

Assessing the Usage and Effect of Credit Derivatives

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April 28, 2003

Submitted in Fulfillment of the Written Work Requirement

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I. INTRODUCTION

By the end of 2001, the size of the credit derivatives global market reached over \$1 trillion.¹ One year later, the market grew to \$2.15 trillion.² This market is estimated to reach \$4.8 trillion by 2004. Relatively new products compared to other derivatives, credit derivatives have grown extremely quickly in a short period of time.

A credit derivative is a financial instrument in which the value is derived from the credit quality of an obligation such as a loan or a bond of a reference entity.³ These instruments allow counterparties to transfer credit risk without transferring ownership of the underlying asset. There are several different types of credit derivatives. The most common forms of credit derivatives are credit default swaps, total return swaps, credit-spread options, and credit linked notes. This paper will be primarily concerned with credit default swaps.

Credit default swaps are the most common form of credit derivative currently used. One recent survey placed credit default swaps' share of the credit derivatives market at 45%.⁴ A credit default swap is a contract in which a buyer (also known as the protection buyer) purchases protection from a seller (the protection seller) against the risk of default by a reference entity on a reference asset. The protection buyer pays a regular fee or premium to the protection seller for the life of the swap or until a credit event occurs. In return, the protection seller will pay the protection buyer an agreed amount only if a specified credit event occurs during the life of the swap. The agreed upon amount that the protection seller will provide the protection buyer depends on whether the transaction will be cash settled or physically settled. If the swap is cash

¹ See BRITISH BANKERS' ASSOCIATION (BBA), CREDIT DERIVATIVES REPORT 2001/2002 (2002).

² See INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION (ISDA), 2002 YEAR-END MARKET SURVEY (Mar. 19, 2003).

³ This reference entity is usually a third party, but it can also be one of the parties to the transaction.

⁴ Forty-five percent only includes single name credit default swaps. See BBA, *supra* note 1.

settled, the buyer receives the difference between par value and the fair market value of the reference asset. If the swap is physically settled, the buyer will deliver to the seller an agreed upon deliverable obligation and in return, receives par value (or another agreed upon reference price) from the seller.

An ever-increasing wide variety of parties use credit derivatives. These include banks, insurance companies, investment banks, corporations, hedge funds, pension funds, mutual funds, and government/export credit agencies. These parties use credit derivatives for several, sometimes interrelated, reasons. Two of the most important reasons for banks in particular to use credit derivatives are to manage credit risk and regulatory capital.⁵ Another important reason why banks choose to use credit derivatives instead of other forms of risk transfer is retention of legal title. When an institution securitizes its assets, legal title is transferred (usually to an special purpose vehicle (“SPV”)). By using credit derivatives, however, that same institution is able to transfer the credit risk, yet retain legal title, and thus, the relationships with their customers. Maintaining this relationship is often cited as a key reason for using credit derivatives instead of other types of risk-transferring transactions. Other important uses include trading and management of portfolios, economic capital, and individual lines of credit.⁶

It is important to distinguish between credit derivatives being used as a trading instrument from those being used as an end-user instrument.⁷ Many banks engage in both types of activities. This paper is primarily concerned with credit derivatives used as end-user instruments by banks.

⁵ Although, according to the BBA’s 2002 Credit Derivatives Report, management of regulatory capital dropped in a ranking of order of importance from first in 1999 to fifth in 2002. It would be interesting to revisit this ordering once the proposed treatment of credit derivatives by the Basel Capital Accord takes effect.

⁶ See BBA, *supra* note 1.

⁷ When a bank uses a credit derivative as an end-user, for regulatory purposes including capital relief, its use is governed by the treatment of the banking book. Alternatively, any credit derivatives used as part of a trading portfolio of the bank are governed by the regulatory treatment for the trading book.

Many important issues surrounding credit derivatives have yet to be explored. This paper attempts to explore the legal issues pertaining to their documentation and introduce several questions about the effect of credit derivatives on market participants. Section II introduces and explores the legal documentation used in credit derivative transactions and the issues that have arisen in connection with this usage. Section III explores in depth the problems created by the Restructuring Credit Event. Lastly, Section IV considers what effect credit derivatives have on the behavior of various parties and what efforts can be made to ensure that the incentives of these participants are properly aligned.

II. LEGAL UNCERTAINTY SURROUNDING THE USE OF CREDIT DERIVATIVES

The most important legal concern that market participants are faced with when they use credit derivatives is a question of legal uncertainty. There are only two published opinions directly involving the enforceability or interpretation of credit derivatives.⁸ Therefore, there is currently little legal precedent with which to gauge how courts will handle disputes between credit derivatives participants. The only published case in the United States involving the enforceability of a credit derivative transaction is *Ursa Minor Ltd. and Bankers Trustee Company Ltd. v. Aon Financial Products, Inc. and Aon Corp.* Bear, Stearns International Limited (“BSIL”) made a loan to Escobel Land Inc. (“Escobel”), a Philippine corporation, in connection with Escobel’s construction of a condominium complex in the Philippines. Escobel obtained a surety bond issued by the Government Service Insurance System (“GSIS”), a government entity of the Philippines, to guarantee payment by Escobel on its loan to BSIL.

⁸ There are other cases such as *Dharmala v. Bankers Trust* that involve such issues as seller liability. These issues are outside the scope of this paper.

Escobel then assigned this surety bond to BSIL. On the same date, Aon Financial Products (“AFP”) entered into a credit default swap agreement with BSIL. Aon Corporation (“Aon”) executed an unconditional guarantee in favor of BSIL for AFP’s payment under the credit default swap. The swap’s Confirmation listed “Failure to Pay” as the only Credit Event. One clause of particular importance in the Confirmation stated that:

[T]he determination of a Credit Event is without regard to, inter alia: (i) any lack or alleged lack of authority or capacity of [GSIS] or [Escobel] to enter into the [Surety Bond] or [Loan Agreement]; (ii) any actual or alleged unenforceability, illegality, or invalidity with respect to the [Surety Bond] or [Loan Agreement]; [or] (iii) the failure of [GSIS] or [Escobel] to make any payment as a result of compliance with any applicable law, order, regulation, decree, or notice....⁹

BSIL subsequently assigned all of its rights under the credit default swap and the guarantee to Ursa Minor, which then assigned all of its rights, as a security interest, to Bankers Trustee Company Ltd. (“Bankers”). AFP also entered into an additional swap agreement with Societe Generale in which Societe Generale agreed to guarantee payment to AFP under the original credit default swap.

Escobel failed to make payment when it came due under the loan agreement, and Bankers demanded payment by GSIS under the surety bond. GSIS refused to pay Bankers under the bond, arguing that the assignment of the surety bond to BSIL by Escobel was invalid. Bankers sent a notice of default under the credit default swap to AFP. AFP refused to pay under the swap because the terms of the agreement required delivery of a valid “Reference Obligation.” Since the Reference Obligation at issue here was the surety bond that GSIS had declared invalid, AFP claimed that it was not obligated to pay under the swap.

AFP brought an action in the District Court for the Northern District of Illinois seeking a declaratory judgment against BSIL, Bankers, Ursa Minor, and Societe Generale. Separately,

⁹ *Ursa Minor Ltd. et al. v. Aon Financial Products, Inc. et al.*, 2000 U.S. Dist. LEXIS 10166 at 7-8 (S.D.N.Y. 2000) quoting Confirmation, Ex. C to Lieratore Decl. P 3.

Ursa Minor and Bankers filed their own action against AFP and Aon in the District Court for the Southern District of New York. The Southern District of New York district court granted Ursa Minor and Bankers' motion for summary judgment. According to the court, any deficiencies in the underlying surety bond were irrelevant for the purposes of the credit default swap. The definition of Credit Event specifically used broad language, referring to failure to pay "for whatever reason or cause." With respect to the issue of the delivery of the invalid surety bond, the court indicated that delivery of a valid bond was not a condition to payment under the swap. Regardless, the bond would still be deliverable due to the inclusion of a waiver by AFP of any possible affirmative defenses in the terms of the Confirmation. The definition of deliverable obligations could have excluded any obligations subject to a defense by GSIS, but AFP's waiver of its defenses was determinative on this matter. Thus, the Southern District of New York district court enforced the terms of a credit default swap in the only case that has moved through the U.S. courts without being settled prior to a judicial determination.

Although this case addressed more general concerns about the enforceability of credit derivatives, there are additional areas of legal uncertainty arising from the credit derivatives documentation that is used by the parties to these transactions.

A. Introduction to ISDA Documentation

In 1998, ISDA published a standard form confirmation for credit swap transactions (1998 Confirmation of OTC Credit Swap Transaction (Single Reference Entity, Non-Sovereign)) ("the Long Form Confirmation"). The 1999 ISDA Credit Derivatives Definitions ("1999 Credit Derivatives Definitions" or "1999 Definitions") were published soon thereafter, and replaced the Long Form Confirmation. The 1999 Definitions serve as the definitions for credit default swaps,

total-return swaps, credit-linked notes, or credit derivative transactions that reference baskets of Reference Entities.¹⁰ These definitions are used in Confirmations of individual transactions governed by agreements such as the 1992 ISDA Master Agreements.¹¹ The 1999 Credit Derivatives Definitions were created in response to concerns that the Long Form Confirmation was too vague and subjective.¹² For example, the Long Form Confirmation contained a materiality clause, which stated that a credit event would be triggered if the terms of an obligation changed in such a way that the terms were “materially less favorable to any holders of the obligation”.¹³ By comparison, the 1999 Definitions do not contain any reference to materiality.¹⁴ In February 2003, ISDA released the 2003 ISDA Credit Derivatives Definitions (“2003 Credit Derivatives Definitions” or “2003 Definitions”). These definitions use the 1999 Definitions as the starting point and include several modifications that are discussed below. The 2003 Definitions can be used in transactions beginning in the spring of 2003.

