Understanding the Securitization Process and the Impact on Consumer Bankruptcy Cases

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I. Introduction to Securitization

Securitization is a complex series of financial transactions designed to maximize cash flow and reduce risk for debt originators. This is achieved when assets, receivables or financial instruments are acquired, classified into pools, and offered as collateral for third-party investment. Then, financial instruments are sold which are backed by the cash flow or value of the underlying assets.

Securitization typically applies to assets that are illiquid (i.e. cannot easily be sold). It is common in the real estate industry, where it is applied to pools of leased property, and in the lending industry, where it is applied to lenders' claims on mortgages, home equity loans, student loans, vehicle loans and other debts. A list of the types of financial debt instruments that have been securitized is included in these materials.

Any assets can be securitized so long as they are associated with a steady amount of cash flow. Investors "buy" these assets by making loans which are secured against the underlying pool of assets and its associated income stream. Securitization thus "converts illiquid assets into liquid assets" by pooling, underwriting and selling their ownership in the form of asset-backed securities (ABS).

Securitization utilizes a special purpose vehicle (SPV) (alternatively known as a special purpose entity [SPE] or special purpose company [SPC]) in order to reduce the risk of bankruptcy and thereby obtain lower interest rates from potential lenders. A credit derivative is also generally used to change the credit quality of the underlying portfolio so that it will be acceptable to the final investors.

II. History

Asset securitization began with the structured financing of mortgage pools in the 1970s. For decades before that, banks were essentially portfolio lenders; they held loans until they matured or were paid off. These loans were funded principally by deposits, and sometimes by debt, which was a direct obligation of the bank (rather than a claim on specific assets). After World War II, depository institutions simply could not keep pace with the rising demand for housing credit. Banks, as well as other financial intermediaries sensing a market opportunity, sought ways of increasing the sources of mortgage funding. To attract investors, bankers eventually developed an investment vehicle that isolated defined mortgage pools, segmented the credit risk, and structured the cash flows from the underlying loans. Although it took several years to develop efficient mortgage securitization structures, loan originators quickly realized the process was readily transferable to other types of loans as well."

In February 1970, the U.S. Department of Housing and Urban Development created the transaction using a mortgage-backed security. The Government National Mortgage Association (GNMA or Ginnie Mae) sold securities backed by a portfolio of mortgage loans.

To facilitate the securitization of non-mortgage assets, businesses substituted private credit enhancements. First, they over-collateralized pools of assets; shortly thereafter, they improved third-party and structural enhancements. In 1985, securitization techniques that had been developed in the mortgage market were applied for the first time to a class of non-mortgage assets — automobile loans. A pool of assets second only to mortgages in volume, auto loans were a good match for structured finance; their maturities, considerably shorter than those of mortgages, made the timing of cash flows more predictable, and their long statistical histories of performance gave investors confidence.

The first significant bank credit card sale came to market in 1986 with a private placement of $50 million of outstanding bank card loans. This transaction demonstrated to investors that, if the yields were high enough, loan pools could support asset sales with higher expected losses and administrative costs than was true within the mortgage market. Sales of this type — with no contractual obligation by the seller to provide recourse — allowed banks to receive sales treatment for accounting and regulatory purposes (easing balance sheet and capital constraints), while at the same time allowing them to retain origination and servicing fees. After the success of this initial transaction, investors grew to accept credit card receivables as collateral, and banks developed structures to normalize the cash flows.

III. Benefits of Securitization

There are good reasons why securitization has taken off. The existence of a liquid secondary market for home mortgages and other financial debt instruments increases the availability of capital to make new loans. This increases the availability of credit. Securitization also helps to decrease the cost of credit by lowering originator's financing costs by offering lenders a way to raise funds in the capital market with lower interest rates. Finally, securitization reallocates risk by shifting the credit risk associated with securitized assets to investors, rather than leaving all the risk with the financial institutions.

