PREFERENCE SECTION OF THE BANKRUPTCY CODE, S. 3023

HEARING

BEFORE THE

SUBCOMMITTEE ON JUDICIAL MACHINERY

OF THE

COMMITTEE ON THE JUDICIARY

UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

S. 3023

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MONDAY, AUGUST 18, 1980

U.S. SENATE,
SUBCOMMITTEE ON IMPROVEMENTS
IN JUDICIAL MACHINERY,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:32 a.m., in room 6226, Dirksen Senate Office Building, Senator Dennis DeConcini (chairman of the subcommittee) presiding.

Present: Senator DeConcini.

Staff present: Romano Romani, staff director; Robert E. Feidler, counsel; and Pamela Phillips, chief clerk.

Also present: Charles F. Vihon, counsel, Committee on the Judiciary, U.S. House of Representatives.

OPENING STATEMENT OF SENATOR DeCONCINI

Senator DECONCINI. The subcommittee will come to order.

Welcome, Mr. Vihon. We are glad to have you with us today.

Two weeks ago I introduced S. 3023, a bill to amend section 547 of the Bankruptcy Code, to create an exemption to the preference section for commercial paper issued with a maturity date not exceeding 9 months and payment of which is supported from the time of its issuance until payment by an irrevocable letter of credit, commitment to lend funds, or bond of indemnity issued by a bank or insurance company.

The bill was introduced in response to what I perceived as a growing problem facing issuers, dealers, and raters of commercial paper. They are concerned that an interpretation conceivably could be given to section 547 that might allow a trustee of a debtor's estate to force a purchaser of the debtor's commercial paper to disgorge payments received from the debtor within 90 days prior to the debtor's filing of a petition in bankruptcy if such payment was not subject to any of the other exemptions found in 547(c).

It certainly was not the intent of the code to affect such transactions and it is the subcommittee's hope today to clarify that issue, delve into the scope of the problem, and attempt to ascertain if the solution embodied in S. 3023 will resolve the problem.

We will hear from raters, dealers, and issuers of commercial paper to hear what their experiences have been under the code and what they perceive for the future of commercial paper financing if section 547 is not amended.

Our first witness will be Prof. Lawrence King of New York University School of Law, who is also the editor-in-chief of Collier's on bankruptcy and reporter to the Advisory Committee on Bankruptcy Rules.

Mr. King, we welcome you here once again. You have appeared before us on many occasions. We thank you for that assistance and your efforts in the entire bankruptcy process as it has been before this committee.

Please proceed with a summary of your statement. Following your statement would you please stay at the witness table? Because of your expertise, we may call on you as we go through several panels this morning.

STATEMENT OF LAWRENCE P. KING, PROFESSOR, SCHOOL OF LAW, NEW YORK UNIVERSITY, ACCOMPANIED BY DENIS F. CRONIN, ATTORNEY

Mr. KING. Thank you, Mr. Chairman. Yes, I would be pleased to stay at the witness table.

I would like to introduce Mr. Denis Cronin and ask that he have permission to be seated with me. He is a partner in the firm of Wachtell, Lipton, Rosen & Katz.

Senator DECONCINI. Welcome, Mr. Cronin.

Mr. KING. One point that I would like to make, Mr. Chairman, is this: Among other things, I am a member of the National Bankruptcy Conference, various bar associations, bankruptcy committees, and the like. However, today I am appearing on my own behalf and not on behalf of any organization. I am not expressing any views on behalf of any organization with which I am connected.

I have prepared and submitted a written statement which I would ask be made part of the record. I would just summarize orally the points that I made in that statement.

Senator DECONCINI. Your prepared statement in its entirety will be inserted at the end of your oral testimony.

Mr. KING. I am testifying in support of S. 3023 because it does attempt to cure a problem which I think was inadvertently caused by the Bankruptcy Code of 1978. That relates to all of the segments of an industry, not to particular companies, banks, dealers, brokers, or the like, but to an industry itself. That is the issuance and purchase of commercial paper backed by letters of credit issued by banks or by indemnity bonds issued by insurance companies.

I say "inadvertently caused by the Bankruptcy Code of 1978" because in the voidable preference section of that statute, section 547, a major change was made from the earlier Bankruptcy Act, the Bankruptcy Act of 1898, which that code repealed.

Under the earlier Bankruptcy Act, a trustee to void a preference had to prove that a creditor receiving payment of a debt from someone who would shortly thereafter become a bankrupt had to prove that at the time of such receipt that creditor had reasonable cause to believe that that debtor was insolvent. That was eliminated.

Most of the bankruptcy experts, the academicians, the practitioners, and the like thought that the reasonable-cause-to-believe

requirement really fostered litigation and did not serve any other real purpose. As a matter of fact, it was more of a hindrance in that it prevented recoveries by a trustee where there should have been recovery.

Unfortunately, what it has also done is to bring into question perfectly valid transactions. I think the best example of that is this commercial paper which is backed by the bank letters of credit industry.

The purchasers of that commercial paper prior to the 1987 code, and even subsequent to it, relied principally on the credit of the bank that was issuing the letter of credit and not on the credit of the issuer of the commercial paper. The letter of credit that is issued by the bank expires once payment has been made to the purchaser.

Therefore, if that issuer of the commercial paper within 90 days after payment files a petition under title 11 of the United States Code, whether in liquidation or reorganization under chapter 11, the trustee presumably would be able to use section 547 to recover the payment from the purchaser of the paper. However, the purchaser of the paper would not be able to go back to the bank which issued the letter of credit inasmuch as the bank's liability had been terminated when payment was made to the investor or the purchaser of the commercial paper.

As far as I know, this certainly was not intended whatsoever by the statute. I think it is a problem that S. 3023 would have to cure.

As I said, under the earlier code the trustee would have to prove in order to get a disgorgement that that investor also had reasonable cause to believe the issuer was insolvent. Under the new code that requirement no longer exists. Therefore, there could be the disgorgement but no recovery over against the bank that issued the letter of credit.

I suggest that this is contrary to all of the expectations of the market. As the businessmen witnesses will state this morning, and they will cite examples of it this morning, this has had distinct effects on the industry itself, both in terms of costing extra money and losing savings and in costing a great deal of time and delay in order to get the necessary financing that a lot of these businesses require.

That is the major thrust of my testimony. I would be glad to respond to any questions that the chairman may have.

Senator DeConcini. Professor King, you were greatly involved in the development of section 457 of the code. We worked so long on the Bankruptcy Code. To your recollection, was there any feeling at any time in the development that there existed a problem with the commercial paper market perference that is now section 547?

Mr. King. No, I do not recall any instance of that.

Senator DeConcini. How did we miss that?

Mr. King. Very easily. One of the problems, of course, all of us having finite minds, we could not think of the various industries and matters that could possibly become problems.

This example might put it in proper light. As you recall, back in the early seventies, or 1970 to be precise, there was established by the Congress the Commission on the Bankruptcy Laws of the United States. That Commission, or the work of that Commission, resulted in a bill that was introduced in both the House and the Senate.

One of the provisions of that bill was an amendment or a complete rewriting of the voidable preference section. It had two parts to it. One of the parts is the one that really is involved today. That is the elimination of the reasonable-cause-to-believe requirement. Once that is eliminated, it makes every transfer within that period of time—whether it is 90 days, 4 months, whatever the statute says—it makes every single transfer to a creditor automatically a preference.

If Congress wants to make every transfer a preference and therefore there can be disgorgement of every single payment made, that is fine. That is a policy matter that the Congress could address and could relate to.

However, it does not do that. It certainly does not want to do that. You do not want to recover from doctors, department stores, or the corner grocery store. There are certain payments that you do not want to recovery in bankruptcy because they are perfectly proper.

Therefore, once you eliminate reasonable cause to believe, you have to create a whole slew of exceptions. There may be preferences, but which ones should not be voidable by a trustee?

What the Commission did was to list—one, two, three, four, down to I don't know how many—exceptions. Therefore, I think the only thing that was a voidable preference when you think of all the exceptions was loans being repaid to a bank. That did not seem right, either—to focus on one thing, such as bank loans.

My recollection is that, therefore, there was a lot of discussion about how do you restructure this section. All of the hearings before the Senate subcommittee and before the House subcommittee were on that original bill of the Commission, and there was a companion bill by the judges.

Subsequently, what came out to be section 547 was rewritten and it came into its present form of having a 45-day exception as one of the exceptions. That is ordinary payments made for debts incurred in the ordinary course of business which are made within 45 days, which have ordinary 45-day credit terms and they are made within 45 days after the debt is incurred, are excepted from the voidable preference provisions. That is how section 547 finally arrives at a result.

There was not any hearing on that. No one knew, for example, why 45 days. Why not 60 days? Why not 90 days? Why not 120 days, et cetera? With 45 days, you say, well, you have 30-day credit terms normally in the trade and another 15 days for mail to go back and forth with the invoice and check, and it comes out to 45 days.

Frankly, Mr. Chairman, it does not work. The whole section needs to be looked at. It just does not work.

In this industry what is happening is that the lawyers are saying to the investment bankers, the dealers, the issuers, and the rating agencies, "We cannot tell you whether there might have to be disgorgement, certainly if you do not have 45-day papers." What used to be maybe 90-day, 120-day or 270-day paper, now for no good reason they are requiring it to be reduced to 45 days, only because there is some statute like the Bankruptcy Act which says so but one that has never focused on the industry itself.

The direct response to your question is that no one was able to focus on particular industries and particular problems.

Senator DECONCINI. Perhaps we were trying to take on too much. Based on experience prior to the effective date of the code, was there a problem of any significance with companies that had issued commercial paper filing the petition and bankruptcy within 90 days of the time they made payments on the commercial paper that had matured to the detriment of other creditors? Do you know?

Mr. KING. No, I do not think there was any great incidence of that at all. As a matter of fact, there was probably just one company that had filed any kind of petition under the former Bankruptcy Act which was involved with commercial paper. That was the Penn Central Railroad Reorganization. However, there has not been any great deal of experience either before or after the code with respect to issuers of commercial papers.

The problem is not that there have been, let's say, actions to recover preferences. The problem is, as these businessmen will testify this morning, that the very threat of that has affected the issuance, purchase, and proper ratings of the paper itself.

Senator DECONCINI. Mr. King, I have not had a chance to read all of your testimony. I started this morning before the hearing. Perhaps you have covered this in your statement. However, should the committee delay consideration of this bill for the purpose of seeing how it works out? Is the problem of such significance that you think we need to address it now, wait a year and see what happens?

Mr. KING. Although I do not have the business experience that others do. I would say from listening to the businessmen that if Congress were to wait about a year it might not have the problem because there might not be the market. The answer is, yes, I would say it is a very urgent problem.

Senator DECONCINI. Do you concur?

Mr. Cronin. Yes, I do, Mr. Chairman. From what I understand—and again I do not have business experience, either—it seems to be that much of the market has been operating in the hope that this amendment will be passed. There is significant business awaiting, if possible, the enactment of this amendment so that they can conduct business as usual prior to the enactment of the Bankruptcy Code.

Senator DECONCINI. Mr. King, do you know where we might find opposition to this bill?

Mr. KING. No. I have not heard of any. The only possible source or reason that I could think of would be related to the question you just asked, Mr. Chairman; that is, whether you ought to just wait and see how the bill works for a while. That is the only possible opposition that I have even heard hinted at. However, I think the response that we just gave to that disposes of that argument. I have not heard of any contrary argument on the merits of the bill at all.

Senator DECONCINI. Mr. Feidler, counsel for the committee, do you have any questions?

Mr. FEIDLER. No, Mr. Chairman.

Senator DECONCINI. Does anybody else care to ask any questions? If you do, please proceed.

Mr. VIHON. I am Charles Vihon, counsel of the House Judiciary Committee.

Mr. King, what if the purchaser did have recourse to the guarantor? Would that obviate the problem that is created by 547(c)(2)?

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Mr. KING. Sure, that would help obviate the problem. The only difficulty with that is that you will not get banks to agree to such a guarantee. First of all, the banks themselves cannot because there are banking laws which prohibit banks from giving guarantees.

