SHADOW BANKING, SHADOW BAILOUTS

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ABSTRACT

Between mid-2008 and late 2009, over $350 billion in credit card securitization programs were bailed out by their sponsors. Despite the massive scale of these shadow bailouts, this episode has received no scholarly attention. Through a careful analysis of fourteen programs' governing documents and regulatory filings—representing almost $450 billion in assets—I piece together the story of twelve programs that experienced substantial financial difficulty during this period, eight of which engaged in some type of shadow bailout.

These bailouts contain four lessons for the way we understand the legal institution of securitization. First, they undermine the prominent "regulatory arbitrage" theory of securitization. Second, they provide evidence that securitization programs such as these were primarily valuable because they were used to create safe assets. Third, these bailouts demonstrate that sponsors had much more discretion in the management of these securitization programs than was previously thought. Finally, far from lacking "skin in the game," these bailouts demonstrate that sponsors stood ready to defend their securitization programs, even in the face of severe stress.

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TABLE OF CONTENTS

I. INTRODUCTION

The financial crisis hit Main Street with a vengeance in 2008. As the great recession wore on, even people who tried to stay current on their credit card bills began to fall behind. Delinquencies and charge-offs rose to alarming levels.

While some of these credit card receivables remained on the balance sheets of the lending banks, an enormous amount of this debt—half a trillion dollars' worth—was repackaged and sold to investors through securitization programs. As it happened, the largest players in this market were also some of the largest banks in the United States, including Bank of America, JPMorgan Chase, and Citigroup (using interchangeably "Citigroup" and "Citi").

With less and less money coming into these programs, the risk that they would fail to meet their obligations to investors started to mount. The investors in these programs had purchased notes, and if the money coming into the programs fell below the level required to pay the noteholders what they were owed, the programs would fail. As losses continued to mount, this started to become a real possibility. In what seemed like a blink of an eye, these credit card securitization programs, long considered virtually riskless, found themselves threatened with downgrades by the credit rating agencies.

And then, almost miraculously, the crisis passed. The ratings agencies affirmed their earlier ratings, the noteholder received their payments on time, and the programs continued to issue new notes to investors.

But it didn't pass on its own. Very quietly, the sponsors and their affiliates had intervened and bailed out their respective programs. The ways in which they did so ranged from plain vanilla—mechanisms that were clearly contemplated at the time that the programs were structured—through the less conventional—approaches that conformed with the letter, if perhaps not the intention, of the governing documents—all the way to maneuvers that had no discernable basis in the governing documents and that the sponsors made no effort to justify. While eight of the fourteen programs for which public documents are available engaged in some kind of bailout, no two were executed in the same way. Most, but not all, employed a mixture of strategies.

Despite the enormous sums at issue—programs with a combined total of $350 billion in credit card receivables were bailed out by their sponsors—this episode has been almost entirely overlooked. Unlike other episodes in the financial crisis, like the run on repo,[1] the crisis in asset-backed commercial paper conduits,[2] and the run in the money market,[3] with the exception of a few contemporaneous articles in the financial press, nothing has been written about these bailouts. They occurred so far in the shadows that even a post-crisis article arguing that credit card securitization programs *have* implicit recourse to their sponsors' balance sheets—written by an eminent scholar in the field—makes no mention of these shadow bailouts.[4]

By diving deeply into the governing documents and public disclosures of fourteen public credit card securitization programs, I unearth the details of these bailouts. While the pieces are almost incomprehensibly arcane on their own, together they tell the story of a series of shadow bailouts that has never been told before.

This story contains four critical lessons about the legal institution of securitization, all of which have important implications for financial regulation. First, it shows that the "regulatory arbitrage" theory is flawed and should not be interpreted as a but-for cause of securitization. Simply put, the fact that Bank of America, JPMorgan Chase, and Citigroup were all willing to bailout their programs even though they *knew* that doing so would force them to bring these programs back on balance sheet, is completely inconsistent with the claim that securitization represents nothing more than "regulatory arbitrage" by banks.

Second, the fact that the sponsors did not seek to advertise this support to noteholders, or prospective noteholders, suggests that securitization programs such as these were primarily valuable because they allowed sponsors to create safe assets. This explanation goes far beyond a simple "funding and liquidity cost" story.[5]

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[1] Gary Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo*, 104 J. FIN. ECON. 425 (2012).

[2] Viral V. Acharya, Philipp Schnabl, & Gustavo Suarez, *Securitization without Risk Transfer*, 107 J. FIN. ECON. 515 (2013).

[3] Marcin Kacperczyk & Philipp Schnabl, *How Safe are Money Market Funds?* 128 Q. J. ECON. 1073 (2013).

[4] Adam J. Levitin, *Skin-in-the-Game: Risk Retention Lessons from Credit Card Securitization*, 81 GEO. WASH. L. REV. 813, 847-50 (2013).

[5] *Id.* at 827–28.

Third, contrary to the prevailing understanding of securitization, in which the programs operate as autonomous "robot companies," this episode demonstrates that, at least in a time of stress, sponsors had a significant amount of discretion with respect to the operation of these programs. Specifically, the fact that under certain conditions, the terms of the programs could be—and often were—amended without the consent of the noteholders but *with the approval* of the rating agencies, suggests that while securitization was intended to limit the ability of management to act against the interest of noteholders, it nevertheless allows managers some discretion to *change* the terms of these programs. As an added layer of protection, these changes were permitted only with the consent of a disinterested intermediary, here, a rating agency.

Finally, this episode shows that program sponsors were willing to use this discretion to bail out these programs, even at a time when the sponsors themselves were in trouble, demonstrating unequivocally that they did have "skin in the game." More importantly, it shows that this legal structure, designed to create safe assets and limit agency costs while preserving enough flexibility to rescue the programs if the need arose, works. Securitization, in other words, is not the problem. It is a legal construct that works remarkably well and has been instrumental in expanding access to credit across the economic spectrum.

The remainder of this article proceeds as follows. In Part II, I present and explain the dominant theories of securitization. In Part III, I describe both the general landscape of credit card securitization leading up to the financial crisis and the specific programs that I analyzed. In Part IV, I describe what happened when the crisis hit these programs and outline exactly how the bailouts took place. In Part V, I analyze these bailouts and argue that while they are inconsistent with regulatory arbitrage, they are completely consistent with safe asset creation, and show that securitizations were able to reduce agency costs while maintaining flexibility to act in a crisis. I discuss policy implications in Part VI. Part VII concludes.

II. WHY DOES SECURITIZATION EXIST?

At its core, securitization is a legal process that moves income-producing assets from a large pool into a smaller pool. Rather than selling claims against the large pool, this allows the securitizer to sell claims against the small pool.

While the concept can be explained in two sentences, the legal process itself is extremely complex. In order to ensure bankruptcy remoteness,[6] there are generally at least a couple of layers of direct or indirect subsidiaries of the sponsor between the sponsor and the entity created to issue the notes to the investors. In addition to these entities, a securitization program requires the services of several outside parties, such as a trustee, an indenture trustee, or a securities intermediary. The rights and obligations of each of these parties is laid out in a series of governing documents, which can be thousands of pages long. Indeed, it is not unusual for the prospectus of a securitization program to be almost 200 pages long and to name a half dozen different entities.[7] The governing documents for a single program, when printed using standard office paper, can easily form a stack over six inches high.[8]

If securitization seems like an awfully complicated legal construct, that's because it is. So, why bother with it? Despite the fact that it has been around for 35 years, there remains an active debate in the academic literature about the purpose of securitization. It is well accepted that sponsors use securitization because it's profitable for them to do so. The reason for this is that it reduces their funding costs; it is cheaper for a sponsor to securitize assets and sell notes to investors than it is to hold onto the assets and sell debt.

The crucial question is why does securitization reduce funding costs? Some scholars argue that securitization is primarily a means of avoiding costly capital regulations—so-called "regulatory arbitrage." Others argue that it represents the production of a safe asset, which can be

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[6] *See* discussion *infra* Part III.B.

[7] *See, e.g.*, Citibank Credit Card Issuance Tr., Prospectus Supplement (May 14, 2008); Citibank Credit Card Issuance Tr., Prospectus (Apr. 15, 2008) (covering a combined total of 184 pages, and identifying five different entities); Chase Issuance Tr., Prospectus (May 29, 2009) (covering 190 pages, and identifying six different entities); Bank of America Credit Card Tr., Prospectus Supplement (July 2008); Bank of America Credit Card Tr., Prospectus (July 28 2008) (covering a combined total of 237 pages and identifying seven different entities).

[8] Author's measurements.

used like money. Still others view it as a way of apportioning risk more efficiently. Finally, some scholars argue that securitization represents a mechanism for reducing agency or other costs. While not all of these explanations are mutually exclusive, some of them are more complementary than others.

A. Regulatory Arbitrage

One of the leading explanations of securitization is the regulatory arbitrage story. This explanation is particularly popular in legal circles and also has support among regulators and some economists. Under this view, securitization represents a way for lenders to avoid regulatory capital requirements.

Unlike other companies, which are free to choose the mix of debt and equity in their capital structures as they like (subject to market pressures), banks are required to have a minimum amount of equity in their capital structure.[9] These requirements are collectively known as capital requirements and are intended to act as a cushion, protecting banks from failure in the event of unexpected losses. For example, a bank with a 5% capital requirement and $100 in loans on its balance sheet is required to have $5 in equity.

There is a widely held belief in both the academic and banking communities that bank capital is costly.[10] Because of this, they argue, banks have an incentive to reduce the size of their balance sheets, as this, in turn, reduces the amount of capital that they need to hold. Returning to our example, suppose that the bank can securitize $50 of the loans on its balance sheet. Its 5% capital requirement is now applied to the $50 worth of loans retained on its balance sheet, meaning that it needs to hold only $2.50 in equity.

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[9] *See Capital Standards for Banks: The Evolving Basel Accord*, 89 FED. RES. BULL. 395, 397 (Sept. 1, 2003) (providing an introduction to *Basel II* and minimum capital requirements).

[10] *See, e.g.*, Malcolm Baker & Jeffrey Wurgler, *Do Strict Capital Requirements Raise the Cost of Capital? Bank Regulation, Capital Structure, and the Low-Risk Anomaly*, 105 AM. ECON. REV. 315, 315 (2015); Douglas J. Elliott, *Higher Bank Capital Requirements Would Come at a Price*, BROOKINGS (Feb. 20, 2013), http://www.brookings.edu/research/papers/2013/02/20-bank-capital-requirements-elliott. This is not entirely uncontroversial. Others argue, based on the Modignlani Miller irrelevance theorem, that bank capital is actually not costly. *See* ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES, 109–11 (2013).

The proponents of the regulatory arbitrage explanation argue that this reduction in regulatory capital is the reason why banks find securitization to be a cheap source of funding. In other words, they argue that securitization is a cheaper source of funding for lenders because it allows them to get around the regulations that were intended to ensure the safety of the banking system. Therefore, while securitization may reduce the funding costs of the lenders, it does not represent a net gain to society, since they are doing so at the expense of the safety and stability of the entire system.

While prominent scholars have disputed this argument,[11] it remains popular. For example, the Financial Crisis Inquiry Report attributed much of the boom in securitization to regulatory arbitrage.[12] While its primary focus is on mortgage-backed securities, the Report noted that "the assets were not just mortgages but equipment leases, credit card debt, auto loans, and manufactured housing loans."[13] The Report then argued that the primary benefit to commercial banks from doing so was that it allowed them to move loans off their books, which "reduced the amount of capital they were required to hold as protection against losses, thereby improving their earnings."[14]

Similarly, in a post-crisis article, Adam Levitin described credit card securitization as "primarily a funding, liquidity, and regulatory capital arbitrage mechanism for card issuers."[15] Levitin points out that prior to 2010, securitization allowed credit card issuers to move receivables off of their balance sheets, and as a result, they "were able to reduce their regulatory capital requirements, which enabled issuers to effectively increase their leverage and thus their return on equity."[16]

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[11] *See, e.g.,* Charles W. Calomiris & Joseph R. Mason, *Credit Card Securitization and Regulatory Arbitrage*, 26 J. FIN. SERV. RES. 5, 8 (2004); Bank for Int'l Settlements, Basel Committee on Banking Supervision, *Report on asset securitization incentives* (July 2011), http://www.bis.org/publ/joint26.pdf ("Although it is popular to point to regulatory capital arbitrage as a main securitization driver, it has garnered little empirical support (although some papers have detected it).").

[12] *The Financial Crisis Inquiry Report*, THE FIN. CRISIS INQUIRY COMM'N, 1, 38–45 (January 2011), https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[13] *Id.* at 42.

[14] *Id.* at 43.

[15] Levitin, *supra* note 4, at 827.

[16] *Id.* at 828. While Levitin also notes that a 2010 change in accounting standards eliminated this "arbitrage" opportunity, he does not go on to discuss why sponsors have continued to engage in credit card securitization.

Another voice in this chorus is that of Erik Gerding, who has argued that securitization is "a valuable tool in gaming regulations,"[17] and that it "helped facilitate regulatory capital arbitrage."[18] He noted that some scholars, including himself, "attribute a significant portion of the increase in securitization … to banks engaging in regulatory capital arbitrage,"[19] and "fault this use of securitization for undermining regulatory capital rules, masking the leverage and systemic risk of important financial institutions, and thus contributing significantly to the severity of the crisis."[20]

Some financial economists also subscribe to the view that regulatory arbitrage is the primary driver of securitization. For example, Acharya et al. have argued that, prior to the financial crisis, a major motive for the use of asset backed commercial paper conduits was regulatory arbitrage.[21] These conduits, which had $1.3 trillion dollars outstanding,[22] were different from credit card securitizations in several respects. Nevertheless, there is little reason to believe that the motivation itself would not carry over to the credit card context.

B. Creation of Safe Assets

A more subtle explanation is that securitization is valuable because it produces a valuable product: safe debt, which functions as money. Under this view, securitization represents a cheaper funding source not only because it allows the securitization sponsor to avoid certain costs. Rather, the outputs of securitization—the asset-backed notes—actually have their own intrinsic value. These notes are different in kind from the underlying assets. Rather than acting as standard financial assets, these notes become a sort of private money.[23]

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[17] ERIK F. GERDING, LAW, BUBBLES, AND FINANCIAL REGULATION 256 (2014).

[18] Erik F. Gerding, *Bank Regulation and Securitization: How the Law Improved Transmission Lines Between Real Estate and Banking Crisis,* 50 GA. L. REV. 89, 107 (2015).

[19] *Id.*

[20] *Id.* at 107–8.

[21] *See* Acharya et al., *supra* note 2.

[22] *Id.*

[23] For an illuminating discussion of how this private money can contribute to instability in the financial system, *see* Kathryn Judge, *Information Gaps and Shadow Banking*, 103 Va. L. Rev. 411, 461 (2017).

As Dang, Gorton, and Holmström have shown, the best thing to use for such private money is debt backed by debt,[24] which is precisely what you get from a securitization program. Because of this structure, these notes become "information-insensitive," by which Dang, Gorton, and Holmström mean that there is almost no point in investing time, money, or effort to learn about the underlying value of the notes.[25]

This information-insensitivity is quite valuable, because it allows the notes to be treated like money. Because of this, buyers are prepared to pay a premium for them. Just like money, the resulting notes are valuable because it is extremely convenient to have a store of value that can be used quickly and efficiently for transactions. Buyers are willing to pay a premium for this convenience, and the amount of this premium is called the convenience yield.[26]

C. Apportionment of Risk

Another alternative explanation for the popularity of securitization is that it allows entities to more efficiently share risks, thereby reducing the risk premium associated with the asset. Because a substantial portion of any funding cost is a risk premium,[27] anything that serves to reduce this premium—including more efficient risk sharing—will reduce funding costs.

Under this view, each investor can choose which risks to bear. By more efficiently allocating the risks among parties, the total risk premium paid will fall, diminishing the overall funding cost. The most common version of this argument is that securitization allows investors to better

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[24] Tri Vi Dang, Gary Gorton & Bengt Holmström, Financial Crises and the Optimality of Debt for Liquidity Provision 2 (May 10, 2010) (unpublished manuscript) (on file with The Becker Friedman Institute for Economics at The University of Chicago).

[25] *Id.* at 2–5.

[26] *See* John H. Cochrane, *Stocks as Money: Convenience Yield and the Tech-Stock Bubble*, *in* ASSET PRICE BUBBLES: THE IMPLICATIONS FOR MONETARY, REGULATORY, AND INTERNATIONAL POLICIES 175, 175 (William C. Hunter, George G Kauffman & Michael Pomerleano eds., 2003) (describing the concept of a convenience yield).

[27] The standard formulation of the return on any asset is that it represents the time value of money plus a risk premium. *See, e.g.*, JOHN H. COCHRANE, ASSET PRICING 14 (2005) ("[A]ll assets have an expected return equal to the risk-free rate, plus a risk adjustment[.]" The first component roughly corresponds to the return on US government debt. The second component represents the additional compensation that market participants demand to bear any additional risk associated with the asset in question.).

diversify risks. Acharya *et al.* claim that this was the traditional goal of securitization,[28] and that it remains "the common understanding of securitization."[29] While Acharya *et al.* ultimately argue that modern securitization no longer represents such a transfer, others continue to argue that securitization allows for more efficient risk sharing.[30]

In order for this diversification argument to hold, at least two things must be true. First, the transfer of risk must not be illusory. In other words, when assets are transferred into the securitization program, the risk of losses on those assets must be transferred with them. If the sponsor bails out the program whenever it runs into trouble, it is difficult to call it a *bona fide* risk transfer, regardless of whether or not the sponsor is legally required to do so.

