YEAR 2001 IN REVIEW
DEVELOPMENTS IN BUSINESS FINANCING

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Preamble: Enron: What Impact on Creative Methods of Financing?

In the nineteen years this Annual Review of Developments on Business Financing has been presented, much has happened. We have seen creation of ever more sophisticated and novel techniques of raising capital, hedging risk and improving market efficiencies. The revelations of the causes behind Enron's staggering collapse in late 2001 may conceivably have very negative effects on new financing techniques in the future. Enron, after all, used all sorts of unusual strategies: off-balance sheet financing; credit derivatives; special purpose vehicles; etc. Its financial reports were signed off on by one of the top accounting firms. But in the end, a billion dollars in reported earnings turned out to be smoke.

Back in 1994, the Annual Review reported on a new device that had been introduced in 1993, called Monthly Income Preferred Shares, or "MIPS." Enron hopped on the MIPS bandwagon in late 1993 when it set up an offshore subsidiary called Enron Capital LLC, which sold $214 million in preferred shares (MIPS) to investors through Goldman Sachs. The preferred carried an 8% annual dividend, paid monthly. The sub then lent the proceeds to its parent, Enron, to be paid back over 50 years. Enron deducted from its taxable income the interest it paid to its offshore sub, treating the obligation as debt. The sub then paid dividends to the holders of the preferred. In its reports to shareholders, Enron treated the obligation not as debt, but "preferred stock in subsidiary companies."[1] Enron eventually issued $1 billion or more in MIPS and related types of "trust preferred" securities.[2]

When the Treasury Department tried to introduce legislation to curb the use of these securities by denying the interest deduction, Wall Street and Congress fought back. Jon Corzine, then CEO of Goldman Sachs and now a U.S. Senator who is criticizing Enron, signed a letter to Congress calling the Treasury "completely arbitrary."[3] As a result of his efforts and those of others, the proposals aimed at MIPS and other trust preferred securities were rejected. And

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[1] John McKinnon and Greg Hitt, How Treasury Lost in Battle to Quash a Dubious Security, WALL ST. J. (Feb. 4, 2002), A1.

[2] Id.

[3] Id., A8.

when the IRS tried to challenge the deductions by Enron for its MIPS-related debt, lobbyists pressured the IRS to abandon its position before the U.S. Tax Court.

What the future holds for taxability of trust-preferreds is now in doubt. This writer does not stake out a position, except to observe that there is a difference between using a complex instrument and abusing it. Arguably, Enron's SEC filings should have disclosed that its treatment of MIPS made its balance sheet look better than it really was.

The risk our capital markets now face is two-fold: (1) that investors, now less confident of the numbers published by public companies, will reduce their participation in the securities markets; and (2) that legislators, regulators and accountants, in their zeal to craft measures to correct perceived abuses in the Enron scandal, will unintentionally deter the development of legitimate new techniques in the world of finance.

When the market crashed in 1929, many Americans stopped buying stock and public ownership did not really recover until the 1950s.[4] It is important to maintain confidence in our securities markets, which have been unmatched in the world in providing the American economic engine with a constant pool of available capital. Certainly, the system of checks and balances by which corporate earnings are reported will be thoroughly reexamined and corrective measures will be introduced. Hopefully, these measures will serve to remedy the kinds of overaggressive—indeed, dishonest—methods exploited by Enron. At the same time, these measures should not curb legitimate new advances in development of financing techniques.

1. AT&T: Definitely Not the Same "Ma Bell" Anymore.

For decades, AT&T used to be the safe blue-chip with essentially safe corporate strategies and bland financing. 2001 illustrated how much has changed since the breakup of the Bell System in the early 1980s, making AT&T into a telecom giant looking for new kinds of markets. Consider the three deals below involving AT&T.

A. Paying $3.43 Billion to Save $1.2 Billion in Taxes.

One of the most bizarre transactions in 2001 was the payment by AT&T of $3.43 billion in its stock in order to avoid having to take more stock in At Home Corporation, in which it already had a control position. Originally,

[4] See Alex Berenson, The Biggest Casualty of the Enron Collapse: Confidence, N.Y. TIMES (Feb. 10, 2002) 2WK.

AT&T made a deal committing to pay $2.96 billion in its own stock to the two other major shareholders in At Home, in exchange for a total of 60.4 million At Home shares that they owned. This would have been a tax-free transaction. At the time—March, 2000—At Home was trading at $34 (down from a high of $99). The other two shareholders—Cox Communications and Comcast—had the right under the deal to "put" their At Home shares to AT&T for $48 per share, payable in cash or AT&T stock.

By May, 2001, however, the price of At Home stock had slipped to $4 per share. AT&T was therefore facing an increase in its ownership stake from 23% to 34% in a company that was apparently floundering. So AT&T cut a new deal to pay Cox and Comcast for releasing AT&T from its obligation to buy their shares in At Home. Because Comcast and Cox now were going to recognize tax on the deal, they insisted on an increase in the value of the AT&T shares they were receiving from the original $2.96 billion to $3.43 billion. AT&T at the same time converted a non-taxable transaction into one which generated a tax loss of $3.43 billion. Result: AT&T saved $1.2 billion in taxes. You could say that the revised deal, in which AT&T issued $3.43 billion in stock and received nothing but escape from a contract, was entirely tax-driven.[5] In hindsight, the deal arguably was good for AT&T, because At Home went into bankruptcy in late 2001.

