

Lighting the match -- Subprime auto ABS structure comes under attack

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Editor's Note: The case *One William Street Capital Master Fund Ltd. et al. v. JPMorgan Chase Bank, N.A. et al.*, discussed in this article, was dismissed in a one-page order by the court in the Southern District of New York on the same day the article was published. The court said it will explain its reasoning in a full order to follow.

Investors in subprime auto asset-backed securities (ABS) have had more than a decade to study the wave of litigation that followed the collapse of subprime residential mortgage-backed securities, assess the theories that generated billions in recoveries, and refine strategies in the event they incurred losses of their own. Now, the collapse of Tricolor Auto, a used-car dealer and subprime auto lender whose “buy here, pay here” dealerships served Hispanic communities in Texas, Arizona, and California, has given the investors the opportunity to put those strategies to the test, and even go a step further.

In the newly filed suit, *One William Street Capital Master Fund Ltd. et al. v. JPMorgan Chase Bank, N.A. et al.*, No. 1:26-cv-01622 (S.D.N.Y. filed Feb. 26, 2026), noteholders who claim they lost hundreds of millions on allegedly fraudulent securitizations have paired conventional fraud claims against the deal underwriters with a novel theory that attacks the subprime auto deal structure itself.

The novel claims, brought under the Delaware and Texas Uniform Fraudulent Transfer Acts, target the warehouse lenders that funded Tricolor's loans to consumers – JPMorgan Chase Bank, Barclays Bank, and Fifth Third Bank – alleging the ordinary flow of funds in the securitization constituted a voidable transfer. The claims are based on two features of the deal that were not prevalent in RMBS: the warehouse SPV's role as the direct seller of receivables to the securitization trust, and the dual role of the defendant banks as both warehouse lenders and securitization underwriters.

Subprime auto and RMBS market origins

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Subprime auto ABS came first, accelerating in the 1990s as a way for non-bank used-car lenders to access capital markets funding for short-duration, high-yield loans to borrowers that traditional banks would not serve. The deals have typically been placed privately, often under Rule 144A of the Securities Act of 1933 to qualified institutional buyers. See 17 CFR § 230.144A.

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The market suffered its own crisis in 1997 when several major subprime auto lenders collapsed amid overaggressive underwriting and rising defaults, but the losses were contained by the relatively small loan sizes and short maturities involved.

Subprime RMBS grew explosively in the early 2000s, fueled by government policies, rising home prices, looser mortgage underwriting standards, and global investors' appetite for yield. The securities were issued largely through registered public offerings by the largest financial institutions in the country, with prospectuses, prospectus supplements, and detailed loan-level data filed with the Securities and Exchange Commission. The originators and sponsors, including the major Wall Street banks, were well-capitalized institutions.

Due to the larger loan balances, longer durations, and housing market exposure, when the RMBS bubble burst in 2007-2008, the resulting losses were systemic in a way that the subprime auto crisis never was.

Differences in deal structures follow differences in assets

The most consequential distinction between the two markets is the nature of the collateral.

A residential mortgage loan is secured by a house, an asset that is presumed to appreciate over a typical loan maturity of 15 to 30 years. The relatively high dollar value of each loan, the long duration of the cash flows, and the complexity of mortgage underwriting gave rise to a securitization framework built around detailed, loan-level representations and warranties, including compliance with underwriting guidelines, accuracy of borrower information, validity of appraisals, and the enforceability of the mortgage lien.

Given the legal challenges faced by subprime auto investors in pursuing breach of contract or fraud claims, all eyes should be on a new theory of recovery for investors.

If a breach of representation was found, the sponsor was obligated to cure the defect, substitute a conforming loan, or repurchase the defective loan from the trust.

In contrast, vehicles historically depreciate (putting aside the Covid-19 pandemic period), have a relatively low dollar value and a short loan maturity of three to six years. Given these dynamics, the securitization market created a different model of investor protection.

Rather than relying on granular, loan-level representations and warranties to ensure individual asset quality, subprime auto ABS transactions have historically relied mainly on structural credit enhancements, including significant levels of overcollateralization (excess loans above the amount invested), subordination, excess spread, and reserve accounts, to absorb losses at the pool level.

The representations and warranties in a typical subprime auto ABS deal are comparatively sparse and often limited to broad statements regarding the originator's compliance with its underwriting guidelines and the law and the validity of security interests in the vehicles.

