THE ROBERTA MITCHELL LECTURE: STRUCTURING RESPONSIBILITY IN SECURITIZATION TRANSACTIONS
STEVEN L. SCHWARCZ

I. INTRODUCTION

It has been my pleasure and honor to present the first Roberta Mitchell Lecture, and to have done so in connection with this symposium on the mortgage-foreclosure crisis. Although this article (based on that lecture) does not address mortgage foreclosure per se, it provides a context in which the crisis can be better understood.

Any discussion of the mortgage-foreclosure crisis must begin with securitization. Securitization facilitates mortgage lending by enabling lenders to easily monetize existing mortgage loans, thereby generating cash to make new loans. Many believe, however, that the originate-to-distribute model of securitization—enabling lenders to sell off their loans as they are made—caused mortgage lenders to relax their lending standards, leading to the multitude of risky subprime loans that now constitute a huge portion of the foreclosures.

In other contexts, I have argued that the originate-to-distribute model of securitization was not the primary culprit. There was significant government pressure on mortgage lenders to make and securitize subprime

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2 Stanley A. Star Professor of Law & Business, Duke University School of Law, and Founding Director, Duke Global Capital Markets Center; schwarcz@law.duke.edu. I thank Sergio Nasarre Aznar for valuable comments on drafts of this lecture and article, and Arie Eernisse and Gregory McKay for invaluable research assistance. Although I am serving as a consultant and potential expert witness in a case that raises some of the issues discussed in this lecture and article, the views expressed here are entirely my own.


mortgage loans to expand homeownership.\textsuperscript{3} The fall in lending standards may also reflect distortions caused by the liquidity glut of that time, in which lenders competed aggressively for business.\textsuperscript{4} Or, it may reflect conflicts of interest between lending firms and their employees in charge of setting lending standards, such as paying employees for booking loans regardless of the loans’ long-term performance.\textsuperscript{5}

Blaming the originate-to-distribute model also does not explain why lending standards were not similarly lowered for non-mortgage securitized loans. Nor does it explain why institutional investors—those who took the bottom-line risk on the value of the mortgage loans—did not govern their investments by the same strict lending standards they would observe but for the separation of origination and ownership.

Regardless of what caused mortgage lending standards to fall, there is no question that securitization increased the number of mortgage loans—and thus the number of subprime mortgage loans—that could be (and in fact were) made. This article begins by explaining securitization as well as the parties in securitization transactions. In that context, it explores a conundrum that I call the “protection gap.”

II. THE PROTECTION GAP

A. Positing the Protection Gap

In complex securitization transactions, there is the following significant protection gap: When entering into a transaction, parties may be unable or unwilling to pay the price for full protection.\textsuperscript{6} As a result, transaction parties may choose or are forced to assume the good faith of the other parties to the transaction and the consistency and completeness of protections provided in the transaction documents. When things go wrong, fingers are pointed at alleged wrongdoers, especially those with deep pockets.


\textsuperscript{4} Id. at 3–4 (noting the deterioration of mortgage underwriting standards in the years prior to the bubble’s collapse).


\textsuperscript{6} See generally FABOZZI & KOTHARI, supra note 1, at 306–10 (explaining the concept of protection buying and selling).
I am not claiming that the protection gap is unique to complex financing transactions. However, I believe that it is an order of magnitude larger than the gap in traditional financings.7

The National Century Financial Enterprises (NCFE) bankruptcy litigation provides an example of a protection gap in monitoring.8 NCFE fraudulently misused collections on the securitized assets, causing more than $2.6 billion of asset-backed securities to default.9 The investors sued the trustee (among others), alleging failure to adequately monitor.10 Prior to becoming aware of a default, however, the trustee’s job is purely ministerial.11 Given the amount of money involved, it is unclear why the investors themselves did not also engage in monitoring.

