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## From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events

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## ARTICLE

# FROM VANILLA SWAPS TO EXOTIC CREDIT DERIVATIVES: HOW TO APPROACH THE INTERPRETATION OF CREDIT EVENTS

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## INTRODUCTION

The credit derivatives instrument market is like a new continent with boundless opportunity.<sup>1</sup> Financial institutions, as well as individual investors, are mobilizing all of their resources as they jump into this frontier head-on.<sup>2</sup> Opportunity overflows in the financial market, but the competition is becoming increasingly fierce.<sup>3</sup> Cutting edge financial products are introduced every day.<sup>4</sup> Credit derivatives lead the way.

The credit derivatives market is somewhat akin to the middle age practice of alchemy, by which practitioners attempted to convert lead into gold.<sup>5</sup> The goal of each is to create new value. Although the alchemists failed, “financial engineering”<sup>6</sup> of the present era succeeds in creating new value through the highest levels of statistical analysis,<sup>7</sup> in many ways actually creating something from nothing. Derivative

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1. See ANTULIO N. BOMFIM, UNDERSTANDING CREDIT DERIVATIVES AND RELATED INSTRUMENTS 291 (2005) (referring to the credit derivatives market as “still a relatively young marketplace”).

2. See Mark Parsley, *Credit Derivatives Get Cracking*, EUROMONEY, Mar. 1996, at 28.

There are hundreds of possible [credit derivatives] applications: 1. for commercial banks that want to change the risk profile of their loan books, 2. for investment bank managing huge bond and derivatives portfolios, 3. for manufacturing companies overexposed to a single customer, 4. for equity investors in project finance deals with unacceptable sovereign risk, 5. for institutional investors that have unusual risk appetites [or just want to speculate], and 6. for employees worried about the safety of their deferred remuneration.

*Id.*

3. See *infra* note 48 and accompanying text.

4. See ROBERT E. WHALEY, DERIVATIVES: MARKETS, VALUATION, AND RISK MANAGEMENT 11-18 (2006) (describing the evolution of derivatives markets and tools).

5. *But see* STANDARD & POOR'S, GLOBAL CASH FLOW AND SYNTHETIC CDO CRITERIA 14 (2002), [http://www2.standardandpoors.com/spf/pdf/fixedincome/cdo\\_criteria2002\\_FINALTOC.pdf](http://www2.standardandpoors.com/spf/pdf/fixedincome/cdo_criteria2002_FINALTOC.pdf) (“This is not alchemy or turning straw into gold, but rather the implementation of structured finance to create different investment risk profiles, based on the structuring of credit support.”).

6. See ROBERT M. MCLAUGHLIN, OVER-THE-COUNTER DERIVATIVES PRODUCTS: A GUIDE TO BUSINESS AND LEGAL RISK MANAGEMENT AND DOCUMENTATION 1 (1998) (introducing uses of the term “financial engineering”).

7. See *id.* at 14. *But see* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1042 (2007) (“Although the mathematic techniques of [derivatives] technology are sophisticated, they are subject to the limitations of ‘garbage in, garbage out.’”).

dealers and financial engineers are indeed the alchemists of the modern era.

Is a credit derivatives instrument transaction a financial transaction? Or is it gambling? The use of credit derivatives instruments greatly increased once the deregulation of the 1980s spurred greater movement of capital internationally.<sup>8</sup> As they became a recognized means of hedging risk, derivative transactions based on the buying and selling of future risks increased in frequency and value.<sup>9</sup> Initially, derivative transactions developed to manage the various types of financial risk<sup>10</sup> that companies typically face.<sup>11</sup> Credit derivatives instruments satisfied the needs of investors who wanted to reduce asset risk in volatile markets.<sup>12</sup> In addition, investors used diverse investment tools through derivative transactions, such as “legging arbitrage,”<sup>13</sup> which takes

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8. See WHALEY, *supra* note 4 and accompanying text (explaining how credit derivatives instrument transactions were developed because U.S. financial institutions made loans to the emerging markets, and have held lots of bonds issued by them since the early 1990s).

9. Generally, the motive of investor participation in derivatives transactions is to reduce or remove risk, if possible, by hedging their portfolios value. See *Bank One Corp. v. Comm’r*, 120 T.C. 174, 206-07 (2003).

In the early days of the swaps market, dealers employed simple hedging strategies. Transactions designed to meet a customer’s requirements were immediately hedged by entering into an offsetting transaction, such as a matched swap. In the later years, many dealers . . . adopted more sophisticated portfolio strategies for hedging market risks. Under this approach, all of the dealer’s transactions were broken down into their component cashflows to yield a measure of the net (residual) market exposures arising from all of the dealer’s positions. The residual market exposures were then hedged in various ways such as by taking positions in the cash market (e.g., holding or selling short U.S. Treasury securities), by using interest-rate futures (which are traded on public exchanges), or by entering into swaps.

*Id.*

10. MCLAUGHLIN, *supra* note 6, at 11. One practicing attorney uses the term financial risk in a unique manner. His literature “uses the term *financial risk* in the economic or statistical sense of uncertainty of outcome, meaning simply that more than one outcome of varying degrees of desirability is possible for any given decision.” *Id.*

11. See DAVID A. DUBOFSKY & THOMAS W. MILLER, JR., DERIVATIVES: VALUATION AND RISK MANAGEMENT 23 (2003).

12. See MCLAUGHLIN, *supra* note 6, at 15-16 (“[R]isk management [applying derivatives] reduces a firm or portfolio’s risks by enabling it to (1) transfer, sell, or hedge the source of the unwanted risk, (2) *diversify* the unwanted risk, or (3) *insure* against any losses that might arise from the unwanted risk.”).

13. See Brandon Becker et al., *Restrictions and Obligations of Broker-Dealers Engaged in Proprietary Trading*, SL047 ALI-ABA 115, 148 (2006) (noting that legging arbitrage is a derivatives transaction skill, “[w]here a market professional introduces an

advantage of the difference between spot price and the price of futures, and synthetic transactions between swaps and futures.<sup>14</sup>

An interesting paradox arose, however, as credit derivatives instruments, developed initially for risk management, continued to grow and become more sophisticated with the help of financial engineering—the tail began wagging the dog.<sup>15</sup> In becoming a medium for speculative transactions, credit derivatives increased, rather than alleviated, risk.

This Article explores interpretation of the term “credit event,”<sup>16</sup> an important element of “settlement”<sup>17</sup> in the credit derivatives instrument transaction. In fact, the definition of a credit event is at the very core of all swap transactions, including the Credit Default Swap (“CDS”).<sup>18</sup> Part I introduces similar derivatives that were historically used by financial institutions and mentions the development process of the derivative financial market. Part II provides a brief explanation of the various financial products that are used in the credit derivatives instrument market. Part III addresses the legal mechanism of a credit derivatives swap, the most frequent type of transaction in the market today. Part IV discusses general issues related to the credit event. Part V reviews pertinent cases that have been litigated in federal court. In particular, as the interpretation of “credit event” faces fierce dispute, the International Swap and Derivatives Association’s (“ISDA”) definition of

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intentional delay (up to one day, or even two days) between the transactions in an effort to profit from short-term price movement”).

14. See Peter Tufano, *Financial Innovation*, in THE HANDBOOK OF THE ECONOMICS OF FINANCE 307, 320 (G.M. Constantinides, M. Harris & R. M. Stulz eds. 2003), available at [http://www.dklevine.com/archive/fininnov\\_tufano\\_june2002.pdf](http://www.dklevine.com/archive/fininnov_tufano_june2002.pdf) (noting that the unique characteristics of modern financial engineering are innovative structuring of financial instruments and designing vehicles under investor’s specific financial goals).

15. See generally Jongho Kim, *Can Risks be Reduced in the Derivatives Market? Lessons from the Deal Structure Analysis of Modern Financial Engineering Debacles*, 6 DEPAUL BUS. & COM. L.J. 29 (forthcoming 2008) (detailing a variety of collapsed derivative transaction cases).

16. CREDIT DERIVATIVES DEFINITIONS § 4.1 (Int’l Swaps & Derivatives Ass’n 1999) [hereinafter 1999 ISDA DEFINITIONS] (“‘Credit Event’ means, with respect to a Credit Derivatives Transaction, one or more of Bankruptcy, Failure to Pay, Obligation Acceleration, Obligation Default, Repudiation/Moratorium or Restructuring, as specified in the related Confirmation.”).

17. See *id.* § 3.11; see also *infra* Part IV.F.

18. See BOMFIM, *supra* note 1, at 289-90.

sovereign debt restructuring has become increasingly important.<sup>19</sup> The discussion focuses on which interpretation is proper under given circumstances. The conclusion includes an assessment of the courts' interpretation of "credit event" and some recommendations.

### I. DEVELOPMENT OF THE DERIVATIVES MARKETS

Credit derivatives instrument transactions originated in 1993 with the buying and selling of notes of specific transactions by Bankers Trust and Credit Suisse Financial Products of Japan, who linked these notes with the specific risk of default.<sup>20</sup> Although it is true that the phrase "credit derivatives instrument transaction" is now common in the financial industry, the notion of linking "credit risk"<sup>21</sup> existed in the past with concepts such as "loan participation,"<sup>22</sup> "risk participation,"<sup>23</sup> and "repo transaction."<sup>24</sup> These transactions can be referred to as traditional credit risk linked transactions, since they all transfer counterparty credit risk to a third party.

Of course, it might be rather far-fetched to claim that these transactions are basically of the same format, since there are some differences in terms of the background, framework and structure of each. In addition, the basic transactional flows—recently referred to as both credit derivatives instrument transactions and transactions of traditional financial products—differ. In particular, risk participation transactions share many similarities with the CDS transactions that are often

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19. See Joseph P. Collins & Pamela J. Sackmann, Mayer, Brown, Rowe & Maw, LLP, *A Structured Finance Trio: Assessing the Legal and Regulatory Environment for Credit Derivatives*, SECTION NEWSLETTER (Am. Bar Ass'n/ Section of Bus. Law, Commercial Fin. Servs. Forum, San Francisco, Cal.), Aug. 11, 2003, at 20, <http://www.abanet.org/buslaw/newsletter/0017/materials/trio.pdf>.

20. See Parsley, *supra* note 2, at 28.

21. See generally DUBOFSKY & MILLER, *supra* note 11, at 318-20; see also Norman Menachem Feder, *Deconstructing Over-The-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677, 689 (2002) ("Credit risk is exposure to the possibility that a counterparty will default on its obligations when due because of insolvency.").

22. See generally ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS § 9:110 (2005) (describing the loan participation mechanism).

23. See generally Risk-based Capital Credit-risk Weight Categories, 12 C.F.R. § 567.6 (b)(6)(i)-(ii) (2003) (providing an example of risk participation regulations).

24. See WHALEY, *supra* note 4, at 624 (discussing repurchase agreements).

regarded as typical credit derivatives today.<sup>25</sup> Even when the transaction is one that deals with a credit derivative of a new format, there are indeed many instances in which the intentions of those engaging in the transactions are, in fact, very similar to the traditional credit risk linked transaction.<sup>26</sup>

Focus should not be placed merely on credit derivatives of the so-called “new” format when considered from the perspective of managing banks’ credit risk. Instead, it is essential to examine which elements of the same transaction are linked to credit risk and how the funding participation, risk participation, and repo transactions are conducted and in which format. This Article next examines funding participation and risk participation transactions.

#### A. Yesterday

Funding participation<sup>27</sup> is conducted mostly by linking a traditional loan transaction with a funding participation agreement.<sup>28</sup> For example, when *Bank A* deals with *Company B* for a typical loan, *Bank A* signs a separate funding participation agreement with *Bank C*. The key to the funding participation transaction is that *Bank C*, referred to as the participant, supplies part or all of the capital for the loan that *Bank A* provides to *Company B*. *Bank A*, in turn, loans the capital in its name to *Company B* by adding the capital provided by *Bank C* to its own. The most important aspect of the funding participation transaction is that if *Company B* does not pay back the loan, then *Bank A* has no obligation to return the capital provided by *Bank C*. Otherwise, *Bank A* assumes the obligation to return the capital to *Bank C* when the loan is paid back by *Company B*.<sup>29</sup> There are instances, however, when *Bank A* agrees on the

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25. See Huntington Bank, Risk Participation Agreement, [https://www.huntington.com/bas/Risk\\_Participation\\_Agreement.htm](https://www.huntington.com/bas/Risk_Participation_Agreement.htm) (last visited Feb. 28, 2008) (illustrating a risk participation agreement and customer hedges floating-rate loan as an essential business tool).

26. COMM. ON THE GLOBAL FIN. SYS., CREDIT RISK TRANSFER, BANK FOR INT’L SETTLEMENTS 4 (2003) [hereinafter CGFS].

27. See JACOBS, *supra* note 22.

28. See CGFS, *supra* note 26, at 37.

29. See E. Carolan Berkley, *Multiple Lender/Multiple Borrower Transactions*, in ASSET BASED FINANCING 2007, at 333, 335 (2007). In the funding participation transaction, *Company B* and *Bank C* negotiate the terms of the loan directly depending on the relationship between the parties. However, there are instances in which a loan is obtained by having *Bank A* act as the fronting bank with the specific goal of cutting

funding participation transaction with *Bank C* after providing the loan to *Company B*, but prior to the loan's maturity. At this time, *Company B* might not know that *Bank A* signed an agreement for funding participation separately with *Bank C*.<sup>30</sup> If such is the case, the funding participation transaction may be considered one that transfers credit risk to a third party. Therefore, this type of transaction has the characteristics of a credit derivative.<sup>31</sup>

Risk participation transactions have been used in financial markets for a long time.<sup>32</sup> While "risk" in the risk participation transaction refers to the parties' credit risk, facets of the underlying transaction may be the actual source of the risk.<sup>33</sup> For example, if *Bank A* lends capital to *Company B*, *Bank A* may sign an agreement for a risk participation transaction with *Bank C* in order to transfer the credit risk of *Company B*. The main details are summarized in the following two ways. First, *Bank A* pays a participation fee to *Bank C* in exchange for *Bank C*'s assumption of *Company B*'s credit risk, either in part or in its entirety, during the lending period.

The transaction process is as follows: (1) *Bank A* provides a loan to *Company B*; (2) *Bank A* then transfers the credit risk to *Bank C*. *Bank C* also pays a participation fee as financial compensation if *Company B* fails to pay back the loan, a burden which would otherwise be borne by *Bank A*. Absent such a failure, *Company B* still bears a loan obligation to *Bank A*. If *Company B* cannot pay back its debt for whatever reason, *Bank C* pays *Bank A* as agreed. This could consist of either a part of or the total amount that *Company B* defaulted. The gain for *Bank A* is the transfer of the risk that *Company B* will default to *Bank C*.

Second, the risk participation transaction may also be used if *Bank A* issues a "performance bond" to yet another company, *Company D*, at *Company B*'s request. In short, *Bank A* signs the agreement for a risk

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taxes or bypassing the loan limit by not having *Company B* get the loan directly from *Bank C*. In this case, funding participation transaction essentially becomes different than the credit risk linked transaction and more similar to a syndicate loan.

30. See *id.* at 337.

31. See DUBOFSKY & MILLER, *supra* note 11, at 17 ("Derivatives allow the user to transfer . . . risks to other parties who are willing and able to accept them").

32. See Blaise Gadanez, *The Syndicated Loan Market: Structure, Development and Implications*, 2004 BANK FOR INT'L SETTLEMENTS Q. REV. 75, 75, available at [http://www.bis.org/publ/qtrpdf/r\\_qt0412g.pdf](http://www.bis.org/publ/qtrpdf/r_qt0412g.pdf).

33. See SATYAJIT DAS, CREDIT DERIVATIVES: TRADING & MANAGEMENT OF CREDIT & DEFAULT RISK 146 (1998).



participation transaction with *Bank C* after issuing a performance bond to *Company D*, thus transferring all or part of *Company B*'s credit risk.<sup>34</sup> If *Company B* does not fulfill its obligation to *Company D*, *Bank A* must pay compensatory damages to *Company D*. These damages substitute for performance protection. Meanwhile, if *Company B* does not fulfill its commitment despite the claim to compensate *Bank A*'s loss, *Bank C* must compensate all or part of *Bank A*'s loss, according to the risk participation agreement. Of course, *Bank A* pays part of the participation fee received by *Bank C* from *Company B* during the duration of the risk participation agreement. In the end, *Bank A* has transferred the credit risk of its investment in *Company B* to *Bank C* through the risk participation transaction, in a similar manner to deals involving credit derivatives.<sup>35</sup>

### B. Today

Since the 1980s, the international financial markets have experienced global integration,<sup>36</sup> with liberalization,<sup>37</sup> deregulation,<sup>38</sup>

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34. (1) Assumption of obligation by *Company B* to *Company D*, (2) *Company B* promises to supply *Bank A*'s guarantee to the *Company D*, (3) *Company B* asks *Bank A* to issue a guarantee for *Company D*, (4) *Bank A*'s promise to perform for *Company B*, (5) *Bank A* issues guarantee for *Company D*, (6) *Bank A*'s right to indemnity for *Company B*, (7) *Bank A* transfers credit risk on *Company B* to *Bank C* in addition to the participation fee payment, (8) *Bank A* performs guarantee to *Company D* if *Company B* fails to pay obligation for *Company D*, (9) *Bank A* asks *Bank C* for compensation for the loss incurred by the performance of guarantee for *Company D*, (10) *Bank C* assumes the risk in case of default.

35. See Berkley, *supra* note 29, at 336-37 (explaining various reasons for multiple lender agreements).

36. See Rosa Giovanna Barresi, *The Impact of Monetary Union and the EURO on European Capital Markets: What May be Achieved in Capital Market Integration*, 28 FORDHAM INT'L L.J. 1257, 1303 (2005) (noting how this trend influences markets of individual nations around the world as well, which in turn means that the liberalization of the financial markets within regions is also gaining momentum every day). With the adoption of "Bancassurance," the different sectors of the financial industry became fully integrated. *Id.*; see also CHARLES W. CALOMIRIS, U.S. BANK DEREGULATION IN HISTORICAL PERSPECTIVE 334 (2000) (identifying the integration between regions and markets as one of the key characteristics of the current financial market); Lawrence L.C. Lee, *Integration of International Banking Supervisory Standards: A Blueprint for the Taiwanese Banking System*, 19 ANN. REV. BANKING L. 455, 536 (2000) ("The globalization of the international banking sector stimulates the functioning of national financial systems and accelerates and broadens the process of financial liberalization

and securitization<sup>39</sup> occurring simultaneously. Meanwhile, efficiency<sup>40</sup> benefits have improved capital liquidity.<sup>41</sup> Moreover, new financial

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and deregulation. Through liberalization and deregulation, the international banking industry becomes a more competitive and efficient market.”) (citation omitted).

37. See generally GARY H. STERN & RON J. FELDMAN, *TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS* 77 (2004) (discussing the expansion of banking power); see also Larry A. Frieder, *Legislating for Interstate Bank Expansion: Financial Deregulation and Public Policy*, 9 J. CORP. L. 673, 728 (1984) (discussing how financial business liberalization increases competition among financial institutions in the non-banking sector such as insurance and trust and securities that are now competing with banks). Increased profit results from increased effectiveness and expansion of the banks’ traditional service offerings. For example, securities companies in the U.S. that handle Money Market Mutual Funds (“ MMMF”) can establish Point-of-Sale (“ POS”) or Customer-Bank Communications Terminals (“ CBCT”) for the end users. *Id.* However, securities companies can also use customer networks along with the traditional securities related work. Thus, actual cost for the amortization assumed by the securities companies for the installation of EFT may not be that high.

38. It is important to note, however that “[d]eregulation has both benefits and costs.” John J. Merrick Jr. & Anthony Saunders, *Bank Regulation and Monetary Policy*, 17 J. MONEY, CREDIT & BANKING 691, 692 (1985). “An essential point sometimes overlooked by critics of bank deregulation is that activity deregulation may provide as much opportunity for banks to explore new approaches to managing current risks as it does to assume new ones.” *Id.* at 695 (emphasis omitted). See, e.g., Extensions of Credit by Federal Reserve Banks, 12 C.F.R. §205.3 (2007) (permitting the link to Fed Wire that can provide Electronic Fund Transfer (“ EFT”) payment service without using a bank account by using POS or CBCT). It was against this backdrop that investors demanded regulation of the interest on deposits. Accordingly, banks have sought to bypass interest rate regulations through financial innovation, or through the very deregulation that sought to alleviate banking restrictions, both of which may account for the introduction of credit risk. Moreover, rapid advances in electronic banking could result in systematic risk as parties become tied to highly sophisticated information and communication systems. Increases in these types of risks may mean higher costs for financial institutions and the entire financial system. Professors Merrick and Saunders indicate that “some off-balance-sheet items—in particular, forward, futures, and options contracts—can serve to explicitly decrease banking sector risk if used properly.” *Id.* (emphasis omitted). It is not clear whether all the risks that are faced by the financial institutions in the wake of deregulation will lead to decreased profitability of the financial institutions. Increased price competition tends to remove inefficiency within the banking system. Thus, deregulation can contribute to cutting cost and increasing profit. Diane P. Wood et al., *Acquisitions and Mergers*, in 30TH ANNUAL ANTITRUST LAW INSTITUTE, at 225, 311 n.12 (1989).

39. See Anshu S. K. Pasricha, *On Financial Sector Reform in Emerging Markets: Enhancing Creditors’ Rights and Securitizing Non-Performing Loans in the Indian Banking Sector—An Elephant’s Tale*, 55 BUFF. L. REV. 325, 357-58 (2007); see also

products and financial engineering techniques are constantly developed in line with advances in information technology.<sup>42</sup> Likewise, diverse financial services are provided to satisfy customer needs.<sup>43</sup> Credit risk is increasing, however, which some consider a necessary evil.<sup>44</sup>

The financial institutions that assume this type of credit risk may collect the applicable loan obligation earlier simply by selling the

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Joseph A. Smith, Jr., *Financial Literacy, Regulation and Consumer Welfare*, 8 N.C. BANKING INST. 77, 79 (2004) (noting that products such as Asset Backed Securities or Credit Linked Notes can be considered part of the securitization trends of the financial industry).

40. See DON M. CHANCE, *AN INTRODUCTION TO DERIVATIVES* 11 (4th ed. 1998). [E]fficiency is the characteristic of a market in which the prices of the instruments trading therein reflect their true economic values to the investors. In an efficient market, prices fluctuate randomly and investors cannot consistently earn returns above those that would compensate them for the level of risk they assume.

*Id.*

41. See David M. Jones, *Fed Policy, Financial Market Efficiency, and Capital Flows*, 54 J. FIN. 1501, 1505 (1999) (noting the existence of massive global capital flows).

42. See Niels Hermes & Robert Lensink, *Does Financial Liberalization Influence Saving, Investment and Economic Growth? Evidence from 25 Emerging Market Economies, 1973-96* 4 (UNU/WIDER Discussion Paper No. 2005/69, 2005); see also MCLAUGHLIN, *supra* note 6, at 6. Drastic decreases in the cost of amortization resulting from technological innovation increases the cost needed to enforce regulations when it comes to the work domain. This can, in turn, speed the process toward alleviation or elimination of regulations. See *id.* at 5. When the cost for the amortization decreases to a point that it can be forgotten altogether, the banking industry could then be considered an industry that enables competition and plays a definite role in the continued participation of the market participants concerning organizational level efficiency. Formation of a market where competition in the banking industry is enabled can increase banks' ability to increase profit. Moreover, this would be a confirmation of the decreases in marginal cost which can result from diversifying the banking industry. *Id.*

43. See Hermes & Lensink, *supra* note 42, at 3. Deregulation brought about drastic expansion and deepening of the open markets such as the stock exchange. As a result, traditional capital sourcing through banks decreased while the share of capital raised through the open market increased. See *id.* at 3-6 (noting that the portion of the banks' profit that was earned through traditional banking decreased significantly, while the portion from investments and participation fees increased). Accordingly, banks began to sell deposits that pay market interest so that the deposits would not leak out of the banking system. They also began to raise the capital that they needed from the short-term market. As the level of reliance on the capital that is closely linked to market interest rates increases, banks have more exposure to the risk that follows a change in interest rates. *Id.*; see also *id.* at 8 (noting how financial liberalization has also increased the liquidity risk of banks).

44. See *id.* at 4.

obligation at a discount.<sup>45</sup> While this may indeed eliminate credit risk easily, it may also mean relinquishing the opportunity to earn profit. Given that the assumption of credit risk is the foundation for a bank's profit creation, the taking on of credit risk is, to a certain degree, essential. Credit risk is not a new concept by any means. Considering that management of credit risk has long been a part of the banking industry, why is it that its importance is so strongly emphasized today?

First, the potential for default or possibility of bankruptcy is increasing due to greater competition among companies.<sup>46</sup> Advances in information technology, along with foreign countries' increased market liberalization,<sup>47</sup> result in global competition. Accordingly, domestic competition is fiercer, as seen in the rise in bankruptcy rates.<sup>48</sup>

Second, capital market advancement creates a winner's curse.<sup>49</sup> As capital markets develop, young and small venture companies with high risk can now raise capital more easily.<sup>50</sup> Consequently, managing and transferring these companies' risk has become an important issue for financial institutions.<sup>51</sup>

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45. See WHALEY, *supra* note 4, at 37.

46. See Will Skowronski, *Business Bankruptcy Rate Will Rise, Report Predicts*, WASH. BUS. J., Aug. 23, 2007, available at <http://washington.bizjournals.com/washington/stories/2007/08/20/daily27.html> ("The U.S. Bankruptcy Courts reported that 6,705 businesses declared bankruptcy in the quarter ended June 30, [2007], up from 4,858 during the same period last year [2006].").

47. See Lee, *supra* note 36, at 455 n.3 (defining liberalization of the banking sector).

48. See Skowronski, *supra* note 46; see also *Business Bankruptcy Rates Continue to Rise in 2007*, PR NEWSWIRE, (Aug. 21, 2007), <http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=109&STORY=/www/story/08-21-2007/0004649151&EDATE=>.

49. See PATRICK A. GAUGHAN, *MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS* 149 (3d ed. 2002) ("[T]he ironic hypothesis . . . states that bidders who over-estimate the value of a target will most likely win a contest.").

50. See generally Jeffrey E. Sohl, *The US Angel and Venture Capital Market: Recent Trends and Developments*, 6 J. PRIVATE EQUITY 7 (2003) (describing the evolution of venture capital markets).

51. *Id.*

Third, there is more competition among financial institutions.<sup>52</sup> As a result of the abolition of the Glass-Steagall Act,<sup>53</sup> financial institutions today compete on a geographic scale beyond their home region.<sup>54</sup> Because profit margin decreases with time in the traditional business domain, a business will inevitably target investments with the highest return. Since this type of investment always comes with a high level of risk,<sup>55</sup> effective management of risk is critical. Against this backdrop, credit derivatives instruments have continued to grow since the 1990s in order to block excessive exposure to and hedge against credit risk.<sup>56</sup>

Fourth, the value of collateral, including real estate, is uncertain,<sup>57</sup> as the 1997 financial crisis in Asia demonstrated.<sup>58</sup> This is a significant limitation on lenders' ability to manage credit risk.

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52. See *Switzerland as a Financial Centre: Top-Quality Performance and Impressive Dimensions*, No. 21 FDF NEWSLETTER (Fed. Dep't of Fin., Bern, Switz.), June 2002, at 2, available at <http://www.efd.admin.ch/dokumentation/00737/00759/00768/index.html?lang=en> (reporting that financial markets are undergoing rapid change as a result of the worldwide deregulation of capital transfers, technological progress and financial innovation). As a consequence, the pressure of international competition in the intensive value-add financial sector has increased considerably. Against this backdrop, it is possible that further global centers for various types of financial services will establish themselves. *Id.*

53. See Reem Heakal, *What was the Glass-Steagall Act?*, INVESTOPEDIA, July 16, 2003, available at <http://www.investopedia.com/articles/03/071603.asp> (“[I]n November of 1999 Congress repealed the [Glass-Steagall Act (“GSA”)] with the establishment of the Gramm-Leach-Bliley Act, which eliminated the GSA restrictions against affiliations between commercial and investment banks. Furthermore, the Gramm-Leach-Bliley Act allows banking institutions to provide a broader range of services, including underwriting and other dealing activities.”); see also JOHN SPIEGEL, ALAN GART & STEVEN GART, *BANKING REDEFINED: HOW SUPERREGIONAL POWERHOUSES ARE RESHAPING FINANCIAL SERVICES* 57 (1996) (“[R]epeal of the act should reduce the risks of most banks by providing the opportunity for further diversification.”) (citation omitted).