Second, the diversification accomplished by securitizing must be something that investors cannot achieve on their own, for example, by investing in many different banks. The reason for this is that while an individual bank may have a concentrated exposure to credit card receivables, both shareholders and bondholders of that bank can diversify this risk by buying shares in many other companies. Alternatively, a single bank could simply become larger, so that each position represents a relatively small portion of the bank's total assets. The first part of this can be thought of as "external diversification," while the second as a form of "internal diversification." Unless there is a reason why both external and internal diversification are limited, there would be no diversification benefit to securitizing.

D. Agency and Other Costs

A final explanation for how securitization reduces funding costs is that it helps to reduce agency and other costs. Standard corporate finance theory holds that a substantial portion of the risk associated with owning a security is that the manager may use his or her discretion to act against

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[28] Acharya et al., *supra* note 2, at 515 ("Securitization was traditionally meant to transfer risks from the banking sector to outside investors and thereby disperse financial risk across the economy.").

[29] *Id.* at 516.

[30] *See* Mathias Hoffman & Thomas Nitschka, *Securitization of Mortgage Debt, Asset Prices and International Risk Sharing* (CESifo, Working Paper No. 2527, 2009).

the interest of the security holders.[31] The costs associated with this discretion are referred to as "agency costs." As Armour, Hansmann, and Kraakman have argued, much of corporate law has evolved to try to mitigate these agency costs.[32]

Under this view, securitization helps to alleviate these agency costs by radically restricting managerial discretion. By placing the receivables in a program that is governed by strict rules, the payoffs that the investors in the securitization program receive are effectively divorced from any managerial decisions.[33] For this reason, some scholars refer to securitization programs as "robot companies" that "simply follow a set of prespecified rules."[34]

Another set of costs that securitization might be able to avoid is bankruptcy costs.[35] Securitization programs are typically structured so that they are effectively bankruptcy proof.[36] Not only are they bankruptcy remote from the perspective of the sponsor, the notes themselves are structured so that in the event that the program cannot meet its obligation to the noteholders, the program simply goes into early amortization, rather than into a legal default. There is a large body of literature on bankruptcy costs.[37] And while there is no single widely accepted figure representing

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[31] *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306 (1976) (positing an agency cost theory of the firm).

[32] Henry Hansmann & Renier Kraakman, *What is Corporate Law*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 1–4 (Renier Kraakman, John Armour, Henry Hansmann et al., eds., 2nd ed. 2009); Henry Hansmann & Renier Kraakman,, *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 37–38 (Renier Kraakman, John Armour, Henry Hansmann et al., eds., 2nd ed. 2009).

[33] *See, e.g.,* Edward M. Iacobucci & Ralph A. Winter, *Asset Securitization and Asymmetric Information*, 34 J. LEGAL STUD. 161 (2005) (analyzing securitization under an asymmetric information framework).

[34] Gary Gorton & Andrew Metrick, *Securitization*, at 11 (NBER, Working Paper No. 18611, 2012).

[35] *See, e.g.*, Gary Gorton & Nicholas S. Souleles, *Special Purpose Vehicles and Securitization*, *in* THE RISKS OF FINANCIAL INSTITUTIONS 549, 549 (Mark Carey & René M. Stulz eds., 2007).

[36] *See* Gorton & Metrick, *supra* note 34, at 6.

[37] *See, e.g.*, Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067 (1984); James S. Ang, Jess H. Chua & John J. McConnell, *The Administrative Costs of Corporate Bankruptcy: A Note*, 37 J. FIN. 219 (1982); Michael J. Barclay & Clifford W. Smith, Jr., *The Capital Structure Puzzle: Another Look at the Evidence*, 12 J. APPLIED CORP. FIN. 8 (1999); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L. J. 1043 (1992); Arturo Bris, Ivo Welch & Ning Zhu, *The*

the exact magnitude of bankruptcy costs, there is little doubt that it is costly.

E. Is Securitization Socially Valuable or Destructive?

These four theories might seem somewhat dry. After all, each of them boils down to reasons why it is cheaper for banks to finance loans using securitization than using on-balance sheet financing. But while the differences may be subtle, they have radically different implications about the social value of securitization.

Under the regulatory arbitrage view, the primary reason why securitization is cheaper is that it allows banks to avoid prudential regulations. While this avoidance may be in the private interest of the banks and their shareholders, to the extent that prudential regulations are a public good, it is not in the interest of society as a whole. Under the regulatory arbitrage view then, this cost savings is coming at the expense of the rest of society—banks are simply transferring (or externalizing) risks. Not only is this simply a transfer of value from the rest of society to bank shareholders, but it is also probably an inefficient one. The cost—as borne by society as a whole—associated with avoiding these prudential regulations in all likelihood exceeds the cost savings enjoyed by bank shareholders.

In contrast, under the safe asset theory, securitization generates a net social gain—it makes society *better off*—because it results in the creation of a valuable and scarce commodity. It is not a transfer at all, but rather the production of something new. Securitization is cheaper not because it allows banks to reduce costs, but because it creates value, and investors are willing to pay a premium for this value. The lower funding costs, in other words, come from the fact that securitization sponsors are actually selling a product as well as raising funds.

The apportionment of risk view is a milder version of a similar phenomenon. Like the safe asset theory, the apportionment of risk explanation also implies that securitization results in a net social gain. In this case, it does so not by creating a new and valuable product, but by making risk sharing more efficient, thus reducing the cost of funding.

Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization, 61 J. FIN. 1253 (2006); Daryl M. Guffey & William T. Moore, *Direct Bankruptcy Costs: Evidence from the Trucking Industry*, 26 FIN. REV. 223 (1991); Jerold B. Warner, *Bankruptcy Costs: Some Evidence*, 32 J. FIN. 337 (1977).

Unlike the regulatory arbitrage view, here the cost being reduced is a *bona fide* reduction in costs, rather than simply an inefficient transfer.

The agency-and-other-cost view is a bit more ambiguous. In many ways it is like the apportionment of risk view. Agency costs are socially inefficient, so a mechanism that results in lower agency costs will make society better off. Things are less clear when it comes to bankruptcy costs. While there is a wide consensus that bankruptcy is costly, are these costs closer to the costs associated with regulatory capital—a side effect of a socially optimal legal structure, or are they more like agency costs—a problem that legal structures have been developed to mitigate? The answer it probably "a bit of both." As a result, it is probably fair to view the avoidance of this particular cost with some skepticism. While it may benefit the banks to avoid these costs, it is not necessarily socially valuable.

III. CREDIT CARD SECURITIZATIONS LEADING UP TO THE CRISIS

Securitization has taken a reputational hit since the financial crisis. Despite this, it is important to remember that securitization evolved to fill a need in the economy. By lowering the cost of borrowing, securitization allowed consumers to access credit at more affordable rates. While some have argued that this credit glut in the mortgage market caused damage to the housing market, few, if any have argued that interest rates on credit cards are too *low*.[38]

A. The Programs

The story of the bailouts begins with the fourteen public credit card securitization programs that, combined, represented almost half a trillion dollars in outstanding receivables. My goal was to investigate every U.S. credit card securitization program with securities outstanding during the period from mid-2008 to the end of 2009 for which the governing documents and marketing materials were available. Because there is no central database of such programs, my search relied on a variety of

[38] *See, e.g.*, Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004) (evaluating credit card pricing and interest rates).

different resources, including data from Bloomberg, Federal Reserve Call Reports, and documents released by rating agencies.[39]

After this thorough search, I identified fourteen securitization programs. In total, the average amount of principal receivables across these programs during the period from June 2008 to December 2009 was just under $425 billion.

I then classified each of these fourteen programs by sponsor type and program size. Table 1 summarizes where each program falls along these dimensions. For the purpose of this discussion and for the remainder of this article, I consider any program sponsored by a subsidiary or affiliate to belong to that subsidiary or affiliate's ultimate parent. I refer to the ultimate parent of the sponsor as the "ultimate sponsor." For example, suppose that Bank A has a subsidiary named Bank B, and Bank B has a subsidiary named Bank C. If Bank C is the sponsor of a securitization program Z, I treat program Z as belonging to Bank A, and Bank A is therefore the ultimate sponsor of the program. For simplicity, I also refer to the ultimate sponsor as the sponsor, unless the particular entity is important or it would cause confusion to do so. In other words, I refer to Bank A as program Z's sponsor, unless it is important to highlight Bank C's role.

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[39] Because I did not have access to a complete listing of credit card securitization programs, I used a variety of methods to create my own master list of programs. I began by searching on Bloomberg. Bloomberg's "Mortgages" category contains asset-backed securities more broadly. Within that category, I searched in the description field for the word "card." This search returned 131 securities, many of which were duplicates. I then investigated each one of these candidates to determine (i) whether they were outstanding during the period of interest, (ii) whether they were U.S. programs, and (iii) whether the governing documents for the program were publicly available. I prioritized those programs that were sponsored by a commercial bank or other financial institution, or an affiliate thereof, rather than retail programs. In order to ensure that I had not missed any programs run by large commercial banks, I supplemented this list using data from quarterly Report of Condition and Income filings (known as "Call Reports"), obtained from the Wharton Research Data Service ("WRDS"). These reports contain accounting (i.e. balance sheet and income statement), prudential (i.e. risk-based capital), and off-balance sheet data. Using the call reports for both commercial banks and bank holding companies, I created a list of all entities with non-zero entries during 2008 and 2009 for certain variables relating to credit card securitization. These variables include "outstanding principal balance of assets sold and securitized with recourse or other seller-provided credit enhancements - credit card receivables," "retained interest-only strips - credit card receivables," and "credit card receivables (abs)." This left me with 117 commercial banks and bank holding companies. I then investigated each of these one by one to determine whether they were actually running a credit card securitization program. Finally, I confirmed my findings by reading reports from two large rating agencies, Moody's and Fitch. After all this, I was left with fourteen programs.

Table 1: Institution Type / Program Size

Institution Type \ Program Size	Large Financial Institution	Credit Card Bank	Medium Sized Bank
Large (over $70 billion)	Bank of America Chase Citi		
Medium (between $10 billion and $70 billion)	GE Capital	Capital One Discover Amex – Lending	
Small (less than $10 billion)	HSBC – Master HSBC – Private Label	Advanta Amex – Charge World Financial Network	National City First National

This table summarizes the fourteen programs along two dimensions: sponsoring institution type and program size. "Large Financial Institutions" are banks that appeared on the initial list of G-SIFI's, or were designated as SIFIs by the FSOC. "Credit card banks" are banks that are primarily focused on providing credit cards and credit card services. "Medium size banks" are banks that are smaller than the large financial institutions but engage in a wide range of commercial banking activities. Program size is measured by the value of principal receivables between June 2008 to December 2009.

I identify three categories of sponsors: large financial institutions, credit card banks, and medium size banks. Large financial institutions are defined as banks that appeared on the initial list of global systemically important financial institutions ("G-SIFI's"),[40] as well as GE Capital, which was designated a non-bank systemically important financial institution by the Financial Stability Oversight Council on July 8, 2013.[41] According to the Financial Stability Board, SIFIs are "financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity."[42]

The second category, credit card banks, encompasses sponsors which, while legally banks, are primarily focused on providing credit cards and credit card services. Medium size banks are banks that are smaller than the large financial institutions but engage in a wide range of commercial banking activities.

Six of the fourteen programs were sponsored by large financial institutions, including two separate HSBC programs. In addition to GE Capital, Bank of America, JPMorgan Chase, and Citigroup round out the list of large financial institution ultimate sponsors. Because JPMorgan Chase had acquired Washington Mutual during this period, I often refer to the JPMorgan Chase program as simply the "Chase" program.

I also classify these programs according to their size. For each program, I calculate the average size of each program, measured by the monthly value of the principal receivables in the pool of assets[43] from June 2008 to December 2009. The programs divide quite naturally into three size classes. The three largest programs, run by Bank of America,

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[40] *Policy Measures to Address Systemically Important Financial Institutions*, FIN. STABILITY BD., at 4 n.1 (Nov. 4, 2011), http://www.fsb.org/wp-content/uploads/Policy-Measures-to-Address-Systemically-Important-Financial-Institutions.pdf.

[41] *Basis of the Financial Stability Oversight Council's Final Determination Regarding General Electric Capital Corporation, Inc.,* FIN. STABILITY OVERSIGHT COUNCIL (July 8, 2013), http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20General%20Electric%20Capital%20Corporation,%20Inc.pdf. This designation was subsequently rescinded by the Financial Stability Oversight Council on June 28, 2016. *Basis for the Financial Stability Oversight Council's Rescission of Its Determination Regarding GE Capital Global Holdings, LLC*, FIN. STABILITY OVERSIGHT COUNCIL (June 28, 2016), https://www.treasury.gov/initiatives/fsoc/designations/Documents/GE%20Capital%20Public%20Rescission%20Basis.pdf.

[42] FIN. STABILITY BD., *supra* note 40, at 1.

[43] *See* discussion *infra* Part IV.A.i.

JPMorgan Chase, and Citi, each contained over $70 billion in principal receivables over the entire period. Together, these three programs represented an average of over $250 billion in principal receivables, or approximately sixty percent of total over the fourteen programs. The medium sized programs were substantially smaller, with average sizes ranging between just over $18 billion to just over $46 billion. These programs were run by Capital One, Discover, American Express, and GE Capital, in descending order of size. The remaining programs were substantially smaller again. The largest of these was a second program run by American Express, with an average principal receivables size of $7.1 billion. The smallest was National City's program, with an average of under $2.15 billion in principal receivables.

B. A Primer on Credit Card Securitization Programs

Securitization made its debut in the early 1970s,[44] but its breakout performance didn't occur until the late 1990s. With the onset of the global financial crisis in 2007, it went from being a niche area of securities law to being central to the conversation about systemic risk.[45] In a nutshell, securitization is the process of placing a pool of income-generating assets into a segregated entity and selling claims against that entity (i.e., securities) to outside investors. The most common type of assets are debt claims, including mortgages, auto loans, and credit card loans.

In order for a securitization program to be effective, the structure must be "bankruptcy remote," in the sense that any financial distress of the sponsor does not affect the rights of the investors in the securitization program.[46] Therefore, a necessary feature of any securitization program is that the underlying assets (in a credit card program, the credit card receivables) be transferred in a "true sale" so that, in the event of sponsor bankruptcy, the assets will not be deemed property of the estate.

So much for the general structure of securitization. There are a few aspects of credit card programs that are unique. For the sake of brevity, I

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[44] Steven L. Schwarcz, *Structured Finance: The New Way to Securitize Assets*, 11 CARDOZO L. REV. 607, 608 (1990).

[45] *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, *supra* note 12, at 38.

[46] Some scholars have argued that bankruptcy remoteness is one of the most critical aspects of securitization. *See, e.g.*, Gorton & Souleles, *supra* note 35, at 549 ("We argue that SPVs exist in large part to reduce bankruptcy costs, and we find evidence consistent with this view.").

will focus on those aspects most necessary for understanding the shadow bailouts to come.[47]

i. Program Structures

While no two programs are identical, the structures fall into one of three categories: "double trust" structures, "common law trust only" structures, and "statutory trust only" structures. The double trust structure is by far the most common, employed by eight of the fourteen programs.[48] The common law trust only and statutory trust only structures were somewhat less popular and employed by four and two of the programs, respectively.

In a double trust structure, the sponsoring bank, either directly or through a subsidiary, designates a pool of credit card receivables to be included in the securitization program. Pursuant to a Pooling and Servicing Agreement (PSA), the sponsor places these credit card receivables in a common law trust, called a Master Trust, typically governed by Delaware or New York law. The Master Trust then issues investor certificates. One such investment certificate (in some cases the only investment certificate) is called the Collateral Certificate, which represents an undivided interest in the Master Trust. This Collateral Certificate is owned by a Delaware statutory trust known as the Issuance Trust, and represents the primary asset of the Issuance Trust. A Delaware statutory trust is a business organization formed pursuant to Title 12, Chapter 38 of the Delaware Code,[49] and is governed by a Trust Agreement.

As its name suggests, the Issuance Trust is the entity that ultimately issues notes to investors. It generally issues multiple series of notes, which may be divided into classes, and in some cases, further subdivided into tranches. These notes are sold to the investors in the securitization programs, known as the Noteholders. The issuance of all notes is governed by an Indenture, and each separate issuance is also governed by a specific indenture supplement, term sheet, and/or other such document. Any portion of the Master Trust not allocated to the Collateral Certificate is

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[47] For a more detailed discussion of credit card securitizations, *see* Levitin, *supra* note 4.

[48] *See* discussion *infra* Part IV.B.i.3. While I include Chase among the eight programs, Chase's program was really a hybrid of the Double Trust and Statutory Trust Only structure. Moreover, as discussed below, Chase seems to have been transitioning away from the former and toward the latter structure.

[49] 38 DEL. CODE ANN. tit. 12, §§ 3801–26 (West 2018).

typically paid out to the Sponsor, as are any funds remaining in the Issuance Trust after all other obligations are satisfied.