There are several choices that must be made as to the Obligations that will be included in each credit default swap transaction. The counterparties to a transaction must choose one or more obligations of the Reference Entity that will be referenced in the documentation (“Reference Obligations”). When there is physical settlement, the Confirmation will also specify which obligations can be delivered after a credit event has been triggered (“Deliverable Obligations”). Parties also have the option to choose “Obligation Categories” and “Obligation Characteristics”. The Obligation Categories include Payment, Borrowed Money, Reference Obligations Only, Bond, Loan, or Bond or Loan. The Obligation Characteristics consist of Pari

¹⁰ See ISDA, 1999 ISDA CREDIT DERIVATIVES DEFINITIONS v (1999).

¹¹ *Id.* ISDA also recently published a new 2002 ISDA Master Agreement.

¹² See Barclay T. Leib, *What's a Default?*, DERIVATIVES WEEK (Jan. 2001).

¹³ ISDA, LONG FORM CONFIRMATION; Leib, *supra* note 12.

¹⁴ See 1999 ISDA CREDIT DERIVATIVES DEFINITIONS, at vi.

Passu Ranking, Specified Currency, Not Sovereign Lender, Not Domestic Currency, Not Domestic Law, Listed, Not Contingent, and Not Domestic Issuance.

B. Credit Events

There are six Credit Events included in the 1999 and the 2003 Definitions: (1) Failure to Pay; (2) Restructuring; (3) Bankruptcy; (4) Cross-Acceleration; (5) Cross-Default; and (6) Repudiation/Moratorium. Some of the issues that arise in connection with determining what constitutes a default will be introduced in this section. In Section III, we will return to consider the specific controversies surrounding the Restructuring Credit Event.

One of the most important considerations for ISDA in deciding upon the language of the Credit Events is what role these products are designed to serve. On the one hand, ISDA documentation can limit the definitions to match the definition of “default” used by credit rating agencies. On the other hand, the documentation can be expanded to capture other events that signal problems with a Reference Entity that do not rise to the level of a “default.” Ultimately, this is a choice embedded in the concept of what credit derivatives should be and opinions will differ depending on the needs of a variety of participants. This problem is particularly acute in the drafting decisions for the Restructuring Credit Event.

1. Failure to Pay Credit Event

Along with Bankruptcy and Obligation Acceleration, Failure to Pay is one of the most commonly used credit events. An important issue that has been raised by at least one rating agency, Moody’s, is how closely the credit events track the definition of “default” used by the agencies in their rating process. Moody’s definition of default is limited to (1) any missed or delayed disbursement of interest and/or principal; (2) bankruptcy or receivership; or (3) a

distressed exchange where (i) the borrower offers debtholders a new security or package of securities that amount to a diminished financial obligation (such as preferred or common stock, or debt with a lower coupon or par amount), or (ii) the exchange has the apparent purpose of helping the borrower avoid default.¹⁵ According to Moody's, Failure to Pay as defined in the 1999 Definitions is consistent with its definition of default.¹⁶ The only recommendation Moody's suggested with respect the Failure to Pay Credit Event would be to create a threshold amount for the Payment Amount to reintroduce the concept of materiality to the definitions.¹⁷

2. *Bankruptcy Credit Event*

The Bankruptcy Credit Event as originally defined in the 1999 Credit Derivatives Definitions was taken from the 1992 ISDA Master Agreement.¹⁸ Moody's and the other rating agencies have expressed concern with this, particularly given the broader scope of the Master Agreement. The ISDA Master Agreement can be used for transactions involving any type of swap and permits early termination due to a counterparty's credit difficulties to minimize losses prior to an actual default.¹⁹ In particular, its definition of Bankruptcy refers to any action by a Reference Entity "in furtherance of, or indicating its consent to, approval of, or acquiescence in" any of the already specified acts.²⁰ According to the rating agencies, this "in furtherance" language could encompass any publicly reported contemplation of bankruptcy by a Reference Entity, regardless of whether actual bankruptcy was a result.²¹ In response to these concerns,

¹⁵ See JEFFREY S. TOLK, MOODY'S INVESTOR SERVICE, UNDERSTANDING THE RISKS IN CREDIT DEFAULT SWAPS 5 (Mar. 16, 2001).

¹⁶ *Id.* at 6.

¹⁷ *Id.*

¹⁸ See TOLK, *supra* note 15, at 6.

¹⁹ *Id.* at 6, fn. 7.

²⁰ 1999 CREDIT DERIVATIVES DEFINITIONS, § 4.2(i).

²¹ See TOLK, *supra* note 15, at 6.

ISDA modified the definition of Bankruptcy in a Supplement by eliminating this clause entirely.²²

3. Obligation Default Credit Event

Obligation Default captures all defaults other than failure to make any required payment. The credit derivatives market does not use this Credit Event due to its extreme broadness.²³

4. Repudiation/Moratorium Credit Event

The Repudiation/Moratorium Credit Event is included in the 1999 and the 2003 Definitions primarily to address actions taken by sovereign borrowers.²⁴ Moody's has expressed some concern with the language contained in the definitions. In relevant part, Repudiation/Moratorium is defined to include a situation when a "Reference Entity or Governmental Authority ... challenges the validity of, one or more Obligations...."²⁵ According to Moody's, this clause could be interpreted to trigger a Credit Event when there is a dispute over a particular Obligation that never leads to failure to pay by the Reference Entity, and would therefore not constitute a "default."²⁶

5. Obligation Acceleration Credit Event

Obligation Acceleration is triggered when an Obligation becomes due and payable before it would otherwise have been due and payable as a result of the occurrence of a default other than

²² See ISDA, SUPPLEMENT RELATING TO SUCCESSOR AND CREDIT EVENTS TO THE 1999 ISDA CREDIT DERIVATIVES DEFINITIONS, Nov. 28, 2001.

²³ See TOLK, *supra note* 15, at 9.

²⁴ *Id.*

²⁵ 1999 CREDIT DERIVATIVES DEFINITIONS, § 4.6. See also TOLK, *supra note* 15, at 9.

²⁶ *Id.*

failure to make a required payment. Of all the Credit Events, only this one can be fully at the discretion of the lender.²⁷ According to Moody's, use of this Credit Event is problematic because true "defaults" under this definition are already captured by other credit events. For example, if the borrower repays less than it owes after acceleration, the Failure to Pay or the Bankruptcy Credit Events would be triggered. If the borrower renegotiates the debt, this may be a Restructuring. Even further, just because there is acceleration does not necessarily mean that there should be a default under the credit derivative if the borrower fully repays its debt.²⁸

Obligation Acceleration and Repudiation/Moratorium are being used less frequently now that European users of credit derivatives have agreed to drop these two credit events from standard corporate credit default swap agreements.

C. Other Issues in the Credit Derivatives Definitions

Although a great deal of attention is placed on the triggering of default under the credit events, other aspects of the 1999 and the 2003 Definitions deserve attention. Recent events have highlighted conflicting interpretations and ambiguous meanings of several other terms and definitions included in ISDA's documentation.

1. "Not Contingent"

In 2001, a dispute arose over the meaning of "Not Contingent" when Railtrack Plc, a UK rail operator, went bankrupt. "Not Contingent" is one of the Obligation Characteristics that the parties to a credit derivative transaction must specify with respect to the Obligations referenced

²⁷ *Id.* at 10.

²⁸ *Id.*

in the transaction. In the 1999 Definitions, “Not Contingent” is defined, in relevant part, as “any obligation ... the payment or repayment of principal in respect of which ... is not subject to any contingency.”²⁹ Protection buyers sought to deliver bonds of Railtrack that were exchangeable for shares of its parent, Railtrack Group Plc, under their credit default swaps. The issue arose as to whether these bonds were eligible for delivery under a physically settled credit default swap transaction which specified that any obligations must be “Not Contingent.”³⁰ Being able to deliver Railtrack’s convertible bonds was especially important for holders of these obligations because the price of the convertible bonds had fallen significantly more than that of straight debt instruments of Railtrack.³¹ Therefore, if these holders were not allowed to deliver the convertible bonds, they would be forced to buy other higher priced Railtrack bonds on the market and suffer a loss reflecting the lower price of the convertible bonds.

The convertible bonds at issue were exchangeable at the option of the bondholder or the trustee on behalf of the bondholder. The complication arose over the so-called “widows and orphans” clause, which refers to an exchange at the trustee’s option. Certain market participants argued that this clause violates the “Not Contingent” requirement because there is a chance that a trustee may not exercise the conversion option.³² ISDA obtained an opinion from an English barrister, Robin Potts Q.C., who analyzed whether the Railtrack convertible bonds were eligible as “Not Contingent.”³³ The opinion first considered whether a bondholder’s conversion option renders the bonds “contingent” because the obligation to pay principal is contingent upon the bondholder’s decision not to exercise his conversion right.³⁴ Robin Potts concluded that this

²⁹ 1999 CREDIT DERIVATIVES DEFINITIONS, § 2.18(b)(vii).

³⁰ See Robin Potts Q.C. Opinion, Oct. 28, 2001. Again, this is a possible “Obligation Characteristic” for physically settled credit default swaps.

³¹ See *Credit Derivatives*, DNA NEWSLETTER (DNA Training & Consulting, London, U.K.), Sept.-Oct. 2001, at 3-4.

³² *Id.*

³³ See Robin Potts Q.C. Opinion, Oct. 28, 2001.

