 percent of its assets in junk bonds. Sabin Russell, *State Reviewing Deal by LA Insurance Firm*, S.F. CHRON., Dec. 23, 1989, at B1.

86. Press Release, Bus. Wire, DOI Completes Executive Life Exam, Orders Action (Jan. 19, 1990).

87. *Executive Life's Junk Bonds—A Case Study in the Manipulation of Investments to Improve Their Apparent Quality and Provide Surplus Relief*, 17 INS. FORUM 81, 81 (1990). The periodical's first reporting on the transaction has the transfer as \$771 million in junk bonds to six corporations, rather than partnerships. *Id.* at 82.

88. *Id.* at 81–82.

89. *Id.* at 81.

90. *Insurer Failures: Regulators Failed to Respond in Timely and Forceful Manner in Four Large Life Insurer Failures: Hearing Before the Subcomm. on Oversight and Investigations of the Comm. on Energy and Commerce*, 102d Cong. 10 (1992), [hereinafter *GAO Insurer Failures*] (statement of Richard L. Fogel, Assistant Comptroller General, General Government Programs, Government Accounting Office), available at <http://archive.gao.gov/t2pbat6/147526.pdf>.

91. *Executive Life's Junk Bonds—A Case Study in the Manipulation of Investments to Improve Their Apparent Quality and Provide Surplus Relief*, *supra* note 87, at 82.

way split avoided the requirement of reporting the investments in FE's annual report.⁹² The CDOs do not appear to have been rated,⁹³ and ELIC never resold them.⁹⁴

Indeed, it never sought to do so, for the transaction was purely a regulatory arbitrage play. Insurance companies are required to maintain a special reserve of capital to protect against losses to their investment portfolio. This reserve, known historically as the Mandatory Securities Valuation Reserve ("MSVR," now called the Asset Valuation Reserve or "AVR"), was determined based on risk-based capital factors set by the Securities Valuation Office of the National Association of Insurance Commissioners. Different types of assets in insurance companies' investment portfolios received different risk-based capital factors, which determined the level of the MSVR required for the asset.⁹⁵ For example, junk bonds (rated CCC and lower) carried a 20 percent reserve requirement,⁹⁶ whereas BBB-rated bonds had just a 2 percent requirement, and bonds rated A or higher had a 1 percent requirement.⁹⁷ Thus, \$100 million in junk bonds required \$20 million in reserves, whereas \$100 million in AAA-rated bonds required only \$1 million in reserves.

For unrated bonds, the regulator assigned reserve requirements based on various bond characteristics. Bonds that were either an "amortizable privately placed bond, or other amortizable bond for which no market quotation is readily available," are categorized as "Yes" and get a 2 percent reserve requirement.⁹⁸ Bonds classified as "No*" or "No,**" namely bonds

92. *Id.*

93. See Anise C. Wallace, *Making "Junk Bonds" Respectable*, N.Y. TIMES, Dec. 15, 1989, at D1, available at <http://www.nytimes.com/1989/12/15/business/market-place-making-junk-bonds-respectable.html?pagewanted=all&src=pm> (providing no ratings for FE's CDOs).

94. *Id.* Daniel Fischel argues that the CDO was "designed to be easier to sell than the underlying high-yield bonds" and implies that the California Insurance Department wrongly concluded that the CDO was merely designed to improperly lower reserve requirements. FISCHEL, *supra* note 41, at 290. Fischel's argument fails, however, if First Executive never resold the CDOs. There is no evidence that it did.

95. GAO *Insurer Failures*, *supra* note 90, at 10, 14.

96. U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-93-35, REPORT TO THE CHAIRMAN, SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS, COMMITTEE ON ENERGY AND COMMERCE, HOUSE OF REPRESENTATIVES: INSURANCE REGULATION, WEAK OVERSIGHT ALLOWED EXECUTIVE LIFE TO REPORT INFLATED BOND VALUES 13 (1992) [hereinafter GAO INSURANCE REGULATION REPORT].

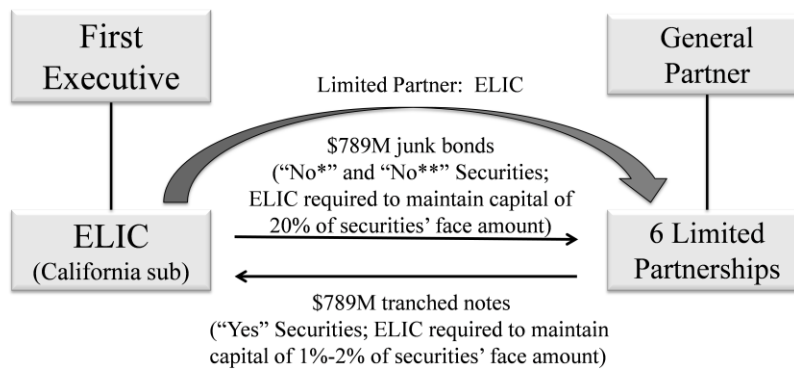
97. Shauna Ferris, "Someone Else's Problem," *The Failure of the Guarantee Security Life Insurance Company*, 16 AUSTL. ACTUARIAL J. 1, 26 (2010), available at http://www.actuaries.asn.au/Libraries/Information_Knowledge/46305_AAJ_v16i1_comp.sflb.ashx.

98. *Executive Life's June Bonds—A Case Study in the Manipulation of Investments to Improve Their Apparent Quality and Provide Surplus Relief*, *supra* note 87, at 83. See also GAO INSURANCE REGULATION REPORT, *supra* note 96, at 36 (providing the rating system).

“classified as eligible for amortization only for life insurers which have established and are maintaining a mandatory securities valuation reserve,” receive 10 percent or 20 percent reserve requirements, respectively.⁹⁹

All of the bonds ELIC transferred to the SPEs were likely “No*” or “No.**”¹⁰⁰ The two senior classes of CBOs ELIC received in return for its junk bonds—around 90 percent of the deal—were classified as “Yes,” with the junior class classified as “No.**”¹⁰¹ Figure 3, below, depicts the transaction.

FIGURE 3. The First Executive CDO



By turning “No*” into “Yes,” ELIC was able to reduce its reserve requirements by at least \$110 million¹⁰² and thereby inflate its surplus, despite the assets and the risks being exactly the same.¹⁰³ As a FE executive explained to the *Wall Street Journal*, the deal “create[d] securities that were worth more than the underlying assets.”¹⁰⁴

99. *Executive Life's Junk Bonds—A Case Study in the Manipulation of Investments to Improve Their Apparent Quality and Provide Surplus Relief*, *supra* note 87, at 83.

100. *Id.*

101. *Id.*

102. *Id.* at 84 (finding that ELIC reduced its reserve requirements by \$126 million); Kathy M. Kristof, *First Executive to Take Big Loss on Junk Bonds*, L.A. TIMES, Jan. 20, 1990, at D1, available at http://articles.latimes.com/1990-01-20/business/fi-112_1_junk-bond; Martin Mayer, *Viewpoints: The Latest Junk Bond Scam?* L.A. TIMES, Jan. 7, 1990, at D3, available at http://articles.latimes.com/1990-01-07/business/fi-82_1_junk-bonds/2 (finding that ELIC reduced its reserve requirements by \$110 million).

103. *GAO Insurer Failures*, *supra* note 90, at 14–15.

104. Mayer, *supra* note 102.

As a matter of economic theory, such alchemy is impossible.¹⁰⁵ But economic theory assumes away regulation. When a real world regulated company faces a regulator's demands for new capital, any legerdemain on the right side of the balance sheet that provides relief is extremely valuable. Other entities in the Milken menagerie took note of FE's success. As one news account related:

Thomas Spiegel, who built Columbia Savings & Loan of Beverly Hills, a rival of Carr's First Executive as Milken's premiere customer, has resigned from the deteriorating S&L and plans to work with the Wall Street house of First Boston to repackage Columbia's nearly \$4-billion junk bond portfolio into [CDO]s that can be sold for more than the assets are worth.¹⁰⁶

The CDO structure was now part of the Wall Street playbook.

Unfortunately for FE, its regulators didn't buy it. A negative write up in the industry press¹⁰⁷ prompted the California Insurance Department to examine the treatment.¹⁰⁸ Disallowance followed in January 1990, forcing FE to increase reserves by \$110 million.¹⁰⁹ The regulator probably had little choice. January 1990 also saw FE disclose a \$968 million loss on its investment portfolio during the previous year.¹¹⁰ Similar losses on the junk bonds in the SPE held out starkly negative implications for the value of the CDO. The junk bond market had collapsed. California's insurance commissioner shut down ELIC in April 1991¹¹¹ followed shortly thereafter by the shutdown of FE's New York insurance subsidiary by that state's insurance commissioner.¹¹² Michael Milken pled guilty to six counts of securities fraud in April 1990, and in May 1991 FE filed for bankruptcy.¹¹³ It was the largest insurance company failure in U.S. history.¹¹⁴ The go-go

105. See Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 262 (1958) (explaining that "marginal yield on physical assets is equal to the market rate of interest").

106. Mayer, *supra* note 102.

107. Eric N. Berg, *An Eye on the Insurance Industry*, N.Y. TIMES, Apr. 17, 1990, at D1, available at <http://www.nytimes.com/1990/04/17/business/an-eye-on-the-insurance-industry.html> (noting that regulators first noticed the First Executive CBO because of a newsletter by Indiana University insurance professor Joseph M. Belth, THE INS. FORUM).

108. DeAngelo, DeAngelo & Gilson, *supra* note 35, at 327.

109. *Id.* at 328. See also GAO *Insurer Failures*, *supra* note 90, at 15 n.6 ("In December 1989, California regulators made Executive Life reverse the bond transactions and recalculate its MSVR.").

110. DeAngelo, DeAngelo & Gilson, *supra* note 35, at 293.

111. *Id.* at 298.

112. *Id.*

113. *Id.*

114. Scott E. Harrington, *Policyholder Runs, Life Insurance Company Failures, and Insurance Solvency Regulation*, 15 REGULATION 27, 28-29 (1992).

junk bond era was over.

C. SUMMARY

What was so wrong with FE's deal structure? As a formal proposition, the junk bonds were transferred pursuant to a contract of sale between the company and an independent entity. But in substance the SPE transferee was FE's alter ego. FE held 99 percent of the equity interest in the SPE, using a limited partnership structure to vest nominal control in a general partner, who happened to be a former FE executive. The entity was physically lodged with another FE affiliate. Meanwhile, the "independent" entity had no assets other than the swapped bonds, which were booked at par and paid for with its own promissory note. Any decrease in the bonds' value meant nonpayment on the note with the resulting loss of value flowing back to FE's balance sheet dollar for dollar. In truth, there was no there, there. FE was swapping pieces of paper with itself. Eleven years later Enron would do the same thing.

The media coverage of the Milken scandal never delved deeply into Milken's financial dealings. Instead, the press focused on the clash of cultures between a white shoe Wall Street and a larger-than-life, upstart Jewish bond trader,¹¹⁵ and lurid tales of insider trading, bad toupees, partying, and excess.¹¹⁶ Even a quarter century later, we still do not have the full story of Michael Milken's dealings.

The true Milken scandal lay in the alleged but unproven junk bond daisy chain and its connection to takeover transactions that made money for some but caused economic and social dislocation for others. Junk bonds' economic disruption was the occasion for, but not the subject of, Rudy Giuliani's prosecution and conviction of Michael Milken for relatively trivial securities law violations.¹¹⁷ The mismatch was to be repeated.

115. See, e.g., FISCHEL, *supra* note 41, at 4–7 (attributing Milken's prosecution to "the public's historic distrust and envy of financiers"); BRUCK, *supra* note 81, at 205, 331 (describing anti-Semitic reactions to Drexel's success).

116. See BRUCK, *supra* note 81, at 11, 14–15.

117. See, e.g., PAUL CRAIG ROBERTS & LAWRENCE M. STRATTON, *THE TYRANNY OF GOOD INTENTIONS* 96–97 (2000) (arguing that prosecutors "criminalized regulatory infractions"). Daniel Fischel described U.S. Attorney Rudolf Guliani's prosecutorial approach as follows:

Giuliani saw RICO's amorphous language as a potent weapon to rubber-hose and coerce guilty pleas and punish those who refused to cooperate. He had already pioneered the criminalization of such standardless offenses as insider trading, stock parking, and manipulation. Now the government could claim that the same underlying conduct that supposedly provided the basis for these standardless offenses also constituted a "pattern of racketeering activity" that justified a RICO prosecution. By this bootstrapping logic, Giuliani was able to drop the equivalent of a nuclear bomb on any target, at any time, no matter how trivial or harmless the underlying conduct.

III. THE FULCRUM: BISTRO

In following years, other more respectable insurance companies succeeded where FE failed, getting junk bonds off of their balance sheets and into SPEs funded by CDOs with their regulators' approval. In these deals, either the insurer or its holding company would take the junior CDO tranche, with the most concentrated risk, while the senior pieces would be sold to outside investors.¹¹⁸ Regulatory capital relief was achieved, even if most risk remained within the insurers' corporate groups. Indeed, as the 1990s progressed, structured financings involving the securitization of bonds and loans became a routine affair. By 1996 annual issuance of CDOs

FISCHEL, *supra* note 41, at 123.

118. In 1991, Connecticut Mutual Life Insurance Co. did a CDO deal, selling \$375 million on junk bonds and junk private-placements to the CDO, which financed the purchase by issuing notes and equity. Steven Bavaria, *Will Connecticut Mutual's Junk CBO Start a Trend?* INVESTMENT DEALERS' DIG., Dec. 23, 1991, at 25. Connecticut Mutual was the investor for a \$90 million cushion of equity and junior debt that comprised a 24 percent first loss position. *Id.* The effect of Connecticut Mutual's deal was much like FE's—it moved \$375 million of junk from the insurer's books and replaced it “with \$90M of assets containing more concentrated but less publicly visible risk.” *Id.* The \$90 million retained had a considerably higher yield than the original \$375 million. *Id.* The transaction reduced the junk asset percentage of Connecticut Mutual's investment portfolio. *Id.* This was important because junk asset percentage was the public litmus test of insurer risk after the failures of First Executive and another life insurance company, First Capital, both of which were major junk bond investors. *Id.* Having a lower percentage of junk assets in portfolio helped Connecticut Mutual's agents market its policies, as “Questions about junk bond holdings are at the top of the list of questions potential policyholders ask when considering one company versus another.” *Id.* Connecticut Mutual's securitization was again being done to mask a company's real financial position. As with First Executive, some insurance officials were concerned, describing the deal “as mere window dressing.” *Id.* But an important distinction should be noted. Even as Connecticut Mutual retained the residual risk on the portfolio, it sold most of the risk to third parties.

A few years later, the Equitable Life Assurance Society of America undertook a CDO, EQ Asset Trust 1993, to upgrade the credit quality of its portfolio, by swapping out junk assets, including numerous defaulted bonds, for higher rated CDO assets. Anne Schwimmer, *Equitable Clears Decks of Junk with \$700M Deal*, INVESTMENT DEALERS' DIG., Oct. 18, 1993, at 12. Equitable Life sold \$703 million of privately placed notes to a CDO it created. *Equitable Debt Sale Yields \$700 Million*, PENSIONS & INVESTMENTS, Jan. 24, 1994, at 78. Equitable Life and its affiliate Equitable Variable Life then purchased the \$200 million mezzanine Class B tranche of the CDO's notes. Anne Schwimmer, *Equitable Clears Decks of Junk with \$700M Deal*, INVESTMENT DEALERS' DIG., Oct. 18, 1993, at 12. Half of the Class B notes were rated investment grade, thereby giving Equitable Life relief from its NAIC reserve requirements, which only applied to the life insurer itself, not its holding company, The Equitable Companies, which purchased the \$50 million of Class C junior notes and \$50 million of the CDO's equity. *Id.* Equitable Life's affiliate DLJ purchased the entire \$325 million AAA tranche, which it resold in the private placement Rule 144A market. *Equitable Debt Sale Yields \$700 Million*, PENSIONS & INVESTMENTS, Jan. 24, 1994, at 78. Equitable Life used the cash proceeds from the sale to purchase investment grade assets. *Id.* The transaction allowed Equitable Life to transmogrify its junk assets into investment grade assets, while still maintaining the yield—and the risk—within its corporate family.

had risen to \$18.6 billion.¹¹⁹ But, there were some structural sticking points. This part describes the Bistro securitization, the deal that surmounted the sticking points, situating it in the business context of a hypothetical bank in 1997. Section A begins with the transaction structures that served as Bistro's building blocks—asset securitization and the credit default swap. Using a hypothetical bank, this section highlights the functions that securitization and credit default swaps performed, but also identifies transactional problems they were unsuited to solve. Section B goes on to show Bistro emerge as a hybrid of the two structures suited to solve the problems.

A. MOTIVATIONS

Imagine a large bank that makes loans to corporations and then holds those loans to maturity. The bank has a corporate lending department that maintains relationships with quality borrowers. There are constraints on the relationships. The bank's internal risk management policies limit the amount that can be loaned to any given borrower, and the restriction sometimes interferes with client relationships.¹²⁰ Additionally, the bank is required to support the loan portfolio with equity capital. Under the Basel Committee on Banking Supervision rules ("Basel I"), adopted by domestic bank regulators, corporate loans require 100 percent support,¹²¹ which translates into an equity cushion amounting to 8 percent of the loans' principal amounts.¹²² The bank seeks a way to reduce the required amount of equity because its alternate sources of funding, deposits and borrowing, are cheaper. Cheaper capital means a higher return on assets and a higher stock price. At the beginning of 1997, there were two ways to attack the problems of lending limits and required capital, CDOs and CDSs.

As we saw in Part I, securitization provides an expeditious way to liquidate the loans and turn them into cash. The bank already is doing this with its portfolio of residential mortgages, getting them off of its balance sheet by securitizing them and then relending the funds received from the sale of the mortgage-backed securities. The replay loans generate fees for

119. Karen Sibayan, *1987 to Present: A Walk Down CDO Lane*, ASSET SALES REP., Apr. 17, 2000. Multi-asset deals that mixed bonds and loans were being done also. *Id.*

120. TETT, *supra* note 12, at 44–45 (describing lending limits and other bank techniques used to limit default risk).

121. BASLE COMM. BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS 22 (1988), *available at* <http://www.bis.org/publ/bcbs04a.pdf>.

122. *Id.* at 14.

the bank. The bank also will have a contract with the SPE pursuant to which it manages (or “services”) the loans in the securitized pool, an additional source of fee income.¹²³ Meanwhile, the bank’s base of assets is smaller, but that is a good thing. When a smaller bank generates more income, fundamental performance yardsticks like return on assets and return on equity improve, and the bank’s stock price goes up. The bank is now “asset light.”

Our bank could do more or less the same thing with its corporate loans, transferring them to an SPE, which would issue CDOs. Unfortunately, there are some sticking points. Here the interest rate profile is unattractive. Our bank is large and strong and enjoys a low cost of borrowing (in part from its access to deposits), as does its excellent collection of borrowers. But even AAA-rated securities issued by an SPE must pay a higher rate of interest than the bank does. So the bank loses an advantageous spread by securitizing. In addition, CDOs work for completed loans but not for committed but undrawn loans: the bank is looking for ways to shift the risk of its loan commitments as well. Finally, if the bank transfers a loan to an SPE, it must notify the borrower or, in some cases, even obtain the borrower’s consent. Either way, the bank’s relationship with the borrower, which is built on a confidentiality agreement,¹²⁴ is disrupted.¹²⁵

The bank can surmount these problems with credit default swaps. CDSs, which first appeared in the early 1990s,¹²⁶ are derivative transactions pursuant to which parties transfer the risk of default on debt securities, called “reference obligations.” To sketch out a simple scenario,

123. Levitin & Twomey, *supra* note 46, at 37.

124. See J.P. MORGAN, THE J.P. MORGAN GUIDE TO CREDIT DERIVATIVES 73 (1999), available at http://www.investinginbonds.com/assets/files/Intro_to_Credit_Derivatives.pdf [hereinafter MORGAN GUIDE] (noting that credit derivatives allow banks to transfer risk but maintain confidentiality).

125. *Cf. id.* at 8–10 (observing that credit derivative confidentiality preserves borrower confidentiality, protecting customer relationships). An additional sticking point should be noted. It is common for the originating bank to retain the first loss tranche of a CDO, but if the tranche amounts to 8 percent of the principal amount in the pool, the bank ends up with no regulatory capital relief. *Id.* at 72.

