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Harmonizing European Union Bank Resolution: Central Clearing of OTC Derivative Contracts Maintaining the Status Quo of Safe Harbors

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I. INTRODUCTION

The continuing European debt crisis is a constant reminder that the financial crisis is not over yet and that mismanagement at financial institutions continues to threaten the stability of the financial markets.[1] The London Interbank Offered Rate ("LIBOR") scandal is just the latest revelation that draws into question whether financial institutions and investment firms will ever become transparent enough to prevent a similar future financial crisis.[2] The role that qualified financial contracts played during the financial crisis, including over-the-counter ("OTC") derivatives and repurchasing agreements, has become a particular concern.[3] Credit Default Swaps ("CDSs") and Collateralized Debt Obligations ("CDOs") may

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[1] *See, e.g.*, Daniel Schäfer & James Shotter, *UBS Takes Swift Action on Job Cuts*, FIN. TIMES, Oct. 30, 2012, http://www.ft.com/intl/cms/s/0/0d1ba8e4-2217-11e2-9ffd-00144feabdc0.html#axzz2ApjY36BZ (arguing that UBS's investment bank has embroiled this bank in a number of "misadventures," including big write-downs in the financial crisis and the largest unauthorized trading loss in British history, as well as the LIBOR scandal); Daniel Schäfer & Caroline Binham, *Barclays Faces US Fine of $470m*, FIN. TIMES, Oct. 31, 2012, http://www.ft.com/intl/cms/s/0/36759eba-22a9-11e2-938d-00144feabdc0.html#axzz2ApjY36BZ (arguing that Barclays is trying to rebuild its reputation after a series of scandals including the manipulation of financial markets); EUR. CENT. BANK, FINANCIAL STABILITY REVIEW: JUNE 2012, at 7–11 (2012), *available at* http://www.ecb.int/pub/pdf/other/financialstabilityreview201206en.pdf (describing bank business models as challenges and key risk factors); INT'L MONETARY FUND [IMF], GLOBAL FINANCIAL STABILITY REPORT: THE QUEST FOR LASTING STABILITY 25–33 (Apr. 2012), *available at* http://www.imf.org/external/pubs/ft/gfsr/2012/01/pdf/text.pdf (arguing that investor concerns were reflected in weak bank equity prices and soaring CDS spreads for banks in countries with the most affected sovereigns in Europe); Steven Erlanger, *After High Note for Euro Plan, Discord Emerges*, N.Y. TIMES, Sept. 7, 2012, http://www.nytimes.com/2012/09/08/world/europe/after-high-note-for-ecb-plan-some-discord-emerges.html; Luke Baker, *EU Says Mismanaged Greek Banks Face "Revamp,"* REUTERS, July 23, 2012, *available at* http://www.reuters.com/article/2012/07/23/us-eu-greece-piraeus-idUSBRE86M0PO20120723; Miles Johnson, *Former Bankia Chief Hits out at His Party*, FIN. TIMES, July 26, 2012, http://www.ft.com/intl/cms/s/0/e03f6328-d73f-11e1-a378-00144feabdc0.html#axzz2ApjY36BZ; Jonas Prager, The Financial Crisis of 2007/8: Misaligned Incentives, Bank Mismanagement, and Troubling Policy Implications 3–8 (June 27, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=2094662; RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 75–117 (2009) (arguing that it was "widely believed . . . that banks miscalculated the safety of the novel financial instruments [derivatives]"); Komal Sri-Kumar, *Europe Losing Battle Against Debt Crisis*, FIN. TIMES, July 23, 2012, http://www.ft.com/intl/cms/s/0/359a5950-d253-11e1-abe7-00144feabdc0.html#axzz27mC91f00; Ruth Sullivan, *Quarterly Review: European Debt Crisis Dampens Flows*, FIN. TIMES, Aug. 19, 2012, http://www.ft.com/intl/cms/s/0/d606318e-e6fd-11e1-af33-00144feab49a.html#axzz27mC91f00.

[2] *See, e.g.*, Martin Wheatley, Managing Dir. of the Fin. Servs. Auth. [FSA], Speech: Pushing the Reset Button on LIBOR (Sept. 28, 2012), *available at* http://www.fsa.gov.uk/library/communication/speeches/2012/0928-mw.shtml; Brooke Masters et al., *Global Regulators Follow UK's Libor Lead*, FIN. TIMES, Sept. 28, 2012, http://www.ft.com/intl/cms/s/0/448c26fc-0965-11e2-a5a9-00144feabdc0.html#axzz27mC91f00; Hanna Kuchler & Brooke Masters, *UK Promises to Reform Libor*, FIN. TIMES, Sept. 28, 2012, http://www.ft.com/intl/cms/s/0/a6807516-0947-11e2-a5a9-00144feabdc0.html#axzz27mC91f00; Brooke Masters, *British Banks Body Bows out of Libor*, FIN. TIMES, Sept. 25, 2012, http://www.ft.com/cms/s/0/bd913acc-071e-11e2-92ef-00144feabdc0.html.

[3] *See, e.g.*, DARRELL DUFFIE ET AL., FED. RES. BANK OF N.Y., STAFF REPORT NO. 424, POLICY PERSPECTIVES ON OTC DERIVATIVES MARKET INFRASTRUCTURE 1 (2010), *available at* http://www.newyorkfed.org/research/staff_reports/sr424.pdf.

have had some of the most prominent roles during the meltdown, triggering counterparties' defaults and runs on collateral posted as security for these agreements. [4] Derivatives remain important financial instruments of international finance and were only one cause for the financial crisis. [5] Regardless, credit derivatives played a significant role during the crisis in allowing the excessive accumulation of leverage by financial and non-financial institutions, which, in turn, required public-funded bailouts.[6]

The European Union ("EU") has taken many legislative initiatives to reduce the risk and limit the effects of any future financial crisis.[7] Perhaps the most important initiative is the European Commission's recent proposal for a directive establishing a framework for the recovery and resolution of credit institutions and investment firms.[8] The proposal attempts to further harmonize EU insolvency regimes by establishing a Union-wide set of uniform resolution tools and powers for financial institutions.[9] The proposal may not achieve all of its goals, however. It expands new safe harbor protections for derivative transactions and central counterparties ("CCPs"), shifting the systemic risk associated with derivatives from banks and investment firms to clearing houses.[10] As noted, financial contracts, including derivatives and repurchase agreements, will continue to play an important

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[4] *See, e.g.*, Lynn A. Stout, *The Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1, 6 (2011); MICHAEL DURBIN, ALL ABOUT DERIVATIVES 195–211 (2d ed. 2011). Warren Buffet has described derivatives as "financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal." *See* Letter from Warren E. Buffett, Chairman of the Bd., Berkshire Hathaway Inc., to Shareholders of Berkshire Hathaway Inc. 15 (Feb. 21, 2003), *available at* http://www.berkshirehathaway.com/letters/2002pdf.pdf.

[5] *See, e.g., Commission Staff Working Document, Impact Assessment Accompanying Document to the Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories*, at 11, COM (2010) 484 final (Sept. 15, 2010) [hereinafter *Commission Staff Working Document*], *available at* http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_impact_assessment_en.pdf; *see also* THE DE LAROSIÈRE GRP., THE HIGH-LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU 25 (2009) [hereinafter DE LAROSIÈRE], *available at* http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

[6] *See, e.g.*, Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts*, 35 J. CORP. L. 469, 470 (2010) (citing Federal Reserve Chairman Ben Bernanke and Treasury Secretary Timothy Geithner noting that there was no alternative to bailing out Lehman Brothers and AIG in the middle of a financial crisis).

[7] *Commission Staff Working Document*, *supra* note 5, at 23–24 (describing the AIG bail out); *see also Commission Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and Amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/ EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No. 1093/2010*, COM (2012) 280 final (June 6, 2012) [hereinafter *Commission Proposal for Bank Resolution*].

[8] *Commission Proposal for Bank Resolution*, *supra* note 7.

[9] *Id.* at 4.

[10] *See infra* Part III.C.

role in international finance.[11] At the same time, certain CDS contracts may not have been made if appropriate risk assessment had been conducted in the first place.[12] Some of the riskiest and most questionable credit derivatives were synthetic CDOs tied to CDS contract pooling.[13] It seems clear today that part of the initial problem and the resulting culture of credit derivatives misuse were fostered by the financial industry's focus on pricing risk in the financial system, rather than prohibiting or restricting that risk.[14]

This Article argues that safe harbors for financial contracts should not be expanded in Europe, but instead should be repealed, as suggested by some commentators in the United States.[15] At the very minimum, credit derivatives, swaps, and repurchasing agreements should be subject to a stay, and the resolution authorities in the Member States should have the power to assume beneficial contracts and to reject other unfavorable contracts. Also, the power of resolution authorities to transfer derivative positions in full or in part should not be sanctioned in favor of a full transfer.[16] Rather, resolution authorities should have the power to cherry pick individual contracts for transfers after determining any potential systemic risk involved. In addition, it is essential to grant resolution authorities clear avoidance powers, specifically the power to avoid preferential transfer prior to bankruptcy. A pre-bankruptcy transfer could be exempted if made "in the ordinary course of business."[17] Without the extension of the avoidance powers, counterparties will simply move for contract termination, set off, and close-out at a time prior to bankruptcy.[18]

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[11] DUFFIE ET AL., *supra* note 3, at 1.

[12] *See, e.g.*, DURBIN, *supra* note 4, at 213–17.

[13] *Id.* at 206–10; *see also* JOHN-PETER CASTAGNINO, DERIVATIVES: THE KEY PRINCIPLES ¶ 4.172 (3d ed. 2009); *see also* GEORGE CRAWFORD & BUDYUT SEN, DERIVATIVES FOR DECISION MAKERS: STRATEGIC MANAGEMENT ISSUES 112 (1996).

[14] *See, e.g.*, Andrew G. Haldane, Exec. Dir., Fin. Stability, & Vasileios Madouros, Economist, Bank of Eng., Speech at the Federal Reserve Bank of Kansas City's 36th Economic Policy Symposium: The Changing Policy Landscape, The Dog and Frisbee 22 (Aug. 31, 2012), *available at* http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf (arguing in favor of a less complex and less complicated regulatory landscape for capital requirements of financial institutions).

[15] *See, e.g.*, Bryan G. Faubus, Note, *Narrowing the Bankruptcy Safe Harbor for Derivatives to Combat Systemic Risk*, 59 DUKE L.J. 801 (2010); *see also* Stephen J. Lubben, *Chapter 11 at the Crossroads: Does Reorganization Need Reform?: Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV. 319 (2010) [hereinafter Lubben, *Crossroads*].

[16] *See infra* Part III.A.2.a.

[17] The U.S. approach may serve as an important starting point in this context. *See, e.g.*, CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 489 (2d ed. 2009); *see also* Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 756–60 (1984) [hereinafter Jackson, *Avoiding Powers*].

