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Secret liens and the financial crisis of 2008

Michael N Simkovic, *Harvard Law School*



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By Michael Simkovic

Abstract

This article explains the roots of financial crises in one of the oldest and most fundamental problems of commercial law: hidden leverage. Common law courts wrestled with this problem for centuries and developed a time-tested solution: the doctrine of secret liens. If the debtor becomes insolvent, the doctrine of secret liens punishes secret lien holders by subordinating their claims to those of other creditors. In other words, by overriding privately negotiated payment priorities, the doctrine of secret liens creates incentives for transparency. This article argues that legal changes over the last 80 years eroded the doctrine of secret liens, and thereby led to the financial crisis. Due to these legal changes, complex and opaque financial products received the highest priority in bankruptcy, and creditors' incentives were therefore to structure transactions using these favored financial products. The opaque credit environment that resulted permitted debtors-particularly investment banks-to hide the extent of their leverage, to the detriment of all creditors. This article argues that Congress can prevent future financial crises by restoring the doctrine of secret liens, or by adopting a modernized regulatory regime built on the doctrine of secret liens' fundamental insight-that creditors should be compelled to disclose their claims in exchange for payment priority.

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I. Introduction: Systemic Risk and Hidden Leverage

This article argues that legal changes over the last 80 years eroded the doctrine of secret liens, and thereby led to the financial crisis. Due to these legal changes, complex and opaque financial products received the highest priority in bankruptcy, and creditors' incentives were therefore to structure transactions using these favored financial products. The opaque credit environment that resulted permitted debtors—particularly investment banks—to hide the extent of their leverage, to the detriment of all creditors.¹ This article argues that Congress can prevent future financial crises by restoring the doctrine of secret liens, or by adopting a modernized regulatory regime built on the doctrine of secret liens' fundamental insight—that creditors should be compelled to disclose their claims in exchange for payment priority.

In 2008, questions of financial system stability became front page news as bulge bracket investment banks declared bankruptcy, were acquired for fire-sale prices, or remained afloat through massive injections of capital from the federal government. To stabilize the financial system, as of November 28, 2008, the federal government committed over \$3.5 trillion in taxpayer money.² To put the scale of this commitment into context, it is roughly 1.5 times the size of the federal government's entire annual tax receipts for 2007.³ Under the circumstances, new regulations seem inevitable, and these regulations will shape the financial services industry—and potentially the global economy—for years to come.⁴ It is

¹ The opaque financial environment may also prove to be to the detriment of all taxpayers, if government rescue efforts lead the government to absorb losses by over-paying for distressed securitized assets and/or for equity stakes in insolvent financial institutions.

² According to the Wall Street Journal, as of November 28, 2008, the U.S. government committed over \$3.5 trillion to rescue programs. The programs include: 1) Up to \$350 billion in FDIC guarantees of bank issued debt; 2) \$700 billion for the Troubled Asset Relief Program (used to inject capital into financial institutions including AIG, Citigroup, Bank of America, Wells Fargo, Morgan Stanley and Goldman Sachs; 3) An estimated \$1.3 trillion for the Federal Reserve to buy commercial paper, effectively loaning money to companies such as GE, GMAC, and Ford Motor Credit; 4) \$540 billion for the Fed to buy short term debt from Money Market funds; 5) \$200 billion in loans so that private investors can buy securitized loans, initially limited to auto-loans, credit card loans, student loans and small business loans; and 6) \$600 billion in government purchases of mortgage backed securities backed by GSEs such as Freddie Mac and Fannie Mae, as well as purchases of GSE debt. See Jon Hilsenrath and Deborah Solomon. Mortgage Rates Fall as U.S. Expands Rescue. Wall Street Journal. November 26, 2008. Of course, there is a difference between contingent guarantees or investments and outright expenditures—the full cost of these efforts is not yet known.

³ According to the Government Printing Office, total federal government receipts for 2007 were \$2.4 trillion. Table 1.1: Summary of Receipts, Outlays, and Surpluses or deficits: 1789- 2011. Available at www.gpoaccess.gov/usbudget/fy07/sheets/hist01z1.xls, last checked November 30, 2008.

⁴ "House Financial Services Chairman Rep. Barney Frank (D., Mass.) predicted that 2009 will be the "best year" for public policy since the New Deal. Speaking before the Consumer Federation of America Thursday, Mr. Frank said Congress would pass a regulatory overhaul comparable to the antitrust laws of the late 19th century and the creation of the Securities and Exchange Commission in 1934." Jessica Holzer. Frank Foresees Sweeping Regulatory Overhaul. Wall Street Journal. December 4, 2008.

therefore imperative that new regulations are crafted in light of the accumulated wisdom of common law systems that have managed insolvency and promoted financial stability for centuries.

Although the current financial crisis involves financial instruments that are new and complex, such as collateralized debt obligations (CDOs) and credit default swaps (CDS), the fundamental causes of the financial crisis are relatively old and simple. This article explains the roots of financial crises in one of the oldest and most fundamental problems of commercial law: hidden leverage.⁵

Financial system stability depends on maintaining a safe level of leverage given the riskiness of underlying assets or cash flows. A highly leveraged financial system is like a powder keg—it can turn a small spark, relatively harmless in most environments—into a large and devastating explosion. In a moderately leveraged business, equity acts as a cushion, absorbing losses and enabling the business to continue. But in a highly leveraged business, the same losses can wipe out equity, rendering the business insolvent and forcing it to reorganize or liquidate. A rapid sell-off of assets—particularly complex, thinly traded assets—pushes down market prices, leading to further losses. If other highly leveraged businesses hold similar assets, declining prices will also wipe out their equity, forcing them to liquidate.

Losses act as a spark; widespread leverage is the powder keg. Leverage can be “regulated” privately by creditors or regulated by government, but only if the extent of leverage is known.

Hidden leverage is a perennial problem because debtors rationally wish to borrow at the lowest price possible. Debtors can borrow at more attractive rates by hiding their existing debts and creating an exaggerated appearance of creditworthiness. Creditors who lend to such borrowers suffer because the interest rates they charge do not adequately compensate them for the risk of default.⁶

Although it is in the collective interests of creditors to gather information about debtors’ creditworthiness, it may not be in an individual creditor’s interest to share his piece of the puzzle with other creditors, who may be competitors. Such mutually harmful competition among creditors is more likely when creditors expect to compete for future business, for example because the debtor is a large repeat-player such as a corporation or financial institution.

Debtors who wish to hide their debts can exploit competition between potential creditors to gain active cooperation from some creditors. These cooperative creditors will work with debtors to hide loans either through simple non-disclosure or through complex and difficult to understand structures. Debtors may compensate these cooperative creditors for their assistance with higher fees, a deeper business relationship with the creditor, or liens on the debtor’s property.

⁵ Leverage can refer to the ratio of debt (and off-balance sheet obligations) to equity, or to value at risk relative to capital.

⁶ See Modigliani & Miller (1958). Any savings achieved by changing one part of a company’s capital structure will result in offsetting costs to other parts of the capital structure, including taking advantage of third parties.

The result of this subterfuge is lower financing costs for the debtor and lower profits—or steeper losses—for unsophisticated unsecured creditors. If the debtor remains solvent, the debtor will repay all creditors and the extent of hidden leverage will remain secret. If the debtor becomes insolvent, the extent of hidden leverage will be exposed too late for creditors to be made whole. Creditors who are not repaid can bring suit, but the debtor’s insolvency effectively caps any recovery.

This is an ancient problem. Professor Peter Coogan has described the history of commercial law as “the 400 year struggle by debtors and their [sophisticated] secured creditors to create security interests of various sorts in the debtors’ property without affording notice to buyers or other creditors, and the attendant demands by [unsophisticated] unsecured creditors generally for some kind of notice when all or part of the debtors’ assets become subject to security interests.”⁷

Common law courts wrestled with this problem for centuries and developed a time-tested solution: the doctrine of secret liens. A first lien (or security interest) gives the lien-holder a claim on the debtor’s property that is superior to claims of other creditors. A lien is “secret” if it is not properly disclosed to other potential creditors.

If the debtor becomes insolvent, the doctrine of secret liens punishes secret lien holders by subordinating their claims to those of other creditors. In other words, by overriding privately negotiated payment priorities, the doctrine of secret liens creates incentives for transparency.

Because secret lien doctrine compels creditors to disclose information, it can reinforce the accuracy of disclosures under regulatory systems that compel debtors to disclose information, such as securities, banking, and insurance regulation.

II. The Common Law Origin of Secret Lien Doctrine

The doctrine of secret liens’ intellectual and legal underpinnings stretch back to 16th century England, to the Statute 13 of Elizabeth.⁸ The doctrine of secret liens was most famously articulated in the early 19th century Pennsylvania case, *Clow v. Woods*.⁹

In *Clow*, a tanner conveyed security interests in his hides and tanning equipment to his creditors.¹⁰ The creditors did not take possession of the hides or equipment, and did not record their security interest.¹¹ The tanner’s former business partner sued the tanner, obtained a judgment, and sent the sheriff to

⁷ Peter F. Coogan, Public Notice Under the Uniform Commercial Code and Other Recent Chattel Security Laws, Including “Notice Filing,” 47 Iowa L. Rev. 289 (1962)

⁸ Jonathan C. Lipson. Secret Liens: The end of Notice in Commercial Finance Law. 21 Emory Bankr. Dev. J. 421, 429-32 (2005)

⁹ *Clow v. Woods* [5 Serg. & Rawle 275 \(Pa. 1819\)](#) 1819 WL 1895 (Pa.)

¹⁰ *Clow v. Woods* [5 Serg. & Rawle 275 \(Pa. 1819\)](#) 1819 WL 1895 (Pa.), at 1.

¹¹ *Id.* at 1-3.

execute by seizing and selling the tanner’s hides and equipment.¹² The secured creditors sued the sheriff, seeking to recover the proceeds of the sale of the hides and equipment. The secured creditors argued that their security interest had priority over the execution lien.

The Supreme Court of Pennsylvania ruled against the secured creditors, finding that an undisclosed security interest constitutes “fraud per se” (in modern parlance, “constructive fraud”) even without any fraudulent intent, because of the potential harm of secret liens to third party creditors.¹³

Judge Gibson explained:

[A] creditor ought not to be suffered to secure himself by means that may ultimately work an injury to third persons Where possession has been retained without any stipulation in the conveyance, the cases have uniformly declared that to be, not only evidence of fraud, but fraud per se. Such a case is not inconsistent with the most perfect honesty; yet a court will not stop to inquire, whether there be actual fraud or not; the law will impute it, at all events, because it would be dangerous to the public to countenance such a transaction under any circumstances. The parties will not be suffered to unravel it, and show, that what seemed fraudulent, was not in fact so.¹⁴

Judge Gibson believed secret liens were too dangerous to permit under any circumstances because of the danger that debtors would misrepresent themselves as more creditworthy than they actually were, and so induce third parties to extend credit:

[It is] against sound policy to suffer a [debtor] to create a secret [e]ncumbrance on his personal property, when to the world he appears to be the absolute owner, and gains credit as such. In every case where possession is not given,¹⁵ the [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]...I do not suppose the parties had, in fact, a fraudulent view, but as such a transaction might be turned to a dishonest use, it was their duty, as far as in their power, to secure the public against it.¹⁶

¹² *Id.*

¹³ *Id.* at 5.

¹⁴ *Id.*

¹⁵ The emphasis in *Clow* on physical possession may seem strange to modern readers. At the time, physical possession and recordation were the two primary means of providing notice of ownership of tangible property. As the economy became more complex, and intangible property rights proliferated, the importance of physical possession declined. See Jonathan C. Lipson. *Secret Liens: The end of Notice in Commercial Finance Law*. 21 *Emory Bankr. Dev. J.* 421, 434-35 (2005)

¹⁶ *Clow v. Woods*, [5 Serg. & Rawle 275 \(Pa. 1819\)](#) 1819 WL 1895 (Pa.) at 6.

The decision in *Clow* highlights the adaptability and flexibility of the common law. Although the judges nominally decided the case under the Statute 13 of Elizabeth, which “renders void all conveyances made to the end, purpose, and intent of defrauding creditors,”¹⁷ the principle they articulate represents a significant extension of fraudulent conveyance doctrine. Under secret lien doctrine, it is not fraudulent intent that matters, but a lack of notice and meaningful disclosure.

Extending these common law principles, Judge Duncan arrived at a conclusion very similar to the thesis of this article—that a lack of transparency threatens not only individual creditors, but the financial system as a whole. In Judge Duncan’s view, secret liens threatened to “put an end to all credit”:

That a secret mortgage to secure a creditor...should be valid and bind the property against creditors...would be a reproach to the law. It ought not, it cannot be so. If it were so, it 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.¹⁸

III. From Common Law to Statute to Financial Crisis

Secret lien doctrine continues today as the “strong-arm power” under the federal Bankruptcy Code, codified at 11 U.S.C. § 544(a)(1)—the power of bankruptcy trustees to void secret transfers made prior to bankruptcy.¹⁹ The strong-arm power was first incorporated into the Bankruptcy Code in 1910 with the explicit goal of preventing secret liens,²⁰ and the prevention of secret liens remains its explicit goal today.²¹

However, a variety of statutory legal changes have replaced the flexibility and breadth of common law secret lien doctrine with a system that is more formal, rigid—and in the view of this author—ineffective.

¹⁷ Id. at 3.

¹⁸ Id at 10. The dire consequences Judge Duncan warned would result from secret liens sound remarkably like recent descriptions of the financial crisis. Nobel Prize winning economist Paul Krugman described the financial crisis as “a crisis of faith.” He wrote: “[T]he ever-widening financial crisis has shaken investor’s faith in the whole system. People no longer trust assurances that fancy financial instruments will function as they’re supposed to... would be borrowers can’t get credit...although the Federal Reserve has sharply cut the interest rate in controls over the past few weeks, the borrowing costs facing many companies and households have actually gone up.” Paul Krugman, *A Crisis of Faith*, *New York Times*. February 15, 2008. Available at www.nytimes.com/2008/02/15/opinion/15krugman.html last accessed 12/15/2008

¹⁹ See [11 U.S.C. § 544\(a\)\(1\) \(2000\)](http://www.uscourts.gov/uscourt/cases/11-544a1).

²⁰ Congress stated that the strong-arm power was needed “to prevent the evil of secret liens.” 61 Cong. Rec. 2275 (1910).

²¹ The 1973 Report of the Commission on Bankruptcy Laws of the United States noted that an “essential feature of any bankruptcy law is the inclusion of provisions designed to invalidate secret transfers made prior to the date of the filing of petition.” Commission on the Bankruptcy Laws of the United States. H.R. Rep. No 93-37, at 18 (1973).

Gaps in this formal system led to an opaque credit environment, excess leverage, and the recent financial crisis.

As secret lien doctrine developed into a formalized statutory system, two key changes took place:

(1) Lower standards of disclosure: formal filing systems de-emphasized meaningful disclosure to creditors, focusing instead on technical compliance; and

(2) Exceptions to facilitate the growth of certain favored financial products: Amendments to the Bankruptcy Code and state law provisions related to “property of the estate” placed certain favored financial products—asset securitizations and derivatives—beyond the reach of the strong-arm power and related Bankruptcy Code provisions.

The financial crisis was proximately caused by credit losses channeled through two of these favored financial products, collateralized debt obligations—a type of asset securitization, and credit default swaps—a type of derivative.

Prior to the financial crisis, these favored products grew rapidly because they received superior treatment in bankruptcy and were not transparent to third parties.

A. Reduced standards of disclosure under the Uniform Commercial Code

Over the last 80 years, commercial law has seen a general decline in the level of disclosure required to perfect security interests.

To deter or correct the problems of secret liens and the related problem of fraudulent conveyances,²² common law legal systems developed recordation systems.²³ Unless a lien holding creditor recorded the lien, the law would treat non-possessory liens as fraudulent and therefore voidable. Early recordation systems required extensive disclosures, including the filing of the mortgage document itself, and sometimes affidavits and acknowledgements of good faith.²⁴

²² A fraudulent conveyance is a transfer not for value at a time when the debtor is insolvent. Fraudulent transfers are similar to secret liens in that both involve an agreement between the debtor and a third party to the detriment of the debtor’s unsecured creditors.

²³ See Jonathan C. Lipson. Secret Liens: The end of Notice in Commercial Finance Law. 21 Emory Bankr. Dev. J. 421, 439 (2005)

²⁴ Peter F. Coogan, Public Notice Under the Uniform Commercial Code and Other Recent Chattel Security Laws, Including “Notice Filing,” 47 Iowa L. Rev. 289 (1962) at 291.

Grant Gilmore, Security Interests in Personal Property § 3.2, at 67; § 8.7, at 274 (1965) (“In the history of our security law there has been one constant factor: whenever a common law device has been covered by a statute, some form of public recordation or filing has been required as a condition of perfection of the security interest.”)

These early recordation systems represented the height of mandatory disclosure under secret lien doctrine. The informational content they provided was exceptionally rich.

However, these recording statutes were burdensome for both filers and searchers because their presentation of credit information was idiosyncratic and fragmented. There were several different independent recording systems for different types of security.²⁵ This forced filers to comply with several different notice systems, and potential creditors wishing to evaluate a debtor's creditworthiness to search several different systems.²⁶

In the mid 20th century, recording statutes were replaced with streamlined notice-filing systems. Unfortunately, these streamlined systems reduced the burden of compliance not by solving the problem of information fragmentation, but by limiting the information content of filings. A precursor to the modern Uniform Commercial Code, The Uniform Trusts and Receipts Act, passed in 1933,

Popularized the idea that for certain kinds of transactions [such as those involving inventory and accounts receivable] it is not essential for all of the details of the transaction to be spread upon the public record, so long as the record gives an indication where an interested party might inquire to learn whether or not a particular collateral of the indicated class or type is subject to the perfected security interest.²⁷

The Uniform Commercial Code similarly operates through a simple filing—the UCC-1 Financing Statement—that puts searchers on “inquiry notice” of the possible existence of a security interest, but does not disclose the details of the transaction. The UCC-1 financing statement need only set forth the debtor's name, the secured party's name, and a brief description of the property subject to the security interest. “What is required to be filed is...only a simple record providing a limited amount of information... Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs.”²⁸

Recent revisions to Article 9 of the U.C.C. mitigated the problem of information fragmentation across geographies, but exacerbated the problem of information fragmentation based on type of property. Revised Article 9 reduced the obligation to file financing statements in multiple states or on a county-by-county basis.²⁹ However, according to Professor Jonathan Lipson, the revised U.C.C. also created new

²⁵ See Jonathan C. Lipson. Secret Liens: The end of Notice in Commercial Finance Law. 21 Emory Bankr. Dev. J. 421, 441 (2005)

²⁶ *Id.*

²⁷ Peter F. Coogan, Public Notice Under the Uniform Commercial Code and Other Recent Chattel Security Laws, Including “Notice Filing,” 47 Iowa L. Rev. 289 (1962) at 314-15

²⁸ Official comment to UCC § 9-502, cmt. 2.