IV. Who are the Players in the Securitization Process?

The primary players in the securitization of any particular pool of assets can vary. Included in these materials is a flow chart for the MBS (mortgage backed securities) issue identified as "*Meritage Mortgage Loan Trust 2005-2, Asset-Backed Certificates, Series 2005-2.*" The flow chart illustrates the roles of and the relationships between the various primary parties in a typical issue. Each party is addressed below:

A. **Originators** – the parties, such as mortgage lenders and banks, that initially create the assets to be securitized.

B. **Aggregator** – purchases assets of a similar type from one or more Originators to form the pool of assets to be securitized.

C. **Depositor** – creates the SPV/SPE for the securitized transaction. The Depositor acquires the pooled assets from the Aggregator and in turn deposits them into the SPV/SPE.

D. **Issuer** – acquires the pooled assets and issues the certificates to eventually be sold to the investors. However, the Issuer does not directly offer the certificates for sale to the investors. Instead, the Issuer conveys the certificate to the Depositor in exchange for the pooled assets. In simplified forms of securitization, the Issuer is the SPV which finally holds the pooled assets and acts as a conduit for the cash flows of the pooled assets.

E. **Underwriter** – usually an investment bank, purchases all of the SPV's certificates from the Depositor with the responsibility of offering to them for sale to the ultimate investors.

The money paid by the Underwriter to the Depositor is then transferred from the Depositor to the Aggregator to the Originator as the purchase price for the pooled assets.

F. **Investors –** purchase the SPV's issued certificates. Each Investor is entitled to receive monthly payments of principal and interest from the SPV. The order of priority of payment to each investor, the interest rate to be paid to each investor and other payment rights accorded to each investor, including the speed of principal repayment, depending on which class or tranche of certificates were purchased. The SPV makes distributions to the Investors from the cash flows of the pooled assets.

G. **Trustee –** the party appointed to oversee the issuing SPV and protect the Investors' interests by calculating the cash flows from the pooled assets and by remitting the SPV's net revenues to the Investors as returns.

H. **Servicer –** the party that collects the money due from the borrowers under each individual loan in the asset pool. The Servicer remits the collected funds to the Trustee for distribution to the Investors. Servicers are entitled to collect fees for servicing the pooled loans. Consequently, some Originators desire to retain the pool's servicing rights to both realize the full payment on their securitized assets when sold **and** to have a residual income on those same loans through the entitlement to ongoing servicing fees. Some Originators will contract with other organizations to perform the servicing function, or sell the valuable servicing rights.

Often, there are multiple servicers for a single SPV. There may be a Master Servicer, a Primary Servicer, a Sub-Servicer, and a Default or Special Servicer. Each will have responsibilities related to the pooled assets, depending on the circumstances and conditions.

V. The Why's and How's of Securitization

A. True Sale and HIDC Status

The securitization process is designed, in most cases, to make the pooled assets "bankruptcy remote." To accomplish this, the transfer of the pooled assets from the Originator to the SPV must be accomplished by way of a "true sale." If the asset transfer is not a true sale, investors are vulnerable to claims against the Originator, including the claims of a bankruptcy trustee that might be appointed if the Originator were to file bankruptcy. Without "bankruptcy remoteness," Investors would bear the risk of default in the underlying pooled assets, as well as any claim by the Originator's bankruptcy trustee that the pooled assets or cash flows from those assets are part of the bankruptcy estate which could be used to satisfy claims of the Originator's creditors. A true sale also protects the Originator from claims by investors. If the pooled assets are sold into an SPV, the Investor can only seek payment from that entity, not from the general revenues of the Originator.