[18] *See infra* note 56 and accompanying text; *see also* Jens-Hinrich Binder, Bankenintervention und Bankenabwicklung in Deutschland: Reformnotwendigkeiten und Grundzüge eines verbesserten Rechtsrahmens 17–18 (Sachverständigenrates zur Begutachtung der Gesamtwirtschaftlichen Entwicklung, Working Paper No. 05/2009, 2009) (Ger.), *available at*

The threat of bankruptcy for credit derivative positions advocated here may function as an important incentive for counterparties to properly assess the risk associated with CDS contracts. [19] If done properly, a run on collateral posted in the context of credit derivative positions should never commence, leaving a distressed financial institution with a sufficient going concern surplus for reorganization and avoiding liquidation. Specifically, the protection of creditors' rights and the principle of equitable disbursement of assets *pari pasu* in bankruptcy may function as enforcement mechanisms for this incentive. More importantly, the threat of bankruptcy as an incentive for more effective risk management may also work in tandem with the clearing obligation under the European Market Infrastructure Regulation ("EMIR").[20] On the one hand, it may provide an incentive to clear OTC derivatives through a CCP, and on the other, it may also secure the financial stability of a CCP by developing a multilevel assessment of risk associated with credit derivatives.

The first part of this Article briefly examines the concepts of OTC derivatives and CDSs. It also discusses safe harbors as a special treatment of derivatives under bankruptcy and provides an overview of the EMIR. The second part reviews the most recent European Commission proposal for a directive establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and discusses the relevance of this proposal for derivatives and clearing of standardized OTC derivatives under the EMIR.

II. OTC DERIVATIVES AND CENTRAL CLEARING

A. *Over-the-Counter Derivatives and Credit Default Swaps*

1. General Remarks

The reliance on OTC derivatives and CDSs has become a significant focus of attention since the financial crisis.[21] Following the failure of Lehman Brothers and the bail-out of American International Group ("AIG") in the United States, it became clear that CDSs pose a significant threat to global

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http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Arbeitspapiere/Bankenintervention_und_Bankenabwicklung_in_Deutschland.pdf (arguing that this is already the case and most default clauses in derivative contracts are structured to allow for pre-bankruptcy termination); *see also Commission Proposal for Bank Resolution, supra* note 7, at 16.

[19] *See, e.g.*, Stephen J. Lubben, *Safe Harbors for Derivatives vs. Chapter 11*, N.Y. TIMES: DEALBOOK, Jan. 11, 2011, http://dealbook.nytimes.com/2011/01/11/derivative-safe-harbors-vs-chapter-11/ [hereinafter Lubben, *Safe Harbors*].

[20] Council Regulation 648/2012, art. 48(5)–(6), 2012 O.J. (L 201) 1 [hereinafter EMIR], *available at* http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF.

[21] *See generally* Steven Lofchie et al., *No Crisis Wasted: Proposed EU and U.S. Regulation of OTC Derivatives (Part I)*, BLOOMBERG L. REP., Nov. 15, 2010, at 1.

financial markets.[22] At best, financial institutions investing in CDSs did so with utter disregard of the risk involved; at worst, they simply did not understand the complex nature of these agreements.[23]

It became apparent that, as highly customized, privately negotiated contracts, OTC derivatives and credit derivative markets are opaque and lack transparency.[24] The resulting lack of information made it difficult, if not nearly impossible, for regulators to accurately assess the systemic risk associated with these instruments.[25] In 2009, the G20 leaders agreed that, by the end of 2012, all standardized OTC derivative contracts should be cleared through a CCP and reported to trade repositories. The goal was to improve transparency and regulatory oversight of derivative markets in an internationally consistent manner.[26] While some countries, such as Singapore, seemed to back away from this commitment,[27] the EU enacted the EMIR in early July 2012, which requires central clearing and reporting of

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[22] *Commission Staff Working Document*, *supra* note 5, at 13; *see also* Paul Kiel, *AIG's Spiral Downward: A Timeline*, PROPUBLICA (Nov. 14, 2008), http://www.propublica.org/article/article-aigs-downward-spiral-1114 (suggesting that AIG's failure was largely due to its exposure to CDSs); *see* Stephen J. Lubben, *Credit Derivatives and the Resolution of Financial Distress*, *in* THE CREDIT DERIVATIVE HANDBOOK 47–56 (Greg N. Gregoriou & Paul U. Ali eds., 2008); Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 405 (2007); Lubben, *Crossroads*, *supra* note 15, at 319–21.

[23] The losses caused by a trading fiasco at J.P. Morgan's London office is just the latest example. *See* Tom Braithwaite, *JPMorgan's 'Whale' Loss Swells to $5.8bn*, FIN. TIMES, July 13, 2012, http://www.ft.com/cms/s/0/cba5010a-ccd8-11e1-b78b-00144feabdc0.html; Shannon D. Harrington et al., *Ex-JP Morgan Trader Feldstein Wins in Betting Against Bank*, BLOOMBERG, July 3, 2012, http://www.bloomberg.com/news/2012-07-02/ex-jpmorgan-trader-feldstein-biggest-winner-betting-against-bank.html.

[24] *Commission Staff Working Document*, *supra* note 5, at 11–13; *see also* Stout, *supra* note 4, at 1–3.

[25] *See, e.g.*, Steven L. Schwarcz, *Controlling Financial Chaos: The Power and Limits of Low*, 2012 WIS. L. REV. 815, 818 (2012) (arguing that complexity was the main reason for financial information failure); *see also* Iman Anabtawi & Steven L. Schwarz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. 1349, 1351–52 (2011) (analyzing the potential of regulation to make the financial system more resilient to risk); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008) (defining systemic risk); *see generally* Sanford J. Grossman & Joseph Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980).

[26] FIN. STABILITY BD. [FSB], OTC DERIVATIVES MARKET REFORMS: THIRD PROGRESS REPORT ON IMPLEMENTATION 1–5 (2012), *available at* http://www.chathamfinancial.com/wp-content/uploads/2012/06/FSB-OTCD-Working-Group-Report-6-15-2012_App1.pdf.

[27] *See* MONETARY AUTH. OF SING., PROPOSED REGULATION OF OTC DERIVATIVES 23 (2012), *available at* http://www.mas.gov.sg/~/media/resource/publications/consult_papers/2012/13%20February%202012%20Proposed%20Regulation%20of%20OTC%20Derivatives.pdf; *see also* HUA ZHANG, OTC DERIVATIVES AND TRADING PLATFORMS IN SINGAPORE 4–5 (2012), *available at* http://www.celent.com/reports/otc-derivatives-and-trading-platforms-singapore; Jeremy Grant, *Singapore Diverges on OTC Regulation*, FIN. TIMES, Feb. 13, 2012, http://www.ft.com/cms/s/0/5e9b544e-566b-11e1-a328-00144feabdc0.html.

derivatives.[28] The United States did so two years earlier under the Dodd-Frank Act.[29]

Derivatives are important and necessary tools in international finance. They are legitimately used for risk management, investment, and many other trading purposes.[30] Derivatives can range from those fully standardized to those that are customized to the specific needs of a particular counterparty. Fully standardized derivatives, such as many futures and options, are typically already traded on exchanges, while the customized contracts are traded bilaterally or over-the-counter.[31]

Generally, derivatives are simply agreements between a future buyer and a future seller, or so-called counterparties.[32] These agreements can be customized to each party's particular needs and derive their value from any underlying reference item the counterparties wish to use. For example, sugar, the weather, or any index or currency may be used as an underlying variable.[33] Other examples may be interest rates, securities, stocks, or debt obligations. To be more specific, currency derivatives derive their value from underlying foreign exchange markets, equity derivatives from the underlying stock markets, and interest derivatives may reference any underlying money market.[34] In addition, while complex in nature, all derivative contracts are a variation of only four basic agreement types: the forward, future, swap, or options contract.[35] This Article focuses on CDSs and their role as OTC derivative agreements. OTC derivatives are derivatives not traded on an exchange but, instead, privately negotiated between counterparties.[36]

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[28] EMIR, *supra* note 20, at 2.

[29] Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[30] *See, e.g.*, CASTAGNINO, *supra* note 13, at 1–2; JOHN E. MARTHINSEN, RISK TAKERS: USES AND ABUSES OF FINANCIAL DERIVATIVES 1–2 (2d ed. 2009); DURBIN, *supra* note 4, at 71–83; PAUL C. HARDING, A PRACTICE GUIDE TO THE 2003 ISDA CREDIT DERIVATIVES DEFINITIONS 3 (2004); CRAWFORD & SEN, *supra* note 13, at 3–5.

[31] *See, e.g.*, *Commission Staff Working Document*, *supra* note 5, at 12.

[32] ANDREW CHISHOLM, DERIVATIVES DEMYSTIFIED: A STEP-BY-STEP GUIDE TO FORWARDS, FUTURES, SWAPS AND OPTIONS 1 (2d ed. 2010).

[33] MARTHINSEN, *supra* note 30, at 3.

[34] HARDING, *supra* note 30, at 1.

[35] *See* CHISHOLM, *supra* note 32, at 1–2.

[36] Press Release, Eur. Comm'n, Making Derivatives Markets in Europe Safer and More Transparent, IP/10/1125 (Sept. 15, 2010), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1125&format=HTML&aged=0&language=EN&guiLanguage=en; *see also* Press Release, Regulation on Over-the-Counter Derivatives and Market Infrastructures—Frequently Asked Questions, MEMO/12/232 (Mar. 29, 2012), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/232.

2. Credit Default Swaps

Credit Default Swaps were invented in the 1990s as an insurance mechanism for commercial debt and corporate bonds,[37] and later extended to include mortgage backed bonds.[38] At the end of 2008, the outstanding notional amount of CDSs reached $38.6 trillion,[39] and in the first quarter of 2009, the notional amount of derivatives held by U.S. commercial banks was approximately $202 trillion, with $14.6 trillion in CDSs as the third largest category of derivatives.[40] By the end of 2009, and as a direct reflection of the reduction in market prices, the total gross market value fell by as much as a third, to $21.6 trillion.[41] Since then, the CDS market continues to grow at a moderate pace with a notional value of $26.3 trillion at mid-year 2010 and remains the third largest category behind interest and foreign exchange derivatives.[42]

In a CDS contract, creditworthiness is the underlying pricing mechanism, effectively making credit risk a tradable product. Under a basic credit derivative contract, a counterparty, in return for a premium payment, promises to make a payment to the other counterparty if a third party or bond issuer defaults on her debt obligation.[43] A CDS thus provides credit default protection and compensates the protection buyer in case of loss or default. Compensation may take place based on a settlement method previously agreed upon by the counterparties. The protection seller may either take physical delivery of the credit-impaired securities at a previously agreed price, or he may instead pay in cash the difference between the price and the securities' current market value.[44]

While similar to an insurance contract,[45] CDSs are different in that their payout is independent from actual loss.[46] Settlement is due when a credit event occurs, regardless of whether the protection buyer suffers or even risks

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[37] HARDING, *supra* note 30, at 3.

[38] DURBIN, *supra* note 4, at 61.

[39] *Summaries of Market Survey Results*, INT'L SWAPS & DERIVATIVES ASS'N, http://www.isda.org/statistics/recent.html (last visited Mar. 17, 2013).

[40] COMPTROLLER OF THE CURRENCY, ADM'R OF NAT'L BANKS, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES: FIRST QUARTER 2009 (2009).