54. See *supra* note 36 and accompanying text.

55. See Parsley, *supra* note 2, at 31-32.

56. See MOORAD CHOUDHRY, *STRUCTURED CREDIT PRODUCTS: CREDIT DERIVATIVES AND SYNTHETIC SECURITIZATION* 5-10 (2004) (illustrating the background of the emerging Credit Derivative instruments); see also MCLAUGHLIN, *supra* note 6 and accompanying text.

57. See, e.g., *Appeals of Material Supervisory Determinations: Guidelines & Decisions*, SARC-97-01 at \*1-2 (FDIC Sept. 15, 1997), <http://www.fdic.gov/regulations/laws/sarc/sarcappeals/sarc9701.html>; see also Technical Memorandum from H. Carl McCall, Off. of the State Deputy Comptroller for the City of New York, *The East Asian Economic Crisis: A Background Report on the Implications for New York City* 14

Fifth, “floor deal type OTC products” and off-balance sheet transactions have grown significantly in popularity.<sup>59</sup> As financial institutions began to handle large volumes of OTC deals, which increased their off-balance sheet transactions, the counterparty risk of each increased dramatically.<sup>60</sup> In addition, counterparty risk can substantially increase with unfavorable fluctuations in exchange rates, interest rates, or index futures.<sup>61</sup> Furthermore, there is a greater chance that the large scale speculative transaction may become useful since the limitation on it is less than that on spot transactions, and it is comparatively easy to execute.<sup>62</sup> This has the potential to cause large scale financial crises.

Most of the credit derivatives instrument transactions require merely a small monetary deposit, known as a margin, which equals the specific percentage of the transacted product’s face value.<sup>63</sup> Therefore, it offers a greater “leverage effect”<sup>64</sup> over the gain/loss fluctuation rate of transactions compared to that of the market price. Accordingly,

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(Apr. 27, 1998), <http://www.osc.state.ny.us/reports/nyc/economic/tm199/tm199.htm> (“[C]apital outflows drove down the prices of real estate and domestic equities, which banks held as collateral.”). “One of the biggest challenges for Japan is to restructure its financial system following stagnation throughout the 1990s brought on by the bursting of a tremendously speculative real estate bubble.” *Id.* at 27.

58. See Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks at the Council on Foreign Relations Financial Crisis Conference \*2 (July 12, 2000), <http://www.federalreserve.gov/boarddocs/speeches/2000/20000712.htm>.

59. See CHRIS FRANCIS, ATISH KAKODKAR & BARNABY MARTIN, MERRILL LYNCH, CREDIT DERIVATIVE HANDBOOK 2003: A GUIDE TO PRODUCTS, VALUATION, STRATEGIES AND RISKS 4-6 (2003) (describing market size and market structure); see also WHALEY, *supra* note 4, at 18-19.

60. See generally WHALEY, *supra* note 4, at 15-19 (describing the nature and amount of risk assumed by the parties involved in a number of OTC transactions).

61. See FRANCIS ET AL., *supra* note 59, at 109 (“This risk reflects the potential failure by the counterparty to make a payment when it is due.”).

62. See ALFRED STEINHERR, DERIVATIVES: THE WILD BEAST OF FINANCE 189-90 (2000).

63. See, e.g., Michael D. Dayan & Glen A. Rae, *OTC Equity Derivatives: Hedging Transactions and Equity Swaps Outline*, in SWAPS & OTHER DERIVATIVES IN 2006, at 560-61 (2006) (“SEC determined that total return swap was a disguised financing that violated the margin regulations.”).

64. See CHANCE, *supra* note 40, at 18 (defining leverage effect as “small price changes can lead to large gains and losses”).

policies regulating financial viability now emphasize credit risk even more than in the past.<sup>65</sup>

### C. Tomorrow

The growth rate of credit derivatives going forward might be forecasted by answering the following question: what exactly is the basic usefulness of credit derivatives instruments? Motives and objectives for engaging in credit derivatives transactions vary in connection with the working-level financial transaction.<sup>66</sup> These objectives do not always manifest in the same way.<sup>67</sup> Moreover, they vary with the individual products related to the specific transaction. The reality is that there are credit derivatives transactions motivated solely by the transfer of credit risk.<sup>68</sup> Likewise, even though buyers and sellers gain different utilities from transferring credit risk, each specific transaction remains valuable to each participant.

The transaction of credit derivatives can become a means for hedging credit risk.<sup>69</sup> A CDS<sup>70</sup> or Total Return Swap (“TRS”)<sup>71</sup> enables banks to transfer a customer’s credit risk. For this reason, “banks will gradually become more willing to actively trade credit risks.”<sup>72</sup> If the possibility of a borrower’s default increases due to a change in circumstances, it is possible for the bank to separate itself from the

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65. See Commodity Exchange Act, 7 U.S.C. §§ 2(d), (g) (2006). Even though OTC derivatives markets are beyond the scope of the SEC’s CFTC jurisdiction, there are certain transactions that may fall within the agency’s jurisdiction. Federal banking regulators oversee bank activities except specific OTC derivatives transactions.

66. See FRANCIS ET AL., *supra* note 59, at 9 (introducing bank’s transaction objectives which mitigate risk in loan portfolios and generate greater returns).

67. See Willa E. Gibson, *Investors, Look Before You Leap: The Suitability Doctrine Is Not Suitable For OTC Derivatives Dealers*, 29 LOY. U. CHI. L.J. 527, 540-42 (1998) (identifying three derivative market participants, all of whom have different transaction motives). Hedgers attempt to offset risks that they hold in underlying portfolios; speculators take unhedged risk in the pursuit of profits; and arbitrageurs, who seek return without risk, take the opposite position in mispriced derivatives vehicles. *Id.*

68. See generally LILLIAN CHEW, *MANAGING DERIVATIVE RISKS: THE USE AND ABUSE OF LEVERAGE* 126-27 (1996) (detailing the credit risk implications of derivative instrument transactions).

69. See CHOUDHRY, *supra* note 56, at 41.

70. See *infra* Part II.B.

71. See *infra* Part II.C.

72. See JANET M. TAVAKOLI, *CREDIT DERIVATIVES: A GUIDE TO INSTRUMENTS AND APPLICATIONS* 242 (1998).

credit risk by transferring the default risk of a loan obligation to another party.<sup>73</sup> This type of transfer (assignment) should be communicated to the borrower, and he or she should pay back the loan to the assignee (the transferee or risk buyer) after the transfer.<sup>74</sup> Thus, some aspects of this transaction make it difficult for the bank to choose this route. Nevertheless, in certain cases, a CDS or TRS can be an appropriate alternative for hedging credit risk.

Conventional wisdom holds that a borrower's financial situation will deteriorate significantly after the loan is granted.<sup>75</sup> If the borrower's financial situation is expected to improve, however, the bank can target a specific time period in which to hedge against the credit risk. The bank can also choose to either not use the CDS until the principal obligation has matured, or to buy a credit option in order to hedge risk for a specific period of time.

Credit derivatives transactions can be a useful tool for solving the "credit paradox."<sup>76</sup> When the credit risk on a specific borrower is too high, a host of regulations could be implicated.<sup>77</sup> Limitations on the loans to the same party are the most typical restrictions under statutory

73. See WHALEY, *supra* note 4, at 680.

74. See SHERREE DECOVNY, *SWAPS* 29 (2d ed. 1998) ("Usually at the outset of a swap transaction, the two counterparties agree that each has the right to assign the contract subject to other's approval, and this should be written into the documentation.").

75. See CHOUDHRY, *supra* note 56, at 41.

76. See Krishna Guha, *World Economy Confronted by Liquidity Paradox*, FIN. TIMES, Aug. 23, 2007, available at <http://www.ft.com/cms/s/0/1c481a66-51a5-11dc-8779-0000779fd2ac.html> (reporting on the liquidity paradox in the world economy); see also Martin Wolf, *The Paradox of Thrift: Excess Savings are Storing up Trouble for the World Economy*, FIN. TIMES, June 13, 2007, available at <http://www.ft.com/cms/s/00b05180-dba8-11d9-913a-00000e2511c8.html> (noting that the term "paradox" is used in various situations). Sometimes "what is good for individuals can be bad for an economy." *Id.*; see also *Prime Movers - Beware the Fragile Relationship Between Prime Brokers and Hedge Funds*, THE ECONOMIST, Aug. 9, 2007, available at [http://www.cfo.com/article.cfm/9641175/c\\_2984411/?f=archives](http://www.cfo.com/article.cfm/9641175/c_2984411/?f=archives) (reporting a paradox at the heart of the financial markets); *infra* note 78 and accompanying text. But see CARBON360, INC., *IMPACT OF INCLUSION OF CAPITAL STRUCTURE ARBITRAGE & OTHER CREDIT STRATEGIES ON HEDGE FUND OPERATIONS* 26 (2005) (arguing the negative impression of transacting of CDSs due to the so called "Credit Paradox").

77. See Smith, *supra* note 39, at 89-90 (citing North Carolina's predatory lending statute which prohibits various loans).



banking regulations,<sup>78</sup> but banks will also often have these types of restrictions as part of their internal policy.<sup>79</sup> If a bank's lending line for a certain client exceeds either the statutory limit or the internal standard, the bank will find it difficult to issue a new loan. The clash between the interests of the bank's loan officer, who is interested in creating new loans, and the credit risk manager, who seeks to manage the credit risk portfolio, is known as the "credit paradox"<sup>80</sup>

The bank may inform the client that new loans cannot be granted because the credit limit has been reached. Denying a new loan creates the risk of jeopardizing the relationship with an existing client, which can result in a client's defection. A lender also faces difficulty denying the loan when the borrower exceeds only the bank's internal standard. In this situation, a bank would likely provide a long-standing customer with a loan and transfer the credit risk by way of a credit derivative.<sup>81</sup> Even when there is almost no profit gained, the bank might hope to strengthen its ties with the client through this type of transaction, while not exceeding its credit limits. This process is similar to the aforementioned "credit risk hedging method" in that they both transfer the credit risk; however, the motives differ.<sup>82</sup> In using a credit risk

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78. See Regulation T, 12 C.F.R. § 220 (2002); see also Regulation U, 12 C.F.R. § 221 (2002).

79. See DAS, *supra* note 33, at 135, 147.

80. *Supra* note 76 and accompanying text. The traditional method with which the banks manage credit risk is diversification of the parties loaned. While diversifying parties loaned for credit risk management, it is difficult to effectively execute the monitoring of the companies, which is a reason for the existence of banks. Monitoring of the companies is still conducted, yet in-depth and specialized monitoring is possible only when monitoring very few companies. This creates a contradictory relationship between efficient monitoring and efficient risk sharing, which is another example of a credit paradox.

81. See, e.g., Robert D. Aicher, Deborah L. Cotton & T.K. Khan, *Credit Enhancement: Letters of Credit, Guaranties, Insurance and Swaps (The Clash of Cultures)*, 59 BUS. LAW 897, 956 (2004).

A credit default swap can be used as a form of credit enhancement in a variety of contexts in substitution for other types of credit enhancement. For example, a lender to a borrower, instead of taking the guaranty of a guarantor, could enter into a credit default swap with such guarantor in respect of the borrower's obligations to the lender.

*Id.*

82. See McLAUGHLIN, *supra* note 6, at 117.

The goal of the hedge is to *freeze* the value of the asset or liability. . . . The purpose of a hedge is to make the cashflows of the derivative and the hedged instrument

hedging method, credit risk is transferred for the purpose of hedging, and is based on the determination that credit risk exists.<sup>83</sup> With a derivative instrument, the bank is simply complying with a statute or internal policy regardless of potential credit risk.

A credit derivatives transaction is also a “market risk”<sup>84</sup> hedging method.<sup>85</sup> In general, credit derivatives instrument transactions are perceived as being conducted in relation to credit risk, not market risk.<sup>86</sup> There is no question that the overall characteristics of a credit derivatives instrument are based on credit risk. Market risks, however, arising from the interest rate,<sup>87</sup> FOREX exchange rate, and stock price<sup>88</sup> can exist depending on the structure and terms of the transaction of the credit derivatives instrument.<sup>89</sup>

For example, assume that the stock price of *Company B* is \$10 on the day of the TRS agreement signing, and *Bank A* has one million shares of the stock. If *Bank A* predicts that the stock price of *Company B* will change frequently within a year, *Bank A* can dispose of applicable stocks and recuperate the invested amount to eliminate the stock price risk. *Bank A*, however, can hedge the stock price volatility through a TRS transaction if there is a possibility that the stock price may fall due to the sudden sale of a large volume of shares, or if the sale of *Company B*'s stock is not desired from a long-term perspective. In other words,

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symmetrical, so that losses and gains will cancel each other out both as an accounting matter and in terms of the timing of actual cashflows.

*Id.*

83. See CGFS, *supra* note 26, at 4.

Innovations in credit risk transfer have widened the options available to credit risk managers and have allowed banks to think about shaping their risk profile independently of their origination business. In the first instance, this has often meant seeking to reduce concentrations of credit risk to particular borrowers or market segments.

*Id.*

84. See TAVAKOLI, *supra* note 72, at 33 (“Market risk . . . is the net exposure to interest rates, foreign exchange rates, commodity prices, and equity prices.”).

85. See CHOUDHRY, *supra* note 56, at 16-17 (noting that market risk can be measured by using the Value-at-Risk methodology).

86. See CHEW, *supra* note 68, at 126-27.

87. See CHOUDHRY, *supra* note 56, at 51 (“The interest rate risk element of the bond can be removed by combining the bond with an interest rate swap . . .”).

88. In an equity default swap, “the triggering event is the point when the reference stock hits a specified low barrier” rather than a specified credit event. *Id.* at 68.

89. See, e.g., Feder, *supra* note 21, at 705 (introducing interest rate swap and currency swap).

the objective is realized when *Bank A* collects a specific amount of interest on the market capitalization of \$10 million from *Bank C*, and by giving or taking the amount following a stock price change. For example, if the stock price increases to \$15, *Bank A* pays \$5 million (a \$5 increase multiplied by one million shares). On the contrary, if the price per stock decreases by \$3, *Bank C* pays \$3 million (a \$3 decrease multiplied by one million shares) to *Bank A*. Accordingly, *Bank A* collects interest on the \$10 million capital obligation (as there is a market capitalization of one million shares). In return, it transfers the gain or loss resulting from the increase or decrease of the stock price to *Bank C* in its entirety, thereby hedging any stock price risk. This type of TRS transaction is not very different from the structure and effect of a typical “equity swap” transaction.<sup>90</sup>

The transaction of credit derivatives instruments is one medium for the creation of new profit. By taking over the credit risk, the assuming party can realize a substantial income without investing its own capital for the underlying asset. The “credit option,” whereby the option seller receives a premium, is just such an example.<sup>91</sup> In the case of a TRS or CDS, the party who assumes the credit risk benefits from the ensuing compensation.

For example, *Bank A* agrees to an interest rate at LIBOR<sup>92</sup>+80 basis points (“bp”) while providing a \$1 million loan to *Company B* with the expectation that the financial situation of *Company B* will deteriorate. *Bank A* then signs the TRS agreement that requires *Bank C* to pay the promised interest (LIBOR+30bp) and principal (\$1 million) to *Bank A* upon agreement that any income resulting from the underlying asset (i.e., the loan provided to *Company B*) will be transferred to *Bank C*. A one-time exchange takes place if the principal is paid in its entirety within the maturity period. An exchange of interest takes place

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90. See, e.g., *id.* at 706 (introducing equity swaps).

91. See CHOUHRY, *supra* note 56, at 78.

Credit options are . . . bilateral OTC financial contracts. A credit option is a contract designed to meet specific hedging or speculative requirements of an entity, which may purchase or sell the option to meet its objectives. . . . By purchasing credit options, banks and other [financial] institutions can take a view on credit spread movements for the cost of the option premium only, without recourse to actual loans issued by an obligor. The writer of credit options seeks to earn premium income.

*Id.*

92. LIBOR refers to the London Interbank Offered Rate. See BBA, BBA LIBOR – Frequently Asked Questions, <http://www.bba.org.uk/bba/jsp/polopoly.jsp?d=225&a=1416> (last visited Mar. 11, 2008); see also BLACK’S LAW DICTIONARY 937 (8th ed. 2004).

whenever interest is paid, so long as such interest is paid at a regular interval, generally either quarterly or semi-annually. The principal is then exchanged at the time of maturity. If *Company B* pays the interest that corresponds to the LIBOR+80bp rate each time interest is paid, *Bank C* will gain the income resulting from the 50bp difference every time. This is equivalent to *Bank C*'s collection of the participation fee of 50bp for guaranteeing the performance of *Company B*'s loan obligation to *Bank A*.

One might question whether *Bank C*'s assumption of risk creates a new transaction. TRS transactions, guarantees,<sup>93</sup> and suretyships<sup>94</sup> should be considered independent financial techniques for profit creation for several reasons. First, in the case of a guarantee or suretyship, it is customary for *Company B* to pay the participation fee while requesting from *Bank C* the issuance of the certificate of guarantee. If *Company B* defaults on the loan, *Bank C*, the obligor in the guarantee agreement, pays the obligation on behalf of *Company B* and at the request of *Bank A*, and so acquires the right of indemnity for *Company B*. Of course, *Bank C* may issue a certificate of guarantee for *Bank A* absent *Company B*'s request. Issuance of a certificate of guarantee by a bank without the request of the principal debtor is referred to as "the guarantee not asked for."<sup>95</sup> One advantage of a TRS, however, is that it is possible to produce the same effect as when a guarantee is obtained from *Bank C* with *Bank A*'s independent business judgment, regardless of *Company B*'s involvement.<sup>96</sup>

Second, *Bank C*'s secured obligation becomes void when *Bank A*'s loan for *Company B* is determined void, for whatever reason, even when *Bank C* provided protection to *Bank A* with the intent to guarantee performance. This is referred to as the secured obligation's "appendant

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93. See *infra* note 656 and accompanying text; see also *infra* notes 689-91 and accompanying text.

94. See *infra* Part V.C.2.

95. See Aicher et al., *supra* note 81, at 910-11. This is a rare case. Generally, [a] guaranty is a promise made by a guarantor to answer for the debt or obligation (the "underlying debt") of an obligor (the "principal") that is owed to a creditor or other obligee (the "underlying creditor" or "lender"). A guaranty is, therefore, a collateral promise by the guarantor to pay the debt or obligation of the underlying obligor for the benefit of the lender.

*Id.* (citation omitted).

96. *Id.*

nature.”<sup>97</sup> However, the general rule is that *Bank A*’s collection on the claim should be recognized since a TRS should not be considered a form of guarantee, even though the legal standards may differ depending on the specific conditions of the transaction. In this respect, a TRS has an independent reason for existing.<sup>98</sup>

Third, a TRS can be used other than as a guarantee.<sup>99</sup> *Bank C* can create the same effect it would through stock investment merely by paying interest on short-term investments and without putting in its own capital. Therefore, a TRS is a new profit creation scheme that affords the realization of various economic effects that could not be obtained with the existing financial devices alone.<sup>100</sup>

Additionally, products such as Credit Linked Notes (“CLN”)<sup>101</sup> can be viewed as financial securitizations that are consolidating their position in the worldwide market. Asset Backed Securitization (“ABS”),<sup>102</sup> which has the effect of transferring credit risk to investors by leveraging loan assets retained by financial institutions, or CLN’s, which factor in credit risk, show that credit derivatives instrument

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97. When the claim secured by a mortgage becomes extinct by completion of prescription or for any other reason, the mortgage shall also lapse with it. *See infra* Part V.C.2.

98. Whether a TRS is applicable to the rule of guarantee was a hidden-issue in the litigation between Daehan Investment Trust Management and JP Morgan in the Southern District of New York. *See* Complaint at 6, Daehan Inv. Trust Mgmt. Co. v. J.P. Morgan Chase Bank, No. 02 Civ. 1379 (CSH) at \*6.1379, 2003 WL 21297304 [hereinafter DITM Complaint].

99. *See* DAS, *supra* note 33, at 11-12.

100. *See, e.g., id.* at 140-45.

101. *See infra* Part II.D.

102. In general, an ABS does not seem to be classified as a credit derivatives instrument. However, ABS complies with the principle of non-recourse financing to exchange/repay financial resources. The bonds are transferred to a company specializing in securitization, with the transferring party of the asset not assuming any obligation to pay back the principal to the investor. *See* George P. Miller, *Regulatory Developments in Securitization*, in *NEW DEVELOPMENTS IN SECURITIZATION 2002*, at 733, 760, 876-77 (2002). From this perspective, ABS, too, may be considered a cutting edge financial method used to transfer credit risk, the essence of a credit derivatives instrument transaction. However, it is also true that it is used to raise capital since it uses methods such as taking over the subordinated notes by the asset transferring party as a method for reinforcing credit. *See id.* at 760. However, if the asset transferring party can completely cast away the credit risk by using methods such as appointing a third party as guarantor to reinforce credit, the characteristics of the credit derivatives instrument transaction will be altered accordingly. *See id.*

transactions serve as catalysts for the financial securitization phenomenon.<sup>103</sup>

So long as the market continues to function properly, no one can accurately forecast the limit on the growth of the new derivative financial market.<sup>104</sup> It is conceivable that this market segment could exceed the mainstream financial market in the near future.<sup>105</sup>

## II. DERIVATIVES SWAP MARKET TOOLS

Credit derivatives instruments are financial products derived from the transaction of underlying assets such as foreign currencies, deposits, bonds, and stocks.<sup>106</sup> This concept includes all transactions, whereby underlying financial assets or the future value of liabilities are sold or bought as they fluctuate according to FOREX exchange rates, interest rates, or stock prices.<sup>107</sup> Derivatives are, as the term indicates, derived from the original product. These derivatives are off-balance sheet transactions, and do not generate asset or liability fluctuation or capital settlement at the time of the transaction.<sup>108</sup> This type of transaction was often used as a means to circumvent restrictions related to assets and liabilities or spot transactions.<sup>109</sup> In general, they are classified as futures,<sup>110</sup> forwards,<sup>111</sup> options,<sup>112</sup> and swap transactions. The

103. See Smith, *supra* note 39 and accompanying text.

104. See Aicher et al., *supra* note 81, at 958 (“Obviously, no one knows exactly what the future holds for credit default swaps. It does seem probable, however, that their attractiveness is only likely to increase.”).

105. On April 18, 2007, the ISDA market survey reported that total “notional amount outstanding” credit derivatives was \$327.4 trillion with a “gross credit exposure before netting estimated to be \$8.8 trillion” as of December 31, 2006. Press Release, ISDA, ISDA Publishes Year-End 2006 Market Survey (Apr. 18, 2007), <http://www.isda.org/press/press041807ms2006.html>.

106. See DAS, *supra* note 33, at 9.

107. See WHALEY, *supra* note 4, at 679-80.

108. See CHEW, *supra* note 68, at 62.

109. See *id.*

110. See DUBOFSKY & MILLER, *supra* note 11, at 126-28. Futures are products that are traded on an exchange. In a futures transaction, a signed trading agreement establishes a currency, interest, or stock price index with the product deliverable at the preset price after the stated period of time. This is the opposed to the spot transaction whereby product delivery and payment are both conducted when the transaction agreement is signed. It is also different from the forward transaction where there is a promise among the parties to deliver and assume products at a specified point in the future. Futures transactions take place in standardized exchange. *Id.*

transaction of financial derivatives was initially used to hedge the risk of fluctuating asset value due to varying economic climates. They have developed, however, into “high risk, high return” investments due to the advanced financial engineering utilizing computer technologies.<sup>113</sup> The risk of asset value fluctuation is more widely assumed because of highly sophisticated, cutting edge financial methods.<sup>114</sup>

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111. See generally Feder, *supra* note 21, at 698-701 (explaining the procedure and operation of forwards transactions). Forwards refer to the products that are transacted outside of exchanges, where the target product is to be delivered and assumed at a specific period in the future at the promised price. The forward exchange, which is a type of forwards agreement, is the most traditional derivative. It is a transaction where the sale or purchase of the currency occurs at a specific FOREX exchange rate and at a specific time in the future. Both futures and forward transaction differ from the spot transaction in that the transaction agreement for both futures and forwards is signed at one point, but payment is not made until some future point. They are similar in the sense that they are used to hedge risk that comes from price fluctuation. However, forward transactions, unlike futures transactions, have no official exchange or standardized production. All of these transactions entail delivery of a product, payment at the point of settlement, and an exchange guarantee that is not part of the performance on the transaction. Thus, this is a transaction that may be accomplished by the average person, because it does not require warrant of money. *Id.*

112. See generally *id.* at 692-98 (explaining the procedure and operation of options transactions). An option is a transaction in which one buys or sells the right to purchase specific assets such as products or securities at a set price or within a specified period of time. The right is sold or bought at and for the present. Options transfer the risk from the buyer to the seller, with the option seller receiving a premium in return for assuming risk. Within this type of transaction, there are both put options and call options. In the case of a futures purchase, profit is generated when the price of the basic asset increases, and loss results when the price goes down. In other words, the profit and loss parallel price fluctuation. In the case of an option purchase, on the other hand, profits are realized when the price of the underlying asset increases. Even when the price goes down, however, no loss may exceed the premium. Therefore, the gain or loss is not parallel with price fluctuation, because the exercise of the option is, in fact, optional. The route that is more favorable to the option buyer is the one that will be utilized. In exchange, a premium for the right is paid to the option seller. *Id.*

113. See MCLAUGHLIN, *supra* note 6, at 1.

114. See STEINHERR, *supra* note 62, at 17-25.

### A. Swap Generally

Swaps<sup>115</sup> are classified into two categories: “commodity swaps” and “financial swaps.” Commodity swaps involve the targeted swapping of crude oil,<sup>116</sup> grains, or other products.<sup>117</sup> “This swap involve[s] the periodic payments by the first counterparty to the second based on a fixed price of a specified amount of some commodity.”<sup>118</sup> Financial swaps refer to the exchange of products such as foreign currencies, bonds, stocks, and other financial assets and liabilities.<sup>119</sup> Financial swaps are then sub-classified as either “foreign currency swaps,” “interest rate swaps,” or “equity swaps.”<sup>120</sup> Foreign currency swaps include the composite buying and selling of foreign currency, as in the purchase of a forward exchange at the same time that a spot exchange is sold, or vice versa.<sup>121</sup> An interest rate swap involves exchanging the flow of interest between two bonds with different interest payment methods or with the same currency indicated.<sup>122</sup> It is the so-called off-balance sheet transaction that does not accompany the exchange of principal.<sup>123</sup> In particular, interest rate swaps are popular because they involve bond issuance or mid- to long-term financing.<sup>124</sup> It is customary for these transactions to be tied together, as opposed to keeping them as independent proprietary transactions. Exchange of the principal does not actually take place.<sup>125</sup> Instead, “[t]he amount of each payment is calculated on the basis of a hypothetical, or ‘notional’

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115. With regard to the swap, “[t]he terminology is further complicated by the U.S. market’s use of the word ‘swap’ to refer to an exchange of one bond for another . . . and the U.K. market’s use of the term ‘switch’ for the same transaction.” TAVAKOLI, *supra* note 72, at 63.

116. See, e.g., Willa E. Gibson, *Are Swap Agreements Securities or Futures?: The Inadequacies of Applying the Traditional Regulatory Approach to OTC Derivatives Transactions*, 24 J. CORP. L. 379, 386 (1999).

117. See, e.g., DUBOFSKY & MILLER, *supra* note 11, at 317.

118. Gibson, *supra* note 116, at 384.

119. See CHANCE, *supra* note 40, at 560-64, 575-84, 627-31.

120. See *id.* at 627 (“In equity swaps one counterparty pays according to the performance of a stock index. A typical equity swap would involve one side paying interest according to LIBOR while the other side makes a payment based on the return on the S&P 500 times the notional principal.”).