The issuance of the letter of credit is recognized as a valid act for the bank to do, but that is as far as they can go. That comes fairly close to guaranteed but it is not guaranteed.

To extend the term of the letter of credit to cover a perspective 90-day period and the like would be impractical for the very reason that the banks will not do it as far as I know. If they were to do that, it would increase the cost to such an extent as to make the market not viable anyway.

It is an alternative that has been investigated. To my knowledge, it just will not work.

Mr. VIHON. Is it significant that the 45-day provision happens to coincide with the 45 days provided for under 6323 of the Internal Revenue Code, the tax lien statute?

Mr. KING. I do not think it has anything to do with that, to tell you the truth.

Mr. VIHON. Finally, would you advise a reintroduction of the reasonable-cause-to-believe test?

Mr. KING. That is a sleeper. Would I advise it? I would advise it, and I would have my head chopped off by a lot of my friends in various parts of the country. I think that would solve an awful lot of problems, yes.

Would I advise it at this moment? Not really. I think that is something that should be studied. I would like very much to see a considered study made of that point because, if there were such a study, I think more people might be in favor of doing it. It would solve a lot of problems.

Mr. VIHON. Thank you, Mr. Chairman.

Senator DECONCINI. Does anybody else have any questions?

[No response.]

Thank you, Professor. We appreciate your testimony.

[The prepared statement of Professor King follows:]

PREPARED STATEMENT OF LAWRENCE P. KING

My name is Lawrence P. King and I am the Charles Seligson Professor of Law at the New York University School of Law. I have been teaching at New York University since 1959 and bankruptcy law has been one of my major responsibilities during all of these years. I served as consultant to the Commission on the Bankruptcy Laws of the United States in 1971–2, as Associate Reporter for the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States from 1968 to 1976 and as Reporter since 1979. I am a member of the National Bankruptcy Conference, and am also of counsel to the New York law firm of Wachtell, Lipton, Rosen & Katz. The views expressed today are my own and are not those of any organization with which I am connected.

A major change effected by the preference provisions of the 1978 Bankruptcy Code (Public Law 95–598 and codified in Title 11, United States Code), which was enacted on November 6, 1978 and effective as to cases commenced on and after October 1, 1979, was the elimination of the "reasonable cause to believe" requirement present in § 60 of the Bankruptcy Act of 1898. The preference provisions of the 1978 Bankruptcy Code, contained in 11 U.S.C. § 547, provide that, except as set forth in § 547(c), every transfer of a debtor's property to a creditor for an antecedent debt within 90 days before the commencement of a case by or against the debtor is a preference. Although the debtor must be insolvent at the

time of the transfer, 11 U.S.C. § 547 presumes insolvency during such 90-day period.

Consequently, the preference provisions of the 1978 Bankruptcy Code now apply to payments to purchasers of commercial paper notes which are supported by letters of credit or commitments to lend issued by banks or by indemnity bonds issued by insurance companies whether or not any such purchaser had reasonable cause to believe the issuer was insolvent at the time of payment thereof. Such commercial paper is issued by the issuer in maturities of up to 270 days and is generally supported by (1) an irrevocable letter of credit issued by a bank for the benefit of the holders of the issuer's outstanding commercial paper, (2) an irrevocable commitment by a bank to the issuer to lend money to the issuer for the sole purpose of paying the issuer's outstanding commercial paper, or (3) an indemnity bond issued by an insurance company for the benefit of the holders of the issuer's outstanding commercial paper, which letter of credit, commitment or indemnity may be drawn against by the holders of the issuer's commercial paper notes upon the failure of the issuer to pay its commercial paper notes at maturity.

As more fully set forth in Senator DeConcini's statement on the floor of the Senate when introducing S. 3023 (Cong. Rec., Aug. 5, 1980, S. 10839), by virtue of the application of the 1978 Bankruptcy Code to such transactions, payments received from the issuer by holders of its commercial paper during the 90-today period preceding the filing of a petition by or against the issuer under the 1978 Bankruptcy Code are vulnerable to avoidance as a preference by the issuer's trustee. After the recovery by the trustee from the holders of such commerical paper, such holders would thereafter no longer have the right to the benefits of any supporting letter of credit, commitment or indemnity bond because of the expiration or termination thereof. Thus, as stated by Senator DeConcini, "a purchaser of commercial paper who has been paid by a debtor could be forced to disgorge the payment he has received and would not thereafter have recourse to the bank or insurance company support for which it had originally bargained while a purchaser who was not paid prior to the filing of the petition could after the filing date obtain payment from the supporting bank or insurance company." Cong. Rec., supra.

The result of the application of the preference provisions of the 1978 Bankruptcy Code is that whereas under the Bankruptcy Act of 1898 the rating agencies and the purchasers of such commercial paper looked solely to the creditworthiness of the bank or insurance company rather than the issuer of the commercial paper the rating agencies and purchasers must now rely as well on the creditworthiness of the issuer. The adverse effect of this change on the commercial paper market will be addressed by the witnesses from the business community who will follow me.

In order to avoid the effect on the commercial paper market of the rating agencies and purchasers of commercial paper relying on the creditworthiness of the issuer, the purchasers of such commercial paper have sought to rely on the "45-day exception" contained in §547(c)(2) of the 1978 Bankruptcy Code. §547(c)(2) provides that a trustee may not avoid a payment made by a debtor in the ordinary course of its business within 45 days after incurrence of the debt if such debt was incurred in the ordinary course of its business. This 45-day period operates to validate ordinary payments when credit terms or maturities of indebtedness are 45 days or less. In the Senate Report on S. 2266 (the Senate bill preceding the 1978 Bankruptcy Code), the 45-day exception is explained as follows:

> The purpose of this exception is to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy.

Senate Report No. 95–989, 95th Cong., 2d Sess. (1978) 88; see also House Report No. 95–595, 95th Cong., 1st Sess. (1977) 373. Under the former bankruptcy law, the length of payment terms or maturity dates of indebtedness was not material in the commerical paper market because the issuers' trustee could not avoid a payment unless the creditor receiving it had reasonable cause to believe the debtor was insolvent when the payment by the debtor was made. Historically, issuers of bank or insurance company supported commercial paper have issued commercial paper having maturities of up to 270 days. Now, however, by virtue of the application of § 547, issuers of such commercial paper are in many cases compelled to limit the maturities of their commercial paper to 45 days or less in an attempt to quality for the § 547(c)(2) exception. The adverse effect on the commercial paper market

of the limitation of such commercial paper to maturities of 45 days or less will also be addressed by the witnesses from the business community who will follow me.

I submit that it was not a purpose of the 1978 Bankruptcy Code to cause valid and established business practices of the commercial paper market to undergo unnecessary change causing additional expense and perhaps loss of access to the commercial paper market merely to comply with a tangentially related bankruptcy law. The requirements of the marketplace along should control the interest rates, ratings and the maturity dates of commercial paper. The inadvertent and artificial burden imposed by the 1978 Bankruptcy Code on the commercial paper market as described above should be alleviated as quickly as possible by the enactment of S. 3023.

Senator DECONCINI. Next we will have a panel of James Ledinsky, senior vice president of A. G. Becker & Co., and George Van Cleave, of Goldman, Sachs & Co.

Good morning, gentlemen. Please introduce your counsel, or whoever is with you, for the record.

Mr. VAN CLEAVE. I am George Van Cleave of Goldman, Sachs. To my left is Mr. Joseph McLaughlin, counsel for Goldman, Sachs.

Mr. LEDINSKY. Mr. Chairman, I am Jim Ledinsky with A. G. Becker. To my right is Mr. Steve Looney, who is associate general counsel to our firm.

Senator DECONCINI. Gentlemen, please proceed with a summary of your statement. Without objection, your full statements will appear in the record at the end of the oral testimony of this panel. If you would summarize it for us, we would appreciate that.

PANEL OF FINANCIAL EXPERTS:

STATEMENTS OF GEORGE M. VAN CLEAVE, PARTNER, GOLDMAN, SACHS & CO., ACCOMPANIED BY JOSEPH McLAUGHLIN, COUNSEL; AND JAMES R. LEDINSKY, SENIOR VICE PRESIDENT, A. G. BECKER & CO., ACCOMPANIED BY STEVEN M. LOONEY, ASSOCIATE GENERAL COUNSEL

Mr. VAN CLEAVE. I am a partner of Goldman, Sachs & Co., and in charge of the commercial paper department.

When I refer to commercial paper, I refer to the unsecured promissory notes issued by the country's largest and best-known corporations. These instruments are sold either directly or through dealers such as Goldman-Sachs. Purchasers of this paper are insurance companies, banks, other corporations, pension funds, and investment companies, particularly the money market funds.

It is a very competitive market, one in which the issuer is seeking to raise dollars as cheaply as possible and the investor is trying to maximize a return on investment while investing in a safe instrument. Prime ratings from at least two of the recognized rating agencies are necessary inasmuch as it is the investor or the buyer's overriding concern that the note be paid at maturity.

To illustrate the nature of the market, at our firm, where we are the largest dealer in terms of outstanding commercial paper in the marketplace, the average commercial paper maturity today is 32 days with an average sale of $2.5 million per transaction.

In recent years a number of issuers have decided to enter the market not based solely on their own credit but by the assistance of a letter of credit or indemnity bond from an insurance company. I hope you will tolerate a little of bit of shorthand in referring to "LOC." We will talk about letter of credit as that pertains to both the bank's support and also that supplied by the indemnity bond insurance company.

I want to emphasize that companies about which we are speaking that use the letter of credit facility are financially strong companies and could obtain ratings on their own, but because of security act reasons they cannot enter the market without the bank's support. Then other companies who are still very financially strong are less known, are smaller, and cannot receive the rating that is necessary to market paper. Therefore, they also seek the same support.

Finally, there are issuers that establish financing vehicles, particularly for utilities, to finance such things as fuel inventory.

Investors in this paper want to be sure of one thing, and that is that if the issuer does not pay, certainly the bank of the insurance company will. Obviously that is the reason why the bank and the insurance company receive their fees.

In my view if any of these issuers or investors were not to be paid at maturity, even though this is somewhat different than other commercial paper, I think that it would be a terrible blow to investors' confidence and our ability to protect legal transactions. It would have a devastating effect on the entire marketplace, even though this portion of the marketplace is very small compared to the total.

Professor King has aptly described the problem. Therefore, I will not go into that aspect.

We have attempted to minimize chances that investors will not be paid. First of all, we make a credit check that we, the dealer, feel that the issuer has the ability to pay, even though the investor, frankly, relies on the bank report or insurance company report, not on the issuer's.

We also have attempted to restrict the maturity and structure transactions in order to mitigate the problem in other ways, restricting maturity, as you heard earlier, to 35 days expecting that this would be eligible for exception in the act.

We also have participated in designing some complex structures that will also help mitigate the problem. We do not really know how successful that will be, but what we can say is that the costs have increased and there are many disadvantages.

The artificially short maturities and the complex structure really narrow the market for letter of credit quite apart even from the question of preference. Just to be specific, we have reviewed our letter of credit program to determine whether there has really been a decline in investor response. Since this has become a popular vehicle, the outstanding LOC-backed paper has increased, yet the number of investors remained constant.

We also have made some comparisons on an interest rate point of view to see if this is in fact costing the issuer money. Going back in the near term makes it difficult because of the volatile interest rates market that we have experienced.

What we have done is focused on a differential between letter of credit paper and banker's acceptances. They are very similar in that

they are both two-name paper. There is an issuer and a bank support. They trade fairly close or have in the recent past.

For example, in the first 9 months of 1979 letter of credit paper sold at four basis points or four one-hundreths of 1 percent higher than bankers' acceptances. In the next 7½ months, after some of the publicity of this preference, the differential increased over 6 times to 25 basis points, or a quarter of 1 percent.

We really do not feel at this point that the investors have focused on the preference problem, but rather have really been focusing on the question of the 45-day restriction. That raises some questions. In our experience of over 100 years issuers, without question, pay higher cost of dollars when they are very restricted in their programs and not offered the full range of maturities. This is particularly true in the case of tight money markets.