Other securitization-transaction disputes concern protection gaps in documentation. For example, in Deutsche Bank Trust Co. Americas v. Victoria Finance Ltd.,12 the parties alleged that the transaction documents failed to explain how the waterfall of payments would be allocated after default.13 In Luminent Mortgage Capital, Inc. v. HSBC Securities (USA) Inc.,14 the complaint alleged that the transaction documents did not adequately specify when the lender could collect bonds posted as collateral.15 In HSH Nordbank AG v. UBS AG,16 the complaint alleged that the transaction documents lacked clarity in establishing UBS’s level of responsibility for monitoring the credit quality of the securitization assets.17

7 See infra notes 35–37 and accompanying text.
9 Id. at *1.
10 Id. at *2 (alleging causes of action against the trustee that included breach of contract and breach of fiduciary duty).
I will attempt to explain why this protection gap exists in securitization transactions. First, however, securitization must be explained.

B. Securitization

Securitization refers to a category of financing transactions in which companies sell income-producing financial assets (such as mortgage loans, accounts receivable, and lease rentals) to a trust or other special-purpose entity (SPE), sometimes interchangeably called a special-purpose vehicle (SPV). This SPE finances its purchases by directly or indirectly selling securities backed by rights to payments from these assets to investors. The investors look to the SPE and its purchased financial assets for repayment.

Companies engaging in securitization transactions are called “originators,” to distinguish them from the SPE companies. Securities of an SPE that are paid, or “backed,” from collections on mortgage loans are called “mortgage-backed securities” (MBS). Securities of an SPE that are paid from collections on other types of financial assets are called “asset-backed securities” (ABS). Sometimes even MBS are referred to as ABS, the more inclusive category (mortgage loans being a type of asset).

Securitization is an important source of low-cost corporate financing as well as a critical means by which banks and other lenders turn their

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19 Id.
20 See, e.g., Steven L. Schwarcz, Securitization Post-Enron, 25 CARDOZO L. REV. 1539, 1540 (2004). To persuade investors to accept risk on an SPE’s securities, the originator generally takes the first risk of loss on the underlying financial assets. It normally does this through “overcollateralization” effectively transferring to the SPE financial assets marginally in excess of the minimum amount needed to repay the securities issued by the SPE. FABOZZI & KOTHARI, supra note 1, at 89–90; Steven L. Schwarcz, Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures, 70 U. CIN. L. REV. 1309, 1316 n.38 (2002).
21 See, e.g., Adam J. Levitin & Tara Twomey, Mortgage Servicing, 28 YALE J. ON REG. 1, 6 (2011).
22 See Schwarcz, supra note 18, at 144.
23 Id. at 135. By not having to borrow from a bank (or other intermediary of funds), a corporate originator avoids the bank’s profit mark-up. See Schwarcz, Securitization Post-Enron, supra note 20, at 1551. This “disintermediation” is not dissimilar to buying wholesale instead of paying the retail price. See, e.g., Steven L. Schwarcz,
financial assets into cash, thereby enabling them to continue making loans. Securitization also helps to lower the cost of loans made to consumers. By 1992, securitization had become so important to the American economy that the Securities and Exchange Commission observed that it was “becoming one of the dominant means of capital formation in the United States.” The growth of securitization continued throughout the 1990s and 2000s, rising to $11.8 trillion in 2008. During the 2008 financial crisis, the federal government initiated a $200 billion Term Asset-Backed Securities Loan Facility (TALF) to keep the securitization markets running, thereby assuring “the availability of credit to households and businesses of all sizes.”

Disintermediating Aravice: A Legal Framework for Commercially Sustainable Microfinance, 2011 U. ILL. L. REV. 1165, 1169 (2011). Securitization also accomplishes a cost saving by allocating risk to parties with special securitization expertise and experience, who are thereby better able to understand and assess risks associated with securitization transactions. STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION § 1:3 (3d ed. 2010) (explaining that except for the most highly rated issuers, securities issued in securitization transactions typically are more highly rated than the issuer’s own debt securities—and that, even where the latter are more highly rated, securitization provides additional market flexibility to obtain financing).

