STRUCTURED FINANCE: USES (AND ABUSES) OF SPECIAL PURPOSE ENTITIES

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I. Introduction

Special Purpose Entity (SPE) is a global term, and is used interchangeably with the term Special Purpose Vehicle (SPV). An SPE is either a Trust or a Company. Special purpose entities can be either on shore or offshore. Special purpose corporations are used for a variety of legitimate purposes, including structured risk management solutions. In securitizations, the SPE houses the asset risk either through the purchase of the assets or in synthetic form. The assets are then used as collateral for notes issued by the SPE.

Special purpose entities are powerful structured finance tools. Both the banking community and the investment community have benefited as SPEs facilitated bank balance sheet management and facilitated the creation of new investment asset classes. Reaction to recent financial scandals threatens to cripple some of the legitimate and beneficial uses of special purpose entities, while failing to address the underlying causes of the problem.

Because of their normally off-balance sheet, bankruptcy remote, and private nature special purpose entities can be used for both legitimate and illegitimate uses. Several structures lend themselves to money laundering, disguising loans as revenue to misstate earnings, concealment of losses, embezzlement, and other accounting improprieties. Even when used legitimately, the way the issuance of special purpose entities is represented is sometimes ethically marginal.

Reaction to recent financial scandals inspired proposed accounting changes for special purpose entities. Some proposed changes, such as recognizing certain upfront derivative contract payments as a financing instead of as revenue, are appropriate. Other proposed changes, such as some aspects of FIN 46, are counterproductive attempts to answer the wrong question. New rules proposed to give the appearance of doing a good accounting job fail to address gaming. Even worse, they provide potential unnecessary complications for collateralized debt obligations (CDOs). In fact, the new rules may exclude some beneficial structures by throwing into question whether reserve accounts built up from residual cash flows in synthetic deals will cause the collateralized debt obligation to be treated as a variable interest entity (VIE).

The Sarbanes-Oxley Act is a step in the right direction, but lacks effective deterrents. The question that requires an answer is how do we competently manage structured finance activity and deter abuse?

II. Legitimate Uses of Structured Finance and Special Purpose Entities

All of the following are examples of special purpose entities: Special Purpose Corporations (SPCs) which may or may not be Special Purpose Subsidiaries or *captives*; Master Trusts; Owners Trusts; Grantor Trusts; Real Estate Mortgage Investment Conduits (REMICs); Financial Asset Securitization Investment Trust (FASIT); Multiseller Conduits; Single Seller Conduits; and certain Domestically Domiciled Corporations.

Special purpose entities used for structured finance are often classified as either *passthrough* or *paythrough* structures. Passthrough structures pass through all of the principal and interest payments of assets to the investors. Passthrough structures are therefore generally passive tax vehicles and do not attract tax at the entity level. Paythrough structures allow for reinvestment of cash flows, restructuring of cash flows, and purchase of additional assets. For example, credit card receivable transactions use paythrough structures to allow reinvestment in new receivables so bonds of a longer average life can be issued.

For securitization of cash assets, the key focus is on non-recourse (non-recourse to the originator/seller) financing. The structures are bankruptcy remote so that the possible bankruptcy or insolvency of an originator does not affect the investors' right to the cash flows of the vehicle's assets. The originator is concerned about accounting issues, especially that the structure meets requirements for off-balance sheet treatment of the assets, and that the assets will not be consolidated on the originator/seller's balance sheet for accounting purposes. For bankruptcy and accounting purposes, the structure should be considered a sale. This is represented in the documentation as a *true sale at law* opinion. The sale is also known as a *conveyance*.

The structured financing should be a debt financing for tax purposes also known as a debt-for-tax structure. Tax treatment is independent of the accounting treatment and bankruptcy treatment. An originator selling assets to a special purpose entity will want to ensure that the sale of assets does not constitute a taxable event for the originator. The securitization should be treated as a financing for tax purposes i.e., treated as debt of the originator for tax purposes. This is represented in the documentation in the form of a tax opinion.

