

THE LIMITS OF SECURITIZATION: WHY  
BANKRUPTCY COURTS SHOULD SUBSTANTIVELY  
CONSOLIDATE PREDATORY SUB-PRIME  
MORTGAGE ORIGINATORS AND THEIR SPECIAL  
PURPOSE ENTITIES

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## INTRODUCTION

During 2007 and 2008, dozens of sub-prime mortgage lenders shut their doors and declared bankruptcy, fueling a global financial crisis centered on the United States housing market.<sup>1</sup> The fallout of the sub-prime mortgage lending market has adversely impacted global credit markets, currency markets, as well as domestic and international stock markets.<sup>2</sup> This global credit crunch is a byproduct of investor fears that nontraditional mortgages<sup>3</sup> will suffer significant defaults, thus significantly increasing expected delinquency and foreclosure rates.<sup>4</sup> Unfortunately, investors’ greatest fears have come true.<sup>5</sup>

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1. Ryan Barnes, *The Fuel That Fed the Subprime Meltdown*, INVESTOPEDIA, Sept. 4, 2007, <http://www.investopedia.com/articles/07/subprime-overview.asp>.

2. *Id.*

3. ALLEN J. FISHBEIN & PATRICK WOODALL, EXOTIC OR TOXIC? AN EXAMINATION OF THE NON-TRADITIONAL MORTGAGE MARKET FOR CONSUMERS AND LENDERS 3 (May 2006), [http://www.consumerfed.org/pdfs/Exotic\\_Toxic\\_Mortgage\\_Report0506.pdf](http://www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf) (“[N]on-traditional mortgages . . . feature lower initial monthly payments than do traditional fixed or adjustable rate mortgages. Interest-only, payment option, piggy-back, and low- or no-documentation loans are all non-traditional mortgages.”).

4. Bankrate.com, Countrywide, The Mortgage Mess and You (Aug. 17, 2007), <http://articles.moneycentral.msn.com/Banking/HomeFinancing/CountrywideTheMortgageMessAndYou.aspx>.

5. See Press Release, Mortgage Bankers Ass’n., Delinquencies Increase in Latest MBA National Delinquency Survey (Sept. 6, 2007), <http://www.mortgagebankers.org/>

This global financial crisis is partially due to the advent of the mortgage-backed securitization industry.<sup>6</sup> Through securitization,<sup>7</sup> mortgage originators can quickly sell their assets and use the proceeds to fund additional loans, thus reducing or eliminating the associated risk of uncollectability on the receivables.<sup>8</sup> These assignment production companies<sup>9</sup> generate tremendous streams of income and fuel capital markets worldwide.<sup>10</sup> When securitized home mortgage transactions proceed as planned, society appears to win as banks and financial institutions reclassify or remove troubling loans from their balance sheets thus reducing existing capital requirements and enabling them to extend new loans.<sup>11</sup> Unfortunately, like many new financial instruments, securitization is not free from abuse.<sup>12</sup>

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NewsandMedia/PressCenter/56555.htm. The author notes that delinquency rates for mortgage loans on residential properties totaled “5.12 percent of all loans outstanding in the second quarter of 2007 . . . up 28 basis points from the first quarter of 2007, and up 73 basis points from one year ago.” *Id.* Furthermore, 1.4% of all loans outstanding at the end of the second quarter were in the foreclosure process. *Id.*; see also Associated Press, Foreclosure Filings Increase at Slower Rate (Sept. 12, 2008), <http://www.msnbc.msn.com/id/26665909/>.

6. See Richard D. Jones & Richard A. Bendit, *Practical Advice on the Preparation of the Substantive Non-Consolidation Opinion in Real Estate Transactions* 2 (June 12, 2002), [http://www.dechert.com/library/Practical\\_Advice\\_on\\_the\\_Preparation\\_RJones\\_6-0.pdf](http://www.dechert.com/library/Practical_Advice_on_the_Preparation_RJones_6-0.pdf).

7. See THE BOND MKT. ASS’N ET AL., INT’L SWAPS AND DERIVATIVES ASS’N, SPECIAL PURPOSE ENTITIES (SPEs) AND THE SECURITIZATION MARKETS 1 (2002), <http://www.isda.org/speeches/pdf/SPV-Discussion-Piece-Final-Feb01.pdf> (“Securitization is a process by which securities are created whose payments are supported by cash flows generated by a pool of financial assets.”); see also Greg Zipes, *Securitization: Challenges in the Age of LTV Steel Company, Inc.*, 2002 ANN. SURV. BANKR. LAW. 105, 107 (2002) (explaining that securitization is a financing technique whereby a mortgage originator “transfers rights in receivables or other financial assets to an entity that serves as a ‘special purpose vehicle’ (‘SPV’), which in turn issues securities to capital market investors and uses the proceeds from the issue to pay for the financial assets, thereby providing liquid capital to the originator”); Investors in the securities receive the income generated via owning the rights to the receivables. *Id.*

8. Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1374-75 (1991) (explaining that asset backed securitization transactions can be “structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets”).

9. See *infra* Subsection I.B.2.

10. Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2188 (2007) (“Collectively, investors have large amounts of capital, but a limited ability to originate and monitor individual loans. Conversely, mortgage lenders are well situated to make loans, but are typically constrained in the number of loans they can make by their limited access to capital.”).

11. *Id.*; see Lois R. Lupica, *Asset Securitization: The Unsecured Creditor’s Perspective*, 76 TEX. L. REV. 595, 605 (1998); see also Zipes, *supra* note 7, at 110 (“[Securitization] converts future income streams of the originator into a present cash payment, which can improve the liquidity of cyclical businesses, both large [and] small. It can pool smaller assets into large funds and spreads risk over large consumer loan portfolios.”).

12. Peterson, *supra* note 10, at 2188; see *infra* Subsection I.B.2.

Predatory lenders,<sup>13</sup> whose practice is “real, pervasive, and destructive . . . [O]perate on the edge of bankruptcy, quickly folding up and moving on whenever the heat gets close. This is possible because in today’s market, mortgage originators and brokers quickly assign predatory loans through a complex and opaque series of transactions . . . .”<sup>14</sup> Special Purpose Entities<sup>15</sup> (SPEs)<sup>16</sup> are formed and used as vehicles for mortgage originators to achieve corporate objectives such as increasing liquidity while minimizing risk.<sup>17</sup> In isolating the risk associated with collection on the loans, the fundamental goal of bankruptcy remoteness may be achievable via a carefully established SPE.<sup>18</sup> Because predatory lending practices have reached a boiling point, bankruptcy courts, in conjunction with the administration of insolvent mortgage originators claims, can exercise their equitable powers and hold a narrowly tailored and limited set of predatory sub-prime mortgage originators accountable for their predatory originations.

As a bankruptcy court is a court of equity,<sup>19</sup> it is not without a remedy to address material deviations from fair lending practices.<sup>20</sup> In pursuit of fair and equitable results, a bankruptcy court has a significant amount of discretion “to the end that fraud will not prevail, that substance will not give way to form, [and] that technical considerations will not prevent substantial justice from being done.”<sup>21</sup> Bankruptcy courts have in their toolkit the equitable doctrine of “substantive consolidation”<sup>22</sup> as conferred to them in sec-

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13. See *infra* Subsection I.B.2 (defining predatory lending).

14. Peterson, *supra* note 10, at 2189.

15. Jones & Bendit, *supra* note 6, at 1-2 (“Fundamentally, an SPE is an entity which conducts no business other than the ownership of the property securing the loan and has, among other things, no debts other than the loan and reasonable trade debt. An SPE borrower can be a corporation, partnership, limited liability company or business trust.”); see THE BOND MKT. ASS’N ET AL., *supra* note 7, at 1 (“Securitization SPEs are legal entities . . . established for a specific and limited purpose. An SPE essentially acts as a depository for a specific group of assets in securitization, and in turn, issues securities to the marketplace for purchase by investors.”).

16. THE BOND MKT. ASS’N ET AL., *supra* note 7, at 1 n.1 (noting that the terms “SPE” and “SPV” can be used interchangeably).

17. Zipes, *supra* note 7, at 1.

18. *Id.* (explaining that the central premise behind securitization is that assets can be isolated from the bankruptcy estate).

19. Ross S. Barr & Mark G. Douglas, When is it Too Late for Substantive Consolidation? 1 (Sept./Oct. 2006), [http://www.jonesday.com/pubs/pubs\\_detail.aspx?pubID=S3756](http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S3756).

20. *Id.* (noting that available remedies “include the power to invalidate pre-bankruptcy transfers that are fraudulent or preferential, the ability to ‘pierce the corporate veil’ if a subsidiary is nothing more than its parent’s ‘alter ego,’ and the power to reorder the priority of claims or interests in cases of misconduct”).

21. *Pepper v. Litton*, 308 U.S. 295, 305 (1939).

22. Jones & Bendit, *supra* note 6, at 2 (“Substantive consolidation is a judicially created doctrine derived from the general equitable powers granted to bankruptcy courts by Section 105(a) of the Bankruptcy Code.”); see Peter J. Lahny IV, *Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential At-*

tion 105(a) of the Bankruptcy Code.<sup>23</sup> Because the doctrine of substantive consolidation is an extraordinary remedy,<sup>24</sup> “the power should be sparingly used and must be tailored to meet the needs of each particular case.”<sup>25</sup> Although consolidation is typically thought of as consolidating two entities already involved in separate bankruptcy proceedings, under certain circumstances, courts have allowed a non-debtor entity to be consolidated with a bankrupt debtor.<sup>26</sup>

By substantively consolidating predatory sub-prime mortgage originators and their affiliated SPEs, courts sitting in equity will advance policy arguments demanded by society to curb inequitable and predatory lending practices.<sup>27</sup> As a result, investors, bearing the loss resulting from consolidation, will be less likely to pool their money in SPE investments carrying loans originated under predatory and illegal circumstances. Bankruptcy

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*tack, Substantive Consolidation*, 9 AM. BANKR. INST. L. REV. 815, 859 (2001) (“Under this remedy, the court treats the assets and liabilities of at least two separate, but affiliated[,] entities as if they were the assets and liabilities of a single bankruptcy debtor.”); *see also* Mary Elisabeth Kors, *Altered Egos: Deciphering Substantive Consolidation*, 59 U. PITT. L. REV. 381 (1998) (noting that Substantive Consolidation is “the effective merger of two or more legally distinct (albeit affiliated) entities into a single debtor with a common pool of assets and a common body of liabilities”); *see also* J. Stephen Gilbert, *Substantive Consolidation in Bankruptcy: A Primer*, 43 VAND. L. REV. 207, 208 (1990) (“Substantive consolidation is a powerful vehicle in bankruptcy by which the assets and liabilities of one or more entities are combined and treated for bankruptcy purposes as belonging to a single enterprise.”).