²⁹ See See Jonathan C. Lipson. Secret Liens: The end of Notice in Commercial Finance Law. 21 Emory Bankr. Dev. J. 421, 485, fn. 302 (2005) citing U.C.C. § 9-401 (2000).

opportunities for secret liens in certain financial assets by creating security interests that do not require a filing because they are perfected through “control.”³⁰

A secured party will have “control” of certain financial assets if the party has the right to dispose of the assets.³¹ For example, a bank will often have a “control” security interest in the cash it holds in the deposit account of a customer to whom it has extended credit. Because control arises by agreement or operation of law, no filing is required.

Although control security interests do not require a U.C.C. filing and are therefore presumably less transparent than security interests perfected through filing,³² “security interests perfected by control ...take priority over those perfected otherwise...”³³

It may be difficult for a third party to discover the existence of a control security interest because a creditor that has entered into a control security agreement “is not required to confirm the existence of the agreement to another person” unless the bank’s customer (the debtor) instructs it to do so.³⁴ Although other creditors can ask the debtor about the existence of control security interests, other creditors will have limited recourse if the debtor’s answer turns out to be false.³⁵

a. Focus on technical compliance rather than meaningful disclosure

Unlike common law secret lien doctrine, which emphasized meaningful disclosure, the strong-arm power under 11 U.S.C. § 544(a)(1) focuses on strict compliance with U.C.C. requirements for perfection

³⁰ See Jonathan C. Lipson. Secret Liens: The end of Notice in Commercial Finance Law. 21 Emory Bankr. Dev. J. 421, 462-467 (2005)

³¹ See Jonathan C. Lipson. Secret Liens: The end of Notice in Commercial Finance Law. 21 Emory Bankr. Dev. J. 421, 462 Fn. 173 (2005) citing [U.C.C. §§ 9-106, 9-104, 9-105, 9-107, 9-314\(a\) \(2003\)](#). Control interests can be created in certain types of collateral, including deposit accounts, investment property, electronic chattel paper, and letter of credit rights.

³² Although there may be general knowledge among banks and broker dealers that other banks and broker dealers will have control security interests in debtors’ accounts, creditors who are not financial institutions may be less knowledgeable. For example, vendors may mistakenly assume that they have a security interest in “proceeds” from the sale goods they supplied. See Jonathan C. Lipson. Secret Liens: The end of Notice in Commercial Finance Law. 21 Emory Bankr. Dev. J. 421, 464-65 (2005).

³³ See Jonathan C. Lipson. Secret Liens: The end of Notice in Commercial Finance Law. 21 Emory Bankr. Dev. J. 421, 439, fn. 185 (2005) citing U.C.C. § 9-322(c), 9-327(1) (“A security interest held by a secured party having control of [a] deposit account under [Section 9-104](#) has priority over a conflicting security interest held by a secured party that does not have control.”)

³⁴ UCC § 9-342. See also UCC § 8-106(g).

³⁵ See Jonathan C. Lipson. Secret Liens: The end of Notice in Commercial Finance Law. 21 Emory Bankr. Dev. J. 421, 466, fn. 189 (2005)

of security interests. As a result, the strong-arm power cannot void relatively secret security interests arising through control, but can void relatively transparent security interests that suffer from minor procedural errors.³⁶ The result of this emphasis on technical compliance is that the strong-arm power is both over- and under-inclusive.

The strong arm power is arguably a blunter and clumsier tool for creating a transparent financial system than its precursor, the common law doctrine of secret liens. The U.C.C., though less burdensome to secured creditors than precursor recording statutes, provides less information to third party creditors.

b. Transparency and U.C.C. filings

Nevertheless, U.C.C. filings are a critical source of information for creditors because they are incorporated into credit reports and ratings by private agencies such as Dun & Bradstreet and Experian.³⁷

The erosion in standards of compulsory creditor-provided disclosure creates opportunities for hidden leverage, particularly in areas where debtor-provided disclosure systems such as financial statements and regulatory filings are inadequate, such as off-balance sheet transactions and derivatives.

B. Minimal Disclosure and Higher Priority in Bankruptcy for Favored Financial Products

An ideal vehicle for hidden leverage will have the following characteristics: (1) Priority in bankruptcy for select creditors guaranteeing that the debtor will repay these creditors first; (2) No requirement for creditors to disclose the transaction to other potential creditors; (3) No requirement for the debtor to disclose the transaction on its balance sheet or other financial statements; (4) Complexity that limits the usefulness of any required disclosures to third parties; (5) Immunity from secret lien doctrine and related provisions of the Bankruptcy Code.

These characteristics roughly describe two types of financial products—asset securitizations and derivatives—which were used by investment banks and insurance companies to hide the extent of their leverage prior to the financial crisis. This hidden leverage magnified mortgage-related write-downs beyond bank and insurance companies' ability to absorb losses, and into a financial crisis requiring massive government intervention.

In the recent financial crisis, asset securitization—including mortgage backed securities and collateralized debt obligations or CDOs—and derivatives—including credit default swaps or CDS—played

³⁶ See Jonathan C. Lipson. Secret Liens: The end of Notice in Commercial Finance Law. 21 Emory Bankr. Dev. J. 421, 449-50 (2005) (“Case law under the strong-arm power is replete with instances of secured parties losing their security interest for reasons that appear, in retrospect, to have been nit-picky, at best, and capricious at worst....Even under the [simplified notice requirements of the U.C.C.]...[m]istakes in the debtor’s name, descriptions of collateral, or the place of filing have all been used against the secured party.”)

³⁷ Jonathan C. Lipson. Secret Liens: The end of Notice in Commercial Finance Law. 21 Emory Bankr. Dev. J. 421, 452-53 (2005)

a critical role. The use of these financial products as vehicles for secret liens is discussed at length below.

a. Asset securitizations as secret liens

This discussion of Asset Securitization that follows relies heavily on a recent, award-winning article by Kenneth Kettering, an experienced derivatives and structured finance law firm partner turned law professor.³⁸

An asset securitization is economically very similar to a secured loan, except that an asset securitization renders the debtor more leveraged and less transparent than the debtor would be if the transaction were structured as a secured loan. As Professor Kettering explains:

“[T]he securitization structure that is prototypical of the genre...is economically identical to a non-recourse loan [to] the Originator [(the debtor)] secured by the same assets that are used to support the financing under the securitization structure.”³⁹

Sophisticated lenders prefer to structure their loans as asset securitizations because, if the debtor seeks bankruptcy protection, these lenders theoretically receive a stronger claim on the assets than would be possible under a secured loan. Asset securitization investors are therefore more likely to be repaid in full and on time than traditional secured lenders. As Professor Kettering explains:

“The distinctive feature of securitization is that the transaction...is structured to isolate the asset pool from the Originator [(the debtor)] in such a way that, if the Originator later becomes subject to an insolvency proceeding, the proceeding will not interrupt the continued receipt by the financiers [(the creditors)] of the payments due to them, as and when due, through realization on the asset pool...[T]hat goal may sometimes be referred to as ‘bankruptcy isolation’ of the securitized assets.”⁴⁰

Secured lenders are in a less attractive position if a debtor seeks Chapter 11 protection. The Bankruptcy Code attempts to improve the chances that a debtor seeking to reorganize will be able to do so by

³⁸ “Kenneth Kettering joined New York Law School as an associate professor of law in 2000 after nearly 20 years in private practice with Reed Smith in Pittsburgh, Pennsylvania, where he was a partner in the firm’s business and finance group. His law practice included a broad range of sophisticated financing and corporate matters. He served as primary counsel to a major financial institution with respect to over-the-counter derivatives and foreign exchange, and had extensive experience with all forms of finance, including syndicated lending, asset-based lending, highly leveraged transactions, structured finance and securitization, and securities offerings.” Kenneth Kettering’s New York Law School Faculty Profile, available at <http://old.nyls.edu/pages/375.asp>, last accessed 12/5/2008.

³⁹ Kenneth Kettering, *Securitization and its Discontents*, 29 *Cardozo L. Rev.* 1553, 1561 (2008).

⁴⁰ *Id.* at 1556-57.

limiting the rights of secured creditors.⁴¹ These limits on the rights of secured creditors benefit unsecured creditors, employees, suppliers, customers and anyone else who would benefit from a successful reorganization.⁴²

Various provisions of the Bankruptcy Code effectively force the secured creditor to continue to extend credit to the bankrupt debtor in possession (the post-petition bankrupt entity) through the duration of the reorganization. Professor Kettering refers to these limits on secured creditors as a “bankruptcy tax,”⁴³ but it may be more illuminating for our purposes to think of these limits as a “mandatory creditor-sponsored bailout”⁴⁴—a bailout that costs taxpayers virtually nothing, but imposes considerable costs on creditors.

The first of these limits on creditors, the automatic stay, prevents the secured creditor from seizing and liquidating the underlying collateral to recoup its investment.⁴⁵ Although an over-collateralized secured creditor may petition to have the stay lifted if its interests are not “adequately protected,” the secured creditor will be deemed to be adequately protected if it is paid post-petition interest.⁴⁶ Furthermore, this post-petition interest may accrue (rather than being paid in cash), forcing the secured creditor to bear further delay and the risk of loss from an unsuccessful reorganization.⁴⁷ If the secured creditor is under-collateralized (or insufficiently over-collateralized), he might not be paid any post-petition interest to compensate him for the delay imposed by the stay.⁴⁸

The second of these limits on creditors, cash collateral, permits the debtor in possession to use the cash collections received on the collateral if the interests of the secured creditor are “adequately

⁴¹ Id. at 1568. See also Edward J. Janger, The [Death of Secured Lending, 25 Cardozo L. Rev. 1759 and fn. 5 \(2004\)](#), (discussing Grant Gilmore’s “latent equity cushion.”)

⁴² See Kenneth Kettering, *Securitization and its Discontents*. 29 Cardozo L. Rev. 1553, 1568 (2008).

⁴³ Id.

⁴⁴ See, e.g., Edward J. Janger, The [Death of Secured Lending, 25 Cardozo L. Rev. 1759 and fn. 5 \(2004\)](#), citing Grant Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 15 Ga. L. Rev. 605, 620 (1981); cf. U.C.C. § 9-204 cmt. 4 (1972) (amended 1998): (“The widespread nineteenth century prejudice against the floating charge was based on a feeling, often inarticulate in the opinions, that a commercial borrower should not be allowed to encumber all his assets present and future, and that for the protection not only of the borrower but of his other creditors a cushion of free assets should be preserved. That inarticulate premise has much to recommend it.”)

⁴⁵ See Kettering, 29 Cardozo L. Rev. at 1566, fn. 31 citing [11 USC §362\(a\)](#).

⁴⁶ See Kettering, 29 Cardozo L. Rev. at 1566-67 and fn. 32 citing [11USC §362\(d\)\(1\)](#); [United Sav. Ass'n v. Timbers of Inwood Forest Assocs., 484 U.S. 365 \(1988\)](#).

⁴⁷ See Kettering, 29 Cardozo L. Rev. at 1567 and fn. 33 citing [11 USC §506\(b\)](#).

⁴⁸ Id.

protected.”⁴⁹ In this context, “adequate protection” may be satisfied if the secured creditor is sufficiently over-collateralized, or if the debtor in possession grants a replacement lien on some illiquid substitute asset.⁵⁰

The third of these limits on creditors, post-petition financing, permits the debtor to use the collateral for post-petition financing (also known as Debtor-in-Possession financing or DIP financing).⁵¹ In some cases, the debtor in possession is permitted to grant a security interest to the DIP lender that is superior to the pre-petition secured creditor, effectively subordinating the secured creditor’s claim.⁵²

Understandably, secured creditors strongly prefer to avoid these limits imposed by the Bankruptcy Code. Asset securitization promises to exempt creditors from the “mandatory creditor-sponsored bailout”—in effect, to give them a more powerful lien than the Bankruptcy Code permits. In return for this exemption, creditors will accept a lower yield on securitized debt than they would demand on a traditional secured loan.⁵³ Securitization can reportedly lower interests rates by 150 basis points compared to an equivalent secured loan.⁵⁴ Credit rating agencies regularly give securitized debt a higher rating than secured debt, because the securitized debt is believed to be bankruptcy-isolated.⁵⁵

From creditors’ perspective, preferential treatment in bankruptcy compared to secured loans is the primary advantage of asset securitization over secured debt.⁵⁶ This preferential treatment drove the

⁴⁹ See Kettering, 29 Cardozo L. Rev. at 1567 and fn. 34 citing [11 USC §§363\(c\)\(2\), 363\(e\)](#).

⁵⁰ *Id.*

⁵¹ See Kettering, 29 Cardozo L. Rev. at 1567 and fn. 36 citing: [11 USC §364\(d\)](#) (allowing the bankruptcy estate to use collateral to secure post-petition financing, with priority over the prepetition security interest, if the prepetition secured creditor's interest is adequately protected); §542 (entitling the bankruptcy estate to possession of collateral); and §§1123(a), 1123(b), and 1129(b)(2) (permitting the plan of reorganization to restructure secured debt by changing financial terms and collateral, which plan may in certain circumstances be confirmed over the objection of the secured creditor).

⁵² *Id.*

⁵³ See Kettering, 29 Cardozo L. Rev. at 1569-70 and fn. 41

⁵⁴ See Edward J. Janger, The [Death of Secured Lending](#), 25 Cardozo L. Rev. 1759, 1773 (2004) citing Lowell Bryan, The Risks, Potential and Promise of Securitization, in A Primer on Securitization 171-73 (Leon T. Kendall & Michael J. Fishman eds., 1996).

⁵⁵ See Kettering, 29 Cardozo L. Rev. at 1568-70.

⁵⁶ Kettering asserts that “substantially all of the benefits claimed for securitization are nothing more than consequences of the structure’s purported avoidance of the Bankruptcy Tax, and the resulting willingness of the rating agencies to rate securitized debt on the assumption that payments thereon from collections of the securitized assets will not be interrupted by the bankruptcy of the Originator.” Kettering, 29 Cardozo L. Rev. at 1569. Kettering is skeptical of claims that securitization creates benefits through “disintermediation.” He notes that banks and other traditional financial intermediaries often extend credit through securitization when the deal

rapid growth of asset securitization.⁵⁷ From 2000 through the first half of 2007, global asset backed securities issuances grew 27% (Compound Annual Growth Rate), from \$532 billion in 2000, to over \$2.5 trillion in 2006.⁵⁸ Securitization became a leading vehicle of corporate finance, growing from 32% of US new credit issuance in 1998 to 49% in 2007.⁵⁹

From debtors' perspective, the primary advantage of asset securitization is that it lowers their cost of borrowing. As discussed in the previous paragraph, securitized debt carries a lower interest rate than secured debt. However, this lower interest rate will only benefit the debtor if it is not offset by higher interest rate charges by third party creditors.⁶⁰ These third party creditors should demand a higher interest rate because the debtor is more highly leveraged, securitized creditors have greater priority in bankruptcy than other creditors, and third party creditors therefore face substantially greater risk of non-payment in case of debtor insolvency.

Asset securitization will create value for the debtor if asset securitization leads some creditors to under-price risk and charge an interest rate that is too low. This will happen either if securitized creditors overestimate the benefits of asset securitization, or if third party creditors underestimate the extent to which the debtor is leveraged through securitization transactions.⁶¹

is large enough to bear the transactions costs (bankruptcy tax avoidance without disintermediation), and that disintermediation is possible without avoiding the bankruptcy tax. *Id.* at 1570. By contrast, Janger suggests that in addition to bankruptcy remoteness, securitization provides benefits through disintermediation by "making [asset backed debt] available in smaller denominations to non-specialized investors" and by "allow[ing] smaller investors to enjoy the benefits of risk pooling." Janger, 25 *Cardozo L. Rev.* 1759, 1769 (2004) citing Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 *Stan. J.L. Bus. & Fin.* 133, 134 (1994). Of course, selling small quantities of credit risk to investors who have neither the expertise nor the incentive to monitor their investment might benefit debtors more than it benefits the investors. See Frank Partnoy and David Skeel. *The Promise and Perils of Credit Derivatives*. 2007. 75 *U. Cin. L. Rev.* 1019 at 1040-41; See also American Securitization Forum, *Restoring Confidence in the Securitization Market*, December 3, 2008 at 4-5 ("The market relied too extensively on ratings that in some instances proved overly optimistic...The level of complexity of products developed during the height of the market boom...exceeded the analytical and risk management capabilities of even some of the most sophisticated market participants).

⁵⁷ See Kettering, 29 *Cardozo L. Rev.* at 1563.

⁵⁸ See American Securitization Forum, *Restoring Confidence in the Securitization Market*, December 3, 2008, exhibit 8 at 24. Data from Thomson Reuters. (First half of 2007 figures annualized are \$2.8 trillion)

⁵⁹ See American Securitization Forum, *Restoring Confidence in the Securitization Market*, December 3, 2008, exhibit 18 at 38. Data from Thomson Reuters, SIFMA; IMF; CNW; McKinsey. Exhibit does not include commercial paper, municipal bonds, treasury bonds, Fed agency bonds and bank loans.

