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The AIG Bailout

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The AIG Bailout

William K. Sjostrom, Jr.*

Abstract

On February 28, 2008, American International Group, Inc., the then largest insurance company in the United States, announced 2007 earnings of \$6.20 billion or \$2.39 per share. Its stock closed that day at \$50.15 per share. Less than seven months later, however, AIG was on the verge of bankruptcy and had to be rescued by the United States government through an \$85 billion loan. Government aid has since grown to \$182.5 billion, and AIG's stock recently traded at less than \$1.00 per share.

The Article explains why AIG, a company with \$1 trillion in assets and \$95.8 billion in shareholders' equity, suddenly collapsed. It then details the terms of the government bailout, explores why it was undertaken, and questions its necessity. Finally, the Article describes the regulatory gap exploited by AIG and offers some thoughts on regulatory reform.

Table of Contents

I. Introduction	944
II. AIG's Operations.....	945
A. Overview	945
B. Credit Default Swap Primer.....	947
C. AIG's Credit Default Swap Business	952
III. AIG's Collapse	959
A. Credit Default Swaps on Multi-Sector Collateralized Debt Obligations.....	959
B. Securities Lending Program.....	961

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C. Inability to Access Capital Markets and Credit Downgrade	962
IV. The Bailout	963
A. Initial Bailout	964
B. Additional Lifelines	968
C. Bailout Restructuring I	969
D. Bailout Restructuring II	972
E. Grand Total	974
F. Legal Issues	976
G. Why the Bailout?	977
V. The (Lack of) Regulation of Credit Default Swaps	983
A. Regulatory Gap	983
B. Regulatory Reform	989
VI. Conclusion	990

I. Introduction

On February 28, 2008, American International Group, Inc. (AIG), then the largest insurance company in the United States,¹ announced 2007 earnings of \$6.20 billion or \$2.39 per share.² Its stock closed that day at \$50.15 per share.³ Less than seven months later, however, AIG was on the verge of bankruptcy and had to be rescued by the United States government through an \$85 billion

1. Based on net premiums underwritten, AIG was the largest life insurer, the largest health insurer, and the second largest property and casualty insurer in the U.S. *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 1–2 (2009) (statement of Donald L. Kohn, Vice Chairman, Board of Governors of the Federal Reserve System) [hereinafter Kohn Statement], available at http://banking.senate.gov/public/_files/KohnStmntMarch52009.pdf.

2. Press Release, American International Group, Inc., AIG Reports Full Year and Fourth Quarter 2007 Results (Feb. 28, 2008), available at <http://idea.sec.gov/Archives/edgar/data/5272/000095012308002282/y50505exv99w1.htm>.

3. Yahoo! Finance, AIG: Historical Prices for American International Group, Inc., <http://finance.yahoo.com/q/hp?s=AIG> (last visited Sept. 29, 2009) (on file with the Washington and Lee Law Review).

loan.⁴ Government aid has since grown to \$182.5 billion,⁵ and as recently as June 2009 AIG's stock traded at less than \$1.00 per share.⁶

AIG's collapse was caused largely by its \$526 billion portfolio of credit default swaps (CDSs), a type of credit derivative widely used by financial institutions but, up until recently, largely unknown by the general public.⁷ AIG's troubles have been covered extensively by the media but are difficult to comprehend fully because of the esoteric financial instruments involved. Thus, this Article weaves explanations of CDSs, asset-backed securities, securitization, tranching, and collateralized debt obligations into a detailed and systematic account and analysis of what went wrong at AIG and why the government bailed it out. A thorough understanding of these events is important because of the unprecedented size of the bailout and attendant calls for increased regulation of CDSs.

Part II provides a brief overview of AIG's operations, a primer on CDSs, and analysis of AIG's CDS activities. Part III explains how AIG's CDS business pushed it to the brink of bankruptcy by draining it of cash. Part IV details the terms of the government bailout (including its two restructurings), explores why it was undertaken, and questions its necessity. Part V describes the regulatory gap exploited by AIG and offers some thoughts on regulatory reform.

II. AIG's Operations

A. Overview

AIG is "a holding company which, through its subsidiaries, is engaged in a broad range of insurance and insurance-related activities in the United States and abroad."⁸ It is incorporated in Delaware,⁹ and its common stock is listed on the New York Stock Exchange.¹⁰ AIG has operations in more than 130 countries with about half of its revenues derived from its foreign operations.¹¹

4. *Infra* Parts III & IV.

5. *Infra* Part IV.E.

6. Yahoo! Finance, *supra* note 3.

7. *Infra* Part III.A.

8. AIG, 2007 Annual Report (Form 10-K), at 3 (Feb. 27, 2008) [hereinafter AIG '07 Annual Report], available at <http://idea.sec.gov/Archives/edgar/data/5272/000095012308002280/y44393e10vk.htm>.

9. *Id.*

10. *Id.* at 26.

11. Moody's Investors Service, Company Profile: American International Group, Inc. 1

Its principal business units are General Insurance, Life Insurance & Retirement Services, Financial Services, and Asset Management.¹² The General Insurance unit underwrites commercial property, casualty, workers' compensation, and mortgage guarantee insurance.¹³ The Life & Retirement Service unit provides individual and group life, payout annuities, endowment, and accident and health insurance policies.¹⁴ The Financial Services unit engages in aircraft and equipment leasing, capital market transactions (including CDS transactions), consumer finance, and insurance premium finance.¹⁵ The Asset Management unit offers a wide variety of investment-related services and investment products to individuals, pension funds, and institutions.¹⁶ AIG ranked tenth in the 2007 Fortune 500¹⁷ and twenty-third in the 2007 Global 500.¹⁸ As of December 31, 2007, AIG had total assets of \$1.06 trillion,¹⁹ shareholders' equity of \$95.8 billion, and a market capitalization of \$150.7 billion.²⁰

The following table summarizes AIG's operating performance by unit for the years ended December 31, 2005, 2006, and 2007, and the nine months ended September 30, 2008.²¹

(Jan. 2008).

12. AIG '07 Annual Report, *supra* note 8, at 3.

13. *Id.* at 6.

14. *Id.* at 10.

15. *Id.* at 11.

16. *Id.*

17. See *Largest U.S. Corporations*, FORTUNE, Apr. 3, 2007, at 210 (showing that in 2006 AIG generated the tenth most revenues among U.S. public companies).

18. *World's Largest Corporations*, FORTUNE, July 23, 2007, at 133. This means that in 2006 AIG generated the twenty-third most revenues among all public companies in the world.

19. AIG '07 Annual Report, *supra* note 8, at 28.

20. This number is based on a closing price of \$58.30 per share on December 31, 2007, and outstanding shares of 2,585,000,000. *Id.* at 13.

21. *Id.* at 36; see also AIG, Quarterly Report (Form 10-Q), at 12 (Nov. 10, 2008) [hereinafter AIG September '08 Quarterly Report], available at <http://idea.sec.gov/Archives/edgar/data/5272/000095012308014821/y72212e10vq> (providing part of this data).

<i>(In Millions)</i>	Nine Months Ended 9/30/08	2007	2006	2005
Revenues				
General Insurance	\$ 35,854	\$ 51,708	\$ 49,206	\$ 45,174
Life Insurance & Retirement	14,271	53,570	50,878	48,020
Financial Services	(16,016)	(1,309)	7,777	10,677
Asset Management	658	5,625	4,543	4,582
Other	531	457	483	344
Consolidation & Eliminations	(436)	13	500	(16)
Total	\$ 34,862	\$110,064	\$113,387	\$108,781
Operating Income (Loss)				
General Insurance	\$ (393)	\$ 10,562	\$ 10,412	\$ 2,315
Life Insurance & Retirement	(19,561)	8,186	10,121	8,965
Financial Services	(22,880)	(9,515)	383	4,424
Asset Management	(2,709)	1,164	1,538	1,963
Other	(2,899)	(2,140)	(1,435)	(2,765)
Consolidation & Eliminations	237	722	668	311
Total	\$ (48,205)	\$ 8,943	\$ 21,687	\$ 15,213

B. Credit Default Swap Primer

As is obvious from the above table, AIG had some major problems within its Financial Services unit in 2007 and 2008. The staggering \$32.4 billion in losses the unit racked up from January 2007 through September 2008 stem almost entirely from the unit's CDS activities. Because, as discussed in Part III below, these activities are at the heart of AIG's collapse,²² this section provides a primer on CDSs.

A CDS is a privately negotiated contract where one party (the "protection seller"), in exchange for a fee, agrees to compensate another party (the "protection buyer") if a specified "credit event" (such as bankruptcy or failure

22. See Monica Langley et al., *Bad Bets and Cash Crunch Pushed Ailing AIG to Brink*, WALL ST. J., Sept. 18, 2008, at A1 (noting that "[t]he rot stemmed largely from losses in a unit that sold a complex kind of derivative, called a credit-default swap, designed to protect investors against default in an array of assets, including subprime mortgages").

to pay)²³ occurs with respect to a company (the "reference entity") or debt obligation (the "reference obligation").²⁴ CDSs are used for a variety of purposes including hedging, speculation, and arbitrage.²⁵

For example, if a mutual fund wants to hedge its credit risk exposure on its \$100 million of XYZ Inc. (XYZ) bonds that mature in five years, it can do so by entering into a five-year, \$100 million CDS with a protection seller. The CDS would designate XYZ as the reference entity and XYZ's bonds as the reference obligation. It would define credit event as XYZ's bankruptcy or payment default on its bonds. In this example, the CDS would have a "notional amount" of \$100 million because that is the amount of protection provided by the CDS.²⁶ In connection with writing the CDS, the protection seller would assess the likelihood of a credit event occurring during the next five years and set its fee for providing the protection accordingly.²⁷ This fee is referred to as the CDS spread or premium and is expressed in basis points²⁸ per annum on the notional amount of the CDS.²⁹ The spread is typically payable quarterly.³⁰ In this example, if the protection seller sets the spread at 100 basis points, the fund

23. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-716, CREDIT DERIVATIVES: CONFIRMATION BACKLOGS INCREASED DEALERS' OPERATIONAL RISKS, BUT WERE SUCCESSFULLY ADDRESSED AFTER JOINT REGULATORY ACTION 5 n.6 (2007) [hereinafter GAO REPORT], available at <http://www.gao.gov/new.items/d07716.pdf>.

24. Nomura Fixed Income Research, *Credit Default Swap (CDS) Primer* 1, 1, May 12, 2004, [hereinafter *CDS Primer*], available at [http://www.classiccmp.org/transputer/finengineer/%5BNomura%5D%20Credit%20Default%20Swap%20\(CDS\)%20Primer.pdf](http://www.classiccmp.org/transputer/finengineer/%5BNomura%5D%20Credit%20Default%20Swap%20(CDS)%20Primer.pdf); see also GAO REPORT, *supra* note 23, at 5. Other types of CDSs include multi-name, which reference more than one corporate or sovereign entity, and index, which are based on an index of corporate entities. *Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Servs.*, 111th Cong. 4 (2009) (statement of Orice M. Williams, Director, Financial Markets and Community Investment, U.S. Gov't Accountability Office) [hereinafter Williams Statement], available at <http://www.gao.gov/new.items/d09397t.pdf>.

25. See Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1022 (2007) (listing the uses of CDSs).

26. See Arvind Rajan, *A Primer on Credit Default Swaps*, in THE STRUCTURED CREDIT HANDBOOK 17, 23 (Arvind Rajan et al. eds., 2007) (defining notional amount as "the amount of exposure to a particular credit (the reference entity) for which protection is being either bought or sold for a particular period of time").

27. See *CDS Primer*, *supra* note 24, at 4 (noting that CDS pricing involves assessing "(1) the likelihood of default, (2) the recovery rate when default occurs, and (3) some consideration for liquidity, regulatory, and market sentiment about the credit").

28. A basis point equals 0.01% (1/100th of a percent) or 0.0001 in decimal form.

29. *CDS Primer*, *supra* note 24, at 3.

30. See Rajan, *supra* note 26, at 23 (noting that protection buyers, at least according to U.S. market convention, typically "pay quarterly on an Actual/360 basis").

would pay the protection seller \$250,000 per quarter during the five-year term of the CDS.³¹

If no credit event occurs during the term of a CDS, the protection seller retains the premium payments and the parties go their separate ways.³² In this example, that means the protection seller would have grossed \$5 million from writing the CDS (\$250,000 per quarter multiplied by twenty quarters). If a credit event does occur during the CDS term, the protection seller is then obligated to compensate the protection buyer. Compensation occurs through either physical or cash settlement, depending on what the CDS specifies.³³ If the CDS provides for physical settlement, it will specify types of "deliverable obligations" that the protection seller is required to buy for par (full face value) upon delivery by the protection seller.³⁴ In this example, assume the CDS provided for physical settlement and designated the XYZ bonds as the deliverable obligation. Following an XYZ credit event, the fund would transfer the \$100 million face amount of XYZ bonds to the protection seller. The protection seller would then pay the fund \$100 million, and the CDS would terminate.³⁵ Obviously, XYZ bonds will have dropped in value as a result of the credit event and, therefore, will be worth much less than par.

If the CDS provides for cash settlement, the parties agree on a market value for the reference obligation.³⁶ The protection seller then pays the protection buyer the difference between the market value and the par value of the reference obligation.³⁷ In this example, assume that the market value of the

31. The calculation is as follows: \$100 million notional amount multiplied by 1% divided by 4 (number of quarters in a year).

32. See Rajan, *supra* note 26, at 23 ("If no credit events occur during the term of the default swap, the swap expires unexercised.").

33. *CDS Primer*, *supra* note 24, at 4.

34. *Id.* at 5.

35. The CDS contract would specify the types and characteristics of XYZ debt that can be used to fulfill the deliverable obligation. See Rajan, *supra* note 26, at 24 ("[Deliverable obligations] are obligations of the reference entity that may be delivered, per the CDS contract, in connection with physical settlement [I]n the most common versions of CDS, the deliverable obligation must be *pari passu* with senior unsecured obligations of the reference entity."); see also ANTULIO N. BOMFIN, UNDERSTANDING CREDIT DERIVATIVES AND RELATED INSTRUMENTS, at 69 (2005).

36. See Rajan, *supra* note 26, at 24 ("If the contract is cash settled, a market value is determined for the reference obligation and the protection seller makes a cash payment to the protection buyer for the implied loss on that obligation."); see also BOMFIN, *supra* note 35, at 292 ("The market value of the reference obligation is commonly determined by a dealer poll typically conducted a few days after the credit event.").