23. Title 11, section 105(a) of the United States Code provides:

(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

11 U.S.C. § 105(a) (2005).

24. *In re Owens Corning*, 419 F.3d 195, 199 (3d Cir. 2005) (noting that substantive consolidation is an “extraordinary remedy”); *see* *Alexander v. Compton (In re Bonham)*, 226 B.R. 56, 88 (Bankr. D. Alaska 1998) (“While this court is mindful of the seriousness of the remedy of consolidation, this is a case where extraordinary circumstances exist and an examination of the equities requires extension and substantive consolidation.”).

25. *Nickless v. Avnet, Inc. (In re Century Elecs. Mfg.)*, 310 B.R. 485, 490 (Bankr. D. Mass. 2004) (quoting *In re Bonham*, 229 F.3d 750, 771 (9th Cir. 2000)).

26. *Bracaglia v. Manzo (In re United Stairs Corp.)*, 176 B.R. 359, 368 (Bankr. D. N.J. 1995) (“While many consolidation cases involve the consolidation of entities already in bankruptcy, it is accepted that a non-debtor entity may be consolidated with a debtor under appropriate circumstances.”).

27. EDWARD D. RE & JOSEPH R. RE, *REMEDIES: CASES AND MATERIALS* 34 (6th ed. 2005) (noting that equitable principles have come to be expressed in the form of maxims). Applicable maxims include: One Who Seeks Equity Must Do Equity, One Who Comes Into Equity Must Come with Clean Hands, Equity Will Not Suffer a Wrong to Be Without a Remedy, Equity Regards as Done That which Ought to Be Done, Equity Regards Substance Rather than Form, and Equality is Equity. *Id.*

courts should substantively consolidate predatory sub-prime mortgage originators and their affiliated SPEs when there exists enough of an “identity of interest” between the entities to justify consolidation and, upon a balancing of the equities, the court determines that the mortgage company has engaged in the origination of illegal predatory loans securitized by investors who knew or should have known that they were investing in and willfully profiting from the illegal predatory originations.

Part I of this Comment briefly discusses the recent history of securitization, the benefits and adverse consequences of securitization, distinctions between prime and sub-prime mortgage originators on predatory lending, traditional attacks on securitization, and common defensive mechanisms companies use to guard against securitization.<sup>28</sup> Part II reviews the historical application of the equitable doctrine of substantive consolidation including tests adopted by the various federal circuit courts, factors that courts of equity use in determining whether to substantively consolidate related entities, and an analysis of relevant case law.<sup>29</sup> Part III sets forth arguments in support of substantively consolidating predatory sub-prime mortgage originators and their affiliated SPEs. Consolidation is justified when the requisite “identity of interest” exists between the parties and, upon a balancing of the equities, the court concludes that the mortgage company has engaged in the origination of illegal predatory loans and has sold these loans to investors who knew or should have known that they were investing in illegal predatory originations.<sup>30</sup>

#### I. HISTORICAL REVIEW OF SECURITIZATION, THE BENEFITS AND CONSEQUENCES OF SECURITIZATION, TRADITIONAL ATTACKS ON SECURITIZATION AND HOW COMPANIES GUARD AGAINST SUBSTANTIVE CONSOLIDATION

“Securitization” is elementarily defined as the process by which companies transform their cash flow generating assets into securities which are subsequently sold to investors.<sup>31</sup> Securitization of mortgages involves the

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28. See *infra* Part I.

29. See *infra* Part II.

30. See *infra* Part III.

31. See Sarah Robinson Borders, *Hot Topics with Respect to Real Estate Bankruptcy Issues*, in COMMERCIAL REAL ESTATE FINANCING: WHAT BORROWERS AND LENDERS NEED TO KNOW NOW 2001, at 611, 636 (PLI Real Estate Law and Practice, Course Handbook Series No. 006E, 2001); see Lupica, *supra* note 11, at 599 (noting that securitization has been defined as a “structured process whereby loans and other receivables are packaged, underwritten, and sold in the form of securities”) (quoting JAMES A. ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 3 (1988)); see also Shenker & Colletta, *supra* note 8, at 1374-75 (defining securitization as “the sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-

pooling of mortgage loans by a mortgage broker who owns the rights to the receivables, the loan originator, in preparation for sale to another entity, typically an affiliated SPE.<sup>32</sup> SPEs, which can take the form of a variety of different legal entities,<sup>33</sup> are created for the limited purpose to hold the transferred assets, to issue securities (backed by the receivables) to investors, and to enter into a limited number of related transactions.<sup>34</sup> The SPE's central goal, and reason for the limited scope<sup>35</sup> of activities granted to the SPE, is to achieve bankruptcy remoteness so that if the mortgage broker files bankruptcy, the SPE will not become part of the insolvency proceedings.<sup>36</sup> However, creating a truly bankruptcy proof entity may not be possible.<sup>37</sup>

#### A. Historical Review of Securitization

The origins of securitization trace their roots to government-backed organizations<sup>38</sup> that began issuing mortgage-backed securities to investors who were seeking interest income combined with lower investment risks.<sup>39</sup> Private institutions soon acknowledged the benefits of securitization,<sup>40</sup> and in 1977, the first generally recognized private mortgage backed securities

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producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets”).

32. Lupica, *supra* note 11, at 599 (“The firm originally owning and selling the receivables is a financing-seeking firm, commonly referred to as the ‘originator,’ and the purchasing and securities issuing entity is generally an affiliated special purpose corporation (SPC).”); see Peterson, *supra* note 10, at 2209 (noting that the originator gives notice of the right to the income stream by recording it with the county recorder’s office). The loan is transferred to an investment banking firm’s subsidiary, “the securitization sponsor, or seller” and subsequently transferred with hundreds of other loans into a single pool of loans. *Id.* This pool of loans is referred to as the special purpose entity. *Id.*

33. Thomas E. Plank, *Toward a More Efficient Bankruptcy Law: Mortgage Financing Under the 2005 Bankruptcy Amendments*, 31 S. ILL. U. L.J. 641, 656 (2007) (noting that such legal entities include “a corporation, limited liability company, Delaware statutory trust, or limited partnership”); see Peterson, *supra* note 10, at 2209 (“The SPV can be a corporation, partnership, or limited liability company, but most often is a trust.”).

34. Plank, *supra* note 33, at 656.

35. See Peterson, *supra* note 10, at 2209 (“Aside from the mortgages, the SPV has no other assets, employees, or function beyond the act of owning the loans.”).

36. Zipes, *supra* note 7, at 108.

37. *Id.* at 109 (“[T]he best that lenders can hope for is that the entity is ‘bankruptcy remote,’ and not necessarily bankruptcy proof.”); see *infra* Section II.B.

38. Peterson, *supra* note 10, at 2198 (explaining that “both Ginnie Mae and then Freddie Mac began issuing mortgage-backed securities that ‘passed through’ interest income to investors”).

39. *Id.* at 2199 (“Because the agencies now guaranteed the principal and interest income of their securities even when mortgagors defaulted, investors saw the securities as a low risk investment . . . .”); see Shenker & Colletta, *supra* note 8, at 1380 (noting that as risks are reallocated and liquidity increases, the securities become more appealing to a greater number of investors).

40. See *infra* Subsection I.B.1.

transaction took place.<sup>41</sup> Over time, this sophisticated and extremely profitable means of amassing large sums of capital into home mortgages grew to enormous proportions.<sup>42</sup> Recently, US mortgage-backed securitization transactions have been estimated to exceed \$6 trillion.<sup>43</sup>

As the American mortgage lending market has developed, so too has the complexity of the transactions and the number of parties involved in any single transaction. The early stages of American lending involved two parties, a lender and a borrower, in any given transaction.<sup>44</sup> After the Great Depression, most mortgage loans included three parties: a borrower, a lender, and a federal government sponsored institution backstopping the lender by purchasing or guaranteeing the mortgage.<sup>45</sup> “[C]ontemporary asset-backed securities conduits often have eleven or more integral parties: a borrower, a broker, an originator, a seller, an underwriter, a trust, a trustee, multiple servicers, a document custodian (which may be closely involved in foreclosure proceedings), an external credit enhancer, a securities placement agent, and investors.”<sup>46</sup> Given the rapid transformation in the lending industry from traditional lending practices to securitization, several benefits and adverse consequences of securitization have been identified.<sup>47</sup>

## B. Benefits and Adverse Consequences of Securitization

Firms securitize their assets, as an alternative to borrowing money, in an effort to raise cash on hand for reinvestment in a variety of different initiatives.<sup>48</sup> Benefits realized by firms securitizing their assets include an improvement in overall liquidity, the diversification of funding sources, the lowering of effective financing rates secured by higher agency ratings available to SPEs, and the removal of overall portfolio risk using off-balance sheet financing.<sup>49</sup> Adverse consequences include an increase in predatory

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41. Peterson, *supra* note 10, at 2200. In 1977 prominent financial institutions (Bank of America and Salomon Brothers) issued securities “where outstanding loans were held in trust, with investors as beneficiaries.” *Id.* The entirely passive trusts (having no employees or assets outside the home mortgages) are “generally recognized as the first mortgage-backed securities issued by the private sector.” *Id.*

42. *Id.* at 2213 (noting that securitization “created an extremely powerful and lucrative device for marshaling capital into home mortgage loans”).