³⁴ *Id.*

type of conversion right should not by itself render the bonds contingent. The real focus, according to the opinion, should be on whether the *obligation* to pay principal is contingent, not on whether the holder has the ability to affect this obligation through its conversion right.³⁵ The opinion next concluded that the “widows and orphans” clause also should not render the bonds “Not Contingent.” Although less forceful in making this conclusion than on the first issue, the opinion suggested that courts would be likely to avoid producing a “perverse” result by finding otherwise. This is particularly true when the contingency (here, exercising a conversion right) is unlikely to occur.³⁶

In connection with this dispute, the Queen’s Bench Division recently agreed with this position in holding that the Railtrack convertible bonds were deliverable securities under a credit default swap entered into between Nomura International plc and Credit Suisse First Boston International (“CSFB”).³⁷ Nomura bought credit protection referenced to Railtrack in a principal amount of \$10 million from CSFB. CSFB refused to accept delivery of the convertible bonds after Nomura’s bankruptcy triggered default under the credit default swap. CSFB argued that the conversion rights held by the holders and the trustee rendered these bonds outside the “Not Contingent” requirement. Justice Langley rejected this contention by relying on the same distinction as Robin Potts (who represented Nomura):

It is, I think, of importance that the predicate to the exercise of the exchange right is the holder’s own decision to take the benefit of it for himself, whereas the predicate to the operation of the credit derivative transaction is a “Credit Event” in relation to Railtrack plc which leads the holder to deliver the bonds to the seller of protection in exchange for payment. In all probability the “Credit Event” itself will reflect and crystallise the lack of benefit to be derived from the exchange right and the fact that the holder chooses to deliver the bonds will reflect the commercial reality that they are worth less than the obligation of the seller of

³⁵ *Id.*

³⁶ *Id.*

³⁷ *See* Nomura Int’l Plc v. Credit Suisse First Boston Int’l, 2003 EWHC 160 (Q.B. Comm. 2003).

protection. That, after all, is what the buyer has bought: protection against the credit risk of the issuer.³⁸

ISDA quickly responded to the controversy by publishing a supplement on convertible, exchangeable, or accreting obligations. According to the supplement, any determination of whether an obligation is “Not Contingent” should focus on whether the repayment of principal may not occur due to events either unrelated to the credit of the issuer or not within the control of the obligation holder or a trustee.³⁹ Much like the thrust of the Robin Potts opinion, ISDA concludes that the “Not Contingent” Obligation Characteristic is designed to address whether the right to receive principal is contingent.

The market generally interprets guarantees, conversion at the option of the holder or a trustee, and bonds with a fixed percentage or scheduled amortization to fall under “Not Contingent.” One of ISDA’s Supplements also suggests that zero coupon bonds should be deliverable as “Not Contingent.”⁴⁰ Bonds convertible at the option of the issuer will not qualify as “Not Contingent.”⁴¹

2. Definition of a Reference Entity and its Successor

The definition of Reference Entity has also proved to be problematic. The 1999 Definitions define a Reference Entity as “each entity specified as such in the Confirmation and any Successor.”⁴² A dispute resulting in at least two lawsuits arose over the proper identification of the Reference Entity when a restructuring by Armstrong World Industries, Inc. led to a default

³⁸ *Id.*, at v.

³⁹ See ISDA, COMMENTARY ON SUPPLEMENT RELATING TO CONVERTIBLE, EXCHANGEABLE OR ACCRETING OBLIGATIONS, Nov. 9, 2001.

⁴⁰ *Id.* According to the Commentary, the new “Section 1(a)(ii) is intended to clarify that zero coupon bonds should be capable of constituting Deliverable Obligations even if the “Not Contingent” characteristic is specified as being applicable.”

⁴¹ See TOLK, *supra* note 15.

⁴² 1999 CREDIT DERIVATIVES DEFINITIONS, at § 2.1.

under several credit default swaps transactions. Swiss Re Financial Products brought suit against XL Insurance Ltd. and UBS AG sued Deutsche Bank AG after both protection sellers disagreed that a default had occurred on their respective credit default swaps.⁴³ Both lawsuits were filed in the High Court of Justice in London. Armstrong World Industries, Inc., a subsidiary of Armstrong Holdings, Inc., declared bankruptcy on December 6, 2000. These protection buyers intended Armstrong World to be the Reference Entity in its credit derivative transaction. Yet the Confirmation listed Armstrong Holdings as the Reference Entity, and then specified an obligation of Armstrong World as the Reference Obligation. After Armstrong World filed for bankruptcy, the respective protection sellers argued that a credit event had not occurred because Armstrong Holdings did not file for bankruptcy. Both lawsuits were settled out of court without disclosure of the terms of settlement.⁴⁴

The meaning of “Successor” to a Reference Entity has also been called into question by several instances of corporate break-ups. This debate has significant implications for buyers and sellers of protection. Any corporate restructuring will inevitably change the terms of the original bargain entered into through a credit default swap transaction. Each party will be left with positions in an entity with different credit characteristics than the original Reference Entity. For example, in November 2000, National Power Plc announced its plan to demerge, with its valuable UK energy business (approximately two-thirds of its assets) going to a new company to be spun-off, Innogy Plc.⁴⁵ National Power would be renamed International Power Plc and would retain its international operations. Sterling obligations owed by National Power would be transferred to Innogy, and International Power would retain a certain amount of National

⁴³ See *Swiss Re Suing XL Over Derivative Deal*, BUS. INSURANCE, June 4, 2001; *Professor: Lawsuit Could be Sign of Confusion in Credit-Default Derivative Market*, BEST’S INSURANCE NEWS, May 5, 2001.

⁴⁴ *Id.*; *XL, Swiss Re Settle Credit Swap Dispute*, BEST’S INSURANCE NEWS, Feb. 27, 2002.

⁴⁵ See David Rule, *The Credit Derivatives Market: its development and possible implications for financial stability*, FIN. STABILITY REV., June 2001, 117, 135.

Power's debt as well. Holders of the Sterling debt were required to consent to the transaction. This was not considered problematic since Innogy's credit rating was expected to increase; International Power's credit rating, on the other hand, was expected to drop significantly. Therefore, the real concern arose for those protection sellers with Reference Obligations now being held by International Power. In the 1999 Definitions, Successor is defined as, in relation to a non-Sovereign Reference Entity, a successor to that Reference Entity that assumes "all or substantially all of the obligations" of the Reference Entity by way of merger, consolidation, amalgamation, transfer, or otherwise.⁴⁶ Since neither Innogy nor International Power met this "all or substantially all" requirement, market participants were left trying to determine who should be the Reference Entity. A similar question was raised when AT&T announced plans to split itself into four units, none of which would assume the majority of its debt.

ISDA responded by issuing a Supplement to clarify the definition of Successor when the "all or substantially all" requirement is not met following a merger or other transaction. The Supplement replaces the "all or substantially all" language with numerical thresholds.⁴⁷ If one of the new entities succeeds to 75% or more of the bonds and loans of the original Reference Entity, then that new entity will be the sole Successor. Alternatively, if the 75% test is not met, then each entity that assumes more than 25% of the obligations will be deemed a Successor, and the credit default swap transaction will be divided into a series of credit default swaps based on the number of entities that are now Successors to the original Reference Entity. Lastly, if none of the entities assume more than 25% of the obligations, the entity that assumes the greatest percentage of obligations will be deemed the sole Successor.

⁴⁶ See 1999 CREDIT DERIVATIVES DEFINITIONS, at § 2.2.

⁴⁷ See ISDA, COMMENTARY ON SUPPLEMENT RELATING TO SUCCESSOR AND CREDIT EVENTS TO THE 1999 ISDA CREDIT DERIVATIVES DEFINITIONS, Nov. 9, 2001.

3. *Process Difficulties*

In addition to these numerous issues of interpretation of the definitions and other language included in the Definitions, ISDA's documentation also raises several additional process concerns. Although less publicized than the debates addressed above, these issues have the potential to cause uncertainty and the need for further modifications to the Definitions.

There is the potential for a conflict of interest whenever a counterparty also serves as the Calculation Agent.⁴⁸ The Calculation Agent is a party specified in the Confirmation (either a third party or one of the parties to the credit derivative transaction) that is responsible for assuming certain administrative duties. Its duties include obtaining quotations from dealers as to the market value of the obligations in the event of a default. A counterparty to the transaction generally serves as the Calculation Agent, particularly when one of the counterparties is a large commercial or investment bank. A conflict could arise most importantly and often in the context of this valuation process. For example, GMO Trust brought a lawsuit against CSFB on behalf of the GMO Fund in connection with two credit default swap transactions entered into between GMO Fund and CSFB.⁴⁹ The GMO Fund bought protection from CSFB with bonds issued by Ecuador serving as the Reference Obligations.⁵⁰ In March 2000, Ecuador defaulted on certain payment obligations and GMO Trust and CSFB agreed that a Credit Event had occurred.⁵¹ Since this was a cash-settled transaction, GMO Trust was entitled to the difference between the face value of the debt and its current market value from CSFB. CSFB was the designated Calculation Agent in the swap confirmations and, therefore, was responsible for determining the market price

⁴⁸ See SCHUYLER K. HENDERSON, Chapter 5 Draft, at 29.

⁴⁹ See *GMO Trust, on behalf of its series GMO Emerging Country Debt Fund v. Credit Suisse First Boston*, No. 00-CV-3760, complaint filed (S.D.N.Y. May 18, 2000).

⁵⁰ *Id.* at para. 7.

⁵¹ *Id.* at para. 10.

of the Reference Obligations to calculate the payment due to the GMO Fund.⁵² According to GMO Trust, CSFB used “manifestly false and inflated prices” for the bonds rather than their fair market values, which had the effect of lowering the payment due to the GMO Fund.⁵³ In particular, GMO Trust pointed to actions allegedly taken by CSFB including asking for a single offer price for the entire \$93.5 million of bonds (despite being separated into three swap transactions) and improperly pressuring one dealer who was not interested in making a market in the bonds to offer a price (which ended up being advantageous to CSFB).⁵⁴ CSFB brought a counterclaim alleging that the price used was actually lower than it should have been, not higher as alleged by GMO Trust. According to CSFB, GMO Trust improperly exerted influence on two of the five dealers making quotations, which resulted in lower offers than otherwise would have been made. GMO Trust and CSFB eventually settled this lawsuit privately.

Another problem may arise when the same party is involved in multiple transactions that result in different lawsuits. Although this problem is not unique to credit derivatives, the likelihood of such a result is important given the need for a market consensus to develop on what constitutes a default under a credit derivative transaction. Whether a default has been triggered is generally determined through consensus, which will be much more difficult in a situation where major market participants cannot advocate one position publicly for fear of upsetting their offsetting positions. This is a problem for large dealers, in particular, which will often serve as both protection sellers and protection buyers on the same Reference Entity. As a result of these opposing positions, these parties may be forced to take one position in one lawsuit, and another position in a second lawsuit. For example, JPMorgan is involved in two previously discussed lawsuits surrounding the restructuring and eventual default of Argentina (*HBK Master Fund* and

⁵² *Id.* at para. 11.