The second structure is the statutory trust only structure. As the name suggests, these programs eschew the common law Master Trust step, and receivables are placed directly into the Issuance Trust. Two programs employed this structure, and a third—Chase—seems to have been transitioning toward this structure during the 2008-2009 period.[50] Finally, there is the common law trust only structure, which employs a single common law trust. In the four programs that chose this structure, the notes were issued directly from the Master Trust. For expositional clarity, Table 2 categorizes the fourteen programs under study by their structure.

ii. Reverse Maturity Transformation

Unlike mortgage backed securities, for example, credit card securitizations are structured as revolvers. The reason for this is simple: unlike many other kinds of loans (whether they be a mortgage, a student loan, or an auto loan), credit card debt has no fixed term.[51] On the other hand, the notes that come out the other end of a securitization program *do* have fixed terms, generally of a few years. The sponsor is therefore in a somewhat unusual position. A traditional bank operates by converting short term liabilities (deposits) into long term assets (loans), resulting in what is known as a "maturity mismatch."[52] Here, the sponsor's goal is to convert short term assets (the receivables) into long term liabilities (notes), flipping the traditional maturity mismatch on its head.

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[50] *See infra* Table 2.

[51] Revolving debt is debt that can be borrowed, repaid, and borrowed at any time. LATHAM & WATKINS LLP, THE BOOK OF JARGON: US CORPORATE AND BANK FINANCE 107 (2nd ed. 2014). In contrast, a term loan is a loan that the borrower must repay according to a predetermined schedule. *Id.* at 126. *See also* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 624 (11th ed. 2014).

[52] *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Deposit Insurance, the Implicit Regulatory Contract, and the Mismatch in the Term Structure of Banks' Assets and Liabilities*, 12 YALE J. ON REG. 1, 3 (1995) (describing the "maturity mismatch" as one of the two characteristics that distinguish banks from other firms). *See also* Frank H. Easterbrook, *Regulation and Responsibility, a Note on Banking*, 77 CORNELL L. REV. 1079, 1081 (1992) (referring to the combination of short-term liabilities and long-term assets as a "maturity mismatch").

Table 2: Program Structures

Double Trust	Statutory Trust Only	Common Law Trust Only
Bank of America	Amex – Charge	HSBC – Master Note Trust
Citi	GE Capital	HSBC – Private Label
Chase*	Chase*	Amex – Lending
National City		Advanta
First National		
Capital One		
Discover		
World Financial Network		

*During this period, Chase was transitioning toward a statutory trust only structure.

This table summarizes the fourteen programs by program structure. Double trust structures have both a master trust (generally a common law trust) and an issuance trust (generally a Delaware statutory trust). The underlying receivables are transferred to the master trust, which then issues one or more certificates to the issuance trust. The issuance trust then sells the notes to investors. Both statutory trust only structures and common law trust only structures use only a single statutory trust, which both holds the receivables and sells the notes to investors.

The sponsors handle this using a revolver structure. The cash flows that come into the program—called collections—are bifurcated,[53] one part is placed in an "interest funding account" and made available to make interest payments to noteholders, while the other part is placed in a "principal funding account." If the amount deposited into the principal funding account reaches a predetermined level in a given month, any remaining principal collections are made available to cover either shortfalls in the interest funding account or accumulated past shortfalls in the principal funding account. While interest payments are made each month, the principal amount of the notes is typically paid off in a single payment.

iii. Flow of Funds to Investors

As part of this revolver structure, credit card securitizations typically draw an important distinction between principal receivables and finance charge receivables. In a conventional loan, the principal refers to the amount of money borrowed. For example, when an individual borrows $100 from a bank, that $100 is the principal. In the same way, in a credit card securitization program, principal receivables refer to amounts billed on the accounts in the pool that represent the "principal" on the associated credit card loans. These amounts generally include the receivables in the pool that represent purchases of goods or services, as well as cash advances.

The financing charges in a conventional loan would typically include any fees paid on the loan. The meaning is similar in the language of credit card securitization: here, finance charge receivables represent specific types of fees charged on credit card accounts (periodic rate finance charges, cash advance fees, late payment fees, and annual membership fees), as well as any other fees so designated by the seller.

This distinction ends up being important in understanding the flow of funds in a credit card securitization program. As discussed above, collections on finance charge receivables are used to pay interest on the notes, while collections of principal receivables are used to fund the repayment of the principal on the notes, and/or to purchase additional receivables to place in the pool. If the amount of principal receivables is low, it reduces the amount of principal receivables in the pool. This

[53] *See* discussion *infra* Part III.B.iii.

increases the likelihood that the seller will be required to add additional receivables into the pool, or that early amortization will be triggered.

The investors in the programs (i.e. the noteholders) are only entitled to their apportioned share of the funds flowing into the trust. The remaining interest in the trust—and in the case of a double trust structure, both trusts—is retained by the seller, an affiliate of the sponsor. In addition to its apportioned share of the funds flowing into the program, the sponsor is also entitled to retain any residual value after all other payments are made.

One critical point is that beyond the collections flowing into the trust from the receivables, there is *no other way to get value to the noteholders*. In most programs, even adding cash alone won't help, since a pile of cash alone has no effect on the *flows* into the trust. It is this flow of funds into the trust, rather than just the dollar value of everything in it, that keeps the trust from defaulting on its obligations to the noteholders.

iv. Sponsor Discretion

In all cases, the governing documents leave little discretion with respect to the allocation of collections from the receivables. At each step in the process, the documents dictate exactly how any funds are to be allocated, which parties have recourse to which assets, and any other rights or obligations of the parties. While the documents permit sponsors some discretion (for example, with respect to the addition of receivables or the issuance of new notes or investment certificates), they generally require that such actions not adversely affect the noteholders or other certificate-holders. In order to protect the noteholders, the governing documents can only be amended without their consent under specific circumstances.

One of these specific circumstances is a rating agency condition. It is clear from the documents that the intention of these provisions is to provide some flexibility to the sponsor while at the same time protecting the interest of the noteholders. For example, the governing documents of Bank of America's program specifically permit certain amendments to the governing documents of the Master Trust without the consent of the noteholders, as long as three conditions are met: (1) an opinion of counsel must be delivered to the trustee stating that the amendment will not "adversely affect in any material respect the interests of any" investor; (2) each rating agency certifies in writing that the amendment "will not result in a reduction or withdrawal of the rating of any outstanding Series or

Class" that is has rated; and (3) the amendment "shall not effect a significant change in the Permitted Activities of the Trust."[54]

There are other places in which the governing documents appear to contemplate substantial sponsor discretion, subject to certain assurances. For example, the Chase program allows for a change to the required subordinated amount—which represents a credit enhancement protecting the noteholders—"at any time without notice to, or without the consent of," the noteholders, as long as the Issuing Trust has (i) received confirmation from the rating agencies that the change will not result in a reduction, qualification with negative implications, or withdrawal of any current rating of the affected notes, and (ii) delivered an opinion of counsel that the change will not result in certain adverse tax consequences.[55] Again, these provisions place the rating agencies front and center.

v. Early Amortization / Failure

As an additional investor protection, credit card securitization programs typically have an early amortization mechanism. While each program is unique, in general, early amortization can be triggered by poor collateral performance, "[s]evere asset deterioration, problems with the seller/transferor or servicer, or certain legal troubles."[56] While early amortization is not the legal equivalent of a default, from the market's perspective, early amortization is virtually synonymous with a program failure.[57] Once a program enters early amortization the noteholders are entitled to begin receiving principal repayments.[58]

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[54] Second Amended and Restated Pooling and Servicing Agreement between BA Credit Card Funding, LLC, FIA Card Serv., N.A. (formerly known as MBNA Am. Bank, N.A.) and The Bank Of New York, § 13.01 (October 20, 2006). The document goes on to enumerate five categories of amendment, including the provision of additional credit enhancements, which may be effectuated with only two conditions: (a) the opinion of counsel and (b) the rating agency condition. Bank of Am. PSA Second Amended and Restated § 13.01.

[55] Third Amended and Restated Indenture between Chase Issuance Tr. and Wells Fargo Bank, N.A., § 3.11(b) (December 19, 2007) [hereinafter Chase Third Amended and Restated Indenture].

[56] *Global Credit Card ABS Rating Criteria*, FITCH RATINGS, 33–34 (June 26, 2015), *available at* http://www.fitchratings.com/site/re/867482.

[57] *Id.*

[58] *Id.* at 34.

IV. THE CRISIS HITS CREDIT CARD SECURITIZATION

The troubles in the credit card lending market began in the middle of 2008 and accelerated through late 2009. Data from the Federal Reserve Board of Governors, presented in Figure 1, paints a grim picture. The red line, representing the delinquency rate on credit card loans at all commercial banks, rose sharply in the fourth quarter of 2008, peaked in the second quarter of 2009, and remained high until the third quarter of 2010. After a short lag, the blue line, depicting the charge-off rate on credit card loans from all commercial banks, followed a similar pattern, peaking in the second quarter of 2010 and returning to its pre-crisis level around mid-2010.

While some of these loans were held on the balance sheets of commercial banks, many of them had been repackaged into securitization programs. Because the rise in delinquencies and charge-offs substantially increased the risk that these securitization programs would not be able to make promised payments to their investors, the credit rating agencies that were involved in rating credit card securitization programs issued watches, warnings, and downgrades.

A. Bailout Basics

We are almost ready to get started with the story of the shadow bailouts. While all of them were slightly different, the techniques they used can be grouped into five broad categories, summarized in Table 3. Before diving in to the story of the individual bailouts, it's worth pausing for an overview of these categories.

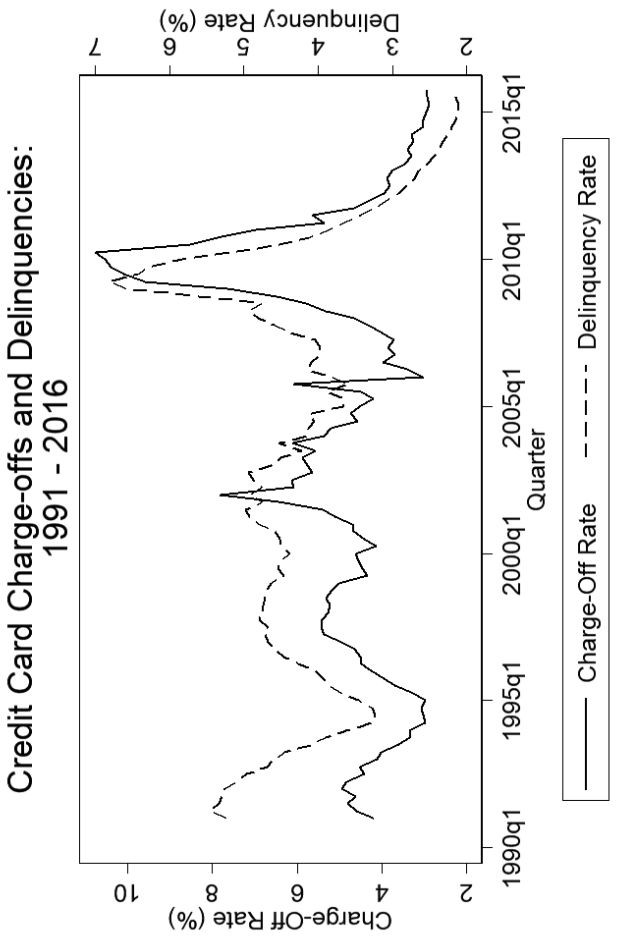

Figure 1: Credit Card Charge-offs and Delinquencies: 1991 – 2016

This figure depicts credit card charge-offs and delinquencies during the period from 1991 to 2016. The solid line depicts the charge-off rate (as a percentage), with values listed on the left scale. The dashed line depicts the delinquency rate (as a percentage), with values listed on the right scale.

i. Principal Receivables Discount

As discussed in Part III.B.ii, credit card securitization programs typically draw an important distinction between principal receivables and finance charge receivables. Principal receivables are all amounts billed on the credit cards in the pool that represent (a) purchases of goods or services, (b) cash advances, and (c) all other fees and charges billed to cardholders *other* than such amounts that represent finance charge receivables.[59] In contrast, finance charge receivables represent specific types of fees charges on credit card accounts (for example, periodic rate finance charges, cash advance fees, late payment fees, and annual membership fees), as well as any other fees so designated by the Sellers, and the amount of any principal receivables discount.[60]

By designating a positive principal receivables discount, the seller can effectively convert what would otherwise be principal receivables into finance charge receivables. The discount percentage is determined by the seller, in its sole discretion, and is initially zero. Increasing the principal receivables discount has the effect of increasing the yield. At the same time, because it effectively reduces the amount of principal receivables in the pool, it increases the likelihood that the seller will be required to add additional receivables into the pool.

ii. Add or Change Assets

A second way to bail out a securitization program is to increase the average quality of receivables in the pool. To do so, a sponsor could either remove low quality receivables from the pool, add new receivables to the pool, replace poorly performing receivables with better ones, or do some combination of all three. While there are some small differences between the three approaches, all of them have the effect of increasing the average flow of collections into the securitization trust. These higher collections flow down to the noteholders.

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[59] *See* discussion *supra* Part III.B.iii.

[60] *See, e.g.*, Citibank Credit Card Master Tr. I Pooling and Servicing Agreement Dated as of May 29, 1991 As Amended and Restated as of October 5, 2011 between Citibank, N.A., and Bankers Trust Company (2001).

Program	Subordinate a portion of seller's interest	Issue subordinated investor certificate (from master trust) to sponsor	Issue subordinated note (from issuer trust) to sponsor	Other	Principal receivables discount
Bank of America		Issued 6 new investor certificates			Yes
Citi	Yes	Issued one new investor certificate			Yes
JPMorgan Chase	Exchanged a portion of the seller's interest for a $3.5B zero-coupon subordinate security			Increased the minimum required subordinated amounts and funding requirements for the issuer's escrow accounts.	Yes
HSBC – Master				Amended the indenture supplements to increase the overcollateralization of the notes.	Yes
GE Capital				Amended the indenture supplements to increase overcollateralization of notes; Removed $1.5B in "low credit quality" accounts from the trust; Transferred receivables to the trust in exchange for subordinated securities	
National City			Issued one new subordinated note for each series of notes		Yes
Amex – Lending		Issued 2 new investor certificates (one for each group)*			Yes
Discover		Issued two new series of investor certificates to support outstanding certificates	Issued one new subordinated note which provides credit enhancement to all notes	Amended the pooling and servicing agreement to allow earlier issuances to receive a share of the interchange fees	

* Because this is a master trust only structure, this could also be characterized as an issuance from the issuer trust.
This table summarizes the actions taken to implement the eight bailouts. For more detail, see the discussion in Part IV.B.

iii. Increase the Credit Enhancements

A third approach is to increase the credit enhancements protecting the classes of notes that were sold to investors. This method works particularly well when the lowest class of notes was retained by the sponsor. While there are several ways to do this, the two most obvious ones are to increase the subordination amounts or the overcollateralization of the senior classes of notes. Both of these approaches end up diverting value away from the sponsor's claim and redirecting it toward the outside investors.

iv. Issue New Notes

Perhaps the most elegant bailout method is to simply issue new notes which are subordinated to the existing ones to the sponsor or an affiliate. Subordinated, or "junior," claims receive payment only after the senior claims—in this case, the existing investors—have been paid.[61] This point is a critical one: buying junior debt in a failing program is essentially a transfer of value to the more senior creditors; in this case, to the existing noteholders.

On its own, however, such an issuance is not enough to constitute a shadow bailout, since it does nothing to increase the flow of available funds. In order to do so, it must be combined with one of several other steps. First, the new class of securities could be issued in exchange for cash. This cash can then be used to purchase receivables that are placed in the pool. These receivables will then generate cash flows which can be used to pay the investors. Because the new issuance is junior to the existing ones, the existing ones get paid first, and are therefore the primary beneficiaries of these new cash flows.

Alternatively, the junior securities can be issued in exchange for receivables. This ends up being almost the equivalent of the first approach, but rather than issuing the securities in exchange for cash, which is used to purchase receivables, this approach cuts out the intermediate step. The most significant difference between these two approaches is that it is somewhat harder to value receivables than it is to value cash. This means that the sponsor might have more flexibility under this second approach.

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[61] *See* BREALEY, MYERS & ALLEN, *supra* note 51, at 357

Finally, the subordinated security can be carved out of the existing seller's interest. This approach is the most subtle. On the surface, it is not clear why such a maneuver benefits the existing noteholders; after all, it does not change the amount of collections flowing into the trusts. What it does do, however, is divert value from the sponsor to the investors. To see how, consider the following stylized example, illustrated in Figure 2. Suppose that the investors had a fixed claim to $70 per month, and their interest represented 50% of the value in the Master Trust. Prior to the crisis, $150 flowed into the Master Trust every month (Panel A). Because the money available to the investors ($75) exceeded the investors' claim ($70), the balance ($5) would be returned to the sponsor at the end of the month.

Now suppose that during the crisis, only $100 flowed into the trust each month (Panel B). The amount available to pay the investors would only be $50, leading to a deficit of $20. In order to forestall this, the sponsor carves out half of its interest in the Master Trust and exchanges it for security that is subordinated to the existing investors (Panel C). Now the combined investor interest in the Master Trust is 75%. Because the existing investors are senior to the new security, they are entitled to get paid first from the $75 directed toward the investor interest. After they are paid their $70, the remaining $5 is returned to the sponsor, in addition to the $25 it receives directly through its seller's interest.

v. Subordinate Existing Interests

Subordinating an existing interest is similar in spirit to issuing a new subordinated security carved out from the seller's interest. Economically, these two techniques are almost identical. Legally, the major difference between them is that, while there are clear mechanisms within the governing documents for issuing new securities, they contain no similar mechanisms for directly subordinating a portion of the seller's interest.