43. Zipes, *supra* note 7, at 1 (finding that the securitization industry is a “6.0 trillion dollar industry”).

44. Peterson, *supra* note 10, at 2256.

45. *Id.*

46. *Id.*

47. See *infra* Section I.B.

48. Lupica, *supra* note 11, at 605 (“Firms securitize their assets for the same reason firms borrow money: to raise money for either special projects or working capital.”).

49. *Id.* (“[B]enefits include improving liquidity, increasing diversification of funding sources, lowering the effective interest rate, improving risk management, and achieving

sub-prime lending practices less prevalent under traditional prime lending structures, a shift in the originators' focus towards short term profit maximization by emphasizing the quantity of loans originated rather than their quality, and the removal of mortgage receivables from the books of the originator in exchange for cash which is rapidly spent, leaving only an under-capitalized bankruptcy remote entity available to satisfy the claims of creditors in the event of insolvency proceedings.<sup>50</sup>

### 1. *Benefits of Securitization*

Arguably the most important result of securitization is that it improves a company's liquidity.<sup>51</sup> This is because securitization converts present rights to future payment streams into lump sum cash payments which, in turn, are used to fund current projects.<sup>52</sup> Lenders with limited capital can quickly assign their loans into a SPE and use the proceeds of the sale to make a new round of loans.<sup>53</sup> As a result of the firms' increased liquidity and ability to fund additional current projects, originators' profitability should increase.<sup>54</sup> With greater liquidity representing an increase in purchasing power, firms will be able to pay short term credit liabilities when due while gaining a competitive advantage in long-term development planning.<sup>55</sup>

Firms securitizing their assets will enjoy a diversification of the funding sources available to them, which, in turn, may lower their effective financing rate.<sup>56</sup> Whereas interest rates on traditional sources of capital may be prohibitively high, individual and institutional investors, previously reserved about investing in lower rated originators, now become viable sources of capital indicated by their willingness to invest in a pool of independently rated assets.<sup>57</sup> Securitization can reduce effective financing rates because capital markets rely on the quality of the underlying assets, rather than the creditworthiness of an originator, in pricing the rate of return for

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accounting-related advantages."); *see generally* Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1667 (2004).

50. *See infra* Subsection I.B.2.

51. Lupica, *supra* note 11, at 605.

52. Lahny, *supra* note 22, at 825-26; *see* Lupicia, *supra* note 11, at 609 (noting that asset sales, even at discounted rates, result in the originator receiving a lump sum cash payment).

53. Peterson, *supra* note 10, at 2220.

54. Lahny, *supra* note 22, at 825-26; *see* Peterson, *supra* note 10, at 2213 (noting that "securitization allows loan originators to make great profit from origination fees by leveraging limited access to capital into many loans").

55. Lupica, *supra* note 11, at 609-10.

56. *Id.* at 610.

57. *Id.*

the securitization of a firm's receivables.<sup>58</sup> Firms with unfavorable financing rates can securitize their assets, thus allowing rating agencies to apply their specific rating criteria<sup>59</sup> to the SPE's assets and not the originators' business.<sup>60</sup> Lower cost financing is thus obtained as high investment grade ratings are assigned to the securitized pool of assets and investors buy up the securities.<sup>61</sup>

Another benefit of securitization is that it can remove "event risks" typically associated with traditional lending practices.<sup>62</sup> Off-balance sheet financing occurs when the present rights to future receivables are converted into current assets and any increases in short or long term liabilities are avoided.<sup>63</sup> Thus, companies receive the benefit of selling off their "event risks" and simultaneously generating capital without negatively impacting their financial statements.<sup>64</sup>

## 2. Adverse Consequences of Securitization

A dark side accompanies securitization.<sup>65</sup> The increase in low cost financing opportunities available to mortgage originators opened up a window of opportunity for a new breed of mortgage lenders, predatory subprime originators, to enter the lending arena and to perfect their trade.<sup>66</sup> While the term 'predatory lending' defines "a variety of practices that may

58. *Id.* at 613.

59. *See* Lahny, *supra* note 22, at 826-27.

These criteria include: the creditworthiness of the transferred assets; the sufficiency of the separation of the assets from the insolvency of the originator; the sufficiency of the steps taken to prevent a voluntary bankruptcy filing of the SPV; the probability of default on the payments of the securities; the value of any credit enhancements; and the ultimate recovery of the assets pledged as collateral, including some assessment of the timing of recovery.

*Id.*

60. Lupica, *supra* note 11, at 613-14.

61. Lahny, *supra* note 22, at 882 ("By separating the assets, the SPV is able to achieve lower cost financing, for the benefit of its parent, by obtaining high investment grade ratings on the securities collateralized by the transferred assets.").

62. Lupica, *supra* note 11, at 611-13 (describing that typical event risks include "the possibility that the value of the collateral will decline, the potential for nonpayment or late payment of the underlying collateral, the prospect of the borrower becoming subject to unexpected (or expected) liability, . . . the uncertainty associated with a limited borrowing history, and the potential of borrower's bankruptcy").

63. Lahny, *supra* note 22, at 827.

64. *Id.* at 827-28.

65. Peterson, *supra* note 10, at 2188.

66. *Id.* at 2214 ("By the early 1990s private label securitization conduits became an entrenched and accepted method of home mortgage finance. It was also in this period that the country saw an explosion in a relatively new and aggressive form of 'subprime' mortgage lending.").

be disadvantageous to the borrower,”<sup>67</sup> the term in this Comment is to be used in the context of home-equity lending practices, which “target a particular population, take advantage of the borrower’s inexperience and lack of information, manipulate a borrower into a loan the borrower cannot afford to pay, or defraud the borrower or investor.”<sup>68</sup>

Due to the increasing number of predatory home-equity lenders entering the market, traditional forms of lending,<sup>69</sup> even in the sub-prime market, were quickly outpaced. Prime and sub-prime mortgage originators, using securitization, could overcome an inability to obtain low cost financing by creating remote SPEs and selling off their receivables, thus increasing the liquidity of their balance sheets while lowering their effective financing rates.<sup>70</sup> An understanding of the basic difference between prime and sub-prime mortgages is central to discussing the consequences of securitization.

There are several fundamental differences between the prime and sub-prime market.<sup>71</sup> Prime mortgages, typically mortgages that can be sold in secondary markets to Fannie Mae or Freddie Mac, “have strict automated underwriting standards, use widely accepted financial models, require standardized documentation, and pay similar prices for all the loans they purchase.”<sup>72</sup> To the contrary, sub-prime mortgages are generally made to borrowers with lower credit ratings and troubled credit histories. Lenders typically securitize subprime mortgages to “aggressive investors and businesses looking to maximize their profits by any possible means,”<sup>73</sup> which gives the

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67. Deborah Goldstein, *Understanding Predatory Lending: Moving Towards a Common Definition and Workable Solutions* (Sept. 1999), [http://www.jchs.harvard.edu/publications/finance/goldstein\\_w99-11.pdf](http://www.jchs.harvard.edu/publications/finance/goldstein_w99-11.pdf) (noting that other uses of the term “Predatory Lending” include payday loans and check cashing services).

68. *Id.* (“Often these tactics are directed at a particular population, most frequently the elderly and low-income minorities, that is viewed as more vulnerable to predatory practices.”).

69. Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 577 (2002) (quoting James B. Kelleher, *What’s Their Angle? Consumers must Be Careful When Borrowing from Subprime Lenders*, CHI. TRIB., June 16, 2000, at 1) (“Before the 1990s, most subprime loans were not securitized and instead ‘were sold as whole loans to individual investors’ looking for high investment returns and not frightened by substantial risk.”).

70. *Id.* at 546 (“Through the securitization process, companies with severe financial problems and abysmal credit ratings can still create bonds carrying investment grade ratings, the highest rating, by transferring valuable assets to an SPV that is effectively remote from the originator.”).

71. *See* Peterson, *supra* note 10, at 2214.

72. *Id.* (recognizing that these factors allow investors to view prime loans as commodities as opposed to individualized, long term assets, which require more oversight).

73. *Id.* at 2215.

lenders “much more leeway when it comes to setting rates and underwriting standards.”<sup>74</sup>

Given the quick assignment of loans and the minimal amounts of capital required to enter the business, widespread accusations of predatory lending surfaced.<sup>75</sup> Because subprime lenders, unlike prime lenders, usually securitize their loans,<sup>76</sup> small businesses became multi-million dollar companies with a newly acquired means to willfully profit from predatory lending.<sup>77</sup> In 1994, sub-prime originations totaled only \$34 billion; by 2002 that figure increased to \$213 billion.<sup>78</sup>

As securitization of sub-prime loans became a mainstream practice, several associated dangers surfaced as a result of rapid industry expansion and “incentives inherent to the current structure.”<sup>79</sup> Predatory sub-prime originators shifted their focus towards short-term profits by adjusting their lending practices and focusing on the number of loans originated rather than the quality of the loans originated.<sup>80</sup> “Unlike with traditional financing arrangements, where profits accrue over the life of a loan, lenders nowadays expect to garner the bulk of their profits up front, in the form of fees and net proceeds from the sale of the obligations.”<sup>81</sup> As mortgage originators increase their short term liquidity, they have cash at their disposal, which is subsequently used up at a faster rate than mortgage receivables would have been had they remained on the books.<sup>82</sup> The vicious cycle continues as

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74. *Id.* at 2214-15 (quoting Michael D. Larson, *It's Buyer Beware When You're Shopping for a Subprime Loan*, Bankrate.com, (Feb. 2, 2001), available at <http://www.bankrate.com/brm/news/mtg/20000420.asp> (last visited Oct. 19, 2008)) (“As a result, rates, fees, and program guidelines vary drastically depending on which broker or lender a consumer visits.’ In the rush to originate new loans, some lenders have even disregarded their *own* underwriting guidelines.”).

75. *Id.* at 2215.

76. *Id.* at 2214.