121. See, e.g., *id.* at 560-62.

122. See Gibson, *supra* note 116, at 384.

123. See CHANCE, *supra* note 40, at 575-84.

124. See Gibson, *supra* note 116, at 384-85.

125. See CHANCE, *supra* note 40, at 579.



principal amount . . . .”<sup>126</sup> Meanwhile, an exchange of principal may occur in a currency swap where a bond obligation with different currencies is exchanged.<sup>127</sup> An interest rate swap, which is a mix of the two, refers to a transaction that entails the exchange of an obligation or assets.<sup>128</sup>

As interest on credit risk increased beginning in the mid 1990s, credit derivatives instruments related to credit risk began to appear *en masse* with regard to the CDS.<sup>129</sup> CDS’s and TRS’s sold by JP Morgan, a pivotal player in the financial derivatives arena, are noteworthy.<sup>130</sup> A credit swap transaction applies the general interest swap technique to a credit risk transaction in order to hedge risk following a change in credit.<sup>131</sup> Cash flows change accordingly, depending on the change in credit level. A credit swap entails dispersing credit risk among the parties to a transaction according to a prearranged formula.<sup>132</sup>

The assumption of an obligation is not part of a swap.<sup>133</sup> From a legal standpoint, a swap transaction does not affect the relationship between the obligee and obligor because it does not implicate the assumption of any obligation, but rather merely creates an agreement “to exchange cash flows.”<sup>134</sup> A swap does not entail a dischargeable or duplicable assumption that involves undertaking the obligation of the other party. Rather, only the specific cash flows of the obligation are exchanged at some future date.<sup>135</sup> While the original obligor must repay the obligee, the counterparty of the swap agreement still does not assume the underlying obligation. Specifically, a swap transaction is not

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126. MCLAUGHLIN, *supra* note 6, at 43.

127. See CHANCE, *supra* note 40, at 560; WHALEY, *supra* note 4, at 18; *cf.* CHEW, *supra* note 68, at 7.

128. See WHALEY, *supra* note 4, at 18. (“The cash flows of the two legs of a swap can be linked to virtually any reference rate, asset price, or index level.”).

129. See DUBOFSKY & MILLER, *supra* note 11, at 320; *see also* CHOUDHRY, *supra* note 56, at 5.

130. See Gibson, *supra* note 116, at 387-88 (citation omitted) (“Banks typically purchase credit swaps to insure payment of a loan made to a client upon the client’s default.”); *see also* MCLAUGHLIN, *supra* note 6, at 18.

131. See CHOUDHRY, *supra* note 56, at 54-58.

132. See DUBOFSKY & MILLER, *supra* note 11, at 8.

133. See CHANCE, *supra* note 40, at 560-64, 575-84, 627-31.

134. See DUBOFSKY & MILLER, *supra* note 11, at 7.

135. *See id.* at 8.

a trade that involves the obligee. Instead, it is an internal issue that occurs between the obligation and the counterparty of the swap.<sup>136</sup>

Generally, markets classify credit derivatives into single-name derivatives and multi-name derivatives, which are classified depending on either the reference asset-issuing institution or the number of the reference entities.<sup>137</sup> Single-name credit derivatives issued by an institution that has a reference asset include single-name CDS and TRS, each having a relatively standardized product structure.<sup>138</sup> Multi-name credit derivatives are issued by many reference entities, and they target bond or loan assets. These derivatives include basket default swaps (“BDS”), portfolio default swaps (“PDS”) and synthetic collateralized debt obligations (“CDO”). On the other hand, a CLN may involve many reference entities that are the target of credit risk.<sup>139</sup>

This Article next examines the basic structure of popular single-name credit derivatives such as CDS’s and TRS’s, and prevalent multi-name credit derivatives such as CLN’s, BDS’s, PDS’s, and synthetic CDO’s.

### B. Credit Default Swap

Generally, “[c]redit default swaps began as instruments for managing credit risk.”<sup>140</sup> A single-name CDS is a mutual agreement whereby the protection buyer (the credit risk seller), pays either a one-time premium to the protection seller (the credit risk buyer or the investor), or, if a credit event occurs in the reference entity, makes periodic payments in exchange for all or part of the loss.<sup>141</sup> If an agreed-upon credit event such as bankruptcy or default occurs, the protection seller must compensate for the value of the lost reference asset.<sup>142</sup> This can be achieved through the payment of cash (i.e., cash settlement), or by purchasing the reference asset at face value, despite the applicable reference asset’s decline in value (i.e., physical settlement).<sup>143</sup>

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136. See Aicher et al., *supra* note 81, at 955 (comparing credit default swap with guaranties and insurance).

137. See WHALEY, *supra* note 4, at 681.

138. *Id.* at 681-85 (describing credit products market by pie chart).

139. See, e.g., *infra* Part II.D.

140. See Aicher et al., *supra* note 81, at 954.

141. See BOMFIM, *supra* note 1, at 6, 68.

142. See CHOUDHRY, *supra* note 56, at 47.

143. See *id.* at 69.

In a CDS, the agreed-upon principal (i.e., the amount of protection against loss), is not paid when the transaction is signed.<sup>144</sup> Thus, a CDS is an unfunded structure that is not accompanied by capital-raising.<sup>145</sup> A CDS is different from a TRS, which will be examined below, in the sense that the protection seller merely assumes the credit risk and does not assume the market risk, the price risk of the reference asset.<sup>146</sup> The CDS is the most fundamental structure of the swap, and hence is also referred to as a “vanilla” CDS.<sup>147</sup>

Like other credit derivatives, a credit event for a CDS triggers the protection seller’s obligation to repay the reference asset to the protection buyer in exchange for a premium.<sup>148</sup> Therefore, a credit event plays an important role in the CDS agreement.<sup>149</sup> A standard CDS transaction typically complies with the categories of credit events that are defined by the ISDA.<sup>150</sup>

A premium is the price of a credit derivative, and is determined by a floating interest rate used to hedge the interest fluctuation risk.<sup>151</sup> Premiums are determined by factors such as the reference entity, the protection seller’s credit risk, the expected “recovery rate”<sup>152</sup> of the principal if a credit event occurs, and conditions in the financial

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144. *See id.* at 54 (explaining that the protection buyer agrees to make periodic payments over a predetermined number of years (the maturity of the CDS) to the protection seller).

145. *See* DOMINIC O’KANE ET AL., LEHMAN BROS., THE LEHMAN BROTHERS GUIDE TO EXOTIC CREDIT DERIVATIVES 7 (2003).

146. *See* TAVAKOLI, *supra* note 72, at 61.

147. *See* BOMFIM, *supra* note 1, at 68.

148. *See* CHOUDHRY, *supra* note 56, at 54-55.

149. *See* Aicher et al., *supra* note 81, at 954-55 (“In a credit default swap, two parties agree that the protection seller will pay to the protection buyer certain amounts upon the occurrence of a credit event with respect to a reference entity and satisfaction of the relevant conditions to payment or . . . settlement.”) (citation and quotation marks omitted).

150. *See id.* at 954 (“Credit default swaps are often documented using ISDA form agreements and by incorporation of standard definitions applicable to credit default swaps published by ISDA.”).

151. *See* Jorge A. Chan-Lau, *Anticipating Credit Events Using Credit Default Swaps, with an Application to Sovereign Debt Crises* (IMF, Working Paper No. WP/03/106, 2003).

152. *See* CHOUDHRY, *supra* note 56, at 15 (“The percentage of the original loan that is received back [when a corporation enters into liquidation, winding-up or dissolution] is known as the recovery rate, which is defined as the percentage of par value that is returned to the creditor.”) (emphasis omitted).

markets.<sup>153</sup> The protection seller's credit risk refers to the concern that the agreement will not be performed because of bankruptcy or other event.<sup>154</sup> This is often referred to as the counterparty risk.<sup>155</sup>

An increase in the credit risk of the reference entity, a decrease in the protection seller's credit risk, and a reduced recovery rate for the underlying asset when the credit event occurs may increase premiums.<sup>156</sup> Curtailing the reference entity's moral hazard and monitoring the management situation may lower premiums.<sup>157</sup> For example, premiums decrease when there are special clauses, such as covenants, prohibiting management activities that might decrease financial viability, or requirements that the reference entity provide management information such as a corporate bond.<sup>158</sup>

Overall, a CDS is the medium for transferring the protection buyer's credit risk position to the protection seller.<sup>159</sup> A reference asset holder signs the CDS agreement as a way to replace the reference entity's credit risk with the protection seller's credit risk, i.e. the counterparty risk, for a specific period of time, by paying a fixed premium to the protection seller.<sup>160</sup> For example, banks use CDS's to sell only the credit spread, which means that they sell the credit risk without selling the retained asset.<sup>161</sup>

In order for a bank to adjust its degree of exposure to credit risk, it must notify the original counterparty in advance to obtain consent.<sup>162</sup> This can result in considerable harm to customer relations and risk management. When a CDS merely separates the credit risk of the reference entity, however, there is no duty to notify the original

153. See BOMFIM, *supra* note 1, at 73. (“[T]he higher the credit risk associated with the entity, the higher the price of protection.”).

154. See *id.* at 71-72.

155. See *id.* at 15.

156. See *id.* at 78-80.

157. See *id.* at 136 (“One manifestation of the moral hazard problem is the concern that the bank may make riskier loans than otherwise if it knows that it can then transfer all of the associated credit risk to CDO investors.”).

158. See BOMFIM, *supra* note 1, at 101-02 (discussing the factors that determine value of premium).

159. See O’KANE ET AL., *supra* note 145, at 4.

160. See *id.* at 4-5; BOMFIM, *supra* note 1, at 54-55.

161. See O’KANE ET AL., *supra* note 145, at 4-5; BOMFIM, *supra* note 1, at 54-55.

162. See CHOUDHRY, *supra* note 56, at 58. In rolling maturity swaps and constant maturity swaps, the contract party can freely and periodically reset the maturity date and swap the premium at each roll date. *Id.*

counterparty. Therefore, it is possible for a bank to adjust its degree of exposure to the credit risk while still avoiding a customer relations problem.<sup>163</sup> From the bank's perspective, it is possible to separate customer relationship and risk management, since the outcome allows for securitization of the credit asset without removing it from the balance sheet.<sup>164</sup>

### C. Total Return Swap

A Total Return Swap is a bilateral financial agreement whereby one party of an agreement (the total return payer or beneficiary) promises to deliver whole numbers of specific cash flow (LIBOR + spread) derived from the reference asset (securities with bank loan or credit risk) to the counterparty (total return receiver or investor) in return for assuming the risk related to the investor's financial assets.<sup>165</sup> Accordingly, a TRS provides the means for managing risk by transferring the market and credit risk of the reference asset to the investor. From the investor's point of view, a TRS provides the means for collecting cash flow without buying the reference asset in person.<sup>166</sup> Thus, it is possible to create the effect of a direct investment on the reference asset. Because the investor receives return from the reference asset, the economic effect is the same as possessing the reference asset without owning it.<sup>167</sup> Therefore, a TRS has the legal characteristics of a synthetic long position in a loan or security.<sup>168</sup>

The agreement terminates when the credit event fails to occur prior to the maturity of the TRS.<sup>169</sup> If a credit event occurs prior to maturity, however, the investor must either settle the loss resulting from the credit event with cash or buy the reference asset, thereby undertaking a physical settlement at that agreed-upon amount, known as the "nominal

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163. See CHOUDHRY, *supra* note 56, at 41 ("Credit derivatives allow investors to manage the credit risk exposure of their portfolios or asset holdings, essentially by providing insurance against a deterioration in credit quality of the borrowing entity.").

164. See *id.* at 45.

165. See BOMFIM, *supra* note 1, at 82; see also TAVAKOLI, *supra* note 72, at 20.

166. See TAVAKOLI, *supra* note 72, at 20 ("The total rate of return payer is the legal owner of the reference asset . . . [and] holds the reference asset on its balance sheet.").

167. See JANET TAVAKOLI, INTRODUCTION TO CREDIT DERIVATIVES TOTAL RETURN SWAPS-TRS, 2-3 (2001), available at <http://www.tavakolistructuredfinance.com/TRS.pdf> [hereinafter "TAVAKOLI, TRS"].

168. See *id.* at 3.

169. See CHOUDHRY, *supra* note 56, at 92.

amount”.<sup>170</sup> Compared to the CDS, in which the payment to offset a loss is made only when the credit event occurs, a TRS factors in the reference asset’s market value during a normal circumstance. This allows for the generation of cash flow between beneficiary and investor regardless of whether the credit event occurs. Put more precisely, a TRS and CDS are different in the sense that the investor pays “LIBOR + spread” to the payer of total return in exchange for undertaking the total return. Therefore, market risk, here the price risk of the reference asset, is taken on in addition to credit risk.<sup>171</sup>

The payer of total return who buys protection through a TRS can be protected from the credit and market risks even when the reference asset is not sold during a specific period of time. As one author explains, “[t]he payer in a TRS creates a hedge for both price risk and default risk of the reference asset, although the payer in the TRS is a legal owner of the reference asset.”<sup>172</sup> If a credit event occurs prior to the maturity of the TRS, the payer of total return is compensated by the receiver of total return for the loss in the form of a cash settlement or physical settlement in an amount previously agreed upon.<sup>173</sup> If a credit event fails to occur prior to the maturity of the TRS, an amount equal to the change in the reference asset’s market value is paid either (a) to the receiver of total return from the payer of total return, or (b) from the total return receiver to the total return payer.<sup>174</sup> A TRS, then, helps to remove the reference asset from the total return payer’s balance sheet during the period of the agreement.<sup>175</sup>

The payer of total return, such as a bank with a high credit rating, uses the capital raised with LIBOR interest to obtain balance sheet assets like loan securities.<sup>176</sup> The bank then receives LIBOR + spread in exchange for transferring the resulting return to the investor.<sup>177</sup> Therefore, it is possible to generate non-risk profit up to the level of the

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170. *See id.* at 92-94.

171. *See* Feder, *supra* note 21, at 712.

172. TAVAKOLI, TRS, *supra* note 167, at 4.

173. *See* 1999 ISDA DEFINITIONS, *supra* note 16, at art. III, §§ 3.1-3.10 for the whole process of the settlement.

174. *See* TAVAKOLI, *supra* note 72, at 20.

175. *See id.* at 21 (“The [TRS] . . . is an off-balance sheet transaction, and the reference asset does not appear on the balance sheet of the receiver.”).

176. *See* CHOUDHRY, *supra* note 56, at 71-74.

177. *See id.*

spread.<sup>178</sup> The LIBOR + spread that the investor pays to the payer of total return is the capital raised with LIBOR interest by the payer of total return. Thus, it can be taken for the premium paid in exchange for buying the reference asset on behalf of the investor. With a TRS, therefore, an investor can benefit from the return generated from the reference asset without actually raising the capital to buy the reference asset.<sup>179</sup> Moreover, the relatively short-term maturity of the TRS is more beneficial than the long-term maturity of the reference asset, allowing investors to raise capital for the short-term with low interest and continue to use it over the long-term with high interest.

#### *D. Credit Linked Notes*

In a CLN transaction, the protection buyer signs a CDS agreement with the dealer, known as the CLN issuer or special purpose vehicle (“SPV”), based on a reference asset such as a retained loan.<sup>180</sup> A CLN is issued to the investor who, in essence, is the protection seller.<sup>181</sup> The CLN issuer will then pay a fixed interest or floating coupon up to the protection fee.<sup>182</sup>

In the CDS, only the protection premium is given and received without the burden of raising capital for the principal.<sup>183</sup> With a CLN, the investor pays for the principal of the first bond issued.<sup>184</sup> Thus, a CLN has a structure that is accompanied by raising capital.<sup>185</sup> The principal paid by the investor to the dealer plays the role of securing the performance of protection. Therefore, if a credit event occurs, the CLN investor receives the remaining balance after deducting compensation for the loss in the middle of the contract period (cash settlement) or

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178. See TAVAKOLI, TRS, *supra* note 167, at 3.

In a very [strict] . . . sense, TRS are not credit derivatives. TRS, considered in their most basic form, are funding cost arbitrages. TRS are applied in a variety of ways: balance sheet management, portfolio management, hedge fund leverage, and asset swap maturity manipulation. While the overall effect of a TRS may have very important credit implications for both the payer and receiver of the total rate of return swap, the use is primarily that of a financing.

*Id.* (emphasis omitted).

179. See TAVAKOLI, *supra* note 72, at 20.

180. See CHOUDHRY, *supra* note 56, at 116.

181. See *id.*

182. See *id.* at 115.

183. See *id.* at 55.

184. See *id.* at 115.

185. See O’KANE ET AL., *supra* note 145, at 7.

acquiring the underlying asset at face value (physical settlement).<sup>186</sup> If a credit event does not occur, the total principal is paid back.<sup>187</sup> Basically, a CLN is a more structured product than the CDS. The use of the SPV makes it possible to eliminate counterparty risk and indirect investment in the credit risk, allowing investors who were previously restricted by regulations or transaction costs to do so directly using a CDS.<sup>188</sup>

Meanwhile, institutions that issue CLNs are not restricted by specific regulations.<sup>189</sup> Rather, the structure issued by the SPV is typical in the financial market, where the SPV secures credit risk via the underlying asset of the CLN and enters into a CDS agreement with the reference asset owner.<sup>190</sup> Accordingly, a CLN can be considered a type of financing device linked to a secured CDS or CDS.<sup>191</sup>

In sum, the CLN issuer uses a CLN as a means for hedging credit risk and provides protections to the protection buyer through the CDS transaction.<sup>192</sup> On the other hand, the investor puts money in to gain the higher interest rate of the CLN.<sup>193</sup> In general, the coupon rate of the CLN is higher than that of the regular bond issued by the dealer or SPV, the CLN issuer.<sup>194</sup> Since it is issued at a discounted rate,<sup>195</sup> the CLN can be an attractive investment for investors who seek a higher return from their investment strategy.<sup>196</sup>

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186. See Feder, *supra* note 21, at 715 (“If the arrangement is cash-settled, the note issuer will deduct a stipulated credit-default amount from the principal. If the arrangement is physically-settled, the note issuer will deliver the reference asset to the note holder, instead of redeeming with cash.”).

187. See CHOUDHRY, *supra* note 56, at 115 (stating that a value less than par, however, will be paid to the investor).

188. *Id.* at 121 (“The majority of CLNs are issued directly by banks and corporates [sic] in the same way as conventional bonds.”).

189. See *id.* at 116 n.2.

190. See *id.* at 118.

191. See WHALEY, *supra* note 4, at 694.

192. See Feder, *supra* note 21, at 716 (“As in the case of a credit default swap, credit-linked debt transfers only credit risk.”).

193. See CHOUDHRY, *supra* note 56, at 116 (“The [CLNs] are often used by borrowers to hedge against credit risk, and by investors to enhance the yield received on their holdings.”).

194. See *id.* at 121.

195. See WHALEY, *supra* note 4, at 695.

196. See FRANCIS ET AL., *supra* note 59, at 46-47 (arguing the advantages and disadvantages of CLNs).



*E. Basket Default Swap*

Unlike single-name CDS's that target one single-reference asset, the Basket Default Swap is a form of CDS that creates a pool of many-reference assets.<sup>197</sup> According to the likely order in which credit events will occur, these risks are classified into categories such as "first-to-default basket" swaps, "second-to-default basket" swaps, and so on.<sup>198</sup> In a sense, it is the same as the CDS because the protection buyer pays a specific premium to the protection seller and the protection seller compensates the protection buyer for the loss if a credit event occurs.<sup>199</sup> It differs from a CDS, however, in the sense that there is not only one reference entity that issues the reference asset, but rather may include five, ten, twenty or more reference entities.<sup>200</sup>

The protection seller of a BDS transaction compensates for losses only for the credit events in the order (e.g., first, second, third, etc.) agreed upon in advance, and then the agreement is terminated.<sup>201</sup> For example, the protection seller of the "first-to-default basket" swap transaction is responsible for the compensation of the credit risk only for the first credit event, even if more than one credit event occurs within the basket.<sup>202</sup> In other words, the protection seller pays the protection buyer for the applicable loss when the first credit event occurs that satisfies the agreed-upon terms, and then the agreement is terminated. Likewise, in the case of a "second-to-default basket" swap, the protection buyer is protected by the protection seller only for the occurrence of the second credit event among the reference entities in the basket.<sup>203</sup> Calculation of the premium for the BDS is significantly

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197. See BOMFIM, *supra* note 1, at 99.

198. See CHOUDHRY, *supra* note 56, at 59, 62-66 (illustrating a basket credit default swap).

199. See *id.*

200. See TAVAKOLI, *supra* note 72, at 158 ("Basket structures are generally best suited for investment-grade credits with low correlations and low covariance.").

201. See CHOUDHRY, *supra* note 56, at 126-29.

202. See O'KANE ET AL., *supra* note 145, at 8 ("The advantage of a FTD basket [swap] is that it enables an investor to earn a higher yield than any of the credits in the basket.")

203. See TAVAKOLI, *supra* note 72, at 160-61 ("The [ ] protection seller will make a payment on only one of the credits, not on all [reference asset], so the protection seller is compensated for only one default plus the increased likelihood of a defaulting occurring."). Generally, "a first-to-default basket (n=1) is riskier than a second-to-default basket." See O'KANE ET AL., *supra* note 145, at 9.

influenced by the CDS's average premium that targets the individual issuing institution, the number of institutions issuing reference assets,<sup>204</sup> and the correlation of credit risk between the reference asset issuing institutions.<sup>205</sup> In addition, “[a]ny theoretical model of pricing basket swaps would include the following key inputs: . . . probability of default of reference entities and protection seller . . . [and] maturity of swap and expected recovery value of the reference entities.”<sup>206</sup> Deciding on the premium rate of a certain default basket is a very complex task. A great deal of research is currently being conducted in this area.<sup>207</sup>

#### F. Portfolio Default Swap

The Portfolio Default Swap is a structured financial product similar to the BDS.<sup>208</sup> The number of institutions that issue reference assets is considerably higher (between forty and one hundred), and the limit for the compensation is not based on the order in which the credit events occur. Rather, the limit for the compensation is determined by a ratio in the portfolio that is an amount agreed upon in advance.<sup>209</sup> For example, an agreed upon credit risk of the protection seller may be 10%. Therefore, the PDS transaction insulates the protection buyer from a loss of up to 10% of the portfolio assets that results from credit events occurring on the reference portfolio. Any loss exceeding this percentage would not be covered.<sup>210</sup>

Likewise, assume there is a “second-loss piece” PDS transaction that is signed to guarantee loss from a credit event that exceeds 10% of the portfolio asset. In this case, the protection seller is not responsible for the loss within the agreed-upon 10% that results from credit events, but protects the protection buyer for any portion that exceeds 10%. Accordingly, a PDS can be structured into various tiers with different risk profiles. This is similar to the way an ABS is issued for various

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204. See BOMFIM, *supra* note 1, at 101.

205. See *id.* at 102.

206. See FRANCIS ET AL., *supra* note 59, at 86.

207. See *id.* at 89.

208. See BOMFIM, *supra* note 1, at 107.

209. See *id.* at 107-10.

210. See *id.* at 107-08.

tranches,<sup>211</sup> such as senior, mezzanine, and equity—each with a different risk profile.<sup>212</sup>

Like a BDS, a PDS's premium rate is influenced significantly by the "correlation of credit risk"<sup>213</sup> among the reference assets. From the investor's point of view, a PDS restricts the actual assumption of loss because the maximum loss is agreed upon in advance. Leverage is provided to the investment in credit risk and provides the means for a high return.<sup>214</sup> From the protection buyer's point of view, a PDS provides the medium for transferring considerable credit risk to the protection seller with relative ease.<sup>215</sup> In other words, it is more convenient for the protection buyer to use a PDS transaction instead of individual CDS transactions with the protection seller of the reference asset that is in the portfolio. Moreover, if the protection buyer wants partial protection on the entire portfolio, a PDS provides a relatively cost-effective means.

#### *G. Synthetic Collateralized Debt Obligation*

A Synthetic Collateralized Debt Obligation is a structured financial product<sup>216</sup> which generates cash flow. It is similar to the traditional cash CDO because it uses the transaction of a credit derivative, such as a credit swap, to transfer the credit risk inherent in reference assets, such as a majority of the loan obligations and regular corporate bonds, to the separately established SPV.<sup>217</sup> This intermediary<sup>218</sup> issues securities

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211. See WHALEY, *supra* note 4, at 695 n.13.

212. See BOMFIM, *supra* note 1, at 135-36.

213. See CHOUDHRY, *supra* note 56, at 20 ("Correlation is a measure of the degree to which a value of one variable is related to the value of another. . . . It is particularly important in the measurement of the variance (hence volatility) of a portfolio.").

214. See BOMFIM, *supra* note 1, at 110.

215. See *id.*

216. O'KANE ET AL., *supra* note 145, at 12 ("[S]ynthetic CDOs . . . were conceived in 1997 as a flexible and low-cost mechanism for transferring credit risk off bank balance sheets.").

217. See FRANCIS ET AL., *supra* note 59, at 95 ("The critical difference between this structure and a traditional CDO is that, unlike a typical CDO, a synthetic securitization does not purchase underlying assets like bonds or loans, but rather references them by way of credit default swaps.") (quotation marks omitted). Generally, SPVs are incorporated as a form of paper company in tax and regulatory havens such as Cayman Island and Bermuda. See *id.* at 47.

218. See WHALEY, *supra* note 4, at 695.

with different credit levels that are linked with the credit risk to sell to the investors.<sup>219</sup> Namely, synthetic CDO's can broadly be defined as the transfer of credit risk plus a cash CDO, consisting of tranches.<sup>220</sup>

From the perspective of the reference asset holder, a synthetic CDO differs from the traditional cash CDO because actual cash inflow does not occur as it does for the traditional cash CDO.<sup>221</sup> The reference asset's credit risk shifts to the investor, however, who realizes the goal of securitization—the conversion of reference assets into a cash equivalent asset. This is called synthetic securitization.<sup>222</sup>

A traditional, non-synthetic cash CDO is issued when the SPV assigns the loan obligation itself from the asset holder.<sup>223</sup> On the other hand, a synthetic CDO does not entail an actual transfer of the loan obligation to the SPV by the asset holder. Instead, credit derivatives such as a credit swap, CLN, or TRS are used to separate out the credit risk of the loan obligation to transfer to the SPV. In other words, a synthetic CDO merely transfers the credit risk of the reference asset to the SPV and an investor, without transferring the legal ownership of the reference asset to the SPV.<sup>224</sup>

Meanwhile, the synthetic CDO is used mainly as a “balance sheet CDO” and “arbitrage synthetic CDO.”<sup>225</sup> These two types of CDO's essentially share the same structure. The major difference between them is the identity of the participants to the transaction and the purpose of the transaction. Typically, banks or other single financial companies that own reference assets sponsor balance sheet synthetic CDO's, and they issue synthetic CDO's for hedging purposes.<sup>226</sup> On the other hand, sponsors of the arbitrage synthetic CDO are one of several asset

219. See BOMFIM, *supra* note 1, at 133.

220. See WHALEY, *supra* note 4, at 695-97.

221. See BOMFIM, *supra* note 1, at 133-37.

222. See FRANCIS ET AL., *supra* note 50, at 95 (“Investors purchasing one of the various risks can tailor their risk exposure to this large and diversified credit portfolio through tranches of a synthetic securitization.”).

223. See Partnoy & Skeel, *supra* note 7, at 1028.

224. See MARK J. P. ANSON ET AL., CREDIT DERIVATIVES: INSTRUMENTS, APPLICATIONS, AND PRICING 140 (2004).

225. See STANDARD & POOR'S, GLOBAL CASH FLOW AND SYNTHETIC CDO CRITERIA 6 (2002).

226. BOMFIM, *supra* note 1, at 136. According to one expert, “banks' desire to free up regulatory capital through balance-sheet CDOs was an important driver of CDO market activity in the 1990s.” *Id.*

management companies that may or may not own reference assets.<sup>227</sup> The goal of the arbitrage synthetic CDO essentially is to gain the difference<sup>228</sup> that results from the price discrepancy between the regular bond market and credit derivatives market.<sup>229</sup>

The balance sheet synthetic CDO is classified into funded and unfunded structures depending on each investor's position.<sup>230</sup> The funded structure, accompanied by raising capital, exists if the investors purchase CDO bonds in cash.<sup>231</sup> The SPV then uses the capital to purchase swap collateral. In contrast, unfunded structures are not accompanied by capital-raising, do not involve the acquisition of swap collateral, and have a structure whereby investors assume the loss that results from a credit event in the reference asset.<sup>232</sup>

The most likely motive for issuing a synthetic CDO is that the financial institutions that own reference assets can remove the credit risk for the reference assets without notifying or obtaining consent from the counterparty.<sup>233</sup> This is done by attaching credit derivatives within the CDO structure. A traditional balance sheet CDO requires notification and approval from the debtor before the loan obligation can be transferred to the SPV.<sup>234</sup> On the other hand, the process of notifying or obtaining approval from the debtor is not necessary for the synthetic CDO transaction, since there is no actual transfer of the reference asset.<sup>235</sup>

The synthetic CDO was initially invented to accommodate the balance sheets of European banks because of the traditional belief that selling a customer's loan obligation would have a negative effect on

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227. *Id.* at 137.

228. *See* ANSON ET AL., *supra* note 224, at 133.

229. *See id.*

230. *See* BOMFIM, *supra* note 1, at 136. Banks use this transaction tool in order to remove assets from their balance sheets. WHALEY, *supra* note 4, at 696.