37. See Rajan, *supra* note 26, at 24 ("[T]he protection seller pays the buyer $N \times (100 - R)$, where R is the price of the reference security after the credit event (recovery value) and N is the notional amount.").

reference obligation dropped to 25% of par following the credit event. The protection seller would then pay the fund \$75 million (\$100 million par value less the \$25 million market value) and the CDS would terminate.³⁸

In addition to hedging, CDSs can be used to speculate on a change in a company's credit quality. For example, if a hedge fund believed that XYZ's credit quality was going to deteriorate within the next two years, it could then buy a three-year \$50 million notional amount 200 basis point cash-settled XYZ CDS. Suppose XYZ suffers a credit event a year later and the CDS reference obligation drops to 20% of par. The hedge fund will have grossed \$39 million on the transaction (\$40 million cash payment from the protection seller less the \$1 million CDS premium the hedge fund paid for the year). Alternatively, if XYZ's credit quality drops significantly a year later but not to the point where a credit event occurs, the spread that parties would be willing to pay on XYZ CDSs might widen to 700 basis points. If the hedge fund believes XYZ's credit quality is likely to improve over the next two years, it could lock in a profit by selling a two-year \$50 million notional amount 700 basis point cash-settled XYZ CDS.³⁹ If, as expected, no credit event occurs during the next two years, the hedge fund will have paid \$2 million on the XYZ CDS it bought but will have received \$7 million on the CDS it sold, netting \$5 million on the two transactions.

Further, CDSs can be used for arbitrage. Arbitrage techniques include buying or selling a debt security and simultaneously buying or selling a CDS on the debt security. The idea is to earn a credit-risk-free return by capturing a temporary mispricing between the debt security and CDS spread.⁴⁰

A prominent risk inherent in a CDS faced by a protection buyer, whether engaging in hedging, speculation, or arbitrage, is counterparty credit risk.⁴¹ Counterparty credit risk is the risk that a protection seller will be unable or unwilling to make the payment due under a CDS following a credit event.⁴² To address counterparty credit risk, a CDS may require the protection seller to post collateral with the protection buyer equal to a specified percentage of the

38. See *id.* (noting the termination of the swap upon cash settlement).

39. Alternatively, the hedge fund could agree to terminate the CDS in exchange for payment from the protection seller reflecting the change in value or could assign the CDS to a third party in exchange for a fee. BOMFIN, *supra* note 35, at 70.

40. MOORAD CHOUDHRY, THE CREDIT DEFAULT SWAP BASIS 116 (2006).

41. BOMFIN, *supra* note 35, at 10.

42. See COUNTERPARTY RISK MGMT. POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE 110 (July 27, 2005), available at <http://www.crmpolicygroup.org/crm/pg2/docs/CRMPG-II.pdf> (discussing counterparty credit risk). Other risks embedded in CDSs include basis risk, legal risk, and operational risk. See *id.* at 111–14 (discussing these types of risks).

notional amount of the CDS.⁴³ If the market spread on the CDS rises above the amount charged by the protection seller, the CDS would typically require the protection seller to post additional collateral as a rising spread indicates a perceived increase in the probability of a credit event occurring.⁴⁴ The initial collateral percentage typically varies depending on the protection seller's credit rating. The higher its credit rating, the lower the collateral percentage. This is because a higher credit rating indicates higher credit quality and, therefore, a lower chance that a protection seller will default on its obligations under the CDS. The CDS will provide for an automatic increase in the collateral percentage for any downgrades to the protection seller's credit rating during the term of the CDS.

CDSs are transacted over-the-counter (OTC), meaning they are not transacted through an exchange.⁴⁵ The CDS market has exploded in size in recent years growing from an estimated \$918.9 billion notional amount at the end 2001 to \$54.6 trillion by mid-year 2008, an increase of approximately 540%.⁴⁶ Active players in the market include more than a dozen large, global

43. See *id.* at 110 (discussing methods of collateral posting); see also Williams Statement, *supra* note 24, at 13 (discussing collateral posting requirements).

44. See Williams Statement, *supra* note 24, at 13 (discussing posting requirements and variation in those requirements by party).

45. *To Review the Role of Credit Derivatives in the U.S. Economy: Hearing Before the H. Comm. on Agriculture*, 110th Cong. 2 (2008) (written testimony of Erik Sirri, Director, Division of Trading and Markets, U.S. Securities and Exchange Commission) [hereinafter Sirri Testimony], available at <http://agriculture.house.gov/testimony/110/h81015/Sirri.pdf>.

46. International Swaps and Derivatives Association, Inc. (ISDA), Summaries of Market Survey Reports, <http://www.isda.org/> (last visited Sept. 29, 2009) (follow Surveys and Market Statistics hyperlink; then follow Summaries of Market Surveys Results) (on file with the Washington and Lee Law Review). Note that total notional amount is not a good measure of actual market exposure because it does not reflect netting. Netting is best explained through an example. If *A* buys \$100 million in protection on *X* bonds from *B*, who buys a \$100 million in protection on *X* bonds from *C*, who buys \$100 million in protection on *X* bonds from *A*, then this scenario would result in \$300 million gross notional amount of CDSs on *X* bonds. The net notional amount and actual economic exposure of the three parties to a credit event on *X* bonds would be zero. The following explains why the credit exposure is zero: (1) *A* bought \$100 million in protection from *B* and sold \$100 million in protection to *C*, netting out to zero exposure; (2) *B* bought \$100 million in protection from *C* and sold \$100 million in protection to *A*, netting out to zero exposure; and (3) *C* bought \$100 million in protection from *A* and sold \$100 million in protection to *B*, netting out in zero exposure. If there is a credit event with respect to *X* bonds, *A* will pay up to \$100 million to *C*, *C* will pay the same amount to *B*, and *B* will pay the same amount to *A*. ISDA estimates actual exposure of CDS counterparties at 1% to 2% of notional amount. See Jonathan R. Laing, *Defusing the CDS Bomb*, BARRONS 44 (Nov. 17, 2008) (noting that "the peak value would have been \$622 million to \$1.24 billion"); see also GAO REPORT, *supra* note 23, at 1 n.2 (noting that notional value is an indicator of the market's value but does not necessarily represent the credit and market risks to which counterparties are exposed from their credit derivative contracts).

banks which serve as CDS dealers.⁴⁷ CDS dealers try to profit by capturing the equivalent of the bid/ask spreads between buying and selling protection and, therefore, constantly buy and sell CDSs on the same reference entities and obligations.⁴⁸ Other players include hedge funds, investment companies, and insurance companies (for example, AIG).⁴⁹

C. AIG's Credit Default Swap Business

AIG operates its CDS business through its subsidiaries, AIG Financial Products Corp. and AIG Trading Group, Inc., and their respective subsidiaries (collectively, AIGFP).⁵⁰ AIG contractually guarantees "all present and future payment obligations and liabilities of AIGFP arising from transactions entered into by AIGFP."⁵¹ The following is a description of AIGFP's CDS business based on publicly available information (SEC filings, documents available on AIG's website, and congressional hearing testimony). The information is incomplete in some respects and, therefore, portions of the description reflect an educated guess as to what actually occurred.

AIGFP's CDS business consisted largely of selling protection on "super senior risk tranches of diversified pools of loans and debt securities."⁵² Deciphering what exactly this means requires a basic understanding not only of CDSs but also of asset-backed securities. Asset-backed securities "are securities that are backed by a discrete pool of self-liquidating financial assets."⁵³ The financial assets could be commercial loans, residential mortgage

47. Sirri Testimony, *supra* note 45, at 2; *see also* GAO REPORT, *supra* note 23, at 6 ("The top five dealers in 2005, ranked by total trading volumes as estimated by Fitch Ratings, were Morgan Stanley, Deutsche Bank, Goldman Sachs, JP Morgan Chase, and UBS.").

48. *See* Editorial, *The Meltdown That Wasn't*, WALL ST. J., Nov. 15, 2008, at A10 (noting that "large dealers generally make their money facilitating trades for customers, not betting one way or another on corporate defaults").

49. *See* Sirri Testimony, *supra* note 45, at 2; GAO REPORT, *supra* note 23, at 6 n.8 ("The top five end-users of credit derivatives are banks and broker-dealers (44 percent), hedge funds (32 percent), insurers (17 percent), pension funds (4 percent), and mutual funds (3 percent).").

50. *See* AIG '07 Annual Report, *supra* note 8, at 11 (outlining operations of AIGFP).

51. AIG September '08 Quarterly Report, *supra* note 21, at 36.

52. AIG '07 Annual Report, *supra* note 8, at 11.

53. Asset-Backed Securities, Securities Act Release No. 8518, Exchange Act Release No. 50,905, 84 SEC Docket 1624 (Dec. 22, 2004) [hereinafter Asset-Backed Securities Release], available at 2004 WL 2964659, at *4. Note that the phrase "asset-backed securities" is sometimes used in a narrower sense to mean securities backed by nonmortgage debt, such as auto loans and credit card receivables. Under that scheme, securities backed by mortgage debt are referred to as mortgage-backed securities (either residential or commercial depending on the borrower). *See* Ratul Roy & Glen McDermott, *ABS CDOs*, in *THE STRUCTURED CREDIT*

loans, credit card receivables, student loans, and similar assets.⁵⁴ Asset-backed securities are created through the process of securitization.⁵⁵

The typical securitization process for residential mortgage loans is as follows: It starts with a borrower applying to a lender (either directly or through a broker) for a mortgage loan to purchase a home or refinance an existing loan.⁵⁶ Assuming the application is approved, the lender funds the loan as part of the purchase or refinancing closing.⁵⁷ Then, the lender sells the loan to an institution called an arranger or issuer.⁵⁸ The arranger then sells the loans—and oftentimes similar loans it has purchased from other lenders—to a newly formed special purpose vehicle (SPV).⁵⁹ The SPV funds the purchase of the loans by selling investors debt obligations representing claims to the cash flows from the pool of residential mortgage loans owned by the SPV.⁶⁰ These obligations are referred to as asset-backed securities because they are "backed" or supported by a financial asset (the mortgage loans).⁶¹ The SPV uses the cash flows from the pool of mortgage loans (primarily monthly loan payments) to service the debt it issued investors to buy the loans.⁶²

Often, the SPV divides the debt securities it issues into different tranches reflecting different levels of seniority or payment priority.⁶³ For example, the SPV could issue three different classes of debt securities: a senior class, a mezzanine class, and a junior class. The SPV's indenture (the document that

HANDBOOK, *supra* note 26, at 335, 336–37 (describing residential mortgage-backed securities, commercial mortgage-backed securities, and asset-backed securities as three different categories of structured finance securities).

54. Asset-Backed Securities Release, *supra* note 53, at *5.

55. *See id.* at *4 (listing steps needed to achieve securitization).

56. *See id.* at *5 (describing the loan origination process).

57. *Id.*

58. *Id.*

59. *See id.* ("The sponsor then sells the financial assets . . . to a specially created investment vehicle.").

60. *Id.*; *see also* U.S. Securities and Exchange Commission, Mortgage-Backed Securities, <http://www.sec.gov/answers/mortgagesecurities.htm> (last visited Sept. 29, 2009) [hereinafter Mortgage-Backed Securities Release] ("Mortgage-backed securities (MBS) are debt obligations that represent claims to the cash flows from pools of mortgage loans.") (on file with the Washington and Lee Law Review).

61. Asset-Backed Securities Release, *supra* note 53, at *4.

62. *See* Mortgage-Backed Securities Release, *supra* note 60 (describing payment process for mortgage-backed securities).

63. *See* COMMITTEE ON THE GLOBAL FINANCIAL SYSTEM, THE ROLE OF RATINGS IN STRUCTURED FINANCE: ISSUES AND IMPLICATIONS 4 (2005), *available at* <http://www.bis.org/publ/cgfs23.pdf> ("Typically, several classes (or 'tranches') of securities are issued.").

specifies the terms of the debt securities) would then provide that obligations (interest and principal) owed to the senior class are to be paid first, followed by those owed to the mezzanine class, with the junior class to be paid last.⁶⁴ If all amounts owed on the loans or other financial assets owned by the SPV are paid timely, the SPV will have sufficient funds to meet its obligations with respect to all three classes. If funds are insufficient, the junior class is the first to not get paid, followed by the mezzanine class.⁶⁵ The senior class would only not get paid if the SPV's shortfall exceeds amounts owed to the junior class and the mezzanine class.⁶⁶

Typically, the SPV will have all but the most junior tranche rated by one or more of the credit rating agencies. As part of the rating process, the SPV will seek input from the rating agencies regarding how the securities need to be tranching for the most senior tranche to receive a rating of AAA (the highest possible rating).⁶⁷ The senior tranche can receive AAA, even if there are no AAA assets in the SPV's pool, because it is the first to be paid and thus the last to suffer a loss.⁶⁸ Its creditworthiness is enhanced because junior tranches insulate it from some level of losses from the SPV's underlying pool of assets.⁶⁹

The higher the credit rating, the lower the interest rate the SPV will need to offer on a particular tranche and vice versa. Thus, tranching provides investors with different risk/reward profiles. The basic idea is to convert a pool of financial assets with a single rating into various debt securities with ratings at, above, and below the pool's rating.⁷⁰ This is desirable because demand for fixed income securities is bifurcated between investors seeking the presumed safety of highly rated (AAA or AA) debt securities and investors seeking the high returns offered by lower rated securities, with demand for highly rated

64. See *id.* (describing various tranches built into mortgage-backed securities).

65. See Ingo Fender & Janet Mitchell, *Structured Finance: Complexity, Risk and the Use of Ratings*, BIS Q. REV. 69 (June 2005), available at http://www.bis.org/publ/qtrpdf/r_qt0506f.pdf (describing process of tranching claims to distribute losses to different levels of mortgage-backed securities).

66. *Id.*

67. See *id.* at 73 ("[S]tructured finance tranches are usually tailored by arrangers with target ratings in mind. This, in turn, requires the rating agencies to take part in the deal's structuring process, with deal origination implicitly involving obtaining structuring opinions from the rating agencies.").

68. See *id.* at 69 (explaining that the senior tranche is insulated from losses by the junior tranches).

69. *Id.*

70. See *Introduction: A Roadmap of the New World of Structured Credit*, in *THE STRUCTURED CREDIT HANDBOOK*, *supra* note 26, at 1, 2 (describing how "the CDO tranching process creates both higher and lower credit quality financial instruments from the original portfolio").

securities the greatest.⁷¹ Through tranching, an SPV can take a pool of assets that falls in between these two points and create securities sought by both types of investors.⁷² In fact, the securities can be tranced easily so that the senior tranche is by far the largest tranche, aligning with the greater demand for highly rated securities.⁷³

Notwithstanding the highly rated nature of the top tranche of an SPV's debt securities, there is demand for credit protection on these securities. As noted above, the bulk of AIGFP's CDS portfolio is comprised of protection it wrote on what it refers to as the "super senior" tranche of various types of asset-backed securities. AIG defines the "super senior" tranche "as the layer of credit risk senior to a risk layer that has been rated AAA by the credit rating agencies, or if the transaction is not rated, equivalent thereto."⁷⁴ As of December 31, 2007, AIGFP had the following net notional amount of protection outstanding on the super senior tranche of securities backed by the specified types of financial assets:⁷⁵

	Net Notional Amount (in billions)
Corporate loans	\$ 230
Prime residential mortgages	149
Corporate debt/Collateralized loan obligations	70
Multi-sector collateralized debt obligations	\$ 78
Total	\$ 527

71. See *id.* ("[T]he demand for assets is split between money seeking absolute safety of principal and money seeking high returns.").

72. See *id.* (describing how structured credit technology has evolved to meet the demands of these investors).

73. See *id.* (noting that a BBB-rated corporate bond portfolio could be tranced so that 90% of the debt securities would be rated AAA).