77. *Id.* at 2221 (“[R]egulators, consumer advocates, student groups, and faith-based investment companies have all alleged that secondary mortgage market participants are willfully profiting from predatory lending.”).

78. Debra Pogrud Stark, *Unmasking the Predatory Loan in Sheep's Clothing: A Legislative Proposal*, 21 HARV. BLACKLETTER L.J. 129, 133 (2005).

79. Michael J. Panzner, *Eau De Liquidity* (May 21, 2007), <http://www.financialsense.com/editorials/panzner/2007/0521.html>.

80. *Id.* (“Naturally, banks and other lenders focus on quantity rather than quality – that is, the volume of loans they can originate and the amount of money they can realize up front, rather than borrowers’ willingness and ability to repay the debt, long-term potential, or the broad banking relationship.”).

81. *Id.*

82. Critical to the idea that cash is used up at a faster rate than mortgage receivables is that the cash generated from the receivable only becomes available as timely payments on the mortgage obligations are made. Cash generated from traditional loans becomes available over a longer period of time, thus forcing originators to obtain alternative sources of capital at higher rates of interest and to focus on loan quality rather than quantity.

these originators then have the ability to fund even greater numbers of loans while focusing less on the quality of the originations.<sup>83</sup>

One final consequence of securitization is that in the event of a predatory subprime mortgage originator's insolvency, very little, if any, of the company's assets will be available to satisfy the debts owed to the unsecured creditors. Cash received from the securitization of the loans is quickly spent to fund an even greater quantity of loans, resulting in an undercapitalized business structure.<sup>84</sup> All the while, investors in the mortgage-backed securities pay little attention to what is inside the assets, so long as the securities have an AAA rating and the potential for a high rate of return. The end result is that those who participate in predatory lending practices profit handsomely in the short run, while the increase in originations "sow[s] the seeds for [our] current [financial] crisis."<sup>85</sup>

### C. Traditional Attacks on Securitized Transactions and How Companies Guard Against Substantive Consolidation

Central to the idea of securitization is that assets can be isolated from a bankrupt entity through a complex and precise series of legal and accounting transactions.<sup>86</sup> While this is an acceptable means of practice, some commentators believe that "bankruptcy remoteness . . . cannot be sustained on either the black letter or on the spirit of the Bankruptcy Code."<sup>87</sup> Other practitioners question whether these creatively structured SPEs "[will] with-

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83. Peterson, *supra* note 10, at 2220 ("Once a loan is sold, the originator can use the proceeds of the sale to find a new consumer for another loan, and so on.").

84. While the potential use (and arguably misuse) of funds is limitless, the most likely uses include: distributions to owners and staff in the form of returns on investment or bonuses, payment of salaries, capital asset acquisitions, business expansion, marketing campaigns and the satisfaction of other short term liabilities. The result is a thinly capitalized structure with no assets available when the market takes a turn for the worst.

85. Robert M. Jaworski, *The Perfect Storm: Legal Issues Surrounding the Subprime Mortgage Lending Crisis*, 2008 Emerging Issues 479, at 1, 2 (LEXIS 2008) ("During the boom, industry players (investment banks, lenders and brokers alike) profited handsomely from unprecedented origination activity, and, no doubt, expected those levels of profitability to continue.").

86. Zipes, *supra* note 7, at 1.

87. David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055, 1119 (1998) (noting that achieving bankruptcy remoteness "requires that secured creditors should contribute collateral in order to rehabilitate debtors").

stand judicial scrutiny.”<sup>88</sup> To date, SPEs and the issue of substantive consolidation have remained relatively untested in bankruptcy courts.<sup>89</sup>

### 1. *Traditional Attacks on Securitized Transactions*

While the primary goal of a securitized transaction is to create an entity that is bankruptcy remote, there are several ways in which the SPE can be exposed to bankruptcy risks.<sup>90</sup> These risks include the following: (1) the transfer of the right to a receivable is not treated as a “true sale” but rather as a pledge of collateral securing a long term loan,<sup>91</sup> (2) the assets of the SPE and an originator are “substantively consolidated” into one bankruptcy proceeding, or (3) the transfer is considered fraudulent or preferential subject to avoidance under a bankruptcy proceeding.<sup>92</sup> While each of these exposure risks is considered by companies as they pursue bankruptcy remoteness, the focus of this Comment remains on substantive consolidation.

### 2. *How Companies Guard Against Substantive Consolidation*

The two primary ways companies guard against substantive consolidation are by obtaining a “non-consolidation opinion” from corporate counsel and by drafting a series of “separateness covenants” used to detail factors that courts should consider when determining whether the bankruptcy remote company is far enough removed from its counterpart that it should be considered a separate entity for bankruptcy purposes. An exploration into each of these concepts follows.

#### a. Non-Consolidation Opinion

Critical to the separateness of the originator and the SPE, the rating agency Standard & Poor’s may require the submission of a non-

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88. Schuyler G. Carroll & Peter Macleod, *SPE Structure Survives Substantial Consolidation, but What Does It Mean for SPE Structures in General?*, 19 REAL EST. FIN. J., Mar. 22, 2004, at 1, available at [http://www.arentfox.com/pdf\\_notReady/icontent577.pdf](http://www.arentfox.com/pdf_notReady/icontent577.pdf) (“In practice, many have often questioned whether the artificially created SPE [will] withstand judicial scrutiny.”).

89. *Id.*

90. Zipes, *supra* note 7, at 1.

91. Plank, *supra* note 49, at 1684. Some scholars argue that “the substance of the [securitized] transaction [does] not match the form.” *Id.* at 1683. In making this argument, scholars claim that the securitized transaction purporting to make a “true sale” of the rights to the receivables “should be disregarded because, in their view, a securitization is only a disguised security interest.” *Id.* at 1684 (footnote omitted).

92. Zipes, *supra* note 7, at 6.

consolidation opinion from independent legal counsel.<sup>93</sup> The essence of the non-consolidation opinion seeks to provide assurance to the rating agency that in the event of an insolvency proceeding against the SPE or the originator, neither their entities nor their assets or liabilities will be consolidated into a single asset pool.<sup>94</sup> To gain the requisite level of assurance, the facts and circumstances of each of the entities' relationships must be evaluated.<sup>95</sup> If substantive consolidation of the entities were to occur, the bankruptcy court's automatic stay would go into effect, preventing investors from collecting on their securities, and allowing the combined assets to be used to pay off the bankrupt party's creditors.<sup>96</sup>

Standard & Poor's has published specific guidelines with respect to non-consolidation opinions that will be useful to entities seeking to securitize assets.<sup>97</sup> Because equity owners owning more than 49% of the SPE will pose the highest risk of consolidation to the SPE if they were to become insolvent, the ratings agency will request a non-consolidation opinion obtained from independent legal counsel.<sup>98</sup> Standard & Poor's recommends that any non-consolidation opinion should be within six months of the date on which the securities were rated.<sup>99</sup> The individualized requirements of each non-consolidation opinion will vary because a SPE can be created in any number of organizational forms.<sup>100</sup> Furthermore, customization of each non-consolidation opinion is required because certain "factual assumption[s] . . . must be supported by a covenant in the loan documents or the organization documents."<sup>101</sup>

Most legal opinions, including non-consolidation opinions, are well reasoned opinions supported by several assumptions but they are not fool-proof. In the case of *In re SONICblue, Inc.*, the debtor corporation, in an attempt to raise financing in a private placement, obtained an opinion letter from outside counsel assuring the enforceability of payments against the

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93. STANDARD & POOR'S, U.S. CMBS LEGAL AND STRUCTURED FIN. CRITERIA 10 (2003), [http://www.standardandpoors.com/spf/pdf/structuredincome/040103\\_cmbslegalcriteria14.pdf](http://www.standardandpoors.com/spf/pdf/structuredincome/040103_cmbslegalcriteria14.pdf) [hereinafter S&P LEGAL CRITERIA]. "Additionally, the opinion giver should state that he or she has reviewed every transaction document, the relevant organizational documents and any other document that he or she has deemed necessary in order for Standard & Poor's to gain comfort that the opinion giver has reviewed all relevant documents." *Id.* at 506

94. *Id.* at 505.

95. *Id.*

96. Borders, *supra* note 31, at 639.

97. S&P LEGAL CRITERIA, *supra* note 93, at 95.

98. *Id.* at 105.

99. *Id.* at 105-06 (explaining that the non-consolidation opinion, at the time of the rating of securities, should not be more than six months old).

100. *Id.* at 106; *see also supra* text accompanying note 33.

101. S&P LEGAL CRITERIA, *supra* note 93, 107.

Company for the benefit of certain senior bondholders.<sup>102</sup> In an ensuing Chapter 11 insolvency proceeding, counsel for the senior bondholders, after settling for an amount less than the full principal amount, sought indemnification from outside counsel responsible for drafting the opinion letter because “[i]n what may have been a scrivener’s error, the bankruptcy limitation in paragraph 9 referenced only paragraph 2 and not paragraph 3 of the opinion letter.”<sup>103</sup> Counsel asserted bondholder reliance on the opinion letter which had been “interpreted as assuring that their claims were allowable in a subsequent bankruptcy case.”<sup>104</sup> Ultimately the bankruptcy court disqualified the drafters of the opinion letter from representing the debtor corporation in the insolvency proceeding for failure to report a conflict of interest; however, this case is illustrative of the potential liabilities faced by drafters of legal opinions.<sup>105</sup>

#### b. Separateness Covenants

In an effort to increase the likelihood that the SPE will not be substantively consolidated into the originator’s bankruptcy, the SPE should agree to adhere to specific separateness covenants.<sup>106</sup> Standard & Poor’s<sup>107</sup> suggests compliance with several separateness covenants to minimize the risk of substantive consolidation with affiliated entities.<sup>108</sup> While all of the cove-

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102. *In re SONICblue Inc.*, 57 Collier Bankr. Cas. 2d (MB) 1488, 1491, 1496 (Bankr. N.D. Cal. Mar. 26, 2007) (noting that section three of the enforceability opinion letter reads: “The issuance and sale of the Debentures [was properly] authorized. Upon issuance and delivery against payment therefore in accordance with the terms of the Indenture and the Purchase Agreement, the Debentures will constitute valid and binding obligations of the Company, enforceable against the Company in accordance with their terms”).