The structured finance solution to the bankruptcy, true sale, and debt-for-tax issues varies by venue. For example, if a U.S. bank wants to securitize receivables, the structured finance solution requires two special purpose entities to avoid a federally taxable asset sale and to achieve off-balance-sheet financing and a bankruptcy remote structure. In the United States, special purpose entities are usually organized as trusts (for tax reasons) under the laws of the state of Delaware or of New York. The first special purpose entity is a wholly owned, bankruptcy remote subsidiary of the originator/seller, and the special purpose entity buys the assets in a true sale. The assets are now beyond the reach both of the creditors of the originator/seller and the originator/seller. Wholly owned subsidiaries are consolidated with the originator/seller for U.S. federal tax purposes, so this achieves the debt-for-tax objective. The second special purpose entity is the issuer of the debt (or asset backed security) and is entirely independent of the originator/seller. It is a bankruptcy remote entity. The second special purpose entity buys the assets of the first special purpose entity as a true sale for accounting purposes and a financing for tax purposes. Figure 1. in the appendix shows a schematic of this structure.

Other venues for structured finance are more problematic, and the regulations with respect to the local equivalent of the U.S. Bankruptcy Court's automatic stay procedures, accounting rules, and tax laws must be verified with experts who have local expertise.

For example, two entities are required for Italian securitizations. The first entity can be onshore and purchases the assets. The onshore entity cannot issue bonds, or it will attract heavy Italian taxes. The second entity is offshore and the second vehicle issues the bonds.

Synthetic securitizations do not get true sale treatment for accounting purposes, since no asset has been sold. This is true whether the vehicle is a special purpose entity or a credit-linked note. The motive behind these structures is to reduce regulatory capital according to regulatory accounting principles. Funding is a non-consideration or a minor consideration. These are usually balance sheet deals for bank regulatory capital relief. Partial funding is feasible with a hybrid structure. A corollary motive is to get credit risk relief. These structures are especially popular with European banks that have cheap and abundant funding relative to U.S. banks.

Repackaging is another legitimate use of special purpose entities. U.S. banks often set up mutli-issuance vehicles (MIEs) in the Cayman's or other tax friendly venues. These are Qualifying Special Purpose Entities (QSPEs) for Financial Accounting Standards Board (FASB) purposes. By definition, they are off balance sheet, bankruptcy remote entities. The assets are put presumptively beyond the reach of the bank transferor's creditors through a true sale. Furthermore, the bank is not obligated to repurchase the transferred assets. Setting up the special purpose entity in this way insulates the customers from the bank's credit risk, and ensures the assets don't re-emerge on the bank's balance sheet, even though the SPE may often purchase assets from the bank sponsor's books.

Accounting rules are always subject to change. FASB continually reviews the conditions to be imposed on active special purpose entity assets through equity ownership, management agreements, or other means. They have regular meetings on special purpose entities, sale criteria, transfers of financial instruments, and modification of the definition of a QSPE.

The MIE issues notes that reference only the underlying collateral specific to each note (unlike the structure in which the collateral for all the Euro medium term notes, EMTNs, is a reference pool of assets). The noteholders do not have a claim to any other asset owned by the SPE. Each set of assets is funded separately with its own EMTN tranche combining the risk characteristics of the underlying assets and/or derivatives. The derivatives may be hedges or may actually be an underlying asset, such as a credit derivative.

Figure 2. in the appendix shows a typical vanilla repackaging. The special purpose entity purchases assets. The assets are pre-funded from proceeds of an EMTN issued by the special purpose entity and underwritten or sold by the bank arranger's (bank sponsor's) capital markets group. The special purpose entity pays the asset cash flows to the bank arrangers swap desk as one leg of a swap payment. The bank arranger provides the structured coupons due to the investors under the EMTN issue.

A diverse group of investors purchases EMTNs issued by an MIE: insurance company funds, independent funds, bank sponsored funds, corporations, insurance companies, commercial banks, merchant banks, investment banks, savings banks, regional banks, and US investors eligible to purchase 144A assets.

