

Note

**NARROWING THE BANKRUPTCY SAFE
HARBOR FOR DERIVATIVES TO COMBAT
SYSTEMIC RISK**

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ABSTRACT

Bankruptcy law establishes proceedings designed to rehabilitate debtors while protecting creditors, but a series of safe harbors effectively exempts from bankruptcy proceedings certain financial contracts known as derivatives. Accordingly, when a party to a derivative contract goes bankrupt, the counterparty may terminate the contract and seize what it is owed from the debtor's assets. Congress enacted these safe harbors to combat the risk of systemic failure by maintaining liquidity in troubled markets; in doing so, however, they allowed counterparties to engage in opportunistic behavior and inefficiently consume a debtor's limited assets. Because these two consequences may harm the debtor and its creditors, the safe harbors may merely substitute one kind of systemic risk for another.

This Note argues that these safe harbors might more effectively combat systemic risk if they did not permit counterparties to terminate derivatives that are more valuable to the debtor. This is likely true of an insurance-like derivative known as the credit default swap (CDS). Just as insurance contracts may not be terminated—because maintaining insurance is crucial both to debtor rehabilitation and creditor protection—certain CDSs should not be eligible for termination under the safe harbors. Narrowing the safe harbors might

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help eliminate unnecessary costs arising from bankruptcy and thereby better reduce systemic risk.

INTRODUCTION

Two thousand and eight was “the year the financial system stopped working.”¹ The bankruptcy of Lehman Brothers, the federal takeover of Fannie Mae and Freddie Mac, and the near failure and subsequent bailout of Bear Stearns and American International Group (AIG) triggered huge losses on Wall Street and across the country,² signaling even to lay observers that the subprime mortgage crisis had metastasized into a serious threat to the American economy.³ These failures were largely symptomatic of the steep decline in value of securities backed by subprime mortgages,⁴ but only a portion of the blame lies in the collapse of the subprime market. In large part, “the [financial] system was vulnerable because of intricate financial contracts known as credit derivatives.”⁵ In light of the role these largely unregulated contracts played in the financial crisis, state regulators and industry insiders have begun working on reform initiatives to make credit derivatives safer.⁶ These initiatives, however, can only address part of the problem.⁷ Credit derivatives

1. Floyd Norris, *A Year of Chaos in Finance*, N.Y. TIMES, Dec. 18, 2008, at B1.

2. *See id.* (cataloging the assorted failures and bailouts of different institutions in 2008).

3. *See Economists Call Subprime Fallout Biggest Threat*, MSNBC.COM, Mar. 3, 2008, <http://www.msnbc.msn.com/id/23436696/> (“The cascading fallout from the subprime loan crisis, barely a cloud on the horizon a year ago, is now viewed by experts as the economy’s gravest threat.”).

4. *See* Jenny Anderson & Vikas Bajaj, *A Wall St. Domino Theory*, N.Y. TIMES, Mar. 15, 2008, at A1 (linking the subprime mortgage crisis to the failure of Bear Stearns and the huge losses suffered by other investment banks, including Lehman Brothers); Serena Ng, *Swaps Market Is Pressed to Ease Market Strains*, WALL ST. J., Oct. 10, 2008, at C2 (tying the Lehman Brothers bankruptcy to the subprime mortgage crisis).

5. Gretchen Morgenson, *Behind Biggest Insurer’s Crisis, a Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 28, 2008, at A1.

6. *See* Danny Hakim, *New York to Regulate a Financial Tool Behind the Credit Crisis*, N.Y. TIMES, Sept. 23, 2008, at C10 (announcing that New York’s insurance department would begin regulating CDSs as “insurance products” in certain cases); Aline van Duyn, *Worries Remain Even After CDS Clean-Up*, FIN. TIMES, Mar. 10, 2009, <http://www.ft.com/cms/s/0/af1efb78-0dc6-11de-8ea3-0000779fd2ac.html> (“Since [the bankruptcy of Lehman Brothers], the industry has pushed through 10 years worth of changes in just a few months.” (quoting Athanassios Diplas, Managing Director, Deutsche Bank)).

7. State-level initiatives cannot fully address, for example, how derivatives are treated in bankruptcy proceedings because the Constitution provides that Congress has the power “to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States.” U.S. CONST. art. 1, § 8.

pose a danger to the financial system in part because they are subject to a series of safe harbors in the Bankruptcy Code that exempts credit derivatives from bankruptcy safeguards designed to help financially distressed firms recover while protecting their creditors.⁸ This Note argues that narrowing the scope of these safe harbors may reduce the potential of credit derivatives to harm the financial system.

One of the primary causes of the market turmoil in 2008 was a species of credit derivative known as the credit default swap (CDS).⁹ Generally, a CDS is a private contract in which a seller guarantees a purchaser (both of these parties are referred to as “counterparties”) a fixed payment if a predefined credit event occurs (typically a credit downgrade, bond default, or bankruptcy).¹⁰ Many in the financial services industry viewed CDSs, which have historically been subject to little regulation,¹¹ as unparalleled engines of profit.¹²

For example, AIG made enormous profits selling CDSs as a kind of insurance against losses on mortgage-backed securities,¹³ but, as the subprime mortgage crisis developed, the value of the underlying

8. See, e.g., *In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197, 209 (3d Cir. 2003) (“Chapter 11 [bankruptcy] is intended to permit the debtor to rehabilitate itself while simultaneously protecting creditors.”).

9. See, e.g., Anderson & Bajaj, *supra* note 4 (“Of particular concern are the insurance contracts known as credit default swaps . . . Investors in such contracts with [distressed firms] are closely studying whether they can get out of them or have them transferred to a more stable firm.”); Shannon D. Harrington, *Credit Swap Clearinghouse to Be Running by Year-End*, BLOOMBERG.COM, Nov. 14, 2008, http://www.bloomberg.com/apps/news?pid=email_en&sid=ahqxOSMiB2bI (“[T]he virtually unregulated . . . market in credit-default swaps has played a significant role in the credit crisis.” (quoting Christopher Cox, former Chairman, SEC)); Liam Pleven & Susanne Craig, *Congress Grills Former AIG Chiefs: Lawmakers Ask Whether Executives Glossed over Warnings About Risks Insurer Faced*, WALL ST. J., Oct. 8, 2008, at A3 (“[D]erivatives . . . were largely responsible for three consecutive multibillion-dollar quarterly losses AIG reported in the months before the government agreed to loan the company as much as \$85 billion.”).

10. Frank Partnoy & David A. Skeel, *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1019 (2007).

11. See Harrington, *supra* note 9 (quoting former SEC Chairman Christopher Cox describing the CDS market as “virtually unregulated”). For a discussion of the regulation (or lack thereof) of CDSs, see *infra* Part III.A.

12. See Morgenson, *supra* note 5. Joseph Cassano, former head of AIG’s Financial Products division (AIGFP), stated in August 2007 that “[i]t is hard for us, without being flippant, to even see a scenario within any kind of realm of reason that would see us losing one dollar in any of those [CDS] transactions.” *Id.*

13. *Id.* Between 1999 and 2005, revenue from AIGFP rose from \$737 million to \$3.26 billion. These profits were primarily derived from selling CDSs on “packages of debt known as ‘collateralized debt obligations.’ . . . [which essentially] were pools of loans sliced into tranches and sold to investors based on the credit quality of the underlying securities.” *Id.*

securities plummeted.¹⁴ Concurrently, AIG's CDS liabilities mounted.¹⁵ These unexpected losses destabilized AIG,¹⁶ sending a shockwave through AIG's trading partners, which consisted of a "global swath" of top-notch entities including "banks and investment banks, pension funds, endowments, foundations, insurance companies, hedge funds, money managers, high-net-worth individuals, municipalities and sovereigns and supranationals."¹⁷ In light of the importance of AIG's stable of trading partners, the firm's possible failure threatened indeterminate losses to the larger financial system.

The risk that AIG's failure could cause a chain of consequences negatively affecting both market participants and the larger economy is an example of "systemic risk."¹⁸ Systemic risk concerns prompted the Federal Reserve to bail out AIG to prevent the likely repercussions of the faltering company's failure.¹⁹ If AIG had failed, its web of trading partners would have suffered direct losses resulting from AIG's inability to meet its obligations.²⁰ More importantly (for

14. See AIG, Inc., Annual Report (Form 10-K), at 30 (Feb. 27, 2008) ("AIG insurance and financial services subsidiaries invest in mortgage-backed securities and CDOs, in which the underlying collateral is composed in whole or in part of residential mortgage loans; and AIGFP provides credit protection through credit default swaps"); see also First Amended Complaint at 1, *In re* AIG, Inc., 2007 Derivative Litig., No. 07-CV-10464 (S.D.N.Y. June 3, 2009) ("[AIG's officers and directors] steered AIG into writing insurance on complex debt instruments (based on mortgages) in such a way that the Company would experience catastrophic losses if such mortgages began to default—as, indeed, occurred.").

15. See Marine Cole, *AIG's Losses Show Swaps Next Domino*, FIN. WK., Feb. 18, 2008, available at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080218/REG/794188688> (noting that AIG underwrote over \$500 billion in CDSs, with close to \$78 billion of that sum allotted to securitized transactions with value derived from mortgage-backed securities).

16. In 2007, to reflect the changing values of its assets, AIGFP wrote down its CDS portfolio by \$11.2 billion. AIG, Inc., Annual Report (Form 10-K), at 28 (Feb. 27, 2008). In the first nine months of 2008, it wrote down the same portfolio by an additional \$21.7 billion. AIG, Inc., Quarterly Report (Form 10-Q), at 3 (Nov. 10, 2008). These write-downs helped trigger a "liquidity crisis" at AIG and ultimately necessitated its bailout by the Federal Reserve Bank of New York on September 16, 2008. *Id.* at 50.

17. Morgenson, *supra* note 5 (quoting Joseph Cassano, former head, AIGFP).

18. See Editorial, *Free AIG*, WALL ST. J., Oct. 2, 2008, at A18 (stating that the Federal Reserve "justified its intervention on systemic risk grounds").

19. See, e.g., Plevin & Craig, *supra* note 9 (explaining the events leading up to the federal bailout of AIG); Editorial, *Closing the Gaps*, WASH. POST, Jan. 1, 2009, at A12 ("[T]he Federal Reserve and the Treasury had to step in, lest its giant web of credit-default swaps collapse and bring the world economy down with it.").

20. See Mary Williams Walsh, *A.I.G. Chief Owns Significant Stake in Goldman*, N.Y. TIMES, Apr. 17, 2009, at B1 ("Had A.I.G. simply declared bankruptcy, the financial institutions

the purposes of this Note), AIG's failure also could have triggered a run on the company's assets by, among others, its CDS counterparties.²¹ These counterparties could have immediately terminated their contracts with AIG and fulfilled their claims by seizing collateral from AIG's assets, further destabilizing the company and leaving slower creditors "stuck with a company whose value took a tremendous dive after counterparties got first dibs on its carcass."²²

CDS counterparties are able to terminate their contracts and seize collateral because a series of safe harbor provisions in the Bankruptcy Code (collectively known as the "Safe Harbor") allow them to sidestep normal bankruptcy proceedings.²³ According to the legislative history of these provisions, Congress crafted the Safe Harbor to reduce systemic risk.²⁴ In theory, the Safe Harbor works to reduce the potentially widespread consequences of a default by maintaining liquidity in troubled markets. Without the Safe Harbor, a bankruptcy filing would effectively freeze the contractual relationship, leaving the counterparties exposed to market movements affecting the value of the contract.²⁵ Because the Safe

doing business with it would have ended up in court . . . fighting to get pennies on the dollar for their claims.").

21. Marie Beaudette, *Bankruptcy for AIG? Think Again*, WALL ST. J., Mar. 18, 2009, <http://blogs.wsj.com/bankruptcy/2009/03/18/bankruptcy-for-aig-think-again/>. For many readers, the word "run" (in this context) will conjure up the bank run scene in Frank Capra's 1946 classic *It's a Wonderful Life*. The same mechanics are at play when creditors run on a debtor's assets: a run is merely a scenario in which competing creditors race to successfully enforce claims against a party possessing resources insufficient to satisfy all claims.

22. *Id.*

23. See 11 U.S.C. § 362 (2006) (outlining the nondebtor derivative counterparty's right to terminate contracts and seize collateral); *id.* §§ 555–56, 559–61 (specifying that counterparties may exercise existing contractual rights, including ipso facto clauses, in different varieties of derivative agreements). For a discussion of the Safe Harbor, see *infra* Part III.B.2.

24. See H.R. REP. NO. 109-31(I), at 3, 20, 131–32 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 89, 105–06, 191–92 (justifying the 2005 amendments as "provisions designed to reduce systemic risk"); *cf.* PRESIDENT'S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 40 (1999) ("The ability to terminate financial contracts upon a counterparty's insolvency enhances market stability. Such close-out netting limits losses to solvent counterparties and reduces systemic risk. It permits the solvent parties to replace terminated contracts without incurring additional market risk and thereby preserves liquidity.").