Contrary to what you might believe, when interest rates are rising, there are a great number of issuers who do not want to sell longer paper because they cannot seem to get adjusted to the fact that it is costing them more. This is a tremendous advantage for the astute issuer to get in and get some longer maturities when interest rates are increasing.

To some degree the reaction has been negative on some of the complex and confusing structure. The investor's concern has been just growing gradually. I do not think we really have seen the full impact of that focus.

A continuation of this type of 45-day maturity restriction really will have investors go elsewhere. There are a lot of instruments that short-term investors can look to, but if they are too short or too complicated it is very easy for them to ask, "What else do you have?"

It would be a shame really to have this market disappear without a single investor even losing 1 penny and also to increase the cost for utilities and some of the smaller companies in this country that would be excluded from this market.

I hope my remarks will be of assistance. I hope I can explain why we strongly support the bill.

Senator DECONCINI. You mentioned that the average time of this credit is 32 days?

Mr. VAN CLEAVE. That is correct.

Senator DECONCINI. What is the shortest time?

Mr. VAN CLEAVE. One day.

Senator DECONCINI. One day?

Mr. VAN CLEAVE. Yes. The 32-day average makes our maturities range from 1 to 270 days.

Senator DECONCINI. That is the maximum, 270 days?

Mr. VAN CLEAVE. Yes.

Senator DECONCINI. The problem caused by section 547, do you believe it to be so significant that it could have severe repercussions if we do not do something about it right away?

Mr. VAN CLEAVE. Yes, I do. I get the feeling every day that we are just hanging on until this thing is resolved. I think we have been able to speak intelligently on the fact that something has to be done. I believe a lot of people think there will be.

Senator DECONCINI. How are you handling the problem now? What do you tell your clients? What do you do? Do you get opinions? Do you just take the chance?

Mr. VAN CLEAVE. We say that we feel that logically this thing probably will be resolved; we are not sure; we think it makes sense that it will be resolved. If not, we are protected to some extent by keeping the maturities to 45 days or shorter.

Senator DECONCINI. That is generally what you are doing?

Mr. VAN CLEAVE. That is what we have been doing.

Senator DECONCINI. That is what you have been doing for the most part?

Mr. VAN CLEAVE. Yes, 100 percent. We have not deviated

Senator DECONCINI. Mr. Ledinsky?

Mr. LEDINSKY. Mr. Chairman, I am responsible for developing and structuring commercial borrowing paper programs at A. G. Becker. Our firm was founded 87 years ago in Chicago, and we have more clients in issue to us than any other dealer.

We especially appreciate the opportunity to issue our strong support for S. 3023 because it addresses a number of problems which have increased financing costs and caused unfortunate delays for a number of our corporate clients.

Since the inception of the act, we have counseled in excess of 70 either active or prospective clients regarding the implication of the act on programs which would be supported by letter of credit, indemnity bonds, and so forth. These companies are located throughout the United States and represent a broad cross section of American industry.

Let me just make one comment for a moment here—and this is in very summary form—as to why companies want to enter the commercial paper market. There are three primary reasons.

To summarize those, the first one is obviously cost. Over the recent past, on the average, commercial paper has been 1.5 percent cheaper than general alternative sources of financing. That means on a $100 million program a company would save $1.5 million. However, somewhat due to the volatile markets that have occurred since the Bankruptcy Act, that differential has been 2.75 percent or $2.75 million per year on a $100 million program. The differences in cost are sizable.

Second, a lot of companies are interested in increased visibility to institutional investors. Our firm only sells commercial paper to institutional investors, substantial size firms. These institutional investors subsequently could be purchasers of long-term debt or other securities. By increasing that visibility, it would be helpful to the company at a later time.

The third principal advantage is really flexibility and simplicity. As Mr. Van Cleave has mentioned, these notes are very short maturity. It is very flexible to get in and out of the market generally. However, unfortunately borrowers wishing to establish these letter-of-credit-type programs have found that simplicity is no longer an advantage at this point.

Of the 70-plus companies that we have discussed the preference problem with over the past 9 months, only nine of those companies are presently in the market. We are still in documentation and resolving legal and related rating agency problems for 16 of the companies. The remaining companies have either taken a wait-and-see attitude or really have not made a decision whether or not to pursue this avenue, which would be quite beneficial to them.

Allow me to provide some examples of companies that have come into the market with us and give some idea of the magnitude of the problem.

A major Midwestern utility's plan to issue commercial paper was deferred twice due primarily to the preference problem. The delay was 5 months. We have estimated that the lost interest savings for that particular company for those 5 months was $1,375,000 plus legal and administrative fees which are estimated at this point to be about $125,000. That is only for the 5 months. That is not an annualized figure.

As you know, lost savings regarding a utility in a number of States are passed on to the consumer in the way of increased costs. We believe that would have been avoided in that particular case if it had not been for the act.

Another example relates to an affiliate of a major manufacturer of durable goods for the automotive and transportation industries. The delay here was 4 months. We have estimated that the cost was about $575,000 that was lost for that 4 month period. The legal and administrative fees have not yet been determined.

The last example I would like to summarize is a large utility holding company whose operating subsidiaries provide coal-generated electric service in several eastern States. In that case, the financing was almost finalized and then the preference problem surfaced. We have estimated in that case, because the initial discussions started in the spring of 1979, that the utility has lost possible savings of about $798,000 since the fall of 1979 when the act became effective.

To summarize, it would be difficult for us to estimate precisely the total dollar cost penalty relating to all the programs that have been under consideration by our 70 or so clients and by the clients of our competitors. We are not privy to that information. However, I hope that the above illustrations provide some insight into what we believe to be the magnitude of the problem.

We are hopeful that the adoption of Senate bill 3023 will occur. We believe that will solve the problem for a number of our clients and prospective clients.

Senator DeConcini. In the examples you gave of losses, were there any alternatives for those clients? Did they go some place else for the money?

Mr. Ledinsxy. Yes. What we did in each of those instances was to compare the commercial paper rate with standard financing rates as published.

Senator DeConcini. Is that where the loss occurred? They had to pay more?

Mr. Ledinsky. Yes. It is difficult in a cost-of-capital analysis to look at a company whose dollars are fungible to identify exactly——

Senator DeConcini. They got their money but they paid more for it?

Mr. Ledinsky. They got it somewhere. In our analysis they paid more. For purposes of our testimony, because it is very difficult to break down each dollar within a large corporate structure, we just compared commercial paper rates with the bank prime, which is the standard in the industry which most companies do borrow under, particularly if they cannot access the commercial paper market.

Senator DECONCINI. I think you said you have 70 clients.

Mr. LEDINSKY. Right; clients and prospective clients.

Senator DECONCINI. Nine were in and sixteen were waiting, or what have you. Those that were not in or were waiting, was this the primary reason or were there other factors as well?

Mr. LEDINSKY. There are a number of factors that come into play in any financing decision. We believe that the preference problem in most of those instances—in almost all of those cases the preference issue was the single factor that was holding up the decision at this point in time.

Senator DECONCINI. Do you concur with Mr. Van Cleave that if we do not do something now you could see severe repercussions if we waited a year?

Mr. LEDINSKY. Yes; I would concur. If we wait, I am nervous like Mr. Van Cleave. I would prefer to see this issue resolved and everybody, including ourselves and investors, would be on firmer ground.

Senator DECONCINI. Your statements and testimony are very, very helpful to point out the severity of this.

Mr. Feidler, do you have any questions?

Mr. FEIDLER. No, Mr. Chairman.

Senator DECONCINI. Does anybody else care to ask questions?

[No response.]

I have no further questions. Thank you, gentlemen, very much for your time and your expert testimony.

[The prepared statements of Messrs. Van Cleave and Ledinsky follow:]

PREPARED STATEMENT OF GEORGE M. VAN CLEAVE

My name is George Van Cleave. I am a partner of Goldman, Sachs & Co. and am in charge of that firm's commercial paper department. I appreciate the opportunity to appear before the subcommittee to speak in support of S. 3023, which I and my firm believe would correct an unfortunate and unintended problem created by the 1978 Bankruptcy Reform Act.

By "commercial paper," of course, one usually refers to the unsecured promissory notes issued by the country's largest and best-known corporations. These notes are sold either directly or through dealers like Goldman Sachs to large institutional investors such as pension funds, banks, other corporations enjoying cash surplus positions, and investment companies. The market is a highly competitive one, with issuers seeking to raise funds at the lowest cost and buyers seeking to maximize the return on their investment. Prime ratings from at least two recognized rating agencies are generally necessary before an issuer can hope to enter this market, since a buyer's overriding concern is that he be able to count on the issuer's ability to repay the amount borrowed on the due date.

By way of illustration of the nature of this market, at Goldman Sachs—which is the country's largest dealer in commercial paper—the average maturity of paper is 32 days, and the average "ticket" (i.e., transaction) is $2½ million.

In recent years, a number of issuers have chosen to enter the commercial paper market not solely on the basis of their own credit standing but with the support and assistance of a bank or insurance company which in effect lends its credit to the issuer by promising the investor that the bank or insurance company will pay the investor the amount of the commercial paper note if the issuer does not pay. This is customarily accomplished by means of a bank letter of credit or an insurance company indemnity bond. I hope you will tolerate a bit of jargon if I refer to this type of commercial paper as "LOC-backed commercial paper," i.e., paper backed by a letter of credit, although my remarks apply equally to paper backed by an insurance company bond of indemnity or by a bank commitment to lend money.

Many issuers of LOC-backed paper are financially strong companies that could obtain ratings on their own, but which for securities act reasons cannot sell paper

publicily without a bank support arrangement. Other issuers are financially strong, but less well-known, companies that believe they can raise funds at a lower net cost by offering buyers of their paper not only their own credit but also that of a well-known bank or insurance company. Finally, other issuers are financing vehicles for public utilities or other companies and serve the purpose of enabling the utility to comply with regulatory requirements or achieve a lower financing cost for such assets as fuel inventories. There are undoubtedly many other reasons for the use of LOC-backed commercial paper, but these are the ones that I am most familiar with.

Investors in this type of paper want to be sure of one thing: that if the issuer of the paper does not pay on the due date—for whatever reasons—then the bank or insurance company will. This is the basis on which the paper is bought by the investor and the reason for which the bank or insurance company is paid a fee. For this expectation to be disappointed for any reason—other, of course, than the inability of the bank or insurance company to meet its obligations—would be a terrible blow to investors' confidence in our legal system's ability to protect legitimate commercial transactions. It would have a devastating effect on the ability of utilities and lesser-known issuers to take advantage of the lower cost offered by the commercial paper market, and it would undoubtedly have severe consequences for all other commercial paper issuers and, ultimately, for all borrowers in the nation's money and capital markets.

Unfortunately, as Professor King has described, the 1978 Bankruptcy Reform Act contains a provision that makes all of the foregoing a theoretical possibility. As he has said, an investor who has been repaid by the commercial paper issuer might find himself required to disgorge those funds to the issuer's trustee in bankruptcy, at a time when the bank or insurance company commitment will long since have expired, all because the issuer filed for bankruptcy within 90 days after the payment to the investor, and without regard to the investor's good faith in accepting payment. I am sure you will agree with me that this is not an acceptable result.

Of course, we as dealers have attempted to minimize the chances that investors' expectations will be disappointed. First of all, we must be confident that the issuer will be able, on its own, to pay its debts as they come due, even though this may be of no concern to the investor who relies exclusively on the bank or insurance company commitment. Second, we have attempted to restrict maturities and structure transactions so as to mitigate the problem in other ways. For example, the maturity of all LOC-backed paper sold by Goldman Sachs since the effective date of the Bankruptcy Reform Act has been limited to 45 days in the expectation that this would make the paper eligible for an express exception contained in the Act. We have also participated with issuers in designing complex financing vehicles in the expectation that these would also mitigate the problem. Unfortunately, while we cannot yet say how successful these steps have been (and we hope we never have to find out), we can say that they have their costs and disadvantages. For example, the combination of artificially short maturities and complex financing structures undoubtedly narrows the market for LOC-backed commercial paper, quite apart from investors' specific concerns regarding the "preference" problem.