The MIE offers more competitive note issuance, because it can take advantage of a more advantageous funding cost relative to the bank's funding cost. The structured financing lowers the cost of funding. From the investor's point of view, the SPE issued note is different from a credit-linked note issued by the bank sponsor, since the investor has no exposure to the bank sponsor (assuming that bank sponsor collateral is not used for synthetic repackagings). The note is securitized by collateral purchased by the special purpose entity and frequently – but not always – selected by the investor.

III. Venue of the Special Purpose Entity

There is no easy answer to the question: "Where is the best place to set up a special purpose entity?" It depends on the structured finance application among other considerations. Special purpose entities are currently set up in a variety of tax friendly venues including Delaware (in the United States), New York, Luxembourg, the Netherlands, the Caymans, Ireland, Jersey, Guernsey, and Gibraltar.

While special purpose entities in the United States are often, but not always, set up as trusts for tax reasons, in non-U.S. venues, the special purpose corporation is a common structure. Venues can be chosen wherever an SPE structure is allowable, but as a rule, only tax friendly venues for the specific structured finance application are chosen.

While choice of venue usually revolves around tax issues, other considerations can be important. For example, many investors in Germany will buy notes issued by SPEs, but often require an OECD issuer. Therefore, the SPE must be set up in an OECD country. Among the OECD countries, the Netherlands, Luxembourg, and Ireland are currently the most commonly used tax-friendly venues.

In tax terms, we want the special purpose entity to pay zero tax on payments flowing in and flowing out. We want to avoid corporate income tax at the venue of the SPE and the bank sponsor. In other words, structured finance should not attract additional taxes beyond what investors would normally expect on investment cash flows. There are two withholding tax issues: 1) withholding tax at the source, the venue of the incorporation of the special purpose entity, on EMTNs issued by the SPEs; and 2) withholding tax imposed on the underlying assets purchased by the special purpose entities by the country in which the assets were originated. The goal is that neither interest nor dividends paid by the SPEs is subject to withholding tax, so an ideal venue does not impose this tax.

If we choose a venue such as the Cayman Islands that does not have tax treaties in place with most jurisdictions, there is no mechanism for reclaiming tax withheld (if any) on the underlying asset income from the country of origination. The special purpose entity will purchase assets that are not subject to withholding at the country of the assets' origination so that investors will not suffer a reduced return.

If instead we choose a venue with tax treaties in place, assets that suffer withholding tax may specifically be chosen so the withholding tax can be reclaimed. This is a legitimate use of a special purpose entity. Tax evasion is illegal; tax avoidance is legal.

We do not want to suffer tax on the special purpose entity's income. In Europe, we also want to avoid value added tax (VAT) and stamp duties. The goal is to have zero tax leakage, if possible. Venues such as the Caymans, Jersey, and Guernsey offer this advantage, but may not enjoy ready investor acceptability.

Other venues such as the Netherlands, Luxembourg, and Ireland, also offer several tax advantages. There is no withholding tax on note interest. There is no stamp duty. There may be a very small value added tax (VAT) on servicing and administration for the SPE. There is no withholding tax on deposits. Among these three venues, there are other considerations that may affect the final choice, however. The Netherlands seems to take several weeks longer to provide tax rulings for special purpose entities compared to Ireland and Luxembourg. In the Netherlands, there seems to be a turf war between Amsterdam versus Rotterdam, and most SPEs are set up in Amsterdam. For speed, one might choose Ireland or Luxembourg. In Ireland, the SPE must fit within the Irish tax securitization code. This may drive up the cost slightly relative to Luxembourg. U.K. based deal arrangers might find it more convenient to deal with Ireland, since Ireland uses an English law based system. Lately, Ireland has been the fastest of the three venues in actual set-up time; usually two to three weeks once the paperwork is in order.