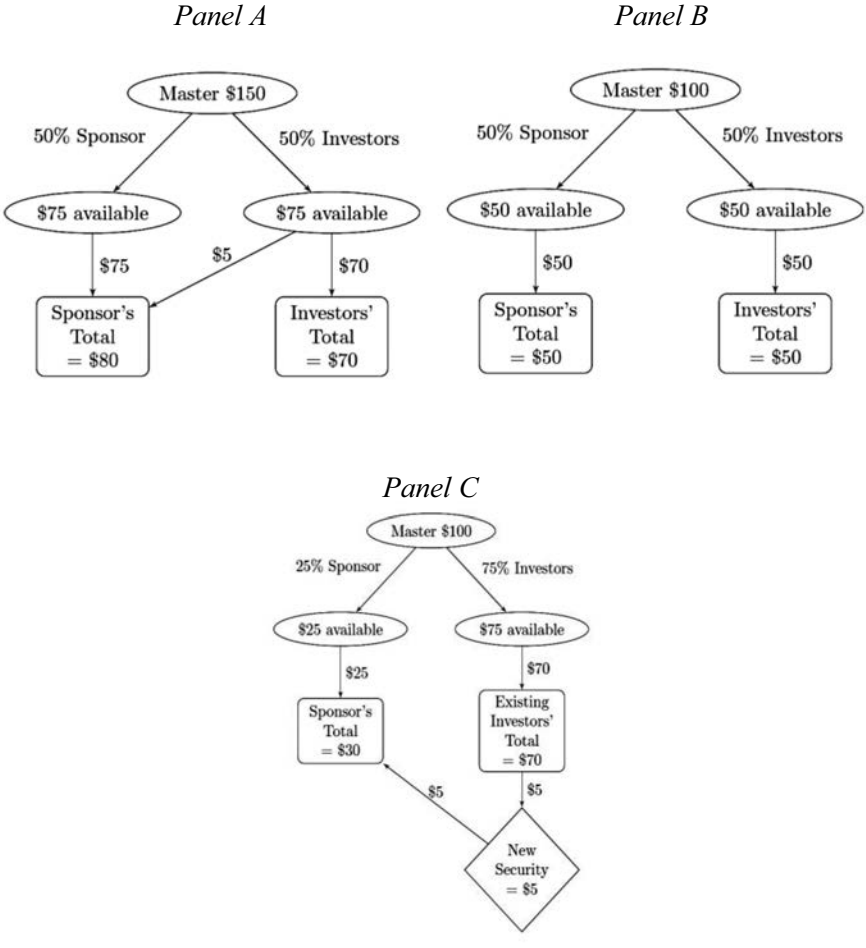

Figure 2: Illustration of Flows

This figure summarizes how the creation of a subordinated security from the seller's interest can be used to support the existing investors. It begins with a stylized hypothetical situation in which the investors have a fixed claim to $70 per month, and their interest represents 50% of the value in the Master Trust. Panel A depicts a situation in which $150 flows into the Master Trust. Because the inflows available to the investors exceed the investors' claim, the investors are paid in full and the surplus is returned to the sponsor. Panel B depicts a situation in which only $100 flows into the Master Trust. The inflows available to the investors fall short of the investors' claim, and the investors are not paid in full. Panel C depicts a situation in which, relative to Panel A, the sponsor has exchanged half of its interest in the Master Trust for a security that is subordinated to the existing investors. The combined investors interest now represents 75% of the value of the Master trust, and the existing investors are paid first from the $75 that flows to the investors. The net result is that the existing investors receive $70, and the sponsor receives $30.

B. Bailouts – Detail

So much for the overview. As the above discussion illustrates, there are a lot of moving pieces in these bailouts, and sponsors used a tremendous amount of creativity in formulating their responses to this crisis. Part of this wide variety of bailout methods is likely due to the particular idiosyncrasies of the programs themselves. These idiosyncrasies, whether they be in terms of the structure of the program, the nature of the outstanding securities, the details of the underlying receivables, or features of the sponsoring institution, add both complexity and richness to this story. The only way to do justice to this richness is to examine each of the programs individually. This allows us to see the individual threads of the story clearly. Later, in Parts V and VI, I pull these threads together and show the tapestry that they create together.

i. Programs with Successful Bailouts

Eight programs, including the three largest programs, employed one or more of the bailout techniques discussed in Part IV.A, between 2008 and 2009. Even when the techniques were similar, the exact form of the bailouts were different. In order to paint a complete picture of the shadow bailouts, I describe each one of them in turn.[62]

1. Citi

Citi's program was one of the three large programs that I studied and is a clean example of the double trust structure. The average size of Citi's program was just over $76 billion.[63] In the first quarter of 2009,

[62] For each program discussed in this section, the average size is computed using data from June 2008 through December 2009, unless otherwise indicated.

[63] Citi also operated three other credit card securitization programs at this time. The first, Omni Trust, was run through the Citibank Omni-S Master Trust ("Omni-S Trust"). On December 6, 2005, the Pooling and Servicing Agreement governing the Omni-S Trust was amended to effect a Defeasance. Citibank Omni-S Master Tr., Current Report (Form 8-K) (Dec. 6, 2005). According to Citi, "the collateral supporting the then-outstanding Series of Citibank Omni-S Certificates was substituted with Floating Rate Bonds issued by the International Bank for Reconstruction and Development (The World Bank), and/or cash." *Citibank Omni-S Master Trust*, FIXED INCOME INVESTORS, http://www.citigroup.com/citi/fixedincome/cccs_omni.htm (last visited Apr. 8, 2019). Citi also operated a credit card securitization program through the Citibank Omni Master Trust ("Omni Trust"), which does not appear to be public. As mentioned below, Omni Trust also benefited from a bailout by Citi. *See, e.g.*, *Moody's Rates Citibank Omni Master Tr. Class 2007-A10 Notes*, MOODY'S INVESTOR SERVICES (Dec. 26, 2007). The third program was Broadway trust, which was part of a Canadian credit card securitization run by

Moody's responded to the "worsening economic environment and continued downward pressure on key performance metrics" by revising its expectations for Citi's securitization program.[64] Citi disclosed as much to its investors in its quarterly 10-Q filing with the SEC.[65]

Citi took three separate actions to support this securitization program. First, it exercised its right to designate a principal receivables discount.[66] Second, it subordinated a portion of its seller's interest in the Master Trust,[67] which allowed it to divert a portion of the income flowing into the Master Trust from Citi to the Issuance Trust, and ultimately to the Noteholders. Interestingly, other than mentions in Citigroup Inc.'s Annual and Quarterly Reports, no details are given regarding the nature of this subordination. In particular, the subordination is not mentioned in any regulatory filings by the Master or the Issuance Trust during this period.

Finally, Citi caused the Master Trust to issue a series of investor certificates to Citibank (South Dakota), National Association ("CBSD") which was subordinated to the existing collateral certificate.[68] This new certificate provided credit enhancement through a reallocation mechanism: if the dollar value of any defaults rose beyond a specified threshold, a portion of the principal collections that would have been allocated to the new certificate would be reallocated to the Collateral Certificate.[69]

Citigroup disclosed in its 2009 10-K that:

> [a]s a result of these actions, based on the applicable regulatory capital rules, Citigroup began including the sold assets for all three of the credit card securitization trusts in its risk-weighted assets for purposes of

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Citi. *See, e.g.*, Broadway Credit Card Trust, Short Form Prospectus (Jul 29, 2004). Because it operated primarily in Canada, I omit the Broadway Trust from this analysis.

[64] *Moody's rates Citibank Citiseries Class (2009-B1) notes A2*, MOODY'S INV. SERV. (Mar. 18, 2009), https://www.moodys.com/research/Moodys-rates-Citibank-Citiseries-Class-2009-B1-ncdbsotes-A2--PR_174443.

[65] Citigroup's Quarterly Report from the first quarter of 2009 reports that "[t]he Master Trust … had bonds placed on ratings watch with negative implications during the first quarter of 2009." Citigroup Inc., Quarterly Report (Form 10-Q) 54 (May 11, 2009).

[66] Citibank Credit Card Issuance Tr., Current Report (Form 8-K) 2 (Mar. 17, 2009).

[67] Citigroup Inc., Quarterly Report (Form 10-Q) 44 (Aug. 7, 2009).

[68] Citibank Credit Card Issuance Tr., Current Report (Form 8-K) 2 (May 1, 2009).

[69] Citibank Credit Card Master Tr. I Series 2009, between Citibank (South Dakota), N.A., and Deutsche Bank Tr. Co. Am., Series 2009 Supplement to Pooling and Servicing Agreement as Amended and Restated § 1.01(a) (May 1, 2009).

> calculating its risk-based capital ratios during 2009. The increase in risk-weighted assets occurred in the quarter during 2009 in which the respective actions took place. The effect of these changes increased Citigroup's risk-weighted assets by approximately $82 billion, and decreased Citigroup's Tier 1 Capital ratio by approximately 100 basis points each as of March 31, 2009, with respect to the Master and Omni Trusts."[70] The same document disclosed that "Citi's Tier 1 Capital ratio was 11.7% at December 31, 2009."[71]

2. Bank of America

Bank of America's program was by far the largest, with an average aggregate amount of principal receivables in the Master Trust of almost $95 billion, and was another classic double trust structure. Citing the deterioration in the quality of the underlying assets, on October 24, 2008, Moody's placed forty-four class B and C notes, issued by the Issuance Trust, "on review for possible downgrade."[72] In particular, Moody's noted that "the proportion of Trust receivables in the deepest sub-prime strata … ha[d] grown from approximately 8.6% in December 2005 to about 12% in June 2008."[73] According to Moody's, "[t]hat shift in the deep subprime strata is greater than for other issuers in its peer group."[74]

Bank of America took two actions to support its credit card securitization program. First, on March 1, 2009, BA Credit Card Funding, LLC ("Funding"), an affiliate of Bank of America and the entity responsible for transferring receivables into the Master Trust, exercised its discount option and began designating 6.00% of principal receivables arising in Master Trust as Discount Option Receivables.[75]

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[70] Citigroup Inc., Annual Report (Form 10-K) 45 (Dec. 31, 2009).

[71] *Id.* at 11.

[72] *Moody's places subordinate classes of Bank of America's credit card receivables-backed securities on review,* MOODY'S INV. SERV. (Oct. 24, 2008), https://www.moodys.com/research/Moodys-places-subordinate-classes-of-Bank-of-Americas-credit-card--PR_165770. Moody's also placed six Certificates issued by the Master Trust on review for possible downgrade at the same time. *Id.*

[73] *Id.*

[74] *Id.*

[75] BA Credit Card Tr., Current Report (Form 8-K) 3 (Mar. 2, 2009).

Second, on March 2, 2009, it caused the Master Trust to issue a new subordinated Investor Certificate, called a "Class D Certificate," to Funding.[76] At the close of the first month after it was issued, the Class D investor interest was just over $8 billion.[77] While the Master Trust and the Issuer Trust's filings do not reveal what, if anything, Funding gave in exchange for the issuance of the Class D certificates, the Issuer Trust's monthly 10-D from March 2009 disclosed that, on March 2, 2009, Funding added accounts worth $7.9 billion to the Master Trust.[78]

These bailout activities represented support for the trusts for regulatory capital purposes, and "resulted in an increase to [its] Tier 1 risk-weighted assets of approximately $67.0 billion at September 30, 2009."[79] Perhaps most strikingly, Bank of America appears to have realized that its actions would have this result *before* it engaged in them. This fact raises questions about the "regulatory arbitrage" theory of asset securitization, introduced in Part II.A. I discuss this issue further in Part V.B.

3. JPMorgan Chase

JPMorgan Chase ("Chase") is my third and final large program and was also a double trust. The average size of Chase's program was almost $82 billion.[80] On April 20, 2009, Moody's placed nineteen classes of subordinated securities issued out of the Issuance Trust on review for possible downgrade, citing "deterioration in some of the Trust's key performance metrics."[81]

JPMorgan and its affiliates took three actions to support its securitization program. First, "during the second quarter of 2009, the Firm

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[76] *Id.* at 2.

[77] *Id.*

[78] BA Master Credit Card Tr. II, Asset-Backed Issuer Distribution Report (Form 10-D) (Apr. 15, 2009). Bank of America Corporation's filings confirm that "[d]uring the three months ended March 31, 2009 the Corporation transferred credit card loans of $8.5 billion and the related allowance for loan and lease losses of $750 million *in exchange for* a $7.8 billion held-to-maturity debt security that was issued by the Corporation's U.S. credit card securitization trust and retained by the Corporation." BA Quarterly Report (Form 10-Q) 6 (May 7, 2009) (emphasis added).

[79] BA Quarterly Report (Form 10-Q) 151 (Nov. 6, 2009).

[80] In this case, the "average size" is measured by the average amount of collateral of Asset Pool One.

[81] *Moody's places subordinate classes of Chase credit card receivables-backed securities on review for possible downgrade,* MOODY'S INV. SERV. (Apr. 20, 2009), https://www.moodys.com/research/Moodys-places-subordinate-classes-of-Chase-credit-card-receivables-backed--PR_177383.

exchanged $3.5 billion of its undivided seller's interest in the Trust for $3.5 billion of zero-coupon subordinated securities issued by the Trust and retained by the Firm."[82] Second, on May 12, 2009, it increased the minimum required subordinated amounts, as well as the funding requirements for the Issuance Trust's escrow accounts.[83] Finally, on June 1, 2009, Chase USA began discounting principal collections.[84]

On May 12, 2009, Moody's confirmed the rating of all nineteen classes, citing the increased credit enhancement and the discount option.[85] Moody's did not mention the subordination of a portion of the seller's interest in its announcement. According to JPMorgan's 10-K for 2009, "[t]hese actions resulted in the addition of approximately $40 billion of risk-weighted assets for regulatory capital purposes, which decreased the Firm's Tier 1 capital ratio by approximately 40 basis points, but did not have a material impact on the Firm's Consolidated Balance Sheets or results of operations."[86]

4. HSBC – Master

With an average size of approximately $4.9 billion,[87] HSBC's "Master" program (in contrast to its "Private Label" program, discussed below) was one of the small programs I studied.[88] HSBC's program ran

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[82] JPMorgan Chase & Co., Quarterly Report (Form 10-Q) 149 (Nov. 9, 2009).

[83] Omnibus Addendum to Terms Documents, which are supplemental to the Third Amended and Restated Indenture, dated as of December 19, 2007, as supplemented by the Second Amended and Restated Asset Pool One Supplement, dated as of December 19, 2007, and as further supplemented by the Amended and Restated CHASE Series Indenture Supplement, between Chase Issuance Tr. and Wells Fargo Bank, N.A., (May 12, 2009) [hereinafter Chase Omnibus Amendment].

[84] Chase Issuance Tr., Prospectus (Aug. 2, 2010). On May 8, 2009, Chase USA caused the amendment of the Transfer and Servicing Agreement to modify the definition of Discount Receivables Collections. First Amendment to the Third Amended and Restated Transfer and Servicing Agreement, between Chase Bank USA, National Association, Chase Issuance Trust and Wells Fargo Bank, National Association § 1 (May 8, 2009). This amendment appears to be cosmetic and was likely executed for the sake of clarity rather than for substantive reasons.

[85] *Moody's Confirms Subordinate Classes of Chase Credit Card Receivables-backed Securities Ratings,* MOODY'S INV. SERV. (May 12, 2009), https://www.moodys.com/research/Moodys-confirms-subordinate-classes-of-Chase-credit-card-receivables-backed--PR_178420.

[86] JPMorgan Chase & Co. Annual Report (Form 10-K) 200 (Feb 24, 2010).

[87] Specifically, I measure size here by the average amount of principal receivables in pool one.

[88] The program has also issued variable funding notes. Because these assets have different characteristics, I omit them from this discussion.

into trouble a little earlier than many of the others. On November 4, 2008, Moody's placed three classes of Class B Notes issued by the HSBC Trust on review for possible downgrade.[89] In doing so, Moody's cited the "deterioration in some key performance metrics and the Trust's relative concentration of obligors domiciled in the Rust Belt," as well as the general weakness in the credit card sector.[90] On November 20, 2008, Fitch affirmed the ratings of the Trust's Class A and B Notes, but left them on negative outlook.[91]

HSBC took two actions to support its program. These actions were relatively mild, especially compared to the actions of the other large financial institutions discussed above. First, on December 15, 2008, it increased the overcollateralization amount of each series.[92] The total increase in overcollateralization was just over $400 million.[93] Second, effective January 1, 2009, HSBC Funding increased the discount percentage from 3% to 6%.[94] Citing both of these actions, Moody's confirmed the ratings of two of the three classes, and upgraded the third.[95] HSBC made no mention of whether or not it brought this program back on its balance sheet as a result of these actions.

5. Discover

Discover's program was medium sized, with a double trust structure, and had an average amount of principal receivables in the Master Trust of about $38.5 billion. On June 2, 2009, Moody's placed thirty-six classes of notes and investor certificates on review for possible downgrade.[96] In doing so, Moody's cited the fact that "the Trust's

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[89] *Moody's places HSBC's subordinate credit card-backed notes under review*, MOODY'S INV. SERV. (Nov. 4, 2008), https://www.moodys.com/research/Moodys-places-HSBCs-subordinate-credit-card-backed-notes-under-review--PR_166609.

[90] *Id.*

[91] Fitch Assigns Rating Outlooks to $313B of U.S. Credit Card ABS; Affirms Ratings, FITCH RATINGS (Nov. 20, 2008), https://www.fitchratings.com/site/fitch-home/pressrelease?id=449997.

