FINANCIAL MARKETS IN RECOVERY

Tax and Regulatory Policy * Planning * Compliance

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Chapter 1

Days That Shook the Financial World: Timeline of a Crisis

Staff of the *Journal of Taxation and Regulation of Financial Institutions**

A BUSY SEPTEMBER 2008

Most employees of federal regulators at all levels have been working non-stop since the financial crisis began the week of September 15, 2008, with releases from the Federal Reserve, the SEC, and other agencies sometimes coming by the hour. Many agencies have posted news releases daily, or summary releases regarding their actions in the market crisis.[1] The following table is a sequential summary of related legal developments that occured in September:

Date/Agency/Summary Caption	Action/Analysis
Tuesday, September 16, 2008	
Federal Reserve Board Federal Open Markets Committee Rate Announcement	Target for the federal fund rate remains at 2%.
Wednesday, September 17, 2008	
Securities & Exchange Commission Short Selling/Accounting Rules	(1) SEC issues new short selling rules (discussed in Chapter 8, this Volume).[2] (2) SEC 's Office of the Chief Accountant, having received questions as to whether the actions by these sponsoring financial institutions may result in on-balance sheet accounting for supported money market funds, clarifies that bank support "generally does not result in a requirement to present the fund on-balance sheet."[3]

(Continued)

* This crisis timeline originally appeared as two separate articles, published in the November-December 2008 and March-April 2009 issues of *Journal of Taxation and Regulation of Financial Institutions*.

[1] See, e.g., CFTC News Rlease 5551-08 "CFTC Update on Efforts Underway to Oversee Markets" (September 19, 2008) (www.cftc.gov/newsroom/generalpressreleases/2008/pr5551-08.html).

[2] SEC, "Emergency Order Pursuant to Section 12(k)(2) of the Emergency Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments," Release 34-58572 (September 17, 2008) (available at www.sec.gov/rules/other/2008/34-58572.pdf), 73 Fed. Reg. 54875 (September 23, 2008).

[3] SEC Press Release 2008-205, "Bank Support for Money Market Mutual Funds" (September 17, 2008) (www.sec.gov/news/press/2008/2008-205.htm).

Chapter 2

Credit Rating Agencies: When a Solution Becomes Part of the Problem

Joan Teresa Kay*

The Securities and Exchange Commission has proposed rule amendments for nationally recognized statistical rating organizations (NRSROs) "in light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages."[1] The SEC is also proposing that credit ratings for structured finance products could carry a different symbol than ratings for other types of obligors or debt securities. NRSROs would not have to use such a different symbol system, but because of burdens that would be required if they did not, most will be expected to do so. Modifications of the Form NRSRO by which rating agencies register with the SEC are also proposed, along with additional requirements regarding confidential reports that are submitted to the SEC under 17 CFR 240.17g-3.

This is just one set of a series of proposed rules. Thus, the NRSROs are likely to complain that the rulemaking adds to their regulatory burden while diminishing the importance of the services regulated. They may also note that even if the SEC is trying to distance itself from NRSROs, the Federal Reserve, in actions taken during the financial crisis,[2] has made more than a few references to NRSROs and the ratings.

SUBPRIME IMPACT

The SEC's concern with NRSROs began with the effects of the decline in the real estate market on residential mortgage-backed securities (RMBSs) backed by subprime loans and on collateralized debt obligations (CDOs) linked to such loans. Lenders were able to move subprime loans off their balance sheets by packaging and selling them as RMBSs and CDOs. The extent of this activity is indicated by the fact that of the approximately $2.5 trillion worth of mortgage loans originated in 2006, $1.9 trillion were securitized into RMBSs. Approximately $520 billion, more than a quarter of the $1.9 trillion in loans, were subprime.

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[1] "Proposed Rules for Nationally Recognized Statistical Rating Organizations," SEC Release 34-57967, 73 Fed. Reg. 36212 (June 25, 2008). See Appendix 2.1 at the end of this chapter.

[2] See events of Friday, September 19, 2008, outlined in Chapter 1 of this volume.

Chapter 3

Credit Default Swaps and the Financial Crisis

Richard R. Lindsey*

It is widely recognized that we are in the midst of the most serious financial crisis since the late 1920s. Millions of people are defaulting on mortgages; the world's financial markets have been shocked both by enormous losses and by the fear that there are more losses to come; financial institutions that were once household names have been forced into bankruptcy or fire sales; and governments around the world are attempting to stabilize the markets with coordinated policies, interest rate cuts, and even direct cash infusions. In the middle of our collective shock at the magnitude and range of this calamity, everyone is looking for the culprit—what caused this crisis? Was it the greed of Wall Street? Incompetent regulators? Deregulation? Derivatives?

Recently there has been a focus on derivative products and, in particular, credit default swaps (CDS). I will provide a brief overview of the credit default swap market and address certain fundamental facts associated with financial derivatives (focusing on credit default swaps) in an attempt to clarify and correct some of the misconceptions that have been widely reported in the popular press. I will then discuss the systemic risks inherent in the use of credit derivatives, the role of regulation in controlling those risks, and what can and should be done to mitigate those risks.[1]

FINANCIAL DERIVATIVES—MYTH AND REALITY

In general, financial derivatives take two forms: (1) exchange-traded derivatives, which are traded on recognized exchanges or boards of trade, and (2) over-the-counter ("OTC") derivatives, which are privately negotiated, customized bilateral contracts, the obligations under which may only be transferred under certain agreed upon terms.

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[1] For more on credit derivatives, see David Mengle, "Credit Derivatives: An Overview," (2007 Financial Markets Conference, Federal Reserve Bank of Atlanta, April 2007) (posted on the website of the Federal Reserve Bank of Atlanta at www.frbatlanta.org/-filelegacydocs/erq407_mengle.pdf); Frank Partnoy and David A. Skeel, Jr., "The Promise and Perils of Credit Derivatives," University of Pennsylvania

Chapter 4

Summary of the Tax Provisions of the Emergency Economic Stabilization Act of 2008

John B. Palmer III, Timothy L. Voigtman, Jeffrey J. Jones, and Michael H. Woolever*

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008.[1] The main thrust of this legislation is the establishment of the Troubled Assets Relief Program ("TARP"), which is intended to restore liquidity and stability to the financial system.

Although it was originally envisioned that TARP would center around the acquisition of troubled assets from participating financial institutions, the TARP program has evolved substantially since enactment. On October 14, 2008, the U.S. Treasury Department announced the development of three separate programs under TARP—the Troubled Asset Auction Program ("TAAP"), the Capital Purchase Program ("CPP"), and Programs for Systemically Significant Failing Institutions—and issued guidance with respect to each program.[2] Since then, the Treasury has focused much more attention on CPP[3] than on TAAP.[4]

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[1] PL 110-343.

[2] Notice 2008-TAAP under section 111(c) of EESA (posted on Treasury's website, at www.ustreas.gov/initiatives/eesa/docs/Exec%20Comp%20TAAP%20Notice.pdf), Notice 2008-PSSFI under section 111(b) of EESA (also on Treasury's website, at www.ustreas.gov/initiatives/eesa/docs/Exec%20Comp%20PSSFI%20Notice.pdf); and 31 CFR Part 30, 73 Fed. Reg. 62205 (October 20, 2008) (containing interim rules under the TARP Capital Purchase Program).