74. AIG '07 Annual Report, *supra* note 8, at 122. It is not clear whether the SPV's are issuing a "super senior" class of securities or that the protection is triggered only after a certain level of losses is incurred on the AAA class. AIG states in its 2007 Annual Report that "AIGFP provides . . . credit protection on a 'second loss' basis, under which AIGFP's payment obligations arise only after credit losses in the designated portfolio exceed a specified threshold amount or level of 'first losses,'" which seems to indicate the latter. *Id.* at 121.

75. See *id.* at 122 (listing asset values). As of September 30, 2008, the net notional amount of the portfolio had decreased to \$377.2 billion. AIG September '08 Quarterly Report, *supra* note 21, at 114.

Approximately \$379 billion of AIGFP's portfolio (the corporate loans and prime residential mortgages CDSs) were written to provide various European financial institutions "regulatory capital relief."⁷⁶ While AIG's filings do not explain exactly what this means, presumably these institutions were able to reduce the amount of capital they are required to maintain against asset-backed securities they hold by purchasing CDSs on the securities. As a recent *Business Week* article explained:

Under international regulations known as the Basel Accords, European lenders have to set aside a certain amount of money to cover potential losses. By owning credit default swaps, banks could make it appear as if they had off-loaded most of the risk of a loan to AIG or another firm, thereby reducing their capital needs. The perfectly legal ploy allowed banks across the Continent to free up money to make more loans.⁷⁷

Most likely, such an institution would buy a CDS in this context only if its expected return from the resulting regulatory capital relief exceeded the cost of the credit default swap. AIG indicated that, as of December 31, 2007, it "expects that the majority of these transactions will be terminated within the next 12 to 18 months by AIGFP's counterparties as they implement models compliant with the new Basel II Accord."⁷⁸

The balance of AIGFP's CDS portfolio (the remaining \$148 billion) was arbitrage motivated.⁷⁹ AIG does not explain what this means but presumably the counterparties bought the protection as part of some type of arbitrage trading strategy.

The following diagram, which appears in AIG's quarterly report for the third quarter of 2008, depicts "a typical structure of a transaction including the super senior risk layer."⁸⁰

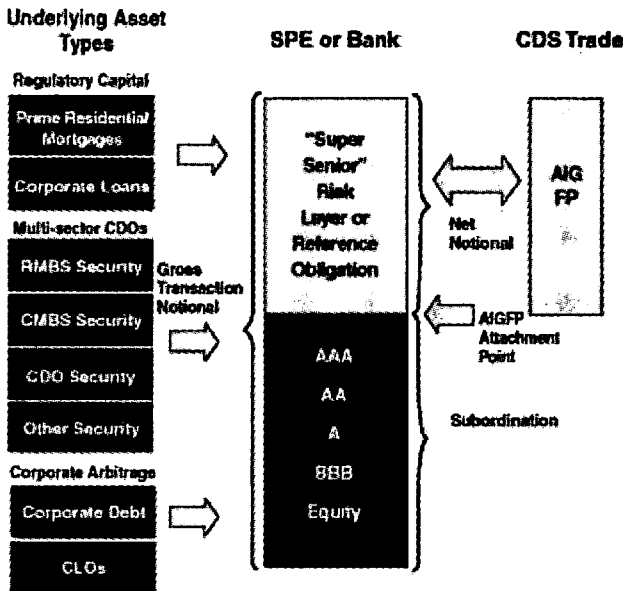
76. See AIG September '08 Quarterly Report, *supra* note 21, at 118 (disclosing that certain CDSs were written to provide regulatory capital relief).

77. David Henry et al., *A Lethal Loophole at Europe's Banks*, BUS. WK., Oct. 27, 2008, at 32; see also BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK 126-30 (2006), available at <http://www.bis.org/publ/bcbs128.pdf> (explaining risk treatment for CDSs); BOMFIN, *supra* note 35, at 299-303 (explaining the treatment of CDSs under Basel I and Basel II).

78. AIG '07 Annual Report, *supra* note 8, at 33.

79. See AIG, Quarterly Report (Form 10-Q) 50 (June 30, 2008), available at <http://media.corporate-ir.net/media-files/irol/76115/reports/Q210Q.pdf> (listing Multi-sector CDOs and Corporate debt/CLOs under the heading "Arbitrage").

80. AIG September '08 Quarterly Report, *supra* note 21, at 115.



Obviously, AIGFP sold protection to make money. A former AIGFP senior executive characterized writing CDSs as "gold" and "free money" because AIGFP's risk models indicated that the underlying securities would never go into default.⁸¹ Thus, the CDSs would expire untriggered, and AIGFP would pocket the premiums.⁸² Basically, AIGFP speculated against a drop in credit quality with respect to innumerable asset-backed securities.

After the fact, as discussed below, the strategy was a disaster, but not necessarily irrational or reckless before the fact.⁸³ Because almost all of

81. Carrick Mollenkamp et al., *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, WALL ST. J., Nov. 3, 2008, at A1; see also Gretchen Morgenson, *Behind Biggest Insurer's Crisis, Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 28, 2008, at A1 (quoting statement from head of AIGFP that "[i]t is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those [CDS] transactions"); AIG, 2006 Annual Report (Form 10-K) 94 (Mar. 1, 2007) [hereinafter AIG '06 Annual Report], available at <http://idea.sec.gov/Archives/edgar/data/5272/000095012307003026/y27490e10vk.htm> ("[T]he likelihood of any payment obligation by AIGFP under each [CDS] transaction is remote, even in severe recessionary market scenarios.").

82. See AIG '06 Annual Report, *supra* note 81, at 94–95 (explaining CDS transactions and why they are likely to have positive results for AIG).

83. But see David Stout & Brian Knowlton, *Fed Chief Says Insurance Giant Acted Irresponsibly*, N.Y. TIMES, Mar. 3, 2009, available at <http://www.nytimes.com/2009/03/04/business/economy/04webcon.html> (citing Federal Reserve Chairman Ben Bernanke's characterization of AIG as a "quasi-hedge fund" that "made irresponsible bets and took huge losses").

AIGFP's CDSs were written on super senior tranches and losses are allocated sequentially starting with the equity tranche, a pool of loans backing the SPV's securities could suffer substantial defaults before any losses would be incurred by the super senior tranche.⁸⁴ If lower rated tranches absorb all the losses, meaning no losses have to be allocated to the super senior tranche, there will be no "credit event" with respect to the super senior tranche and, therefore, no payment obligation under the CDS AIGFP wrote on the tranche.⁸⁵ The weighted average attachment points at which the securities underlying different categories of AIGFP's CDSs ranged from 12.9% to 22.9%.⁸⁶ "Attachment point" essentially means the percentage of loans in the pool that would have to be in default for any losses to be allocated to the super senior tranche. AIGFP's historical models indicated that these levels of default would never occur.⁸⁷

Through its CDS business, AIG was leveraging further its then-AAA credit rating and trillion dollar balance sheet.⁸⁸ Counterparties were presumably willing to pay AIGFP a higher premium for protection because of AIG's guarantee than they would pay for the same protection from a seller with a lower credit rating, lesser balance sheet, or less-favorable guarantee.⁸⁹ Further, as AIG noted in a May 2008 conference call presentation, its CDS business was very similar to its excess casualty insurance business, a business in which it had been profitably engaging for years.⁹⁰

84. See *supra* notes 63–73 and accompanying text (describing different tranches of securities).

85. See *supra* note 64–66 and accompanying text (explaining why no losses would accrue to the super-senior tranche).

86. AIG, Conference Call Credit Presentation 12 (May 9, 2008), http://media.corporate-ir.net/media_files/irol/76/76115/ConferenceCallCreditPresentation_05_09_08.pdf (last visited Sept. 29, 2009) (on file with the Washington and Lee Law Review).

87. See *id.* at 6 (noting that "[t]he attachment point for the 'Super Senior' portion of each portfolio is modeled as a minimum threshold above which there is no expected loss to AIGFP"). AIG also noted that "[t]he final attachment point is negotiated to exceed the modeled attachment point, giving AIGFP an additional cushion of subordination to its risk position." *Id.*

88. See Kohn Statement, *supra* note 1, at 2 ("Financial Products . . . was able to take on substantial risk using the credit rating that AIG received.").

89. See BOMFIN, *supra* note 35, at 10 ("[O]ther things being equal, the higher the credit quality of a given protection seller relative to other protection sellers, the more it can charge for the protection it provides.").

90. *Id.* at 41.

III. AIG's Collapse

This Part explains why a company with \$1 trillion in assets and \$95.8 billion in shareholders' equity suddenly collapsed. The answer is that AIG ran out of cash largely as a result of the CDSs AIGFP wrote on multi-sector collateralized debt obligations.

A. Credit Default Swaps on Multi-Sector Collateralized Debt Obligations

A collateralized debt obligation (CDO) is a type of asset-backed security whose underlying pool of assets consists of tranches of other asset-backed securities (for example, mortgage-backed securities) and other debt obligations.⁹¹ Just like the asset-backed securities structure described above, a CDO is typically tranching into different classes of debt securities reflecting different levels of seniority and, therefore, a range of credit ratings (from AAA to BB).⁹² A multi-sector CDO is one whose underlying assets consist of tranches of asset-backed securities with underlying pools of assets from multiple sectors such as residential mortgage loans, commercial mortgage loans, auto loans, credit card receivables, and other similar assets. AIG wrote protection on super senior tranches of these CDOs as well as "high grade" and mezzanine tranches.⁹³

Unfortunately for AIG and its shareholders, \$61.4 billion in net notional amount of AIGFP's CDS portfolio was written on multi-sector CDOs with underlying residential mortgage-backed securities whose asset pools included subprime mortgage loans.⁹⁴ As AIG noted in its 2007 annual report, "[i]n mid-2007, the U.S. residential mortgage market began to experience serious disruption due to credit quality deterioration in a significant portion of loans originated, particularly to non-prime and subprime borrowers . . ."⁹⁵ Defaults

91. See Douglas J. Lucas et al., *Collateralized Debt Obligations and Credit Risk Transfer* 1 (Yale ICF Working Paper No. 07-06, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=997276 (noting that a CDO might contain corporate loans or mortgage-backed securities).

92. See *id.* at 2 (describing seniority structure of CDOs).

93. AIG September '08 Quarterly Report, *supra* note 21, at 115. "High grade" refers to CDO securities with underlying collateral credit ratings on a stand-alone basis of predominantly AA or higher at origination. *Id.* "Mezzanine" refers to CDO securities in which the underlying collateral credit ratings on a stand-alone basis were predominantly A or lower at origination. *Id.*

94. See AIG '07 Annual Report, *supra* note 8, at 122 ("Approximately \$61.4 billion in notional amount of the multi-sector CDO pools include some exposure to U.S. subprime mortgages.").

95. *Id.* at 30.

by these borrowers rippled through the chain, ultimately leading to massive write-downs in AIGFP's CDS portfolio totaling \$11.2 billion in 2007⁹⁶ and \$19.9 billion for the first nine months of 2008.⁹⁷ Specifically, (1) the defaults negatively impacted the cash flow of the SPVs who issued debt securities backed by the loans, which (2) negatively impacted the credit quality of the SPVs and their securities, which (3) negatively impacted the credit quality of the multi-sector CDOs which purchased some of the SPVs' securities, and which (4) caused the estimated spread on the CDSs written on the CDOs' securities to widen resulting in unrealized losses on AIGFP's CDO CDS portfolio. While these write-downs certainly contributed to AIG's cash woes, they were not the main culprit given they were unrealized and, therefore, did not actually directly impact AIG's cash flow.⁹⁸

The principal cause of AIG's cash woes was the collateral posting obligations in AIGFP's multi-sector CDO CDSs.⁹⁹ As discussed above, these provisions are a common feature of CDSs designed to reduce the counterparty credit risk assumed by a CDS protection buyer.¹⁰⁰ The amount of collateral that AIGFP is required to post depends on the terms of the provisions.¹⁰¹ These terms are subject to negotiation and thus vary across AIGFP's portfolio.¹⁰² Some CDSs require AIGFP to post collateral equal to the difference between the estimated cost to replace the applicable CDS and the collateral posted to date (subject to certain thresholds) with the calculation performed daily, weekly, or at some other interval as provided in the CDS.¹⁰³ The large majority of AIGFP's multi-sector CDO CDSs base collateral posting requirements on the difference between the notional amount of the particular CDS and the market value of the underlying CDO security.¹⁰⁴ Accordingly, as CDO values tanked, AIG was obligated to post more and more cash collateral. For example, from July 1, 2008, to August 31, 2008, declines in the CDO securities on which

96. See *id.* at 122 (showing table listing loss).

97. See AIG September '08 Quarterly Report, *supra* note 21, at 114 (showing table).

98. The write-downs had an indirect impact on AIG's cash flow because they made it difficult for AIG to access the capital markets for additional cash. *Infra* Part III.C.

99. See AIG September '08 Quarterly Report, *supra* note 21, at 118 (discussing the collateral posting requirements).

100. See *supra* note 43 and accompanying text (describing posting obligations).

101. See AIG September '08 Quarterly Report, *supra* note 21, at 118 ("These provisions differ among counterparties and asset classes.").

102. See *id.* (noting that posting requirements vary).

103. See *id.* (explaining mechanism for determining amount to be posted).

104. See *id.* at 119 ("[T]he exposure amount [is] determined pursuant to an agreed formula that is based on the difference between the net notional amount of such transaction and the market value of the relevant [CDO].").

AIGFP wrote protection, together with rating downgrades on these securities, resulted in AIGFP posting or agreeing to post \$6.0 billion in collateral, representing approximately 34% of the \$17.6 billion in cash and cash equivalents AIG had available on July 1, 2008, to meet the cash needs of its operations.¹⁰⁵

B. Securities Lending Program

Adding to AIG's cash struggles was its securities lending program, a program managed by AIG Investments, AIG's institutional asset management unit.¹⁰⁶ Under the program, AIG Investments loaned securities from the investment portfolios of AIG's insurance companies to various financial institutions (the typical reason an institution borrows securities is to sell them short) in exchange for cash collateral posted by the borrower.¹⁰⁷ AIG Investments would then invest the collateral in debt securities to earn a return which would serve as compensation for lending securities.¹⁰⁸ At one point, AIG investment had loaned \$76 billion in securities to U.S. companies.¹⁰⁹

As borrowers received news about AIG's massive write-downs and collateral posting obligations, they became concerned about the safety of the cash collateral they had posted with AIG Investments. Thus, many of them decided to return lent securities and get their collateral back.¹¹⁰ Unfortunately, AIG Investments had invested a significant portion of the cash in residential mortgage-backed securities which had plummeted in value and liquidity.¹¹¹ As

105. *See id.* at 49 (noting amount of loss and level of cash on hand).

106. *See id.* at 143 (noting that the program was run for the benefit of AIG's insurance companies).

107. *See id.* (describing program). Short selling is a technique used to profit from a drop in value of a security. The short seller borrows a security and immediately sells it with the hope that the price of the security will drop allowing the short seller to buy it back at a lower price and then return it to the lender.

108. *See id.* ("Cash collateral is received and invested . . . to receive a net spread.").

