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# HAMMERSMITH MEETS ORANGE COUNTY: “WISHING UPON A STAR”<sup>1</sup> WITH TAXPAYER MONEY IN THE MUNICIPAL BOND DERIVATIVE MARKET

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## I. INTRODUCTION

Since the founding of the colonies, England has continually provided the United States with institutions and ideas—the basis of a legal system, the concept of insurance, theories of governance, and fish-and-chips, to name a few. Unfortunately, municipal governments in the United States have borrowed another facet of English life that they would have done well to leave unexplored—speculation in the derivative market.<sup>2</sup>

Derivatives are complex financial instruments used by businesses, financial institutions, mutual and pension funds, and government

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1. LEIGH HARLINE, *When You Wish Upon a Star* (Irving Berlin 1940). This song is featured in the full length motion picture “Pinocchio” by Walt Disney. The Walt Disney amusement park “Disneyland” is located in Orange County, California (Orange County or the County). See *Protect the Public From Speculation in Derivatives*, USA TODAY, Dec. 7, 1994, at 10A.

2. See *infra* note 30 for the definition of a derivative and part II for a detailed explanation of how a derivative works. For purposes of this Note, the terms “derivative,” “derivative transaction,” and “derivative agreement” will be used interchangeably.

entities<sup>3</sup> to hedge<sup>4</sup> against interest rate fluctuation.<sup>5</sup> The use of derivatives, which began in ancient civilizations, has exploded in recent years.<sup>6</sup> When used cautiously and sparingly by sophisticated investors, derivatives can protect investments against dramatic fluctuations in interest rates and secure future cash flow to the entity entering into the derivative agreement.<sup>7</sup> Although institutions well-trained in their complexities have used derivatives effectively,<sup>8</sup> municipal governments

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3. See U.S. GEN. ACCOUNTING OFFICE, REPORT TO CONGRESSIONAL REQUESTERS, PUB. NO. B-257099, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM 24, 29 (1994) [hereinafter GAO REPORT]. This Note will focus on the use of derivatives by municipal governments.

4. *Id.* at 26. An act of hedging is: "Safeguarding one's self from loss on a bet or speculation by making compensatory arrangements on the other side." BLACK'S LAW DICTIONARY 722 (6th ed. 1990).

5. See *infra* notes 30-33 and accompanying text. See also text accompanying notes 20-22 (describing Orange County's failed attempt to predict interest rate movement).

6. Derivatives of some form were used in financial matters by ancient civilizations. JERRY W. MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION 3 (1987) (tracing futures transactions by merchants as far back as 2000 B.C.). The recent popularity of derivatives as a financial hedging device began in the early 1980s. See Martin Loughlin, *Innovative Financing in Local Government: The Limits of Legal Instrumentalism - Part I*, 1990 PUB. LAW 372, 388 (Autumn 1990) [hereinafter Loughlin, *Part I*] (discussing growth of the swaps market). For the fiscal year 1992, the notional/contract amount of derivatives outstanding worldwide was estimated to be \$12.1 trillion. This represents a 145% increase from the end of fiscal year 1989 (the first year comparable data is available). GAO REPORT, *supra* note 3, at 34-35. Municipal investors in the derivative market have primarily entered into the type of derivative agreements known as interest rate swaps (swaps). See *id.* at 132, figure I.2. For the definition of a notional/contract amount, see *infra* note 38.

7. See *infra* note 43.

8. The Port Authority of New York and New Jersey was able to lock in savings of \$640,000 by entering into two swaps that effectively lowered its borrowing rate from 6.50% to 5.32%. See John Hauptert, *Using Interest Rate Swaps as Part of an Overall Financing and Investment Strategy*, GOV'T FIN. REV., Oct. 1992, at 13, 14. See also Bruce D. Bohlen, *Utilization of an Improved Forward Delivery Bond to Enhance Interest Rate Management*, GOV'T FIN. REV., Feb. 1994, at 13.

In 1988, the City of Columbia, Missouri estimated that it would save \$3,365,000 in interest payments over the following 10 years as the result of a favorable interest rate swap. Rising interest rates, however, could temper this optimistic prediction. Harold Boldt, *Reducing Interest Costs with an Interest Rate Swap in Columbia, Missouri*, GOV'T FIN. REV., June 1988, at 23, 24.

In Scotland in 1989, the Glasgow District Council estimated that it had already saved £3.8 million (\$6.4 million) through 11 swap transactions and further estimated that these deals would save the authority an additional £3.4 million (\$5.7 million) per year. Loughlin, *Part I*, *supra* note 6, at 394-95.

have recently incurred extraordinary losses because their financial investors failed to properly predict interest rate fluctuations.<sup>9</sup>

In February 1989, the Hammersmith and Fulham London Borough Council (Hammersmith or the Council)<sup>10</sup> defaulted on payments it owed various banks under its swap agreements.<sup>11</sup> This default, the world's largest in the derivative market at that time, totaled over £200 million (\$337.4 million).<sup>12</sup> In *Hazell v. Hammersmith & Fulham London Borough Council*,<sup>13</sup> the House of Lords held that the Council never had the authority to enter into the swap transactions and that the swaps were, thus, *ultra vires*.<sup>14</sup> The House of Lords terminated all swap agreements between local governments and banks and left in doubt whether all previously paid money from the agreements had to be returned.<sup>15</sup>

Derivative failure of this magnitude eluded the United States financial market until December 1994 when shock waves reverberated throughout the nation as Orange County, California (Orange County or the County) declared bankruptcy.<sup>16</sup> The bankruptcy, the largest in

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9. See *infra* part III for a detailed discussion of derivative losses suffered by the Hammersmith and Fulham London Borough Council and part IV for a detailed discussion of derivative losses suffered by Orange County.

10. See *infra* text accompanying note 49.

11. See *infra* note 34 (defining swap agreements) and part III.A (discussing the swap default by Hammersmith).

12. Martin Loughlin, *Innovative Financing in Local Government: The Limits of Legal Instrumentalism - Part II*, 1991 PUB. LAW 568, 574 (Winter 1991) [hereinafter Loughlin, *Part II*].

March 31, 1989 is the date used by the English courts to determine the total value of outstanding swaps for purposes of the Hammersmith lawsuits. The exchange rate used throughout this Note is based on the March 31, 1989 exchange rate of 1.6870 United States dollars per pound sterling. WALL ST. J., Apr. 1, 1989, at C13 (Exchange Rates table).

13. *Hazell v. Hammersmith & Fulham London Borough Council*, [1991] 2 W.L.R. 372 (Eng. H.L.) [hereinafter *Hammersmith III*].

14. *Id.* at 373. An *ultra vires* act is one "performed without any authority to act on subject. . . . *Ultra vires* act of municipality is one which is beyond powers conferred upon it by law." BLACK'S LAW DICTIONARY 1522 (6th ed. 1990).

15. *Hammersmith III*, [1991] 2 W.L.R. at 389-90. Under the swap agreements, the Council had both received and made payments to its counterparties, the banks. The status of those payments was in doubt. *Id.* See also *infra* notes 76-90 and accompanying text.

16. Mark Platte et al., *Orange County Files for Bankruptcy Protection as Creditor Seeks Payment*, L.A. TIMES, Dec. 7, 1994, at A1.

United States municipal government history,<sup>17</sup> was the result of improper use of taxpayer funds in the derivative market.<sup>18</sup> The treasurer of Orange County, Robert Citron, lost \$1.7 billion of a \$7.5 billion investment pool<sup>19</sup> by entering into an unusually large number of derivative agreements. The majority of these agreements were reverse repurchase agreements (reverse repos).<sup>20</sup> Citron made the mistake of speculating that interest rates would either stay the same or decrease.<sup>21</sup> When interest rates rose, the reverse repos obligated Orange County to pay large sums of interest, a loss that the County would not have incurred under a conservative fiscal policy.<sup>22</sup> Numerous lawsuits have been filed to determine who will incur liability for the loss,<sup>23</sup> a question

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17. *Id.*

18. *See infra* notes 98-101.

19. Ted Bunker, *Congressional Panel Weighs Charges to Municipal Bankruptcy Laws*, INVESTOR'S BUS. DAILY, July 27, 1995, at A3. An investment pool is a group of government entities "who organize for the purpose of exploiting a certain stock or stocks; . . . [or] a joint venture of [a] temporary association of speculators." CHARLES J. WOELFEL, THE DICTIONARY OF BANKING 181 (1994).

Over 180 pool participants invested in the Orange County derivative fund. Andy Pasztor, *Orange County's Chief Executive Quits in Wake of Clashes with Elected Board*, WALL. ST. J., July 13, 1995, at A1. These school districts, cities, counties, special districts, and other government agencies used their investments to earn money needed for new construction, daily operations, and loan payments. For an agency-by-agency breakdown of how much money each government entity and each mutual fund invested in the pool, see *Orange County in Bankruptcy: Mutual Funds' Stake*, L.A. TIMES, Dec. 8, 1994, at A26 (itemizing the holdings of mutual funds in Orange County debt); Platte, *supra* note 16, at A1 (detailing the amount invested in the pool by each government agency).

20. Reynolds Holding, *Suits Sure to Follow Bankruptcy: Assessing Blame in Orange County*, S.F. CHRON., Dec. 10, 1994, at A1. Reverse repurchase agreements (reverse repos) are "transaction[s] involving the sale of securities along with an agreement to repurchase the securities at an agreed upon price, date, and interest payment." WOELFEL, *supra* note 19, at 201. *See generally* Stephen A. Lumpkin, *Repurchase and Reverse Repurchase Agreements*, in INSTRUMENTS OF THE MONEY MARKET 65 (Timothy Q. Cook & Timothy D. Rowe eds., 6th ed. 1986).

21. *See infra* note 100. It is estimated that the fund lost \$1.7 billion. Pasztor, *supra* note 19, at A1.

22. *See infra* notes 98-101 and accompanying text (discussing the risky derivative transactions entered into by Orange County).

23. *See, e.g., First Lawsuit by an Orange County Pool Participant Filed in Federal Court Against Merrill Lynch, Citron and Stamenson over Orange County Debacle*, BUS. WIRE, Jan. 10, 1995, available in LEXIS, News Library, ARCNEWS File [hereinafter *First Lawsuit Filed*] (detailing a class action suit filed by the Schools Excess Liability Fund alleging that the defendants carelessly invested public money); Holding, *supra* note 20 at

of first impression in the United States.<sup>24</sup> It remains to be seen whether the American courts will follow the holding in the British case of *Hammersmith* and declare the derivatives agreements *ultra vires*.<sup>25</sup>

With the increase in derivative deals that adversely affect municipalities, and the attendant losses of taxpayer money, cries for regulation of the municipal derivatives market grow louder.<sup>26</sup> This Note examines the events that led to the Orange County debacle and proposes a strict rule that would greatly decrease the possibility that municipal governments could squander taxpayer money away in that fashion again. Part II briefly discusses the intricacies of a derivative agreement. Part III examines the *Hammersmith* decision and the potential consequences if United States courts adopt a similar doctrine. Part IV analyzes the evolving Orange County disaster and contemplates who could incur liability as a result of the failed derivative agreements. Part V addresses current municipal authority to enter into derivative agreements based on state statutes. Part V also reviews congressional initiatives to curtail this authority. Finally, Part VI proposes a stringent federal statute that attempts to eliminate the risk that a municipal government will gamble in the derivative market with taxpayer money while retaining its ability to enter derivative transactions to protect against the risks associated with fluctuating interest rates.