[92] HSBC Credit Card Master Note Tr. (USA) I, Current Report (Form 8-K) 2 (Dec. 15, 2008).

[93] *Id.*

[94] HSBC Credit Card Master Note Tr. (USA) I, Current Report (Form 8-K) 2 (Jan. 2, 2009).

[95] *Moody's confirms and upgrades ratings on HSBC's credit card-backed notes*, MOODY'S INV. SERV. (Jan. 5, 2009), https://www.moodys.com/research/Moodys-confirms-and-upgrades-ratings-on-HSBCs-credit-card-backed--PR_170306.

[96] *Moody's places Discover credit card receivables-backed securities on review for possible downgrade,* MOODY'S INV. SERV. (June 2, 2009),

performance, as measured by charge-offs, delinquencies and principal payment rate ha[d] deteriorated markedly," as well as the downgrade of Discover Bank on the previous day.[97]

On June 17, 2009, Discover announced that it would cause the Issuer Trust to issue one subordinated note and the Master Trust to issue two subordinated certificates to support its securitization program.[98] The initial stated principal amount of the Note was just under $600 million,[99] while the certificates were issued with initial investor amounts of $1 billion[100] and $500 million.[101] These securities were sold at par for cash[102] to Discover Bank or one of its affiliates[103] and did not bear interest.[104] These actions were enough to satisfy Moody's. On July 10, following the issuance of the subordinated Note, Moody's confirmed the rating of the Notes.[105] On August 7, following the issuance of the subordinated certificates, Moody's confirmed the rating of the other Investor Certificates.[106]

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https://www.moodys.com/research/Moodys-places-Discover-credit-card-receivables-backed-securities-on-review--PR_180303.

[97] *Id.*

[98] Discover Card Execution Note Tr., Current Report (Form 8-K) (June 17, 2009). In addition, on October 1, 2008, Discover Bank added accounts consisting of approximately $2 billion in receivables to the Master Trust. Discover Card Execution Note Tr., Current Report (Form 8-K) (Oct. 1, 2008). Because this occurred several months before the ratings actions, I omit it from the analysis.

[99] Discover Card Execution Note Tr., Current Report (Form 8-K) (July 2, 2009).

[100] Series Supplement to Amended and Restated Pooling and Servicing Agreement Series 2009-CE Certificates between Discover Bank and U.S. Bank N.A., (July 24, 2009) [hereinafter Series 2009-CE Supplement].

[101] Series Supplement to Amended and Restated Pooling and Servicing Agreement Series 2009-DS Certificates between Discover Bank and U.S. Bank N.A., (Sept. 22, 2009) [hereinafter Series 2009-DS Supplement].

[102] *See* Discover Card Execution Note Tr., Current Report (Form 8-K) (July 2, 2009) *supra* note 99; Series 2009-CE Supplement, *supra* note 100; Discover Card Execution Note Tr., Current Report (Form 8-K) (Sept. 23, 2009).

[103] *See* Discover Card Execution Note Tr., Current Report (Form 8-K) (June 17, 2009).

[104] Class D(2009-1) Terms Document to Indenture Supplement for the Discover Series Notes to Indenture, between Discover Card Execution Note Tr., and U.S. Bank N.A. (July 2, 2009), Definitions; Series 2009-CE Supplement, *supra* note 100; Series 2009-DS Supplement, *supra* note 101.

[105] *Moody's confirms ratings of Discover Card Execution Note Trust credit card receivables-backed securities*, MOODY'S INV. SERV. (July 10, 2009), https://www.moodys.com/research/Moodys-confirms-ratings-of-Discover-Card-Execution-Note-Trust-credit--PR_182215.

[106] *Moody's confirms ratings of Discover Card Master Trust I credit card receivables-backed securities,* MOODY'S INV. SERV. (Aug. 7, 2009),

6. GE Capital

Like Discover, GE Capital's program was medium sized, with an average amount of principal receivables in the master trust of approximately $19 billion. This program used a Statutory Trust Only structure, and while it does not seem to have experienced downgrades, on February 27, 2009 Fitch did describe GE Trust's performance as having "deteriorated."[107]

GE took three actions to support its credit card securitization program. First, it exercised its right to remove a number of accounts from the Issuer Trust.[108] The total value of the removed accounts was just under $1.3 billion,[109] and the accounts were removed as of February 21, 2009.[110] Fitch described the accounts that were removed as being of "low credit quality."[111] Fitch cited this action in its press release affirming the ratings of all outstanding notes from the Issuer and assigning them a "Stable Rating Outlook."[112]

That was not enough. On April 28, 2009, S&P announced that it was placing a number of Issuer Trust's notes on CreditWatch with negative implications. This led to a second attempt to support its securitization program, which involved amending the governing documents of four then-outstanding series of notes to increase the overcollateralization on those notes.[113] In doing so, it effectively

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https://www.moodys.com/research/Moodys-confirms-ratings-of-Discover-Card-Master-Trust-I-credit--PR_184582.

[107] *Fitch: GE Removes Low Credit Quality Accounts from Credit Card Trust,* FITCH RATINGS (Feb. 27, 2009), https://www.fitchratings.com/site/fitch-home/pressrelease?id=463262.

[108] It did so by way of the Eighth Amendment to the Transfer Agreement between RFS Holding, LLC, and GE Capital Credit Card Master Note Trust (Feb. 26, 2009) [hereinafter Eighth Amendment to the Transfer Agreement], and the Sixth Amendment to the Receivables Sale Agreement, between GE Money Bank and RFS Holding, LLC (Feb. 26, 2009) [hereinafter Sixth Amendment to the Receivables Sale Agreement].

[109] *See, e.g.*, GE Capital Credit Card Master Note Tr., Asset-Backed Issuer Distribution Report (Form 10-D) Exhibit 4 *Monthly Noteholder's Statement GE Capital Credit Card Master Note Trust Series 2007 – 4* (Mar. 30, 2009); Fitch reports this amount as $1.5 billion.*GE Removes Low Credit Quality Accounts from Credit Card Trust,* FITCH RATINGS (Feb 27, 2009), https://www.fitchratings.com/site/fitch-home/pressrelease?id=463262.

[110] Eighth Amendment to the Transfer Agreement, *supra* note 108, at § 3; Sixth Amendment to the Receivables Sale Agreement, *supra* note 108, at § 3.

[111] FITCH RATINGS, *supra* note 107.

[112] *Id.*

[113] GE Capital Credit Card Master Note Tr., Current Report (Form 8-K) (Sept. 10 2009).

subordinated a portion of the sponsor's claim on the trust and provided credit support to these notes. Both Moody's and Fitch cited each of these actions favorably in separate reports[114]

Third, according to GE Capital's quarterly and annual reports, "in the second and third quarters of 2009, we transferred … $328 million of credit card receivables to the [Issuer] Trust in exchange for additional subordinated interests."[115] $145 million of this amount was transferred in June 2009.[116]

7. Amex – Lending

Like HSBC, Amex ran two separate securitization programs during this period. The first, which I call the Lending program, securitized receivables from American Express credit cards. The second, which I call the Charge program and discuss below, securitized receivables from American Express charge cards. The Amex Lending program was a medium sized program with a Common Law Trust Only structure and an average amount of principal receivables of almost $38 billion.

On March 19, 2009, Moody's placed fifty-seven classes of subordinated certificates on review for possible downgrade.[117] While Moody's noted that Amex's trusts had generally performed better than

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[114] *Moody's upgrades ratings on four subordinate classes of notes issued from GE's credit card trust,* MOODY'S INV. SERV. (June 23, 2009), https://www.moodys.com/research/Moodys-upgrades-ratings-on-four-subordinate-classes-of-notes-issued--PR_181605; *Moody's upgrades five subordinate classes of notes from GE's credit card trust,* MOODY'S INV. SERV. (Sept. 16, 2009), https://www.moodys.com/research/Moodys-upgrades-five-subordinate-classes-of-notes-from-GEs-credit--PR_186547; *Fitch Upgrades Certain GE Capital Credit Card Master Note Trust Subordinated Notes*, FITCH RATINGS (June 22, 2009), https://www.fitchratings.com/site/fitch-home/pressrelease?id=491056; *Fitch Places 3 GE Credit Card ABS Sub Classes on Watch Positive,* FITCH RATINGS (Sept. 14, 2009), https://www.fitchratings.com/site/fitch-home/pressrelease?id=508519; *Fitch Upgrades Ratings on 4 GE Credit Card ABS Sub Classes*, FITCH RATINGS (Nov. 18, 2009), *available at* https://www.fitchratings.com/site/fitch-home/pressrelease?id=538036.

[115] General Electric Capital Corp., Quarterly Report (Form 10-Q) 38 (Nov. 2, 2009)

[116] General Electric Capital Corp., Quarterly Report (Form 10-Q) (Aug. 3, 2009).

[117] *Moody's places subordinate classes of American Express credit card receivables-backed securities on review for possible downgrade*, MOODY'S INV. SERV. (Mar. 19, 2009), https://www.moodys.com/research/Moodys-places-subordinate-classes-of-American-Express-credit-card-receivables--PR_175441.

average, it cited the higher than average credit lines and the concentration of obligors in states that were particularly hard hit by the housing crisis.[118]

Amex took two actions to support the Lending program. First, beginning in July 2009, it increased the discount percentage.[119] Second, on or about June 5, 2009, Amex caused the Master Trust to issue two subordinated investor certificates to an affiliate of American Express.[120] As of June 25, 2009, the first 10-D statement in which the two certificates appeared, the invested amounts of these certificates were just under $21 million and just over $1.5 billion, respectively.[121]

Citing these two actions, on June 22, 2009, Moody's confirmed the ratings on thirty-four of the securities under review and downgraded twenty-two others.[122] These actions also "resulted in the inclusion of the … Trust's assets as risk-weighted assets for regulatory capital purposes."[123]

8. National City

National City's program was a small one with a Double Trust structure and an average amount of principal receivables of just under $2.15 billion. National City's bailout is particularly remarkable because the sponsoring bank was itself severely distressed. During the period of the bailout, National City was preparing for its own rescue at the hands of another bank, consummated with the help of funds from the US Government. The fact that the bailout went ahead anyway, with the apparent support of the acquiring bank, indicates the length to which sponsors were prepared to go to rescue their programs and the degree to which these programs were perceived as valuable to the sponsors.

Citing the "deterioration in some key Trust performance metrics as well as steep increases in the Trust's average account balances and average

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[118] *Id.*

[119] Am. Express Credit Acct. Tr., Asset-Backed Issuer Distribution Report (Form 10-D) Exhibit 99, Monthly Servicer's Certificate (Aug. 17, 2009).

[120] Am. Express Credit Acct. Tr., Current Report (Form 8-K) (May 22, 2009).

[121] Am. Express Credit Acct. Tr. Asset-Backed Issuer Distribution Report (Form 10-D) Exhibit 99, Monthly Servicer's Certificate (July 15, 2009).

[122] *Moody's concludes rating review of American Express' credit card receivables-backed securities,* MOODY'S INV. SERV. (June 22. 2009), https://www.moodys.com/research/Moodys-concludes-rating-review-of-American-Express-credit-card-receivables--PR_181639.

[123] Am. Express Co., Quarterly Report (Form 10-Q) 55 (Aug. 3, 2009).

credit lines," on April 16, 2009, Moody's announced that it had placed several subordinated notes from the National City program on review for possible downgrade.[124] A month later, Fitch revised it rating for the Class C notes to "Rating Outlook Negative" from "Rating Outlook Stable."[125]

In response, on July 1, 2009, National City caused the Issuer Trust to issue, for each series, a subordinated note. These notes were issued to National City and accrued interest at a rate of zero percent.[126] While it is not clear from the documents what, if anything, National City contributed to the Issuer Trust in exchange for the notes, these issuances would have increased the cash flows available to pay the existing noteholders, even if National City had exchanged nothing for the Class D notes because they effectively subordinated a portion of National City's own interest.[127]

Both Fitch and Moody's looked favorably on these actions,[128] and Moody's confirmed the ratings of twelve outstanding classes of securities.[129] As of 11:59 p.m. on November 6, 2009, National City was merged into PNC Bank, National Association (PNC).[130] The acquisition of National City Corporation by PNC Financial Services Group, Inc. was announced on October 24, 2008.[131] At the same time, PNC announced that it would be participating in the U.S. Department of the Treasury's Troubled Asset Relief Program ("TARP") to the tune of $7.7 billion, and

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[124] *Moody's places subordinate classes of National City credit card receivables-backed securities on review for possible downgrade,* MOODY'S INV. SERV. (Apr. 16 2009), https://www.moodys.com/research/Moodys-places-subordinate-classes-of-National-City-credit-card-receivables--PR_176687.

[125] *Fitch Affs 98% of U.S. Credit Card ABS Ratings; Puts 11 Sub Bonds on Rtg Watch Negative,* FITCH RATINGS (May 11, 2009), https://www.fitchratings.com/site/fitch-home/pressrelease?id=474041.

[126] National City Credit Card Master Note Trust, Current Report (Form 8-K) (Jul. 1, 2009).

[127] *See, e.g.*, Amended and Restated Series 2006-1 Indenture Supplement, between Nat'l City Credit Card Master Note Tr. and The Bank of New York Mellon (July 1, 2009) (defining "Initial Dollar Principal Amount," and a positive "Nominal Liquidation Amount"); *see also id.* § 3.11(d).

[128] *Fitch Affirms National City Credit Card Master Note Trust Upon Increases To Trust Credit Enhancement,* FITCH RATINGS (July 2, 2009), https://www.fitchratings.com/site/fitch-home/pressrelease?id=499136; *Moody's confirms ratings on National City's subordinate classes of credit card securities* (July 8, 2009), MOODY'S INV. SERV.https://www.moodys.com/research/Moodys-confirms-ratings-on-National-Citys-subordinate-classes-of-credit--PR_182468.

[129] MOODY'S INV. SERV., *supra* note 128.

[130] Nat'l City Credit Card Master Note Tr., Current Report (Form 8-K) (Nov. 12, 2009).

[131] The PNC Fin. Serv. Group, Inc., Current Report (Form 8-K) (Oct. 24, 2008).

that "[a] portion of the $7.7 billion amount assumes the consummation of the acquisition of National City."[132] This acquisition was characterized as a distressed sale in contemporary press reports.[133]

ii. Programs without Bailouts

With the whirlwind of bailouts described in Part IV.B.i, one could be mistaken for believing that *all* the programs received a shadow bailout. This is not the case. Rather, I found no evidence of any bailout activities with respect to five programs. Two of these programs do not seem to have experienced the threat of downgrades that prompted the bailouts in other programs. The other three programs did experience downgrades but nevertheless did not engage in bailouts. In exploring the shadow bailouts, it would be a grave mistake to ignore the programs that did not engage in bailouts, particularly the three that experienced adverse credit events. To do so would be to ignore potentially valuable information about these bailouts and this period.

1. Capital One

Capital One ran a medium sized program, with an average amount of principal receivables in the Master Trust of over $46 billion. On April 20, 2009, Moody's placed fourteen classes of Class C and D securities issued by Capital One Issuer Trust on review for possible downgrade.[134] In doing so, Moody's cited the increase in the Trust's charge-off rate, as well as expectations about the continued consumer and economic environment.[135]

There is no evidence that Capital One took any action to support its program during this period. On July 1, 2009, Moody's concluded its review and downgraded thirteen of the fourteen classes under review.[136]

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[132] *Id.*

[133] *See, e.g.*, Dan Fitzpatrick, David Enrich & Damian Paletta, *PNC Buys National City in Bank Shakeout*, WALL ST. J. (Oct. 25, 2008), http://www.wsj.com/articles/SB122485472991366463.

[134] *Moody's places Class C and D subordinate classes of Capital One credit card receivables-backed securities on review for possible downgrade,* MOODY'S INV. SERV. (Apr. 20, 2009), https://www.moodys.com/research/Moodys-places-Class-C-and-D-subordinate-classes-of-Capital--PR_177446.

[135] *Id.*

[136] *Moody's downgrades Class C and D subordinate classes of Capital One credit card securities,* MOODY'S INV. SERV. (July 1, 2009), https://www.moodys.com/research/Moodys-downgrades-Class-C-and-D-subordinate-classes-of-Capital--PR_182245.

The rating of the remaining class, which had a scheduled maturity of August 2009, was confirmed.[137] The following day, Moody's withdrew the ratings on one of the Class D series, citing "business reasons."[138] Business reasons refers to Moody's business reasons, and "generally do not reflect any concerns about . . . creditworthiness or the quality of [] management."[139] Capital One did continue to issue securities out of its credit card securitization program, albeit with an unusually large gap. The next issuance after these events was on February 2, 2013.[140]

2. First National

First National's program was small, with an average amount of principal receivables in the Master Trust of just over $2.6 billion. On May 20, 2009, Moody's placed three of First National's notes "on review for possible downgrade."[141] This decision affected Class A, B, and C notes.[142] On July 13, 2009, Fitch downgraded several of the notes in question.[143] There is no evidence that First National took any actions in 2009 to address the situation,[144] but on August 21, Moody's confirmed the ratings on the

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[137] *Id.*

[138] *Moody's withdraws rating on COMET Class D(2002-1) asset-backed securities,* MOODY'S INV. SERV. (July 2, 2009), https://www.moodys.com/research/Moodys-withdraws-rating-on-COMET-Class-D2002-1-asset-backed--PR_182450.