24 Cf. Patric H. Hendershott & James D. Shilling, The Impact of the Agencies on Conventional Fixed-Rate Mortgage Yields, 2 J. REAL ESTATE FIN. & ECON. 101 (1989) (finding that securitization of conforming fixed-rate mortgage loans significantly lowered interest rates on mortgage loans relative to what they would otherwise have been); C.F. Sirmans & John D. Benjamin, Pricing Fixed Rate Mortgages: Some Empirical Evidence, 4 J. FIN. SERVICES RES. 191 (1990) (finding significantly lower interest rates on fixed-rate mortgages that can be sold in the secondary market versus those that cannot, thereby indicating the value of the ability to securitize mortgages).


Securitization transactions are inherently complex insofar as they have many different steps and many parties who participate at different stages. From the standpoint of originator-risk assessment, however, they can be less complex than ordinary lending. This is because in a properly structured securitization, the sale of the financial assets to the SPE separates payment risk from the risks generally associated with the originator, including the risk of originator default. This is referred to as achieving “bankruptcy remoteness.” Bankruptcy remoteness can reduce asymmetric information by enabling the investors to focus on risks specifically associated with well-defined and well-diversified financial assets.

Certain types of securitization transactions can inadvertently cause information failure, or at least make it difficult for investors and other parties to understand risks associated with the transferred financial assets. This occurs in securitizations of ABS and MBS already issued in prior securitization transactions—effectively securitizations of securitizations—where the resulting securities are issued in multiple layers of different priorities. In these more complex transactions, relatively small errors in cash-flow projections can have dramatic consequences.

For example, at least one cause of the 2008 financial crisis was that relatively small errors in cash-flow projections (resulting from unexpectedly high default rates due to initially declining housing prices on subprime mortgage loans underlying a portion of the MBS supporting these complex transactions) created defaults and ratings downgrades on substantial amounts of securities issued in these transactions. The

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29 See, e.g., Zachary J. Gubler, The Financial Innovation Process: Theory and Application, 36 DEL. J. CORP. LAW 55, 66–67 (2011). Information asymmetry refers to a situation in which one party has more information than another regarding, for example, the quality or risk of an asset. See id. at 94 (explaining the asymmetries that have arisen from “the modern financial innovation process”).


defaults and ratings downgrades occurred even before the financial crisis itself began to cause massive job losses and a spiraling collapse of the housing market.

III. HYPOTHESES AND TRANSACTION PARTIES

Several interrelated reasons can help to explain the existence of the protection gap. Securitization transactions involve an extraordinary multitude of transaction parties, which can make it unusually difficult to coordinate or allocate responsibility among them. The multitude of parties might also mislead some parties into thinking that other parties will protect their interests, leading to overreliance. Therefore, one hypothesis for the protection gap is that the multitude of parties creates collective action problems.

Some securitization transactions, especially securitizations of securitizations, are also extremely complex, in both their design and documentation. The structured nature of these transactions—including their many different steps and the different parties who participate at each step—also introduces novel elements that are atypical in ordinary financing, such as lending. By making it difficult to comprehend the transaction as an entirety, these complexities and novelties create uncertainty, causing parties to over-focus on relatively simple and straightforward elements, such as the underlying financial assets (e.g., mortgage loans), and to under-focus on less certain elements, such as the structure and the documentation. This suggests another hypothesis for

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33 Schwarcz, supra note 30, at 220.

the existence of the protection gap—the complexity and novelty of securitization transactions undermine analysis.

Even traditional financing transactions can, to some extent, have protection gaps. Companies with ongoing business relationships typically operate based on mutual trust established through long-standing repeated contacts between the companies.35 Trust plays a crucial role in creating and managing inter-company alliances because it “reduces complex realities far more quickly and economically than prediction, authority, or bargaining.”36 It therefore is common for transaction parties to assume the good faith of other transaction parties. Similarly, even in traditional financing transactions, it may be impossible to anticipate, and therefore contractually protect against, every possibility.37 Securitization transactions, however, can multiply the protection gap because they have many more parties, often with complex interrelationships, and much more complex and novel documentation and structures.

A. Transaction Parties

In general, the transaction parties in a securitization transaction include the originator, the SPE (sometimes multiple SPEs), underwriters, multiple classes (or tranches) of investors having different payment priorities, rating agencies, trustees, servicers, and professionals such as lawyers and accountants. Sometimes additional parties, such as monoline insurance companies, act as credit enhancers. I will not treat monoline insurance companies as separate parties, however, because from a risk-analysis standpoint, they are effectively lower priority, or “subordinated,” investors.

