



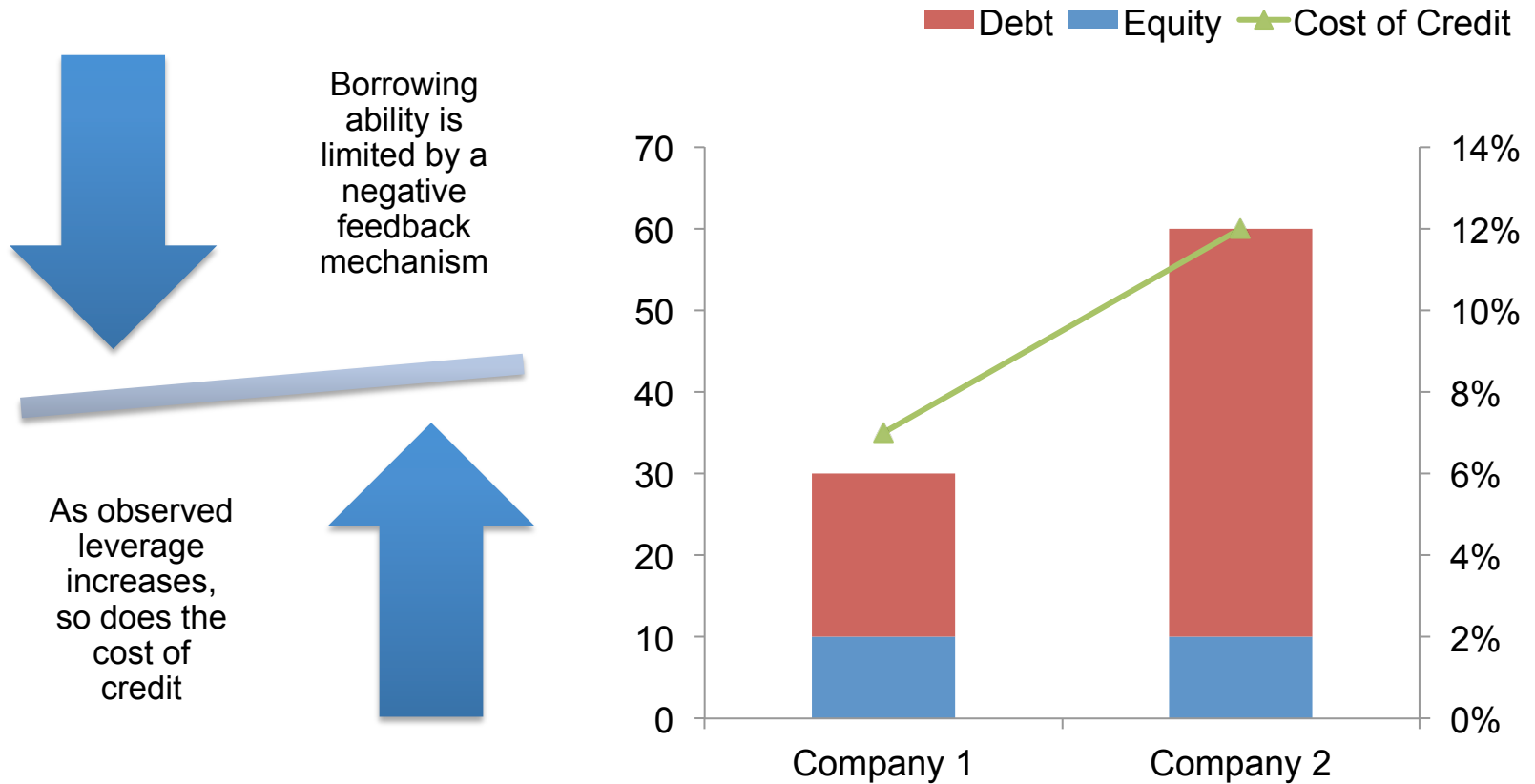
Bankruptcy Immunities, Transparency, and Capital Structure