B. Comcast Takes AT&T Broadband From AT&T.

In late December 2001, Comcast won a bidding war it had created for AT&T Broadband, the nation's largest cable company. Comcast had made an unsolicited $44.5 billion bid for AT&T Broadband in July, 2001. AT&T Corp.'s board rejected the offer as inadequate, but ordered its CEO (Michael Armstrong) to "explore financial and strategic alternatives." That set off a scramble for Ma Bell's crown jewel among a number of suitors that also involved AOL Time Warner, Cox Communications and Microsoft Corp.[6]

In the end, Comcast's bid trumped the others. Comcast had to sweeten its initial offer, so it threw in another $3 billion in stock and the assumption of an additional $12 billion in debt and liabilities. The Roberts family, which controlled Comcast, also agreed to reduce its proposed voting stake in the new company. Overall, Comcast will pay $47 billion in stock and $25 billion in assumed debt and

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[5] See Floyd Norris, AT&T In Deal To Avoid More At Home Stock, N.Y. TIMES (May 21, 2001) C-12.

[6] Justin Dini, Comcast Reels In AT&T Broadband, INST. INV. (Jan. 2002) 66.

other liabilities to create AT&T Comcast Corp. (Microsoft will also own a chunk of the new company.)

Ironically, AT&T's CEO, Armstrong, had earlier laid the groundwork for his own departure in late 2000, when he unveiled a plan to spin out AT&T Broadband after AT&T had spent nearly $100 billion buying two cable companies during the late 1990s to create it. He will leave AT&T when the deal closes, probably sometime in mid-2002, to serve as the new company's chairman.

C. Spinning Off Stock for Existing Debt.

AT&T later was involved in another unusual deal involving the issuance of new common stock in its AT&T Wireless Services Inc. to replace the previous AT&T Wireless Group Inc. tracking stock. Most of the new AT&T Wireless shares went to existing AT&T shareholders, who received 0.3218 AT&T Wireless shares for each AT&T share held. AT&T retained about $3 billion of AT&T Wireless stock. There also was a public component to the deal: about $1 billion of AT&T Wireless stock was sold on the market through Credit Suisse Group's Credit Suisse First Boston and Goldman Sachs Group Inc.

The significant twist here was that AT&T itself did not offer the shares that went onto the market. Rather, the two underwriters agreed to buy existing AT&T debt in the open market and then exchange that debt with AT&T for new AT&T Wireless shares; they then placed those wireless shares with funds whose investments track stock indexes.[7] (AT&T Wireless had just recently been added to the S&P 500-Stock Index.)

2. Lucent/Agere: Another Debt For Equity Swap.

The AT&T Wireless transaction bore some resemblance to a debt-for-equity swap that was used in the IPO of Agere Systems Inc., the micro-electronics unit of Lucent Technologies Inc., which itself had been a former AT&T unit (known as Western Electric). In the Agere offering, Morgan Stanley, acting as underwriter, exchanged debt it held in Lucent, the parent, for 90 million shares of Agere, and then placed those shares with investors.[8] The debt-for-equity swap made the entire offering tax-free for Lucent.

Some Wall Street firms privately criticized the Morgan Stanley/Agere deal, taking the position that underwriters should not assume the risk of holding

[7]Raymond Hennessey, Wall Street Is Wary of AT&T IPO Strategy, WALL ST. J. (July 9, 2001) C15.
[8]Id.

debt as part of an equity deal. Others viewed the transaction as one of tax efficiency, since the Lucent swap, just as the AT&T swap, was structured to be tax-free.[9] A spinoff of securities of a sub can generally be tax-free to shareholders so long as the parent has 80% voting control at the time of the distribution. Although this method of distribution typically has been done with stock, it can also be used for debt.

Normally, a tax-free spinoff is geared to spinning off a unit whose valuation is higher than its tax basis; the parent seeks to avoid the gains tax. If the parent also wants to use the spinoff as an opportunity to pay down debt, it needs to find an underwriter willing to take on risk of holding debt. Although the debt-for-equity exchange occurs at the time of the IPO, underwriters normally buy outstanding debt in the market and hold it until the debt can be exchanged for shares. The risk to the underwriter is that something catastrophic could happen at the parent company, such as a bankruptcy filing, and leaving the underwriter with debt that can't be converted to equity and sold.

Between the time the idea of a Lucent/Agere swap first arose in the summer of 2000 (when Lucent was trading at more than $40 a share) and the filing of the swap with the Securities and Exchange Commission on Feb. 7, 2001, Lucent's stock had collapsed, along with much of the telecommunications market. Under the original terms of the swap, Morgan Stanley would buy up to $2.5 billion of Lucent debt, which would be swapped with Lucent for Agere shares. Those shares were to be included in the Agere IPO, which originally was set at almost $6.5 billion in stock. When worsening market conditions compelled Agere to pare back its offering, it ultimately sold $3.6 billion of stock at $6 per share on March 27, 2001. The contemplated debt-for-equity swap was aborted in favor of a much smaller arrangement under which Morgan Stanley's overallotment option allowed Lucent to swap more than $500 million of its debt.

3. Money-Center Banks Show Their Muscle In The Underwriting Arena.

A. The Agere Deal: "No Outlay, No Play."

The Agere deal had one other notable feature, which shook up the investment banking world. The Parent, Lucent, shut leading IPO investment bankers Goldman, Sachs & Co. and Credit Suisse First Boston out of the deal, only weeks after it had named them co-managers (Goldman had co-led Lucent's own IPO back in 1996.) The reason: the two investment banks declined to participate in a $6.5 billion short-term commercial paper backstop credit line for

[9] Id.