126. The precise origin of the CDS seems shrouded in history. Various instruments for separating credit risk from other risks, such as guarantees and bond insurance, have existed for decades. But the particular derivative form of the transaction seems to date back to the early 1990s. Bankers Trust has been credited with some of the earliest deals as far back as 1991. SATYAJIT DAS, TRADERS, GUNS, AND MONEY: KNOWN AND UNKNOWN IN THE DAZZLING WORLD OF DERIVATIVES 269–70 (2006); TETT, *supra* note 12, at 45–46. Morgan did its first deal in 1993, arranging for the European Bank for Reconstruction and Development to assume the credit risk on a \$4.8 billion line of credit to Morgan’s long-standing client Exxon, which was facing a \$5 billion fine for the Exxon Valdez oil tanker spill. TETT, *supra* note 12, at 46–47.

the bank enters into a swap that references a loan in its portfolio. The bank is the “protection buyer” and its swap counterparty is the “protection seller.” The protection seller agrees to pay the principal amount of the loan in the event the borrower defaults. In exchange for this commitment, the protection seller receives periodic premium payments from the protection buyer, here the bank; the riskier the reference obligation, the higher the premium. Economically, the protection seller is selling insurance on the reference obligation, making the protection seller “long” on the obligation’s performance and the protection buyer “short” on the obligation’s performance. From the point of view of the bank, no loss will befall it on a loan under a CDS until two defaults occur—first, the loan itself defaults, and second, the swap protection seller defaults.¹²⁷

The CDS holds out an advantage over securitization because the loan the CDS references is not transferred¹²⁸—derivatives are contracts that specify payments based on the performance of external securities; the parties to the derivative need not own the securities referenced. As a result, the loans referenced by the CDS just sit in the bank’s portfolio as if nothing had happened. The bank retains its funding cost advantage accordingly.¹²⁹ Effective risk transfer under a swap also frees up room under the bank’s internal risk management guidelines for more lending to the client. More importantly, risk transfer to another bank means regulatory capital relief. Where corporate obligations carry a 100 percent equity capital requirement—the full 8 percent—obligations guaranteed by another bank require only 20 percent of the 8 percent or 1.6 cents of equity for every dollar of principal amount. The regulatory authorities accept bank swap counterparties as the functional equivalent of bank guarantors.¹³⁰ And banks do swap with other banks as a means to the end of loan portfolio diversification.¹³¹

Unfortunately, to limit the universe of swap counterparties to other

127. MORGAN GUIDE, *supra* note 124, at 16.

128. There are, accordingly, neither accounting nor tax issues. *Id.* at 15.

129. *Id.* at 16.

130. *Id.* at 59. BD. OF GOVERNORS OF THE FED. RESERVE SYS., DIV. OF BANKING SUPERVISION AND REGULATION, SR 96-17, SUPERVISORY GUIDANCE FOR CREDIT DERIVATIVES (1996), available at <http://www.federalreserve.gov/boarddocs/srletters/1996/sr9617.htm>; BD. OF GOVERNORS OF THE FED. RESERVE SYSTEM, DIV. OF BANKING SUPERVISION AND REGULATION, SR 97-18, APPLICATION OF MARKET RISK CAPITAL REQUIREMENTS TO CREDIT DERIVATIVES (1997), available at <http://www.federalreserve.gov/boarddocs/srletters/1997/SR9718.HTM>. Note that the bank protection seller must, in turn, support the risk taken with its own equity capital, limiting the utility of the device. MORGAN GUIDE, *supra* note 124, at 59.

131. See WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 394 (7th ed. 2012) (identifying the CDS as a means to limit banks’ risks).

banks is to limit access to the swaps market, in which hedge funds and other institutional investors that are not primary lenders take on the risk and return of corporate lending without actually having to have money to lend or the capacity to service loans.¹³² This is not the only limitation respecting the use of CDSs to shift the risk of the bank's corporate loans. Matching up a given corporate loan with a given swap counterparty entails transaction costs—you have to find an institution looking for that particular risk. A further problem arises if the potential protection sellers want to conduct due diligence on the borrower, for the bank's confidentiality agreement with the borrower gets in the way.¹³³

In sum, the bank wants two things: to shift the risk of corporate loans and to obtain regulatory capital relief. A conventional CDO would shift the risk of corporate loans by transferring the loans. The bank, however, does not want to transfer the loans. A CDS would accomplish the risk shift without the transfer. But, in order to reduce transaction costs and surmount the confidentiality problem, the loans to be swapped must be bundled into a portfolio that can be evaluated as such as is the case with CDOs. In theory, a CDS could be done on a portfolio basis. That portfolio CDS, however, would not simultaneously satisfy the bank's second objective of obtaining regulatory capital relief.

B. BISTRO BREAKTHROUGH

Bistro solves the bank's problems. It builds on the "credit linked note" ("CLN"), a contraption that literally splices a securitization together with a credit default swap.¹³⁴

Let's construct a simple CLN for the bank. Assume the bank is

132. Or to book the loans on their balance sheets. See MORGAN GUIDE, *supra* note 124, at 16.

133. See TETT, *supra* note 12, at 57 (explaining that banks were originally hesitant to issue CDOs for fear of breaking confidentiality and losing customers).

134. Anne Schwimmer & Philip Maher, *Derivatives Pros Snubbed on Latest Exotic Product*, INVESTMENT DEALERS' DIG., Nov. 29, 1993, at 5. SBC Warburg created a similar structure at the same time, a \$1.7 billion vehicle known as SBC Glacier Finance, Ltd. Glacier was completely funded via CLNs, whereas Bistro had an unfunded super senior position. Ronald E. Thompson Jr., & Eva F.J. Yun, *Collateralized Loan and Bond Obligations: Creating Value Through Arbitrage*, in HANDBOOK OF STRUCTURED FINANCIAL PRODUCTS 251, 261–62 (Frank J. Fabozzi ed., 1998).

There appear to have been some early attempts to marry securitization with credit derivatives, under the name of "credit derivative bonds." We have been able to locate little information about these products. Apparently they were marketed by "derivatives dealers including Citibank, Bankers Trust Co., JP Morgan, Merrill Lynch, and Salomon Brothers." Schwimmer & Maher, *supra*, at 5. It is unclear whether any deals ever closed. These products seem to have involved an issuer that was a party to swaps on a pool of reference assets, presumably owned by the swap counterparty. The product was "essentially a synthetic version of a CBO equity tranche." *Id.*

seeking regulatory capital relief for a loan portfolio of \$700 million principal amount. We form an SPE. The SPE sells CLNs into the public markets, raising \$700 million in exchange for \$700 million principal amount. Since the SPE is not buying any mortgages or notes from the bank, it retains the \$700 million and invests it in U.S. Treasury securities. We cannot stop here, for at this point the SPE is in a position only to pay its note investors the rate on U.S. Treasuries minus its own transaction costs, an uncompetitive yield. So we have the SPE enter into a CDS with the bank that references the \$700 million loan portfolio; the SPE is the protection seller, and the bank the protection buyer. The SPE is now getting the CDS protection premiums, which enable it to provide a higher yield on its notes.¹³⁵

But what is the point of swapping with a shell entity like an SPE? The answer is the same as the one given in regard to the purchase of a note issued by an SPE—it depends on the assets in the SPE. This one has \$700 million of Treasury securities to cover the risk of default on the reference portfolio and so makes sense as a CDS counterparty; the SPE is fully funded and conducts no other business in which it could lose money, so it does not present the counterparty default risk of a real operating entity. To the extent that defaults occur in the reference portfolio, they come at the expense of the note holders. The SPE will liquidate its Treasury securities to the extent necessary to cover its obligations under the swap; as the collateral in the SPE disappears, the value of the CLNs declines proportionately, with the holders of the SPE's junior tranches taking the first loss, then the mezzanine, and finally the senior.

Importantly for the bank, the bank regulators accept credit default swaps with SPEs as a basis for equity capital relief, looking through to the assets in the SPE in setting the capital minimum.¹³⁶ In our CLN set up, the SPE holds sovereign debt securities that have a zero percent risk-weighting under Basel I capital requirements, which means the bank no longer needs to support the loan portfolio with equity capital.¹³⁷ For the bank, the CLNs add up to a good deal so long as the value of the regulatory capital relief exceeds the cost of the periodic payments on the swap. Importantly, the relief is only from regulatory capital; there is no relief for purposes of

135. See MORGAN GUIDE, *supra* note 124, at 24–25, 74 (noting that the additional risk of CLNs is recognized by the fact that their yield “is higher than that of the underlying collateral and the premium on the [c]redit [s]wap individually”).

136. *Id.* at 59–61.

137. *Id.* Note that we could tweak the returns on the CLNs upwards by placing debt securities with higher yields in the SPE—securities like AAA CMOs. So doing will have a regulatory impact, diminishing the extent of the minimum capital relief. *Id.* at 60–61.

generally applicable accounting principles (“GAAP”) because even though the risk of the reference portfolio is transferred from the bank to the SPE, the actual title is not.

We now turn to the Morgan bank in 1997, where transaction engineers were busy inventing Bistro. They wanted equity capital relief on more than a mere \$700 million loan portfolio. Thus, the first Bistro structure sold \$700 million of CLNs and deposited the proceeds in an SPE, using the SPE as a swap counterparty to cover a Morgan loan portfolio made up of, not \$700 million of loans, but \$9.7 billion to 307 borrowers!¹³⁸ The mismatch between the \$700 million collateral in the SPE and the \$9.7 billion in credit exposure referenced by the swap amounted to a considerable departure from the traditional securitization model.¹³⁹

This was the tricky part. The purported solution lay in a combination of credit risk analysis and tranching of the notes issued by the SPE.¹⁴⁰ For simplicity, assume that the Bistro SPE was structured to issue three tranches of notes—junior, mezzanine, and senior (called “super senior” in this context). Assume further that the SPE planned to issue and sell only the junior and mezzanine CLNs, not the super senior CLNs. It turned out that there was no way to package marketable super senior CLNs—the yield would be too low to attract buyers.¹⁴¹ Accordingly the deal will be structured on an “as if” basis. The SPE will sell \$700 million junior and mezzanine CLNs, the rights of which will be determined by reference to a hypothetical super senior interest. Morgan took this package to the credit rating agencies armed with an analysis asserting that it was inconceivable that the widespread default on the reference portfolio could exhaust the \$700 million in the SPE.¹⁴² The agencies agreed and rated the junior (which made up one-third of the pot) Ba2 and the mezzanine (the remaining two-thirds) AAA.¹⁴³

So far, so good.¹⁴⁴ But the unfunded “super senior” tranche remained a problem. Morgan planned to retain the super senior risk on the reference

138. TETT, *supra* note 12, at 54–55.

139. MORGAN GUIDE, *supra* note 124, at 75.

140. *Id.*

141. TETT, *supra* note 12, at 53.

142. *Id.* at 54–55.

143. *Id.* at 55.

144. Bistro securities were accepted in the debt markets based on investment-grade portfolios. The names of the borrowers and amounts were disclosed to the note buyers; in some European countries the names were withheld due to bank secrecy laws, with only the “type” of credit being disclosed. MORGAN GUIDE, *supra* note 124, at 78. The practice was that the loans in the reference portfolio were set as of the closing date—there was no active management or trading of the portfolio loans. *Id.* at 79.

portfolio.¹⁴⁵ But it simultaneously wanted to get regulatory capital relief for the entire \$9.7 billion based on the \$700 million in the SPE.¹⁴⁶ It argued that the “real” risk had been transferred to the holders of the junior and mezzanine tranches. But Morgan’s regulator, the Federal Reserve Board (“Fed”), did not buy it. So Morgan turned around and swapped the super senior risk with an AAA-rated insurance company, AIG.¹⁴⁷ AIG was paid \$0.02 cents per year per dollar of risk undertaken in the swap. This the Fed accepted, AIG being the functional equivalent of a bank counterparty.¹⁴⁸ The square was circled.

Bistro was a hit. Morgan promptly marketed the structure to other banks looking for regulatory capital relief (and still other banks promptly copied the structure and competed with Morgan).¹⁴⁹ When marketing Bistro deals to others, Morgan finessed the problem of super senior risk by standing between the bank doing the protection buying and the SPE doing the protection selling by swapping with both. When the smoke cleared, Morgan had swapped with its bank customer for the super senior risk on the other bank’s loan portfolio, taking the role played by AIG in its own deal.¹⁵⁰ Having Morgan as swap counterparty on the super senior meant regulatory capital relief. Instead of holding eight cents of capital for every dollar of loan, the bank would only have to hold a fifth of that—1.6 cents for every dollar of loan on its books.¹⁵¹ Eventually, after marketing a bunch of Bistro deals, Morgan decided it had accumulated too much super senior risk on its balance sheet and looked to swap it with another party. Ominously, Morgan went back to AIG, which was always willing to take the risk.¹⁵²

C. SUMMARY

Morgan’s Bistro followed from the same motivation as First Executive’s CDO. In both cases a regulated financial company devised an

145. TETT, *supra* note 12, at 63–64.

146. *Id.* at 55.

147. *Id.* at 60–62.

148. MORGAN GUIDE, *supra* note 124, at 63.

149. *Id.* at 57–58.

150. TETT, *supra* note 12, at 62–63, 70.

151. *See id.* at 59 (describing capital relief shift from 100 percent to 20 percent). A question arises: Aren’t Morgan’s bank capital requirements stacking up as it accumulates super-senior risk on the portfolios of other banks? The answer is yes but not onerously so, due to the magic of a combination of value at risk credit analysis and trading book treatment. *Id.* at 75. (“Provided that the third party bank is able to apply internal models to its residual risk position in a trading book, this risk will not consume a disproportionate amount of regulatory capital for the intermediating bank.”).

152. *Id.* at 70.

innovative variation on securitization in order to get relief from mandatory capital regulation. There also were striking structural similarities. In both cases the regulated financial company “swaps” with a self-created entity. In FE’s case the swap is the junk-for-note exchange; in Morgan’s case the swap is a derivative contract. In both cases an asset-less SPE without an equity base gets its asset on credit.

But there were also material differences. FE filled its SPE with assets in exchange for the SPE’s own note, which meant that the SPE obligation that bootstrapped FE’s regulatory capital was ultimately undermined by a matching obligation on the original junk-for-note swap. The Bistro structure brought in new risk capital, both on the sales of the CLNs and on the super senior swap.

Let us strip Bistro down to its essentials. A promoter that seeks to swap away the risk of a portfolio of securities sets up an SPE; the SPE funds itself with borrowed money; the borrowed money is invested in super safe securities that support a swap between the SPE and the promoter; and the SPE’s note holders assume the economic risk of a decrease in the value of the promoter’s securities portfolio, taking as compensation the swap premium and the interest on the collateral—the SPE’s super safe investment in Treasuries.

The structure could be tweaked in various ways. Could Treasuries be replaced with any other valuable securities as collateral? Could the outside investors be entities other than buyers in the market for securitized notes? Might not another mode of financing do just as well? In Part IV we will see Enron answer these questions in the affirmative, creating a toxic variant on Bistro that bears a more than passing resemblance to the failed FE CDO.

Note also that Bistro employs a derivative contract to effect a hedge for the holder of a portfolio of securities.¹⁵³ That party reduces its risk, selling it to another party that seeks to take the risk. This is one of the two primary uses of a CDS. The other possible function is speculation—a party can enter into a derivative contract to bet for or against the reference obligation without actually owning it. Derivatives make it easier to place such bets, because the bettor is not required to front the money to purchase the asset on which the bet is made (when the bet is that the asset’s value will increase, a long position) or to incur the cost of borrowing the asset (when the bet is that the asset’s value will decrease, a short position).

Bistro accordingly could be adapted for speculation as well as

153. See MORGAN GUIDE, *supra* note 124, at 74–76.

hedging. Nothing requires the party in the position of the bank to own the reference portfolio. The reference portfolio can be any debt portfolio, with the protection buyer in effect making a bet that the portfolio will default. In addition, nothing requires full funding of the SPE by the buyers of the CLNs. After all, why pay the full amount of the note where the proceeds are going to be invested in Treasury securities or some other low risk, low return debt paper? The note buyer can hold onto that capital and make its own investments. In this scenario, the Bistro deal cuts to the chase, putting the note buyer on the hook as the CDS counterparty.¹⁵⁴ After 1999, most Bistro deals, by then termed “synthetic securitizations,” had both of these features, so that the party in the bank’s position was neither required to own the reference portfolio nor to procure full funding for the SPE. These variations will be implicated in Goldman’s ABACUS deal, discussed in Part VI.

IV. THE ILLEGITIMATE CHILD: ENRON’S SWAPS

Down in Houston, Enron was watching the banks as they disaggregated their balance sheets and raised returns. Much enthused, Enron resolved to adapt the asset light strategy and high tech financial innovation to the old industrial economy, grandly claiming that it would transform the fundamentals of industrial organization. Unfortunately for Enron, grand claims are one thing and making money another, and the face of American industry would remain untransformed. One thing Enron did manage to transform was the Bistro transaction structure. But Bistro, once Enronized, would blow up in its creators’ faces and bring down their company. This part looks at the explosion, highlighting the surprisingly close connection between financial innovation at the banks, Enron’s business plan, and the transactions at the center of the Enron scandal.

A. ASSET LIGHT FROM WALL STREET TO MAIN STREET

To understand Enron’s business plan is to see the positive side of Bistro. One must momentarily resist the temptation to compare Bistro to the latest tax shelter and dismiss it as a financial innovation motivated by regulatory avoidance and holding out no other advantages. To see the

154. See Michael S. Gibson, *Understanding the Risk of Synthetic CDOs 1* (Fed. Reserve Bd., FEDS Working Paper No. 2004-236, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=596442 (“CDO ‘investors’ take on exposure . . . effectively selling credit protection to the CDO ‘issuer.’”). In this scenario, any regulatory capital relief for the protection buyer will depend on the identity of the note holder. But because the protection buyer does not own the reference portfolio, regulatory capital relief is not its objective.

argument in favor is to begin with Bistro's two building blocks, securitization and CDSs. Both enable arm's-length risk transfers that theretofore had not existed. Both facilitate the reallocation of bank exposures to non-bank parties willing to take the risks. Securitization also opens access to new sources of liquidity and funding by the banks. Investors in securities issued by SPEs and CDS counterparties get access to classes of investment that formerly were the banks' exclusive preserve.¹⁵⁵ As more investors take on more risk from the banks, risk becomes diffused more widely, making the financial system safer (or so said many prior to the financial crisis).

Bistro's synthetic aspect also adds something—the opportunity to create bespoke products. Risk and portfolio modeling have become more sophisticated. Managers need products fitting very specific risk-return profiles. Synthetic credit products, unlike primary credit products, can be tailored to meet specific demands.

Summarizing the positive case, transactional technicians at the banks created markets where no markets existed, creating opportunities for value-maximizing exchanges. Their innovations helped complete markets and improved the banks' financial profiles by facilitating active management of loan portfolios and increased return on assets.

Jeffrey Skilling, who became CEO of Enron in 2001,¹⁵⁶ was much impressed by the pattern of innovation in the financial sector and in particular by the resulting increase in return on assets. Financials were yielding better returns on capital than the energy industry: “[I]t's very hard to earn a compensatory rate of return on a traditional asset investment. . . . In today's world, you have to bring intellectual content to the product, or you will not earn a fair rate of return.”¹⁵⁷

Enron aspired to make like the banks. If the banks could become more nimble and profitable by transferring assets from their balance sheets to buyers in new liquid trading markets, so could Enron. It would leave behind its original business, the asset-laden production and transport of natural gas, to become a pure financial intermediary. Enron would make

155. BASEL COMM. ON BANKING SUPERVISION, THE JOINT FORUM: REPORT ON SPECIAL PURPOSE ENTITIES 7 (2009), available at <http://www.bis.org/publ/joint23.pdf>. For some originators, securitization also meant access to cheaper borrowing—by securitizing an A-rated borrower could segregate a portfolio of assets 90 percent of which, once tranching, could command an AAA rating. *Id.* at 12.

156. *OnLine Extra: Q & A with Enron's Skilling*, BUSINESSWEEK ONLINE (Feb. 12, 2001), http://www.businessweek.com/2001/01_07/b3719010.htm?scriptFramed [hereinafter *Skilling Q&A*].