Let me be more specific. We have reviewed our largest LOC-backed commercial paper programs to determine whether there has been a noticeable relative decline in investors' participation in these programs. While the volume of outstanding LOC-backed paper has significantly increased, the number of investors has remained constant.

We have also compared the rates of interest paid by issuers of LOC-backed paper both before and after the effective date of the Bankruptcy Reform Act. These comparisons are difficult, of course, since the period in question involved particularly volatile interest rates. We have attempted to allow for this by focussing on the degree to which the LOC-backed rate exceeded the rate on bankers acceptances. We believe bankers acceptances to provide a good comparison, since they are similar to LOC-backed paper in that both types of instrument involve short-maturity, two-name paper where a major bank is regarded as ultimately responsible for payment (the principal difference is that the bank pays an acceptance in the normal course of events; while it pays in the case of LOC-backed paper only if the issuer fails to pay). Historically, the difference in rate between the two instruments has been small. For example, during the first nine months of 1979 30-day LOC-backed paper was sold by Goldman Sachs at an average weekly rate only four basis points, i.e., four one-hundredths of a percent, higher

than bankers acceptances of the same maturity. During the next seven and one-half months, however, the difference increased by more than six-fold, to 25 basis points.

We regard the decline in investor participation as well as the increase in rates paid by LOC-backed commercial paper issuers to be attributable not so much to investors' specific concern about the "preference" problem but rather to the restriction of maturities to 45 days or less. In our experience of over 100 years in marketing commercial paper, we have found that issuers inevitably pay higher rates whenever they are unable to offer a wide range of maturities. This is particularly the case during difficult periods in the money market when many issuers tend to limit maturities so as not to lock themselves into high rates, thus offering other issuers the opportunity to profit from the relatively attractive rates investors are willing to pay for relatively scarce longer maturities.

In our view, it is important to recognize that the deterioration in the LOC-backed paper market that I have described is only indirectly attributable to the "preference" problem, i.e., it is the result of investors' reaction to the artificially short maturities that have been offered. Undoubtedly, it is also the result to some degree of investors' reaction to some of the more complex and confusing structures that have been created in an attempt to mitigate the problem. I must emphasize that investors' specific concern about the "preference" problem has been growing only gradually and that we have therefore probably not yet seen the full impact of the problem on the LOC-backed paper market. A continuation of the present state of circumstances will undoubtedly lead many investors to conclude that, however much they should be able to rely on the 45-day exception or other "solutions" to the problem, it is easier to invest funds elsewhere. This would mean the end of the market, even without a single investor's having lost a single dollar, and this in turn would mean increased financing costs for utilities and lesser-known companies as they are excluded from the commercial paper market for particular kinds of financing.

I hope that my remarks will be of assistance to you in your consideration of the bill before you, and that I have been able to explain why we strongly support the bill.

PREPARED STATEMENT OF JAMES R. LEDINSKY

My name is Jim Ledinsky and I am responsible for developing and structuring commercial paper borrowing program at A. G. Becker Incorporated. A. G Becker is a leading dealer in the distribution of debt securities and provides short-term financing through the commercial paper market for more corporate borrowers than any other dealer. Our firm was founded 87 years ago, in Chicago, as a commercial paper dealer and we have been particulrly active in'the commercial paper market throughout our history.

We especially appreciate this opportunity to express our strong support for Senate Bill 3023 because it addresses a problem which has increased financing costs and caused unfortunate delays for a number of our corporate clients. We share the concerns of Professor King, other commercial paper dealers, corporate borrowers, and the independent firms which provide credit ratings on commercial paper that are relied upon by investors. We also believe that the unintended effects of the preference sections of the Bankruptcy Reform Act may have more serious consequences for existing and potential commercial paper issuers during the months ahead.

Since the Act's inception we have counseled in excess of 70 active and prospective clients regarding the implications of the Act on commercial paper issuance programs which are supported by letters of credit, irrevocable commitments to lend, other bank facilities and insurance company indemnity bonds. For the purpose of this discussion, I will refer to all of these arrangements simply as LOC programs. Those we have counseled include major manufacturers, natural resource companies, transportation companies, public utilities, agricultural companies and firms involved in the housing industry. They are located throughout the United States and represent a broad cross-section of American industry. Most of these companies have used or are considering LOC programs to finance specific projects or to obtain commercial paper ratings which are more favorable than they might otherwise have been assigned.

There are a number of reasons why these companies are interested in utilizing the commercial paper market. One of the primary reasons is that the market historically has allowed companies with top-quality commercial paper ratings to

borrow, on average, at 1.5 percent or more below the cost of alternate sources of short-term funds—a savings of $1.5 million annually on every $100 million of short-term borrowings. Since the 1978 Bankruptcy Reform Act became effective, these interest savings have averaged more than 2.75 percent or $2,750,000 per year on each $100 million of short-term debt.

A second advantage is that commercial paper is generally sold to substantial institutional investors. These institutions become more familar with the borrowing company through commercial paper investment and that familiarity often leads to reduced interest costs on other longer-term securities issued by the borrower. The third principal advantage relates to flexibility and simplicity. Notes can be issued on the day funds are required for virtually any amount and any maturity up to 270 days with little advance notification. Unfortunately, however, borrowers wishing to establish LOC-type programs since the enactment of the 1978 Bankruptcy Reform Act can no longer include simplicity as an advantage of this market. Of the 70-plus companies with whom we have discussed the preference issue over the last nine months, only nine are presently in the market. We are still in documentation or resolving legal and related rating agency problems with an additional 16 companies. The remaining companies have taken either a "wait-and-see" attitude, or have made no decision on whether or not to pursue this approach.

These uncertainties have added significant legal and administrative expenses as well as timing problems to the many other considerations—such as banking relationships, legal structure and fluctuations in the debt markets—that are involved in any type of debt financing plan. Allow me to provide some examples of delays and increased costs that have resulted.

In one instance, a major Midwestern utility's plan to issue commercial paper was deferred twice as a result of the preference problem. We have estimated that the resulting delay of over five months may have caused lost interest savings of approximately $1,375,000 plus legal and administrative fees in excess of $125,000 for that utility. This lost interest figure was determined by comparing the rates on top-rated commercial paper with the rates on standard alternative bank borrowing sources. As you know, lost savings often are ultimately borne by a utility's customers through increased changes for service and by its shareholders through reduced income. We believe a substantial portion of these expenses would have been avoided if it had not been for the Act.

In another case, our Credit Department and Credit Committee had reviewed (as we do for all of our corporate clients) a transportation company's financial position and prospects and had concluded that they were sound. However, we recommended, because of its size and the probability the company would not be able to obtain a prime or top commercial paper rating, that it consider an LOC program. Because of the problems associated with the preference issue, this client has been unable for over seven months to obtain an agreement with a bank and establish an acceptable financing structure that would solve the concerns of the bank and rating agencies. Therefore, that client has been denied the cost savings which the commercial paper market would have afforded.

A third example relates to a financing affiliate of a major manufacturer of durable goods for the automotive and transportation industries. The implementation of this company's LOC program was delayed four months and it is estimated that the company sacrified approximately $575,000 in interest savings. This does not include legal and administrative expenses relating to the preference issue which have not yet been determined.

My last example involves a large ultility holding company whose operating subsidiaries provide coal-generated electric service in several Eastern states. This utility began to establish a bank-supported commercial paper program to finance coal inventories in the Spring of 1979. The program's structure was nearly finalized when the preference issue surfaced. Although the program was restructured, it has not yet been completed because of delays related to the preference issue. This utility has forgone interest savings estimated at $798,000 since the Fall of 1979. Incremental legal and administrative costs associated with restructuring the program have not been determined, but are expected to be significant.

It would be difficult to estimate precisely the total dollar cost penalty relating to all the programs that have been under consideration by our clients and by those of our competitors. However, I hope the above illustrations give some insight into the magnitude of the costs to date associated with uncertainties relating to the preference issue.

We concur with the findings of others that—in addition to the delays and expenses we have enumerated—other costs have resulted from limiting maturities to

45 days or less and from the use of more complex, special purpose financing structures. We are hopeful that the adoption of Senate Bill 3023 will reduce concerns which have led to these unnecessary added interest costs and delays and increase the ability of many enterprises, including smaller companies and companies in the housing and durable goods industries, to raise short-term capital at more favorable interest rates. In short, we believe that this Bill will remove an unnecessary hindrance to the use of the commercial paper market. We strongly support Senate Bill 3023 and urge its speedy adoption.

Senator DECONCINI. Our next panel will be Mr. Merle Welshans, vice president-finance, Union Electric Co.: Mr. Fred Hervey, chairman and chief executive officer of Circle K Corp.: and Walter Boris, executive vice president, finance and corporate affairs, Consumers Power Co.

Gentlemen, your full statements will be in the record following the oral testimony of this panel.

Mr. Hervey, we are very glad to see you here from Phoenix, Ariz., where it is only 110° today, I understand.

Mr. HERVEY. If it is 110, my business is better.

Senator DECONCINI. You will sell a lot of that ice cream, pop, and what have you.

As you know, we have had experience with your company in my family for many years. We are very proud to have you located in Phoenix, Ariz., and pleased to see you here today.

Do you care to start, Mr. Hervey?

Mr. HERVEY. Yes, sir, that would be fine.

Senator DECONCINI. Please proceed.

PANEL OF CORPORATE OFFICERS:

STATEMENTS OF FRED HERVEY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CIRCLE K CORP.; MERLE T. WELSHANS, VICE PRESIDENT OF FINANCE, UNION ELECTRIC CO., AND WALTER R. BORIS, EXECUTIVE VICE PRESIDENT, FINANCE AND CORPORATE AFFAIRS, CONSUMERS POWER CO.

Mr. HERVEY. I just would like to comment on the Circle K. We started with three stores in 1951. By 1957 we had expanded to 13 stores and moved into Arizona. By 1960 we had 36 stores; by 1974, 123 stores; and in 1980, 1,200 stores.

Of course, the expansion of those Circle K's has always been a challenge. In the early days we begged and borrowed money wherever we could get it. Of course, milk companies helped us, banks helped us, and suppliers helped us. Of course, our profits helped us, too.

Then in those days the landlord built the building and we negotiated the lease and proceeded on that basis. As we got a little bit more sophisticated we found it was easier to buy the land and build our building and then sell it to an investor and lease it back from him. Of course, this required more capital and required more investment in that time that it took to build the buildings and get them ready.

Therefore, for some time I had eyed the commercial paper thinking what a great deal it would be if I ever got to a point where I could

borrow it that way because I would be saving about 2 percent. They said, "Well, we can't let you borrow money until you are worth $50 million." In April 1979, we were worth $50,533,000. I said, "Here I am. I'm ready." They said, "Well, the problem is you must get a bank to get a letter of credit to guarantee that because that is the way it goes."

Finally, I got a letter of credit from the bank and was ready to go again. Every week I thought next week would be the week I would start selling commercial paper. However, it turned out in May 1980, I was worth $62 million and still had not had a first commercial paper to sell. It was because the lawyers were conferring about the preference and the various problems that arose. Therefore, as to this week I am still momentarily expecting someone to call me and say, "You are ready to sell commercial paper." We have not sold any as yet.

Of course, this has created quite an expense of 2 percent maybe on $5 million per year as well as the lawyer bills and the strain of wondering. It has slowed our expansion program considerably because we keep thinking we are going one way and then we really cannot go that way. Then we hesitate to say, well, we are going to go back the old way because we have to make our plans and where we are going to get the money. It has created quite a problem for Circle K.

I do not know exactly what the answer is. To put it bluntly, I am a little frustrated as to which way to go.

Senator DeConcini. Excuse me, Mr. Hervey. Your testimony is that the issue before us here is the major reason you have not been able to proceed with issuing your paper and a substantial expansion as a result of that; is that correct?

Mr. Hervey. Yes. It seems to be the uncertainty of the situation as far as the rating agencies are concerned. It seems as though there is a reluctance for the industry itself to go forward.

