

## Investors In MF Global's 'Key Man' Bonds Have Potentially Strong Legal Claims

Nov. 10, 2011 3:24 PM ET3 comments

by: Mark Strauss

Financial transactions are seldom so ironic. Barely three months ago, **MF Global (OTC:MFGLQ)** sold \$325 million in 6.25% senior unsecured bonds due August 2016. Dubbed MF's "Key Man" bonds, the issuance featured an interest rate that would rise if Chairman and Chief Executive Officer Jon Corzine received a federal appointment from the U.S. president.

"Key Man" Corzine's chances of landing a presidential appointment - reportedly, he was in line for Treasury Secretary - are now about the same as those of Lindsey Lohan. MF has been driven into bankruptcy under suspicious circumstances relating to a \$6.3 billion, highly-levered wager on European sovereign debt. Authorities are investigating whether MF improperly diverted some \$600 million in unaccounted for customer funds to meet margin calls in connection with the trade. The bonds defaulted before MF's first coupon payment.

Everyone is rightfully concerned that MF's customers recover their missing money. But how about the losses of the investors in the "Key Man" bonds, which are now trading for 40-50 cents? Section 11 of the Securities Act of 1933 imposes a duty on issuers to disclose all material information in connection with offerings of securities. It looks like MF violated this statute and that bond investors have potentially strong claims under it.

MF's 10-K in the spring apparently disclosed certain aspects of the \$6.3 billion sovereign debt trade. What MF did not disclose in its filings, in connection with the bond offering, or at any time prior to September 1, 2011, however, was that FINRA had contacted MF as early as June expressing concern over MF's accounting and capital treatment of it. Specifically, MF had structured the sovereign debt trade as a "repo-to-maturity" - a type of off-balance-sheet transaction that MF believed entitled it to omit the position from its value-at-risk and capital calculations. FINRA regulators, however, disagreed with this characterization, according to a reports by Reuters and Dealbook. The regulators informed MF that they thought the firm was not appropriately holding capital against its position. Several months passed as FINRA conferred with the SEC on the issue

Second, the subordination you mention would only involve claims in the bankruptcy against MF Global. Claims against the underwriters and MF Global's officers and directors, by comparison, would be completely outside the bankruptcy and not subject to subordination.

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The security fraud claim isn't worth the paper this article is printed upon. Security fraud claims by law are subordinated to general unsecured debt in BK. Thus if the unsecureds aren't paid in full the security fraud claims get nothing thus the claim is worth zero and if they are paid in full there are no damages and the claim is zero.

10 Nov 2011, 10:57 PM

Finally, after reportedly lengthy discussions, MF "yielded" to the regulators' view. On September 1, 2011, the firm revealed that it had modified the trade's capital treatment and infused additional capital in order to satisfy regulators. This prompted the rating agencies to downgrade MF and led to the reported customer defections, counter-party demands for additional collateral, and bankruptcy.

The information that MF failed to disclose at the time of the offering - that regulators were questioning the off-balance-sheet treatment of its European sovereign debt position and pressing it to allocate capital against the transaction - would have been highly material to bond investors. It raised adequacy-of-capital risks that materialized into a debacle for them. Thus far, no lawsuits have been filed on behalf of the bond investors, but it appears certain that such investors will seize on these potentially strong claims. Although MF is bankrupt, such a lawsuit would name the underwriters of the offering and MF's top officers and directors such as "Key Man" Corzine himself.

**Disclosure:** I have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

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## Comments (3)

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At best the bondholders have a securities fraud claim. These are subordinated to general unsecured creditors. Thus unless unsecureds are paid 100 cents on the dollar in which case there are no damages the securities fraud claims get nothing. Ergo the securities fraud claim is worthless in all cases.

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### Mark Strauss

#### Contributor

Author's reply » Thank you for your comments, but if I may point out two important distinctions:

First, the article is not about potential securities "fraud" claims (which would be claims under section 10(b) of the Securities Exchange Act of 1934). Instead, what I'm talking about are about potential claims under Section 11 of the Securities Act of 1933. Section 11 imposes strict liability for misrepresentations and omissions in a registration statement. "Fraud" is not an element of a Section 11 claim.