Lucent. Because of the drop in stock prices in the telecom sector, Lucent's shares had plummeted from $82 to the mid-teens in little more than a year, and Lucent risked being shut out of the commercial paper market. J.P. Morgan Chase and Citigroup arranged the credit package. As a result they were brought in as co-managers in the Agere IPO.

B. Another "Lend To Play": WorldCom's Debt Offering.

WorldCom's May 2001 offering of $11.9 billion in bonds marked the biggest-ever issue by a U.S. company. Even more significant was who did and did not underwrite the deal and why. Every firm in the syndicate, led by J.P. Morgan Chase and Citigroup, also took part in a $4.3 billion loan package that the telecommunications carrier needed to secure its short-term financing activity in the balky commercial paper market. Conspicuously missing were Goldman, Sachs & Co., Lehman Brothers, Merrill Lynch and Morgan Stanley. J.P. Morgan had never worked on a securities deal for WorldCom before, while Goldman and Lehman had previously led its bond sales. They were shut out of the underwriting syndicate because they had chosen not to lend WorldCom money.[10]

That shutout led many observers to see WorldCom's deal as a harbinger of things to come, with "one-stop" shops like J.P. Morgan and Citi becoming more appealing to corporate clients than traditional investment banks, whose less robust balance sheets make them more reluctant to extend certain kinds of loans.[11]

C. Another "Lend to Play": Motorola's Debt Offering.

The WorldCom transaction can be compared with a deal J.P. Morgan Chase and Citigroup did with Motorola. Motorola, eager to shed noncore assets and boost cash, agreed in October 2000 to sell wireless assets in Latin America to Spanish telecom conglomerate Telefónica. But Telefónica couldn't provide the cash to close the deal until an anticipated equity offering several months later.

Enter Goldman, Sachs & Co., Motorola's longtime investment banker. In February, 2001 it offered a $2 billion bridge loan secured by the Telefónica receivables. This looked like a reasonable offer—except to J.P. Morgan Chase and Citigroup—which in September 2000 had arranged an unsecured $1.5 billion credit facility for Motorola. That credit included a total indebtedness covenant

[10]Justin Shack, WorldCom's Record Setter, INST. INV. (Jan. 2002) 75.
[11]Id.

that the company was in danger of violating by taking out the bridge loan from Goldman.

The situation presented an opportunity for the big commercial banks to horn in on Goldman's relationship. The banks gave a waiver of the loan covenant and persuaded Motorola to alter the structure of the bridge to preserve their senior status in the company's capital structure, and wound up as co-leads on the transaction with Goldman. More important, they extracted a pledge from Motorola to split forthcoming investment banking deals evenly among the three firms. Sure enough, when Motorola decided to issue $1.05 billion in convertible bonds in October, Goldman had to share the lead manager role with the two megabanks.

D. The Kraft IPO: Another "Lend to Play".

In a sparse year for IPOs, a runaway success was Kraft Foods. Parent Philip Morris had bought Nabisco Group Holdings from R.J. Reynolds in 2000 and merged it with Kraft. On June 12 Kraft issued 280 million shares, raising $8.7 billion, which was the second-biggest U.S. IPO ever and the biggest of the year. The shares priced out at $31, the top of their anticipated range of $26 to $31.

The size of this deal made it that much more critical for Wall Street underwriters, led by Credit Suisse First Boston and Citigroup/Salomon Smith Barney, to get in on the act. However, some top firms, notably Goldman, Sachs & Co. and Merrill Lynch, again were not invited. Reason? They had declined to take part in the $9 billion credit facility that backed Philip Morris's acquisition of Nabisco some ten months earlier. Though neither firm had a relationship with Philip Morris beforehand, their absence from such a landmark deal is striking because offerings of this size usually include all of the top equity underwriters, if only to maximize the syndicate's ability to place shares with investors.

4. The Resurgence Of Convertibles.

In troubled markets, investors tend to like convertible bonds and preferred stock, which not only pay a regular coupon or dividends, much like other fixed-income securities, but also allow investors the opportunity to benefit from appreciation in the company's common stock. In the Spring of 2001, convertible bond issues gained almost instant momentum from the Fed's unexpected mid-April interest rate cut. Until then, only one convertible deal had been sold in the month of April. After April 18, there were 10 such deals, bringing the total for the month to 11 deals valued at a record $5.8 billion. (Data from ConvertBond.com, the online bond research site owned by Morgan Stanley). Included in the April gusher of debt sales was one by Cendant of $800 million on April 30, following

earlier deals of $850 million by Calpine and $175 million by Heller Financial. Raytheon and PPL also sold convertibles. A record $119.7 billion in convertible bonds was issued in all of 2001, versus $74.0 billion in 2000.

A. Cendant's Zero-Coupon, Zero-Yield Convertibles.

The $800 million Cendant deal was the most unusual of these issuances, because the securities were both zero-coupon and zero-yield, meaning they lacked not only the coupon payment typical of fixed-income securities, but also the yield-to-maturity provided by securities sold at a discounted price. Such offerings typically allow the issuer to pay little interest and still deduct for taxes at the same higher rate as on its equivalent straight senior debt. However, Cendant added a new wrinkle: interest is payable to investors if Cendant's stock price falls below 60% of the conversion price before the bonds become callable.[12]

B. Mandatory Convertibles.

The equity-oriented convertibles issued in 2001 included the "mandatory convertible." The issues by Raytheon and PPL fell into that category. This instrument pays dividends and automatically is converted into preferred shares when it matures. Mandatory convertibles offer a tax advantage for the issuer: since they are sold through a trust, the issuer can cut taxable income by the amount of interest paid out.