[41] *See, e.g.*, *Commission Staff Working Document*, *supra* note 5, at 12.

[42] *Summaries of Market Survey Results*, *supra* note 39.

[43] *See* CASTAGNINO, *supra* note 13, at 86.

[44] Oskari Juurikkala, *Credit Default Swaps and Insurance: Against the Potts Opinion*, 26 J. INT'L BANKING L. & REG. 128, 135 (2011) (arguing that CDS contracts in some cases may be construed as insurance contracts).

[45] *See, e.g.*, Arthur Kimball-Stanley, *Insurance and Credit Default Swaps: Should Like Things Be Treated Alike?*, 15 CONN. INS. L.J. 241, 246–47 (2008).

[46] HARDING, *supra* note 30, at 19; *see also* Lloyds & Scottish Fin. Ltd. v. Cyril Lord Carpets Sales Ltd., [1992] B.C.L.C. 609.

suffering a loss.[47] Moreover, the definitions of credit events triggering a settlement are usually much broader than those in insurance contracts.[48] The most common credit events triggering contract termination and settlement are the potential failure to pay, bankruptcy, and restructuring.[49] In order to ensure the optimal level of protection, the typical termination clause establishes default even before any formal bankruptcy or restructuring proceedings are initiated.[50] For example, in the ISDA Master Agreement (1992), which is the standard master agreement of most credit derivatives in the United States and Europe, default is assumed if a reference entity "makes a general assignment, arrangement or composition with or for the benefit of its creditors"[51] or "seeks or becomes subject to the appointment of an administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official for it or for all or substantially all its assets."[52] This already very broad definition is further supplemented by a catchall clause establishing a termination right if a party causes any event that has an analogous or equivalent effect to bankruptcy.[53]

B. Special Insolvency Treatment of OTC Derivatives

1. Bankruptcy Basics

The bankruptcy codes of the United States[54] and all EU Member States[55] contain special exceptions for securities or market contracts.[56] This now also includes CCPs and clearing houses.[57] Under these so-called safe harbors, the general insolvency rules do not apply, an exception that may negatively affect

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[47] HARDING, *supra* note 30, at 19.

[48] *Id.*

[49] *Id.* at 6.

[50] *See, e.g.*, Int'l Swap Dealers Ass'n, Inc., Master Agreement, Wachovia Bank Nat'l. Ass'n and Novastar Mortg. Supplemental Interest Trust, § 5(a)(vii)(3) (May 27, 2005) [hereinafter Master Agreement], *available at* http://www.sec.gov/Archives/edgar/data/1328469/000119312505124580/dex105.htm; HARDING, *supra* note 30, at 109; *see also* Binder, *supra* note 18, at 17–18. One reason for these early termination rights is clearly to avoid any potential conflict with differing national insolvency rules.

[51] Master Agreement, *supra* note 50, § 5(a)(vii)(3).

[52] *Id.* § 5(a)(vii)(6).

[53] *Id.* § 5(a)(vii)(8).

[54] 11 U.S.C. §§ 101–1532 (2012).

[55] Council Directive 2002/47, art. 7, 2002 O.J. (L 168) 43, 49 (EC).

[56] The term securities and market contracts can be used synonymously with financial or qualified financial contracts.

[57] Council Directive 2002/47, *supra* note 55, art. 1.

debtor and creditor protection.[58] Before discussing these safe harbors in more detail, it may be helpful to first provide the context in which they operate and the rights that they exempt. Most important in this context is the stay, or the temporary suspension, of any individual enforcement actions against the bankruptcy estate. Of equal importance is the debtor's right to assume or reject executory contracts (so-called "cherry picking") and the power to set aside preferential transfers of property prior to the commencement of any bankruptcy proceeding.

a. The Stay

One of the most important goals of any insolvency proceeding is to protect the bankruptcy estate and to preserve a going concern surplus in reorganization.[59] In this context, interim measures such as the automatic stay under the U.S. Bankruptcy Code[60] are essential tools to stop creditors' collection actions immediately.[61] The stay serves only to provide interim protection for creditors and the debtor during the pendency of the bankruptcy case.[62] A grab race by creditors and the uncontrolled run on assets of the debtor may prevent an orderly reorganization of liquidation.[63] Put differently, in a U.S. context:

> [T]he automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors . . . . The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors.[64]

In the United Kingdom, a court may order a total or limited stay "at any time after an order for a winding up, on the application either of the liquidator or the official receiver or any creditor or contributory" order a total

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58 ANTHONY C. GOOCH & LINDA B. KLEIN, DOCUMENTATION FOR DERIVATIVES: ANNOTATED SAMPLE AGREEMENTS AND CONFIRMATIONS FOR SWAPS AND OTHER OVER-THE-COUNTER TRANSACTIONS 294 (4th ed. 2002).

59 Thomas H. Jackson, *Chapter 11F: A Proposal for the Use of Bankruptcy to Resolve (Restructure, Sell, or Liquidate) Financial Institutions*, *in* ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM 217 (Kenneth E. Scott et al. eds., 2009).

60 11 U.S.C. § 362 (2012).

61 *See generally* Thomas H. Jackson, *Of Liquidation, Continuation, and Delay: An Analysis of Bankruptcy Policy and Nonbankruptcy Rules*, 60 AM. BANKR. L.J. 399 (1986) [hereinafter Jackson, *Of Liquidation*].

62 *See, e.g.*, TABB, *supra* note 17, at 244.

63 *Id.*

64 *Id.*

or limited stay.[65] In Germany, a court may order an interim measure if necessary "to avoid any detriment to the financial status of the debtor."[66] Additionally, in Germany a court may stay termination rights of all obligations and contracts under the Financial Institution Reorganization Act.[67] The stay includes derivatives, swaps, and repurchasing agreements.[68] In Germany, the stay starts on the day of the petition for reorganization and terminates at the end of the next business day.[69] Assuming the petition was filed on a Friday, termination rights and close-out-netting may be stayed for up to ninety-six hours in Germany.[70]

Acting on its mandate from the G20,[71] the Financial Stability Board ("FSB")[72] has endorsed the integral role of the stay for the resolution of failing financial institutions.[73] The FSB concluded that counterparties of derivative contracts should not generally be entitled "to exercise early termination rights [against a financial institution in resolution] provided the substantive obligations under the contract, including payment and delivery

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[65] Insolvency Act, 1986, c. 45, § 147(1) (Eng.).

[66] Insolvenzordnung [InsO] [German Insolvency Act], Oct. 5, 1994, BUNDESGESETZBLATT, Teil I [BGBL. I] at 2866, as amended by Gesetz [G], Dec. 20, 2011, BGBL. I at 2854, § 21 (1) (translation by author).

[67] Gesetz zur Reorganisation von Kreditinstituten [KredReorG] [Financial Institution Reorganization Act], Dec. 9, 2010, BGBL. I at 1900 (Ger.).

[68] *See generally id.*

[69] *See generally id.*

[70] *Id.* § 13 ("Schuldverhältnisse mit dem Kreditinstitut können ab dem Tag der Anzeige nach § 7 Absatz 1 bis zum Ablauf des folgenden Geschäftstages im Sinne des § 1 Absatz 16b des Kreditwesengesetzes nicht beendet werden. Eine Kündigung gegenüber dem Kreditinstitut ist in diesem Zeitraum ausgeschlossen. Die Wirkung sonstiger in diesem Zeitraum eintretender Beendigungstatbestände ist bis zu seinem Ablauf aufgeschoben. Abweichende Vereinbarungen sind unwirksam . . . ."); Gesetz über das Kreditwesen [KWG] [The German Banking Act], Sept. 9, 1998, BGBL. I at 2776, last amended by Gesetz [G], Nov. 6, 2012, BGBL. I at 2286, § 1, ¶ 16(b) ("Der Geschäftstag eines Systems umfasst Tag- und Nachtabrechnungen und beinhaltet alle Ereignisse innerhalb des üblichen Geschäftszyklus eines Systems."); *see also* Christoph K. Henkel & Wulf A. Kaal, *Contingent Capital in European Union Bank Restructuring*, 32 NW. J. INT'L L. & BUS. 191, 232 (2012).

[71] Grp. of Twenty [G20], G20 Leaders' Statement: The Pittsburgh Summit ¶ 13, (Sept. 24–25, 2009) [hereinafter Pittsburgh Summit], *available at* http://www.g20.org/load/780988012.

[72] *Financial Stability Board*, FSB, http://www.financialstabilityboard.org/ (last visited Mar. 17, 2013). The FSB is an international body that has been established to coordinate the work of national financial authorities and international standard setting bodies. *Id.* "The FSB develop[s] and promote[s] the implementation of effective regulatory . . . [and] supervisory policies for the financial sector." *Id.* Members of the FSB are national regulatory authorities, national and international financial institutions, associations, committees, and experts in the financial sector. *Links to FSB Members*, FSB, http://www.financialstabilityboard.org/members/links.htm (last visited Nov. 8, 2012).

[73] FSB, KEY ATTRIBUTES OF EFFECTIVE RESOLUTION REGIMES FOR FINANCIAL INSTITUTIONS 41 (2011) [hereinafter FSB, KEY ATTRIBUTES], *available at* http://www.financial stabilityboard.org/publications/r_111104cc.pdf.

obligations, and provision of collateral, continue to be performed."[74] At a minimum, if early termination rights are deemed necessary, the FSB suggested that a resolution authority should have the power to stay such rights temporarily where they arise "by reason only of entry into resolution or in connection with the use of resolution powers and provided that the substantive obligations under the contract, including payment and delivery obligations, and provision of collateral, continue to be performed."[75] The FSB did not express a preference over whether or not any stay may be imposed at the discretion of the resolution authority on a "case-by-case" basis or made to be automatic, leaving this choice to national legislators.[76] At the same time, the FSB proposed limiting the power of imposing a temporary stay and making it contingent upon the fulfillment of certain conditions:[77] (1) the stay may only apply to early terminations rights triggered by the "entry into resolution or in connection with the use of resolution powers"; (2) "the stay is strictly limited in time"; (3) the resolution authority is not allowed to "cherry-pick"; (4) "[f]or contracts that are transferred to a third party or bridge institution, the acquiring entity would assume all the rights and obligations at the firm from which the contracts were transferred"; (5) "early termination rights of the counterparty are preserved against the firm in resolution in the case of any default occurring before, during or after the period of stay"; (6) if financial contracts are transferred, early termination rights of the counterparty "are preserved against the acquiring entity" should there be a subsequent, independent default; (7) "the counterparty can exercise the right to close-out immediately against the firm in resolution on expiry of the stay or earlier if the authorities inform the firm that the relevant contracts will not be transferred"; and (8) early termination rights may be transferred, after the period of the stay, for any contracts which were not transferred "to a sound firm, bridge institution or other public entity."[78] The FSB further proposed that any stay may not inhibit rights of counterparties with regard to netting and collateralization agreements or "interfere with payment or delivery obligations" of CCPs.[79]

b. *The Right to Assume or Reject*

There is no precise definition of what kind of contract qualifies as an executory contract.[80] In an executory contract, however, the obligations of

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[74] *Id.*

[75] *Id.*

[76] *Id.* at 42.