## II. A BRIEF HISTORY OF THE DERIVATIVE/SWAP MARKET

With the abandonment of the Bretton Woods system of fixed currency rates in the early 1970s<sup>27</sup> and the volatility of interest rates in

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A8 (“[T]here will no doubt be more than just a spate of lawsuits. They will probably come against those in the private sector who allowed this to happen. . . .”) (quoting Orange County attorney Ronald Rus); Susan M. Owen & Jodi Wilgoren, *Orange County in Bankruptcy: 9 Class-Action Suits Against Wall Street Firm, Others Joined*, L.A. TIMES, Jan. 10, 1995, at A8 (discussing the consolidation of class action lawsuits brought against Merrill Lynch).

24. Holding, *supra* note 20, at A8.

25. *Id.* See *infra* notes 76-84 and accompanying text (discussing the House of Lords’ decision in *Hammersmith*).

26. See *infra* notes 142-56 (outlining the various reform movements). See also Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1460 n.12 (1993).

27. “The Bretton Woods system, established in 1944, maintained exchange rate stability by fixing non-U.S. currencies to the U.S. dollar, which was convertible into gold at \$35 per ounce. The United States suspended convertibility into gold in 1971, and the

the early 1980s,<sup>28</sup> investors clamored for a new financial device that would protect them from risks due to unpredictable fluctuations in the currency and interest rate markets.<sup>29</sup> Responding to this demand, financial institutions turned to a product designed to control some of the risk—the derivative.<sup>30</sup> As the use of derivatives has exploded in recent years, the reasons for using them have expanded beyond their original protective function.<sup>31</sup> Investors use derivatives for four main purposes: (1) to hedge against adverse changes in the value of assets or liabilities; (2) to restructure financing terms more favorably; (3) to change the asset mix of portfolios; and (4) to speculate on the direction interest rates will move in the hope of gaining pure profit.<sup>32</sup>

In order to appreciate the risks inherent in derivative agreements, it is important to understand the basic elements of these transactions.<sup>33</sup>

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system of fixed currency rates was abandoned in 1973.” GAO REPORT, *supra* note 3, at 24 n.1.

28. Prior to 1979, the Federal Reserve (FED) considered it imperative to control interest rates. In October 1979, government policy changed to a greater open market as the FED allowed interest rates to oscillate more freely. *See* GAO REPORT, *supra* note 3, at 24. With this change, interest rates in the early 1980s became much more unpredictable. *See* Hu, *supra* note 26, at 1466.

29. Emete Hassan & Bill Chew, *Municipal Derivatives in the Primary Market*, CREDITWEEK MUNICIPAL, June 14, 1993, at 1.

30. Derivatives are “[f]inancial instruments that derive their value from the performance of assets, interest, currency exchange rates, or indexes; a security whose value depends in some way upon the values of other more basic underlying securities, e.g., futures on the long Treasury bond and the call option on a stock.” WOELFEL, *supra* note 19, at 78. *See generally*, Hu, *supra* note 26, at 1464-67 (defining the derivative and its uses).

31. *See* Loughlin, *Part I*, *supra* note 6, at 389-90 (stating that swaps can be used to avoid limits on borrowing power and to generate income). *See also* GAO REPORT, *supra* note 3, at 25-26 (noting that derivatives can be used to speculate for profit and to obtain more desirable financing terms).

32. GAO REPORT, *supra* note 3, at 25-26. *See also* Philip N. Shapiro & T. Spencer Wright, *An Issuer's Perspective on Interest Rate Swaps*, GOV'T FIN. REV., Oct. 1992, at 7 (noting additional uses of the derivative known as “interest rate swaps”).

33. The Government Finance Officers Association (GFOA) offered the following explanation of the use of derivative products:

Participants in the derivatives markets are dealers and end users. End users include financial institutions, businesses, mutual and pension funds, and government entities. Dealers are usually large commercial banks or securities firms and insurance companies and their affiliates. Derivatives can be traded through established exchanges. Derivatives can also be traded through contracts negotiated privately between two parties, called over-the-counter (OTC)

Municipal governments entering the derivative market most commonly engage in interest rate swaps (swaps).<sup>34</sup> In fact, the £200 million (\$337.4 million) loss in *Hammersmith* was solely the result of incorrect speculation in interest rate swaps.<sup>35</sup> Thus, this section will focus on the mechanics of a municipal government swap.

The typical municipal government swap agreement involves a contract between the municipality and a swap company<sup>36</sup> to exchange specified interest payments tied to some predesignated index<sup>37</sup> or underlying principal.<sup>38</sup> The simplest swaps are the fixed-to-floating rate

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derivatives. While payments between counterparties of exchange-traded derivatives are guaranteed, those between counterparties of OTC derivatives are not.

*Government Finance Association Policy Statement on Regulation of Derivative Products*, GOV'T FIN. REV., Aug. 1994, at 16 [hereinafter *Gov't Fin. Ass'n Policy*]. See generally KPMG, SOLVING THE MYSTERY OF DERIVATIVES (Matthew Bender 1994) [hereinafter SOLVING THE MYSTERY] (describing several types of derivatives and their uses).

34. Unless otherwise noted, this Note will use the terms "swap," "swap transaction," and "swap agreement" interchangeably. A swap is "[a] financial transaction in which two counterparties agree to exchange streams of payments over time according to a predetermined rule, normally used to transform the market exposure associated with a loan or bond borrowing from one interest rate base or currency of denomination to another." WOELFEL, *supra* note 19, at 225. Swaps are further defined as "the exchange of one asset or liability for a similar asset or liability for the purpose of lengthening or shortening maturities, or raising or lowering coupon rates to maximize revenue or minimize financing costs." *Id.* See also Hu, *supra* note 26, at 1476 (describing swap agreements); SOLVING THE MYSTERY, *supra* note 33, at 4-7 (discussing swaps).

Of all local government entities using derivative products in fiscal year 1992, approximately 50% reported using interest rate swaps. Use of other types of derivatives—futures, foreign exchange, options and forwards—ranged between 10 and 15%. GAO REPORT, *supra* note 3, at 132 Figure I.2. In an interest rate swap, two parties, typically through an intermediary, agree to exchange their payment obligations on their debts. Shapiro & Wright, *supra* note 32, at 7. It is important to note that the parties do not exchange principal; nor do they alter underlying debt obligations. *Id.* at 7-8.

35. See Loughlin, *Part I*, *supra* note 6, at 394. See *infra* part III.A (detailing Hammersmith's involvement in the swap market).

36. The swap company is often a middle man who arranges the swap independently with both parties. The company can attempt to perfectly match the swap so that it has absolutely no exposure to interest rate risk. When the swap company matches two parties desiring opposite terms, the company receives a commission from both parties, without incurring risk. See SOLVING THE MYSTERY, *supra* note 33, at 38-39. In addition to acting as intermediaries, dealers may enter the derivatives market as counterparties. *Id.*

37. See *infra* note 42 (identifying the different indices).

38. The underlying principal of a derivative transaction is called the "notional" or "contract" amount. This amount represents the total outstanding debt to which the interest

swaps<sup>39</sup> and the floating-to-fixed rate swaps.<sup>40</sup> This section examines the fixed-to-floating rate swap.

In a fixed-to-floating rate swap, the municipal government receives a fixed rate of interest from the swap company<sup>41</sup> and, in return, pays the swap company a floating rate of interest based upon some previously designated index for a specified period of time.<sup>42</sup> This device, when used successfully, results in a restructuring of cash-flow for the municipality and can provide a hedge against interest rate risk.<sup>43</sup> Problems arise, however, when a fast-talking, high-profile swap company attempts to push a swap agreement on an unsophisticated municipality

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rates are applied in order to calculate the payment obligations. Although this figure far exceeds the actual credit exposure from the derivative, estimates of swap volumes are generally given in this amount. John A.M. Price & Schuyler K. Henderson, CURRENCY AND INTEREST RATE SWAPS 203 (2d ed. 1988).

39. In a fixed-to-floating rate swap, the municipality makes floating-rate interest payments to the swap company in exchange for a fixed interest payment to the municipality based on a fixed notional amount for a specified time period. Shapiro & Wright, *supra* note 32, at 8. The municipality uses the fixed-rate payment it receives from the swap company to pay its fixed-rate obligations. In effect, the municipality trades its fixed-rate liability, based on its underlying debt obligations, for a floating-rate liability to the swap company. *Id.*

40. The floating-to-fixed rate swap is identical to the fixed-to-floating rate swap—it is merely the same transaction from the viewpoint of the other party. For a graph of this transaction, see *id.* at 8.

41. The municipality often seeks a fixed payment that is equal to the amount that it is paying on a previous bond issue, using the same notional amount and the same rate. *See, e.g., id.* at 8-9. For example, if the municipal government funds a project with a 10-year, 7% bond and subsequently desires to change this to a floating rate, the municipality will receive 7% on the notional amount from the swap company.

42. This type of swap transaction is generally referred to as a "Plain-vanilla" interest rate swap. SOLVING THE MYSTERY, *supra* note 33, at 100 (defining the Plain-vanilla swap).

The parties regularly reset the floating or variable rate to coincide with one of three main indices: the JJ Kenny Index, the Public Securities Association Municipal Swap Index (PSA), or the London Inter-Bank Offered Rate (LIBOR). Shapiro & Wright, *supra* note 32, at 8. *See also* GAO REPORT, *supra* note 3, at 28.

43. GAO REPORT, *supra* note 3, at 28-29. *See also* Shapiro & Wright, *supra* note 32, at 8-9 (discussing benefits of fixed-to-floating rate swaps).

*See generally*, Dan Fischer, Note, WPPSS and Hammersmith: Increased Credit Risk Protection Resulting from Unprecedented Defaults, 9 ARIZ. J. INT'L & COMP. L. 513, 520-24 (1992) (providing detailed analysis of the various swaps and how they can be used (1) to lower borrowing costs; (2) as a gap management tool; and (3) to manage basis risk).

treasurer or financial advisor.<sup>44</sup> Not understanding the steps necessary to hedge against fluctuations in the interest rate, the treasurer or advisor may be blinded by the promise of initial cash savings and not realize the great risk of potential losses.<sup>45</sup>

The losses occur when interest rates suddenly or unexpectedly rise.<sup>46</sup> While the municipality still receives from the swap company the fixed rate from the agreement, the rise in interest rates drives the floating rate it must pay above the fixed rate it receives. This forces the municipality to pay in excess of the bond's coupon rate—the original debt obligation it was seeking to reduce through the swap agreement.<sup>47</sup>

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44. See, e.g., Jeff Brown, *Exotic Gamblers; Orange County's Woes Prompt Rush to Regulate Municipal Investments*, PITT. POST-GAZETTE, Dec. 9, 1994, at C8 ("The problem with municipalities getting into these things is that almost invariably, the guy on the other side of the contract is a lot smarter than they are, because that's his business.") (quoting Richard Lehmann, president of the Bond Investors Association); Shapiro & Wright, *supra* note 32, at 10 ("Swaps are complicated instruments, the risks of which need to be explained fully and completely to [government officials]. Most [officials] are not active in these markets and the concepts are fairly elusive to most people.").