Through the end of 2001, these mandatory convertibles continued their notable comeback. Motorola Inc.'s $1 billion mandatory-convertible offering hit the market in late October, and mandatories accounted for four of 13 convertible deals in the next several weeks, including Duke Energy Corp.'s $750 million offering.[13]

From the issuer standpoint, companies can sell the closest thing to equity at a premium to their relatively depressed stock price, while shoring up their balance sheet. For debt-laden companies ranging from investment-grade-rated Motorola to junk-rated Adelphia Communications Corp., protecting the credit rating is a priority.[14]

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[12] See Tom Barkely, Convertible-Bond Issues Surge After Fed Rate Cut As An Attractive Financing Vehicle For Companies, WALL ST. J. (May 1, 2001) C18.

[13] See Tom Barkely, Mandatory Convertibles Make Comeback In Response to a Convergence of Factors, WALL ST. J. (Nov. 20, 2001) B9 ("Barkely").

[14] Id.

These equity-sensitive securities are sometimes viewed as a sign of better days ahead for stocks. Indeed, they are treated largely like equity by rating agencies because they convert automatically after three or four years and therefore avoid any refinancing risk. The dividend is seen as an interest expense, but because companies don't have to repay the principal, pressure is taken off the balance sheet.

Mandatories also can be used as an alternative to an equity offering. Prudential Financial Inc., in conjunction with the reorganization of Prudential Insurance from a mutual to a stock life insurance company, accompanied its IPO of 110 million shares of common with $500 million of mandatories. These took the form of equity security units, each consisting of a contract to purchase shares of Prudential common and a redeemable debenture in the amount of $50.00.[15] In October, AT&T Corp. monetized its stake in Cablevision Systems Corp. by selling $970 million in mandatory securities that are exchangeable into the cable company's stock.[16]

Meanwhile, interest-rate cuts forced investors to look beyond just simple fixed-income to get some extra yield. An average conversion premium of 20% for the five mandatories in late 2001 was attractive—compared with an average 29% for convertible bonds, according to ConvertBond.com.[17] A low conversion premium indicates greater equity sensitivity, since a stock doesn't have to appreciate as much before conversion becomes profitable. As a result, in favorable market conditions, mandatories attract a lot of crossover interest from growth and income-equity funds, in addition to outright convertible investors and hedge funds.

C. Comeback for "Make Whole" Convertibles.

Another type of convertible that made a comeback in 2001 was the "make whole" issue. As the name suggests, "make whole" convertibles offer protection to the holder by prohibiting their call by the issuer unless the issuer's share price appreciates by a certain amount. The benefit to issuers is that if their stock price appreciates to the designated level, they can convert the outstanding debt into equity. Emcore in early May privately sold $175 million of 5% five-year make-whole convertible notes. The notes were convertible into common at $48.7629 per share which it could not call for the first three years unless its stock

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[15] See Prudential Financial Inc. Registration Statement on Form S-1/A, SEC File No. 333-70888-01 (Dec. 12, 2001).

[16] Barkely, supra note 13.

[17] Id.

price appreciated to 150% of the conversion price. If the securities are called, Emcore will pay investors all the interest due for the first three years.[18]

D. Contingent Convertibles.

Tyco International led the way for other investment-grade issuers in convertibles with a $2.25 billion offering in February, 2001 underwritten by Credit Suisse First Boston. Tyco used a new instrument called contingent convertible zero-coupon bonds. This twist in contingent converts, developed by Merrill Lynch & Co., is that they carry a conversion premium, usually 10 to 20 percent above the strike price. Before conversion can be exercised, the share price has to rise that much above the strike.[19] The structure allows issuers like Tyco to raise money cheaply with less likelihood of dilution. There was a lot of demand in the market, and pricing was quite attractive given that investors got an investment-grade credit with a put option that allowed them to cash out after one year. Hedge funds could strip out and sell the bonds, keep the conversion option and short the stock. The put option limited their risk.[20]

5. New Appeal for the "Treasury Inflation-Protected Securities".

The risk-averse investor in 2001 began to pay attention to a newer type of Treasury bond that had been quietly introduced in 1997. TIPS, or "Treasury Inflation-Protected Securities," were little-noticed when the Treasury introduced the securities in 1997. These bonds have a soothing appeal to the mutual funds that hold them, because they have the stability of Treasuries, but will generally beat rising inflation. The bond increases its principal by the changes in the Consumer Price Index.

Thus, the Vanguard Inflation-Protected Securities Fund, created June 29, 2000, had risen 12.07% through mid-2001. TIPS, like ordinary Treasury bonds, are backed by the government and are exempt from state and local taxes, though they are taxable at the federal level.

The downside of TIPS is that a drop in inflation makes regular Treasuries more valuable in real terms, while it doesn't improve real returns for TIPS. That means investors risk passing up better returns—from regular Treasuries, stocks and any manner of other investments—by buying TIPS or funds holding them you might be leaving something on the table.

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[18]Emcore Corp. S-3 Registration Statement, File No. 333-65526 (July 20, 2001).

[19]Tyco's New Twist on Convertibles, INST. INV. (Jan. 2002) 78.

[20]Id.