25. See H.R. REP. NO. 97-420, at 2 (1982), reprinted in 1982 U.S.C.C.A.N. 583, 583–84 ("The prompt closing out or liquidation of [derivatives] freezes the status quo and minimizes the potentially massive losses and chain reactions that could occur if the market were to move sharply in the wrong direction."); *cf.* PRESIDENT'S WORKING GROUP ON FIN. MKTS., *supra* note 24, at 26 ("[The Safe Harbor provisions] serve to reduce the likelihood that the procedure for

Harbor frees CDS counterparties to claim the debtor's assets upon filing for bankruptcy,²⁶ however, there is a risk that a run on the debtor will lead to a liquidity shortage "that has the potential to spill over to other firms and markets and cause widespread instability in financial markets."²⁷ Put simply, the Safe Harbor may merely substitute one kind of systemic risk for another.

This Note argues that the Safe Harbor would more effectively reduce systemic risk if it did not exempt *all* CDSs from bankruptcy proceedings. The Safe Harbor's blanket exemption presupposes that the benefits of increased market liquidity when CDS counterparties liquidate their contracts and seize collateral will outweigh the costs of an unrestrained run on the debtor's assets. That is true when CDSs are practically fungible,²⁸ but not all CDSs hold the same value for both the debtor and creditor.

This Note posits that when CDSs are analogous to insurance contracts, they likely have more value in the hands of the debtor than in the hands of a counterparty. The argument is as follows: Insurance-like CDSs protect the debtor firm against a certain risk. Removing this protection subjects the debtor to greater risk, further devaluing the firm.²⁹ If the decrease in the debtor firm's value exceeds the value created by liquidation of the CDS, the liquidation results in a net loss.³⁰ If these kinds of liquidations are widespread or the debtor firm is sufficiently large, the operation of the Safe Harbor may have negative systemic consequences.³¹ Thus, modifying the Safe Harbor to

resolving a single insolvency will trigger other insolvencies due to the creditors' inability to control their market risk.").

26. For a discussion of the dangers posed by a "run" on the debtor's assets, see *infra* Part IV.A.1.

27. Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 105–06 (2005).

28. *See id.* at 95 (arguing that derivatives "are fungible assets and can be seized by creditors without" undue negative consequences).

29. *See id.* at 115 ("[I]ncreased exposure to . . . risk can harm the firm's operations and its other creditors.").

30. The values at play here can be conceptualized as follows: the decrease in the debtor's value caused by the counterparty's termination of contracts and seizure of collateral can be thought of as the difference between the firm's liquidation value and the firm's going-concern value, plus the situation-specific losses arising from the termination of the debtor's hedges. *See infra* Part IV.B. Weighing against these losses is the liquidity value that a counterparty gains when it terminates a contract with the debtor and is no longer locked into the contract (rendering the counterparty safe from market fluctuations that would affect the contract's value). Additionally, the aggregate effect of these individual settlements is to ease market-wide uncertainty as to the exposure of market participants to the debtor. *See infra* Part IV.C.

31. *See infra* notes 174–75, 183–89 and accompanying text.

subject insurance-like CDSs to normal bankruptcy proceedings might, on the whole, reduce the possibility that a firm entering bankruptcy will pose a systemic threat.

This argument depends upon an understanding of how CDSs raise systemic risk problems in the context of bankruptcy proceedings. As such, this Note begins by discussing in Part I the most salient features of CDSs and derivatives (the family of financial instruments to which they belong). Part II explains the conceptual underpinnings of systemic risk. Part III concludes the background discussion with a closer look at the regulation of derivatives and their treatment under the Bankruptcy Code.

The remainder of the Note identifies some crucial problems with the Safe Harbor and proposes a reform. Part IV evaluates how the Safe Harbor interacts with the dynamics of systemic risk by examining two case studies: the collapse of Long-Term Capital Management, a hedge fund, and the bankruptcy of Lehman Brothers, a financial services firm. Finally, Part V outlines a reform that may make the Safe Harbor a better tool for reducing systemic risk. Without empirical evidence, it is impossible to know whether this Note's proposed reform would provide greater benefits than the current blanket exemption; this Note simply seeks to outline the dynamics at play in order to guide future inquiries into the matter.

I. DERIVATIVES, CREDIT DERIVATIVES, AND CREDIT DEFAULT SWAPS

Understanding how derivatives pose a danger to the financial system requires understanding how these financial instruments are used and why they are unique. The term “derivatives” generically refers to a family of financial instruments linked together by certain common traits. A basic understanding of these traits will help illuminate the particular species of derivative that is the focus of this Note—the CDS. Accordingly, this Part begins with a brief primer on derivatives, before the discussion narrows to focus on credit derivatives and the mechanics and uses of the CDS.³² This Part closes with a brief look at how the widespread use of CDSs has changed the way that the financial markets function, for better and for worse.

32. FRANK J. FABOZZI, HENRY A. DAVIS & MOORAD CHOUDHRY, *INTRODUCTION TO STRUCTURED FINANCE* 45 (2006).

A. *Derivatives Generally*

A derivative is a bilateral financial contract contemplating that “either or both of two parties (each referred to as a ‘counterparty’) agrees to make payments or deliveries to the other based on the performance or change in the value” of an external instrument, rate, or event (the “reference subject”).³³ The reference subject is limited only by the imaginations of the contracting parties: “anything that can be quantified and objectively verified can be the subject of a derivative.”³⁴ For example, the most common types of derivative securities are “financial contracts that ‘derive’ their value from *cash market* instruments such as stocks, bonds, currencies and commodities.”³⁵ Derivative instruments commonly reference interest rates, currency exchange rates, or physical commodities,³⁶ but a derivative may also reference such unusual subjects as weather conditions and mortality rates.³⁷

The payout value of a derivative is *derived* from the change in value of the reference subject.³⁸ The most salient characteristic of a derivative is that its value is a function of the reference subject’s value. The relationship between the two values does not necessarily correlate in a linear fashion; rather, it is defined by the terms of the

33. Mark A. Guinn & William L. Harvey, *Taking OTC Derivative Contracts as Collateral*, 57 BUS. LAW. 1127, 1128 (2002).

34. *Id.* at 1129.

35. SALIH N. NEFTCI, AN INTRODUCTION TO THE MATHEMATICS OF FINANCIAL DERIVATIVES 2 (2d ed. 2000) (citing Joseph S. Rizello, *The Development and Evolution of Derivative Products*, in THE HANDBOOK OF DERIVATIVES & SYNTHETICS: INNOVATIONS, TECHNOLOGIES AND STRATEGIES IN THE GLOBAL MARKETS 1, 2 (Robert A. Klein & Jess Lederman eds., 1994)).

36. See Guinn & Harvey, *supra* note 33, at 1128–29 (describing typical reference subjects).

37. The Chicago Mercantile Exchange offers weather derivatives that derive their value from average temperature fluctuation around a predetermined average temperature. See GEOFFREY CONSIDINE, AQUILA ENERGY, INTRODUCTION TO WEATHER DERIVATIVES (1999), http://www.cmegroup.com/trading/weather/files/WEA_intro_to_weather_der.pdf (presenting a broad overview of weather derivatives). For a discussion of mortality derivatives, which are designed to allow pension funds to hedge against the costs incurred when pensioners live longer than expected, see GUY COUGHLAN ET AL., JPMORGAN, Q-FORWARDS: DERIVATIVES FOR TRANSFERRING MORTALITY AND LONGEVITY RISK 1 (2007), http://www.jpmorgan.com/cm/cs?pagename=JPM/DirectDoc&urlname=LM_Q_forwards.pdf.

38. See U.S. Dep’t of the Treasury, FAQs: Financial Markets, <http://www.treas.gov/education/faq/markets/derivatives.shtml> (last visited Nov. 21, 2009) (“A derivative is a financial instrument whose price is derived from the value of one or more underlying assets, liabilities, or indices.”).

contract.³⁹ By tying a set payout or exchange to changes in the state of a reference subject, derivatives allow firms to plan for future risks. Therefore, derivatives serve as “the basic building blocks of all more complicated risk management positions.”⁴⁰

Derivatives have transformed finance over the last thirty years by “fostering more precise ways of understanding, quantifying, and managing risk.”⁴¹ In discussing risk management, former Chairman of the Federal Reserve Alan Greenspan explained that, because derivatives “permit[] the unbundling of financial risks . . . individual financial instruments now can be analyzed in terms of their common underlying risk factors, and risks can be managed on a portfolio basis.”⁴² A well-designed derivatives transaction can isolate and shift onto a willing derivative seller almost any imaginable risk. As the financial services industry has recognized the versatility and usefulness of these instruments, the derivatives market has grown exponentially.⁴³ Firms use derivatives not only to hedge against a wide variety of risks, including fluctuations in interest and exchange rates,⁴⁴ but also as speculative investments and for arbitrage.⁴⁵

39. The customizability of derivative agreements contributes to their versatility, which is desirable, and their complexity, which is not. In some cases, complexity can obscure the ultimate value of an instrument, which may lead to nasty surprises. For a cogent and entertaining account of how complexity can wreak havoc in financial markets, see generally RICHARD BOOKSTABER, *A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION* (2007).

40. ROBERT W. KOLB & JAMES A. OVERDAHL, *FINANCIAL DERIVATIVES*, at vii (3d ed. 2003).

41. Letter from Lawrence H. Summers, Sec’y, Dep’t of the Treasury, et al., to Al Gore, President of the Senate, U.S. Senate (Nov. 9, 1999), in *PRESIDENT’S WORKING GROUP ON FIN. MKTS., OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT 5*, 5 (1999), available at <http://www.ustreas.gov/press/releases/reports/otcact.pdf>.

42. Alan Greenspan, Chairman, Fed. Reserve, Remarks to the Federal Reserve Bank of Chicago’s Forty-first Annual Conference on Bank Structure (May 5, 2005), available at <http://www.federalreserve.gov/boarddocs/speeches/2005/20050505/default.htm>.

43. A 2003 survey found that 92 percent of the world’s five hundred largest companies use derivatives to hedge risk. Press Release, Int’l Swaps and Derivatives Ass’n, *Over 90% of the World’s 500 Largest Companies Use Derivatives to Help Manage Their Risks, According to New ISDA Survey* (Apr. 9, 2003), available at <http://www.isda.org/statistics/surveynewsrelease030903v2.html>.

44. See Guinn & Harvey, *supra* note 33, at 1130–32 (describing various kinds of derivatives transactions).

45. John T. Lynch, Comment, *Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention—A Model for the Future of U.S. Regulation?*, 55 *BUFF. L. REV.* 1371, 1373 (2008). According to another source, “derivatives are unsurpassed as tools for speculation.” KOLB & OVERDAHL, *supra* note 40, at vii.

Regardless of the instrument's purpose, derivatives generally fall into two broad categories: exchange-traded and over-the-counter (OTC).⁴⁶ This Note focuses on the largely unregulated OTC market,⁴⁷ which consists of parties directly entering into private contracts without using a clearinghouse intermediary.⁴⁸ In the OTC market, the counterparties can negotiate the details of the contract directly and enter into transactions tailored to their unique needs. Consequently, there is a great amount of innovation and variation among OTC transactions. Nevertheless, the OTC derivative market can be roughly divided into five groups: "foreign currency exchange contracts, interest rate contracts, equity-linked contracts, commodity contracts, and credit derivatives."⁴⁹ Since the early 1990s, the credit derivative market in particular has experienced explosive growth.⁵⁰

B. Credit Derivatives and Credit Default Swaps

Credit derivatives are generally defined as "financial instruments whose payoffs are linked in some way to a change in credit quality of an issuer or issuers."⁵¹ A "change in credit quality" can be as straightforward as a downgrade in credit rating or as dramatic as bankruptcy.⁵² Credit quality reflects credit risk,⁵³ which is generally

46. Lynch, *supra* note 45, at 1375.

47. See Partnoy & Skeel, *supra* note 10, at 1036 ("Because swaps are structured as over-the-counter (OTC) derivatives, they are largely unregulated. Among other things, this means that the details of particular swaps often go undisclosed.").

48. Lynch, *supra* note 45, at 1375. In contrast to OTC instruments, exchange-traded instruments are "traded on an organized financial exchange." KOLB & OVERDAHL, *supra* note 40, at 4. In this market, the counterparties enter into standardized contracts with an exchange clearinghouse (such as the Chicago Mercantile Exchange or the Chicago Board of Trade), Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 10 (1996), and the clearinghouse acts as the counterparty both to the buyer and the seller, *id.* at 16.