103. *Id.* at 1491 (discussing that paragraph nine of the opinion letter notes that the opinion in paragraph two does not apply to “the effect of applicable bankruptcy, insolvency, reorganization, fraudulent conveyance, receivership, conservatorship, arrangement, moratorium or other laws affecting or relating to the rights of creditors generally”).

104. *Id.* at 1496.

105. *Id.* at 1500 (noting that outside counsels “failure to disclose this significant and disabling conflict in any reasonable fashion mandates immediate disqualification . . . from its representation in this case”).

106. S&P LEGAL CRITERIA, *supra* note 93, at 95 (“[I]n order to increase the likelihood that an SPE will be insulated from the liabilities and obligations of its affiliates and third parties, the SPE should agree to abide . . . by . . . separateness covenants with respect to the SPE . . .”).

107. STANDARD & POOR’S, PRODUCTS & SERVICES, <http://www.standardandpoors.com> (follow “Products & Services” hyperlink) (noting that Standard & Poor’s offers “credit ratings and credit risk analysis, with ratings on approximately US\$ 32 trillion of debt issued in 100+ countries,” and offers that include “insight into the credit risk of structured finance deals, providing an independent view of credit risk associated with a growing array of debt-securitized instruments”).

108. S&P LEGAL CRITERIA, *supra* note 93, at 95. Covenants include:

nants are applicable to mortgage originators and their SPEs, a review of the most likely situations where covenants may be violated is appropriate.

To effectuate its independent identity, the SPE will maintain books, records, and accounts separate from any other person or entity; will seek to maintain an arm's-length relationship with the mortgage originator(s); and may even appoint an independent director to oversee the SPE's operations.<sup>109</sup> Strict compliance with such corporate formalities will likely continue to receive respect from federal courts.<sup>110</sup> Problems may arise in situations where the SPE is a wholly owned subsidiary of the mortgage originator and the companies begin to relax sound professional practices. If the SPE fails to maintain adequate capital in light of its contemplated business operation; guarantees debts of another entity; guarantees debts of its partners, members, or shareholders; or pledges its assets for the benefit of any other entity, courts would be more likely to substantively consolidate the two entities.<sup>111</sup>

## II. BRIEF HISTORY OF THE EQUITABLE DOCTRINE OF SUBSTANTIVE CONSOLIDATION, TESTS ADOPTED BY FEDERAL CIRCUIT COURTS, AND FACTORS AIDING IN A COURT'S DECISION

"Substantive consolidation, a construct of federal common law, emanates from equity."<sup>112</sup> Absent any express statutory basis, substantive con-

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To maintain books and records separate from any other person or entity; To maintain its accounts separate from any other person or entity; Not to commingle assets with those of any other entity; To conduct its own business in its own name; To maintain separate financial statements; To pay its own liabilities out of its own funds; To observe all partnership formalities; To maintain an arm's-length relationship with its affiliates; To pay the salaries of its own employees and maintain a sufficient number of employees in light of its contemplated business operations; Not to guarantee or become obligated for the debts of any other entity or hold out its credit as being available to satisfy the obligations of others; Not to acquire obligations or securities of its partners, members, or shareholders; To allocate fairly and reasonably any overhead for shared office space; To use separate stationery, invoices, and checks; Not to pledge its assets for the benefit of any other entity or make any loans or advances to any entity; To hold itself out as a separate entity; To correct any known misunderstanding regarding its separate identity; and To maintain adequate capital in light of its contemplated business operations.

*Id.*

109. *Id.*

110. Plank, *supra* note 49, at 1683.

111. *See infra* Section III.A.

112. *In re Owens Corning*, 419 F.3d 195, 205 (3d Cir. 2005); *see Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 764 (9th Cir. 2000) ("At present, consistent with its historical roots, the power of substantive consolidation derives from the bankruptcy court's general equity powers as expressed in § 105 of the Bankruptcy Code.").

solidation is “a product of judicial gloss.”<sup>113</sup> The theory of substantive consolidation is derived “from the core of bankruptcy jurisprudence.”<sup>114</sup> While the Bankruptcy Act’s primary focus is to promote the “equality of distribution,”<sup>115</sup> the central goal of substantive consolidation is “to ensure the equitable treatment of all creditors.”<sup>116</sup> Because the Bankruptcy Code does not expressly provide for the substantive consolidation of different entities, courts, in exercising their equitable powers, must determine, on a case-by-case basis, whether appropriate circumstances are present to merit substantive consolidation.<sup>117</sup> Partial substantive consolidation and substantive consolidation of non-debtors with debtors are common deviations within the equitable realm of the judge.<sup>118</sup>

The practical effect of substantive consolidation merges, for purposes of the bankruptcy proceeding, independent legal entities into a single surviving entity by combining the assets and liabilities of each entity.<sup>119</sup> The claims of creditors against each debtor taken separately are merged into one set of claims against the consolidated survivor.<sup>120</sup> Because the foundational underpinnings for application of the doctrine are found in equity, each federal appellate circuit has adopted some variation of the tests utilized to date.<sup>121</sup> In applying the doctrine of substantive consolidation, courts are careful to point out that “[i]t is a power which should be used sparingly, for while the term has a disarmingly innocent sound, consolidation in bankruptcy is no mere instrument of procedural convenience, but a measure vitally affecting substantive rights.”<sup>122</sup>

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113. *In re Augie/Restivo*, 860 F.2d 515, 518 (2d Cir. 1998).

114. *In re Bonham*, 229 F.3d at 764.

115. *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941).

116. *In re Augie/Restivo*, 860 F.2d at 518; *see In re Murray Indus.*, 119 B.R. 820, 830 (Bankr. M.D. Fla. 1990); *see also Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.)*, 810 F.2d 270, 276 (D.C. Cir. 1987) (noting that substantive consolidation “almost invariably redistributes wealth among the creditors of the various entities”).

117. *Jones & Bendit*, *supra* note 6, at 3; *see infra* Section III.B.

118. *See, e.g., Patrick C. Sargent, Bankruptcy Remote Finance Subsidiaries: The Substantive Consolidation Issue*, 44 BUS. LAW. 1223, 1240 (1989) (“Substantive consolidation occurs not only when the parent and subsidiary are both insolvent, but also when a non-debtor solvent entity is consolidated with an affiliate, such as its parent or subsidiary corporation or sister corporation.”).

119. *In re Owens Corning*, 419 F.3d 195, 205 (3d Cir. 2005) (citing *In re Genesis Health Ventures, Inc.*, 402 F.3d 416, 423 (3d Cir. 2005)). The effect of substantive consolidation is that legal entities are treated “as if they were merged into a single survivor left with all the cumulative assets and liabilities.” *Id.*

120. *Id.* (“The result is that claims of creditors against separate debtors morph to claims against the consolidated survivor.”).

121. *See infra* Section II.A.

122. *In re Snider Bros.*, 18 B.R. 230, 234 (Bankr. D. Mass. 1982).

Where extraordinary circumstances exist, examination of the equities can require application of the doctrine of substantive consolidation.<sup>123</sup> As the Eleventh Circuit points out in *Eastgroup Properties v. South Motel Associates*, there is “a ‘modern’ or ‘liberal’ trend toward allowing substantive consolidation” as a result of “the increased judicial recognition of the widespread use of interrelated corporate structures by subsidiary corporations operating under a parent entity’s corporate umbrella for tax and business purposes.”<sup>124</sup> Defining the test for substantive consolidation varies throughout the federal circuits.

#### A. Substantive Consolidation Tests by Federal Appellate Circuit

The fundamental inquiry upon which a proposed substantive consolidation is evaluated is “whether ‘the economic prejudice of continued debtor separateness’ outweighs ‘the economic prejudice of consolidation.’”<sup>125</sup> As courts grapple with the application of this basic criterion, two similar tests have emerged.<sup>126</sup>

In *Auto-Train*, the D.C. Circuit described a burden-shifting test where the proponent of substantive consolidation “must show not only a substantial identity between the entities to be consolidated, but also that consolidation is necessary to avoid some harm or to realize some benefit.”<sup>127</sup> In meeting the burden, the proponent of consolidation should consider several factors, including those outlined in *Vecco Construction*.<sup>128</sup> Furthermore, additional factors<sup>129</sup> may be considered but “[n]o single factor is likely to be determinative in the court’s inquiry.”<sup>130</sup> Upon a showing of a prima facie case, the “creditor may object on the grounds that it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation.”<sup>131</sup> “If a creditor makes such a showing, the court may order consolidation only if it determines that the demonstrated benefits of consolidation ‘heavily’ outweigh the harm.”<sup>132</sup> Four years later, the Eleventh Circuit

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123. *In re United Stairs Corp.*, 176 B.R. 359, 369 (Bankr. D. N.J. 1995).

124. 935 F.2d 245, 248-49 (11th Cir. 1991) (citing *In re Murray Indus., Inc.*, 119 B.R. 820, 828-29 (Bankr. M.D. Fla. 1990); see *In re Vecco Constr. Indus., Inc.*, 4 B.R. 407 (Bankr. E.D. Va. 1980).

125. *Eastgroup Props. v. S. Motel Assoc., Ltd.*, 935 F.2d 245, 249 (11th Cir. 1991); see *In re Snider Bros.*, 18 B.R. at 234.

126. *In re Bonham*, 229 F.3d 750, 765 (9th Cir. 2000).

127. *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.)*, 810 F.2d 270, 276 (D.C. Cir. 1987).

128. *In re Vecco Constr. Indus.*, 4 B.R. at 410; see *infra* Section II.B.

129. See *infra* Section II.B.

130. *Eastgroup Props.*, 935 F.2d at 250.

131. *In re Auto-Train Corp.*, 810 F.2d at 276.