6. Impact of September 11 On Debt Offerings.

After the September 11 terrorist attacks, the capital markets saw a virtual torrent of debt offerings by blue-chip corporations. Ford, General Electric, I.B.M., Kraft, AT&T, General Motors and other companies doubled and even trebled their initial plans for bond offerings. In all, companies issued 31.5% more debt in the period from mid-September to late November than in the comparable period in 2000.[21]

What were the motivating factors? One was the chance to raise cash at extremely low interest rates, and to retire more expensive debt. Another was concern that money would be scarcer in the future, particularly if the economic downturn were to persist and the recovery prove less vigorous than hoped. Bank lending in late 2001 hit a 30-year low, according to the Conference Board, and buyers were hard to find for commercial paper, the short-term debt that corporate purebreds rely on.[22] According to Standard & Poor's, the amount of commercial paper issued by nonfinancial companies has shrunk roughly 30% in 2001. The alternative was bonds.

With bonds, companies could lock in substantially lower overall borrowing costs. They could pile up reserves to help them through the hard times. Before the terrorist attacks, analysts had been expecting the issuing of debt to slow late in 2001; the opposite proved true. Where Ford had originally planned to raise $3 billion after September 11, it found itself able to raise $9.4 billion before December and was said to be thinking about trying to raise $7 billion more.[23] Kraft Foods, part of the Philip Morris Companies, had planned to issue $2 billion worth of bonds, and instead offered $4 billion.

AT&T raised $10.1 billion, twice as much as it originally planned. Indeed, AT&T's and Ford's debt issues rank as the second-and third-largest ever.[24] All told, 573 corporations have issued $181 billion of debt between Sept. 11 and late November, compared with 692 companies that raised $138 billion in the comparable period of 2000, according to Thomson Financial/First Call. For all of 2001, the investment grade corporate bond market issued a record $707 billion.[25]

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[21] Stephanie Strom, Top Companies Issuing Debt At Fast Pace, WALL ST. J. (Nov. 27, 2001) C1 ("Strom")

[22] Id.

[23] Id.

[24] Id.

[25] U.S. Market Outlook, BOND MARKET ASSN. (Jan. 2002).

Issuers and underwriters often cited the low interest rates on Treasury bills as the reason for the surge in corporate debt, since corporate bonds are often priced in relation to United States government debt. The cascade of interest rate cuts by the Federal Reserve during 2001 in effect helped blue-chip companies borrow at extremely attractive rates.

Investment-grade companies also moved from the short-term debt markets toward the long end, not just because debt was cheap, but perhaps because they were anticipating a time when money will be more scarce.[26] The automakers, for example, used the money they raised in part to support the customer incentive programs that offered zero-interest financing. Thus, they paid as much as 7.25 percent to lend money to car buyers for nothing.

Although some of the new debt was used to retire commercial paper, companies took on more than they need to accomplish that goal.[27] The longer-term money they have been borrowing is more expensive than the commercial paper, even if it is cheaper than it has been in a long time. The spread—the difference in interest rates between Treasuries and corporate bonds—generally widened after September 11, although not across the board. Like many of the companies issuing debt, Ford reduced its dependence on the commercial paper market: through Oct. 16, 2001, Ford had cut the amount of paper it had outstanding by almost 60 percent, to $17 billion.[28]

Ford was also a victim of having its credit ratings cut. Many buyers of commercial paper, like money market funds, lend to only the highest-rated companies. By late 2001, Standard & Poor's had knocked 57 companies out of the top ratings for commercial paper, compared with 49 in 2000. The total amount of outstanding commercial paper had fallen 30 percent in 2001, according to Diane Vazza, head of global financial investment research at Standard & Poor's, thanks to that downgrading and to great caution among investors. "We've seen some issuers driven out of the market," Ms. Vazza said.[29]

According to several credit analysts, DaimlerChrysler was scheduled to roll over $7 billion of commercial paper in June but decided to take the offering to Europe, where investors are less particular about ratings quality. Similarly, Enron careered into its crisis when it was forced to redeem commercial paper as its credit ratings fell.

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[26] Id.
[27] Id.
[28] Id.
[29] Id.

Underwriters of corporate debt insist that the decline in the commercial paper market has more to do with companies' ability to borrow for the long term cheaply than with their inability to issue short-term debt. However, they concede that lending by banks has all but dried up, falling to its lowest level in three decades. Bank lending has been curtailed at the behest of Federal regulators like the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency at the Treasury Department, putting them seemingly at cross-purposes with the Fed.[30]

7. Citicorp's Enron Hedge: Credit-Linked Notes.

Credit-Linked Notes were not new in 2001: they had been used for a decade by financial institutions to remove risk from their balance sheets. However, 2001 saw a very timely use of this device by Citigroup in connection with its loans to Enron. Citigroup, starting in August 2000 through May 2001, set up trusts that issued a total of $855 million in five year notes. The note proceeds went into highly rated government and corporate debt, generating a steady stream of payments to the investors. The notes were payable in five years, except that if Enron ever went bankrupt, Citigroup had the right to take possession of the highly rated securities and give the investors unsecured Enron debt.[31] The investors, in the wake of Enron's bankruptcy, now have to settle with Enron's many other creditors in bankruptcy court. The Credit-Linked Notes here were notable for the aggregate amount—the highest to date linked to one borrower—and the relatively low interest rate. Although the investment memorandums described the notes as "subject to the same credit risks" as Enron's regular bonds, the interest rates were lower than normally would apply to a borrower rated Baa1 by Moody's.[32]

8. The End Of The 30-Year Treasury Note Threatens Pension Plans.

Unless they can prod Congress to act quickly, businesses may have to pour as much as $40 billion of cash into needless contributions to top off their defined-benefit pension plans, according to consultants Watson Wyatt & Co.[33] The problem is that the effective interest rates on 30-year U.S. Treasury bonds play a crucial role in federal pension law. The Internal Revenue Service forces companies to use a four-year average of the long bond yields to compute whether their pension plans are adequately funded—even if their investments are earning higher returns. The lower the yields, the more the plans had to pump up to meet

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[30] Id.

