

**2009 AALS CONFERENCE ON BUSINESS ASSOCIATIONS:
TAKING STOCK OF THE FIELD**

***Teaching Debt Leverage, Market Structure, and Firm Funding
Liquidity in the New Credit Market***

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Yearly debt issuance exceeds that of equity, yet our curricula give short shrift to debt financing. Because it matters to firms and regulators (and me), I teach upper-level seminars that put legal questions about debt financing in the larger context of credit markets and their implications for corporate finance lawyers. My presentation traces how the seminar has evolved during the three times that I have taught it. Below I excerpt text (without changing verb tenses) from the respective syllabus for each of the three seminars – *International Finance: The Issuer’s Perspective*, *Legal Trends in Debt Finance*, and *Finance Sector: Crisis and Regulation*.

I. Spring 2006 seminar: *International Finance: The Issuer’s Perspective*

The purpose of the seminar is to survey the range of legal and operational issues faced by a capital issuer as it funds its activities. The seminar covers the issuance and funding practices of both private issuers (e.g. multinational corporations) and major public issuers, like the World Bank and the U.S. Treasury. In particular, the seminar focuses on liquidity management and debt financing in an international context, although this coverage necessarily overlaps with equity instruments too. Because of their unique funding structures, banks and other regulated entities are also covered in the seminar. In a general sense, the purpose of this seminar is to prepare students to provide legal and financial advice to the chief financial officer function of an international firm. Students are expected to participate actively in the seminar meetings.

II. Spring 2008 seminar: *Legal Trends in Debt Finance*

SEMINAR COVERAGE

The purpose of the seminar is to expose you to the major legal issues, financial concepts and transactional skills (especially drafting) which lawyers must draw on in a corporate or commercial debt transaction. After the introductory session, we spend two sessions discussing the major types of “intermediaries” in the debt market. In this context, “intermediaries” refers to the range of different firms which play distinct roles in the debt market. These “intermediaries” include borrowing firms, commercial banks, investment banks, broker-dealers, hedge and equity funds, credit rating agencies, insurers, and others. Then we move on debt instruments themselves, starting with whole debt, which refers to an undivided debt obligation. Many forms of debt start out as whole debt (they are “originated”) and are then get repackaged into new instruments. We examine these and other forms of structured finance in a separate session. The next three sections take a closer look at the structure of debt instruments themselves (both

whole and structured debt), emphasizing the role of covenants in ordering the relationship between borrower and lender.

After surveying the intermediaries and instrument structure, we examine particular kinds of leveraged restructuring by firms. To appreciate the impact of leverage on a firm's liquidity, we then examine how a firm manages the liquidity of its capital structure. To expand the analysis from firms to governments, we also spend one session on special problems in how sovereigns finance themselves. We conclude with a section on the documentation and organizational problems which junior lawyers face in debt financing deals. Because much is happening in the credit markets, I may – with ample notice – change part of the topic sequence to take advantage of current events.

The required text for the seminar – DRAFTING FOR CORPORATE FINANCE – emphasizes practical skills and concrete issues which arise when negotiating, designing, and interpreting debt instruments. The supplemental readings and in-class discussions will put these skills in the context of the debt financing market overall. Members of the seminar are expected to participate actively during class.

Because the goal of a seminar is to develop the research and writing skills of participants, we will also use class time to discuss selected topics in organizing and drafting a research paper. On reserve at the law library I have put what I consider to be the finest guide to research writing – Booth, Colomb, and Williams, THE CRAFT OF RESEARCH. I encourage you to consult it throughout the semester.

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SEMINAR TOPICS*

January 10th: INTRODUCTION

January 17th: INTERMEDIARIES I

- Paris, Chapter 2 *The Players*, pp. 7-24 (Issuer and Investors)

January 24th: INTERMEDIARIES II

- Paris, Chapter 2 *The Players*, pp. 24-36 (Markets, Industry Groups, and other Intermediaries)
- World Federation of Exchanges Cost Survey
- S&P note on exchange consolidation

January 31st: INSTRUMENTS I

- Paris, Chapter 3 *The Instruments* pp. 43-56 (Whole Debt)
- Leveraged Loan Primer, pp. 1-30.