[3] On October 12, 2008, the Treasury announced that up to $250 billion in TARP funds would be disbursed under CPP. On October 26, 2008, the Treasury purchased $115 billion in preferred stock from the nation's nine largest banks under CPP, and it has continued to make such purchases from both banks and other institutions since that time. Statement by Secretary Henry M. Paulson, Jr. on the Capital Purchase Program (October 20, 2008, HP-1223); Remarks by Secretary Henry M. Paulson, Jr. on Financial Rescue Package and Economic Update (November 12, 2008, HP-1265).

[4] On November 12, 2008, Secretary Paulsen announced that the purchase of troubled assets under TAAP "is not the most effective way to use TARP funds, but we will continue to examine whether targeted forms of asset purchase can play a useful role . . . ." Remarks by Secretary Henry M. Paulson, Jr. on Financial Rescue Package and Economic Update (November 12, 2008, HP-1265).

Chapter 5

New Considerations in Debt Workouts Under the American Recovery and Reinvestment Act of 2009

Thomas A. Humphreys, Stephen L. Feldman, Robert A. N. Cudd, Arthur Man, and Armin M. Gharagozlou*

On February 17, 2009, the American Recovery and Reinvestment Act of 2009 ("ARRA") was signed into law. ARRA adds Section 108(i) to the Internal Revenue Code (the "Code"), which permits certain taxpayers to elect to defer, for federal income tax purposes, the recognition of cancellation-of-indebtedness ("COD") income arising from certain repurchases, exchanges, or modifications of outstanding debt that occur during 2009 and 2010. ARRA also amends Section 163(e)(5), suspending the limitations on interest deductions for certain applicable high yield discount obligations ("AHYDOs") issued in 2008 and 2009. While temporary, these provisions should facilitate or remove barriers from the repurchase, refinancing, or restructuring of debt instruments trading at discounts.

BACKGROUND: CANCELLATION OF INDEBTEDNESS INCOME

In general, COD income results when a taxpayer has its debt discharged without fully repaying the amount originally borrowed. The discharge is generally taxable income in the year of discharge for federal income tax purposes unless otherwise exempted under the Code.[1] For example, if a taxpayer borrows $100x at a single fixed interest rate payable annually, the $100x is not taxable in the year of the borrowing because the taxpayer is obligated pay it back. However, if the lender forgives $30x of principal so that the taxpayer has to pay only $70x in full satisfaction of the debt, then the $30x is generally income includible in the year of discharge (unless otherwise

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[1] Section 61(a)(12) (gross income means all income from whatever source derived).

Chapter 6

Whither TARP? Was Treasury's Creative Interpretation of the Legislation Inevitable? Where's the Monitoring?

Joan Teresa Kay*

In *Troubled Assets Relief Program: Additional Actions Needed to Better Ensure Integrity, Accountability, and Transparency* ("GAO I"),[1] issued on December 2, 2008, the Government Accountability Office began its review of the government's actions in the financial crisis.[2]

EMERGENCY ECONOMIC STABILIZATION ACT

On October 3, 2008, Congress passed and the President signed the Emergency Economic Stabilization Act of 2008 (EESA), which established the Office of Financial Stability (OFS) inside of Treasury, and provided Treasury with the authority to buy up to $700 billion of troubled assets under the Troubled Asset Relief Program ("TARP"). The legislation also created the Financial Stability Oversight Board, including the Chairman of the Federal Reserve, the Secretary of the Treasury, the Director of the Federal Housing Finance Agency (FHFA), the Chairman of the SEC, and the Secretary of Housing and Urban Development (HUD).[3] The Act also created a Special Inspector General for the program[4] as well as a Congressional Oversight Panel.

EESA also allowed Treasury to purchase and insure mortgages and securities based on mortgages and, in consultation with the Chairman of the Board of Governors of the

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[1] GAO-09-161 (December 2, 2008).

[2] See also Testimony of Gene L. Dodaro, Acting Comptroller Gernal, GAO-09-266T (December 10, 2008).

[3] The Congressional Oversight Board's members now include Richard H. Neiman, Superintendent of Banks in New York (appointed by the Speaker of the House); Representative Jeb Hensarling (appointed by the House Republican Leader); Elizabeth Warren, Harvard Law School (appointed by the Senate Majority Leader); Senator Judd Gregg (appointed by the Senate Republican Leader); and Damon Silvers, of the AFL-CIO Associate General Counsel, (jointly appointed by the Speaker of the House and the Senate Majority Leader).

[4] EESA, § 121.

Chapter 7

Kudos to the Tax Writers: The Bailout Demanded Quick Answers and the Government Responded Admirably

Robert N. Gordon*

The government rescue plan inevitably will produce many villains. But one group that has performed like heroes through this turmoil are the Washington tax writers, who acted quickly to remove possible tax roadblocks in order to free up seized credit markets. As Steve Rosenthal, an attorney with Ropes & Gray LLP, said to me, "Sometimes Washington works really well."

All of the activity was summed up by attorney Bill Paul of Covington & Burling LLP, who was quoted as saying that "Treasury and IRS are in high gear in their efforts to address tax uncertainties arising as a result of the crisis in the credit markets . . . the pace at which they are able to generate the guidance is remarkable."

First, before the current crisis but helpful in it, came Notice 2008-27,[1] which was needed because of the mess in auction rate securities. The notice made clear that a debt modification is not a new issuance. The notice was written—

> to provide greater certainty and flexibility to address certain potential federal tax issues that have arisen in the tax-exempt bond market as a result of recent

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[1] 2008-10 IRB 543, which Notice 2008-41, 2008-15 IRB 742, "clarifies, amends, supplements, and supersedes." ("This [Notice 2008-41] retains the basic rule framework outlined in Notice 2008-27 except that it makes certain technical changes and extends, temporarily, the period of time, from 90 days to 180 days, during which an issuer may hold qualified tender bonds prior to their remarketing without causing such bonds to be treated as retired. This notice also introduces a temporary rule which allows a governmental issuer to purchase and hold its own tax-exempt auction rate bonds for 180 days without causing a retirement or extinguishment of the debt represented by the purchased tax-exempt bonds.") On October 1, in Notice 2008-88, 2008-42 IRB 933, the IRS amended and supplemented Notice 2008-41, by (1) providing that the Treasury Department and the IRS will treat a tax-exempt "qualified tender bond" (as defined in Notice 2008-41) or "tax-exempt commercial paper" (as defined in § 2 of this Notice) that is purchased by its "governmental issuer" (as defined in Notice 2008-41) on a temporary basis as continuing in effect without resulting in a reissuance or retirement of the purchased tax-exempt bond if the governmental issuer holds the bond until not later than December 31, 2009; and (2) extending the final date for the purchase of bonds pursuant to a qualified tender right, and the final date on which covered waivers of interest rate caps are disregarded, to December 31, 2009.

Chapter 8

Clothing and Disclosing the Short: SEC Tightens Short-Selling Regulations

Alexis B. Stokes and Peter A. Stokes*

Proclaiming "zero tolerance for naked short selling,"[1] and a commitment to "using every weapon in its arsenal,"[2] the Securities and Exchange Commission adopted a series of new rules in September 2008 intended to prevent "unlawful manipulation" of stock prices by short sellers.[3] State regulators, too, have increased investigative and enforcement efforts against alleged short selling abuses. These actions reflect ongoing concerns that manipulative short sellers may be exacerbating the recent crisis on Wall Street.