157. *Id.*

money by making other companies asset light in turn. Much as the banks were doing with securitization and CDSs, Enron's intermediary business would create markets where none existed. This wasn't just an aspiration—Enron was starting up markets that covered not just energy but anything which could be traded—pulp and paper, metals, even broadband services. Few limits were acknowledged—only “unique” products (“knickknacks”) could not be brought into Enron's trading space.¹⁵⁸ Within the trading space, Enron did another thing the banks were doing—it offered a line of risk management products, most prominently over the counter derivatives addressed to its customers' exposure to price risks.¹⁵⁹

To see how all of this was supposed to work, hypothesize the creation by Enron of a new market in pulp and paper products. Jumpstarting a market where none existed meant asset purchases by Enron; to be a pulp and paper seller one needs an assured source of supply. If supply contracts are unavailable, one must own the source of the product directly, here timber tracts. Thus, matching pulp and paper buyers and sellers meant an investment in land. Once Enron established itself as a seller, it would bring other sellers together with timber buyers. As Enron saw it, such a new market could grow spectacularly if many timber users had captive sources of supply. Vertically-integrated forest products companies would notice the Enron market. At first they would draw on it for marginal supplies. Over time they would see that the Enron market had sufficient volume to supply their needs at lower prices than did their captive timber sources. They also would see that the Enron market made available price stability through the purchase of derivative contracts. The product users would add this up: where they once purchased captive sources of supply to insulate themselves from upward price fluctuations in times of high demand, they now could get both the lowest price and price stability through Enron's intermediary operation.¹⁶⁰ Unbundling followed naturally: the companies in the industry would go asset light, selling off their forest tracts and pocketing the gain. Enron, having started the process by buying timber tracts, would in the end

158. *Id.*

159. *See id.* (noting Enron's transformation into a “buyer and seller of . . . energy-related financial derivatives”).

160. As Enron stated in its 2000 Annual Report:

In Volatile Markets, Everything Changes But Us. When customers do business with Enron, they get our commitment to reliably deliver their product at a predictable price, regardless of the market condition. This commitment is possible because of Enron's unrivaled access to markets and liquidity. . . . We offer a multitude of predictable pricing options. Market access and information allow Enron to deliver comprehensive logistical solutions that work in volatile markets or markets undergoing fundamental changes, such as energy or broadband.

ENRON, ENRON ANNUAL REPORT 2000, at 6 (2000), available at <http://picker.uchicago.edu/Enron/EnronAnnualReport2000.pdf> [hereinafter ENRON, ANNUAL REPORT 2000].

divest the hard assets too, and continue to profit on its proprietary market.

Enron took two further cues from the banks. Just as mortgage pools created value by diversifying risk across different borrowers and regional housing markets, so did Enron claim to reduce risk for those who bought a product through the network of contacts brought together in its market, a risk reduction that isolated producer-sellers in the industry could not duplicate. Skilling explained:

[T]he fundamental advantage of a virtually integrated system vs. a physically integrated system is you need less capital to provide the same reliability. . . . Nondelivery is a nonsystematic risk. If a pipeline blows up or a compressor goes down or a wire breaks, the bigger your portfolio, the greater your ability to wire around that. So, if for example, I'm just starting in the gas merchant business and I'm selling gas from central Kansas to Kansas City, if the pipeline blows up, I'm out of business. For Enron, if that pipeline blows up, I'll back haul out of New York, or I'll bring Canadian gas in and spin it through some storage facilities. If you can diversify your infrastructure, you can reduce nonsystematic risk, which says there's a . . . very strong tangible network effect. . . . But you've got to get big, you've got to get that initial market share, or you're toast.¹⁶¹

Moreover, just as the banks tailored risk management products for their customers' needs, so did Enron. It claimed that its financial innovators provided a level of intelligence higher than that of a traditionally-conceived marketplace: "[We] provide high-value products and services other wholesale service providers cannot. We can take physical components and repackage them to suit the specific needs of customers. We treat term, price and delivery as variables that are blended into a single, comprehensive solution."¹⁶²

In the end, Enron aspired to outdo the banks, bringing virtual integration to the old economy and a new dawn of industrial organization:

There's only been a couple of times in history when those costs of interaction have radically changed One was the railroads, and then the telephone and the telegraph. . . . [W]e're going through another one right now. The costs of interaction are collapsing because of the Internet, and as those costs collapse, I think the economics of temporarily assembled organizations will beat the economics of the old vertically integrated organization.¹⁶³

161. *Skilling Q&A*, *supra* note 156.

162. ENRON, ANNUAL REPORT 2000, *supra* note 160, at 2.

163. Jerry Useem, *And Then, Just When You Thought the "New Economy" Was Dead . . .*, BUS.

In Skilling's projection, virtual integration would replace vertical integration and force Big Oil, Big Coal, or Big Anything to split up into multitudinous of micro firms, each working a niche. Enron would put the whole back together through its trading operation, all the while securing lower prices for all.¹⁶⁴ The nexus of contracts firm hypothesized by Jensen and Meckling would be realized in fact.¹⁶⁵

B. A BISTRO OPENS IN HOUSTON

Problems festered beneath Enron's veneer of big think. Enron had been reporting steady increases of revenue and earnings. Its stock rose from a low of \$17 in 1996 to a peak of \$90 in 2000 on expectations of further increases.¹⁶⁶ Meeting those expectations was becoming more difficult. For one thing, there were competitors. It turned out that entry barriers were low once Enron opened a new territory to market trading. Dozens of competitors were vying for its bread and butter businesses, undercutting its profit margins.¹⁶⁷ For another thing, Enron had just made a particularly big gamble that was not coming in. It had invested \$1.2 billion to jumpstart a market in bandwidth by building a national fiber optic network.¹⁶⁸ In 2001 the broadband operation was burning \$710 million a year with no profit in sight.¹⁶⁹ Worse, the stock market, besotted with broadband in 2000, abruptly changed its mind as overcapacity and financial distress hit the business. That meant trouble for Enron, whose stock had levitated to close to \$90 on broadband enthusiasm. Enron's stock fell along with all the others,¹⁷⁰ losing 39 percent of its value in the first six months of 2001.¹⁷¹

2.0, Aug.–Sept. 2001, at 69, 74.

164. *A Survey of Energy: The Slumbering Giants Awake*, ECONOMIST, Feb. 8, 2001, available at <http://www.economist.com/node/497418>.

165. Jensen and Meckling took the large firm and explained it as by-product of equilibrium contracting by rational economic actors. Given the complexity of relations among actors in the complex, agency cost reduction emerged as the problem for solution in the economics of firm organization. Jensen & Meckling, *supra* note 16, at 310. For an explication of the theory, see William W. Bratton, Jr., *The New Economic Theory of the Firm*, 41 STAN. L. REV. 1471, 1478–80 (1989). Enron aspired to use real world market contracting to unwind Jensen and Meckling's contractual complexes into simpler, more transparent units. With each unit directly disciplined by the market for its own product, agency costs inevitably would be less of a problem.

166. C. William Thomas, *The Rise & Fall of Enron*, 193 J. ACCT. 41 (2002), available at <http://www.journalofaccountancy.com/Issues/2002/Apr/TheRiseAndFallOfEnron.htm>.

167. Wendy Zellner & Stephanie Anderson Forest, *The Fall of Enron*, BUS. WK., Dec. 16, 2001, at 30, available at <http://www.businessweek.com/stories/2001-12-16/the-fall-of-enron>.

168. *Id.*

169. George J. Benston, *Fair-Value Accounting: A Cautionary Tale from Enron*, 25 J. ACCT. & PUB. POL'Y 465, 474 (2006).

170. Zellner & Forest, *supra* note 167, at 34–35.

171. *Id.* at 33. Enron also had made a number of big-ticket, old-economy investments abroad, all

Compounding its losses, Enron had a portfolio of “merchant investments” stuffed with large block holdings of stock in technology and energy companies. Enron’s income statement had reflected unrealized gains on the portfolio as the tech bubble rose. A falling market would do the opposite. Exacerbating the problem, the stock issues were illiquid and thinly traded; hedges were either expensive or unavailable.¹⁷² This left Enron in roughly the position of Morgan in 1997: It needed a swap counterparty for a portfolio of illiquid investments. As the market was not bringing forth that counterparty, Enron, like Morgan, needed to create it.

1. Chewco and LJM

Enron was a heavy user of SPEs.¹⁷³ This followed from the asset light strategy—it was easier to engineer the transfer of an asset to an SPE than to negotiate a sale to a third party. It also followed from the need to manufacture earnings—once an asset was off balance sheet in an SPE, Enron could engineer transactions with it that generated earnings. Asset light also meant debt light. Enron needed to maintain an investment grade credit rating to maintain credibility as a trading entity, and that meant limiting the amount of debt on its balance sheet. SPEs were useful there too, for they could be used as off-balance-sheet borrowing conduits. Finally, Enron sometimes wanted to transfer an asset to an SPE and book a gain but could not find a third-party lender. It went ahead anyway, just taking the SPE’s own promissory note as payment.

Under the accounting rules of the day, Enron’s SPEs fell into a residual, somewhat underspecified category.¹⁷⁴ As with securitization, a

of which were performing badly. Among others, there was a \$3 billion power plant in Dahbol, India; a \$1.3 billion purchase of the main power distributor to Sao Paulo Brazil; and a \$2.4 billion purchase of the Wessex Water Works in Britain. *Id.* at 32 (providing the cost figure for the purchase of the Dahbol plant); MIMI SCHWARTZ & SHERRON WATKINS, *POWER FAILURE: THE INSIDE STORY OF THE COLLAPSE OF ENRON 194–95* (2003) (providing the cost figures for the Sao Paulo and Wessex plants).

172. See WILLIAM C. POWERS, JR., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 77 (2002) [hereinafter POWERS REPORT] (regarding stock in Rhythms NetConnections, Inc., the report explains, “given the size of Enron’s position, the relative illiquidity of Rhythms stock, and the lack of comparable securities in the market, it would have been virtually impossible (or prohibitively expensive) to hedge Rhythms commercially”).

173. Enron’s 2001 10-K listed more than 3,000 affiliated entities. William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1305 (2002).

174. Compare ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENT OF LIABILITIES, Statement of Fin. Accounting Standards No. 125 (Fin. Accounting Standards Bd. 1996), available at <http://www.fasb.org/pdf/fas125.pdf> (defining SPEs generically), with ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENT OF LIABILITIES, Statement of Fin. Accounting Standards No. 140 (Fin. Accounting Standards Bd. 2000), available at <http://www.fasb.org/pdf/fas140.pdf> (providing specific guidelines for defining and

true sale to a bankruptcy-remote entity was necessary to qualify as an SPE.¹⁷⁵ It was also thought that 3 percent of the SPE's total capital must come from an outside equity investor,¹⁷⁶ who had to have the power to control the disposition of the asset in the SPE.¹⁷⁷ In addition, the outside equity capital had to be "at risk"—Enron, as originator, could not guarantee the investment's results.¹⁷⁸

The outside equity requirement had a way of getting in Enron's way. Enron's managers wanted deals done quickly and outside risk money could be hard to scare up. In 1997, Skilling decided that a cluster of assets (with associated liabilities) needed to be put into an SPE on the double. Enron's managers dutifully formed an SPE called Chewco (after the Star Wars character, the wookie Chewbacca) to buy the asset with borrowed money guaranteed by Enron.¹⁷⁹ Enron went on to book "nearly \$400 million" of revenue and gains respecting transactions with Chewco.¹⁸⁰ Unfortunately, Enron had never gotten around to finding the 3 percent outside equity investor needed to qualify Chewco as an independent SPE, concealing the fact. The arrangement came to light within Enron in fall 2001. All previous accounting entries respecting the SPE were disqualified with the result that Enron's earnings from 1997 to mid-2001 were retroactively reduced by \$405 million.¹⁸¹ Meanwhile, the SPE's return to Enron's balance sheet

transferring SPEs).

175. ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Fin. Accounting Standards No. 140, at 4–5, 7, 9–10 (Fin. Accounting Standards Bd. 2000), available at <http://www.fasb.org/pdf/fas140.pdf>.

176. The 3 percent test is an SEC accounting rule. It originated in a 1991 letter of the Chief Accountant of the SEC issued in respect of a leasing transaction. The GAAP authorities were EITF Topic D-14, "Transactions involving Special Purpose Entities," EITF 90-15, "Impact of Nonsubstantive Lessors, Residual Value Guarantees and Other Provisions in Leasing Transactions," and EITF 96-21, "Implementation Issues in Accounting for Leasing Transactions involving Special Purpose Entities." The SEC insisted that there is no bright line 3 percent test and that the level of outside funding should follow from the nature of the transaction. William W. Bratton, *Rules, Principles, and the Accounting Crisis in the United States*, 5 EUR. BUS. ORG. L. REV. 7, 22–23 & n.50 (2004). The accounting profession nonetheless treated the standard as a numerical rule. *Id.*

177. *Testimony of Edmund L. Jenkins, Chairman, Financial Accounting Standards Board, Before the Subcomm. on Commerce, Trade and Consumer Protection of the Comm. on Energy and Commerce*, 107th Cong. 11 (2002), available at <http://www.fasb.org/testimony/testimony.pdf> [hereinafter *Jenkins Testimony*]. This meant that the outside equity holder had to hold at least a majority of the SPE's equity. *Id.* If the equity participation is minimal—at the 3 percent level—then it must own 100 percent of the equity. *Id.* at 9.

178. *Id.* at 10.

179. POWERS REPORT, *supra* note 172, at 42–44.

180. John Emshwiller, *Fall of an Energy Giant: Andersen CEO Apparently Testified Inaccurately*, WALL ST. J., Jan. 11, 2002, at A4.

181. See POWERS REPORT, *supra* note 172, at 41 (setting out Enron's annual profit disallowances from 1997 to 2000).

increased Enron's total indebtedness by \$628 million.¹⁸² We will see that this was not even the largest SPE disqualification to occur at Enron in fall 2001.¹⁸³

Enron's CFO, Andrew Fastow, concocted a convoluted solution to the outside equity problem. In 1999, he organized two limited partnerships, LJM Cayman, L.P. ("LJM1") and LJM2 Co-Investment L.P. ("LJM2").¹⁸⁴ LJM1 and LJM2 raised \$390 million from institutional investors on the promise of a piece of the best deals from Enron.¹⁸⁵ In fact, the entities were formed to participate as the outside equity investor in SPEs set up by Enron, solving the compliance problem that had led to under-the-table dealings at Chewco.¹⁸⁶ Fastow controlled LJM1 and LJM2, serving as the managing member of their respective general partners.¹⁸⁷ The setup, rife with self-dealing, looked more than a little awkward.¹⁸⁸ Indeed, it bore a more than passing resemblance to the sham limited partnership FE had set up for its CDO swaps. But at least asset light transactions could be set up and executed smoothly and quickly.

2. Bistro Inferno

Recall that Enron was worried about the income statement effect of losses on a portfolio of tech and energy stocks. Equity swaps might have solved this problem. These are everyday hedging vehicles for holders of large, undiversified equity stakes, such as executives holding sizable positions in their own companies' stock. Ordinarily the counterparty is a financial institution and the swap's duration is short or intermediate term. To describe a very simple transaction, if the stock subject to the swap goes up during the period of the swap, the executive pays the bank the amount of the price increase. Since the executive is hedging and owns a block of stock in the company, the transaction is a wash so far as the executive is concerned because the loss on the swap is matched by the gain on the stock. If the stock goes down, the bank pays the amount of the decrease to

182. *Id.* at 42.

183. *See* Enron Corp., Current Report (Form 8-K), at 5 (Nov. 8, 2001) (discussing the disqualification of additional Enron income).

184. POWERS REPORT, *supra* note 172, at 67–70 (discussing the formation of LJM1 and LJM2).

185. The investors included J.P. Morgan Chase, Citigroup Inc., Credit Suisse First Boston, and Wachovia; Merrill Lynch, which marketed the interests, also kicked in \$22 million. John R. Emshwiller, Anita Raghavan & Jathon Sapsford, *How Wall Street Greased Enron's Money Engine: The Financial Firms' Many Well-Paid Roles Raised Many Conflicts*, WALL ST. J., Jan. 14, 2002, at C1.

186. POWERS REPORT, *supra* note 172, at 3.

187. *Id.* at 73–74.

188. The Powers Report questions whether an adequate separation of control ever really was achieved. *Id.* at 74–75.

the executive. The bank in turn hedges its downside risk on the stock by selling the stock short or purchasing a put option on the stock.

But the swap market did not have the depth to cover the equity securities in Enron's portfolio.¹⁸⁹ So Enron took a cue from Morgan and Bistro and created a series of SPEs to act as counterparties.

Enron's first step was to find a 3 percent outside equity investor, a step unneeded with Bistro due to different accounting rules. That was LJM's job, and it invested in every SPE in the series. (Whether these investments were large enough to meet the 3 percent test is a much mooted question.¹⁹⁰ Let us assume for the moment that they were.)

The remaining steps in Enron's swap setup admit a direct comparison with Bistro. The next step, as at Bistro, was funding the SPE followed by investment by the SPE. The result was an asset base within the SPE that provided the financial wherewithal to support a swap. With Bistro, the funding came from outside lenders, with the proceeds of the loan being used by the SPE to buy super safe debt securities. With Enron's SPEs, the asset base was Enron stock transferred to the SPE by Enron in exchange for a promissory note from the SPE to Enron. In all, Enron transferred to the LJM-related SPEs \$1.2 billion worth of stock and rights to purchase more stock plus \$150 million of Enron notes in exchange for \$1.5 billion face amount SPE notes.¹⁹¹ Enron also increased its shareholders' equity by \$1.2 billion to reflect the issue of its stock to the SPEs.¹⁹² As with Bistro, then, there was debt financing, but not from an outside source—it was as if Morgan itself had loaned the money to its SPE swap counterparty. As with Bistro, the SPE ended up with an asset base, but here that asset base was in its own promoter's common stock, rather than in super safe debt securities.¹⁹³

Note too that in Enron's case no money changed hands at the funding stage. The SPE was funded by shunting pieces of paper across a table at

189. *Id.* at 96–98.

190. *Id.* at 83–84.

191. ENRON, ANNUAL REPORT 2000, *supra* note 160, at 48–49.

192. POWERS REPORT, *supra* note 172, at 24.

193. In one particularly egregious arrangement, Enron's middle management had no Enron stock available to fund the SPE. Instead of going to the board to get more authorized, they funded the SPE with a block of the same stock being hedged by the swap. Needless to say, the SPE became insolvent rather quickly when the stock went south. POWERS REPORT, *supra* note 172, at 114–17. The stock in the SPE was that of The New Power Company, an Enron startup slated to market power directly to consumers. The enterprise flopped rather badly. Rebecca Smith, *New Power Saga Shows How Enron Tapped IPO Boom to Boost Results*, WALL ST. J., Mar. 25, 2002, at A1, available at <http://online.wsj.com/article/0,,SB1017015132933556040.djm,00.html>.

Enron rather than through arm's-length investments by outsiders. At Bistro, in contrast, third-parties parted with \$700 million cash. In fact, the closer resemblance lies with the First Executive CDO setup, but at a step down the credibility ladder. FE at least transferred a bond portfolio in exchange for the SPE's promissory note. Enron manufactured new shares of stock out of whole cloth, betting that its stock market price would remain buoyant and cover its tracks.

The SPEs entered into equity swap contracts with Enron with a notional amount of \$2.1 billion¹⁹⁴ with the SPEs relying on their holdings of Enron common stock to maintain enough value to cover any losses on the swaps. The shares referenced by the swaps promptly went down, however. Across the last five fiscal quarters before Enron entered bankruptcy, the value of the referenced stock fell by \$1.1 billion.¹⁹⁵ Enron marked the value of its rights under the swap contracts to market for income statement purposes, even though no gain had been realized. The swaps, by thus covering \$1.1 billion of losses, added \$1.1 to Enron's income during the period.¹⁹⁶ In the end, the swaps contributed 72 percent of the net income reported.¹⁹⁷

Even as Enron was using the swaps to cover losses on its income statement, its SPE counterparties were collapsing. The Enron common used to fund the SPEs fell along with the stock referenced by the swaps. Once Enron stock's value fell below the SPEs' exposure on their swaps, the SPEs became insolvent. Enron's middle managers tried a series of seat-of-the-pants restructurings of the SPEs, concealing the difficulties from the board of directors.¹⁹⁸ But it was all to no avail. The stock protected by the swaps was not going to go back up; the loss had to be covered by the Enron stock or not at all and the Enron stock kept going down. Enron finally threw in the towel, folding the SPEs and the swaps back onto its balance sheet in the third quarter of 2001, restating past earnings downward and unwinding the entry of \$1.2 billion shareholders' equity made upon the issue of the stock to the SPEs.¹⁹⁹

194. ENRON, ANNUAL REPORT 2000, *supra* note 160, at 48–49

195. POWERS REPORT, *supra* note 172, at 98.

196. *Id.*

197. *Id.*

198. *Id.* at 118–19.