49. Lynch, *supra* note 45, at 1376.

50. See Partnoy & Skeel, *supra* note 10, at 1021 ("[T]he market for credit derivatives has grown from virtually nothing a decade ago to the range of \$20 trillion of notional value in 2006.").

51. *Id.* at 1019.

52. See MOORAD CHOUDHRY, AN INTRODUCTION TO CREDIT DERIVATIVES 13 (2004) (listing as typical credit events defaults on bond payments, credit rating downgrades, restructuring, and bankruptcy).

53. "Credit risk is the oldest form of risk in the financial markets." JOHN B. CAOUILLE, EDWARD I. ALTMAN & PAUL NARAYANAN, MANAGING CREDIT RISK: THE NEXT GREAT FINANCIAL CHALLENGE 1 (1998).

thought of as the probability of default on an outstanding obligation.⁵⁴ Thus, credit derivatives allow parties to reduce the credit risk of an investment or transaction by shifting some or all of the risk onto a derivative seller.⁵⁵

The most common type of credit derivative is the CDS,⁵⁶ a private contract that transfers credit risk from a credit protection buyer to a protection seller.⁵⁷ A protection buyer can use a CDS to unbundle and hedge the credit risks associated with a particular entity, a group of entities, or even an entire industry.⁵⁸ By using a CDS in combination with other derivatives, a protection buyer may customize a transaction or business relationship such that it has “almost any desired risk profile.”⁵⁹

In a CDS transaction, the protection buyer makes either fixed periodic payments or a single up-front payment to the protection seller⁶⁰ and, in return, the protection seller is obligated to make a payment or swap upon the occurrence of a predefined credit event.⁶¹

54. See Société Générale, Credit Risk, <http://www.equityderivatives.com/what-the-experts-say/glossary/credit-risk/> (last visited Nov. 21, 2009) (defining credit risk as “the risk that a loss will be incurred if a counterparty to a (derivatives) transaction does not fulfill its financial obligations in a timely manner”); see also *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y.*, 375 F.3d 168, 171 (2d Cir. 2004) (discussing a particular type of credit risk known as “country risk”).

55. See *Eternity Global Master Fund Ltd.*, 375 F.3d at 171 (“Banks, investment funds and other institutions increasingly use financial contracts known as ‘credit derivatives’ to mitigate credit risk.”).

56. *Id.*

57. See *id.* at 171–72 (defining a CDS as “[a] contract which transfers credit risk from a protection buyer to a credit protection seller” (alteration in original) (quoting OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC BANK DERIVATIVES REPORT: FOURTH QUARTER 2003, at 5 (2003), available at <http://www.occ.treas.gov/ftp/deriv/dq403.pdf>)).

58. Bruce Kayle, *The Federal Income Tax Treatment of Credit Derivative Transactions*, in THE HANDBOOK OF CREDIT DERIVATIVES 221, 225 (Jack Clark Francis, Joyce A. Frost & J. Gregg Whittaker eds., 1999) (“A [CDS] can be written with respect to a single obligation, but frequently will provide for a payment based on the default of any one or more obligations in an identified portfolio of reference obligations.”). The reference subject may be a debt or equity asset (or group of assets) or an entity (or group of entities). CHOUHRY, *supra* note 52, at 16–19. If the reference subject is an asset, the CDS would be concerned with the credit quality of bonds or other securities. If the reference subject is an entity, the CDS would be concerned with the credit of “[a] corporate or sovereign name.” *Id.* at 14 n.8.

59. Partnoy & Skeel, *supra* note 10, at 1024. For example, “[i]f the lender wishes to bear a borrower’s firm specific default risk, but not risk related to the industry as a whole . . . the lender could purchase derivatives that would compensate the lender in the event of an industry downturn (such as a derivative linked to the stock prices of a broad group of companies in the industry).” *Id.*

60. Kayle, *supra* note 58, at 224.

61. *Eternity Global Master Fund Ltd.*, 375 F.3d at 172.

The payment or swap takes place according to the terms articulated in the contract: generally, the protection seller is obligated to pay the buyer using a predefined settlement mechanism.⁶² The settlement mechanism may call for either “cash settlement . . . or physical delivery of the reference asset, in exchange for a cash payment equal to the initial notional [*i.e.*, face] amount [of the CDS contract].”⁶³ Typically, the protection seller’s payout equals “the difference between the reference obligation’s original principal amount or fair market value at the time the [CDS] is entered into and post-[credit event] market value of the reference obligation,” but the counterparties are free to specify any desired variety of payout in the CDS contract.⁶⁴ In essence, CDS counterparties wager on the occurrence of a credit event, typically a “bankruptcy, default, or restructuring,”⁶⁵ and the CDS buyer transfers to the seller the risk that the credit event will occur.

CDSs are used primarily for hedging⁶⁶ or “trading to reduce risk” by taking a position in one investment to offset the risk of another investment position.⁶⁷ A hedging strategy sacrifices some of the potential return on the initial investment in exchange for limiting the risk posed by the initial investment.⁶⁸ Thus, a hedge will not increase the return of an investment (it will, in fact, decrease the return), but it does make a desired outcome more certain.⁶⁹ A typical CDS transaction illustrates this principle: a bank might hedge the credit risk associated with a major loan by buying a CDS from a third party with payout triggered by the borrower’s credit event. If the borrower defaults on the loan, “the bank will lose money on the loan but make money on the [CDS]; conversely, if the [borrower] does not default, the bank will make a payment to the [protection seller], reducing its profits on the loan.”⁷⁰

62. *Id.* at 172.

63. *Id.* at 173 (alterations in original) (quoting Joyce A. Frost, *Credit Risk Management from a Corporate Perspective*, in *THE HANDBOOK OF CREDIT DERIVATIVES*, *supra* note 58, at 87, 90).

64. Kayle, *supra* note 58, at 224–25.

65. Partnoy & Skeel, *supra* note 10, at 1019.

66. *See id.* at 1023 (“[H]edging benefits[] [are] the most familiar virtue of credit default swaps.”).

67. Romano, *supra* note 48, at 9.

68. Lynch, *supra* note 45, at 1374.

69. Romano, *supra* note 48, at 9.

70. Partnoy & Skeel, *supra* note 10, at 1019.

As illustrated by the example above, a CDS used to hedge credit risks is much like an ordinary insurance contract.⁷¹ Hedging CDSs are often used as “insurance policies for holders of corporate bonds or other securities against downgrades in the credit of the issuing companies.”⁷² As with an insurance policy, the protection buyer pays either an upfront or periodic fee, “like an insurance premium,”⁷³ to the protection seller in exchange for “a contingent payment if a predefined credit event occurs.”⁷⁴ The similarity between hedging CDSs and insurance contracts plays a central role in this Note’s argument regarding how CDSs should be regulated.⁷⁵

CDSs are also useful tools in arbitrage and speculative investment.⁷⁶ A speculative CDS investment (referred to as a “naked” CDS) is essentially a bet on the occurrence of a specified credit event.⁷⁷ This is true because an investor may purchase a CDS referencing specific risks or market segments “without having to purchase outright the instruments or assets that make up that market.”⁷⁸ This distinguishes naked CDSs from insurance-like hedging CDSs: when the specified credit event occurs in a naked CDS transaction, the protection buyer will receive payment without regard

71. *Merrill Lynch Int’l v. XL Capital Assurance Inc.*, 564 F. Supp. 2d 298, 300 (S.D.N.Y. 2008); see also CHOUDHRY, *supra* note 52, at 1 (noting that a CDS is “conceptually similar to an insurance policy taken out against the default of a bond”); Kayle, *supra* note 58, at 224–25 (stating that a CDS “functions as a form of insurance against the risk of default” when the protection buyer is exposed to the reference subject); cf. Ng, *supra* note 4 (describing CDSs as “insurance against a Lehman default”). For a more detailed discussion of the similarities between insurance contracts and CDSs, see *infra* notes 213–20 and accompanying text.

72. *Deutsche Bank AG v. AMBAC Credit Prods., LLC*, No. 04 Civ. 5594 (DLC), 2006 WL 1867497, at *2 (S.D.N.Y. July 6, 2006).

73. *Merrill Lynch Int’l*, 564 F. Supp. 2d at 300.

74. *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y.*, 375 F.3d 168, 172 (2d Cir. 2004) (quoting Frost, *supra* note 63, at 90).

75. See *infra* Part III.B.2.

76. See *Eternity Global Master Fund Ltd.*, 375 F.3d at 172 (characterizing the protection seller’s use of credit derivatives as a strategy to “earn income and diversify their own investment portfolios” (footnote omitted)).

77. See Jerome A. Madden, *A Weapon of Mass Destruction Strikes: Credit Default Swaps Bring Down AIG and Lehman Brothers*, BUS. L. BRIEF, Fall 2008, at 15, 21 n.9 (citing Terry Kivlan, *Senate Agricultural Panel Reviews Credit Default Swaps*, CONGRESS DAILY, Oct. 14, 2008, available at 2008 WLNR 19567728)).

78. Lynch, *supra* note 45, at 1374.

to whether they suffered an actual loss (that is, without an “insurable interest”⁷⁹).

C. CDSs and the Financial System

The ubiquitous use of CDSs by banks and other market participants to hedge credit risk has changed the way that the credit markets function and, according to some, has resulted in “system-wide benefits.”⁸⁰ Alan Greenspan argued that the widespread use of CDSs mitigated the potentially devastating repercussions of the “largest corporate defaults in history (WorldCom and Enron) and the largest sovereign default in history (Argentina).”⁸¹ Many of the firms that were exposed to risk posed by the defaults of these entities had hedged that risk by purchasing CDSs.⁸² This use of CDSs to insure against credit risk—if widespread—may contribute to a more resilient economy that is less susceptible to system-wide shocks resulting from the failure of a major market participant.⁸³

The widespread use of CDSs, however, also has the potential to harm the economy. Putting aside issues relating to the substance of individual contracts (for example, whether accurate information about the reference subject exists),⁸⁴ the increase in derivatives-based hedging strategies may contribute to systemic risk by increasing the “linkages among market participants.”⁸⁵ In their capacity to create

79. The phrase “insurable interest” is defined as “[a] legal interest in another person’s life or health or in the protection of property from injury, loss, destruction, or pecuniary damage.” BLACK’S LAW DICTIONARY 829 (8th ed. 2004).

80. See, e.g., Partnoy & Skeel, *supra* note 10, at 1024 (describing the benefits of CDSs if used widely by banks); *id.* at 1023–27 (discussing the beneficial consequences of credit derivatives on the credit markets); *id.* at 1032–40 (describing the detrimental consequences of credit derivatives).

81. Alan Greenspan, Chairman, Fed. Reserve, Corporate Governance, Remarks to the Federal Reserve Bank of Chicago’s 2003 Conference on Bank Structure and Competition (May 8, 2003), available at <http://www.federalreserve.gov/boarddocs/speeches/2003/20030508/default.htm>.

82. *Id.*

83. See, e.g., Partnoy & Skeel, *supra* note 10, at 1024 (citing the arguments of Alan Greenspan and others that “credit derivatives served as a shock absorber during the corporate crises of 2001 and 2002”).

84. This was one of the problems underlying AIG’s collapse. See Morgenson, *supra* note 5 (“Because the underlying debt securities . . . carried blue-chip ratings, [AIG] was happy to book income in exchange for [selling CDSs]. After all, [AIG’s executives] apparently assumed, they would never have to pay any claims.”).

85. Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 221 (2008).

linkages, CDSs are analogous to vectors⁸⁶ for systemic risk: “If an institution fails, it potentially would impact many more other institutions” through these linkages.⁸⁷ Thus, although CDSs strengthen financial markets by allowing market participants to transfer credit risk to those (hopefully) better able to handle it, they also tie market participants together in a fashion that makes it difficult to contain market shocks. The relationship between CDSs and systemic risk is explored in detail in Part II.

II. SYSTEMIC RISK

Systemic risk is generally defined as the risk that a “trigger event” such as a market or institutional failure will cause a chain of consequences negatively affecting both market participants and the larger economy.⁸⁸ In the worst case scenario, the consequences of a systemic risk trigger event might encompass the failure of financial institutions or entire markets. Less severely, a trigger event could cause losses to financial institutions and volatility in financial markets. In any case, the consequences affect financial institutions, markets, or both.⁸⁹

Systemic risk differs from normal market risk, which is common to an entire market and not unique to any individual market participant.⁹⁰ Market fluctuations relating to market risk are inevitable and even desirable; they “facilitate[] market equilibrium and curb[] excessive interest rates or periods of inflation.”⁹¹ In contrast, systemic risk is the risk that market dynamics may cause an otherwise ordinary problem to spread, harming other market participants or, in the most dramatic scenario, causing an entire

86. In biology, a vector is defined as “[an] organism that transmits a pathogen[] . . . [or] any agent that acts as a carrier or transporter.” RANDOM HOUSE WEBSTER’S UNABRIDGED DICTIONARY 2108 (2d ed. 2001).