Underwriters help the SPE issue its securities by marketing the securities to potential investors.38 Under the federal securities laws, they

36 Id. at 993. There is a significant literature on relational contracting, in which parties with ongoing business relationships deal on the basis of trust. See, e.g., Benjamin Klein & Keith B. Leffler, The Role of Market Forces in Assuring Contractual Performance, 89 J. POL. ECON. 615 (1981); L.G. Telser, A Theory of Self-Enforcing Agreements, 53 J. BUS. 27 (1980).
37 Volery & Mensik, supra note 35, at 988–89.
38 Katina J. Dorton, Auctioning New Issues of Corporate Securities, 71 VA. L. REV. 1381, 1381–82 (1985). Underwriters are paid fees for their services. Id. For example, an underwriter may earn a spread equal to the difference between the amount paid to the issuer of the securities and the offering price to investors, net of expenses incurred.
must provide investors in public deals with detailed information regarding the issued securities\textsuperscript{39} (usually included in a prospectus or a supplement thereto). However, most securities are issued by SPEs in private placements.\textsuperscript{40}

Investors are typically large, sophisticated financial institutions, such as banks, pension funds, mutual funds, and hedge funds.\textsuperscript{41} Investors choose the priority level of the securities they purchase.\textsuperscript{42} The most senior priority securities are paid first; more subordinated priority securities are paid thereafter, and thus are the first to absorb losses on the underlying financial assets.\textsuperscript{43} This makes the senior securities less risky than the average risk on the SPE's financial assets because collections on all those assets, even collections intended to otherwise support payment of subordinated priority securities, are dedicated first to assure payment of the senior securities.\textsuperscript{44} This so-called "senior-subordinated" structure enables an SPE to sell very highly rated senior securities to investors who demand a relatively risk-free financial product.

Rating agencies are private companies, such as Standard and Poor's (S&P) and Moody's, and provide credit ratings for debt securities, including MBS and ABS.\textsuperscript{45} A rating reflects their assessment of the likelihood of timely payment of interest and return of principal to investors.\textsuperscript{46} Rating agencies assert that they merely express an opinion,}


\textsuperscript{43} Id.


\textsuperscript{46} See generally id. The highest rating on long-term debt securities is AAA, with ratings descending to AA, then to A, and then to BBB and below. Id. at 7. The higher the (continued)
which they maintain is First Amendment protected speech, and that they do not take on transactional responsibility.

Trustees have a bifurcated role in securitization transactions. Prior to a default, the trustee’s role is largely ministerial,\textsuperscript{47} including holding security for investors, monitoring covenant compliance, making payments, investing idle assets, monitoring the servicer’s collections, and administering the underlying financial assets.\textsuperscript{48} After default, however, a trustee must act as a prudent person in the best interests of the investors.\textsuperscript{49}

Servicers act on behalf of the SPE to collect the payments from the underlying financial assets. To this end, a servicer performs administrative duties that typically include mailing billing statements, collecting payments, and supervising delinquent financial assets, such as engaging in debt workout and foreclosure proceedings.\textsuperscript{50} The originator itself or an affiliate of the originator, being familiar with and having procedures in place to monitor and collect payment on the financial assets, often acts as the servicer for a fee.\textsuperscript{51}

Professionals include accountants and lawyers, encompassing both outside and in-house counsel. The client, often acting through in-house counsel, sets the scope of work of outside counsel.\textsuperscript{52} However, in-house counsel may have a broader, perhaps more proactive, responsibility to the rating, the lower the credit risk associated with the securities in question as determined by the rating agency. \textit{Id.} Ratings below BBB are deemed non-investment grade (or “junk,” as in junk bonds) and indicate that full and timely repayment on the securities may be speculative. \textit{See, e.g., Credit Ratings Definitions & FAQs, STANDARD & POOR’S, http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us#def_1 (last visited Jan. 22, 2011).}


\textsuperscript{48} Christopher J. Brady et al., \textit{The Role of the Trustee in Securitization Transactions, in Securitization of Financial Assets} 9–3 (Jason H.P. Kravitt ed., 2d ed. 2010).