In order to create the desired "bankruptcy remoteness," the pool assets must be transferred by "true sale." Such a sale also provides the SPV with Holder in Due Course (HIDC) status and protection. In order to gain HIDC status, the SPV must satisfy the requirements of UCC section 3-302. The SPV must: take the instrument for value, in good faith, without notice that the instrument is overdue, dishonored or has an uncured default, without notice that the instrument contains unauthorized signatures or has been altered, and without notice that any party has a claim or defense in recoupment. Additionally, the instrument, when issued or negotiated to the holder, cannot bear any evidence of forgery or alteration or have irregularities that would give rise to questions of authenticity. The main benefit of HIDC status is that the holder may enforce the payment rights under the negotiable instrument free from all by a limited number of defenses as outlined in UCC 3-305. The HIDC takes the note or instrument free from competing claims of ownership by third parties.

B. Pooling and Servicing Agreement

One of the most important documents in the securitization process is the Pooling and Servicing Agreement (PSA). This is the contract that governs the relationship between the various parties in the securitization process. The PSAs in many securitization deals can run 300-500 pages in length, spelling out the duties and obligations of each party and the mechanics by which the actual securitization is accomplished. Included in these materials is an excerpt of the PSA for the *Meritage Mortgage Loan Trust 2005-2 Asset-Backed Certificates, Series 2005-2.*

VI. Impact of Securitization on Consumer Bankruptcy Practice

A. Does the Trust Actually Own a Securitized Obligation? Challenges Based on Standing

Securitization impacts consumer bankruptcy practice in a number of ways, most frequently in the context of motions for relief from stay and proofs of claim. Specifically, debtors' counsel must consider who actually owns the mortgage note, auto loan or credit card receivable that has been securitized. Is the Trust that is asserting ownership the true owner?

Many times the answer is "NO" because the Trust has failed to properly acquire ownership of the note or receivable.

As discussed above, the goal of securitization is to achieve a true sale so that the SPV (Trust), not the Originator, will be the owner of each obligation in the pool. In order to achieve this goal, each party in the chain of transfer, from Originator to Aggregator, to Depositor, to Issuer mush actually pay value for the assets in order to acquire them by of true sale and be able to transfer them to the next party in the chain.

It is one thing for a Trust to assert ownership of a securitized obligation, but proving ownership requires more than a certification of hearsay statements. Ownership is a fundamental pre-requisite to give a movant constitutional standing to enforce any rights on the underlying obligation in the bankruptcy court. Despite the importance of this issue, most motions for relief from stay fail to properly establish the Trust's ownership of the underlying debt.

The issue of standing has become increasingly prominent over the past few years. In 2007, a series of foreclosure cases in the United States District Courts in the Northern and Southern Districts of Ohio considered whether the plaintiff in the foreclosure cases was in fact the holder of the mortgage and note on the real property. *See In re Foreclosure Cases*, 521 F. Supp. 2d. 650 (S.D. Ohio 2007), *In re Foreclosure Cases*, 2007 WL 4034554 (N.D. Ohio Nov. 14, 2007). In these cases, the Judges dismissed more than 60 cases finding that, despite the plaintiff's assertion that it was the holder of the note and mortgage; the documentation provided showed that the Originator was the holder of the note and mortgage.

Many bankruptcy courts have cited the *In re Foreclosure* cases in disallowing proofs of claim and denying motions for relief from stay on standing grounds. In *In re Nosek,* 386 B.R. 374 (Bankr. D. Mass. 2008), the court was presented with conflicting proofs of claim and representations regarding ownership of the note and mortgage. The *Nosek* Court stated that "the confusion and lack of knowledge, or perhaps sloppiness" resulted in the Court having to "expend time and resources . . . because of the carelessness of those in the residential mortgage industry." The *Nosek* Court went on to impose significant sanctions under Bankruptcy Rule 9011.

So, what must a Trust produce to establish ownership of a securitized obligation? In order for the Trust to asset and establish ownership of an instrument that has been securitized the Trust must demonstrate that it has acquired the note by proper indorsement and delivery in strict accordance with the mandatory transfer procedures and time requirements established in the PSA. This will require producing the original note with all proper indorsements establishing an unbroken chain of transfer from the Originator to the Aggregator, from the Aggregator to the Depositor, and from the Depositor to the Trustee.