[139] *Policy for Withdrawal of Credit Ratings,* MOODY'S INV. SERV. (Sept. 9, 2011), https://www.moodys.com/sites/products/ProductAttachments/Compliance/Exhibit 2/SP13418_Policy for Withdrawal of Credit Ratings. pdf.

[140] Capital One Multi-Asset Execution Tr., Current Report (Form 8-K) (Feb. 1, 2013).

[141] *Moody's places FNBO credit card receivables-backed securities on review for possible downgrade,* MOODY'S INV. SERV. (May 20, 2009), https://www.moodys.com/research/Moodys-places-FNBO-credit-card-receivables-backed-securities-on-review--PR_179378.

[142] *Id.*

[143] *Fitch Downgrades First National Master Note Trust's Subordinated Notes Class B & D,* FITCH RATINGS (July 13, 2009), https://www.fitchratings.com/site/fitch-home/pressrelease?id=500757.

[144] First National did take action in the summer of 2010, when the risks stemmed from a downgrade of First National itself. For the rating effect, *see Moody's places FNBO's credit card-backed senior and subordinate notes on review for possible downgrade,* MOODY'S INV. SERV. (Mar. 3, 2010), https://www.moodys.com/research/Moodys-places-FNBOs-credit-card-backed-senior-and-subordinate-notes--PR_195696; *Moody's confirms ratings on FNBO's credit card-backed senior and subordinate notes,* MOODY'S INV. SERV. (July 21, 2010), https://www.moodys.com/research/Moodys-confirms-ratings-on-FNBOs-credit-card-backed-senior-and--PR_202866. For steps taken in response, *see* First Nat'l Master Note Tr., Current Report (Form 8-K) (Jul 1, 2010).

notes.[145] First National did continue to issue notes after these events. The next such issuance was on October 24, 2013.[146]

3. World Financial Network

World Financial Network also ran a small program with an average amount of principal receivables in the trust of about $3.2 billion. On August 29, 2008, Moody's placed eleven classes of World Financial Network's notes under review for possible downgrade.[147] In doing so, Moody's cited WFN's "relatively limited access to the capital markets" and its "focus on the retail sector."[148] On February 19, 2009, Moody's concluded its review and downgraded eight of the classes of outstanding notes, and confirmed the other three.[149]

In addition to general concerns about both the credit card sector and the credit markets, Moody's again cited WFN's focus on private label credit cards as a cause for concern.[150] Fitch does not appear to have downgraded any of WFN's securities. There is no evidence that WFN took any actions in 2009 to address the situation.[151] WFN continued to issue securities after this episode: for example, on April 14, 2009,[152] August 13, 2009,[153] and July 8, 2010.[154]

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[145] *Moody's resolves review action for FNBO credit card receivables-backed notes,* MOODY'S INV. SERV. (Aug. 21, 2009), https://www.moodys.com/research/Moodys-resolves-review-action-for-FNBO-credit-card-receivables-backed--PR_185347.

[146] First Nat'l Master Note Tr., Current Report (Form 8-K) (Oct. 24, 2013).

[147] *Moody's places ratings of twelve classes of WFN's notes under review for possible downgrade,* MOODY'S INV. SERV. (Aug. 29, 2008), https://www.moodys.com/research/Moodys-places-ratings-of-twelve-classes-of-WFNs-notes-under--PR_162078.

[148] *Id.*

[149] *Moody's downgrades eleven classes of WFN's credit card-backed notes,* MOODY'S INV. SERV. (Feb. 19, 2009), https://www.moodys.com/research/Moodys-downgrades-eleven-classes-of-WFNs-credit-card-backed-notes--PR_173293.

[150] *Id.*

[151] On April 14, 2009 WFN did disclose that, subject to rating agency consent, on April 20, 2009, it would "reduce the numerator of the Allocation Percentage used for purposes of allocating Principal Collections for Series 2004-A to $67,500,000." World Fin. Network Credit Card Master Note Tr., Current Report (Form 8-K) 2 (Apr. 14, 2009) Rather than acting as a credit enhancement, this action would appear to reduce the credit protection of that particular class of notes. I therefore do not classify this action as a bailout, or as a credit enhancement.

[152] *Id.*

[153] World Fin. Network Credit Card Master Note Tr., Current Report (Form 8-K) 2 (Aug. 13, 2009).

[154] World Fin. Network Credit Card Master Note Tr., Current Report (Form 8-K) 2 (July 8, 2010).

4. HSBC – Private Label

HSBC – Private Label was a small program, with an average size of approximately $6.8 billion. There is no indication that Moody's downgraded or placed HSBC's Private Label notes under review, and Fitch explicitly gave the program a stable outlook on November 20, 2008.[155] No action appears to have been taken to support the program.

5. Amex – Charge

Amex – Charge was another small program, with an average amount of principal receivables in the Master Trust of just over $7.1 billion. As mentioned above, it securitized receivables from American Express charge cards.[156] Like HSBC – Private Label, there is no indication that Amex – Charge experienced any difficulty during this period.

iii. Advanta – The Program that Failed

So far, we have looked at thirteen programs. Eight of them received shadow bailouts of one form or another from the sponsors. Two more did not seem to need any help and three others ran into trouble, were not bailed out, but made it through the crisis. We now turn to the only program that actually failed.

Not only is Advanta's program the only one that failed during the crisis, it has the distinction of being the only public program in the United States to have failed, resulting in a loss to investors, since 2003.[157] In fact, it is one of only eight transactions that have triggered early amortization events in the history of U.S. credit card securitization.[158] As it turns out, it appears that the program failed not because its sponsor didn't *want* to bail it out, but rather because it *couldn't*.

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[155] *Fitch Assigns Rating Outlooks to $313B of U.S. Credit Card ABS; Affirms Ratings,* FITCH RATINGS (Nov. 20, 2008), https://www.fitchratings.com/site/fitch-home/pressrelease?id=449997.

[156] Charge cards, which must be paid in full each month, represent a substantially different product from credit cards. AMERICAN EXPRESS, https://www.americanexpress.com/us/financial-education/types-of-cards.html?linknav=US-oneAmex-axpSearchResults-6&searchresult=credit%20cards%20vs%20charge%20cards (last visited Feb. 18, 2019) (explaining American Express Charge and Credit Cards).

[157] *See Global Credit Card ABS Rating Criteria, Appendix 7: History of Early Amortization,* FITCH RATINGS (July 21, 2016).

[158] *Id.*

Advanta's program was quite small: at the end of June 2008, it held just under $5.8 billion in principal receivables. For reasons that will become clear in a moment, this amount declined rapidly in the months that followed, and at the end of December 2009 there were less than $2.3 billion in principal receivables left in the trust. Advanta's program focused primarily on business credit card receivables. These credit cards were issued to small businesses to be used for business purposes.

In February 2009, both S&P and Moody's downgraded all four classes of notes in Advanta's program.[159] According to SEC filings, Advanta Bank "and its affiliates did not provide any financial support to the trust and there were no amendments to any transaction documents" between January and March 2009.[160]

As late as April 30, 2009, Advanta Corp.'s management maintained that early amortization could be avoided.[161] During the month of April, Advanta Corp attempted to support the program by purchasing charged off receivables from the Trust, which generated "$7.5 million of additional recovery proceeds for the Trust."[162] On May 11, Advanta reversed itself and announced that, based on May's performance, the Trust would go into early amortization.[163] Days later, both S&P and Moody's downgraded the notes a second time.[164]

At this point, Advanta was still trying to rescue the most senior noteholders in its program. On May 11, the same day that it announced that the Trust would go into early amortization, Advanta Corp. announced a tender offer for the Class A senior notes.[165] This tender offer was

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[159] Advanta Bus. Card Master Tr., Asset-Backed Issuer Distribution Report (Form 10-D) (Feb. 20, 2009).

[160] Advanta Bus. Card Master Tr., Asset-Backed Issuer Distribution Report (Form 10-D) (March 20, 2009)

; Advanta Bus. Card Master Tr., Asset-Backed Issuer Distribution Report (Form 10-D) (Apr. 20, 2009).

[161] Advanta Bus. Card Master Tr., Current Report (Form 8-K) (Apr. 30, 2009).

[162] Advanta Bus. Card Master Tr., Asset-Backed Issuer Distribution Report (Form 10-D) (May 20, 2009).

[163] Advanta Corp. Current Report (Form 8-K) Exhibit 99.1 Advanta Announces Plan to Maximize Capital and Dramatically Reduce Risk (May 12, 2009).

[164] Advanta Bus. Card Master Tr., Asset-Backed Issuer Distribution Report (Form 10-D) (May 20, 2009).

[165] Advanta Corp., Current Report (Form 8-K) Exhibit 99.1 Advanta Announces Plan to Maximize Capital and Dramatically Reduce Risk (May 12, 2009).

cancelled on June 8, 2009,[166] reportedly because of objection from the FDIC.[167] Two days later, the trust entered early amortization.[168] On June 30, 2009, Advanta Bank entered into a Stipulation and Consent to the issuance of an Order to Cease and Desist with the FDIC restricting Advanta Bank's activities.[169] On November 8, 2009, Advanta Corp. filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code.[170] The FDIC closed Advanta Bank, and it was appointed receiver effective March 19, 2009.[171]

Advanta's program thus became the first and only casualty of the crisis in credit card securitization.[172] The Invested Amount of the Class D notes was wiped out in July 2009,[173] and the Invested Amount of each of the Class B and C notes was gradually reduced. According to Moody's, the Class C notes were ultimately wiped out, and the Class B notes were partially written down.[174]

V. LEGAL AND ECONOMIC ANALYSIS OF THE BAILOUTS

Now that we are familiar with the story of the bailouts, we can return to the discussion in Part II and ask what they can tell us about the nature and purpose of securitization. Armed with this analysis, we can then, in Part VI derive policy implications such as how securitization should be regulated going forward.

A. Consistent with Safe Assets

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[166] Advanta Corp., Current Report (Form 8-K) Exhibit 99.1 *Advanta Announces Termination of Its Cash Tender Offer for Class A Senior Notes* (June 8, 2009).

[167] Jeff Blumenthal, *Advanta president Rosoff explains leadup to bankruptcy*, PHILA. BUS. J. (Nov. 9, 2009), http://www.bizjournals.com/philadelphia/blogs/law/2009/11/advanta_president_rosoff_explains_leadup_to_bankruptcy.html (last visited Aug. 3, 2016).

[168] Advanta Corp., Current Report (Form 8-K) (June 10 2009); Advanta Bus. Card Master Tr., Current Report (Form 8-K) (June 10, 2009).

[169] Advanta Corp., Current Report (Form 8-K) (June 30, 2009).

[170] Advanta Corp., Current Report (Form 8-K) (Nov. 8, 2009).

[171] Advanta Corp., Current Report (Form 8-K) (Mar. 12, 2010).

[172] *See* FITCH RATINGS, *supra* note 155.

[173] Advanta Bus. Card Master Tr., Asset-Backed Issuer Distribution Report (Form 10-D) (Aug. 20, 2009).

[174] *Moody's Approach to Rating Credit Card Receivables-Backed Securities,* MOODY'S INV. SERV. 23 (June 16, 2015).

Of all the explanations for securitization discussed in Part II, this episode is by far the most consistent with the safe asset story. Under this view, securitization is valuable because it results in the production of safe, information-insensitive debt.[175] The whole point of this exercise is *not* to create an asset with a high risk-adjusted return. Rather, it is to create an asset that is effectively riskless.

i. Securities Law Concerns

This goal—to produce riskless debt—explains why sponsors had no interest in advertising their support for their programs. If the goal is to produce safe debt, the fact that the sponsor bailed out the program, while better than letting it fail, is not a desirable attribute. Sponsors therefore had an incentive to try to sweep the whole episode under the rug. In Chase's case, it could be argued that this desire to divert attention away from its support went so far as to raise questions under the securities laws.

As discussed in Part IV.B, Chase took three actions to support its securitization program. Two of these, exercising the discount option and increasing the required enhancement level for each tranche of outstanding notes, were disclosed in an 8-K filed jointly by Chase Bank and the three Trusts.[176] The third one, in which a JPMorgan entity "exchanged $3.5 billion of its undivided seller's interest in the [Issuer] Trust for $3.5 billion of zero-coupon subordinated securities issued by the [Issuer] Trust and retained by" a JPMorgan entity, was only disclosed in JPMorgan's quarterly filings.[177] It is clear that all three of these actions were taken specifically to support the securitization program. Indeed, in a quarterly filing, JPMorgan introduced these three actions by stating that "given market uncertainty concerning projected credit costs in the credit card industry, and to mitigate any further deterioration in the performance of the Trust, *the Firm took certain actions, as permitted by the Trust agreements, to enhance the performance of the Trust*."[178] While these actions may have been *permitted* by the governing documents, they were not *required.* Indeed, the filing goes on to disclose that "*[t]hese actions resulted in the addition of approximately $40 billion of risk-weighted assets for regulatory capital purposes, which decreased the Firm's Tier 1 capital ratio by approximately 40 basis points*, but did not have a material

[175] *See* discussion *supra* Part II.B
[176] *See generally* Part IV.B
[177] JPMorgan Chase & Co., Quarterly Report (Form 10-Q) 141 (Aug. 10, 2009).
[178] *Id.* (emphasis added).

impact on the Firm's Consolidated Balance Sheets or results of operations."[179]

JPMorgan and Chase Bank did not advertise this support in its later registration statements or prospectuses. Indeed, rather than highlighting these actions, later prospectuses and registration statements play down the interventions. For example, the Issuance Trust's prospectus dated August 2, 2010, states that "[n]one of the asset-backed securities issued by the issuing entity have experienced any losses, events of default[,] or early amortization events and *Chase USA has not taken any action outside of the ordinary performance of any of the issuing entity's transactions to prevent such an occurrence*."[180] The statement goes on to disclose the principal receivables discount employed between June 2009 and July 2010.[181]

This statement seems to conflict with the above discussion, and in particular, with the decision to subordinate a portion of its interest in the trust. Indeed, it seems almost as though Chase is trying to divert attention from its bailout activities. Were JPMorgan's and Chase Bank's actions "outside of the ordinary performance?" Moreover, the specific disclosure of the discount option, which is probably the least drastic intervention, seems to make the omission of the other two interventions even more noticeable. Indeed, an argument could be made that the statement in the prospectus could be misleading to potential investors.

The American securities regulation regime is essentially one of disclosure.[182] While there is "no general duty to disclose all material information,"[183] conditional on disclosure, the issuer must ensure that such disclosure is not misleading. For example, consider Rule 10b-5, perhaps the most well-known and versatile rule associated with the Securities Exchange Act of 1934.[184] Rule 10b-5 prohibits fraud, including material misstatements or omissions, in connection with the purchase or sale of

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[179] *Id.* (emphasis added).

[180] *See* Chase Issuance Tr., Prospectus (Form 424B3) 34 (Aug. 2, 2010) (emphasis added).

[181] *Id.*

[182] *See, e.g.*, STEPHEN J. CHOI & A. C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 48 (3rd ed. 2012) ("disclosure is the focal point of federal securities regulation.").

[183] *Id.* at 49.

[184] Securities Exchange Act of 1934, 15 U.S.C. § 78a (2018).

securities.[185] An important feature of Rule 10b-5 is that it covers the purchase or sale of securities and can therefore be applied in secondary market transactions. Section 11 of the Securities Act of 1933 contains a separate anti-fraud provision for misstatements of omissions in a registration statement.[186] While section 11 mirrors rule 10b-5 in many respects, it relaxes many of the requirements, tilting the scales in favor of investors.[187]

Unlike Rule 10b-5, section 11 requires only that "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."[188] In the context of the federal securities laws, the "materiality requirement is satisfied when there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[189]

In such cases, "any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue" a list of persons enumerated in the statute.[190] There is no need to prove that the plaintiff relied on the misstatement at the time of purchase, or even that the plaintiff read the registration statement.[191] Similarly, while certain defendants may rely on a due diligence defense,

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[185] 17 C.F.R. § 240.10b-5 (2018).

[186] Securities Act of 1933 § 11(a), 15 U.S.C. § 77a (2018).

[187] *See* CHOI & PRITCHARD, *supra* note 182, at 468.

[188] Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (2018).

[189] Matrixx Initiatives, Inc. v. Siracusano, 563 U.S. 27, 38 (2011) (quoting Basic Inc. v. Levinson, 485 U.S. 224, 231–-32 (1988)) (some internal quotation marks omitted). While the claim in Matrixx was brought under § 10(b) rather than under § 11, both provisions use the same standard of materiality. *See* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 681 (S.D.N.Y. 1968).

[190] Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (2018).

[191] An exception to this requirement is that if the investor "acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person." Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (2018).

unlike claims under section 10(b) of the Securities Exchange Act, there is no need to prove scienter.[192]

Even if the prospectus does not contain a statement that is untrue, per se, omitting information such that the statement, taken as a whole, is misleading, is a basis for liability. The securitization programs under study were registered using form S-3, and the registration statements therefore included the Prospectus, Prospectus Supplement, and any documents incorporated by reference. While the forms do incorporate, for example, any 10-D's and 8-K's filed "prior to the termination of the offering of the notes," as well as the governing documents of the program,[193] filings by JPMorgan are *not* incorporated by reference. Moreover, it is not clear that *past* 8-Ks are incorporated by reference, and, if they are, the registration statement suggests that the information in the prospectus should control in the case of any conflict.[194]

This question may be largely academic. Section 11 damages are limited to "the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit[,] but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security."[195] Unfortunately, these securities are extremely thinly traded, making it extremely difficult to ascertain their value. Moreover, many of these securities have been repaid in full, meaning that the diminution in value is zero.