109. *See American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 5 (2009) (written testimony of Eric Dinallo, Superintendent of Insurance, New York State Insurance Department) [hereinafter Dinallo Testimony], available at http://banking.senate.gov/public/_files/DinalloTestimonyAIG3509.pdf ("At its height, the U.S. pool had about \$76 billion.").

110. *See* AIG September '08 Quarterly Report, *supra* note 21, at 144 ("Counterparties began curtailing their participation in the program by returning securities."); Dinallo Testimony, *supra* note 109, at 6 (noting that crisis at AIGFP "caused the equivalent of a run on AIG securities lending").

111. AIG September '08 Quarterly Report, *supra* note 21, at 144.

a result, the program lacked sufficient funds to satisfy collateral-return obligations.¹¹² Accordingly, AIG was forced to transfer billions in cash to the program, cash which was immediately paid out to these borrowers.¹¹³ Through August 31, 2008, AIG had transferred \$3.3 billion in cash to the program.¹¹⁴

C. Inability to Access Capital Markets and Credit Downgrade

By early September 2008, AIG realized its cash situation was dire and, therefore, accelerated its ongoing efforts to raise additional capital.¹¹⁵ It held discussions with private equity firms, sovereign wealth funds, and other investors but was unable to strike a deal.¹¹⁶ In more bad news, several of AIG's subsidiaries were unable to roll over their commercial paper financing,¹¹⁷ meaning AIG was essentially shut out of the commercial paper market.

After considering the massive write-downs on AIGFP's CDS portfolio, the billions of dollars of collateral posting obligations, AIG's inability to access the capital markets, and its insurance company investment portfolio losses, the credit rating agencies downgraded AIG's long-term debt rating on September 15, 2008—S&P by three notches and Moody's and Fitch by two notches.¹¹⁸ These downgrades triggered in excess of \$20 billion in additional collateral calls because the collateral posting provisions contained in many of AIGFP's CDSs also took into account the credit rating of AIG, with a credit downgrade triggering additional posting obligations.¹¹⁹

112. *See id.* (noting that AIG did not have sufficient liquidity to pay).

113. *See id.* at 49 (noting that AIG paid \$6 billion); *see also* Kohn Statement, *supra* note 1, at 7 (noting that decline in RMBS values caused a strain on AIG's finances).

114. AIG September '08 Quarterly Report, *supra* note 21, at 49.

115. *See id.* (describing AIG's efforts to raise capital, including hiring J.P. Morgan).

116. *See id.* at 50 (noting that AIG discussed raising capital with multiple parties but could not reach agreement).

117. *See id.* (noting that AIG had to give \$2.2 billion to its subsidiaries to make payments).

118. S&P's rationale for the downgrade was "the combination of reduced flexibility in meeting additional collateral needs and concerns over increasing residential mortgage-related losses." Standard & Poor's, Research Update: American International Group Rating Lowered and Kept on Credit Watch Negative, 2 (Sept. 15, 2008). Moody's rationale was "the continuing deterioration in the US housing market and the consequent impact on [AIG]'s liquidity and capital position due to its related investment and derivative exposure." Moody's Investors Service, Moody's Downgrades AIG (senior to A2); LT and ST ratings under review, 1 (Sept. 15, 2008). Fitch's rationale was "that AIG's financial flexibility and ability to raise holding company cash is extremely limited due to recent declines in the company's stock price, widening credit spreads, and difficult capital market conditions." Fitch Ratings, Fitch Downgrades AIG to 'A'; Remains on Rating Watch Negative, 1 (Sept. 15, 2008).

119. *See* AIG September '08 Quarterly Report, *supra* note 21, at 50 ("Subsequently, in a

The day after the downgrade, AIG made a last ditch effort to raise additional financing. Among other things, AIG management met with representatives of Goldman, Sachs & Co., J.P. Morgan, and the Federal Reserve Bank of New York (NY Fed) to discuss putting together a \$75 billion secured lending facility syndicated among various financial institutions.¹²⁰ By the early afternoon, however, it was apparent that no private sector lending facility was forthcoming¹²¹ and that AIG "had an immediate need for cash in excess of its available liquid resources."¹²² As a result, the government decided to intercede.

IV. The Bailout

At 9:00 p.m. EDT on September 16, 2008, the Federal Reserve Board (Fed) announced, with the support of the U.S. Department of the Treasury (Treasury), that it had authorized the NY Fed to bail out AIG through an \$85 billion revolving credit facility (Fed Credit Facility).¹²³ The intent of the loan was to "facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy."¹²⁴ This Part discusses the initial bailout and subsequent restructurings, analyzes some legal issues associated with the bailout, and probes why the government stepped in.

period of approximately [fifteen] days following the rating actions, AIGFP was required to fund approximately \$32 billion, reflecting not only the effect of the rating actions but also changes in market levels and other factors.").

120. See *id.* (noting that AIG met with those firms to try to arrange a loan).

121. See *id.* (stating that private firms could not organize a facility). The banks advising AIG determined that "it would be all but impossible to organize a loan of that size." Matthew Karnitschnig et al., *U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up; Emergency Loan Effectively Gives Government Control of Insurer; Historic Move Would Cap 10 Days that Reshaped U.S. Finance*, WALL ST. J., Sept. 17, 2008, at A1; see also Kohn Statement, *supra* note 1, at 4 (commenting that the private sector effort "was unsuccessful in a deteriorating economic and financial environment in which firms were not willing to expose themselves to risks—a risk aversion that greatly increased following the collapse of Lehman Brothers on September 15").

122. AIG September '08 Quarterly Report, *supra* note 21, at 50.

123. See Press Release, The Federal Reserve Board (Sept. 16, 2008) [hereinafter 9/16/08 Fed Press Release], available at <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm> (announcing bailout and explaining that failure of AIG would damage markets).

124. *Id.*

A. Initial Bailout

As initially struck, the Fed Credit Facility provided for a line of credit of up to \$85 billion in principal amount, had a two-year term expiring on September 22, 2010,¹²⁵ and bore interest at the greater of 3.5% per annum and 3-month LIBOR,¹²⁶ plus 8.5% per annum (meaning a minimum interest rate of 12%).¹²⁷ AIG was required to pay an initial gross commitment fee of \$1.7 billion¹²⁸ and an ongoing commitment fee of 8.5% per annum on undrawn amounts.¹²⁹ As described below, these terms have been revised but the other terms of the original agreement remain in place.¹³⁰

The Fed Credit Facility requires AIG to pay interest and commitment fees through increases to the outstanding principal balance under the facility,¹³¹ although AIG has the option to pay them in cash.¹³² AIG may use borrowings under the facility for general corporate purposes, including as a source of liquidity.¹³³ Additionally, AIG is required to use any net cash proceeds from the sale of certain assets or the issuances of equity or debt securities to pay down the outstanding balance on the Fed Credit Facility.¹³⁴ The amount available for borrowing under the Fed Credit Facility is reduced permanently by the amount of any such payments.¹³⁵

The Fed Credit Facility required AIG to issue 100,000 shares of preferred stock (Series C Preferred) to AIG Credit Facility Trust (Trust),¹³⁶ "a new trust

125. See Credit Agreement Between American International Group, Inc. and Federal Reserve Bank of New York § 4.12 (Sept. 22, 2008) [hereinafter Credit Agreement], available at <http://www.sec.gov/Archives/edgar/data/5272/000095012308011496/y71452exv99w1.htm> (defining terms of agreement, including the \$85 billion commitment and the September 22, 2010 maturity date).

126. LIBOR stands for London Inter-Bank Offer Rate. It is the rate of interest at which banks lend money to one another in the London wholesale money markets.

127. See Credit Agreement, *supra* note 125, § 2.06(a) (defining terms of loan and giving Applicable Margin as 8.5%).

128. See *id.* § 4.02(e) (requiring AIG to pay 2% of total \$85 billion on closing date).

129. See *id.* § 2.05(a) (describing exact terms of available commitment fee).

130. See *infra* Parts IV.C–D (noting that revised terms are less harsh for AIG).

131. See Credit Agreement, *supra* note 125, § 2.06(b) (discussing loan payment mechanism).

132. See *id.* § 2.11(c) (requiring two days notice of AIG cash payment).

133. See *id.* § 5.07 (referencing preamble's list of acceptable uses for money).

134. See *id.* § 2.10 (listing events triggering AIG payment obligation).

135. See *id.* § 2.10(h) (stating that loan commitment reduced simultaneously with any prepayment by AIG).

136. AIG's initial Form 8-K filed with the SEC with respect to the Fed Credit Facility stated:

established for the benefit of the United States Treasury."¹³⁷ AIG issued the shares to the Trust in March 2009. Following the requisite vote of AIG stockholders to amend AIG's certificate of incorporation to increase the number of authorized shares of common stock to 19 billion and reduce their par value from \$2.50 to \$0.000001 per share, the Series C Preferred will be convertible at the Trust's option into a number of shares of common stock equal to 77.9% of AIG's then outstanding shares of common stock plus the maximum number of shares reserved for issuance with respect to the equity units AIG sold in a May 2008 offering.¹³⁸ The Series C Preferred will vote with the common stock on

AIG issued a warrant to the Board of Governors of the Federal Reserve ("Federal Reserve") that permits the Federal Reserve, subject to shareholder approval, to obtain up to 79.9% of the outstanding common stock of AIG (after taking into account the exercise of the warrant). AIG anticipates calling a special meeting for such purpose as promptly as practicable.

AIG, Current Report (Form 8-K) 1 (Sept. 18, 2008). AIG filed an amended Form 8-K the next day indicating that AIG did not in fact issue a warrant but will be issuing a 79.9% equity interest. AIG, Amended Current Report (Form 8-K/A) 1 (Sept. 19, 2008).

137. Credit Agreement, *supra* note 125, § 5.11, Exhibit D, at 1. Presumably, because the government had, and continues to have, many fires to put out, the trust was not actually created until January 16, 2009. AIG Credit Facility Trust Agreement Among Federal Reserve Bank of New York et al. (Jan. 16, 2009), *available at* <http://www.newyorkfed.org/newsevents/news/markets/2009/AIGCFTAgreement.pdf>. A NY Fed press release describes the trust as follows:

Pursuant to the terms of the Trust Agreement, the trustees will have absolute discretion and control over the AIG stock, subject only to the terms of the Trust Agreement, and will exercise all rights, powers and privileges of a shareholder of AIG. The trustees will not sit on the board of directors of AIG. Day-to-day management of AIG will remain with the persons charged with such management.

To avoid possible conflicts with the New York Fed's supervisory and monetary policy functions, the Trust has been structured so that the New York Fed cannot exercise any discretion or control over the voting and consent rights associated with the equity interest in AIG. The New York Fed will, however, continue to monitor closely the financial operations of AIG in connection with its role as lender.

Press Release, The Federal Reserve Bank of New York, Statement Regarding Establishment of the AIG Credit Facility Trust (Jan. 16, 2009), *available at* <http://www.newyorkfed.org/newsevents/news/markets/2009/an090116.html>. The trust agreement provides for three initial trustees: Jill M. Considine, former chairman of the Depository Trust & Clearing Corporation; Chester B. Feldberg, former chairman of Barclays Americas; and Douglas L. Foshee, president and chief executive officer of El Paso Corporation. *Id.* For speculation as to why the shares are held in trust as opposed to directly by the U.S. Treasury or Fed, see Steven M. Davidoff & David T. Zaring, *Big Deal: The Government's Response to the Financial Crisis* 32 (Nov. 24, 2008), *available at* <http://ssrn.com/abstract=1306342>.

138. Credit Agreement, *supra* note 125, Exhibit D, at 1–2. For a description of the May 2008 offering of equity units, see AIG September '08 Quarterly Report, *supra* note 21, at 26. As of September 30, 2008, AIG had five billion authorized shares of common stock and nearly three billion shares outstanding. *Id.* at 2. Thus, it needs to increase its authorized shares of common stock so that it has sufficient authorized but unissued shares to issue upon conversion

all matters submitted to AIG's stockholders and will be entitled to one vote per share into which the Series C Preferred is then convertible, not to exceed 77.9% of the aggregate voting power.¹³⁹ The Series C Preferred is entitled to participate on an as-converted basis in any dividends paid on the common stock, not to exceed 77.9% of the aggregated dividends paid.¹⁴⁰ The 77.9% figures were originally set at 79.9% but were reduced as part of the bailout restructuring discussed below.¹⁴¹ The government's stake was purposely set below 80% so that it would not have to consolidate AIG's financials with its own.¹⁴²

The terms of the Series C Preferred restrict AIG, subject to certain exceptions, from issuing any capital stock or securities convertible into capital stock without the consent of the Trust, so long as the Trust's equity ownership in AIG is above a specified level.¹⁴³ Additionally, the terms of the Series C Preferred provide that "AIG and its board will work in good faith with the trustees of the Trust to ensure corporate governance arrangements satisfactory to the trustees."¹⁴⁴ Further, AIG entered into an agreement requiring it to register on demand the Series C Preferred and underlying shares of common

of the Series C Preferred. The issuance of convertible preferred stock is valid even if there are insufficient authorized shares for issuance upon conversion at the time of issuance of the convertible preferred stock. *See Hildreth v. Castle Dental Ctrs., Inc.*, 939 A.2d 1281, 1283–84 (Del. 2007) (allowing issuance of convertible preferred stock in excess of authorized shares). Presumably, the par value is being reduced because section 153(a) of the Delaware General Corporation Law (AIG is incorporated in Delaware) provides the following: "Shares of stock with par value may be issued for such consideration, having a value not less than the par value thereof" DEL. CODE ANN. tit. 8, § 153(a) (2009). Reducing the par value of AIG's common stock to one ten-thousandth of a penny forecloses any argument that an issuance of shares on conversion of the preferred stock somehow violated Section 153(a) (perhaps the argument would be that the value of the credit facility was less than \$2.50 per share). AIG's certificate of incorporation requires any preferred stock to have a par value of \$5.00 per share. *See* AIG '07 Annual Report, *supra* note 8, at 180 (stating that preferred stock had a par value of \$5.00, but that none of the preferred stock was then outstanding). In that regard, the credit facility provides AIG will deduct from its initial commitment fee to cover the par value of the preferred shares to be issued to the Trust. *Id.*

139. *See* Credit Agreement, *supra* note 125, Exhibit D, at 1 (stating terms on which preferred shares were issued).

140. *See id.* (reciting dividend terms of preferred shares).

141. *Infra* Part IV.C.

142. *See* Liam Plevin et al., *AIG Seeks to Ease Its Bailout Terms*, WALL. ST. J., Feb. 24, 2009, at A1 (explaining that AIG did not believe the government would seek a bigger stake).

143. *See* Credit Agreement, *supra* note 125, at 2 (giving conditions for issuances of equity).