February 7th: INSTRUMENTS II

* To take advantage of the ongoing turmoil in the credit markets, I may make certain changes to this sequence of topics.

- Paris, Chapter 3 *The Instruments* pp. 56-62 (Structured finance)
- S&P Ratings Guidelines for Structured Finance, pp. 7-10 and Chapter 8 *Criteria Related to Collateralized Debt Obligations*
- Asset Securitization guide, pp. 6-23.

February 14th: INSTRUMENT STRUCTURE: SENIORITY, SUBORDINATION, AND CREDIT

- Paris, pp. 101-132

February 21st: INSTRUMENT STRUCTURE: COVENANTS I

- Paris, Chapter 12, *Debt and Lien* (Negative Pledge) and Chapter 13 *General Business Covenants*
- Moody's event risk covenant proposal

February 28th: INSTRUMENT STRUCTURE: COVENANTS II

- Paris, Chapter 14, *Financial Covenants*

March 6th: LEVERAGED TRANSACTIONS

- Paris, Chapter 2 *The Players*, pp. 36-42 (Leveraged buyouts)

March 7th First draft due.

March 13th: ISSUER LIQUIDITY MANAGEMENT

- Liquidity, OCC Handbook , pp. 1-3, 6-8, 9-22, 35-40.

March 20th: No class. Spring break

March 27th: SOVEREIGN DEBT: ISSUANCE, MANAGEMENT, AND RESTRUCTURING

- International Monetary Fund, *Sovereign Debt Restructuring Mechanism*, pp. 1-20, 29-35.

April 3rd: NO CLASS (WORK ON YOUR PAPERS)

April 10th: TRANSACTIONAL LAW SKILLS

- Paris, Chapter 9 *A Deal in Time* and Chapter 16 *Risk-based Review; Transaction Analysis*

April 17th: NO CLASS (WORK ON YOUR PAPERS)

April 18th: **Final paper due**

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III. Spring 2009 seminar: Finance Sector: Crisis and Regulation

The goal of the seminar is to examine the financial crisis that began in 2007 and to assess the efficacy of regulatory responses. Unlike other courses where you may study law in isolation, my approach emphasizes the role of key institutions, transactions, instruments, and market segments in the current financial crisis. The seminar also exposes you to the technical vocabulary and concept base of finance (“the financial register”), so that, after the seminar, most of you will feel substantially more comfortable discussing, analyzing, and working in financial law. In particular, I follow a “balance sheet” approach to modeling and understanding the financial situations of entities, countries, and other economic systems.

You are free to reach your own conclusions about our financial sector and its current state; the requirement of the seminar is that you reach and express these conclusions as part of an analytical framework that is formed by technical vocabulary, a concept base, and some classic themes about the relationship between law, markets, financial innovation, and systemic risk. Because our analytical framework is rich and dense, it may seem overwhelming at first, but I am confident that, if you invest in class time and your own directed study, you will be rewarded with increased proficiency in financial law.

To introduce the major course themes, we start by examining the American Insurance Group (AIG). The goal is to introduce the balance sheet, its conventions, and vocabulary. We also focus on the AIG business line that has justified a massive federal rescue – credit default swaps. The story of AIG is the story of the financial crisis and it introduces the vocabulary, themes, and dynamics which will occupy us all semester. It also introduces us to the study of financial intermediaries. Financial intermediaries play a key role in the financial economy because they broker funds based on the maturity, liquidity, and risk preferences of market participants. These intermediaries include private entities (like borrowing firms, commercial banks, investment banks, broker-dealers, hedge and equity funds), public entities (like the U.S. Department of the Treasury, the International Monetary Fund, and the state of Florida), and entities with both public and private elements (like the Federal Reserve and sovereign wealth funds).