[77] *Id.*

[78] FSB, KEY ATTRIBUTES, *supra* note 73, at 42.

[79] *Id.* at 41.

[80] H.R. REP. NO. 95-595, at 347 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963. For a broader discussion on the importance of the right to assume or reject executory contracts, see Jay

both parties generally are "so far unperformed that failure of either to complete performance would constitute a material breach excusing the performance of the other."[81] This means that executory contracts at the time of bankruptcy are only those contracts that combine an asset with a liability.[82] Derivative contracts and CDSs fall into this category and are considered executory contracts.[83] For the bankruptcy estate, executory contracts pose the problem that the property right in these contracts is inevitably also tied to a liability.[84] The estate simply cannot acquire any executory contractual property right without incurring a contractual obligation at the same time.[85] To address this dilemma, a bankruptcy trustee has the basic choice "subject to court approval" to either assume or reject any executory contract.[86] If the contract is assumed, the estate is obligated under the contract and the claim of the creditor may receive a priority status.[87] By rejecting the contract, on the other hand, the trustee or debtor in possession will not receive the benefit of the contract and will thus not succeed to either the asset or the liability represented by that contract.[88] Rejection is also considered a pre-petition breach, leaving the creditor only an unsecured claim for damages without priority.[89] In most cases, the decision on whether to assume or reject the contract will depend on whether or not the obligation will be beneficial for the debtor in bankruptcy.[90]

Creditors and non-defaulting parties consider the choice of assumption and rejection, known as cherry picking, to be unfair.[91] Banks and investment firms, in particular, consider this to be inequitable, because a debtor can

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Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 231 (1989) (proposing to eliminate the threshold requirement of "executoriness" for these contracts).

[81] Camp v. Nat'l Union Fire Ins. Co. of Pittsburgh (*In re* Gov't Sec. Corp.), 111 B.R. 1007, 1011 (S.D. Fla. 1990) (quoting Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973)), *aff'd*, 972 F.2d 328 (11th Cir. 1992).

[82] *See, e.g.*, TABB, *supra* note 17, at 806.

[83] *See, e.g.*, Kevin Dolan & Carlyn DuPuy, *Equity Derivatives: Principles and Practice*, 15 VA. TAX REV. 161, 164 (1995).

[84] *See* TABB, *supra* note 17, at 802.

[85] *Id.*

[86] *See, e.g.*, 11 U.S.C. § 365(a) (2012). Generally the trustee has four basic choices. Not only can he assume or reject, the trustee also has the right to assign the contract after assuming it or to do nothing effectively putting any executory contract into limbo. *Id.* § 365. *See also* Copeland v. Stephens, (1818) 106 Eng. Rep. 218 (K.B.).

[87] *See, e.g.*, Daniel J. Bussel & Edward A. Friedler, *The Limits on Assuming and Assigning Executory Contracts*, 74 AM. BANKR. L.J. 321 (2000).

[88] *See, e.g.*, TABB, *supra* note 17, at 809; *see* also Texas Importing Co. v. Banco Popular de Puerto Rico, 360 F.2d 582 (5th Cir. 1966).

[89] *See, e.g.*, 11 U.S.C. § 365(g)(1) (2012).

[90] *See, e.g.*, Jesse M. Fried, *Executory Contracts and Performance Decisions*, 46 DUKE L.J. 517 (1996).

[91] *See, e.g.*, Faubus, *supra* note 15, at 824.

simply retain any favorable derivative contract and reject unfavorable contracts. According to banks, this in turn may result in systemic risk.[92] This argument is hardly convincing, however. Under the safe harbor protection, only non-defaulting counterparties want to be able to cherry pick, while at the same time arguing that extending the same right to debtors would be inequitable and not justified.[93] Yet, a de facto termination or set off under a master agreement amounts to nothing more than a rejection of an executory contract.

c. *Preferences*

Without a brief discussion of preference law, which is one of the most important avoidance powers in bankruptcy, the discussion of rights affected by safe harbors would not be complete. Under preference law, the trustee may set aside preferential transfers made within a specified time prior to the filing of bankruptcy.[94] A preference is an ex post transaction that favors one creditor over another and need not be fraudulent.[95] Bankruptcy serves to collectively satisfy all creditors and to promote the fair and equitable distribution of assets among them.[96] Without preference law, this principle would be disrupted and bankruptcy law would amount to nothing more than a race for the debtor's assets.[97] Creditors could simply utilize any pre-petition informational advantage to grab assets that would otherwise automatically become part of the estate. More importantly, preferential transfers usually occur when the debtor knows or assumes that he is entering the vicinity of insolvency.[98] Now in financial distress, the debtor may choose to pay some of

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[92] *See* Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance into the Abyss?*, 43 AM. U. L. REV. 1023, 1059–60 (1994).

[93] *See, e.g.*, Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123, 130 (2010) [hereinafter Lubben, *Bankruptcy Code*].

[94] *See, e.g.*, 11 U.S.C. § 547(b)(4)(A) ("(4) made — (A) on or within 90 days before the date of the filing of the petition."). According to German preference law,

> [l]egal transactions on the part of the debtor constituting a direct disadvantage to insolvency creditors may be contested if they were made [(1)] during the last three months prior to the request to open insolvency proceedings, if the debtor was illiquid on the date of such transaction, and if the other party was aware of such insolvency on this date, or [(2)] subsequent to the request to open insolvency proceedings, and if at the time when the legal transaction was made the other party was aware of such insolvency or of the request to open insolvency proceedings.

Insolvenzordnung [InsO] [German Insolvency Act], Oct. 5, 1994, BGBl. I at 2866, § 132(1) (translation by author); *see also* German Insolvency Act, § 239.

[95] *See, e.g.*, TABB, *supra* note 17, at 486–91; 1 COLLIER PAMPHLET EDITION: BANKRUPTCY CODE 581 (Alan N. Resnick & Henry J. Sommer eds., 2008) [hereinafter COLLIER].

[96] *See, e.g.*, Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 748 (1985).

[97] *See, e.g.*, Jackson, *Avoiding Powers*, *supra* note 17, at 756–60.

[98] *See, e.g.*, TABB, *supra* note 17, at 488.

his preferred creditors first, instead of satisfying all creditors pro rata.[99] Some creditors may also have a better appreciation of a debtor's financial situation than others and try to act expeditiously in order to secure their own financial situation and avoid bankruptcy.[100] While U.S. law no longer focuses on a "reasonable cause to believe"[101] and instead looks towards "unusual action"[102] or "opt out"[103] activities to determine whether any particular transfer may be avoidable, some European insolvency regimes simply require that the other party has been aware of an impending insolvency.[104] At the same time, some insolvency regimes, such as the U.S. Bankruptcy Code, include a presumption in favor of an existing preference if a transaction was made during a "preference period," which is ninety days in the United States.[105] It is clear that for many creditors, specifically counterparties to derivatives and swaps, preference law is of major concern. If applied to settlement agreements, "close-out" and "set off" before bankruptcy may generally become impossible.

2. Safe Harbors

The U.S. Bankruptcy Code[106] and all EU Member State insolvency regimes[107] contain special exceptions for securities or market contracts, including credit derivatives and swap agreements.[108] Under these so-called safe harbors, the general insolvency rules do not apply.[109] Bankruptcy filing may ipso facto become an event of default allowing the immediate termination, set off, or "close-out" of derivative contracts.[110] With the contract

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[99] *Id.*

[100] *Id.*

[101] H.R. REP. NO. 95-595, at 177–178 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963.

[102] *Id.* at 373.

[103] *See, e.g.*, Jackson, *Avoiding Powers*, *supra* note 17, at 759.

[104] *See, e.g.*, Insolvenzordnung [InsO] [German Insolvency Act], Oct. 5, 1994, BGBl. I at 2866, § 132(1).

[105] 11 U.S.C. § 547(b)(4)(A) (2010). The preference period is one year in the United States if the creditor was an insider. *Id.* § 547(b)(4)(B).

[106] *Id.* § 362 (outlining the non-debtor derivative counterparty's right to terminate contracts to seize collateral); *id.* §§ 555–56, §§ 559–61 (stipulating that existing contractual rights, including ipso facto clauses, may be exercised by derivative counterparties).

[107] Council Directive 2002/47, *supra* note 55.

[108] The term securities and market contracts can be used synonymously with financial or qualified financial contracts. *See, e.g.*, 12 U.S.C. § 1821(e)(8)(D)(i) (giving the U.S. definition of market contracts); Companies Act, 1989, c. 40, § 155 (giving the English definition of market contracts).

[109] GOOCH & KLEIN, *supra* note 58.

[110] Eleanor Heard Gilbane, *Testing the Bankruptcy Code Safe Harbors in the Current Financial Crisis*, 18 AM. BANKR. INST. L. REV. 241, 243 (2010) (close-out and set-off are contractual termination rights that may be exercised under ipso facto clauses during bankruptcy); David A. Skeel, Jr. & Thomas H. Jackson, Essay, *Transaction Consistency and the New Finance in*

terminated, little or nothing may be left for the bankruptcy trustee to assume.[111] Derivative contracts are also generally not subject to any stay,[112] interim,[113] or interlocutory relief.[114] Even more significant, any collateral collected immediately before a bankruptcy petition and following the termination of a swap agreement can also not be attacked as a preference.[115] Moreover, neither the debtor nor the trustee retains any right to freely decide whether to assume or reject a credit derivative or CDS.[116]

The main reason for safe harbors, according to the financial industry, is the prevention of cherry picking and avoiding systemic risk by maintaining liquidity in the market.[117] It is argued that safe harbors are necessary to allow for close-out netting,[118] which is the technical term for the enforcement of ipso facto clauses in bankruptcy.[119] According to banks and investment firms, the insolvency of any counterparty may trigger a chain reaction of insolvencies among other counterparties who hold accounts for the defaulting party.[120] This, in turn, it is feared, would potentially lead to widespread

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Bankruptcy, 112 COLUM. L. REV. 152, 166 (2012) (mass termination of CDS contracts would be possible in bankruptcy by the counterparties' ability to invoke ipso facto clauses).

111 *See, e.g.*, TABB, *supra* note 17, at 854.

112 Lubben, *Safe Harbors*, *supra* note 19.

113 Insolvenzordnung [InsO] [German Insolvency Act], Oct. 5, 1994, BGBl. I at 2866, § 21; Insolvency Act, 1986, c. 45, § 147(1) (Eng.).

114 *See* Jackson, *Of Liquidation*, *supra* note 61, at 402.

115 *See, e.g.*, 11 U.S.C. § 546 (e)–(g); H.R. REP. NO. 109-31, Pt. 1, at 134 (2005); *see also* Skeel & Jackson, *supra* note 110, at 189.

116 Lubben, *Bankruptcy Code*, *supra* note 93, at 131.

117 *See, e.g.*, H.R. REP. NO. 109-31, at 3, 20, 131–32 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88 (justifying 2005 amendments to the U.S. Bankruptcy Code as "provisions designed to reduce systemic risk"); H.R. REP. NO. 97-420, at 2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583 (invoking systemic risk to justify the initial exemption for derivatives from automatic stay); *see also* Council Directive 2002/47, *supra* note 55, at 43 (noting that the "Directive has demonstrated the importance of limiting systemic risk").