45. See *infra* part IV (discussing the derivative-caused bankruptcy of Orange County). See also Janin Friend, *Portfolios of Eight Texas Colleges Laden With Risky Derivatives, Report Finds*, BOND BUYER, Dec. 22, 1994, at 1 (reporting that eight Texas universities and junior colleges face future financial difficulty because of poor derivative investment); Aaron Pressman, *When Swaps Go Bad: Philadelphia's Deal Provides a Lesson in Basis Risk for Issuers*, BOND BUYER, Dec. 6, 1993, at 1 (describing the unexpected occurrences that turned a Philadelphia swap agreement into a loser).

For example, in Philadelphia, city officials and its financial advisor agreed to pay a fixed rate to Merrill Lynch in exchange for a variable rate that the city anticipated would match the amount it owed its bondholders. However, several unanticipated events, such as a drop in the city's bond rating, forced the amount Philadelphia owed to its bondholders over the amount it took in from Merrill Lynch. Pressman, *supra*, at 2. This is an example of "basis" risk. Shapiro & Wright, *supra* note 32, at 9. "Interest rate" risk is due to the potential for rising interest rates in the underlying index to which the floating rate is tied, thus driving up the municipality's obligation to the swap company. *Id.*

The author of this Note observed a sales pitch by a swap company to a municipality. The swap company produced elaborate graphs explaining how much money the municipality could save immediately by swapping its fixed rate for a lower rate based on the PSA Municipal Swap Index. The graphs showed that the municipality would still make money with a small increase in the PSA. Just hours before finalizing an unprotected, fixed-to-floating swap, municipality officials asked the all-important question: "What if interest rates go up more than the amounts on your projections?" Not satisfied with the answer, the municipality chose not to enter into the speculative derivative transaction.

46. See *supra* text accompanying notes 19-22.

47. Of course, if short-term market interest rates decline, the value to the floating-rate payer increases with each basis point drop in the interest rate. See Shapiro & Wright,

If the floating rate continues to rise, the municipality will experience large losses and be forced to explain why it is paying out large sums of money at a higher percentage rate than called for in the original bond issue. Recently, this unfortunate scenario has occurred with greater frequency,<sup>48</sup> leaving the courts with two important questions: (1) Who is to blame when a municipal government loses large sums of money in the derivative market?; and (2) Can this trend be curtailed? As will be seen below, the English courts, investors, financial analysts and politicians all have different answers to these questions.

### III. *HAMMERSMITH* AND ITS CONSEQUENCES IN THE UNITED STATES

#### A. *The History of Hammersmith*

Hammersmith and Fulham London Borough Council is a Royally Chartered borough subject to the Local Government Act of 1972.<sup>49</sup> The Council engaged in a small number of interest rate swaps between December 1983 and March 1987.<sup>50</sup> Between April 1987 and July 1988, however, the Council entered into an unusually large number of speculative transactions in the hope of making a profit to supplement the Borough's revenue.<sup>51</sup> Having already been granted authorization to

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*supra* note 32, at 8-9.

48. See, e.g., Friend, *supra* note 45 (discussing losses at eight Texas colleges and universities); Pressman, *supra* note 45 (discussing Philadelphia's losses).

49. See *Hammersmith III*, [1991] 2 W.L.R. 372, 376 (Eng. H.L.). Section 111 of the Local Government Act codifies the common law principle that local authorities have implied power to take any action necessary to discharge their functions. Anthony Hill, *Legal Capacities of Statutory Bodies in Relation to Financial Dealings—The Hammersmith Decision*, 2 BOND L.R. 90, 92 (1990). See *infra* part III.B for a discussion of the lower courts' interpretations of § 111 as it relates to the derivatives agreements Hammersmith entered. The relevant portion of § 111 states, "(1) [A] local authority shall have power to do any thing (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions." Local Government Act, 1972, ch. 70, § 111(1) (Eng.) (emphasis added).

50. Hill, *supra* note 49, at 91.

51. During this time period, the Council entered into 592 derivative transactions with a total notional amount of £6.1 billion (\$10.3 billion). Loughlin, *Part I*, *supra* note 6, at 392. This figure is approximately 15 times the total outstanding debt that Hammersmith incurred to undertake capital projects over many years. Fischer, *supra* note 43, at 526. The following figure illustrates the speculative nature of the transactions the Council entered—over 63% of the interest rate swaps that were still outstanding on March 31, 1989 were unprotected fixed-to-floating rate swaps, thus exposing the Council to great risk from

conduct the Council's borrowing, the director of finance received further power when he was explicitly granted authority to arrange transactions in the London Money and Capital Market.<sup>52</sup> He was given this prerogative by the Council to allow him to take advantage of predicted favorable movements in interest rates.<sup>53</sup> The Council would benefit from these transactions if interest rates fell and would lose if interest rates rose.<sup>54</sup>

As interest rates began to rise and the Council began to lose large sums of money, the Audit Commission of Local Authorities in England and Wales appointed an auditor to check the accounts of Hammersmith.<sup>55</sup> Upon the auditor's determination that the swap transactions could be illegal, Hammersmith's director of finance closed all of the swap accounts that were then losing money.<sup>56</sup> Between August 1988 and February 1989, Hammersmith engaged in only those swap transactions designed to reduce the Council's exposure to loss from increasing interest rates—this became known as the "interim strategy."<sup>57</sup> Finally, on February 22, 1989, counsel for Hammersmith advised that the magnitude of the Council's speculation was beyond reasonable

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fluctuations in interest rates. *Hazell v. Hammersmith & Fulham London Borough Council*, [1990] 2 W.L.R. 17 app. at 53-54 (Eng. Q.B. Div'l Ct.) [hereinafter *Hammersmith I*].

To understand why Hammersmith entered these transactions, see Gregory J. Millman, *Derivatives as Dump Trucks*, WASH. POST, Dec. 18, 1994, at C2 ("When Margaret Thatcher cut government budgets in England, the managers of this township decided to make up what they had lost by speculating in the financial markets—ultimately making the township the biggest single player in the British sterling swap markets.")

52. *Hammersmith III*, [1991] 2 W.L.R. at 372.

53. *Id.* For a thorough discussion of the interrelationship between the central government and local authorities and its impact on local finances, see Loughlin, *Part I*, *supra* note 6, at 374-76.

54. *Hammersmith III*, [1991] 2 W.L.R. at 372. *See also supra* notes 34-42 and accompanying text (explaining the intricacies of a swap transaction).

55. *Id.*

56. *Id.*

57. *Id.* at 372-73. *See also* Loughlin, *Part I*, *supra* note 6, at 392-93. The interim strategy was designed to reduce exposure to losses for outstanding swaps by entering into additional swaps that hedged against the outstanding swaps that were losing money. This could be viewed as "interest risk management" and not "trading." *See* *Hazell v. Hammersmith & Fulham London Council*, [1990] 2 W.L.R. 1038, 1040 (Eng. C.A.) [hereinafter *Hammersmith II*].

parameters and, therefore, unlawful.<sup>58</sup> Thereafter, the Council ceased participation in further swap transactions.<sup>59</sup>

On March 31, 1989, the Council had 297 outstanding swap agreements involving an aggregate notional amount of £2.996 billion (\$5.054 billion).<sup>60</sup> This sum represented approximately fifteen times the amount of actual borrowing the Council had outstanding on the same date.<sup>61</sup> Estimates of the cost to Hammersmith if it were required to pay losses on the swap transactions ranged from a low of £13 million (\$21.9 million), if restitution were allowed,<sup>62</sup> to losses in excess of £406.3 million (\$685.4 million) if interest rates rose by as little as one percent.<sup>63</sup> As a result of the projected losses, the auditor filed a suit pursuant to section 19 of the Local Government Finance Act of 1982, leaving it up to the courts to determine the validity of the swap transactions.<sup>64</sup>

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58. *Hammersmith III*, [1991] 2 W.L.R. at 373. Earlier that day, the auditor advised the director of finance not to engage in any further activity unless his actions could be supported by legal opinion. *Id.*

59. Loughlin, *Part I*, *supra* note 6, at 393.

60. *Hammersmith I*, [1990] 2 W.L.R. app. at 53 (depicting the kinds of derivatives the Council entered into and the amounts invested).

61. *See supra* note 51. *See also* Fischer, *supra* note 43, at 526 n.69 (arguing that the amount borrowed was excessive because "the Council only needed to enter into swap contracts equal to, at most, the amount of their borrowing (£390 million) in order to protect themselves against adverse interest rate movements").

62. *See* Loughlin, *Part II*, *supra* note 12, at 574 ("[F]ull restitution of payments by Hammersmith exposed the authority to a maximum loss of around £13 million."). Here, Loughlin is referring to the possibility that, if the Council had no authority to enter the agreements, all payments made pursuant to the swaps might be restored to the payers. Loughlin, *Part I*, *supra* note 6, at 395.

63. *Hammersmith III*, [1991] 2 W.L.R. at 381. "If interest rates rise by one per cent. the council will lose £406.3 m[illion]." *Id.* (quoting from the sworn affidavit of the auditor on May 30, 1989). The exact amount of the maximum loss depended upon both the rise in interest rates and which underlying index was used to calculate the payments under the swaps. *Id.*

64. *Hammersmith I*, [1990] 2 W.L.R. app. at 17-18. Section 19 provides the following: "(1) Where it appears to the auditor carrying out the audit of any accounts . . . that any item of account is contrary to law he may apply to the court for a declaration that the item is contrary to law except where it is sanctioned by the Secretary of State." Local Government Finance Act, 1982, ch. 32, § 19(1) (Eng.). Hammersmith sought approval from the Secretary of State to make and receive payments under the swaps. This approval was denied on Feb. 28, 1989, prompting Hammersmith's suspension of its swap involvements. Loughlin, *Part I*, *supra* note 6, at 393.

### B. *The Lower Courts' Disagreement*

On application of the auditor to the Divisional Court, the court held that there was no express statutory power for a local authority to enter into swap transactions.<sup>65</sup> Thus, the court determined that all 592 transactions the Council entered into between 1987 and 1989 were *ultra vires*.<sup>66</sup> The court examined section 111 of the Local Government Act of 1972<sup>67</sup> and asserted that swap transactions were not incidental to the borrowing and investing powers of the government.<sup>68</sup> Therefore, the swaps did not have the required nexus to qualify as within the power granted to the local authority.<sup>69</sup>

Less than four months later, the Court of Appeal reversed the Divisional Court's decision, holding that the critical factor in determining a swap's validity was the purpose for which a local authority entered into the swap transaction.<sup>70</sup> If the Council had entered into the swap agreements to hedge against fluctuations in interest rates, the swaps would be held legal and enforceable.<sup>71</sup> If, however, the Council had

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The auditor brought suit against the Council seeking a declaration that the transactions in the capital market fund between 1987 and 1989 were not legal and ordering rectification of the accounts. Because there was no incentive for the Council to win the case (indeed, the Council wanted to lose the case so that its swaps would be found illegal and it could possibly escape payment on their agreements), the court granted leave to five banks, "selected because they have . . . been involved in a cross-section of the transactions," to enter the litigation as plaintiffs in order to protect their commercial interests. *Hammersmith I*, [1990] 2 W.L.R. app. at 29. See also Loughlin, *Part I, supra* note 6, at 394-95 (describing the interests of local authorities and banks in the proceedings). The banks argued that the Council had the authority to enter into the swap agreements under § 111 of the Local Government Act.