199. Actually, that entry never should have been made in the first place. Under GAAP, notes received in exchange for a company's own common stock must be booked as deductions from shareholders' equity. FIN. ACCOUNTING STANDARDS BD., EMERGING ISSUES TASK FORCE, CLASSIFYING NOTES RECEIVED FOR CAPITAL STOCK ISSUE NO. 85:1, at 1 (1985); SEC Staff Accounting Bulletin No. 40, 46 Fed. Reg. 11513, 11522 (Jan. 23, 1981). The newly issued stock is credited to the

Enron was bankrupt within a month of these disclosures.²⁰⁰ Later investigations would reveal a long list of other sham transactions.²⁰¹ But the LJM swaps were by far the greatest in magnitude and, by virtue of their disclosure before the bankruptcy, take pride of place as the transactions that brought down the company.

C. IMPLICATIONS

What was so scandalous about these swaps? Bistro holds out a comparative tool that helps us appreciate the insidious nature of Enron's structure. Where the Bistro SPE relied on outside lenders for its funding, Enron's SPEs followed the lead of First Executive and did their borrowing from Enron itself, which also happened to be the party whose balance sheet risk was being covered by the borrowed money. The risk accordingly was never really externalized—if the SPE lost heavily on the swaps but without exhausting the value of the Enron stock with which it was funded, it still would have had no capital left to repay the loan from Enron. Thus Enron, having covered \$1.1 billion of losses under the swaps in the short run, would in the long run have to write off \$1.1 billion of SPE notes payable (or a portion thereof). The only scenario that would avoid the write-off is if the value of the Enron stock in the SPE increased by \$1 for every \$1 of loss covered by the swaps.

The transaction structure would have been subject to question even if the Enron stock had gone up. Stock goes up because of projected earnings increases. Earnings projections depend in turn on recent earnings results. In this case, Enron was stoking its earnings with a swap contract that derived its economic substance from Enron stock, which in turn derived its economic substance from positive earnings reports, reports that would not be forthcoming absent the swap contract. This causal chain of stock to earnings to stock to earnings to stock made the transaction and accounting result intrinsically unsound.

The substance came down to this: Enron issued its own common stock to cover a loss on its own income statement. This violates the most basic rules of accounting, and indeed, the most basic rules of capitalism. Corporations issue stock to raise capital. They then use the capital to do

capital stock account at the purchase price, but the capital stock accounts elsewhere are debited (reduced) in the amount of the note.

200. Bratton, *supra* note 173, at 1322–23.

201. See Regan, *supra* note 14, at 1156–62, 1180–86, 1191–95 (describing various Enron sham transactions).

business and generate income. They are not permitted to skip the step and enter the proceeds of the sale of stock directly into income. The value of a firm stems from its ability to take the capital and earn money over time; its stock market capitalization reflects projections of its ability so to do. Enron used SPEs and swaps to subvert the system, using its market capitalization—the value of its common—to support the value of its common.

The surprising thing about the Enron scandal is that, for all the outrage and fulmination, little attention was paid to the transaction structure's substantive implications. Everybody got the point that Enron's earnings were fake. Almost no one worked through the smoke and mirrors to see how Enron had faked it and how fine the line was that separated Enron's fraud from transaction structures that were moving billions daily.

Significantly, Enron never concealed the LJM structures. Its financials provided the financial community an adequate basis to do the analysis above and start asking questions about the soundness of Enron's results.²⁰² Apparently, it lay beyond the system's ability to comprehend. Transaction engineers were inventing structures that only other engineers could understand. The engineers worked with their eye on the asset light prize but without working through the implications of downside scenarios, whether for the promoter or the economy at large.

V. THE STILLBORN SCANDAL: THE SIVS

Enron also used SPEs as off-balance-sheet resting places for underperforming assets and associated indebtedness. The arrangements were conditional and put Enron back on the hook for the debt if its stock price fell below stated levels. It received its final kick into bankruptcy when those off-balance-sheet obligations came due.²⁰³ They went off like roman candles during its last week of life.²⁰⁴

202. Enron noted the arrangement in the footnotes to its 2000 Annual Report. ENRON, ANNUAL REPORT 2000, *supra* note 160, at 48. The report tells us of the hedges. Further, "Enron recognized revenues of approximately \$500 million related to the subsequent change in the market value of these derivatives, which offset market value changes of certain [investments]." *Id.* The report further notes that Enron transferred to the LJM-related SPEs more than \$1.2 billion in assets, including millions of shares of Enron common stock and long term rights to purchase millions of more shares, plus \$150 million of Enron notes payable, and that the SPEs had paid for all of this with their own debt instruments with a face amount of \$1.5 billion. *Id.* We are not told in that sequence how the SPE will be covering its \$500 million loss exposure. It is, in short, all there. See ENRON, ENRON ANNUAL REPORT 1999, at 59 (1999).

203. Bratton, *supra* note 176, at 21.

204. The first GAAP coverage of SPEs came in ACCOUNTING FOR TRANSFERS AND SERVICING OF

Tighter accounting rules followed the Enron scandal.²⁰⁵ Indeed, for all intents and purposes, a full set of accounting rules for SPEs only emerged following Enron. Prior to Enron, some types of SPEs, such as CDOs and other securitizations, were already covered by elaborate rules promulgated by the Financial Accounting Standards Board (“FASB”), a private body that sets forth generally accepted accounting principles (“GAAP”).²⁰⁶ In contrast, accounting treatments respecting the residual category of SPEs that included Enron’s SPEs developed at the level of practice. The “3% outside equity rule” was not GAAP at all, but a convenient inference drawn by reporting companies and their auditors from an SEC opinion letter about a lease.²⁰⁷ The FASB had been grumbling about consolidation and off-balance-sheet treatments for years, but never got enough political wind at its back to facilitate intervention.²⁰⁸ Enron changed the climate, opening a door for a FASB pronouncement on the residual category, described as “variable interest entities” (“VIEs”)²⁰⁹ in FASB Interpretation Number 46(R) (“FIN 46(R”).²¹⁰ The objective of the standard was to set out principles, as opposed to rules, for identifying when entities related to a reporting company but less than majority-owned should nonetheless be consolidated with the reporting company due to contingent contractual ties between them.²¹¹

FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Fin. Accounting Standards No. 125 (Fin. Accounting Standards Bd. 1996). It was followed by ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Fin. Accounting Standards No. 140 (Fin. Accounting Standards Bd. 2000). For the most recent iteration, see ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS—AN AMENDMENT TO FASB STATEMENT NO. 140, Statement of Fin. Accounting Standards No. 166 (Fin. Accounting Standards Bd. 2009).

205. See Bratton, *supra* note 176, at 8–11 (detailing the enactment of stricter accounting rules following Enron).

206. See William W. Bratton, *Enron, Sarbanes-Oxley, and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1043–44 (2003).

207. *Id.* See also BARRY J. EPSTEIN, RALPH NACH & STEVEN M. BRAGG, WILEY GAAP 2010: INTERPRETATION AND APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES 677–78 (2009).

208. Bratton, *supra* note 206, at 1040.

209. See CONSOLIDATION OF VARIABLE INTEREST ENTITIES, FASB Interpretation No. 46, at 11–12 (Fin. Accounting Standards Bd. 2003) (listing the conditions by which an entity becomes a VIE).

210. *Id.* There was also a series of follow-up FASB interpretations. *E.g.*, DETERMINING THE VARIABILITY TO BE CONSIDERED IN APPLYING FASB INTERPRETATION NO. 46(R), Staff Position No. FIN 46(R) (Fin. Accounting Standards Bd. 2006).

211. The bank regulators would not produce a response to Enron abuses until 2007. In 2003, in the wake of Enron, the U.S. Senate’s Permanent Subcommittee on Investigations called on federal financial regulators to “immediately initiate a one-time, joint review of banks and securities firms participating in complex structured finance products with U.S. public companies to identify those structured finance products, transactions, or practices which facilitate a U.S. public company’s use of deceptive accounting in its financial statements or reports.” PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE

In the wake of Enron, the FASB's prior rules-based approach to standard setting had been widely criticized as ineffective and manipulable.²¹² FIN 46(R) showed that the FASB had internalized the criticism and was eminently capable of taking a principles-based approach. The new standard elevated substance over form, looking through to the economic risks of enterprise regardless of legal form.²¹³ Historically, consolidation followed from control in the form of ownership of a majority of the voting equity. SPEs revealed this approach's limitations. Exhaustive contractual instructions and high leverage combined to render the equity interest more nominal than real, a formal incident without relevance to either the entity's management or its risks and returns, including the residual risk and return. FIN 46(R) abandoned "equity ownership" as the determinative mode of participation in favor of an open-ended concept of "subordinated financial support." If a party was exposed to most of the entity's losses, to most of the entity's gains, or to both, consolidation would follow.²¹⁴ Sponsorship also mattered: on some fact patterns, the fact that an interest holder "designed" the entity (or participated significantly therein)

S. COMM. ON GOVERNMENTAL AFFAIRS, FISHTAIL, BACCHUS, SUNDANCE, AND SLAPSHOT: FOUR ENRON TRANSACTIONS FUNDED AND FACILITATED BY U.S. FINANCIAL INSTITUTIONS 36–37 (2003). Delayed by intense lobbying, it took four years for the federal regulators to issue their final "Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities." See FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 205 (2011), available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> [hereinafter FCIC FINAL Report] (outlining reasons for the final statement's delay). The guidance instructed financial institutions to apply greater diligence, be more circumspect, and better document elevated risk complex structured finance activities. Examples of such activities were deals that:

[l]ack economic substance or business purpose; [were] designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year end or at the end of a reporting period for the customer; [r]aise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements; [i]nvolve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose; [and] [i]nvolve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or accounting treatment of the related transaction, or the client's disclosure obligations.

72 Fed. Reg. 1372, 1378 (Jan. 11, 2007). This guidance did not contemplate transactions that banks undertook for themselves, such as the creation of SIVs. Instead, it was designed to prevent banks from facilitating Enrons, not making their own Enrons.

212. Bratton, *supra* note 206, at 1040.

213. See PRICEWATERHOUSECOOPERS, GUIDE TO ACCOUNTING FOR VARIABLE INTEREST ENTITIES: FIN 46R AND OTHER RELATED ISSUES 54–55 (2007) [hereinafter PRICEWATERHOUSECOOPERS] (detailing the new principle-based approach).

214. EPSTEIN, NACH & BRAGG, *supra* note 207, at 684.

brought the entity into the VIE category.²¹⁵

Consider a hypothetical. A sponsor floats an SPE, financing it with 3 percent outside equity and 80 percent outside debt. The remaining 17 percent of financing is a subordinated loan from the sponsor to the SPE. The sponsor has also issued a guarantee to the lender representing half of the outside debt. There would be a case for consolidation under FIN 46(R) because the sponsor, while having provided only 17 percent of the capital, bears the next 57 percent of the loss after the 3 percent outside equity and thus most of the risk of loss on the entity. More generally, if the outside equity amounted to less than 10 percent of the total invested in the SPE, substantive scrutiny of contractual ties to a sponsor is particularly likely under FIN 46(R). Since an equity layer under 10 percent was too thin to soak up the expected losses, other interest holders potentially could be deemed to hold the residual economic interest, or in the FASB's terminology, the "primary beneficiary."

FIN 46(R) was a big step forward. Even so, the big banks managed to continue with Enron-style off-balance-sheet investing and borrowing without triggering consolidation. Their purpose was to expand levered debt portfolios without showing the borrowing on their own balance sheets. SPEs called Structured Investment Vehicles or SIVs were the means.²¹⁶

At their height, SIVs were a \$400 billion cutting-edge part of the financial sector.²¹⁷ They were touted as efficient financial innovation,²¹⁸ the "Rolls-Royce of modern finance,"²¹⁹ and a must-have for any self-respecting major financial institution.²²⁰ Yet the entire SIV sector disappeared in little over a year between 2007 and 2008. The collapse of the SIVs was a major step toward complete market breakdown in the fall of 2008. Despite this, the SIVs have attracted comparatively little attention, both because their failure was dwarfed by later events and because they were a little-known, esoteric part of the already complex structured finance landscape. In our view, the demise of the SIVs is the scandal that never

215. More particularly, FIN 46(R) has a scope exception for conventional operating businesses that is blocked for a designing interest holder. *Id.* at 682.

216. *Once-Thriving SIV Market In Financial Throes*, ASSET BACKED ALERT (Feb. 22, 2008), <http://www.securitization.net/news/article.asp?id=364&aid=7988>.

217. John Mauldin, *Taking Out the SIV Garbage*, SAFE HAVEN (Oct. 20, 2007), <http://www.safehaven.com/article/8662/taking-out-the-siv-garbage>.

218. See, e.g., Donna Mitchell, *SIV Market Grows, So Do SIV-lites*, ASSET SECURITIZATION REP. (Aug. 21, 2006), available at <http://www.highbeam.com/doc/1G1-149763401.html>.

219. HENRY TABE, *THE UNRAVELLING OF STRUCTURED INVESTMENT VEHICLES: HOW LIQUIDITY LEAKED THROUGH SIVS 8* (2010).

220. *Id.*

was, but should have been.

A. STRUCTURED INVESTMENT VEHICLES

The origins of the SIVs, like those of Bistro, lay in bank capital regulations. The first round of risk-weighted bank capital regulations (Basel I) went into effect in 1988. Basel I made it expensive for banks to hold certain types of assets. Citigroup recognized that by creating an SPE and transferring high risk-weight assets to the SPE, it could reduce its regulatory capital requirements while at the same time using the structure of the SPE to retain the economic benefits of the high risk-weight assets.²²¹ The result was Alpha, the first SIV.²²²

The purpose, then, of a SIV was to do the same business as a bank, arbitraging the spread in yields between long-term debt investments and short-term liabilities but without relying on deposit-based funding. SIVs had diversified portfolios of actively-managed, highly rated assets funded through the issuance of medium-term notes and commercial paper. They combined features of hedge funds, securitization, and traditional banking.²²³ Like hedge funds, SIVs were thinly regulated and had a highly sophisticated investor base.²²⁴ Also like hedge funds, the SIVs had sponsors who maintained a continuing advisory relationship; the better the SIV's returns, the higher the stream of payments on the sponsor's management contract.²²⁵ Like securitization vehicles, SIVs were off-balance sheet, bankruptcy remote, and constrained in their activities by operating limits and guidelines.²²⁶ And like traditional banks, SIVs were levered with short-term borrowing and long-term assets.²²⁷

The difference between a SIV and a bank was that the SIV took no deposits and hence was unregulated—a category of shadow bank. There was thus a motivational tie to the Bistro structure. When a bank sold an asset to a SIV the bank got regulatory capital relief plus liquidity leading to further lending. Similarly, as with plain vanilla securitization, the issuance of structured debt by SIVs enabled banks to capitalize the investment off-

221. *Id.* at 46–47.

222. *Id.*

223. *Id.* at 5–7.

224. *Id.*

225. *Id.* at 78.

226. *Id.* The sponsor devised an “operating manual” in consultation with the credit rating agencies. The manual laid down the entity's investment and financing strategy, constraining the discretion of the manager. *Id.* at 78–80.

227. *Id.* at 78.

balance sheet. There was even a cost advantage. Recall that when Bistro was invented, the bank's cost of borrowing was lower than that available through securitization. SIVs solved that problem, earning AAA-interest rates that could be lower than the rate paid by the bank on its own borrowing.

SIVs' assets were generally diversified but included some U.S. mortgage-related securities.²²⁸ Whatever the asset class, virtually all SIV assets were high investment grade, at least at the time of purchase. SIVs did not want to be exposed to credit risk, on the theory that a base of super high quality assets would lead to a maximal credit rating and a minimal cost of borrowing. SIVs raised funds for their purchases of long-term assets by issuing shorter-term liabilities.²²⁹ And, because all else being equal short-term liabilities are less risky than long-term liabilities, they have lower yields and thus result in a lower cost of borrowing. A duration arbitrage resulted, allowing the SIVs to capture a spread. Because SIVs' debt was AAA-rated, they were able to invest in apparently safe assets and still make a durational arbitrage profit—the spread between the return on their long-term assets and the lower costs of their short- and medium-term borrowing. As the SIVs offered slightly higher yields than other AAA-rated short-term debt, they were easily able to attract capital.²³⁰

Related to SIVs was a smaller class of entities known as SIV-lites (memorably referred to by Gillian Tett as SIVs' "mutant cousins").²³¹ SIV-lites tended to invest more heavily in mortgage-related securities than traditional SIVs.²³² SIV-lites also differed from basic SIVs in that their funding tended to be shorter term.²³³ The weighted average life of SIV-lite liabilities was three to six months, half of that of the basic SIVs.²³⁴ They also tended to have slightly lower leverage than basic SIVs as

228. *Id.* at 78. Newer SIVs tended to invest more heavily in mortgage-related securities. *Once-Thriving SIV Market In Financial Throes*, *supra* note 216; Jacob Gaffney, *In One Week, Two European SIVs Face Liquidations*, ASSET SECURITIZATION REP. (Sept. 17, 2007), <http://www.securitization.net/knowledge/article.asp?id=421&aid=7625>.

229. TABB, *supra* note 219, at 6–7.

230. *Id.* at 122.

231. Gillian Tett, *Why Financiers Have Missed the New Monster*, FIN. TIMES (Sept. 6, 2007, 9:50 PM), <http://www.ft.com/intl/cms/s/0/9ffb0bea-5cac-11dc-9cc9-0000779fd2ac.html>. SIV-lites were a concept born on the CDO desk of Barclays. NICHOLAS DUNBAR, *THE DEVIL'S DERIVATIVES* 194 (2011); Helen Thomas, *Barclays and Cairn Capital Declare \$1.6bn "SIV Restructuring Success"*, FT ALPHAVILLE (Aug. 31, 2007), available at <http://ftalphaville.ft.com/blog/2007/08/31/6965/barclays-and-cairn-capital-declare-16bn-siv-restructuring-success/>.

232. *Once-Thriving SIV Market In Financial Throes*, *supra* note 216; Gaffney, *supra* note 228.

233. Primarily via one to three month repos or three to twelve month commercial paper. TABB, *supra* note 219, at 125–26.

234. *Id.* at 129.

compensation for their greater rollover risk.²³⁵

SIVs' capital structures were relatively simple. They had notional equity held by Cayman Islands or Jersey charitable trusts (an arrangement not unlike Imperial Savings Association giving the junior tranche of its second CDO to charity),²³⁶ and they issued short-term and medium-term debt with a senior-subordinate structure.²³⁷ The most junior debt often had an equity-like aspect in the form of a performance-sensitive upside cut of the SIV's returns.²³⁸

Why, though, would a bank give up the profit yielded by the spread to an independent entity? The answer was that it need not and did not. The bank entered into a management contract with the SIV and drained out profits in the form of incentive compensation under the contract.²³⁹ In addition to acting as investment advisors, SIV sponsors acted as dealers for their SIVs' investments and connected their SIVs with debt investors.²⁴⁰

235. *Id.* at 128.

236. SIVs' formal equity was generally shares with a par value of \$500 or \$1000, which were held by charitable trusts based in the Cayman Islands or Jersey for tax purposes. *Id.* at 119. SIVs would generally have a Delaware subsidiary. *Id.* The SIV itself would issue Euro-denominated debt, and the subsidiary would issue dollar-denominated debt (often co-issued with the SIV) that was eligible for purchase by U.S. insurance companies. The debt would be collateralized by all assets other than those pledged for repo transactions. *Id.*

237. The majority of SIV debt was in the form of medium term notes ("MTNs") with tenors of one to ten years, but typically of thirteen to eighteen months. *Id.* at 124. MTNs made up 80 percent of the typical SIV's funding. *Id.* at 120. The other 20 percent was primarily commercial paper ("CP") with tenors of under a year. *Id.* The MTN and CP typically received AAA ratings and were tranced by maturity and / or in senior-subordinate structures. SIVs also issued subordinated debt in the form of "capital notes" or "income notes" with ten year tenors. *Id.* at 122. The capital notes were the SIV's functional equity, in that they bore the residual risk, and they sometimes had an "equity kicker" that gave them excess spread and boosted yields by 200 bps. *Id.* at 121. The SIV's managers shared profits *pari passu* with the capital note investors, *Id.* at 160, and the SIV's sponsor typically invested in the capital notes. SIVs were not particularly leveraged. Their leverage ratio—in terms of senior debt (MTN and CP) to capital notes tended to be around 13x, meaning that there were \$92.30 in senior debt for every \$7.70 in capital notes. *Id.* at 127. Taken as a whole, the weighted average life ("WAL") of SIV liabilities was six to twelve months. *Id.* at 129.