HARD T+3 DELIVERY REQUIREMENT

The centerpiece of the new SEC short-selling regulations is a "hard T+3" delivery requirement intended to eliminate naked short positions.[4] In a naked short sale, the short seller sells shares of stock that it does not possess or intend to possess, pockets the sale proceeds, and never delivers the shares to the buyer[5]—a practice that critics believe can artificially depress an issuer's stock price and cause instability. The new "hard T+3" rule, which the SEC adopted on an interim final basis, aims to stop this practice by requiring short sellers and their broker-dealers to deliver securities by the close of business on the settlement date (three days after the sale transaction date, or "T+3"), and by imposing strict penalties for violations of this rule.[6] Under the new regulations,

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[1] SEC Press Release, "SEC Issues New Rules to Protect Investors Against Naked Short Selling Abuses," September 17, 2008 (available at www.sec.gov/news/press/2008/2008-204.htm) ("September 17 Press Release").

[2] SEC Press Release, "SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets," September 19, 2008 (available at www.sec.gov/news/press/2008/2008-211.htm) ("September 19 Press Release").

[3] September 17 Press Release.

[4] See id.

[5] See, e.g., September 17 Press Release.

[6] SEC Release 34-58572 (September 17, 2008) (available at www.sec.gov/rules/other/2008/34-58572.pdf), 73 Fed. Reg. 54875 (September 23, 2008) ("SEC Release 34-58572").

Chapter 9

The Impact of the Credit Crisis and Weaker Economy on U.S. States and Municipal Entities

Nick Samuels*

This chapter summarizes Moody's perspective on the potential short- and long-term credit challenges currently faced by states and closes with more general comments on credit challenges for local government and enterprise issuers.

Our primary conclusions with regard to credit challenges at the state level are that:

- The current credit market disruption has caused states that issue variable rate debt greater near-term expense but has not posed any long-term financial stress. However, states that rely on cash flow borrowing to even out low points in tax receipts during their fiscal years—especially those that needed to issue notes before the end of 2008—may be more severely affected if sufficient market access is not restored soon.
- The weakening economy creates long-term financial stress for states. Sales taxes—on average approximately one-third of state general fund revenue—are likely to continue to decline as consumer spending retracts in reaction to the weak economy.
- Moody's also expects state personal income taxes to weaken further during the next year. Withholding personal income taxes will decline as payrolls contract and as bonuses decline, especially in states dependent on manufacturing, construction, and financial services employment. Non-withholding personal income tax collections will fall in tandem with the weaker stock market, decline in the exercise of stock options, fewer and lower estimated tax payments, and larger tax refunds. Personal income taxes, on average, account for nearly 40% of state general fund revenue.
- While representing significantly smaller percentages of state revenues, corporate business taxes and mortgage transfer taxes are likely to continue to fall off due to the weaker economy and real estate market.

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Chapter 10

When Market Risk Becomes a Credit Factor: Short-Term Markets and Government's Response

Natalie R. Cohen*

Low borrowing rates and juiced-up investment returns have long been the Holy Grail of financial market professionals. As credit market inventors have come up with new products, state and local governments have been counted among the willing customers. With lots of available cash to invest (coupled with aggressive marketing of these new products) and a good supply of paper (thanks to a cash-hungry federal government), structured products have been the answer to state and local governments' prayers. Both corporate and public-sector investment managers have been active participants in this market. The first catch is that it works only in the right interest rate environment. The second catch is that it works only when the assets securing the debt are available and performing.

What is now frequently dubbed the "100-year storm" in financial markets has rapidly worked damage across all aspects of the U.S. and world economy. State and local governments have already reported sharp losses in first-line revenues—mortgage transfer taxes, sales taxes, and gas taxes—followed soon after by losses in corporate and personal income taxes, property taxes, and investment losses in pension funds and endowments. A look back to recent history however, shows that the perfect storm makes its appearance with regularity. More unusual is the glow of amnesia that settled over financial markets and participants during the latest bubble.

Excessive leverage, insufficient collateral, betting on interest rate movements, inventive structures combining short-term borrowing with long-term investing—the very same features that tripped up state and local government in the 1970s, 1980s, and 1990s—are with us again today. What differs from prior crises is the extensive global and systemic reach of today's storm into the pockets of governments, corporations, and individuals across the world. While causes of today's crisis will be the subject of authoritative books for years to come, this chapter focuses specifically on the short-term markets and touches on the history of these repeated perfect storms and, more specifically, on the consequences for state and local governments.

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Chapter 11

Municipal Market Struggles to Maintain Broad Retail Participation Without Bond Insurance

Paul Kwiatkoski*

INTRODUCTION

Like other credit markets, the credit crisis has had a profound effect on the U.S. municipal market. Much of the municipal market's supporting infrastructure and process, and many of its long-standing practices, have been changed, if not permanently altered. The structure of the market going forward will have to adapt in ways that incorporate the effects of this crisis, an upheaval that could strip the market of one of its principal actors—bond insurers. If this occurs, the market will have to find new means to achieve the value previously produced by bond insurers.

Retail investors are the dominant holders of municipal bonds and are expected to continue to be so. Retail investors and bond insurers have had a mutually beneficial relationship because bond insurance is a product that provides bond investors with value in several respects. An important question for the municipal market to address as it recovers from the credit crisis is how retail investors can function in an environment where fewer of these services may be provided from the traditional sources. Furthermore, the means by which these questions are addressed can have a significant effect upon state and local borrowing costs going forward.

The municipal market has important characteristics that have contributed to the ways in which it developed prior to the credit crisis. These include:

- Fragmentation;
- Poor disclosure; and
- Retail reliance.

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The author would like to note with appreciation the thoughtful and constructive review and comments by Steven Klein, David Stevens, and Charles Webster.

Chapter 12

What Happens When Municipal Bond Insurance Companies Lose Credit?

Dwight V. Denison*

Bond insurance appeared in the municipal bond market about 40 years ago and since that time has penetrated more than 50% of the municipal bond market. During the last year, however, bond insurance use nearly disappeared when the credit ratings of the major bond insurance firms were downgraded due to portfolio exposure to tainted mortgage security investments. This chapter discusses the role that bond insurance plays in the municipal bond market and comments on the impact that the demise of the bond insurance industry will have on bond buyers, issuers, and insurers in the municipal bond market.

Municipalities in the United States first began to issue municipal securities around 1812 (Godfrey, 1990, p. 18). Use of the tax-exempt bond market escalated each year so that by the beginning of the 20th century, the annual issue was well over $150 million. During the following decades, use of the tax-exempt markets exploded, and in 1919, the annual issue of municipal bonds exceeded $1 billion. The municipal bond market continued this rapid explosion, and by 1970, the tax-exempt bond market was fast approaching $150 billion in total outstanding debt. The volume of municipal bonds in the market over nearly half a century is illustrated in Figure 12.1. The municipal bond market has maintained this exponential growth to the point that the outstanding debt now exceeds $2.5 trillion.

Bond insurance basically guarantees the timely payment of principal and interest to the bond buyer in the event that the issuer is unable to make payments. In 1971, the first municipal bond insurer, American Municipal Bond Assurance Corporation (AMBAC), began to insure municipal bond issues. Later, other companies, such as the Municipal Bond Investors Assurance Insurance Corporation (MBIA), Financial Guaranty Insurance Company (FGIC), and Assured Guaranty Corporation (AGC), began insuring municipal bond issues. By 2007, the outstanding volume of insured

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Chapter 13

State and Local Government Finance in the Current Crisis: Time for Emergency Federal Relief?