⁵³ *Id.* at para. 12.

⁵⁴ *Id.* at para. 48, 52.

Eternity). In both of these lawsuits, JPMorgan is making identical arguments as the protection seller in each transaction. Yet JPMorgan is asserting the opposite position as a protection buyer in another lawsuit brought by Daehan Investment Trust Management Co., Ltd. (“Daehan”) against JPMorgan over a \$96 million credit derivative transaction involving Argentina’s debt.⁵⁵ The type of credit derivative used in this transaction was a basket credit linked note tied to the obligations of emerging market countries Argentina, Brazil, and Mexico.⁵⁶

Credit linked notes combine a bond with a credit default swap. The protection buyer issues a bond to the protection seller that pays periodic interest payments and is redeemable at par value upon maturity if a specified credit event does not occur with respect to a reference asset. If the credit event occurs, the bond is redeemed for an amount equal to the difference between par value and the market value of the reference asset. Typically, SPVs serve as the actual issuer of the bonds. Credit linked notes are referred to as funded credit derivatives because the protection buyer receives payment upfront from the protection seller upon the issuance of the bond. In comparison, a credit default swap is considered an unfunded credit derivative because the protection buyer is still exposed to counterparty risk from the protection seller.⁵⁷ Under the terms of a credit linked note, the protection buyer (here, JPMorgan) is obligated to turn over all payments received on the underlying obligations (here, Argentina’s bonds) once received until a default occurs. This allows the protection seller to recover the amount it has already “advanced” to the protection buyer when the bond is issued. Once a default occurs, however, the payments under the credit linked note terminate. Therefore, once

⁵⁵ See *Daehan Investment Trust Management Co., Ltd. v. J.P. Morgan Chase Bank*, No. 02-CV-1349, complaint filed (S.D.N.Y. Feb. 22, 2002) [hereinafter *Daehan*].

⁵⁶ *Id.* at para. 12.

⁵⁷ See FINANCIAL SERVICES AUTHORITY (FSA), CROSS-SECTOR RISK TRANSFERS, 10, 11, May 2002.

JPMorgan sent notice that the Restructuring Credit Event was triggered, it was relieved of its obligation to pay Daehan the payments it received on the underlying bonds.

In the transaction between JPMorgan and Daehan, a Pricing Supplement was used in which the definition of default included the announcement of an intention to restructure by any of the reference entities.⁵⁸ Any default would have resulted in the loss of repayment of principal and any remaining interest on the credit linked notes that Daehan had purchased from JPMorgan through SPVs. On December 7, 2001, JPMorgan set a notice of default to Daehan with respect to Argentina's debt obligations, which resulted in Daehan's failure to receive principal and interest due on the notes on December 17, 2001, its scheduled maturity date.⁵⁹ JPMorgan took the position that a default had occurred with respect to these credit derivatives transactions after having insisted in *HBK Master Fund* and *Eternity* that the developments in Argentina amounted to a voluntary restructuring that did not constitute a default.

D. Will Credit Derivatives Be Recharacterized As Insurance?

Another concern that has been raised in recent years is whether credit derivatives will be recharacterized as insurance contracts. If credit derivatives are considered to be insurance contracts, the two most important consequences are: (1) requirement of good faith and (2) requirement of insurable interest.⁶⁰ Parties to an insurance contract are subject to a duty of "utmost good faith." This good faith requirement requires both parties to disclose all material facts relating to any risks involved in entering the contract.⁶¹ Parties are otherwise subject to the

⁵⁸ See *Daehan*, at para. 26-27.

⁵⁹ *Id.* at para. 29, 31.

⁶⁰ See FSA, *supra note 57*, at Annex B, 1.

⁶¹ *Id.*

principle of caveat emptor when dealing with other general types of contracts, including credit derivatives transactions. An insurance contract also must have an insurable interest such as an economic and legal connection to the subject matter of the risk.⁶² Although certain credit derivative transactions will meet this requirement, swaps used for trading purposes are less likely to qualify.⁶³

To address these concerns, ISDA sought a legal opinion from Robin Potts Q.C. in 1997 to determine whether a credit default swap could be construed as an insurance contract. Robin Potts concluded that, under British law, credit derivatives do not fall under the UK's Insurance Companies Act 1982 because they are not structured to provide loss indemnity. Credit derivatives transactions are only concerned with the occurrence of a credit event, not with whether or not the buyer of protection actually suffers a loss. According to the opinion, the fact that credit derivatives and insurance contracts are often economically equivalent is not determinative. Robin Potts recommended that the ISDA documentation should include a clause that makes clear that the parties do not intend to enter into an insurance contract. According to the UK's Financial Services Authority in a paper discussing the risks associated with both credit derivatives and insurance, there are still some weaknesses with the insurance recharacterization issue that cannot be ignored.⁶⁴ First, any contracts drafted prior to 1997 would not have included such a clause.⁶⁵ Second, a credit derivative transaction may be structured in such a way that the occurrence of a credit event could only be triggered when the buyer of protection suffers actual loss.⁶⁶ An example of this might be when a party buys protection for a self-originating loan that

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.* Since most contracts last up to five years, this should be less of an issue.

⁶⁶ *Id.*

is not transferable or illiquid.⁶⁷ Therefore, if a credit event occurred, this protection buyer would have no other choice but to deliver the obligation for which the credit protection was bought. Third, British law is not clear on whether actual loss indemnity is the only defining characteristic of insurance contracts.⁶⁸ Lastly, any “no intention to insure” clause could be overridden by evidence of the parties intention to insure against loss.⁶⁹

III. THE RESTRUCTURING CREDIT EVENT

A. Introduction

The Restructuring Credit Event is by far the most controversial of the Credit Events. The definition of Restructuring in the 1998 Long Form Confirmation contained a materiality component. In the 1999 Definitions, ISDA aimed to develop a more objective approach by listing specific events that would constitute a Restructuring.⁷⁰ In the Practice Notes to the 1999 Definitions, ISDA admits that its definition risks capturing those events that do not result from, or indicate, the deterioration in the credit quality or financial condition of the Reference Entity.⁷¹ ISDA attempted to partially address this issue by including an exception to a Restructuring Credit Event when an event occurred “in circumstances where such event does not directly or indirectly result from deterioration in the creditworthiness or financial condition of the Reference Entity. Whether or not [this section] will apply depends on the facts and circumstances at the type of the relevant event.”⁷² Although not the same language used in the materiality clause of

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.* at 2.

⁷⁰ See 1999 ISDA CREDIT DERIVATIVES DEFINITIONS, at x.

⁷¹ *Id.*

⁷² *Id.* at x-xi.

the Long Form Confirmation, this new exception reintroduces the concept of materiality. This clause also introduces uncertainty since whether an event results from deterioration in the financial condition of the Reference Entity is not always self evident.

As originally drafted, the Restructuring Credit Event identified five events that can qualify as a restructuring, including a reduction in interest payments or principal repayments, the postponement or deferral thereof, a restructuring that leads to a change in the priority of the Reference Obligation, and any change in the currency or composition of any interest or principal payment. As will be discussed in Part B and C of this section, several disputes quickly arose after the publication of the 1999 Definitions. These disputes fall within two documentation areas. The first, more specific problem arose in the context of Deliverable Obligations. Deliverable Obligations are not specific to the Restructuring Credit Event only, but Conseco's restructuring in 2001 resulted in a Supplement that impacts Restructuring more than the other credit events⁷³ and led certain parties to begin excluding Restructuring as a credit event. The second, more general problem is what constitutes a default under the Restructuring Credit Event definition. This ongoing dispute is focused on both the proper definition of Restructuring, and even further, the decision whether to include Restructuring as a Credit Event.

The largest restructuring to occur to date is Argentina's restructuring of its sovereign debt. JPMorgan is currently involved in three lawsuits based on its participation in credit default swap agreements. In November 2001, Argentina announced its plan to "voluntarily restructure" most of its \$132 billion debt by swapping existing bonds with high interest rates for new ones capped at a much lower rate.⁷⁴ Argentina asserted that the bond swap was voluntary and thus, did not constitute a default. According to Argentina, the lower interest rates on the new bonds

⁷³ See *infra* Section III.B.

⁷⁴ See Anthony Faiola, *Argentine Debt Downgraded; Nation Effectively in Default, Two Wall St. Rating Firms Say*, WASH. POST, Nov. 7, 2001 at E1.

would be offset by dedicated tax revenue that would function as an “added value” guarantee for the new bonds.⁷⁵ Yet, the rating agencies and other analysts disagreed with this assessment and termed the “voluntary” restructuring a default because of its economic implications. The “added value” guarantee would be of little value due to Argentina’s plummeting tax revenue.⁷⁶ According to these analysts, the default was not “voluntary” as an economic matter because an investor who chose not to swap its bonds would be subject to a greater risk than the risk associated with participation in the exchange.⁷⁷ In a complaint filed against JPMorgan in connection with credit default swaps referencing Argentina’s sovereign debt, HBK Master Fund L.P. also suggested that the restructuring was mandatory in practical terms because of the pressure that Argentina exerted on its local banks to force them to accept the exchange, or else Argentina would default.⁷⁸

In *HBK Master Fund L.P. v. JPMorgan Chase Bank*, HBK Master Fund L.P. (“HBK Master Fund”), a hedge fund, had entered into confirmations with JPMorgan for two credit swap transactions relating to Argentina’s sovereign debt. One of the designated Credit Events provided for in the confirmations was “Restructuring.” When HBK Master Fund gave written notice to JPMorgan in early December 2001, JPMorgan maintained that a “Restructuring” Credit Event had not occurred because the Argentine government claimed that the restructuring was a voluntary one.⁷⁹

The conflict between HBK Master Fund and JPMorgan as to whether the restructuring was “voluntary” centered upon the meaning of “Obligation Exchange” in the 1999 Definitions.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ See *HBK Master Fund L.P. v. JPMorgan Chase Bank*, No. 02-CV-0579, complaint filed (S.D.N.Y. Jan. 24, 2002), at para. 42.