238. Michael Ehrlich, *Innovation, Regulation and Financial Bubbles: The Evolution of Structured Investment Vehicles* 8–11 (Leir Ctr. for Fin. Bubble Research, Working Paper No. 8, 2012), available at <http://www.leirbubblecenter.org/2012/03/innovation-regulation-and-financial.html>.

239. BASEL COMM. ON BANKING SUPERVISION, *supra* note 155, at 55–56; INT'L ACCOUNTING STANDARDS BD., INFORMATION FOR OBSERVERS 3–5 (July 23, 2008).

240. This function also could be outsourced. Former Moody's SIV analyst Dr. Charles Tabe describes SIV compensation arrangements as follows:

[M]anagement compensation was structured as a base fee and a performance fee. The base fee was typically 25 basis points of capital raised. The performance fee was typically half the vehicle's profits or amounts left after the repayment of senior investors, ancillary costs, and the fixed income component of capital note returns (Libor flat or Libor plus a small spread which was again set at about 25 basis points).

An example might be helpful. Suppose the SIV manager raised US\$1.5 billion in capital notes and levered this 13.33 times, yielding an asset portfolio of US\$20 billion (which was

They also were often invested in their SIVs, taking subordinated debt that was as a practical matter the equity in the entity and also soaked up a slice of the profit. So long as the sponsors were not deemed to exercise control over their SIVs for accounting and regulatory capital purposes, it was another heads-I-win-tails-I-win asset light play.

The nature of SIVs' funding meant that SIVs had to refinance between 20 percent and 50 percent of their debt every year, more in the case of SIV-lites. Therein lay the risk. Investing long-term with short-term funds requires periodic refinancing of debt in order to match maturities. This made the SIVs dependent on steady access to the credit markets. Any disruption to capital markets could spell disaster for SIVs that found themselves illiquid.

Relationships between SIVs and their sponsors get complicated at this point in the story. Bank sponsors committed to give their vehicles "liquidity support," that is, to provide funding (or to promise to repurchase SIV assets) if the external markets proved unwilling. Under Basel I rules, the banks were excused from holding regulatory capital against these liquidity facilities.²⁴¹ Such support was limited, however, typically in the range of 5 to 10 percent of the entity's asset base.²⁴² As a result the SIVs were highly exposed to disruptions in debt markets and the possibility of having to liquidate assets quickly to pay down debt in the wake of the lenders' refusal to roll over their obligations.²⁴³

not atypical of second generation vehicles at their apogee). Net earnings after the repayment of senior debt and ancillary costs typically averaged 35 basis points of the entire portfolio, or US\$70 million. Of this amount, capital note investors typically received their fixed income payment of US\$48.75 million (assuming a through-the-cycle Libor rate of 3%). After subtracting this fixed income component and the base management fee of US\$3.75 million, the vehicle had US\$17.5 million left to share equally between the manager (performance fee) and the capital note investor (equity component of capital note returns). Thus, the SIV manager received a total of US\$12.5 million for the year in this example.

Email from Dr. Charles Tabe to Adam Levitin (July 29, 2012) (on file with author).

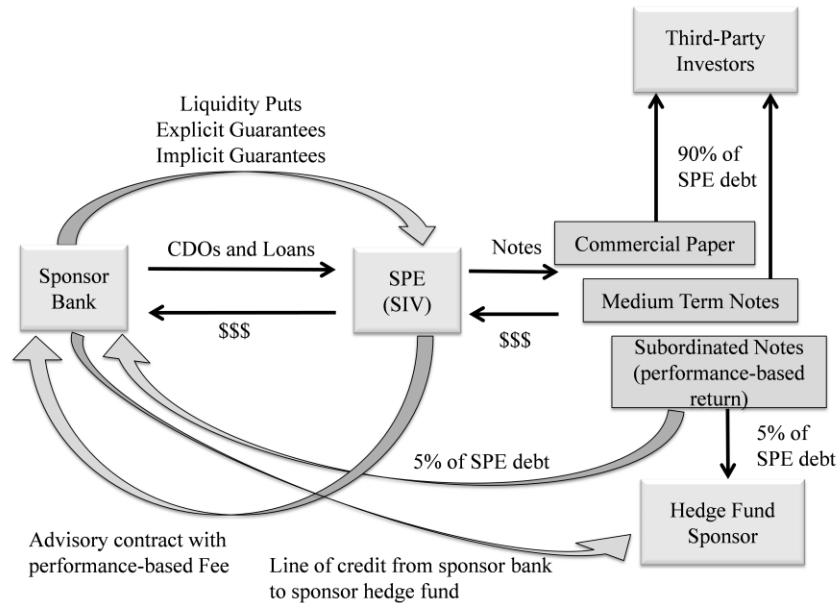
241. See 12 C.F.R. pt. 3, app. A, § 3(b)(4) (2009) (10 percent conversion factor for unused portions of asset-backed commercial paper liquidity facilities of less than one year maturity); *Id.* § 3(b)(5) (0 percent risk-weighting for other unused commitments with less than one-year maturity or for unused commitments with longer maturities that are unconditionally cancellable by the bank.).

242. EMMA-JANE FULCHER ET AL., FITCH RATINGS, THE DIFFERENCE BETWEEN TRADITIONAL ABCP CONDUITS AND SIVS, ABCP/EUROPE SPECIAL REPORT 2 (2008), available at <http://www.immfa.org/about/faq/ABCPconduits.pdf>. Early era SIVs (that is, during the 1990s) were set up differently. The bank sponsor offered 100 percent liquidity support for a one-year duration; all notes issued were senior. As SIVs shifted to a mixed senior/subordinated note structure, the liquidity commitment contracted. Ehrlich, *supra* note 238, at 7–11. By 2007 only about half of the SIVs were sponsored by banks. The other half was sponsored by hedge funds. *Id.* at 11. Hedge funds sponsors contracted with banks for back up lines of credit.

243. The risk created by SIVs' asset-liability duration mismatch is perhaps clearest when compared to a similar type of structured financial vehicle, the asset-backed commercial paper

Even so, SIV investors often believed that there was unconditional 100 percent liquidity support, just as there was implicit credit risk recourse. Fitch Ratings has observed, “Some investors believed that the investment banks that were affiliated to the SIV management companies were providing implicit liquidity support. The rationale was the potential reputational risk faced by the bank if the SIV defaulted.”²⁴⁴

FIGURE 4. The Structured Investment Vehicle (SIV)



In sum, the asset-liability duration mismatch in the SIVs' business model posed a major risk. If SIVs were not able to roll over their short-term liabilities, they would have to liquidate their assets to maintain leverage

("ABCP") conduit. ABCP conduits only issued short-term commercial paper (ten or equal to or less than 364 days), whereas SIVs issued both commercial paper and medium term-notes ("MTN"). This means ABCP conduits were more exposed to rollover risk than SIVs. To compensate, however, ABCP had 100 percent liquidity facility support. This means that ABCP investors were exposed to credit risk on the conduit's assets, but not to market value risk, as the conduit would not be forced to liquidate its assets at market prices to pay off its commercial paper that it could not refinance. SIVs, in contrast, had only very limited liquidity support. TAFE, *supra* note 219, at 175-76.

244. FULCHER ET AL., *supra* note 242, at 2. The former Moody's SIV analyst has noted, "Although sponsors had no legal obligation to support their vehicles, it was thought that a sponsor would not allow its vehicle to default in senior debt for reputational reasons." TAFE, *supra* note 219, at 135.

ratios and to satisfy investor redemptions. The business model assumed that in the event of rollover failure, the SIV could delever by selling assets at marked-to-market values without huge losses. This had been the case prior to 2007 on the few occasions when SIVs got into trouble.²⁴⁵

It seems that no one seriously considered the possibility of a market-wide freeze, in which a rollover failure would force multiple SIVs simultaneously to liquidate assets at depressed fire-sale prices, setting off a “death spiral.” This is precisely what unfolded starting in the summer of 2007, as a panic swept up first the SIV-lites, then the newer SIVs that had SIV-lite asset-characteristics, and then finally the older, more-established SIVs.

B. THE SIV PANIC

The U.S. residential mortgage market—and thus all the securities based on it—began showing signs of stress in the spring of 2007. Some subprime mortgage originators had already failed under the stress of putback claims from investors.²⁴⁶ But the scope of the subprime mortgage problem only became clear on Wall Street in June 2007 when two Bear Stearns-sponsored hedge funds displayed signs of distress.²⁴⁷ Both were invested in assets very similar to SIV-lites, including large exposures to U.S. subprime mortgage-backed securities (“MBS”) and CDOs.

Bear Stearns attempted to bail out the healthier fund by extending it a \$1.6 billion collateralized repo line of credit,²⁴⁸ in order to buy the fund time to recover. Bear did not extend funding to the other fund, and by mid-

245. TABE, *supra* note 219, at 136–38.

246. Ownit Mortgage Solutions filed for bankruptcy in December 2006; Mortgage Lenders Network USA filed for bankruptcy in January 2007. Worth Civilis & Mark Gongloff, *Subprime Shakeout: Lenders That Have Closed Shop, Been Acquired or Stopped Loans*, WALL. ST. J. ONLINE, <http://online.wsj.com/public/resources/documents/info-subprimeloans0706-sort.html> (last visited Apr. 22, 2013). New Century Financial filed for bankruptcy on April 2, 2007. Julie Creswell, *Mortgage Lender New Century Financial Files for Bankruptcy*, N.Y. TIMES (Apr. 2, 2007), http://www.nytimes.com/2007/04/02/business/worldbusiness/02iht-loans.5.5118838.html?_r=0. Other subprime lenders simply shut down operations without filing for bankruptcy. Civilis & Gongloff, *supra*.

247. These two funds, the High-Grade Structured Credit Strategies Leveraged Fund and the High-Grade Structured Credit Strategies Enhanced Leverage Fund, were the focus of early SEC financial crisis litigation. Complaint at 1–2, SEC v. Cioffi, 868 F. Supp. 2d 65 (E.D.N.Y. 2012) (No. 08CV02457), available at <http://www.sec.gov/litigation/complaints/2008/comp20625.pdf>.

248. Letter from Bear Stearns to hedge fund clients (July 17, 2007), http://online.wsj.com/public/resources/documents/WSJ071707_Bear_Stearns_Co.pdf [hereinafter Bear Stearns Client Letter]. Originally, Bear Stearns indicated that it would provide \$3.2 billion in funding. Julie Creswell & Vikas Bajaj, *\$3.2 Billion Move by Bear Stearns to Rescue Fund*, N.Y. TIMES, June 23, 2007, at A1, available at http://www.nytimes.com/2007/06/23/business/23bond.html?pagewanted=all&_r=0.

July, Bear announced that it would seek an “orderly wind down” for both funds.²⁴⁹ Both funds lost almost all their value,²⁵⁰ and their failure spooked the market regarding anything invested in subprime mortgage markets. The market was further unnerved when credit rating agencies Moody’s and Standard & Poor’s downgraded hundreds of MBS on July 10, 2007. Commercial paper investors such as money market funds refused to roll over the paper of the SIV-lites and a run ensued.²⁵¹

Absent a rollover, the SIV-lites had to sell assets. Unfortunately, the run occurred, not coincidentally, at the very time the assets’ market value was falling because of the ratings downgrades, making it harder for the SIV-lites to generate liquidity by selling their assets. As the SIVs conducted a mass fire sale of their MBS and CDO securities they drove down their prices still further.²⁵² Two SIV-lites failed by mid-August,²⁵³ their notes having been dramatically downgraded directly from AAA to CCC.²⁵⁴ The precipitous downgrade set off a full-blown stampede from anything with the SIV label.²⁵⁵ As one investor noted, “This is an environment where there has been a big loss of confidence and nobody is distinguishing between apples and oranges.”²⁵⁶

Many of the SIVs were taken back onto their sponsor’s balance sheets, despite the absence of any legal obligation to do so.²⁵⁷ The sponsors were

249. Bear Stearns Client Letter, *supra* note 248.

250. *Id.*; Kate Kelly, Serena Ng & Michael Hudson, *Subprime Uncertainty Fans Out*, WALL ST. J. (July 18, 2007), <http://online.wsj.com/article/SB118470713201469384.html>.

251. Credit Suisse’s Institutional Money Market Fund’s Prime portfolio alone withdrew almost \$9 billion in funding from the SIV sector between June and October 2007. TABB, *supra* note 219, at 10–11.

252. Paul J. Davies, *SIV-lite Sector Raises Fresh Credit Concerns*, FIN. TIMES (Aug. 21, 2007, 10:55 PM), <http://www.ft.com/intl/cms/s/0/d8ea9a64-5019-11dc-a6b0-0000779fd2ac.html#axzz2R2n3YcTx>.

253. TABB, *supra* note 219, at 11.

254. David Henry, *Anatomy of a Ratings Downgrade*, BUS. WK. (Sept. 30, 2007), <http://www.businessweek.com/stories/2007-09-30/anatomy-of-a-ratings-downgrade>.

255. The panic spread from SIV-lites to SIVs proper with the collapse of Rhineland Funding, a SIV sponsored by the German bank IKB. Rhineland had nearly \$27.3 billion in commercial paper notes outstanding in July of 2007. Davies, *supra* note 253; Gillian Tett, Paul J. Davies & Norma Cohen, *Structured Investment Vehicles’ Role In Crisis*, FIN. TIMES (Aug. 12, 2007, 7:28 PM), <http://www.ft.com/intl/cms/s/0/8eebf016-48fd-11dc-b326-0000779fd2ac.html#axzz2QybYEltv>. Its commercial paper investors refused to roll over some of the notes, and IKB refused to provide a credit line because it was itself experiencing a liquidity crunch, in part related to the failure of Sachsen Funding, a \$7 billion SIV-lite IKB sponsored. Tett, Davies & Cohen, *supra*. The panic then spread to Cheyne Capital’s Cheyne Finance SIV. Harald Berlinkicke, *Subprime Contagion*, RISK, Sept. 2007, at 105, 106, available at http://www.risk.net/data/risk/pdf/articles/2007/105-107_Risk_0907.pdf.

256. Tett, Davies & Cohen, *supra* note 255.

257. See, e.g., Michael Connolly, *HSBC’s SIV Bailout May Increase Pressure on Other Banks*, WALL ST. J. (Nov. 27, 2007), <http://online.wsj.com/article/SB119612785731704755.html> (noting that HSBC took \$45 billion in SIV assets onto its balance sheet); Aaron Kirchfeld & Neil Unmack,

often obligated to provide liquidity puts, but rarely for the full value of the SIVs' assets. The banks provided liquidity nonetheless, assuming the SIVs' debt as they attempted to protect their reputational capital and dampen distress in the market, perhaps fearing that fire-sale prices would create low marks for their own mark-to-market assets, forcing them to raise more capital.

In the end, none of the six-SIV-lites or 28 SIVs in existence in July 2007 survived; the last SIV, Sigma Finance, failed in October 2008.²⁵⁸ In little over a year, all of the SIVs and SIV-lites were either put into insolvency proceedings or taken back onto their sponsors' balance sheets. A \$400 billion sector of the financial services industry had disappeared, but with little public outcry or understanding.

C. REVENGE OF THE SIV: THE NON-SCANDAL

The SIV collapse is the scandal that wasn't. The scandal lay not in the fact of financial collapse—that reran the classic fact pattern of asset-liability duration mismatch and panic. The scandal lay partly in the accounting and regulatory capital treatment: What were these multibillion liabilities doing off of the banks' balance sheets? The scandal also lay in the sponsors' reactions: Since when is it a bank's business to bail out exposed creditors of a separate entity? If the SIVs were the truly independent entities the banks had claimed them to be for accounting and regulatory purposes, the banks would never have assumed their liabilities.

It can be argued that the SIV rescue followed from reasonable business judgments. For sponsors the move made sense because of reputational risks that were real even if there was really not supposed to be any recourse, and banks with their own subprime MBS exposure may have

Dresdner Rescues \$19 Billion SIV, Follows Citigroup, BLOOMBERG (Feb. 21, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arZ_ycdFEkRk&refer=home (noting that Dresdner Bank AG took \$18.8 billion in SIV assets on balance sheet and a total of \$140 billion in SIV assets taken back on other banks' balance sheets); Parmy Olson, *Barclays Bails Out Avendis Fund*, FORBES.COM (Sept. 12, 2007, 2:00 PM), http://www.forbes.com/2007/09/12/barclays-golden-key-markets-equity-cx_po_0912markets08.html (noting that Barclays had bailed out four SIV-lites it had sponsored, paying one-hundred cents on the dollar despite only being obligated to pay twenty-five cents on the dollar); Neil Unmack & Doug Alexander, *Bank of Montreal Raises SIV Bailout to \$12.7 Billion*, BLOOMBERG (Feb. 19, 2008, 4:41 PM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aJzO9pEcoL5w>; David Wighton, *Citi Launches \$49bn SIV Rescue*, FIN. TIMES (Dec. 14, 2007), <http://www.ft.com/intl/cms/s/0/6626b45e-a9dd-11dc-aa8b-0000779fd2ac.html> (noting that Citigroup took \$49 billion in SIV assets on balance sheet).

258. TABE, *supra* note 219, at 6. Gwen Robinson, *Sigma Collapse Marks End of SIV Era*, FT ALPHAVILLE (Oct. 2, 2008), <http://ftalphaville.ft.com/blog/2008/10/02/16576/sigma-collapse-marks-end-of-siv-era/>.

been desperate to avoid low marks from fire sales that would force them to raise capital to meet Basel ratios. For SIV managers, the sponsor bank buyout was the best deal they could get. Yet, the unavoidable fact is that the whole SIV game was founded on the benefits of implicit recourse even as the SIVs were held forth to the world as standalone entities and were regulated (or more precisely not regulated) as such.

Given that, were the SIVs properly omitted from the banks' balance sheets? It is a nice question. The answer depends on one's reading of FIN 46(R). Consider a hypothetical SIV, financed 90 percent with medium-term notes and asset-backed commercial paper and 10 percent with subordinated notes split fifty-fifty between the sponsoring bank and a hedge fund. The trivial equity interest is in a charitable trust. Finally, there is an implicit guarantee.

We will first read FIN 46(R) to require consolidation. The implicit guarantee is supposed to be put on the table for purposes of determining the appropriate accounting treatment; under FIN 46(R), implicit guarantees should be taken into account as variable interests.²⁵⁹ Since the guarantee potentially puts the bank on the hook for the entire risk of the SIV, the bank absorbs a majority of the economic risk of the entity and arguably should be deemed the "primary beneficiary."²⁶⁰ Under FIN 46(R) consolidation with the sponsor's financial statements is the result.²⁶¹ Of course, the nature of an implicit guarantee is that it is implicit—the guarantee does not exist until it is acted upon. This makes it more than a little awkward to include it in an accounting treatment.

Now let us try a different reading of FIN 46(R) under which the bank would not be the primary beneficiary as of the time the SIV was set up. Under FIN 46(R), a VIE's "expected loss" is not determined as a matter of hypothetical exposure on an extreme downside. It instead follows from a present valuation of the entity's expected cash flows.²⁶² In other words, FIN 46(R) looks at the likely, rather than potential losses. Given the assumptions inherent in AAA-rated assets, such a valuation would project only a small likelihood of loss. For the above bank, a trivial expected loss

259. PRICEWATERHOUSECOOPERS, *supra* note 213, at 74; IMPLICIT VARIABLE INTERESTS UNDER FASB INTERPRETATION NO. 46, Staff Position No. FIN 46(R)-5, at 1 (Fin. Accounting Standards Bd. 2005).

260. PRICEWATERHOUSECOOPERS, *supra* note 213, at 12.

261. *Id.* at 11. A question does arise: What does it mean to bring an "implicit" guaranty into an accounting determination? It would seem that so doing would transform implicit into explicit and with it the nature of the obligation. "Implicit" leaves the bank the option to walk away; "explicit" invites reliance and binding obligation.