In some cases, despite the requirements of the PSA, the note was never transferred to the Trust's Document Custodian or the note was transferred but was not properly indorsed. Unless ownership is established, a movant lacks standing to enforce a negotiable instrument.

B. Who Can Assert the Trust's Ownership Rights in Court? Real Party in Interest Status

Related to the issue of ownership and standing is the issue of whether or not a Servicer that purports to act on behalf of the Trust is a "real party in interest" and entitled to file claims and motions for relief from stay. The Servicer is not the owner of the underlying obligation in a typical securitization transaction. Instead, the Servicer collects payments due and remits them to the Trustee on behalf of the Investors. Despite this, most courts have recognized that real party in interest status is not the same as the constitutional pre-requisite of standing and have concluded that, even though a Servicer doesn't own the obligation it seeks to enforce, it is a real party in interest and is able to file motions and claims on behalf of the Trust.

C. How and Where does the Mortgage Electronic Registry System ("MERS, Inc.") Fit In?

MERS, Inc. is a Delaware corporation owned by 26 mortgage originators and buyers of brokered loans. MERS is a national electronic registry that tracks servicing rights and beneficial ownership interests in mortgage loans. MERS also acts as a nominee for the Servicers. MERS is not a lender, it is not an Originator. MERS never owns the note and cannot therefore establish standing on its own.

Many standing and evidentiary issues arise when MERS attempts to file motions for relief from stay. This is illustrated in the case of *In re Vargas*, 2008 WL 4864986 (Bankr. C.D. Cal. 2008). The Court in the *Vargas* case denied MERS' motion for relief from stay because MERS failed to prove it had standing and that it was a real party in interest. Instead, MERS was attempting to obtain relief from stay on behalf of undisclosed third parties. The opinion provides a thorough review of the evidentiary requirements necessary for establishing (a) standing and ownership of a mortgage note; (b) the amount claimed to be due; and (c) the admissibility of computer and business records. It emphasizes the need to prove ownership through competent and admissible evidence.