65. *Hammersmith I*, [1990] 2 W.L.R. app. at 34-39 (discussing the application of relevant statutes).

66. *Id.* at 38 ("We therefore come to the conclusion that none of the transactions are capable of being lawfully entered into by the council.")

67. See *supra* note 49.

68. *Hammersmith I*, [1990] 2 W.L.R. app. at 34-39.

69. *Id.* In order to be valid, the swap transactions would have to have been incidental to the borrowing powers of the authority. The court maintained that it was an incident of borrowing that one pays interest, thus swapping interest rates was only capable of being "incidental to the incidental." *Id.* at 37.

70. *Hammersmith II*, [1990] 2 W.L.R. 1038, 1071 (Eng. C.A.).

71. *Id.*

The purpose for which a local authority enters into a swap transaction goes to whether the local authority was empowered to enter into that particular transaction: if it was by way of interest rate risk management, it was so empowered; if it was not by way of interest rate risk management but was by way of trading, the authority was not so empowered. . . .

entered the agreements in the hope of profiting from interest rate movements, the action would be deemed "trading" and thus illegal.<sup>72</sup> If a specific, previous legal debt transaction could be directly linked to a particular swap transaction, the court would view this as a hedge on the interest rate of the first transaction and, therefore, a legal transaction.<sup>73</sup> The Court of Appeal ultimately found that the swap agreements that the Council had entered into prior to July 1988 were illegal because they were made in the hope of making a profit and, thus, constituted "trading."<sup>74</sup> Because the swap transactions instituted after the Council began its interim strategy were entered into for the purpose of hedging against rising interest rates in order to protect taxpayers from further losses, the court held that these swap agreements were valid.<sup>75</sup>

### C. *The House of Lords Declares All Swaps Ultra Vires*

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72. *Id.* See *supra* note 69. See also Richard Clutterbuck, Editorial, *Local Authorities and Interest Rate Swaps: When Is Swapping Trading?*, 1990 J. BUS. L. 182, 186-87 (May 1990) (scrutinizing the logic behind the differing opinions of the Divisional Court and the Court of Appeal and determining that they really are trying to reach the same conclusion).

73. *Hammersmith II*, [1990] 2 W.L.R. at 1073-74. The court stated, "Counsel were not able to suggest any proper purpose which could have led the officers to sell . . . 217 swap options while buying only one." *Id.* at 1074.

74. *Id.* In a formal report dated March 15, 1989, the chief executive of the Council stated, "The original intention was that accumulated surplus from the [capital market] fund would have been released to support revenue expenditure in future years once the capital market fund had met all its major liabilities." *Id.* (alteration in original). The Court of Appeal refused to view this strategy as a hedge because its intended purpose was to make profits to be used for later outlays. See *id.* at 1076.

75. *Id.* at 1076-77.

The correct principle . . . is that, if a local authority has unwittingly and in good faith exceeded its powers, but is with good reason uncertain whether or not it has done so, it has implied power for such period as it reasonably takes to resolve that uncertainty to take such steps as it reasonably and prudently can to limit and reduce the loss which its earlier conduct may cause to its ratepayers or community charge payers.

*Id.*

On January 24, 1991, the House of Lords adopted the approach of the Divisional Court by holding that all swap agreements entered into by local authorities were *ultra vires*.<sup>76</sup> The House of Lords maintained that there was no express power for the local authorities to enter into the swap agreements.<sup>77</sup> Thus, in order to support the validity of the swaps, the banks had to prove that the Council had an implied power under section 111 of the Local Government Act.<sup>78</sup> However, because the transactions were neither calculated to facilitate, nor conducive or incidental to the discharge of the Council's power to borrow under section 111, they were illegal.<sup>79</sup>

The House of Lords next addressed the Court of Appeal's holding that the agreements entered into during the interim strategy were valid because their purpose was to facilitate a hedge against further interest rate risks due to the earlier swaps.<sup>80</sup> The House of Lords concluded that the interim strategy merely involved fresh swap agreements intended to alleviate risks from the earlier transactions.<sup>81</sup> Because the House of Lords had already decided that no authority existed for municipalities to enter into swap transactions, the mere fact that these new swap agreements related to the interim strategy was not sufficient to make them legal.<sup>82</sup> Section 111 did not provide the Council with power to enter into the interim swap agreements because the only function these

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76. *Hammersmith III*, [1991] 2 W.L.R. 372, 390-91 (Eng. H.L.).

77. *Id.* at 382. The banks conceded that local authorities had been given no express powers to enter into swap agreements. *Id.*

78. *See supra* note 49. Under this Act, the question of municipal authority to enter into a swap agreement rested on whether the swap transaction was planned to "facilitate," or was "conducive or incidental to," the discharge of Hammersmith's function of borrowing. Local Government Finance Act, 1982, ch. 32, § 111 (Eng.). The banks were not able to show that the swaps qualified under § 111 by any of these means. *Hammersmith III*, [1991] 2 W.L.R., at 382-89 (examining the statute to determine whether local authorities have borrowing powers).

79. *Id.* at 388. The House of Lords added, "If swap transactions were lawful a local authority would be under a duty to consider entering into swap transactions as part of its duty of debt management." *Id.*

80. *Id.* at 390-92. *See supra* note 75 and accompanying text.

81. *Id.* at 391. Any power to enter into swap transactions during the interim strategy still had to derive from § 111 of the Local Government Act. *Id.*

82. *Id.* The House of Lords explained: "No authority was cited which suggested that in certain circumstances an *ultra vires* transaction could be remedied by another *ultra vires* transaction. . . . [S]wap transactions undertaken during the period of the interim strategy are no different from swap transactions entered into at any earlier period." *Id.* at 391-92.

transactions were incidental to was the earlier *ultra vires* transactions.<sup>83</sup> Thus, the interim strategy agreements were unlawful.<sup>84</sup>

The ramifications of the *Hammersmith* decision are far-reaching. Of importance to both the Council and the financial institutions that entered into the swap agreements with the Council, *Hammersmith* does not have to make future payments on the £13.0 million to £406.3 million (\$21.9 million to \$685.4 million) that it would have been required to pay if the swap agreements had been held valid.<sup>85</sup> On the surface, this appears to be a favorable decision for local authorities because the taxpayers will not have to bear the liabilities incurred by this calamity.<sup>86</sup> However, commentators predict that obtaining credit from financial institutions will become more expensive for local governments as financial institutions try to recover their losses.<sup>87</sup> Furthermore, financial institutions in England now face an additional element of risk when entering into any swap agreement with a local authority—whether the courts will find the

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83. See *supra* notes 81-82.

84. *Hammersmith III*, [1991] 2 W.L.R., at 391-92. The banks put forward one last argument: Because the Council had been incorporated by Royal Charter, the banks contended that the Council had the capacity of a natural person to enter into contracts and thus was not limited by the Local Government Act. *Id.* at 392. The House of Lords, however, held that the charter incorporated the London Government Act of 1963 and, thus, the Council was confined to the powers conferred on it by statute. *Id.* at 395-96. Therefore, *Hammersmith* could not enter into transactions as a corporation either in its own name or in the name of the borough. *Id.* at 396. Lord Templeman stated that “[the banks’] argument strikes me as being not so much arcane as absurd.” *Id.* at 393.

85. Fischer, *supra* note 43, at 528-29. But see Loughlin, *Part II, supra* note 12, at 572 (stating that many local authorities were unhappy with the result in the House of Lords, feeling “honour-bound” to fulfill their swap agreements and advocating legislation that would validate all existing swap transactions).

86. Loughlin, *Part II, supra* note 12, at 574. Using a relatively moderate estimate of the total losses *Hammersmith* would have incurred had the swap transactions been found legal, each taxpayer would have had to pay approximately £4,000 (\$6,748) to cover the Council’s losses. *Id.*

87. As one scholar explains:

The relationship between the banks and the local authorities has been soured. The latter are no longer seen for the present as “blue-chip” clients. As their credit rating drops so local authorities cannot hope for the same favourable treatment as before. . . . The banks will now feel free to recover monies by way of restitution.

Richard Clutterbuck, Editorial, *Interest Rate Swaps: Gambling Not Insurance*, 1991 J. BUS. L. 105, 108 (Mar. 1991).

agreement illegal if the deal has an adverse effect on the authority.<sup>88</sup> It is conceivable that this could render the credit market for government entities in the United Kingdom extinct.<sup>89</sup> Without the ability to raise credit and supplement their municipalities' revenue by borrowing needed funds, local governments could be in serious jeopardy.<sup>90</sup>

If courts in the United States hold similarly, there will be several consequences. The United States' financial market is still trying to regain the investor confidence it lost during the Savings and Loan fiasco.<sup>91</sup> While investors have previously viewed municipal governments as safe, low-risk investments for their funds,<sup>92</sup> a holding

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88. *See id.* Clutterbuck continues:

Commercial men . . . have been shocked to find that normal commercial rules do not always govern commercial transactions. . . . They cannot now sleep easily if a legal system characterises what would in all other situations be a commercial transaction as something else because of a lack of capacity on the part of one of the parties. . . .

*Id.* at 109.

89. The House of Lords' holding has frightened banks that would normally enter into deals with local authorities. *See* Loughlin, *Part II, supra* note 12, at 573. In an attempt to regain the banks' trust, the Governor of the Bank of England has strongly supported legislation to retrospectively validate all municipal government swap contracts, finding it necessary

both [to restore] the principle of the sanctity of conduct and secondly to enable a large number of local authorities to complete the deals which they wish to complete and which they can complete without serious financial embarrassment and thereby restore their name into the top level in the financial markets.

*Id.* (alteration in original).

90. Most local governments rely heavily on their ability to raise funds through debt as a means of facilitating their financial needs. Without the ability to raise funds, financing local projects, protections, and services could become extremely difficult. Municipalities would have to rely primarily on current tax revenue for all of their budgeting. *See generally* LENNOX L. MOAK & ALBERT M. HILLHOUSE, *CONCEPTS AND PRACTICES IN LOCAL GOVERNMENT FINANCING* 290-92 (1975) (discussing the uses and limits of debt policy).

91. *See, e.g.,* Robert G. Day, Note, *Administrative Watchdogs or Zealous Advocates? Implications for Legal Ethics in the Face of Expanded Attorney Liability*, 45 *STAN. L. REV.* 645, 669 (1993) (explaining the reasons behind the lack of investor confidence in the late 1980s and subsequent government attempts to get this confidence back by creating enforcement mechanisms).