144. *Id.*

stock under the Securities Act of 1933 in order to facilitate resale of the shares.¹⁴⁵

The Fed Credit Facility contains various affirmative and negative covenants. Among these covenants is a requirement that AIG use all reasonable efforts to cause the composition of its board of directors to be satisfactory to the Trust¹⁴⁶ and prohibitions against AIG (1) entering into CDSs except consistent with policies approved by the NY Fed from time to time,¹⁴⁷ and (2) permitting liquidity (unrestricted cash and cash equivalents on hand plus available borrowings under the Fed Credit Facility)¹⁴⁸ to drop below \$15 billion.¹⁴⁹ Additionally, the NY Fed is not required to loan AIG funds under the Fed Credit Facility, unless, among other things, the NY Fed is "reasonably satisfied in all respects with the corporate governance of [AIG]."¹⁵⁰

Borrowings under the Fed Credit Facility are secured by AIG's pledge of the capital stock and assets of certain of its subsidiaries, subject to certain exceptions.¹⁵¹ As a condition to the bailout, Treasury Secretary Henry Paulson required AIG's CEO, Robert Willumstad, to resign.¹⁵²

It may appear that the government initially drove an extremely hard bargain with AIG. A minimum interest rate of 12% plus a continuing commitment fee of 8.5% on undrawn amounts translates into over \$9 billion per year assuming an average outstanding balance of \$60 billion. However, when compared to junk bonds, the yields on which were approximately 17.6% on September 17, 2008,¹⁵³ 12%/8.5% is perhaps below market considering AIG was on the verge of bankruptcy. Of course, AIG also had to give up what was then a 79.9% stake in itself. However, on September 16, 2008, prior to the bailout being announced, AIG's stock closed at \$3.75 per

145. See *id.* (agreeing that AIG would seek to register the preferred shares).

146. See *id.* § 4.11 (stating that AIG will make its Board satisfactory to the trust "in its sole discretion").

147. See *id.* § 6.10 (restricting AIG's ability to enter into CDSs).

148. See *id.* § 1.01 (defining aggregate liquidity).

149. See *id.* § 6.12 (stating that \$15 billion will be minimum liquidity).

150. *Id.* § 4.01(e).

151. See Guarantee and Pledge Agreement Among American International Group, Inc. et al. (Sept. 22, 2008), available at <http://www.sec.gov/Archives/edgar/data/5272/000095012308011496/y71452exv99w2.htm> (detailing guarantees made by AIG in exchange for Fed loans).

152. See Karnitschnig et al., *supra* note 121, at A1 (stating that Paulson personally informed Willumstad of this condition to the loan).

153. See *Tracking Bond Benchmarks*, WALL ST. J., Sept. 17, 2008, at C9 (listing the yield on Triple-C-rated bonds at 17.57%).

share,¹⁵⁴ representing a market capitalization of approximately \$10.1 billion.¹⁵⁵ Based on that number, the 79.9% stake had a value of roughly \$8.1 billion, less than one year of interest and fees under the Fed Credit Facility. Regardless, the interest rate and commitment fee has since been substantially reduced, as discussed below.

B. Additional Lifelines

Notwithstanding the government bailout, AIG's securities lending program continued to impair greatly its liquidity. During the third quarter of 2008, AIG had to contribute \$14.9 billion to certain domestic life and retirement services subsidiaries largely due to other-than-temporary impairment charges of \$11.7 billion recognized on the invested collateral of its securities lending program.¹⁵⁶ Additionally, borrowers under the program continued to return securities requiring AIG Investments to return their cash collateral.¹⁵⁷ As of September 30, 2008, AIG had borrowed approximately \$11.5 billion under the Fed Credit Facility to meet the liquidity needs of its securities lending program.¹⁵⁸ In light of this situation, on October 8, 2008, certain AIG life insurance and retirement services subsidiaries entered into a securities lending agreement with the NY Fed.¹⁵⁹ The agreement provided that the NY Fed would borrow up to \$38.7 billion in investment grade fixed maturity securities from these AIG subsidiaries on an overnight basis in return for cash collateral.¹⁶⁰ AIG Investments could then use these funds to

154. Yahoo! Finance, Historical Prices for AIG, <http://finance.yahoo.com/q/hp?s=AIG&a=08&b=16&c=2008&d=08&e=16&f=2008&g=d> (last visited Sept. 29, 2009) (on file with the Washington and Lee Law Review).

155. This figure results from multiplying the per share price of \$3.75 by 2.7 billion shares outstanding. See AIG September '08 Quarterly Report, *supra* note 21, at 3 (stating that AIG had approximately 2.7 billion shares outstanding during September 2008).

156. See *id.* at 143 (discussing AIG's payments to subsidiaries).

157. See *id.* ("Counterparties began . . . returning lent securities and requiring the return of cash collateral.").

158. *Id.*

159. See *id.* (providing details of the agreement); see also Press Release, The Federal Reserve Board (Oct. 8, 2008) [hereinafter 10/8/08 Fed Press Release], available at <http://www.federalreserve.gov/newsevents/press/other/20081008a.htm> (stating that the Fed had authorized the NY Fed to borrow the securities).

160. See AIG September '08 Quarterly Report, *supra* note 21, at 143 (stating that the Fed had agreed to borrow the securities).

return the cash collateral posted by the borrowers.¹⁶¹ As of November 5, 2008, AIG owed the NY Fed \$19.9 billion under the agreement.¹⁶²

Additionally, on October 27, 2008, four AIG subsidiaries applied to participate in the Commercial Paper Funding Facility.¹⁶³ The Fed established the facility on October 7, 2008, to "provide a liquidity backstop to U.S. issuers of commercial paper through a special purpose vehicle (SPV) that will purchase three-month unsecured and asset-backed commercial paper directly from eligible issuers."¹⁶⁴ AIG's subsidiaries are participating in the facility on the same terms as other participants and can borrow an aggregate of \$20.9 billion under the facility.¹⁶⁵ As of November 5, 2008, these subsidiaries had borrowed \$15.2 billion under the facility.¹⁶⁶ AIG used these funds to make voluntary repayments on the Fed Credit Facility,¹⁶⁷ taking advantage of the more favorable interest rate under the Commercial Paper Funding Facility (3-month overnight index swap rate plus 100 or 300 basis points per annum)¹⁶⁸ as compared to the Fed Credit Facility (3-month LIBOR plus 8.5% per annum).¹⁶⁹

C. Bailout Restructuring I

On November 10, 2008, the Fed announced that the government was restructuring its aid to AIG "in order to keep the company strong and facilitate its ability to complete its restructuring process successfully."¹⁷⁰ The intent

161. See Kohn Statement, *supra* note 1, at 7 (stating that the facility "was designed to provide the company additional time to arrange and complete the orderly sales of RMBS and other assets in a manner that would minimize losses to AIG and disruption to the financial markets").

162. See AIG September '08 Quarterly Report, *supra* note 21, at 144 (noting that AIG owed a total of \$34.2 billion in securities lending payables).

163. See *id.* at 53 (listing subsidiaries that applied to facility).

164. Press Release, Federal Reserve Board (Oct. 7, 2008), available at <http://www.federalreserve.gov/newsevents/press/monetary/20081007c.htm>.

165. See AIG September '08 Quarterly Report, *supra* note 21, at 53 (listing amounts each subsidiary could borrow individually).

166. *Id.*

167. See *id.* (noting that AIG used the money to repay Fed Facility borrowings).

168. See Federal Reserve Bank of New York, Commercial Paper Funding Facility: Program Terms and Conditions (Oct. 14, 2008), http://www.newyorkfed.org/markets/CPFF_Terms_Conditions.html (last visited Sept. 29, 2009) (providing table listing terms and conditions of the CPFF) (on file with the Washington and Lee Law Review).

169. See *supra* notes 126–27 and accompanying text (discussing the interest terms of the Fed Credit Facility).

170. Press Release, Board of Governors of the Federal Reserve System (Nov. 10, 2008) [hereinafter 11/10/08 Fed Press Release], available at <http://www.federalreserve.gov/news>

behind the original deal was that AIG would sell some of its \$1 trillion in assets and use the proceeds to pay off the Fed Credit Facility.¹⁷¹ Perhaps at the time the government assumed that the worst of the financial crisis had passed and, therefore, AIG would be able to unload assets fairly quickly and in a non-fire-sale manner.¹⁷² However, with markets remaining in turmoil, few, if any, buyers were in a position to make acquisitions.¹⁷³ As a result, it was feared that AIG would go bankrupt notwithstanding the Fed Credit Facility and other loans. As Maurice Greenberg, a former CEO of AIG, put it, "[T]he loan from the Federal government to AIG, as it is currently structured, will result in the liquidation of AIG, the loss of thousands of jobs, and the irretrievable loss of billions of dollars in shareholder value."¹⁷⁴

The restructuring consisted of three components: an equity purchase, changes to the Fed Credit Facility, and creation of additional lending facilities.¹⁷⁵ Under the equity purchase component, the U.S. Treasury purchased \$40 billion of newly created AIG Series D Preferred Stock (Series D Preferred) pursuant to the Troubled Asset Relief Program (TARP) included in the Emergency Economic Stabilization Act of 2008.¹⁷⁶ The shares have limited class voting rights and provide for cumulative dividends of 10% per annum.¹⁷⁷ AIG was required to use the proceeds from the issuance to pay down the Fed Credit Facility.¹⁷⁸ Additionally, AIG issued the U.S. Treasury a warrant to purchase two percent of AIG's common stock at \$0.00001 per share.¹⁷⁹

events/press/other/20081110a.htm.

171. See Karnitschnig et al., *U.S. Throws New Lifeline to AIG, Scrapping Original Rescue Deal*, WALL ST. J., Nov. 10, 2008, at A1 (noting that original intent of rescue deal was for AIG to sell its assets to pay back the loans).

172. See *id.* (noting criticism that deal would have forced AIG to sell assets in a declining market).

173. See *id.* (noting that "the turmoil in the markets has made it difficult for potential buyers to secure funding").

174. Letter from Maurice R. Greenberg to Edward Liddy, Chairman & Chief Executive Officer, American International Group, Inc. (Oct. 13, 2008), available at <http://www.sec.gov/Archives/edgar/data/5272/000135982408000030/exhibit2.htm>.

175. See 11/10/08 Fed Press Release, *supra* note 170, at 1 (listing these as major restructuring categories).

176. Pub. L. No. 110-343, 122 Stat. 3765 div. A (2008) (codified as amended in scattered sections of 12 & 26 U.S.C.).

177. See AIG September '08 Quarterly Report, *supra* note 21, at 51 (noting that dividends would be paid when AIG's board declared payment).

178. *Id.*

179. See *id.* at 52 (stating that warrant would last for ten years).

As for changes to the Fed Credit Facility, the principal amount available for borrowing was reduced from \$85 billion to \$60 billion.¹⁸⁰ The term was changed from two years to five years.¹⁸¹ The interest rate was reduced from 3-month LIBOR (not less than 3.5%) plus 8.5% to 3-month LIBOR (not less than 3.5%) plus 3.0%.¹⁸² The ongoing commitment fee was reduced from 8.5% to 0.75%.¹⁸³ As mentioned above, the voting, dividend, and conversion rights of the Series C Preferred were reduced from 79.9% to 77.9% to offset the two percent increase in the government's beneficial ownership of AIG from the warrant issued to the U.S. Treasury as part of the Series D Preferred deal.¹⁸⁴ The warrant was included as part of that deal to meet the requirements of TARP.¹⁸⁵

Further, to address continuing problems related to AIG's securities lending program, the NY Fed, through a wholly-owned limited liability company, purchased \$39.3 billion face amount in residential mortgage-backed securities from AIG for \$19.8 billion.¹⁸⁶ These securities were purchased by AIG with cash collateral posted by borrowers under its securities lending program.¹⁸⁷ AIG used the proceeds from the NY Fed and additional funds to repay this cash collateral, and it then terminated its securities lending program as well as the securities lending agreement it entered into with the NY Fed in October 2008.¹⁸⁸ The intent of this facility was to "provide a permanent solution to the AIG securities lending program's losses and liquidity drains."¹⁸⁹

Finally, to address AIG's continuing collateral posting obligations from its CDS portfolio, AIG and the NY Fed established a facility to purchase CDOs from counterparties to AIG's multi-sector CDO CDSs in exchange for these

180. See *id.* at 44 (stating that decrease would come subsequent to Series D issuance).

181. See *id.* ("[T]he NY Fed agreed [to] . . . extend the term . . . from two years to five years.").

182. *Id.*

183. *Id.*

184. See *id.* (explicitly connecting warrant issuance with decrease in control by Series C Preferred shares).

185. See 12 U.S.C. § 5223(d) (Supp. 2008) (requiring the Secretary to receive a warrant when buying troubled assets).

186. See AIG, Current Report (Form 8-K) 2 (Dec. 15, 2008), available at <http://idea.sec.gov/Archives/edgar/data/5272/000095012308017611/0000950123-08-017611-index.idea.htm> (giving details of Fed's asset purchase from AIG).

187. See *id.* (stating that AIG had bought the securities on behalf of its life insurance subsidiaries).

188. See *id.* (stating that AIG used the money to pay off the NY Fed along with other outstanding securities transactions).

189. Kohn Statement, *supra* note 1, at 9.

counterparties concurrently terminating the related CDSs.¹⁹⁰ The NY Fed has agreed to provide a term loan of up to \$30 billion to fund the purchase of the CDOs, and AIG contributed \$5 billion.¹⁹¹

D. Bailout Restructuring II

On March 2, 2009, the Fed and Treasury jointly announced that the government was again restructuring its aid to AIG "in order to stabilize this systemically important company in a manner that best protects the U.S. taxpayer. Specifically, the government's restructuring is designed to enhance the company's capital and liquidity in order to facilitate the orderly completion of the company's global divestiture program."¹⁹² The announcement also stated that "[o]rderly restructuring is essential to AIG's repayment of the support it has received from U.S. taxpayers and to preserving financial stability [and] [t]he U.S. government is committed to continuing to work with AIG to maintain its ability to meet its obligations as they come due."¹⁹³

The announcement came concurrently with AIG's announcement that it had a net loss of \$61.7 billion for the fourth quarter of 2008, the largest quarterly loss in U.S. corporate history,¹⁹⁴ bringing its net loss for full year 2008 to \$99.3 billion.¹⁹⁵ The fourth quarter loss reflected "continued severe credit market deterioration, particularly in commercial mortgage-backed securities, and charges related to ongoing restructuring-related activities."¹⁹⁶

190. See AIG September '08 Quarterly Report, *supra* note 21, at 53 (stating that AIG and the NY Fed expected to establish an LLC for this purpose).

191. See AIG, Current Report (Form 8-K) 2 (Dec. 2, 2008), available at <http://idea.sec.gov/Archives/edgar/data/5272/000095012308016800/0000950123-08-016800-index.idea.htm> (stating that NY Fed offered \$30 billion in loans to Maiden Lane III LLC and AIG purchased an equity interest for \$5 billion).

192. Press Release, Board of Governors of the Federal Reserve System and U.S. Dep't of the Treasury, U.S. Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan (Mar. 2, 2009) [hereinafter 3/2/09 Treasury/Fed Press Release], available at <http://www.federalreserve.gov/newsevents/press/other/20090302a.htm>.

193. *Id.*

194. See *U.S. Offers More Funds to Help Fraught AIG*, MSNBC, Mar. 2, 2009, <http://www.msnbc.msn.com/id/29455792/> (last visited Sept. 29, 2009) (stating that AIG's loss was a U.S. corporate record) (on file with the Washington and Lee Law Review).