⁶⁰ See Steven L. Schwarcz, *The [Alchemy of Asset Securitization](#)*, 1 *Stan. J.L. Bus. & Fin.* 133 at 148 (1994)

⁶¹ There is a third possible explanation—the "non-adjusting" creditor exploitation hypothesis—that should be mentioned because of the widespread attention it has received in commercial law scholarship. However, the "non-adjusting" creditor exploitation hypothesis is tangential to this article as long as one accepts that the

Both mistakes are plausible because securitization transactions are less transparent than secured loans. The reasons for this lack of transparency are complex, but may be summarized as follows: secured debt must be disclosed by creditors through U.C.C. filings and by debtors through presentation on their consolidated balance sheets; asset securitizations potentially require neither U.C.C. filings nor disclosure on the debtor's balance sheet.

In an asset securitization, the debtor (or "Originator" in the language typically used in documentation) transfers financial assets such as credit card receivables or mortgage receivables to a special purpose entity, or SPE, typically a wholly owned subsidiary of the debtor.⁶² The SPE (or another transferee) issues debt to investors.⁶³ Investors pay the SPE, which then pays the debtor.⁶⁴

For the securitization to isolate the underlying assets from a debtor bankruptcy, the transfer of assets from the debtor to the SPE must qualify as a "true sale."⁶⁵ Most securitizations do not economically resemble "true sales" because the debtor retains the risk of default or non-performance of the

hypothesis does not fully explain the pattern of secured credit and securitization. According to this hypothesis, a debtor and its "adjusting" creditors (financial investors) may benefit at the expense of "non-adjusting" creditors such as tort-claimants, who cannot charge higher interest rates, through a bilateral agreement between the debtor and its adjusting creditors that adjusting creditors will receive higher priority in bankruptcy than non-adjusting creditors. See e.g. Lucian Bebchuk and Jesse Fried. *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*. 105 Yale L.J. 857, 891-95 (1996) See also Lynn LoPucki, *The Death of Liability*, 106 Yale L.J. 1, 14 (1996) (describing debtor's use of secured debt as "the most complex and most common of judgment proofing strategies.") This non-adjusting creditor exploitation hypothesis was originally advanced as a possible explanation for secured credit, but works equally well as an explanation for securitized credit because both give investors higher priority than tort claimants.

However, empirical studies suggest that non-adjusting creditor exploitation does not explain the pattern of secured credit, and that other factors such as reducing risk of non-payment play a larger role. See e.g., Ronald J. Mann. *Explaining the Pattern of Secured Credit*. 110 Harvard L. Rev. 625, 683 (1997) (finding that "secured credit provides borrowers with benefits that are wholly distinguishable from the cost-shifting benefits condemned in the existing scholarship. Specifically, secured credit lowers the costs of lending transactions not only by increasing the strength of the lender's legal right to force the borrower to pay, but also by enhancing the borrower's ability to give a credible commitment to refrain from excessive future borrowing and by limiting the borrower's ability to engage in conduct that lessens the likelihood of repayment.") See also Yair Listokin. *Is Secured Debt Used to Redistribute Value from Tort Claimants in Bankruptcy? An Empirical Analysis*, 57 Duke Law Journal 1037 (2008) (finding that firms facing high tort claims do not use secured credit more than firms facing low tort claims).

⁶² Kettering, 29 Cardozo L. Rev.at 1564-66 (2008). See also Lipson, 12 Emory Bankr. Dev. J. 421 at 468 (2005).

⁶³ Id.

⁶⁴ Id.

⁶⁵ Id.

underlying assets.⁶⁶ The debtor retains risk because the debtor owns the equity (or “first loss tranche”) in the SPE, and because the debtor may be required to repurchase assets from the SPE if losses reach a level exceeding the equity cushion or another pre-set trigger.⁶⁷

Such guarantee provisions played a critical role in the recent financial crisis. Citigroup, virtually on the brink of insolvency and desperately in need of cash, announced a \$17.4 billion repurchase of assets from one of its SPEs and a write-down of \$1 billion in mid-November 2008.⁶⁸ In response, Citigroup stock lost almost one-fourth of its value.⁶⁹ By the end of the week, the federal government agreed to guarantee \$300 billion in risky Citigroup assets and inject \$20 billion new capital into Citigroup, after having injected \$25 billion only one month before.⁷⁰

Because asset securitizations in which the originator/debtor retains substantial risk more closely resemble secured financings than “true sales,” asset securitizations are vulnerable to recharacterization as secured loans in bankruptcy proceedings.⁷¹ In the one case that adjudicated this issue, *LTV Steel*, the bankruptcy court issued an interim order based on the premise that the underlying assets were a part of the bankrupt debtor’s estate, effectively treating the securitization as a disguised secured loan.⁷²

In response to the risk that bankruptcy judges would recharacterize securitizations as secured loans, the securitization industry pushed for legal changes to insulate securitization transactions from judicial scrutiny.⁷³ The securitization industry was unsuccessful in its efforts to amend the Bankruptcy Code to exempt asset securitizations from the debtor’s estate⁷⁴ because of the perceived similarity between asset securitization and Enron’s allegedly fraudulent use of SPEs.⁷⁵

⁶⁶ See Kettering, 29 *Cardozo L. Rev.* at 1570-71 (2008). See also Lipson, 12 *Emory Bankr. Dev. J.* 421 at 469-70 (2005).

⁶⁷ *Id.*

⁶⁸ David Enrich. *Citi's Slide Deepens as Investors Bail Out*. Wall Street Journal. November 20, 2008.

⁶⁹ *Id.*

⁷⁰ Dan Wilchins and Jonathan Stempel. *Citigroup Gets Massive Government Bailout*. Reuters. November 28, 2008.

⁷¹ Kenneth Kettering describes the legal foundations of asset securitization as “shaky.” Kettering 29 *Cardozo L. Rev.* at 1558 (2008).

⁷² See Kettering 29 *Cardozo L. Rev.* at 1558 fn. 17, at 1582 fn 79 (2008) citing *In re LTV Steel Co.*, 274 B.R. 278, 285-86 (Bankr. N.D. Ohio 2001). See also Lipson, 12 *Emory Bankr. Dev. J.* 421 at 471 (2005).

⁷³ Janger, [The Death of Secured Lending](#), 25 *Cardozo L. Rev.* 1759 at 1768, 1775-77

⁷⁴ See Lipson, 12 *Emory Bankr. Dev. J.* 421 at 471-72. § 912 of the Bankruptcy Reform Act of 2001 would have excluded qualifying transactions from the debtor’s estate.

⁷⁵ *Id.* at 472.

However, the securitization industry successfully promoted the passage of laws in Delaware and several other states that, according to Professor Kettering, “attempt to make an end run around the Bankruptcy Code.”⁷⁶ If these laws, in particular Delaware’s Asset-Backed Securities Facilitation Act, are valid as literally interpreted, they protect securitization from recharacterization based on economic substance.⁷⁷ By protecting securitization’s bankruptcy-remote status, facilitation statutes effectively exempt securitizations from disclosure through creditor U.C.C. filings⁷⁸ or through the debtor’s balance sheet.⁷⁹

Asset securitizations need not be disclosed through U.C.C. filings because, as a general matter, the U.C.C. requires notice to perfect a security interest, but does not require notice of a “true sale.”⁸⁰ Asset-Backed Securitization Facilitation Statutes give effect to all transfers that are described as a “sale” in

⁷⁶ Kettering 29 Cardozo L. Rev.at 1558 (2008). See also Lipson 12 Emory Bankr. Dev. J. 421, fn. 192 citing [Del. Code Ann. tit. 6 §§ 2701A-2703A \(2004\)](#); Alabama, [Ala. Code § 35-10A-2\(a\)\(1\) \(2004\)](#); Louisiana, [La. Rev. Stat. Ann. §10:9-109\(e\)](#) (West 2002); North Carolina, [N.C. Gen. Stat. § 25-9A-102 \(2002\)](#); Ohio, [Ohio Rev. Code Ann. § 1109.75](#) (Anderson 2002); Texas, [Tx. Bus. & Com. § 9.109\(e\)](#) (Vernon 2002).

“The statutes in Alabama, North Carolina, and Ohio are substantially similar to ABSFA, with all but Ohio’s statute entitled “Asset-Backed Securities Facilitation Act.” See [Ala. Code § 35-10A-2\(a\)\(1\)](#); [N.C. Gen. Stat. § 25-9A-102](#); [Ohio Rev. Code Ann. § 1109.75](#). Texas and Louisiana, by contrast, simply added a new subsection to Article 9 of the revised UCC that left it up to the parties involved in securitization transactions to classify the nature of transfers. See [La. Rev. Stat. Ann. §10:9-109\(e\)](#); [Tx. Bus. & Com. § 9.109\(e\)](#).”

⁷⁷ Lipson 12 Emory Bankr. Dev. J. 421 at 472-473 (2005). Delaware’s Asset Backed Securitization Facilitation Statute provides that “[n]otwithstanding any other provision of law...a bankruptcy trustee...shall have no rights, legal or equitable, whatsoever to reacquire, reclaim...or recharacterize as property of the transferor any property” transferred in a securitization.

Kettering argues that these state laws may not be effective because Federal Law may govern what constitutes property of the estate. Kettering 29 Cardozo L. Rev.at 1581 (2008). (“The leading cases are ambivalent as to the respective roles of federal and state law on this point: on the one hand, they say that what constitutes “property of the estate” is a federal question, in the sense that state-law labels do not govern whether a particular right is to be considered “property” for this purpose; on the other hand, they also say that state law does determine the substantive attributes of a debtor’s rights, and those state-law attributes are to be respected “unless some federal interest requires a different result.””)

⁷⁸ See Lipson, 12 Emory Bankr. Dev. J. 421 at 472-473 (2005). Delaware’s Asset Backed Securitization Facilitation Statute provides that “[n]otwithstanding any other provision of law...a bankruptcy trustee...shall have no rights, legal or equitable, whatsoever to reacquire, reclaim...or recharacterize as property of the transferor any property” transferred in a securitization. “Notwithstanding any other provisions of law” means that Article 9 and any other state commercial finance statutes do not apply if property is conveyed through a securitization.

⁷⁹ See Kettering, 29 Cardozo L. Rev.at 1573 (2008).

⁸⁰ See Janger, [Death of Secured Lending, 25 Cardozo L. Rev. 1771-72 \(2004\)](#). There are exceptions. Notice is required for sales of accounts and chattel paper, and real estate sales must be recorded in land records.

securitization documents, whether or not such transfers are “true sales” under bankruptcy law.⁸¹ In other words, Asset-Backed Securitization Facilitation Statutes override the Article 9 filing requirement.⁸²

Asset securitizations need not be disclosed on the balance sheet because, under Generally Accepted Accounting Principals (GAAP), asset securitizations may qualify for off-balance sheet treatment if the assets in the securitization are beyond the reach of the debtor in bankruptcy.⁸³ Under GAAP, a transaction can qualify for off-balance-sheet treatment even if the debtor retains virtually all of the risk of non-performance of the assets in the securitization.⁸⁴ Bankruptcy law would normally prevent off-balance sheet treatment in that case because an asset securitization in which the debtor retained substantial risk would likely be recharacterized as a disguised financing and therefore not be

⁸¹ Id. at 1772.

⁸² Id.

⁸³ From 1996 onward, qualifying for off-balance sheet treatment required that the assets in the securitization be beyond the reach of the debtor in bankruptcy. See Kettering, 29 Cardozo L. Rev.at 1573 (2008) citing Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (2000), which is proposed to be revised in Fin. Accounting Standard Bd., Exposure Draft (Revised)-- Proposed Statement of Financial Accounting Standards: Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140 (2005).

“SFAS No. 140 replaced a release issued only four years previously, Fin. Accounting Standards Bd., Statement of Financial Account Standards No. 125: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (1996). SFAS 125 introduced the concept of requiring bankruptcy isolation of the securitized assets as a condition of off-balance sheet treatment. Before then accounting treatment nominally rested on murky and inconsistent pronouncements pertaining to sale and to consolidation, of which the most important are summarized in Appendix B to SFAS 125. Each of the foregoing publications is available at <http://www.fasb.org>.”

⁸⁴ Id. citing Office of the Chief Accountant et al., U.S. Sec. & Exch. Comm'n, Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filing by Issuers (2005), available at <http://www.sec.gov/news/studies/soxoffbalancerpt.pdf>. The Staff's first recommendation was to “Eliminate (or at least Reduce) Accounting-Motivated Structured Transactions,” among which it included securitization:

“[A]n issuer might contemplate a secured borrowing transaction because it needs capital--a true business purpose. However, if that issuer transfers the assets to an SPE, which then borrows the funds and transfers them to the issuer in a transaction that keeps the debt off the balance sheet while exposing the issuer to virtually the identical risks and rewards as if the simple secured borrowing had been undertaken, the Staff considers the transaction to be accounting-motivated.”

Id. at 99-100. See also id. at 102 (disapprovingly noting that “with respect to securitizations, current standards allow issuers to structure transactions to achieve desired accounting results--that is, either sale or borrowing treatment for the items being securitized--for what are economically similar transactions.”)

bankruptcy-remote. However, under the Asset-Backed Securitization Facilitation Statutes, the economic substance of the transaction is irrelevant—any “securitization” will be bankruptcy-remote.

Kenneth Kettering refers to off-balance sheet treatment of asset securitizations as “the prize much coveted by [debtors].”⁸⁵ Off-balance sheet treatment is a prize because it enables debtors to hide the extent of their leverage from unsophisticated creditors and borrow from them at lower cost.

Financial professionals seek to identify asset securitizations in which the debtor retains risk and consolidate them with the debtor’s balance sheet for purposes of evaluating the debtor’s creditworthiness.⁸⁶ However, not all creditors are so sophisticated. Furthermore, because of limited disclosure of asset-securitizations, even professionals can underestimate the extent of debtors’ exposure to losses from securitized assets.

Sophisticated creditors who structure their investments through asset securitizations are at risk of under-pricing credit to the extent that these creditors rely on guarantees from the debtor to shield them from losses by repurchasing securitized assets. If the debtor is more highly leveraged than creditors realize, the debtor is at greater risk of becoming insolvent, and its guarantees to repurchase assets are of limited value.

Rating agencies such as Moody’s may have lead investors in securitized debt to under-price risk because the rating agencies generally gave securitized debt a very high rating on the grounds that “companies retain the subordinated interest in the transaction known as the equity tranche or “first-loss” piece, which is where all the risks associated with the asset pool resides.”⁸⁷ These high debt ratings “constitute an evaluation by experts that...all practical risk of the performance of the assets remains with Originator [(debtor)] and none is shifted to the financiers [(creditors)].”⁸⁸ However, as the many downgrades of

⁸⁵ Id.

⁸⁶ Kettering, 29 *Cardozo L. Rev.* at 1572 (2008), noting that credit rating agencies such as Moody’s and S&P adjust their analysis to treat securitizations as if they were on-balance sheet debt; to see also Kettering 29 *Cardozo L. Rev.* at 1573 citing Vincent Ryan, *Debt in Disguise*, *CFO Mag.*, Nov. 2007, at 78, 84 (naming companies that have shunned off-balance-sheet treatment of their securitization transactions, and quoting Bob Finley, managing director of Fifth Third Bank’s securitization business, on the practice as follows: “Professionals--debt analysts, bankers, and equity analysts--all add [receivables] securitizations back onto the balance sheet in figuring leverage and debt ratios. [Off-balance-sheet treatment is] window dressing at best. Let’s just call it debt.”)

⁸⁷ Kettering, 29 *Cardozo L. Rev.* at 1572 (2008) citing Moody’s Investors Service, *Special Comment: Demystifying Securitization for Unsecured Investors*, at 6 n.15 (Jan. 2003) available at <http://www.moodys.com> (“There are few examples of securitization having been used successfully for both funding and risk transference purposes.”); Moody’s Investors Service, *Special Comment: Securitization and its Effect on the Credit Strength of Companies: Moody’s Perspective 1987-2002*, at 2 (Mar. 2002) [available at <http://www.moodys.com> (“Moody’s has not seen many instances of this.”); also Standard & Poor’s, *Corporate Ratings Criteria 2006* at 120 (it is “much more common” for the Originator to retain the bulk of risks related to the assets).

⁸⁸ Kettering, 29 *Cardozo L. Rev.* at 1571 (2008).

CDOs in 2007 shows, the experts were overly optimistic and substantial risk remained with securitized debt investors.⁸⁹

Attempts to make securitization meaningfully more transparent, for example by forcing rating agencies to disclose all of the underlying data they use to rate debt, have met with strong resistance.⁹⁰

In sum, asset securitization constitutes a secret lien because it grants some creditors a very strong claim on specific assets of the debtor while hiding from other creditors the extent to which the debtor is leveraged and retains risk. Extensive use of these secret liens enabled sophisticated debtors such as investment banks to borrow cheaply, while creditors under-priced risk.

Low cost-financing and extensive leverage magnified positive returns, and for many years, investment banks were exceptionally profitable.⁹¹ For example, in 2007 most investment banks paid about \$300,000 in bonus per employee,⁹² roughly six times median U.S. household income.⁹³

Many sophisticated creditors supported asset securitization,⁹⁴ believing they were protected by higher payment priority. However, priority is always relative to other creditors; as securitized assets accounted for an ever larger share of credit in the US economy⁹⁵ and an ever larger share of creditors' claims,⁹⁶ there was relatively less equity and unsecured credit to absorb losses and shield securitized creditors.

⁸⁹ Kettering, 29 Cardozo L. Rev.at 1571 fn. 44.

⁹⁰ Kara Scannell and Aaron Lucchetti. SEC Tightens Rules for Ratings Firms. Wall Street Journal. December 4, 2008. ("The SEC also didn't implement an earlier proposal that would have required the rating firms to disclose to the public all underlying information about any debt they are rating... New York Sen. Charles Schumer, a senior Democrat on the Senate Banking Committee, said, "None of the rules adopted today are a substitute for the larger regulatory reform that is coming next year"...The three major rating firms...released statements voicing support for the new SEC rules. Others were more critical...The SEC's rules are "baby steps" that fail to address "the underlying problem," said Janet Tavakoli, a structured-finance consultant in Chicago).

⁹¹ Fees from structuring and managing asset securitizations also contributed to banks' profitability.