262. EPSTEIN, NACH & BRAGG, *supra* note 207, at 684–85.

would be completely soaked up by the subordinated notes. So long as the bank did not hold more than 50 percent of the notes, it would not be on the hook for a majority of the loss and would not be the principal beneficiary. Later deterioration in asset values did not reverse the treatment: FIN 46(R) did not require periodic updating of valuation assumptions. Note that under this reading, it would make no difference whether the guarantee was implicit or explicit.

Actual bank disclosures were consistent with the second interpretation. They make for strange reading today. For example, Citibank, in its 2006 financial statements, reported in a footnote that it had \$227.8 billion in unconsolidated VIE assets.²⁶³ It added the following:

The Company may be a party to derivative contracts with VIEs, may provide loss enhancement in the form of letters of credit and other guarantees to the VIEs, may be the investment manager, and may also have an ownership interest in certain VIEs. Although actual losses are not expected to be material, the Company's maximum exposure to loss as a result of its involvement with VIEs that are not consolidated was \$109 billion²⁶⁴

The \$109 billion presumably regarded only the "explicit" guarantees. In any event, it seems to us that a \$109 billion exposure is a little too large to be popped off without further explanation in a footnote.

Yet the SIV episode prompted no enforcement actions concerning bad accounting treatments or audit failure, although there certainly was criticism once the red ink started to flow.²⁶⁵ By hypothesis, either the implicit guarantees were deemed appropriately left off the table when the accounting treatment was determined, or low risk of loss valuations made all guarantees irrelevant for accounting treatment purposes.

Significantly, the FASB significantly amended FIN 46(R) in the 2009

263. Citigroup Inc., Annual Report (Form 10-K), at 147 (Feb. 23, 2007), *available at* http://www.sec.gov/Archives/edgar/data/831001/000119312507038505/d10k.htm#fin49490_57.

264. *Id.* See also Bank of Am. Corp., Annual Report (Form 10-K), at 132 (Feb. 28, 2007), *available at* <http://www.sec.gov/Archives/edgar/data/70858/000119312507042036/d10k.htm> (explaining that Bank of America had \$51.9 billion of assets in unconsolidated VIEs, and its total maximum loss exposure for these VIEs was \$46 billion); SunTrust Banks, Inc., Annual Report (Form 10-K), at 48 (Mar. 1, 2007) *available at* <http://www.sec.gov/Archives/edgar/data/750556/000119312507043429/d10k.htm> (explaining that SunTrust had \$2.2 billion of assets in unconsolidated VIEs, and its total maximum loss exposure for these VIEs was \$32.2 million).

265. See Jonathan Weil, *Citigroup SIV Accounting Looks Tough to Defend*, BLOOMBERG (Oct. 24, 2007, 12:13 AM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a6dgIOAfMlrl> (criticizing Citigroup's accounting analysis).

Statement of Financial Accounting Standards No. 167.²⁶⁶ The new rule, which flows through to bank capital regulation,²⁶⁷ recasts the primary beneficiary inquiry, emphasizing the power to direct the activities that “most significantly impact the entity’s economic performance,”²⁶⁸ in addition to the majority risk of loss. The effect is to make it more likely that a sponsor that enters into a management contract with an SPE will be deemed the primary beneficiary, particularly if the contract includes performance-based compensation. Additionally, quantitative analysis is to be displaced by a qualitative approach.²⁶⁹ In other words, primary beneficiary status is no longer determined by loss percentage numbers. Finally, a sponsor’s status must be reconsidered on a going concern basis, and financial distress can trigger a change in treatment.²⁷⁰ Apply these factors, and the SIVs would have been consolidated.²⁷¹

D. ENRON REDUX?

Enron and the SIV collapse certainly are distinguishable: scandal in the former case, no scandal in the latter. Enron was self-consciously shunting junk assets away from itself, doing everything it could to construct transactions that pumped its earnings in the process. The banks that set up SIVs apparently thought in good faith that an AAA credit rating implied safety and soundness. Enron also pushed the accounting rules much harder than did the banks, and when it all came tumbling down, Enron resorted to concealment.

But the benefit of hindsight permits us to identify core properties in common. Both cases involved sales to captive entities that turned out to be

266. AMENDMENTS TO FASB INTERPRETATION NO. 46(R), Statement of Fin. Accounting Standards No. 167 (Fin. Accounting Standards Bd. 2009) [hereinafter SFAS 167].

267. See 12 C.F.R., pt. 3, app. A., § 3(a)(6) (2009) (requiring banks to maintain risk-based capital based on consolidation of VIEs if consolidation is required for accounting purposes by GAAP); 12 C.F.R. § 3.4(b) (2009) (reserving the Office of the Comptroller of the Currency’s right to require a bank to treat exposures as if they were on balance sheet for regulatory capital purposes); 12 C.F.R. pt. 3, app. A, § 5 (2009) (optional transition rules for SFAS 167 for VIEs); 12 C.F.R. pt. 3, app. C, pt. V, § 41 (2009) (incorporating GAAP sale treatment for determination of whether risk-based capital must be held against securitized assets for internal ratings-based and advanced measurement approaches under Basel II); 12 C.F.R. pt. 3, app. C, pt. X, § 81 (2009) (optional transition rules for SFAS 167 for internal ratings-based and advanced measurement approaches under Basel II).

268. SFAS 167, *supra* note 266, at 7.

269. *Id.* at 3 (“Judgment, based on consideration of all the facts and circumstances, is needed to distinguish substantive terms, transactions, and arrangements from nonsubstantive terms, transactions, and arrangements.”).

270. *Id.* at 6 (discussing events that could trigger a change in treatment).

271. The FASB’s examples in SFAS 167 make this abundantly clear. *Id.* at 32–39 (examples 3 and 4).

shams when the chips were down. In both cases the SPEs were ticking time bombs, and their detonation had materially negative consequences for the sponsors' financial statements. In both cases, the structures were set up on the overly optimistic assumption that highly regarded assets, whether Enron stock or subprime CDOs, always retain their value. Risk was formally transferred but in substance never left the sponsor. Form overtook substance. The accounting standards were gamed in both cases, and the FASB reacted in exactly the same way, taking the occasion to redraft the standards to assure that the events in question do not recur.

VI. THE RIGHTFUL HEIR: GOLDMAN SACHS'S SYNTHETIC CDOs

On July 15, 2010, Goldman agreed to pay a record penalty of \$550 million to the SEC to settle securities fraud charges arising from a synthetic CDO transaction known as ABACUS 2007-AC1.²⁷² The nub of the SEC's complaint was that Goldman, as placement agent for the SPE's notes, had told investors that the CDO's assets were chosen by an independent agent when a hedge fund that was short on the assets had in fact played a "significant role" in the selection.²⁷³

The ABACUS 2007-AC1 transaction became the leading symbol of Wall Street excess during the housing bubble.²⁷⁴ The deal was structurally generic and unremarkable among synthetic CDOs. ABACUS 2007-AC1 was one of forty-seven synthetic CDOs that Goldman did between 2004 and 2007.²⁷⁵ Other banks did similar deals; Citibank has agreed to settle a similar enforcement action for \$285 million, although the district court refused to approve the settlement on the basis of the agreed-upon factual record.²⁷⁶

272. Press Release, SEC, Goldman Sachs to Pay Record \$550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), *available at* <http://www.sec.gov/news/press/2010/2010-123.htm> [hereinafter SEC Goldman Settlement Release].

273. Complaint at 1–2, SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147 (S.D.N.Y. 2011) (No. 1:10CV3229), *available at* <http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf> [hereinafter SEC Goldman Complaint].

274. Goldman also had to deal with an enforcement action by the UK Financial Services Authority, which charged that Goldman had failed to inform the FSA that Fabrice Tourre, a Goldman employee, received a Wells notice from the SEC, which indicated that SEC was going to bring an enforcement action against him. Chris V. Nicholson, *F.S.A. Fines Goldman over ABACUS Investigation*, N.Y. TIMES DEALBOOK (Sept. 9, 2010, 3:14 AM), <http://dealbook.nytimes.com/2010/09/09/goldman-sachs-said-to-be-fined-30-9-million-in-britain>. Goldman was required to inform the UK Financial Services Authority about the Wells notice, but did not do so until seven months after the notice was issued. *Id.*

275. FCIC FINAL REPORT, *supra* note 211, at 145.

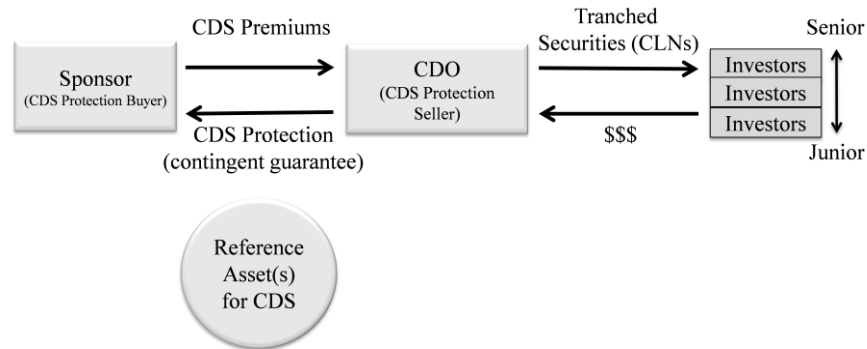
276. The settlement was announced on October 19, 2011 and involved a \$1 billion hybrid cash-synthetic CDO called Class V Funding III. Press Release, SEC, Citigroup to Pay \$285 Million to Settle

As a matter of transaction structure, ABACUS was a Bistro replay, but with a twist. Bistro, along with First Executive and Enron, involved captive entities created to enable contracts that dodged regulatory or accounting requirements applied to actual portfolios of securities. The CDSs securitized in Bistro were being used to hedge Morgan's existing exposure. In contrast, the CDSs in ABACUS were not undertaken to hedge Goldman's existing exposures. Instead, they were "naked" CDSs, in which the protection buyer has no "insurable interest" in the reference assets. The CDSs in ABACUS were not hedges, but pure gambles on the reference assets' performance. This means that none of the parties to the ABACUS transaction actually owned the referenced securities. Instead, the reference portfolio was hypothetical, constructed for the occasion out of the universe of existing debt obligations. It was just a list of debt securities. Synthetic CDOs like ABACUS had moved beyond asset light and dispensed with assets entirely.

Given a list of securities, bets can be placed on its performance, much as a bookie takes bets on the outcome of a sporting event. The Bistro structure provides a vehicle particularly well suited for this purpose. Recall that the SPE enters into a credit default swap in which it is the protection seller. The SPE funds itself by issuing credit-linked notes ("CLNs"). The holders of the CLNs issued by the SPE in effect bet that the referenced securities will not default. Given that outcome, their notes pay handsomely. The counterparty to the SPE's credit default swap bets that the referenced obligations will default. Given that outcome, it makes a killing, while the holders of the CLNs get stuck with a nonperforming investment. Figure 5 summarizes.

SEC Charges for Misleading Investors About CDO Tied to Housing Market (Oct. 19, 2011), available at <http://www.sec.gov/news/press/2011/2011-214.htm>. The SEC said Citigroup set up the CDO to hedge a proprietary position, rather than acting as a dealer between the CLN investors and a third-party short, and failed to disclose that it was using the CDO as a hedge, rather than as a dealer. *Id.* The settlement was not approved by the district court because it wanted a more robust factual basis for determining the fairness of the settlement. *SEC v. Citigroup Global Mkts. Inc.*, 827 F. Supp. 2d 328, 335 (S.D.N.Y. 2011). The Second Circuit Court of Appeals stayed the trial in the district court pending appeal of the rejection of the settlement. *SEC v. Citigroup Global Mkts., Inc.*, 673 F.3d 158, 169 (2d Cir. 2012). Separately, Citigroup banker Brian Stoker was acquitted in a jury trial for his alleged securities violations in the sale of the CDO. Chad Bray & Jean Eaglesham, *Loss in Citi Case Deals Blow to U.S.*, WALL. ST. J., July 31, 2012, at C3, available at <http://online.wsj.com/article/SB10000872396390444860104577561380191553796.html>.

FIGURE 5. Synthetic Collateralized Debt Obligations (Synthetic CDOs)



Goldman and the other banks viewed these structures as a source of new inventory for their armies of dealers. While a synthetic CDO occasions no new investment in producing assets, it does occasion the brokering of arm's-length risk trades between willing long and short investors. From Goldman's perspective, the ABACUS transaction was nothing more than putting together matched sets of contracts and making a spread, a normal derivatives dealer operation.

But for the catastrophic losses on the deal following from the subprime mortgage market's collapse, no one would have cared. But when the deal performed dismally, Goldman found that not everyone accepted its dealer-based framing. A synthetic CDO is not just a swap. It is a swap with an SPE "sponsored" by Goldman that was created to issue debt securities. When a traditional operating company sells its own securities, it is not viewed as an arm's-length contract seller. A massive regulatory apparatus is there to make sure it tells the truth about itself. It certainly can be argued that a sale by an SPE in a structured transaction is different and should be viewed contractually, particularly in view of the fact that the securities are privately placed. But this is ambiguous, uncharted territory. Thus did Goldman stumble into a securities law infraction in the position of a securities issuer with disclosure duties to its purchasers rather than as a dealer in a freewheeling world of caveat emptor. Dealers that manufacture their own securities inventories start to look like issuers.

A. THE ABACUS 2007-AC1 TRANSACTION

Goldman created ABACUS 2007-AC1 at the request of Paulson &

Co., a hedge fund to which Goldman provided prime brokerage services, an important source of Goldman's revenue.²⁷⁷ Paulson had previously gone to at least one other investment bank—Bear Stearns—with the request to create the CDO, but was refused.²⁷⁸

Paulson's motivation for pursuing the deal was a belief that mortgage default rates were going to soar. Accordingly, Paulson was looking for ways to be short on mortgages. Mortgages, however, cannot be shorted directly, as they rarely, if ever, trade.²⁷⁹ A mortgage-backed security ("MBS"), however, can be shorted by taking a derivative short position using a credit default swap with the MBS as the reference asset.

Paulson wanted to take a short position on MBS using a CDS. As we have seen, a CDS requires two parties: a short, known as the protection buyer, and a long, known as the protection seller. Goldman agreed to sell protection to Paulson only if it could enter into a closely matched set of swaps with a third-party in order to hedge its exposure.²⁸⁰ In effect, Goldman was looking to act as a swap dealer, selling protection to Paulson out of one pocket while buying it from another party out of the other pocket, a very typical arrangement in the swaps market.²⁸¹

1. The SPE

That third-party protection seller was to be the ABACUS 2007-AC1, a synthetic CDO that Goldman created for the purpose of marketing the long

277. WILLIAM D. COHAN, *MONEY AND POWER: HOW GOLDMAN SACHS CAME TO RULE THE WORLD* 489–90 (2011).

278. Complaint at 8, *ACA Fin. Guaranty Corp. v. Goldman, Sachs & Co.*, No. 650027/11, 2012 N.Y. Misc. LEXIS 1940 (N.Y. Sup. Ct. Apr. 23, 2012), available at <https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=Npp7667JRe2pWxCEf63SUw==&system=prod> [hereinafter *ACA Goldman Complaint*] ("At least one investment bank that Paulson approached before approaching Goldman Sachs declined to assist Paulson out of concern for its reputation. Scott Eichel of Bear Stearns, who reportedly met with Paulson several times, has been quoted as saying that Paulson wanted: 'especially ugly mortgages for the CDOs, like a bettor asking a football owner to bench a star quarterback to improve the odds of his wager against the team.' According to Eichel, such a transaction 'didn't pass [Bear's] ethics standards; it was a reputation issue, and it didn't pass our moral compass. We didn't think we should sell deals that someone else was shorting on the other side.'" (alteration in original)).

279. Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 *GEO. L.J.* 1177, 1242 (2012).

280. See Submission on Behalf of Goldman, Sachs & Co. at 11, *In re ABACUS CDO*, No. HO-10911 (Sept. 10, 2010) [hereinafter *Goldman SEC Submission*], available at <http://av.r.ftdata.co.uk/files/2010/04/Goldman-defence-doc-Part-I.pdf> (explaining how Goldman structured two transactions to minimize its risk).

281. See JOSEPH CILIA, *FED. RESERVE BANK OF CHI., ASSET SWAPS: CREATING SYNTHETIC INSTRUMENTS* 13 (1996) (illustrating Merrill Lynch's STEERS deal, showing Merrill as the SPE's original swap counterparty swapping out its risk with a third party).

position on a swap that matched its swap with Paulson. Goldman's synthetic CDO followed the Bistro template. The promoter, here Goldman, creates an SPE that funds itself by selling CLNs. The SPE, backed by the proceeds of the sale of the notes, enters into a CDS as protection seller. The CDS references a portfolio of securities, in this case MBS. The SPE invests the proceeds from the sale of the notes in AAA-collateral, typically Treasuries. The interest on the Treasuries together with the premiums on the CDS flow through to the note holders as interest (and also pay the SPE's expenses). In the event of a default on the reference portfolio, the Treasuries in the SPE are liquidated to pay the protection buyer. The note holders take the loss.

Formally, ABACUS 2007-AC1 was a Delaware corporation and the wholly-owned subsidiary of a Cayman Island limited liability company.²⁸² Its assets were securities purchased with the proceeds of its credit-linked notes and the right to premiums on CDS on a \$2 billion portfolio comprised of ninety reference assets.²⁸³ No asset substitution was allowed.²⁸⁴ The reference portfolio consisted solely of subprime or midprime MBS rated Baa2 by Moody's.²⁸⁵ The reference portfolio was also diversified in terms of issuers, tranches, and servicers.²⁸⁶

282. GOLDMAN SACHS, ABACUS 2007-AC1: \$2 BILLION SYNTHETIC CDO REFERENCING A STATIC RMBS PORTFOLIO SELECTED BY ACA MANAGEMENT, LLC 19 (2007) [hereinafter ABACUS FLIPBOOK], available at <http://www.math.nyu.edu/faculty/avellane/ABACUS.pdf>. The Delaware co-issuer was necessary to make the CLNs marketable to U.S. insurers, which are sometimes restricted in their ability to invest in foreign issuers' obligations. DOUGLAS J. LUCAS, LAURIE S. GOODMAN & FRANK J. FABIOZZI, COLLATERALIZED DEBT OBLIGATIONS: STRUCTURES AND ANALYSIS 14 (2d ed. 2006). See, e.g., CONN. GEN. STAT. § 38a-102c(d) (2012) (limited investments in foreign-issued obligations); N.Y. INS. LAW § 1405 (McKinney 2006) (permitting only limited investments in foreign-issued obligations). CDOs are based in low-tax foreign locales like the Cayman Islands, Ireland, Luxembourg, and the Netherlands. See Donald Gray Carden & Zey Nasser, *U.S. Tax Operating Guidelines for CDO Transactions*, in DEUTSCHE BANK, GLOBAL SECURITIZATION AND STRUCTURED FINANCE 2007, at 120 (2007), available at http://www.globalsecuritisation.com/07_americas/DB07_120_127_US_CC.pdf (describing the importance of avoiding U.S. corporate tax). This is critical in order to avoid entity-level U.S. taxation. Whereas RMBS and CMBS can obtain pass-through U.S. tax status if they qualify as a Real Estate Mortgage Investment Conduit ("REMIC") under 26 U.S.C. § 860A-G (2006), CDOs do not qualify as REMICs unless they hold solely untranching mortgage pass-through certificates. CDOs avoid U.S. entity-level taxation by being foreign issued, as merely investing and holding U.S. securities is not considered as being engaged in business or activity in the United States, which would subject the CDO to U.S. taxation. Carden & Nasser, *supra*, at 123.

283. ABACUS FLIPBOOK, *supra* note 282, at 11-12.

284. *Id.* at 12.

285. *Id.* at 11.

286. *Id.* at 12. None of the assets were themselves CDOs or RMBS backed by option ARMs. *Id.*

2. The Credit-Linked Notes

Recall that in *Bistro* only a part of the risk on the reference portfolio was covered by the CDS with the SPE. It was the same with *ABACUS*. To illustrate, if the SPE does not sell its most junior tranches of CLNs, tranches comprising 10 percent of the possible notes that might be issued, the SPE would not write CDS protection on the first 10 percent of the losses in the reference portfolio; the wager is only on losses above 10 percent, much like a wager on who will finish in the top three in a race, rather than on the order of finish of the complete field. The unsold (and unoffered) tranches of CLNs are ghost tranches with only a notional existence. Flexibility results: synthetic CDOs allow sponsors to tailor risks to the specific demands of their investors' portfolio managers.