195. Press Release, American International Group, Inc., AIG Reports Fourth Quarter and Full Year 2008 Loss, at 2-3 (Mar. 2, 2009), available at <http://idea.sec.gov/Archives/edgar/data/5272/000095012309003740/e74794exv99w1.htm> (listing statistics in tables).

196. *Id.* at 1. Market disruption-related items included the following:

Pre-tax net realized capital losses arising from other-than-temporary impairment charges of \$18.6 billion (\$13.0 billion after tax) as well as a \$6.7 billion pre-tax

Restructuring II also consisted of three components: a share exchange, creation of an equity capital commitment facility, and further modifications to the Fed Credit Facility. Under the share exchange, all outstanding shares of Series D Preferred were exchanged for shares of Series E Preferred Stock (Series E Preferred) with terms substantially the same as those of the Series D Preferred, except that the 10% Series E Preferred dividends are not cumulative.¹⁹⁷ Therefore, if AIG fails to pay them in a particular year, they do not carry over to the next year, potentially saving AIG roughly \$4 billion a year.¹⁹⁸

Under the equity capital commitment facility, the Treasury has agreed to provide AIG with up to approximately \$30 billion over the next five years.¹⁹⁹ As part of this facility, AIG issued the Treasury 300,000 shares of Series F Preferred Stock.²⁰⁰ These shares have an initial liquidation preference of zero which increases dollar-for-dollar by the amount of any draw-downs under the facility.²⁰¹ Other terms of the Series F Preferred are substantially similar to the Series E

(\$4.4 billion after tax) charge related to AIGFP's credit valuation adjustment for mark-to-market adjustments where counterparty spreads increased and AIG's own credit spread decreased, causing fair value losses on both AIGFP's assets and liabilities.

Id. at 3. Restructuring-related items included the following:

Pre-tax losses of \$4.7 billion (\$3.3 billion after tax) consisting of pre-tax net realized capital losses of \$2.4 billion (\$1.7 billion after tax) for certain securities lending activities which were deemed to be sales due to insufficient levels of collateral received from counterparties, plus pre-tax losses of \$2.3 billion (\$1.6 billion after tax) related to the decline in fair value of RMBS for the month of October 2008 . . . [and] \$5.2 billion of pre-tax losses (\$3.4 billion after tax) related to AIGFP mark-to-market losses for the month of October 2008 on super senior credit default swaps.

Id.

197. AIG, Current Report (Form 8-K) 1 (Sept. 18, 2008).

198. *See id.* at 2 (noting that the Series E Preferred dividends, if declared, are payable quarterly, and if AIG fails to pay them in full for four or more quarters, whether or not consecutive, holders of the Series E Preferred will have the right to elect two directors or 20% of AIG's board). The right to elect directors, however, will end, and such directors will be required to resign, when AIG has paid the dividends in full for four consecutive quarters following triggering of the election right. *Id.*

199. *See* Term Sheet (Mar. 2, 2009) 1, *available at* http://www.ustreas.gov/press/releases/reports/030209_aig_term_sheet.pdf (providing the terms of that loan).

200. *See id.* at 2 (stating that AIG would be issuing Series F stock).

201. *See id.* (stating that liquidation preference of shares would go up along with AIG drawdowns).

Preferred.²⁰² AIG also issued the Treasury a warrant to purchase one percent of the shares of AIG common stock at \$0.00001 per share.²⁰³

The Fed Credit Facility was modified to allow AIG to repay amounts owed under it with preferred equity interests in two newly-formed SPVs.²⁰⁴ One SPV will hold 100% of the outstanding common stock of AIG's operating subsidiary, American International Assurance Company, which provides life insurance and retirement services primarily in China (including Hong Kong), Singapore, Malaysia, Thailand, Korea, Australia, New Zealand, Vietnam, Indonesia, and India.²⁰⁵ The other SPV will hold 100% of the outstanding common stock of AIG's operating subsidiary, American Life Insurance Company, which provides life insurance and retirement services in Europe, Latin America, the Caribbean, the Middle East, South Asia, and the Far East, with Japan being the largest territory.²⁰⁶ Additionally, AIG can repay amounts owed with senior certificates in one or more newly-formed SPVs with underlying assets of inforce blocks of life insurance policies.²⁰⁷ Furthermore, the interest rate on the facility was changed from 3-month LIBOR (not less than 3.5%) plus 3.0% to 3-month LIBOR plus 3.0%, at the time effectively dropping the interest rate from 6.5% to 4.25% because 3-month LIBOR was then approximately 1.25%.²⁰⁸

E. Grand Total

The following table tallies the funds that the government has provided or made available to AIG and its subsidiaries since its collapse, and how much of those funds AIG had borrowed or used as of March 2, 2009:

202. *See id.* at 2 n.1 (giving minor differences between terms of Series E and Series F stock).

203. *See id.* at 2 (stating that AIG had issued a warrant to the Fed).

204. *See* AIG, 2008 Annual Report (Form 10-K) 44 (Mar. 2, 2009), *available at* <http://idea.sec.gov/Archives/edgar/data/5272/000095012309003734/y74794e10vk.htm> (stating that price would initially be \$2.50, but would be adjusted downward when permitted by amendments to AIG's Articles).

205. *See id.* at 13 (describing AIA's operations and geographical base).

206. *See id.* (describing ALICO's operations and base).

207. *See id.* (stating that voting power of Series C stock would be reduced by the number of shares subject to the warrant).

208. *See id.* (describing changes in interest rate on Fed facility).

	Amount Authorized (in billions)	Amount Borrowed/Used (in billions)²⁰⁹
Fed Credit Facility	\$60.0	\$42.0
TARP Investment	\$40.0	\$40.0
RMBS Purchase Facility	\$22.5	\$19.8
Multi-Sector CDO Purchase Facility	\$30.0	\$24.3
Equity Capital Commitment Facility	\$30.0	\$0
Total	\$182.5	\$126.1

Note that AIG has used funds from the TARP Investment and Commercial Paper Funding Facility to repay amounts owed under the Fed Credit Facility.²¹⁰ This tally does not include the \$37.8 billion loaned to AIG subsidiaries under the securities lending program facility because AIG repaid these amounts and terminated the facility in connection with the RMBS Purchase Facility established as part of Restructuring I.²¹¹ Additionally, the tally does not include the \$15.2 billion borrowed by AIG subsidiaries under the Fed's Commercial Paper Funding Facility because this facility was not created specifically for AIG and numerous issuers participate in the program.

209. See *American International Group's Impact on the Global Economy: Before, During, and After Federal Intervention: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government-Sponsored Enterprises of the H. Comm. on Financial Servs.*, 111th Cong. 3-4 (2009) (statement of Orice M. Williams, Director, Financial Markets and Community Investment, U.S. Gov't. Accountability Office), available at <http://www.gao.gov/new.items/d09490t.pdf> (providing this chart).

210. See *supra* text accompanying notes 167, 178 (stating that AIG used these funds for the specified purposes).

211. See *supra* Part IV.B (describing the securities lending program facility); *supra* Part IV.C (discussing Restructuring I).

F. Legal Issues

Ordinarily, Federal Reserve banks lend money only to depository institutions.²¹² However, section 13(3) of the Federal Reserve Act allows the Fed to authorize a Federal Reserve bank to lend to nondepository institutions in "unusual and exigent circumstances."²¹³ The Fed relied on section 13(3) in authorizing the NY Fed to enter into the Fed Credit Facility, Securities Lending Program Facility, RMBS Purchase Facility, Multi-Sector CDO Purchase Facility, and the Equity Capital Commitment Facility.²¹⁴ Prior to the AIG bailout, no such lending had occurred since the 1930s.²¹⁵

Similarly, New York Stock Exchange (NYSE) listing standards require a company to get stockholder approval prior to an issuance of capital stock that will result in a change of control of the company.²¹⁶ Because the Series C Preferred represents 77.9% of the voting power of AIG, control shifted to the Trust upon issuance.²¹⁷ However, NYSE listing standards allow the NYSE to grant an exception to the requirement if a company's audit committee

212. See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM PURPOSES & FUNCTIONS 46 (2005) [hereinafter FED PURPOSES & FUNCTIONS] (stating that the Fed usually extends discount window credit to depository institutions).

213. Federal Reserve Act § 13(3), 12 U.S.C. § 343 (2006). Section 13(3) provides:

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal reserve bank: *Provided*, That before discounting any such note, draft, or bill of exchange for an individual partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.

Id.

214. See 9/16/08 Fed Press Release, *supra* note 123 (authorizing Fed credit facility); 10/8/08 Fed Press Release, *supra* note 159; 11/10/08 Fed Press Release, *supra* note 170; 3/2/09 Treasury/Fed Press Release, *supra* note 192.

215. See FED PURPOSES & FUNCTIONS, *supra* note 212, at 46 ("Such lending has not occurred since the 1930s."). For a discussion of loans made to non-depository institutions in the 1930s, see David Fettig, *Lender of More than Last Resort*, REGION, Dec. 2002, available at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3392.

216. NYSE, INC., LISTED COMPANY MANUAL § 312.03(d) (2008).

217. See AIG September '08 Quarterly Report, *supra* note 21, at 60 (noting that "[t]he Trust will control AIG by virtue of its ownership of the Series C Preferred Stock").

determines that delay in securing stockholder approval "would seriously jeopardize the financial viability of the enterprise."²¹⁸ AIG applied for such an exception, and the NYSE granted it.²¹⁹

AIG was and is able to issue the Series C, D, E, and F preferred stock without stockholder approval in accordance with Delaware law because its authorized capital stock includes six million shares of "Serial Preferred Stock" for which the board of directors is empowered, as contemplated by section 151(a) of Delaware General Corporation Law, to fix the rights, preferences, and limitations.²²⁰ Thus, the board of directors continues to be able to use a portion of these shares to create and issue the various series of preferred stock. Holders of AIG common stock are entitled to vote as a separate class on the authorized shares and par value certificate amendments discussed above.²²¹

G. Why the Bailout?

So why did the federal government decide to bail out AIG? According to the Fed press release announcing the initial bailout, it was because "in current circumstances, a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance."²²² As a *Wall Street Journal* article explained:

218. NYSE, INC., LISTED COMPANY MANUAL § 312.05 (2008).

219. See Press Release, American International Group, Inc., AIG Notice (Sept. 26, 2008), available at <http://ir.aigcorporate.com/phoenix.zhtml?c=76115&p=irol-newsArticle&ID=1202814&highlight=> (announcing that AIG's board applied for and received an exemption).

220. See AIG, 1996 Annual Report (Form 10-K) Exhibit 3(i), at 2 (Mar. 28, 1997), available at <http://www.sec.gov/Archives/edgar/data/5272/0000950123-97-002720.txt> (stating that AIG had six million shares of \$5 Serial Preferred stock authorized).

221. See DEL. CODE ANN. tit. 8, § 242(b)(2) (2009) (providing the shareholder entitlement). Specifically, the Delaware General Corporation Law states:

The holders of the outstanding shares of a class shall be entitled to vote as a class upon a proposed amendment, whether or not entitled to vote thereon by the certificate of incorporation, if the amendment would increase or decrease the aggregate number of authorized shares of such class, [or] increase or decrease the par value of the shares of such class

Id.; see also *Hildreth v. Castle Dental Ctrs., Inc.*, 939 A.2d 1281, 1283 (Del. 2007) (noting that certificate amendments to increase authorized shares were ineffective because they were not approved by the common stockholders voting as a separate class).

222. 9/16/08 Fed Press Release, *supra* note 123. Henry Paulson, Secretary of the Treasury, released the following statement concerning the bailout:

These are challenging times for our financial markets. We are working closely with the Federal Reserve, the SEC and other regulators to enhance the stability and

[A] toppled AIG could throw a wrench in a wide range of markets, from ultrasafe money-market funds owned by individual investors to complex derivatives used by Wall Street banks and tools used to finance corporations. AIG's size and complexity meant that its tentacles were spread throughout the financial system, making it almost impossible to be certain about the impact of a collapse—other than to know it was potentially catastrophic.²²³

The *New York Times* noted particular concern about the effect of an AIG bankruptcy on its CDS counterparties. "If A.I.G. had collapsed—and been unable to pay all of its [CDS] claims—institutional investors around the world would have been instantly forced to reappraise the value of those securities, and that in turn would have reduced their own capital and the value of their own debt."²²⁴ It was feared that this would lead to a domino effect of failures reaching around the world.²²⁵ There was also concern because "[AIG] was one of the 10 most widely held stocks in 401(k) retirement plans, and that its collapse could potentially cause an enormous run on mutual funds."²²⁶ At the time, however, there was no mention of concern for policyholders with AIG's insurance companies, apparently because state insurance regulation had preserved the companies' solvency and restricted AIG's ability to access their cash holdings.²²⁷

orderliness of our financial markets and minimize the disruption to our economy. I support the steps taken by the Federal Reserve tonight to assist AIG in continuing to meet its obligations, mitigate broader disruptions and at the same time protect the taxpayers.

Press Release, U.S. Dep't of Treasury, Statement by Secretary Henry M. Paulson, Jr. on Federal Reserve Actions Surrounding AIG (Sept. 16, 2008), available at <http://www.treasury.gov/press/releases/hp1143.htm>.

223. Langley et al., *supra* note 22.

224. Edmund L. Andrews et al., *Fed in an \$85 Billion Rescue of an Insurer Near Failure*, N.Y. TIMES, Sept. 17, 2008, at A1.

225. See Karnitschnig et al., *supra* note 121 (noting that, if AIG failed, the "domino effect could reach around the world").

226. Eric Dash & Andrew Ross Sorkin, *Throwing a Lifeline to a Troubled Giant*, N.Y. TIMES, Sept. 18, 2008, at C1.

227. See *Causes and Effects of AIG Bailout: H. Comm. on Oversight and Gov't Reform*, 110th Cong. 2 (2008) (written testimony of Eric Dinallo, Superintendent of Insurance, New York State Insurance Department), available at <http://oversight.house.gov/documents/20081007100906.pdf> (stating that New York-regulated insurance companies were solvent); see also AIG, 2006 Annual Report (Form 10-K) 17 (Mar. 1, 2007), available at <http://www.sec.gov/Archives/edgar/data/5272/000095012307003026/y27490e10vk.htm> (noting that "AIG's insurance subsidiaries are subject to laws and regulations that authorize regulatory bodies to block or reduce the flow of funds to the parent holding company, or that prohibit such transfers altogether in certain circumstances"); Press Release, American International Group, Inc., AIG Issues Statement to Address Policyholder Concerns (Sept. 16, 2008), available at

The bottom line is that nobody knew for certain the scope of damage that would result from an AIG bankruptcy. Because of AIG's size and interconnectedness, and the fact that financial markets were already under serious distress, it was feared that AIG's failure would lead to the collapse of the entire financial system.²²⁸ The federal government was unwilling to take this risk and, therefore, bailed out AIG.

Unfortunately, there were many fires to put out in September 2008.²²⁹ As a result, the attention of the government was focused on the fates of Lehman Brothers and Merrill Lynch.²³⁰ By the time it turned its focus to AIG, the company was just a few days from collapse. Thus, the government had to make the bailout decision quickly and with incomplete information.²³¹ On top of that, AIG was likely overselling the impact of its collapse in an effort to secure a bailout and avoid bankruptcy.