92. These safe, high-rated local authorities have always been able to rely on debt financing because of the near-guarantee that they would have no problem repaying the debt. However, sometimes these high credit ratings may not be justified. *See* Randall Smith & John Connor, *Matter of Security: Risky Derivatives Are Huge Source of Funds*

that renders municipalities' derivative agreements *ultra vires* could have devastating effects on financial institutions and, thus, the economy.<sup>93</sup> If financial institutions were forced to return all profits they have gained from these agreements, public trust in these institutions would once again be shaken—a very undesirable result.<sup>94</sup>

#### IV. DERIVATIVE FAILURES HIT THE UNITED STATES: THE ORANGE COUNTY DEBACLE

On Tuesday, December 6, 1994, Orange County, California became the largest United States municipality to file for federal bankruptcy protection.<sup>95</sup> Orange County was forced to file for bankruptcy when it could not meet a \$1.2 billion payment on its investment pool<sup>96</sup> that had come due.<sup>97</sup> The County's financial demise resulted from large investments in interest-sensitive reverse repos<sup>98</sup> and inverse floaters<sup>99</sup> that would benefit the investors only if interest rates dropped or remained the same.<sup>100</sup> When short-term interest rates rose, income from the

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*For Federal Agencies*, WALL ST. J., Jan. 20, 1995, at A1 (discussing the issuing of structured notes by federal entities).

93. See Richard M. Whiting, *A Perspective on Financial Services Restructuring*, 37 CATH. U. L. REV. 347, 358 (1988) ("Colloquially speaking, the health of the banking system and the health of our country's economy go hand-in-hand.")

94. Laura Jereski, *Orange County to Seek Summary Ruling Against Merrill*, WALL ST. J., Feb. 1, 1995, at B8; see Joseph M. Heppt, *An Alternative to Throwing Stones: A Proposal for the Reform of Glass-Steagall*, 52 BROOK. L. REV. 281, 289 (1986) ("Congress realized that once the public had lost confidence in the banking system, that system and the economy it serviced were doomed to failure.")

95. Platte, *supra* note 16, at A1.

96. See *supra* note 19.

97. Platte, *supra* note 16, at A1.

98. See *supra* note 20 (discussing reverse repos).

99. Plaintiff's Complaint ¶ 24, *County of Orange v. Merrill Lynch & Co.*, Bankr. C.D. Cal. (Case No. SA 94-22272-JR) [hereinafter Plaintiff's Complaint]. An inverse floater is defined as "[a] derivative security, created from bonds issued by corporations and government agencies, carrying interest rates that vary in the opposite direction of prevailing short-term rates." WOELFEL, *supra* note 19, at 136.

100. See Scot J. Paltrow, *Investors Weigh Their Options: Legal Action Against Brokers is Inevitable, Experts Predict*, L.A. TIMES, Dec. 8, 1994, at D1 (discussing actions taken by Merrill Lynch that contributed to Orange County's losses).

Orange County magnified its exposure to losses with speculative investments made with the money received from the repurchase agreements. The County would sell a bond issue, agreeing to repurchase the security at a price tied to a specific index on an agreed upon

long-term investments of the County was not sufficient to meet the short-term cash outflows and bankruptcy ensued.<sup>101</sup>

Through massive litigation,<sup>102</sup> the County is attempting to regain the money lost on the derivative deals by arguing that the investments were *ultra vires* because they exceeded a constitutional limitation on municipal debt.<sup>103</sup> Liability for Orange County's losses will depend on how the courts answer three important questions: (1) Did the County have the authority to make the investments?;<sup>104</sup> (2) Did the securities firms adequately disclose the risks associated with the investments?;<sup>105</sup> and (3) Who was responsible for determining whether the investments were appropriate for the County?<sup>106</sup>

The answer to the question of whether the County ever had the authority to enter the reverse repo agreements could depend on whether these transactions are viewed as securities or loans.<sup>107</sup> If the courts

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date. After receiving the money for this bond issue, the County invested these funds in another security tied to an interest rate index for repurchase at a later date. This action could continue, with the County exposing itself perhaps three times for one investment. When interest rates rose, the loss to Orange County was magnified by the series of agreements tied to the first repo. Plaintiff's Complaint, *supra* note 99, ¶¶ 24-33.

101. *Orange County's Woes Won't Spur Swaps Bill*, 5 AM. BANKER WASH. WATCH 1, 5 (Jan. 9, 1995) ("Orange County got into financial trouble because it was highly leveraged and there was a significant duration gap between its assets and liabilities.") (quoting acting Treasury Secretary Frank N. Newman, speaking before the Senate Banking Committee).

Orange County's losses are estimated at \$1.7 billion. Debora Vrana, *Brokerage May Be Quizzed Further*, L.A. TIMES, Apr. 11, 1995, at A16.

102. *See supra* note 23.

103. Jereski, *supra* note 94, at B8. *See infra* note 107 for the relevant provision of the California Constitution and related statutes.

104. *See infra* notes 107-10 and accompanying text.

105. *See infra* notes 111-18 and accompanying text.

106. *Id.*

107. Jereski, *supra* note 94, at B8. Orange County will argue that the derivative agreements it entered into were loans (thus subject to the California constitutional limit on debt) because, although title to the securities involved transferred to Merrill Lynch, the risk of gain or loss remained with the County. *Id.* Merrill Lynch, however, will claim that this transfer of title means the reverse repos are securities, not debt, and thus not subject to the constitutional ceiling on debt. *Id.* Courts have split over whether repurchase agreements are securities or loans. *Id.* For this reason, the decision of the California courts on this issue alone could determine the outcome of the case. *Id.*

In Plaintiff's Complaint, Orange County fully sets forth its claim that the derivative deals with Merrill Lynch should be held *ultra vires* based on a violation of article XVI, § 18 of the California Constitution. Plaintiff's Complaint, *supra* note 99, ¶¶ 15-21, 34-50.

find that these agreements were in fact loans, Orange County would have violated the State's constitutional debt limitation.<sup>108</sup> Thus, courts could hold the reverse repos *ultra vires*.<sup>109</sup> A holding of this nature could have a devastating effect on financial institutions that deal with municipal governments. Fearing that municipalities could walk away from losing agreements, securities firms would be reluctant to provide much-needed financing for local governments.<sup>110</sup>

If the courts find that Orange County had the authority to enter into the derivative agreements as an investment in securities, the County will attempt to assert that it should not be held liable for the losses because Merrill Lynch<sup>111</sup> failed to adequately disclose the risky nature of the derivatives to the municipality.<sup>112</sup> The County will further assert that

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Article XVI, § 18 of the California Constitution provides that no county "shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the qualified voters thereof." CAL. CONST. of 1879, art. XVI, § 18 (1974).

Further, California Government Code § 25256 states that "[a]ny debts or liabilities which exceed in any fiscal year the income and revenue provided for that year" are void. CAL. GOV'T CODE § 25256 (West 1988).

Additionally, the California Government Code limits every county official and person from the "incurring or paying of obligations to the amounts of the appropriations allowed by the budget." CAL. GOV'T CODE § 29120 (West 1988).

Finally, California Government Code §§ 53601 and 53635, *infra* note 134, restrict investments in repurchase agreements "to those where the proceeds are utilized 'solely to supplement the income' which would normally be received from the securities, and further limit such investments to those made with the prior approval of the legislative body of the applicable local agency." Plaintiff's Complaint, *supra* note 99, ¶ 21.

108. See *supra* note 107.

109. Jereski, *supra* note 94, at B8.

110. *Id.*

111. Merrill Lynch has been the main investment company named in every suit Orange County has filed. This is due to the fact that "Merrill . . . played by far the biggest role in selling risky derivatives to the county's ill-starred investment fund. . . . Merrill . . . also helped the county borrow huge sums to buy still more of the securities that plummeted in value as interest rates rose." Paltrow, *supra* note 100, at D1. Merrill reportedly earned \$80 million for services provided to Orange County. *Id.* Merrill and Orange County have had a close relationship for over twenty years. See Holding, *supra* note 20, at A8.

In a memo released by Merrill, the firm admitted that it was one of 11 investment firms that paid the City of San Jose, California a total of \$12.1 million to settle a suit in which the firm was accused of advising the city to invest in speculative transactions while lending San Jose the money to enter these transactions. *Id.* These agreements also involved reverse repos and resulted in a \$73 million loss to San Jose. *Id.*

112. *Id.* (discussing inadequate disclosure in similar cases).

it was the responsibility of the investment firm to determine whether the investment strategy of Orange County was appropriate or not for a local government.<sup>113</sup>

On January 9, 1995, the first class-action complaint against Merrill Lynch was filed in federal court. The complaint identified six areas in which the investment firm failed to act in a proper and legal manner.<sup>114</sup> Orange County attorneys emphasized the municipality's lack of sophistication and inability to understand the complexities of the transactions it entered.<sup>115</sup> The County maintains that Merrill Lynch failed in its duty to appraise the County of the risks associated with its investment decisions.<sup>116</sup> Merrill Lynch, however, insists it warned

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113. *Id.* (listing questions to be resolved by suit).

114. *First Lawsuit Filed, supra* note 23. The Schools Excess Liability Fund, one of the Orange County pool participants, filed suit against Merrill Lynch and others. The complaint alleges that:

(1) Defendants failed to disclose to the Pool Participants the true nature of the risks; (2) Defendant failed to properly advise Pool Participants in 1994 that their investment funds were so highly leveraged that the already substantial risks of investing in derivatives were dramatically increased; (3) Defendants knew, as early as May 1994, of the extreme volatility of the derivative securities; (4) Defendants knew, as early as August 1993, the Orange County Treasurer's Office was operating without adequate internal controls, which enabled Merrill Lynch effectively to direct and control the investment policy of the pool; (5) Merrill Lynch and Orange County engaged in a number of unusual transactions which were apparently designed to assist Merrill Lynch to meet certain financial statement ratios required by the Securities and Exchange Commission; and (6) even while Merrill Lynch designed this high risk investment strategy, it protected itself against loss and reaped in excess of \$80 million in fees.

*Id.*

115. *See generally* Holding, *supra* note 20, at A1 (noting that large corporations such as Proctor & Gamble and Gibson Greetings have claimed a lack of sophistication in suits against Bankers Trust for losses in derivatives agreements); Platte, *supra* note 16, at A1 (quoting local official's bitterness over the ability of "hotshot" investment bankers to pitch derivatives and suck unsophisticated investors into entering transactions).

116. Attorney Jan Adler, plaintiff's counsel in securities lawsuits, states that brokers have "a very strict legal duty" to an investor who is "unknowing" and dependant on the investment banker for advice. Holding, *supra* note 20, at A8.

*See also* Mary S. Ludwig, *What Went Sour in Bob Citron's Orange County Portfolio*, CORP. CASHFLOW, Feb. 1995, at 37, 38 ("Some have likened Merrill's role in this mess to that of a bartender serving a drunk another drink.").