118 *See, e.g.*, THE PRESIDENT'S WORKING GRP. ON FIN. MKT., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT (1999); H.R. REP. NO. 109-31(I); Lubben, *Bankruptcy Code*, *supra* note 93, at 130.

119 Directive 2002/47 defines close-out netting in art. 2(1)(n) as

> a provision of a financial collateral arrangement or of an arrangement of which a financial collateral arrangement forms part, or, in the absence of any such provision, any statutory rule by which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise: (i) the obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount. . .; and/or (ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.

Council Directive 2002/47, *supra* note 55, art. 2(1)(n).

120 Memorandum from the Int'l Swaps & Derivatives Ass'n, Inc., on the Implementation of Netting Legislation: A Guide For Legislators and Other Policy-Makers 4 (Mar. 2006), *available*

contagion among non-defaulting counterparties and compromise the overall integrity of the financial markets.[121] Freeing up illiquid assets otherwise locked up in bankruptcy, on the other hand, would maintain the liquidity in the markets by allowing new investments.[122]

3. Consequences

The AIG bail-out may be the best example for the failed assumption that safe harbors avoid systemic risk.[123] The bail-out of AIG became necessary because AIG developed a significant liquidity problem after being unable to post sufficient collateral to ensure meeting its obligations under the majority of its CDS agreements.[124] Under ordinary insolvency rules, AIG could have sought protection under Chapter 11, but this was not an option.[125] AIG experienced a run on its collateral by its derivative counterparties and CDS protection buyers, all of which were protected and were able to grab AIG's collateral under the safe harbor provisions of the U.S. Bankruptcy Code.[126] The obvious conclusion is that safe harbors did not prevent, but rather created, systemic risk by encouraging, if not incentivizing, a run on AIG's derivative positions.[127] In fact, the safe harbors triggered a chain reaction of default in the market. The safe harbors offered derivative counterparties an unfair advantage over any other creditor in bankruptcy, secured and unsecured alike. Derivative counterparties, and it seems now also CCPs,[128] may foreclose on a debtor's assets without court permission or supervision and are entirely uninhibited by bankruptcy proceedings.[129] Derivative contracts may also be set off prior to and after bankruptcy has commenced,

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at http://www.isda.org/docproj/pdf/Memo-Model-Netting-Act.pdf; Lynn A. Stout, *Why The Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 707 (1999); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-94-133, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM 7–8 (1994) (discussing systemic risk).

[121] *See, e.g.*, COLLIER, *supra* note 95, at 904.

[122] *Id.*

[123] *See generally Actions Related to AIG*, FED. RES. BANK OF N.Y., http://www.newyorkfed.org/aboutthefed/aig/index.html (last visited Mar. 17, 2013); *see also* Shahien Nasiripour, *US Treasury Launches $18bn AIG Offering*, FIN. TIMES, Sept. 10, 2012, http://www.ft.com/intl/cms/s/0/3b651de8-fad0-11e1-b775-00144feabdc0.html.

[124] *See* Kiel, *supra* note 22; Lubben, *Crossroads*, *supra* note 15, at 319–21.

[125] Lubben, *Crossroads*, *supra* note 15, at 319–21.

[126] 11 U.S.C. § 362 (2012) (outlining the non-debtor derivative counterparty's right to terminate contracts to seize collateral); 11 U.S.C. §§ 555–56, 559–61 (stipulating that existing contractual rights, including ipso facto clauses may be exercised by derivative counterparties).

[127] Lubben, *Bankruptcy Code*, *supra* note 93, at 125–26; *see also* Lubben, *Safe Harbors*, *supra* note 19.

[128] *See infra* Part III.C.

[129] Lubben, *Crossroads*, *supra* note 15, at 322–24.

and any form of settlement can no longer be avoided under preference law.[130] In addition, all counterparties still have the right to de facto terminate their credit derivative positions, which is the very right they criticized as potentially causing systemic risk if exercised by any defaulting counterparty.[131] More importantly, safe harbors and their use during the financial crisis prove why the threat of bankruptcy has not functioned as a deterrent during the crisis. Counterparties simply had no incentive for proper risk management, knowing that they may grab any collateral without fear of avoidance before, during, or even after default.

C. *The European Market Infrastructure Regulation (EMIR)*

In response to the role that CDSs played during the financial crisis,[132] the EU enacted the EMIR in July 2012.[133] While there is a three-year transitional period for the regulation's entry into force, the regulation is directly applicable in all EU Member States.[134]

1. Goals and Intentions

The primary goal of the regulation is to increase transparency and reduce counterparty and operational risk through the use of post-trading market infrastructure, such as CCPs and trade repositories.[135] The regulation is part of an international effort to address global concerns about systemic risk and problems of the OTC derivative markets.[136] At the London and Pittsburgh G20 summit in 2009, the G20 leaders committed to promote the standardization of all credit derivative markets in an internationally coordinated manner.[137] The summit leaders specifically stated that "all

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[130] *See supra* note 115 and accompanying text.

[131] *Id.*

[132] *Commission Staff Working Document, supra* note 5, at 92–95 (recognizing the global dimension of derivative markets and stressing the need for further progress notably on transparency and stability of derivative markets); *see also* DE LAROSIÈRE, *supra* note 5 (highlighting the risks associated with the rapid explosion of the use of credit derivatives, stressing the need to address the lack of transparency in the market, and recommending action to simplify and standardize OTC derivatives and to introduce CCP clearing); *Communication from the Commission: Ensuring Efficient, Safe and Sound Derivatives Markets*, COM (2009) 644 final (July 3, 2009); *Commission Staff Working Paper Accompanying the Commission Communication*, SEC (2009) 905 final (July 7, 2009).

[133] EMIR, *supra* note 20.

[134] Consolidated Version of the Treaty on the Functioning of the European Union art. 288, Sept. 5, 2008, 2008 O.J. (C 115) 47, 171 ("A regulation shall have general application. It shall be binding in its entirety and directly applicable in all Member States.").

[135] *Commission Staff Working Document, supra* note 5, at 6.

[136] *See, e.g.*, FIN. SERVS. AUTH., EUROPEAN MARKET INFRASTRUCTURE REGULATION (EMIR) (2012), *available at* http://www.fsa.gov.uk/pages/about/what/international/pdf/emir.pdf.

[137] *See* G20, Declaration on Strengthening the Financial System: The London Summit (Apr. 2, 2009), *available at* http://www.g20.utoronto.ca/2009/2009ifi.html; Pittsburgh Summit, *supra* note 71.

standardized OTC derivative contracts should be . . . cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories."[138]

As noted above, the OTC derivative market is highly complex, and contracts are usually negotiated on a bilateral basis between counterparties.[139] As a result, information about the size of the positions and segments in the OTC market are often not fully known to the public or to regulators.[140] With the lack of information, effective supervision and proper risk assessment were essentially impossible during the crisis.[141] To some degree, CDS protection buyers faced the same dilemma and, without necessary information, were unable to properly assess the default risk of any of their counterparties.[142]

2. Central Clearing

Under the EMIR, central clearing of all standardized OTC derivatives is now required throughout the European Union.[143] Generally, through novation, central clearing "involves inserting a [CCP] between the original parties to the derivative transaction."[144] In other words, a CCP is "the buyer to every seller and the seller to every buyer."[145] Central clearing of transactions through a CCP creates two new, perfectly offsetting contracts and, in turn, may improve liquidity in the market.[146] The clearinghouse assumes the risk of default of its clearing members,[147] thereby eliminating

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[138] Pittsburgh Summit, *supra* note 71.

[139] CASTAGNINO, *supra* note 13, at 16.

[140] *Id.*

[141] DUFFIE ET AL., *supra* note 3, at 1.

[142] *Commission Staff Working Document*, *supra* note 5, at 14 (arguing that "[b]y its very nature, the OTC derivative market is opaque. This is because OTC derivatives are privately negotiated contracts and consequently any information concerning any one of them is usually only available to the counterparties.").

[143] EMIR, *supra* note 20, art. 1(1).

[144] CASTAGNINO, *supra* note 13, at 15–16; *see also*, Paul M. McBride, *The Dodd-Frank Act and OTC Derivatives: The Impact of Mandatory Central Clearing on the Global OTC Derivatives Market*, 44 INT'L LAW. 1077, 1096 (2010).

[145] EMIR, *supra* note 20, art. 2(1).

[146] *See, e.g.*, McBride, *supra* note 144, at 1096.

[147] *Id.* EMIR distinguishes between a clearing member and its client. A "'clearing member' means an undertaking which participates in a CCP and which is responsible for discharging the financial obligations arising from that participation." EMIR, *supra* note 20, art. 2(14). A "'client' means an undertaking with a contractual relationship with a clearing member of a CCP which enables that undertaking to clear its transactions with that CCP." *Id.* art. 2(15).

the counterparty's risk that it would otherwise maintain under a bilateral clearing or netting agreement.[148]

While a CCP assumes the credit risk of all transactions it clears, it accumulates risk through these transactions and inevitably bears a much higher default risk in case of its own failure.[149] As a result, a CCP is effectively a systemically important financial institution, which may pose a significant threat to financial stability.[150] At the very minimum, any CCP failure may lead to a temporary breakdown of the market. This disrupts the entire system, through which positions are established, maintained, set off, and closed out.[151] To mitigate this risk, CCPs rely on various reinforcing mechanisms, also known as the "default waterfall," under EMIR.[152] The first line of defense is a restriction on membership.[153] CCPs may set their own membership criteria based on creditworthiness and operational capability.[154] The membership of any clearing member is contingent upon fulfilling and maintaining these established standards.[155] The second line of defense includes various risk management techniques, such as multilateral netting and imposing collateral requirements.[156] If the posted margin or collateral is not sufficient to offset any losses, the CCP may access default funds

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[148] CASTAGNINO, *supra* note 13, at 15; *see also* Richard Heffner, *The Regulation of Multinational Clearing in the United Kingdom and the United States*, *in* EXCHANGES AND ALTERNATIVE TRADING SYSTEMS 97, 98–99 (2002) (arguing that the risk only shifts to the CCP after the contracts become binding).

[149] *Commission Staff Working Document*, *supra* note 5, at 64.

[150] *Id.* at 63–65 (the failure becomes a potentially systemic event); BANK FOR INT'L SETTLEMENTS, PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES 126 (2012) [hereinafter CPSS-IOSCO PRINCIPLES], *available at* http://www.bis.org/publ/cpss101a.pdf (defining CCPs as systemically financial payment systems); BANK FOR INT'L SETTLEMENTS, RECOVERY AND RESOLUTION OF FINANCIAL MARKET INFRASTRUCTURES: CONSULTATIVE REPORT 1 (2012) [hereinafter CPSS-IOSCO RECOVERY AND RESOLUTION], *available at* http://www.bis.org/publ/cpss103.pdf (noting that in some jurisdictions CCPs are systemically important); IMF, *World Economic and Financial Surveys: Summary Version Global Financial Stability Report Meeting New Challenges to Stability and Building a Safer System*, ch. 3 at 2 (2010) [hereinafter *IMF Stability Report 2010*], *available at* http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/text.pdf (CCPs concentrate counterparty and operational risks magnifying the systemic risk related to their own failure); *see also* Skeel & Jackson, *supra* note 110, at 194–95 (arguing that clearing houses are the new too-big-to-fail entities).