⁹² See Joseph A. Giannone. Goldman success brings unwanted attention. Reuters. December 17, 2007. See also Louise Story. On Wall Street, bonuses, not profits, were real. New York Times. December 18, 2008. (Reporting that Goldman Sachs paid bonuses averaging \$600,000 per employee, double the industry average).

⁹³See U.S. Census Bureau, Income Poverty and Health Insurance Coverage in the United States: 2007, 5 Available at <http://www.census.gov/prod/2008pubs/p60-235.pdf> last accessed 1/4/2009 (median household income in 2007 was \$50,233)

⁹⁴ See e.g., Partnoy, The Promise and Perils of Credit Derivatives, 75 U. Cin. L. Rev. 1019 at 1041 ("The purchasers of CDO tranches typically are sophisticated.")

⁹⁵ The percentage of home mortgages that were securitized increased from approximately 10% in 1980 to over 55% in 2008. The percent of commercial mortgage and consumer credit loans that were securitized increased from almost nothing to over 20%. American Securitization Forum, Restoring Confidence in the Securitization

The opaque credit environment that resulted from widespread use of asset securitization was ultimately to the detriment of all creditors. If not for the massive government bailout of investment banks, these investors would have realized even more significant losses.

If not for legal changes which permitted secret liens in the form of asset securitization, asset securitization probably would not have grown to a multi-trillion dollar market, and the tax-payer funded bailout probably would not have been necessary.

b. Derivatives as secret liens

Prior to the financial crisis several investment banks sought to modify the extent of their exposure to CDOs through the use of derivative contracts known as “credit default swaps.”⁹⁷ Credit default swaps are largely unregulated, over-the-counter (OTC) derivative contracts that are economically similar to bond insurance.⁹⁸

Markets (December 3, 2008) Exhibit 17 at 37 (Data comes from Federal Reserve US Flow of Funds Accounts, Tables L2, L125 and L126.)

⁹⁶ Securitization grew from 32% of available US new credit issuances in 1998 to 49% in 2007. American Securitization Forum, Restoring Confidence in the Securitization Market, December 3, 2008, exhibit 18 at 38. Data from Thomson Reuters, SIFMA; IMF; CNW; McKinsey. Exhibit does not include commercial paper, municipal bonds, treasury bonds, Fed agency bonds and bank loans.

⁹⁷ See e.g. Kate Kelly. How Goldman Won Big on Mortgage Meltdown. Wall Street Journal. December 14, 2007. (“During a discussion with [mortgage department head Dan] Sparks and others, [CFO David] Viniar noted that Goldman had big exposure to the subprime mortgage market because of CDOs and other complex securities it was holding, these people say. Emerging signs of weakness in the market, meant that Goldman needed to hedge its bets, the group concluded, these people say. Mr. Swenson and his traders began shorting certain slices of the ABX, or betting against them, by buying credit-default swaps”

“[Goldman’s traders’] big bet that securities backed by risky home loans would fall in value generated nearly \$4 billion of profits during the year ended Nov. 30, according to people familiar with the firm’s finances. Those gains erased \$1.5 billion to \$2 billion of mortgage-related losses elsewhere in the firm.”)

⁹⁸ Id. See also Partnoy, The Promise and Perils of Credit Derivatives, 75 U. Cin. L. Rev. 1019 at 1050 and fn. 79; Stephen J. Lubben. Credit Derivatives and the Future of Chapter 11. 81 Am. Bankr. L.J. 405 (2007), 411-12.

Unlike an insurance contract, a credit default swap does not require that the protection buyer have an “insurable interest” or provide proof of actual loss, i.e., own the third party’s debt at the time of default. Credit default swaps can be used to speculate (or place a “naked” bet), as well as to hedge (or place a “covered” bet). See Lubben. 81 Am. Bankr. L.J. at 412 and fn 49, citing [N.Y. INS. LAW § 3401](#) (McKinney 2007) (“No contract or policy of insurance on property made or issued in this state, or made or issued upon any property in this state, shall be enforceable except for the benefit of some person having an insurable interest in the property insured. In this article, ‘insurable interest’ shall include any lawful and substantial economic interest in the safety or preservation of property from loss, destruction or pecuniary damage.”).

In a credit default swap transaction, there are two counterparties, a protection buyer and a protection seller.⁹⁹ The two counterparties place opposite bets on whether a third party will default on its debts (the “reference debt”). In case of a “credit event”—the third party defaults on its debt, restructures its debt, or files for bankruptcy—the protection seller agrees to pay the protection buyer an amount that is calculated based on losses that would be experienced by an investor who holds a “notional” amount of a third party’s debt.¹⁰⁰ In return for this default protection, the protection buyer pays up-front and periodic fees to the protection seller.¹⁰¹

Investment banks can reduce their exposure to CDOs by entering into credit default swap contracts as protection buyers. Banks typically buy credit default swap protection from well-capitalized counterparties, because as protection buyers, they bear risk that the protection seller will become insolvent.¹⁰² For example, prior to the corporate crisis of 2001 and 2002, banks that extended credit to Enron and Worldcom protected themselves from roughly \$18 billion in losses by purchasing credit default swap protection from insurance companies and pension funds.¹⁰³

Prior to the financial crisis of 2008, several investment banks similarly sought to shield themselves from CDO losses by purchasing credit default swaps from the insurance company AIG.¹⁰⁴ As of September 2008, AIG had sold roughly \$440 billion of CDO protection, much of it to investment banks.¹⁰⁵ Unfortunately for these investment banks—and for taxpayers forced to bail them out—AIG appears to

⁹⁹ See Lubben, 81 Am.Bankr. L.J. 405, 411-12.

¹⁰⁰ *Id.* It is not necessary that the protection buyer actually own the bonds and experience any loss.

¹⁰¹ *Id.*

¹⁰² Lubben, 81 Am.Bankr. L.J. 405, 413 (“In a credit default swap transaction, the protection buyer...takes on the risk of concurrent default by both the protection seller and the underlying debtor.”)

¹⁰³ Frank Partnoy and David Skeel. *The Promise and Perils of Credit Derivatives*. 75 U. Cin. L. Rev. 1019 (2007), 1024 and fn. 1, 7 citing Alan Greenspan, Chairman Fed. Reserve, Remarks by Chairman Alan Greenspan Before the Council on Foreign Relations (Nov. 19, 2002), available at <http://www.federalreserve.gov/BoardDocs/Speeches/2002/20021119/default.htm> (concluding that credit derivatives “appear to have effectively spread losses from defaults by Enron, Global Crossing, Railtrack, WorldCom and Swissair...over the past year...from banks, which have largely short-term leverage, to insurance firms, pension funds, or others”).

Banks used credit derivatives to hedge approximately \$8 billion of risk associated with Enron debt and \$10 billion of risk associated with WorldCom debt. Partnoy and Skeel. 75 U. Cin. L. Rev. 1019 fn. 2

¹⁰⁴ Mark Pittman. *Goldman, Merrill Collect Billions After Fed's AIG Bailout Loans*. Bloomberg.com September 29, 2008 (reporting that AIG paid Goldman Sachs, Merrill Lynch & Co., Morgan Stanley, and Deutsche Bank AG as much as \$37 billion of Fed bailout money. AIG had sold approximately \$440 billion in credit default swap protection, including roughly \$60 billion tied to subprime CDOs.)

¹⁰⁵ *Id.*

have used credit default swaps as a kind of secret lien, hiding the extent of its leverage and appearing more creditworthy than it actually was.

Credit default swaps, like most OTC derivatives, are an ideal vehicle for hidden leverage and secret liens because of their inherent complexity, limited disclosure, and superior treatment in bankruptcy.

OTC derivatives are complex for numerous reasons. Unlike exchange traded derivatives, which are standardized, simplified, and priced by the market through frequent trading, OTC derivatives are custom, bilaterally negotiated, relatively illiquid contracts and therefore difficult to price.¹⁰⁶ The value of the derivative depends on three things: (i) the value of the underlying asset; (ii) the contractually negotiated formula which determines the counterparties' obligations to one another based on that value; and (iii) the creditworthiness of the counterparty to the derivative, which determines the likelihood that the obligation will actually be paid.¹⁰⁷

All three of these variables can be a source of tremendous uncertainty and complexity. In the case of credit default swaps written on CDO tranches held by financial institutions: (i) the value of the underlying assets is difficult to determine because of the mathematically complex structuring that governs loss allocation among tranches¹⁰⁸ and because of limited information about the credit quality of

¹⁰⁶ Lubben, 81 Am.Bankr. L.J. 405 at 408.

¹⁰⁷ Id. at 408-13.

¹⁰⁸ Frank Partnoy and David Skeel describe the analysis used by the rating agency S&P and their investment banking clients to rate different CDO tranches as follows:

“The rating agency and client evaluate the tranches of a CDO using a mathematical algorithm. First, they calculate the expected cash flows of the underlying assets over time. Then they determine how those cash flows would be paid out to each tranche over time. The equity, or most junior, tranche absorbs losses up to the first “attachment point.” Then the most junior mezzanine tranche absorbs losses up to the next attachment point, and so on. The rating agencies then give a credit rating to each of the tranches (but usually not to the junior tranche) based on assumptions about certain key variables, including expected default rates, recovery rates, and correlation rates among assets.

This process employs sophisticated mathematical techniques. For example, a rating agency might run 100,000 computer simulations to determine the number of times a breach would occur, that is, how often a particular tranche would lose value beyond a specified level. The variable in this assessment is the number of breaches out of the 100,000 runs, not the magnitude of the breach or any qualitative analysis of the breach. For example, for a typical five-year synthetic CDO, S&P might establish a confidence interval for the AAA level of 0.284%, meaning that the particular tranche would be “breached” in 284 runs out of 100,000.”

See Frank Partnoy and David Skeel. *The Promise and Perils of Credit Derivatives*. 75 U. Cin. L. Rev. 1019, 1030 (2007). See also Andrew W. Lo. *Hedge Funds, Systemic Risk, and the Financial Crisis of 2007-2008*. Testimony Before the U.S. House of Representatives committee on Oversight and Government Reforms, 26 (November 13, 2008) available at <http://oversight.house.gov/documents/20081113101922.pdf> (“Pricing [CDOs] is even more complex, involving a blend of mathematical, statistical, and financial models and computations, all of which are

the underlying loans;¹⁰⁹ (ii) the extent of counterparties obligations to each other is difficult to determine because of the subjective nature of determining when a “credit event” has occurred and the risk that disagreement will result in litigation;¹¹⁰ and (iii) the creditworthiness of counterparties is

typically done under simplistic assumptions that rarely hold in practice, such as constant means, variances, and correlations that are measured without error...Models such as these are central to the current financial crisis, and their mis-calibration is one possible explanation for how so many firms under-estimated the risks of subprime-related securities so significantly. Unless senior management has the technical expertise to evaluate and challenge the calibrations of these models, they cannot manage their risks effectively.”)

The complexity inherent in CDOs creates opportunities for sophisticated parties to profit at the expense of less sophisticated investors:

“[H]edge funds and other sophisticated investors have incentives to manipulate the pricing and structuring of CDOs, and some studies suggest that CDO managers manipulate collateral in order to shift risks among the various tranches.”

See Frank Partnoy and David Skeel. *The Promise and Perils of Credit Derivatives*. 75 U. Cin. L. Rev. at 1040 citing Kedran Rae Garrison, *Manager Incentives in Collateralized Debt Obligations*, 6 (August 15, 2005). Available at SSRN: <http://ssrn.com/abstract=720481>

¹⁰⁹ The rating agency Standard and Poor’s (S&P) allegedly sought to accommodate its investment banking clients by rating CDO tranches without access to information about the underlying loans:

“In 2001, [S&P analyst Frank] Raiter was asked to rate an early collateralized debt obligation called ‘Pinstripe.’ He asked for the ‘collateral tapes’ so he could assess the creditworthiness of the home loans backing the CDO. This is the response he got from Richard Gugliada, the managing director:

“Any request for loan level tapes is TOTALLY UNREASONABLE!!! Most investors don’t have it and can’t provide it. Nevertheless we MUST produce a credit estimate. ...It is your responsibility to provide those credit estimates and your responsibility to devise some method for doing so.”

Mr. Raiter was stunned. He was being directed to rate Pinstripe without access to essential credit data. He e-mailed back: ‘This is the most amazing memo I have ever received in my business career.’”

Chairman Henry A. Waxman. Committee on Oversight and Government Reform. 110th Congress. Opening Statement. October 22, 2008 available at <http://oversight.house.gov/story.asp?ID=2255> last accessed 12/18/2008

¹¹⁰ See Frank Partnoy and David Skeel. *The Promise and Perils of Credit Derivatives*. 75 U. Cin. L. Rev. 1019, 1039 and fn. 44 (2007) (“In the context of credit derivatives, counterparties also might use ambiguous terms to their advantage. For example, what is the meaning of the term “restructuring” ? If payment on a credit derivatives contract is to be made upon an event of “restructuring,” a sophisticated counterparty might argue that the event had been triggered with respect to payments counterparties owed to it, but not with respect to payments it owed to counterparties... [T]his issue arose in litigation related to credit derivatives based on debt issued by the government of Argentina. See [Eternity Global Master Fund Ltd. v. Morgan Guaranty Trust Co. of New York, 375 F.3d 168 \(2d Cir. 2004\)](#) (discussing definition of credit event related to Argentine government bonds)”)

difficult to determine because they too have extensive and difficult to measure exposures to derivatives such as credit default swaps.¹¹¹

These difficulties might be surmounted by talented and sophisticated risk managers equipped with detailed information such as the identity of all counterparties to derivatives transactions, the text of the contracts that govern them, and the financial models that calculate obligations under the contracts.

Unfortunately, however, even basic information about OTC derivatives transactions can be extremely hard to come by. Market participants themselves are often unaware of the extent of their net exposures¹¹² or the identity of counterparties to their transactions.¹¹³ Mandatory disclosures to third

¹¹¹ See Peter Breuer. Measuring off-balance sheet leverage. 26 J. Bank. & Fin. 223, 236 (2002) (“It is impossible to precisely measure leverage for institutions active in derivative markets without full knowledge of their positions, including hedges...[D]ata filed by commercial banks and trust companies in the United States with the Office of the Comptroller of the Currency (OCC) allow a rough approximation...In the absence of better data, the best approximation...is an approximation to gross leverage, not net-leverage because it does not take into account netting across positions...gross leverage ratios...have to be interpreted as the upper limit to the [net leverage] ratio.”)

In the case of Lehman Brothers (which, as an investment bank, was regulated by the SEC, not the OCC), the lack of transparency may have led the market to over-estimate the extent of Lehman’s downside exposure:

“A lack of disclosure on CDS exposures has frequently led the market to overestimate risks: had it been realized that settlement payments on Lehman swaps would be only \$6 billion, rather than the hundreds of billions feared, much of the turmoil in debt markets could have been avoided.” The Economist. The Great Untangling. November 6th, 2008.

The difficulty of evaluating counterparty risk may be even greater when counterparties include unregulated entities with minimal disclosure requirements. See e.g. Andrew Lo Testimony at 3 (“Without more comprehensive data on hedge fund characteristics such as assets under management, leverage, counterparty relationships, and portfolio holdings, it is virtually impossible to draw conclusive inferences about systemic risk posed by hedge funds.”)

¹¹² See e.g. Andrew Lo Testimony at 27, (“Senior management typically has little time to review the research, much less guide it, and in recent years, many quants have been hired from technically sophisticated disciplines...but without any formal training in finance or economics...[T]he broad-based failure of the financial industry to fully appreciate the magnitude of the risk exposures in the CDO and CDS markets suggests that the problem was ... too little knowledge.”)

The derivatives market also faces significant challenges from a large backlog of unconfirmed trades. See Frank Partnoy and David Skeel. The Promise and Perils of Credit Derivatives. 75 U. Cin. L. Rev. at 1026 (reporting an agreement among key banks to work to resolve the issue); See also Stacy-Marie Ishmael, Banking Staff Face Derivatives Backlog, FIN. TIMES, Oct. 25, 2007, at 27 (reporting ongoing difficulties due to increased volumes).

In its 2007 Form 10-K, AIG revealed that it did not understand the value of its credit default swap portfolio (“[C]ontrols over the AIGFP super senior credit default swap portfolio valuation process and oversight thereof were not effective. AIG had dedicated insufficient resources to design and carry out effective controls to prevent or

parties are even more limited,¹¹⁴ and the industry group, the International Swaps and Derivatives Association, has resisted voluntary disclosure.¹¹⁵

detect errors and to determine appropriate disclosures on a timely basis.”) See Lynn E. Turner. Testimony before the House of Representatives Committee on Oversight and Government Reform. 4-5. October 7, 2008. available at <http://oversight.house.gov/documents/20081007101007.pdf>

¹¹³ See e.g., Lubben, 81 Am.Bankr. L.J. 416 (“Many credit default swaps were assigned to new protection buyers without the prior consent of the seller. Under the terms of the ISDA Master Agreement the prior written consent of the other party is required when its counterparty in a trade wishes to assign its position in a trade to a third party. However, this non-conforming practice has apparently been tolerated in the community. Thus...it may not be clear which creditors are protected.”) See also Liz Rappaport and Serena Ng. Spotlight Shines on Swap Brokers. Wall Street Journal. November 13, 2008. (“‘Everything is supposed to be anonymous before the deal is done,’ said Howard Lutnick, chief executive of Cantor Fitzgerald, which owns and interest in interdealer broker BGC. Mr. Lutnick said his brokerage customers want anonymity. If they didn't want that secrecy, they wouldn't trade through brokers.”)

¹¹⁴ Partnoy and David Skeel. 75 U. Cin. L. Rev. at 1036 (“Because swaps are structured as over-the-counter (OTC) derivatives, they are largely unregulated. Among other things, this means that the details of particular swaps often go undisclosed.”)

See also Andrew Lo Testimony at 24 (“ [A] simple fixed/floating interest-rate swap contract...has zero value at the start, hence is considered neither an asset nor a liability, but is an “off-balance-sheet” item. We have learned from experience that off-balance-sheet items can have enormous impact on a firm’s bottom line, hence it is remarkable that our accounting practices have yet to incorporate them more directly in valuation...There is no natural way to capture risk from the current GAAP accounting perspective. Yet accounting concepts like capital ratios and asset/liability gaps are used to formulate and implement regulatory requirements and constraints.”)