\textsuperscript{50} \textit{Fabozzi & Kothari, supra} note 1, at 124–28.

\textsuperscript{51} \textit{Schwarz} \textit{supra} note 23, § 4:5, at 4–10; \textit{Andrew Davidson et al., Securitization: Structuring and Investment Analysis} 521–22 (2003).

\textsuperscript{52} Steven L. Schwarz, \textit{The Limits of Lawyering: Legal Opinions in Structured Finance, 84 Tex. L. Rev.} 1, 9 (2005).
client. In-house counsel are particularly well-situated to serve anticipatory and preventative functions for their business clients. They are usually present and can offer legal advice early in the decision-making process. Because they only serve a single client, in-house counsel benefit from superior information about that client’s organization, operations, and business culture.

Accountants act on behalf of the originator to decide how the securitization transaction should be treated (or “booked”) for accounting purposes in the originator’s financial statements. The primary question is whether to book the transaction as a sale of the financial assets or, instead, as a loan secured by the financial assets. In answering this question, the accountant’s duty is to act fairly and objectively.

IV. TESTING THE HYPOTHESES

Although the scope of this article does not permit a full proof, let us begin to test the hypotheses for the protection gap in securitization

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55 Chayes & Chayes, supra note 54, at 281; Simmons & Dinnage, supra note 54, at 113.

56 Albeit a complex client, generally speaking. Simmons & Dinnage, supra note 54, at 111.

57 Id. at 113–14.

58 Schwarcz, supra note 52, at 2.

59 Id. at 27.
transactions—that the multitude of parties creates collective action problems, and that the complexity and novelty of the transactions undermine analysis. In preparation, we must first distinguish the protection gap from larger issues of financial failure.

In other research, I have explored those larger issues, including the problem of systemic risk. I have argued that financial failure should be addressed within an overall conceptual framework, which I call the “3Cs-and-TOC.” This is comprised of four types of market imperfections: (1) conflicts of interest; (2) complacency of investors and other market participants; (3) complexity of financial markets and of the securities traded therein; and (4) a type of tragedy-of-the-commons (TOC) collective action problem in which the benefits of exploiting finite capital resources accrue to individual market participants, each of whom is motivated to maximize use of the resources, whereas the costs of exploitation, which affect the real economy, are distributed among an even wider class of persons.

The 3Cs-and-TOC framework can help to inform an understanding of the protection gap in securitization transactions. Complexity is itself part of one of the hypotheses for the protection gap. Complacency contributes to creating the gap, and conflicts and the TOC almost certainly exacerbate it. Because the protection gap ties to a particular type of financial

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62 For example, I have examined the existence of secondary management conflicts, in which the investors’ analysts recommend deals based on ratings and the like without adequate further inquiry. See generally Steven L. Schwarcz, Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs, 26 Yale J. on Reg. 457 (2009).

transaction (i.e., securitization) and because it has consequences that may not be systemic, it is a subset of financial failure.64


The protection gap also represents more of a tactical failure—the failure of transaction parties to design appropriate documentation and monitoring protections.

One scholar has recently developed a multitude-of-parties type of argument to broadly explain financial transaction failures, arguing they result from a “multiple gatekeeper phenomenon.”65 Because of the multitude of professionals involved in complex financial transactions (Tuch focuses on outside law firms66), professionals individually have an incentive to minimize their role.67

Focusing on collective action problems of professionals, however, ignores the essential fact that professionals are merely agents of the principals—usually the underwriters and investors. The real question should be why the principals who actually suffer losses—such as investors—do not adequately protect themselves.68

To some extent, the answer may be that the multitude of investors can mean that no individual investor has enough at risk to engage in sufficient

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64 The protection gap also represents more of a tactical failure—the failure of transaction parties to design appropriate documentation and monitoring protections.