⁷⁹ *Id.* at para. 22, 36, 38, 39.

Obligation Exchange is defined as the “mandatory transfer” of any securities, obligations, or assets to holders of Obligations in exchange for these existing Obligations.⁸⁰ An Obligation Exchange would be triggered, for example, if the issuer called the outstanding bonds.⁸¹

According to JPMorgan, since Argentina described the call and issuance of new bonds as voluntary, no Obligation Exchange had occurred. HBK Master Fund responded to JPMorgan’s position by arguing that the inquiry as to whether a Restructuring Credit Event had occurred should focus on the effects of the exchange and not on whether an Obligation Exchange had actually occurred. According to HBK Master Fund, an Obligation Exchange is not needed to trigger the Restructuring Credit Event. Therefore, regardless of whether an Obligation Exchange had occurred, the exchange triggered the Restructuring Credit Event because it led to a reduction in principal and interest and a deferral of the maturity dates. These events are all included in the definition of Restructuring.⁸²

The facts of *Eternity Global Master Fund L.P. v. Morgan Guaranty Trust Company of New York and JPMorgan Chase Bank* are quite similar to *HBK Master Fund*. Eternity Global Master Fund L.P. (“Eternity”) bought protection from JPMorgan through three credit default swaps with Argentina as the Reference Entity. Restructuring and Moratorium/Repudiation were included as Credit Events in the Confirmation. As with *HBK Master Fund*, Eternity sent notice to JPMorgan of the occurrence of a Restructuring Credit Event following Argentina’s voluntary

⁸⁰ See 1999 CREDIT DERIVATIVES DEFINITIONS, at § 4.9.

⁸¹ Under the 1999 Definitions, if an Obligation Exchange occurs, the terms of the existing Obligation and the newly Obligation will be compared to determine if one of the five events under the Restructuring definition was triggered as a result. These five events are:

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

Id. at § 4.7(a)(i) – (v).

⁸² See *supra* note 81.

debt exchange.⁸³ JPMorgan again denied that Argentina's voluntary exchange was a Restructuring within the meaning of the 1999 Definitions.⁸⁴ On December 17, 2001, one of the three transactions terminated on its scheduled termination date.⁸⁵ Approximately one week later, Argentina declared a moratorium on payments to holders of its debt obligations.⁸⁶ JPMorgan immediately declared a Repudiation/Moratorium Credit Event as to the two remaining Transactions and paid Eternity on these two swaps. Eternity brought an action over JPMorgan's failure to make payment on the terminated transaction, and for failure to make earlier payment on the other two transactions as to a Restructuring Credit Event rather than the later Moratorium Credit Event.⁸⁷ Again, JPMorgan's defense primarily hinged on the need for an Obligation Exchange, which requires a "mandatory transfer."⁸⁸ JPMorgan recently filed a motion to dismiss Eternity's complaint.

As a result of this uncertainty as to whether voluntary exchanges would constitute Restructuring Credit Events, the 2003 Definitions eliminates the term "Obligation Exchange" from the definition of Restructuring. It is unclear whether this change would resolve these disputes between JPMorgan and HBK Master Fund and Eternity. According to the plaintiffs in these cases, the occurrence of an Obligation Exchange does not affect the triggering of a Credit Event. Even if an Obligation Exchange had not occurred, a Restructuring Credit Event is triggered if one of the specified five events occurred, including the reduction or postponement of interest and principal.

⁸³ See *Eternity Global Master Fund L.P. v. Morgan Guaranty Trust Company of New York*, No. 02-CV-1312, complaint filed (S.D.N.Y. Feb. 22, 2002); Motion to Dismiss, at 7.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.* at 8.

⁸⁸ *Id.* at 10-17.

B. Deliverable Obligations

On September 22, 2000, Conseco announced that its lender banks, led by Bank of America and Chase Manhattan Bank, agreed to a \$2.8 billion restructuring of its credit facilities.⁸⁹ The extension allowed Conseco to avoid declaring bankruptcy and helped with an impending liquidity crunch.⁹⁰ Although technically a restructuring under the Restructuring Credit Event definition because the maturity date was deferred, only a short-term loan was extended as part of the restructuring plan. When certain protection buyers delivered long-term securities to protection sellers under their credit default swap transactions, many market participants felt that such a response was inappropriate. Some even questioned whether this should be considered a Restructuring Credit Event, despite technical compliance with the language in the 1999 Definitions.⁹¹

As a result of the Conseco restructuring, U.S. dealers in particular advocated removal of restructuring as a credit event and began pricing credit derivatives “with restructuring” and “without restructuring.” These dealers added a significant premium for any credit derivative in which restructuring would be a specified credit event.

ISDA responded by publishing a Restructuring Supplement to the 1999 Credit Derivatives Definitions in May 2001. First, ISDA added a new provision, which provides that when there is a physically settled transaction, a buyer can deliver only a Deliverable Obligation with a final maturity date no later than thirty months after the maturity date of the restructured

⁸⁹ See *Conseco Restoration Plan Moves Forward; Company and Banks Close on Debt Restructuring; Debt to be Cut by \$3 Billion Over 3 Years*, BUS. WIRE, Sept. 22, 2000.

⁹⁰ See Leib, *supra* note 12; HENDERSON, *supra* note 48, at 13.

⁹¹ See Leib, *supra* note 12 (quoting a credit derivatives broker: “I think there was a gentleman’s perception that this loan restructuring should not have caused a default trigger even though the nitty-gritty of [ISDA’s] document clearly allowed it to be such. Even fewer dealers thought it was an appropriate response to get delivered longer-term paper when it was a short-term loan that got extended.”).

obligation.⁹² This limitation was designed to address the problem that arose with the Conseco restructuring. The protection buyers that delivered Conseco debt with a significantly longer term maturity than the restructured debt employed the “cheapest to deliver” option. This maturity date limitation reduces protection sellers’ exposure to this option. Second, the Supplement excludes restructurings in connection with bilateral loans from the definition by requiring more than 3 holders of the Reference Obligation and consent by a super-majority (two-thirds) in order to qualify as a Restructuring Credit Event. The Supplement also provided that in order for a subordination to constitute a credit event, any changes in pari passu ranking must be based on contractual subordination. Structural subordination will not trigger the Restructuring Credit Event. Another new requirement is that the Deliverable Obligation must be a Fully Transferable Obligation. A Deliverable Obligation is considered a Fully Transferable Obligation if it is “capable of being assigned or novated ... without the consent of any person being required.”⁹³ Lastly, the Supplement allows a party to settle only part of a transaction in the event of a Credit Event, and thus, to deliver multiple credit notices until the full settlement has occurred.

As evident by the continued debate over the Restructuring Credit Event definition, this solution does not address the fundamental differences in views of the purposes of credit derivatives attributable to various market participants. This Supplement was only designed to

⁹² Section 2.29 of the Supplement provides that the protection buyer can deliver to the protection seller a Deliverable Obligation that has a final maturity date not later than the Restructuring Maturity Limitation Date. The Restructuring Maturity Limitation Date is defined as a date that is the earlier of (x) 30 months after the Restructuring Date and (y) the latest final maturity date of any Restructured Bond or Loan, subject to the following: (1) the Restructuring Maturity Limitation Date cannot be any earlier than the Scheduled Termination Date of the Credit Derivative Transaction; and (2) the Restructuring Maturity Limitation Date cannot be any later than the date that is 30 months following the Scheduled Termination Date.

⁹³ This applies to all obligations except bonds. For bonds, a Deliverable Obligation is considered a Fully Transferable Obligation if it is “Transferable.” Transferable is one of the Obligation Characteristics already provided for under the 1999 Definitions. The definition of Transferable covers an obligation transferable to institutional investors without any contractual, statutory, or regulatory restrictions. *See supra* Section III.A for a discussion of the Obligation Characteristics and 1999 CREDIT DERIVATIVES DEFINITIONS, § 2.20(b) (Deliverable Obligation Characteristics).

deal with the debate over Deliverable Obligations, and so it does not address the very subjectivity of this particular credit event and the potential for abuse over its usage.

C. What Constitutes a Restructuring Credit Event?

Conseco's restructuring highlighted the lack of consistency between the triggers for ISDA's credit events and for the rating agencies' definition of default. Moody's equivalent of a restructuring is termed a "distressed exchange," which is defined under the default definition as whether either:

(i) the borrower offers debtholders a new security or package of securities that amount to a diminished financial obligation (such as preferred or common stock, or debt with a lower coupon or par amount), or (ii) the exchange has the apparent purpose of helping the borrower avoid default.⁹⁴

According to Moody's, Conseco's restructured bank debt did not qualify as a "diminished financial obligation," and thus, was not a "distressed exchange" default. Even though the restructuring resulted in a three-month maturity deferral, the lenders were compensated for this extension with an increased coupon, a new corporate guarantee, and additional covenants.⁹⁵ Examples such as the Conseco restructuring have led Moody's to press ISDA to tailor the language of the Credit Events in its documentation to achieve conformity with the Moody's definition of default.

The 2001 Restructuring Supplement did not provide a resolution for market participants. After its publication, divergent trading market developed in the United States and in Europe. On the one hand, European banks continued to employ the Restructuring definition from the original 1999 Definitions. On the other hand, U.S. banks switched to the 2001 Supplement, which became known as "ModR." Commentators have offered a variety of reasons for why European

⁹⁴ See TOLK, *supra* note 15, at 5.