[151] CPSS-IOSCO PRINCIPLES, *supra* note 150, at 20; CPSS-IOSCO RECOVERY AND RESOLUTION, *supra* note 150, at 3–4.

[152] EMIR, *supra* note 20, art. 45.

[153] *Id.* art. 37.

[154] *Id.*

[155] *Id.*

[156] *Id.* arts. 39, 41, 46 (segregation and portability; margin requirements; and collateral requirement, respectively).

established for this purpose by the defaulting clearing member.[157] As the last line of defense, the CCP may rely on its own resources and capital.[158] Proper risk management is further incentivized by the requirement[159] that a CCP's own resources must be used first, before the default fund contributions of any non-defaulting clearing member can be accessed.[160] In addition, margins posted by non-defaulting clearing members may not be used to cover any losses.[161]

3. Porting

Under EMIR, if a clearing member becomes insolvent and files for bankruptcy, the positions of the insolvent clearing member's clients held in client accounts may be transferred directly to another non-defaulting clearing member.[162] Clients are institutions that have a contractual relationship with a clearing member of a CCP, allowing them to clear required transactions through a CCP without being a clearing member.[163] The transfer from the account of the insolvent member to a so-called back-up clearing member is called porting.[164] Porting is part of the default procedure of CCPs requiring strict segregation of clients' funds and prohibiting the pooling of client funds for distribution.[165] Porting may also be described as a safe harbor for clients of insolvent clearing members. While client positions may be comparable to deposits in bank accounts, the sanction of pooling effectively treats clients of an insolvent clearing member as creditors in a preferential manner compared to other creditors of the clearing member, including the CCP itself. Clients of clearing members are sophisticated market participants that either may not meet the specific membership requirement for CCPs or may have opted not to

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157 EMIR, *supra* note 20, art. 43 (the default fund or funds and other financial resources must "at all times enable the CCP to withstand the default of at least two clearing members to which it has the largest exposure under extreme but plausible market conditions").

158 *Id.* art. 16. The initially required capital is €7.5 million. *Id.* Furthermore, a CCP's capital must be proportionate to the risk stemming from its activities and the capital must "at all times be sufficient to ensure an orderly winding-down or restructuring of the activities over an appropriate time span and an adequate protection of the CCP against credit, counterparty, market, operational, legal and business risks . . . ." *Id.*

159 *Commission Staff Working Paper*, *supra* note 5, at 64 n.145.

160 EMIR, *supra* note 20, art. 45.

161 *Id.* art. 44(4) ("A CCP shall not use the margins posted by non-defaulting clearing members to cover the losses resulting from the default of another clearing member.").

162 *Id.* arts. 39, 48.

163 *Id.* art. 2.

164 *See, e.g.*, FIN. SERVS. AUTH., CONSULTATION PAPER CP12/22, CLIENT ASSETS REGIME: EMIR, MULTIPLE POOLS AND THE WIDER REVIEW 5 (2012), *available at* http://www.fsa.gov.uk/static/pubs/cp/cp12-22.pdf.

165 *Id.* at 6.

become a clearing member.[166] As such, they should also be obligated to practice proper risk management, which is not encouraged through porting. Creating safe harbors for clients of clearing members may therefore diminish the overall benefit of clearing OTC derivatives through a system of CCPs. This seems even more important when taking into account that the transfer to a back-up clearing member requires that clearing member's consent.[167]

III. EUROPEAN BANK RECOVERY AND RESOLUTION FRAMEWORK

In June 2012, the European Commission proposed a directive establishing a framework for the recovery and resolution of credit institutions and investment firms in Europe.[168] The directive is part of a larger Commission initiative to establish a comprehensive EU-wide crisis prevention framework for troubled banks, and it attempts to harmonize different insolvency regimes throughout the EU.[169] The framework is based on seven major objectives,[170] which the Commission initially outlined in an October 2010 communication,[171] which a consultation paper published in early 2011 later detailed.[172] Other regulatory reforms[173] include the revised capital requirements under the Capital Requirements Directive ("CRD")

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[166] *See, e.g.*, EMIR, *supra* note 20, art. 2(15) (defining client as an undertaking involving a contractual relationship with a clearing member of a CCP); EUR. MKTS. AND SEC. AGENCY, FINAL REPORT: DRAFT TECHNICAL STANDARDS UNDER REGULATION (EU) NO. 648/2012 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL OF 4 JULY 2012 ON OTC DERIVATIVES, CCPS, AND TRADE REPOSITORIES 8–10, *available at* http://www.esma.europa.eu/system/files/2012-600_0.pdf (discussing the need for direct and indirect client clearing); Goldman Sachs Int'l, Comments to ESMA Discussion Paper on OTC Derivatives and CCPs 1–2, *available at* http://www.esma.europa.eu/system/files/goldman_sachs_international_comments_to_esma_dp_on_otc_derivatives_and_ccps.pdf (noting that many counterparties which are subject to a clearing obligation may be unwilling or unsuitable to become direct clearing members).

[167] EMIR, *supra* note 20, art. 48(5)–(6).

[168] *Commission Proposal for Bank Resolution*, *supra* note 7.

[169] *DG Internal Market and Services Working Document: Technical Details of a Possible EU Framework for Bank Recovery and Resolution* 7–9 (2011) [hereinafter *DG Internal Market and Services*], *available at* http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

[170] The seven objectives are (1) put prevention and preparations first, (2) provide credible resolution tools, (3) enable fast and decisive action, (4) reduce moral hazard, (5) contribute to a smooth resolution of cross-border groups, (6) ensure legal certainty, and (7) limit distortions of competition. *Communication from the Commission: An EU Framework for Crisis Management in the Financial Sector*, at 3–4, COM (2010) 579 final (Oct. 10, 2010).

[171] *Id.*

[172] *See DG Internal Market and Services*, *supra* note 169.

[173] For a more detailed discussion of some of these changes, see Wulf A. Kaal & Christoph K. Henkel, *Contingent Captial with Sequential Triggers*, 49 SAN DIEGO L. REV. 221 (2012) (distinguishing between short- and long-term initiatives).

IV,[174] the EMIR,[175] and a new proposal intended to amend the Markets in Financial Instruments Directive (MiFID).[176]

The proposed European Bank Recovery and Resolution Directive[177] may be considered the core structural element of the future EU crisis prevention framework. Concluding that normal insolvency proceedings may not always be "apt to deal efficiently with the failure of financial institutions,"[178] the proposal establishes a special insolvency regime for credit institutions[179] and investment firms.[180] The main objectives are preparation, recovery, and resolution,[181] with a specific focus aimed at preventing any escalation of problems for financial markets during a crisis, and reducing the risk of actual bank failures.[182] Most noteworthy, the Commission proposal links bank recovery and resolution directly with the CRD, the EMIR, and the MiFID.[183]

This Article argues that despite the fundamental importance of the Commission Proposal, the Proposal may not sufficiently integrate the objectives of prevention and preparation with those of the EMIR. Exempting CCPs under the proposed resolution regime may instead renew the risk associated with OTC derivatives and CDSs by failing to incentivize CCPs for performing their risk management properly. Exemptions in the proposed directive create new safe harbors for CCPs and indirectly for non-defaulting derivative counterparties. As a result, the Commission Proposal may promote, rather than prevent, excessive risk taking. In fact, the exemptions for CCPs may encourage counterparties' belief that they no longer need to worry about default since a CCP will clear their derivative obligations and may allow close-out obligations in a manner not much different from that

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[174] *See Proposal for a Regulation of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firms*, at 10, COM (2011) 452 final (July 20, 2011); *Proposal for a Directive of the European Parliament and of the Council on the Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms*, at 2–13, COM (2011) 453 final (July 20, 2011).

[175] EMIR, *supra* note 20.

[176] *See generally* Council Directive 2008/10, 2008 O.J. (L 76) 33 (EC).

[177] *See generally Commission Proposal for Bank Resolution*, *supra* note 7.

[178] *Id.* at 5.

[179] *Id.*; Council Directive 2006/48, art. 4(1), 2006 O.J. (L 177) 1 (EC).

[180] *Commission Proposal for Bank Resolution*, *supra* note 7, arts. 1, 2; Council Directive 2006/49/EC, art. 3(1)(b), 2006 O.J. (C 177) 201 (EC). It may also apply to financial institutions as defined in art. 4(5) of Directive 2006/48/EC and various types of financial holding companies, subsidiaries, and parent undertakings. *See Commission Proposal for European Bank Resolution*, *supra* note 7, at 41–60.

[181] *Commission Proposal for European Bank Resolution*, *supra* note 7, at 8; *see also Commission Staff Working Document, Impact Assessment Accompanying the Document Proposal for a Directive of the European Parliament and of the Council*, at 8 (2010) [hereinafter *Staff Working Document*].

[182] *Staff Working Document*, *supra* note 181, at 9, 49–58.

[183] *See, e.g.*, *id.* at 3.

available before the financial crisis. The only difference made by the Commission Proposal is that the systemic risk associated with derivatives shifted from counterparties to CCPs, which fails to improve risk management in reality.

A. *Proposed Recovery and Resolution Tools*

Before going into more detail on the temporary suspension of termination rights of credit derivatives and swap agreements, it is necessary to discuss the new recovery and resolution tools for banks proposed by the Commission. This is even more important, as some of these tools directly include safe harbors for derivatives, repurchase agreements, and swaps.[184] It is beyond the scope of this Article to discuss all of the recovery and resolution powers in broad detail, but a more general overview may suffice to contextualize the temporary suspension of rights in the proposal. It is also important that the Commission Proposal establishes only a minimum set of resolution tools and powers. Member States will generally be permitted to retain additional tools and powers, including more stringent intervention powers, as long as they are compatible with the objectives of the EU resolution framework.[185] Ring fencing of financial institutions as a preventative measure will not be allowed in this context, however.[186] The Commission explicitly finds ring fencing to be incompatible with the objectives of the proposal.[187]

1. Resolution Plans and General Principles

Similar to the Dodd-Frank Act,[188] the proposal would require credit institutions and investment firms to draw up recovery plans.[189] The plans should set out arrangements and measures enabling them to restore their long-term viability should their financial situation deteriorate.[190] The goal of these recovery plans is to minimize taxpayer exposure to bank losses while protecting the financial markets.[191] The recovery plans are also intended to allow resolution authorities to determine whether recovery is feasible and to initiate additional measures if necessary.[192] Such measures may include requiring changes to the legal or operational structure of a bank, separating

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[184] *See infra* Part II.B.2.

[185] *Commission Proposal for Bank Resolution, supra* note 7, at 12–13.

[186] *See, e.g.*, INDEP. COMM. ON BANKING, INTERIM REPORT: CONSULTATION ON REFORM OPTIONS 7 (2011), *available at* http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf.