Although various comments demonstrate Citron's confidence in his ability to enter the derivative agreements, *see infra* note 117, an excerpt of a letter from Citron to Merrill Lynch Director Michael Stamenson indicates Citron's reliance on the investment firm: "In fact, Mike, it was only after extensive consultation with highly placed Merrill Lynch

Orange County on several occasions of the inherent risks in its investment decisions, but the County, specifically County Treasurer Robert Citron, refused to take any corrective action.<sup>117</sup> The investment

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officials by conference call, in person, and in writing well over a year ago that we felt secure in investing an even larger percentage of our portfolio in derivative securities." Letter from Robert L. Citron, County Treasurer, to Michael G. Stamenson, Municipality Unit Director, Merrill Lynch (Apr. 26, 1993) available in LEXIS, Genfed Library, Extra File [hereinafter Letter from Citron to Stamenson of 4/26/93].

117. Merrill Lynch released documents intended to prove that Orange County was warned at least six times during 1992 and 1993 that its investment strategy was risky. Brad Altman, *Merrill Lynch Warned Orange County of Investment Strategy Risk*, *Firm Says*, BOND BUYER, Jan. 12, 1995, at 3. The investment firm further states that in March 1993, Merrill Lynch salesman Michael G. Stamenson offered to repurchase the derivatives he sold the County, cautioning that the securities might be highly risky. *Id.* Additionally, at further meetings with Orange County officials, Merrill Lynch again stressed the negative consequences that could befall the municipality if interest rates were to rise. Altman, *supra*, at 3.

Merrill Lynch released its correspondence with Citron made during 1992 and 1993. These letters show Merrill's efforts to warn Citron of the riskiness of his investment strategy and shield the company from liability.

[T]he Orange County portfolio has a modified duration of approximately seven years. The duration indicates substantially more price volatility than would be expected from a portfolio with such short average maturity. . . .

. . . .  
. . . [Although Orange County has enhanced the yield and decreased its maximum average maturity on its fund with reverse repos and inverse floaters,] it has also made maturity a less reliable indicator of the price sensitivity of the portfolios. We suggest that Orange County constantly review the volatility in the existing portfolio and review incorporating some measure of duration as an additional portfolio guideline.

Letter from Michael G. Stamenson, Municipality Unit Director, Merrill Lynch, to Robert L. Citron, County Treasurer (Oct. 14, 1992) available in LEXIS, Genfed Library, Extra File.

In a subsequent letter to Citron, Stamenson advised:

If you are interested in selling any or all of your portfolio we would be pleased to update [our] bids, subject to changed conditions in the marketplace.

As we have discussed in the past, the prices of these securities can fluctuate. I would like to reiterate that the market for these notes will be affected by a number of factors independent of the credit worthiness of the issues and the value of the applicable currency or interest rate index. Secondary market bids may be affected by the volatility of the applicable currency or interest rate index, the time remaining to maturity of each note, the amount outstanding of such notes and general interest rate movements.

Letter from Michael G. Stamenson, Municipality Unit Director, Merrill Lynch, to Robert L. Citron, County Treasurer (Mar. 31, 1993) available in LEXIS, Genfed Library, Extra File.

firm also asserts that Orange County officials indeed possessed the

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To this letter, Citron replied:

Thank you for offering to make a secondary market for repurchase of derivative securities that we have previously purchased from you. At this point in time, and even projecting into the far future, we do not believe that we would be interested in selling these derivative securities. . . .

. . . We have always been aware of the vicissitudenary [sic] nature of the derivative securities that we have mainly bought from Merrill Lynch and others. Although there may be an alleged interest rate risk in this type of securities, we believe because of future low interest rates that the securities that we now own may be even more valuable than they are today.

Letter from Citron to Stamenson 4/26/93, *supra* note 116.

Stamenson repeated his warning:

While we certainly endeavor to maintain secondary markets in securities we sell, we are not allowed to guarantee the existence of any secondary market and would not want any investor to be under the impression that we would . . . .

In addition, I appreciate that you are aware of the risks involved in purchasing derivative securities and your expectation of low or lower interest rates in the future. I am also aware of our discussions with economists and market strategists at Merrill Lynch, but would not and could not represent that Orange County should base its' [sic] portfolio strategy exclusively on Merrill interest rate projections. The reason for our March bid letter was to allow Orange County the opportunity to lower its' [sic] risk profile in derivative securities at a profit. While no one knows for certain the direction of interest rates, we thought it appropriate to advise Orange County of the profitable market opportunity at this time. While the decision is yours to make, it was our hope to assist you in bringing the O.C. portfolio in line with a risk profile that is less leveraged and better positioned to perform in the event of unanticipated movements in interest rates.

Letter from Michael G. Stamenson, Municipality Unit Director, Merrill Lynch, to Robert L. Citron, County Treasurer (June 16, 1993) *available in* LEXIS, Genfed Library, Extra File.

Merrill Lynch also sought to reduce its liability in an interoffice memorandum dated January 10, 1995. This memorandum detailed the steps Merrill took to warn and advise Orange County of the riskiness of the derivative security agreements the County had entered into. Interoffice Memorandum from Daniel P. Tully, Merrill Lynch Chairman and Chief Executive Officer to Merrill Lynch Employees (Jan. 10, 1995) *available in* LEXIS, Genfed Library, Extra File.

*See also Agent Orange*, THE ECONOMIST, Apr. 15, 1995, at 19 ("It gradually emerged that [Citron] had long ago adopted a high-risk, high-reward investment strategy. . . . At the height of his success Mr. Citron was confident enough to ridicule the acumen of investment bankers at Goldman Sachs who tried to persuade him that he was riding for a fall.").

While Citron appeared amazingly confident in his ability to predict trends in interest rate movements when dealing with the taxpayers' funds, his personal investment strategy earned him the nickname "the cowardly lion" because he invested primarily in savings accounts and tax-free funds. Ludwig, *supra* note 116, at 38.

requisite sophistication and knowledge to enter into derivative transactions as they saw fit; they just made poor financial decisions.<sup>118</sup>

As the Orange County cases make their way through the court system, taxpayers, municipal officers, and financial investors remain fearful of the results an adverse decision would have on their future prosperity.<sup>119</sup> If the courts hold the local government liable for its money-losing investment decisions, taxpayers will have no recourse for their officials' mistakes and will be forced to bear the burden of this speculative investment strategy.<sup>120</sup> Given the potential magnitude of derivative losses<sup>121</sup> and the predictions that reported losses have just scraped the surface of forthcoming losses,<sup>122</sup> derivative loss could be

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118. Acting Treasury Secretary Frank N. Newman downplayed the role derivatives had in the Orange County bankruptcy. Instead, Newman believes that the loss was the result of highly leveraged loans that left the county susceptible to short-term interest rate risk. He suggested that this act of borrowing short to invest long, not investments in derivatives, caused the bankruptcy. *Derivative Financial Instruments Relating to Banks and Financial Institutions: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 15 (1995) (testimony of Frank N. Newman, Acting Treasury Secretary) [hereinafter Newman testimony].

119. See *infra* notes 120-27 and accompanying text.

120. With a population of 2.6 million and losses now estimated at \$1.7 billion, see *supra* note 101, each person in Orange County would have more than a \$650 share in the loss. Anne Willette, *In Long Run, Taxes Could Rise to Offset Damage*, USA TODAY, Dec. 8, 1994, at 3B. While police and fire protection will continue and employees will get paid, residents of Orange County may well end up paying higher taxes so that the County can continue to meet its obligations. *Id.*

On June 27, 1995, however, Orange County voters rejected a half-penny sales-tax increase, the proceeds of which were to be used to help reduce the County's debt to its bondholders. The financial world was stunned by the taxpayers' refusal to back the credit of the County—a municipality's ability and willingness to raise tax revenues to pay its debts is the foundation upon which credit ratings rest. Daniel Heimowitz, executive vice-president of Moody's Investors Service, summed up this shock: "Basically, what Orange County is saying [to bondholders] is, 'We took your money, lost your money and now we don't owe you money.' We think this is unprecedented. . . ." Fred Vogelstein, *Voter Revolt Shakes Faith In Muni Sector*, WALL ST. J., June 29, 1995, at C1.

121. See *supra* text accompanying notes 12, 19 & 62-63.

122. Because derivatives became popular as a financing device for municipal governments, see *supra* note 34, and interest rates continued to rise, it can only be expected that Orange County will not be the last municipality to lose large sums in this market. In fact, Congress' General Accounting Office reports that dozens of state and local pension plans are losing hundreds of millions of dollars in the derivative market—the burden of which is to be borne by the taxpayers. *Protect the Public from Speculation in Derivatives*, USA TODAY, Dec. 7, 1994, at 10A.

to the taxpayer of the 1990s what the Savings and Loan bail-out was to the taxpayer of the 1980s.<sup>123</sup>

Alternatively, the courts could maintain that the municipality never had the authority to enter into the derivative transactions. Under this scenario the financial institutions could be forced to reimburse the pool participants for their losses in the speculative investment strategy.<sup>124</sup> A decision of this kind would severely cripple the investment banking firms involved because of the massive drain on their assets.<sup>125</sup> Further, the decision would seriously limit the future borrowing ability of local governments because investment banking firms would either be unwilling to deal with them or charge exorbitant fees to cover their exposure to potential losses on the loans.<sup>126</sup> The possible ramifications to both

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123. See *supra* notes 91-94 and accompanying text (discussing the similarities between the Savings and Loan crisis and the problems that a similar disaster in the derivatives market could cause).

124. If the courts hold the derivative agreements *ultra vires*, the deals would have been beyond the powers conferred upon the municipality by law and, thus, the transactions would be void. Were this to occur, Orange County could potentially get back all of the money it lost on the deals and the financial institutions would have to absorb all of the losses. See generally Paltrow, *supra* note 100, at D1 (stating experts believe the brokerage firms face a significant risk of being forced to reimburse the County for its loss).

125. With their generally low capital reserves, financial institutions lack sufficient funds to cover a rapid draining of assets from their balance sheets. See Harris Weinstein, *Moral Hazard Deposit Insurance and Banking Regulation*, 77 CORNELL L. REV. 1099, 1101 (1992) ("The average equity capital-to-asset ratio for all nonfinancial firms in 1986 was 36%. By contrast, the average bank capital-to-asset ratio is generally 6%. Several of the largest thrifts that eventually failed operated with less than 2% capital.") (footnotes omitted).

126. One scholar has noted:

Where things are never going to be the same is in the municipal bond market. When the financial ground shifted in the once-AA-rated county, the tremors were felt—and the aftershocks continue to rumble—clear across the country to Wall Street. And there, the fallout from the disaster will be felt for years—in the status of investor confidence, in the increase in regulatory oversight, and in the ways credit analysts and bond insurers cast their scrutinous eyes on issuers' financial situations.

Penelope Lemov, *After The Fiscal Quake*, GOVERNING, Feb. 1995, at 34.

A commentator further explains:

Already, players are talking about the Orange County fiasco possibly driving yields on other municipal bonds higher—making it more expensive for other cities to borrow, and perhaps forcing more to pay for insurance . . . .