⁹⁵ *Id.* at 8.

banks did not switch to the 2001 Supplement. One explanation advanced is that the European banks had yet to suffer a Conseco type of restructuring that brought to bear the issues that led to the supplement. Another suggested reason is that the maturity limitation clause of thirty months in the 2001 Supplement was too restrictive for European banks whose corporate debt capital consists of longer-term bonds. If the bonds that European banks held exceeded the maturity limitation date of the 2001 Supplement, these banks would be left holding obligations that would not qualify as Deliverable Obligations in the event of a triggered, physically-settled credit derivative transaction. Lastly, many European loans require the lender to obtain the borrower's consent to transfer the loan. This requirement would again limit the ability of European banks to deliver these types of loans because they would not qualify as Fully Transferable Deliverable Obligations.⁹⁶

The recently published 2003 Definitions provide four Restructuring options for parties to choose from: (1) exclusion of Restructuring as a Credit Event; (2) "full" Restructuring (the original language from the 1999 Definitions); (3) "Modified Restructuring," (or ModR) (definition from the 2001 Supplement); or (4) "Modified Modified Restructuring," (also known as ModModR or ModR²) (a new provision in the 2003 Definitions).⁹⁷

The biggest impediment to eliminating the Restructuring option is the position of European banks and bank regulators who require restructuring as a credit event for regulatory capital relief purposes.⁹⁸ At the other extreme, there are many problems with allowing two separate markets, one for those credit derivatives "with restructuring" and another for those "without restructuring," to continue to develop. This would most likely result in decreased

⁹⁶ See *supra* Section III.B for a discussion of addition of "Fully Transferable Deliverable Obligation" in 2001 Supplement.

⁹⁷ See ISDA, *ISDA Publishes 2003 ISDA Credit Derivatives Definitions* (Feb. 11, 2003), available at <http://www.isda.org/press/index.html>.

⁹⁸ See *infra* Section III.D.1.

liquidity for both markets.⁹⁹ Yet, it recognizes that banks holding loans have different needs from other protection buyers, which includes satisfying the regulatory capital relief requirements. A bifurcated approach recognizes the fundamental distinction between parties that use credit derivatives to hedge their exposure and parties that treat credit derivatives as trading instruments. It is not unreasonable for banks with outstanding exposure to a Reference Entity to desire the inclusion of Restructuring as a Credit Event. Yet for those parties who are simply trading credit derivatives without exposure, the inclusion of Restructuring only decreases liquidity and increases pricing.¹⁰⁰

The new ModR² definition was designed for European banks, which are still desirous of including Restructuring as a Credit Event and had not adopted the use of the definition from the 2001 Supplement. This definition differs from the ModR definition in two important ways. The first difference relates to the question of whether the protection buyer must obtain consent of the Reference Entity to transfer a loan that is a Deliverable Obligation after the occurrence of the Restructuring to satisfy the terms of a physically settled credit default swap. Under ModR², a Deliverable Obligation need only be a “Conditionally Transferable Obligation.”¹⁰¹ A loan will be considered a Conditionally Transferable Obligation even if consent of the Reference Entity is required, so long as the terms of the loan provide that such consent “may not be unreasonably withheld or delayed.” This consent relaxation diverges from the ModR definition of Restructuring, which provides that any Deliverable Obligation must be fully transferable.¹⁰² ModR²’s relaxed consent provision is aimed to address the needs of European banks, which often hold loans that require borrower consent.

⁹⁹ See HENDERSON, *supra* note 48, at 14.

¹⁰⁰ For these parties without exposure to a Reference Entity, credit derivatives primarily serve as synthetic securities.

¹⁰¹ See ISDA, 2003 ISDA CREDIT DERIVATIVES DEFINITIONS § 2.33(a) (2003).

¹⁰² Fully transferable refers to an obligation with no consent requirement. See *supra* Section III.B.

The second difference between ModR and ModR² is the length of the maturity limitation date. Under ModR², the maturity of the Deliverable Obligation can extend to 60 months after the Restructuring Date of a restructured bond or loan. This length is 30 months longer than the one provided for in the ModR definition.¹⁰³ The maturity limitation date provision is also designed to address the concern of European banks, which generally hold bonds with much longer maturity dates than their U.S. counterparts.

Another option, suggested by Schuyler K. Henderson, a London-based derivatives lawyer, that is not currently provided for in the Definitions or elsewhere would be to allow for the creation of a specialized niche market, in which a specialized “standard” restructuring transaction would be used.¹⁰⁴ This contract would only include restructuring as a credit event and loans would be the only type of obligation (both the reference obligations and deliverable obligations).¹⁰⁵ This product would be designed specifically for banks attempting to purchase credit protection for outstanding loans that are desirous of meeting the regulatory capital relief requirements (which includes restructuring as a credit event as currently drafted). This alternative also recognizes the differences between those parties entering into credit derivatives transactions to hedge their current exposures and those parties that are purely interested in trading synthetic securities.

D. Should Restructuring Be Included As a Credit Event?

Xerox’s restructuring of its credit facility in 2002 exacerbated some of these outstanding issues over the proper definition of Restructuring and led several significant market participants

¹⁰³ The ModR provision is referred to as the Restructuring Maturity Limitation Date. This extends to 30 months beyond the Restructuring Date. The ModR² provision is referred to as the Modified Restructuring Maturity Limitation Date.

¹⁰⁴ See HENDERSON, *supra* note 48, at 15.

¹⁰⁵ *Id.*

to eliminate the use of Restructuring as a Credit Event. In late 2000, Xerox was experiencing financial difficulties. In June 2002, Xerox refinanced its credit facility that was set to expire in October 2002 with its bank lenders. A controversy quickly developed over whether this refinancing constituted a Restructuring Credit Event. Parties that viewed this as a Restructuring Credit Event argued that Xerox's earlier financial difficulty was the direct cause of this refinancing. However, in the press release announcing the credit facility refinancing, Xerox indicated that its improved financial condition made the refinancing possible. Many experienced market participants expressed disbelief that this credit facility refinancing could constitute a Restructuring. Yet several protection buyers claimed that this event triggered the Restructuring Credit Event. As discussed further below, this position angered several prominent protection sellers.

JPMorgan became the first major participant in the credit derivatives market to announce that it would no longer include Restructuring in its credit derivatives contracts. Although the bank would still offer Restructuring as a Credit Event in any swaps for which is served as a dealer, its decision would apply to all of the swaps that JPMorgan entered as an end user. Several insurance companies who provide credit protection (as protection sellers) followed shortly thereafter with a proposal addressed to ISDA advocating that Restructuring be removed as a credit event.

In a memorandum to ISDA, JPMorgan indicated that there were several reasons for its decision to drop the Restructuring Credit Event from its credit derivatives contracts.¹⁰⁶ The bank blamed the inclusion of Restructuring for hampering the growth of the credit derivatives market. According to JPMorgan, this restricted growth resulted from concerns about real or perceived

¹⁰⁶ See Memorandum from Blythe Masters, JPMorgan, New York, NY, to ISDA Credit Derivatives Market Practice Committee, European and US Bank Portfolio Managers and ISDA Credit Derivatives Market Practice Committee G6 Working Group (undated) (on file with author).

conflicts of interests on the part of banks who operate in both the lending and derivatives market. This concern stems from the two functions that banks play as protection buyers. First, the bank will have a lending relationship with the Reference Entity. The portfolio management group that oversees these loans will have access to material, nonpublic information about the Reference Entity as a result of this relationship. Second, the trading desk of the bank will enter into credit derivatives transactions. A firewall should ensure that the bankers who have access to the Reference Entity's nonpublic information will not divulge this information to the traders. However, many market participants believe that these firewalls are less than fully effective.¹⁰⁷ In addition, JPMorgan suggested that it will be "almost impossible" to arrive at a universal definition of Restructuring. In the absence of agreement, a modified version will limit liquidity because less protection buyers and sellers will be willing to participate as a result of this uncertainty. Even bank portfolio managers who wish to completely hedge loan restructuring risk by buying credit protection that includes Restructuring as a Credit Event will never be able to achieve this because they will be exposed to early terminations triggered by protection sellers at a point when the protection buyer gains little economic value.¹⁰⁸ After the credit default swap is triggered, the protection buyer will still be subject to exposure to default on its now unhedged position. Although JPMorgan conceded that the exclusion of Restructuring eliminates valuable hedging opportunities, it views the increased liquidity as more valuable.

Several insurance companies also responded to the decision by certain market participants to classify the Xerox credit facility refinancing as a Restructuring Credit Event by

¹⁰⁷ See *infra* note 150.

¹⁰⁸ For example, a protection seller could trigger a Restructuring Credit Event under a credit default swap after a refinancing that leads to little change in the value of the Reference Entity's underlying asset in the short term. As a result, a protection seller will be able to close out the credit default swap at a time when its payout to the protection buyer is minimal.

proposing that Restructuring should be removed as a Credit Event.¹⁰⁹ In the meantime, however, the insurers suggested that the Restructuring definition should be modified to eliminate the problems caused by the “subjective causation” test included in § 4.7 of the Definitions.

According to these protection sellers, the root of the problem stems from the language of § 4.7(b)(iii), which provides that none of the listed events shall constitute a Restructuring if such an event “does not directly or indirectly *result from* a deterioration in the creditworthiness or financial condition of the Reference Entity” (emphasis added). According to these insurers, there are two problems that arise from this “result from” causation test. The first problem is that this language leaves open the possibility of multiple causes. Secondly, this causation test raises issues as to the motivations of the participants and the opportunity for manipulation of the occurrence of a Credit Event. Accordingly, the insurance companies suggest that the test should be replaced with a more objective standard and redrafted to ensure that the definition of Restructuring does not include ordinary course loan refinancings that are not caused by imminent bankruptcies, reorganization, or imminent payment defaults. By eliminating these types of restructurings, the Restructuring Credit Event would be limited to “restructuring-as-workout” model. This approach excludes non-distressed exchanges such as the ones mentioned above in which the restructured obligation of the Reference Entity does not become a diminished obligation, and therefore, the obligation holders suffer no economic loss. In the Xerox situation, for example, these companies believed that Xerox’s refinancing of its credit facility was not a Restructuring Credit Event because it occurred at a time that was consistent with general practice and significantly after its financial difficulties. Yet how market participants could systematically determine which is the proper assessment seems impossible to fathom and laden with concerns of conflicts of interest.