87. Schwarcz, *supra* note 85, at 221.

88. *Id.* at 198.

89. *Id.*; see also H.R. REP. NO. 97-420, at 1–2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583–84 (describing systemic risk as the risk that “the insolvency of one commodity or security firm [may] spread[] to other firms and possibl[y] threaten[] the collapse of the affected market”).

90. See Schwarcz, *supra* note 85, at 204 (“Although these downturns are sometimes conflated with systemic risk, they are more appropriately labeled *systematic* risk, meaning risk that cannot be diversified away and therefore affects most, if not all, market participants.”).

91. *Id.*

market or the entire financial system to collapse. It is noteworthy that even normal market fluctuations may trigger systemic problems.⁹²

The best-known illustration of a systemic risk scenario is the 1998 collapse of the hedge fund Long-Term Capital Management (LTCM). The Russian government defaulted on its bonds that year,⁹³ causing “LTCM to lose hundreds of millions of dollars and approach a default.”⁹⁴ Motivated by the fear of enormous losses to LTCM’s counterparties and the failure of multiple credit and interest rate markets,⁹⁵ “the Federal Reserve proactively stepped in to broker a settlement of LTCM’s debts.”⁹⁶ Notably, the systemic risk posed by LTCM’s near failure resulted from LTCM’s derivatives-based hedging strategy;⁹⁷ the derivatives used by LTCM provided the very linkages through which the repercussions of its default would have traveled.⁹⁸ An LTCM default presumably would have harmed counterparties to LTCM that were also linked to other institutions

92. *Id.* at 204 n.53 (citing Michael D. Bordo, Bruce Mizrach & Anna J. Schwartz, *Real Versus Pseudo-International Systemic Risk: Some Lessons from History* 8–9 (Nat’l Bureau of Econ. Research, Working Paper No. 5371, 1995), available at <http://ssrn.com/abstract=225434>).

93. See Desmond Eppel, Note, *Risky Business: Responding to OTC Derivative Crises*, 40 COLUM. J. TRANSNAT’L L. 677, 677 (2000) (“[T]he Russian government declared a debt moratorium and devalued the ruble on August 17, 1998 . . .”).

94. Schwarcz, *supra* note 85, at 201.

95. *Id.* at 201 (“Had Long-Term Capital . . . default[ed], its [derivatives] counterparties would have immediately ‘closed out’ their positions. If counterparties would have been able to close-out their positions at existing market prices, losses, if any, would have been minimal. However, if many firms had rushed to close-out hundreds of billions of dollars in transactions simultaneously, they would have been unable to liquidate collateral or establish offsetting positions at the previously-existing prices. Markets would have moved sharply and losses would have been exaggerated . . . [Moreover, as a result of these market moves,] there was a likelihood that a number of credit and interest rate markets would . . . possibly cease to function for a period of one or more days and maybe longer. This would have caused a vicious cycle: a loss of investor confidence, leading to a rush out of private credits, leading to further widening of credit spreads, leading to further liquidations of positions, and so on.” (third and fourth alterations in original) (quoting *Hedge Fund Operations: Hearing Before the H. Comm. on Banking and Fin. Servs.*, 105th Cong. 18–19 (1998) (statement of William J. McDonough, President, Fed. Reserve Bank of N.Y.), available at <http://newyorkfed.org/newsevents/speeches/1998/mcd981001.html>). For further discussion of the dynamics of LTCM’s collapse, see *infra* notes 183–89.

96. Schwarcz, *supra* note 85, at 201.

97. *Id.*

98. *Id.*

and markets.⁹⁹ Thus, LTCM's default would have "adversely affected many market participants with no [direct] connection to LTCM."¹⁰⁰

The specter of these widespread consequences makes systemic risk "the totem of choice for proponents of increased risk regulation."¹⁰¹ Ironically, "systemic failures are very rare events, indeed so rare that one has never been observed in modern economies."¹⁰² Perhaps because the threat of systemic failure is more theoretical than actual,¹⁰³ the question of how best to regulate systemic risk is hotly debated.¹⁰⁴ Before discussing approaches to regulating systemic risk, it is worth examining why regulation is an appropriate response to the problem.

A. Systemic Risk as a Tragedy of the Commons

Regulation is appropriate to control systemic risk because, without regulation, individual market participants will take

99. *Id.* at 221 ("[D]iversifying risk through hedging increases linkages among market participants, which . . . could . . . foster systemic risk. If an institution fails, it potentially would impact many more other institutions." (footnote omitted)).

100. Edwards & Morrison, *supra* note 27, at 100.

101. Eppel, *supra* note 93, at 689. Skepticism is warranted when systemic risk is invoked to prompt government action. Financial commentator Barry Ritholtz described systemic risk as the "buzzword du jour," claiming that government interventions in the financial system in response to systemic risk concerns "occur far more regularly than an honest definition of that phrase would require. Indeed, systemic risk has become the rallying cry of those who patrol the corridors of Washington, D.C., hats in hand, looking for a handout." BARRY RITHOLTZ & AARON TASK, BAILOUT NATION: HOW GREED AND EASY MONEY CORRUPTED WALL STREET AND SHOOK THE WORLD ECONOMY 5 (2009).

102. Eppel, *supra* note 93, at 689 (quoting Jón Daniélsson, *The Emperor Has No Clothes: Limits to Risk Modelling* 18 (London Sch. of Econ., Working Paper, 2001), available at http://www.seclabanki.is/uploads/files/Malstofa_050301-JD.pdf). Even so, institutional failures such as LTCM and AIG were thought to be potential trigger events capable of causing systemic failure; in both cases, the government intervened to forestall systemic failure.

103. *But see infra* notes 109–11 and accompanying text.

104. For example, recently, systemic failure concerns prompted a round of government bailouts. Post hoc bailouts are criticized for increasing moral hazard in the markets, especially in firms that are "too big to fail." David Lawder, *U.S. Bailout Program Increased Moral Hazard: Watchdog*, REUTERS, Oct. 21, 2009, <http://www.reuters.com/article/ousivMolt/idUSTRE59K0UQ20091021> (quoting OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS: OCTOBER 21, 2009, at 3, available at http://www.sig tarp.gov/reports/congress/2009/October2009_Quarterly_Report_to_Congress.pdf); *see also* RITHOLTZ & TASK, *supra* note 101, at 5 ("Perhaps what the government should be doing is acting to prevent systemic risk before it threatens to destabilize the world's economy, rather than merely cleaning up and bailing out afterward.").

insufficient measures to prevent systemic failure.¹⁰⁵ The motivation of market participants “is to protect themselves but not the system as a whole. Every firm has an incentive to restrain its risk taking in order to protect its capital No firm, however, has an incentive to limit its risk taking in order to reduce the danger of contagion for other firms.”¹⁰⁶ Given this incentive structure, systemic risk can be conceptualized as a tragedy of the commons because “the benefits of exploiting finite capital resources accrue to individual market participants, each of whom is motivated to maximize use of the resource, whereas the costs of exploitation . . . are distributed among an even wider class of persons.”¹⁰⁷ Protective measures taken by individual market participants will combat aspects of systemic risk,¹⁰⁸ but self-imposed regulation, without more, will not address the full range of problems posed by systemic risk.

Systemic failure would not only harm market participants but would also result in externalities negatively affecting the larger economy and society as a whole.¹⁰⁹ The former president of the Federal Reserve, Timothy Geithner (who became the Secretary of the Treasury in 2009), voiced this concern in 2008 when he testified before the Senate that

[t]he most important risk is systemic. . . . [Systemic risk] is not theoretical risk, and it is not something that the market can solve on its own. It carries the risk of significant damage to economic activity. Absent a forceful policy response, the consequences would be lower incomes for working families, higher borrowing costs for housing, education, and the expenses of everyday life, lower value of retirement savings, and rising unemployment.¹¹⁰

105. See Schwarcz, *supra* note 85, at 205–06 (discussing systemic risk as a tragedy of the commons); cf. Garret Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243, 1244 (1968) (defining and describing the tragedy of the commons).

106. PRESIDENT’S WORKING GROUP ON FIN. MKTS., *supra* note 24, at 31.

107. Schwarcz, *supra* note 85, at 206.

108. See *id.* at 231–34 (discussing ways in which the market regulates itself with varying degrees of success).

109. See *id.* at 207 (“Failure of the financial system can generate social costs in the form of widespread poverty and unemployment, which in turn can destroy lives and foster crime. . . . Protecting health and safety therefore should be additional goals of regulating systemic risk.” (footnote omitted)).

110. *Turmoil in U.S. Credit Markets: Examining the Recent Actions of Federal Financial Regulators: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs*, 110th Cong. 4 (2008) (statement of Timothy Geithner, President and CEO, Fed. Reserve Bank of N.Y.), available at http://banking.senate.gov/public/_files/OpgStmtGeithner4308Testimony.pdf.

Market participants would not be willing to internalize these societal costs,¹¹¹ and thus, in the absence of regulation, would exercise an insufficient degree of care to prevent systemic failure.

B. Systemic Risk Regulation

Even before the events of 2008, “[g]overnments and international organizations [were] calling for increased regulation of systemic risk.”¹¹² Although events in the last two decades have intensified the call for increased regulation,¹¹³ controlling systemic risk is not a new item on the legislative agenda.

Historical attempts to regulate systemic risk focused on the most important source of capital and thus the natural target for regulation: the banking system.¹¹⁴ But, given that firms increasingly have more access to “capital-market funding without going through banks or other intermediary institutions,”¹¹⁵ modern systemic risk models also consider nonbank financial institutions and market failures.¹¹⁶ The dynamics of systemic risk remain similar in both the banking system model and the more diffuse modern model. In both models, trigger events cause institutional failures, and the consequences travel “through linkages in a chain of relationships,” leading to even more institutional and market failures.¹¹⁷ In the banking system, “the linkages are interbank borrowings and the interbank clearing system

111. Schwarcz, *supra* note 85, at 206.

112. *Id.* at 194. Professor Schwarcz lists several government and nongovernment entities that displayed concern about the problem of systemic risk. *Id.* at 194–96.

113. The 1998 collapse of LTCM spurred a flurry of government activity concerned with reducing systemic risk. See Rhett G. Campbell, *Financial Markets Contracts and BAPCA*, 79 AM. BANKR. L.J. 697, 698 (2005) (“The financial markets amendments found in [the 2005 amendment of the Bankruptcy Code] . . . can be traced back to the near failure of [LTCM].”); Schwarcz, *supra* note 85, at 211 (“After the near failure of LTCM, several U.S. government agencies have attempted to study how to mitigate systemic risk . . .”).

114. See Schwarcz, *supra* note 85, at 198–211 (examining systemic risk in the context of banks and other financial institutions and listing regulations imposed on the banking system designed to control systemic risk, including federal insurance of bank deposits and mandatory minimum capital requirements).

115. *Id.* at 248; see also *id.* at 200 (“Companies today are able to obtain most of their financing through the capital markets without the use of intermediaries.”); *Turmoil in U.S. Credit Markets: Examining the Recent Actions of Federal Financial Regulators*, *supra* note 110, at 7 (“Over the past thirty years, we have moved from a bank-dominated financial system to a system in which credit is increasingly extended, securitized and actively traded in a combination of centralized and decentralized markets.”).

116. Schwarcz, *supra* note 85, at 213.

117. *Id.* at 201.

for payments.”¹¹⁸ In the modern systemic risk model, negative consequences “spread through capital-market linkages, rather than merely through banking relationships.”¹¹⁹

In accordance with the modern conception of systemic risk, one regulatory approach focuses on the linkages through which a trigger event can affect the market. As noted in the discussion of the LTCM crisis,¹²⁰ derivatives contracts are one linkage through which the repercussions of a firm’s failure may reach other market participants, creating the possibility that an individual institution’s failure may cause a systemic failure.¹²¹

Even though it is understood that the use of derivatives can exacerbate systemic risk, derivatives have historically enjoyed a light regulatory regime (relative to securities and other financial instruments). This lack of regulation has allowed derivatives markets to prosper. In light of the growth that derivative markets have experienced and their integral role in modern risk management, Congress has chosen to address derivative regulation by deploying what could charitably be described as indirect legislative solutions. Of these solutions, this Note is primarily concerned with the series of amendments to the Bankruptcy Code that created the Safe Harbor and thereby exempted derivatives from bankruptcy proceedings.¹²²

III. DERIVATIVES REGULATION

This Note focuses on the regulation of derivatives in the context of bankruptcy proceedings. In an attempt to give an accurate portrayal of the federal regulation of derivatives, this Part begins with a brief discussion of the history of derivatives regulation and the modern regulatory framework. The remainder of this Part discusses several concerns unique to derivatives in the bankruptcy context and

118. *Id.*

119. *Id.* at 200.