See also Bob Jensen. The Missing Part of SFAS 133: Accounting for Derivative Instruments and Hedging Activities. (“Probably the most gaping hole in SFAS 133 is the lack of guidance on valuation of custom contracts that are not traded in exchange markets. This is serious because over half of the financial instruments derivative contacts are estimated to be custom interest rate swaps and forward contracts.”) available at <http://www.trinity.edu/rjensen/acct5341/speakers/133accr.htm> last accessed 12/19/2008.

In response to criticism that SFAS 133 provided inadequate disclosures, the Financial Accounting Standards Board passed SFAS 161: Disclosures about Derivative Instruments and Hedging Activities ,in March of 2008. (SFAS 161 at 23). SFAS 161 amends SFAS 133 “with the intent to provide users of financial statements with an enhanced understanding of (a) how and why an entity uses derivative instruments (b) how derivative instruments and related hedged items are accounted for under statement 133 and its related interpretations and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flows.” SFAS 161 at 1. SFAS 161 went into effect November 15, 2008. SFAS 161 at 37. However, there remain significant gaps in disclosure standards that limit the forward-looking, predictive value of the disclosures unless there are already clear signs of distress. “[Disclosure of] contingent features...capture[s] information about only the reporting entity’s credit-risk related contingent features for derivatives that are in a liability position at the end of the reporting period (for example, a credit downgrade of the reporting entity)...The board may consider in the

Derivatives enjoy widespread use in part because they provide large risk exposure with minimal up-front capital required and minimal disclosure.¹¹⁶ In other words, they permit very high leverage without tell-tale signs on the balance sheet that would alert creditors or regulators.¹¹⁷

With high leverage comes heightened volatility,¹¹⁸ and there have been several well publicized instances of derivatives losses rendering large and well capitalized institutions suddenly insolvent. In December 1994, Orange County, California, became the wealthiest municipality ever to file for bankruptcy protection, due to \$1.7 billion in losses from highly leveraged derivatives.¹¹⁹ In 1995, Barings Bank, the

future a separate project to enhance disclosures about credit-indexed derivatives such as credit default swaps.”) SFAS 161 at 35.

¹¹⁵ Id. (“ISDA has actively resisted disclosure of credit default swap documentation, insisting that this information is proprietary”). Some industry participants have recently suggested moving credit default swaps to an exchange, which might somewhat improve transparency with respect to credit default swaps, but not any other OTC derivative contracts. See, e.g., *The Economist*. *The Great Untangling*. November 6, 2008. (“Federal regulators...are circling [the credit default swaps market]. Dealers are hoping to head them off with a series of initiatives, which have been stepped up recently at the prompting of the Federal Reserve. Chief among them is the creation of a central clearing house for credit derivatives. Several groups, including a dealer-backed venture led by Intercontinental Exchange and a tie-up between CME Group, another exchange operator, and Citadel, a hedge fund, are vying for licenses. One or more is likely to be awarded in the next few weeks.”)

¹¹⁶ See Peter Breuer. *Measuring off-balance sheet leverage*. 26 *J. Bank. & Fin.* 223, 225 (2002) (“[D]erivatives positions (such as futures and options) allow the investor to earn the return on the notional amount underlying the contract by committing a small portion of equity in the form of initial margin or option premium payments.”) Derivatives enhance “the ability of highly leveraged institutions to accumulate leverage off the balance sheet and thus their ability to elude the scrutiny of supervisors and...counteryparty due diligence.” Id. at 224. “The most striking feature...is that total gross off-balance-sheet leverage of the top 25 U.S. commercial banks *exceeds* total on-balance-sheet leverage by a wide margin...a factor as large as 16, with total gross leverage reaching a level as high as 97.”) Id. at 237-38.

¹¹⁷ Id. at 224 fn. 1. (“[Failed hedge fund] LTCM’s on-balance sheet leverage may have conveyed a misleading picture: News reports indicate that its on-balance sheet leverage ratio moved from a factor of 25 to 167 at the height of the collapse while its (undefined) off-balance sheet leverage ration moved from a factor of 270 to 2100.”)

¹¹⁸ Id. at 225-26.

¹¹⁹ See John M. Halstead, Shantaram Hegde and Linda Schmid Klein. *The Financial Review*, 2004, vol. 39, issue 2, pages 293-315, 294 (“On December 6, 1994, Orange County, California became the largest municipality in U.S. history to declare bankruptcy. This bankruptcy is prominent not only because of its unprecedented loss of \$1.7 billion, but also because it was caused by a highly leveraged derivatives strategy rather than by fundamental cash flow problems of tax revenue shortages and excess spending.”)

See also Michael B. Marois and William Selway. “Orange County Funds Hold SIV Debt on Moody’s Review.” *Bloomberg*. (December 5, 2007) available at <http://www.bloomberg.com/apps/news?pid=20601103&sid=afpq.tBYeEO4&refer=us> last accessed 12/20/2008

oldest investment bank in London, collapsed after “rogue” trader Nick Leeson lost \$1.3 billion in the futures market.¹²⁰ In 1998, widely respected hedge fund Long Term Capital Management (LTCM), whose advisory board included Nobel-prize winning economists Myron Scholes and Robert C. Merton, lost 50% of its equity due to derivatives related losses.¹²¹ LTCM was on the verge of collapse when the Federal Reserve organized a consortium of 14 banks and securities firms—LTCM’s largest counterparties—to bail out LTCM by injecting \$3.6 billion in new capital.¹²² In late 2007 and early 2008, leading insurance company AIG’s derivatives trading subsidiary (AIG Financial Products, or AIGFP) lost over \$18 billion on its credit default swap portfolio.¹²³ AIG, which guaranteed the AIGFP subsidiary’s obligations,¹²⁴ was in danger of being unable to meet collateral calls when the Federal Reserve bailed it out by loaning AIG \$85 billion.¹²⁵

Derivatives may be associated with massive losses in part because it is in the interest of investment managers to use derivatives to take on a moderate probability of extremely high losses.¹²⁶ Investment managers with minimal skill can employ derivative strategies that feature a low probability of very high losses in any given year, but have a high probability of generating returns that will attract investors and

¹²⁰ See Shmuel Vasser, [Derivatives in Bankruptcy, 60 Bus. Law. 1507, 1508 \(2005\)](#) citing Philip McBride Johnson, *Derivatives: A Manager’s Guide to the World’s Most Powerful Financial Instruments* ix (McGraw-Hill 1999), Appendix B; See also Howard Chua-Eoan, *The Collapse of Barings Bank, 1995* available at <http://www.time.com/time/2007/crimes/18.html> last accessed 12/20/2008.

¹²¹ See Franklin R. Edwards & Edward R. Morrison, [Derivatives and the Bankruptcy Code: Why the Special Treatment?, 22 Yale J. on Reg. 91, 99-100 \(2005\)](#)

¹²² *Id.*

¹²³ James B. Kelleher. Buffett's "time bomb" goes off on Wall Street. September 18, 2008. available at <http://www.reuters.com/article/newsOne/idUSN1837154020080918?pageNumber=1&virtualBrandChannel=0> last accessed 12/20/2008

¹²⁴ AIG 2007 Form 10-K at 179 (“AIG has issued unconditional guarantees with respect to the prompt payment, when due of all present and future payment obligations and liabilities of AIGFP arising from transactions entered into by AIGFP.”)

¹²⁵ See James B. Kelleher. Buffett's "time bomb" goes off on Wall Street. September 18, 2008. available at <http://www.reuters.com/article/newsOne/idUSN1837154020080918?pageNumber=1&virtualBrandChannel=0> last accessed 12/20/2008

¹²⁶ See Dean Foster and H. Peyton Young. “The Not So Real McCoy.” *Institutional Investor*. December 15, 2008. (“Let’s say you want to deliver a performance record [that will] attract large amounts of money [to your fund]. In fact, it is surprisingly easy to duplicate this performance using the piggybacking strategy as long as investors can’t see your positions, and as long as you are willing to accept a small annual probability that your fund could go bust.”)

reward the investment manager with large management and performance fees.¹²⁷ Absent detailed disclosure of derivatives positions, it is virtually impossible for investors or regulators to tell such high risk, low-skill strategies apart from true investment management skill (i.e., generating alpha, or excess returns given the riskiness of the investment strategy)¹²⁸ until massive losses result, probably after several years of seemingly strong performance.¹²⁹

It may be in the interest of derivatives dealers such as investment banks to sell such strategies to investment managers because dealers collect substantial transaction fees. Assuming dealers have many customers (preferably with offsetting positions) and a reasonably long time horizon (to minimize “noise” and produce an outcome consistent with statistical predictions), dealers bear minimal investment risk.¹³⁰ As in gambling, the house almost always wins in the long run.¹³¹ However, derivatives dealers,

¹²⁷ Id. (“Here’s how to do it: At the start of the year, invest all your funds in the S&P 500. Once a year take a short position in a bundle of asset-or-nothing puts on the S&P 500 that have a nearby expiration date. (An asset-or-nothing put pays out one share of the index if and only if the closing price is less than the strike price on the expiration date. You can create such a derivative by combining a plain-vanilla European put with a cash-or-nothing put, both of which are routinely traded on exchanges.) Let α be the target amount by which you plan to inflate your total return over the next 12 months — the amount of fake alpha. For example, to achieve the result in Figure 1, you would take $\alpha = 0.07$, which will generate an annual return that is 7 percent higher than the return on the S&P 500.

Once you have established the target value of α , choose the strike price so that the options are exercised with probability $\alpha/(1 + \alpha)$. In our present example, the strike price would be chosen so that the probability of exercise is approximately $0.07/1.07 = 0.065$, or 6.5 percent. Now go short the maximum number of puts you can cover. The idea is to go for broke: If the puts are exercised, the fund will be cleaned out; but if they are not exercised, you will increase the number of shares in the fund by the factor $(1 + \alpha)$.¹ In the latter case you just sit back and wait until the end of the year (or any 12-month period), at which time you report that the fund grew by a factor of $(1 + \alpha)$ times the total return on the S&P 500 in that year. (During the entire time you have been fully invested in the S&P 500, which you used as collateral on your options position.) To the investors it looks as if you generated excess returns, and you collect a substantial performance fee. In reality you took a gamble and got lucky.”)

¹²⁸ Id. (“[S]teady growth might look a bit suspicious, but you could dress it up by targeting a value of alpha that varies from one year to the next.”)

¹²⁹ Id. (“A mimic can set up shop and pad the returns on the S&P 500 by an extra 7 percentage points a year. After five years he will collect his performance fee with a probability of more than 70 percent. If the fee is postponed for ten years, he will collect it with a probability of more than 50 percent...In five years such a fund will more than double; in ten years it will more than quadruple.”)

¹³⁰ See Jonathan Keath Hance. Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm. 65 Wash. & Lee L. Rev. 711, 721-22 and fn. 62 (2008) citing Mark A. Guinn & William L. Harvey, [Taking OTC Derivative Contracts as Collateral](#), 57 Bus. Law. 1127, 1129 fn. 7 (2000). (“Dealers primarily include large commercial investment banks whose goal is to make money by collecting premiums and other up-front fees while end-users typically include entities seeking “to shift certain market risk associated with the company’s assets or liabilities to the dealer.”...As a result of acquiring additional risk from an end-user in the derivative transaction, the dealer will, in turn, hedge that market risk by entering into additional agreements with third parties.”)

¹³¹ The comparison between derivatives dealers and casinos is not completely accurate because regulations generally prohibit the use of gambling as a hedge, whereas derivatives can be used to hedge (or off-load) existing risks. See Thomas Lee Hazen, Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance. 24 Ann. Rev. Banking & Fin. L. 408 (“[F]utures, options, and other derivatives contracts are treated as bona fide investment vehicles rather than being regulated as differences contracts or other types of gambling. This is in part because derivatives, unlike gambling, are viewed as providing a useful hedging device for at least some market participants...”)

Regulators permit speculation in derivatives markets because speculation facilitates hedging. *Id.* at 436. (“[O]ne answer to the charge that derivatives are nothing more than legalized gambling is that they provide legitimate hedging opportunities for investors and, more importantly, for commercial participants in the underlying commodities markets. It also is often pointed out that speculators help make markets more efficient by providing additional liquidity, which in turn performs a price discovery function. Commercial participants in the public commodities and derivatives markets (designated contract markets) may thus be relying on speculators to provide them with efficient markets for their hedging activities.”)

However, under a more consistent regulatory regime, gambling could also serve as a hedge for at least some market participants. *Id.* at 434-36 (“Consider, for example, merchants in a city hosting major league baseball who have recently enjoyed great success in the fall as a result of the home team making it through divisional playoffs and into the World Series. The merchants clearly have a legitimate interest in hedging against lost sales due to the absence of a post season event...[T]o the extent that attendance will increase even during the regular season according to the team's success, there could be an interest in hedging against losses on a daily basis... Presumably, these hedging contracts against a loss in revenues occasioned by losing a game would constitute illegal gambling.”)

Entrepreneurs have recently closed the gap between permissible derivatives and illegal gambling, creating a “futures market” for tickets to championship sporting events. Because the contracts are tradable, they permit risk exposures essentially identical to wagers on the outcomes of individual games. See Brett Nelson. Forbes.com. Final Four Tickets at 80% Off. December 22, 2005 available at http://www.forbes.com/home/entrepreneurs/2005/12/21/yoonew-ticketmaster-tickets-cx_bn_1222yoonew.html last accessed 12/24/2008 (“A gutsy Web startup called Yoonew... [sells sports fans] the right to take delivery of tickets when--and if--their teams make it to a coveted playoff game...Given the uncertainty of the bet, those contracts sell for a fraction--call it an insurance premium--of the future market value of the underlying tickets. If your team makes it to the big game, you've locked in a cheap seat; if it falls short, you lose that premium...This spring it will launch an online futures pit where both fans and speculators (those who might have an opinion about a team's probability of making the playoffs, but who have no intention of attending the game) can trade ticket contracts in a secondary market. Yoonew will manage the exchange and take a small cut of each trade, as Nasdaq does with public equities...What's the difference between betting on ticket futures and illegal gambling? Like all derivatives, futures have an economic purpose by allowing buyers and sellers to hedge exposure to ticket prices; gambling, by contrast, is pure speculation.”) See also Alan B. Krueger. Wait Till Next Year, but Lock In the Ticket Price Now. New York Times. February 2, 2006. available at <http://www.nytimes.com/2006/02/02/business/02scene.html?ex=1296536400&en=1dad087aa14ece8&ei=5088&partner=rssnyt&emc=rss> last accessed 12/24/2008 (“[T]he weekly gambling odds from SportingbetUSA explained 96 percent of the variability in Yoonew's futures prices”)

like casinos that allow customers to place bets on credit, remain vulnerable to counterparty risk—the risk that the customer will lose more than he can repay.¹³²

Because derivatives users may suddenly and unexpectedly become insolvent—and because the value of leveraged derivatives depends critically on the solvency of counterparties—the derivatives industry has sought to protect itself by amending the Bankruptcy Code to insure that derivatives dealers are paid before any other creditors.¹³³ The original purpose of the bankruptcy exceptions for derivatives was to prevent investment bank failures.¹³⁴ However, the exceptions were subsequently widened to protect other market participants. The widening of the bankruptcy exemptions for derivatives helped drive growth in the derivatives market—and therefore growth in investment banks’ revenue—but it degraded the value of those exemptions as protection against investment bank failures.

¹³² Jonathan Keath Hance. Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm. 65 Wash. & Lee L. Rev. 711, 722 (2008) (“OTC derivatives place the risk of default not on the exchange but on the individual actions of the OTC counterparty. Performance risk, therefore, remains a paramount concern to parties entering into OTC derivatives.”)

¹³³ See Rhett G. Campbell, [Financial Markets Contracts and BAPCPA](#), 79 Am. Bankr. L.J. 697, 712 (2005) (“A cynic might argue that the financial safe harbors are indeed a “bankruptcy opt-out clause” for a certain class of capitalists because their money is more important than everyone else’s. Does that mean that Chapter 11 reorganization rules apply to the average company but not to those who deal in sophisticated financial instruments? At what point does a class of financial instruments or market group become so important that the threat of being mired in bankruptcy sufficiently threatens world financial markets and, as a result, traditional Chapter 11 rules ought not apply?”)

See also Franklin R. Edwards & Edward R. Morrison, [Derivatives and the Bankruptcy Code: Why the Special Treatment?](#), 22 Yale J. on Reg. 91, 122 (2005) (“Our analysis, however, should worry members of Congress and legislators in other countries. They have been lobbied heavily by special interest groups (such as ISDA) to expand the special treatment of derivatives on grounds that such legislation is necessary to prevent a systemic meltdown in OTC derivatives markets should a derivatives counterparty suffer financial distress. Our analysis casts serious doubt on this proposition. Systemic risk may be a real threat, but bankruptcy law has no role to play in minimizing it.”)

¹³⁴ See [H.R. Rep. No. 97-420, at 2 \(1982\)](#) (“[T]he Bankruptcy Code (92 stat. 2549; [public law 95-598](#)), as enacted in 1978, expressly provides certain protections to the commodities market to insure the stability of the market. These protections are intended to prevent the insolvency of one commodity firm from spreading to other brokers or clearing agencies and possibly threatening the collapse of the market.”)

Subsequent amendments contained similar language about mitigating systemic risk by protecting the solvency of derivatives dealers. See Edward R. Morrison & Joerg Riegel, [Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges](#), 13 Am. Bankr. Inst. L. Rev. 641, fn. 14(2005) citing H.R. REP. NO. 109-31 at 3, 20, 131, 132 (2005) (justifying amendments to Code as “provisions designed to reduce systemic risk”).