132. *Id.*

adopted the D.C. Circuit's test in *Eastgroup*.<sup>133</sup> One year later, the Eighth Circuit, in *In re Giller*, adopted a three factor variant of the *Auto-Train* test.<sup>134</sup>

After reviewing tests adopted by other circuits, the Second Circuit chose to reject the existing tests and to create its own test which was adopted in *Augie/Restivo*.<sup>135</sup> The court held that the pertinent considerations "are merely variants on two critical factors: (i) whether creditors dealt with the entities as single economic units and did not rely on their separate identity in extending credit, or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."<sup>136</sup> The Ninth Circuit adopted this test in *In re Bonham* noting that "[t]he presence of either factor is a sufficient basis to order substantive consolidation."<sup>137</sup> In applying the *Augie/Restivo* test, this Court provided additional insight into the rationale and application of the test.<sup>138</sup>

Given the fact-sensitive nature of the inquiry into whether substantive consolidation is warranted, the tests enumerated above attempt to synthesize the analysis based on relevant case law. In applying the available tests, judges are not constrained to a single test or single set of factors because they are free to use their jurisprudential guidance in deciding a case involving the balancing of the equities.<sup>139</sup>

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133. *Eastgroup*, 935 F.2d at 249 (noting that D.C. circuit has adopted the same standard adopted by this court).

134. See *In re Giller*, 962 F.2d 796, 799 (8th Cir. 1992) (finding that factors to consider when weighing consolidation include: "1) the necessity of consolidation due to the interrelationship among the debtors; 2) whether the benefits of consolidation outweigh the harm to creditors; and 3) prejudice resulting from not consolidating the debtors").

135. *In re Augie/Restivo*, 860 F.2d 515, 518 (2d Cir. 1998).

136. *Id.* (quoting 5 COLLIER ON BANKRUPTCY §§ 1100.06, 1100-33 (Lawrence P. King ed., 15th ed. 1988)).

137. *In re Bonham*, 229 F.3d 750, 766 (9th Cir. 2000).

138. *Id.* (quoting *In re Augie/Restivo*, 890 F.2d at 518-19) ("The first factor, reliance on the separate credit of the entity, is based on the consideration that lenders 'structure their loans according to their expectations regarding th[e] borrower and do not anticipate either having the assets of a more sound company available in the case of insolvency or having the creditors of a less sound debtor compete for the borrower's assets.' Consolidation under the second factor, entanglement of the debtor's affairs, is justified only where 'the time and expense necessary even to attempt to unscramble them [is] so substantial as to threaten the realization of any net assets for all the creditors' or where no accurate identification and allocation of assets is possible.")

139. *Jones & Bendit*, *supra* note 6, at 5 (noting that "enough fuzziness and uncertainty" exists to allow courts to select appropriate factors, tailored to meet the needs of the case at hand, and to apply "its own view of the jurisprudential guidance").

## B. Factors Available to Determine Whether Substantive Consolidation is Warranted

Several factors need to be evaluated when considering if the proponent of substantive consolidation has satisfied his burden. The *Vecco* court noted the following factors:

First, the degree of difficulty in segregating and ascertaining individual assets and liability. Second, the presence or absence of consolidated financial statements. Third, the profitability of consolidation at a single physical location. Fourth, the commingling of assets and business functions. Fifth, the unity of interests and ownership between the various corporate entities. Sixth, the existence of parent and inter-corporate guarantees on loans. Seventh, the transfer of assets without formal observance of corporate formalities.<sup>140</sup>

Scholars have previously termed the factors above as “separateness factors.”<sup>141</sup> In determining whether a subsidiary is an “instrumentality” of a parent corporation, the court in *Fish*, presents a list of ten factors which can be useful in evaluating a case for substantive consolidation.<sup>142</sup> These factors have been coined the “alter ego factors”:<sup>143</sup>

(1) The parent corporation owns all or majority of the capital stock of the subsidiary. (2) The parent and subsidiary corporations have common directors or officers. (3) The parent corporation finances the subsidiary. (4) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation. (5) The subsidiary has grossly inadequate capital. (6) The parent corporation pays the salaries or expenses or losses of the subsidiary. (7) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation. (8) In the papers of the parent corporation, and in the statements of its officers, “the subsidiary” is referred to as such or as a department or division. (9) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation. (10) The formal legal requirements of the subsidiary as a separate and independent corporation are not observed.<sup>144</sup>

With what appears to be a limitless number of factors, no single factor or combination of factors is determinative on its own.<sup>145</sup> The Third Circuit case of *Nesbit*, in declining to endorse any preset listing of factors, “adopt[ed] an intentionally open-ended, equitable inquiry . . . to determine when substantively to consolidate two [or more] entities.”<sup>146</sup> In clarifying

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140. *In re Vecco Constr. Indus.*, 4 B.R. at 410.

141. *Jones & Bendit*, *supra* note 6, at 3.

142. *Fish v. East*, 114 F.2d 177, 191 (10th Cir. 1940) (noting that in determining whether a subsidiary should be classified as an instrumentality is “primarily a question of fact and degree”).

143. *Jones & Bendit*, *supra* note 6, at 3.

144. *Fish*, 114 F.2d at 191.

145. *Eastgroup Props. v. S. Motel Assoc., Ltd.*, 935 F.2d 245, 250 (11th Cir. 1991).

146. *Nesbit v. Gears Unlimited, Inc.*, 347 F.3d 72, 87 (3d Cir. 2003).

the holding, the court distinguished between financial entanglement and operational entanglement<sup>147</sup> while concluding that “the line between operational and financial may be blurred.”<sup>148</sup> The Third Circuit, in *In re Owens Corning*, points out that the primary flaw in following a factor checklist can be that it fails to separate out the extraneous material from that which is relevant.<sup>149</sup>

In summary, the factor checklists can be a useful tool for courts analyzing whether or not to consolidate two or more entities, but courts are not required to use any checklist.<sup>150</sup> Furthermore, “to ensure the equitable treatment of all creditors”<sup>151</sup> the only inquiry which must be met is that upon balancing the harms, consolidation of the entities outweighs the potential harms suffered by the non-movants.<sup>152</sup>

### C. Analysis of Relevant Substantive Consolidation Case Law

While the Bankruptcy Code and public policy do not support substantive consolidation of a solvent finance subsidiary solely to benefit creditors of a debtor parent or other affiliate, the presence of compelling circumstances such as fraud will merit invoking the doctrine of substantive consolidation.<sup>153</sup> “One of the clearest, but sometimes most difficult to prove, justifications for applying substantive consolidation is when the subsidiary or affiliate has been formed for the purpose of delaying, hindering, or defrauding creditors.”<sup>154</sup> A careful review of cases applying the doctrine of

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147. *Id.* (“While in the bankruptcy context the inquiry focuses primarily on financial entanglement, . . . the focus more often rests on the degree of operational entanglement—whether operations of the companies are so united that nominal employees of one company are treated interchangeably with those of another.”).

148. *Id.* at 88.

149. *In re Owens Corning*, 419 F.3d 195, 210 (3d Cir. 2005).

150. *See Lahny, supra* note 22, at 879.

151. *In re Augie/Restivo*, 860 F.2d 515, 518 (2d Cir. 1998); *see Lahny, supra* note 22, at 883 (“[C]ompliance with all of the *Vecco Construction* factors can potentially have no bearing on the Bankruptcy Judge’s decision to substantively consolidate the originator and SPV in a modern securitization transaction.”).

152. *In re Auto-Train Corp.*, 810 F.2d 270, 276 (D.C. Cir. 1987) (finding that a court must “conduct a searching inquiry to ensure that consolidation yields benefits offsetting the harm it inflicts on objecting parties”); *see In re United Stairs Corp.*, 176 B.R. 359, 369 (Bankr. D. N.J. 1995) (“[T]his court adopts the ultimate test of balancing the equities. In doing so, the court must weigh the economic prejudice of continued debtor separateness against the economic prejudice of substantive consolidation.”); *see also In re Snider Bros.*, 18 B.R. 230, 234 (Bankr. D. Mass. 1982) (“While several courts have recently attempted to delineate what might be called ‘the elements of consolidation,’ (citation omitted) I find that the only real criterion is that which I have referred to, namely the economic prejudice of continued debtor separateness versus the economic prejudice of consolidation.”).

153. *In re United Stairs Corp.*, 176 B.R. at 369.

154. *Sargent, supra* note 118, at 1227.

substantive consolidation suggests that the doctrine should be extended when extraordinary circumstances exist and the examination of the equities requires extension.<sup>155</sup> In fact, courts have previously ruled in favor of consolidating a non-debtor into the bankruptcy proceeding of a debtor.<sup>156</sup>

In *Sampsell*, the debtor acquired substantial debts while engaged in an unincorporated business and later transferred all the assets of his business to a newly formed corporation with the help of the respondent creditor, prior to filing for personal bankruptcy protection.<sup>157</sup> The Supreme Court held that substantive consolidation of a non-debtor corporation with the individual's bankrupt estate was proper where the transfer of property was in bad faith, was made for the purpose of placing it beyond the reach of the original debtor's creditors, and where the effect of the transfers was to hinder delay or defraud the individual's creditors.<sup>158</sup> The bankruptcy court's decision to consolidate the entities under these circumstances is consistent with the theme of the Bankruptcy Act, equality of distribution.<sup>159</sup>

In *In re United Stairs Corp.*, the defendant debtor defaulted on mortgages held by plaintiff bank and filed a Chapter 7 bankruptcy petition.<sup>160</sup> Prior to filing the bankruptcy petition, the defendant incorporated separate entities and fraudulently transferred its corporate assets to other family members in control of these entities.<sup>161</sup> The court ordered substantive consolidation of the defendant's estate with the alter ego estates.<sup>162</sup> In this case, the plaintiff bank was able to demonstrate a common scheme to defraud creditors through the fraudulent conveyance of property.<sup>163</sup> Similar to *Sampsell*, the transfers of property were not in good faith but were made for the purpose of placing the company's assets beyond the reach of their creditors.<sup>164</sup>

*In re LTV Steel Co.*, is perhaps the most intriguing decision to date which questions the legal foundations of securitization.<sup>165</sup> In this case, the debtor, LTV Steel and forty-eight of its subsidiaries, filed chapter 11 petitions under the Bankruptcy Code.<sup>166</sup> Two non-debtor subsidiaries, LTV Sales Finance Co. and LTV Steel Products, purportedly purchased the rights

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155. *In re United Stairs Corp.*, 176 B.R. at 369.