231. *See* BOMFIM, *supra* note 1, at 134 ("To fund the purchase of the loan portfolio, the issuer sells debt obligations (notes) to investors."); *see also* WHALEY, *supra* note 4, at 696 ("The sponsor of the CDO usually sets the size of the senior class so that it can attain a triple-A rating.").

232. *See* BOMFIM, *supra* note 1, at 36.

233. *See* STANDARD & POOR'S, *supra* note 225, at 5, 13 (arguing sponsoring institution's motivation of synthetic CDO).

234. *See* BOMFIM, *supra* note 1, at 137 (It is because "many bank loans are inherently illiquid.").

235. *See* ANSON ET AL., *supra* note 224, at 140.

customer relations.<sup>236</sup> Today, some nations are demanding fuller disclosure of the reference asset portfolio as a way to protect investors against synthetic CDOs, as well as narrowly defining the scope of the credit event.<sup>237</sup> Compared to the first synthetic CDO transactions, there is now better protection for investors because of the improvements that have been made.<sup>238</sup>

For the asset holder, another advantage of synthetic CDOs is the potential to curtail the unnecessary raising of funds. When an unfunded structure is used that is not accompanied by formal capital raising, the asset holder benefits from the mitigation of regulated capital while transferring only the credit risk on the reference asset. Besides the BIS ratio,<sup>239</sup> transfer of the loan asset waives both the mandatory procedure of satisfying the countermeasure and the cost, prevents the leaking of customers' confidential information, and might also eliminate the burden of exercising the right of the mortgage.<sup>240</sup>

In addition, a CDO issued by the SPV in connection with the synthetic CDO offers a favorable term to the investor since the coupon rate is high compared to the interest rate of the AAA-rated regular floated rate note<sup>241</sup> as long as a credit event does not occur. This high return, however, is only compensation for payment protection. Thus, the investor needs to remember that credit risk management is the key to investment.<sup>242</sup> As for the basic issuance structure of the synthetic CDO, it is comprised of three classes that are different in terms of the degree of

236. See BOMFIM, *supra* note 1, at 139.

237. See CGFS, *supra* note 26, at 2, 25-29.

238. See Partnoy & Skeel, *supra* note 7, at 1027-31. Professors Partnoy and Skeel, however, warned that “[t]he transaction costs associated with CDOs are very high, and there is reason to believe that the potential benefits of CDOs . . . are not real.” *Id.* at 1040-41.

239. The BIS ratio gives an indication of the solvency of a bank. It gives the ratio between the risk-bearing capital and the risk-weighted assets. See BizTerms.net, <http://www.bizterms.net/term/BIS-ratio.html> (last visited Mar. 15, 2008).

240. See *id.* at 1027-31 (arguing the benefits of CDOs).

241. See Partnoy & Skeel, *supra* note 7, at 1028-29.

242. See TAVAKOLI, *supra* note 72, at 8. Sometimes, the synthetic CDO is called an investor-driven product. Market experts believe “[t]he advantage of CDOs is that by changing the details of the tranche in terms of its attachment point (this is the amount of subordination below the tranche) and width, it is possible to customize the risk profile of a tranche to the investor’s specific profile.” O’KANE ET AL., *supra* note 145, at 13. Of course, “[a] synthetic CDO offers further diversification by enabling investors to invest in a diversified portfolio of credit default swaps.” Partnoy & Skeel, *supra* note 7, at 1031.

exposure to the credit risk.<sup>243</sup> That is, a synthetic CDO has a structure whereby the loss-generating risk of the reference asset is applied sequentially depending on the seniority of each tier.<sup>244</sup> If the company loan included in the reference asset portfolio defaults due to bankruptcy, the loss is first assumed by the equity investor,<sup>245</sup> followed by the mezzanine investor, the owner of the mezzanine tranche, and finally, the senior investor, the owner of the senior tranche.<sup>246</sup>

### III. OPERATING MECHANISMS OF CREDIT DERIVATIVE SWAPS

A swap refers to a transaction whereby specific products, financial assets, or liabilities are exchanged with the counterparty's products, assets, or liabilities on a specific day or during a specific period in the future.<sup>247</sup> A swap transaction is the dealing of future assets and liabilities, and is a type of forward transaction. In addition, the transaction is an over-the-counter transaction rather than an officially recognized exchange.<sup>248</sup> Originally, a swap was the product of financial engineering, first occurring between different currencies. Subsequently, interest swaps developed, eventually followed by the implementation of commodity swaps.<sup>249</sup>

Recently, the use of swaps expanded to the stock markets.<sup>250</sup> A company or financial institution undertakes a swap transaction because it seeks a "comparative advantage" in terms of lending. This comparative advantage is characterized as the difference between lending costs and investment gains that exist among the foreign currency market, short-term financial markets, long-term capital markets, and the various financial markets existing within the same region or between

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243. See BOMFIM, *supra* note 1, at 135.

244. See *id.*

245. See WHALEY, *supra* note 4, at 696. When an equity investor in the synthetic CDO assumes high default risk, it is sometimes called "toxic waste." *Id.*

246. See BOMFIM, *supra* note 1, at 135-36.

247. See WHALEY, *supra* note 4, at 679-85.

248. See MCLAUGHLIN, *supra* note 6, at 36-41; see also GEOFFERY POITRAS, RISK MANAGEMENT, SPECULATION, AND DERIVATIVE SECURITIES 10 (2002).

249. See generally BOMFIM, *supra* note 1, at 53-58 (for asset swaps), at 67-73 (for credit default swaps), at 83-87 (for total return swaps), at 99-101 (for basket default swaps), at 107-10 (for portfolio default swaps); see also CHEW, *supra* note 68, at 10; WHALEY, *supra* note 4, at 637-38, 648-53.

250. See BOMFIM, *supra* note 1, at 17-25; see also WHALEY, *supra* note 4, at 11-19.

multiple regions.<sup>251</sup> As swap transactions become more prominent, the differences between these markets tend to decrease. Thus, in the end, swap transactions play a role in integrating international financial markets.<sup>252</sup>

A CDS is the standardized financial agreement that transfers credit risk among the parties of a transaction.<sup>253</sup> It is the most important and popular tool used in the credit derivatives instrument market.<sup>254</sup> Essentially, the CDS is the device that transfers credit risk from one party to a specified counter-party within the parameters of a bilateral OTC agreement entered into by the parties.<sup>255</sup> A CDS thus has an effect similar to a guaranty of payment.

As examined above, companies and financial institutions today are exposed to uncertain business factors.<sup>256</sup> In particular, exposure to the counterparty's credit risk is increasing.<sup>257</sup> This phenomenon is a reality from which companies simply cannot escape. Therefore, companies or financial institutions should focus not on escaping credit risk, but rather on effectively managing this inevitable credit risk. The following subsection examines the legal characteristics of the transaction of a credit derivatives instrument, particularly the CDS.

#### A. Bilateral Agreements

A credit derivatives instrument transaction is an agreement by which all or part of the third party's (the original obligor's) credit risk

251. See DECOVNY, *supra* note 74, at 2.

252. See WHALEY, *supra* note 4, at 679-85. One writer emphasizes that:

The key to [derivatives] investment management is to minimize risk while maximizing return. In theory, for every risk appetite there is an "efficient frontier" of returns. This is sort of the demilitarized zone (DMZ) of investment management. Below the DMZ one is safe-too safe to win the war against [fluctuation of value]. . . . Credit derivatives are a tool to help move the DMZ farther into risky territory without taking more casualties. Specifically, credit derivatives can help diversify the credit risk of a portfolio to dampen the volatility of potential returns.

TAVAKOLI, *supra* note 72, at 8.

253. See WHALEY, *supra* note 4, at 687-90.

254. See BOMFIM, *supra* note 1, at 67.

255. See *id.* at 67-70.

256. See MCLAUGHLIN, *supra* note 6, at 1.

257. See TAVAKOLI, *supra* note 72, at 33 ("Counterparty risk . . . is the mark-to-market exposure for the credit derivative due to the possibility that the counterparty may default on their obligation or potential obligation under the terms of the credit derivative transaction.").



inherent in the underlying asset is transferred from the third party to the party that actually assumes the credit risk.<sup>258</sup> This risk is encompassed in financial transactions such as loans or investments in securities. In other words, a credit derivatives instrument is a device for transferring credit risk between two parties through a bilateral agreement. That is, it refers to a counter-agreement that transfers specific credit risk resulting from a financial transaction to the other entity under specific conditions.

From an economic point of view, a credit derivatives transaction can be referred to as a means of buying and selling the quantified economic value of the credit risk. An agreement can be reached on the combination of various risks to use, including collateralized debt obligations or on a single risk. Accordingly, credit derivatives instruments are based on financial assets or cash flow.<sup>259</sup> If default occurs, the asset value is offset up to the maturity of the applicable reference asset.<sup>260</sup> Alternatively, cash flow is performed on behalf of the counterparty of the applicable transaction.

While its function appears to be similar to that of a suretyship or guaranty, a credit derivatives transaction is legally defined as a non-specific atypical agreement, and thus is not regulated by statute. This characteristic offsets loss through built-in conditions that can be met through the occurrence of a credit event.<sup>261</sup> Generally, the 1999 ISDA definitions prescribe the designation of this agreement in credit derivatives instruments and ISDA swap documents.<sup>262</sup>

### B. OTC Transactions

Credit derivatives instruments developed through four techniques known as forwards,<sup>263</sup> futures,<sup>264</sup> options,<sup>265</sup> and swaps.<sup>266</sup> These generally can be classified into two categories, depending on the type of transaction: “exchange-traded products” transacted within the

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258. See WHALEY, *supra* note 4, at 679.

259. See DAS, *supra* note 33, at 7-12; see also BOMFIM, *supra* note 1, at 123.

260. See DAS, *supra* note 33, at 14.

261. See WHALEY, *supra* note 4, at 679.

262. See *infra* Part III.I.

263. See *supra* text accompanying note 111.

264. See *supra* text accompanying note 110.

265. See *supra* text accompanying note 112.

266. See *supra* Part II.A.

exchanges<sup>267</sup> and “over-the-counter products” transacted one-to-one between parties without use of an exchange.<sup>268</sup> Among the OTC transactions, the options include the “floor deal type OTC products,”<sup>269</sup> which have a relatively simple format, and “structured OTC products,”<sup>270</sup> which are transacted by developing complex structures depending on the situation. According to this classification, stock price index futures and stock price index options that are traded at the securities exchange can be classified as the financial products that derive from an exchange.<sup>271</sup> The forward exchange agreement or interest swap agreement, transacted with a one-to-one agreement between the parties, is a regular “floor deal type OTC product.”<sup>272</sup>

Credit derivatives instrument agreements may be executed as OTC transactions depending on special needs, but many such agreements comply with standardized methods.<sup>273</sup> Credit derivatives instruments are generally transacted as off-balance sheet transactions,<sup>274</sup> but there are also balance-sheet transactions that are conducted using CLNs.<sup>275</sup> The parties can ensure significant flexibility for leverage due to the nature of the off-balance sheet transaction.<sup>276</sup> That is, as the investment is made on the credit itself, it is possible to set the degree of leverage that the investor wants. Traditionally, hedge fund or non-bank financial institutions faced obstacles while attempting to invest in loan obligations due to the absence of the repo market and high cost of managing the loan obligations.<sup>277</sup> Today, they can invest in loan obligations by using credit derivatives instruments such as over-the-counter TRSs.

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267. See WHALEY, *supra* note 4, at 27-33.

268. See *id.* at 16.

269. See MCLAUGHLIN, *supra* note 6, at 36-41 (introducing G-30’s derivatives contracts).

270. See STEINHERR, *supra* note 62, at 83-85 (introducing structured notes and Tesobono swaps); see also MCLAUGHLIN, *supra* note 6, at 59-62.

271. See WHALEY, *supra* note 4, at 27, 31, 33.

272. See CHANCE, *supra* note 40, at 572-81.

273. See Partnoy & Skeel, *supra* note 7, at 25 (“The rapid standardization of credit default swaps may benefit existing market makers by increasing the volume of their credit default swaps practice, for instance, but the reduction in transaction costs also benefits other parties.”).

274. See CHEW, *supra* note 68, at 62.

275. See *supra* note 176 and accompanying text; see also Bomfim, *supra* note 1, at 8.

276. See CHOUDHRY, *supra* note 56, at 46.

277. See BOMFIM, *supra* note 1, at 23, 57.

*C. Diverse Reference Entity*

Economic or reference entities that become subject to credit risk vary widely, as they might include financial institutions, public entities, the government, and general companies.<sup>278</sup> In the case of banks, if a loan is granted to a specific company, it is possible to use a credit derivatives instrument to disperse the company's risk of bankruptcy or default. A bank can then assume the risk and still have the power to make profit by dealing the product between the parties through a credit derivatives instrument. If a certain nation or company is considered to have a high credit risk, it is possible for worldwide investors to hedge risk by leveraging credit derivatives instruments.<sup>279</sup> Credit derivatives instruments aim to hedge the default risk of a specific economic entity, but sometimes can be used to hedge the risk of non-performance of a specific duty.

*D. Separation of Notes and Risk*

The most prominent characteristic of the credit derivatives instrument is the separation of the capital raising method and the credit risk.<sup>280</sup> The parties to an agreement can change their degree of credit risk exposure by using a credit derivatives instrument without actually buying or selling a bond in the financial markets.<sup>281</sup> From a securities structuring point of view, this is closely related to the distribution of cash flow, risk, and management power. Moreover, a credit derivatives instrument is a financial product that can transfer risk and still retain an

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278. See FRANCIS ET AL., *supra* note 59, at 3; see also *supra* text accompanying note 2; WHALEY, *supra* note 4, at 684 tbl.19.1 (citing top 25 reference entities appearing in credit derivative contracts in 2003 by gross dollars sold and gross dollars purchased).

279. See ROMAIN G. RANCIERE, CREDIT DERIVATIVES IN EMERGING MARKETS 8 (2001). The foreign investors who invested in the bonds issued by the Korean Development Bank during the end of 1997, when the Korean economy was in a crisis, hedged the sovereign risk of Korea through the credit derivatives instrument transaction. Generally, “[b]roker dealers, which provide the market with liquidity, are mainly the major investment banks involved in the emerging bond market (Deutsche Bank, JP Morgan-Chase, Salomon-CitiBank, etc.)” *Id.* By participating in market, “[t]hey provide also added-value services by structuring and distributing portfolios of credit risk.” *Id.*

280. See CHOUDHRY, *supra* note 56, at 41.

281. See FRANCIS ET AL., *supra* note 59, at 3.

ownership right.<sup>282</sup> In particular, it is able to separate the credit risk from the other risks of the transaction. When examined from this perspective, credit derivatives instruments are the opposite of securitization. In short, when a bond undergoes securitization, the asset is removed from the balance sheet, but the bank continues to assume the remaining credit risk.<sup>283</sup> In contrast, credit derivatives instruments retain the asset while eliminating risk because the risk itself, not the asset, is sold in the market.<sup>284</sup> CDSs are developing into standardized devices for transferring credit risk among the various credit derivatives instruments.<sup>285</sup>

#### *E. Protection Buyer and Protection Seller*

Credit risk is an inevitable element of the banking business. The concept of credit risk protection lies at the core of a CDS. Most of the transactions in the market are conducted by selling or buying protection.<sup>286</sup> Here, the protection buyer (the party who is actually selling its risk) transfers credit risk in exchange for payment of a premium.<sup>287</sup> The protection seller, on the other hand, receives a premium in return for assuming the counterparty's credit risk.<sup>288</sup>

Accordingly, the payer of a fixed amount in a swap transaction agreement is the protection buyer, or risk seller, while the payer of a floating amount is the protection seller, or risk buyer.<sup>289</sup> The protection buyer pays a fixed cash flow through the CDS and receives the cash flow contingent upon a credit event.<sup>290</sup> The diagram below illustrates the parties' relationship.

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282. See WHALEY, *supra* note 4, at 690.

283. See BOMFIM, *supra* note 1, at 136-37.

284. See ANSON ET AL., *supra* note 224, at 105.

285. See WHALEY, *supra* note 4, at 687-90.

286. See WHALEY, *supra* note 4, at 690.

287. See FRANCIS ET AL., *supra* note 59, at 109. "The only risk faced by the protection seller is that the protection buyer fails to pay the premium for whatever reason." *Id.*

288. See *id.*

The protection buyer faces two key risks: 1. The reference entity defaults *and* the protection seller is unable to pay the notional amount due to the protection buyer on delivery of the appropriate obligation. 2. The reference entity does *not* default *but* the protection seller files for bankruptcy thus rendering its protection worthless.

*Id.*

289. See BOMFIM, *supra* note 1, at 24-25, 70-71.

290. See *id.*

Relationship of the Parties in the CDS Market<sup>291</sup>

Credit Default Swap Market	Swap payment	Underlying credit position
Protection buyer	Fixed	Short position (selling a bond)
Protection seller	Floating	Long Position (buying a bond)

*F. Underlying Assets and Reference Assets*

Generally, the concepts of underlying assets and reference assets are interchangeable. Credit derivatives instruments target specific obligations such as loans or bonds to repay the original obligor. In this case the credit risk seller usually holds the applicable loan obligation or bond.<sup>292</sup> There is not necessarily a need for the credit risk seller to hold the asset, however. If various types of loan obligations or bonds are held in hand, the credit risk seller could not only engage in a credit derivatives transaction that covers specific assets individually, but also could choose comprehensive transactions for credit risk hedging by targeting bonds that show the original obligor's credit standing.

Firstly, a "reference entity" is a specific company that has credit risk, which serves as the underlying asset of the transaction.<sup>293</sup> "Reference obligation" refers to the specific corporate bond issued by the reference entity,<sup>294</sup> designated by the credit derivatives agreement or loan of the reference entity.<sup>295</sup> The reference entity can be interpreted as a reference asset as well, referring to the underlying asset to which one transfers credit risk.<sup>296</sup> Meanwhile, "reference obligation" refers to a special obligation such as large scale bond issuance, which is issued or guaranteed by a reference asset or reference entity.<sup>297</sup> The reference obligation is effectively linked to the default swap in terms of the reference entity's capital structure.<sup>298</sup> Accordingly, if a credit event

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291. MERRILL LYNCH, CREDIT DERIVATIVE HANDBOOK 2003, at 10 (2003).

292. *See id.*

293. *See* 1999 ISDA DEFINITIONS, *supra* note 16, § 2.1.

294. *See* WHALEY, *supra* note 4, at 691 n.9; 1999 ISDA DEFINITIONS, *supra* note 16, § 2.3.

295. *See* BOMFIM, *supra* note 1, at 289.

296. *See* WHALEY, *supra* note 4, at 681; *see also* CHOUDHRY, *supra* note 56, at 49.

297. *See* 1999 ISDA DEFINITIONS, *supra* note 16, § 2.3.

298. *See* FRANCIS ET AL., *supra* note 59, at 65.

occurs while the reference asset is the senior priority of the unsecured obligation, then the protection buyer can transfer the obligation or duty of the same priority as the reference asset.<sup>299</sup>

Although it is difficult to clearly distinguish the concepts, the term “underlying asset” is commonly used when a fixed third asset targeted by a credit derivatives transaction is specified or when the credit risk seller holds on to the particular asset.<sup>300</sup> On the other hand, there is a tendency to use the term “reference asset” more frequently when it is difficult to specify an original obligation such as the third party’s credit rating or the credit risk seller’s decision not to retain the asset that is the target of the transaction. The business world tends to use the two terms interchangeably without clearly distinguishing them.

### G. Fixed Fee Payment and Escaping Credit Risk

Trading strategies in the CDS include fixing fee payments and escaping credit risk. A CDS mandates that the protection buyer pay a premium to the protection seller for each fixed term in exchange for protection from credit events relating to the reference entity.<sup>301</sup> Like other swap transactions, a transaction of the original asset itself does not take place prior to the occurrence of a credit event.<sup>302</sup> The fixed fee is generally referred to as a premium and is indicated as “bp,” which is paid quarterly.<sup>303</sup> This is the manner in which credit risk in the reference entity is hedged.

The specific premium amount paid by the protection buyer to the protection seller is set at the beginning of the transaction.<sup>304</sup> Several factors affect the premium that the protection seller receives. One influential factor is the maturity of the transaction.<sup>305</sup> When the

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299. *See id.*

300. *See DAS, supra* note 33, at 127-28.

301. *See supra* Part II.B.

302. *See CHOUHRY, supra* note 56, at 47.

303. *See BOMFIM, supra* note 1, at 291.

304. *See CHOUHRY, supra* note 56, at 50.

305. *See* N.Y. BD. OF TRADE, UNDERSTANDING FUTURES & OPTIONS 22 (2004), available at [http://www.iepstein.com/CD\\_Brochure/pdfs/nybot12.pdf](http://www.iepstein.com/CD_Brochure/pdfs/nybot12.pdf).

Time and intrinsic value are reflected in the option premium in much the same way that an insurance premium reflects the calculated risk that the coverage in the policy will be utilized. The greater the volatility and the longer the time until expiration, the higher the option premium will be.

*Id.*

transaction has matured for a longer period of time, the protection seller must assume a higher risk that becomes increasingly difficult to measure.<sup>306</sup> A second factor that increases the premium is the higher possibility of default.<sup>307</sup> Moody's or Standard & Poor's credit rating is the typical index that shows the possibility of default.<sup>308</sup>

The credit rating of a CDS counterparty also influences the premium.<sup>309</sup> For example, from the point of view of the protection buyer, who has a credit rating of "A" and is trying to transfer credit risk to the reference asset, there is no point in signing an agreement with a counterparty whose credit rating is "BB" because that counterparty has a high risk of defaulting before it can perform the agreement. Accordingly, higher premiums must be paid when signing an agreement with a protection seller who has a high credit rating.<sup>310</sup> In addition, the premium increases when the correlation between the credit of the reference asset and the credit of the counterparty is lower.<sup>311</sup> If the correlation between the two parties is higher, there is a higher possibility that the counterparty will default if the reference asset is facing default.<sup>312</sup> When the counterparty faces default, a protection buyer is unable to hedge the credit risk through a CDS.

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306. See WHALEY, *supra* note 4, at 688-95.

307. See Partnoy & Skeel, *supra* note 7, at 1042-43 (listing S&P default rate assumptions for CDOs).

308. See *id.* at 1026. "Importantly, the [credit rating] agencies rate bonds within a particular rating category, say AAA, even though market prices imply different probabilities of default." *Id.* at 1043.

309. See WHALEY, *supra* note 4, at 688-90.

310. See *id.* at 1043. It is because "the ratings of CDO tranches should be sensitive to the correlation of the underlying assets." *Id.*

311. See J.P. MORGAN, THE J.P. MORGAN GUIDE TO CREDIT DERIVATIVES 41, available at [http://www.investinginbonds.com/assets/files/Intro\\_to\\_Credit\\_Derivatives.pdf](http://www.investinginbonds.com/assets/files/Intro_to_Credit_Derivatives.pdf).

Counterparty risk consequently affects the pricing of credit derivative transactions. Protection bought from higher-rated-counterparties will command a higher premium. Furthermore, a higher credit quality premium; protection purchased from a counterparty against a Reference Entity is less valuable if a simultaneous default on the two names has a higher probability.

*Id.*

312. See CHOUDHRY, *supra* note 56, at 35.

The “recovery rate”<sup>313</sup> of the reference asset also influences the premium. The loss incurred by the protection buyer determines the amount that the protection seller must pay to the protection buyer during a credit event.<sup>314</sup> The loss is calculated by deducting the value of recovery from the reference asset’s face value.<sup>315</sup> The premium decreases as the asset’s recovery rate increases.<sup>316</sup> Realistically, however, the recovery rate of the reference asset can change drastically depending on the protection seller’s capacity to manage a nonperforming loan or bad asset.<sup>317</sup> Likewise, a protection seller with outstanding management capacity over such an asset can increase the recovery rate compared to other protection sellers who have a lower management capacity on that asset. Protection sellers with better management capacities give incentive to sign a CDS at a lower-than-average premium. This is the reason why investment banks with an outstanding ability to restructure failing companies can actively leverage a CDS. If default does not occur during the period of swap agreement, the premium that the protection buyer paid to the protection seller simply becomes cash flow.

#### *H. Balance Sheet Rent and the Leverage Effect*

The party who assumes a credit risk with regard to the TRS transaction does not need to raise capital to invest in the underlying asset. Looking back to the example in Part I.C, the party that provided the capital for *Company B* is *Bank A*, the credit risk seller, not *Bank C*, the party assuming the credit risk. *Bank A* signed the loan agreement with *Company B* to provide a \$1 million loan. According to the loan

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313. See FRANCIS ET AL., *supra* note 59, at 22.

In the bond market, . . . the Recovery Rate of a defaultable obligation [is defined] as the percentage of par claim of the obligation recovered by investors following default. Recovery rates depend not only on the actual recovery rate post default but also the time taken for the recovery rate to be realised. . . . In the CDS market, recovery [rate] is defined as the market price of the delivered obligation in the default swap contract following a credit event.

*Id.* (emphasis omitted).

314. See CHOUDHRY, *supra* note 56, at 7, 15-16.

315. See *id.*

316. See *id.* at 16.

317. Partnoy & Skeel, *supra* note 7, at 1042-43 (“Recovery rates . . . for assets vary depending on the nature of the asset, particularly its seniority.”). Furthermore, “[t]his is far from an exact science . . . and there rarely is historical evidence of default rates for particular assets . . .” *Id.*



agreement, *Bank A* is the lender and the loan obligation for *Company B* is left on *Bank A*'s balance sheet since *Bank A* retains the status as a lender in accordance with the loan agreement. This is the case even when *Bank A* carries out a TRS transaction with *Bank C* using said loan obligation as the underlying asset.

At this time, the LIBOR+30 bp that *Bank C* paid *Bank A* is the same or very similar to the interest that is applied when *Bank C* lent money from *Bank A*. Applying the same or similar interest rate is logical since this is similar to *Bank C* borrowing \$1 million from *Bank A* in order to lend it to *Company B*. The loan for *Company B* is then recorded on *Bank A*'s balance sheet while *Bank C* enjoys the same position as if it had actually lent the money directly to *Company B*, ostensibly allowing *Bank C* to hold *Bank A*'s balance sheet.<sup>318</sup> Products that factor in the "leverage effect"<sup>319</sup> by including more than the margin of value fluctuation of the underlying asset to the terms, however, are becoming more prevalent.

### I. ISDA Swap Documents

The International Swaps and Derivatives Association's<sup>320</sup> efforts to standardize swap agreements have been integral in advancing the use of credit derivatives instruments, particularly in the areas of standardization of interest and currency swaps.<sup>321</sup> Above all, ISDA contributed greatly to preventing disputes and reducing transaction costs by standardizing the swap agreement.<sup>322</sup> Specifically, a general swap transaction is made

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318. See ANSON ET AL., *supra* note 224, at 105-09 (2004) (illustrating the TRS mechanism as applied in the bank loan market).

319. See *supra* note 64 and accompanying text.

320. See ISDA, <http://www.isda.org> (last visited Mar. 15, 2008). The International Swaps and Derivatives Association, Inc. (known commonly as "ISDA") was incorporated in 1985 in New York by the banks that participate in swap transactions. The participating banks needed to discuss the key topics of interest in the industry, and to help the general public understand swap transactions. They also hoped to establish transaction practices, and define transaction standards in order to advance the swap market. *Id.*

321. See BOMFIM, *supra* note 1, at 285-91.

322. See Feder, *supra* note 21, at 736-41; see also Partnoy & Skeel, *supra* note 7, at 39.

ISDA currently has a monopoly on credit derivatives documentation, and market participants must pay fees for documents. ISDA suggests that it has copyrights to these documents and that it will enforce its intellectual property rights. It should

based on the ISDA “Master Agreement”<sup>323</sup> and “Credit Derivatives Definitions.”<sup>324</sup> An agreement for a detailed transaction tends to modify parts of the matter related to the credit event or restructuring with the “Supplement,” which includes the “Schedule” and “Confirmation”.<sup>325</sup>

The “Confirmation” lays out the transaction conditions such as swap principal, amount of payment, interest, and payment method.<sup>326</sup> “Supplement” relates to the organization of specific parties, transaction, cross-default, restructuring, and other default. It also pertains to the application of a “Master Agreement” clause, as well as assumption of withholding tax, notification method, and applicable law.<sup>327</sup> These three documents comprise a single agreement; if there is disagreement between the parties, the validity follows the order of “Confirmation” that

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abandon those positions and practices. ISDA should make all credit derivatives documentation available for free on the Internet.