[31] Daniel Altman, How Citicorp Hedged Bets on Enron, N.Y. TIMES (Feb. 8, 2002) C1, C5.

[32] Id.

[33] David Henry, $40 Billion Short?, BUS. WEEK (Dec. 3, 2001) 88.

potential future payouts.[34] Lately the yields had been pushed down, because bond prices were bid up due to the fact that long bonds had been in short supply for months. The last straw came on October 31, 2001 when the Treasury announced that it would no longer issue 30-year bonds.

Such long-bond Treasury yields are a full percentage point too low compared with similar corporate bonds, according to the American Academy of Actuaries. Under current law, though, companies cannot use a more realistic substitute, such as top-quality corporate issues. (The IRS rules have no bearing on 401(k) defined-contribution retirement plans.) The Academy sees the one-percentage-point error exaggerated by the current value of future obligations of the average pension plan by 12% to 15%. Companies are leery of discussing their own situations, but actuaries describe a manufacturer that will have to cough up $40 million, a food-service company that will owe $60 million, and a consumer-goods company facing an $85 million tab. In one extreme case, an employer will have to contribute $10,000 for each worker.[35]

Unnecessary makeup payments are just the start. Some companies will be socked for higher insurance premiums by the Pension Benefit Guaranty Corp. (PBGC), charged by the government with making good on plans of bankrupt companies. Once their plans become underfunded, companies may face a raft of bureaucratic entanglements with the PBGC. For instance, they may have to give 30 days' advance notice of any takeover deals.

Companies seeking to cut costs by firing employees will get a nasty surprise, too. They'll have to pay out much larger lump-sum benefits to people leaving their plans. For a 45-year-old employee, for example, the payment will be 30% higher.

Government officials say the PBGC, the Labor Dept., and the IRS are reviewing alternative formulas to replace long-bond yields, although they won't give details. Private experts say one solution would be to use a rate tied to the higher yield on Moody's Aa Corporate Index, a measure widely used to figure pension liabilities for financial reporting. No remedy had been enacted as of the end of 2001, so any 2002 change will have to be retroactive. This could muck up corporate cash-flow planning for months and, at worst, increase the need for economic stimulus.

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[34] Id.

[35] Id.

9. China's First Open-End Mutual Fund.

Last September, the China Securities Regulatory Commission allowed the launch of China's first-ever open-end mutual fund. The Huaan Innovation Fund started with 5 billion yuan $609 million), and if it succeeds it may be the start of a potentially multibillion-dollar market.[36] Firms like Deutsche Asset management, Invesco Asset Management and J.P. Morgan Fleming Asset Management have signed technical-assistance agreements with Chinese firms and anticipate that China's accession to the WTO will open up the opportunity to purchase minority stakes in Chinese money managers.[37] Peregrine projects that funds under management will rise from 90 billion yuan currently to 120 billion yuan just by the end of next year and to 250 billion yuan by the end of 2005. Market-penetration rate for funds in Asia of 8% would translate into 100 million accounts in China.

The government's three-year-old push to allow foreign firms to participate in this making of a market has set off a whirl of mating dances. Among the leading foreign firms to pair off with locals: Deutsche Asset Management with Da Cheng Fund Management Co.; HSBC Asset Management Hong Kong with China Southern Fund Management Co.; Invesco Asset Management with Penghua Fund Management Co.; J.P. Morgan Fleming Asset Management with Han's Huaan and UBS Asset Management with China Guotai Fund Management Co. Huaan and J.P. Morgan took their relationship a step further in July when they agreed to form a joint venture in which J.P. Morgan Fleming Asset Management would hold a 33 percent stake once China joins the WTO.

Other foreign firms have chosen instead to forge ties with Chinese securities houses, many of which have good retail distribution through extensive branch networks. Securities firms are expected to obtain licenses to run open-end funds over the next year or two. BNP Paribas Asset Management has teamed up with Shenyin & Wanguo Securities Co., Fortis Investment Management is linking up with Haitong Securities Co., and Schroder Investment Management is joining with China Galaxy Securities Co., China's top brokerage house.

Many of the enter-China-now managers find it reassuring that the country's often lumbering bureaucracy has shown an unusual resourcefulness in cultivating the open-end fund business. The government is showing a preference for Chinese firms with a solid relationship to a major foreign firm. China also

[36] Kevin Hamlin, Great Leap, INST. INV. (Oct. 2001) 88.

[37] Id.

requires that foreign partners have at least $50 billion in assets and Chinese experience.