156. *Id.* (finding that, under the circumstances, the balancing of equities test favors consolidation of the non-debtor into the debtor's bankruptcy).

157. *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 215-17 (1941).

158. *In re United Stairs Corp.*, 176 B.R. at 368 (citing *Sampsell*, 313 U.S. at 218-19).

159. *Sampsell*, 313 U.S. at 219.

160. *In re United Stairs Corp.*, 176 B.R. at 363.

161. *Id.*

162. *Id.* at 369.

163. *Id.* at 370-71.

164. *See supra* text accompanying note 158.

165. *In re LTV Steel Co.*, 274 B.R. 278 (Bankr. N.D. Ohio 2001).

166. *Id.* at 280.

to the accounts receivables and the title and interest in the inventory, respectively, of the parent corporation.<sup>167</sup> The securitization of the receivables and inventory came into question when the debtor sought to challenge the validity of the securitizations by filing a motion seeking an interim order permitting it to use the cash collateral owned by the subsidiaries.<sup>168</sup> The debtor argued, under fears that it would be forced to cease operations if it did not receive authorization to use the cash collateral, that the apparent “true sales” were in reality “disguised financing vehicles.”<sup>169</sup> After the court granted the interim order, scholars began questioning whether the legal foundations of securitization were in jeopardy.<sup>170</sup>

Ultimately, upon a full hearing, the court determined that the interim order granting the use of the subsidiaries cash collateral was void.<sup>171</sup> In determining that the court maintained jurisdiction over the receivables sold to the SPE by the parent, the court determined that the “Debtor has at least some equitable interest in the [securitized] inventory and receivables, and that this interest is property of the Debtor’s estate.”<sup>172</sup> Although scholars criticize the court’s analysis in *LTV Steel* as being “a conclusory declaration devoid of analysis,”<sup>173</sup> the case illustrates the power of a judge sitting in equity and suggests that if the facts and circumstances of a particular case merit avoidance of a securitized transaction, it may just be ordered.

### III. WHY BANKRUPTCY COURTS SHOULD SUBSTANTIVELY CONSOLIDATE PREDATORY SUB-PRIME MORTGAGE ORIGINATORS AND THEIR SPECIAL PURPOSE ENTITIES

There are many benefits to securitization including the fact that “[s]ecuritization has a lower cost *precisely due to bankruptcy remote-*

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167. *Id.*

168. *Id.*

169. *Id.* at 280-81.

170. Plank, *supra* note 49, at 1686-99.

171. *In re LTV Steel Co.*, 274 B.R. at 285.

172. *Id.*

Furthermore, there seems to be an element of sophistry to suggest that Debtor does not retain at least an *equitable* interest in the property that is subject to the interim order. Debtor’s business requires it to purchase, melt, mold and cast various metal products. To suggest that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept. Accordingly, the Court concludes that Debtor has at least some equitable interest in the inventory and receivables, and that this interest is property of the Debtor’s estate. This equitable interest is sufficient to support the entry of the interim cash collateral order.

*Id.*

173. Plank, *supra* note 49, at 1691.

ness.”<sup>174</sup> Securitization draws additional investments from capital markets and reinvests the funds by making home mortgage loans available to scores of additional people while furthering corporate growth and entrepreneurship.<sup>175</sup> However, because of securitization,<sup>176</sup> the economy has experienced an explosion of new and aggressive sub-prime mortgage lenders<sup>177</sup> whose growth has been aided by the opening of markets previously underserved by prime lenders.<sup>178</sup> This new breed of lender was given an opportunity to generate tremendous profit by using “Wall Street capital to transform relatively small businesses into multi-million dollar institutions with a tremendous impact on the lives of entire communities.”<sup>179</sup> As one author criticizing securitization remarks, securitization “is financial alchemy, through which subprime mortgage loans are transformed into AAA-rated paper for unsuspecting investors.”<sup>180</sup> While not discounting the many benefits of securitization, predatory sub-prime mortgage originators, using securitization as a vehicle for perfecting their trade, have also had a negative impact on the entire economy. To address the adverse consequences stemming from the rapid expansion of securitization, bankruptcy courts sitting in equity are not without a remedy to prevent certain market participants from willfully profiting from their predatory lending practices.<sup>181</sup> “Equity will not suffer a wrong to be without a remedy.”<sup>182</sup>

A bankruptcy court is wholly within its powers to order substantive consolidation when the ultimate test of balancing the equities, balancing the economic prejudice of continued debtor separateness versus the economic prejudice of substantive consolidation, weighs in favor of consolidation.<sup>183</sup> In evaluating whether substantive consolidation is appropriate for certain

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174. Steven L. Schwarcz, *Securitization Post-Enron*, 25 *CARDOZO L. REV.* 1539, 1573-74 (2004) (emphasis added); see *supra* Subsection II.B.1.

175. Rodrigue Tremblay, *Financial Bankruptcy, the US Dollar and the Real Economy* (Aug. 24, 2007), [http://onlinejournal.com/artman/publish/article\\_2341.shtml](http://onlinejournal.com/artman/publish/article_2341.shtml) (“Residential mortgage-backed security (RMBS) are created when mortgage lenders sell their loans (and the risks associated with such loans) to banks, which package them together and slice them into different classes before selling them to (gullible) investors.”).

176. See *supra* Subsection I.B.2.

177. Peterson, *supra* note 10, at 2214.

178. *Id.* at 2213 (noting that sub-prime mortgage lenders were given “the ability to penetrate into markets not served well by prime lenders”).

179. *Id.* at 2221.

180. Tremblay, *supra* note 175, at 1.

181. Peterson, *supra* note 10, at 2221 (“[S]econdary mortgage market participants are willfully profiting from predatory lending.”).

182. RE & RE, *supra* note 27, at 34 (noting a list of equitable maxims including: “[1] ubi jus ibi remedium—where there is a right, there is a remedy, and [2] lex semper dabit remedium—the law always gives a remedy”).

183. See *In re Owens Corning*, 419 F.3d 195, 199 (3d Cir. 2005); *In re United Stairs Corp.*, 176 B.R. 359, 369 (Bankr. D. N.J. 1995); see also *supra* Part II.

predatory sub-prime mortgage originators, the analysis is fact sensitive<sup>184</sup> and should be granted only under appropriate circumstances.<sup>185</sup> Furthermore, by limiting the application of the doctrine of substantive consolidation to a narrowly tailored set of circumstances, the bankruptcy court's primary goal, to ensure fairness to all parties involved in the bankruptcy proceeding, is promoted.<sup>186</sup> When a predatory sub-prime mortgage originator and its affiliated SPE share enough of an "identity of interest," the analysis requires a detailed evaluation of the facts and circumstances in each particular case and the application of the balancing the equities test. The remedy of substantive consolidation is appropriate in cases where predatory sub-prime mortgage lenders engage in the origination of illegal predatory loans and where investors in the SPEs knew or should have know that they were aiding in the origination and securitization of illegal loans.

A. Courts sitting in equity are justified in considering substantive consolidation of a predatory sub-prime mortgage originator and its affiliated SPE when the requisite "identity of interest" is present

At the core of a securitized transaction, by its very structure, is an "identity of interest" between the originator and the SPE.<sup>187</sup> When an originator establishes a wholly owned SPE that solely deals with its affiliated originator, the viewpoint is strengthened.<sup>188</sup> As noted by one scholar, loan originators and their specially created SPEs share the following traits:

1. The SP[E] is created and incorporated by the originator, specifically to complete the financing transaction; . . .
3. The SP[E] will have no creditors other than those necessary to the financing;
4. The SP[E] will only engage in business necessary to complete the financing transaction;
5. The SP[E] will not incur any debt unrelated to the transaction;
6. Very often, the originator will continue to act as collection agent for the incoming stream of payments on the assets transferred to the SP[E]; and
7. The SP[E] will typically be liquidated when the transaction is complete.<sup>189</sup>

In considering the factors above, a case can be made for consolidation of the two entities because the SPE, which may be a "mere instrumentality" of

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184. Jones & Bendit, *supra* note 6, at 5.

185. See *supra* text accompanying note 153.

186. See *In re Augie/Restivo*, 860 F.2d 515, 518 (2d Cir. 1998) ("The sole purpose of substantive consolidation is to ensure the equitable treatment of all creditors.").

187. Lahny, *supra* note 22, at 879.

188. Plank, *supra* note 49, at 1684.

189. Lahny, *supra* note 22, at 879-80.

the originator, is not a separate business in pursuit of separate objectives.<sup>190</sup> In fact, the SPE can transact no business at all outside of the limited scope assigned to it by its creators as evidenced by the separateness covenants.<sup>191</sup>

While securitized transactions draft separateness covenants<sup>192</sup> to protect the SPE and to promote bankruptcy remoteness,<sup>193</sup> advocates of securitization frequently view substantive consolidation as a risk that can be eliminated by compliance with these formalities.<sup>194</sup> Even if a company is found to have complied with all of its separateness covenants, it “amounts to straightening the deck chairs on a sinking ship, for nowhere is it written that the only justification for invoking substantive consolidation is failure to comply with such formal requirements.”<sup>195</sup> Rating agencies such as Standard & Poor’s<sup>196</sup> require legal opinions assuring the investors that in the event of the mortgage originator’s insolvency, the originator and the SPE will not be substantively consolidated and that all sales of mortgages to the SPE are true sales.<sup>197</sup> Thus, the focus of the legal opinion letters and separateness covenants is on compliance with formalities, but “one wonders how likely it is that an SPE actually will be found to have complied with them if and when its Originator files for bankruptcy.”<sup>198</sup> Certainly, a court of equity is justified in substantively consolidating a predatory sub-prime lender and its related SPE if separateness covenants are not strictly followed.