66 Tuch’s article does not address why in-house counsel do not fill the gap left by outside counsel, as legal gatekeepers. See generally Barnes, Cully & Schwarze, *supra* note 53 (discussing the role of in-house counsel as gatekeepers in securitization transactions).


68 Tuch also argues that the multiple-gatekeeper phenomenon allows clients to position themselves between gatekeepers so that no party has complete knowledge of transactions. See Tuch, *supra* note 65, at 1603–04 (discussing the merger of Bank of America and Merrill Lynch as an illustration of this concern). Although this argument incongruously assumes that the clients themselves wish for court failure, it might have some explanatory power in a fraud.
due diligence—a problem “akin to a tragedy of the anticommons.” 69
Another answer may be that the multitude of parties misleads investors
into thinking that other parties will protect their interests, causing
overreliance. Consider how that latter answer may play out with the
example of overreliance on trustees.

There certainly appears to be overreliance on trustees. Because
securitization transactions are essentially financings, 70 the trustee in these
transactions is not a traditional fiduciary trustee, but rather an indenture
trustee or a collateral trustee. 71 This type of trustee “is more like a
stakeholder whose duties and obligations are exclusively defined by the
terms of the indenture agreement.” 72

In accord with this stakeholder nature, the trustee’s legal duties are, at
least prior to a default, ministerial. 73 The American Bankers Association
has also observed that trustees—who receive low fees 74 and usually are late
additions to a securitization transaction, with little opportunity to negotiate
their position 75—view themselves as having little substantive oversight and
no duties to make independent investigations to detect default, fraud, or

70 See Steven L. Schwarcz, Commercial Trusts as Business Organizations: Unraveling
the Mystery, 58 BUS. LAW. 559, 569–70 (2003) (discussing trust indentures used in
financing transactions and the nature of the “hybrid form of a trust” created by such
indentures).
71 See generally In re Med. Capital Sec. Litig., No. SAML 10–2145 DOC, 2011 WL
5067208, at *1 (C.D. Cal. July 26, 2011) (discussing the differences between these types of
trustees and traditional fiduciary trustees).
73 See Macaulay, supra note 49; Levitin & Twomey, supra note 21, at 58–63 (noting
that residential mortgage-backed securities trustees are “passive ministerial entities and
financial backstops”).
74 See, e.g., Press Release, Fitch Ratings, Fitch: Seller/Servicer Risk Trumps Trustee’s
Role in U.S. ABS Transactions (Feb. 24, 2003), available at http://www.securitization.net/
pdf/fitch_risk_022403.pdf (“The trustee’s role in ABS transactions has clearly been
marginalized over time due to a combination of fear of liability and low fees.”).
75 AM. BANKERS ASS’N, CORPORATE TRUST COMMITTEE, THE TRUSTEE’S ROLE IN ASSET-
Corporate Trust Committee’s report represented the views of “virtually all trustees for
asset-backed securities”).
breach of transaction documents. Moreover, trustees are often ill-equipped to fill gaps in securitization transactions because they do not have the expertise to make substantive business decisions, especially when the language in the documentation is vague or ambiguous.

Transaction parties, however, often have highly divergent views of the role of the trustee, sometimes viewing the trustee as a crucial figure in complex financial transactions. This can lead to overreliance. For example, prominent rating agency Moody’s has stated that trustees “have argued that their conduct is subject to the ‘prudent person’ standard of care only after a transaction has defaulted.” Yet, in “the majority of cases, and especially transactions involving unrated or noninvestment-grade-rated seller/servicers, this was not Moody’s understanding of the trustee’s role when these transactions were initially rated.” Moody’s has even suggested that trustee performance falls short of expectations in monitoring cash flows, taking action when evidence of improprieties arise, assuming backup servicing duties, and noting covenant breaches.

The litigation surrounding the bankruptcy of NCFE exemplifies how overreliance on trustees can cause a protection gap. Recall that the investors alleged a wide range of causes of action against the trustee, including failure to adequately monitor. The court, however, dismissed all claims except those founded on express provisions of the transaction documents, accepting the trustee’s narrow conception of its duties.