Furthermore, the statute of limitations, which is the lesser of "one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence" and "three years after the security was bona fide offered to the

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[192] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 207–8 (U.S. 1976) (noting that unlike section 10 of the Securities Exchange Act, section 11 of the Securities Act imposes what is essentially a negligence standard).

[193] *See* Chase Issuance Trust, Registration Statement (Form S-3) 147 (Nov. 23, 2010).

[194] *Id.* ("In all cases, you should rely on the later information over different information included in this prospectus or the accompanying prospectus supplement.").

[195] Securities Act of 1933 § 11(e), 15 U.S.C. § 77k(e) (2018).

public,"[196] means that no case can be brought relating to any security issued before January 2014. While this forecloses liability relating to older issuances, Chase continued to use this language well after that date. For example, it is included in a prospectus, dated May 12, 2016.[197] At this point, however, it is extremely difficult to determine what effect the omission has on price today. As noted above, the market is extremely thin, making prices unreliable. Moreover, market conditions have undoubtedly changed since the shadow bailout, but without a counterfactual, it is impossible to know what the issuance prices would have been without this omission.

Nevertheless, the fact that Chase appears to be so unwilling to disclose its intervention is itself informative. It stands to reason that Chase knows its market at least as well as the author does. It is therefore reasonable to interpret this silence as evidence of what the market values, and there is little doubt that Chase was, at the very least, not eager to advertise its past support for the program. This is clear evidence in favor of the safe asset story.

ii. Lack of a Bailout

Even Capital One's decision not to bail out its program is consistent with the safe asset story. The problems with Capital One's program appear to have been limited to its subordinated Class C and D securities, not to its safer Class A and B securities.[198] Even before the downgrade, Moody's had rated these Class C and D securities in the B-range, indicating that even the highest ranked among them may have possessed "certain speculative characteristics."[199] These assets, in other words, were not "money-like" to begin with. Therefore, as long as there was no danger of contagion to its safer Class A or B securities, the downgrade of its subordinated classes should not have been a huge concern. Moreover, the fact that Capital One decided not to intervene to provide credit enhancement when only its most subordinated securities were in any

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[196] Securities Act of 1933 § 13, 15 U.S.C. § 77m (2018).

[197] Chase Issuance Tr., Prospectus (May 12, 2016).

[198] *See, e.g.*, *Moody's downgrades Class C and D subordinate classes of Capital One credit card securities,* MOODY'S INV. SERV. (July 1, 2009), https://www.moodys.com/research/Moodys-downgrades-Class-C-and-D-subordinate-classes-of-Capital--PR_182245.

[199] *Rating Symbols and Definitions,* MOODY'S INV. SERV. (2015), https://www.moodys.com/sites/products/AboutMoodysRatingsAttachments/MoodysRatingsSymbolsand%20Definitions.pdf.

danger of downgrade might not be informative about how it might have responded had its Class A or B securities been at risk.

Unlike Capital One, World Financial Network's program experienced downgrades to two series of Class A notes, which had previously been rated Aaa.[200] Here, however, regulatory reasons appear to have played a role in preventing WFN from engaging in a bailout. During the crisis, WFN was subject to an operating agreement with the Office of the Comptroller of the Currency (OCC) dated on or about September 8, 2003.[201] The operating agreement required that WNF both provide the OCC with a minimum ten-day advance written notice prior to making any changes to its securitization program, and that it refrain from implementing any such change until it received supervisory non-objection from the OCC.[202] This suggests that WFN may not have been able to intervene to bail out its program.

B. Inconsistent with Regulatory Arbitrage

The shadow bailouts are completely inconsistent with the regulatory arbitrage story because the sponsoring banks bailed out their securitization programs *knowing* that by doing so, they would have to bring the assets back onto their balance sheets for regulatory capital purposes. As discussed above, the regulatory arbitrage theory posits that banks engage in securitization to "reduce their effective capital requirements."[203] If avoiding regulatory capital was the primary reason for engaging in asset securitization – its but-for cause – it would be completely illogical for a sponsor to engage in a bailout that would result in a loss of this "arbitrage" opportunity.

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[200] *Moody's downgrades eleven classes of WFN's credit card-backed notes,* MOODY'S INV. SERV. (Feb. 19, 2009), https://www.moodys.com/research/Moodys-downgrades-eleven-classes-of-WFNs-credit-card-backed-notes--PR_173293.

[201] Operating Agreement, between World Fin. Network Nat'l Bank, and The Office of the Comptroller of the Currency (Sept. 8, 2003) (on file with author). This document was obtained from The Office of the Comptroller of the Currency by way of the Freedom of Information Act (FOIA) request.

[202] *Id.* § VII (1). Specifically, the Operating Agreement required such notice and non-objection relating to changes to "the two-step process … related to the securitization that will ensure sale accounting treatment under FAS 140 or such similar funding structure that will support sale accounting treatment under FAS 140." *Id.*

[203] Acharya et al. *supra* note 2, at 535 (arguing that ABCP conduits are a form of regulatory arbitrage).

To see this more clearly, consider the decision tree faced by one of these ultimate sponsors. For simplicity, assume that if a sponsor declined to bail out its program, it would face such a large reputational hit that it would never be able to securitize credit card receivables again. We already know that a bailout would also result in a loss of this regulatory arbitrage opportunity. Therefore, *regardless* of whether the bank decided to engage in a bailout, the regulatory arbitrage opportunity would be lost! The only difference is that a bailout is expensive, since it involves a transfer of value from the sponsor to the investors in the securitization program. It would therefore be entirely illogical for a sponsor to engage in a costly bailout if the primary purpose of the program was regulatory arbitrage: why direct value into a bailout when, either way, the arbitrage opportunity—the presumed purpose of the program—would be gone?[204]

The effect of the bailouts on regulatory capital was not trivial. As discussed in Part IV.B.i, several sponsors were required to include all of the assets in their programs in the calculation of risk-weighted assets for the purposes of calculating risk-weighted capital ratios. At this time, banks were required to maintain a minimum tier 1 capital ratio of 4%. The effect of the inclusion was to reduce the affected bank's tier 1 capital ratio, in one case by 100 basis points.

For example, Citigroup disclosed in its 2009 10-K that, as a result of its bailout actions, regulatory capital rules forced it to begin "including the sold assets for all three of the credit card securitization trusts in its risk-weighted assets for purposes of calculating its risk-based capital ratios during 2009." [205] According to Citigroup's filings, "[t]he effect of these changes increased Citigroup's risk-weighted assets by approximately $82 billion, and decreased Citigroup's Tier 1 Capital ratio by approximately 100 basis points each as of March 31, 2009, with respect to the Master and Omni Trusts."[206]

Bank of America, JPMorgan Chase, and American Express found themselves in similar situations regarding regulatory capital. In JPMorgan Chase's case, the actions resulted in the addition of approximately $40

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[204] This is not to say that regulatory arbitrage could not have been a motivating factor early on, or even that it was not a "sweetener," up until the financial crisis. The point is that, by the mid-2000s, regulatory arbitrage could not have been the primary, or but-for, cause of securitization. As in life, there are often many factors that make a business decision attractive but are not necessarily dispositive.

[205] Citigroup Inc., Annual Report (form 10-K) 204 (Feb. 26, 2010).

[206] *Id.*

billion of risk-weighted assets for regulatory capital purposes, which decreased the Firm's Tier 1 capital ratio by approximately 40 basis points."[207] Similarly, Bank of America's bailout activities "resulted in an increase to [its] Tier 1 risk-weighted assets of approximately $67.0 billion,"[208] and American Express's actions regarding the Amex-Lending program "resulted in the inclusion of the Lending Trust's assets as risk-weighted assets for regulatory capital purposes."[209]

More damningly for the regulatory arbitrage theory, the ultimate sponsors appear to have been *aware* of this consequence before they engaged in these bailouts. Indeed, at least one ultimate sponsor disclosed as much to its shareholders. In its 2008 10-K, filed on February 27, 2009, Bank of America disclosed its plan to purchase an additional subordinated security from its program in the first quarter of 2009, as well as to exercise its discount option.[210] While it stated that these actions were "not expected to have a significant impact on the Corporation's results of operations," it disclosed that "[i]f these actions had occurred on December 31, 2008, the impact would have increased our Tier 1 risk-weighted assets by approximately $75 billion or six percent."[211]

While Bank of America had already begun its bailout before its 2008 10-K was filed, Citi and Chase did not begin theirs until the second quarter of 2009, after it had been filed and was publicly available. It therefore seems implausible that these financial institutions, with their legions of lawyers and accountants, were unaware of the consequences of the bailouts. Similarly, in disclosing its intention to engage in bailout activities, Discover noted that these actions would "result in the inclusion of [the program's] assets as risk-weighted assets for regulatory capital purposes," and thus reduce the company's capital ratios.[212] This disclosure occurred *before* Discover took these actions.

A proponent of the regulatory arbitrage might argue that sponsors might have been willing to engage in these bailouts at the cost of losing the *current* regulatory arbitrage because they wanted to maintain the

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[207] JPMorgan Chase & Co., Annual Report (Form 10-K) 200 (Feb. 24, 2010).
[208] Bank of Am. Corp., Quarterly Report (Form 10-Q) 151 (Nov. 6, 2009).
[209] Am. Express Co., Quarterly Report (Form 10-Q) 59 (Aug. 3, 2009).
[210] Bank of Am. Corp., Annual Report (Form 10-K) 51 (Feb. 27, 2009).
[211] *Id.*
[212] Discover Fin. Serv., Current Report (Form 8-K) 3 (June 17, 2009).

ability to engage in *future* regulatory arbitrage. In other words, perhaps the arbitrage opportunity going forward was *so* valuable that it alone was worth engaging in the bailouts.

This seems highly unlikely—as Levitin pointed out, a pair of 2010 changes in accounting rules brought most of these programs back onto banks' balance sheets anyway.[213] These changes, codified as Statements of Financial Accounting Standards 166 and 167, became effective "at the start of a company's first fiscal year beginning after November 15, 2009, or January 1, 2010, for companies reporting earnings on a calendar-year basis."[214] The Financial Accounting Standard Board (FASB) concluded its deliberations on these two rules on May 18, 2009, and finalized them as standards on June 12, 2009,[215] at the height of the bailouts. Moreover, these rules came at the end of a long public process; the original proposals were released for comment in September 2008.[216]

It is simply implausible to argue that securitization sponsors were unaware of these impending rules at the time of the bailouts. Nevertheless, the sponsors decided to go ahead and engage in massive voluntary bailouts of their programs. Such a decision simply makes no sense if the primary motivation for securitization is regulatory arbitrage. If the reason for securitization is the arbitrage, and the arbitrage opportunity is being taken away, there is no incentive for the sponsor to try to preserve its ability to securitize.

C. Consistent with Agency Cost Explanation, but with a Twist

While the shadow bailouts are also consistent with an agency cost explanation for securitization, the story here is more complex. The simplest version of the agency cost story—that securitization creates robot companies, which are beyond the discretion of the sponsor's managers—is clearly not true in a crisis. Nevertheless, as the crisis and the shadow bailouts also showed, the discretion that remains to sponsors is only on the "upside." While intervention is possible, it is only possible if it benefits the noteholders. In other words, by setting a floor, but not a ceiling,

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[213] Levitin, *supra* note 4, at 828.

[214] *News Release, FASB Issues Statements 166 and 167 Pertaining to Securitizations and Special Purpose Entities,* FIN. ACCT. STANDARD BOARD (June 12, 2009), https://www.fasb.org/cs/ContentServer?cid=1176156240834&d=&pagename=FASB%2FFASBContent_C%2FNewsPage.

[215] FIN. ACCT. STANDARD BOARD, *Briefing Document: FASB Statement 166 and 167*, https://www.fasb.org/news/051809_fas140_and_fin46r.shtml (last visited Feb. 18, 2019).

[216] *Id.*

securitization protects investors from agency problems while at the same time allowing sponsors to retain the flexibility to intervene for their benefit.

i. Securitization Programs are not 'Robot Companies'

At first glance, this episode doesn't look good for the agency cost explanation of securitization. While they may operate like "robot companies" when things are going well, the sponsors intervened in a number of ways during the crisis. Some of these interventions were clearly contemplated at the time that the programs were designed, suggesting that these safety valves were built into the programs from the start. Most obviously, the ability to designate a principal receivables discount is a clear instance of discretion granted to the securitization sponsor. It is hard to reconcile such built-in discretion with something that is truly meant to be an autonomous robot.

Other interventions appear to have been designed as desperate bailout measures in the midst of the crisis. The extensive amendments and addenda that were executed to enhance the protections of the noteholders reflect not only a willingness to engage in a bailout, but also an ability to do so. Similarly, the fact that sponsors were able and willing to subordinate their own interests demonstrates that sponsors had far more flexibility to affect the cash flows to noteholders than scholars had previously thought.

On a deeper level, however, these findings are completely consistent with a slightly more nuanced form of the agency cost explanation. While securitization does create robot companies, it preserves managerial discretion to *go beyond* the protections and benefits contained within the program. In other words, it acts as a floor on managerial discretion. While it prevents managers from acting against the interest of the noteholders, it *permits* them to give them extra value. In other words, the bailouts demonstrate that securitization programs are flexible enough to withstand a crisis.

ii. Amendments and Addenda

The most obvious instance of this flexibility is the rating agency condition. As discussed in Parts IV.A and IV.B.i, sponsors are permitted to make a surprising number of changes to the programs, as long as they

obtain the approval of the rating agencies first. Several of the bailout methods used in the crisis involved either the execution of new contracts or contractual amendments. For example, the issuance of new investor certificates (notes) typically entailed the execution of a supplement to the Pooling and Servicing Agreement (Indenture). Moreover, some programs also executed an Omnibus Amendment (or Addendum) to Terms Documents or to the Indenture Supplement, in some cases to give effect to the issuance of a subordinated security,[217] and in others to increase the overcollateralization of the notes.[218]

The most illuminating example comes from Chase's bailout. As discussed in Part B.3, Chase's bailout included changes to the required subordinated amounts of Class A and B notes, as well as the targeted deposit in the Class C Reserve Account. All three of these provide vital credit enhancements to the outstanding notes. Moreover, it is clear that substantial thought went into the selection of the original levels. For example, the Class A Required Subordinated Amount of Class B Notes and C Notes were originally set to 6.49718% and 6.49718%, respectively, and the Class B Required Subordinated Amount of Class C Notes was originally set to 6.10080%. In other words, the percentages were chosen down to the fifth decimal place. Nevertheless, the governing documents seem to permit the sponsor to change these amounts "at any time without the consent of the Noteholders provided the conditions specified in . . . the Indenture are satisfied."[219] The Indenture, for its part, permits the issuer to change the required subordinated amount "at any time without the consent of Noteholders," subject to certain conditions, including the consent of rating agencies and a tax opinion.[220]

If these amounts, while clearly carefully selected at the time of the program formation, can be modified without the consent of the noteholders, it is clear that the numbers themselves are not what the parties are really agreeing to. Instead, these provisions should be understood as providing a minimum amount of protection to the noteholders. In order to

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[217] *See, e.g.*, Omnibus Amendment to the Terms Documents to the Second Amended and Restated Indenture, as supplemented by the Amended and Restated BA Series Indenture Supplement, between BA Credit Card Tr. and The Bank of New York Mellon (Apr. 14, 2009); Omnibus Amendment to Indenture Supplement to the Amended and Restated Indenture, (as amended and restated), between Am. Express Issuance Tr. and The Bank of New York Mellon (Oct. 2, 2009); Omnibus Amendment to Indenture Supplement and Terms Document, between Discover Card Execution Note Tr. and U.S. Bank N.A., (July 2, 2009).

[218] *See, e.g.*, Chase Omnibus Amendment, *supra* note 83.

[219] Amended and Restated CHASEseries Indenture Supplement, between Chase Issuance Trust and Wells Fargo Bank, National Association § 2.03(d) (Oct. 15, 2004).

[220] Chase Third Amended and Restated Indenture, *supra* note 55, § 3.11(b).

preserve flexibility, the numbers themselves can be changed, as long as the change does not diminish the level of protection. At the same time, the determination of whether or not a change will diminish the level of protection is taken away from the sponsor, thus mitigating the agency problem. Instead, the rating agencies are charged with making this determination. This is a wonderful example of the genius of securitization. The structure is rigid enough to mitigate agency problems, while at the same time remaining flexible enough to withstand a crisis.

iii. Citi and Chase – Subordination of Seller's Interest

The most extreme instance of managerial discretion during the shadow bailouts was the subordination of seller's interests. As discussed in Part IV.B.i, both Citigroup and JPMorgan Chase reported that they had subordinated a portion of their seller's interest, Citi in the Master Trust, and Chase in the Issuer Trust. However, in both cases, I was not able to find any authority under which it was able to do so, nor could I find any evidence of how they accomplished this subordination.

Without any documentation, the most plausible explanation for how this came to pass is simply that there was no one to object. The noteholders could only gain from this, and in any event, the disclosures regarding the subordination were made in the ultimate parents' filings, not the programs. This is itself puzzling, as the subordination would seem to be a material event for the program as well as (and perhaps even more than) for the ultimate sponsor. Consistent with the discussion in Part IV.B.i, it also suggests that the ultimate sponsor was not eager to advertise the subordination to the noteholders.

iv. Fiduciary Concerns

So far, we have only addressed the agency costs associated with the securitization programs. But, what about the shareholders of the ultimate sponsors? With so much value being transferred to the outside investors in the securitization programs, we would be remiss not to at least consider the perspective of the sponsors' shareholders.[221]

[221] *See* discussion *supra* Part III.A. This discussion has ignored the distinction between the legal entities involved in these programs. It does so in order to "follow the money" and get at the true economic content of the shadow bailouts. But while these distinctions may be irrelevant from an economic perspective, from a legal perspective they may be dispositive.