As discussed above, the Bankruptcy Code contains several provisions designed to increase the likelihood that a debtor will be able to reorganize. These provisions, which may be thought of as either a “mandatory creditor-sponsored bail-out” or as a “tax” on leverage, facilitate reorganization by limiting creditors’ rights. Derivatives enjoy unique exemptions from these provisions.¹³⁵

Debtor-friendly provisions from which derivatives are exempt include: the prohibition on ipso facto clauses (or clauses that terminate a contract upon insolvency of the debtor);¹³⁶ the automatic stay (which prohibits creditors from seizing and liquidating collateral without permission from the Bankruptcy Court);¹³⁷ the rights of debtors in possession to selectively assume profitable contracts while

¹³⁵ See e.g., Franklin R. Edwards & Edward R. Morrison, [Derivatives and the Bankruptcy Code: Why the Special Treatment?](#), 22 *Yale J. on Reg.* 91, 91 (2005) (“[T]he Bankruptcy Code...contains numerous provisions affording special treatment to financial derivatives contracts, the most important of which exempts these contracts from the “automatic stay” and permits counterparties to terminate derivatives contracts with a debtor in bankruptcy and seize underlying collateral. No other counterparty or creditor of the debtor has such freedom; to the contrary, the automatic stay prohibits them from undertaking any act that threatens the debtor's assets.”)

¹³⁶ See Shmuel Vasser, [Derivatives in Bankruptcy](#), 60 *Bus. Law.* 1507, 1525 and fn. 110-16 (2005) citing 11 U.S.C.A. §§ 365(e)(1), 541(c)(1) (prohibiting ipso facto clauses). Derivatives are exempt under the following provisions: 11 U.S.C.A. § 555 (exemption for securities contracts); 11 U.S.C.A. § 556 (exemptions for forward and commodities contracts); 11 U.S.C.A. § 559 (exemptions for repos); 11 U.S.C.A. § 560 (exemptions for swaps); and 11 U.S.C. § 561 (exemption for master netting agreements).

Contracts for extension of credit enjoy a similar exemption. See Franklin R. Edwards & Edward R. Morrison, [Derivatives and the Bankruptcy Code: Why the Special Treatment?](#), 22 *Yale J. on Reg.* 91, 111 (2005) citing 11 USC § 365(c)(2).

¹³⁷ See Rhett G. Campbell, [Financial Markets Contracts and BAPCPA](#), 79 *Am. Bankr. L.J.* 697, (2005) citing 11 U.S.C. §§ 362(b)(6) & (7), 546(e), (f) & (g), 555 and 556; *Id.* at 705-709.

The Automatic Stay at 11 U.S.C. § 362(a) prohibits:

“(1) the commencement or continuation...of a judicial, administrative, or other action or proceeding against the debtor...to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

rejecting unprofitable contracts,¹³⁸ and the right of debtors in possession to void pre-petition transfers of property that were “not for-value” (i.e., to recover payments made before bankruptcy on bad deals) as fraudulent conveyances.¹³⁹

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor.”

However, there are exemptions for derivatives at [11 U.S.C. § 362\(b\)\(6\)](#), (7), (17) and (27).

¹³⁸ See Franklin R. Edwards & Edward R. Morrison, [Derivatives and the Bankruptcy Code: Why the Special Treatment?](#), *22 Yale J. on Reg.* 91, 95-96 (2005) (“Generally, when a debtor firm enters bankruptcy, it is party to many ongoing (“executory”) contracts, in which the debtor and its counterparties have continuing obligations to each other. Some of these contracts will be profitable to the debtor (they are “in the money”); others will not be (they are “out of the money”). The automatic stay prevents counterparties from taking any step to terminate these ongoing contracts. Instead the debtor has an exclusive right to “assume” profitable contracts and “reject” (i.e., breach) unprofitable ones, the consequence being that the counterparty to the “rejected” contract will receive an unsecured claim for damages, which will usually be paid a few cents on the dollar. In other words, the Bankruptcy Code generally allows debtors to “cherry pick” profitable from unprofitable contracts.”) See also 11 USC § 365(a) (“Except [as provided otherwise in this statute], the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.”)

The extensive rights of derivatives dealers to set-off through cross-product netting and to terminate contracts upon the debtor’s bankruptcy prevent this sort of “cherry-picking.” See Franklin R. Edwards & Edward R. Morrison, [Derivatives and the Bankruptcy Code: Why the Special Treatment?](#), *22 Yale J. on Reg.* 91, 96 (2005) (“This cherry-picking power comes to an end, however, when the underlying contracts are derivatives contracts. Thanks to an exemption from the automatic stay, derivatives counterparties typically may terminate ongoing contracts when a debtor enters bankruptcy. Moreover, if a counterparty has entered multiple derivatives contracts with the debtor, the counterparty can set-off in-the-money contracts against out-of-the-money contracts. (The process of terminating and setting-off contracts is often termed “close-out netting.”) Finally, if a debtor posted margin or other collateral to support its obligations under these contracts, the counterparty is free to seize it to the extent that the debtor is a net obligor to the counterparty. In other words, thanks to an exemption from the automatic stay, derivatives counterparties can minimize their exposure to losses arising from the insolvency of a debtor. If the debtor has posted collateral sufficient to cover its obligations, the exemptions from the automatic stay effectively eliminate a counterparty’s exposure to loss.”)

However, critics contend that extensive rights to netting and termination for derivatives have created a reverse situation in which non-debtor counterparties can cherry-pick contracts to net, terminate other contracts, and drain cash from the bankrupt debtor. See Rhett G. Campbell, [Financial Markets Contracts and BAPCPA](#), *79 Am. Bankr. L.J.* 697, 706 and fn. 56 (2005) citing *Subcomm. Hearing on H.R. 833, Part III* at 369 (statement of Randal Picker, on behalf of the National Bankruptcy Conference); see also *Bankruptcy Reform Act of 1999 (Part II), Hearing on H.R. 833 Before the Subcomm. on Commercial and Administrative Law of the House Comm. on the Judiciary*, 106th Cong., 1st Sess. 256-57 (1999) (statement of Kenneth Klee, on behalf of the National Bankruptcy Conference), available at http://commdocs.house.gov/committees/judiciary/hju63593.000/hju63593_Of.htm (last visited on May 31, 2005) (hereafter “*Subcomm. Hearing on H.R. 833, Part II*”).

See Shmuel Vasser, [Derivatives in Bankruptcy](#), *60 Bus. Law.* 1507, 1529-32 (2005)

Derivatives counterparties who are eligible for these exemptions enjoy far better treatment under the Bankruptcy Code than even secured creditors.¹⁴⁰ Unlike secured creditors, derivatives counterparties effectively bear no risk of loss to the extent that the debtor posts collateral to cover its obligations.¹⁴¹

Derivatives receive treatment in bankruptcy that is superior even to asset securitization. Whereas asset securitization transactions remain vulnerable to recharacterization as secured financings,¹⁴² 2005 reforms to the Bankruptcy code under BAPCPA effectively rendered derivatives immune from recharacterization based on economic substance, even if the transactions transparently resemble loans.¹⁴³ The court recently confirmed this interpretation of the Bankruptcy Code in *American Home Mortgage, Inc.*¹⁴⁴

¹³⁹ See Edward R. Morrison & Joerg Riegel, [Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges](#), 13 *Am. Bankr. Inst. L. Rev.* 641, 646 and fn.32(2005) citing 11 U.S.C. § 546(e) (declaring that, unless payment was fraudulent transfer under § 548(a)(1)(A), trustee cannot use its powers under §§ 544, 545, 547, 548(a)(1)(B), and 548(b) to avoid margin or settlement payments by or to protected parties to commodity, forward, and securities contracts prior to case commencement); 11 U.S.C. § 546(f) (offering same safe harbor for margin or settlement payments in connection with repurchase agreements); 11 U.S.C. § 546(g) (offering same safe harbor for transfers under or in connection with swap agreements). See also *Id.* at 660 (“If the counterparty acted “with actual intent to hinder, delay, or defraud” the debtor’s other creditors, a judge can unwind any settlement payments. But evidence of such fraud is rare.”) See also *Id.* at 662 (“Protection is extended to *any* “margin payment” or “settlement payment” under a securities contract or repo and to *any* “transfer” under a derivatives contract—with only one limitation, for cases involving intent to defraud creditors.”)

See also Shmuel Vasser, [Derivatives in Bankruptcy](#), 60 *Bus. Law.* 1507, 1534 and fn. 184 (2005) (“Protection is supplemented by [Bankruptcy Code sections 548\(d\)\(2\)\(B\), \(C\), \(D\) and \(E\)](#) providing that protected parties that receive margin or settlement payments are deemed to have provided value... The legislative history on this point is clear: “[T]his provision exempts these types of customary setoff payments in the forward contract trade from scrutiny as to whether they are actually fair value for the amount used.” [H.R. Rep. No. 101-484, at 7 \(1990\)](#), reprinted in 1990 U.S.C.C.A.N. 223, 229.”)

¹⁴⁰ See *Supra* notes 45 to 52 and accompanying text. Although lenders with executory contracts to extend credit may terminate those agreements upon bankruptcy, ordinary lenders who have already extended credit enjoy relatively limited rights of set-off. Pre-petition payments to secured creditors on the eve of bankruptcy are voidable as preferences to the extent that these payments place creditors in a better position than they would have been in bankruptcy. The automatic stay prevents secured creditors from seizing and liquidating collateral.

¹⁴¹ See Franklin R. Edwards & Edward R. Morrison, [Derivatives and the Bankruptcy Code: Why the Special Treatment?](#), 22 *Yale J. on Reg.* 91, 96 (2005) (“If the debtor has posted collateral sufficient to cover its obligations, the exemptions from the automatic stay effectively eliminate a counterparty’s exposure to loss.”)

¹⁴² See *supra* notes 71 to 77 and accompanying text.

¹⁴³ See Edward R. Morrison & Joerg Riegel, [Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges](#), 13 *Am. Bankr. Inst. L. Rev.* 641(2005) (“The reforms of 2005 direct judges to apply a formalistic inquiry based on industry custom: a financial transaction is a “swap,” “repurchase transaction,” or other protected transaction if it is treated as such in the relevant financial market. The

Prior to BAPCPA, the prospect that derivatives replicating loans might be recharacterized based on economic substance “sent shockwaves through the financial industry...[because it placed] billions of dollars in notional amounts of outstanding repos...in danger of being labeled as security interests.”¹⁴⁵ In other words, a significant portion of the value proposition of derivatives is their superior treatment in bankruptcy relative to secured loans. Legal rules that threaten derivatives’ superior treatment are a threat to the derivatives market, and therefore to derivatives dealers.¹⁴⁶

transaction’s loan-like features or its effect on outstanding obligations of the debtor are irrelevant, unless they affect the transaction’s characterization in financial markets. Absent fraud, form trumps substance.”)

See also *Id.* 656-57 (“Absent badges of fraud...A combination of financial contracts, even one that mimics a loan, merits protection if the underlying contracts fall within formal categories explicitly protected by the Code. This follows directly from the text of the new Code. It protects not only any transaction that a market participant would call a “swap,” “repo,” “forward,” “commodity contract,” or “securities contract,” but also any *combination* of such transactions. No exception is made for combinations that, in effect, resemble a loan. Additional support for this conclusion can be found in the new definition of “securities contract,” in section 741(7). It extends protection to “any other agreement or transaction that is similar to” those mentioned elsewhere in the definition, including “repurchase or reverse repurchase transactions.” Thus, a combination of agreements that resembles a repo would seem to merit protection, even if it exhibits loan-like features.

The new Code, in other words, places *form over substance* in characterizing protected transactions. A combination of contracts merits protection--regardless of its underlying economics--if the contracts are commonly recognized in the marketplace as swaps, forwards, or another type of contract protected by the Code. Indeed, margin *loans*--loans secured by the debtor’s securities portfolio--are now explicitly protected even though they are, in form *and* in substance, simply loans.”)

¹⁴⁴ See *In re American Home Mortg., Inc.* 379 B.R. 503, 516-17 (Bkrtcy.D.Del., 2008) (“The reference to “repurchase and reverse repurchase transactions” is intended to eliminate any inquiry under [section 555](#) and related provisions as to whether a repurchase or reverse repurchase transaction is a purchase and sale transaction or a secured financing...Succinctly stated, if the definition of “repurchase agreement” is met, the [section 559](#) safe harbor provisions apply, period.”)

¹⁴⁵ See Jeanne L. Schroeder, [A Repo Opera: How Crimi Mae Got Repos Backwards](#), 76 *Am. Bankr. L.J.* 565, 567 (2002) discussing *In re Crimi Mae, Inc.* 251 b.R. 796 (Bankr. D. Md. 2000).

Although repos are sometimes referred to as “financial market contracts” rather than “derivatives,” repos are referred to as “derivatives” throughout this article because they receive essentially the same treatment in bankruptcy as derivative contracts such as forwards, futures, and swaps. See e.g., Edward R. Morrison & Joerg Riegel, [Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges](#), 13 *Am. Bankr. Inst. L. Rev.* 641(2005). Repos are equivalent to a forward contract combined with a cash transaction.

¹⁴⁶ See e.g., The Economist. *The Great Untangling*. November 6th, 2008. (“[For the] big dealers, such as Goldman Sachs and JPMorgan...estimates of...total revenue related to CDSs run as high as \$30 billion a year.”) See also Carrick Mollenkamp and Charles Fleming. *Why Students Of Prof. El Karoui Are In Demand*. Wall Street Journal. March 9, 2006 available at

The market for derivatives has grown along with the bankruptcy exceptions that favor them.¹⁴⁷ When the first bankruptcy exceptions for derivatives were introduced in 1978, they applied only to a narrow range of products.¹⁴⁸ The range of products eligible for superior treatment in bankruptcy has since grown dramatically.¹⁴⁹ In 2005, BAPCPA changed the definition of “swaps” such that the exemption will automatically encompass virtually any derivative that dealers begin trading as “swaps,” however they may choose to define that term, without any further legislative action.¹⁵⁰ The derivatives market has

http://www.finmath.rutgers.edu/home/Why_Students_Of_Prof_ElKaroui_Are_In_Demand.pdf last accessed 12/26/2008 (“On average, revenue from derivatives based on stocks now accounts for about 30% of an investment bank’s total revenue from stock-related businesses, according to a Citigroup Inc. report issued in January.”)

¹⁴⁷ For a brief history of the growing exemptions for derivatives, See Jonathan Keath Hance. Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm. 65 Wash. & Lee L. Rev. 711, 737-759 (2008)

¹⁴⁸ Id. at 737-38.

¹⁴⁹ Id. at 753-55. See also Kenneth Kettering. Securitization and its Discontents. 29 Cardozo L. Rev. 1553, 1710 (2008) (“Congress has provided broad exceptions from most of the ordinary consequences of bankruptcy for various classes of financial markets contracts, and has seen fit to add to those favored classes from time to time. The Bankruptcy Code of 1978 gave that privileged treatment to “commodity contracts” and “forward contracts”; to these favored classes were added “security contracts” in 1982, “repurchase agreements” in 1984, and finally “swap agreements” in 1990... For a detailed survey of the provisions of the Bankruptcy Code and bank and thrift insolvency laws applicable to each class of protected transactions under current law, see Seth Grosshandler et al., Securities, Forward and Commodity Contracts and Repurchase, Swap and Master Netting Agreements under U.S. Insolvency Laws (Apr. 18, 2007), in *Advanced Swaps and Other Derivatives in 2007* (Practicing Law Institute 2007).”)

¹⁵⁰ See Edward R. Morrison & Joerg Riegel, [Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges](#), 13 *Am. Bankr. Inst. L. Rev.* 641, 650-52 (2005) (“[BAPCPA included] massive changes to the definition of “swap agreement.” Old section 101(53B) defined it as a swap involving currencies, interest rates, commodities, or “any other similar agreement,” including “any combination of” or “master agreement for” such agreements. The newly amended definition covers these transactions as well as options, forwards, and futures involving the same subject matter. Additionally, a “swap agreement” now includes swaps, options, forwards, and futures on debt or equity and various other derivative products, such as credit swaps, total return swaps, and weather options. And there is the familiar opening clause, making clear that nearly all “similar” agreements are covered as well.

These amendments do much more than simply expand the list of protected swaps. They expand it to include virtually every contract traded in derivatives markets...It is difficult to imagine a derivative that would not be encompassed by section 101(53B).”)

See also Jonathan Keath Hance. Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm. 65 Wash. & Lee L. Rev. 711, 754-55 (2008). (“Congress determined that the term “swap agreement” was too limited to address the evolving nature of derivatives agreements...Protected “swap agreements” now include “any agreement or transaction that is similar to any other agreement or transaction referred to in [\[§ 101\(53B\) of the](#)

also grown dramatically over this time period, from less than \$1 trillion in notional value outstanding globally in the 1980s to over \$280 trillion in 2006.¹⁵¹

The range of market participants eligible to take advantage of the bankruptcy exceptions for derivatives has also grown, from a small group of derivatives dealers before BAPCPA, to almost any derivatives end-user.¹⁵² This change may have dramatically altered the mix of participants in the derivatives market, as hedge funds rushed in to take advantage of exceptions previously only available to more established players such as banks.¹⁵³

[Bankruptcy Code](#) and that is of a type that has been, is presently, or in the future becomes the subject of recurrent dealings in the swap markets.”) citing [11 U.S.C. §§ 101\(53B\)](#)).

¹⁵¹ See Jonathan Keath Hance. Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm. 65 Wash. & Lee L. Rev. 711, 715 and fn. 17-18 (2008) citing International Swaps and Derivatives Association, Summaries of Market Survey Results, 2006, <http://www.isda.org/statistics/recent.html> and Emil E. Henry Jr., Assistant Sec. of the Treasury, Remarks Before the Fixed Income Forum: Hedge Funds and Derivatives Markets: History, Issues, and Current Initiatives (Mar. 9, 2006).

¹⁵² See Edward R. Morrison & Joerg Riegel, [Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges](#), 13 Am. Bankr. Inst. L. Rev. 641, 650-52 (2005) (“With respect to forward, commodity, and securities contracts, the original Code singled out particular parties for protection—a “commodity broker, forward contract merchant, stockbroker, financial institution[], or securities clearing agency...[However] amendments [to the definition of “swaps” under BAPCPA] expand the list of protected swaps...to include virtually *every contract traded* in derivatives markets...[T]hese amendments also extend the Code’s protections to every counterparty to a derivatives contract because the definition of “swap participant”... encompass[es] any entity that “at any time before the filing of the petition, has an outstanding swap agreement with the debtor.” As a result, the amendments to “swap agreement,” move the Code from protecting particular parties (to forwards and commodity contracts) to protecting entire derivatives markets.”)