David E. Wildasin*

INTRODUCTION

State and local governments are among the many institutions, both public and private, that are suffering from the recent turmoil in financial markets. Disruptions of the market for auction-rate securities, doubts about the financial stability of municipal bond insurers (reflected in downgrades by rating agencies), and uncertainty about the meaningfulness of bond ratings themselves are among the symptoms of this turmoil.[1] Increasingly, stresses arising within the financial markets are compounded by changing economic conditions. A downturn in overall economic activity is reducing revenue flows to state and local governments at the same time that demands for many public services—income- and employment-conditioned social services in particular—are rising. As of the time of writing, it is far too early to draw any firm conclusions about the fundamental causes and ultimate consequences of the current economic and financial crisis. But it may be useful to review some branches of previous research, based on the experience of subnational government finance in the United States and abroad, that can provide some partial insights into recent events. As will become apparent, our

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The author is grateful to T. Buettner for comments on an earlier version of this paper but retains responsibility for the views expressed here, as well as for any errors or omissions. Dr. Wildasin can be reached by email at *dew@davidwildasin.us*.

[1] Many examples could be cited to illustrate the difficulties facing bond market participants. This quotation, from a December 2007 news report (Barr, 2007), captures some of the flavor:

> By issuing warnings on FGIC and XL Capital Assurance, [Moody's] is also putting more than 90,000 securities that the companies had guaranteed on review for a possible downgrade, according to global fixed-income analysts at UBS. The majority of those securities—89,709—are in the public finance sector, the analysts said, noting that this was "unprecedented" in the municipal bond market.

Chapter 14

The Other "S&L Crisis": A Policy Window for Reform?

Beth Walter Honadle*

The "Other 'S&L Crisis'" refers to the dire circumstances state and local governments (S&Ls) are currently experiencing. Some of the problems are recent and beyond the control of these governments, but some of the challenges stem from policies they pursued in the past. Two examples are the commitment to provide post-retirement benefits to public employees without having funded those liabilities, and the widespread use of tax abatements to lure industry. The latter practice has had several unintended consequences, including inequitable taxation, underinvestment in infrastructure, and forgone tax revenues. Of the measures available for dealing with the current crisis—including doing nothing—this chapter argues that providing federal funds to state and local governments to fund programs to assist people in need and to build infrastructure is a promising option.

Nearly 20 years ago, Charles Goldner wrote:

> The . . . evidence paints a dark picture: there will be no short-term easing of the fiscal problems of state and local governments. . . . The states, municipalities, investment bankers, debt rating agencies, and residents all realize that serious fiscal problems exist. . . . Will the fiscal problems be resolved in a timely, responsible, and efficient way? (Goldner, 1991, p. 925)

As we consider the effects of the current financial crisis on state and local public finance, we see that previous eras provide parallels in terms of the nature of the problems and their seriousness, scope, and magnitude. The passage quoted above from an article published nearly two decades ago could just as easily have been written today.

THE CONTEXT

It is beyond the scope of this chapter to delineate the causes of the current problems, but some review of recent developments is provided for context. The global

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The author would like to thank James M Costa, senior vice president and head of credit strategies of Wachovia Risk Management, and two anonymous reviewers for comments and advice on an earlier draft. Dr. Honadle takes full responsibility for any shortcomings in the final article. She can be reached by email at *beth.honadle@uc.edu*.

Chapter 15

The Current Impact of the Tightening Credit Market on Municipal Borrowing Costs: A Case Study

Jane Beckett-Camarata*

INTRODUCTION AND BACKGROUND

This chapter describes a multiple case study of the current impact of the tightening credit market on municipal borrowing costs. The goal of the research was to collect data to assess the current impact of tightening credit markets on municipal borrowing costs. Because of the subprime mortgage market problems and subsequent tightening of the credit market, local governments have seen an increase in borrowing costs (DiNapoli, 2008). In the past, local governments have used these markets for obtaining relatively low interest funds and timely borrowing. Although the municipal bond market is currently very large (Simonson, Robbins, & Helgerson, 2001), "this $2.7 trillion municipal bond market is in a 'deeply depressed state' by historical standards" (Phillip Fischer, as quoted by Herman (2008)). General obligation bond sales have decreased 60.5% compared to 2007, and the new-issue market will probably not increase until early in 2009 (Bond Buyer, 2008).

The subprime mortgage crisis affects the municipal bond market in two ways: Banks have been affected by the falling value of the mortgage bonds they hold; and banks have reduced lending, regardless of the creditworthiness of the borrower. Many banks that purchased municipal bonds in recent years have currently experienced significant financial problems. These banks are now selling those bonds. As a result, some local governments that are seeking to issue bonds are having difficulty finding banks that are willing to underwrite their debt at interest rates feasible for the local governments, even for AAA-rated issues. The problems stem from the reduction in the number of Wall Street banks that provide municipal bond underwriting and the collapse of secondary market making.

With the loss of Bear Stearns and Lehman Brothers, and the sale of Merrill Lynch, the municipal bond market has been considerably weakened. In addition, Citigroup,

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Chapter 16

Subprimes, Shortfalls, and Spillovers: The Impact of the Financial Crisis on Mortgage-Related Revenues in NYS Counties

Helisse Levine*

INTRODUCTION

It is the best of times, the worst of times, unprecedented times. To say that the pervasive practice of subprime mortgage lending has had an extraordinary impact on both private and government sectors is an understatement at the very least. At this writing, it has cost banks and financial institutions more than $435 billion in write-downs and credit losses (O'Rourke, 2008), driven millions of residents from their homes across the country (Aversa, 2008), and adversely affected state and local government revenues (Saulny, 2008; Walsh, 2008). From individual home foreclosures to multi-million dollar corporate bankruptcies and historical government takeovers, it has become increasingly apparent that few individuals, corporations, and/or government entities will go unscathed. Specifically, for state and local governments, the consequences of financial crises are high taxes, inadequate government services, or some combination of the two (Mikesell, 2002).

The financial crisis of 2008 is further exacerbated by a declining economic environment that is forcibly challenging subnational governments more than ever before with the task of staying whole amid ever-increasing challenges. Such challenges include:

- Declining tax receipts associated with mortgage sales;
- Decreased property tax revenues from unsold homes and plummeting assessed property values;

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Chapter 17

The New York State Insurance Department and Credit Default Swaps: Good Intentions, Bad Idea

Andrea S. Kramer, Alton B. Harris, and Robert A. Ansehl*

Acting in the belief that the use and misuse of credit default swaps (CDSs) were in large part responsible for the extraordinary current financial crisis,[1] the New York State Insurance Department (NYID) on September 22, 2008, issued Circular Letter No. 19 (2008) (Circular 19) announcing that as of January 1, 2009, it would view CDSs as insurance contracts if they are purchased by persons with a "material interest" in the referenced bonds or assets (covered CDSs).[2] At the same time, the Governor of New

* © 2008 by Andrea S. Kramer, Alton B. Harris, and Robert A. Ansehl. All rights reserved. An earlier version of this chapter was published in the January-February 2009 issue of *Journal of Taxation and Regulation of Financial Institutions.* Portions of this chapter originally appeared in Ms. Kramer and Mr. Harris' chapter, "Credit Derivatives, Insurance, and CDOs: The Aftermath of Enron," published in *Structured Finance & Insurance* (Christopher L. Culp ed., John Wiley & Sons, Inc. 2006). Ms. Kramer is a partner in McDermott Will & Emery LLP. Mr. Harris is a partner in Ungaretti & Harris LLP. Mr. Ansehl is a partner with Nixon Peatody. Ms. Kramer can be reached at akramer@mwe.com, Mr. Harris can be reached at abharris@uhlaw.com, and Mr. Ansehl can be reached at ransehl@nixonpeabody.com.