IV. Enron, J.P. Morgan, and Sureties: Recent Abuse

Enron used J.P. Morgan's special purpose corporations to transform a liability into revenues. The special purpose corporations, Mahonia and Stoneville, had the same board of directors, the same shareholder, the same address in Jersey, in the U.K. Channel Islands, and were set up by the same law firm. They received loan money from J.P. Morgan by way of two special purpose vehicles. They agreed to pay back the loan over time via the same set of special purpose vehicles. Figure 3. in the appendix shows a schematic of the transactions. Enron and J.P. Morgan's special purpose corporations also engaged in an alleged sham gas trade with the same vehicles using prepaid commodity forwards. The gas trade was a wash transaction. One leg of the sham gas transaction allowed Enron to receive the upfront payment of the loan monies. Another leg of the sham gas transaction allowed Enron to repay the loan. The structured finance transaction's lack of cash flow transparency gives added weight to this interpretation.

J.P. Morgan had a small problem. They already had a lot of Enron exposure. The special purpose vehicle that was paying back the loan had assets that could be directly tied to Enron and had no other assets of its own. J.P. Morgan had to hedge their Enron exposure.

A credit derivative, would have been more expensive than J.P. Morgan's ultimate structural decision. The credit derivative would also have explicitly documented that the underlying revenues and credit risk was Enron's, which would have made it difficult for Enron to disguise their liability and book the loan as revenue.

J.P. Morgan used a back-door to get exposure protection. Since loan payments cannot be insured, J.P. Morgan used surety bonds to protect the series of gas deliveries Enron was to make to Mahonia. Surety bonds are a form of insurance, and protect against losses on specific assets. The insurance companies or *sureties* included Citigroup's Traveller's Property Casualty, Liberty Mutual Insurance, and St. Paul companies among others. The value of the gas deliveries was equal to the loan payments.

When Enron declared bankruptcy on December 2, 2001, J.P. Morgan had $965 million in losses from payments due on oil and gas contracts with Enron. The insurers claimed J.P. Morgan and Enron used fraudulent inducement to cause them to enter into the contracts. They used this as a defense against not making immediate payments under the terms of the surety bonds. J.P. Morgan sued in an attempt to recover payments.

The judge, Jed Rakoff ruled that a senior J.P.Morgan official's e-mail describing the transactions as "disguised loans" could be used in the trial. On the other hand, he dismissed claims that J.P. Morgan aided in Enron's financial fraud.

JP Morgan Chase and the insurers agreed to a settlement just before the case was due to go to jury trial in January 2003. Instead of $965 million, JP Morgan Chase will get about $600 million and will take a fourth quarter pre-tax charge of about $400 million to recognize the net loss.

This was poetic justice. The insurers wanted to claim they were innocent of the details of the disguised loan transaction. J.P. Morgan wanted to claim they were ignorant of Enron's accounting intentions. In the end, both J.P. Morgan and the insurers suffered economic loss for trying to earn riskless fees on what was a structural obfuscation

What would have been the outcome had the case gone to trial? We may never know, but J.P. Morgan still has civil suits pending related to its dealings with Enron. All of these issues may be reopened.

Were these transactions a good idea in the first place? What we consider clever finance today, may be viewed as fraud tomorrow and vice versa. Tax avoidance is legal; tax evasion is illegal. Tax avoidance today may become tax evasion under tomorrow's public policy. Whenever someone is getting something for nothing, there is always that added risk.

Anytime we use offshore vehicles and structured finance to legally translate the character of cash flows, we need to be aware of public policy risk. Where were the clearer heads questioning how this transaction would look to a disinterested party?

V. The Sarbanes-Oxley Act of 2002

The U.S. Congress seems to be fed up with the various excuses of corporate officers: "I'm responsible, but I'm not guilty. I'm guilty, but I'm not responsible. I'm not responsible, and I'm not guilty."

Individual corporate managers grow wealthy, but somehow that elusive combination of guilt and responsibility belongs to someone else in corporate management. It seems those quickest to claim credit, those quickest to claim compensation, are also the quickest and most adept at denying liability.

President Bush signed into law the Sarbanes-Oxley Act of 2002, which was passed by the U.S. Congress on July 30, 2002. The bill was named for Senator Paul Sarbanes (Democrat from Maryland) and Representative Michael Oxley (Republican from Ohio) who were instrumental in drafting the necessary compromises to get it passed. The Act addresses issues of accounting oversight and corporate responsibility.