*Id.*

323. See ISDA Master Agreement and Bridge, <http://www.isda.org/publications/isda-masteragrmnt.html> (last visited Feb. 28, 2008). The ISDA Master Agreement was drafted in 1992 and has since been superseded by the 2002 ISDA Master Agreement.

324. See 1999 Credit Derivatives Definitions, Supplements and Commentaries, <http://www.isda.org/publications/isdacredit-deri-def-sup-comm.html> (last visited Feb. 28, 2008). The ISDA Credit Derivatives Definitions are composed with main text and various supplements:

The 2003 ISDA Credit Derivatives Definitions (the “2003 Definitions”) are intended for use in confirmations of individual transactions governed by agreements such as the 2002 ISDA Master Agreement or the 1992 ISDA Master Agreements published by ISDA. The 2003 Definitions update the 1999 ISDA Credit Derivatives Definitions and offer the basic framework for the documentation of privately negotiated credit derivative transactions. The 2003 Definitions update provisions in the 1999 ISDA Credit Derivatives Definitions relating to Successor and several Credit Events. In addition, the 2003 Definitions offer new provisions relating to guarantees, Sovereign credit default swaps, novation of credit derivative transactions and alternative procedures in the event the Bond or Loan specified in the Notice of Physical Settlement is not Delivered.

*Id.*

325. See BOMFIM, *supra* note 1, at 286-87.

326. See *id.* at 287; see also Donald A. Bendernagel, Richard Ostrander and Brian D. Rance, *Credit Derivatives: Usage, Practice and Issues*, 1559 PLI/CORP. 713, 939-55 (2006).

327. See Collins & Sackmann, *supra* note 19, at 19. Those items have caused explosive growth of the market and “substantially reduced negotiation time and costs.”

*Id.*

regulates special matters: “Supplement,” “Master Agreement,” and “Credit Derivatives Definitions.”<sup>328</sup>

On May 11, 2001, ISDA issued a Restructuring Supplement to the 1999 ISDA Credit Derivatives Definitions (“Mod-R”).<sup>329</sup> Mod-R requires that at least three bondholders and two-thirds of the total number of holders must agree to the readjustment concerning the restructuring event.<sup>330</sup> Mod-R explains in detail how and when subordination can be considered a restructuring event.<sup>331</sup> Mod-R also outlines what can be delivered in order to satisfy the physical settlement that follows a credit event.<sup>332</sup> Additional matters concerning restructuring are adopted only with the approval of the parties to the agreement.<sup>333</sup> The practice in the U.S. derivatives market is based on Mod-R,<sup>334</sup> but this practice does not appear to be increasing in use in the European Union.<sup>335</sup>

#### IV. CREDIT EVENTS

Credit derivatives instruments, CDSs in particular, depend on the cash flow and performance of the agreement between the parties based on a specific credit risk related event. Thus, the core concern is which event is defined as a credit risk related event or default event.<sup>336</sup> The “credit event” becomes the standard for triggering the performance of the contract terms previously agreed upon by the parties.<sup>337</sup> In general,

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328. See MASTER AGREEMENT § 1(b) (Int’l Swap Dealers Ass’n 1992) 1992 ISDA Master Agreement [hereinafter 1992 ISDA MASTER AGREEMENT].

329. See Press Release, ISDA, ISDA Publishes Credit Derivatives Restructuring Supplement (May 11, 2001), available at <http://www.isda.org/press/index.html>.

330. See RESTRUCTURING SUPPLEMENT TO THE 1999 ISDA CREDIT DERIVATIVES DEFINITIONS § 4.10(b) (2001) [hereinafter 2001 RESTRUCTURING SUPPLEMENT].

331. See *id.* § 2.30(b).

332. See *id.* § 2.29.

333. See CHOUDHRY, *supra* note 56, at 47.

334. See FRANCIS ET AL., *supra* note 59, at 70.

335. See CHOUDHRY, *supra* note 56, at 48.

336. See BOMFIM, *supra* note 1, at 289-92.

337. Emily R. Pollack, Assessing the Usage and Effect of Credit Derivatives, at 42 (Harvard Law School Int’l Fin. Seminar, Apr. 28, 2003).

What if Restructuring Was Not Included as a Credit Event? . . . When the Restructuring Credit Event is included, banks that are asked to restructure loans are put in an enviable position. These banks are given the opportunity to grant an extension, presumably collect fees for providing this service, and then still have the

something is recognized as a credit event only when a minimum set of terms outlined in the agreement has been satisfied.<sup>338</sup> In the past two decades, however, “[a] variety of new swap[] [techniques] have appeared to meet the risk management needs of the capital markets.”<sup>339</sup>

A credit event refers to the credit risk connected event that becomes the standard for triggering performance of the agreement for cash or physical settlement as performance upon the credit derivatives instrument.<sup>340</sup> A credit event can be defined in a number of ways depending on the purpose of the transaction, which includes a “failure to pay” principal or interest, “bankruptcy” of borrower companies, “work-out” or “restructuring,” “decrease or increase” of credit rating above or below a certain level, and so forth.<sup>341</sup> Thus, the procedures used to determine whether a credit event has occurred and the events that will actually create an obligation on the part of the counter-party need to be specified in the agreement in a way that will minimize ambiguity.

In general, assessment of a credit event is verified with information that can be obtained publicly in order to ensure objectivity. When the materiality threshold<sup>342</sup> is met and the set of terms outlined in the agreement has been satisfied, the credit event prerequisite has occurred. For instance, in the case of a simple performance delay, the market value of the reference asset has to have decreased 10% relative to the face value.<sup>343</sup> With the understanding that there may be a dispute about whether a credit event has occurred or on the timing of the credit event, it is customary to include a clause in the agreement that the parties agree

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occurrence of the Restructuring Credit Event if they have bought protection through a credit default swap.

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Yet, if Restructuring was eliminated as a Credit Event, banks would also be put in a difficult position. If the creditworthiness and financial condition of a Reference Entity had deteriorated significantly, banks might be placed in the uncomfortable position of having to force default in orders to obtain protection through the triggering of a Credit Event such as Bankruptcy or Failure to Pay.

*Id.*

338. See CHOUDHRY, *supra* note 56, at 49.

339. See Aicher et al., *supra* note 81, at 953.

340. See CHOUDHRY, *supra* note 56, at 47.

341. See *id.*

342. See *infra* Part IV.C.

343. Such a materiality clause was included in the 1998 ISDA document labeled, “Confirmation of OTC Credit Swap Transaction Single Reference Entity–Non-Sovereign.” It was “too vague and subjective.” See Pollack, *supra* note 337, at 8. However it is very useful in the application of BDS and PDS transactions.

to abide by the decision of a neutral third party who is knowledgeable of the market situation.

### A. Classifications

In 1999, ISDA drafted the “Definitions” of “Credit Derivatives,” and specified the situations that are classified as credit events. With this set of definitions, ISDA concluded that a credit event takes place amidst at least one of these situations: bankruptcy,<sup>344</sup> obligation acceleration,<sup>345</sup> obligation default,<sup>346</sup> failure to pay,<sup>347</sup> repudiation/moratorium,<sup>348</sup> and restructuring.<sup>349</sup>

Meanwhile, the 1992 ISDA Master Agreement defines default, which may result in relation to obligation, as one of following eight events: failure to pay or deliver,<sup>350</sup> breach of agreement,<sup>351</sup> credit support default,<sup>352</sup> misrepresentation,<sup>353</sup> default under specified transaction,<sup>354</sup> cross default,<sup>355</sup> bankruptcy,<sup>356</sup> and merger without assumption.<sup>357</sup>

According to the definitions specified by section 4.7(a) of the 1999 ISDA Credit Derivatives Definitions:

Restructuring means that, with respect to one or more Obligation, including as a result of an Obligation Exchange, and in relation to aggregate amount of not less than the Default Requirement, any one or more of the following events occurs, is agreed between the Reference Entity or a Governmental Authority and the holder or holders of such Obligation or is announced (or otherwise decreed) by a Reference Entity or a Governmental Authority in a form that is binding upon a Reference Entity, and such event is not provided for under the terms of such Obligation in effect as of the later of the

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344. 1999 ISDA DEFINITIONS, *supra* note 16, § 4.2.

345. *Id.* § 4.3.

346. *Id.* § 4.4.

347. *Id.* § 4.5.

348. *Id.* § 4.6.

349. *Id.* § 4.7.

350. 1992 ISDA MASTER AGREEMENT, *supra* note 328, §5 (a)(i).

351. *Id.* §5 (a)(ii).

352. *Id.* § 5(a)(iii).

353. *Id.* § 5(a)(iv).

354. *Id.* § 5(a)(v).

355. *Id.* §5 (a)(vi).

356. *Id.* § 5(a)(vii).

357. *Id.* § 5(a)(viii).

Trade Date and the date as of which such obligation is issued or incurred:

(i) a reduction in the rate or amount of interest payable or the amount of scheduled interest accruals; (ii) a reduction in the amount of principal or premium payable at maturity or at scheduled redemption dates; (iii) a postponement or other deferral of a date or dates for either (A) the payment or accrual of interest or (B) the payment of principal or premium; (iv) a change in the ranking and priority of payment of any Obligation, causing the subordination of such Obligation; or (v) any change in the currency or composition of any payment of interest or principal.<sup>358</sup>

Restructuring also includes the result of bond/obligation exchange,<sup>359</sup> which requires that the result is greater than the standards of minimum “default requirement” in accordance to the “materiality clause.”<sup>360</sup> The declaration of unredeemed, moratorium or maintenance of the status quo is included as well.<sup>361</sup>

This credit event is often outlined in the agreement between related parties. When creating a CDS agreement, a detailed rule is laid out by which a credit event triggers transfer of risk on the business transaction level.

[I]f an occurrence would otherwise constitute a Credit Event, such occurrence will constitute a Credit Event whether or not such occurrence arises directly or indirectly from: (a) any lack or alleged lack of authority or capacity of a Reference Entity to enter into any Obligation, (b) any actual or alleged unenforceability, illegality, impossibility or invalidity with respect to any Obligation, however described, (c) any applicable law, order, regulation, decree or notice, however described, or the promulgation of, or any change in, the interpretation by any court, tribunal, regulatory authority or similar administrative or judicial body with competent or apparent jurisdiction of any applicable law, order, regulation, decree or notice, however described, or (d) the imposition of, or any change in, any exchange controls, capital restrictions or any other similar

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358. 1999 ISDA DEFINITIONS, *supra* note 16, § 4.7(a); *see also* BOMFIM, *supra* note 1, at 293.

359. 1999 ISDA DEFINITIONS, *supra* note 16, § 4.9.

360. *Id.* § 4.8(a).

361. *See* STEINHERR, *supra* note 62, at 167.

restrictions imposed by any monetary or other authority, however described.<sup>362</sup>

Regarding ISDA's definitions of the credit derivatives instrument, "certainty and objectivity" are important standards concerning the definition of the credit event.<sup>363</sup> When interpreting a credit event, the text should be interpreted narrowly, and any analogical interpretation following the situation should be limited.

*1. Tendency to Downplay the Scope of Credit Events*

The scope of a credit event is significantly narrower than the general scope of the default concept. If the concept of a credit event is interpreted broadly enough to include simple delay or even minor factual elements of default for technical reasons, the protection seller would face the risk that settlement may be triggered before the credit of the reference entity reaches the critical point. In particular, a significant part of the risk relating to the CDS transaction results from the moral hazard of the intermediary financial institutions.<sup>364</sup>

The fact that the intermediary financial institutions decide on the timing of the credit event and the amount of loss incurred gives rise to frequent conflicts due to the difference of opinion on a specific event and any contradictory terms that could be inherent in the transaction agreement. Investors will want to use a broad definition with regard to the scope of a credit events and default events.<sup>365</sup> A CDS might be

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362. 1999 ISDA DEFINITIONS, *supra* note 16, § 4.1.

363. See Collins & Sackmann, *supra* note 19, at 23.

Under the 1999 Definitions, [a] sovereign [may] conducted [restructuring] while its credit rating was being downgraded, a Restructuring would occur even though the sovereign may be financially sound. Hence, sovereign default swaps could be triggered before there has been a material change in the creditworthiness of the sovereign. In effect, users of sovereign default swaps may obtain a higher probability of receiving a payout than standard default swap users. Due to this enhanced risk, [swap] dealers are reluctant to provide sovereign default swaps that include a Restructuring credit event until the ambiguity over what constitutes a Restructuring is resolved.

*Id.*

364. This is the same for the TRS as well as other credit products. See, e.g., TAVAKOLI, *supra* note 72, at 10-12.

365. See TAVAKOLI, *supra* note 72, at 224 ("Buyer of credit default protection will attempt to put as many trigger events as possible in to the credit default protection language.").

different, however, because the agreement ends with the delivery of the asset.

In a broad interpretation scenario, the protection buyer would not be compensated for the even more serious future credit event that decreases the value of the buyer's reference obligation.<sup>366</sup> Protection under the CDS agreement is a swap agreement, not an option agreement.<sup>367</sup> Most of the credit derivatives instruments settlement processes can be triggered by both the protection buyer and protection seller.<sup>368</sup> As a result, many efforts were made to simplify the permissible scope of the credit event.<sup>369</sup> Unlike the U.S., where rescheduling of debt, acceleration, and default are excluded from the scope of credit events under swap agreements with non-sovereign debt, the E.U. "market participants . . . argue that any restructuring, regardless of its purpose, should be deemed a Credit Event for the [derivatives transaction.]"<sup>370</sup>

## 2. Definition from International Credit Rating Agency of Failure to Pay

The concept of the credit event used with the credit derivatives instrument is broader than that of default used by the credit rating agencies.<sup>371</sup> Credit derivatives instruments are an over-the-counter transaction between the protection buyer and protection seller.<sup>372</sup> Accordingly, the concept of a credit event is one that is outside the traditional scope of interest for the credit rating agencies, since it is not typically linked with the capital funding agreement of the primary market.

Moody's, the international credit rating agency, identified in its structured finance special report the difference between the credit event

366. See CHOUDHRY, *supra* note 56, at 7, 92-94.

367. See TAVAKOLI, TRS, *supra* note 167; see also BOMFIM, *supra* note 1.

368. See CHOUDHRY, *supra* note 56, at 7, 92-94.

369. Language such as "downgrade," "currency convertibility," "governmental action including war, hostilities, and confiscation," and "market disruption" are removed from definitions list. See, e.g., TAVAKOLI, *supra* note 72, at 225.

370. See Collins & Sackmann, *supra* note 19, at 21.

371. See CHOUDHRY, *supra* note 56, at 11. In the international financial marketplace, various players are using the credit rating obtained from the U.S. headquarters of two influential credit rating agencies. *Id.*

372. See WHALEY, *supra* note 4, at 679.



and Moody's own definition of default.<sup>373</sup> Moody's definition was partially adopted by the market, playing a role in narrowing the scope of the concept of a credit event. According to the report, Moody's has rated numerous structured transactions, focusing on the analysis of the cash settlement market.<sup>374</sup>

Interestingly, the cash settlement is used mostly for the evaluation of synthetic CDOs or CLNs, but is almost never used in the CDS market.<sup>375</sup> Moody's report targeted synthetic CDO or CLN investors, who seek additional risk with which to expose the sellers of protection.<sup>376</sup> Furthermore, this report viewed the credit derivatives instrument as a tool for hedging credit risk for both the protection buyer and the protection seller.<sup>377</sup> Accordingly, some elements that Moody's considers additional risk related to a CDS agreement can be viewed as devices for mitigating risk of the protection buyer.<sup>378</sup>

A swap is a clear means to hedge the state of default or mandatory exchange that decreases the value of an investor's bond. Moody's establishes three means for default:

Any missed delayed disbursement of interest, and/or principal; bankruptcy or receivership; and Distressed exchange where (i) the borrower offers debt-holders a new security or package of securities that amount to diminished financial obligation (such as preferred or common stock, or debt with a lower coupon or par amount) or (ii) the exchange that has the apparent purpose of helping the borrower avoid default.<sup>379</sup>

Moody's factors for setting a credit rating relate not only to the possibility of defaulting, but also to the recovery value after the default, as mentioned above.<sup>380</sup> Moody's evaluates the market value of the defaulted bond after one month to determine its remaining value.<sup>381</sup>

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373. See JEFFREY S. TOLK, UNDERSTANDING THE RISKS IN CREDIT DEFAULT SWAPS 5 (2001), available at <http://www.securitization.net/pdf/MoodysSyntheticCDORisks.pdf>.

374. See TOLK, *supra* note 373, at 1.

375. See WHALEY, *supra* note 4, at 689 n.10 (introducing British Bankers' Association's report).

376. See TOLK, *supra* note 373, at 2.

377. See *id.* at 1-2.

378. See *id.* at 4.

379. See *id.* at 5.

380. See *id.*

381. See *id.*

This perspective is the result of Moody's historical studies and its belief that it is possible to forecast such events.<sup>382</sup>

Standard & Poor's has not expressed an official view on the CDS. It is clear that S&P gives a better credit rating for the obligation that is supported by two reference entities, however, which are considered independent credit risks rather than one entity having implications for the other.<sup>383</sup> If a reference entity with an A- rating is protected by a reference entity with an A+ rating, then the credit rating can increase to AA+.<sup>384</sup>

### 3. Difference between ISDA and Credit Rating Agency

There is a potential difference between a credit event and a default event on the level of a credit derivatives instrument transaction. This difference develops when the credit event definition broadens.<sup>385</sup> In particular, a credit event uses a broader concept than that of default defined by Moody's.<sup>386</sup> Moody's reasoned as follows regarding the difference between ISDA's definition on the elements of a credit event and its own concept of default.

(i) *Bankruptcy*: There are many similarities between bankruptcy as defined by ISDA<sup>387</sup> and Moody's concept of default,<sup>388</sup> but there are

382. *See id.*

383. *See* STANDARD & POOR'S, CRITERIA: REVISED FRAMEWORK FOR APPLYING COUNTERPARTY AND SUPPORTING PARTY CRITERIA, at 4 (May 8, 2007), available at <http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/3,1,1,0,1148443971718.html> (last visited Sept. 21, 2007). "For an eligible direct support counterparty to participate in a 'AAA' rated transaction, the minimum rating is a short-term rating of at least 'A-1', or a long-term rating of at least 'A+', if it has no short-term rating." *Id.*

384. *See* CHOUDHRY, *supra* note 56, at 9 fig. 1.4. A- is upper-medium grade, while AA+ is high-grade, high credit quality. *Id.*

385. *See* TOLK, *supra* note 373, at 5-12.

386. According to Moody's Special Comment, a sovereign issuer is in default when one or more of the following conditions are met:

1. There is a missed or delayed disbursement of interest and/or principal, even if the delayed payment is made within the grace period, if any.
2. A distressed exchange occurs, where: (1) The issuer offers bondholders a new security or package of securities that amount to a diminished financial obligation such as new debt instruments with lower coupon or par value. (2) The exchange had the apparent purpose of helping the borrower avoid a "stronger" event of default (such as a missed interest or principal payment).

PRAVEEN VARMA, SOVEREIGN BOND DEFAULTS, RATING TRANSITIONS, AND RECOVERIES (1985-2002) 4 (2003).

387. 1999 ISDA DEFINITIONS, *supra* note 16, § 4.2.

some differences as well. For example, included among ISDA's definition of bankruptcy is when an entity "takes any action in furtherance of, or indicating its consent to, approval of, or acquiescence in any of the foregoing acts."<sup>389</sup> Investors might be exposed to risk because the definition does not explicitly mention the default, making this regulation on the credit event vague and difficult to interpret.<sup>390</sup> Moreover, there is no clear explanation of when the insolvency starts.<sup>391</sup> Thus, a credit event may occur even without reaching the actual state of bankruptcy.<sup>392</sup>

(ii) *Failure to pay or deliver*: Failing to pay, as defined by SDA,<sup>393</sup> is also the same as Moody's definition of default.<sup>394</sup> Both the failure to pay and the default uphold the materiality condition that states that the impaired portion of payment should exceed a specific amount.

(iii) *Restructuring*: Moody's presumes that only restructuring following a mandatory exchange triggers default.<sup>395</sup> Moody's maintains three conditions that constitute default following a mandatory exchange: the restructured obligation should result in a "diminished financial obligation;" restructuring should have been "involuntary for all investors;" and restructuring should have taken place to avoid the state of default that they would have faced.<sup>396</sup> Moody's interpreted ISDA's 1999 definition of a credit derivatives instrument, however, to allow a credit event to be triggered even when the debtor voluntarily agrees to restructuring.<sup>397</sup> In other words, Moody's definition of restructuring is "distressed exchange" and is broader than the scope set by ISDA.<sup>398</sup>

(iv) *Repudiation/Moratorium*: Moody's questioned the need to include repudiation or moratorium as instances that trigger a credit event as was defined by ISDA,<sup>399</sup> when the concept of the failure to pay is already in place.<sup>400</sup>

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388. See TOLK, *supra* note 373, at 5.

389. See *id.* § 4.2(i) (repealed by the 2003 ISDA Definitions).

390. See TOLK, *supra* note 373, at 6.

391. See 1999 ISDA DEFINITIONS, *supra* note 16, § 4.2.

392. See TOLK, *supra* note 373, at 6.

393. 1999 ISDA DEFINITIONS, *supra* note 16, § 4.5.

394. See TOLK, *supra* note 373, at 6.

395. See *id.* at 8.

396. See *id.* at 7.

397. 1999 ISDA DEFINITIONS, *supra* note 16, § 4.7(a).

398. See TOLK, *supra* note 373, at 7-8.

399. 1999 ISDA DEFINITIONS, *supra* note 16, § 4.6(a).

400. See TOLK, *supra* note 373, at 9.

(v) *Obligation Acceleration*: From Moody's point of view, obligation acceleration itself would not be a credit event, but rather would constitute default only when it actually triggered the involuntary restructuring.<sup>401</sup> Moody's opposes including obligation acceleration within the concept of default where a specific obligation structure loses the benefit of the given period for repayment due to the impairment on a specific contract clause, and if the duty to pay back occurs for entire obligations by the debtor.<sup>402</sup>

### B. Publicly Available Information

In order for an event to become a credit event, the information needs to be publicly available to the general investor in the marketplace.<sup>403</sup> The information should be made available so that at least two "internationally recognized" news providers can confirm its existence.<sup>404</sup> Administrative measures by governmental agencies, such as an act of the financial supervisory institution or a court's binding decree, will not result in the occurrence of a credit event.<sup>405</sup> Only an objective announcement to the general public through the news media constitutes an effective public announcement. Under the parties' agreement, the source of the information can be specified arbitrarily. Public announcement by the media, however, is an important standard for determining at what point a credit event has actually occurred.

### C. Materiality

In addition to the requirement that information be made publicly available, there is one other prerequisite for a credit event—the condition of materiality.<sup>406</sup> In order for the conditions of the agreement to be triggered, regardless of whether a public announcement has been made, the price of the related notes must meet the specific level the

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401. *See id.* at 10.

402. *See id.* at 10-11.

403. 1999 ISDA DEFINITIONS, *supra* note 16, § 3.2(c).

404. *Id.* §§ 3.5(a)(i), 3.8; *see also* FRANCIS ET AL., *supra* note 59, at 68.

405. *Cf.* 1999 ISDA DEFINITIONS, *supra* note 16, § 3.5(a)(i) (stating that the information must be "publicly available" and published or electronically displayed in "internationally recognized" news sources).

406. *See* DAS, *supra* note 33, at 23, 118 (stating that "materiality clauses prevent spurious triggering of the credit derivatives").

parties agreed upon at signing.<sup>407</sup> This is referred to as the “materiality clause” and it is a condition precedent set to prevent the triggering of a credit event by mistake.

A general example of the materiality condition is one in which a reference entity’s default is necessary only if an additional condition is met that a set amount of money must be lost.<sup>408</sup> It is this additional condition that serves as the materiality condition.<sup>409</sup> There is a default condition of materiality set at \$10 million in the case of an obligation acceleration, where there is an early arrival of the period for paying back due to a breach of duty.<sup>410</sup>

#### D. Notice

Notice should occur at least once, and often occurs three times before a credit event that triggers actual payment under the CDS.<sup>411</sup> Furthermore, some of the features of the notice can have a significant impact under the contract. One requirement is that when a credit event occurs before the ending date specified on the contract, there must be a reasonably detailed statement showing that a credit event has occurred.<sup>412</sup> At a minimum, notice should be provided no later than

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407. See, e.g., *id.* at 57, 59 (introducing materiality option in the Credit Default Swap).

408. CHOUDHRY, *supra* note 56, at 7 (“The risk that an issuer of the debt is unable to meet its financial obligations . . . is known as default.”). Materiality as an optional condition

allows the parties to require that in addition to the occurrence of a Credit Event there has been a significant drop in the price of a Reference Obligation (Price Materiality) or a significant widening of the spread applicable to a Reference Obligation (Spread Materiality). The materiality concept protects parties . . . against nominal defaults that inadvertently may have caused a Credit Event.

Daniel P. Cunningham, R. Brent Jones, & Thomas J. Werlen, *ISDA Offers Standard Documents for Credit Swaps*, 17 INTL FIN. L. REV. 21, 23 (1998).

409. See BOMFIM, *supra* note 1, at 291-92; cf. 2001 RESTRUCTURING SUPPLEMENT, *supra* note 330, § 3.11(a) (requiring that the Credit Event Notice set forth an “amount of 1,000,000 units of the currency in which the Floating Rate Payer Calculation Amount is denominated”).

410. See DAS, *supra* note 33, at 23.

411. FRANCIS ET AL., *supra* note 59, at 67.

412. 1999 ISDA DEFINITIONS, *supra* note 16, § 3.3.

fourteen days after the scheduled termination date.<sup>413</sup> The notice should include an objective description of the event that has occurred.<sup>414</sup>

For approval of the swap transaction, it is essential to establish which party has the power to give notice of a credit event.<sup>415</sup> In some instances, only the protection buyer can provide notice. In other instances, both protection seller and protection buyer can provide notice. “The Confirmation will also specify who is capable of serving the Credit Event Notice.”<sup>416</sup> Recently, the trend has been toward allowing either the protection buyer or protection seller to provide notice.<sup>417</sup> When the protection seller initiates a triggering agreement, it is then possible to provide the necessary help for the utilization of a settlement process of the market participants who have entered into diverse agreements that involve actual buying and selling of the protection with the reference asset.<sup>418</sup>

In theory, if the definition of credit event is applied broadly, it can be used as a management strategy whereby protection buyers may release the bond into the market before its value drastically decreases to avoid a complete default. This is mostly theoretical and is very rare in the actual marketplace.

When a credit event occurs, the party who has a duty to provide notice may only provide notice of the occurrence of a credit event one time.<sup>419</sup> A protection buyer can then demand settlement for only the portion of the transaction that relates to that credit event, with the remaining portion of the credit risk protection terminating at that point.<sup>420</sup>

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413. FRANCIS ET AL., *supra* note 59, at 67; *see also* BOMFIM, *supra* note 1, at 292 n.6 (“[T]he Credit Event Notice and Notice of Publicly Available Information can [both] be delivered up to 14 days after the maturity date of the contract.”).

414. *See* FRANCIS ET AL., *supra* note 59, at 67.

415. *Id.*

416. *Id.*

417. *See* 1999 ISDA DEFINITIONS, *supra* note 16, § 3.2(e); *see also* FRANCIS ET AL., *supra* note 59, at 67.

418. FRANCIS ET AL., *supra* note 59, at 67-68.

419. *See* 1999 ISDA DEFINITIONS, *supra* note 16, § 3.3. While there is not a number of required notice specified in the ISDA Definitions the definitions provide that “[a] Credit Event Notice must contain a description in reasonable detail of the facts relevant to the determination that a Credit Event has occurred.” *Id.*

420. *See* 2001 RESTRUCTURING SUPPLEMENT, *supra* note 330, § 4 (Commentary on Restructuring Supplement).

*E. Sources*

Notice of publicly available information, along with the credit event notice, is required.<sup>421</sup> This verifies the source of information for the occurrence of the credit event. If the information is not such that is recognized by an official record or reference entity, then it is crucial for the coverage of the credit event to be carried out by the specified number (usually two)<sup>422</sup> of internationally authorized sources of information.<sup>423</sup>

For clearing purposes, the “event termination date,” “if the [n]otice of [p]ublicly [a]vailable [i]nformation is applicable, . . . [is the date] when both the [c]redit [e]vent [n]otice and [n]otice of [p]ublicly [a]vailable [i]nformation are first effective.”<sup>424</sup> When the agreement uses the physical settlement method, then notice of physical settlement must be served within 30 days of the event determination date.<sup>425</sup>

This notice should outline the type of obligations that are to be delivered by the protection buyer to the protection seller. Physical settlement should occur within thirty business days from the time of notice of intended physical settlement.<sup>426</sup> In this case, the protection buyer should transfer the appropriate obligation within five days from the date when the physical settlement period ends, or assume the risk that accompanies loss of protection.<sup>427</sup>

*F. Settlement*

Defining the scope of the obligation is critical when deciding whether a credit event has occurred.<sup>428</sup> In order to decide whether a credit event has occurred in the reference entity, the applicable scope of the term is an important determinant. ISDA’s 1999 definition of a credit derivatives instrument divides the scope of obligation into six

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421. 1999 ISDA DEFINITIONS, *supra* note 16, § 3.2(c).