1 With allegations that CDSs are at the root of the global financial crisis, gaps in CDS regulation have come into the spotlight. See Alex Blumberg, "Unregulated Credit Default Swaps Led to Weakness" (available at www.npr.org/templates/story/story.php?storyId=96395271); James B. Kelleher, "Buffett's 'Time Bomb' Goes Off on Wall Street," Reuters, September 18, 2008. Wolfgang Munchau, "Not Merely a Subprime Crisis," Financial Times, January 14, 2008 (available at www.eurointelligence.com/index.php?id=581&type=98&tx_ttnews[tt_news]=1996). As Eric Dinallo, Superintendent, NYID, said in addressing CDSs:

> The unregulated marketplace in credit derivatives was a central cause of a near systemic collapse of our financial system. Credit default swaps played a major role in the financial problems at AIG, Bear Stearns, Lehman and the bond insurance companies. A major cause of our current financial crisis is not the effectiveness of current regulation, but what we chose not to regulate.
>
> "Testimony To The United States House Of Representatives Committee On Agriculture Hearing To Review The Role Of Credit Derivatives In The U.S. Economy" (by Eric Dinallo, Superintendent, New York State Insurance Department (November 20, 2008)) (www.ins.state.ny.us/speeches/pdf/sp0811201.pdf) (hereinafter "Dinallo Testimony"). See also Press Release, New York State Insurance Department, Recognizing Progress by Federal Government in Developing Oversight Framework for Credit Default Swaps, New York Will Stay Plan to Regulate Some Credit Default Swaps (November 20, 2008) (available at www.ins.state.ny.us/press/2008/p0811201.htm).

2 New York State Insurance Department, Circular Letter No. 19 (September 22, 2008) (available at www.ins.state.ny.us/circltr/2008/cl08_19.pdf) (hereinafter Circular 19).

Chapter 18

"I Never Knew It Could Be Like This": Lessons From the 1980s for California's Budget Crisis

Daniel J. B. Mitchell*

In the film *From Here to Eternity*, after a passionate embrace on a wave-swept beach, Deborah Kerr says to Bert Lancaster, "I never knew it could be like this." Some observers of the latest California budget fiasco—including Governor Arnold Schwarzenegger—have suggested that no one could have known that California would find itself in 2008 in a fiscal crisis of the same magnitude as the crisis that culminated in the 2003 recall of the governor's predecessor, Gray Davis. Indeed, when Governor Schwarzenegger signed the previous year's budget in August 2007, he proclaimed—incorrectly—that he had achieved a zero-deficit budget.

But although he may feel that his fiscal predicament is unique, Arnold Schwarzenegger is not the first California governor to inherit a budget crisis, solve it sufficiently to be re-elected, and then end up where he started as his second term progressed. Another Republican, George Deukmejian, had a similar experience in the 1980s. Deukmejian, however, had two advantages relative to Schwarzenegger.

One was an accident of timing. The renewed crisis came late enough in Deukmejian's second term that he was able to hand it off to his successor, Pete Wilson. The second advantage was that voters did not impose term limits until the end of the Deukmejian regime. Thus, Deukmejian had experienced legislative leaders with whom to work on fiscal matters. That fact helped him overcome the disadvantage faced by contemporary California governors: the requirement—dating back to the Great Depression—that budgets be enacted by a two-thirds vote of both houses of the legislature.

Both Governors Deukmejian and Schwarzenegger took steps that, inadvertently perhaps, reduced the ability of the state to accumulate a reserve during good times. In the Deukmejian case, the misstep—which we will see was partly directed by

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Chapter 19

Holding a Hot Potato? The Credit Crisis and Its Impact on State Cash and Short-Term Investment Portfolios

Beth-Anne S. Leech*

INTRODUCTION

The adverse effects of economic downturns on state and local government revenues and expenditures have been well documented (e.g., McGranahan, 2002; McGuire & Steuerle, 2003; Poterba, 1994). Often overlooked, however, is the impact these downturns have on cash and short-term investment portfolios. Cash is often considered to be immune from losses and risks in the market except over the longer term, when inflation will erode its purchasing power. Investors assume that U.S. Treasuries, certificates of deposits, commercial paper, repurchase agreements, and other short-term investments are "safe," that is, risk-free (de Luna, 1999). However, cash equivalents, short-term investments, and even cash, are vulnerable to severe economic declines and mismanagement.

State and local governments manage large sums of money through their pension funds, trusts, reserve funds, and cash balances in their operating funds. Although the National Association of State Treasurers (NAST, 2006) conducts periodic surveys of state treasury management practices, including cash management, relatively little has been written—beyond recommended practices for government financial officers—about state and local government cash management and short-term investment practices and the income derived from those investments. The purpose of this chapter is to provide an overview of the cash and short-term investment management of state government treasuries and investment pools and to discuss the effects that the current recession will have on these holdings. In doing this, it seeks to answer two research questions:

1. To what extent are cash and short-term investment holdings exposed to market risk during declining economic markets?

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Chapter 20

Managing Fiduciary Risk Associated With the Administration of Complex Financial Instruments and Structures in Fiduciary Accounts

Suzanne L. Shier*

Financial institutions that act in a fiduciary capacity face increasing challenges in connection with the administration of complex financial instruments and structures in fiduciary accounts. Recent experience with auction rate securities in fiduciary accounts is a sobering reminder of the risks associated with the management of such investments. Hedge fund products are another example of increased complexity in fiduciary account administration, as over the past 30 years the hedge fund industry has grown to an estimated 8,000 funds with approximately $2 trillion in assets and many fiduciaries have expanded their asset allocations to hedge funds.[1] This chapter discusses the recent experience with auction rate securities in fiduciary accounts as a type or example of considerations germane to investment in any complex financial instrument, product, or structure in a fiduciary account.

BRIEF HISTORY OF AUCTION RATE SECURITIES

An auction rate security typically refers to a debt instrument (corporate or municipal bonds) with a long-term nominal maturity for which interest is regularly reset through a "dutch" auction (typically every seven to 35 days). In the auction, broker-dealers submit bids on behalf of potential buyers and sellers of the bonds. Based on the

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[1] The Asset Managers' Committee to the President's Working Group on Financial Markets issued Best Practices for the Hedge Fund Industry and the Investors' Committee to the President's Working Group issued Principles and Best Practices for Hedge Fund Investors on April 15, 2008. The Investors' Committee report includes a Fiduciary Guide which provides guidelines for evaluation of the appropriateness of hedge funds as a component of an investment portfolio. The full reports can be found at www.amaicmte.org.