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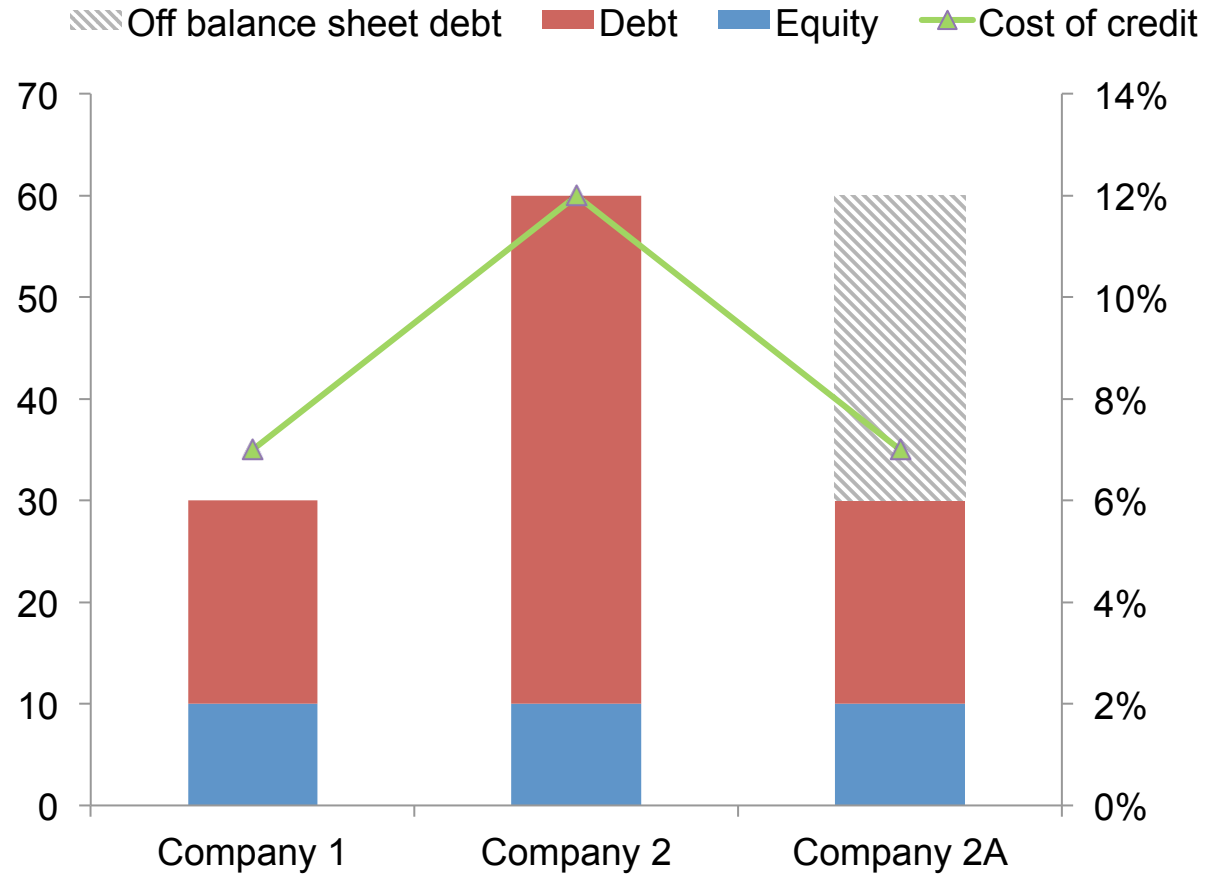
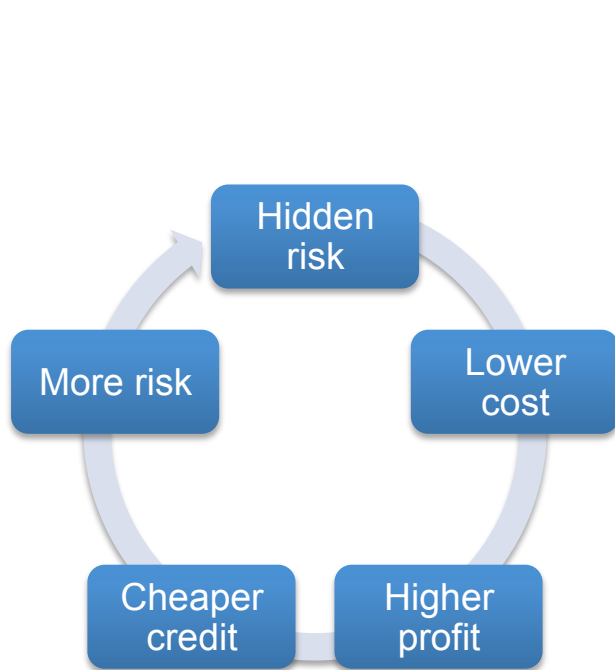
World Bank Task Force, Bankruptcy Treatment of Financial Contracts
Washington, D.C.