422. *Id.* § 3.8.

423. *See* FRANCIS ET AL., *supra* note 59, at 68.

424. 1999 ISDA DEFINITIONS, *supra* note 16, § 1.8.

425. FRANCIS ET AL., *supra* note 59, at 68.

426. *Id.*

427. *See* CREDIT DERIVATIVES DEFINITIONS §§ 8.1, 9.2(c)(ii) (Int’l Swaps & Derivatives Ass’n 2003) [hereinafter 2003 ISDA DEFINITIONS].

428. *Cf.* BOMFIM, *supra* note 1, at 289 (“[O]ne of the most important definitions in a credit default swap contract is that of ‘default.’”).

categories.<sup>429</sup> The most frequently used obligation category is “borrowed money,”<sup>430</sup> which means payment is made from the borrowed money. The protection buyer discontinues periodic premium payments as defined by the agreement once a credit event occurs.<sup>431</sup> The mere fact that the credit event occurred, however, does not mean that it is impossible to claim the right of the reference entity.

When a credit event occurs, the protection seller must pay the protection buyer the amount agreed upon.<sup>432</sup> Ordinarily, this type of payment takes the form of an exchange of the actual asset between the buyer and seller. The protection buyer provides a trustworthy certificate of obligation for the reference entity, which is referred to as the “deliverable obligation,”<sup>433</sup> and receives, in return, a cash settlement that is equal to the face value of the total asset.<sup>434</sup>

As a result of mergers and acquisitions or corporate restructuring, the rights and liabilities of the reference entity can actually be succeeded by the new entity.<sup>435</sup> The CDS agreement is structured with a financial technique that allows a bondholder’s experience to be effectively reflected with the obligation of the reference entity in the cash market. In general, a minimum specific amount of distributed shares are paid to the creditor even when the company is liquidated. After the declaration of a credit event, a bond’s market value decreases significantly compared to its face value. A protection buyer who signed the CDS agreement benefits from the protection, however, despite the decrease in market value.

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429. FRANCIS ET AL., *supra* note 59, at 64.

430. BOMFIM, *supra* note 1, at 289; *see* FRANCIS ET AL., *supra* note 59, at 64. “Other more narrow Obligation Categories are Borrowed Money, Bond, Loan, Bond or Loan, Reference Obligations Only.” *Id.*

431. WHALEY, *supra* note 4, at 689.

432. *See id.* at 686, 688.

433. *See* 1999 ISDA DEFINITIONS, *supra* note 16, § 2.15 (defining deliverable obligation). In the CDS agreement pertaining to the physical settlement method, the protection buyer is guaranteed to be paid the total face value in cash in exchange for the right to transfer the proper obligation of the reference asset to the protection seller. Because the reference asset is being issued in various bonds or obligations under the declaration and with different market values on default, accurate information pertaining to deliverable obligations is critical for the calculation of the protection seller’s risk.

434. *See* Chan-Lau, *supra* note 151, at 5.

435. *See* BOMFIM, *supra* note 1, at 288.



Physical settlement is used more frequently than cash settlement in the CDS transaction.<sup>436</sup> In the case of physical settlement, valuation is not required since the protection buyer simply transfers the total face value duty for the reference asset to the protection seller. Currently, however, cash settlement methods are becoming more widespread in other types of deals such as Synthetic CDO transactions. In these transactions, a one time cash payment is required as the terms pertaining to the decrease in market value assumed by the specific obligation of the reference asset are considered in advance.<sup>437</sup>

The cash settlement method is different from the physical settlement method in the sense that it requires actual cash payment to the protection seller when a credit event occurs, entitling the protection buyer to “the difference between the par and market values of the reference obligation.”<sup>438</sup> Because physical settlement involves returning the original bond certificate to the protection seller, it prevents the protection buyer from closing the applicable transaction at the market price when the credit event occurred.<sup>439</sup>

## V. APPLICATION

The most important legal issue regarding the CDS is, perhaps, the occurrence of a credit event that induces actual transfer of risk between the parties to an agreement.<sup>440</sup> Argentina’s sovereign debt restructuring epitomizes a hotly debated credit event that is often cited in CDS

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436. See WHALEY, *supra* note 4, at 689 n.10 (noting that the British Bankers’ Association in 2004 reported that 86% of credit derivatives contracts had physical settlement).

437. WHALEY, *supra* note 4, at 688.

438. See BOMFIM, *supra* note 1, at 292.

439. Cf. Angus Duncan, *Loan-only Credit Default Swaps: The March to Liquidity*, COM. LENDING REV. (2006), at 21 (stating that delivery of the “reference obligation is exchanged for its par value”). In order to “avoid the difficulty of arriving at fair and timely outcomes from the perspective of both sellers and buyers of protection” a relatively new settlement mechanism, also known as “pay-as-you-go for CDS of ABS (“PAYG”),” “has been developed in the U.S.” *Id.* at 20-21. Under this mechanism, the protection seller paid to protection buyer “floating payments” meaning that “principal or interest shortfall or principal write-down amounts on the reference obligation on a current basis.” *Id.* at 21.

440. Cf. Brief of Appellee at \*1, *Eternity Global Master Fund, Ltd. v. Morgan Guar. Trust Co.*, 2003 WL 24072300 (S.D.N.Y. 2003) (No. 03-7652) [hereinafter Appellee Brief] (putting forth before the Court of Appeals the question of whether a credit event had occurred under the swaps).

litigation.<sup>441</sup> The purpose of restructuring as a credit event is to assist in the declaration of default by the creditor and debtor, and to mitigate the negative atmosphere that surrounds the attempt of parties to change the terms of their loan agreement.

On December 24, 2001, Argentina's interim President, Adolfo Rodriguez Saa, signed a moratorium decreeing the suspension of all external debt.<sup>442</sup> This declaration was significant because of the legal dispute that ensued between the financial institutions over whether the restructuring up until the announcement of the moratorium constituted a credit event according to the CDS agreement.<sup>443</sup>

#### A. Eternity Global Master Fund

Eternity Global Master Fund ("EGMF"), managed and operated by HWF Capital,<sup>444</sup> signed three credit swap agreements with the Morgan Guaranty Trust Company of New York and JP Morgan Chase Bank ("JP Morgan").<sup>445</sup> The two parties signed a \$14 million credit swap agreement, transferable at specific intervals with various maturity dates.<sup>446</sup> While they were executed on different dates with different lengths of maturity, the three agreements comprising the swap were

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441. See FRANCIS ET AL., *supra* note 59, at 64; see also Collins & Sackmann, *supra* note 19, at 20 (introducing Xerox case).

442. See Carina Lopez, *The Argentina Crisis: A Chronology of Events After The Sovereign Default*, STANDARD & POOR'S, Apr. 12, 2002, at \*2.

443. Cf. J.F. Hornbeck, *Argentina's Sovereign Debt Restructuring 4* (CRS Report for Congress) Order Code RL32637 (Oct. 19, 2004) (citation omitted) (discussing the general framework for recovering defaulted sovereign debt). With regard to such measures:

When a country becomes insolvent and defaults on its debt, a general framework for analyzing its options points to three critical responses. First, the country must adjust policies. This includes correcting fiscal and current account deficits, as well as structural imbalances, which in Argentina's case involve the banking sector, utility regulation, and federal-provincial fiscal relations. Second, [so called] emergency IMF financing is needed. Third, debt must be restructured to achieve longer-term financial sustainability.

*Id.*

444. Complaint ¶ 7, *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co.*, 2002 WL 32150389 (S.D.N.Y. 2002) (No. 02-CV-1312) [hereinafter EGMF Complaint].

445. *Id.* ¶ 21.

446. *Id.*

essentially the same transaction.<sup>447</sup> In the credit swap agreement, EGMF purchased emerging market<sup>448</sup> bonds from JP Morgan, and specifically set out that a default of Argentina would constitute a credit event.<sup>449</sup> At the time of the agreement, JP Morgan was an advisor to Argentina's Ministry of Finance, and was the largest underwriter of Argentina's dollar-denominated sovereign debt.<sup>450</sup> In the above mentioned agreement, EGMF was the risk buyer (protection seller) and JP Morgan was the risk seller (protection buyer). Their credit swap agreement incorporated the 1999 ISDA Credit Derivatives Definitions and the 1992 ISDA Master Agreements.<sup>451</sup> These two documents outlined the terms of payment and defined specific terms such as settlement, portfolio, and credit event.<sup>452</sup>

Under the definitions adopted in the agreement, settlement referred to "physical settlement," while portfolio meant "deliverable obligation."<sup>453</sup> The physical settlement amount was set as the "floating rate payer calculation amount,"<sup>454</sup> which is a multiplication of the reference price.<sup>455</sup> The agreement required that the parties provide reasonable detail regarding notice of the credit event.<sup>456</sup> The target credit events were divided into four categories: (i) "failure to pay," (ii) "obligation acceleration," (iii) "repudiation/moratorium," and (iv) "restructuring."<sup>457</sup> The two parties specified that The Wall Street Journal, the New York Times, The Financial Times, Reuters, Bloomberg, and the Dow Jones News Wires would qualify as sources of information for publicizing the credit event.<sup>458</sup>

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447. See *id.* (stating the parties entered into the three agreements within a seven-day period and that the terms of the agreements were essentially the same).

448. See TAVAKOLI, *supra* note 72, at 172. "Emerging markets is the term usually reserved for developing economies." *Id.* "The emerging markets are often classified as Latin America including Mexico, Eastern Europe, and most Asian countries." *Id.*

449. See EGMF Complaint, *supra* note 444, ¶ 30.

450. *Id.* ¶ 13.

451. *Id.* ¶ 22.

452. *Id.* ¶¶ 24, 27, 30.

453. *Id.* ¶¶ 24, 27.

454. 1999 ISDA DEFINITIONS, *supra* note 16, § 2.13 (defining the term "floating rate payer calculation amount").

455. See EGMF Complaint, *supra* note 444, ¶ 25.

456. *Id.* ¶ 28.

457. *Id.* ¶ 30.

458. *Id.* ¶ 28.

When Argentina's economy collapsed, EGMF notified JP Morgan on three occasions that the reference entity of the credit swap agreement, the Republic of Argentina's debt restructuring, constituted a credit event.<sup>459</sup> JP Morgan refused the payment, however, claiming that the credit event had not occurred.<sup>460</sup> EGMF subsequently initiated litigation as JP Morgan refused payment on the \$3 million credit swap agreement.<sup>461</sup>

### *B. Daehan Investment Trust Management*

Daehan Investment Trust Management ("DITM") signed a CDS agreement in 1996 for an emerging market basket note that entailed paying 10.2% of the original capital of \$96 million every year as a premium to JP Morgan Chase Bank.<sup>462</sup> From an economic standpoint, DITM and JP Morgan were the parties to the agreement, but DITM used an off-shore Daehan Global Bond 2 Fund ("DGB2") and JP Morgan used a paper company, Perana, for regulatory, legal, and financial purposes.<sup>463</sup> In the CDS agreement, DITM assumed the role of protection seller while JP Morgan assumed the role of protection buyer. The emerging market basket note was the CLN,<sup>464</sup> which granted the right to DITM to receive interest incurred every year and principal on the maturity date, based on credits from Latin American nations such as Argentina, Brazil, and Mexico.<sup>465</sup> The agreement included a clause, however, whereby JP Morgan would not pay the principal or interest for the applicable part of the note if a credit event occurred in the related nations.<sup>466</sup> If default had not occurred, the residual could have been one of the credit derivatives instruments under the CDS that would have been included in the maturity.<sup>467</sup>

On December 24, 2001, after the maturity date of the note, Argentina issued its debt moratorium.<sup>468</sup> This declaration by Argentina

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459. *Id.* ¶¶ 38, 40.

460. *Id.* ¶ 39.

461. *Id.* ¶¶ 63, 65.

462. *See supra* Part II.E; *see also* DITM Complaint, *supra* note 98, ¶ 9.

463. DITM Complaint, *supra* note 98, ¶¶ 4, 11.

464. *See* discussion *supra* Part II.D.

465. *See* DITM Complaint, *supra* note 98, ¶ 12.

466. *Id.* ¶ 27.

467. *Id.* ¶ 34.

468. EGMF Complaint, *supra* note 444, ¶ 57.

constituted a credit event. A problem emerged, however, when the Argentine government requested that domestic investors initiate a second swap, in which a \$60 billion bond with an average interest rate of 11 to 12 % would change to a 7% interest rate.<sup>469</sup> Ostensibly, this was a voluntary restructuring since the investors in Argentina were not required to accept the new swap transaction.

JP Morgan Chase Bank provided notification on December 7, 2001 that it would not pay back the remaining interest and principal of \$96 million on the DGB2 fund because of the Argentine default.<sup>470</sup> DITM objected to this, and brought suit in federal district court in New York in February 2002 for the payment of the \$96 million principal and punitive damages of \$100 million.<sup>471</sup> The purpose of the suit was to request a declaratory remedy for the alleged wrongful acts of JP Morgan<sup>472</sup> and for breach of contract with regard to the \$96 million credit derivative instrument transaction<sup>473</sup> that was signed in 1996.

### 1. Background

The swap agreements that EGMF and DITM each signed with JP Morgan were specific about the Argentine economic situation as it pertained to credit events. Although different parties signed the agreements at different times, the relevant credit event remained the same. The following addresses how the same credit event applies to these two cases, and how they were interpreted by the court.

It is important to analyze the sovereign debt restructuring and development of Argentina's crisis. In 1992, the Argentine government adopted a monetary policy that pegged the peso to the United States dollar.<sup>474</sup> As such, it induced almost revolutionary change in terms of economic policy and the financial market structure.<sup>475</sup> "Thereafter, the

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469. See Hornbeck, *supra* note 443, at 37. ("International bond rating agencies consider[ed] it an effective default."). The first debt swap was conducted on June 16-17, 2001. "The de la Rúa government announces a \$29.5 billion voluntary debt restructuring in which short-term debt is exchange[d] for new debt with longer maturities and higher interest rates." *Id.* at 3.

470. See DITM Complaint, *supra* note 98, ¶ 35.

471. See *id.* ¶ 71.

472. See *id.* ¶¶ 67-70.

473. See *id.* ¶¶ 46-55.

474. See EGMF Complaint, *supra* note 444, ¶ 14.

475. See Pham Anh et al., Argentina's Sovereign Debts Restructuring and Creative Solutions 342 (on file with Princeton University).

international demand for Argentine investments increased dramatically to accommodate the Republic's ambitious plans for economic development."<sup>476</sup> The same situation occurred in Ecuador in 1999, Russia in 1998, and Mexico in 1995.<sup>477</sup> In 2001, Argentina became a "hot market" among sovereign debt investors wanting to reap the benefits of the economic situation.<sup>478</sup> Several funds began aggressively investing in Argentina's short-term sovereign debt while hedging via CDS transactions based on default risk.<sup>479</sup> Contrary to Argentine hopes, the economy headed into a state of regression beginning in 1998. This regression led to a cycle of decreases in tax revenue, peso prices edging downward, and drastic decreases in foreign currency reserves that followed a fixed FOREX exchange rate system.

In the end, Argentina declared the need to restructure the \$95 billion in sovereign debt issued in late 2001 at high interest rates for relatively short maturity periods.<sup>480</sup> During October and November of 2001, numerous economic news sources and periodicals publicized Argentina's proposed plans to re-adjust their debt.<sup>481</sup> On November 1, 2001, Fernando De la Rúa, the President of Argentina, asked the creditors to extend the maturity period on the \$95 billion in debt accompanied by lower interest rates.<sup>482</sup> On November 6, 2001, the

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476. See EGMF Complaint, *supra* note 444, ¶ 14.

477. *Id.* ¶ 16.

478. *Id.*

479. *Id.* ¶ 18.

480. *Id.* ¶ 34.

Sovereign debt restructurings differ from corporate debt restructurings for a host reasons, most of which do not stem from the absence of an international sovereign bankruptcy regime. No firm issues its own currency, or indirectly backstops the banking system. Sovereign debt is, typically a far more important asset in a country's financial system than the debt of even a very large local firm, so a sovereign default is bound to be more disruptive than the default of a firm. The magnitude of the set of problems that can be solved by introducing a completely new legal regime for sovereign debt restructuring is too small to justify imposing such a regime on reluctant creditors and debtors, with unknowable consequences.

Nouriel Roubini & Brad Setser, *The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions and the Argentine Episode*, 1 J. RESTRUCTURING FIN. 10-11 (2004) (citation omitted).

481. Jonathan Fuerbringer, *International Business: Analysts Worry of Ripple Effect in Argentina's Latest Debt Plan*, N.Y. TIMES, Nov. 3, 2001, at C1; see also Kevin G. Hall, *Argentina Seeks to Restructure All Its Debt: Nation Braces For Fallout of Asking For Lower Rate*, ST. PAUL PIONEER PRESS, Oct. 29, 2001, at A2.

482. EGMF Complaint, *supra* note 444, ¶ 33.

Argentine government announced the final restructuring plan.<sup>483</sup> According to this plan, residents of Argentina who owned an Argentine bond certificate were entitled to new bonds that paid 15% interest in exchange for longer-term securities that paid less than 7% of the maximum interest imposed.<sup>484</sup> In the short run, “Argentina [had partially] succeeded in swapping its debt, its weight in the EMBI Global [Index had increased] from 1.9% to 2.7%.”<sup>485</sup> According to the restructuring plan, the maturity date on these bonds extended three years, each en bloc.<sup>486</sup>

Argentina declared officially on November 19, 2001 that it intended to execute a voluntary debt exchange for domestic pension funds and for sovereign debt holders.<sup>487</sup> This was a measure to extend the maturity of Argentina’s sovereign debt owned by domestic bondholders, as well as an attempt to lower the coupon rate.<sup>488</sup> On December 1, 2001, a minimum of \$40 billion of Argentine bonds held by domestic investors was repaid to the government as a guaranteed bond with a significantly longer maturity date and lower interest rate.<sup>489</sup> Tax benefits were included as part of the restructuring plan.

Argentina insisted that this type of debt restructuring would be voluntary rather than forced, and thus would not constitute a default.<sup>490</sup> Payment on Argentina’s public debt was suspended following Rodriguez Saa’s December 24, 2001 announcement.<sup>491</sup> The financial markets agreed that this type of measure by the president was sufficient enough to trigger a credit event. On December 7, 2001, JP Morgan notified Perana and DITM that default had occurred in Argentina.<sup>492</sup>

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483. See Hornbeck, *supra* note 443, at 4.

484. See *Argentina Announces Debt “Default” Plan*, BBC NEWS, Nov. 2, 2001, <http://news.bbc.co.uk/1/hi/business/1633369.stm>.

485. Ray Hervandi, *Argentina’s Debt Restructuring: The Dark Side of the Credit Market Revealed?*, CROWDOUT, Mar. 14, 2005, <http://longrun.typepad.com/crowdout/> (last visited Feb. 28, 2008).

486. See EGMF Complaint, *supra* note 444, ¶ 42.

487. See *id.* ¶ 36.

488. See *id.* ¶ 34. “Sovereign debt workouts typically involve issuing new debt for old, under more lenient conditions that allow a country to eventually recover its financial standing in the international community.” See Hornbeck, *supra* note 443, at 6.

489. See EGMF Complaint, *supra* note 444, ¶ 42.

490. See *Timeline: Argentina’s Financial Crisis*, FOXNEWS.COM, Dec. 6, 2001, <http://www.foxnews.com/story/0,2933,40274,00.html>.

491. See EGMF Complaint, *supra* note 444, ¶ 57.

492. DITM Complaint, *supra* note 98, ¶ 29.

Specifically, JP Morgan informed the companies that an event occurred on December 5, 2001 that was presumed to be a default based on Argentina's reference portfolio.<sup>493</sup>

JP Morgan argued that, back in 1996, the term "restructuring" was used in a broader way when the transaction of credit derivatives instrument agreement was signed between the DGB2 fund and Perana.<sup>494</sup> JP Morgan asserted that although the Argentine government averred the voluntary nature of the restructuring, it was essentially mandatory.<sup>495</sup> JP Morgan further claimed that notice of the credit event was publicly available on the basis of five news articles from the Bloomberg terminal.<sup>496</sup> According to these allegations, the Argentine currency crisis should have been considered a credit event.

Restructuring should be agreed upon by the reference entity, government authority, or the holders of the obligation, or, in the alternative, should be declared by a governmental authority in a mandatory form that binds the reference entity. The 1999 ISDA definitions of a credit derivatives instrument do not include restructuring by the reference entity as a credit event if such restructuring is voluntary.<sup>497</sup> Moreover, the definitions specify that only events that are involuntary or mandatory may constitute credit events.<sup>498</sup> The 1999 ISDA definitions, however, did not have a direct influence on the agreement that was signed by DPIM and JP Morgan. At the time, Moody's and other international credit rating agencies recognized that Argentina's declaration of sovereign debt restructuring was technically a declaration of default.<sup>499</sup>

The 2001 terrorist attacks that worsened a recession in the United States served to exacerbate Argentina's long-term economic

493. *Id.*

494. *See id.* ¶¶ 9, 11 (detailing the terms of the 1996 agreement between JP Morgan and Daehan).

495. *See* EGMF Complaint, *supra* note 444, ¶ 37.

496. *See* DITM Complaint, *supra* note 98, ¶ 29.

497. *Cf.* 1999 ISDA DEFINITIONS, *supra* note 16, § 4.9 ("Obligation Exchange" means the mandatory transfer . . . of any securities, obligations, or assets to holders of Obligations in exchange for such Obligations. When so transferred, such securities, obligations or assets will be deemed to be obligations.").

498. *See, e.g.*, 2003 ISDA DEFINITIONS, *supra* note 427, § 4.9 (defining an "obligation exchange" as a "mandatory transfer of any securities, obligations or assets to holders of Obligations in exchange for such Obligations").

499. *See* EGMF Complaint, *supra* note 444, ¶ 44.



stagnation.<sup>500</sup> The Argentine sovereign bond began to be transacted at below 40% of the U.S. dollar. On October 30, 2001, S&P downgraded Argentina's long-term sovereign credit rating from CCC+ to CC,<sup>501</sup> junk bond status<sup>502</sup>—the same rating Ecuador received when it declared default in 1999.<sup>503</sup> On October 12, 2001, S&P's competitor, Moody's, also lowered Argentina's credit rating to Caa3.<sup>504</sup> According to a survey conducted by Morgan Stanley Dean Witter & Co. targeting emerging market portfolio managers, 85% believed that Argentina's declaration of default was inevitable.<sup>505</sup> There was, however, an argument among the international credit rating agencies over whether a voluntary restructuring would lead to a default.<sup>506</sup>

Credit rating agencies generally set ratings for a bond once the terms of the agreement are satisfied. Even though it is not clear that Argentina actually defaulted, it is clear that these terms do not apply in financial crises. Accordingly, a logical conclusion is that Argentina was in a generalized state of default. This analysis is based on the argument that the value of the new bond that is issued in exchange should be considered a default because even when the nominal value was greater than the current market value, the bond was impaired through government measures without proper compensation.<sup>507</sup>

Moody's perspective varied little. The argument about the timing of the default was merely an academic question. Argentina's Caa3 rating had many characteristics of default even when it was technically not in a state of default, because investors knew the ramifications of a

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500. See Jonathan Fuerbringer, *Argentina May Restructure Its Debt, Risking Default*, N.Y. TIMES, Oct. 30, 2001, at C4.

501. See Bruno Boccara et al., *Argentina Long-Term Sovereign Credit Rating Lowered to CC; Outlook Negative*, STANDARD & POOR'S, Oct. 30, 2001, <http://www.mecon.gov.ar/download/financiamiento/sp10-30-01i.pdf>.

502. See generally Marie Cavanaugh, *Sovereign Credit Characteristics by Rating Category*, STANDARD & POOR'S, Nov. 19, 2003, <http://www2.standardandpoors.com/spf/pdf/fixedincome/sovereigncreditcharacteristics.pdf> (noting that in bonds below the 'B' category there is a "clear and present danger of default").

503. See VARMA, *supra* note 386, at 20 app. III.

504. See *id.* at 14 app. I.

505. Joshua Goodman, *Now, Argentina's Default Looks Inevitable*, BUSINESSWEEK, Oct. 29, 2001, available at [http://www.businessweek.com/magazine/content/01\\_44/b3755149.htm](http://www.businessweek.com/magazine/content/01_44/b3755149.htm).

506. See Fuerbringer, *supra* note 500.

507. See *id.* (reporting S&P's statements on Oct. 16, 2007).

Caa3 rating. Thus it can be concluded that Argentina's Caa3 rating should not be considered a default, since it was a voluntary restructuring obligation, even though the obligation exchange was seemingly driven by the government and creditors were damaged from the plan.

## 2. Interpretation of Restructuring

There are two basic approaches to interpretation of a restructuring that constitutes a credit event: the passive interpretation and the active interpretation. There is also a modified approach that should be examined.

### (i) Passive Approach

The rationale for the passive approach is that definitions of agreements should not be ambiguous and should be explicit as they pertain to the terms of restructuring.<sup>508</sup> Using the passive approach means that the interpretation of the voluntary restructuring is a legal issue to be decided by the courts with one literal meaning that accepts the contract objectively as it is defined.<sup>509</sup> Because the Argentine government declared voluntary debt exchange,<sup>510</sup> it might be mandatory in the economic sense, but legally it should be accepted as a voluntary obligation exchange in accordance with the wording of the agreement. This view holds that the court should not reinterpret the agreement among the two parties.<sup>511</sup>

"Traditionally, a heavily indebted country could either renegotiate with its creditors or unilaterally reschedule its debt simply by announcing the new terms."<sup>512</sup> During early December 2001, investors demanded that Argentina repay its \$40 billion obligation; the government accepted all requests for repayment, eventually carrying out

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508. This approach applied to defendant JP Morgan's position.

509. *Cf. Krumme v. Westpoint Stevens, Inc.*, 238 F.3d 133, 139 (2d Cir. 2000) (quoting *Seiden Assoc. v. ANC Holdings*, 959 F.2d 425, 428 (2d Cir.1992)) (discussing the principles of contract interpretation).

510. EGMF Complaint, *supra* note 444, ¶ 37.

511. *See Grumman Allied Indus. v. Rohr Indus. Inc.*, 748 F.2d 729, 734 (2d Cir. 1984) (holding that the court should not intervene in the contractual relationship of the two parties if the parties clearly laid out the risk in the agreement).

512. *See Farisa Zarin, Sovereign Debt: What Happens if a Sovereign Defaults?*, MOODY'S INVESTOR SERVICE, at 5 (July 2000) available at <http://www.moodys.com/cus/t/specialreport/SearchReportFSC.aspx?type=SOV> [hereinafter Zarin, *Sovereign Debt*].

a debt swap.<sup>513</sup> Contrary to the way news agencies and credit rating agencies analyzed it,<sup>514</sup> in the passive approach, Argentina's debt swap was considered voluntary and did not constitute default. Specifically, the declaration of default is not actually default since the government afforded added value by transferring tax revenues to the issued bond that compensated for the loss in interest.

On November 19, 2001, the Argentine government requested the voluntary obligation exchange of pension fund and domestic bondholders, and allowed qualified bondholders to choose whether to demand that the government repay under the specific obligation terms.<sup>515</sup> Argentina had unlimited discretion with regard to accepting or rejecting the demand for repayment. Accordingly, obligation exchanges would have resulted only if the qualified bondholders demanded repayment and Argentina chose to accept the demand for repayment of the obligation. This constituted voluntary restructuring since the obligation that was repaid was in a trust and the new bond would have been issued to the bondholder, regardless of who would have then made the demand for repayment.<sup>516</sup>

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513. See EGMF Complaint, *supra* note 444, ¶ 36.

514. *Id.* ¶ 37.

515. *Id.* ¶ 36.

516. See HARALD FINGER ET AL., INT'L MONETARY FUND, CROSS-COUNTRY EXPERIENCE WITH RESTRUCTURING OF SOVEREIGN DEBT AND RESTORING DEBT SUSTAINABILITY 10, tbl. 3 (2006) (discussing that the restructuring was a debt for equity swap called a megaswap).