¹⁰⁹ See Proposal from ISDA End-User (Protection Seller) Constituency to ISDA (Aug. 8, 2002) (on file with author).

Despite the decisions of these protection sellers and the most active bank participant in the credit derivatives market to eliminate Restructuring as a Credit Event, there is still significant opposition to its exclusion on the part of European banks. There are several reasons that have been advanced for why European banks in particular wish to include Restructuring. The most often used and persuasive explanation is fear of losing regulatory capital relief.

1. Regulatory Capital Relief

The Basel Committee first issued the Basel Capital Accord in 1988 (“the 1988 Accord”) to provide guidance for regulatory treatment of bank capital requirements. The general thrust of the 1988 Accord is to provide a systematic approach for weighting the risk of a bank’s assets to determine how much capital a bank should hold to correspond to this risk. Nowhere in the 1988 Accord is credit derivatives mentioned. In January 2001, the Basel Committee issued a proposal for the new Capital Accord (“the Proposed Accord” or “Basel II”). Basel II consists of three pillars: (1) minimum capital requirements, (2) supervisory review process, and (3) market discipline. Within the first pillar, the default is a standardized approach; this approach relies heavily on the use of credit rating agencies to weigh the risk of a bank’s assets more sensitively than the risk weight buckets used in the 1988 Accord. More sophisticated banks have the option of using an internal ratings-based (“IRB”) approach. The IRB approach is split between the foundation and advanced approaches.

Credit derivatives are considered one of several types of credit risk mitigation techniques that can be used by banks to reduce credit risk. These include taking collateral, use of guarantees, or taking an offsetting position subject to a netting agreement.¹¹⁰ Basel II

¹¹⁰ See BASEL COMMITTEE ON BANKING SUPERVISION, THE NEW BASEL CAPITAL ACCORD para. 61 (Jan. 2001).

specifically describes how credit derivatives (only credit default swaps and total return swaps¹¹¹) will be treated, both when used as part of the banking book and as part of the trading book. First, any bank using credit derivatives (or guarantees) must satisfy a certain number of minimum conditions.¹¹² Before granting capital relief, a banking supervisor must be satisfied that the bank fulfills these conditions relating to risk management processes and that the credit derivative is direct, explicit, irrevocable, and unconditional.¹¹³ According to the Basel Committee, credit derivatives simultaneously reduce credit risk and increase other risks for banks such as legal risk.¹¹⁴ In order to control these risks, banks must develop procedures and processes that consider the underlying credit, systems, and management of concentration risk arising from its use of credit derivatives as well as the effect on the bank's overall credit risk profile.¹¹⁵ The credit derivative must represent a *direct* claim on the protection provider.¹¹⁶ It also must be *explicit*; the credit derivative must be linked to specified exposures in such a way that the credit protection is clear and unquestionable.¹¹⁷ The credit derivative cannot be revocable or conditional.¹¹⁸

There is also a set of operational requirements for credit derivatives that must be met in order to obtain regulatory capital relief. First, there are specific credit events that must be included in the documentation.¹¹⁹ These include failure to pay the amounts due according to the reference asset, a reduction in the rate or amount of interest payable or the amount of scheduled interest accruals, a reduction in the amount of principal or premium payable, and a change in the

¹¹¹ Credit linked notes issued by the bank will be treated as cash collateralization transactions. *Id.* at 28, fn. 25.

¹¹² *Id.* at 25.

¹¹³ *Id.*

¹¹⁴ *Id.* at 26.

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 27.

ranking of priority of payment of an obligation that causes subordination of that obligation.¹²⁰ Basel II specifically requires the inclusion of the Failure to Pay and Bankruptcy Credit Events. However, the Restructuring Credit Event is also considered a required credit event under the Accord as it is currently drafted. The specified credit events listed above include events only covered by the Restructuring Credit Event. Later Accord-related documents have also confirmed that Restructuring is a required credit event.¹²¹ This directly affects ISDA documentation because any bank desirous of obtaining regulatory capital relief will want the Restructuring Credit Event included in the ISDA Credit Derivatives Definitions. Second, cash settlement for credit derivatives transactions may be used only if the bank has a robust valuation process that can reliably estimate loss.¹²² In addition, there must be a specified period for obtaining such valuations after a credit event has occurred.¹²³ Third, the credit protection must be legally enforceable in all relevant jurisdictions.¹²⁴ Fourth, any material event such as filing for bankruptcy or failure to make payments must trigger default events.¹²⁵ Fifth, any grace period in the credit derivative transaction cannot be longer than the period provided for in the underlying loan agreement.¹²⁶ Sixth, in a physically settled transaction, the protection buyer must have the ability to transfer the reference asset to the protection provider upon the occurrence of a credit event.¹²⁷ Seventh, the identity of the parties responsible for determining whether a credit event

¹²⁰ *Id.*

¹²¹ See BASEL COMMITTEE ON BANKING SUPERVISION, QUANTITATIVE IMPACT STUDY 3 TECHNICAL GUIDANCE 33 (Oct. 2002) (including, in addition to failure to pay and bankruptcy, restructuring of the underlying obligation involving forgiveness or postpone of principal, interest or fees that results in a credit loss event (i.e., charge-off, specific provision or other similar debit to the profit and loss account) must be included).

¹²² See BASEL COMMITTEE ON BANKING SUPERVISION, THE NEW BASEL CAPITAL ACCORD 27 (Jan. 2001).

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

has occurred must be clearly defined.¹²⁸ The protection buyer must be one of the parties allowed to provide notice of the occurrence of such a credit event.¹²⁹ Lastly, when there is an asset mismatch between the credit exposure and the reference asset, then (1) both assets must be issued by the same obligor and (2) the reference asset must rank *pari passu* or more junior than the underlying asset and there must be legally effective cross-reference clauses included as terms of the transaction.¹³⁰

The risk weight assigned to the underlying exposure incorporates both the reference entity's risk weight and the protection provider's risk weight. If an exposure is fully protected, the entire amount is assigned a risk weight that is a weighted average of the reference entity's risk weight and the protection provider's risk weight.¹³¹ If the exposure is not fully protected, the protected portion is treated the same as the previous example, and the unprotected portion is assigned the risk weight of the reference entity.¹³² If there are materiality thresholds included in the credit derivative transaction, that amount must be fully deducted from the capital of the bank purchasing protection.¹³³ In the event of a currency mismatch, the amount of the exposure considered to be protected will be reduced by the application of a haircut.¹³⁴

Therefore, any bank desirous of obtaining the proposed Basel Accord regulatory capital relief through the use of credit derivatives must comply with these requirements. Compliance with the Accord as it is currently drafted requires use of Restructuring as a Credit Event. Market participants have lobbied the Basel Committee and other regulatory agencies to reconsider the inclusion of Restructuring as a required Credit Event. Only a couple of months after the

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ *Id.* at 28.

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.* at 30.

Conseco restructuring and the ensuing calls for removing restructuring as a credit event, a Federal Reserve Board official warned that the Federal Reserve would not consider credit derivatives for the purposes of regulatory capital relief if ISDA removed the term from its documentation.¹³⁵ Several market participants have responded to this position by arguing that at least there should be capital relief for credit protection on loans held by banks that do not include the Restructuring Credit Event. As one senior credit derivatives dealer argued, “[s]ince all bank loans can only be restructured with the 100-percent approval of those holding these loans, where’s the harm in allowing capital relief at least until such a restructuring transpires?” According to this dealer, a bank will only grant an extension on the loan if the terms are attractive enough.¹³⁶ Others, particularly European banks, have expressed their concern with eliminating this credit event because it leaves banks exposed to some level of risk that is not covered by the other credit events. In late 2002, the Federal Reserve Bank of New York suggested it would consider this issue further when it invited representatives from major credit derivatives market players to participate in a review of this issue.¹³⁷ The future role of Restructuring in the regulatory capital relief area remains far from clear.

An obvious question that follows from the concern of European banks to ensure that credit derivatives meet the regulatory capital relief structure is why don’t U.S. banks care? The answer to this question is not fully clear. Some U.S. banks that use credit derivatives to provide protection from exposure advocate the inclusion of the Restructuring Credit Event. For others, however, the difficulties arising over the Restructuring Credit Event have made its use so undesirable that the corresponding loss in regulatory capital relief from the exclusion of Restructuring is a price they are willing to pay. When posed this issue, a senior lawyer at a

¹³⁵ See Leib, *supra* note 12.

¹³⁶ *Id.*

¹³⁷ See *Fed Seeks Input on Restructuring Debate*, DERIVATIVES WEEK, Nov. 3, 2002.

major U.S. bank suggested that large U.S. banks engage in sophisticated portfolio management that prioritizes economics over capital relief.¹³⁸ In other words, these banks will not let the benefits of regulatory capital relief overly influence their decision as to the proper means of utilizing credit derivatives to manage their portfolios.¹³⁹

2. *What if Restructuring Was Not Included as a Credit Event?*

A helpful way to approach the Restructuring Credit Event issue is to consider what happens when Restructuring is and is not included as a Credit Event. When the Restructuring Credit Event is included, banks that are asked to restructure loans are put in an enviable position. These banks are given the opportunity to grant an extension, presumably collect fees for providing this service, and then still have the occurrence of the Restructuring Credit Event if they have bought protection through a credit default swap.¹⁴⁰ Presumably, the banks involved could structure the transaction in such a way that a Restructuring Credit Event would occur only if such a result was more attractive. The bank's decision as to whether it will participate in the restructuring of a distressed borrower may be tied to whether the bank has taken a short or long position on the credit default swaps.¹⁴¹ Yet, if Restructuring was eliminated as a Credit Event, banks would also be put in a difficult position. If the creditworthiness and financial condition of a Reference Entity had deteriorated significantly, banks might be placed in the uncomfortable position of having to force default in order to obtain protection through the triggering of a Credit Event such as Bankruptcy or Failure to Pay.