So, even as *ABACUS* referenced a \$2 billion portfolio, the SPE did not actually write \$2 billion of protection. Instead, it only wrote protection for the losses between 21 and 44 percent,²⁸⁷ and then only to the extent it sold the tranches of CLNs in that range. With Goldman acting as placement agent for a private placement under Rule 144A,²⁸⁸ *ABACUS* sold slightly over half of the CLNs for the bottom 21–34 percent range of its capital structure (class A-2) and a quarter of the CLN for the 35–44 percent range (class A-1).

The buyers were *IKB*, a German bank, which purchased all \$50 million of class A-1 notes and \$100 million of the class A-2 notes. *ACA Capital Management, LLC*, which also acted as the portfolio selection agent, purchased \$42 million of class A-2 notes.²⁸⁹

Thus, if the \$2 billion reference portfolio incurred losses of less than \$420 million (21 percent), *ABACUS* would not be obligated to pay out on the CDS. If the losses exceeded \$420 million, however, *ABACUS* would have to pay on the CDS, but would not be liable for losses on the portfolio beyond \$880 million (44%). Based on the principal amount of CLNs actually sold, *ABACUS* was liable for just over half of the portfolio's losses between \$420 and \$700 million (21–34 percent) or up to \$142 million, and for a quarter of the portfolio's losses between \$700 and \$880 million (35–44 percent) or up to \$50 million. As to these losses, *IKB* and *ACA* bore the risk.

287. We assume, but are not sure, that losses were calculated on the net portfolio, rather than on an individual reference asset basis.

288. Goldman SEC Submission, *supra* note 280, at 11.

289. It purchased for itself and three CDOs it managed. *ACA Goldman Complaint*, *supra* note 278, at 16.

3. The Credit Default Swap and the Portfolio Selection Agent

We turn now to the ABACUS CDS. The direct protection buyer from the SPE was not Paulson, but Goldman; Paulson was not mentioned in the offering documents. As with Morgan and Bistro, Goldman was swapping with its own SPE. Yet because of Paulson's subsequent matched swaps with Goldman,²⁹⁰ Paulson, rather than Goldman, was economically the short party in interest, just as the CLN holders were economically the real long parties in interest. The press has made much of Goldman's place as initial swap counterparty.²⁹¹ But it was not an unusual arrangement. Many CDO sponsors, such as Deutsche Bank and Morgan Stanley, did their synthetic CDOs this way.²⁹² There was a business justification: with the sponsor on the hook on the swap directly, the CLNs benefitted from the sponsor's credit rating regarding the certainty of the stream of premiums on the CDS; Goldman was a safer counterparty than Paulson.

Indeed, it was not even necessarily problematic for the synthetic CDO's sponsor to be the short as an economic proposition, so long as the reference assets were selected independently or negotiated at arm's length between the short and long interests. And such was the practice. Before the promoter took a synthetic CDO to market, it designated an entity, the "portfolio selection agent" to negotiate the selection of the issues in the reference portfolio on behalf of the yet-to-exist CLN investors. For ABACUS 2007-AC1, the portfolio selection agent was ACA Capital Management, LLC, which would also be a note purchaser. ACA Capital Management was a wholly-owned subsidiary of a monoline bond insurance company, ACA Financial Guaranty Corp., which also managed assets like CDOs.²⁹³ ACA was supposedly incentivized to take care in portfolio selection because it received a percentage fee on each tranche, with larger fees for more junior tranches.²⁹⁴ As ABACUS 2007-AC1 was not an actively managed CDO, ACA's involvement was therefore limited to

290. Goldman SEC Submission, *supra* note 280, at 11.

291. *E.g.*, Gretchen Morgenson & Louise Story, *Banks Bundled Debt, Bet Against It and Won*, N.Y. TIMES, Dec. 24, 2009, at A1, available at http://www.nytimes.com/2009/12/24/business/24trading.html?pagewanted=all&_r=0. Goldman also entered into an interest rate swap and a liquidity put provision with the CDO. ABACUS FLIPBOOK, *supra* note 282, at 15, 50.

292. Morgenson & Story, *supra* note 291.

293. For purposes of this discussion the distinction between the entities in the ACA family is immaterial and both will be referred to as ACA.

294. ABACUS FLIPBOOK, *supra* note 282, at 27 ("A portion of management fees are subordinated and performance based."). It is not clear if ACA collected management fees on unissued CLNs based solely on the performance of the reference portfolio. If so, then the functional management fee was substantially higher than stated and partially subordinated to the issued CLNs.

selecting the reference assets for the swap.²⁹⁵ After the initial selection, ACA's role as portfolio selection agent was over.

4. The Super Senior Swaps

Recall that the "super senior" tranche of the CDO created a sticking point when Morgan constructed *Bistro*.²⁹⁶ No super senior credit-linked notes could be sold out of the SPE, for the arithmetic did not work out. The yields on any super senior notes just would not have been competitive. To get the Fed to sign off on the deal, Morgan had to find an investment grade CDS counterparty to sell unfunded protection on the super senior credit risk of the reference portfolio and found that counterparty in AIG.

When we fast-forward to synthetic CDOs, we find that a super senior CDS also has become strictly optional. As no one is looking to the synthetic structure for regulatory capital relief,²⁹⁷ super senior comes into the deal only because someone wants to make a super-senior bet. As it happened, Paulson did. Thus Goldman entered into a CDS with Paulson covering losses on the ABACUS reference portfolio across the loss range from 21–100 percent. Goldman's swap with the ABACUS SPE covered 21–45 percent of the range. That left the remaining 45–100 percent of exposure—the super senior—to be shifted away from Goldman via a matched swap with a third party. ACA proved willing to be the counterparty on the reference portfolio range from 50–100 percent—a nearly \$1 billion super-senior commitment.²⁹⁸ As with *Bistro*, this super senior CDS was entered into on the side, directly between the parties rather than with the SPE. Note that the swap with ACA didn't quite go the distance, covering 50–100 percent but leaving Goldman an unhedged long on the 45–49 percent band, a \$100 million exposure.²⁹⁹

The swap left Goldman relying on ACA's creditworthiness as a counterparty to the tune of \$1 billion. Goldman was not comfortable with ACA and so recruited the Dutch bank ABN Amro to serve as a swap intermediary.³⁰⁰ ABN Amro entered the swap on the 50–100 percent slice

295. The CDO's operations—namely providing investors with reporting and collecting and disbursing funds, were handled by LaSalle Bank NA, in its capacities as indenture trustee, note calculation agent, and payment agent. *Id.* at 19.

296. *See supra* Part III.A.

297. IKB, the German bank that purchased the CLNs, was looking for low-risk weighted assets with high returns.

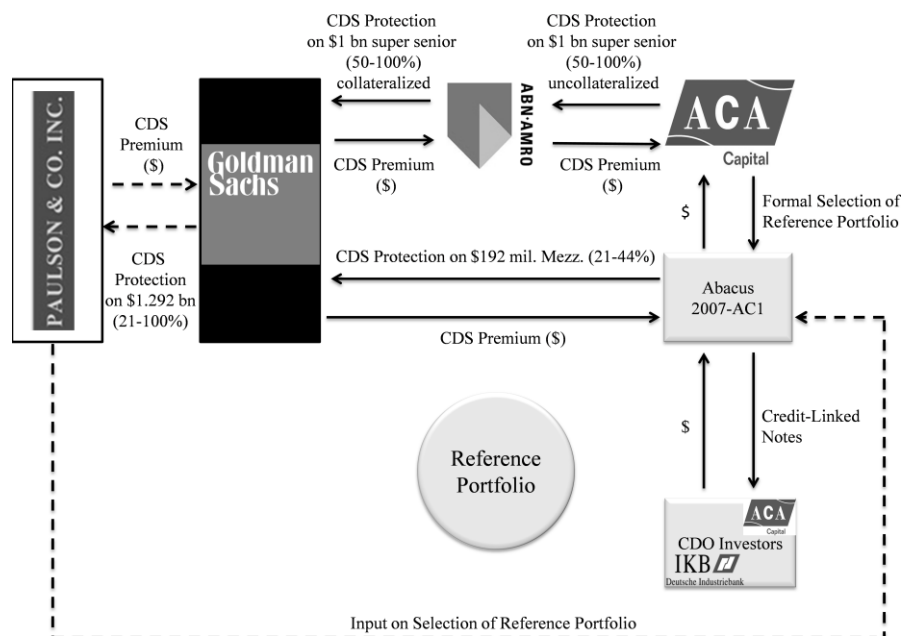
298. Goldman SEC Submission, *supra* note 280, at 14.

299. *See id.* (describing how ABN Amro entered into a CDS with ACA, agreeing to be liable for its risk in the deal.)

300. *Id.*

of the reference portfolio with Goldman and into a matched set of swaps with ACA on which it took a spread for intermediating.³⁰¹ If ABN Amro had to pay out on the swap it would turn around and look to be made whole by ACA, which economically was the ultimate long on the senior half of the reference portfolio risk. ABN Amro also seems to have had some concerns about ACA, for it followed up the matched swaps by taking out \$27 million in corporate CDS protection on ACA from Goldman.³⁰² Figure 6 summarizes the critical parts of the ABACUS 2007-AC1 transactions.

FIGURE 6. Complete ABACUS 2007-AC1 Transaction (elements not disclosed in dashes)



B. THE HITCH

Let us put ourselves in the position of a client who goes to the Goldman swap desk looking to sell credit protection. It enters into a swap

301. ACA Goldman Complaint, *supra* note 278, at 14–15, 19.

302. Goldman SEC Submission, *supra* note 280, at 14 n.3 (noting that the CDS entitled ABN to payment if ACA's credit rating fell below a certain level). ACA was to receive a \$4.5 million annual premium on the swap from ABN Amro. ACA Goldman Complaint, *supra* note 278, at 15.

with Goldman as the short, fully expecting that the swap desk will then hedge, seeking out a counterparty to enter into the short position on a matched swap. Now let us put ourselves in the position of buyers of CLNs from a synthetic CDO, the reference portfolio of which is selected by an independent agent and the swap counterparty of which is Goldman. The expectation about the swap desk and the third-party matched swap is exactly the same. Indeed, Goldman would have no reason to sponsor the CDO if it did not already have or fully expect to find such a swap counterparty.³⁰³ In the world of derivatives, every long presupposes a short. Indeed, Goldman swapped over its short risk starting with its first synthetic CDO, ABACUS 2004-1,³⁰⁴ and the ABACUS 2007-AC1 investors had no basis for assuming that Goldman would not hedge. Paulson (or the equivalent) had to be there.

But packaging a synthetic CDO is more complicated than acting as dealer matching conventional CDS sellers and buyers.³⁰⁵ With a synthetic, the reference portfolio is the substance over which the buyers and sellers trade risk. It is not a given; it must be created. Therein lay the problem with ABACUS.

ACA was touted to investors as the “portfolio selection agent,” and the ABACUS offering materials emphasized that there was an “Alignment of Economic Interest” between ACA and the CLN holders based on ACA’s compensation and investment.³⁰⁶ ACA’s name was used to sell the deal: an internal Goldman email noted “we expect to leverage ACA’s credibility and franchise to help distribute this Transaction.”³⁰⁷

Further, ACA did formally select the assets in the reference portfolio. But Paulson also had input on the selection and seems to have vetoed the inclusion of several reference securities.³⁰⁸ The result was that a party that was economically short on the deal (and thus had every incentive to choose

303. There was the possibility, of course, that the promoter was hedging a proprietary position, as was the case with Citigroup’s Class V Funding III CDO. *See supra* note 276 and accompanying text (discussing the possibility that Citigroup set up a CDO as a hedge).

304. FCIC FINAL REPORT, *supra* note 211, at 143.

305. *See* Robert B. Thompson, *Market Makers and Vampire Squid: Regulating Securities Markets After the Financial Meltdown*, 89 WASH. U. L. REV. 323, 338–39 (2011) (observing how in synthetic securitization “the dealer or market maker is no longer a neutral provider of inventory seeking to make money on the spread. Rather, like a traditional underwriter, the dealer becomes a producer of a synthetic inventory, selling incentives that will distort the neutral market maker function.”).

306. ABACUS Flipbook, *supra* note 282, at 11, 27.

307. Felix Salmon, *Goldman’s Abacus Lies*, REUTERS (Apr. 10, 2010), <http://blogs.reuters.com/felix-salmon/2010/04/16/goldmans-abacus-lies/>. Some communications went from Paulson to Goldman and thence to ACA. SEC Goldman Complaint, *supra* note 273, ¶ 24.

308. Goldman SEC Submission, *supra* note 280, at 12–13.

the junkiest assets in the class) had a voice in determining the economic profile of the issuer of the securities sold in the deal. This fact was not disclosed to the securities purchasers.

The omission was arguably material. Why otherwise would Goldman make such a show of interposing a properly-incented independent decisionmaker at the risk-return margin? But a strong counter argument can be made. In this case the independent agent is not only an expert on the asset class but a purchaser of CLNs from the SPE. If Paulson's portfolio choices were unacceptably risky, ACA presumably would have pushed back. Finally, the other long parties were sophisticated debt investors and understood that the deal had to be constructed so as to be satisfactory to a short-side bettor, be it Goldman or some ultimate short.

Now let us thicken the plot: ACA knew that Paulson had its hand in, although it is not clear if ACA knew the extent of Paulson's input.³⁰⁹ At the same time, ACA appears to have been misled about Paulson's role in the deal. ACA allegedly believed, based on representations from Goldman employee Fabrice "Fab" Tourre, that Paulson was actually going to be investing in the ABACUS notes, purchasing the most junior CLNs at the first loss position of up to 10 percent.³¹⁰ That would have made Paulson the longest of the longs, rather than the short. Accordingly, ACA had no reason to object to Paulson's involvement, as it is common practice in structured finance issuance for the buyer of the most junior or "equity" tranche to have a say in portfolio selection.³¹¹ Because ACA believed Paulson was in fact long, it did not think Paulson's involvement in the asset selection was unusual or contrary to its interest; nor, presumably, would the other

309. See *id.* ("There is no indication that ACA 'rubber stamped' any of the securities suggested by Paulson, or that it behaved in any way inconsistent with the normal obligations of a Portfolio Selection Agent.").

310. SEC Goldman Complaint, *supra* note 273, at 13–15.

311. With RMBS and CMBS, the equity or "B-piece" investor has "kickout rights," allowing it to inspect and eliminate assets from a deal before sale. Adam J. Levitin & Susan M. Wachter, *The Commercial Real Estate Bubble*, 2 HARV. BUS. L. REV. (forthcoming 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1978264.

The infamous Magnetar deals also involved the equity investor selecting the synthetic CDO's assets. Jesse Eisinger & Jake Bernstein, *The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going*, PROPUBLICA (Apr. 9, 2010, 11:59 AM), <http://www.propublica.org/article/all-the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble>. In the Magnetar deals, the Magnetar hedge fund's equity investment (the junior tranche) was real, but the Magnetar hedge fund was also short on the mezzanine tranches via CDS. *Id.* Magnetar used its privileged equity position to urge the selection of assets that would cause losses not just to its junior tranche, but also to the mezzanine tranches on which it was short. *Id.* The Magnetar's purchase of the equity tranches was the sacrificial lamb, the buy in for being able to select junk assets that it could then short. *Id.*

ABACUS investors have objected.³¹²

C. THE RECKONING

The ABACUS 2007-AC1 reference assets performed dismally, just as Paulson had hoped. By the fall of 2007, 83 percent of them were in default.³¹³ By January 2008, 99 percent of the reference portfolio had been downgraded, resulting in near total losses for ABACUS longs.³¹⁴ The CLN investors lost their investments.³¹⁵ ABN Amro closed out its super senior swap with Goldman by paying \$841 million, which Goldman turned over to Paulson on its matched swap.³¹⁶ ABN Amro then turned to ACA for payment on its matched swap, but ACA was by then insolvent.³¹⁷ ABN Amro, as a claimant in ACA's insurance receivership, ended up with \$15 million cash and some "surplus notes" of dubious value.³¹⁸ Even Goldman seems to have lost: it claimed a \$100 million loss on the deal, which matches its unhedged long position on the 45–49 percent level of the reference portfolio.³¹⁹

The SEC seemed to have been investigating the transaction as early as August 2008.³²⁰ Why? The Enron precedent holds out an explanation: you can spin structures, get lawyers and accountants to sign off on them, and

312. ACA seems to have recognized that the 0–9 percent CLN tranche never sold, but not to have recognized the significance, namely that Paulson was not long. See Salmon, *supra* note 307 (observing that ACA never intended to sell the 0–9 percent tranche).

313. ACA Goldman Complaint, *supra* note 278, at 18. See also Morgenson & Story, *supra* note 291 (reporting that by September 2007, "the ratings on 84 percent of the mortgages underlying [the CDO] had been downgraded, indicating growing concerns about borrowers' ability to repay the loans").

314. ACA Goldman Complaint, *supra* note 278, at 18.

315. Except to the extent they had received payments prior to default.

316. ACA Goldman Complaint, *supra* note 278, at 19.

317. Cecile Gutscher & Christine Richard, *ACA Agrees to Give Regulator Some Control Over Unit*, BLOOMBERG (Dec. 27, 2007), <http://marketpipeline.blogspot.com/2007/12/aca-gives-control-to-regulator-to-avert.html> (noting that ACA agreed to give up control to regulators to avert bankruptcy).

318. ACA Goldman Complaint, *supra* note 278, at 20. Adding in ABN Amro's CDS on ACA, it seems that ABN Amro (and thus its interim purchaser, the Royal Bank of Scotland) lost \$799 million on the transaction, less the spread in protection payments made and received on the matched super senior swaps.

319. Landon Thomas, Jr., *A Routine Deal Became an \$840 Million Mistake*, N.Y. TIMES, Apr. 22, 2010, at A1, available at http://www.nytimes.com/2010/04/23/business/23cdo.html?_r=0. It is not clear what Goldman's bottom line was net of fees (such as an upfront premium from Paulson). ACA Goldman Complaint, *supra* note 278, at 10. Goldman may also have received pre-default CDS premiums, including those from ABN Amro for the protection on ACA, and the payout on the CDS protection sold to ABN Amro on ACA. Also, note that Goldman's swap desk might have hedged its ABACUS exposure.

320. Susanne Craig, Kara Scannell & Gregory Zuckerman, *Firm Contends It Was Blindsided by Lawsuit*, WALL ST. J., Apr. 19, 2010, at A1, available at <http://online.wsj.com/article/SB10001424052748703594404575192460560075600.html>.

line up blue chip financials as your counterparties, but no one ever pays much attention until there's red ink all over the table. Then they start asking questions. The SEC finally filed suit against Goldman in April 2010.³²¹ Goldman settled within three months for a record amount,³²² having incurred considerable reputational damage from a deal on which it may have lost money.

D. CONTRACT OR FIDUCIARY?

We are accustomed to thinking of companies that issue securities as legal entities that act through agents—human beings who pull the strings and are ultimately responsible for what the firm does. Viewed contractually, a conventional producing corporation is a mix of explicit contractual instructions and open-ended principal-agent relationships. The gaps are filled in by governance institutions and fiduciary law.

Synthetic CDOs work differently, occupying a higher stage of transactional evolutionary development. For all intents and purposes, the ABACUS SPE is a firm without human agents.³²³ All functions are performed by contract counterparties like indenture trustees and paying agents, and the tasks they perform are ministerial, set out *ex ante* in contractual instructions. Here, at last we encounter a gapless contractual firm—the documentation provides complete instructions. ABACUS is, in short, the apotheosis of the Jensen and Meckling “nexus of contracts” firm.

Let us view the ABACUS transaction, thus described, through Goldman's eyes. The advantage of the synthetic deal structure is its facilitation of direct manufacture of products—swaps and notes—that can be marketed by the Goldman sales force. And, despite the transactional complexity, the product brought forth is relatively simple when compared to debt securities issued by conventional operating companies. Even though a conventional operating company's debt contract is simpler than the product's, the analysis must still grapple with the factual complexity of the company and its business; there will be inevitable opaque patches in its profile. Accordingly, the bank that markets the conventional debt product

321. SEC Goldman Complaint, *supra* note 273, at 22.

322. SEC Goldman Settlement Release, *supra* note 272.

323. While the firm's Delaware subsidiary presumably has a board of directors and its Cayman LLC parent presumably has a managing member (or members), these managing actors have nothing to manage and perform only formal functions. *Cf. In re Parmalat Sec. Litig.*, 684 F. Supp. 2d 453, 482–83 (S.D.N.Y. 2010) (holding that SPE promoter breached fiduciary disclosure duties to Cayman-based board of directors but that because the Cayman board was a rubber-stamp, actual disclosure would have made no difference to the outcome).

will have to invest in disclosure to ameliorate information asymmetries. Assuming the debt is unrated, potential purchasers will also have to invest in research and then go on to evaluate the debt against the yardstick of their existing portfolios; the new debt may or may not fit.