The Act applies to companies that must file Form 10-K, 10-Q, and 8-K reports required by the Securities Exchange Act of 1934, but every U.S. company will consider its implications.

The part that seems to most affect structured finance is that the 10-K and 10-Q must disclose off-balance sheet transactions, contingent obligations, and relationships with unconsolidated entities. Corporations will be obliged to report swaps, other derivatives, contingent liabilities, and the activity of offshore special purpose entities, so potential hidden risks are fully disclosed. In other words, the financial reports should tell the entire structured finance story, and tell it accurately.

Some of the provisions of the Act merely seem to ask corporate officers to behave in a responsible manner. The Act asks people who are paid millions of dollars to do their jobs, ask them to do them honestly, spell out what would be considered dishonest, and threaten retribution if they don't.

The Act is a step in the right direction. The Act doesn't specifically regulate structured finance, even though that is what sparked off most of Congress. Many of these products are difficult to understand and our Congressmen and Congresswomen weren't up to addressing them, since it is a specialized area of expertise. Nonetheless, the Act is meant to discourage corporate officers from gaming the system. It seems designed to put a scare into those who want to straddle the foul line.

Among other provisions of the Act, the officers who provide financial statement signatures are responsible for establishing and maintaining internal controls.

The Act requires CEOs and CFOs to give up their bonuses for a year after the publication of a financial statement that needs to be redone because of misconduct. *But they may get to keep their jobs.*

The SEC will make companies say whether or not they have a code of ethics (and if not, why not) for their principal financial officers and comptrollers or principal accounting officers or persons performing similar functions. It would be interesting to hear an attempt to justify the absence of a code of ethics.

Audit committees now have more responsibility by statute. Audit committees will be directly responsible for choosing, paying, and overseeing the auditor; and for resolving financial reporting disagreements.

The SEC will adopt rules for companies to disclose whether or not the audit committee of the company has at least one member who is a "financial expert", and if not, why not. This expert has to understand generally accepted accounting principles (GAAP) and audit committee functions. The expert must also have experience preparing or auditing financial statements and with internal accounting controls.

The Act left out something, however. They might have asked that at least one member of the committee have experience and understanding of structured finance – if the company engages in structured finance, and most companies do – since this expertise does not go hand-in-hand with accounting expertise. Many of the problems in recent history resulted partly because accountants were duped by structured finance experts.

While the SEC can invoke only civil penalties, the Department of Justice can also pursue criminal prosecution and levy criminal penalties.

There are newly created criminal penalties for tampering with records in federal investigations and bankruptcy. Destroying audit records or work papers within five years will get a criminal penalty, too. Certain securities fraud will also get criminal penalties. If CEO's and CFO's fail to perform the certifications the Act told them to, they'll get a criminal penalty. If the company retaliates against a whistleblower, there will be a criminal penalty.

Why not mandatory minimums? How many executives who violate this law will do even one day of hard time, as opposed to "soft" time in a minimum security, white collar crime, facility? The majority of prisoners in the United States serve hard time for non-violent crimes. Mandatory minimum sentences are handed out to crack cocaine users and/or sellers, who are mainly African Americans (White Americans tend to use powdered cocaine, and the punishment structure is different). Justice is legally blind, but not color blind, or indifferent to class. Who has harmed the American economy more, the folks who inspired this Act, or the folks who are currently long-term guests of the U.S. prison system? While I believe the U.S. system of government is the best in the world, there's room for improvement.

VI. Will Sarbanes-Oxley Make a Difference?

If the following example is any indicator, Sarbanes-Oxley won't make a difference.

Frank Walsh, former head of Tyco International Ltd.'s (a Bermuda registered conglomerate) corporate governance committee, Tyco International Ltd., pled guilty to charges of securities fraud in December, 2002. When Tyco acquired The CIT Group in June 2001 for $9.5 billion, Mr. Walsh was paid a $20 million finders fee. He neglected to mention it to his board members.