Senator DeConcini. What alternatives do you have as a corporation for raising that kind of capital?

Mr. Hervey. I have to go back to the old way of doing it, which is to borrow it from banks. Of course, the problem has accentuated itself because of inflation and the cost of land. Today to build a convenience store of the kind we are talking about with gasoline and so forth it costs $250,000. In 1960 it cost $85,000. It has snowballed to the point where financing has become a real major problem.

Senator DeConcini. If you go back to the banks, that costs you more?

Mr. Hervey. It cost 2 percent more.

Senator DeConcini. Thank you. Please proceed. Is there anything further?

Mr. Hervey. I think that is about it.

Senator DeConcini. OK. Thank you.

Mr. Welshans?

Mr. Welshans. Mr. Chairman, my name is Merle Welshans. I am financial vice president of Union Electric Co. of St. Louis. We are an investor-owned utility providing gas, steam, water, and electric power primarily in the State of Missouri, southern Iowa, and to a small extent in western Illinois.

We have a $100 million nuclear fuel lease arrangement utilizing letter of credit commercial paper. I am now in the process of trying to establish an additional $100 million nuclear fuel lease on the same basis.

The Bankruptcy Reform Act of 1978 has made this arrangement more difficult and I believe more expensive for us.

I would categorize these problems in three ways. First of all, the protracted lead time involved in establishing the arrangement is quite extensive. It takes a great deal of my time as well as that of our in-house counsel and our outside counsel, mirrored by the dealer's inside counsel and all of the rest of the legal staff. Then, of course, the banks spend an equal amount of time or perhaps even more time than we do in satisfying themselves that all of these eventualities have been covered in connection with the voidable preferences.

This does take a great deal of time. It postponed the implementation of our first $100 million arrangement, which cost us some money because in the meantime we have to finance with our conventional bank lines and to a lesser extent with regular commercial paper.

The second category of problem is that of simple cost. Of course, all of this time spent by the various counsel and by the financial managers of the institutions, including myself, has a very obvious cost. Then since we have attempted to solve the problem by keeping the maturities at less than 45 days, I am inclined to believe that this has cost us something as well.

This brings in the third category of this problem. That is financial flexibility. We simply are bunching up our maturities within that 45-day period. This cannot help but have some added cost to the matter of letter of credit commercial paper financing.

We also sell regular commercial paper. From time to time we find it convenient and economical to choose maturities in excess of 45 days, such as 60 days or even 100 days, if we happen to get a deal that fits in nicely with the needs of an investor. However, with the letter of credit commercial paper we are forced to restrict our maturities to that 45-day period. This has a very obvious cost.

All of these difficulties are ultimately reflected in higher costs to us that must be passed on to our customers, of course. There seem to be no offsetting benefits whatsoever to our customers as a result of what we consider to be a misuse of our limited resources.

Thank you.

Senator DeConcini. Thank you.

Mr. Boris?

Mr. Boris. Thank you, Mr. Chairman.

My name is Walter Boris. I am an executive vice president of Consumers Power Co. I handle finance, corporate affairs, and governmental affairs.

It is a little hard to be the third one on this list because a lot of these things have been said. However, I would like to indicate to you that I am at the other end of the spectrum from Fred Hervey. We are a very large utility, probably in the top 10 in the United States on the basis of revenues collected.

We have a massive construction program which runs about $650 million per year with a very heavy reliance on outside financing. This $650 million a year does not include nuclear fuel. As a matter of policy, we lease our nuclear fuel.

Because of the large requirement for external capital, we have been downgraded from A–2 to A–3 on a commercial paper rating by Standard & Poor's. The effect of this downgrade, of course, virtually

takes us out of the commercial paper market in terms of size of the paper you can raise and in terms of the rate, which will be much more expensive.

We have two nuclear fuel leases in place. One is for $60 million; the other for $90 million. On this latter nuclear fuel lease we are still in the process of negotiating with the rating agencies for a proper paper rating. In the meantime, we are borrowing under one of the alternatives. We have several there. One is at prime, which is a little high. The other one is an LIBO rate plus an override. The third one is a commercial paper rate plus an override.

Everthing has been said here about the desirability of this paragraph 7 on the preference matter. Therefore, all I want to do is to give you an idea of the amount of cost that we are going to.

We negotiated this last $90 million nuclear fuel arrangement in May. We still do not have a commercial paper rating because we are worried about what happens to the bank's backup in the event of a preference treatment of a commercial paper that has been taken out. We do not have that rating. We have been borrowing at LIBO. The LIBO rate, which traditionally runs, say, a quarter over the commercial paper rate, carries with it a three-quarters of 1 percent support fee. A commercial paper rating would carry a three-quarters of 1 percent—let me correct myself.

The LIBO rate, which runs a quarter normally over paper, carries a 1½ percent support fee. That is 1.5 percent. A commercial paper rating would carry the three-quarters of 1 percent fee. There is a pure three-quarters of 1 percent difference.

Now on an annual basis of $100 million of nuclear fuel this is three-quarters of a million dollars per year. Add to this the additional legal fees which we are paying because our lawyers are concerned about the documentation—the fact of bankruptcy is not the matter; the possibility theoretically is the real problem the lawyers are facing on interpretation of the new Bankruptcy Act. That adds another $30,000 to $40,000 to our annual bill.

As we look to our full fuel requirements to fuel four plants, we are saying $350 million per year for gross amount of nuclear fuel. The spread on that kind of dollars, given the option of financing at the paper rate as against either direct borrowings at prime or the London Interbank offered rate is staggering. It is several million dollars a year. Again, these are paid for by the customers eventually.

That completes my comments, Mr. Chairman.

Senator DeConcini. Gentlemen, thank you. You make the case very clear and distinct to me.

Going back to Mr. Hervey, in your dealings with other small businesses the size of Circle K, have you had contact with other people in comparable businesses that have witnessed the same problem?

Mr. Hervey. No, I really have not. As far as I am concerned, I guess, being a small company as we are, we were rather unique in having so much audacity to go ahead and try to get the commercial paper. It looked like it was going to work. It looks like it still might work. It is just a question of timing. It is just putting it off from day to day.

Senator DeConcini. Gentlemen, in the utility business, I take it that your capital needs are certainly exceptional. Is it fair to say that is pretty common among utilities?

Mr. Welshans. That is correct. That is typical of the utility industry.

Senator DeConcini. We have this across the country and across the board facing us in the area of utilities.

Mr. Welshans. Yes, sir.

Senator DeConcini. When you have to borrow at a larger fee, you obviously pass that on to your consumers, your customers; is that right?

Mr. Welshans. That is right.

Senator DeConcini. In the cost of higher rates. Does anybody have anything to add?

Mr. Hervey. Senator, I might say that I have had many requests from other companies to tell them how I did it, but up to this time, I have made no speeches because we have not done it.

Senator DeConcini. I hope maybe that will change, Mr. Hervey, and you can start going on a speaking tour telling how great it is.

Thank you, gentlemen.

Mr. Welshans. Mr. Chairman, I would ask permission at this time to submit for the record statements of two other issuers of this type of commercial paper: Puget Sound Power & Light Co. of Belleview, Wash., and the Peabody International Corp. of Stamford, Conn., both in support of the bill.

Senator DeConcini. Without objection, they will appear in the record. Thank you for submitting those to us.

Thank you, gentleman, very much.

[The additional prepared statements can be found in the appendix.]

[The prepared statements of Messrs. Hervey, Welshans, and Boris follow:]

Prepared Statement of Fred Hervey

I am Fred Hervey, Chairman and Chief Executive Officer of Circle K Corporation. I am pleased to have an opportunity to speak to you this morning regarding our experiences with the so called preference question and to speak in favor of S. 3023 which would correct an unintended effect of the new bankruptcy law on issuers of commercial paper. I am particularly pleased to have an opportunity to voice my support of this amendment which has been introduced by Senator DeConcini of Arizona, the state in which our company is headquartered.

Circle K started with three stores in 1951. By 1957, we had expanded to 13 stores and moved into Arizona. By 1960, we had 36 stores; in 1970, 423 stores; in 1980, 1,200 stores. Financing our expansion has always been a major challenge. We orginally financed our new stores with bank loans, help from milk companies and other suppliers, and, of course, our profits. Most of our early stores were built by landlords and leased by us. We later, and presently, expand mostly by purchasing land, building our buildings, then selling the package to investors and leasing the stores back from them.

This procedure, of course, takes more capital but allows us to expand more quickly. In order to continue expanding, we went public in 1963. Since then we have sold more stock and have had two convertible debenture issues. After the economic slowdown of 1973–1974, we slowed our building of stores from a 20-percent expansion goal to a 10-percent expansion goal, which now compares to our present expansion rate of 5-percent. In 1979, we had sales of $438,559,000; we made $19,628,000, paid income tax of $8,950,000, paid stockholders dividends of, $4,728,000, leaving an equity gain of $5,950,000. In 1980, sales were $533,103,000. we made $31,703,000, paid income tax of $14,755,000, and dividends of $5,697,000,

leaving an equity gain of $11,251,000. We made this gain because we have upgraded our stores, increased sales per store, closing 24 old stores in 1979 and 22 in 1980. We built 77 new ones in 1979 and 64 new ones in 1980. Average site costs have risen from about $20,000 in the 1960's to about $55,000 in the 1970's: partly due to inflation and partly due to our upgrading our site selection. Building costs increased from about $30,000 in 1960 to about $100,000 in the 1970's. Equipment costs increased from about $20,000 in the 1960's to $40,000 in the 1970's; gasoline installations from $15,000 in the 1960's to $40,000 in the 1970's. So a new store today costs, without merchandise for sale, $235,000 vs. $85,000 in the 1960's. Our building fund program has required about $10 million in rotating funds to buy land and build stores; this is without the funds necessary to purchase equipment or install gasoline pumps. We have for several years eyed the commercial paper market as a source of borrowing for this expansion.

In April 1979, we reached an equity of $51,508,000. We then began negotiating with Goldman Sachs to sell our paper. We then found out we had to arrange a bank back-up. We finally got this arranged.

The major advantage of our using the commercial paper market with a bank LOC is that it would give us an opportunity to borrow funds at a somewhat lower rate. We would get this lower interest rate because generally the commercial paper market offers interest rates that are less than the bank prime rate. We will have access to the commercial paper market solely because the bank's support will enable us to get the top commercial paper ratings. We have been frustrated for many months in our efforts to enter this market as a result of the change in the bankruptcy law. Although, as a businessman, I do not claim to know all the details of the technical, legal matters involved I would like to tell you about how this change has just plain cost us money. To be more specific, there are four ways in which this law has cost us money, three of which are a result of the delay we've experienced.

These four cost areas are (1) foregone interest cost savings, (2) management time, (3) delays in expansion resulting from uncertainty regarding the financing, and (4) potential increases in interest costs of LOC backed paper.

First, although it is hard to calculate precisely because we have had rather volatile interest rates during the period, I would nonetheless estimate that we have not been able to realize interest cost savings of perhaps as much as $100,000 during the period in which we would have been borrowing in the commerical paper market. During the last twelve months, when we would have hoped to be in the market, our short term borrowings have averaged about $5 million and we believe that the average differential between what we have actually paid, which has been approximately the bank prime, and what we would have paid under our commercial paper program is about 2.2 percent.

The second cost is even harder to specify, but it consists of the management time that has been spent on first of all, trying to understand this problem and secondly trying to develop solutions to it. In addition, our legal expense has been significantly increased.

Another cost to us has resulted from the uncertainty regarding the likelihood that these legal problems would ever be resolved. In the absence of certainty regarding our funds' sources and their likely cost, we have somewhat curtailed our construction program. This curtailment has probably decreased our achievable sales levels and most certainly has, in its own way, contributed to the problems of the construction industry in general.

Finally, the solution which has developed, which is to limit the maturities of our commercial paper notes to 45 days or less, will also cost us money. We are effectively prohibited now from issuing longer term commercial paper if we should think that the market in the longer maturity ranges is more attractive for our purposes. This will have the effect again of increasing our interest costs relative to what they might otherwise be because certain commercial paper investors who wish to invest for maturities longer than 45 days will invest in the paper of non-LOC issuers.