Anxious to avoid attracting speculators, Han, with the CSRC's encouragement, the Huaan Innovation Fund is sold exclusively through Bank of Communications. The fear was that if securities firms sold the fund, too many of the buyers would turn out to be short-term speculators. By selling through the bank instead, the Fund aims to attract older, more conservative bank depositors to buy and hold stocks.[38]

Distributing through a bank also gives Huaan the sort of geographical reach and penetration that no brokerage in China even approaches. And it adds credibility. As a Bank of Communications' official put it, Chinese customers "think that what banks sell is 100 percent safe."[39] Of the fund's 5 billion yuan, 60 percent came from individuals but 40 percent came from insurance companies and other institutional investors, such as corporations and university scholarship funds. (Insurers have recently won permission to invest up to 15 percent of their assets in stocks through third parties.) The theory is that with a balanced investor base, the fund can limit withdrawals.

The CSRC has taken its own precautions. To help maintain the fund's stability, for instance, it is requiring that 20 percent of all open-end funds be invested in government bonds. Several institutions, including the Shanghai Stock Exchange, plan to create special benchmarks for the funds.

Despite the mutual fund prospects, the PRC has a long way to go in pension reform. Under the current system, state-owned enterprises organize their own retirement plans while large portions of the labor force get ignored. Even at state enterprises retirement funds are often mingled with working capital to finance company operations. The pension system is still so haphazard that no reliable figures exist on where most of China's retirement funds are based or how they're allocated.

However, since the mid-1990s China has been working to build a unified system that receives regular contributions from employees, employers and state enterprises. Overseeing this reform effort is the Ministry of Labor and Social Security, although it will eventually be up to the Ministry of Finance to manage most national pension assets. As reform proceeds, however haltingly, contributions are expected to rise rapidly. For instance, in mid-June the

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[38]Id.

[39]Id.

government announced that state enterprises selling their shares to the public should allocate 10 percent of the IPO proceeds ($22 billion of deals were done last year) to the National Social Security Fund ("NSSF"), which the government set up in September 2000 to raise money for pensions, health care and unemployment.[40] In August the NSSF was allowed to invest up to 6 billion yuan in stocks.

Private plans should also see growing employee contributions as Beijing seeks to reduce the drain of pension payments on its own coffers. Under an experimental program launched last year in Liaoning province, workers contribute 8 percent of the their income to a mandatory fund. If this three-year test proves successful, the program is sure to be rolled out in other provinces.

10. Section 529 Plans Can Now Pay-out Tax Free.

For middle-class and affluent parents saving for their children's college education, Section 529 college-savings plans were already a valuable tax-reduction option even before they got a big boost from the 2001 tax-cut legislation. The plans, which were first Section 529 of the Federal Internal Revenue Code in 1996, are established by individual states. So far, 43 states have set them up and hired money managers including Fidelity, Vanguard, TIAA and Merrill Lynch to run them. Many 529 plans welcome non-residents and allow contributions to be used toward out-of-state college tuition and expenses. Although contributions aren't tax-deductible (at least not on federal tax returns), earnings grow tax-free.

Starting January 1, 2002, withdrawals to pay for tuition or college expenses are free of federal income taxes, too. Moreover, unlike Education IRAs, contributions to 529 Plans are not sharply limited. The maximum contribution, which differ from state to state, can be as much as $235,000. In addition, assets in 529 Plans don't have a major impact on financial aid, in contrast to prepaid tuition plans (and Education IRAs). Though Congress may eventually change the rules, prepaid plans are treated more severely than savings plans under federal financial-aid formulas. Prepaid plans are considered a 'resource' that reduces a family's aid eligibility, dollar for dollar. Savings plans are treated as a parental asset, of which only 5.6% is considered available to cover college costs each year.

11. Airline Bailout.

Less than two weeks after terrorists hijacked and crashed four commercial jets on September 11, Congress voted $5 billion in emergency aid to

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[40] Id.

the airline industry and agreed to guarantee up to $10 billion in borrowings. The government had shut down the airlines for nearly three days, so the idea in the Capitol was that it would be only fair to provide compensation. The bailout was aimed at making the airlines whole—in effect, turning back the clock to September 10.

But for airlines, September 10 wasn't such a great time. Airlines are a cyclical business, not unlike commodity manufacturing or commercial real estate, swinging from boom to bust. Moreover, like many old-line industries, airlines have huge fixed costs. Their debt levels are traditionally high. Airline workforces are highly unionized and highly paid. Pilots and mechanics, in particular, have serious clout over management because their specialized skills are tough to replace.

Even before the terrorists attacked, analysts expected the airlines to lose $2 billion this year. With fearful tourists and business travelers avoiding flights, that turned into a $6 billion loss for 2001.

The bailout comes with strings that give the government more say in basic business decisions. For example, airline executives who earned at least $300,000 last year can't be paid more this year or next. And their severance pay can't be more than two years' salary. In return for guaranteeing an airline's debts, the government will get warrants, stock, or stock options in the airlines.

In January, the federal government tentatively approved the first bailout: a $380 million loan guarantee for America West Airlines in exchange for a 33% stake in the carrier. The government demanded to own that much of America West to "reflect the risk of issuing the guarantee," according to documents from the three-member Air Transport Stabilization Board. In addition, the board's loan approval "is conditioned on receipt from America West of a commitment . . . to control growth in labor costs that could prevent America West from achieving the goals of the business plan and, thereby, cause America West to fail to repay the loan to be guaranteed."[41] America West, which came back from bankruptcy a decade ago in the last recession, had less than $200 million in cash and credit before the bailout.