A synthetic, in contrast, is more transparent—the assets are there on a list for all to see, each rated by a credit rating agency. The autopilot contractual instructions for the SPE eliminate most operational risk.³²⁴ The issuing entity, moreover, can be tailored to the preexisting demands of institutional debt portfolio managers. Goldman's role is also different—it goes out into the market and finds out what bets actors want to place and then sets up the gambling table: step up and place your bet. If you don't like this bet, we'll construct another one for you. The deal, viewed as a whole, looks less like a long-term investment of capital than a collection of arm's-length one-off bets entered into at the swap desk—a series of discrete contractual trades without fiduciary overtones.

Commentators concur, situating the ABACUS fact pattern in an arm's-length trading framework. The choice of strict contract as the frame magnifies the policy implications of the SEC's enforcement action. This framework heralds a break in the traditional treatment of the relationship between broker-dealers and customers, pushing it out of the contractual sphere and into fiduciary territory.³²⁵

This is a legitimate reading of the case.³²⁶ Alternatively, it has been noted that Goldman literally underwrote the ABACUS CLNs, buying them from the SPE and reselling them to the purchasers. From this perspective, Goldman is a gatekeeper with an information cost economizing role and a reputational interest in assuring the accuracy of the issuer's disclosures.³²⁷ Perhaps, but Goldman's role here is more accurately characterized as the CLNs' placement agent.³²⁸ Goldman assumed no underwriting risk; this

324. See Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1078, 1087 (2009) (describing SPE immunity from bankruptcy and management discretion).

325. Steven M. Davidoff, Alan D. Morrison & William J. Wilhelm, Jr., *The SEC v. Goldman Sachs: Reputation, Trust, and Fiduciary Duties in Investment Banking*, 37 J. CORP. L. 529, 551–52 (2012); Onnig H. Dombalagian, *Investment Recommendations and the Essence of Duty*, 60 AM. U. L. REV. 1265, 1270–71 (2011).

326. For a hypothetical application of later-to-be-enacted provisions of the Dodd-Frank Act prohibiting specified bank conflicts of interest to the ABACUS fact pattern, see Andrew F. Tuch, *Conflicted Gatekeepers: The Volcker Rule and Goldman Sachs* 49–53 (Harvard John M. Olin Ctr. for Law, Econ., and Bus. Fellows' Discussion Paper Series, Discussion Paper No. 37, 2011), available at <http://ssrn.com/abstract=1809271>.

327. *Id.* at 56–57.

328. The SEC complaint describes, but never labels, Goldman's role in the transaction.

was a private placement and Goldman would not have purchased the CLNs (and indeed ABACUS would not have come into existence) had it not already identified ready buyers.³²⁹

We would like to experiment with a third, narrower reading that focuses on the facts of the case and the SPE structure. On the facts, ABACUS is a straightforward fraud case lacking in paradigmatic implications. It involves an affirmative representation—Fab Tourre’s statement that Paulson would be taking the first loss tranche.³³⁰ There is also a plausible defense: Goldman argues that between ACA’s own sophistication and disclaimers in the documentation there was no basis for reasonable reliance on the statement. There is in turn a plausible counter to the defense—that Goldman concealed Paulson’s role in the deal, the true nature of which was a fact exclusively in Goldman’s possession.³³¹ The case, thus stated, poses a choice between caveat emptor and self-reliance on the one hand, and investor protection on the other. But the same choice is implied by the facts of any good fraud case. Whatever the choice made here, the law of fraud emerges in more or less the same shape, and the playbook for Goldman and its agents need not be rewritten.

The case would be harder if Fab Tourre had kept his mouth shut. Then the issue would be whether Goldman had an affirmative duty to disclose, a duty that presupposes a fiduciary relationship, something that clearly does not exist at the swap dealer’s desk or otherwise between stockbrokers and their customers. Interpolating such a duty means taking a much bigger step than finding an actionable fraud on the facts of the case. But a fundamental realignment of broker-customer relationships would not need to be implied if the duty arose as an incident of the sponsor-SPE relationship.

ABACUS, even as its actions were fully determined by a set of contracts, was also a firm that issued securities. It was an issuer of a particular sort, for it lacked human agents able to make representations about itself and its securities. Indeed, ABACUS didn’t even exist at the time the representations were made to ACA about Paulson’s involvement. Even as the fraud was perpetrated through ABACUS, ABACUS was an

329. It is also questionable whether Goldman added an underwriter’s bonding function to the transaction. Goldman’s brand and savior faire surely helped ABACUS obtain favorable credit ratings—a type of indirect bonding—but the existence of ACA as portfolio selection agent suggests that there were clear limits to any bonding value Goldman brought to the table in a transaction structured like ABACUS.

330. *SEC v. Goldman, Sachs & Co.*, 790 F. Supp. 2d 147, 151, 162 (S.D.N.Y. 2011).

331. *See ACA Fin. Guar. Corp. v. Goldman, Sachs & Co.*, No. 650027/11, 2012 N.Y. Misc. LEXIS 1940, at *42 (N.Y. Sup. Ct. Apr. 23, 2012) (denying defendant’s motion to dismiss in ACA’s action against Goldman).

empty shell incapable of perpetrating a fraud. It was a vehicle, not an actor. Ergo, it is natural to look through ABACUS to Goldman as its progenitor. Goldman created and controlled it; Goldman's agents made representations regarding it. Goldman accordingly was not just a dealer here; it had duties to disclose as if it were the issuing entity.

The case for putting Goldman in the entity's shoes strengthens when we look at Fab Toure's misrepresentation. Fab seems to have lulled ACA into complacency by portraying Paulson as a participant in a co-venture in the entity's equity. Accordingly, ACA and Goldman were not in the position of one-off swap counterparties. Goldman sold the transaction to ACA as an investment in a firm—a firm in which Paulson was investing first loss, equity capital and so had an interest directly aligned with ACA's. Irrespective of whether Goldman made an affirmative misrepresentation or simply failed to disabuse ACA of its misunderstanding, it was a material deception, no different than if Goldman underwrote the common stock of an operating company after knowingly choosing a CEO whose entire net worth was staked on a short position in the company's stock.

How strong is our theory doctrinally? It has indirect support in the Southern District of New York's *Parmalat* decision of 2010, in which an SPE promoter was held to owe fiduciary duties to the SPE entity.³³² Whether such a duty somehow flows through to the holders of the SPE's notes presents a question, but the inference arises. Another source of indirect support comes from section 15 of the Securities Act of 1933³³³ and section 20(a) of the Securities Exchange Act of 1934,³³⁴ the control person liability provisions. In the SEC's interpretation of these sections, control person liability attaches to actors with the power to direct the management or policies of a primary violator of the securities laws, whether through equity ownership, contract or otherwise.³³⁵ This bespeaks a substance-over-form approach to fraud liability and Goldman certainly controlled ABACUS. Unfortunately for our theory, liability presupposes a primary violation by the ABACUS SPE, and any violation here originated with Fab Toure, Goldman's own agent on the deal.

The closest analogies for our theory lie in doctrines that, much as does accounting when it mandates consolidated reports, consolidate legal entities for liability purposes. The corporate law of piercing the veil³³⁶ and

332. *In re Parmalat Sec. Litig.*, 684 F. Supp. 2d 453, 479–81 (S.D.N.Y. 2010).

333. 15 U.S.C. § 77o (2006).

334. 15 U.S.C. § 78t(a) (2006).

335. *See* 17 C.F.R. § 240.12b-2 (2011) (providing the SEC interpretive definition of “control”).

336. *See, e.g., Walkovsky v. Carlton*, 223 N.E.2d 6, 8–9 (N.Y. 1966) (discussing the conditions

bankruptcy consolidation³³⁷ are primary exemplars. Unfortunately for our reading, the Supreme Court recently rejected a theory that posed treatment of two closely related entities as one for federal securities law purposes. In *Janus Capital Group, Inc. v. First Derivative Traders*,³³⁸ a plaintiff sought to attach primary liability for a misstatement in a mutual fund prospectus to the fund's investment advisor. But for a placeholder board of directors at the fund entity, the advisor entity ran the fund, including the drafting of document issued in the fund's name. Even so, the court took a form-over-substance approach, ruling that the entity with "ultimate authority" over a statement, here the fund, makes a statement for securities law purposes.³³⁹

The cases of Goldman and ABACUS can easily be distinguished from the facts of *Janus*. But we take away a negative implication even so. The days when the federal securities laws could be relied upon to cut through layers of entities, ferret out a fraud's economic motivations, and attach liability appear to be over. So while scandal and financial disaster have triggered an overhaul of the rules governing appearances, bringing SPEs into the zone of accounting consolidation, the regime of financial accountability remains impervious. It may even accord more respect to entities like SPEs than heretofore.

VII. CONCLUSION: THE NATURE OF THE FIRM AND REGULATION BY SCANDAL

Scandal presupposes defalcation, but defalcation does not necessarily trigger scandal. The banks' SIV accounting was clearly infirm, but the resulting mess did not grow into scandal because the very act that was scandalous, taking back the SIVs and thereby showing that they never had really been independent, limited the immediate financial pain. Nor was there any concealment; the regulators had signed off on SIV structures long before. That the SIVs were a financial disaster, then, was not by itself a

under which courts may pierce the corporate veil).

337. See, e.g., *In re Owens Corning*, 419 F.3d 195, 203–04 (3d Cir. 2005) (adopting a standard for determining when to apply the equitable doctrine of substantive consolidation, which permits a court to "treat separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities" (quoting *In re Genesis Health Ventures, Inc.*, 402 F.3d 416, 423 (3d Cir. 2005))).

338. *Janus Capital Group, Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2230–01 (2011).

339. *Janus*, 131 S. Ct. at 2302. But see William A. Birdthistle, *The Supreme Court's Theory of the Fund*, 37 J. CORP. L. 771, 772 (2012) (criticizing the *Janus* decision); Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1966 (2010) (arguing that mutual funds should be conceived of as financial products rather than firms); Donald C. Langevoort, *Lies Without Liars? Janus Capital and Conservative Securities Jurisprudence* 25 (Georgetown Public Law Research, Paper No. 12-019, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2010745 (analyzing how "conservative interpretivism" led to the *Janus* decision).

sufficient cause for scandal.

Indeed, financial disaster is not even a necessary cause. The junk bond market still levitated when the federal government went after Michael Milken. Milken pleaded guilty in April 1989; the junk bond market would not collapse until October of that year. Milken was targeted because he was a financial success whose actions entailed negative externalities. Goldman became a post-financial crisis enforcement target for a similar reason. Each of the Drexel, Enron, and Goldman enforcement proceedings involved securities law violations. But the tie that binds them together in the minds of most people is the perpetrators' free market arrogance.

This Article has focused on a different tie, the SPE, as manifested in Bistro and its variants and asset light business planning more generally. Our account highlights strategic use of corporate alter egos facilitated by technocratic obfuscation. SPEs are suspicious because no one quite understands what they are. No one quite understands what they are because these entities take their form, but not their substance, from existing legal models. SPEs evolved in practice, and so lack a genesis in a generalized, planning intelligence, even as transaction engineers have shaped them to serve their sponsors' immediate financial goals. An operative theory of the SPE is emerging, a theory based on economic fundamentals. Even though it is a theory of the firm, it does not come out of corporate law. It instead comes from GAAP.

Corporate law is tolerant of alter-ego entities. Historically, these have been subsidiary corporations.³⁴⁰ So long as a subsidiary maintains its formal integrity, its liabilities are unlikely to flow through to the parent company, even though the subsidiary in substance does the parent's bidding.³⁴¹ It is accordingly unsurprising that corporate law has had little to say about SPEs. Indeed, its formalism makes them possible. It registers no policy objections: if asset light transactions enhance shareholder value, boards of directors should pursue them; the evaluation of concomitant risks is a matter of business judgment. When Enron and the bank SIV sponsors took the entities' assets and liabilities back to their balance sheets, it was not as a result of some corporate law compulsion.

But the convention of respect for formal separation has never applied

340. A related jurisprudence exists in bankruptcy relating substantive consolidation of separate entities. See *In re Owens Corning*, 419 F.3d at 203-04 (listing the factors an appellate court considers to decide whether it has jurisdiction over a bankruptcy appeal).

341. See, e.g., *Walkovsky v. Carlton*, 223 N.E. 2d 6, 9 (N.Y. 1966) (finding that formal corporate separation will generally insulate companies from liability).

universally. Unsurprisingly, the qualifications tend to come from outside of corporate law. For example, accountants require consolidation of a majority-owned subsidiary for financial reporting purposes. Consolidation does two things: first, the alter ego's assets and liabilities flow through to the parent's statement, and second, contracts between the parent and the alter ego cannot create profits.

The whole point of an SPE is to create an alter ego that, like a subsidiary, does the sponsor's bidding but does so without being deemed controlled for accounting purposes (and, in the case of a regulated financial company, without being subject to regulatory capital requirements). The primary reason, as we have seen again and again, is to facilitate super-high leverage financing. SPEs proliferated on the theory that super-high leverage is appropriate for segregated, super-safe assets. An SPE that has no cognizable equity investment tends to be the entity that best serves this purpose.

The Bistro structure is the ideal exemplar. Contracts create the SPE, assign its assets, and govern the terms under which the CDO pays or is paid. Once the structure is set up, there is nothing for the firm to do. The deal documents do not, of course, determine the performance of the reference securities. But that is the whole point. With a synthetic CDO the messy business of buying and managing risky assets is avoided altogether. The only risk investors assume is the performance of the reference assets; operational risk is eliminated.³⁴² It is far better to "reference" the assets, sell the CLNs, and put the proceeds into Treasury securities, which, among all the real assets in the world are the ones that have the least risk and require the least effort to manage. To the extent there are profits, the contracts in the structure drain them off, while losses are also allocated contractually by tranching.³⁴³ Add it up and the traditional function of equity is eclipsed. Even when a synthetic CDO like ABACUS employs an SPE organized as a corporation rather than as a trust, the corporation's board of directors is a placeholder dummy and the beneficial interest is vested in a charitable trust. Form prevails over substance.

The Bistro SPE is a "firm," but it is a firm in the purest sense of being nothing more than a nexus of contracts—a credit default swap here and a note there. It is a pure node of contractual risk allocation. But, unlike prices on a trading market, contracting nexuses do not coalesce in spontaneous

342. See Gelpert & Levitin, *supra* note 324, at 1078, 1087 (discussing investors' protections from risk).

343. *Id.* at 1121–22 (discussing tranching in SPEs as a type of "contractual bankruptcy").

order. They must be created; investors must be solicited. Formal separation between the sponsor and the entity becomes operative only once the deal closes. Thus did Goldman get into trouble regarding its formation stage representations and omissions regarding the content of ABACUS. Until the notes are sold, there is no ABACUS, only Goldman.

Now compare the SIVs, where the sponsors got into trouble at the operating stage rather than the formation stage. Where the Bistro structure carries super-safe to its logical conclusion, filling the SPE with Treasuries, at the SIVs super-safe meant AAA- and AA-rated assets, but not without default risk. When an unexpected downside resulted, the sponsors' regime of formal separation was wrecked. Because the outside world associated the SIVs with their bank sponsors, the banks proved unwilling to enforce their own formal regime. It followed that in substance the SIVs had never really been separate.³⁴⁴

Now consider the role that contracts played at the SIVs. With Bistro everything goes on autopilot once the "on" switch is flicked. In contrast, the SIVs were managed, and management is an equity function under the traditional legal model of the firm. But once again a controlling equity interest is incompatible with the SPE business model. The solution was a management contract with the sponsor that included a performance-sensitive fee. The sponsor also took on the junior creditor interest in the form of a subordinated note that had performance sensitive upside built into its interest rate. The traditional functions of equity—management control and residual risk bearing—have been contracted out, but to a sponsor that is not consolidating the entity for accounting and regulatory capital purposes, despite controlling it and holding the performance risk.

It is, then, in the nature of a SPE to reallocate the functions of equity by contract, even as the SPE uses business forms that presuppose and create an equity interest. Given this profile, the original, non-GAAP "3% outside equity" rule was profoundly misguided. It presupposed that the traditional, equity-based theory of the firm determined the SPE's economic substance, and then conveniently held that separation could follow from a minimal dollop of non-sponsor equity capital. The result was Enron's LJM transaction. LJM in turn taught the lesson that outside equity cannot solve

344. A similar story emerges for credit card securitizations, which have always been founded on implicit recourse to the card issuer / securitization sponsor. See Adam J. Levitin, *Skin-in-the-Game: Risk Retention Lessons from Credit Card Securitization*, 81 GEO. WASH. L. REV. (forthcoming 2013), available at www.papers.ssrn.com/sol3/papers/cfm?abstract_id=1898763 (discussing card issuer bailouts of their securitization trusts). Following SFAS 166 and 167, most credit card securitizations were required to be taken back on balance sheet. *Id.*

the SPEs' separation problem because SPEs are not about outside equity. To require it for real is to suppress the business model.

The FASB, which as a political proposition is not situated to suppress trillion dollar business models, figured this out. Its two-step response to SPEs in FIN 46(R) and SFAS 167³⁴⁵ abandons traditional legal model of the firm and substitutes a new approach tailored for the SPE. Under the traditional approach, inter-firm connections follow from equity ownership; once the tie is established, inter-firm contracts literally drop out for reporting purposes. In contrast, FIN 46(R) and SFAS 167 look at equity only at the threshold: if the entity is well-capitalized with equity from outside, it is independent and there is no issue; if it is not, then contracts determine the outcome of the inquiry into sponsor separation. Thus, loss exposure on debt can lead to primary beneficiary status and consolidation. Control of business decisionmaking and profit sharing through an investment advisory contract can too. Moreover, determination of the business model through a controlling document imposed at formation by a sponsor weighs in the balance.

This is a radical rethinking of inter-firm connectedness and firm boundaries. The old approach made everything follow from a line of separation between the equity interest and the interests of contract counterparties—equity was inside the firm, and contract was outside. Under the new approach, the line is drawn case by case, based on allocations of risk and directive power. Significantly, the new approach is very much compatible with a contractual theory of the firm—the firm as a “nexus of contracts”—even as it rejects the notion that contract constructs devised by SPE technicians should determine regulatory results. If the firm is a collection of different contracts, then an “equity” designation by itself should not determine substantive inquiries into financial presentation and risk capital adequacy. The SPEs teach us that residual risk and control can be allocated any number of different ways, only one of which is formal equity. The substance of each set of inter-firm relationships needs to be evaluated individually. Equity ownership may or may not be relevant.

This does not go to say that FIN 46(R) and SFAS 167 solve all SPE-related accounting problems. The SIVs showed that gaming can proceed even under a new substance over form regime. Decisions as to treatments continue to be opaque, for only the reporting company and its auditor know the governing analysis. The outside world gets a look only when things go wrong.

345. SFAS 167, *supra* note 266, at 2.

But the conceptual barrier has been surmounted. That it took the Enron scandal and collapse of the SIVs to get us over the barrier is unsurprising. The balance of power between reporting companies and the FASB guarantees that standard setting is a reactive proposition. In this singular, but critical corner of business regulation, scandal has proved a necessary driver of incentives. It is in this limited sense a cause for celebration.

In contrast, our look at Goldman, ABACUS, and federal securities liability regime shows just how embedded superannuated notions of entity integrity can be. In our view, Goldman and ABACUS should have been consolidated for securities fraud purposes, with Goldman emerging as the securities issuer. But we doubt our theory has much traction in light of the Supreme Court's recent *Janus* decision. Taking *Janus* together with the formalism of state corporate law, we fear that the legal environment remains as susceptible as ever to SPE shenanigans so far as concerns financial accountability.

The SPE is a marvel of modern transaction engineering—a new form of corporate alter ego, controlled by contract rather than by equity ownership. The SPE has expanded the boundaries of the operating companies without law and regulation keeping pace. Only accounting principles have confronted the challenge of identifying and corralling the SPE's abusive aspects. Accounting may be the occasion for fraud, but when incorporated into securities law, it can be a powerful mandate against fraud. While accounting treatment is traditionally derivative of legal status, the law now needs to take its cue from accounting and embrace a more functional model in which legal duties follow from substantive relationships rather than contractual forms.