The credit markets normally limit leverage by making it more expensive to borrow as leverage levels and risk increase



Economic Leverage	Low	High
Observed Leverage	Low	High
Cost of credit	Low	High

Debtors can reduce their cost of borrowing by hiding their outstanding debts from lenders / investors



Economic Leverage	Low	High	High
Observed Leverage	Low	High	Low
Cost of credit	Low	High	Low

It is easier to hide debts with the cooperation of some creditors

The debtor gets . . .

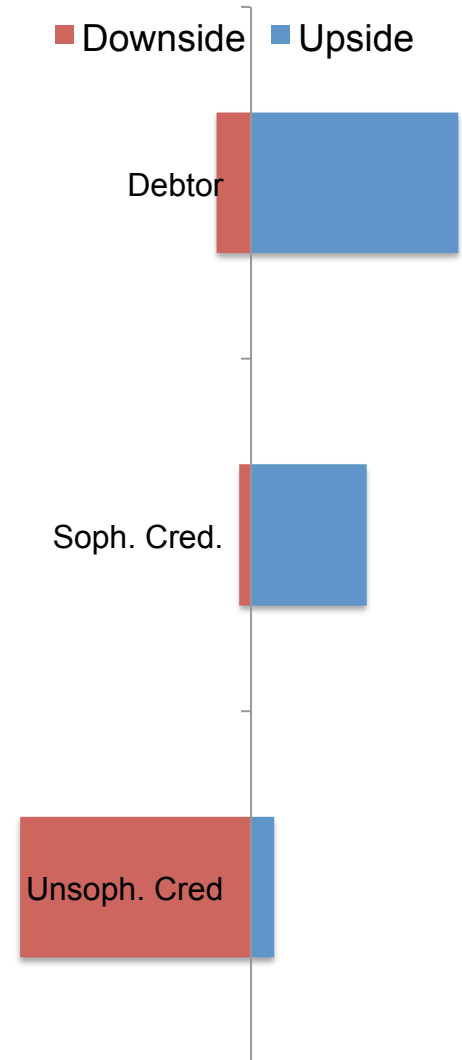
- More leverage and more potential profit
- Capped downside because of limited liability or insolvency
- Lower cost of credit

The cooperative creditor gets . . .

- Security interests in the debtor's property for downside protection
- Fees for structuring the transaction
- A deeper business relationship with the debtor

Unsophisticated creditors get . . .

- Undercompensated for risk if everything goes well
- Steep losses in case of insolvency



Judges recognized the danger of hidden leverage 200 years ago

Clow v. Woods, 1819

- It is] against sound policy to suffer a [debtor] to create a secret incumbrance on his personal property, when to the world he appears to be the absolute owner, and gains credit as such. [Creditors] must leave nothing unperformed, within the compass of their power, to secure third persons from the consequences of the apparent ownership of the [debtor].
 - Judge Gibson
- That a secret mortgage to secure a creditor . . . should be valid . . . **would put an end to all credit. Credit is given on...faith....I know not any doctrine that would tend to annihilate all credit, more than the establishment of such a principle.**
 - Judge Duncan

Paul Krugman, *A Crisis of Faith, 2008*

- **The ever-widening financial crisis has shaken investors' faith in the whole system. People no longer trust assurances that fancy financial instruments will function the way they're supposed to [W]ould-be borrowers can't get credit [A]lthough the Federal Reserve has sharply cut the interest rate it controls over the past few weeks, the borrowing costs facing many companies and households have actually gone up.**

Common law and early statutes mandated disclosure in exchange for priority

Clow v. Woods

- Penalty is avoidance or subordination of the secret lien holder's claims
- No fraudulent intent required
- Mere failure to provide adequate disclosure is sufficient

Strong arm power

- § 544(a)1) incorporated holding of Clow v. Woods into the bankruptcy code
- Explicit goal to prevent secret liens
- Extent of disclosure required tied to state law

Recordation

- Early state law systems for registering liens required extensive disclosures, including the underlying loan documents
- Burdensome to secured creditors

UCC

- Less burdensome for secured creditors
- Less disclosure, but still provided some notice

Chapter 11 stabilizes insolvent debtors by forcing a creditor “bail-in” and limiting rights of high-priority creditors