All of this seems to me to be completely unnecessary. The deal we have arranged with the bank is that in exchange for or paying them a fee, they add their credit to ours and this lets us get a net cost of funds lower than we could otherwise get. The bank has agreed to substitute its credit for ours and the investor is relying on this. There is really no question of our favoring investors in our commercial paper over other creditors since the commercial paper buyers are not relying on our credit but on the bank's credit, while our other creditors are looking solely to Circle K. The law should not make possible a frustration of these legitimate expectations.

In summary, I would like to say that Circle K is a good company and that after much delay and expense it appears at last that we may be receiving our rating and entering the commercial paper market. I would hope that for the benefit of other companies like ourselves which are too small to enter this market on their own that the proposed changes would be made in this law so that a broader range of American companies can make use of this attractive short term market. I appreciate having the opportunity to share our experiences with you.

PREPARED STATEMENT OF MERLE T. WELSHANS

My name is Merle Welshans. I am the Vice President—Finance of Union Electric Company located in St. Louis, Missouri. I sincerely appreciate the opportunity to appear before the subcommittee to speak in favor of S. 3023 which I believe would correct an unfortunate and unintended problem created by the 1978 Bankruptcy Act.

Union Electric is an investor-owned public utility which was incorporated in Missouri in 1922 and is the successor to a number of companies, the oldest of which was organized in 1881. We are primarily an electric utility servicing a 24,000 square mile area covering the eastern and central portions of Missouri, portions of Illinois adjacent to St. Louis, Missouri and the southeastern portion of Iowa. The estimated population of our service area is approximately 2,700,000 people.

As a private enterprise entrusted with an essential public need, we strive to render service of the highest quality at the lowest possible cost consistent with sound business principles.

As I'm sure you know, one of the major components of our cost structure is interest expense. Perhaps the most important responsibility I have as Vice President-Finance is to arrange for appropriate financings in all markets at the lowest possible cost to the company and hence to the consumers we serve.

Very clearly, the Bankruptcy Reform Act of 1978, as it now stands, makes that task significantly more difficult and costly in the letter of credit commercial paper market. Under the old law, that market had consistantly proved itself to be an excellent financing vehicle for the utility industry. We at Union Electric have advantageously used this market to finance some of our fuel inventories through a financing vehicle.

The major problems caused by the new law for a public utility using the letter of credit commercial paper market to finance its activities are essentially threefold in nature:

First—Protracted lead time;

Second—Increased initial and ongoing borrowing costs;

Third—Reduced financial flexibility.

I would like to touch briefly on each of these areas to give you an idea of just how costly and difficult the new law has now unintentionally made what was formerly a relatively inexpensive and simple financing vehicle without any offsetting benefit which I can perceive.

PROTRACTED LEADTIME

The significantly more complex agreements and legal opinions necessary to simply put the commercial paper investor back into the position he was prior to the New Act require major new time and effort from at least the following groups:

A. Our financial management.
B. Our in-house legal counsel.
C. Our outside counsel.
D. The dealer's financial and credit staffs.
E. The dealer's in-house legal counsel.
F. The dealer's outside counsel.

Since there doesn't seem to be any universally accepted solution to the problem other than an amendment to the act many, many hours are spent in meetings within and among the various groups I have just mentioned. These meetings produce numerous drafts for all to review which in turn cause more meetings. The opportunity cost alone of this unproductive (but necessary under the act) use management time is very high. And none of these legal solutions has been truly tested as yet.

Once the above groups have completed their "final draft" work, additional time is required to obtain a commercial paper ratings from the recognized rating services. As you know, this rating is critically important if the marketing of the

commercial paper notes is to be successful. Because the underlying documents are not only very complex but also unique to a certain extent, the rating services must review each transaction on a detailed case by case basis. During the course of this review, the rating agencies may require an amendment or slightly different legal opinions. This has the effect of re-involving many if not all of the groups mentioned above necessitating even further delay. It is very hard to quantify how many wasted man hours are involved in this process but it is substantial.

One of the rating agencies now requires that the utility or other borrower involved in the transaction be at least investment grade in its own right. We at Union Electric have no difficulty here as we are rated single A by both services. But despite our own creditworthiness, we still have to fulfill all of the documentation required for a weaker credit to enter the LOC backed commercial paper market. And, it is my understanding weaker credits (those below investment grade i.e., bond ratings less than BBB or Baa) for whom the LOC should help in gaining market access, now can't even get a rating from one of the major rating agencies. This policy implies that the bank's LOC is of limited credit value to the investor in those cases where it is needed the most.

INCREASED INITIAL AND ONGOING BORROWING COSTS

The more complex agreements and legal opinions and the time involved to produce them invariably lead to sharply higher legal fees. The protracted lead times involved in setting up a commercial paper program under the New Act simply means that we must continue to finance our needs elsewhere at a higher interest cost for a longer period of time which could easily mean many months.

Under the various solutions which do not require 45 days or less initial maturities, the bank providing the LOC and/or the note release bank usually have sharply increased lending risks and/or operating costs. For example, the bank providing the LOC might be willing to make whole any prior note holder (for whom the LOC has expired) from which a trustee in bankruptcy has required a disgorgement of previously paid interest and principal. Another possible solution occurs when the letter of credit bank or the note release bank pays the note holder directly at maturity by drawing under the LOC. These methods result in higher continuing bank fees which are in addition to the previously mentioned higher legal fees.

I am also very concerned that as these LOC-backed transactions become more complex and require a greater explanation to the investor, there will be less desire on the part of that investor to purchase this class of security. Accordingly with fewer and fewer investors willing to take the time to learn and understand the security behind his investment, the interest rate will have to be increased to compensate him for his additional time effort. In terms of supply and demand, with less demand on the part of the investor, the interest rate will again have to be increased to keep outstanding notes at the required levels.

REDUCED FINANCIAL FLEXIBILITY

Under one solution which limits the commercial paper maturities to 45 days or less; we lose the very important financial flexibility to utilize the 45–270 day maturity range. This can cause a higher level of interest expense in certain rate environments. Perhaps even more importantly, being restricted to the 45 days or less maturity range tends to lead to the "bunching" of maturities in all markets. This can force us to sell a greater dollar amount of notes to the marketplace on a given day than would normally be the case. It goes without saying that this will also tend to increase the interest rate.

Obviously, as the number of notes issued goes up as a result of the reduced maturity range, transactions costs will be sharply increased. For example if we have to issue two times as many notes, our transaction costs will double.

In closing, I would just like to again note that all of the increased interest expense and additional costs, either directly or indirectly, must ultimately be passed on to our customers and consumers. From our point of view, there is no public benefit from this misuse of limited resource—management time and consumers money.

I trust that my remarks have been of some assistance to you in your consideration of the bill before you, and that I have been able to explain why I so strongly support the bill.

PREPARED STATEMENT OF WALTER R. BORIS

My name is Walter Boris and I am an Executive Vice President of Consumers Power Company. Consumers Power Company is an electric and gas utility operating in the State of Michigan. I am in general charge of all financial affairs of Consumers Power Company, including commercial paper sales both by Consumers Power Company and its affiliates.

Because of severe financial pressure, Consumers Power Company has recently received an A–3 commercial paper rating from Standard & Poor's Corporation. This action has effectively taken Consumers Power Company out of the commercial paper market. Consumers Power Company, however, has two leasing programs, one for $60,000,000 and one for $90,000,000, which utilize corporations owned by others to issue commercial paper to raise funds in reliance upon bank support agreements. Under these agreements, the supporting banks promise to make available on the day the commercial paper comes due, funds sufficient to pay off the paper if the issuer for some reason cannot. Consequently, investors buying this paper do not look to the credit of the issuer but rather to the credit of the bank issuing the support. The issuer pays each of the banks a fee for such support.

The old bankruptcy act contained a requirement that to create a voidable preference the creditor must have knowledge of the insolvency of the debtor at the time he received payment from the debtor. This requirement has been deleted under the new act. This deletion has caused substantial difficulties in negotiating and drafting certain commercial paper support transactions involving banks because of the problems which could arise under a commercial paper support agreement if the issuer makes a payment to the commercial paper holders and within 90 days petitions for bankruptcy. Under the new act, even though the paper holders had no knowledge of the insolvency of the issuer and in fact had looked only to the credit of the bank, they could then be forced to pay over the payments to the bankruptcy trustee as a preference. The support of the bank, however, terminated when the commercial paper was paid at maturity as new commercial paper was issued and the support attached to the new paper. The old paper holders then, who had bargained in good faith for the credit of the bank, would have no bank support and would be relegated to the position of an unsecured creditor of a corporation whose credit was of a much lower rating.

Consumers Power has incurred substantial delays in attempting to structure the leasing and support documents in such a way as to avoid this problem. In addition to the legal expense involved, the company has incurred hundreds of thousands of dollars of expense in the form of the opportunity costs of not being able to borrow at the cheaper commercial paper rate but instead having to borrow at prime or some other higher rate.

Our experience along these lines is far from unique in the industry. We are hopeful that Senate Bill S. 3023 will alleviate these concerns and believe that the adoption of this bill will increase the availability of commercial paper to many small companies which cannot now use this valuable financial market. Thus we strongly support the adoption of Senate Bill S. 3023.

Senator DECONCINI. Our last witness is Neil Baron of Booth & Baron, counsel to Standard & Poor's Corp.

STATEMENT OF NEIL BARON, COUNSEL, STANDARD & POOR'S CORP.

Mr. BARON. Thank you, Mr. Chairman.

I am here to support the adoption of S. 3023. My experience in this marketplace derives primarily from my representation of Standard & Poor's Corp., more particularly their bond rating operations. That includes commercial paper ratings.

I should say at the outset that a commercial paper rating and a bond rating is an assessment of the credit quality of the particular issuer. That is, it talks in terms of default risk. Commercial paper markets,

being a financial marketplace, are quality conscious, like you would imagine any financial marketplace would be. Therefore, they require some statement regarding default risk of the particular issuer.

As has been pointed out previously, there are differences in rates among the various rating categories. In addition, unrated commercial paper has a very difficult time selling if it can be sold at all. There are a number of reasons for this other than just the requirement of a statement regarding default risk.

There is, for example, the SEC's haircut rule which requires a greater haircut for unrated commercial paper for purposes of meeting minimum net capital requirements.

Many institutions have an institutional criteria that they cannot buy paper rated below a certain category. Also, the legal investment laws of various States prohibit investment in paper which is rated below a certain rating category.

Now many issuers who would be rated below A–1 and many more issuers who would not be rated at all have sought credit support of banks in connection with the issuance of commercial paper in order to access the market. Without that, there is doubt whether they could access the market at all. As you know, these have been in the form of a letter of credit or an irrevocable commitment to lend on the part of the bank to pay the commercial paper in the event that the issuer cannot.

In these instances Standard & Poor's has been asked to rate solely on the creditworthiness of the bank and without regard to the creditworthiness of the issuer. In order to do so, we must be satisfied that fiiling of a petition with respect to the issuer could not delay payment under the letter of credit and, as importantly, could not result in a disgorgement of that payment as a result of a filing of a petition with respect to the issuer.

I have advised Standard & Poor that there is a very high likelihood that 547(d), considering the deletion of the reasonable-cause provision, could be read to cause a disgorgement of the payment made by the issuer to the commercial paper holder because of the filing of a petition with respect to the issuer.

As you can see, that would put Standard & Poor's in a position where they could not ignore the issuer's creditworthiness. Therefore, the A–1 rating, assuming it was an A–1 bank, would not be forthcoming.

As was pointed out before, these credit agreements for commercial paper and irrevocable bank supports do not have provision where they cover a disgorgement. The reasons for that were made clear before you—smacked up against a guarantee problem. It is my understanding guarantees are prohibited by applicable banking law and regulation.