To prevent an injustice to the creditors, the “identity of interest” is a factor a bankruptcy judge can take into consideration when balancing the equities and, if the circumstances are right, to support substantive consolidation.<sup>199</sup> One possible way around the perception of a single economic unit would be for the SPE to service multiple originators, thus limiting the effect of the “mere instrumentality” label. This argument fails, however, if the judge sitting in equity determines that, regardless of the number of originators it transacts business with, because the of the SPE’s severely limited scope, it is merely in the business of serving the prescribed needs of its mas-

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190. *Id.* at 880.

191. *See supra* Subsection I.C.2.b.

192. *See supra* Section III.B.

193. *See supra* Section I.C.

194. Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 *CARDOZO L. REV.* 1553, 1628 (2008); *see, e.g.*, Schwarcz, *supra* note 174, at 1543 n.22 (“[S]ubstantive consolidation is a risk that can be controlled in securitization transactions by maintaining appropriate formalities . . . between the transferor and transferee.”).

195. Kettering, *supra* note 194, at 1629.

196. *See supra* Subsection I.C.2.

197. *Id.*

198. Kettering, *supra* note 194, at 1628 (“In public securitization transactions, at least, it is not clear that any independent monitoring of the SPE’s compliance with its separateness covenants typically occurs.”).

199. *See supra* Section II.B.

ters. Given the fact sensitive nature of the inquiry, bankruptcy courts are justified in substantively consolidating entities when the requisite “identity of interest” is present and a balancing of the hardship supports consolidation.<sup>200</sup> By ordering consolidation, courts sitting in equity “assure the sensible functioning of the bankruptcy system” and provide a remedy where injustice begs for action.<sup>201</sup>

- B. Assuming that the requisite “identity of interest” is present, upon a balancing of the equities, the court should order substantive consolidation when it determines that the sub-prime mortgage lender has engaged in the origination of illegal predatory loans and investors in the affiliated SPE knew or should have known that they were aiding in the origination and securitization of illegal predatory loans

The American mortgage lending market has grown in complexity because of the number of parties involved in any given transaction.<sup>202</sup> Given the number of parties involved in contemporary lending practices, the question becomes who should be held accountable for the lending practices of certain predatory mortgage originators? While there is no “one-size fits all” solution, a tailored solution, holding the investors with knowledge of the predatory originations accountable for driving the demand for predatory originations in the first place, will ensure that originators’ creditors are made whole while promoting a remedy that benefits society as a whole. Consolidation under these circumstances will not only serve as a deterrent for those savvy mortgage originators who profit greatly from predatory lending, with the knowledge that they can simply file for bankruptcy in one origination outfit and create a new outfit not yet encumbered by hounding creditors,<sup>203</sup> but it will also put investors on notice that if they choose to invest in mortgage backed securities collateralized with loans obtained in a predatory fashion, their investments will be reduced proportionately.

As case law suggests, under appropriate circumstances, courts will order consolidation of affiliated entities. In *Sampsell* and *In re United Stairs* the courts validated substantive consolidation as a remedy for fraudulent transfers.<sup>204</sup> The debtors created the corporations which were “nothing but a sham and a cloak” employed “for the purpose of hindering, delaying and defrauding . . . [their] creditors.”<sup>205</sup> Similar to a traditional securitized transaction, the SPE can be viewed as nothing more than a scheme to remove

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200. See *supra* Section II.A.

201. Kettering, *supra* note 194, at 1629.

202. See *supra* Section I.A.

203. Peterson, *supra* note 10, at 2189.

204. See *supra* Section II.C.

205. *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 217 (1941).

assets from the books “for the purpose of hindering, delaying and defrauding . . . creditors.”<sup>206</sup> Although the *Sampsell* and *United Stairs Corp.* cases illustrate fraudulent transfers made in bad faith,<sup>207</sup> most securitization transactions are made in purported good faith and are transparent in both form and substance.<sup>208</sup> Given this fact, a court sitting in equity would not be foreclosed from substantively consolidating an SPE into an originator’s bankruptcy if the original loan origination or the originator’s motivation behind the securitization transaction was made under fraudulent pretenses.<sup>209</sup> While an insolvent mortgage originator that has properly structured its securitization transaction to conform to industry norms has not perpetrated the type of direct fraud found in the cases above, there remains an inherent inequity relating to the transfer made by the mortgage originator to the SPE which may justify consolidation under certain circumstances.<sup>210</sup>

In a situation where the court determines that a predatory sub-prime mortgage originator and its SPE share a common “identity of interest,”<sup>211</sup> all that remains is for equity to step in and to determine that the securitized assets should be included in the originator’s bankruptcy estate. Just as the court noted in *LTV Steel*, that the debtor had some equitable interest in the receivables and inventory sold off to affiliated subsidiaries, predatory sub-prime mortgage originators involved in the origination and assignment of illegal loans share similar equitable interests with their SPEs.<sup>212</sup> Although the court in *LTV Steel* did not disturb the fundamental underpinnings of securitization, the facts simply were not present to merit consolidation.<sup>213</sup> However, predatory lenders that share a similar “identity of interest” with their SPEs have demonstrated through their patterns of practice, misrepresentation and violation of state and federal laws that the situation is different. Upon a balancing of the equities, innocent creditors should not be harmed at the expense of originators and investors engaged in a common scheme to willfully profit from predatory lending.<sup>214</sup>

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206. *Id.*

207. *See supra* Section II.C.

208. Plank, *supra* note 49, at 1685.

209. Kettering, *supra* note 194, at 1629 (“The bankruptcy-gaming asset transfer from the Originator to the SPE in the prototypical securitization can quite readily be characterized as a fraudulent transfer . . .”).

210. *See supra* Section II.C.

211. *See supra* Section III.A.

212. *In re LTV Steel Co.*, 274 B.R. 278, 285 (Bankr. N.D. Ohio 2001) (“To suggest that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept. Accordingly, the Court concludes that Debtor has at least some equitable interest . . .”); *see supra* Section II.C.

213. *See supra* Section II.C.

214. Peterson, *supra* note 10, at 2221.

As evidenced by the recent collapse of the sub-prime lending market, predatory sub-prime mortgage originators have perpetuated a pattern of sharp dealings and misrepresentations in violation of regulations imposed by state and federal law. Although a thorough discussion of the laws and regulations violated by predatory lenders is outside the scope of this article, a court sitting in equity is not rendered powerless for “equity will not suffer a wrong to be without a remedy.”<sup>215</sup> As discussed earlier, the only inquiry that must be met is that upon balancing the harms, consolidation of the entities outweighs the potential harms to be suffered by the non-movants.<sup>216</sup> From the beginning, the SPE was created for the sole purpose of serving only the interests of the originator while making high rates of return available to eager investors.<sup>217</sup> Surely the SPE’s investors would not suffer a harm greater than the one unsecured creditors would suffer when trying to collect debts from an insolvent entity where illegal loans, originated in a predatory fashion, were quickly assigned away in an effort to remove assets from the books.<sup>218</sup> The net effect of a consolidation would benefit the creditors of the bankrupt mortgage originator, in that the benefits derived from the balancing of the equities outweighs the harm suffered by the investors who knowingly invested in pools of illegal loans in the first place.<sup>219</sup>

Substantive consolidation penalizes “secondary mortgage market participants [who] are *willfully* profiting from predatory lending”<sup>220</sup> and rightfully holds predatory sub-prime mortgage originators and investors who derived financial gain with the knowledge that they were aiding in the securitization of illegal (predatory) loans accountable. Equity begs that these parties be held responsible; thus, consolidating two entities when fraud or illegality is present holds persons accountable “to the end that fraud will not prevail, that substance will not give way to form, [and] that technical considerations will not prevent substantial justice from being done.”<sup>221</sup> In due time, the proper case and controversy will arise justifying a court’s decision to substantively consolidate a predatory sub-prime mortgage originator and

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215. See *supra* text accompanying note 27.

216. See *supra* Section II.B; see *supra* note 152 and accompanying text.

217. See Kettering, *supra* note 194, at 1630 (“One of the standard elements of ‘bankruptcy remoteness’ that an SPE is obligated to follow in securitization transactions . . . is that the SPE is not to engage in any business or activity other than those associated with the securitization transaction.”).

218. *Id.* (“It is therefore likely that the only significant creditors of the SPE are the financiers that hold the securitized debt, and the Originator itself. Neither of those have reason to complain about substantive consolidation of the SPE and the Originator.”).

219. *Id.* at 1630 (“The financiers will not have their recovery diluted by substantive consolidation, because the financiers are secured by the securitized assets and will continue to have the benefit of their security after substantive consolidation.”).

220. Peterson, *supra* note 10, at 2221 (emphasis added).

221. *Pepper v. Litton*, 308 U.S. 295, 305 (1989).

its affiliated SPE. In the words of Justice Benjamin Cardozo, “[l]et the hardship be strong enough, and equity will find a way.”<sup>222</sup>

#### CONCLUSION

The recent sub-prime mortgage market collapse has had widespread implications on the domestic and global economies. While predatory sub-prime mortgage lenders enjoyed years of excess profits at the expense of the uneducated, misinformed, and weak, this Comment identifies but one judicial remedy available to help cure the tailspin occurring in the marketplace. The question becomes who should be held accountable for predatory lending practices that have adversely affected millions of consumers. Substantive consolidation appropriately places the financial and moral burden on investors and the mortgage lenders who were involved with the origination and securitization of illegal loans while serving as a deterrent to future lending abuses. Substantive consolidation sends a clear message to market participants considering predatory lending practices that their loans lack a secondary trading market and reinforces the notion that predatory mortgage companies will not get off the hook by filing for bankruptcy protection. Applying the equitable doctrine of substantive consolidation to predatory sub-prime mortgage originators and their SPEs, protects consumers and prevents future mortgage market fallout before widespread market losses are realized.

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222. *Graf v. Hope Bldg. Corp.*, 171 N.E. 884, 888 (N.Y. 1930).