A Firm That Failed Well

Manager's Journal

By Daniel R. Fischel
And Randal C. Picker

Many commentators have decried the recent restructuring of the Long-Term Capital Management hedge fund as a "bailout." But to students of bankruptcy, the plan to save Long-Term Capital is unremarkable: A firm lacks the cash to pay its creditors, negotiations take place, additional cash is infused, and a large chunk of the equity of the firm is transferred to creditors or new investors. Piecemeal liquidation of the firm is avoided through coordinated and collective action by the creditors. Out-of-court settlements of this sort occur every day without appearing on the front pages.

Exotic Derivatives?

Why then all the brouhaha this time? We hear a lot about a "bailout"—a term always used pejoratively—and we are told of the bad precedent and the resulting moral hazard. Anticipating a similar bailout, other hedge funds will be induced to take more risk than they otherwise would, the story goes, and lenders to these hedge funds will be careless knowing that protection looms should the fund fail.

Some of the heat undoubtedly relates to the very nature of the fund, often described as speculation in exotic derivatives, operating in the dark recesses, outside the reach of governmental regulators. That is a misguided view of the fund's activities. The interest-rate bets made by Long-Term are at worst no more than just that: bets, leading ultimately to the transfer of money from one person to another without social loss. But derivatives also serve a vital social function of allocating risk to the party best able to bear it. Concerned about the direction of interest or exchange rates? Buy a hedge—for a price of c[illegible]rse—and allocate that risk and the h[illegible]hes that come with it to someone el[illegible]e should favor financial innovation generally, and the growth of these particular investments tells us much about their social value.

Putting to one side, then, the activities of the fund itself, should we be troubled by the restructuring? We should start by noting that no government funds were used to prop up Long-Term Capital. The new funds were provided by private entities with a keen sense of their own private interest and bottom lines. Goldman, Sachs & Co., which played a leading role in the restructuring, remains a private partnership, putting its own money at risk. If these investors infused funds not merely because of their private interests but because of their perception of possible broader harms that might result from the failure of this hedge fund—*systemic risk* is the phrase of the day—all the better and all the more remarkable.

Long-Term's collapse was handled quickly and efficiently with no taxpayer funds at risk. The losses were borne entirely by the fund's investors.

As to the moral-hazard concern, this seems to argue in favor of the most draconian insolvency regime possible, one that ensures that assets subject to financial distress realize as little value as possible. It would follow from this that if we make filing for bankruptcy equivalent to blowing up the assets of the firm, it would induce careful investing before the fact by the firm. This hardly seems right: There is little reason to think that creditors would want assets to be sold in a fire sale. Surely they would prefer the chance to liquidate the assets on an orderly basis.

Alan Greenspan

Federal Reserve Chairman Alan Greenspan made this point in his t[illegible]mony before the House Committee Banking and Financial Services when he said he viewed the restructuring as the chance "to enhance the probability of an orderly private-sector adjustment." The moral-hazard concern is mitigated further by the likelihood that market participants often will not care one whit about helping a failed competitor. This is insurance of a very uncertain sort: no assurance that it will be there when you need it, and the premium—here, 90% of the equity of the firm and loss of control—is negotiated when the insurance is needed the most.

What about the presence of the Fed in the negotiations? It is clearly this fact that has fueled the rhetoric of special treatment for the privileged few and raised the specter of a public bailout. Mr. Greenspan and other senior Fed officials have attempted to allay these concerns by emphasizing that the Fed's presence was required to prevent panic and preserve investor confidence.

These statements have only made the critics more suspicious—and for good reason. Historically, the rationale of "preserving investor confidence" has been the justification of choice for the most standardless and misguided governmental interventions in financial markets. This case seems to fit the same pattern. Nowhere has Mr. Greenspan ever explained why failure of Long-Term Capital would trigger a financial panic (except of course for its megawealthy investors). Even if Long-Term Capital were forced to liquidate all its assets to pay creditors, these assets would simply be purchased by other investors. The world would go on as before. The chairman's statements are simply a thinly disguised version of the shopworn "too big to fail" justification for government regulation that has been so discredited in other contexts.

Nevertheless, we believe the Fed did play a constructive role in the Long-Term Capital negotiations, but for different reasons than those advanced to date. First, it is often difficult to coordinate creditors in distressed situations. Each creditor fears actions by others to its detriment, and may therefore move quickly against the distressed firm to suit its own interests. It is this coordination problem that is solved by a formal bankruptcy petition, though often at substantial cost and with substantial government involvement through federal bankruptcy court. In many ways, out-of-court restructuring, even with some federal presence as in this case, minimizes the government intrusion.

Neutral Mediator

Second, in this particular case, the Federal Reserve may have played the role of neutral mediator. Long-Term used strategies it regarded as proprietary. It would naturally fear in any negotiation with firms in the same business that its trade secrets would be revealed. It is possible that the presence of the Fed mitigated this concern and thereby facilitated the negotiations.

What now? There will be inevitable calls for increased regulation of hedge funds, but such a course would be misguided. Long-Term's collapse was handled quickly and efficiently with no taxpayer funds at risk. The losses were borne entirely by the fund's investors. The only complaint seems to be regret that these high-flying investors did not lose more as punishment for their sins. This may yet happen. Most bankruptcy reorganizations fail, and experienced bankruptcy lawyers talk routinely of "Chapter 22s"—firms that file under Chapter 11, reorganize and file again—and even of the occasional "Chapter 33."

Sometimes, though, the point is just to fail well. So far Long-Term has done that, with the help of the Fed and its new owners.

Mr. Fischel is a professor of law and business and dean-designate and Mr. Picker a professor of commercial law a[illegible] University of Chicago Law School.