Heather Rush, president of the Public Securities Association, the industry trade group, said, "Uncertainty about the county's willingness to pay is already

parties in the Orange County disaster of an unfavorable court decision lead many experts to conclude that they will settle rather than leave their fate in the hands of the courts.<sup>127</sup>

## V. MUNICIPAL DERIVATIVE REFORM IN THE UNITED STATES

As more local governments experience trouble in the derivative market,<sup>128</sup> the cry for reform grows louder.<sup>129</sup> Those supporting reform believe that it is necessary primarily because understanding and avoiding the risks associated with the use of derivatives requires a high degree of sophistication.<sup>130</sup> Before exploring legislative reform, however, it is important to understand how municipal governments obtain the power to enter into derivative agreements.<sup>131</sup>

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raising the cost of general obligation debt across the country. If elected officials and taxpayers in one of the nation's wealthiest counties can avoid the hard choices . . . , how can we expect less well-off communities to uphold their commitments when the going gets rough?"

Vogelstein, *supra* note 120, at C1, C20.

127. Following the *Hammersmith* decision, several test cases were selected by the High Court which addressed major points of law left unanswered by the House of Lords' decision in *Hammersmith*. All of these cases were settled before going to trial. John Mason, *Final Swaps Test Case Settled*, FIN. TIMES, May 16, 1992, at 4.

This same scenario could occur in the Orange County cases if the parties are unsure of what the courts will hold and do not want to risk an all-or-nothing decision. Further, the rejection of the tax increase makes the likelihood of settlement much more probable. Michael Siconolfi, *Rejection of Orange County Tax Boost May Help Merrill Lynch in Negotiations*, WALL ST. J., June 29, 1995, at A5 (noting that the County will be more likely to settle for a smaller amount as a result of the tax-hike rejection).

128. See *supra* note 45.

129. See *infra* notes 142-56 and accompanying text (detailing Congressional movements for reform in the derivative market).

130. In early 1994, the Government Finance Officers Association (GFOA) and the Municipal Bond Investors Assurance Corporation jointly surveyed over 1,600 government finance professionals. The results demonstrate that government officials lack knowledge of the derivatives market. For example: (1) only 6% had actually used a derivative product in debt financing; (2) only 4% thought of themselves as being "very knowledgeable about derivative products" and another 20% felt they only understood the basics of a derivative transaction; (3) 76% felt they had only some or no knowledge of derivative products; and (4) 36% perceived derivative products to be too risky. *Financial Derivatives: Governments as End Users*, GOV'T FIN. REV., Aug. 1994, at 13, 15 [hereinafter *Financial Derivatives*].

131. For a detailed discussion of state and local governments' authority to enter into swaps, see Jeanette Redmond, Note, *State and Local Governmental Entities: In Search of . . . Statutory Authority to Enter into Interest Rate Swap Agreements*, 63 FORDHAM L.

Municipal governments' authority to enter into derivative agreements derives from state statutes.<sup>132</sup> The statutes either grant this authority explicitly with well-defined rules,<sup>133</sup> or implicitly through the investing powers granted to the municipalities.<sup>134</sup> However, there is a

REV. 2177 (1995).

132. *See id.* at 2180 (discussing the growth of express statutory authority).

133. *See, e.g.*, ALA. CODE § 41-1-42 (Supp. 1994):

Notwithstanding any other provision of law, governmental entities shall be authorized to enter into swap agreements as follows:

(1) Subject only to subdivision (2) of this section, any governmental entity may enter into one or more swap agreements which the governmental entity determines to be necessary or desirable in connection with, or incidental to, the conduct of its proper activities, including in connection with its acquisition or carrying of investments or the issuance, acquisition, carrying, or securing of its authorized debt instruments, bonds, notes, agreements, or indebtedness. . . .

(2) No governmental entity shall enter into any swap agreement unless all of the following occur:

a. The governmental entity's governing body first finds and determines, and certifies to the counterparty, that the swap agreement is entered into for the purpose of hedging against an interest rate, investment, payment, or other similar risk that arises in connection with or incidental to the proper activities of the governmental entity.

b. The swap agreement requires the counterparty to pledge collateral to the governmental entity in the approximate amount estimated at least quarterly, that would be payable by the counterparty to the governmental entity if the counterparty defaulted under the swap agreement on such estimation date.

*Id.*

134. *See, e.g.*, CAL. GOV'T CODE § 53601 (West Supp. 1995):

The legislative body of a local agency having money in a sinking fund of, or surplus money in, its treasury not required for the immediate necessities of the local agency may invest such portion of the money as it deems wise or expedient in:

. . . .

(i) Investments in repurchase agreements or reverse repurchase agreements of any securities authorized by this section.

*Id. See, e.g.*, CAL. GOV'T CODE § 53635 (West Supp. 1995):

As far as possible, all money belonging to, or in the custody of, a local agency, including money paid to the treasurer or other official to pay the principal, interest, or penalties of bonds, shall be deposited for safekeeping in state or national banks, or state or federal savings and loan associations in the state selected by the treasurer or other official having the legal custody of the money, or may be invested in the following unless otherwise directed by the legislative body pursuant to Section 53601:

. . . .

small, yet growing number of states that forbid local governments from entering into derivative transactions.<sup>135</sup>

While states have begun to constrict local governments' ability to enter into these transactions, federal agencies continue to assert that no legislation is needed to curtail activity in this exploding market. Time and again, the various federal regulatory agencies have given the derivative market a clean bill of health.<sup>136</sup> In a hearing before the Senate Banking Committee on January 5, 1995, acting Treasury Secretary Frank Newman, Federal Reserve Board Chairman Alan Greenspan, Securities and Exchange Commission Chairman Arthur Levitt, and Commodity Futures Trading Commission Chairman Mary Schapiro, four of the United States' most influential financial leaders, asserted that the derivative market is sound and that no new legislation is needed to regulate this financial instrument.<sup>137</sup>

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i) Investments in repurchase agreements or reverse repurchase agreements of any securities authorized by this section.

*Id.*

135. Municipalities in the State of New York are only allowed to invest in items which are deemed "eligible securities". Effective June 30, 1995, "eligible securities" included only:

(i) Obligations issued by the United States of America, an agency thereof or a United States government sponsored corporation or obligations fully insured or guaranteed as to the payment of principal and interest by the United States of America, an agency thereof or a United States government sponsored corporation.

(ii) Obligations issued or fully guaranteed by the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, and the African Development Bank.

(iii) Obligations partially insured or guaranteed by any agency of the United States of America, at a proportion of the market value of the obligation that represents the amount of the insurance or guaranty.

(iv) Obligations issued or fully insured or guaranteed by this state, obligations issued by a municipal corporation, school district or district corporation of this state or obligations of any public benefit corporation which under a specific state statute may be accepted as security for deposit of public moneys.

N.Y. GEN. MUN. LAW § 10.1.f (McKinney Supp. 1995).

Thus, municipal governments do not have the authority to enter into derivative agreements.

136. See, e.g., Bloomberg Reports, *Clean Bill of Health for US Derivatives*, S. CHINA MORNING POST, Nov. 4, 1993, at Business 4 (noting that the Commodity Futures Trading Commission found no need for changes in derivatives regulation).

137. *Regulators Tell Senate Panel No Derivatives Legislation Needed Now*, 64 BANKING REP. (BNA) No. 2, at 67 (Jan. 9, 1995) [hereinafter *Regulators Tell . . .*]. The

While agreeing that regulators need to keep a watchful eye on the derivative market,<sup>138</sup> the financial leaders professed their belief that the Orange County calamity was the result of an improper investment strategy rather than the use of derivatives.<sup>139</sup> Furthermore, Levitt contended that federal agencies generally do not have the authority to regulate municipal governments' investment decisions.<sup>140</sup> Chairman Greenspan added that legislation was not the answer due to the rapidly changing nature of the derivative market.<sup>141</sup>

While these four financial leaders apparently want to retain their own power and preserve the states' power to decide the future of the derivative market, many senators and representatives are tiring of burdensome taxpayer losses and contend that Congress must restrict

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four members who testified are all members of the President's Working Group on Financial Matters. This group was initially formed in the wake of the Black Monday stock market crash of October 19, 1987. In 1994, Treasury Secretary Lloyd Bentsen revived the group. *Id.*

138. See, e.g., *Derivative Financial Instruments Relating to Banks and Financial Institutions: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 72 (1995) (statement of Arthur Levitt, Securities and Exchange Commission Chairman) [hereinafter Levitt statement] ("As I have said on prior occasions, derivatives are not inherently bad or good—they are a bit like electricity: Dangerous if mishandled; but bearing the potential to do tremendous good. Like any new innovation, the use of derivatives needs to be watched closely by end-users and by regulatory agencies.").

139. See Levitt statement, *supra* note 138, at 72 ("One can not understate the seriousness of the effects of the Orange County bankruptcy. It would be a grave error, however, to demonize derivatives and blame them for the loss."); *Derivative Financial Instruments Relating to Banks and Financial Institutions: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 52 (1995) (statement of Alan Greenspan, Federal Reserve Board Chairman) [hereinafter Greenspan statement] ("[I]t is by no means clear that these losses have been attributable solely, or in some cases, even primarily, to . . . derivatives. . . . [It] would be a serious mistake to respond to these developments by singling out derivative instruments for special regulatory treatment."). *Id.*

140. Levitt statement, *supra* note 138, at 61 ("The Commission generally does not have, nor does it seek, the ability to regulate investment decisions by municipalities. . . . In the case of State and local public instrumentalities, investment decisions should be made with the guidance and oversight of State and local governments.").

141. See Frank Shafroth, *A Sobering Event: County's Bankruptcy Filing Rattles Bond Market*, NATION'S CITIES WKLY., Dec. 12, 1994, at 1 ("The trouble with legislation is that it is very likely in this type of market to become rapidly obsolete, and could very readily become counter-productive to the required flexibility that we need to address the types of problems that we are addressing.") (quoting Alan Greenspan).

municipalities' ability to enter these agreements.<sup>142</sup> The biggest push for legislative reform began in 1993, when Representative Jim Leach, the current Chairman of the House Banking Committee, issued a 900-page report on derivatives<sup>143</sup> and proposed massive legislation that would attempt to ensure the safety of derivative investments.<sup>144</sup> As the dangers inherent in the derivative market become more readily apparent, members of Congress are sensing the inadequate response of the regulatory agencies<sup>145</sup> and are resolving to combat the problem themselves.<sup>146</sup> The remedies that legislators have proposed range from greater disclosure by financial institutions of the risks involved in

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142. For example, U.S. Representative Jim Leach used the following analogy in a speech at the GAO Conference on Banking to explain why he thought federal legislation prohibiting improper derivatives use would be better than comparable state legislation:

Just as in banking and S&L regulation the public must be wary of ever allowing the fox to guard the chicken coop, so in the derivatives arena it must insist that foxes be guarded by more than roosters. Crowing in the morning must be followed by a careful tending to eggs in the afternoon.

Jim Leach, *GAO Conference on Banking—Orange County Bankruptcy*, Congressional Press Releases, Dec. 8, 1994, available in LEXIS, News Library, Wires File.