Prior to the default in late 2001, two rounds of debt treatment were undertaken: [one is] a debt swap (*megaswap*) involving debt equivalent to 11% of GDP, followed by a restructuring of debt held mainly by domestic investors . . . , covering debt equivalent to 19% of GDP. The November/December 2001 [the above] restructuring, completed under the imminent threat of default, did not involve any reduction in principal, but yielded a 32% [Net Present Value] reduction on restructured principal. Given that the Phase I operation covered a larger portion of debt (\$51 billion) than the megaswap (\$29.5 billion), together the two debt exchanges resulted in a net NPV reduction of approximately 10%.

*Id.* at 15 tbl. 7 (formatting altered).

During Phase I in December 2001, approximately \$41 billion in sovereign debt and \$9 billion in provincial debt was exchanged into new government-guaranteed loans featuring a reduction of interest rates to 70% of the contractual level (up to a maximum of 7%), a 17-month grace period for interest payments, and a three-year extension of maturities for those original claims maturing up to 2010. The exchange involved no reduction in principal.

*Id.* at 48 annex II (formatting altered).

A scenario in which a debtor pursues restructuring through an obligation exchange is laid out in the 1999 ISDA restructuring credit event definition,<sup>517</sup> and is clearly limited to mandatory exchanges.<sup>518</sup> Here, the fact that an agreement is not ambiguous means that the interpretation is a legal issue, and that the court should interpret it using its literal meaning.

As a matter of law, the obligation exchange may satisfy the definition of restructuring only when a voluntary exchange is considered mandatory.<sup>519</sup> Arguing whether an obligation exchange was actually voluntary, however, runs the risk of letting the courts decide the issue. This compels the tribunals to forecast whether interested parties will choose to participate in an obligation exchange, and to perform an economic analysis of the obligation exchange. The passive approach stands for the belief that the explicit agreement will dictate whether a restructuring should be classified as mandatory or voluntary.

If a party wanted to argue that a court's decision should have been made based on questions about whether the obligation exchange is economically coercive or whether there is a practical alternative to debt swap, they would say that those questions should have been specified in advance by the agreement. If the parties had intended to include clauses about what is a voluntary exchange and how such exchanges should be applied, they should do so in the agreement regardless of whether they were economically favorable to the creditor. For example, it could be argued that the following should be included in the definition of an obligation exchange: "If there is a request for repayment of the bond for at least a certain amount with regard to the voluntary exchange, this is considered mandatory, and thus is within the scope of the obligation exchange." In order to be sufficiently forceful, a clearly codified exception clause to a voluntary obligation exchange should have been included for repayment of the voluntary obligation exchange due to economic coercion.

Ostensibly, all obligation exchanges can appear mandatory. Moreover, all bondholders who are involved with the exchange of bonds tend to disclaim a valuable right in order to obtain a greater chance of recovery, even though there are lower profits because of the reference

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517. See 1999 ISDA DEFINITIONS, *supra* note 16, §§ 4.7(a), 4.9.

518. *Id.* § 4.9.

519. *Id.*

entity's collapse. In that case, some degree of economic pressure is inevitable.<sup>520</sup>

Even though “[h]istorically, investors in sovereign debt have been in a weak position because they were compelled to accept any new terms,”<sup>521</sup> when there are no incentives, no bondholder would accept a lower interest rate or any of the prerequisites that are essential for the application under the 1999 ISDA definitions. Accordingly, it is unnecessary to find a limiting meaning of the term “mandatory” that is used in section 4.9 of the ISDA definitions.<sup>522</sup> During litigation, when a court tries to interpret this agreement, it should not let the agreed terms become worthless. If the agreement between parties is re-interpreted by the court, the agreement itself could become unclear, further introducing uncertainty into the market. Courts should dismiss the crafty intentions of the parties that are trying to have their contracts interpreted according to default definitions.

The economic coercion test for restructuring does not apply to the risk seller and risk buyer who enter into a credit derivatives instrument transaction. Specific clauses of the obligation exchange that were suggested by the Argentine government do not provide sufficient information that would allow for a determination of whether the suggestion was made to protect the buyer or coerce the protection seller. In fact, the question of whether economic coercion existed can be

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520. See Farisa Zarin, *Sovereign Restructurings: Putting Too Much Faith in Exit Consents*, MOODY'S INVESTOR SERVICE, at 4 (2001) (citation omitted), <http://www.moodys.com/cust/specialreport/SearchReportFSC.aspx?type=SOV> (indicating that it is “both time-consuming and costly to argue with a sovereign”). Zarin states:

If inevitable restructuring becomes hard reality, the sovereign begins the process by offering to exchange its old bonds for new debt which, generally speaking, have less favourable financial terms for the creditors. Bondholders are “invited” to tender their existing bonds in exchange for new debt instruments. Once the offer is accepted, the old bonds tendered and exchanged for new, the creditor in effect surrenders all of its rights under the original terms. The duties and responsibilities of the sovereign toward the creditor, going forward, are those articulated in the new structure. . . . [T]he majority of bondholders are likely to participate in rescheduling. . . . But a few creditors will continue to hold the old bonds. In most instances the holdouts are likely to be “sleepers”—creditors who inadvertently miss the exchange boat. In other more dubious cases, bondholders may deliberately refrain from tendering. They instead can demand—and possibly extract—preferential payoffs after the close of the offer through legal threats.

*Id.*

521. Zarin, *Sovereign Debt*, *supra* note 512, at 6.

522. 1999 ISDA DEFINITIONS, *supra* note 16, § 4.9.

decided only by examining each specific bondholder, and individual situations must be factored in sufficiently. Even when the demand for an obligation exchange could have been coerced regarding a bondholder, when one considers tax burdens and/or accounting standards, it might not have been coercive on other parties. Thus, an unclear standard that is classified as economic coercion cannot become the standard under any circumstances, and applying subjective criteria under the pretext of objective criteria should not be tolerated.

If a decision is made about how much economic pressure is sufficient to effectively transform a voluntary obligation exchange into a mandatory one, the conclusion will likely be different depending on who makes the decision. Like EGMF and DITM, market participants who entered CDS agreements with the counterparty at the same time have come to rely upon contradictory decisions. These types of conclusions may bring about more litigation and hotly contested disputes. In fact, this might induce the exact scenario that the 1999 ISDA definitions hoped to prevent—lack of a clear idea of restructuring as it pertains to credit events.

Unlike the transaction with the DITM, JP Morgan argued<sup>523</sup> that although the Argentine government-conducted voluntary obligation exchanges, a credit event through restructuring did not take place.<sup>524</sup> JP Morgan argued that the definition is limited to a mandatory obligation exchange as long as the restructuring, according to the 1999 ISDA documents, is enumerated as a form of credit event.<sup>525</sup>

Defendant JP Morgan contended that the obligation exchange in terms of definition can result only when this type of voluntary exchange is considered mandatory,<sup>526</sup> and further argued that the plaintiff should not demand that the voluntary obligation exchange be redefined as mandatory by the courts since the actions taken by Argentina are clearly voluntary.<sup>527</sup>

EGMF then argued that despite the fact that the restructuring credit event defined in sections 4.7(a)(i), (iii), and (iv) of the 1999 ISDA definitions happened before December 17, 2001—the maturity date—JP

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523. See generally Appellee Brief, *supra* note 440 (detailing JP Morgan's arguments before the Second Circuit).

524. See *id.* at \*8.

525. See *id.*

526. See *id.* at \*15-16, \*20-21.

527. See *id.*

Morgan did not make the payment that was required under the CDS agreement.<sup>528</sup>

(ii) Active Approach

The rationale of the active interpretation is that the obligation exchange requires swapping the obligations of the bondholders, whether they choose to or not, and regardless of whether the obligation exchange is controlled by the agreement. The transfer of the instrument to the bondholders is achieved by order of the reference entity or government authority. In short, this approach takes the view that these obligation exchanges forcibly transform the bond certificates into new notes.<sup>529</sup>

According to the 1999 ISDA definitions, restructuring includes unfavorable treatment such as interest or principal reduction, delay in payment, change of the currency for payment, and change of priority of obligation repayment during the liquidation or dissolution procedure.<sup>530</sup> These events, caused by aggravation of the reference entity's payment capacity or financial condition, should not be included when this type of event does not take place. In other words, despite the fact that a reference entity actually undergoes a mandatory obligation exchange, which is disguised as voluntary, it may qualify as a mandatory obligation exchange and be included as a credit event. This becomes even clearer in light of the 2001 restructuring supplement to the 1999 ISDA definitions.<sup>531</sup> According to the supplement, a credit event is said to occur after a restructuring event if at least three holders and two-thirds of all holders have agreed to the restructuring.<sup>532</sup>

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528. See Reply Brief of Plaintiff-Appellant at \*20, *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co.*, 2003 WL 24072301 (S.D.N.Y. 2003) (No. 03-7652) [hereinafter Appellant Brief].

529. See generally Appellant Brief, *supra* note 528 (setting forth plaintiff, EMGF's position in the litigation).

530. See 1999 ISDA DEFINITIONS, *supra* note 16, § 4.7(a).

531. See 2001 RESTRUCTURING SUPPLEMENT, *supra* note 330.

532. See *id.* § 4.10(b). This section provides that:

'Multiple Holder Obligation' means an Obligation that (i) at the time the Credit Event Notice is delivered, is held by more than three unaffiliated holders and (ii) with respect to which a percentage of holders (determined pursuant to the terms of the Obligation) at least equal to sixty-six-and-two-thirds is required to consent to the event which would otherwise constitute a Restructuring Credit Event.

*Id.*

To determine whether the voluntary restructuring measures taken by Argentina were in fact coerced, it is essential to understand the facts on the ground in December 2001, when “Argentina, due to its rigid monetary regime and fiscal structure, slid into the largest-ever sovereign default at the end of 2001.”<sup>533</sup> Since January 2001, “[A]rgentina’s economy [has] seemed to be teetering on the brink of collapse.”<sup>534</sup> From March 2001, “investors [became] increasingly skeptical of [the Argentine] government’s ability to revive the economy.”<sup>535</sup> In July 2001, hedge fund investors began to speculate about the default that Argentina appeared to face.<sup>536</sup> From July to September 2001, “there [were] fears that a widespread sell-off in emerging currencies could spark a broader financial crisis”<sup>537</sup> and international financial news immediately published that the speculation into Argentine default was now a warning.<sup>538</sup> On August 28, 2001, JP Morgan acknowledged the financial turmoil in Argentina.<sup>539</sup> As one analyst noted, “[T]he key question for investors now [was] whether Argentina [would] default or restructure its debts.”<sup>540</sup> On October 31, 2001, JP Morgan, in an e-mail message to HWF Capital, entitled “scenario in case of restructuring,” expressed that the possibility of restructuring had increased to “a high implied probability of restructuring” and that the bondholders would possibly recover only a part of their investment when their bonds were swapped into new bonds.<sup>541</sup> On November 2, 2001, the Argentine government officially declared that the voluntary obligation exchange would be provided to domestic bondholders and pension funds, “which many analysts regard[ed] as a technical default.”<sup>542</sup> Of the total amount

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533. See David Levey, *Sovereign Rating History*, Moody’s Investor Service, Special Comment at 3 (2002).

534. See *Argentina Switch Rattles Currencies*, BBC NEWS, June 19, 2001, <http://news.bbc.co.uk/2/hi/business/1397193.stm>.

535. See *Political Turmoil in Argentina*, BBC NEWS, Mar. 4, 2001, <http://news.bbc.co.uk/2/hi/americas/1201074.stm>.

536. See EGMF Complaint, *supra* note 444, ¶ 32.

537. *Currency Nerves Hit Emerging Markets*, BBC NEWS, July 9, 2001, <http://news.bbc.co.uk/2/hi/business/1429957.stm>.

538. EGMF Complaint, *supra* note 444, ¶ 32.

539. *Id.* ¶ 33. “Argentina initially juggled its debt dilemma by putting off private bondholders while negotiating with the IMF.” Hornbeck, *supra* note 443, at 7.

540. *Argentina’s Economy Set to Shrink*, BBC NEWS, Sept. 1, 2001, <http://news.bbc.co.uk/2/hi/business/1520268.stm>.

541. EGMF Complaint, *supra* note 444, ¶ 33.

542. *Argentina Announces Debt “Default” Plan*, *supra* note 484.



of Argentina's sovereign debt (\$132 billion), this amount corresponded to between \$40 and \$50 billion.<sup>543</sup> De la Rúa implored the bondholders to readjust their bonds into ones with lower interest rates and longer maturity,<sup>544</sup> causing many analysts to say that the coercive nature of the bond swap made it a default in all but name.<sup>545</sup> The measures taken by Argentina, Latin America's third largest economy, constituted the largest sovereign debt default since 1824.<sup>546</sup> In fact, "[S&P] warned that it might downgrade Argentina's sovereign credit rating again, depending on the losses bondholders suffer in the debt swap."<sup>547</sup>

The government's restructuring plan changed the contractual arrangements of the debts, which decreased the value of the investments of domestic bondholders.<sup>548</sup> The news media and credit rating agencies implied that the voluntary obligation exchange was essentially a default, and that domestic creditors had no real choice but to accept the voluntary obligation exchange.<sup>549</sup>

Although the Argentine government purported the restructuring to be voluntary,<sup>550</sup> the obligation exchange was actually economically coercive. The domestic bondholders to whom the "suggestion" was issued had no real choice but to give in. A news article on the emerging market describes the "Hobson's choice"<sup>551</sup> proposed to the investors as follows:

Significant volume bondholders do NOT have an alternative but to participate in the swap. Not doing so is to shoot themselves dead. If

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543. EGMF Complaint, *supra* note 444, ¶ 36.

544. *Id.* ¶ 33.

545. *Argentina Announces Debt "Default" Plan*, *supra* note 484.

546. See EGMF Complaint, *supra* note 444, ¶ 34; see also Hornbeck, *supra* note 443, at 1.

547. *Argentina Announces Debt "Default" Plan*, *supra* note 484. One should generally "note that a credit rating is not a recommendation to buy (or equally, sell) a particular bond, nor is it a comment on market expectations." CHOUDHRY, *supra* note 56, at 11.

548. See EGMF Complaint, *supra* note 444, ¶ 35.

549. *Id.*

550. *Argentina Announces Debt "Default" Plan*, *supra* note 484 ("President de la Rúa said the bond swap will be voluntary, but gave no details to how it would be achieved."); see also Hornbeck, *supra* note 443, at 2 (showing that, in fact, the Argentine government has reasoned that the voluntary participants in restructuring plans are only the International Financial Institutions such as IMF, World Bank, which have continued to lend to republic Argentina, and those creditors).

551. See EGMF Complaint, *supra* note 444, ¶ 50.

they participate they still have at least a shot of things working out . . .  
 . . . [T]hey are given par to par without having to undergo the painful  
 process of having to mark their brand new loans down.<sup>552</sup>

If individual bondholders refused the debt swap, according to one source, the Argentine financial authority planned to provide pressure by threatening an audit in the near future,<sup>553</sup> which was bound to have significant damages<sup>554</sup> as “[f]ears [were] still growing that three years of economic stagnation [w]ould leave the country without the funds to pay its [astronomical] debt.”<sup>555</sup> The gun was pointed at the domestic bondholders’ heads.<sup>556</sup> Including a “package of measures designed to bolster the country’s economy,” the voluntary obligation exchange provided by the Argentine government forced them to choose from “only one path.”<sup>557</sup> The only choices they had were to accept the restructuring that came with payment protection, and which had a lower interest rate, longer maturity, and was supported with tax revenue, or to retain the bonds and face severe loss due to the revision of Argentine law.<sup>558</sup> Regardless of whether rational standards or common sense was applied, this was mandatory and in line with the purpose as described under the ISDA definitions, so accepting the terms was an economic necessity.<sup>559</sup> If the terms were denied, then creditors who were already saddled with loss would have ended up in economic destruction.<sup>560</sup> Moreover, contrary to JP Morgan’s statement, the so-called “debt swap” did not include cancelling the bond obligation.<sup>561</sup> Bonds were included in a trust used to protect the performance of the government in the form of modified bonds.<sup>562</sup> Payment of the bonds changed so that the bonds could be returned in case of Argentina’s default.<sup>563</sup> Thus, investors felt

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552. *Id.*

553. *See id.* ¶ 51.

554. *See id.*

555. *Argentina Minister Appeals for Calm*, BBC NEWS, July 13, 2001, <http://news.bbc.co.uk/2/hi/business/1436129.stm>.

556. *See* EGMF Complaint, *supra* note 444, ¶ 51.

557. *See id.* ¶ 52; *see also* *Argentina Debt Sparks Foreign Fears*, BBC NEWS, July 12, 2001, <http://news.bbc.co.uk/2/hi/business/1434592.stm>.

558. *See* EGMF Complaint, *supra* note 444, ¶ 52.

559. *Id.*

560. *Id.*

561. *Id.* ¶ 53.

562. *Id.*

563. *See id.*

that this government-driven “restructuring” plan was a default in all but name.

EGMF sent a third notice of default on December 12, 2001, but JP Morgan once again denied that a credit event had occurred, but did so without any back-up or rational explanation.<sup>564</sup> JP Morgan provided the following to EGMF on December 27, 2001:

This letter is our Credit Event Notice to you that a “Repudiation/Moratorium” Credit Event occurred with respect to the Reference Entity [Argentina] on or about December 24, 2001 when the Reference Entity declared a moratorium, whether de facto or de jure, with respect to one or more Obligations in an aggregate amount of not less than the Default Requirement. This letter also comprises our Notice of Publicly Available Information with respect to this Credit Event.<sup>565</sup>

On December 24, 2001, Argentina’s interim President Rodriguez Saa declared in his inaugural speech that the time allowed for payment of interest and principal on Argentina’s foreign obligations would be extended.<sup>566</sup> In detail, the Argentine government declared that it would immediately delay payment of the principal and interest on all foreign debts, and that “devaluation and dollarization were not under consideration.”<sup>567</sup> Both President De la Rúa and Domingo Cavallo, Argentina’s Minister of Economy, were dishonorably discharged in December 2001, and the Argentine economy subsequently collapsed.<sup>568</sup>

The Argentine government “defaulted on billions of dollars in public obligations,” and gave up the fixed FOREX exchange rate system that was linked to the U.S. dollar.<sup>569</sup> This, in turn, led to the devaluation of Argentina’s peso. Stringent restrictions on withdrawal of bank deposits led the new president, Eduardo Duhalde, to refer to the situation as a bloodbath.<sup>570</sup> All of these events were the by-product of the economic crisis that swept the nation in 2001, causing Argentina to

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564. *See id.* ¶ 54.

565. *Id.* ¶ 56.

566. *See id.* ¶ 57.

567. *See Lopez, supra* note 442, at 2.

568. *See EGMF Complaint, supra* note 444, ¶ 60.

569. *See id.* ¶ 60.

570. *Id.*

restructure its billions of U.S. dollars in public debts during November and early December 2001.<sup>571</sup>

A claimant, who demanded active interpretation of the restructuring, argued that numerous credit rating agencies concluded that Argentina's obligation exchange amounted to a default on the bond and that the restructuring took place due to government threats.<sup>572</sup> Although exchanged obligation is protected by Argentina's tax revenue, it meant that these bonds were placed on an inferior level compared to all other bonds of the same class.<sup>573</sup> Based on this claimant's argument, Argentina's restructuring satisfied the conditions of the credit event occurrence.

In response to EGMF's notification to JP Morgan that a credit event had occurred, JP Morgan stated that the Obligation Exchange declared by Argentina did not actually constitute a credit event because "[t]he Domestic Exchange was not mandatory, it was not, as a matter of law, an Obligation Exchange."<sup>574</sup> Therefore, under JP Morgan's theory, the parties were not bound to any duty under the payment clause in the agreement.

In their second notice to JP Morgan, EGMF argued that Argentina undertook a restructuring, and thus a credit event occurred according to the 1999 ISDA Definition sections 4.7 and 4.9.<sup>575</sup> EGMF provided the following as proof:

- (i) numerous debt rating agencies had concluded that Argentina's 'debt exchange' constituted a default on the Republic's dollar-denominated bonds; (ii) the restructuring was conducted under threats by the Argentine government, and (iii) the amended or 'exchanged,' obligations were now secured by Argentine tax deposits, thereby effectively subordinating all remaining obligations of the same class.<sup>576</sup>

JP Morgan again refused payment of the premium under the swap agreement clause. Instead, in a letter dated December 3, 2001, JP Morgan insisted that, under restructuring, as it is defined by the ISDA, the situation in Argentina was never voluntary and thus fell outside the

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571. See *id.* ¶ 61.

572. See *id.* ¶ 40.

573. See *id.*

574. Appellee Brief, *supra* note 440, at \*16.

575. See EGMF Complaint, *supra* note 444, ¶ 40.

576. *Id.*

scope of a credit event.<sup>577</sup> JP Morgan argued that protection of the securing bond of the same class as a result of the obligation exchange merely turned the remaining bonds into a lower priority, but did not change their priority upon payment.<sup>578</sup> EGMF, however, responded that these types of arguments neglected the clear realities of Argentina's restructuring.<sup>579</sup>

### (iii) Modified Approach

Ignoring the market participant's arguments, ISDA continues to employ its modified version of the Credit Derivatives Definitions, which preserves the definition of a restructuring credit event by discarding a few sections and both modifying and inserting words.

Prior to creating its 1999 definitions, ISDA declared that restructuring ("old-R") is a credit event<sup>580</sup> that triggers existing swap-contract termination where it makes "the terms of the reference obligation 'materially less favorable' to the creditor (or protection seller) from an economic perspective."<sup>581</sup> "The original 1999 ISDA [definitions] defined restructuring ["origin-R"] among the standard credit events<sup>582</sup> without containing the direct materiality clause and the five specified conditions included in the definitions."<sup>583</sup> This definition aimed to remove vagueness, but was still open to more than one interpretation, and created fierce arguments when courts aimed to determine whether a credit event had occurred.<sup>584</sup> Thus, in order to

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577. *Id.* ¶ 41.

578. *Id.*

579. *Id.*

580. See Conrad G. Bahlke & Paul N. Watterson, Jr., *Credit Derivatives 2000: Legal and Regulatory Update*, FUTURES & DERIVATIVES L. REP., Apr. 2000, at 7, available at <http://www.srz.com/publications/publicationsDetail.aspx?publicationId=1389> (introducing "Confirmation of OTC Credit Swap Transaction Single Reference Entity – Non-Sovereign" a/k/s 1998 ISDA Long Form Confirmation); see also *Taking Stock of Derivatives: Commodity Exchange Act and CFTC Face Uncertain Futures FAS 133 Arrives in Y2k*, CAPITAL STROOCK MARKETS (Stroock & Stroock & Lavan LLP, New York, N.Y.), Feb. 2000, at 7, <http://www.stroock.com/SiteFiles/Pub87.pdf>.

581. CHOUDHRY, *supra* note 56, at 47.

582. *Id.* at 48.

583. See *id.* at 47-48; *supra* note 360 and accompanying text.

584. See CHOUDHRY, *supra* note 56, at 48.

reduce disputes, ISDA promulgated the Restructuring Supplement (“Modified Restructuring” “Mod-R”).<sup>585</sup>

The Mod-R definitions stipulated more precise conditions than the prior version. Included within the definition was any action that brought a “reduction in the amount of principal”<sup>586</sup> and “limited the term to maturity of deliverable obligations” in the portfolio.<sup>587</sup> The Mod-R was intended to reduce the conflict between the parties to the agreement. Unfortunately, however, when the reference obligation in the credit derivatives swap agreement was sovereign debts, the Mod-R clause was not usually included. Furthermore, “[i]t is now viewed as a risk that all forms of the Restructuring Credit Event could create a conflict of interest for bank lenders who are also [taking] long protection [positions].”<sup>588</sup> For this reason, even well-developed U.S. derivatives markets have strongly supported erasing the Restructuring Credit Event completely from the definitions.<sup>589</sup>

Nevertheless, the Mod-R, which has now been consolidated into the 2003 ISDA definitions (“Mod-Mod-R”), has been used widely in U.S. derivatives markets.<sup>590</sup> In fact, subsequent to the introduction of the Mod-R, a divergent derivatives business was transacted, subject to these clauses.<sup>591</sup>

When incorporated by ISDA, Mod-R contains several restructuring-related supplemental clauses, including section 4.10(b) of the Multiple Holder Obligation (“MHO”).<sup>592</sup> This section requires that “the Restructuring Credit Event can occur only with respect to an obligation . . . [when it is] held by more than three holders that are not Affiliates of each other, at the time the Credit Event Notice is delivered.”<sup>593</sup> It further stipulates that “with respect to [the] percentage of holders (determined pursuant to the terms of the Obligation) at least equal to

585. FRANCIS ET AL., *supra* note 59, at 70.

586. See CHOUDHRY, *supra* note 56, at 47-48.

587. *Id.* at 48 (“[I]n practice this has placed a maturity limit on deliverable obligations of 30 months.”).

588. FRANCIS ET AL., *supra* note 59, at 72.

589. *Id.*; see BOMFIM, *supra* note 1, at 295 (“[M]ost market participants point to the Consec case . . . as a major catalyst of the debate that culminated with the adoption of a new set of provisions regarding restructuring in CDS contracts.”).

590. FRANCIS ET AL., *supra* note 59, at 70.

591. See *id.*

592. See, e.g., 2001 RESTRUCTURING SUPPLEMENT, *supra* note 330, § 4.10(b).

593. *Id.* § 4.10(b)(i).

sixty-six-and-two-thirds is required to consent to the event which would otherwise constitute a Restructuring Credit Event.”<sup>594</sup>

Mod-R extends its scope of application into all types of restructuring in the Mod-Mod-R Definitions<sup>595</sup> and amends the prior restructuring definitions to remove any reference to Obligation Exchange.<sup>596</sup>

The 2003 [ISDA] Definitions offer parties four choices relating to Restructuring: (i) trade without Restructuring [“no-R”]; (ii) trade with “full” Restructuring [“origin-R”], with no modification to the Deliverable Obligations aspect; (iii) trade with “Modified Restructuring” [“Mod-R”], as has been market practice in North America since the publication of the Restructuring Supplement in May 2001; or (iv) trade with “Modified Modified Restructuring” [“Mod-Mod-R”], which is a new provision, generally aimed to address issues raised in the European market.<sup>597</sup>

Under the origin-R definitions, the obligation exchange caused restructurings and the obligation’s underlying terms did not actually change, but protection sellers were subject to a “mandatory” exchange into other bonds that treated the bonds less favorably regarding both maturity and interest rate.<sup>598</sup>

The 2003 ISDA definitions provided further clarification by replacing opaque language, stating that “the restructuring credit event had to be binding on ‘all’ holders of the restructured debt.”<sup>599</sup> Furthermore, the Mod-Mod-R definitions repealed both the concept of obligation exchange and the mandatory requirement of the exchange.<sup>600</sup> Instead, restructuring only applies when the following conditions are met:

With respect to one or more Obligation, and in relation to aggregate amount of not less than the Default Requirement, any one or more of

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594. *Id.* § 4.10(b)(ii).

595. *See* FRANCIS ET AL., *supra* note 59, at 70.

596. *Id.* at 63.

597. Press Release, ISDA, ISDA Publishes 2003 ISDA Credit Derivatives Definitions (Feb. 11, 2003), <http://www.isda.org/press/index.html>.

598. *See* FRANCIS ET AL., *supra* note 59, at 69.

599. CHOUDHRY, *supra* note 56, at 49; 2003 ISDA DEFINITIONS, *supra* note 427, § 4.7(a) (emphasis added).

600. *See* 1999 ISDA DEFINITIONS, *supra* note 16, § 4.9 (defining obligation exchange).

the following events occurs, (i) is agreed between the Reference Entity or a Governmental Authority and a sufficient number of holders of such Obligation to bind all holders of the Obligation or (ii) is announced (or otherwise decreed) by a Reference Entity or a Governmental Authority in a form that is binding upon all the holders of such Obligation, and (iii) such event is not expressly provided for under the terms of such Obligation in effect as of the later of the Trade Date and the date as of which such Obligation is issued or incurred.<sup>601</sup>

The Mod-Mod-R did not provide a substitute to “voluntary” sovereign debt restructurings, however, and without a multiple action clause in its definitions, a restructuring credit event cannot be triggered on a reluctant minority of creditors.<sup>602</sup> Thus, under this section, “a voluntary [obligation] exchange would not trigger a restructuring credit event unless and until all [bond]holders tendered their obligations.”<sup>603</sup> One possible interpretation of this analysis is that if all bondholders individually agree to the restructuring plans without coercion and accept the given conditions by tendering their bonds regardless of damages, it might trigger a credit event.<sup>604</sup> This situation is unlikely, however, given that it is impossible for every bondholder to participate in a debt exchange.<sup>605</sup>

For these reasons, the Mod-Mod-R definitions are similar to the origin-R definitions under the de facto test.<sup>606</sup> Therefore, the voluntary debt exchange will not trigger a credit event even under up-to-date definitions.<sup>607</sup> Many swap market participants learned that it is difficult to objectively distinguish between voluntary and mandatory obligation exchanges, as evidenced in EGMF.<sup>608</sup> Reflecting such understanding, voluntary obligation exchanges were excluded from the origin-R definition.