	Benefit to the debtor / reorganization	Harm to secured creditors
Automatic stay	<ul style="list-style-type: none"> •Prevents secured creditors from seizing and liquidating the underlying collateral •Enables debtors to continue operations with access to critical property •Prevents value destroying fire-sale 	<ul style="list-style-type: none"> •Prevents creditor from cashing out early at 100 cents on the dollar •Forces continued risk exposure to debtor and possible failed reorganization
Post-petition Interest accrual	<ul style="list-style-type: none"> •Gives debtor more time—reduces cash drain during reorganization •Reduces need for expensive DIP financing 	<ul style="list-style-type: none"> •Coverts coupon loans into zero coupon (PIK) without increased interest as compensation for increased risk and longer duration
Cash Collateral	<ul style="list-style-type: none"> •Debtor may use cash collections received on collateral •Cheap access to cash •Reduced need for DIP financing 	<ul style="list-style-type: none"> •Payments to secured creditors are delayed
Post-petition financing	<ul style="list-style-type: none"> •New post-petition lender may “prime” prepetition lenders’ security interests •Forces many pre-petition secured creditors to extend credit in a defensive DIP •Reduces costs and increases availability of DIP financing 	<ul style="list-style-type: none"> •Secured creditors move from first priority secured prepetition to second lien (Bridge / Mezzanine) post petition

Financial market contracts offer heightened priority and require minimal disclosure

Financial market contracts

Super-priority in insolvency

- No risk to extent of collateral
- Exempt from automatic stay; all avoidance actions other than for actual fraud
- No risk of recharacterization (BAPCPA, etc.)
- FDIC bailout / loan for “systemically important” institutions under Dodd-Frank Financial reform act

No mandatory disclosure

- OTC derivatives
- Off balance sheet treatment
- Proposed reforms(such as moving contracts to central clearing or an exchange) would not provide entity level details on risk exposures

Complexity aids secrecy

- Opaque creditworthiness of counterparties
- Technical contracts
- Extremely complicated mathematics
- Need for net exposures, not gross

Immune from secret lien doctrine

- See above—no disclosure requirements and generally exempt from avoidance actions

Real-world examples of use of financial market contracts to hide debt and risk

Lehman

LEHMAN BROTHERS

Lehman's use of \$50 billion in Repo 105 transactions to characterize debt as sales instead of debt

BofA

Bank of America



Bank of America's admitted mischaracterization of approximately \$10.7 billion in repos as sales instead of debt

Citi



Citigroup's admitted mischaracterization of ~\$5 billion in repos as sales instead of debt

Greece



Greece's possible use of interest rate and currency swaps with Goldman Sachs and other banks to disguise debt

Italy



Italy's possible use of currency swaps with JP Morgan to disguise debt

AIG



AIG's admitted mischaracterization of ~\$4 billion in repos as sales

Inadequate disclosure by AIG of its exposures to mortgage risk through CDS and securities lending