143. Robert A. Rosenblatt, *Orange County in Bankruptcy*, L.A. TIMES, Dec. 8, 1994, at A26.

144. Leach, *supra* note 142 (describing his bill, H.R. 3748).

145. At the January 5, 1995 Senate Hearing on derivatives, Senator Paul Sarbanes told the federal regulatory agency Chairpersons that they were "so busy trying to make the point' that broad derivatives legislation is not needed at this time that they 'minimized the problems of derivatives.'" *Regulators Tell . . .*, *supra* note 137, at 67. See also Leach, *supra* note 142.

146. *Headlines May Result in Legislative Controls*, BANKING ATT'Y, Dec. 19, 1994, at 1, 4 (predicting that the Orange County crisis would spur legislative action). But see *Regulators Tell . . .*, *supra* note 137, at 67. ("We can hold all the hearings we want, but we will never eliminate risk in a capitalistic society. . .") (quoting Senator Phil Gramm).

derivative agreements<sup>147</sup> to a complete prohibition on entering derivative transactions by municipal governments.

In June 1992, the House of Representatives' Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce began investigating the use of derivatives.<sup>148</sup> After surveying over 4,600 state and local government entities that are members of the Government Finance Officers Association (GFOA), the General Accounting Office issued a 195-page report disclosing the survey's findings.<sup>149</sup> Based in part on the findings of this report, the GFOA issued a policy statement on the regulation of derivatives.<sup>150</sup> The statement suggests four courses of action to be taken by the federal government: (1) close regulatory gaps for dealers of derivative products;<sup>151</sup> (2) clarify current suitability rules and promulgate new rules;<sup>152</sup> (3) accelerate the Financial Accounting Standards Board's standard-setting process for accounting and disclosure of derivative

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147. Keith Bradsher, *As Washington's Old Order Gives Way, No Clear Signs from the New*, N.Y. TIMES, Nov. 10, 1994, at D7.

The most recent proposal in the House of Representatives, introduced by Rep. Christopher Cox (R-Cal.), seeks to decrease local governments' and private investors' abilities to recover their losses due to securities fraud. *Congress is Wrong to Limit Investor Suits*, SEATTLE TIMES, May 29, 1995, at B4 [hereinafter *Congress is Wrong*]. The bill will make it more difficult for investors to recover from accountants, lawyers, stockbrokers, insurance agents and financial advisors who have defrauded the investors. Jerry Knight, *Securities Bill Called Too Lenient*, WASH. POST, May 25, 1995, at B10. Critics claim that passage of this bill would have the effect of discouraging taxpayer suits in situations such as Orange County and the Savings and Loan scandal. *Id.* at B10, B13.

For a discussion of an earlier proposal with similar provisions, see Lynn S. Hume, *Rep. Markey's Bill Sounds Battle Cry Over Reform of Securities Litigation*, BOND BUYER, Jan. 19, 1995, at 25.

148. *Financial Derivatives*, *supra* note 130, at 14.

149. *Id.* The final result was the GAO REPORT, *supra* note 3.

150. *Gov't Fin. Ass'n Policy*, *supra* note 33, at 16.

151. The GFOA notes that currently, "[w]hile financial institutions are subject to periodic regulatory examinations regarding their use of derivatives, there are no federal regulations regarding derivative activities by securities and insurance firm affiliates, and there is little or no state oversight of derivatives activities of insurance company affiliates." *Id.*

152. The GFOA notes that, "State and local governments must be assured that the product recommended for their use is appropriate and that the broker or dealer has disclosed his or her own position with regard to the derivatives contract." *Id.*

See generally Peter M. Geckeler, Note, *Municipal Derivatives Use and the Suitability Doctrine*, 49 WASH. U. J. URB. & CONTEMP. L. 285 (1996) (providing a comprehensive look at the application of suitability standards to the sale of derivatives to municipalities).

activities by brokers and dealers;<sup>153</sup> and (4) examine and establish reasonable capital requirements for brokers and dealers.<sup>154</sup> The GFOA contends that legislation or regulation covering these matters will alleviate end-user<sup>155</sup> losses on derivatives.<sup>156</sup>

## VI. PROPOSAL

Municipal-bond derivative transactions are a complicated area of local financing, requiring investor sophistication and lots of luck. As more and more municipalities ask their taxpayers and the courts to cover million dollar losses from improper speculation on interest rates, the push for reform of the derivative market grows stronger. Opinions on how to reform the market range from relying on a *laissez faire* attitude, allowing municipal governments to squander taxpayer money through faulty investments,<sup>157</sup> to an approach that declares unlawful all prior, present, and future derivative deals.<sup>158</sup>

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153. This suggestion responds to the delay in getting accurate information: "Investors, creditors, regulators and other users of financial reports must be able to rely on consistent reporting of material information. Lack of accounting rules can result in inconsistent and misleading reporting on derivative products." *Gov't Fin. Ass'n Policy*, *supra* note 33, at 16.

This acceleration could be accomplished more easily by requiring municipalities to "mark" their investments to the market. "Mark-to-market" is "[t]he adjustment of a position to its current market value." SOLVING THE MYSTERY, *supra* note 33, at 95. This would ensure that the derivatives' present value is more accurately portrayed to investors.

154. As the policy explains, "[c]apital requirements are imposed to provide protection from unexpected losses, reduce the likelihood of failure of an institution or firm, and protect clients and creditors. Currently, only banks have capital requirements. There are no capital requirements for securities firms or insurance companies [sic] affiliate derivative dealers." *Gov't Fin. Ass'n Policy*, *supra* note 33, at 16.

155. *See supra* note 33.

156. *Financial Derivatives*, *supra* note 130, at 16.

157. *See, e.g.*, Patrick Cox, *Don't Ban Derivatives*, USA TODAY, Dec. 7, 1994, at 10A (proposing that banning derivatives use is counterproductive). *See also Regulators Tell . . .*, *supra* note 137, at 67 (quoting Senator Gramm's contention that the risk of failure must always be present if we are to live in a capitalist society).

158. *See, e.g.*, Walker F. Todd, *Prescribing for Orange County Ills*, SACRAMENTO BEE, Jan. 8, 1995, at F01. The author states "[derivatives] normally belong nowhere near fiduciaries entrusted with public funds. Someone is almost certainly going to get burned when so volatile a mixture gets combined with the securities firms' political contributions, the gullibility of public treasurers and the eagerness of elected county and state officials to maximize nontax revenues." *Id.*

Todd further argues that it is quite alright for an investment firm using private capital to invest in derivatives or reverse repos—whether to reduce investment risk or to speculate

While both alternatives have negative aspects,<sup>159</sup> Congress and the Securities Exchange Commission (SEC) could fashion their own way to eliminate local government speculation in the derivative market. This can be done without stripping away a municipality's ability to safely and prudently use derivatives as a hedging mechanism against interest rate risk. To do this, Congress would first have to give the SEC jurisdiction over state and local government investment policies. This could be done through the Interstate Commerce Clause, the Securities Act of 1933, or the Securities Exchange Act of 1934.<sup>160</sup>

Despite the argument made by some critics that the GFOA policy statement represents the best alternative,<sup>161</sup> Congress should realize that this policy is geared towards the regulation of derivative dealers, brokers, and investment companies—not the end-user municipal governments. While this type of regulation would necessarily have a positive regulatory effect on end-users, legislation directly limiting the powers of local governments to enter speculative derivative transactions would be a more logical policy choice. It would also ensure that catastrophes like Orange County do not occur again, while maintaining municipal authority to reduce interest rate risk through the use of derivatives.

To ensure security in the derivative market, Congress and the SEC should pass a four-part law that would effectively guarantee that municipal governments could not gamble with taxpayer money by speculating on interest rate movement. First, local authorities should be forced to match a derivative transaction with a specific debt transaction and be able to show how the derivative deal will act as a hedge against the interest rate exposure of the original transaction. This requirement increases the likelihood that derivative agreements will be entered into

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on interest rates—but that it is a completely different story when a public official is charged with managing public funds. *Id.*

159. For an example of how the “hands-off” approach to municipal derivatives can have negative aspects, one need only look to the Orange County case. *See supra* part IV.

To understand why an absolute ban on municipalities engaging in the derivative market could cripple the municipal bond market, see Fischer, *supra* note 43, at 520-24 (providing an excellent discussion of the interest rate hedging that swaps can accomplish).

160. *See* Securities Act of 1933, 15 U.S.C. §§ 77a-77bbb (1988); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll (1988). The sheer magnitude of present bond deals virtually assures that the Interstate Commerce Clause can be invoked, because bondholders and investors throughout the country will be involved in the transactions.

161. *See supra* notes 151-57 and accompanying text.

with the original transactions in mind, and decreases the likelihood of municipalities pursuing a gamble to increase rates of return.

Second, any derivative deal that forces the total notional amount of outstanding derivatives above the municipality's outstanding debt should be made *per se* illegal and void from its inception. A municipality can gain absolutely no hedging advantage once the notional amount equals the outstanding debt.<sup>162</sup> Thus, this level should be set as the cap for derivative deals. Coupled with the first step of this proposal, all derivative transactions would then be tied to a specific debt and the municipal authority would not be able to over-invest in the derivative market, ensuring the non-speculative nature of the investments.

Third, municipal officers who wish to engage in derivative transactions should first have to complete a certified educational program on municipal derivatives and pass a test demonstrating sophistication in this market. Congress and the SEC should specify an agency or the GFOA to certify such educational programs. In addition, the designated agency should administer a uniform test covering the broad range of derivative deals that a municipality might enter. Ensuring that the municipal officers are knowledgeable in derivative transactions will make them much less susceptible to the temptation to invest in speculative derivatives pushed by aggressive financial institutions.

Fourth, the average maturity on a municipal government's outstanding derivative transactions should be limited to no more than 180 days. Municipalities become more susceptible to losses in the derivative market from interest rate fluctuations when their derivative deals do not mature for a long period of time.<sup>163</sup> Shortening the average maturity period for a local authority's derivatives to 180 days would significantly reduce the risk of massive losses—if a derivative deal is losing money for the municipality, the short-term nature of the deal will minimize loss as the transaction quickly closes.

Implementing these four steps at the federal level would be the most effective way to curb municipalities' wild speculation on interest rate

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162. With proper hedging techniques, all interest rate risk from outstanding debt can be hedged when the notional amount equals the outstanding debt. See Fischer, *supra* note 43, at 520-21.

163. *Local Gov't's Must Learn to Manage Portfolios - Hayes*, REUTERS, Dec. 19, 1994, available in LEXIS, News Library, Reufin File (noting that the average maturity of Orange County's portfolio before the municipality declared bankruptcy was four years, but that plans were underway to reduce the average maturity to 180 days or less).

movements in the hope of gaining a quick profit. It would, however, still allow municipal governments the flexibility they need to hedge against these same fluctuations.

## VII. CONCLUSION

As the municipal bond market has grown, government officials have looked for ways to decrease their debt payments. This desire has led to widespread speculation in the municipal-bond derivative market. As illustrated by the Orange County disaster, taxpayers are left with nothing but unanswered questions when their local governments squander billions of dollars. Congress should not sit idly by and watch the derivative market turn into another Savings and Loan fiasco. Congress must impose mandatory guidelines that forbid municipalities from gambling on the direction interest rates will move while still allowing the local governments to use derivatives safely as a hedge against future interest rate fluctuation.

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