The following week, we telescope out in order to analyze the function and structure of financial markets, emphasizing new trends in financial intermediaries, markets, and financial instruments. We take as a case study a unique financial intermediary – the U.S. Treasury. It is the world’s largest debt issuer and has assumed even more importance during the financial crisis. As with AIG, we will look at the Treasury’s balance sheet and, in particular, how it finances itself through debt issuance.

Then we identify precisely what and who we mean by ‘financial crisis’ by going through an event chronology of the financial crisis. This review emphasizes how risk cascaded through different product sectors, starting with subprime mortgages, moving into derivative securities based on these mortgages, spreading across the riskier part of the market (occupied by “junk” and leveraged products), and, surprisingly, finally spilling over into financial markets long seen as extremely stable, such as investment-grade commercial paper and collateralized borrowing through repurchase agreements. In addition to revealing the risk transmission channels across different asset classes and intermediaries, the chronology illustrates how financial regulators have been on a learning curve about the new credit market. After depleting their traditional supervisory and monetary tools, regulators responded to the financial crisis in an ad hoc

fashion, using statutory authority last used against the Great Crash to create special programs that extended the Federal Reserve's liquidity beyond the charmed circle of commercial banks and "bailing out" major intermediaries like Fannie Mae and Freddie Mac that were deemed to pose a systemic risk to the financial sector. When these ad hoc interventions failed to stop the crisis, the central bank, the White House, and Congress joined in the first major concerted response against the financial crisis: the Troubled Asset Relief Program of 2008 ("TARP") or, as I think of it, the "No Bank Left Behind" program.

We start our study of TARP by looking at the enactment process and the text of the statute itself, which suggests that the main purpose of the authority granted by TARP was to let the Secretary of the Treasury buy "troubled assets" of banks, i.e., loans or loan derivative products that had lost value. To date, though, it is not assets that have been purchased but, instead, preferred stock in banks and other financial institutions. (Again, we are working off a balance sheet perspective.) It is as though TARP funds were used to set up a sovereign wealth fund at the Treasury, one made up of preferred stock in troubled financial institutions.

We then adopt an intermediary perspective by focusing on what is emerging as the premier financial regulator in the United States—the Federal Reserve. We study its statutory capital structure to see that it is designed to function both as a public and private institution. Importantly, we examine trends in the Federal Reserve's balance sheet to appreciate how the central bank has come to absorb the risk that had formerly been in private balance sheets. Because the new administration is expected to announce some new regulatory initiatives for the financial market, we will also consider these proposals as they are introduced. To appreciate the international significance of the financial crisis, we also study the role of another key financial intermediary and regulator – the International Monetary Fund ("IMF"). By comparing IMF financial stability reports from 2007 to 2008, we see how financial regulators did an about-face in terms of their attitudes towards financial risk, going from risk-friendliness to financial pessimism, reminding us that there may be no escaping the boom and bust of financial cycles. We will also study how the current crisis revealed cross-border ties between credit markets. After a short break during which you will work on your papers, we meet for one final time to consider our tentative conclusions on the questions posed by the seminar.

Because much is happening in the credit markets, I may – with ample notice – change part of the topic sequence to take advantage of current events. Because the goal of a seminar is to develop the research and writing skills of participants, we will also use class time to discuss selected topics in organizing and drafting a research paper. On reserve at the law library I will put what I consider to be the finest guide to research writing – Booth, Colomb, and Williams, *THE CRAFT OF RESEARCH*. I encourage you to consult it throughout the semester.

RESEARCH FRAMEWORK

As you go through the course, ask yourself the following questions. There is no single right answer to any of them. Your papers can relate to one of these research themes or another that you clear with me:

- What led to the financial crisis?

- Which instruments, markets, practices, or entities played the most important role in the events leading up the financial crisis?
- How much of what led to the financial crisis was cyclical and how much of it was due to one-time events that are unlikely to be repeated?
- What is the relationship between the financial economy and industry? What role should law play in regulating the financial economy?
- What role should the federal government have in responding to these events?
- How does one's philosophical or economic orientation influence, first, our analysis of causes and, second, our policy recommendations?

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