THE WALL STREET JOURNAL.
WSJ.com

OPINION | APRIL 9, 2009, 11:46 P.M. ET

'Empty Creditors' and the Crisis

How Goldman's $7 billion was 'not material.'

By HENRY T.C. HU

The defining moments of our financial crisis are now familiar. Last September, Lehman collapsed and AIG was teetering. Because an AIG collapse was viewed as posing unacceptable systemic risks, the Federal Reserve provided the company with an emergency $85 billion loan on Sept. 16.

But a curious incident that fateful day raises significant public policy issues. Goldman Sachs reported that its exposure to AIG was "not material." Yet on March 15 of this year, AIG disclosed that it paid $7 billion of its government loan last fall to satisfy obligations to Goldman. A "not material" statement and a $7 billion payout appear to be at odds.

Why didn't Goldman bark that September day? One explanation is that Goldman was, to use a term that I coined a few years ago, largely an "empty creditor" of AIG. More generally, the empty-creditor phenomenon helps explain otherwise-puzzling creditor behavior toward troubled debtors. Addressing the phenomenon can help us cope with its impact on individual debtors and the overall financial system.

What is an empty creditor? Consider that debt ownership conveys a package of economic rights (to receive principal and interest), contractual control rights (to enforce the terms of the agreement), and other legal rights (to participate in bankruptcy proceedings). Traditionally, law and business practice assume these components are bundled together. Another foundational assumption: Creditors generally want to keep solvent firms out of bankruptcy and to maximize their value.

These assumptions can no longer be relied on. Credit default swaps and other products now permit a creditor to avoid any actual exposure to financial risk from a shaky debt -- while still maintaining his formal contractual control rights to enforce the terms of the debt agreement, and his legal rights under bankruptcy and other laws.

Thus the "empty creditor": someone (or institution) who may have the contractual control but, by simultaneously holding credit default swaps, little or no economic exposure if the debt goes bad. Indeed, if a creditor holds enough credit default swaps, he may simultaneously have control rights and incentives to cause the debtor firm's value to fall. And if bankruptcy occurs, the empty creditor may undermine proper reorganization, especially if his interests (or non-interests) are not fully disclosed to the bankruptcy court.

Goldman Sachs was apparently an empty creditor of AIG. On March 20, David Viniar, Goldman's chief financial officer, indicated that the company had bought credit default swaps from "large financial institutions" that would pay off if AIG defaulted on its debt. A Bloomberg News story on that day quotes Mr. Viniar as saying that "[n]et-net I would think we had a gain over time" with respect to the credit default swap contracts.

Goldman asserted its contractual rights to require AIG to provide collateral on transactions between the two, notwithstanding the impact of such collateral calls on AIG. This behavior was understandable: Goldman had responsibilities to its own shareholders and, in Mr. Viniar's words, was "fully protected and didn't have to take a loss."

Nothing in the law prevents any creditor from decoupling his actual economic exposure from his debt. And I do not suggest any inappropriate behavior on the part of Goldman or any other party from such "debt decoupling." But none of the existing regulatory efforts involving credit derivatives are directed at the empty-creditor issue. Empty creditors have weaker incentives to cooperate with troubled corporations to avoid collapse and, if collapse occurs, can cause substantive and disclosure complexities in bankruptcy.

An initial, incremental, and low-cost step lies in the area of a real-time informational clearinghouse for credit default swaps and other over-the-counter (OTC) derivatives transactions and other crucial derivatives-related information. Creditors are not generally required to disclose the "emptiness" of their status, or how they achieved it. More generally, OTC derivatives contracts are individually negotiated and not required to be disclosed to any regulator, much less to the public generally. No one regulator, nor the capital markets generally, know on a real-time basis the entity-specific exposures, the ultimate resting places of the credit, market, and other risks associated with OTC derivatives.

With such a clearinghouse, the interconnectedness of market participants' exposures would have been clearer, governmental decisions about bailing out Lehman and AIG would have been better informed, and the market's disciplining forces could have played larger roles. Most important, a clearinghouse could have helped financial institutions to avoid misunderstanding their own products, and modeling and risk assessment systems -- misunderstandings that contributed to the global economic crisis.

Mr. Hu is a professor at the University of Texas Law School.

Please add your comments to the Opinion Journal forum.