Chapter 21

FDIC Coverage, Asset Titling, and Tax Planning in Response to the Emergency Economic Stabilization Act of 2008

Caroline K. Craig and Richard B. Toolson*

The Emergency Economic Stabilization Act of 2008 (EESA) was signed into law on October 3, 2008, in an attempt to shore up the U.S. banking system and stabilize financial and credit markets in the midst of almost unprecedented turmoil resulting from the subprime mortgage meltdown that began during summer 2007.[1] In addition to the federal government's $700 billion bailout package of bank equity injections and purchases of "toxic paper," securities collateralized by home mortgages issued to less than creditworthy borrowers, two other key provisions of EESA had an important and immediate effect on all interest-bearing bank deposits covered by the Federal Deposit Insurance Corporation (FDIC). These two provisions were (1) to increase immediately, but temporarily, the FDIC limit per account from $100,000, where it has stood since 1980, to $250,000 and (2) to grant the FDIC unlimited borrowing power from the U.S. Treasury on an as-needed basis.[2]

In addition to these two legislative provisions, two other changes were also made to FDIC coverage rules. First, effective September 26, 2008, the FDIC Board approved an interim rule to eliminate the so-called "kinship requirement" that restricted FDIC

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[1] PL 110-343. While many believe the credit crisis began in summer 2007 with the closing of two Bear Stearns hedge funds that were heavily invested in collateralized debt obligations, the severity of the crisis accelerated when Bear Stearns, as a firm and the fifth largest U.S. investment bank, declared bankruptcy in March 2008. During the next six months, the following events also occurred: (i) FDIC seizure of Washington Mutual resulting in the biggest bank or savings & loan failure in U.S. history, followed by the FDIC-facilitated acquisition of Washington Mutual assets by JPMorgan Chase; (ii) acquisition of Wachovia Bank, a large regional bank, by Wells Fargo; and (iii) change in the status of the other four largest U.S. investment banks with Lehman Brothers declaring bankruptcy, Merrill Lynch being acquired by Bank of America, and Morgan Stanley and Goldman Sachs converting to commercial banks (from investment banks) to attract deposits and stabilize their financial positions.

[2] HR 1424, Sections 136(a)(1) and (a)(3), respectively.

Chapter 22

Tax Consequences of Distressed Debt Investing

Russell E. Nance and Daniel R. Read*

Investing in distressed debt instruments is not a new practice. However, current financial conditions have created an abundance of opportunities for such investments, resulting in an intense focus from potential investors of all kinds. Coupled with the burgeoning interest in distressed debt is a need to understand the tax consequences of these investments—consequences that are not always intuitive. This chapter discusses the fundamental tax consequences to investors of these distressed debt investments.

The first part of this chapter discusses the general tax treatment of investors upon receipt of payments on distressed debt investments, and how general and well established tax principles are implicated by investments in these assets. Specifically, this part addresses the distinction between the treatment of interest versus the treatment of principal payments and the potential impact of the market discount rules that would recharacterize payments of principal into ordinary income, as a substitute for interest payments. Also discussed is the general tax principle of the doubtful collectibility doctrine and the unexpected results that can occur when applied to debt instruments with original issue discount. The following part discusses the various tax issues involved in actively working out distressed debt investments. By working out a distressed debt instrument, an investor may find itself party to a deemed exchange for tax purposes that, depending on the nature of the "old" and "new" instrument, could have the result of triggering significant gain on the exchange or creating original issue discount on a new debt instrument. Finally, the last part of this chapter addresses the interaction of the two regimes that could be implicated in dealing with a loss on a distressed debt investment: the worthless security rules and the bad debt deduction. In some circumstances, application of these long-existing general principles in the context of distressed debt investing can yield what might be unexpected, and at times irrational, results.

This chapter only addresses the tax consequences to the investors in distressed debt instruments. Issuers and obligors of debt instruments that are credit impaired face different issues, including cancellation of indebtedness income and the inability to utilize interest and original issue discount deductions. Although these issues are not directly relevant to investors, they may color negotiations to modify a debt instrument. In addition, non-U.S. investors may face additional tax issues and consequences that are not addressed in this chapter. In particular, working out distressed debt instruments may

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Chapter 23

The End of Deferral as We Know It: The New Rules Prohibiting the Deferral of Compensation Paid to U.S. Managers by Off-Shore Hedge Funds

Mark Leeds and Yoram Keinan*

"A duty dodged is like a debt unpaid; it is only deferred, and we must come back and settle the account at last."[1] With all due deference to Mr. Newton, deferral of the duty to pay federal income tax is one of the holy grails of tax planning. Income tax deferral arrangements have existed almost from the day the modern Internal Revenue Code was enacted in 1913.[2] Deferred compensation arrangements have also existed almost from this date. A deferred compensation arrangement generally involves payments for services that are earned in one year but are made in a later year.[3] Deferred compensation arrangements are generally between an employer and employee, but can also apply to an independent contractor. In the majority of cases, deferred compensation arrangements are driven by nontax reasons; nevertheless, tax planning is an important driver of deferred compensation arrangements. The paramount federal income tax issue with respect to deferred compensation arrangements is whether the service provider (i.e., employee or manager) should recognize income prior to the actual receipt of the compensation, or he or she can defer the income recognition until it is paid.

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1 Joseph F. Newton (posted at www.quotes.net/quote/16029).

2 See Joint Committee on Taxation, *Present Law and Background Relating to Executive Compensation* (JCX-29-02), April 17, 2002. Reprinted in 2002 TNT 75-19. See also Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (the "Enron Report") (JCS-3-03) (February 2003).

3 Id.

Chapter 24

Corporate Theft, Fraudulent Financial Statements, and Ordinary Investment Losses

Edward J. Schnee and W. Eugene Seago*

In a recent Tax Court summary opinion, *Taghadoss,*[1] the taxpayer argued that fraudulent financial statements led him to invest in WorldCom common stock and as a result he suffered an economic loss of over $1.3 million. His allegation appeared true. However, if he could prove his allegations, he would still face the more difficult task of collecting from a bankrupt corporation or from the perpetrators in separate civil actions. The tax law then rubs salt into the taxpayer's wounds by, in effect, denying him the right to deduct the amount he had previously included in income that was used to purchase the stock.

When a taxpayer has made a "bad investment," the tax benefit he or she can expect is a capital loss that can only be used to offset capital gains, and then ordinary income of no more than $3,000 each year. Often, the tax benefits of the loss are of very little consequence, relative to the amount of the economic loss. On the other hand if the taxpayer keeps his or her money in a mattress and the money is stolen or destroyed, the taxpayer has an ordinary loss can that can reduce ordinary income, and can even create a net operating loss carryback, and a refund of taxes paid in prior years. Thus, the tax benefits from the theft or destruction are much greater than the loss from improvident investments. Suppose the taxpayer lends money to a corporation, or is issued stock by the corporation in exchange for money, but the funds are stolen from the corporation and the corporation becomes insolvent. Should the investor's tax treatment of the loss be any different than if the funds were stolen from the taxpayer? Perhaps the tax results should not differ, but in fact they often do. This chapter will review the current state of ordinary investment losses and suggest other situations in which taxpayers may be entitled to ordinary losses from theft.

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[1] TC Summary Opinion 2008-44. Under Section 7463(b), summary opinions may not be treated as precedent for any other case.

Chapter 25

The Treatment of Payments on Distressed Debt Instruments

John Kaufmann*

The current rules for accounting for payments on debt instruments are not well-suited for the treatment of payments on distressed debt instruments. These include the rules for accruals of interest and OID under Reg. 1.451-1(a) and Sections 1272 to 1275 and the regulations thereunder, the rules for accounting for market discount under Sections 1276 to 1278, and the rules for allocating payments to interest and principal under the "interest first" rules of Regs. 1.446-2(e) and 1.1275-2(a). This chapter examines the applicability of the foregoing rules to distressed debt obligations, as well as the potential for treating pools of distressed debt obligations as single mass assets. The chapter notes the need for regulatory guidance in this area, and ends with a suggestion regarding the proper treatment of "distress" in this context.