I should add that there have been many attempts to solve the preference problem. Some of them have been successful. We have been able to rate certain types of commercial paper issuances because we have received opinions from reputable counsel that a preference problem does not exist. These are in limited circumstances and are not, in my opinion, applicable across the board or applicable to a significant number of issuers. However, let me tell you what they are anyway.

Of course, there is the 45-day exception. Under certain circumstances, counsel has been able to apply the ordinary course requirements of the 45-day exception. Unfortunately, there is no judicial precedent in this area. The opinions, while they are not qualified, I call them reasoned. There are counsel who have not been able to give this opinion because of the purpose to which the proceeds from the sale of the commercial paper are put. In other words, if the proceeds of that sale are not used for ordinary course functions, then the issuer cannot obtain the rating because counsel will not give a preference opinion.

Another structure is where the bank has agreed to pay in all events. In other words, the issuer does not pay the commercial paper; the bank pays under the letter of credit or under a note purchase agreement.

As far as the bank paying under the letter of credit, that really has only been suitable for foreign banks. My understanding is that for domestic banks, the promise by a bank to pay under the letter of credit in all events creates certain additional reserve requirements and also creates balance sheet problems.

As far as the note purchase agreement where a bank agrees to buy the note back in all events so that the commercial paper issuer never has to pay, that smacks up against the guarantee problem again, I am told. Therefore, we have seen that only in one instance.

Finally, there is a mechanism where an insolvency proof issuer is used. Obviously if the issuer cannot file a petition or if a petition cannot be filed with respect to the issuer, we do not worry about a preference problem.

Let me back up for a second.

That is done primarily by creating a single purpose corporation or a finance company which has no business other than to issue the commercial paper and turn the proceeds back to the company whose operations are being financed with those proceeds.

We ask in that instance for an opinion that the company who is using the proceeds and the issuer could not be consolidated in the event of an insolvency of the company using the proceeds. That, again, is only suitable for a very limited number of issuers.

In conclusion, as a result of dealing with many of these commercial paper issuers, I can attest to the significantly higher costs associated with the issuance of commercial paper backed by letters of credit as a result of the elimination of the reasonable cause provision and as a result of the language of 547(d).

While more substantial issuers may be able to afford these additional costs, it is my feeling that the smaller issuers cannot and are therefore precluded from the market to a large extent. What makes this result, in my opinion, even more unacceptable is that I have become convinced through dealing with counsel for issuers, counsel for banks, and counsel for the dealers that the preference section was never intended to apply to this type of commercial paper.

You asked a question previously regarding whether or not a delay in this bill would have an effect. My experience is that there will not be a test period if you want to wait 1 year because there are many commercial paper issuers who are waiting for this problem to be resolved. I know from talking, for example, to many of the banks that issue letters of credit in connection with this commercial paper that

at this particular time they will not come forward into this marketplace until the problem is resolved. I concur with the prior testimony regarding the advisability of having a waiting period.

Senator DECONCINI. Mr. Baron, you were here for our last panel. We had two executives of large utility companies. If this were corrected, if S. 3023 were enacted, would you anticipate that would have a bearing on a different rating for such utilities?

Mr. BARON. Certainly to the extent that the utility could obtain a letter of credit—and I think they could—yes, I think the rating would be an A–1 rating.

Senator DECONCINI. Is that a significant factor in your rating?

Mr. BARON. Yes, absolutely, because we have to ignore the bank's credit worthiness if a preference problem does exist. You could have an A–1 bank and an A–3 issuer, and they could get a letter of credit. If the preference problem were not solved, we would still rate it A–3.

Senator DECONCINI. You would?

Mr. BARON. Yes, absolutely. Standard & Poor's approach is this: Either there is a preference problem or there is not. If there is a preference problem, we will not rate based on the bank's creditworthiness; we will look to the issuer.

Senator DECONCINI. I have no further questions.

Does anyone here care to question?

Mr. VIHON. Mr. Baron, as we have heard from the previous witnesses concerning their otherwise excellent creditworthiness, if they are in fact creditworthy, then why is Standard & Poor's concerned about the preference problem if the potential for a bankruptcy proceeding is virtually nil?

Mr. BARON. By the way, I might as well ask now that these be made part of the record. I have submitted a written statement with attachments.

Senator DECONCINI. Your statements as well as the attachments will be inserted in the record following your oral testimony.

Mr. BARON. Attached to that statement are the rating definitions. An A–3 company is a credit worthy company but not as creditworthy as an A–1 company. Because of the sophistication of the commercial paper marketplace, they require gradations of creditworthiness. These gradations are expressed by Standard & Poor's in terms of A–1, A–2, and A–3. A–1 is the most creditworthy company.

An A–3 company may be able to issue commercial paper but it would have to pay what I believe to be a significantly higher rate than an A–1 company would. Yes, a credit worthy company could issue paper but it would pay a higher rate. Is that your question?

Mr. VIHON. Not really. My question was this: If a company is an A–2 company, I understand you to say and I understood, unless I misheard the earlier witnesses, that because of the 547(c)(2) situation the ratings are really not A–2 but A–3.

Mr. BARON. Oh, no, that is not the case. I did not mean to give that impression. I apologize if I did. The A–2 company would be rated A–2. An A–2 company often tries to get an A–1 rating because of the difference in rates and the ability to sell paper by getting a letter of credit.

What I am saying is that if the letter of credit does not work because of the preference problem, we will look solely to the credit-

worthiness of the issuer of the commercial paper. That means that they are limited to the rating which is arrived at based on their creditworthiness. However, if there is not a preference problem and they have a letter of credit, we basically will ignore the creditworthiness of the issuer of the commercial paper and look solely to the credit worthiness of the bank issuing the letter of credit.

Mr. VIHON. When you say "preference problem," what you are referring to is the pure statutory structure at the moment without any particular reference to the potential for petition being filed against the particular issuer?

Mr. BARON. Yes, because when we say A–3, for example, we say the likelihood of the filing of the petition with respect to that company is A–3. That means that if there is a preference problem, the likelihood of disgorgement is also A–3. Therefore, the company would be rated A–3.

However, if you have an A–3 company with an A–1 letter of credit, assuming the preference problem is solved, it does not matter what the likelihood of filing of petition is with respect to the issuer of the commercial paper because there is an A–1 credit behind it.

Mr. VIHON. What about the obverse? What about the other situation where there is little likelihood of a petition being filed against the issuer?

Mr. BARON. How little—A–1, A–2, or A–3?

Mr. VIHON. If it is an A–2 company, then why would the fact that the statute sits the way it does now have any effect upon the ability of that issuer to get into the market in terms of rating?

Mr. BARON. It does not. We would rate that issuer A–2. To the extent that an 1–2 rating makes it more difficult to access the marketplace than an A–1 rating does, that is your problem.

Mr. VIHON. Then why not the A–1 if it does get an LOC?

Mr. BARON. Because of the preference problem.

Mr. VIHON. If the company is in a financial situation which is not likely to present itself in most reasonable analysts' views of a petition being filed against it, then what difference does it make?

Mr. BARON. The difference is that the likelihood of a petition being filed with respect to an A–2 company is A–2. That is what we will rate it.

Mr. VIHON. Thank you.

Senator DECONCINI. Thank you very much, Mr. Baron.

[The prepared statement of Mr. Baron follows:]

PREPARED STATEMENT OF NEIL D. BARON

My name is Neil Baron. I am a member of the law firm of Booth & Baron. My experience regarding commercial paper supported by letters of credit and other types of irrevocable bank commitments derives from my representation of Standard & Poor's Corporation in connection with its ratings of such obligations In this regard I am submitting an article by me published in the July 21, 1980, issue of Standard & Poor's Corporation's Fixed Income Investor which addresses the subject matter at hand. I am also submitting a copy of Standard & Poor's rating definitions. It is my recommendation that S. 3032 be adopted in its entirety. In support of this recommendation, I would like to discuss the effect of Section 547(b) of the U.S. Bankruptcy Code on the ability of Standard & Poor's to rate bank-supported commercial paper. It may be helpful first to make a very brief statement regarding the relevance of the ratings to the commercial paper markets.

The ability to borrow in the commercial paper markets at a cost which is significantly lower than those associated with open bank lines of credit has

resulted in extraordinary growth in those markets. The commercial paper markets, like any capital market place, is quality conscious and demands some measure of default risk. It is precisely this type of risk that is assessed by the rating. Therefore, issuers of commercial paper have found the rating to be essential to their ability to sell their paper at desirable rates and, in cases where commercial paper is unrated, to sell commercial paper at all. The principal reasons that there is relatively no market for unrated commercial paper are that (1) there is insufficient information regarding the default risk of nonrated paper, (2) the SEC's "haircut rule" requires dealers to apply a greater haircut to unrated commerical paper for purposes of meeting minimum net capital requirements, (3) a rating is often an institutional criterion for purchasing commercial paper, and (4) state legal investment laws prohibit investment in unrated commercial paper.

Most issuers that seek irrevocable bank support would be unrated without it. Such support, therefore, is essential to their ability to borrow in the commercial paper markets. This support has generally taken the forms of a letter of credit or an irrevocable commitment to lend money to the issuer for the sole purpose of paying the commercial paper. In order for the rating to adequately reflect the bank support, the rating must be based solely on the creditworthiness of the bank and without regard to the creditworthiness of the issuer. If, as a result of Section 547(b), an insolvency of the issuer could result in disgorgement of the payment received by the commercial paper holder, S&P could not disregard the issuer's creditworthiness and, therefore, could not consider the bank's creditworthiness as a basis for the rating.

The terms of the bank support agreements do not require the bank to reimburse the commercial paper holder for amounts the latter may be required to return as a preference. (I understand that there is concern that an undertaking by the bank to do so may constitute the support agreement a guarantee, which is prohibited by applicable banking laws.) Therefore, S&P has adopted a policy of obtaining assurance (in the form of a legal opinion) that the payment to the commercial paper holders would not constitute a preference even if a petition were filed with respect to the issuer within 90 days after such payment. To date, these opinions have been rendered only in three specific types of situations: The first is where the maturity of the commercial paper does not exceed 45 days and counsel for the issuer can opine that the debt was incurred and that payment is to be made in the ordinary course of business or financial affairs of the issuer. There has been testimony regarding the problems, questions and limitations associated with the use of the 45 day exception. It is true that reputable counsel have differed with respect to the applicability of this exception. One reason is that different uses of commercial paper proceeds could result in different conclusions regarding the "ordinary course" issue.

The second situation is where the bank agrees to make payment of the commercial paper in all events pursuant to either a letter of credit or note purchase agreement so that no "property of the debtor" is being transferred. Only foreign banks have extended this type of letter of credit, while one domestic bank has entered into such a note purchase agreement. While I am not very familiar with banking law and regulation, it appears that the note purchase commitment is unacceptable to most banks due to the reserve requirements and balance sheet problems precipitated by it. The third situation is where the commercial paper, is issued by an insolvency proof, single purpose issuer or finance company. Here S&P requests an opinion that the issuer could not be consolidated with the bankrupt estate of the company whose operations are being financed with the commercial paper proceeds. The latter situation has been suitable only for a very limited number of issuers. Other than these three specific types of situations, S&P has not been provided enough assurance to rate any bank-supported commercial paper on the basis of the banks financial strength.

These opinions and structural acrobatics have resulted in substantially higher legal costs. While more substantial issuers are able to bear these costs, it is doubtful that smaller issuers could. What makes these costs even more disturbing is that, according to counsel representing the banks and issuers, the application of Section 547(b) to bank-supported commercial paper was not considered by the drafters of that section, but that, regrettably, its language seems to apply. It is my feeling that, as a result of the application of Section 547(b) to bank-supported commercial paper, many commercial paper issuers have been required to pay substantially higher rates and, in many cases, have been precluded from the commercial paper markets.

Of course, the foregoing discussion would equally apply to commercial paper supported by bonds of indemnity.

Attachments.

Standard & Poor's Corporation

DEBT SUPPORTED BY IRREVOCABLE LETTERS OF CREDIT, IRREVOCABLE COMMITMENTS AND NOTE PURCHASE AGREEMENTS

(Prepared by Mr. Neil Baron, a member of the firm Booth & Baron, counsel to Standard & Poor's Corporation.)