Arguably, the necessity of the bailout was dubious—perhaps because the doom and gloom surrounding an AIG bankruptcy was overblown. Specifically, the bulk of AIGFP's CDS portfolio (\$379 billion out of \$527 billion or 72% of total notional amount as of December 31, 2007) consisted of CDSs written to provide various European financial institutions regulatory capital relief.²³² As

<http://www.tradingmarkets.com/site/news/Stock%20News/1885906/> ("The insurance policies written by AIG companies are direct obligations of its regulated subsidiary insurance companies around the world. These companies are well capitalized and meet or exceed local regulatory capital requirements. The companies continue to operate in the normal course to meet obligations to policyholders.").

228. See Hugh Son & Erik Holm, *Fed Takes Control of AIG with \$85 Billion Bailout*, BLOOMBERG, Sept. 17, 2008, <https://http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=a6QAz6YiyRAI> (last visited Sept. 29, 2009) ("'Nobody really knows what it would have meant if they would have been allowed to fail, but there was an enormous amount of systemic risk,' said David Havens, a credit analyst at UBS AG in Stamford, Connecticut.") (on file with the Washington and Lee Law Review); Justin Fox, *Why the Government Wouldn't Let AIG Fail*, TIME, Oct. 1, 2008, <http://www.time.com/time/business/article/0,8599,1841699,00.html> (last visited Sept. 29, 2009) ("[T]he fear was that it could lead to total chaos . . . Its collapse would be as close to an extinction-level event as the financial markets have seen since the Great Depression.") (on file with the Washington and Lee Law Review).

229. See generally Davidoff & Zaring, *supra* note 137, at 26–29 (describing the bankruptcy of Lehman Brothers and the sale of Merrill Lynch).

230. See Dash & Sorkin, *supra* note 226 (noting that "[w]ith all the attention paid to beleaguered investment banks, few seemed to realize the risks that A.I.G. posed" and that "inside the Fed, everyone was consumed by the fates of Lehman and Merrill").

231. See Langley et al., *supra* note 22 ("The decision was happening so fast no one felt they'd had enough time to dig into AIG's finances or perform a thorough analysis of the impact of a collapse.").

232. See *supra* notes 76–77 and accompanying text (describing AIG regulatory capital and the reasons why European banks needed it).

of September 30, 2008, AIG had not taken any unrealized market valuation losses on this part of the portfolio.²³³ This indicates that, as of that date, equivalent CDSs could be purchased from third parties for the same prices that AIG originally sold the CDSs. Put differently, if AIG had gone bankrupt, counterparties on these CDSs may very well have been able to replace them without taking a material financial hit. It also indicates that the credit worthiness of the securities underlying these CDSs had not materially degraded. Certainly, the CDS market may not have been able to accommodate the large demand from these counterparties for replacement CDSs. However, if the government had more time perhaps it could have facilitated the replacement process, including the temporary relaxation of European net capital requirements if necessary.

Furthermore, the \$61.4 billion notional amount of CDSs on multi-sectored CDOs on which AIG took billions of dollars in write downs were collateralized by billions of dollars. An AIG bankruptcy presumably would have allowed the counterparties to terminate these CDSs, entitling them to damages equal to the amount it would cost them to replace the CDSs.²³⁴ Notably, CDSs are afforded special treatment under federal bankruptcy law.²³⁵ Among other things, "[t]he non-bankrupt counterparty is specifically permitted to offset any claim against collateral it holds, without restraint by the automatic stay or other provisions of bankruptcy law."²³⁶ Thus, AIGFP's counterparties would have been able to retain the billions of dollars of collateral AIG posted, decreasing the negative impact they would suffer from an AIG bankruptcy.²³⁷ Additionally, it is likely that a number of counterparties purchased CDSs on AIG from third parties to

233. See AIG September '08 Quarterly Report, *supra* note 21, at 114. (stating that AIG recognized unrealized market valuation losses of \$397 million on "transactions where AIGFP believe[d] the counterparties [were] no longer using the transactions to obtain regulatory capital relief").

234. See James Wehner, *Credit Default Swaps and the Bankrupt Counterparty—Entering the Undiscovered Country*, MONDAQ BUS. BRIEFING 2 (Sept. 22, 2008), available at <http://www.mondaq.com/article.asp?articleid=66524> (noting that a CDS typically provides that "when one of the parties enters bankruptcy, the non-bankrupt party may terminate the swap").

235. See *id.* ("The termination provisions in credit default swap contracts enjoy special treatment under the Bankruptcy Code, and particularly under amendments made in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which clarified the treatment of credit default swaps and other derivative contracts.").

236. *Id.* (citing 11 U.S.C. §§ 362(b)(17), 560 (2006)).

237. For example, Goldman Sachs Group Inc. reportedly "pried from AIG \$8 billion to \$9 billion, covering virtually all its exposure to AIG—most of it before the U.S. stepped in." Mollenkamp et al., *supra* note 81.

hedge their AIG counterparty credit risk, meaning that these CDSs would pay out if AIG declared bankruptcy.²³⁸

Because there currently is no central platform for CDS transactions or mandatory transaction reporting, there is and was no quick, easy, and reliable way for the government to gauge the actual exposure of CDS counterparties to an AIG bankruptcy.²³⁹ In fact, the government may have relied on misinformation. For example, Goldman Sachs had reportedly purchased \$20 billion in CDSs from AIG,²⁴⁰ leading the *New York Times* to report that "[a] collapse of the insurer threatened to leave a hole as much as \$20 billion in Goldman's side."²⁴¹ According to Goldman Sachs, however, its "exposure to AIG is offset by collateral and hedges and is not material to Goldman Sachs in any way."²⁴² As a result, it characterized the *New York Times* report as "seriously misleading."²⁴³

Skepticism about the bailout has since abated somewhat in light of a March 2009 *New York Times* article based on a confidential twenty-one-page document prepared for regulators by AIG entitled *A.I.G.: Is the Risk Systemic?*²⁴⁴ The article notes that AIG's insurance subsidiaries have issued 375 million policies in the U.S. with a face value of \$19 trillion.²⁴⁵ The article explains:

If policyholders lost faith in A.I.G. and rushed to cash in their policies all at once, the entire insurance industry could falter.

A "run on the bank" in the life and retirement business would have sweeping impacts across the economy in the U.S. according to the A.I.G. document. In countries around the world with higher savings rates than in the U.S., the failure of insurance companies would be a catastrophe.

238. See *id.* (noting that "Goldman hedged its [AIG counterparty credit risk] exposure by making a bearish bet on AIG, buying credit-default swaps on AIG's own debt").

239. See Partnoy & Skeel, *supra* note 25, at 1036 (noting that the CDS market is "quite opaque" and "that the details of particular swaps often go undisclosed").

240. See *Goldman Had \$20 Bln in AIG CDS Exposure-Willumstad*, REUTERS, Oct. 7, 2008, <http://www.reuters.com/article/idINN0746281820081007> (last visited Sept. 29, 2009) (stating that Goldman was AIG's largest trading partner) (on file with the Washington and Lee Law Review).

241. Morgenson, *supra* note 81.

242. *Goldman Sachs Faults NY Times Story on AIG Risk*, REUTERS, Sept. 28, 2008, <http://www.reuters.com/article/ousiv/idUSTRE48R3HQ20080928> (last visited Sept. 29, 2009) (on file with the Washington and Lee Law Review).

243. *Id.*

244. Andrew Ross Sorkin, *The Case for a Giant, by a Giant*, N.Y. TIMES, Mar. 3, 2009, at B1.

245. *Id.*

Even though [AIG]'s insurance business is regulated by states, there probably would not be enough money to pay out to consumers from what's known as a guarantee fund. Other regulated insurance companies, which have been weakened by credit losses, would be required to pay money into the fund to cover the shortfall, weakening them further and in some cases bankrupting them.

Some would have to sell more and more of the bonds in their portfolios to honor their obligations to the scared-off policyholders. And that would freeze up the bond markets again, because life insurance companies to a very great extent are the bond markets. They buy more corporate debt than any other institutions.²⁴⁶

In a similar vein, a March 2009 post on *The New York Times DealBook Blog* by a bankruptcy attorney challenged the conventional wisdom that "the wide arm of state regulation would surround A.I.G. subsidiaries" protecting them from an AIG bankruptcy.²⁴⁷ Specifically, the post envisions a bankruptcy leading to an intense battle between a creditors' committee or trustee and state insurance regulators over the insurance subsidiaries' reserves leading to "regulatory gridlock and high administrative expenses, delaying payment and decreasing funds available to pay claims."²⁴⁸ Additionally, because AIG provides credit enhancements to its insurance subsidiaries, such a bankruptcy could "set in motion a chain of events leading to the subsidiaries' own insolvency."²⁴⁹

Finally, the joint Treasury and Federal Reserve press release announcing Restructuring II included the following:

Given the systemic risk AIG continues to pose and the fragility of markets today, the potential cost to the economy and the taxpayer of government inaction would be extremely high. AIG provides insurance protection to more than 100,000 entities, including small businesses, municipalities, 401(k) plans, and Fortune 500 companies who together employ over 100 million Americans. AIG has over 30 million policyholders in the U.S. and is a major source of retirement insurance for, among others, teachers and non-profit organizations. The company also is a significant counterparty to a number of major financial institutions.²⁵⁰

246. *Id.*

247. David E. Wood, *Another View: Imagining an A.I.G. Bankruptcy*, N.Y. TIMES, Mar. 2, 2009, <http://dealbook.blogs.nytimes.com/2009/03/02/another-view-imagining-an-aig-bankruptcy/> (last visited Sept. 29, 2009) (on file with the Washington and Lee Law Review).

248. *Id.*

249. *Id.*

250. 3/2/09 Treasury/Fed Press Release, *supra* note 192, at 1; *see also* Kohn Statement, *supra* note 1, at 3 ("[T]he failure of AIG would impose unnecessary and burdensome losses on

One could conclude from the fact that the government has twice restructured the bailout after having weeks and months instead of 48 hours to make a decision indicates that AIG's bankruptcy truly does pose significant systemic risk.²⁵¹ The decisionmakers (Treasury Secretary Geithner and Fed Chairman Bernanke), however, may have believed it politically unfeasible to reverse course given the billions of taxpayer dollars already sunk into AIG, or they may have been subject to cognitive biases such as the confirmation trap.²⁵² It is also hard to put a lot of weight on the document prepared by AIG given AIG's obvious conflict of interest in making a case for its bailout. In the end, it is impossible to know for sure whether the \$200 billion in aid and nationalization of the largest United States insurance company was the most effective thing to do.

V. *The (Lack of) Regulation of Credit Default Swaps*

Parts II and III described AIG's CDS business and the role the business played in AIG's collapse leading to the bailout discussed in Part IV. This Part addresses the lack of regulation of CDSs, which some have suggested was a catalyst for all that followed, and offers some thoughts on regulatory reform.

A. *Regulatory Gap*

A CDS has characteristics of a security, a contract of sale of a commodity for future delivery, and an insurance contract. Securities are generally subject to regulation under the Securities Act of 1933 (Securities Act)²⁵³ and the Securities Exchange Act of 1934 (Exchange Act).²⁵⁴ Contracts of sale of a commodity for future delivery are generally subject to regulation under the Commodity Exchange Act (CEA).²⁵⁵ Insurance contracts are generally subject

many individuals, households and businesses, disrupt financial markets, and greatly increase fear and uncertainty about the viability of our financial institutions.").

251. For a discussion of systemic risk, see Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008).

252. The confirmation trap is a cognitive bias "whereby the decision maker seeks confirmation for what is already thought to be and neglects opportunities to acknowledge or find disconfirming information." JOHN R. SCHERMERHORN ET AL., *ORGANIZATIONAL BEHAVIOR* 364 (2002).

253. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2006).

254. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78mm (2006).

255. Commodity Exchange Act, 7 U.S.C. §§ 1–27f (2006).

to regulation under state insurance laws. As discussed below, however, CDSs are expressly excluded from each of these regulatory schemes.

Until December 2000, the prevailing opinion among practitioners was that CDSs were securities under the Securities Act and the Exchange Act.²⁵⁶ This is because the definition of a security under these acts includes "any . . . evidence of indebtedness"²⁵⁷ as well as any "put . . . on any security,"²⁵⁸ and a CDS was viewed as a put on an evidence of indebtedness.²⁵⁹ A put gives a party the right to require another party to buy a specified asset from it at a specified price. Under most CDSs, a protection buyer has the right to require the protection seller to buy the deliverable obligation (such as a bond or other evidence of indebtedness) from it or pay the difference between par and the market value following the occurrence of an event of default under the CDS.²⁶⁰ The offer, sale, and trading of securities are subject to extensive regulation under the Securities Act and the Exchange Act. While CDSs were structured to fall within various exemptions from these acts, the possibility existed that the SEC could adopt rules, if deemed necessary, to regulate aspects of the CDS market.

CDS regulation by the SEC, however, is no longer possible following the enactment of the Commodity Futures Modernization Act of 2000 (CFMA).²⁶¹ Among other things, the CFMA amended the Securities Act and the Exchange Act to exclude from the definition of security "any security-based swap agreement."²⁶² A "swap agreement" is defined as:

[A]ny agreement . . . between eligible contract participants . . . the material terms of which (other than price and quantity) are subject to individual negotiation, and that . . . provides on an executory basis for the exchange, on a fixed or contingent basis, or one or more payments based on the value . . . of one or more . . . securities . . . or other financial or economic interests, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction . . . the financial risk associated with a future change in any such value or level without also

256. See Adam W. Glass, *CFMA Brings Legal Certainty, but Additional Liability for Credit Derivatives: Part One*, Apr. 20, 2001, available at <http://www.linklaters.com/pdfs/publications/us/cfmaapril2001.pdf> (explaining why prevailing opinion held that CDSs were securities) (on file with the Washington and Lee Law Review).

257. 15 U.S.C. § 77b(a)(1) (2006).

258. *Id.* § 78c(a)(10).

259. See Glass, *supra* note 256 (stating that CDSs "are 'puts' on debt securities").

260. See *supra* Part II.B (explaining operation of CDSs).

261. Commodity Futures Modernization Act of 2000 (CFMA), Pub. L. No. 106-554, 114 Stat. 2763 app. E (2000) (codified as amended in scattered sections of 7, 11, 12, and 15 U.S.C.).

262. 15 U.S.C. §§ 77b-1(b)(1), 78c-1(b)(1) (2006).

conveying a current or future direct or ownership interest in an asset . . . known as [a] . . . credit default swap.²⁶³

The definition of "eligible contract participant" includes, among other things, financial institutions, insurance companies, investment companies, business entities with net worths exceeding \$1 million and who enter into the contracts in connection with the conduct of their businesses, and individuals with total assets exceeding \$10 million.²⁶⁴ A "security-based swap agreement" is a swap agreement "of which a material term is based on the price, yield, value, or volatility of any security"²⁶⁵ The reference obligation, deliverable obligation, term, and definition of credit event of a CDS are negotiated between the protection seller and protection buyer, both of whom presumably fall within the definition of eligible contract participant. The CDS transfers financial risk associated with a change in the value of the reference entity or obligation resulting from a credit event to the protection seller, and the premium and payout amount under a CDS is based on the value of the deliverable obligation. Thus, a CDS is a security-based swap agreement and, therefore, not a security for purposes of the Securities Act or the Exchange Act.