But See Kenneth Kettering. Securitization and its Discontents. 29 Cardozo L. Rev. 1553, 1711 (2008). (“[T]he Bankruptcy Code limits the availability of these benefits to particular kinds of counterparties. In the case of securities contracts, commodity contracts, and forward contracts that limitation has some bite, as the Bankruptcy Code generally limits the full range of benefits to narrowly-circumscribed classes of financial professionals (though the 2005 amendments expanded the class of protected counterparties to include any sufficiently large and active participant in financial market contracts of the protected types).”)

¹⁵³ See International Monetary Fund (IMF). Global Financial Stability Report: Containing Systemic Risks and Restoring Financial Soundness. April 2008 at 79 Table 2.3 Available at <http://www.imf.org/external/pubs/ft/gfsr/2008/01/pdf/text.pdf> (Showing a sharp increase in participation by hedge funds in the credit default swap market relative to banks between 2004 and 2006. Hedge funds increased from 16% of protection buyers to 28%, while banks declined from 67% to 59%. Similarly, Hedge Funds increased from 15% of protection sellers to 31%, while banks declined from 54% to 43%).

As more creditors extended credit through derivatives,¹⁵⁴ expecting to have first priority in bankruptcy, it became harder for those creditors to communicate with one another and monitor debtors' leverage. It became correspondingly easier for debtors to increase the extent of their off-balance sheet leverage, and less likely that debtors would maintain sufficient liquid assets to meet margin calls. In other words, a widening opportunity to use derivatives as secret liens lead to a collective action problem among creditors—a collective action problem that shrewd debtors sought to exploit.

This appears to be what happened with AIG. AIG sold rough \$440 billion in protection on CDOs through credit default swaps.¹⁵⁵ As a protection seller, AIG resembled a borrower who accepts a relatively small amount of money now in return for a promise to pay a larger amount of money in the future.¹⁵⁶

¹⁵⁴ Virtually all derivatives combine extensions of credit with directional bets. For example, if an investor wants to place a leveraged bet that stock X will increase in value, he can either borrow money and buy stock X or he can sell put options and buy call options on stock X. Either series of transactions combines a directional bet with leverage to produce a range of potential gains or losses that is much greater than the size of the initial investment. However, it is possible to structure a series of derivatives contracts in which the directional bets cancel each other out, leaving only an extension of credit. The simplest example is a cash sale combined with a futures contract (i.e., a repo). For additional examples of such derivatives-as-loans structures, see Edward R. Morrison & Joerg Riegel, [Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges](#), 13 Am. Bankr. Inst. L. Rev. 641(2005). To the extent that an investment bank acts as a pure market-maker in the derivatives market rather than a directional player—in other words the bank enters back to back transactions that cancel each other out—the investment bank can reduce its own financing costs by requiring counterparties to both transactions to post collateral. From the perspective of the investment bank, the collateral is an interest-free short-term callable loan, similar to a checking account (or demand deposit) for a retail bank. The investment bank bears no market risk. Unfortunately for the bank, however, it aggregates counterparty risk. See supra notes 130 to 132 and accompanying text.

¹⁵⁵ See supra note 104.

¹⁵⁶ A protection seller receives small upfront payments, and possibly periodic fees, in return for taking on the risk that at some future time, the protection seller may have to make a relatively large payment to protection buyers. The difference between a credit default swap and a loan is that the repayment amount and date are contingent on a credit event. Put differently, AIG mixed borrowing with a directional bet. See Edward R. Morrison & Joerg Riegel, [Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges](#), 13 Am. Bankr. Inst. L. Rev. 641, 653 (2005) (“Many financial contracts have a credit component; one party temporarily extends credit to the other.”)

See also *Id.* at 641 (“form trumps substance—a desirable outcome, we argue, in light of the impossibility of drawing coherent lines between combinations of ordinary financial contracts and loans, dividends, or debt repurchases.”)

Because AIG had many anonymous creditors,¹⁵⁷ none of its creditors were aware of the full extent of AIG's CDS exposure. Although AIG disclosed the notional amount of its CDS contracts,¹⁵⁸ this information was not sufficient to evaluate its exposure for three reasons. First, some of the CDS contracts could have offset one another if AIG were a protection buyer as well as a protection seller.¹⁵⁹ Second, because the specific debts on which AIG had written protection was not disclosed, it was difficult to know to what extent the CDS contracts were correlated with one another.¹⁶⁰ And third, AIG's disclosures were misleading with respect to the value of its credit default swap portfolio, the amount of collateral that it would need to post.¹⁶¹

¹⁵⁷ The identity of many of AIG's credit default swaps counterparties remains a closely guarded secret, even from founder, former CEO, and large shareholder Maurice "Hank" Greenberg. See Lilla Zuill. Greenberg wants more info from AIG on U.S. deal. Reuters. December 2, 2008 available at <http://www.reuters.com/article/ousiv/idUSTRE4B15OG20081202> last accessed 12/28/2008

However, according to Bloomberg, AIG's CDS counterparties include investment banks such as Goldman Sachs, Merrill Lynch & Co., Morgan Stanley, and Deutsche Bank AG. See Mark Pittman. Goldman, Merrill Collect Billions After Fed's AIG Bailout Loans. Bloomberg.com September 29, 2008.

According to the Wall Street Journal, there were at least 24 counterparties. The largest beneficiaries of the Federal Reserves bailout were Société Générale SA, Goldman Sachs, Deutsche Bank AG, Crédit Agricole SA's Calyon investment-banking unit, and Merrill Lynch & Co. See Rick Mollenkamp and Michael Siconolfi. AIG Faces \$10 Billion in Losses on Bad Bets. Wall Street Journal. December 10, 2008.

¹⁵⁸ See AIG 2007 Form 10-K at 33 ("Approximately \$379 billion of the \$527 billion in notional exposure on AIGFP's super senior credit default swap portfolio as of December 31, 2007...")

¹⁵⁹ See Robert Pickel. Net exposure is the best guide to derivatives' market impact. Financial Times. January 29, 2008 available at <http://marketpipeline.blogspot.com/2008/01/net-exposure-is-best-guide-to.html> last accessed 12/28/2008. ("[C]onventional market use of economically offsetting positions [in credit default swap contracts]...reduces the amounts at stake sharply...[T]he \$50,000bn "notional" or nominal amount [of CDS outstanding] is just that; a nominal figure that references the "underlying" bonds and loans being protected by use of credit derivatives. Focus on the net exposure of these transactions, many of which hedge or offset one another. A recent Fitch Ratings survey estimates net exposure at less than \$1,000bn.") Robert Pickel is the CEO of ISDA.

¹⁶⁰ See Id. ("[N]ot all defaults occur suddenly. A market participant that has written net protection will probably have an opportunity to manage its position in response to what is usually a gradual decline in creditworthiness by the reference entity. While this does not alter the net amount of protection written, it clearly reduces the financial impact on that individual participant of the entity's default.")

¹⁶¹ See Lynn E. Turner. Testimony before the House of Representatives Committee on Oversight and Government Reform. 4-5. October 7, 2008. available at <http://oversight.house.gov/documents/20081007101007.pdf>

("[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:

Without detailed communication between creditors (protection buyers), AIG was able to deceive its creditors until a rush of margin calls made its collapse imminent.¹⁶² If the Federal Reserve had not

“...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**. Further, additional downgrades could result in requirements for substantial additional collateral, which could have a material effect on how AIGFP manages its liquidity. The actual amount of additional collateral that AIGFP would be required to post to counterparties in the event of such downgrades depends on market conditions, the fair value of the outstanding affected transactions and other factors prevailing at the time of the downgrade...”

But just six months later in its annual report, the company disclosed:

“As of February 26, 2008, AIGFP had received collateral calls from counterparties in respect of certain super senior credit default swaps...AIG is aware that valuation estimates made by certain of the counterparties...for purposes of determining the amount of collateral required to be posted by AIGFP...differ significantly from AIGFP’s estimates. AIGFP has been able to successfully resolve some of the differences...AIGFP is also in discussions with other counterparties ... As of February 26, 2008, AIGFP had posted collateral (or had received collateral, where offsetting exposures on other transactions resulted in the counterparty posting to AIGFP) based on exposures, calculated in respect of super senior default swaps, in an aggregate amount of approximately **\$5.3 billion....**”

“In this disclosure, the accuracy of the early statement is seriously called into question as the company discloses (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:

“As of July 31, 2008, AIGFP had received collateral calls from counterparties in respect of certain super senior credit default swaps...[V]aluation estimates made by certain of the counterparties with respect to certain super senior credit default swaps or the underlying reference CDO securities...have differed significantly from AIGFP’s estimates...In almost all cases, AIGFP has been able to successfully resolve the differences or otherwise reach an accommodation with respect to collateral posting levels...As of July 31, 2008, AIGFP had posted collateral ... in an aggregate net amount of **\$16.5 billion...The unrealized market valuation losses of \$26.1 billion** recorded on AIGFP’s super senior multi-sector CDO credit default swap portfolio represents the cumulative change in fair value of these derivatives, which represents AIG’s best estimate of the amount it would need to pay to a willing, able and knowledgeable third party to assume the obligations under AIGFP’s super senior multi-sector credit default swap portfolio as of June 30, 2008.”

...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.”)

¹⁶² Id.

stepped in with \$150 billion in emergency loans, capital injections, and distressed asset purchases¹⁶³ AIG's credit default swap counterparties would have faced one of two unpleasant outcomes. AIG could have rushed to meet margin calls through a value destroying fire sale of its subsidiaries,¹⁶⁴ potentially failing to make its credit default swap credit counterparties whole and disrupting global financial markets.¹⁶⁵ Or AIG could have filed for bankruptcy to maximize overall creditor recovery,¹⁶⁶ in which

¹⁶³ See Rick Mollenkamp and Michael Siconolfi. AIG Faces \$10 Billion in Losses on Bad Bets. Wall Street Journal. December 10, 2008. ("The Fed first stepped in to rescue AIG in mid-September with an \$85 billion loan when the collateral demands from banks and losses from other investments threatened to send the firm into bankruptcy court. A bankruptcy filing would have created losses and problems for financial institutions...that were relying AIG to insure them ... By November, AIG had used up a large chunk of the government money it had borrowed to meet counterparties' collateral calls and began to look like it would have difficulty repaying the loan. On Nov. 10 the government stepped in again with a revised bailout package. This time, the Treasury said it would pump \$40 billion of capital into AIG in exchange for interest payments and proceeds of any asset sales, while the Fed agreed to lend as much as \$30 billion to finance the purchases of AIG-insured CDOs at market prices.")

¹⁶⁴ See e.g., Lynn M. LoPucki & Joseph W. Doherty, Bankruptcy Fire Sales, 106 Mich. L. Rev. 1, 3-4 (2007) ("We compared the prices for which thirty large public companies were sold with the values of thirty similar companies that were reorganized in the period 2000 through 2004. We found that companies sold for an average of 35% of book value but reorganized for an average fresh-start value of 80% of book value and an average market capitalization value--based on post-reorganization stock trading--of 91% of book value. Even controlling for the differences in the pre-filing earnings of the two sets of companies, sale yielded less than half as much value as reorganization. These results suggest that creditors and shareholders can more than double their recoveries by reorganizing large public companies instead of selling them.")

¹⁶⁵ See Ben. S. Bernanke. Speech at the Economic Club of New York, October 15, 2008. available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081015a.htm> last accessed 12/28/2008 ("In the case of AIG, the Federal Reserve and the Treasury judged that a disorderly failure would have severely threatened global financial stability and the performance of the U.S. economy. We also judged that emergency Federal Reserve credit to AIG would be adequately secured by AIG's assets. To protect U.S. taxpayers and to mitigate the possibility that lending to AIG would encourage inappropriate risk-taking by financial firms in the future, the Federal Reserve ensured that the terms of the credit extended to AIG imposed significant costs and constraints on the firm's owners, managers, and creditors.")

Several critics, including former AIG Chairman and CEO Maurice "Hank Greenberg," have suggested that AIG shareholders and taxpayers would have been better off if AIG had declared bankruptcy, and that the primary beneficiaries of the bailout are AIG's credit default swap counterparties. See Statement of Maurice R. Greenberg Before the United States House of Representatives Committee on Oversight and Government Reform, October 7, 2008. ("It was not necessary to wipe out virtually all of the shareholder value held by AIG's millions of shareholders, including tens of thousands of employees and many more pensioners and other Americans on fixed incomes. Those millions of Americans could have fared better if AIG had filed for bankruptcy protection, since they would at least have had the chance of recouping value on their investments in AIG over the longer term. Bankruptcy would not have had to affect AIG's sound operating companies because the bankruptcy could have been limited to the parent company and impaired subsidiaries. Although AIG stockholders could have fared better if the company had filed for bankruptcy protection, other stakeholders – like AIG's Wall Street counterparties in swaps and other transactions – would have fared worse. Those transactions would have been frozen in a

case its credit default swap counterparties would have been general unsecured creditors to the extent that AIG did not post collateral to cover its obligations.¹⁶⁷

If the bankruptcy exception for derivatives had worked as intended, then the Federal Reserve's intervention at AIG would not have been necessary to protect AIG's credit default swap counterparties, and taxpayers would not be risking billions in losses.¹⁶⁸ As explained above, the ostensible purpose of

bankruptcy rather than gradually unwound. Although that result could have posed systemic risk absent a broader federal bailout, it's not clear that dismantling AIG was a better solution. Nor is it clear why, in designing a federal response to AIG's short-term liquidity problem, some AIG stakeholders were prioritized over others.")

See also Carol D. Leonnig. Effectiveness of AIG's \$143 Billion Rescue Questioned. Washington Post. November 3, 2008. available at http://www.washingtonpost.com/wp-dyn/content/article/2008/11/02/AR2008110202150_pf.html

¹⁶⁶ See supra notes 164 and 165.

¹⁶⁷ Although derivatives have many advantages over secured loans, obligations under derivatives contracts remain vulnerable to losses in bankruptcy to the extent that the debtor has not posted collateral and the non-bankrupt counterparty does not have an obligation to the debtor that it can setoff. See 11 USC § 544 (b)(1) ("the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under [section 502](#) of this title"); 11 USC § 502(g)(2) ("A claim for damages calculated in accordance with [section 562](#) shall be allowed under subsection (a), (b), or (c), or disallowed under subsection (d) or (e), as if such claim had arisen before the date of the filing of the petition."); 11 USC § 502(h) ("A claim arising from the recovery of property under [section 522](#), [550](#), or [553](#) of this title shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.");

11 USC § 553(b)(1) ("Except with respect to a setoff of a kind described in [section 362\(b\)\(6\)](#), [362\(b\)\(7\)](#), [362\(b\)\(17\)](#), [362\(b\)\(27\)](#), [555](#), [556](#), [559](#), [560](#), [561](#), [365\(h\)](#), [546\(h\)](#), or [365\(i\)\(2\)](#) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to [a certain specified] extent.")

¹⁶⁸ See Carol D. Leonnig. Effectiveness of AIG's \$143 Billion Rescue Questioned. Washington Post. November 3, 2008. available at http://www.washingtonpost.com/wp-dyn/content/article/2008/11/02/AR2008110202150_pf.html last accessed 12/28/2008 ("Another concern is that in this depressed market, AIG, and the taxpayers that now own 80 percent of the company, will lose coming and going. The company may be forced to borrow additional federal funds for rising payouts to counterparties...The company also may be forced to sell many more assets at low, fire-sale prices. As part of its loan deal, AIG was to sell some assets -- valued at \$1 trillion before the crisis -- to raise cash to pay off the loan.")

But See Ben. S. Bernanke. Speech at the Economic Club of New York, October 15, 2008. available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081015a.htm> last accessed 12/28/2008 ("I would like to stress once again that the taxpayers' interests were very much in our minds and those of the Congress when these programs were designed...In the case of the TARP program, the funds allocated are not simple expenditures, but rather acquisitions of assets or equity positions, which the Treasury will be able to sell or redeem down the road. Indeed, it is possible that taxpayers could turn a profit from the program, although, given the great

the bankruptcy exceptions for derivatives is to protect investment banks from liquidity problems at derivatives counterparties. Derivatives problems at AIG—a large derivatives counterparty to many investment banks—led to the bailout of AIG. The bankruptcy exception did not work as intended because derivatives’ complexity, opacity, and superior treatment in bankruptcy made them ideal vehicles for secret liens. Although derivatives exposures can make a debtor’s financial state virtually impenetrable to creditors,¹⁶⁹ derivatives are not vulnerable to challenge as secret liens under the strong-arm power of 11 USC § 544.¹⁷⁰

As long as this situation persists, unregulated OTC derivatives will continue to be popular. As derivatives become more common, the benefits to sophisticated creditors will shrink even further and the danger to the financial system will grow. When exempt instruments represent a small portion of a debtor’s capital structure, exempt instruments offer a significant advantage to sophisticated creditors, because unsophisticated creditors using less favored instruments provide a cushion for losses. However, as more creditors learn to use exempt instruments to lend, the relative size of the cushion offered by less

uncertainties, no assurances can be provided...The larger point, though, is that the economic benefit of these programs to taxpayers will not be determined primarily by the financial return to TARP funds, but rather by the impact of the program on the financial markets and the economy. If the TARP, together with the other measures that have been taken, is successful in promoting financial stability and, consequently, in supporting stronger economic growth and job creation, it will have proved itself a very good investment indeed, to everyone's benefit.”)

¹⁶⁹ See Supra notes 111 to 117 and accompanying text. During a telephone conversation with the author (12/24/2008), a managing director at one of the leading distressed debt investing firms confirmed the extreme difficulty of assessing the finances of companies with extensive derivatives exposure.