Additionally, market participants prefer to exclude voluntary restructurings because if such definitions were included as part of the

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601. 2003 ISDA DEFINITIONS, *supra* note 427, § 4.7(a).

602. See Pierre-Hugues Verdier, Credit Derivatives and the Sovereign Debt Restructuring Process 71 (Apr. 27, 2004) (Harvard Law School Int’l Fin. Seminar) (on file with author), [http://www.law.harvard.edu/programs/pifs/pdfs/pierre\\_verdier.pdf](http://www.law.harvard.edu/programs/pifs/pdfs/pierre_verdier.pdf).

603. *Id.*

604. *See id.*

605. *See id.*

606. *See id.*

607. *Id.*

608. *See id.*



credit events list, protection buyers would be reluctant to enter into derivatives transactions due to the attendant uncertainty.<sup>609</sup> Furthermore, after successful restructuring, protection sellers would change their investment strategy because of the significantly downgraded obligations. On the other hand, since restructuring plans are usually carried out by bondholders at large, most unsecured bondholders are reluctant to accede to the given terms. In fact, this problematic scenario might not arise because of the small number of secured bondholders who would free-ride on the government or institutions-driven debt restructuring schemes. Consequently, “even as the sovereign credit derivatives market gradually migrates to the 2003 ISDA definitions, the distortion in restructuring incentives created by these instruments will endure.”<sup>610</sup> Ultimately, a credit event would be triggered by a prior default even under the Mod-Mod-R definitions in a sovereign pre-default restructuring context. The real question that needs to be asked, therefore, is: If the protection buyer and protection seller use the multiple holder obligation clause on their credit derivatives transaction, would the voluntary sovereign debt restructuring effectively trigger a credit event?

It is generally understood that “[t]he changes in [contractual] terms adopted as part of a restructuring normally fit one or more of the events listed in the restructuring definition.”<sup>611</sup> Therefore, under either the origin-R<sup>612</sup> or Mod-Mod-R<sup>613</sup> definitions, “[MHO] restructurings . . . [clauses] are prima facie covered by the restructuring definition.”<sup>614</sup> It is important to note, however, both definitions may be excluded if the

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609. *See id.* at 71-72.

610. *Id.* at 72.

611. *Id.*

612. *See* 1999 ISDA DEFINITIONS, *supra* note 16, § 4.7(a). “The origin-R Definitions cover events that are agreed [upon] between the Reference Entity . . . and the holder or holders of such Obligation.” *Id.*

613. *See* 2003 ISDA DEFINITIONS, *supra* note 427, § 4.7(a). The Mod-Mod-R Definitions more clearly define that if the terms “are agreed between the Reference Entity . . . and a sufficient number of holders of such Obligation to bind all holders of the Obligation” and it constitute restructuring credit event. *Id.*

614. Verdier, *supra* note 602, at 73.

parties did not expressly include this in their agreement.<sup>615</sup> Based on this approach, “no restructuring credit event would be triggered.”<sup>616</sup>

Even with such an interpretation, there are different arguments as to why this approach ought to be dismissed.<sup>617</sup> One commentator, who analyzed the drafters’ intentions, stated that the drafters clearly did not intend to exclude the collective action clause and the origin-R does not expressly describe collective action clauses.<sup>618</sup> The true reason is that derivatives market practices vary slightly between the United States and Europe.<sup>619</sup> Considering the drafters’ knowledge of this fact, one can conclude that the absence of MHO clauses in the definitions can trigger the restructuring if their application was intentionally excluded.<sup>620</sup> This outcome is even clearer under the Mod-R and Mod-Mod-R definitions. As seen above, “voluntary [obligation] exchanges do not trigger the clause.”<sup>621</sup> Therefore, it can only be assumed that “the drafters must have been incorporating the use” of MHO clauses.<sup>622</sup>

By adopting MHO clauses,<sup>623</sup> the drafters presumably intended to erase the holdout creditor problem and solve the restructuring problem in a collective manner that “otherwise makes restructurings difficult or impossible.”<sup>624</sup> It has been said that “[t]he adoption [of MOH clauses in the Mod-R and Mod-Mod-R definitions] is seen as a market-based alternative to a more elaborate international bankruptcy regime,”<sup>625</sup> where the sovereign has no bankruptcy proceedings. It is not surprising,

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615. See 1999 ISDA DEFINITIONS, *supra* note 16, § 4.7(a) (1999). Note that the 2003 Definitions contain a substantially identical clause, but use the adverb “expressly.” See 2003 ISDA DEFINITIONS, *supra* note 427, § 4.7(a).

616. See Verdier, *supra* note 602, at 73.

617. See *id.*

618. See *id.*

619. See *id.* at 73-74 (arguing that regardless of ISDA Definitions, “[b]onds issued in London, both corporate and sovereign, routinely include collective action clauses, and these provisions are frequently used to implement restructurings”).

620. See *id.* at 74.

621. *Id.*

622. See *id.*

623. See *id.* (indicating that these clauses allow a supermajority of holders to bind the minority to the financial terms of a restructuring).

624. See *id.*

625. *Id.* at 73; see, e.g., John B. Taylor, Under Sec’y of Treasury for Int’l Affairs, Sovereign Debt Restructuring: A U.S. Perspective, Speech at the Conference “Sovereign Debt Workouts: Hopes and Hazards” (Apr. 2, 2002) (Inst. for Int’l Econ., Washington, D.C.), available at <http://www.iie.com/publications/papers/print.cfm?doc=pub&ResearchID=455>.

however, that if MHO clauses control the credit derivatives agreement, “the protection buyer’s argument that the [obligation] exchange is in fact involuntary is stronger, because the [debt] restructuring can be enforced against him even if he votes against it.”<sup>626</sup> Indeed, “even if a protection buyer votes for a restructuring, some coercion still occurs, as the [restructuring] negotiations are conducted under the shadow of the . . . [MHO clause’s] potential utilization.”<sup>627</sup>

Thus far, no data or reports indicate that MHO clauses have been used in actual restructurings in the marketplace. Excluding such clauses from credit event definitions would “dilute their effect,”<sup>628</sup> however, with the desire that the restructuring will fail and the reference entity “will default, thus triggering the credit event.”<sup>629</sup> Obviously, the current argument about restructuring would be somewhat alleviated by the 75% or 85% super-majority voting prong under MHO clauses, as an alternative to the de facto prong voluntary debt exchange.<sup>630</sup>

### 3. Suggested Approach

The concepts of default and credit event occurrence are not considered the same. As the case of Conseco shows, a credit event is a priority concept that includes default.<sup>631</sup> Even when default does not

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626. Verdier, *supra* note 602, at 75.

627. *Id.*

628. *See id.*

629. *Id.*

630. *See id.*

631. *See* BOMFIM, *supra* note 1, at 294 (summarizing the consequences of the Conseco case). A brief history of the restructuring of Conseco Inc. is as follows:

In October 2000, [in order to overcome a deteriorating financial outlook], the company and its [lending] bankers agreed to a restructuring of its [outstanding] loans, which included an extension of maturity [under the higher interest rate charge and add extra collateralization]. In the bank loan market [arena] this was not seen particularly as a credit negative as it headed off a potential liquidity crisis. [Because such a restructuring helps Conseco’s currently impending liquidity crunch]. However, some bankers who had bought protection on Conseco gave notice of restructuring and then delivered long-dated bonds, which were trading significantly lower than the restructured bank loans. This outcome was viewed negatively by protection Sellers who were not expecting to suffer an economic loss on a “soft” Credit Event that was a result of credit deterioration but fell short of a full default or bankruptcy.

FRANCIS ET AL., *supra* note 59, at 70. “Under the modified restructuring definition, where the triggering event is restructuring, the delivered obligation cannot have a maturity that is longer than the original maturity date of the credit derivative contract, or

actually take place, a credit event may occur when the conditions for payment on the CDS agreement are satisfied.<sup>632</sup>

On November 6, 2001, S&P and Pitch lowered the credit rating of the Argentine bonds, stating that Argentina's domestic restructuring plan constituted a partial default.<sup>633</sup> At the time, S&P announced publicly that it would lower the rating on the investments made on Argentina's existing obligations to the default level.<sup>634</sup> In other words, credit rating agencies defined this event as a de facto default.

The 1999 ISDA definitions were intended to classify what constitutes a credit event because certainty and objectivity are extremely important factors when laying out the parameters of what constitutes a credit event.<sup>635</sup> When the scope of the credit event is divided, it is necessary that it be interpreted narrowly using the literal meaning; it also means staying away from analogical interpretation after the fact. In the past, the credit event occurred automatically, even without default, because a credit event is a broader concept than restructuring. As time passed, however, it was interpreted more narrowly.<sup>636</sup>

Further review is required to determine whether the voluntary restructuring that occurred in Argentina in 2001 should be perceived as a de facto state of default, which would result in conditions for payment in accordance with the credit agencies' interpretation. To determine whether de facto events of default took place in Argentina, it is important to understand what kind of default the parties had in mind at the time of the agreement.

When DITM signed the agreement with JP Morgan in 1996, they used an earlier ISDA definition regarding what restructuring would constitute a credit event. After defining credit event in 1999, ISDA

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more than 30 months after the original maturity date." CHOUHRY, *supra* note 56, at 48 n.9.

632. See *supra* note 362 and accompanying text.

633. See Kathryn M.E. Dominguez & Linda L. Tesar, International Borrowing and Macroeconomic Performance in Argentina 25, Univ. of Mich. and NBER (Nov. 30, 2004; revised Feb. 14, 2005), <http://www-personal.umich.edu/~ltesar/pdf/NBER2005.pdf>.

634. See Geert Bekaert & Campbell R. Harvey's Chronology of Economic, Political and Financial Events in Emerging Markets, [http://www.duke.edu/~charvey/Country\\_risk/chronology/argentina.htm](http://www.duke.edu/~charvey/Country_risk/chronology/argentina.htm) (last visited Feb. 28, 2008).

635. See Pollack, *supra* note 337, at 45.

636. See 2003 ISDA DEFINITIONS, *supra* note 427, § 4.9 (indicating evidence that ISDA repealed the original section 4.9 definitions and transplanted a different, narrower standard).

continued to focus on narrowing the scope of application of the credit event. Accordingly, based on the 1999 ISDA definition of a credit event, CDS agreements that were signed by United States hedge funds like EGMF and JP Morgan should be interpreted narrowly and passively in accordance with the Master Agreement when determining the scope of application for the credit event. In the meantime, the definition of restructuring related to the DGB2 fund that existed prior to the ISDA definitions should be used in a more comprehensive manner.<sup>637</sup> Although the credit event referred to by the agreement between hedge funds and DGB2 funds leads to the same crisis because of Argentina's restructuring, it could be construed differently. Although JP Morgan insists that a credit event did not occur under the agreement, a credit event would have occurred under the agreement if it were a DGB2 fund.

### C. Aon Financial Products

#### I. Background

Ursa Minor Ltd. ("Ursa") is a Cayman Islands company, while Bankers Trustee Company Ltd. ("Bankers") and Bear Stearns International Ltd. ("BSIL") are both English businesses.<sup>638</sup>

On February 4, 1999, BSIL signed an agreement for a loan in the amount of \$9,307,000, with Ecobel Land, Inc. ("Ecobel"), a Philippines company that sought to construct a high rise condominium.<sup>639</sup> As a requirement of this agreement, Ecobel had to procure a surety bond protected by the government, and the Philippine government had to guarantee payment to the creditor, BSIL.<sup>640</sup>

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637. Cf. Pollack, *supra* note 337, at 45.

Even if the Restructuring definition was revised to only capture distressed exchanges . . . such an objective definition will still create areas of unmatched risk hedging. For example, protection sellers may manipulate the termination of a credit default swap by prematurely triggering at a time when such a result maximizes their financial gain. Therefore, regardless of whether the Restructuring definition is redefined to eliminate more subjective restructurings, the definition will still lead to less than complete credit protection.

*Id.*

638. Complaint ¶¶ 6-7 Aon Fin. Prods., Inc. v. Societe Generale, 2000 WL 34015582 (S.D.N.Y. 2000) Nos. 00CIV. 5863, 00CIV 2474.

639. *Id.* ¶ 9.

640. *See id.* ¶ 10.

On February 4, 1999, BSIL and Aon Financial Products (“AFP”) signed a CDS agreement.<sup>641</sup> A little over a month later, on March 8, 1999, AFP and Societe Generale signed a second CDS agreement as additional security for AFP’s undertakings with BSIL.<sup>642</sup> The agreement enumerated what constituted a credit agreement.<sup>643</sup>

According to the agreement, AFP agreed to pay BSIL when a credit event occurred, in this instance meaning if the loan was not paid by the Philippine government.<sup>644</sup> Detailed information about the credit event under the agreement is as follows: (i) lack of authority or capacity regarding the loan agreement or surety bond, (ii) the inability to perform, illegality, or a void of the loan agreement or surety bond, and (iii) default as a result of an applicable law, order, regulation, decree, or notice.<sup>645</sup>

On March 26, 1999, AFP, BSIL, Ursa and Bankers signed the assignment and assumption agreement.<sup>646</sup> In this agreement, BSIL transferred all rights dictated under the credit swap agreement to Ursa, with the other parties agreeing.<sup>647</sup> Ursa designated Bankers as trustee, and assigned all rights under the agreement to Bankers.<sup>648</sup>

On March 11, 1998, GSIS issued a surety bond with the Philippine Veterans Bank as creditor, naming Ecobel as the principal debtor.<sup>649</sup> The surety bond was to be transferred to BSIL on February 10, 1999.<sup>650</sup> The surety bond was never issued to BSIL, however, and was not assigned or transferred to the Philippine Veterans Bank.<sup>651</sup>

Ecobel, the principal debtor, intended to default on or about March 1, 2000.<sup>652</sup> Thus, Bankers notified Ecobel by facsimile on March 7, 2000 of the failure to pay.<sup>653</sup> They also notified GSIS to provide payment according to the loan agreement.<sup>654</sup> On the same day, Bankers

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641. *Id.* ¶ 11.

642. *See id.* ¶ 12.

643. *See id.* ¶ 14.

644. *Id.* ¶ 13.

645. *Id.* ¶ 14.

646. *Id.* ¶ 16.

647. *Id.* ¶ 17.

648. *Id.*

649. *Id.* ¶ 19.

650. *Id.* ¶ 20.

651. *Id.* ¶ 21.

652. *See id.* ¶ 24.

653. *Id.* ¶ 25.

654. *Id.* ¶ 26.

notified AFP of this event, and advised that they intended to pursue a claim following the credit swap agreement.<sup>655</sup> This notice said that Bankers would not get any repayment from GSIS or Ecobel, and that GSIS did not duly authorize the issuance of a surety bond, and none was transferred.<sup>656</sup>

BSIL subsequently requested that AFP make payment as originally agreed under the credit swap agreement.<sup>657</sup> On March 10, 2000, Aon replied that there was no failure to pay because it was yet to be determined whether this was, in fact, a credit event.<sup>658</sup>

On March 15, 2000, GSIS notified BSIL and Ecobel that the surety bond issued for the Philippine Veterans Bank had been cancelled.<sup>659</sup> Accordingly, because the obligee had not joined this event, no assignment occurred, and a reference obligation did not exist under the credit swap agreement.<sup>660</sup> At the same time, it induced a dispute about whether a credit event occurred.<sup>661</sup>

A week later, on March 22, 2000, AFP brought a declaratory judgment suit against BSIL and Ursa asserting that AFP was obligated to the surety bond in accordance with the credit swap agreement.<sup>662</sup> If AFP was to lose the litigation, Societe Generale would have to provide reimbursement.<sup>663</sup> On the same day, Aon notified Societe Generale of the credit event and requested immediate payment.<sup>664</sup>

On March 31, 2000, Ursa, with Bankers and BSIL as co-plaintiffs, initiated a separate suit against AFP and Aon alleging that each company's obligations under the CDS agreement were violated.<sup>665</sup> In this suit, the court recognized that a credit event took place in March 2000, and the court entered summary judgment in favor of the plaintiffs.<sup>666</sup>

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655. *Id.* ¶ 27.

656. *Id.* ¶ 28.

657. *Id.* ¶ 29.

658. *See id.* ¶ 30.

659. *Id.* ¶ 31.

660. *See id.* ¶ 31.

661. *See id.* ¶ 32.

662. *Id.* ¶ 33.

663. *See id.* ¶ 34.

664. *See id.* ¶ 33.

665. *See id.* ¶ 35.

666. *See id.* ¶ 36.

## 2. Issue

Among other things, the issue in this scenario is whether the guarantor's (GSIS) refusal of repayment constitutes a credit event. In general, a suretyship obligation refers to the debt that needs to be performed, in all or in part, or payment of an undertaking, if the principal obligation is defaulted.<sup>667</sup> A suretyship obligation assumes the same duty, nature, and scope as the principal debt, and functions in a way that secures the principal obligation.<sup>668</sup> In general, a suretyship obligation is established by an agreement between the creditor and guarantor.<sup>669</sup> This agreement is not independent, but rather is signed within the document in order to secure the debt between the creditor and principal debtor.<sup>670</sup>

In the end, the conditions for establishment of a suretyship obligation are the existence of a surety agreement between the guarantor and the creditor and the existence of a principal obligation. The specifics of the suretyship obligation are decided by the surety agreement and the principal obligation. For one obligation or payment, each of the two debtors assumes independent obligations.

Suretyship obligations have inherent legal characteristics such as independence,<sup>671</sup> appendant nature, accompaniment, complementariness,

667. See Berkley, *supra* note 29, at 354.

668. See *id.* Strictly speaking, surety and guaranty have different meanings: The former means "an agreement to be jointly and severally liable for the payment or performance obligation without necessity for first exhausting rights and remedies against borrower," while the latter means "technically an agreement to pay or perform an obligation only if primary obligor fails to do so." *Id.* at 354; see also RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 1 cmt. m (1996) [hereinafter RESTATEMENT]. But see Aicher et al., *supra* note 81, at 920.

The reality is that, as a practical matter, surety and guaranty have lost their distinctions in the modern world. After endless hours of discussion, much research and nearly as much frustration, the authors have concluded that although some differences might exist, it simply isn't useful to proceed on the premise that the differences between surety agreements and guaranties are meaningful outside of the context of insurance.

*Id.*

669. See RESTATEMENT § 1 cmt. m, *supra* note 668, at 7 (stating that "[t]he [guarantor] may undertake its obligation as a result of direct dealings with the obligee without the consent or knowledge of the principal obligor").

670. See RESTATEMENT § 1 cmt. a, *supra* note 668. Thus, two contracts are made in the general suretyship: "one between the secondary obligor and the principal obligor, the other between the secondary obligor and the obligee." *Id.*

671. Some commentators state that:



and homogeneity. The suretyship obligation assumes the same content, scope and quantity as the principal obligation. A suretyship obligation, however, includes interest penalties on the principal obligation, compensation for damages, and other obligations within the principal obligation.<sup>672</sup>

A suretyship obligation is separate, or independent from, the principal obligation and “need not be identical to the underlying obligation.”<sup>673</sup> These obligations form a subordinate relationship with the principal obligation, however, in the sense that its purpose is to secure performance of the principal obligation. Suretyship obligations have the characteristic of becoming a subordinate of the principal obligation. Thus, when a principal obligation is voided,<sup>674</sup> cancelled,

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The relationship between the guarantor and creditor a guaranty creates is contractual in nature and is generally subject to the laws of contract. . . . a guarantor is not primarily liable on the underlying debt but instead has a secondary liability that will be required to be paid only when the underlying obligor has defaulted in its obligation to pay the underlying debt. A corollary of this distinction is that a guarantor is generally not liable to pay the creditor on the underlying debt unless the underlying obligor is liable to pay such debt to the creditor. Put differently, the independence principle does not exist in the law of guaranties.

Aicher et al., *supra* note 81, at 912 (citation omitted).

672. See *E. Quincy Servs. Dist. v. Gen. Accident Ins. Co. of Am.*, 105 Cal. Rptr. 2d 694 (Cal. Ct. App. 3d Dist. 2001).

[O]nce a surety assumes the contract of its principal, it stands in the same position to the contract as the principal, including all liabilities; [and] a surety is thus liable for all liquidated damages accruing before it assumed the contract, and is no longer limited to its bond in completing the contract thereafter.

*Id.* at 697; see also *In re Conservatorship of Huerta*, 41 P.3d 814 (Kan. 2002).

In the case of debt on [a surety bond] for the payment of money only, . . . interest may be recovered after default, even though it exceeds the penalty, and whether the action be against principal or surety.

. . . .

The penalty of the bond covers the misconduct of the principal; but the interest allowed on the penalty is for the misconduct of the sureties for the delay in payment.

If the damages were paid when due, they would have earned interest.

*Id.* at 818 (citations omitted); see also *Edmonds v. W. Sur. Co.*, 962 P.2d 323, 326 (Colo. Ct. App. 1998) (“When a [surety] bond is legally mandated, the obligation does not include any penalties imposed on the principal obligor beyond actual losses suffered by the obligee for failure of the principal to fulfill the underlying obligation, unless the secondary obligation so provides.”).

673. See RESTATEMENT § 1 cmt. k, *supra* note 668 (noting that a secondary obligation does not have to be identical to the original obligation).

674. See Aicher et al., *supra* note 81, at 913 (stating that “[A]s a general rule, if the underlying debt is void, the guaranty is not enforceable either”).

modified,<sup>675</sup> or terminated, the suretyship obligation's fate is the same.<sup>676</sup> When the bond on the principal obligation is transferred, the suretyship obligation is also transferred. On the contrary, if there is a change in the principal debtor as an assumption, the suretyship obligation is terminated under the doctrine of collapsed fidelity.<sup>677</sup>

Because a suretyship obligation is formed by the surety agreement between creditor and guarantor, the guarantor's mistake as to an essential part of the contract will not become void even when the grantor was deceived by the principal debtor's inducement.<sup>678</sup> Originally, upon arrival of the suretyship obligation's due date, the creditor may require its performance pursuant to their agreement that the guarantor be liable in the event of default of the principal debtor.<sup>679</sup> When a specific credit event takes place as it did here, a creditor may require performance by the guarantor even before maturity, since the conditions on the agreement are fulfilled.<sup>680</sup>

### 3. Argument

As mentioned above, there is no question that the debtor's failure to pay constitutes a credit event. There is a dispute regarding whether the guarantor's refusal for repayment applies to the credit event, because the guarantor has *peremptory notice and inquiry rights*. In other words, the guarantor may demand that the creditor make a claim to the principal

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675. See *id.* “[I]f the terms of the underlying debt are altered materially without the consent of the guarantor, the guaranty may be unenforceable.” *Id.*

676. See Aicher et al., *supra* note 81, at 913.

677. See, e.g., *Bier Pension Plan Trust v. Estate of Schneierson*, 74 N.Y.2d 312, 315 (1st Dept. 1989) (“Under general contract rules, an obligation may not be altered without the consent of the party who assumed the obligation.”); see also *Midland Steel Warehouse Corp. v. Godinger Silver Art Ltd.*, 276 A.D.2d 341, 343 (N.Y. App. Div. 2000).

678. See *Bier Pension Plan Trust*, 74 N.Y.2d at 315.

Although parties are generally bound by the terms of the agreement they sign, it is a well-settled rule of law, that a contract of guaranty cannot be enforced by the guarantee, where the guarantor has been induced to enter into the contract by fraudulent misrepresentations or concealment on the part of the guarantee.” (citation and emphasis omitted).

*Id.*

679. See RESTATEMENT § 1, *supra* note 668.

680. See *Phillips Factors Corp. v. Harbor Lane of Pensacola, Inc.*, 648 F. Supp. 1580, 1583 (M.D.N.C. 1986) (“[D]efault of one primarily liable triggers guarantor's duty of performance on the obligation.”).

debtor first since they have the ability and capacity to repay. Under this scenario, the creditor claims first to the principal debtor, and may only make a claim to the guarantor if the principal debtor cannot repay. Because of the time lapse between these two events, the relationship between the parties could have changed significantly.

In this case, it is unclear whether GSIS exercised the “peremptory notice and inquiry rights.” If this right was exercised, then the judgment might differ because the guarantor can exercise the refusal of performance by right due to the nature of the suretyship obligation and, as such, it would be necessary to interpret what constitutes a credit event.

GSIS denied the formation of a suretyship obligation and the courts recognized it as a credit event.<sup>681</sup> Still, it is necessary to separate the non-existence of a suretyship obligation, which cannot constitute a credit event, from the guarantor’s refusal to repay. Only the latter should be recognized as a credit event, because if suretyship does not exist between a creditor and guarantor, for whatever reason, logically, a credit event could not occur. The trial court’s finding that a credit event occurred is questionable.<sup>682</sup>

On appeal, however, the Second Circuit court stated that:

[n]either the default, which constituted a Failure to Pay under the BSIL/Aon CDS contract, nor the Republic [of the Philippines’] failure to honor its alleged statutory obligation, constituted a Failure to Pay under the Aon/SG CDS contract. For the same reasons, neither event constituted a “Repudiation.” They similarly do not satisfy the other definitions of Credit Event enumerated in the Aon/SG CDS contract.<sup>683</sup>

Note, however, that this holding was based on the analysis of whether the credit event notice was sent before the termination date, not on a direct analysis of whether the enumerated credit events occurred.<sup>684</sup> The true meaning of the court’s holding is that there was a credit event, but it simply had late notice. This reasoning is not satisfactory and has not solved any of the confusion in this area of the law.

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681. *See* Aon Fin. Prods. v. Société Générale, No. 00 Civ. 5863GBD, 2005 WL 427535, at \*1, \*2 (S.D.N.Y. Feb. 22, 2005).

682. *See id.* at \*6.

683. Aon Fin. Prods. v. Société Générale, 476 F.3d 90 (2d Cir. 2007).

684. *See id.* at 102-03.

## CONCLUSION

This Article explored the development of credit derivatives and examined swap products, which are now important market tools. It also introduced the legal characteristics of a credit derivatives swap and examined various issues related to credit events that trigger changes in the relationship of rights in credit derivatives agreements. Further, lawsuits between EGMF and JP Morgan, and DITM and JP Morgan, were examined to scrutinize the legal issues pertaining to Argentina's declaration of moratorium in the context of credit derivative instruments and the occurrence of a credit event. Failure to pay was examined in relation to the interpretation of the credit event, which was an issue between Aon and Societe Generale.

As Moody's declared, the investor's main risk in credit derivatives type transactions stems from the moral hazard of intermediary financial institutions.<sup>685</sup> Due to the characteristics of the credit derivatives instrument whereby intermediary financial institutions decide whether a credit event occurred or not and make decisions on the scope of the loss, a dispute might be inevitable.<sup>686</sup> The brokerage financial firms will surely want to interpret the terms credit event and boundary of loss as broadly as they possible.

As the Aon example shows, financial institutions that transact credit derivative instruments want to interpret the term "credit event" as broadly as possible. This argument is not convincing, however, when principles such as materiality, objectivity, and certainty are factored into the credit event. "[R]esolution of the debate over the [r]estructuring [c]redit [e]vent is far from near."<sup>687</sup> One critic further remarked that "[i]t seems highly implausible that there will ever be a definition of [r]estructuring that satisfies all market participants."<sup>688</sup> The need for a definition of restructuring, however, is undeniable. "There is a valid concern expressed by market participants who favor inclusion of [r]estructuring that its exclusion will create mismatches in credit risk

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685. See e.g., TOLK, *supra* note 373, at 13. "Some other models do not rely on moral hazard to explain financial crises . . ." *Id.*; see STERN & FELDMAN, *supra* note 37, at 28.

686. See TOLK, *supra* note 373, at 2.

687. Pollack, *supra* note 337, at 44.

688. *Id.*

hedging.”<sup>689</sup> Only when the definition of a credit event is interpreted narrowly, as it is under the ISDA, is it possible to avoid confusion.

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689. *Id.*