[187] *Commission Proposal for Bank Resolution, supra* note 7, at 12 n.15.

[188] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No 111-203, § 165(d)(1), 124 Stat. 1376, 1426 (2010).

[189] *Commission Proposal for Bank Resolution, supra* note 7, at 9.

[190] *Id.*

[191] *Id.*

[192] *Id.*

deposit taking and investment functions, restricting certain activities, and requiring the issuance of additional convertible capital instruments.[193] The Commission further established a set of specific principles for the allocation of losses that apply to all resolution tools. First, while the principle of "no creditor worse off" generally applies, losses should first be allocated to the shareholders in full and, then, to the creditors.[194] Second, creditors of the same class may be treated differently if it is justified by public interest and if it is considered necessary to ensure financial stability.[195]

2. Resolution Tools and Powers

a. Asset Sale and Transfer

The Commission proposal includes four general resolution tools: the sale-of-business, the bridge institution, the asset-separation, and the bail-in tool.[196] Shareholder consent is not required for any of these actions, and procedural requirements established under applicable company or securities law may be disregarded for the purposes of the asset sale and transfer of an institution in resolution.[197]

The sale-of-business tool allows the resolution authority to sell the financial institution under resolution as a whole or in part.[198] Specifically, the resolution authority has the power to transfer shares or other instruments of ownership; transfer all or specified assets, rights, or liabilities; or transfer any combination of some or all assets, rights, and liabilities of an institution under resolution.[199] Proceeds of a partial transfer must "benefit the institution under resolution," and if all shares, "instruments of ownership," or assets were transferred, proceeds must "benefit the shareholders who have been divested of their rights."[200] The sale of any of the assets should be marketed without discrimination[201] and cannot be transferred to any bridge institution.[202]

A bridge institution is a temporary institution with the purpose of facilitating the sale of the business to a private sector purchaser when

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[193] *Id.* at 9–10.

[194] *Commission Proposal for Bank Resolution, supra* note 7, at 11.

[195] *Id.*

[196] *Id.* at 12.

[197] *Id.* art. 32(1).

[198] *Id.*

[199] *Commission Proposal for Bank Resolution, supra* note 7, art. 32(1)(a)–(c).

[200] *Id.* art. 32(1)(3).

[201] *Id.* art. 33(2)(b).

[202] *Id.* art. 32(1).

market conditions are appropriate.[203] Similar to the sale-of-business tool, the resolution authority may transfer all or part of the business of an institution in resolution to a bridge institution.[204] Following the transfer to the bridge institution, the asset sale to the private sector may be achieved by selling part of the bridge institution's assets or the bridge institution itself.[205] Operation of the bridge institution is terminated if the institution merges with another institution, the majority of the bridge institution's capital is acquired by a third party, a substantial number of its assets are assumed by another person,[206] or at the end of a two-year period following the date on which the last transfer form an institution under resolution was made.[207] The bridge institution must be a publicly controlled entity and must fulfill all capital requirements under the CRD.[208] Shareholders or creditors, whose property, rights, or liabilities were not transferred, have no claim against the bridge institution.[209]

The asset-separation tool allows the resolution authority to transfer assets to a management vehicle.[210] As the bridge institution, the management vehicle shall be owned by at least one public authority, which may include the resolution authority.[211] Similar to a "bad bank,"[212] the purpose of the asset-separation tool is to transfer impaired or problem assets from an institution in resolution to a management vehicle and if these assets are of "such a nature that the liquidation of those assets under normal insolvency proceedings could have an adverse effect on the financial market."[213] Over time, such problem assets may be managed and worked out by the management vehicle.

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[203] *Id.* at 11.

[204] *Commission Proposal for Bank Resolution, supra* note 7, art. 34(1).

[205] *Id.* art. 35(3).

[206] *Id.*

[207] *Id.* art. 35(5).

[208] *Id.* art. 35.

[209] *Commission Proposal for Bank Resolution, supra* note 7, art. 34(9).

[210] *Id.* art. 36(1).

[211] *Id.* art. 36(2).

[212] *See, e.g.*, Raphael Minder, *Spain Approves Establishment of 'Bad Bank,'* N.Y. TIMES, Aug. 31, 2012, http://www.nytimes.com/2012/09/01/business/global/spain-approves-establishment-of-bad-bank.html?_r=0; James Wilson, *German 'Bad Bank' in Greek Debt Swap*, FIN. TIMES, Sept. 2, 2011, http://www.ft.com/intl/cms/s/0/ad02c288-d56b-11e0-bd7e-00144feab49a.html#axzz27mC91f00.

[213] *Commission Proposal for Bank Resolution, supra* note 7, art. 36(4).

b. The Bail-In Tool

The bail-in tool may be the most important resolution tool introduced by the Commission.[214] It is a conversion tool allowing resolution authorities to write down unsecured debt and convert that debt into equity.[215] The primary purpose of a bail-in is to restructure a failing financial institution to recapitalize "an institution that meets the conditions for resolution."[216] The bail-in tool may generally be applied to all liabilities,[217] but excludes secured liabilities, covered deposits, and liabilities with an original maturity of less than one month.[218] In addition to the safe harbor protection, national regulatory authorities may also exempt derivatives that fall under "liabilities with an original maturity of less than one month,"[219] if determined necessary to ensure the critical operations of a financial institution or in order to avoid adverse effects on financial stability, in general.[220] The Commission may, however, limit resolution authority discretion by adopting delegated acts in the future and specifying when exclusion is necessary or appropriate.[221] The factors the Commission may consider in this context are the systemic impact of closing-out derivative positions, the effect on CCPs and their clearing

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[214] *See id.* arts. 37–51. In addition to the bail-in resolution tool, the Commission proposal also introduced a write-down tool for capital instruments, which must be distinguished from those discussed here. *Id.* arts. 51–55.

[215] *See id.* art. 37.

[216] *Id.* art. 37(2)(a).

[217] *Commission Proposal for Bank Resolution, supra* note 7, art. 38(1).

[218] *Id.* art. 38(2).

[219] *Id.* art. 38(2)(d). Of specific interest is the fact that the Commission refers to "residual maturity" in its explanatory memorandum, noting that "there are, however some liabilities that would be excluded ex-ante . . . such as secured liabilities, covered deposits and liabilities with *a residual maturity of less than one month.*" *Id.* at 13 (emphasis added). However, the actual text of the proposed directive under article 38(2)(d) refers to "liabilities with an *original maturity of less than one month.*" *Id.* art. 38(2)(a) (emphasis added). Both are different maturities. Original maturity is the period from the issue date until the final contractually scheduled payment, whereas remaining or residual maturity refers to the period from the reference date of a debt security until the final contractually scheduled payment. *See, e.g.*, IMF, *Handbook on Securities Statistics, Part 1: Debt Securities Issues* 38 (2009), *available at* www.imf.org/external/np/sta/wgsd/pdf/051309.pdf.

[220] *Commission Proposal for Bank Resolution, supra* note 7, art. 38(3) ("Where resolution authorities apply the bail-in tool, they may exclude from the application of the write-down and conversion powers liabilities arising from derivatives that do not fall within the scope of point (d) of paragraph 2, if that exclusion is necessary or appropriate to achieve the objectives specified in points (a) and (b) of Article 26(2)."). In Article 38(2)(d), the proposal includes a safe harbor for "liabilities with an original maturity of less than one month." *Id.* art. 38(2)(d). Article 26(2) stipulates that one of the resolution objectives under the proposal is "(a) to ensure the continuity of critical functions" and "(b) to avoid significant adverse effects on financial stability, including by preventing contagion, and maintaining market discipline." *Id.* art. 26(2).

[221] *Id.* art. 38(4).

activities, and the effect on risk management of counterparties to derivatives, in general.[222]

Bail-in requires a sufficient amount of bail-inable liabilities, in order to achieve the objective of recapitalization. The Commission proposal suggests that the minimum aggregate amount "will be proportionate and adapted for each category of institutions on the basis of their risk or the composition of its sources of funding."[223] The Commission further suggests that, based on the "evidence from the recent financial crisis and of performed model simulations, an appropriate percentage of total liabilities that could be subject to bail-in could equal to ten percent of total liabilities (excluding regulatory capital)."[224]

Finally, the bail-in tool also establishes its own priority of claims.[225] Shareholder claims should be written down first,[226] followed by subordinate debt holders in second place[227] and senior debt holders only if the total reduction of liabilities is less than the aggregated amount after that.[228] Within the same rank, losses are allocated equally between liabilities by reducing the principal amount or outstanding amount payable pro rata to their value.[229]

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[222] The proposal provides:

> 4. The Commission shall be empowered to adopt delegated acts adopted in accordance with Article 103 in order to specify further:
>
> > (a) specific classes of liabilities covered by point (d) of paragraph 2, and.
> >
> > (b) the circumstances when exclusion is necessary or appropriate to achieve the objectives specified in points (a) and (b) of Article 26(2), having regard to the following factors:
> >
> > > (i) the systemic impact of closing out derivative positions in order to apply the debt write-down tool;
> > >
> > > (ii) the effect on the operation of a Central Counterparty of applying the debt write-down tool to liabilities arising from derivatives that are cleared by the Central Counterparty; and
> > >
> > > (iii) the effect of applying the debt write-down tool to liabilities arising from derivatives on the risk management of counterparties to those derivatives.

Id. art. 38(4)(a)–(b)(i)–(iii).

[223] *Commission Proposal for Bank Resolution*, *supra* note 7, at 13.

[224] *Id.*; *see also id.* art. 39(3).

[225] *Id.* art. 43.

[226] *Id.* art. 43(1)(a).

[227] *Commission Proposal for Bank Resolution*, *supra* note 7, art. 43(1)(b)–(c).

[228] *Id.* art. 43(1)(d).

[229] *Id.* art. 43(2).

B. Suspension of Termination Rights and Netting out

The Commission proposal establishes a temporary suspension of contractual termination rights for financial contracts.[230] While not providing for an automatic stay, the power to temporarily suspend termination rights of derivatives and other financial contracts[231] is similar to § 5390(c)(8)(F)(ii) of the Dodd-Frank Act[232] and clearly draws on the "Key Attributes" published by the FSB.[233] Resolution authorities are provided with the power to impose a temporary stay on the exercise of rights by creditors and counterparties to enforce claims and close-out, declare default, accelerate, or otherwise terminate contracts with a failing institution solely by reason of an action taken by the resolution authority.[234] The temporary suspension is viewed as an essential tool to providing the resolution authority with "a period of time to identify and value those contracts that need to be transferred to a solvent third party"[235] and avoids the risk of rapidly changing values resulting from a run on the assets of a failing financial institution.[236] The temporary stay is short and may not last longer than until 5 PM of the next business day.[237] During the stay, the resolution authority is required to "make all reasonable efforts to ensure that all margin, collateral and settlement obligations" are met.[238] After the end of the stay, existing termination rights resume, but only for those counterparties whose contractual obligations remain with the institution in resolution.[239] A temporary stay with a suspension of termination rights is not available if financial contracts are linked through a master or netting agreement and if only part of the rights and liabilities

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230 *Id.* arts. 61–63.

