Constraints and Opportunities Offered by the Involvement of Hedge Funds and Private Equity

Hedge funds and banks operate by different rules, respond to different incentives, and recoil from different threats; they have differing financial underpinnings and goals. They do, however, experience the same political, economic and monetary, legal accounting and valuation forces that can destabilize them, and affect their differing treatment by the Bankruptcy Court.

Money · Liquidity · Value · Solvency

PRESENTED AT:

UT Advanced Bankruptcy Conference
35th Annual Jay L. Westbrook Bankruptcy Conference
November 18, 2016
Austin, TX.

BY:

Dr. Gerald Olson
JD, PhD (London)
President, GN Olson & Company, LLC, Dallas, TX

Introduction.

The essence of insolvency for debtors and creditors, whatever their legal structure may be and whatever assets lie at the heart of their underlying business, turns on liquidity; income or cash flow solvency; the ability of the entity in question to pay its debts as they become due; and balance sheet solvency; the value of the entity's assets in excess of its liabilities. These concepts are fundamental to insolvency law. They are also fundamental to roles and claim priorities creditor, equity holder and credit holders in insolvency proceedings. Claim priorities reflect historical developments in law identifying the parties most responsible for and most capable of avoiding the necessity of seeking relief under insolvency laws and establishing claims priority that reflect the determination of such roles and claim priorities. The consideration of liquidity and value are expressed in monetary terms and unit of money denomination is assumed. This is not new information.

The actual calculations supporting a determination of solvency or insolvency and the legal and accounting principles governing those calculations have historically been largely considered peripheral to the role of bankruptcy counsel in insolvency proceedings. These considerations have been primarily left to experts in valuation and accounting.

Times have changed.

I suggest to you that the time is upon bankruptcy lawyers to broaden their understanding of all of the factors that bear on liquidity, value and insolvency. It is time to assess changes in perspective and treatment of the legal status, rights and remedies and priorities of claims of the various constituents in insolvency proceedings brought upon us by recent developments in investment, finance and banking and monetary law and policy that are manifest in a series of series financial crises over that past 45 years.

Liquidity and then value are being driven now by the largest Wall Street banks and related or affiliated parties, including investment banks, primary dealers, hedge funds and private equity investors; all of whom operate to a greater or lesser degree in what is now referred to as the financial world of shadow banking. Most of you are aware that the banking industry is defined through state law and federal law and regulation regarding charter, activities and conduct of banking. Shadow banking can be generally described as the conduct of banking activities largely outside of the state and federal legal and regulatory banking arena.

My colleague on the panel, Stephen T. Crosson, MAI, SRA, FRICS, Principal of Capright, an international valuation consulting firm, has prepared a presentation on the "Truths of Valuation;" valuation axioms that apply to any type of asset. The valuation methodologies detailed in his presentation represent the starting point for determinations of asset liquidity and value before you consider the matrix of new legal, accounting and monetary distortions that bear directly on asset valuations and determinations of insolvency and may; or perhaps should, affect priority of claims in bankruptcy and the structure of plans of reorganization in bankruptcy court. The primary truths of valuation are grounded in holding period, time → liquidity; and in evidence of amount and timing of future income to be generated by the asset and multiples of current gross or net income (or rates of discount of future gross or net income) over the defined holding period before the expected liquidity event for asset evaluated. Multiple rates and discount rates for present or future asset income are determined by valuation experts such as Mr. Crosson based on evidence and informed opinion[1].

The common denominator for determination of holding periods (liquidity) and multiple of or discount rates applied to the present or future expected income of the asset, producing an asset value estimate is the unit of measurement; money: the United States Dollar. Lawyers generally, and insolvency lawyers in particular, assume the stability, integrity and therefore utility of the dollar as a monetary tool upon which the validity of their role in insolvency resolution proceedings is grounded.

Banks, hedge funds and private equity, in different ways and in different legal and accounting contexts, exploit dysfunction in monetary policy and action to distort asset liquidity and value in the market place and profoundly affect the timing and equity of constituents' interests in a bankrupt estate in bankruptcy court. Mr. Crosson's presentation focuses on the fundamental valuation methodology consisting of the application of a rate or rates of multiple of an assets present gross income or net cash flow, based on established sources of evidence and expert opinion. This method concentrates on the risks and uncertainties attendant to the present liquid value of a stream of future income. While pricing information in active trading markets may seem compelling, very often dramatic changes in asset valuation occur primarily when assets become illiquid. It is precisely at the time that the liquidity of any asset is tested. It is also precisely the time that the value of the unit money in which the asset value denominated is also properly determined for purpose of its service as a money substitute. In an insolvency proceeding that day is the filing date for initiation of insolvency proceedings. That day likely is a day when the assets of the bankrupt estate are likely to be least liquid; and when the value of money in which values are denominated, and the money's necessary attribute of liquidity are tested.

In our new financialized economy where markets are roiled during and following financial crises, and asset valuations are shifting so dramatically that many hedge funds can find good hunting in exploiting liquidity and valuation distortions. When asset liquidity and values are manipulated, as they have been by the United States Federal Reserve System since the great recession, through interest rate policy and quantitative easing, hedge funds' hunting grounds have thinned out and potential yields shrunk. The liquidity and valuation manipulation to which I refer is predominantly conducted by the United States Federal Reserve System, the national

Title search: Constraints and Opportunities Offered by the Involvement of Hedge Funds and Private Equity

Also available as part of the eCourse
2016 Bankruptcy eConference

First appeared as part of the conference materials for the
35th Annual Jay L. Westbrook Bankruptcy Conference session
"Constraints and Opportunities Offered by the Involvement of Hedge Funds and Private Equity"