

# The Big Bad Debt Collector

by Gordon Yale, CPA, CFE

*A flamboyant entrepreneur soared to financial heights on the wings of bad credit-card debt and fraudulent collection claims. But, like Icarus, he burned out fast, and scorched a lot of investors on the way down.*

**BILL BARTMANN** was larger than life. When his oil services firm, went broke in the mid-1980s, leaving him \$1 million in debt and on the receiving end of threats from apoplectic collectors, Bartmann was inspired. Instead of licking his wounds, the Oklahoma businessman founded Commercial Financial Services (CFS), a private company that bought and collected delinquent credit-card debt and became the self-proclaimed “collector with a heart.” His unorthodox practices and genius in finance propelled CFS from obscurity into America’s biggest purchaser of delinquent credit-card receivables deemed worthless by banks and other credit card issuers.

His home-spun charm helped him convince 15 of America’s top banks to sell him their charged-off credit-card debt at 2 to 12 cents on the dollar. Bartmann told analysts that for every 10 cents he spent, he could collect an average of 35 cents. With CFS’ cash collection histories apparently supporting his

contentions, he pioneered the securitization of delinquent credit card receivables.

Wall Street was almost immediately receptive to CFS securitizations for the great investment banking firms had themselves figured out the synergy of asset-backed debt instruments. The more ways bankers parsed bonds – their cash flows, their risks, and their security – the more commissions and trading profits there were to be earned.

By 1998, CFS, which had grown to 3,900 employees, was pursuing \$11.5 billion in bad debt owed by 3.6 million customers. Early that year *Inc.* magazine estimated CFS, which was 80 percent owned by Bartmann and his wife Kathryn, had a value of approximately \$3 billion. *Forbes* magazine estimated their personal wealth at \$530 million – each.



But by late 1998, this one-time darling of Wall Street came crashing down into bankruptcy amid widespread allegations of fraud.

The catalyst was an anonymous letter to bond rating agencies from a CFS whistleblower who questioned the company’s debt collection rates and its insider dealings. CFS closed its doors in June 1999 and left the courts the long and unenviable task of trying to unravel what was allegedly a massive fraud.

How did such CFS rise and fall so quickly?

The key to CFS’ phenomenal growth was its ability to borrow substantial sums of relatively low-cost money on favorable terms and conditions. Bartman could borrow because investment bankers and rating agencies, which presumably understood the nuances of the complex products CFS was selling, gave Bartmann’s company their collective blessing. It was a mistake they would regret.

Asset-backed bonds are generally nothing more than a large loan secured solely by a pool of smaller loans, each with similar credit risks. The most common asset-backed

ILLUSTRATION BY JOSH LEIPCIGER

securities are mortgage-backed bonds although almost any kind of debt has, or can be, securitized.

Typically, in securitization, bonds are over-collateralized. For example, if you're borrowing \$10-million for a higher risk commercial mortgage-backed securitization, you may have to effectively pledge \$10.5 million or more.

### **The CFS Wrinkle**

Bartmann's genius was to securitize delinquent credit-card receivables in a way asset-backs had never before been structured. He presented bank and bond purchasers with CFS' histories of debt collection, which indicated it was consistently able to collect, for example, 35 cents on the dollar for debts it had purchased for 10 cents. Using those histories, Bartmann persuaded his bankers and bond purchasers that the security for the loan should not be, say, 105 percent of the value of the collateral (the pool of delinquent accounts), but rather a percentage of future collections. As a result, he was able to issue bonds secured by as little as 60 percent of anticipated collections. In other words, under some circumstances, CFS was borrowing 18 cents (60 percent of 30 cents) on a pool of assets that cost it 10 cents.

In theory, the practice made sense, as long as CFS' collection histories were accurate and it remained efficient in collecting. The problem was that Bartmann's collection histories were an undiscovered fiction because no one actually verified them. If they had, they would have discovered that Bartmann was often unable to collect even his original purchase price.

### **His Success Caused Him Problems**

Bartmann's troubles were exacerbated by a slew of imitators who wanted to cash in on his apparent success. As more players entered the delinquent-debt market, banks and other financial institutions began raising the prices, ending the days when the reasonably collectible receivables could be bought for just a few cents on the dollar. CFS' ability to collect the delinquencies was also crippled by the inexperience of its large, relatively untrained staff, which had been quickly assembled to meet its growing needs.

But Wall Street was oblivious to CFS' problems and the ratings agencies continued to assign CFS asset-backed bonds glowing ratings.

### **Misguided Accounting Rules**

But it wasn't just Wall Street that helped Bartmann get rich quick. Misguided accounting rules also helped substantially

Accounting for the purchase and securitization of receivables is a reasonably straightforward process in theory but a quagmire of complexity in practice. The main issues in respect to CFS were how do you account for the collections on debt purchased at a substantial discount and how do you account for the sale of an asset in which a significant interest was retained.

In both instances, according to GAAP, if you could reasonably estimate future collections, you could calculate the appropriate implicit rate of return and allocate each dollar of collection in interest income and return of principal in the case of purchased receivables, or increase the value of your residual interest in the collateral in the event of a securitization. Either

way, income of one sort or another, sometimes considerable income, could be recognized up front.

Whether the CFS and its auditors were negligent in the preparation or audit of CFS' financial statements will be determined by the legal process. But the greater problem is that under present accounting standards, entities can record income or defer loss based on estimates that are often complex and arcane. The greater the complexity, the more that financial results may be subject to significant manipulation by an ingenious fraudster.

Did Wall Street learn its lesson from CFS? Apparently not. While CFS was unraveling and the lawsuits (many pending) began to be filed, the investment bankers anointed another collection agency, Creditrust, as their darling. Creditrust was also securitizing its delinquent receivables and recognizing substantial gains as soon as the first dollar was collected. Based upon those up-front gains, it raised \$95 million in equity from the public, much of it subsequent to the CFS meltdown. And like CFS, it too came crashing down under the weight of allegations of fraudulent collection histories.

So while many of us know that accounting is often more art than science, we must also conclude that even the most sophisticated analysts are frequently swept away by both a fast buck and the apparent financial innovations of the moment. ■

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