Other than in the event of impending insolvency or bankruptcy,[222] the only restrictions on a manager's ability to transfer value out of a firm are fiduciary duties. While the shareholders are the owners of a company, the board of directors is responsible for managing its "business and affairs."[223] In carrying out their managerial responsibilities, "directors owe fiduciary duties of care and loyalty to the corporation and its shareholders."[224] Generally, courts will intervene only if the directors have violated one or both of these duties. Under certain conditions, shareholders may bring suit against a director that has violated these duties.

The duty of care is a fairly low bar. Under the business judgment rule, most everyday decisions of directors are given broad, albeit not unlimited, deference.[225] In general, as long as the directors have taken steps to inform themselves before making a decision, and the decision did not rise to the level of gross negligence,[226] the business judgement rule will protect a board action from challenge under the duty of care.[227] On the

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Unfortunately, the question of which directors are legally responsible would turn on facts that are not available in public filings. Therefore, for the purposes of the discussion in this section, I continue to ignore this distinction, and assume that any fiduciary claims may be brought by the shareholders of the ultimate sponsor. Because I ultimately find that such claims are weak at best, I do not enter into a further discussion of this issue.

[222] Such transfers are known as fraudulent conveyances and may be avoided by the courts. There are two types of fraudulent conveyance – actual fraud, and constructive fraud. Actual fraud arises in cases where the debtor's actual intent is to "hinder, delay or defraud" creditors. *See* 11 U.S.C. § 548(a)(1)(A) (2012). *See also* JEFFERY T. FERRIELL & EDWARD J. JANGER, UNDERSTANDING BANKRUPTCY 583-85 (2nd ed. 2007). 11 U.S.C. § 548(a)(1)(B)(i) (2012). Stated broadly, the second element "is that the debtor, one way or another, was insolvent or otherwise at inappropriate risk of being unable to pay its debts. FERRIELL & JANGER, at 585-86.

[223] DEL. CODE ANN. tit. 8, § 141 (West 2016).

[224] *See, e.g.*, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989).

[225] *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors … [i]t is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts." (internal citations omitted)).

[226] *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) ("We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.").

[227] *See, e.g.*, Gimbel v. Signal Companies, Inc., 316 A.2d 599, 615 (Del. Ch. 1974) *aff'd*, 316 A.2d 619 (Del. 1974) (articulating the standard for overcoming the presumption of the business judgment rule as that "direcotrs [*sic*] acted so far without information that they can be said to have passed an unintelligent and unadvised judgment."). *See also* Smith, 488 A.2d at 872 ("The determination of whether a business judgment is an informed one turns on whether

surface, there is no evidence that the boards of the ultimate sponsors acted so as to violate the duty of care in the context of the bailouts. Without knowing more about the board's deliberations, there is no basis for pursuing a claim under the duty of care.

The duty of loyalty, on the other hand, requires that directors act in the best interest of the company and its shareholders. This duty generally arises in the context of self-dealing by the directors: situations, in other words, where the directors are "on both sides of a transaction."[228] In such cases, directors face a heavy burden: "they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain. The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts."[229]

While it is possible that the bailouts may have involved self-dealing, there is no evidence to that effect. For example, one serious red flag would be if one or more members of the board of directors of the ultimate sponsor was also a noteholder in one or more of that sponsor's programs. Barring this type of self-dealing, however, the bailouts seem to satisfy the standard duty of loyalty analysis.

An offshoot of the duty of loyalty is the doctrine of corporate waste. While waste claims are often associated with excessive managerial compensation, in principle, the claims can extend to other areas of board activities. As articulated by the Delaware Court of Chancery:

> a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade. Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift. If, however, there is any substantial consideration received by the corporation, and if there is a good faith judgment that in the circumstances the

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the directors have informed themselves prior to making a business decision, of all material information reasonably available to them" (internal quotations omitted)).

[228] Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

[229] *Id.*

> transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude [ex] post that the transaction was unreasonably risky. . . . Courts are ill-fitted to attempt to weigh the 'adequacy' of consideration under the waste standard or, ex post, to judge appropriate degrees of business risk.[230]

The Delaware Supreme Court described the requirements of the waste test as "stringent," and cited with approval the Court of Chancery's formulation of "an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[231]

Did the bailouts rise to the level of corporate waste? Putting aside the issue of the various levels of wholly-owned subsidiaries and consolidating the analysis up to the ultimate parent, the question becomes: did the ultimate parent benefit from the bailouts? On the one hand, it is clear that the bailouts constituted a transfer to the noteholders with no *direct* benefit to the ultimate sponsor. Indeed, in some sense, there was no exchange at all; the bailouts were, at least formally, unilateral and donative. On the other hand, corporations regularly engage in what looks, on the surface, like donative actions. Charitable donations, "socially responsible" behavior, and making voluntary tax payments[232] are just three examples of such behavior.

Perhaps the most famous judicial decision affirming a corporate board's right to consider such external interests is Shlensky v. Wrigley, in which a stockholder brought a derivative suit against the directors of Chicago National League Ball Club, owners of the Chicago Cubs, for refusing to install lights in Wrigley Field.[233] The plaintiff argued that these lights would allow the Cubs to play night games, thus increasing the club's revenue.[234] According to the plaintiff, the reason for the board's refusal to do so was one board member's "personal opinions that baseball is a

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[230] Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) (internal citations omitted).

[231] Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000).

[232] For example, Starbucks has a history of making voluntary tax payments to the UK government. *See* Jia Lynn Yang, *The British want to stop Starbucks from dodging taxes. It won't work.* WASH. POST (Apr. 18, 2014), https://www.washingtonpost.com/news/wonk/wp/2014/04/18/the-british-want-to-stop-starbucks-from-dodging-taxes-it-wont-work.

[233] Shlensky v. Wrigley, 237 N.E.2d 776, 777 (Ill. App. Ct. 1968).

[234] *Id.* at 778.

'daytime sport' and that the installation of lights and night baseball games w[ould] have a deteriorating effect upon the surrounding neighborhood."[235] The lower court dismissed the suit and the Illinois Appellate Court affirmed.[236] Because the plaintiff had alleged "no fraud, illegality[,] or conflict of interest," the board was free to consider the "long run interest" of the corporation, including taking steps to keep the neighborhood around the stadium from deteriorating.[237]

The sponsors' directors could have made similar arguments. Rather than a concern about the neighborhood, the sponsors could have pointed to their firm's reputation, which is clearly a valuable commodity. After all, the sponsors may have believed that, without the bailouts, they would have lost the ability to engage in such securitization programs in the future. All of the theories of securitization agree that it is valuable for sponsors to have these programs; they differ only in their explanations for the source of this value.[238]

The fact that the sponsor is not *advertising* its bailout makes this an unusual kind of reputational benefit. It is more common to think of corporate reputation building as advertising or highly publicized charitable campaigns. The reason this situation is different is precisely because, as discussed *infra*, the sponsors were engaged in the creation of safe assets. When you are creating safe assets, the best thing you can do is to stay as quiet as possible, and the best reputation you can have is that you never do anything at all. Nevertheless, just because this is an unusual kind of reputation preservation does not mean that it is not genuine.

The belief that failing to engage in a shadow bailout could jeopardize future securitization programs was probably reasonable. For example, contemporary accounts indicate that analysts had described Advanta's decision to allow its trust to go into early amortization as

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[235] *Id.* (some internal quotations omitted).

[236] *Id.* at 781.

[237] *Id.* at 780.

[238] In principle, a court that believed (incorrectly) that regulatory arbitrage was the predominant driver of value in securitization might conclude that the bailouts constituted a waste under current law. As discussed in Part V.B, the arbitrage opportunity was effectively destroyed by the combination of having to bring the programs back on balance sheet and the change in accounting rules.

something that "would likely alienate potential investors."[239] Even Advanta's Chief Financial Officer acknowledged that the firm was "not counting on having access to the asset-backed debt market anytime soon."[240] Moreover, even before the crisis, there was a strong view in the academic community that investors expected to have recourse to the sponsor in the event of distress.[241]

D. Inconsistent with Apportionment of Risk

The simple fact that the shadow bailouts occurred is inconsistent with the apportionment of risk story. Far from transferring the risk from the sponsors to the investors, the bailouts demonstrate that the sponsors effectively retained the risk in the form of implicit guarantees.

Moreover, we already saw in Part IV that contemporary accounts suggest that failing to bail out a program would jeopardize a sponsor's future securitizations. This is inconsistent with the apportionment of risk story. If failing to engage in bailouts would close the door to further securitizations, this suggests that the implicit contract between the noteholders and the ultimate sponsors was that the ultimate sponsors would stand ready to support their programs in the event of a crisis. This finding—that rather than apportioning risk, it was being retained by the sponsors—may be the single least novel aspect of this article. It is entirely consistent with prior research on both securitization in general[242] and credit card securitization in particular.[243]

VI. POLICY IMPLICATIONS

The fact that securitization exists primarily for the creation of opaque, "safe" assets has important policy implications that go far beyond these shadow bailouts. First, it means that securitization is socially valuable in its own right. Second, while the very notion that opacity is preferred to transparency is anathema to the entire SEC regulatory

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[239] *See, e.g.*, Harry Terris, *Will Advanta Plan Spook Market for Card Paper?* 174 AM. BANKER 1, 1 (2009).

[240] *Id.*

[241] *See, e.g.*, Calomiris & Mason, *supra* note 11; Gorton & Souleles, *supra* note 35; Eric J. Higgins & Joseph R. Mason, *What is the Value of Recourse to Asset-Backed Securities? A Clinical Study of Credit Card Banks*, 28 J. BANKING & FIN. 875–99 (2004).

[242] *See, e.g.*, Acharya et al., *supra* note 2.

[243] *See, e.g.*, Levitin, *supra* note 4, at 818 ("Credit card securitization did not produce the same disastrous results as unregulated mortgage securitization because it has never been a true credit risk transfer mechanism."); Gorton & Souleles, *supra* note 35.

apparatus, this analysis suggests that, at least in this context, more disclosure may not be socially desirable. Rather, regulators should treat securitization programs the same way that they treat banking activity and monitor it much more closely. In the same way, the fact that securitization structures act as a floor, rather than as a firm constraint against managerial action, means that regulators should take this extra downside risk into account when monitoring sponsors. I discuss each of these implications in turn.

A. Securitization is Socially Valuable

The discussion in Part V vindicated the view of securitization as the creation of a valuable asset. As with anything else that is adding value to society, this suggests that securitization is something that should actually be encouraged. Of course, the fact that securitization is valuable does not mean that it carries no risks. Cars are socially valuable; they serve a useful social function in assisting with transportation. They also have risks. According to the National Highway Traffic Safety Administration, there were 29,989 fatal motor vehicle crashes in the United States in 2014, resulting in a total of 32,675 deaths.[244] The response is not to ban cars. Rather, it is to regulate them for safety. The same is true for securitization. Once we recognize that securitization is a vital part of the banking system, it becomes obvious that the right policy approach is to design regulations that treat it as such.

B. Increasing Disclosure about Securitization Programs is a Mistake

As with the rest of the banking system, the parties involved in securitization do not *want* disclosure. The whole point of securitization, as it is used today, is opacity. Attempts by regulators to force disclosure will at best be futile and at worst be harmful. At best, securitizers will respond by making meaningless disclosures that provide no insight to anyone. Because even meaningless disclosure is costly, this outcome will be wasteful, but is actually the best-case scenario.

In the alternative, regulatory efforts to induce disclosure might be successful, in the sense that they succeed in forcing securitizers to provide information to the market. This will have one of two results. One possibility is that it could destroy the market entirely. Given that

[244] National Highway Traffic Safety Administration, *Traffic Safety Facts 2014*, 2, https://crashstats.nhtsa.dot.gov/Api/Public/ViewPublication/812261.

securitization is socially valuable, this is clearly not a desirable outcome. The more likely outcome is that securitization will move out of the regulated arena and further into the shadows. For example, the SEC's asset-level disclosure rules,[245] known as Regulation AB II and coming into effect in November 2016,[246] apply only to publicly issued securitizations.[247] The obvious response is for securitization to move into the private placement market. Not only will such a move restrict access to this market, it will also make it *harder* to keep an eye on it.[248]

Instead of trying to force disclosures, regulators should focus on data collection. Superficially, this may seem like a contradiction. It isn't. There is no reason that data collection by regulators must go hand in hand with public disclosures.[249] This misunderstanding is not entirely unfounded. After all, the SEC's regulatory role is essentially to act as a conduit. The SEC collects data from filers and makes it available to the public. To the extent that the SEC performs any vetting function, even this is subject to public disclosures. For example, the SEC's division of Corporation Finance selects certain corporate filings for review and provides comments to the company.[250] The company is then given an opportunity to respond to the SEC's comments.[251] All of these documents are publicly available on the SEC's website.

But this is not the only way to regulate securitization. A better model is the one that the U.S. currently uses for banking. The Federal Reserve collects a tremendous amount of data from U.S. banks, only a fraction of which is made available to the public.[252] The same approach can be taken with respect to securitizations; rather than forcing *public*

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[245] Regulation AB II, 79 Fed. Reg. 57,184 (Sept. 24, 2014).

[246] *Id.*

[247] Fortunately for issuers of credit card securitizations, the brunt of this new rule will be borne by other categories of securitizers. Under these new rules, issuers of certain types of securitization programs, including auto loans, commercial mortgages, and residential mortgages, will be required to make detailed, ongoing asset-level public level disclosures. *Id.* at 57, 201–31.

[248] For example, it should be obvious at this point that this article relied extensively on SEC regulatory filings. It is not an exaggeration to say that without public securitizations, this article would not have been possible.

[249] Again, I acknowledge the value of the existing disclosures. My argument here is not that there should be *no* disclosure in public securitizations. Rather, it is simply that we do not need *more* disclosure.

[250] *Division of Corporate Finance, Filing Review Process*, U.S. SEC. & EXCH. COMM'N (Jan. 29, 2019), https://www.sec.gov/divisions/corpfin/cffilingreview.htm.

[251] *Id.*

[252] *See generally* Gary Gorton, *The Development of Opacity in U.S. Banking*, 31 YALE J. ON REG. 825 (2014).

disclosure, bank regulators should increase *their* data collection with respect to securitizations. Rather than pushing securitization further into the shadows, this would allow regulators to keep an eye on this market.

More importantly, the fact that these shadow bailouts occurred is proof that, in a time of severe stress, securitization sponsors may choose to take steps to bail out their programs. Bank regulators are therefore overlooking a potentially significant downside risk of commercial banks if they do not take this risk into account. Of course, the only way that they can do this is if they know how big this risk is. The obvious solution is for regulators to closely monitor this area of shadow banking.

In fact, rather than attempt to block internal bailouts, regulators should actually encourage them. To those who are accustomed to the risk transfer or regulatory arbitrage theories of securitization, this will be counterintuitive. From the perspective of the creation of safe assets, however, it is entirely natural. The best way to prevent a run on any safe asset is to have a powerful backstop step-in during a time of crisis. In a full-blown financial crisis, that entity is normally a central bank. However, it need not always be so. For example, in the panic of 1907-08, before the development of the Federal Reserve System, it was the bankers themselves that got together to end the crisis.[253]

In the case of credit card securitization programs, the most natural candidate for this role is the sponsor. Not only does the sponsor have the best information about the program, it also has the best incentives. The standard moral hazard problem—that programs will take on too much risk knowing that they have a backstop in the event of a crisis—is inapposite here, since the party most likely to benefit from such moral hazard is also the one on the hook for the bailout.

One potential objection to this argument is that it simply kicks the moral hazard can down the road. The sponsor may be the one to save the program, but perhaps the sponsor itself expects a public bailout. This may or may not be true: a full discussion of the question of whether or not the

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[253] OTTO C. LIGHTNER, THE HISTORY OF BUSINESS DEPRESSIONS 200–18 (1922). Perhaps somewhat ironically, the protagonist in that story was a banker by the name of J. P. Morgan, founder of the eponymous financial institution. *See also* GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007 33–37 (2010).

Dodd-Frank Act[254] was successful in ending the belief that large financial institutions are "too-big-to-fail" is a question for another day. Nevertheless, what is clear is that this risk is best addressed through efforts to address the "too-big-to-fail" problem at its source. Such efforts are underway across the financial regulatory space. Adding a presumption that sponsors will bail out their programs in a time of stress, coupled with the increased information collection discussed above, will actually make it *easier* for regulators to monitor and address systemic risk build-up in the financial system.

VII. CONCLUSION

By chronicling the previously unexplored shadow bailouts, this article adds a new chapter to the story of the financial crisis. It also adds to our understanding of securitization as a legal and financial institution. First, I show that the "regulatory arbitrage" theory is flawed and should not be interpreted as a but-for cause of securitization. Second, my analysis supports the view that securitization programs such as these were primarily valuable because they were used to create safe assets. Third, these bailouts demonstrate that sponsors had much more discretion in the management of a securitization program than was previously thought. Finally, far from lacking "skin in the game," these bailouts show that sponsors stood ready to defend their securitization programs, even in the face of severe stress.

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[254] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No: 111–203, 12 U.S.C. §§ 5301 et seq. (2012).