120. *See supra* Part II.

121. *See Eppel, supra* note 93, at 689 (“Systemic risk is the risk most frequently associated with derivatives in press reports and congressional testimony attempting to arouse public concern about the dangers of these financial products.”).

122. The first of these amendments was passed in 1982 and the latest in 2005. *See* H.R. REP. NO. 109-31(I) at 3, 20, 131–32 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 89, 105–06, 190–91 (justifying the 2005 amendments as “provisions designed to reduce systemic risk”); H.R. REP. NO. 97-420, at 2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583–84 (listing as a goal minimizing the “potentially massive losses and chain reactions that could occur if the market were to move sharply in the wrong direction”).

the de facto exemption of derivatives from normal bankruptcy proceedings—one approach taken by Congress to address the systemic risk problems posed by derivatives.

A. *A Brief Sketch of Derivatives Regulation*

The federal regulatory regime governing derivatives is the product of a long and convoluted history that began as early as 1864.¹²³ And although this history makes for an interesting read,¹²⁴ it says little about the body of federal law governing derivatives. It will suffice to note that, after passing the Commodity Exchange Act of 1936 (CEA),¹²⁵ which provided for federal regulation of all commodities and futures trading activities and required all futures contracts to be traded on a “contract market” (such as the Chicago Board of Trade),¹²⁶ Congress acted in 1974 to cure uncertainties about the legal status of newer forms of derivatives (which fell outside of the categories of derivatives expressly covered by the CEA) with the Commodity Futures Trading Commission Act.¹²⁷ This act created the Commodity Futures Trading Commission (CFTC), an oversight commission for the futures markets that is in some ways analogous to the SEC.¹²⁸ A quarter of a century later, Congress passed the Commodity Futures Modernization Act of 2000 (CFMA),¹²⁹ which is the source of most modern derivatives regulation.

Congress enacted the CFMA, among other reasons, “to promote innovation for . . . derivatives and to reduce systemic risk by

123. The earliest attempts to regulate derivatives failed: the Anti-Gold Futures Act of 1864 was repealed by Congress two weeks after its enactment and the Future Trading Act of 1921 was held unconstitutional by the Supreme Court only one year later in *Hill v. Wallace*, 259 U.S. 44 (1922). JERRY W. MARKHAM, *THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION* 7, 13 (1987).

124. See generally MARKHAM, *supra* note 123 (examining the impact of regulation on the development and growth of the commodity futures trading market). The modern regulatory structure began with the Grain Futures Act of 1921 (GFA), which regulated grain futures contracts traded on exchanges. See *Bd. of Trade v. Olsen*, 262 U.S. 1, 43 (1923) (upholding the validity of the GFA). The GFA was subsequently replaced by the Commodity Exchange Act of 1936 (CEA), 7 U.S.C. §§ 1–27 (2006).

125. Commodity Exchange Act of 1936 (CEA), 7 U.S.C. §§ 1–27 (2006).

126. *Id.* § 6; MARKHAM, *supra* note 123, at 13.

127. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389; see also Lynch, *supra* note 45, at 1377 (describing the passage of the act).

128. Congress delegated power to both the SEC and the CFTC to regulate their respective financial instruments. Lynch, *supra* note 45, at 1379.

129. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, § 1(a)(5), 114 Stat. 2763, 2763A-365 (codified in scattered sections of 7, 11, 12, and 15 U.S.C.).

enhancing legal certainty in the markets for certain . . . derivatives transactions[, and] to reduce systemic risk and provide greater stability to markets during times of market disorder.”¹³⁰ These principles indicate that Congress sought to create a regulatory framework that addresses the dangers of systemic risk without stifling the innovation in derivatives markets with excessive regulation.

The regulatory regime established by the CFMA treats OTC and exchange-traded derivatives very differently. Whereas exchange-traded derivatives are generally subject to regulation under both the CEA and the CFMA, OTC derivatives have enjoyed an almost complete lack of regulation for as long as they have been used.¹³¹ OTC derivatives owe their lack of regulation to the failure of early regulatory efforts to anticipate the development of an OTC market for derivatives.¹³² This lack of regulation allowed the OTC market to develop—and flourish—with little government oversight, laying the groundwork for the popular belief that the OTC derivatives market flourished precisely because it lacked regulation.¹³³

This belief is well founded: the OTC derivatives market has demonstrated that it has the capacity to address problems through self-regulation and market initiatives.¹³⁴ The self-sufficiency of the OTC market helps to explain why it has historically escaped federal regulation.

B. Derivatives in Bankruptcy Proceedings

Congress’s general reluctance to encumber the OTC derivatives market is exemplified by the Bankruptcy Code’s treatment of OTC derivatives. Under the series of amendments to the Bankruptcy Code that make up the Safe Harbor,¹³⁵ OTC derivatives are generally exempt from bankruptcy safeguards. Even after the debtor initiates bankruptcy proceedings, the Safe Harbor allows the nondebtor derivative counterparty to terminate derivatives contracts and seize

130. 7 U.S.C. § 1 (2006).

131. Jerry W. Markham, “Confederate Bonds,” “General Custer,” and the Regulation of Derivative Financial Instruments, 25 SETON HALL L. REV. 1, 2 n.6 (1994).

132. See *supra* note 126 and accompanying text.

133. See Lynch, *supra* note 45, at 1380–83 (tying the explosion in OTC derivatives to a general lack of regulation).

134. See generally *id.* (describing the OTC derivatives industry’s effort to self-regulate). For a discussion of the market’s response to Lehman Brothers’ bankruptcy filing, see *infra* Part IV.C.

135. For a discussion of the Safe Harbor, see *infra* Part III.B.2.

collateral from the debtor's assets.¹³⁶ No other financial instrument receives such preferential treatment under the Bankruptcy Code.¹³⁷ The purpose of these favorable amendments, according to the legislative history, is to regulate systemic risk.¹³⁸ But understanding how Congress intends this treatment to reduce systemic risk requires understanding the basic mechanics of bankruptcy proceedings.

1. *Bankruptcy Proceedings Generally.* Chapter 11 of the Bankruptcy Code, which governs bankruptcy proceedings in which the debtor plans to reorganize and continue its business,¹³⁹ “is intended to permit the debtor to rehabilitate itself while simultaneously protecting creditors.”¹⁴⁰ The “central idea” of Chapter 11 reorganizations is to preserve going-concern surplus.¹⁴¹ Going-concern surplus, which is “the value a firm has above and beyond the liquidation value of its discrete assets,”¹⁴² only exists

if the firm's assets are worth more to the firm than to outsiders. This asymmetry arises when assets are customized to meet a firm's idiosyncratic needs or the needs of firms in the same industry These specialized assets cannot be readily redeployed by other firms (if the assets are firm specific) or by firms outside the industry (if they are industry specific).¹⁴³

A bankruptcy filing creates an estate consisting of “all legal or equitable interests of the debtor in property as of the commencement of the case,”¹⁴⁴ and, more importantly, imposes an automatic stay on creditors.¹⁴⁵ The stay prohibits creditors from taking “any act to obtain possession of property of the [bankruptcy] estate . . . or to

136. See *supra* note 23.

137. Edwards & Morrison, *supra* note 27, at 91.

138. See H.R. REP. NO. 109-31 at 3, 20, 131–32 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 89, 105–06, 190–91 (justifying the 2005 amendments as “provisions designed to reduce systemic risk”); H.R. REP. NO. 97-420, at 2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583–84 (invoking systemic risk to justify the initial exemption for derivatives from automatic stay).

139. 11 U.S.C. §§ 1101–74 (2006).

140. *In re PPI Enters. (U.S.), Inc.*, 324 F.3d 197, 209 (3d Cir. 2003).

141. Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 754 (2002). The preservation of going-concern surplus is central to Chapter 11 bankruptcy law because it encourages ex ante investment in firms and maximizes creditor recovery ex post. Edwards & Morrison, *supra* note 27, at 108 n.69.

142. Baird & Rasmussen, *supra* note 141, at 754.

143. Edwards & Morrison, *supra* note 27, at 111.

144. 11 U.S.C. § 541(a)(1) (2006).

145. *Id.* § 362(a).

exercise control over property of the estate.”¹⁴⁶ Because it freezes the debtor’s assets and thwarts otherwise valid claims to these assets, the automatic stay is perhaps the most powerful effect of a bankruptcy filing.

The bankruptcy estate includes both physical assets and the debtor’s interest in executory contracts.¹⁴⁷ Executory contracts are agreements in which “the obligations of both the bankrupt and the other party to the contract are ‘so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other.’”¹⁴⁸ Accordingly, the automatic stay generally prohibits creditors from terminating executory contracts for any reason.¹⁴⁹ Additionally, the automatic stay provision nullifies so-called ipso facto contractual clauses,¹⁵⁰ or clauses that “specif[y] the consequences of a party’s bankruptcy.”¹⁵¹ Typically, an ipso facto clause specifies that a bankruptcy filing will result in an automatic “default and a termination payment.”¹⁵²

The Bankruptcy Code also gives the debtor power, “subject to the court’s approval, [to] assume or reject any executory contract” impacted by the automatic stay.¹⁵³ The purpose of this provision is to help the financially distressed debtor maximize the value of its assets by allowing it to assume beneficial contracts and reject unattractive contracts. This practice, known as cherrypicking, is undesirable for creditors holding executory contracts with the debtor but is crucial to the rehabilitative function of Chapter 11 bankruptcy.

2. *The Safe Harbor.* Even though derivatives are typically executory contracts,¹⁵⁴ the Safe Harbor gives counterparties limited

146. *Id.* § 362(a)(3).

147. *In re Carroll*, 903 F.2d 1266, 1270–71 (9th Cir. 1990).

148. *In re Gov’t Sec. Corp.*, 111 B.R. 1007, 1011 (S.D. Fla. 1990) (quoting Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973)). While the Bankruptcy Code does not define “executory contract,” the legislative history of § 365 states that an executory contract is a contract in which performance remains due on both sides. H.R. REP. NO. 95-595, at 347 (1977), *reprinted in* 1978 U.S.C.A.N. 5963, 6303.

149. *See* 11 U.S.C. § 362 (detailing comprehensive limits on a creditors’ ability to collect).

150. *Id.* § 365(e).

151. BLACK’S LAW DICTIONARY 847 (8th ed. 2004).

152. *See, e.g., In re Mirant Corp.*, 440 F.3d 238, 240 (5th Cir. 2006).

153. 11 U.S.C. § 365(a).

154. Guinn & Harvey, *supra* note 33, at 1137; *see also* Debtor’s Motion Pursuant to Sections 105(a), 362 and 365 of the Bankr. Code to Compel Performance of Metavante Corp.’s Obligations Under an Executory Contract and to Enforce the Automatic Stay at 7, *In re Lehman Brothers Holdings Inc.*, 2009 WL 1569988 (Bankr. S.D.N.Y. May 29, 2009) (Trial

power to enforce ipso facto clauses in certain derivatives contracts (including CDSs).¹⁵⁵ Because ipso facto termination clauses are standard provisions in derivatives contracts, the Safe Harbor provisions effectively exempt derivatives contracts from the automatic stay and, consequently, the possibility of cherrypicking. The Safe Harbor is only available, however, “to the extent that [counterparties] seek to liquidate, terminate, or accelerate their contracts with the Debtors, or offset or net out their positions.”¹⁵⁶

The legislative history of the Safe Harbor indicates that this special treatment of derivatives is aimed at reducing systemic risk by maintaining liquidity in the market in the event of default.¹⁵⁷ The Safe Harbor maintains market liquidity because it permits counterparties to terminate their contracts, unfreezing the previously illiquid assets and freeing the counterparties to deploy the assets elsewhere in the market.¹⁵⁸ By allowing counterparties to terminate their relationship with the debtor, the Safe Harbor “minimizes the potentially massive losses [to counterparties] and chain reactions that could occur if the market were to move sharply in the wrong direction.”¹⁵⁹ Without the Safe Harbor, when the debtor counterparty filed for bankruptcy the automatic stay would freeze the contractual relationship between the counterparties, leaving the nondebtor counterparty exposed to market movements affecting the value of the contract.

The effects of the Safe Harbor are not completely salutary. For example, the Safe Harbor opens the door to the threat that a run on

Motion, Memorandum and Affidavit) [hereinafter Debtor’s Motion] (arguing that “[t]he [derivative contract at issue] is an executory contract because material performance—i.e., payment obligations—remains due by both [parties]”).

155. See *supra* note 23. The Safe Harbor has been described as “a narrow exception to the general rule that *ipso facto* clauses are void.” Debtor’s Motion, *supra* note 154, at 11.