¹⁷⁰ See Morrison & Riegel at Supra note 139. See also. [11 U.S.C. § 546\(e\)](#) (“Notwithstanding [sections 544, 545, 547, 548\(a\)\(1\)\(B\)](#), and [548\(b\)](#) of this title, the trustee may not avoid a transfer that is a margin payment...or settlement payment...made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency...in connection with a securities contract... commodity contract...or forward contract, that is made before the commencement of the case, except under [section 548\(a\)\(1\)\(A\)](#) of this title”); [11 U.S.C. § 546\(f\)](#) (“Notwithstanding [sections 544, 545, 547, 548\(a\)\(1\)\(B\)](#), and [548\(b\)](#) of this title, the trustee may not avoid a transfer made by or to (or for the benefit of) a repo participant or financial participant, in connection with a repurchase agreement and that is made before the commencement of the case, except under [section 548\(a\)\(1\)\(A\)](#) of this title.”); [11 U.S.C. § 546\(g\)](#) (“Notwithstanding [sections 544, 545, 547, 548\(a\)\(1\)\(B\)](#) and [548\(b\)](#) of this title, the trustee may not avoid a transfer, made by or to (or for the benefit of) a swap participant or financial participant, under or in connection with any swap agreement and that is made before the commencement of the case, except under [section 548\(a\)\(1\)\(A\)](#) of this title.”) ; [11 U.S.C. § 546\(j\)](#) (“Notwithstanding [sections 544, 545, 547, 548\(a\)\(1\)\(B\)](#), and [548\(b\)](#) the trustee may not avoid a transfer made by or to (or for the benefit of) a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered thereby that is made before the commencement of the case, except under [section 548\(a\)\(1\)\(A\)](#) and except to the extent that the trustee could otherwise avoid such a transfer made under an individual contract covered by such master netting agreement.”)

sophisticated creditors shrinks. As a result, debtors' capital structure becomes both more highly leveraged and less transparent.

Although all creditors would be better off if debtor finances were fully transparent, each individual creditor will try to gain an advantage by lending through derivatives, and all will suffer as a result. The dynamic is similar to the prisoners dilemma, or a positive feedback loop, or a tragedy of the commons.

IV. Conclusion: Reviving Recordation

If bankruptcy and commercial law were the same during the last 30 years as it had been for most the last 400 years, creditors seeking priority in bankruptcy would be forced to publically disclose their claims in full. AIG's CDS counterparties would have had sufficient information to ascertain the full extent of AIG's CDS exposure, and AIG probably could not have sold as much CDS protection as it did. Investment banks with solid risk management practices would either have purchased protection from other more creditworthy issuers, or would have curtailed their participation in the CDO market.

Furthermore, investors in CDOs would have realized that even as investment banks sold them CDOs as safe, highly rated investments, those same investment banks were reducing their own exposure to CDOs through credit default swaps. Investors would have realized that CDOs were riskier than acknowledged by rating agencies and investment banks, and the CDO bubble would probably have burst earlier, while it was smaller and could do less damage.

The CDO market might also have been smaller—and the economic damage less—if creditors who were financing investment banks through secret liens such as CDOs and derivatives were forced to disclose those relationships. If the full extent of investment bank leverage were apparent to all, creditors might have demanded higher interest rates or capital reserves, thereby reducing investment banks' leverage and shrinking their balance sheets. Again, the result would have been a smaller and less damaging market crash, possibly not requiring government Intervention and taxpayer money.

Almost 200 years ago, common law judges warned of the dangers of products that—like CDOs and credit default swaps—can serve as vehicles for secret liens. Legal acceptance of secret liens, they warned, threatened to “put an end to all credit.” States responded with recordation systems requiring detailed disclosure of liens.

I suggest that Congress incorporate this wisdom into Federal law. The Bankruptcy Code should establish a universal recordation system for any instrument that gives a creditor priority greater than a general unsecured creditor. The recordation system should apply whether that instrument is a security interest, a derivative, an asset securitization, or anything else financial engineers may invent in the future. As in traditional recordation systems, the instrument should be given legal effect upon recordation. If not properly recorded, the instrument should be subordinate to general unsecured debt.

Recordation should require that creditors post sufficient information for other creditors to assess the impact of the instrument on the creditworthiness of the debtor. For complex instruments such as derivatives, this would presumably include the contract, the financial model used to calculate obligations under the contract, a description of any collateral that is or may need to be posted under the

contract, and a sensitivity analysis showing the range of possible obligations under the contract including “best-case” and “worst-case” scenarios for the debtor.

Recordation would also place certain obligations on the debtor to ensure that filings do not present the debtor as more leveraged than the debtor actually is. To prevent fraud, confirmation from the debtor should be required before a creditor can record an instrument. To keep filings up to date and relevant, debtors should be required to post updates whenever a contract is modified or rescinded.

With such detailed and reliable information, creditors could rationally decide for themselves whether to extend credit, on what terms and at what price. Creditors would not need to rely on rating agencies or auditors, which might be conflicted or mistaken. They would not need to rely on government or private regulators such as exchanges, which might also be conflicted or mistaken. They would not need to rely on disclosures from debtors, who are by definition conflicted and who might also be mistaken.

Under the recordation system described above, it would be in the interest of each individual creditor to disclose his relationship with the debtor. The collective action problems that plague creditors would largely disappear.

Unlike previous recordation systems, the system should be universal. It should incorporate all liens, in any form of property. The recordation system should be Federal, thereby reducing the redundancy and cost of state-based systems. Although optimal presentation should be worked out in consultation with creditors, I suggest that the recordation database have the following features: it should be easily searchable by name of the debtor or the creditor; it should be possible to sort disclosures by counterparty, type of instrument, type of collateral, size of obligation, date of obligation, and/or duration of obligation. The database should also include hyperlinks between counterparties and their guarantor and include a hyperlinked organizational structure of institutional debtors with limited liability (i.e., corporations, LLCs, LLPs, charities, etc.). Costs should be kept to a minimum through electronic filing and low filing fees for creditors, while the database itself should be publically searchable at no cost.

Broad public access will reduce the likelihood of future credit bubbles or credit crunches, because it will make rumors easy to verify or discredit. And with free access for academics and journalists, as well as financial service companies and regulators, problems can be identified sooner, when they are smaller and less likely to lead to systemic risk.

I’ll attempt to anticipate and address some potential criticisms of these reforms.

One potential criticism is that a more regulated/transparent financial system will be less profitable, will not attract the brightest minds, and will therefore be less innovative. As Fed Chairman, Alan Greenspan made this argument—albeit in more subtle form—against derivatives regulation.¹⁷¹ Shortly before the

¹⁷¹ Testimony of Chairman Alan Greenspan Before the Committee on Banking and Financial Services, U.S. House of Representatives, The regulation of OTC derivatives (July 24, 1998) available at <http://www.federalreserve.gov/BOARDDOCS/TESTIMONY/1998/19980724.htm> last accessed 1/4/2009 (“Professional counterparties to privately negotiated contracts...have demonstrated their ability to protect

financial crisis, a variation of this argument was also used by some U.S. political leaders with strong ties to the financial services industry to urge deregulation through reduced mandatory disclosure and reduced liability.¹⁷²

themselves from losses from fraud and counterparty insolvencies... The huge increase in the volume of OTC transactions reflects the judgments of counterparties that these instruments...add significant value to our financial structure, both here in the United States and internationally... Inappropriate regulation distorts the efficiency of our market system and as a consequence impedes growth and improvement in standards of living.”)

After the financial crisis of 2008, Greenspan admitted that he may have been “partially” wrong in opposing derivatives regulation. See Edmund L. Andrews, Greenspan Concedes Error on Regulation, New York Times, (October 23, 2008) available at

http://www.nytimes.com/2008/10/24/business/economy/24panel.html?_r=2&partner=rssnyt&emc=rss&oref=slogin last accessed 1/4/2008

¹⁷² See Charles Schumer and Michael Bloomberg, Sustaining New York’s and the US’ Global Financial Services Leadership (January 22, 2008) available at http://schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf?PHPSESSID=cd358db60ef4522223e10eebed385a56 last accessed 1/4/2009 (the report was commissioned by Bloomberg and Schumer, but prepared by the consulting firm McKinsey & Company).

“[N]ew guidance should enable auditors and management to exercise more judgment rather than rely on specific rules. It should also emphasize materiality – i.e., what really important to investors and management – rather than comprehensiveness...” Id. at 98.

“[B]usiness professionals believe that the pendulum has swung toward excessive litigiousness, imposing unreasonable costs on market participants...[T]he legal environment is detrimental to America’s spirit of entrepreneurialism and innovation...[U]nless significant changes are made to America’s litigation system, financial services businesses will likely continue to shift an increasing share of their activities to less litigious jurisdictions.” Id. at 101.

The report praised the UK’s less burdensome regulatory regime. Id. at 17 (“Business leaders increasingly perceive the UK’s single, principles-based financial sector regulator – the Financial Services Authority (FSA) – as superior to what they see as a less responsive, complex US system of multiple holding company and industry segment regulators at the federal and state levels. Regulatory enforcement style also matters, with the UK’s measured approach to enforcement seen as more results-oriented and effective than a US approach sometimes described as punitive and overly public.”)

Ironically, a report commissioned by the Mayor of London on the UK’s financial competitiveness suggested that, in the wake of the financial crisis, more stringent regulation would make the UK more competitive. See London: Winning in A Changing World at 7 (June 2008) available at <http://www.london.gov.uk/mayor/economy/docs/london-winning-changing-world.pdf> last accessed 1/04/2009 (“In the wake of the financial crisis, the industry and regulatory authorities must act together to rebuild the UK’s reputation. The industry must support the Financial Services Authority’s planned move from risk-based supervision to a more intense supervisory model and do all it can to support the creation of a new global regulatory framework. The Government must urgently review the UK’s administration laws to restore trust in London-based financial services subsidiaries of overseas firms. Statutory immunity must be granted to whistleblowers as one step

Under the circumstances, this criticism is overly cynical. It assumes that even after the worst financial crisis since the Great Depression, the most talented investment professionals, like cartoon villains, are motivated purely by mercenary considerations. In fact, investment banks have foregone bonuses for top ranked executives and accepted pay limits to secure government assistance.¹⁷³ Furthermore, many investment professionals have acknowledged the importance of greater transparency,¹⁷⁴ even if it reduces profitability. For example, industry participants have supported standardizing credit default swaps and trading them on an exchange, a move that will increase transparency and is expected to reduce profit margins on each trade (but perhaps increase trading volume).¹⁷⁵

A recordation system furthers the goal of transparency by preventing exchanges and other private data collection agencies from withholding important information from creditors.¹⁷⁶ A recordation system will also increase transparency of derivatives that continue to be traded OTC (i.e., OTC derivatives other than credit default swaps). Although these other OTC derivatives may not have played a role in the financial crisis of 2008, without mandatory disclosure, they will likely contribute to future financial crises. Financial products that were not involved in the financial crisis nevertheless have the potential to serve as vehicles for secret liens and hidden leverage to the extent that these products are opaque and receive superior treatment in bankruptcy.

Another flaw in the critique is that it implicitly assumes that the profitability of financial institutions will always depend on information asymmetries that create opportunities to exploit investors. Mandatory disclosure and new regulation may shift investment banks efforts away from hiding leverage and beautify balance sheets and toward value-creating innovation, such as developing more reliable, lower cost, and more data-rich trading platforms. Such operational improvements are protectable by patent, copyright and trade secret, and would not be endangered by a recordation system.

to establishing “credible deterrence” to insider dealing.”) (The report was commissioned by London Mayor Boris Johnson, but prepared by a panel of financial services executives chaired by Merrill Lynch’s chairman of Europe, the Middle East, and Africa.)

¹⁷³ See e.g., David Enrich, Citi’s Chairman, CEO won’t get 2008 bonuses, Wall Street Journal (January 1, 2009); See also Erich Dash and Louise Story, Citigroup’s Top Executives to Forgo ’08 Bonuses, New York Times (December 31, 2008) available at <http://www.nytimes.com/2009/01/01/business/01pay.html?ref=business> last accessed 1/4/2009

¹⁷⁴ Industry-led drives toward greater transparency include the American Securitization Forum’s Project RESTART for mortgage backed securities (see <http://www.americansecuritization.com/story.aspx?id=2655>).

¹⁷⁵ See John Glover and Hamish Risk, Exchange-Traded Credit Derivatives Poised to Curb Bank Monopoly, Bloomberg.com (December 11, 2008) available at <http://www.bloomberg.com/apps/news?pid=20601109&sid=auKjphV5t9FA&refer=home> last accessed 1/4/2009

¹⁷⁶ If public disclosures are content-rich but wanting in terms of presentation or ease of use, private fee-based services will likely reorganize the data into a more user-friendly format. For example, Dunn & Bradstreet gathers information for its credit reports in part from state-based filing systems.

This critique is also flawed because it ignores the fact that, absent government patronage, financial institutions can not be profitable unless they attract private investors. Investors were burned once by placing their faith in the assurances of bankers, rating agencies, and regulators. Next time around, they will demand facts—the kind of cold, hard, unfiltered facts that only a recordation system—armed with the threat that improperly recorded claims will be subordinate—can provide.

The beauty of a recordation system is that it relies on self-interested creditors to put their own interests ahead of debtors by making a full and complete disclosure in return for payment priority. It relies on creditors to use the disclosed information to price and distribute capital appropriately. It frees creditors from reliance on intermediaries who can profit by misleading them. It lays the ground work for a truly transparent, efficient capital market with minimal government intervention.

Another possible criticism of recordation is that it will be too expensive.

This seems unlikely. Costs of preparing filings will likely be minimal. Market participants already have all of the required materials on hand. Market participants will have a copy of the contract and at least one financial model on hand. If each party has a different financial model, recordation will force them to agree up-front on which model reflects the terms of the contract, thereby avoiding litigation down the road. Market participants with good risk management practices will also have run scenario analyses to evaluate possible outcomes under the contract. Publically filing these analyses will reassure investors that the company has strong internal controls.

Costs of maintaining the database will likely also be reasonable. For comparison purposes, TRACE, the Trade Reporting and Compliance Engine for corporate bonds, charges a trade reporting fee of \$20-\$80 per month plus at most \$2.375 per trade.¹⁷⁷ Unlimited data access is free for individuals and non-professionals and \$400 per-month for non-profits.¹⁷⁸ Professional investors pay anywhere from \$60 per month to \$7,500 per month, depending on the level of access and number of display terminals they require.¹⁷⁹

Costs are also likely to be lower now than they will be at any point in the near future because of reduced labor costs. Many financial professionals with intimate knowledge of asset securitization and derivatives are currently unemployed. Those who are willing to accept modest compensation could help the government develop the new recordation system and assist creditors who wish to record their claims. Given the weakened state of many financial service firms following the financial crisis, the government

¹⁷⁷ FINRA manual online: 7730 Trade Reporting and Compliance Engine (a),(b) available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4480 last accessed 1/2/2009

¹⁷⁸ FINRA manual online: 7730 Trade Reporting and Compliance Engine (c) available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4480 last accessed 1/2/2009

¹⁷⁹ Id.

may wish to subsidize creditors' efforts, at least in the short-run.¹⁸⁰ This would simultaneously boost investor and consumer confidence, and yield lasting benefits of greater financial stability.

The SEC reports spending a total of \$124 million in 2007 on disclosure efforts.¹⁸¹ This comes to approximately 0.003% of the government's commitment under the bailout.¹⁸² If one assumes the costs of a recordation system will be similar to disclosures under the securities laws, recordation will pay for itself 29,000 times over in any year in which it prevents the need for a government bailout of financial institutions comparable to the bailout of 2008.¹⁸³

The appropriate question, it would seem, is not how much disclosure costs, but how much less it costs than the alternative.

Another possible criticism of recordation is that disclosure by creditors is redundant. According to this critique, improved disclosure from debtors under GAAP, or improved monitoring from intermediaries such as derivatives exchanges, credit rating agencies, or regulators will make disclosure of individual transactions by creditors unnecessary.

The problem with this reasoning is that disclosures under GAAP come from debtors and are audited by professionals whom they select and compensate. Intermediaries can be similarly conflicted, or can make mistakes. One of the best ways to ensure the reliability of information is to have multiple sources and minimal filters—i.e., to require disclosure by both debtors and creditors. Creditors should have the opportunity to trust, but verify.

¹⁸⁰ President-elect Obama has called for a trillion-dollar stimulus plan to improve "infrastructure" and create jobs. See Beth Fouhy, Cash Poor States Eager for a Piece of Obama Plan, Associated Press (January 2, 2009), available at <http://www.google.com/hostednews/ap/article/ALeqM5gxH700g9sChXPLU0jKZr0MfLgFkwD95F8BI00> last accessed 1/4/2009 ("The rescue plan, which Obama has called "the largest new investment in national infrastructure since the creation of the federal highway system in the 1950s," is part of a broader legislative package intended to create up to 3 million new jobs, provide tax relief to middle-class families and help governors cover the soaring costs of education and Medicaid, the public health program for the poor. It is estimated to cost as much as \$1 trillion.")

Although the Obama plan currently calls for physical infrastructure projects such as roads, bridges, and broadband internet access, given the origins of the economic downturn in financial services, the administration may wish to extend the stimulus to financial infrastructure as well.

¹⁸¹ U.S. Securities and Exchange Commission. FY 2009 Congressional Justification. Goal 3: Foster Informed Investor Decision Making, 23 (Feb. 2008) Available at <http://www.sec.gov/about/secfy09congbudgjust.pdf> last accessed 1/2/2009

¹⁸² \$124 million / \$3.6 trillion = 0.003%

¹⁸³ $1 / 0.003\% = 29,032$. This treats the full \$3.6 trillion government outlay as an expense. If one assumes instead that only 1/3 of the bailout commitment is an expense, disclosure still pays for itself almost 10,000 times over in any year that it prevents a bailout.

The last criticism of recordation I shall address is that a recordation system deprives creditors and debtors of their basic privacy by mandating disclosure.

However, this criticism is misleading. Recordation only mandates disclosure of *liens*. Creditors who are content with a subordinate claim—and debtors who are willing to compensate them for the additional risk by paying a higher interest rate—do not need to disclose their dealings. Recordation simply imposes greater transparency as a cost of priority. It forces sophisticated parties to internalize risks that secret liens enable them to offload onto unsophisticated investors and taxpayers. The result will likely be a financial system that is more stable, more efficient, and more just.

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