The chapter first examines whether owners of distressed debt are required to accrue coupon interest and OID on obligations that are substantially certain never to pay these amounts. Since 1930, taxpayers have not been required to accrue coupon interest that is substantially certain never to be paid. However, the Service took the position in unpublished guidance in 1995 that taxpayers are required to accrue OID on debt instruments outside the bankruptcy context, even if it is substantially certain that no such OID will be paid. The chapter discusses the inconsistency of this position with the rule regarding accrual of coupon interest, and suggests that Treasury issue new guidance on point.

Second, the chapter examines whether payments on distressed debt obligations should be treated wholly or in part as market discount. It begins by reviewing pre-1984 common law rules governing the proper method for accounting for market discount. Prior to the passage of the statutory market discount rules, holders of healthy debt instruments purchased below par were required to allocate payments other than interest pro rata to discount income and return of basis, but holders of "speculative" debt instruments (as defined) were permitted to allocate payments to basis recovery first. Although the current statutory market discount rules in Sections 1276 to 1278 do not contain an explicit exemption for payments on distressed debt, the legislative history makes it clear that Congress crafted the rules with healthy debt instruments in mind, and there is no evidence of a congressional intent to preempt pre-existing common law doctrines applicable to distressed debt instruments. Under general principles of

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Chapter 26

Bad Debts, Worthless Securities: Effect of Pending Collection Litigation and Other Common Issues

David Herzog*

This chapter examines the availability of a deduction for a bad debt, with a specific focus on the distinctions between worthless securities and bad debts in the context of a simple promissory note issued by the taxpayer. The discussion reviews the law applicable to what might occur where a taxpayer attempts to take a deduction based on the "worthlessness" of the debt, while, at the same time, filing a lawsuit in the hope that the debt is not, in fact, completely worthless.

THE GENERAL RULE

Generally speaking, bad debts are deductible as either nonbusiness or business bad debts.[1] The loss may also be characterized as a worthless security.[2] The distinction between these is critical. If the debt is a business bad debt, the taxpayer can take a full, or partial (with certain restrictions), deduction against *ordinary* income; ordinary loss is typically, but not always, a taxpayer's best case scenario.

However, if the debt is a *non*business bad debt, the taxpayer takes a *capital* loss, i.e., a loss which will offset any capital gains. Any capital losses that are not "used up" in the year of the loss by writing it off against capital gains can be carried over to successive years to write down future gains on the sales of capital assets. Characterization as a capital loss may be beneficial if the taxpayer has, or expects, sufficient capital gains in the future; however, because the tax rate on capital gains is currently significantly lower than on ordinary income, taxpayers are generally seeking deductions against ordinary income, which losses may be carried back to prior years for refunds, or carried

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[1] Section 166. Section 166 addresses bad debts.

[2] Section 165 addresses losses, such as wagering, theft, worthless securities, and casualties.

Chapter 27

Combating Expert Appraiser Bias

Hugh J. Totten*

As the financial markets melt down, attention will turn to the causes of the current crisis: who is to blame and how will we fix the markets? Without doubt, the greed of Wall Street and the banks, their unconscionable neglect in not following basic principles of sound underwriting, and the carefully orchestrated program of laying off risk to unsophisticated, unsuspecting investors, is at the heart of the matter. So too is overvalued real estate and, for the second time in 20 years, misleading and biased appraisals.

Over the years, testifying appraisers in particular frequently have served as hired guns and outright mountebanks who have claimed an inside perspective of a seemingly unattackable fog of "art" and "judgment." Such slights-of-hand led the United States Supreme Court in 1943 to declare that "even in the ordinary case, assessment of market value involves the use of assumptions which make it unlikely that the appraisal will reflect true value with nicety" because determining market value "involves, at best, a guess by informed persons."[1] Were an equivalent statement to be made about medical doctors, it would be a stab by "a reader of medical textbooks." Indeed, one federal district court judge has confessed that: "The whole subject of appraisal of property: it's not an art and it's not a science; in my opinion, it's a mystery."[2]

Legal and practical hurdles have prevented litigants from using the civil tort system to stop appraisal gunslinging. In particular, lack of standing to sue biased appraisers and economic disincentives (appraisers frequently are not rich financial targets) have made civil suits essentially ineffective. When the U.S. Supreme Court decided *Daubert v. Merrell*, *Dow Pharmaceuticals, Inc*.[3] 15 years ago, there was hope that judges could use it at least to prevent biased expert appraisers from testifying. There, the Supreme Court recognized that because juries sometimes can be swayed unusually by the testimony of an "expert," juries should be protected from having to decide which of two expert opinions are correct if one expert has put a finger on the scale to produce a predetermined result. Instead, trial judges were directed to act as gatekeepers to exclude

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[1] U.S. v. Miller, 317 U.S. 369, 374 (1943).

[2] American Society of Appraisers, Machinery and Technical Specialties Committee, *Valuing Machinery and Equipment: The Fundamentals of Approving Machinery and Technical Assets* (2d ed. 2005), quoting Judge Carlisle B. Roberts in the Preface, written by Richard A. Kaufman.

[3] 509 U.S. 579 (1993).

Chapter 28

Litigating Financial Losses Under State Law: Defenses and Issues to Consider

Robin A. Henry*

Recent months have witnessed a staggering loss of wealth across virtually every asset class. Not unexpectedly, litigation seeking recovery for such losses has followed and is expected to increase. While "traditional" class action claims continue to be brought under the federal securities laws, procedural and substantive impediments to such litigation may push some plaintiffs in the direction of individual (non-class) state law litigation. In fact, substantial, high-stakes cases are increasingly being pursued under state law.[1] Theories of recovery range from breach of contract to fraud.

While state law is often viewed favorably by plaintiffs and with great trepidation by defendants, both sides to state law litigation should be aware of potential defenses that can substantially alter the presumed balance of risks. This chapter highlights a number of such defenses.

FEDERAL VERSUS STATE LAW

Defendants have long believed that state law—and state courts—favors plaintiffs. Indeed, that sentiment was part of what motivated the Class Action Fairness Act of 2005

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[1] See, e.g., M&T Bank v. Gemstone CDO VII, Ltd., et al. (New York State Supreme Court) (claim by a CDO investor against entities that "marketed" the investment); UBS Securities LLC v. Highland Capital Management, L.P., et al. (New York State Supreme Court) (indemnification and breach of contract action arising out of failed CDO); City and County of San Francisco v. Ambac Financial Group Inc., et al. (Superior Court of the State of California, San Francisco County) (state law claims relating to alleged improprieties in the municipal bond insurance industry); and HSH Nordbank AG v. UBS AG and UBS Securities LLC (New York State Supreme Court) (state law claims arising out of plaintiff's purchase of CDO investment).

[2] PL 109-2 (2005). CAFA expanded federal jurisdiction over class action lawsuits in order to cut back on what Congress perceived to be "forum shopping" by plaintiffs in pro-plaintiff state courts. See 151 Cong. Rec. S1076 (daily ed. February 8, 2005) (statement of Sen. Specter explaining that "[t]he class action bill has as its central focus to prevent judge shopping to various States and even counties where courts and judges have a prejudicial predisposition on cases."); id. at S1081 (statement of Sen. Lott addressing "a

Chapter 29

Countdown to Meltdown: Speeding Up U.S. Antitrust Review of M&A Transactions in a Distressed Economic Environment

Mark J. Botti and David T. Blonder*

The current worldwide financial turmoil and its still-uncertain aftermath have sparked major mergers and acquisitions (M&A) requiring very rapid antitrust regulatory approval to both calm distressed markets and salvage shareholder value. More of these deals are surely on the horizon. Given that these exigent circumstances require quick completion of a transaction, efforts to quickly obtain the required necessary antitrust clearance under the Hart-Scott-Rodino Act, Section 7A of the Clayton Act, 15 U.S.C. 18a ("HSR Act"), can sometimes be inhibited. Under the HSR Act, parties are prohibited from closing deals during a suspensory waiting period while the antitrust review is conducted, or risk substantial fines for doing so. Under the right circumstances, however, procedural mechanisms and substantive arguments can be employed to try to mitigate any potential harm that is caused by delay.