156. Debtor’s Motion, *supra* note 154, at 11 (citing 11 U.S.C. § 560). For example, when faced with a counterparty that refused to pay money owed to the debtor under a swap agreement, the debtor argued that “withholding performance . . . is not permitted under the plain terms of the Safe Harbor Provisions.” *Id.*

157. COLLIER’S BANKRUPTCY CODE: PART 1, at 904 (Alan N. Resnick & Henry J. Sommer eds., 2008) (explaining that the purpose of these provisions is to “ensure that nothing interferes with the prompt liquidation of a debtor’s positions, due to the fear that the insolvency of one party could trigger a chain reaction of insolvencies among others who carry accounts for that party, which might compromise the integrity of the securities markets”).

158. See, e.g., PRESIDENT’S WORKING GROUP ON FIN. MKTS., *supra* note 24, at 40 (“The ability to terminate financial contracts upon a counterparty’s insolvency . . . permits the solvent parties to replace terminated contracts without incurring additional market risk and thereby preserves liquidity.”).

159. H.R. REP. NO. 97-420, at 2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583–84.

the debtor will cause an even greater liquidity shortage with “the potential to spill over to other firms and markets,” leading to widespread instability.¹⁶⁰ In addition, the Safe Harbor gives counterparties the freedom to engage in opportunistic behavior that can further destabilize the distressed firm and thereby increase the risk of failure. Thus, the Safe Harbor gives rise to both costs and benefits. The question, then, is whether the salutary effects of the Safe Harbor outweigh its costs.

IV. EVALUATING THE SAFE HARBOR

This Note argues that the Safe Harbor likely produces costs in excess of its benefits and thus does not optimally reduce systemic risk. To be sure, the Safe Harbor combats systemic risk by facilitating speedy settlement of derivatives contracts and thereby maintains liquidity in troubled markets.¹⁶¹ But the Safe Harbor is also a source of systemic risk because it allows derivatives counterparties to run on the assets of a distressed firm. A run or “grab race” (this Note uses the terms interchangeably) occurs when counterparties race to seize collateral from the distressed firm’s assets; this can result in less efficient distribution of those assets than would otherwise occur under bankruptcy proceedings, or even in the event of the firm’s failure. In both cases, the costs created by the run are borne by some of the distressed firm’s creditors.¹⁶² These costs, in the aggregate, may lead to systemic consequences that ultimately eclipse the benefit of the liquidity provided by the Safe Harbor.

In order to illustrate the complex effects of the Safe Harbor, this Part examines two case studies: the collapse of LTCM and the bankruptcy of Lehman Brothers (Lehman). The events that transpired in the LTCM scenario demonstrate how the Safe Harbor opens the door to an alternative type of systemic risk that arises when

160. Edwards & Morrison, *supra* note 27, at 105–06.

161. See PRESIDENT’S WORKING GROUP ON FIN. MKTS., *supra* note 24, at 40 (“The ability to terminate financial contracts upon a counterparty’s insolvency enhances market stability. . . . [by] limit[ing] losses to solvent counterparties and permit[ting] the solvent parties to replace terminated contracts without incurring additional market risk and thereby preserv[ing] liquidity.”).

162. See Thomas H. Jackson, *Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules*, 60 AM. BANKR. L.J. 399, 402 (1986) (“Creditors will attempt to grab assets away from the debtor before others can reach them. This can make a bad situation worse, for it can destroy any going-concern value that might otherwise exist if the creditors would cooperate and leave the assets in place.”).

counterparties run on a distressed firm's assets. The events of the Lehman bankruptcy demonstrate that even though the Safe Harbor may lead to harmful behavior by a distressed firm's counterparties, it can help stabilize a troubled market. And although these two cases ultimately provide equivocal evidence as to the effectiveness of the Safe Harbor, they show that the Safe Harbor is in need of repair.

A. *The Costs of the Safe Harbor: The Grab Race and Opportunistic Behavior*

The Safe Harbor creates costs by allowing counterparties to run on a distressed firm's assets and engage in opportunistic behavior that may further harm the distressed firm. This Section looks at each cost in turn.

1. *The Grab Race.* By allowing derivatives counterparties to circumvent the automatic stay and exercise their claims against a financially distressed firm,¹⁶³ the Safe Harbor allows creditors to run on a distressed firm in a grab race for the firm's assets.¹⁶⁴ The mechanics of a run by CDS counterparties under the Safe Harbor are as follows: a counterparty is free to invoke an ipso facto clause in a CDS contract with a distressed firm (generally if that firm files for bankruptcy). This extends to both protection buyers and sellers; either party may terminate the contract and claim what it is owed. As a general rule, however, the protection seller will have only a small claim (or no claim at all) against the protection buyer's assets. This is true because the protection buyer pays as a premium either a single upfront payment or a series of periodic payments.¹⁶⁵ In contrast, the protection seller's potential liability under the contract is tied to the performance of the reference subject. If, at the time of bankruptcy, the distressed protection seller owes money to the protection buyer (this is known as an "in the money" contract),¹⁶⁶ the protection buyer will invoke the ipso facto clause and terminate the contract; subsequently, the protection buyer will act to secure its collateral. The act of seizing collateral from the distressed protection seller's

163. See *supra* note 136.

164. See *supra* note 162.

165. Kayle, *supra* note 58, at 224.

166. Stephen R. Krufft, *Cross-Default Provisions in Financing and Derivatives Transactions*, 113 BANKING L.J. 216, 231 n.24 (1996) ("In the typical derivative . . . a party may at any time be 'in the money,' meaning that it is entitled to a payment from its counterparty, or 'out of the money,' meaning that it will be required to pay its counterparty.").

efficient and equitable fashion.¹⁷⁴ In this way, bankruptcy law avoids the unnecessary costs that a grab race would otherwise impose on both the debtor and slower creditors.

In the absence of bankruptcy protections, the grab race can have a powerful destabilizing effect on the debtor firm by “destroy[ing] any going-concern value that might otherwise exist if the creditors would cooperate and leave the assets in place.”¹⁷⁵ Moreover, the distressed firm’s slower creditors will be unable to satisfy their claims and thereby will be harmed by the grab race.

The grab race does, however, have at least one positive aspect: it allows for a speedy distribution of the debtor’s assets. Bankruptcy proceedings take time, and for the duration of the proceedings the ultimate values of the claims of many creditors may be uncertain. Thus, without regard for whether their claims are ultimately fulfilled, creditors benefit from an increase in the speed of the settlement of their claims against the debtor. Markets also benefit when creditors resolve uncertainties regarding their exposure to market movements or distressed firms. These positive values—speed and certainty—must be weighed against the costs of the grab race in order to clarify whether the ultimate value of the Safe Harbor is positive or negative.

2. *Opportunistic Behavior.* By exempting derivatives from the automatic stay, the Safe Harbor amplifies the power asymmetry inherent in bankruptcy proceedings. One way in which the automatic stay maximizes the financially distressed debtor’s rehabilitative chances is by placing it in a position to bargain with its creditors. But when the stay does not apply, the debtor has little bargaining power and creditors are free to act opportunistically. Take a typical CDS transaction as an example: a counterparty is free to invoke an ipso facto clause and terminate a contract upon bankruptcy, and assuming that the contract is in-the-money (or very nearly so), a protection seller is more likely to terminate if the price of the contract has gone up.¹⁷⁶ In the case of a CDS contract, price would increase along with an increased risk of default on the part of the reference entity. For example, if a CDS references the bonds of an issuer whose credit

174. Under U.S. bankruptcy law, the claims of creditors may have different priorities depending on the substance of their claims against the debtor. Generally speaking, the claims of secured creditors have priority over unsecured creditors. 11 U.S.C. § 1129(b)(2)(A)(i)(II) (2006). The claims of unsecured creditors are prioritized in accordance with the nine-level hierarchy established in Section 507 of the Bankruptcy Code. *Id.* § 507.

175. Jackson, *supra* note 162, at 402.

rating is downgraded, then the price of the CDS will increase.¹⁷⁷ In such a case, if the protection seller terminates the derivative contract, the debtor will be exposed to a more risky reference subject and it will be more expensive for the debtor to secure a replacement hedge.¹⁷⁸

Moreover, if there is a downside to the derivative contract, it is assured to go to the debtor.¹⁷⁹ To illustrate, assume that the debtor has purchased a CDS protecting it against a credit downgrade of one or more of several auto manufacturers that are its major clients. If, at the time of bankruptcy, one or more of the auto manufacturers is at an increased risk of default (relative to when the CDS was issued), then the CDS is a valuable asset. In this scenario, the nondebtor protection seller will terminate either because it no longer wishes to sell protection on the auto manufacturer given its increased risk of default or because it wishes to reissue the contract to another party at a higher price. If at the time of bankruptcy, however, the auto manufacturers are not at an increased risk of default, then the protection seller will likely not terminate the CDS,¹⁸⁰ but (possibly) retains the option to do so unilaterally.¹⁸¹ Thus, the Safe Harbor shifts costs onto distressed firms,¹⁸² costs that could potentially increase the likelihood of failure. And if the firm is large enough, such failure may have systemic risk implications.

176. See Partnoy & Skeel, *supra* note 10, at 1050 (explaining that counterparties may have an incentive to terminate a derivative strategically).

177. See *id.* (explaining that a CDS is more valuable when “the likelihood of issuer default or downgrade has increased”).

178. *Id.*

179. See Shmuel Vasser, *Derivatives in Bankruptcy*, 60 BUS. LAW. 1507, 1542 (2005) (“[O]nly the non-debtor counterparty obtains the upside of a derivative in a bankruptcy, not the debtor.”).

180. This illustration is cobbled together from hypotheticals in Partnoy & Skeel, *supra* note 10, at 1050, and Vasser, *supra* note 179, at 1542.

181. It is unclear how long the nondebtor may wait without taking action under the Safe Harbor before the nondebtor’s right to terminate the contract is waived. In *In re Lehman Bros. Holdings Inc.*, Nos. 08-13555 (JMP) and 08-13900 (JMP), 2009 WL 3088795 (Bankr. S.D.N.Y. Sept. 25, 2009), the debtor argued for the court to invalidate a provision in the standard contract governing derivative agreements permitting the nondefaulting party to suspend payment otherwise owed under the contract while an event of default was ongoing. Debtor’s Motion, *supra* note 154, at 6, 10–11. The debtor argued that a counterparty who refuses to make payments under their contract and does not attempt to “liquidate, terminate, or accelerate their contract” in accordance with the Safe Harbor is “withholding performance[, which] . . . is not permitted under the plain terms of the Safe Harbor Provisions.” *Id.* at 11

182. See Partnoy & Skeel, *supra* note 10, at 1050 (“[Strategic] terminat[ion] mak[es] it much more expensive for the debtor to enter a new hedging contract.”).

B. *Revisiting LTCM: When the Safe Harbor Hurts More Than It Helps*

The possible systemic consequences of a run on a distressed firm under the Safe Harbor are best illustrated by the facts surrounding the near failure of LTCM.¹⁸³ When it became apparent that LTCM was on the brink of filing for bankruptcy, the Federal Reserve Bank of New York intervened to bail out the distressed hedge fund. The president of the Federal Reserve, William McDonough, explained that the action was necessary because the “abrupt and disorderly closeout of [LTCM]’s positions would pose unacceptable risks to the American economy.”¹⁸⁴ McDonough elaborated that this scenario presented the “likelihood that a number of credit and interest rate markets would experience extreme price moves and probably cease to function This would have caused a vicious cycle. A loss of investor confidence . . . leading to further liquidation of positions, and so on.”¹⁸⁵ Essentially, McDonough described the possibility of a systemic failure resulting from the rush of LTCM’s counterparties to simultaneously liquidate “hundreds of billions of dollars of derivatives contracts.”¹⁸⁶

The Federal Reserve intervened to avoid the probable systemic consequences of counterparties terminating derivatives contracts under the Safe Harbor and seizing collateral from LTCM’s assets.¹⁸⁷ Had the Federal Reserve not intervened, and had LTCM filed for bankruptcy, the resulting run on LTCM’s assets would likely have had systemic consequences “adversely affect[ing] many market participants with no connection to LTCM.”¹⁸⁸ Those creditors who arrived first would have received collateral, quickly depleting the assets of the firm and leaving nothing for latecomers. This, in turn, would have rendered other creditors unable to meet their own obligations. In addition, the confusion of multiple counterparties simultaneously terminating their outstanding derivatives contracts

183. See Schwarcz, *supra* note 85, at 201 (endorsing the view that the rush of counterparties to close out derivatives contracts would have had systemic consequences). *But see* Edwards & Morrison, *supra* note 27, at 103–06 (rationalizing the role of the Safe Harbor provisions in the LTCM crisis by invoking their lack of a role in the Enron failure, which posed no systemic threat despite similar circumstances).

184. *Hedge Fund Operations*, *supra* note 95, at 19.