Security-based swap agreements are, nonetheless, subject to antifraud provisions under the Securities Act and the Exchange Act.²⁶⁶ The CFMA, however, prohibits the SEC from promulgating, interpreting or enforcing rules "in a manner that imposes or specifies reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading with respect to any security-based swap agreement."²⁶⁷

The CFMA also amended the CEA. The CEA gives the Commodity Futures Trading Commission (CFTC) exclusive jurisdiction over "transactions involving contracts of sale of a commodity for future delivery,"²⁶⁸ and requires such contracts, with certain exceptions, to be traded only on a CFTC-regulated exchange.²⁶⁹ The CEA defines "commodity" as certain specified agricultural products (for example, wheat, cotton, rice, corn, soybeans, and livestock) and

263. CFMA, Pub. L. No. 106-554, tit. III, sec. 301, §206A(a), 114 Stat. 2763 App. E, at 2763A-445 to -450 (2000), *reprinted in* 15 U.S.C. § 78c note (2006).

264. 7 U.S.C. § 1a(12) (2006) (defining "eligible contract participant"). For the definition of "financial institution" see *id.* § 1(a)(15).

265. CFMA, Pub. L. No. 106-554, tit. III, sec. 301, § 206B, 114 Stat. 2763 app. E, at 2763-451 (2000), *reprinted in* 15 U.S.C. 78c note (2006).

266. 15 U.S.C. §§ 77q(a), 78j(b) (2006).

267. *Id.* §§ 77b-1(b)(3), 78c-1(b)(3).

268. 7 U.S.C. § 2(a)(1)(A) (2006).

269. *Id.* § 6(a)(1); see also Mark Jickling, *The Commodity Futures Modernization Act*, CRS REPORT RS 20560, at 2 (Feb. 3, 2003) (describing features of the CFMA).

"all other goods and articles, . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."²⁷⁰ This broad language arguably pulls CDSs within the definition of commodity, creating uncertainty as to the legality of CDSs under the CEA, since they are not transacted through an exchange. The concern was that "if a court had ruled that swaps were in fact illegal, off-exchange contracts, trillions of dollars in OTC derivative contracts might have been rendered void and unenforceable."²⁷¹

The CFMA put this uncertainty to rest. Specifically, it amended the CEA to exclude from coverage of the CEA and regulation by CFTC contracts between "eligible contract participants"²⁷² with respect to "excluded commodities"²⁷³ executed and traded off-exchange.²⁷⁴ An excluded commodity includes "an interest rate, exchange rate, currency, security, security index, credit risk or measure, debt or equity instrument, index or measure of inflation, or other macroeconomic index or measure."²⁷⁵ Therefore, there is no question that a CDS sold by an insurance company such as AIG to a bank or other institution falls outside CEA coverage.

The decision to exclude swaps and other credit derivatives from CEA coverage followed the recommendations of a November 1999 report from a working group comprised of the Secretary of the Treasury, Chairman of the Fed, Chairman of the SEC, and Chairman of the CFTC.²⁷⁶ The report concluded that the legal uncertainty concerning the U.S. OTC derivatives markets, "if not addressed, could discourage innovation and growth of these important markets and damage U.S. leadership in these arenas by driving

270. 7 U.S.C. § 1a(4) (2006).

271. Jickling, *supra* note 269, at 2. The CFTC addressed this concern in 1993 by adopting rules exempting swap agreements from most provisions of the CEA, but, for a variety of reasons, uncertainty remained. Memorandum from Cravath, Swain and Moore to ISDA Members 11 (Jan. 5, 2001) [hereinafter Cravath Memo], available at http://www.isda.org/speeches/pdf/Analysis_of_Commodity-Exchange-Act-Legislation.pdf.

272. See *supra* note 264 and accompanying text (discussing eligible participants).

273. 7 U.S.C. § 2(d)(1) (2006).

274. See *id.* (stating that restrictions will not apply if the transaction is not completed in a trading facility).

275. *Id.* § 1a(13).

276. Report of the President's Working Group on Financial Markets, Over-the-Counter Derivatives Markets and the Commodity Exchange Act (Nov. 1999) [hereinafter Report of PWG], available at <http://www.ustreas.gov/press/releases/reports/otcact.pdf>; see also Jickling, *supra* note 269, at 1 (noting that "[t]he CFMA's provisions generally followed the recommendations contained in a November 1999 report by the President's Working Group on Financial Markets"); Cravath Memo, *supra* note 271, at 12 (noting that Working Group's recommendations "provided the foundations" for the CFMA); Williams Statement, *supra* note 24, at 9 (agreeing with Cravath Memo's conclusions).

transactions off-shore."²⁷⁷ As a result, the working group, among other things, unanimously recommended "[a]n exclusion from the CEA for bilateral transactions between sophisticated counterparties (other than transactions that involve non-financial commodities with finite supplies)."²⁷⁸ Presumably, similar reasoning was behind the exclusion of swap agreements between eligible contract participants from the definition of security under federal securities laws.

The exclusions follow the familiar securities law paradigm that sophisticated investors can "fend for themselves" and, therefore, require considerably fewer legal safeguards.²⁷⁹ The sophistication limitation is reflected in the eligible contract participants concept. The CFMA used the concept as an objective proxy for sophistication to avoid the uncertainty that a subjective test would entail.²⁸⁰ The SEC has long used a similar approach for determining sophistication in various contexts.²⁸¹ The approach is based on the assumption that wealthy parties are sophisticated in financial matters.

As mentioned above, insurance contracts are subject to state insurance regulations. Under these regulations, states impose licensing requirements, regulate policy terms, review rates, and conduct financial examinations of insurers.²⁸² The basic definition of insurance is "[a] contract by which one party (the *insurer*) undertakes to indemnify another party (the *insured*) against risk of loss, damage, or liability arising from the occurrence of some specified contingency."²⁸³ A CDS certainly appears to fall within this definition given that the protection seller contractually agrees to compensate the protection buyer following the occurrence of a credit event.²⁸⁴

277. Report of PWG, *supra* note 276, at 1.

278. *Id.*

279. See William K. Sjostrom, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. 639, 669 (2009) (discussing the "fend for themselves" concept).

280. See *id.* at 666 (discussing problems associated with using a subjective test for sophistication).

281. See, for example, the "accredited investor" test of Regulation D under the Securities Act, 17 C.F.R. 230.501(a), and the "qualified institutional buyer" test under Rule 144A of the Securities Act, 17 C.F.R. 230.144A(a). See also Sjostrom, *supra* note 279, at 666 (discussing additional contexts in which the objective test approach is used).

282. See NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS STATE INSURANCE REGULATION 2 [hereinafter STATE INSURANCE REGULATION], available at http://www.naic.org/documents/consumer_state_reg_brief.pdf (last visited Sept. 29, 2009) (discussing functions of state insurance regulations).

283. BLACK'S LAW DICTIONARY 870 (9th ed. 2009).

284. See Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167, 181 (2007) (noting that CDSs' "general form and function reflect many basic insurance

Notwithstanding their insurance-like characteristics, CDSs generally have not been considered insurance for purposes of state insurance regulations and, therefore, have not been subject to these regulations. This was made crystal clear by the state of New York in 2004 when it amended its insurance laws specifically to exclude CDSs from coverage.²⁸⁵ A number of other states have done likewise.²⁸⁶ The basic justification for the exclusion is that the purpose of insurance regulation is "to protect American consumers."²⁸⁷ Because the CDS market is comprised entirely of institutional investors, the thinking went that there is no consumer interest with respect to CDSs in need of protection.²⁸⁸

While CDSs themselves are not regulated, many of the players in the CDS market are.²⁸⁹ For example, nationally chartered banks are supervised by the Office of the Comptroller of the Currency, and bank holding companies are regulated by the Fed.²⁹⁰ In fact, since 1999, when AIG organized AIG Federal Savings Bank, it has been subject to Office of Thrift Supervision (OTS) regulation, examination, supervision, and reporting requirements.²⁹¹ According to AIG, "[a]mong other things, this permits the OTS to restrict or prohibit activities that are determined to be a serious risk to the financial safety, soundness or stability of AIG Federal Savings Bank."²⁹² While the OTS was aware of AIG's CDS business, reviewed some of the contracts, and knew about the collateral posting provisions, they failed to recognize the extent of the risk.²⁹³ As a result, because CDSs fall within a regulatory gap and the OTS did

arrangements").

285. *Id.* at 173.

286. *See id.* (noting that many states have followed New York's lead).

287. STATE INSURANCE REGULATION, *supra* note 282, at 2.

288. *See* Schwartz, *supra* note 284, at 182 (explaining the argument that objectives of parties involved in CDSs were such that there was no need for the protection of insurance-style regulation).

289. *See* GAO REPORT, *supra* note 23, at 10 (noting that some parties involved in CDSs are themselves regulated).

290. *Id.*; *see also* Williams Statement, *supra* note 24, at 6 (noting that "banking regulators' oversight of CDS activity is largely limited to activity that is deemed to pose risks to the safety and soundness of the institutions they regulate").

291. AIG '07 Annual Report, *supra* note 8, at 13.

292. *Id.*

293. *See* Jeff Gerth, *Was AIG Watchdog Not up to the Job?*, MSN MONEY, Nov. 10, 2008, <http://articles.moneycentral.msn.com/Investing/Extra/was-aig-watchdog-not-up-to-the-job.aspx> (last visited Sept. 29, 2009) (stating that, although OTS knew there was risk, it failed to recognize the danger posed by AIG) (on file with the Washington and Lee Law Review). In testimony before the Senate Committee on Banking, Housing and Urban Affairs, the Acting Director of the OTS stated as follows:

You will see that where OTS fell short, as did others, was in the failure to recognize

not appreciate their risks, AIG was able to pursue a multi-billion dollar CDS business free from regulatory filings, mandated capital requirements, and government intervention.

B. Regulatory Reform

Unsurprisingly, a number of proposals for regulating CDSs and other credit derivatives have been put forth since AIG's collapse.²⁹⁴ Most prominent is the Obama Administration's proposal released in May 2009.²⁹⁵ Among other things, the proposal recommends amendments to the CEA and securities laws "to require clearing of all standardized OTC derivatives through regulated central counterparties (CCP)."²⁹⁶ The proposal calls for CCPs to "impose robust margin requirements and other necessary risk controls."²⁹⁷ Thus, had the contemplated CCP clearing requirement been in place, it is likely that margin and other risk control mechanisms would have prevented AIG from building such a large and uncollateralized CDS position and, therefore, perhaps prevented its collapse. The CCP clearing requirement would apply only to standardized OTC derivatives meaning nonstandard ones could be transacted outside of a CCP. Thus, the definition of "standardized" will be a key component of the regulation.

in time the extent of the liquidity risk to AIG of the "super senior" credit default swaps in AIGFP's portfolio. In hindsight, we focused too narrowly on the perceived creditworthiness of the underlying securities and did not sufficiently assess the susceptibility of highly illiquid, complex instruments (both CDS[s] and CDOs) to downgrades in the ratings of the company or the underlying securities, and to declines in the market value of the securities. . . . In retrospect, if we had identified the absolute magnitude of AIGFP's CDS exposure as a liquidity risk, we could have requested that AIGFP reduce its exposure to this concentration.

American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before S. Comm. on Banking, Housing & Urban Affairs, 111th Cong. 6 (2009) (statement of Scott M. Polakoff, Acting Director, Office of Thrift Supervision), available at http://banking.senate.gov/public/_files/PolakoffTestimony3509.pdf.

294. See, e.g., Derivatives Markets Transparency and Accountability Act of 2009, H.R. 977, 111th Cong. (2009), available at <http://agriculture.house.gov/inside/legislation.html>; Derivatives Trading Integrity Act of 2009, S. 272, 111th Cong. (2009); Press Release, Gov. David A. Patterson, Governor Patterson Announces Plan to Limit Harm to Markets from Damaging Speculation (Sept. 22, 2008), available at http://www.ny.gov/governor/press/press_0922081.html.

295. Press Release, U.S. Department of the Treasury, Regulatory Reform Over-the-Counter (OTC) Derivatives (May 13, 2009), available at <http://www.ustreas.gov/press/releases/tg129.htm>.

296. *Id.*

297. *Id.*

The proposal also calls for amendments to the CEA and securities laws to empower the CFTC and SEC to impose recordkeeping and reporting requirements for OTC derivatives and to develop "a system for timely reporting trades and prompt dissemination of prices and other trade information."²⁹⁸ Had mechanisms along these lines been in place, presumably the government would have been able to make a more informed decision concerning AIG's bailout.

The proposal is light on specifics but states that the administration will work with Congress to develop the proposed measures.²⁹⁹ CCP clearing requirements and information requirements are reasonable responses to AIG's collapse. In fleshing out the details, however, Congress should be mindful of several things. First, CDSs play an important role in global credit markets. Among other things, they allow lenders to manage credit risk more efficiently by transferring it to lower cost bearers which translates into wider availability of credit and lower interest rates for borrowers. Thus, regulation that hampers the CDS market could result in less credit and higher interest rates. Second, regulation has a tendency to squelch innovation. While extensive regulation of OTC derivatives may prevent the repeat of an AIG-type collapse, it will also hinder socially desirable financial innovation if it is overbroad or inflexible. Finally, the CDS market undoubtedly will correct, if it has not already, for problems revealed by AIG's collapse. CDS pricing models will be reworked to account for the possibility of a nationwide housing slump. Protection buyers will insist on increased collateral and will scrutinize more carefully the liquidity and CDS exposure of protection sellers. These considerations warrant a measured approach to regulation.

VI. Conclusion

AIG collapsed because collateral obligations embedded in the CDSs it wrote triggered a chain reaction that drained it of cash. Unable to raise funds in the private markets or quickly sell off some of its trillion dollars in assets, AIG was forced to accept a government bailout. In hindsight, it is easy to conclude that AIG should have never gotten into the CDS business, or at least not written the \$61.4 billion of CDSs on multi-sector CDOs with subprime mortgage loan exposure. Ultimately, however, AIG took a calculated business risk that turned out disastrous.

298. *Id.*

299. *See id.* (stating that the administration will "work with Congress to implement this framework").

In the wake of the bailouts of Bear Stearns, Freddie Mac, and Fannie Mae, and the bankruptcy of Lehman Brothers, the government determined that the financial markets were too fragile to absorb an AIG bankruptcy. Thus, it rescued AIG with a package that soon grew to over \$182.5 billion.

Given the central role CDSs played in AIG's collapse, the billions in taxpayer dollars committed in the bailout, and the financial Armageddon rhetoric surrounding the episode, talk of regulating CDSs is unsurprising. Regulators, however, should not lose sight of the important function served by CDSs in our financial markets and the tendency of regulation to squelch financial innovation. As a result, regulation of CDSs should be measured and flexible enough to adapt to our constantly evolving financial markets.

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