AIG inadequately disclosed its exposures to mortgage risk

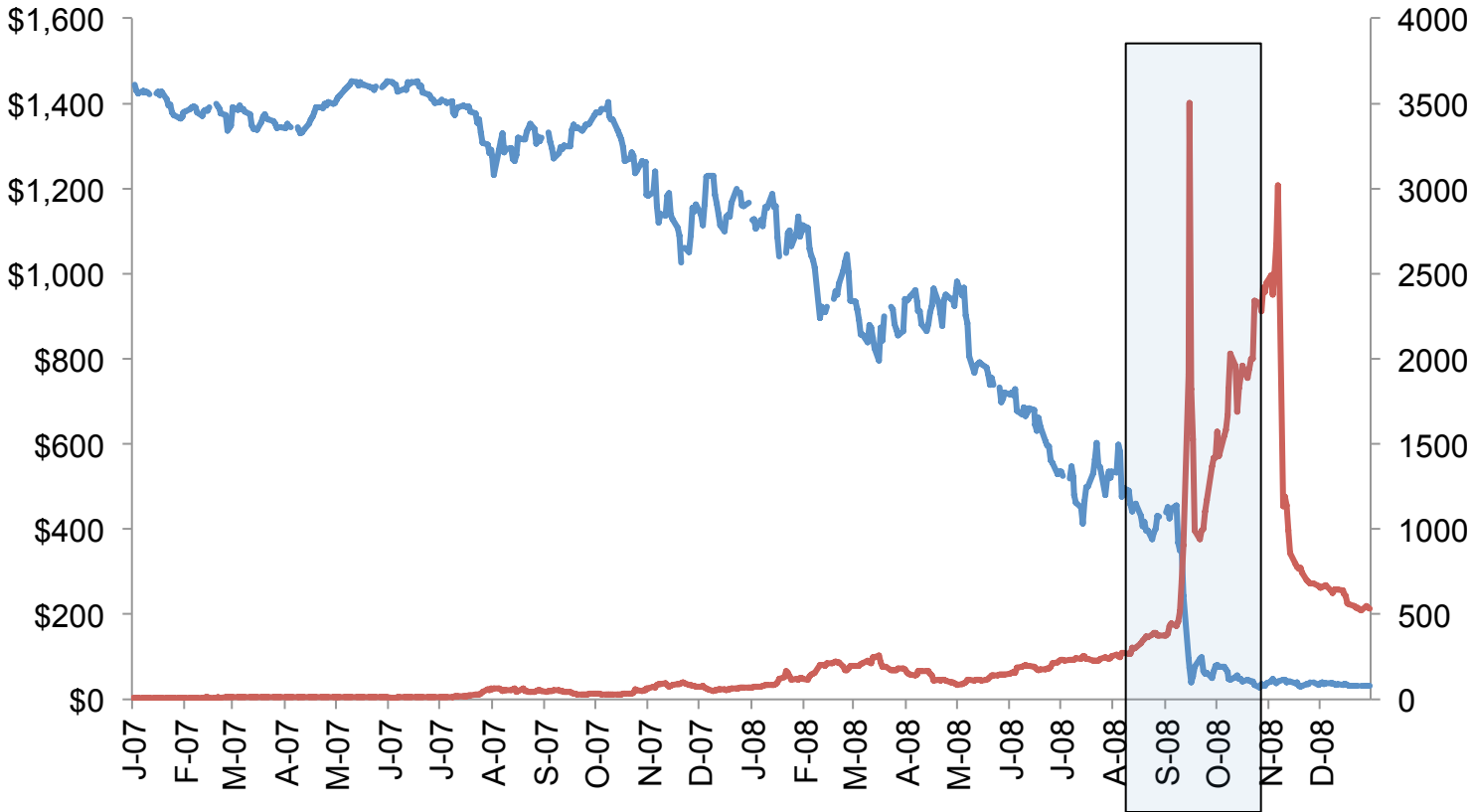
- “[T]ime and time again AIG has failed to provide the requisite transparency to its investors If one follows the disclosures made by the company, they . . . raise questions.
 - For example, in AIG’s June 30, 2007 quarterly filing, the company disclosed: ‘. . . a downgrade of AIG’s long-term senior debt ratings to ‘Aa3’ by Moody’s or ‘AA-’ by S&P would permit counterparties to call for approximately \$847 million of collateral.’ . . .
 - But just six months later in its annual report, the company [made disclosures that seriously called into question the earlier disclosures] as the company disclose[d]
 - (1) that counter parties have questioned the company’s valuations and
 - (2) required \$5.3 billion in collateral, as opposed to the \$847 million amount disclosed earlier. . . .
 - Six months later, AIG disclosed in its June 30, 2008 quarterly report that ‘AIGFP had posted collateral . . . in an aggregate net amount of \$16.5 billion [and faced] unrealized market valuation losses of \$26.1 billion’
- **In one year, the disclosures from the company had gone from not losing a dollar to over \$26 billion in valuation losses** and counter parties that to this day have not been disclosed demanding over \$16 billion in collateral.
- And on October 3, 2008 the Company disclosed that at the end of September it had borrowed \$61 billion from the federal government due to the liquidity crisis such calls on collateral had placed on AIG. Clearly it would seem that in light of this, the company had failed to provide investors with a clear view of the magnitude of the potential demands for collateral.”

AIG nearly became insolvent after CDO related losses forced it to post collateral to make good on its CDS guarantees