Many companies seeking to raise capital in the commercial paper market have found it advantageous to obtain irrevocable bank support for their commercial paper in the form of (1) a letter of credit—a promise by the bank to the commercial paper holders or a depositary acting on their behalf to pay the commercial paper in the event that the issuer does not, (2) an irrevocable commitment—a promise by the bank to the issuer to lend money to the issuer for the sole purpose of paying the commercial paper in the event that the issuer cannot, or (3) a note purchase agreement—a promise by the bank to the commercial paper holders or a depository acting on their behalf to purchase the commercial paper at maturity in the event that the issuer does not pay the commercial paper at maturity. Standard & Poor's has been requested to rate bank-supported commercial paper on the basis of the credit-worthiness of the bank and without regard to the credit-worthiness of the commercial paper issuer or any company whose operations are being financed with the proceeds from the sale of the commercial paper (the "operating company"). In order to do so, S&P must be satisfied that (1) the insolvency or bankruptcy of the commercial paper issuer or any operating company could not result in the impairment of the timely payment of the commercial paper pursuant to the bank support agreement and (2) payment of the commercial paper could not constitute a voidable preference under the Bankruptcy Code (the "Code").

The substantive provisions of the Code became effective on October 1, 1979. Legal decisions under the Code are virtually nonexistent, and, therefore, important factual patterns and legal arguments have not yet been fully tested. It is for this reason that S&P has proceeded cautiously in rating this type of debt. The following is intended to articulate S&P's views and policies in this area.

Effect of Issuer's Bankruptcy on Timely Payment Pursuant to Bank Support Agreements

Under the Code, once a petition has been filed with respect to a debtor (e.g.: a commercial paper issuer), the bankruptcy court has exclusive jurisdiction of all of the debtor's property wherever located, and original (although not exclusive) jurisdiction over all civil proceedings related to the debtor's case. It is arguable, therefore, that the bankruptcy court could restrain or enjoin a bank's payment pursuant to its support agreement to the extent that such payment affects property of the debtor. S&P has, however, received legal opinions to the effect that the law does not provide a basis on which a bankruptcy court should be allowed to enjoin payment pursuant to these credit supports. Many of these opinions, however, have expressly indicated that a court could issue a temporary restraining order ("TRO") (and, in some cases, a preliminary injunction) in order to unravel some of the complex factual patterns that exist in these financings in order to determine the applicability of the Code.

A TRO could extend to 20 days, and, in some cases, even longer; a preliminary injunction could involve additional time. Since Standard & Poor's commercial paper rating indicates the likelihood of timely payment, S&P will not rate such paper solely on the basis of a bank's credit-worthiness where a meaningful likelihood of a TRO or preliminary injunction with respect to the bank support attends the insolvency of the commercial paper issuer or of any operating company.

However, in order for a TRO (or a preliminary injunction) to be issued by a court, the bankruptcy trustee must make application for it after determining that the debtor's estate will benefit from such relief. Therefore, S&P will rate commercial paper based solely on the credit-worthiness of the bank only in those instances in which S&P believes that a bankruptcy trustee would have nothing to gain by enjoining or restraining payment pursuant to a bank support agreement. Whether S&P would make this determination must be viewed in light of the following.

Typically, the commercial paper issuer becomes indebted to the bank to the extent that the bank makes advances pursuant to the bank support agreement. This indebtedness may be secured or unsecured. If the bank is secured and the commercial paper holder is unsecured, a bankruptcy trustee would appear to have an interest in avoiding the substitution of a secured creditor for an unsecured creditor by seeking an injunction against payment under the bank support agreement. On the other hand, a bankruptcy trustee would appear to have no interest in incurring the expense of litigating for the mere purpose of substituting one creditor for another creditor of the same class or with equal rights. (In fact, a bankruptcy trustee may prefer to deal with a single bank as a creditor rather than a number of commercial paper holders.) Therefore, S&P's rating will be based solely on the credit-worthiness of the support bank only where (1) neither the commercial paper holders nor the bank are secured, (2) both the commercial paper holders and the bank are secured by the same collateral (S&P does not want to be in a position of comparing the values of different collateral), and (3) the commercial paper holders are secured, but the bank is unsecured. For rating purposes, a bank with a legal or contractual right to setoff debt of the commercial paper issuer to the bank against the issuer's balances with the bank will be viewed as a secured creditor. Where such a right exists, S&P will not rate solely on the basis of the support bank's credit-worthiness unless the setoff problem is resolved by waiver, by providing the commercial paper holder with a prior lien on the balances subject to the right of setoff, or by other means.

If payment pursuant to a support agreement does not affect property of the debtor or create new debt of the debtor, a bankruptcy trustee would, obviously, have no interest in restraining or enjoining such payment. This result could be achieved, even where the support bank has a right of setoff, by the use of a depositary that agrees to acquire the commercial paper with its own funds and then look to the support bank for reimbursement. So long as the issuer does not have funds (not including funds held in trust

for the commercial paper holders) on deposit with the depositary with respect to which the depositary could assert a legal right of setoff against the issuer's indebtedness to the depositary as a result of the depositary's purchase of the commercial paper, such purchase by the depositary would not result in any liability on the part of the commercial paper issuer which is greater or different than its liability to the commercial paper holders until the support bank has reimbursed the depositary (thereby triggering the support bank's right of setoff). (A bankruptcy trustee, therefore, might seek to restrain such reimbursement, while not preventing the purchase of the commercial paper by the depositary.) The economic substance of this structure would be to shift the risk of a TRO from the commercial paper holders initially to the depositary and then to the support bank, which would have to provide arrangements satisfactory to the depositary to make the depositary whole. This risk might be acceptable to the depositary inasmuch as the opinions S&P has received regarding these questions conclude that any TRO or preliminary injunction in a properly structured commercial paper support transaction would be lifted in short order.

Another method used to avoid impairment of timely payment under a bank support agreement due to the bankruptcy of the commercial paper issuer or any operating company is a note purchases agreement pursuant to which the support bank agrees to purchase the commercial paper at its maturity if it is not otherwise paid. In such event, the support bank would succeed to the rights of the commercial paper holders. If the support bank does not have an additional right of setoff, a trustee in bankruptcy would have no reason to restrain or enjoin the bank's purchase of the commercial paper. This structure would, therefore, appear to be the basis of a legal opinion which would allow S&P to rate the commercial paper on the basis of the bank's credit-worthiness. (As will be seen later, this also helps resolve the preference problem.)

The issuance of a restraining order or injunction under the Code is not a possibility until a petition has been filed under the Code. Therefore, an insolvency-proof commercial paper issuer (whose indebtedness is restricted) has been used to avoid the application of the Code. In typical financings that utilize such a commercial paper issuer, the only creditors or foreseeable claimants of the commercial paper issuer would be the support bank (including any other bank participating in the credit), the depositary, the commercial paper holders and the operating company or companies. Typically, these claimants (other than the commercial paper holders) agree not to cause the filing of a petition with respect to the commercial paper issuer until at least 91 days (or in some cases one year and one day) after payment of the latest maturing commercial paper. (As will be seen later, this also helps resolve the preference problem.) In such event, S&P requests, and has received, opinions that in a final adjudication a bankruptcy court should not consolidate the issuer with any operating company or companies in the event of a bankruptcy of such operating company or companies. However, for TRO purposes, S&P will view the issuer and any operating company as a single entity. Therefore, any security interest or right of setoff with respect to any assets of any operating company should be resolved as indicated above.

As previously indicated, an irrevocable commitment differs from a letter of credit in that the former is a promise to lend money to the issuer, while the latter is a promise to pay the commercial paper holders directly. Therefore, there appears to be a higher risk of a bankruptcy trustee successfully claiming that the proceeds from a loan by the bank to the issuer is, in fact, property of the issuer. The insolvency-proof issuer method has been used to avoid this problem. (As previously indicated, for purposes of determining the likelihood of a TRO, the issuer and any operating company will be viewed as the same entity.) From a final adjudication standpoint, S&P will request a legal opinion that the commercial paper issuer could not be collapsed into the estate of any operating company or companies in the event of the bankruptcy of such operating company or companies.

The Preference Problem

Under the Code, a trustee in bankruptcy may set aside, or recapture, payments made to a creditor within 90 days* prior to the filing of a petition and while the issuer was insolvent. The Code differs from the prior Bankruptcy Act by adding a presumption of insolvency during the 90 day period and eliminating the requirement of reasonable knowledge of insolvency on the part of the recipient of such payment. Therefore, it appears easier for a bankruptcy trustee to set aside preferential payments under the Code than under the prior law.

Typically, bank credit supports (particularly letters of credit) terminate within 5 to 15 days after all commercial paper has been retired. Therefore, if the commercial paper issuer retires its commercial paper and subsequently files a bankruptcy petition within 90 days, and the trustee is ultimately successful in setting aside this payment, the bank support will not be available when the commercial paper holders have to return the payments received by them from the commercial paper issuer.

Accordingly, S&P requests legal opinions indicating that payments by the commercial paper issuer to the holders of commercial paper could not constitute voidable preferential payments within the meaning of the Code. These opinions have been based on various legal and structural grounds, such as the following.

Under the Code, payments by the commercial paper issuer to the holder of commercial paper cannot constitute voidable preferences to the extent that the holder of the commercial paper is secured. There is also an exception from the preference section under the Code for debt with a maturity of no more than 45 days which is incurred and paid in the ordinary course of business of both the creditor and the debtor and paid according to ordinary business terms. Further, a preferential payment can be made only with respect to property of the debtor. Therefore, if the bank instead of the issuer pays the commercial paper holders, (or the depositary on their behalf) the payment would appear not to be a preference. In this connection, it has been asserted that where the bank makes advances under an irrevocable commitment to the depositary as agent for the commercial paper issuer for the sole purpose of paying the commercial paper (this practice is known as "earmarking"), it is arguable that there is no preference because there is no transfer of the property of the commercial paper issuer. The use of these methods would appear to be the basis of a legal opinion indicating that such payment would not constitute a preference.

Another way of dealing with the preference problem is to issue the paper from an insolvency-proof issuer, the creditors of whom agree not to cause the filing of a petition for at least 91 days (or one year and one day for "insiders") after payment of the latest maturing commercial paper. As previously indicated, in such instances S&P requests a legal opinion that such an issuer could not be considered part of the estate of any operating company or companies.

S&P will continue to request favorable legal opinions with respect to the legality of the particular method utilized to support commercial paper and assurance that the particular credit support agreement is not an executory contract subject to disaffirmance.

The Code is new, and it is anticipated that existing questions will be resolved and that new questions will arise. Therefore, S&P expects to continue to refine its policies in this area as the law under the Code continues to develop.

*Where the recipient of such payment is an "insider" by virtue of controlling the commercial paper issuer, this period is extended to one year.

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Ratings are graded into four Categories, ranging from "A" for the highest quality obligations to "D" for the lowest. The four categories are as follows:

"A" Issues assigned this highest rating are regarded as having the greatest capacity for timely payment. Issues in this category are further refined with the designations 1,2, and 3 to indicate the relative degree of safety.

"A-1" This designation indicates that the degree of safety regarding timely payment is very strong.

"A-2" Capacity for timely payment on issues with this designation is strong. However, the relative degree of safety is not as overwhelming as for issues designated "A-1".

"A-3" Issues carrying this designation have a satisfactory capacity for timely payment. They are, however, somewhat more vulnerable to the adverse effects of changes in circumstances than obligations carrying the higher designations.

"B" Issues rated "B" are regarded as having only an adequate capacity for timely payment. However, such capacity may be damaged by changing conditions or short-term adversities.

"C" This rating is assigned to short-term debt obligations with a doubtful capacity for payment.

"D" This rating indicates that the issue is either in default or is expected to be in default upon maturity.

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Senator DeConcini. We have no further witnesses this morning. Therefore, the subcommittee will stand in recess subject to the call of the chairman.

[Whereupon, at 10:42 a.m., the subcommittee recessed, to reconvene at the call of the Chair.]

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