185. *Id.*

186. Edwards & Morrison, *supra* note 27, at 100.

187. *Id.*

188. *Id.*

with LTCM would have further reduced trading in the affected markets. The rush of counterparties closing out derivatives contracts with LTCM “would have resulted in tremendous uncertainty about how far prices might move,” and most market participants would be unwilling to trade in such volatile conditions.¹⁸⁹

C. Lehman Brothers: The Safe Harbor Doing Its Job

The outcome of the Lehman Brothers bankruptcy illustrates that the Safe Harbor helps to calm troubled markets despite having the potential to harm the distressed firm. On the one hand, the Safe Harbor enabled the OTC derivatives market to respond swiftly and effectively to Lehman’s bankruptcy with a series of initiatives that resolved much of the uncertainty in the \$57.3 trillion CDS market.¹⁹⁰ On the other hand, the Safe Harbor enabled counterparties with Lehman to engage in opportunistic behavior that harmed the firm and its creditors. On the whole, however, it appears that in Lehman’s case the Safe Harbor did more good than harm.

As of this Note’s publication, Lehman’s bankruptcy filing is the biggest in history.¹⁹¹ This event left financial markets across the globe “in cryogenesis” as market participants struggled to sort out the uncertainties caused by Lehman’s filing.¹⁹² This was no small task in the CDS market, in which Lehman played a “central role” as both a counterparty and a reference entity.¹⁹³ Lehman’s bankruptcy triggered ipso facto clauses in “CDS contracts referencing Lehman, and . . . terminate[d] the contracts that the firm had entered into as a counterparty.”¹⁹⁴ To complicate matters, there was no reliable public information about the “volume of CDS contracts referencing Lehman or the net amounts required to settle them The absence of such

189. *Id.*

190. Ingo Fender, Allen Frankel & Jacob Gyntelberg, *Box 1: Three Market Implications of the Lehman Bankruptcy*, in Ingo Fender & Jacob Gyntelberg, *Overview: Global Financial Crisis Spurs Unprecedented Policy Actions*, BIS Q. REV., Dec. 2008, at 6, 6, available at http://www.bis.org/publ/qrtrpdf/r_qt0812x.htm.

191. Jonathan D. Glater & Gretchen Morgenson, *Firm’s Creditors, Large and Small, Compete for a Piece of What’s Left*, N.Y. TIMES, Sept. 16, 2008, at C8 (“Lehman lists total assets of \$639 billion—more than the gross domestic product of Argentina and roughly 10 times the size of Enron when it filed for bankruptcy in 2001.”).

192. Bo Peng, *Lehman CDS Net Settlement Only \$6B: What Does It Mean?*, SEEKING ALPHA, Oct. 13, 2008, <http://seekingalpha.com/article/99654-lehman-cds-net-settlement-only-6b-what-does-it-mean>.

193. Fender et al., *supra* note 190, at 6.

194. *Id.*

information created great uncertainty about the capacity of already strained money markets to accommodate the anticipated corresponding liquidity needs.”¹⁹⁵

Leaders in the OTC derivatives market joined together to repair the damage wrought by Lehman’s bankruptcy.¹⁹⁶ The result of their efforts was a net settlement payment of \$5.2 billion from sellers of CDS protection on Lehman to their counterparties.¹⁹⁷ The exchange of this relatively small sum had “no noticeable impact on liquidity conditions at the time of settlement,”¹⁹⁸ but the settlement did ease some of the uncertainties that likely contributed to the volatility of capital markets following the bankruptcy filing.¹⁹⁹

Even as the Safe Harbor provided the means for market participants to mend the OTC market, it also gave some counterparties the means to evade their liabilities to Lehman. In accordance with the Safe Harbor, counterparties to which Lehman owed money were “terminating their contracts with Lehman . . . [and] trying to close [their derivatives] positions and come up with [settlement] values.”²⁰⁰ But as predicted,

195. *Id.*

196. First, an “extraordinary trading session” was organized just before the bankruptcy filing to help major derivatives dealers net counterparty positions involving Lehman and “enter[] into transactions with other participants that . . . fully or partially offset OTC derivatives positions that they have with Lehman.” Press Release, Int’l Swaps & Derivatives Ass’n, Lehman Risk Reduction Trading Session and Protocol Agreement (Sept. 14, 2008), available at <http://www.isda.org/press/press091408lehman.html>. Second, an auction was conducted among CDS dealers to determine the price of Lehman’s bonds, which established the amount that CDS sellers would have to pay their counterparties. Mary Williams Walsh, *Insurance on Lehman Debt Is the Industry’s Next Test*, N.Y. TIMES, Oct. 11, 2008, at B1. Finally, the Depository Trust and Clearing Corporation, which provides clearance, settlement, and information services for over-the-counter derivatives, closed out \$72 billion in CDS contracts referencing Lehman. Press Release, Depository Trust & Clearing Corp., DTCC Successfully Closes Out Lehman Brothers Bankruptcy (Oct. 30, 2008), available at http://www.dtcc.com/news/press/releases/2008/dtcc_closes_lehman_cds.php.

197. Press Release, Depository Trust & Clearing Corp., *supra* note 196.

198. Fender et al., *supra* note 190, at 7.

199. *Id.* Still, the settlement left banks and other credit providers uncertain about the potential liabilities of trading partners: “Banks know how much they’re liable for. But they don’t know how much others are [liable for], including their hedge fund clients.” Peng, *supra* note 192.

200. Glater & Morgenson, *supra* note 191 (quoting Robert G. Pickel, CEO, Int’l Swaps & Derivatives Ass’n). About 85 percent of Lehman’s trading partners terminated their derivatives contracts, and “roughly 800 counterparties, mostly small players facing hefty terminations fees, opted to leave about 6,000 Lehman trades outstanding.” Serena Ng & Mike Spector, *The Specter of Lehman Shadows Trade Partners: Derivatives Pacts Remain in Limbo for Municipalities, Firms*, WALL ST. J., Sept. 17, 2009, at C1.

contemporaneous with Lehman's bankruptcy, some counterparties owing money to Lehman tried "to slip away into the night [because i]t is a waste of precious time for the bankruptcy trustee to have to chase people down."²⁰¹ Some of Lehman's clients "stopped paying when Lehman filed for bankruptcy protection, prompting a series of lawsuits from Lehman's estate."²⁰² As of this Note's publication, Lehman has only been able to recoup from its derivatives counterparties "\$6 billion . . . out of a targeted \$12 billion."²⁰³ This money recovered from Lehman's derivatives business is used to pay out on its creditors' claims.²⁰⁴

These two cases highlight the central conflict in using the Safe Harbor to regulate systemic risk. On the one hand, as exemplified by the Federal Reserve's rationale for bailing out LTCM, there is a risk that the unrestrained liquidation of derivatives contracts held by a large financial institution can lead to "another form of systemic risk, namely the risk that a 'run' by derivatives counterparties on the debtor will itself destabilize financial markets."²⁰⁵ On the other hand, Lehman's bankruptcy showed that market participants can work together under the Safe Harbor to resolve uncertainties and stabilize the market. Nevertheless, Lehman's lesson is ultimately equivocal as the settlement did little to enhance liquidity in the market.²⁰⁶

There are at least two complicating factors that dilute the lessons of these two cases. First, Lehman filed for bankruptcy whereas LTCM did not; the systemic dangers posed by LTCM's bankruptcy were preempted by the Federal Reserve's intervention. And second, because Lehman was a financial enterprise with assets consisting almost entirely of financial contracts, it was not a typical candidate for Chapter 11 reorganization.²⁰⁷ This means that the Lehman bankruptcy

201. Glater & Morgenson, *supra* note 191 (quoting David A. Skeel, Jr., Law Professor, University of Pennsylvania). According to the head of Lehman's derivatives legal team, the process of reconciling the derivatives is "unbelievably time-consuming." Ng & Spector, *supra* note 201 (quoting Locke McMurray, head of Lehman's derivatives legal team).

202. Ng & Spector, *supra* note 200. One of these cases, *In re Lehman Bros. Holdings Inc.*, is discussed *supra* at note 181.

203. Ng & Spector, *supra* note 201.

204. *Id.*

205. Edwards & Morrison, *supra* note 27, at 94.

206. See PRESIDENT'S WORKING GROUP ON FIN. MKTS., *supra* note 24, at 40 (describing the liquidity benefits of the Safe Harbor provision).

207. See Edwards & Morrison, *supra* note 27, at 114 ("The assets of [financial enterprises] consist almost entirely of financial contracts. Although much talent and energy may have been spent to assemble and manage its contracts, there is little or no going-concern surplus in an

was less concerned with rehabilitation than with the orderly liquidation of the firm's assets. The negative effects of the Safe Harbor should be less apparent in this type of case because there is no rehabilitation effort for it to hinder. Any run on Lehman's assets would have been unlikely to result in serious costs that could have been avoided through bankruptcy proceedings because, as a firm possessing primarily financial assets, Lehman had little going-concern surplus to preserve.²⁰⁸

Even though the evidence is murky, the Lehman case indicates that there is a danger that the Safe Harbor may not work as Congress intended. The liquidity benefits produced by the Safe Harbor may be outweighed by the corresponding losses caused by opportunistic behavior and, if the firm has going-concern surplus to preserve, the costs of the grab race. This is especially true when dealing with derivatives that are more valuable to the debtor than to the counterparty, because the liquidation of these derivatives will result in a net loss. The aggregate effect of these losses is a greater likelihood of debtor failure and the concomitant systemic consequences. Because the purpose of the Safe Harbor is to reduce systemic risk, there is little reason why it should apply to such derivatives.

V. NARROWING THE SAFE HARBOR

The Safe Harbor would better reduce systemic risk if it did not apply to CDSs used to hedge against a risk to the firm's assets or investments.²⁰⁹ In the rehabilitative context of Chapter 11 bankruptcy, the following maxim answers the question of whether the automatic stay should apply to a particular asset: "if the asset is worth more in the hands of the debtor than it would be in the hands of a third party, the stay should not be lifted."²¹⁰ Hedging CDSs—like insurance contracts—are likely worth more in the debtor's hands.²¹¹ They

insolvent [financial enterprise]. If a [financial enterprise] is insolvent, it is because the value of its portfolio has diminished . . .").

208. *Id.*

209. For a discussion of hedging CDSs, see *supra* notes 66–75 and accompanying text.

210. JACKSON, *supra* note 169, at 183.

211. See *Holland Am. Ins. Co. v. Sportservice, Inc. (In re Cahokia Downs, Inc.)*, 5 B.R. 529, 530 (Bankr. S.D. Ill. 1980) ("[M]aintenance of insurance . . . is essential for the rehabilitation of the debtor and the protection of the creditors."). On the other hand, the Safe Harbor should still apply to "naked" CDSs. In a naked CDS, the CDS holder has not purchased the CDS to

protect against risks to assets and investments, and, if the CDS is terminated, the debtor will most likely have to pay a premium to replace the hedge (if a replacement can be found at all). These costs of allowing CDSs to be terminated under the Safe Harbor increase the probability of debtor failure, and firm failure is a classic systemic risk trigger event.²¹² It follows that the inclusion of hedging CDSs within the Safe Harbor may undermine its ultimate goal of reducing systemic risk.

A. *The Case for Narrowing the Safe Harbor*

1. *Hedging CDSs Are Analogous to Insurance Contracts.* In terms of economic substance, CDSs used to hedge a risk are very similar to insurance contracts.²¹³ Purchasers enter into a hedging CDS to “insure” an interest in an investment or asset against the risk that a change in the credit quality of the reference subject will damage that interest.²¹⁴ The analogy to insurance is not perfect,²¹⁵ but the differences between the two types of contract are largely immaterial. CDSs, when used to hedge against the possibility of default, “have payouts that are economically similar to insurance contracts.”²¹⁶

Insurance contracts, as assets of the bankruptcy estate, are subject to the automatic stay, so insurers are forbidden from terminating an insurance policy when the policyholder files for

protect against a risk to investments or assets, so the CDS is merely a bet on the default of the reference entity. For a discussion of naked CDSs, see *supra* notes 76–79 and accompanying text.

212. For a discussion of systemic risk trigger events, see *supra* notes 88–89 and accompanying text.

213. See *Merrill Lynch Int’l v. XL Capital Assurance Inc.*, 564 F. Supp. 2d 298, 300 (S.D.N.Y. 2008) (“A credit default swap is an arrangement similar to an insurance contract.”); Partnoy & Skeel, *supra* note 10, at 1050 (describing the similarities and differences between CDSs and normal insurance policies).

214. For example, most hedging CDSs protect a stream of income (from a bond or other security) against the possibility that the obligor will default or otherwise be unable to meet its obligations.

215. For a detailed discussion of the differences between CDSs and standard insurance policies, see Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 423–24 (2007). Professor Lubben discusses, among other subjects, how the differences between CDSs and standard insurance contracts affect the incentive to monitor counterparties and implicate moral hazard issues. *Id.* at 423–30.