This chapter addresses the relevant waiting period in the United States under the HSR Act, some of the procedural pitfalls that can often arise, and, in certain circumstances, the pertinent strategies and arguments that, in an effort to secure rapid antitrust clearance, can be employed for transactions where one of the merging or acquired parties is in severe financial distress.

AN OVERVIEW OF THE HSR ACT

The HSR Act established the federal premerger notification program in the United States, which provides the Federal Trade Commission ("FTC") and the Antitrust Division of the U.S. Department of Justice ("DOJ") with information about significant mergers and acquisitions before they occur. The HSR Act is a "file and wait" premerger

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Chapter 30

Someone Made Off With My Money, Now What? Tax Issues Affecting Ponzi Scheme Victims

David Shechtman, Mark Wilensky, and Leila Fusfeld*

GENERAL BACKGROUND

In 2008 it came to light that a number of high-profile investment managers, most notably Bernard L. Madoff Investment Securities LLC (BMIS), had defrauded investors by engaging in so-called "pyramid" or "Ponzi" schemes in which no actual investments were acquired with investor funds and new contributions to the fund were used to make distributions and redemption payments to existing investors.[1] Investors in BMIS and similar schemes received annual statements purporting to show income earned on investments, now known to be fictitious, and reported the income on their annual tax returns accordingly.[2]

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[1] Ponzi schemes are not new. The scheme that gave rise to the name was a phony investment plan promoted by one Charles Ponzi in 1920. In 2001, a major West Coast Ponzi scheme carried out by Reed Slatkin came to light; it involved almost $240 million and hundreds of investors. A $450 million scheme involving The Bayou Hedge Fund Group came to light in 2005. However, the size (over 5,000 direct and an unknown number of indirect investors) and scope (perhaps $60 billion in losses) of the Madoff scheme, together with the notoriety of some victims (not to mention the perpetrator's bizarrely apt last name—pronounced "made off") have given rise to much greater coverage about the case in both the popular and business media and also created fodder for late-night television comedians. The technical tax issues affecting investors have also received substantial coverage in the business press. See, e.g., Arden Dale, "Getting Personal: IRS Guidance on Madoff May Be Elusive," Dow Jones Factiva, Feb. 26, 2009, available at http://online.wsj.com/article/BT-CO-20090226-712735.html; Arden Dale, "Update: IRS Says it Will Issue Guidance Soon," Dow Jones Business News, Mar. 13, 2009, available at http://online.wsj.com/article/BT-CO-20090313-713572.html. Of course, not all of Madoff's victims were famous or particularly wealthy, and while the potential tax benefits discussed in this chapter may provide some degree of relief for those victims, the financial devastation caused by the scheme remains difficult to overstate. This is particularly the case for charities and pension plans that invested with BMIS as they will receive no tax recoveries absent substantial unrelated business taxable income.

[2] BMIS purported to use a sophisticated "split strike option conversion" strategy (a strategy which, despite the name, is apparently unrelated to the sport of bowling) to produce returns in the range of 10 percent to 20 percent each year in both up and down stock markets. Criminal Information, U.S. v. Bernard L. Madoff, 9 Cr. 213 (S.D.N.Y. Mar. 10, 2009).

Chapter 31

Replacing a Swap Counterparty:A Primer on Deemed Termination, Withholding, and Other U.S. Tax Issues

Angela Sellman*

The current financial crisis has prompted an increase in the already common practice of substituting counterparties to swaps and other derivative contracts. Indeed, failure to replace a swap counterparty whose creditworthiness is declining may trigger litigation, such as the recently filed lawsuit by Lehman Brothers Holdings Inc. against Wells Fargo Bank, as trustee, for not replacing Lehman as swap counterparty in a credit default swap.[1] Legislative proposals that would raise regulatory capital requirements will also encourage transfers of derivative contracts to affiliates located in jurisdictions with less stringent regulatory capital requirements.[2] Substitutions of counterparties may also result from ratings downgrades and bankruptcies; when those events affect one party or its guarantor, the terms of many swap agreements permit it to avoid termination by the other party by acting within a specified window of time to transfer its position.[3]

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[1] In Re Lehman Bros. Hldgs. Inc. (Complaint Lehman Bros. Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Ltd. and Wells Fargo Bank, N.A.), Case No. 08-13555 (JMP), (Bankr. S.D.N.Y. Feb. 3, 2009).

[2] See, e.g., Financial Stability Forum's recommendations and principles to strengthen financial systems. Press Release (April 2, 2009), available at http://www.bis.org/press/p090403b.pdf; prepared testimony of Timothy Geithner, U.S. Treasury Secretary, at the Committee on Financial Services Hearing in the U.S. House of Representatives (March 26, 2009), transcript available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/geithner032609.pdf. For a useful summary of the regulatory response to the global banking crisis see Freshfields Bruckhaus Deringer LLP Briefing on Regulatory Capital Reform (April 2009), available at http://www.freshfields.com/publications/pdfs/2009/apr09/25555.pdf.

[3] Some transactions even require the replacement of a defaulting counterparty before the transaction can be terminated. For example, § 6(b)(ii) of the 1992 and 2002 International Swaps and Derivatives Association (ISDA) Master Agreement provides that if certain tax events occur and there is only one affected party, the affected party must, subject to certain exceptions and as a condition to its right to terminate the swap, use all reasonable efforts to transfer the swap within a certain period of time after the notice of termination is provided.

Chapter 32

Tax Opportunities and Issues for Acquirers of Banks Arising Under Section 1261 of the American Recovery and Reinvestment Act of 2009

Philip C. Cook and Charles W. Wheeler*

No IRS or Treasury administrative guidance in recent memory has generated a greater public and congressional furor[1] than last year's issuance of Notice 2008-83,[2] dealing with the application of the built-in loss rules of Section 382(h)[3] to banks experiencing a change of control during the financial crisis. Despite the furor, Section 1261 of The American Recovery and Reinvestment Act of 2009[4] ("ARRA Section 1261") grandfathers the provisions of Notice 2008-83 with the force of law for bank acquisitions occurring on or prior to January 16, 2009, or pursuant to binding contracts entered into on or before January 16, 2009. Accordingly, ARRA Section 1261 potentially has major implications for last year's mega financial institution rescues and for smaller, less publicized financial institution changes of ownership that occurred as well.[5]

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[1] No sooner had the notice been issued than expressions of indignation emerged. Senators Grassley and Baucus called for an investigation by Treasury's inspector general for possible conflicts of interest; the inspector general announced his investigation; Congressman Doggett introduced H.R. 7300 to revoke the Notice; Senator Sanders wrote to all of his Senate colleagues expressing his indignation and introduced S.3692, calling for revocation; and Eric Solomon of Treasury wrote a somber and detailed justification of the guidance to these congressional figures on the meaning and purpose of the Notice.

[2] 2008-42 IRB 905.

[3] Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the IRC).

[4] P.L. 111-5.

[5] Consider, for example, Countrywide and Wachovia, as well as National City, which potentially are covered by ARRA § 1261 if the transactions were structured as carryover basis transactions.