231 Financial contracts include securities contracts, commodities contracts, futures, forwards, options, and repurchase agreements relating to securities, swap agreements, and master agreements for any of these contracts. *See id.* art. 63(6)(a)–(f).

232 Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5390(c)(8)(F)(ii) (2010).

233 While drawing on the "Key Attributes," the Commission did not explicitly include an exemption for CCPs. The FSB specifically stated that

> [r]esolution authorities should have at their disposal a broad range of resolution powers, which should include powers to do the following: . . .
>
> > (xi) Impose a moratorium with a suspension of payments to unsecured creditors and customers (except for payments and property transfers to central counterparties (CCPs) and those entered into a payment, clearing and settlement system[s]) . . . .

See FSB, KEY ATTRIBUTES, *supra* note 73, art. 3.2(xi).

234 *Commission Proposal for Bank Resolution, supra* note 7, art. 63(1).

235 *Id.* at 14; *see also DG Internal Market and Services, supra* note 169, at 64.

236 *Commission Proposal for Bank Resolution, supra* note 7, at 14.

237 *Id.* art. 63(1).

238 *Id.* art. 63(2).

239 *Id.* art. 63(4)(a).

under that agreement are being transferred.[240] Generally, under a partial property transfer, all linked agreements must be transferred together, including "set-off arrangements, title transfer financial collateral arrangements, security . . . and structured finance arrangements." [241] Whether this safeguard also applies to CCPs is unclear. Complex netting and set-off arrangements may not only be part of the general clearing procedure of CCPs, each CCP may also be a direct party to a netting and set-off arrangement with each of their clearing members.[242] It is further noteworthy that, in the context of the enforcement of security interests of secured creditors, the Commission proposal includes an explicit exemption for CCPs from a temporary suspension.[243] Under the proposal, resolution authorities have the power to restrict, for a limited period, secured creditors from enforcing "security interests in relation to any assets of" the financial institution under resolution.[244] The term "limited period" is not defined, but remains in the discretion of the resolution authority. As a result, the definition of the time period may depend on what the respective resolution authority determines to be necessary in achieving its resolution objective.[245]

C. *Exceptions for Derivatives and Central Counterparties*

The European Commission Proposal for a Directive Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms includes many improvements, but also expands safe harbors for derivative and financial agreements under the proposal's resolution regime. [246] The proposed framework is a specialty resolution regime for banks directly addressing shortcomings in EU Member State insolvency regimes when dealing with failing financial institutions.[247] The

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240 *Id.* arts. 65, 68(2)(d).

241 *Commission Proposal for Bank Resolution, supra* note 7, at 14; *see also DG Internal Market and Services, supra* note 169, at 69–74.

242 *See, e.g.*, Sixteenth Meeting of the IMF Committee on Balance of Payment Statistics, Washington, D.C., Dec. 1–5, 2003, *Developments in Market Clearing and Settlement Arrangements: Some Balance Sheet Recognition and Measurement Issues*, at 2, BOPCOM-03/13 (noting the scope of CCP clearing is to maximize netting through a single legal set-off), *available at* http://www.imf.org/external/pubs/ft/bop/2003/03-13.pdf; *IMF Stability Report 2010, supra* note 150, at 2 (the primary advantage of CCP clearing is its ability to reduce systemic risk through multilateral netting); *Commission Staff Working Document, supra* note 5, at 64 ("[T]he 'many-to-many' chain of credit is replaced by [sic] 'one-to-many' arrangement.").

243 *Commission Proposal for Bank Resolution, supra* note 7, art. 62(2).

244 *Id.*

245 *See id.* art. 62(3)–(4).

246 *See generally id.*

247 *Id.* at 4; *see also Final Report to the European Commission on Pre-Insolvency—Early Intervention—Reorganization—Liquidation*, at 3–12, (Nov. 2009), *available at* http://ec.europa.eu/internal_market/bank/docs/windingup/200911/final_report200911_en.pdf; *Final Report to the European Commission Concerning a Study on the Feasibility of Reducing Obstacles to the Transfer of Assets Within a Cross Border Banking Group During a Financial*

resolution tools proposed are significant—they would harmonize and clarify many aspects of insolvency law throughout the Union.[248] For example, the proposal includes a clear ipso facto clause according to which "the resolution action shall in itself not make it possible for anyone to . . . exercise any right or power to terminate, accelerate or declare a default or credit event under any contract or agreement to which the institution under resolution is a party."[249] At the same time, "liabilities with an original maturity of less than one month" are exempt from the scope of the bail-in tool. [250] Even more significantly, national resolution authorities are granted the power to "exclude from the application of the write-down and conversion powers liabilities arising from derivatives"[251] if determined necessary "to ensure the continuity of critical functions"[252] and "to avoid significant adverse effects on financial stability, including by preventing contagion, and maintaining market discipline."[253] While these are already broad safeguards for financial contracts which may lead to significant regulatory differences among the Member States, the Commission has also proposed that it may be given the authority to further extend safeguards for financial contracts by delegated act.[254] The Commission has broad powers to do so not only with regard to bilateral counterparties, but also with regard to CCPs.[255]

A CCP's powers to realize assets or foreclose on collateral are also exempt from any limited suspension during the resolution phase of a financial institution,[256] which may not prevent a "grab race," such as that experienced by AIG or Lehman Brothers.[257] The only difference from AIG and Lehman Brothers in 2008 may be the fact that under the European Commission proposal, central (but not bilateral) counterparties will try to realize their assets and commence a run on the assets of the financial institution under resolution. Finally, the resolution proposal broadly follows other national and

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Crisis, at 5–7 (Dec. 18, 2009), *available at* http://ec.europa.eu/internal_market/bank/docs/windingup/200908/final_report20091218_en.pdf.

[248] *See, e.g.*, Thomas M.J. Möllers, Dominique Christ & Andreas Harrer, *Nationale Alleingänge und die europäische Reaktion auf ein Verbot ungedeckter Leerverkäufe*, NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT 1167–71 (2010) (Ger.).

[249] *Commission Proposal for Bank Resolution*, *supra* note 7, arts. 57(5)(a), 63(4)(a)(i).

[250] *Id.* art. 38(2)(d).

[251] *Id.* art. 38(3).

[252] *Id.* art. 26(2)(a).

[253] *Id.* art. 26(2)(b).

[254] *Commission Proposal for Bank Resolution*, *supra* note 7, art. 38(4)(a).

[255] *See id.* art. 38(4)(b)(i)–(iii).

[256] *Id.* art. 62(2).

[257] *See, e.g.*, Stephan Madaus, *Das Insolvenzverfahren der Lehman Brothers Holding Inc. - ein in jeder Hinsicht besonderes Reorganisationverfahren*, NEU ZEITSCHRIFT FÜR INSOLVENZRECHT 715–16 (2008) (Ger.).

international initiatives, such as Dodd-Frank[258] in the United States, in allowing the temporary suspension of termination rights.[259] However, a temporary suspension of termination rights is not available if the resolution authority decides that it does not want to transfer all of the assets under a netting arrangement to a private sector purchaser or a bridge institution. Netting and master agreements, which are typically the norm in OTC derivative documentation,[260] are therefore guaranteed at least a partial safeguard, and cherry picking is not permitted.[261] Netting and master agreements may also be the norm between clearing members and CCPs if central clearing of standardized OTC derivative contracts becomes the international norm. It is highly questionable whether all derivative positions under a master agreement between a clearing house and a defaulting clearing member will ever be capable of anything but a partial transfer, thereby inevitably undermining the effect of any temporary suspension of termination rights or any temporary stay.

IV. CONCLUSION

Derivatives are essential financial instruments in international finance and will continue to play this role in the future. Derivatives, and specifically CDSs, are also highly complex financial instruments posing significant risk to financial markets. However, despite best efforts by financial institutions and regulators, this risk may never be entirely manageable. At the same time, a better, more efficient recovery and resolution system need not be an even more complex regulatory and crisis management framework. Indeed, one may ask: may something be learned from a dog catching a Frisbee?[262] Complex decision-making is simple.[263]

The European Commission's proposal for a directive on bank recovery and resolution will be essential in ensuring the stability of financial markets

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[258] 12 U.S.C. § 53 (2012).

[259] *Commission Proposal for Bank Resolution*, *supra* note 7, art. 63.

[260] *See, e.g.*, Binder, *supra* note 18, at 16; *see also* CASTAGNINO, *supra* note 13, at 184–85; HARDING, *supra* note 30, at 20.

[261] This is not to disregard a creditor's general right to set off mutual obligations or possible recoupment rights. *See, e.g.*, 11 U.S.C. § 553(a) (2012). However, some of these obligations may have been incurred within 90 days before the date of the filing of a bankruptcy petition or simply for the purpose of obtaining a right of setoff. *See, e.g.*, 11 U.S.C. § 553(a)(3). In addition, if porting is permitted, many of these claims may qualify as transfers by an entity other than the debtor after the commencement of the case or 90 days before the date of the filing of the petition. *See, e.g.*, 11 U.S.C. § 553(a)(2). If claims are ported, the mutuality of claims may also be questionable. Mutuality is meant to protect against triangular setoffs and requires that each party owns its claim with the right to collect the claim in their own name. *See, e.g.*, COLLIER, *supra* note 95, at 617. Finally, recoupment rights should only be available if they arise from the same transaction. *See, e.g.*, *In re* B & L Oil Co., 782 F.2d 155 (10th Cir. 1986) (noting this requirement). For a less restrictive view, see Skeel & Jackson, *supra* note 110, at 188.

[262] Haldane & Mandoures, *supra* note 14.

[263] *See id.*

in Europe by creating a harmonized resolution framework. While, on the one hand, instituting a stay and a temporary suspension of termination rights, as well as an asset transfer tool not unlike the option to resume obligations under preference law, the Commission proposal expands safe harbors for financial contracts in other areas and creates a complicated network of exceptions. These exceptions undermine the best efforts of bilateral risk management, especially in the context of central clearing of OTC derivatives. Safe harbors reduce the incentive of CCPs to monitor their members.[264] Without any counterparty risk and the ability to always realize their assets, CCPs have no incentive to reduce systemic risk.[265] The expansion of safe harbors under the current Commission proposal may allow a CCP "to remove itself from the middle of trades."[266] However, this does not take the objectives of the European Market Infrastructure Regulation into account and may run counter to its goals. The European clearing industry is already calling for a further expansion of safe harbors.[267] The reasoning is not new—safe harbors are viewed as being "crucial for the stability of the financial systems as a whole."[268] However, this view is shortsighted. The EU should not continue to expand safe harbors, but should rather ensure that derivative counterparties retain a certain degree of counterparty risk in the form of a real and enforceable bankruptcy threat.

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[264] *See, e.g.*, Lubben, *Bankruptcy Code*, *supra* note 93, at 134.

[265] *See id.*

[266] *Id.*

[267] *See, e.g.*, Comment from the Eur. Ass'n of CCP Clearing Houses on the Proposal for a Directive on Bank Recovery and Resolution 1–2 (July 25, 2012), *available at* http://www.eachorg.eu/each/cm/.

[268] *Id.* at 2.