So what happened to Mr. Walsh? The court directed him to pay $250,000 in fines to prosecutors, pay $2.5 million in fines to New York state and New York city, and to repay the $20 million to Tyco. In exchange, Mr. Walsh got a conditional discharge. No hard time for Mr. Walsh. No soft time for Mr. Walsh either. In fact, no prison time at all. He immediately wrote the checks. I'm sure that left a dent in Mr. Walsh's financial portfolio, but it was nothing compared to the dent in Tyco's balance sheet and to the amount lost by Tyco shareholders.

When Tyco disclosed the news about Walsh, it appeared to cause a one-day sell-off of Tyco shares, resulting in a decline of about $16 billion in market capitalization. At least that's what Tyco's civil law suit against Walsh alleges, so it may not be over for Mr. Walsh.

But what about all of that hard work on the June 2001 acquisition of The CIT Group for $9.5 billion? Surely some good had to come out of that?

In 2002, Tyco sold The CIT Group for about half that amount. Somehow Mr. Walsh's $22.75 million almost seems like a get-out-of-jail free card. The payment can't make a dent in the real damages. As for Mr. Walsh, it is unlikely he'll suffer economic hardship.

It seems corporate malfeasance is a matter of risk and reward. Vast rewards come with limited downside. If economics is the only consideration, rational managers should do the crime. Recent history suggests they won't do the time.

The extraordinary payments which corporate executives earn for their services should also come with extraordinary consequences when things go badly wrong. The Sarbanes-Oxley Act will have little impact on executive behavior if the risk isn't commensurate with the rewards.

References

Tavakoli, Janet M. *Collateralized Debt Obligations & Structured Finance: New Developments in Cash and Synthetic Securitization*, John Wiley & Sons, August, 2003. Adapted and condensed from Chapters 3 and 8.

Figure 1.

Double SPE Structure for U.S. Accounting and Tax Regulations

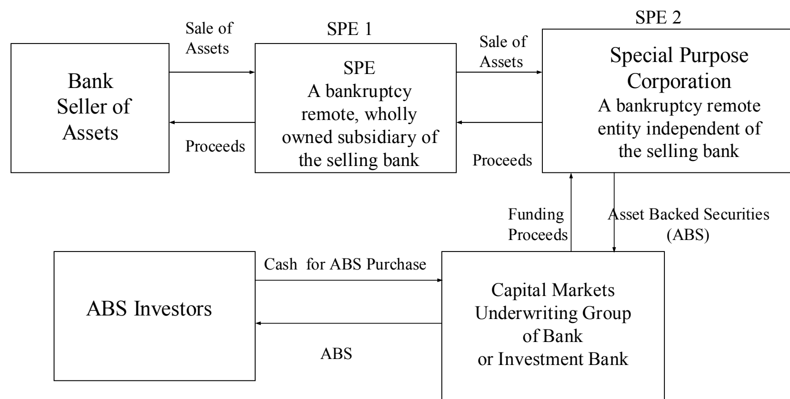

Figure 2.

Vanilla Repackaging
EMTN has Structured Coupons Backed by Single Asset

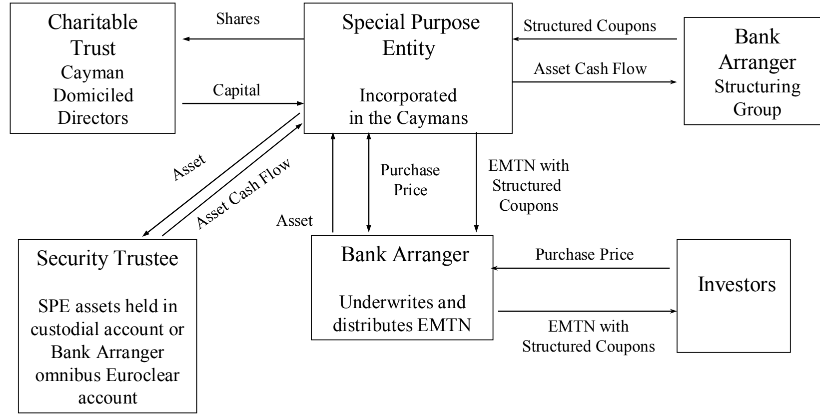

Figure 3.

Disguised Loan