216. *Id.* at 423; see also CHOUDHRY, *supra* note 52, at 1 (noting that a CDS is “conceptually similar to an insurance policy taken out against the default of a bond”); Kayle, *supra* note 58, at 224–25 (stating that a CDS “functions as a form of insurance against the risk of default” when the protection buyer is exposed to the reference subject).

bankruptcy.²¹⁷ At the policy level, the automatic stay applies to insurance contracts because the “maintenance of insurance . . . is essential for the rehabilitation of the debtor and the protection of the creditors.”²¹⁸ In other words, allowing the debtor to maintain insurance is crucial because those contracts help further the rehabilitative goals of Chapter 11 bankruptcy.²¹⁹

The strength of the analogy between insurance contracts and hedging CDSs buttresses the argument for similar treatment of both. As with insurance contracts, a hedging CDS may be crucial to the debtor firm’s value.²²⁰ It follows that the termination of an insurance-like CDS may hinder the rehabilitation of the debtor and thereby run counter to the purpose of the Bankruptcy Code.

2. *Termination of a Hedging CDS Exposes the Debtor to Greater Risk.* Debtors enter into hedging CDSs to hedge particular risks, and this hedge disappears when a counterparty liquidates the contract.²²¹ Increased risk exposure can potentially destabilize the firm, increasing the risk of firm failure.²²² And even if it does not lead to failure, increased risk lowers the value of the debtor firm.²²³ In both cases, the effects of terminating a hedge extend beyond the debtor to other creditors.²²⁴

Even though the termination of a CDS diminishes the debtor’s value, Professors Franklin R. Edwards and Edward R. Morrison argue that the Safe Harbor rightly exempts derivatives from bankruptcy proceedings because the termination of a derivative

217. Partnoy & Skeel, *supra* note 10, at 1050. The policy is generally treated as property of the estate, so its termination would violate the automatic stay. *See* Holland Am. Ins. Co. v. Sportservice, Inc. (*In re* Cahokia Downs, Inc.), 5 B.R. 529, 531 (Bankr. S.D. Ill. 1980) (holding that an insurance policy “constitute[s] an asset of the bankrupt estate” and is therefore subject to the automatic stay).

218. *In re Cahokia Downs, Inc.*, 5 B.R. at 530.

219. Protecting a firm’s going-concern surplus is the central aim of Chapter 11 reorganization. Baird & Rasmussen, *supra* note 141, at 758.

220. *See, e.g.*, Partnoy & Skeel, *supra* note 10, at 1049–50 (expressing skepticism about the Safe Harbor’s presupposition that the termination of a derivative is a “no harm, no foul” scenario); Vasser, *supra* note 179, at 1542 (expressing similar skepticism).

221. Edwards & Morrison, *supra* note 27, at 115.

222. *Id.*

223. *Id.*

224. *See id.* (explaining that removing a hedge may harm both the debtor and its creditors because “a firm in bankruptcy . . . will be unable to replace a derivative contract on precisely the same terms” and the new high premium may cause the firm to decrease in value, damaging the firm’s creditors).

contract is unlikely to diminish the debtor's going-concern surplus.²²⁵ Going-concern surplus is the value that Chapter 11 "reorganization exists to preserve."²²⁶ Without diminution in this value, then, there is no harm in allowing counterparties to avoid the automatic stay.²²⁷ Whereas this argument may be true for financial firms, which generally lack going-concern surplus because their assets primarily consist of fungible financial contracts,²²⁸ it is not true for "non-financial firms, such as manufacturing, energy supply, and telecommunications concerns."²²⁹ For these firms, increased risk exposure may indeed "reduc[e] the value of [the firm's] non-financial assets . . . [which] can harm the firm's operations and its other creditors."²³⁰

Even so, Professors Edwards and Morrison contend that the Safe Harbor rightly ignores the costs of termination because the costs imposed on the debtor (and by extension, on the other creditors) are "no different from the effect of an economy-wide increase in demand for a critical input (say, oil). Assuming a stable supply, the increase in demand will raise the price of fuel, thereby increasing debtor's costs, reducing profits, and reducing (at least temporarily) firm value." This argument posits that, just as the Bankruptcy Code is unconcerned with losses caused by macroeconomic events such as increases in demand, it should not be concerned with the negative effect of a counterparty's decision to cancel a contract because, in both cases, "the debtor firm [is merely exposed] to the desirable discipline of market-based prices."²³¹

Although this argument is persuasive, it ultimately fails because it conflates macroeconomic events with actions that fall squarely within the purview of the Bankruptcy Code. The potentially harmful termination of contracts with a debtor is exactly the kind of behavior that bankruptcy law regulates.²³² The purpose of Chapter 11 is to

225. *Id.* at 114.

226. Baird & Rasmussen, *supra* note 141, at 758.

227. Edwards & Morrison, *supra* note 27, at 116.

228. *Id.* at 114.

229. *Id.* at 115.

230. *Id.*

231. *Id.*

232. For example, the automatic stay prohibits creditors from "any act to obtain possession of property of the [bankruptcy] estate or of property from the estate or to exercise control over property of the estate." 11 U.S.C. § 362(a)(3) (2006).

balance the interests of the debtor and its creditors,²³³ and it is generally concerned with regulating creditor-debtor relationships.²³⁴ Moreover, because Congress has chosen to combat systemic risk through the Bankruptcy Code, the Code is explicitly concerned with regulating events in the bankruptcy context that may contribute to systemic risk.²³⁵ If this kind of termination does in fact increase the systemic consequences of bankruptcy, it falls within the Code's regulatory purview.

3. *Hedging CDSs Are Not Practically Fungible.* When a counterparty unilaterally chooses to terminate an insurance-like CDS, diminishing the debtor's value, it leaves fewer assets to satisfy other creditors.²³⁶ In a sense, the terminating counterparty "imposes an externality on other creditors."²³⁷ When a derivative contract is fungible, however, the opportunistic termination of that contract does not lead to an overall loss. In this case, "the harm to the debtor firm is generally equal to the counterparty's gain: . . . the [debtor] loses a hedge . . . and the counterparty ceases providing this hedge."²³⁸ Furthermore, when derivatives contracts are "fungible, replaceable assets much like cash," their termination will not affect the going-concern surplus value of the debtor.²³⁹ In this scenario, termination does not undermine the rehabilitative function of Chapter 11.²⁴⁰

But, in practice, a debtor's hedging derivatives will rarely be fungible, if only because "[n]ew counterparties will charge a premium to deal with a distressed firm."²⁴¹ The debtor will incur increased costs to replace the hedge simply because it is in bankruptcy.²⁴² Thus, in

233. See, e.g., *In re PPI Enterps. (U.S.) Inc.*, 324 F.3d 197, 209 (3d Cir. 2003) ("Chapter 11 [bankruptcy] is intended to permit the debtor to rehabilitate itself while simultaneously protecting creditors.").

234. 11 U.S.C. § 105 grants bankruptcy courts "broad authority to modify creditor-debtor relationships." *United States v. Energy Res. Co.*, 495 U.S. 545, 549 (1990).

235. Cf. H.R. REP. No. 109-31(I), at 132 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 192 (justifying the Safe Harbor as "consistent with the policy goal of minimizing systemic risk").

236. See Edwards & Morrison, *supra* note 27, at 115 (noting that the loss of a hedge "can harm the firm's operations and its other creditors").

237. *Id.*

238. *Id.*

239. *Id.* at 114.

240. See Baird & Rasmussen, *supra* note 141, at 758 (noting that preserving going-concern surplus is "the thing the law of corporate reorganizations exists to preserve").

241. Edwards & Morrison, *supra* note 27, at 115.

242. See Karen Brettell, *Lehman CDS Counterparties Begin Resetting Trades*, REUTERS, Sept. 15, 2008, <http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/>

most scenarios in which the Safe Harbor applies, insurance-like CDSs are not practically fungible.²⁴³ And in some cases, “[t]he [replacement] premium may be so high that the firm can no longer hedge certain risks; as a result, firm value may fall, to the detriment of all creditors.”²⁴⁴ Termination under the Safe Harbor is not always a “no harm, no foul” scenario;²⁴⁵ it can result in serious consequences to the debtor and its creditors. As such, it has systemic risk implications.

B. Potential Problems with Narrowing the Safe Harbor

The task of narrowing the Safe Harbor is not without issues. First, it is unclear whether the reasoning behind exempting hedging CDSs from the Safe Harbor would necessarily extend to other hedging derivatives. Even if it does, there is little need to change the regulation of other derivatives markets without evidence that they are malfunctioning. Regardless of whether the reasoning behind this approach would apply to other derivatives, CDSs are uniquely in need of special treatment (as evidenced by their role in the economic crisis of 2008 and 2009).

Second, the Bankruptcy Code generally avoids rules that differentiate between contracts “based on the subject matter of the transaction.”²⁴⁶ As such, this proposal runs contrary to the Bankruptcy Code’s general disapproval of inquiry into the substance of derivatives contracts.²⁴⁷ A narrowed Safe Harbor would almost necessarily rely on a court’s assessment of the substance of the contract, clouding the bankruptcy settlement process with uncertainty

idUSN1529868020080915 (noting that, for CDSs terminated as a result of the Lehman bankruptcy, entering into replacement CDSs would “for some protection buyers . . . be in many cases significantly more expensive”).

243. The analogy to insurance proves useful here: if an insurance provider were able to terminate an insurance policy with a bankrupt policyholder, it is unlikely that the debtor would be able to find a replacement policy without demonstrating the ability to pay a premium to compensate the new provider for dealing with the risks of a firm in bankruptcy. And if the debtor is unable to afford the increased cost of a new policy, the firm is exposed to the risk against which it was previously insured.

244. Edwards & Morrison, *supra* note 27, at 115.

245. See Partnoy & Skeel, *supra* note 10, at 1049–50 (reaching a similar conclusion based on the likelihood of opportunistic behavior under the Safe Harbor). *But see* Edwards & Morrison, *supra* note 27, at 115 (reaching the opposite conclusion).

246. Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 663 (2005) (discussing potential problems posed by the kind of rule that differentiates between contracts in this way).

247. *Id.* at 664.

as to the rights of the counterparties.²⁴⁸ As a result, the transaction costs of entering into a CDS would likely rise if parties sought to define *ex ante* whether the economic substance of a particular CDS would subject it to the automatic stay. Such a rule would also likely increase the cost of purchasing a CDS in order to compensate for *ex post* uncertainty. But it makes little sense for the Bankruptcy Code to treat derivatives as though they are all identical, especially when differentiating between contracts could help the Code meet its goal of reducing systemic risk.

CONCLUSION

Put simply, the case for narrowing the Safe Harbor rests on the premise that different contracts have different values in different circumstances. This Note argues that the Safe Harbor would more effectively reduce systemic risk if it did not exempt *all* CDSs from bankruptcy proceedings. Insurance-like CDSs are likely more valuable in the debtor's hands than in the counterparty's hands. The Safe Harbor ignores the possibility that such a disparity in value may exist, presupposing instead that, in the aggregate, the value of liquidity outweighs the costs inflicted by opportunistic behavior or the grab race for the debtor's assets. The Safe Harbor should not ignore the possibility that this disparity in value exists because, if it does exist, the Safe Harbor may allow counterparties to unnecessarily damage the debtor and increase the probability that debtor firms will fall deeper into a liquidity crisis with the potential to affect the larger market. The Safe Harbor's sanctioning of such costs is at cross-purposes with Congress's intent to reduce systemic risk.

Narrowing the Safe Harbor could have widespread beneficial consequences. The notional value,²⁴⁹ or "amount that is used to calculate payments made on swaps and other risk management products,"²⁵⁰ of the CDS market was "\$54.6 trillion in the first half of

248. *See id.* (arguing that broad definitions prevent analysis based on substance and limit the role of the judge to working with formal definitions).

249. The notional value generally overstates the true amount of the investment at stake, as "the notional amount does not trade hands and is not at risk." Romano, *supra* note 48, at 46. But because the true size of the OTC market is difficult to ascertain, the best measure available is in terms of notional value. *Id.* at 4 (explaining that the difficulty in quantifying the OTC derivative market exists "because there is no accurate mechanism for tracking" it).

250. InvestorDictionary.com, Notional Amount, <http://www.investordictionary.com/definition/notional+amount.aspx> (last visited Nov. 21, 2009).

2008.”²⁵¹ With major bankruptcy proceedings probable in the near future, there are huge amounts of money at stake. But even more importantly, the change proposed by this Note might help protect the American economy from systemic failure and make the financial system stronger going forward.

251. Int'l Swaps and Derivatives Ass'n., *Summaries of Market Survey Results: 2008 Mid-Year Market Survey*, <http://www.isda.org/statistics/recent.html> (last visited Nov. 21, 2009).