Peter Walsh, chief of Mercer Management Consulting's aviation unit, predicts: "Even with this aid package, there still will be bankruptcies."[42] Even AMR, parent of American Airlines and Trans World Airlines, and UAL seem

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[41]Lisa DiCarlo, Now Boarding: A Failed Bailout, FORBES.COM (Jan. 4, 2002).
[42]A Bailout—With Strings Attached, BUSINESS WEEK (Oct. 8, 2001) 64.

vulnerable. While they rank first and second in the world in traffic, the airlines could have faced ruinous claims if they had been forced to reimburse people and businesses for losses on the ground when the hijackers crashed their planes. Congress shielded them from those liabilities, while putting forth the bailout package. Of the $5 billion in bailout funds, AMR would receive the most aid, an estimated $915 million, followed by UAL, at $804 million, while American Trans Air Inc., which ranks 10th, would get $51 million. All told, passenger airlines will get an estimated $4.5 billion, while cargo-only carriers will receive $500 million.[43] However, no other airlines except for America West and Vanguard Airlines in Kansas City had applied as of February 13, 2001. It was expected that Midwest Airways would apply to the Board soon thereafter.

12. Saturday Night Live: The Toks Inc. IPO.

"We are not amused," the SEC said in effect when it initiated a stop order proceeding against the initial public offering of Toks Inc.

In a preposterous filing on Form SB-2, Toks had announced a master plan to take over General Motors, General Electric, AT&T, Hughes Electronics, AT&T Wireless, AOL Time Warner and Marriott International—for roughly $2 trillion in "Toks" stock.

In September, Toks had filed an amended Form SB-2 Registration Statement for its IPO, to cover 20 shares of common stock at $5,000 a share. Its prospectus indicated that Mr. Ogunjobi planned to buy all 20 shares once the registration statement was declared effective by the SEC. The Company claims that it plans to ask its "main bank" to form a syndicate that will raise $10 billion, which will be used principally for working capital, to pay for the tender offer filings, and to start production of "100 feature films."

Corporation Finance notified Toks in writing on October 3, 2001, that its initial registration statement "fails in numerous material respects to comply with the requirements of the Securities Act of 1933." The letter was not all encompassing, but focused only on what Corporation Finance believed were the fundamental deficiencies. Corporation Finance advised Toks to revise or supplement its disclosures given its concern about Tok's ability to conduct the proposed tender offer. The letter's main points were:

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[43] Id.

a. General. The staff said registration statement contained no explanation that supported Tok's assumption that if it raised $100,000 it could then qualify to obtain a $10 billion bank loan or raise $10 billion in a registered offering of debt securities. Also, the registration statement did not explain why Toks believed it could register $2 trillion of securities to be offered in a tender offer for the outstanding shares of large, publicly traded corporations.

b. Tender Offer Rules. The staff cited SEC Rule 14e-8, which provides that it is a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the [Exchange] Act (15 U.S.C. 78n) for any person to publicly announce that the person . . . plans to make a tender offer that has not yet been commenced, "if the person . . . [d]oes not have the reasonable belief that the person will have the means to purchase securities to complete the offer.:

c. Plain English. The staff said the registration statement did not meet the Plain English requirements of Regulation C under the Securities Act, Rule 421(b) and (d).

d. Accounting. The staff pointed out the lack of any audited financial statements or other disclosures required under Reg. S-B.

On October 3, Toks filed an amendment which proposed that the acquisitions "could create up to additional $300 billion in annual revenues, even after liquidation of assets or spin-offs recommended by regulators and initiated by the Company." And if taking control of the nation's leading auto manufacturer, electricity provider, telecommunications company, entertainment conglomerate and hotel chain was not enough, the "business plan will include aggressive expansion of Toks Inc. into other industry sectors and its subsidiaries." As the Toks filing put it:

> The potential to make Toks Inc. the largest U.S public entity. Or the largest public entity in the world. Expansion will cover all corners of the globe. Our Company listing will cover different exchanges around the globe to gain access to their capital markets. This will include developing countries as well.

Toks didn't own any stock in these companies, and did not appear to have any cash. It planned to exchange $2 trillion worth of Toks stock for shares of the giant businesses. Toks said that shareholders of the target companies would get to exchange 12 to 36 shares of their current holdings for one share of Toks common stock. Toks did not indicate how it arrived at the exchange ratios but, it was planning to issue that single share of Toks common stock in exchange for 12

shares of General Motors, 15 shares of General Electric, 16 shares of AOL Time Warner, 36 shares of AT&T Wireless, or 16 shares of Marriott International. The Company would not be soliciting proxies because, in Tok's words "[t]he Company is not interested in wasting resources to seek proxy votes."

If shareholders of the big targets did not rush to make swaps for Toks stock, the company said it "will take its securities to others if those we first seek rejected our offer." The SEC filings suggested that Toks is already thinking about the post-takeover composition of its acquisitions. Some divisions will be consolidated; others will be sold or closed. Toks was not certain what will become of the existing management teams, but saw it "inevitable" that "some executives will be let go."

Of course, Toks may have contemplated replacing management at these leading corporations with its own "team," which consisted solely of the Company's founder, Chairman of the Board, Chief Executive Officer, and sole stockholder, Ade O. Ogunjobi. The SEC filing describes the 41 year old Mr. Ogunjobi, a naturalized U.S. citizen, as an "alter boy" who "abandoned" his undergraduate education "to concentrate in raising capital to finance Toks."

In any event, the SEC promptly initiated a stop-order proceeding. The decision of the Administrative Law Judge is attached to this paper. While members of the ABA can probably get a chuckle from the outlandish nature of the filing, it is clear the SEC staff does not like to have its resources strained by frivolous filings.