VII. Conclusion

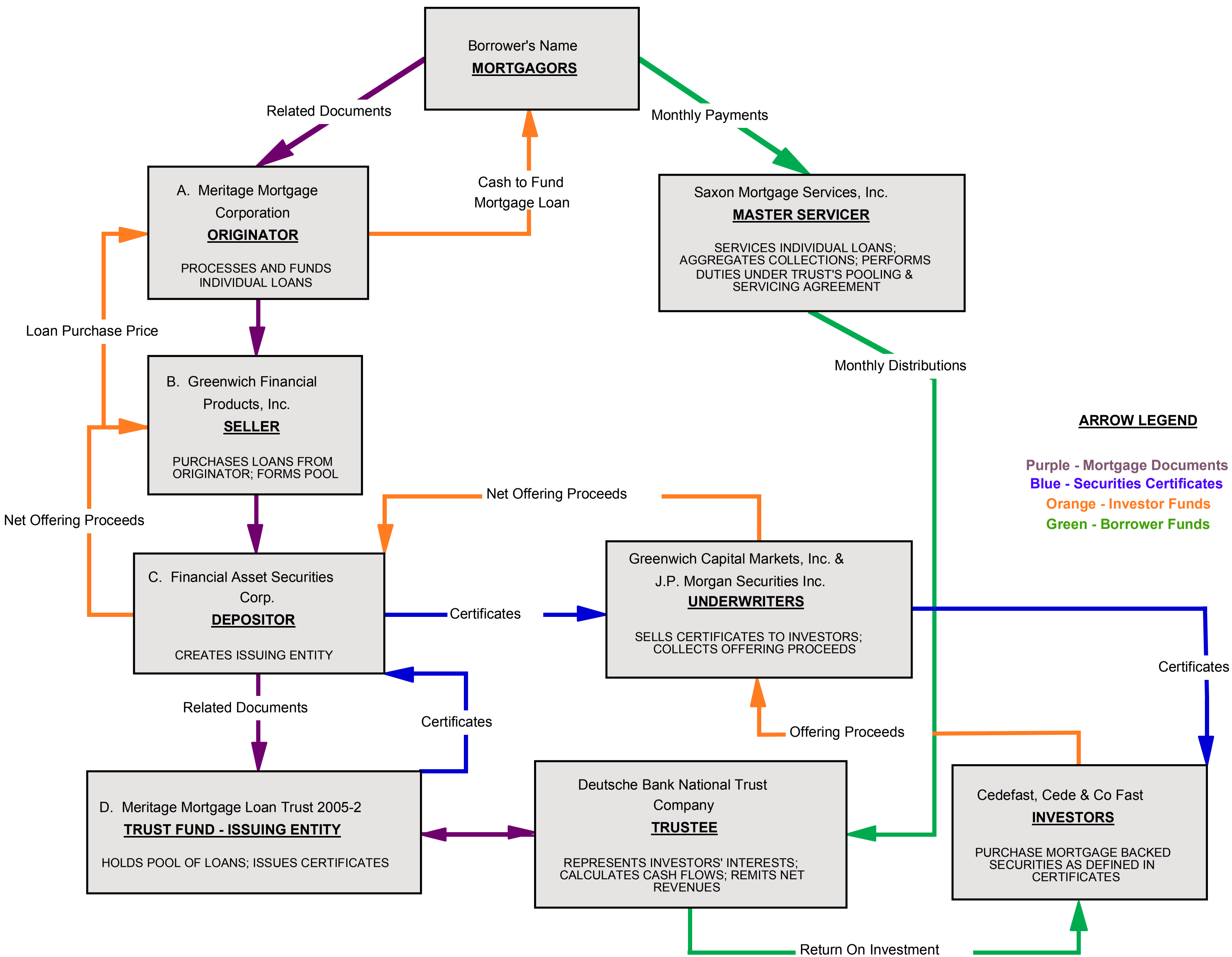
The securitization process is complex and often confusing. Understanding how securitization affects consumer debtors and the bankruptcy process is the first step in properly protecting your clients.

Types of Financial Debt Instruments or Obligations That Have Been Made the Subject of Securitization Issues

Residential Mortgages (Prime)
Residential Mortgages (Alt-A)
Residential Mortgages (Sub-prime)
Home-improvement Loans
Home-equity Loans
Home-equity Lines of Credit
No-equity Mortgage Loans
Reverse Mortgages
Manufactured Housing Loans
Non-performing Mortgages
Timeshare Loans
Construction Loans
Auto Loans (Prime)
Auto Loans (Sub-prime)
Auto Leases
Truck Loans
Truck Leases
Motorcycle Loans
ATV Loans
Boat Loans
RV Loans
Student Loans
Unsecured Consumer Loans
Credit Card Debts
Pay-day Loans
Bank Loans
Rent Receipts
Aircraft-lease Receivables
Airline-ticket Receivables
Municipal Leases
Mutual Fund Fees
Natural Resources
Collateralized Debt Obligations
Project Finance Receivables
Royalties
Delinquent Receivables
Equipment Loans
Equipment Leases
Small-business Loans
Export Receivables
Legal Settlements
Franchise Fees
Franchise Loans
Tax Liens
Floor Plan Loans
Trade Receivables
Guaranteed Investment Contracts
Toll-road Receivables
Healthcare Receivables
Transportation Receivables
Utility Receivables
Insurance-premium Loans
Weather and Climate Risk Obligations
Viatical Settlements (Investments in Another Person's Life Insurance Policy)

SECURITIZATION FLOW CHART

Meritage Mortgage Loan Trust 2005-2, Asset-Backed Certificates, Series 2005-2



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