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76 Id. at 6.
77 Id. at 11.
79 Claire M. Robinson, Moody’s Re-Examines Trustees’ Role in ABS and RMBS, in Moody’s INVESTORS SERVICE: STRUCTURED FINANCE 1, 2 (Feb. 4, 2003).
80 Id. at 1 (noting the trustee’s “key role” in securitization transactions).
81 Id. at 2.
82 See supra text accompanying notes 8–11 (discussing that litigation). NCFE provided health care receivable financing by wholly-owned SPEs offering bonds backed by the receivables. Suffering from shortages of cash, NCFE transferred funds between reserve accounts. NCFE’s indiscretions eventually led to bankruptcy and a deluge of litigation. Brady et al., supra note 48, at 9–3.
83 See supra text accompanying note 20.
investors therefore relied (or, at least, claimed they relied) on the trustee to perform monitoring duties that the trustee legally had no obligation to (and therefore did not) perform.

An unanswered question is the extent to which the public nature of these litigations is resolving—and are likely to resolve—overreliance on trustees.

B. Hypothesis: The Complexity and Novelty of Securitization Transactions Undermine Analysis

In this hypothesis, complexity and novelty create uncertainty, which undermines analysis. The greater the complexity and novelty, the harder something is to understand and the less certain we are about it. We then focus on the simpler and more straightforward elements with which we are familiar. In a complex and unusual MBS transaction, for example, we may focus on the fact that the transaction is supported by mortgage loans, missing key elements of the transaction’s structure.

The notion that uncertainty undermines analysis is fairly well-established. In behavioral psychology, for example, uncertainty can cause people to view actual and certain costs as more important than uncertain future costs, even though the latter, if they occur, may be huge. This might help explain why even sophisticated institutional investors viewed the relatively high interest rates on MBS as more important than possible future risk on those securities.

Uncertainty can also reduce the perception of responsibility. For example, uncertainty enables soldiers in firing squads to choose to believe they did not fire the kill shot. Perhaps this also helps explain why investors did not govern their investments by the same strict lending standards they would observe but for the separation of origination and ownership.

Uncertainty also causes people to believe what they want to believe. It is reported that King Croesus of Lydia wanted to make war on Cyrus, but was wary of doing so without heavenly sanction. After singling out the Delphic Oracle as the most reliable, the King’s messengers “asked the

who undertook to perform ‘only such duties as are specifically set forth in [the] Master Indenture.’”)

85 Cf. Anabtawi & Schwarcz, supra note 61.
87 See supra text accompanying note 5.
practical question about the advisability of Croesus’ going to war, and received the famous [and famously ambiguous] response that ‘Croesus by crossing the Halys would destroy a mighty kingdom.’ Croesus interpreted this to mean what he wanted to hear—that Cyrus would fall—but in fact the empire that fell was his own. This may help to explain why investors were prepared to believe that the AAA-rated and other investment-grade rated securities issued in securitization transactions (offering much higher returns than other similarly rated securities), represented good investments even though they were at least partly backed by subprime mortgages.

V. CONCLUSION

This article has explored a conundrum that I call the “protection gap.” In complex securitization transactions, parties may be unable or unwilling to pay the price for full protection. As a result, they may choose or are forced to assume the good faith of the other parties to the transaction and the consistency and completeness of protections provided in the transaction documents.

The article identifies, and also tests, several interrelated hypotheses for the protection gap. One hypothesis is that the multitude of parties in securitization transactions creates collective action problems. Another hypothesis is that the complexity and novelty of securitization transactions undermine analysis.

Even traditional financing transactions can, to some extent, have protection gaps. The article argues, however, that securitization transactions can multiply the protection gap because they have many more parties, often with complex interrelationships, and much more complex and novel documentation and structures.

89 Id. at 71, 107 (discussing the historical method of the oracles as sheltering ignorance behind a “studied ambiguity” and vagueness). This same method of response is said also to be used today by fortune tellers. See J. Barkley Rosser Jr., Alternative Keynesian and Post Keynesian Perspectives on Uncertainty and Expectations, 23 J. POST KEYNESIAN ECON. 545, 554–57 (2001) (arguing that uncertainty leads to self-fulfilling mistakes).