Deal structure shapes litigation claims

Repurchase actions based on breaches of reps were the dominant form of RMBS litigation. In addition, because the vast majority of private-label RMBS were issued through registered public offerings, investors had access to claims under Sections 11 and 12(a)(2) of the Securities Act of 1933, which impose liability for material misstatements in registration statements and prospectuses without requiring proof of scienter (that the defendant acted with an intent to deceive, manipulate, or defraud). These statutory claims provided an alternative to contractual remedies, and they were deployed extensively.

Courts held that repurchase actions required strict compliance with the repurchase protocol as the sole contractual remedy

available under pooling and service agreements. Failure to adhere to conditions precedent of notice of breach and cure periods could be fatal to a claim. However, despite the procedural and substantive requirements, repurchase claims were the preferred theory for RMBS investors for good reason. Detailed representations provided a contractual basis for recovery that avoided the significantly higher evidentiary burden associated with fraud claims.

In contrast to RMBS, the relative thinness of loan-level representations and warranties in subprime auto ABS deals generally makes the breach of contract repurchase theory more challenging.

In addition, the securities law framework is less favorable. Because subprime auto ABS deals are typically issued as private placements rather than registered offerings, the strict-liability and negligence-based claims available under Sections 11 and 12(a)(2) of the Securities Act are generally unavailable.

An investor seeking to assert a federal securities fraud claim would likely need to proceed under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, which require proof of scienter, as well as reliance, economic loss, and loss causation, subject to the heightened pleading standards of the Private Securities Litigation Reform Act.

Fraudulent transfer claims in 'One William Street'

In *One William Street*, plaintiffs, institutional investors in Tricolor Auto Securitization Trusts ("TAST trusts"), allege that the trusts transferred cash raised from note sales to warehouse SPVs and received in return receivables that were "partially fictitious, double-pledged, or otherwise significantly impaired."

In addition to the typical fraud claims, Plaintiffs seek to recover from the lender defendants as "subsequent transferees" of over \$1.8 billion across seven securitizations, asserting both actual fraudulent transfer (based on badges of fraud and lack of good faith) and constructive fraudulent transfer (based on lack of reasonably equivalent value and insolvency).

Defendants characterize the fraudulent transfer claims as meritless, raising several independent grounds for dismissal. These include plaintiffs' lack of standing to challenge the transfers, failure to plead a stripping of assets to defeat creditors, and that the use of note proceeds to repay warehouse loans was repayment of an antecedent debt. In addition, they argue the constructive fraud claim fails for several reasons, including that bankruptcy-remote passthrough entities cannot logically be rendered insolvent.

Why the fraudulent transfer theory emerged

The fraudulent transfer claim is made possible by a structural feature generally not found in RMBS. In RMBS transactions, originators typically sold whole loans to a depositor that contributed them to the trust; the warehouse payoff occurred at the originator level, creating distance between noteholders

and warehouse lenders. In the Tricolor deals, however, the receivables were in warehouse SPVs that sat in the middle of the deal structure and the warehouse lenders held security interests in them as collateral.

When securitization occurred, receivables were sold from the warehouse SPV through the depositor to the trust, and cash flowed back through the same chain to pay down the warehouse lines. That structure placed the warehouse lenders directly in the flow of funds, creating the transactional nexus the plaintiffs characterize as a fraudulent transfer from debtor to subsequent transferee.

Plaintiffs argue that the dual role provided further fuel to Tricolor's alleged fraud: Because the same institutions controlled both the release of warehouse collateral and the underwriting of the takeout securitization, it is alleged they had both the motive, repayment of their own advances, and the means, structuring and closing the deal, to keep the pipeline running.

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Conclusion

Given the legal challenges faced by subprime auto investors in pursuing breach of contract or fraud claims, all eyes should be on a new theory of recovery for investors. Defendants' arguments emphasize the traditional sanctity of legally distinct steps in the securitization process, while Plaintiffs' arguments exemplify an integrated transaction framing. Whether the court accepts plaintiffs' focus on economic substance or treats the SPV structure as dispositive will likely determine whether this theory survives.

Either way, the proverbial match has been lit, and the market is on notice. Going forward, warehouse lenders and other market participants in subprime auto will need to consider whether litigation risk is hiding in plain sight in their deal structures.

Joseph Cioffi is a regular contributing columnist on consumer and commercial financing for Reuters Legal News and Westlaw Today.

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