AIG equity closing price
USD per share

AIG CDS spreads
Basis points

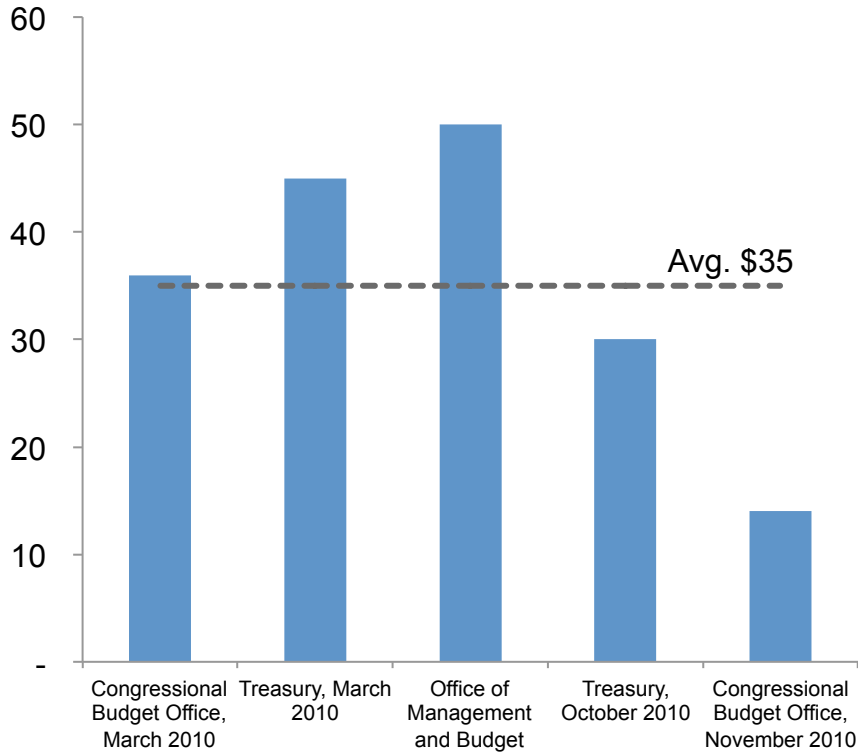
- Equity
- CDS



Source: Bloomberg, Credit Market Analysis NY; Wall Street Journal

AIG's CDS counterparties were saved from tens of billions in losses by U.S. government intervention

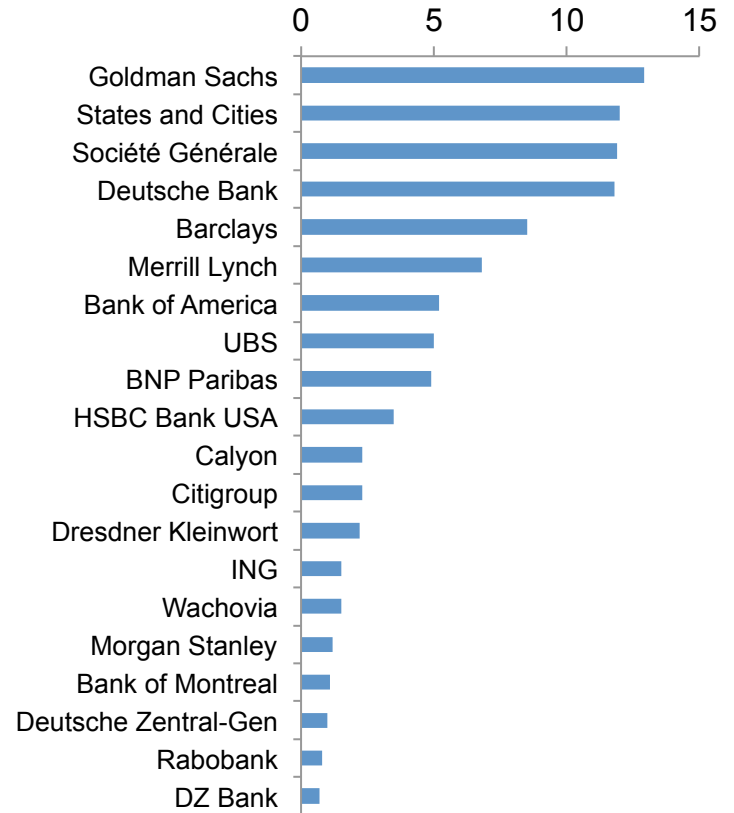
Estimates of U.S. government losses from AIG rescue
USD, Billions



Note: SigTarp criticized a change in Treasury's methodology in November 2010.

Source: Congressional Budget Office, SigTARP, Congressional Oversight Panel, Treasury, Office of Management & Budget, AIG

AIG related payments to its largest credit default swap counterparties
USD, Billions



Source: Business Week

What sort of mandatory disclosure regime is necessary for the credit markets to appropriately price risk and limit leverage?

Detailed transaction information

- Contract
- Financial model used to calculate obligations under the contract
- Description of collateral that may need to be posted
- Sensitivity analysis
 - Best case
 - Worst case

Easily to access and analyze

- Free or inexpensive
- Electronic
- Searchable
 - Name of the debtor
 - Name of creditor
- Sortable
 - Counterparty
 - Type of instrument
 - Type of collateral
 - Size, Date and Duration of Obligation
- Contextual
 - Organization chart of different corporate entities clearly showing obligations
 - Hyperlinks to other entities or counterparties