¹³⁸ Interview (see author for details).

¹³⁹ See also Memorandum from Blythe Masters, *supra* note 106 (“While dropping Restructuring as a standard term will reduce the economic value of the impacted credit derivative hedges, we feel comfortable that the ultimate improvement in liquidity and pricing will more than offset this.”).

¹⁴⁰ See *supra* note 138.

¹⁴¹ *Id.*

If we return to the Xerox credit facility example, it is evident that there is an opportunity for the banks participating in the refinancing to structure the transaction in two ways depending on their incentives. First, the banks could amend the existing credit facility. This refinancing would trigger the Restructuring Credit Event under the literal language of the definitions of Restructuring set forth in the 1999 Definitions and the 2001 Supplement as long as the maturity date was extended.¹⁴² This might even trigger the Restructuring Credit Event even if the actual value of the obligation was left unchanged because of the limitations of the materiality concept in the Restructuring Credit Event. Second, the banks could instead provide Xerox with a new credit facility with a later maturity date, which would provide Xerox with the money with which to repay the banks under the expiring credit facility. This option would not trigger the Restructuring Credit Event because the existing credit facility would be paid off upon maturity.

In considering these two possibilities, the obvious follow-up question we must ask is to what extent do (and will) banks engage in this type of behavior. At least one bank vigorously contests that it engages in this type of opportunistic behavior. Admitting that other banks might enter restructuring negotiations with an eye towards ensuring that the Credit Event is triggered, this bank focuses on “maintaining distribution franchise.” This means that the bank does not wish to be perceived as taking advantage of protection sellers and Reference Entities in the short-term.

The recent situation involving Marconi Plc highlights some of these issues. Marconi issued a press release that stated: “Marconi has taken action in furtherance of or indicating its consent to, approval of, or acquiescence in, making a general assignment, arrangement or composition with or for the benefit of its creditors.” As discussed above, this statement fits

¹⁴² This assumes that the Reference Entity does not provide a corresponding benefit such as an increased interest rate to offset the extended maturity date. Even if this type of benefit was provided, there would still be an issue of whether the benefit fully offset the loss.

within the Bankruptcy Credit Event definition in the original 1999 Definitions. Linklaters, a British law firm, issued an opinion supporting the view that a credit event occurred as to both Marconi Plc and its debt-incurring subsidiary, Marconi Corporation Plc. According to a London-based derivatives lawyer in a guest column in *Derivatives Week*, Marconi's loan and bond holders have two divergent perspectives on this issue since most bought credit protection.¹⁴³ The debt holders are on the one hand interested in obtaining preferential terms through restructuring, but on the other hand need not be too concerned because of their credit protection.¹⁴⁴ The presence of credit protection directly affects Marconi because its lenders do not have the same incentives as lenders without credit protection in mind with regards to an effective reorganization.¹⁴⁵

E. The Future of Restructuring as a Credit Event

As evident by the preceding discussion, resolution of the debate over the Restructuring Credit Event is far from near. It seems highly implausible that there will ever be a definition of Restructuring that satisfies all market participants. There is a valid concern expressed by market participants who favor inclusion of Restructuring that its exclusion will create mismatches in credit risk hedging. Banks that purchase credit protection will still be exposed to risk associated with restructurings. Yet, the difficulty in looking to the Restructuring definition to solve this

¹⁴³ See Anonymous, *Marconi: The Story So Far*, DERIVATIVES WEEK, Sept. 15, 2002.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* This also creates a problem in the future for Reference Entities such as Marconi. After Marconi negotiates with its current creditors (including banks who no longer hold risk because of their credit protection), it will eventually have to deal with the protection sellers after a default has been triggered. Marconi might then face a new bondholder's committee and syndicate bank group as a result of the "musical chairs" that occurs when the buyers of protection pass debt to protection sellers. Marconi will still have to be concerned with whether these new creditors will agree to the terms of the restructuring. By not involving protection sellers earlier in the negotiation process, Marconi is subject to even more future uncertainty.

problem is that the use of the definition is fundamentally flawed. Even putting aside the moral hazard problems that arise when banks are faced with a troubled Reference Entity in need of debt refinancing, the Restructuring definition currently contains subjective criteria that hinder the certainty (and by extension, liquidity) of credit default swaps. Even if the Restructuring definition was revised to only capture distressed exchanges (the “restructuring-as-workout” model advocated by protection sellers presented above), such an objective definition will still create areas of unmatched risk hedging. For example, protection sellers may manipulate the termination of a credit default swap by prematurely triggering at a time when such a result maximizes their financial gain. Therefore, regardless of whether the Restructuring definition is redefined to eliminate more subjective restructurings, the definition will still lead to less than complete credit protection.

Accordingly, Restructuring should be removed as a Credit Event. In any event, the Basel Committee should consider alternative ways of capturing this residual risk exposure for banks desirous of obtaining regulatory capital relief. Possible solutions include utilizing the second pillar of Basel II, the supervisory review process, to address this risk, or the development of a specialized credit derivative for banks to use that would only include Restructuring as a Credit Event.¹⁴⁶

IV. THE EFFECT OF CREDIT PROTECTION ON THE BEHAVIOR OF MARKET PARTICIPANTS

The discussion in the previous section about the effect of the inclusion of Restructuring as a Credit Event on the behavior of protection buyers highlights a broader issue that arises in the

¹⁴⁶ Much like a two-tiered system, this second solution might be too cost prohibitive.

context of credit derivatives usage. Specifically, the increasing use of credit derivatives raises questions as to whether lenders with credit protection will engage in opportunistic behavior and whether the “right” players are participating in negotiations with a distressed Reference Entity that is on the brink of triggering a Credit Event.

The moral hazard and incentives problem arises from the basic structure of the use of credit derivatives. Protection buyers have reduced incentives to monitor borrowers and increased incentives to prematurely trigger defaults.¹⁴⁷ Some banks are quick to respond that the moral hazard argument does not hold up because they do not hedge anywhere near the full amount of their outstanding credit risk.¹⁴⁸ Most large banks possess a significantly large enough exposure that it would be extremely difficult to eliminate their full exposure to a particular Reference Entity. However, this does not address the moral hazard problem that may arise if a credit default swap does not include Restructuring as a credit event and the protection buyer forces the Reference Entity into bankruptcy in order to trigger a default under the swap. Whether the protection buyer is fully hedged or not does not affect this issue. Banks also must be sensitive to concerns about long-term lending relationships with Reference Entities. Any actions on the part of banks that are perceived by these Reference Entities to be affected by ulterior motives could lead to a termination of this relationship and the resulting benefits. The strength of this argument is weakened, however, if the Reference Entity goes bankrupt.

Although several economists have identified the moral hazard problem that exists when banks purchase credit protection, there has yet to be a systematic study of the effect of the use of

¹⁴⁷ See John Kiff et al., *An Analytical Review of Credit Risk Transfers* (Jan. 2003) (unpublished manuscript, on file with author).

¹⁴⁸ See *supra* note 138.

credit derivatives as a method of credit protection for banks.¹⁴⁹ For example, if we return to the Restructuring Credit Event, there is an important moment of negotiation that occurs when the Reference Entity turns to its lenders and attempts to restructure its debt. If we accept the premise that lenders who purchase credit protection will be influenced by the presence of this protection, these protection buyers will engage in behavior different from other lenders who have not purchased credit protection. Therefore, I would suggest that we should consider how to, and whether we should, address this incentives-based problem. Solutions might include obtaining meaningful participation from true parties of interest in this situation (protection sellers), increased disclosure of the use of credit protection, and exposure retention requirements. Accordingly, we must ask how we can ensure that the parties with “improper” incentives are not adversely affecting distressed Reference Entities by engaging in opportunistic behavior. Before we can address these considerations, we must first analyze the various capabilities and roles assumed by protection buyers and sellers and the concerns that arise in connection therewith.

A. The Role of Protection Buyers and Sellers

Once a bank purchases credit protection to hedge its exposure to a Reference Entity, this protection buyer has a much different economic position, yet retains the same relationship with the Reference Entity. Therefore, despite possessing incentives that are no longer aligned with that of a normal holder of debt of a Reference Entity, the protection buyer serves as the only face for negotiations with distressed Reference Entities. This relationship persists despite the existence of a new interest holder (the protection seller). So we must ask, why is there no role

¹⁴⁹ See, e.g., Kiff, *supra* note 147; COMMITTEE ON THE GLOBAL FINANCIAL SYSTEM, BANK FOR INTERNATIONAL SETTLEMENTS, CREDIT RISK TRANSFER (Jan. 2003); TOLK, *supra* note 15.

available for protection sellers in these negotiations with Reference Entities? If the credit default swap is a physically settled one, the protection seller may or may not ultimately hold the obligations that are the subject of these negotiations. For example, banks are probably less likely to deliver defaulted loans, and will instead deliver bonds. Presumably in either case, the incentives of protection sellers will be aligned with that of a normal creditor of a Reference Entity. It would appear to be in the best interests of protection sellers and reference entities for protection sellers to enter these negotiations.

One difficulty that arises for protection sellers who are concerned with protection buyers engaging in opportunistic behavior is that protection sellers are at a significant disadvantage in their monitoring capability. The banks that enter into lending relationships with Reference Entities on whose debt they ultimately purchase credit protection have access to material, nonpublic information by virtue of this lending role.¹⁵⁰ In addition to not having access to this nonpublic information, protection sellers in the aggregate are not as sophisticated as their protection buyer counterparts. Although many of the bigger protection sellers are sophisticated financial institutions, there has been an increasing number of new, less sophisticated parties entering the credit derivatives market. Illustrative of this trend is the recent litigation over credit-linked notes issued by Enron-related special purpose entity (“SPE”) limited partnerships.¹⁵¹ The plaintiffs, purchasers of these credit-linked notes, allege that Credit Suisse First Boston Corp.,

¹⁵⁰ This also raises an important issue as to the benefits that a bank can gain as dealers through access to this nonpublic information. According to banks, this concern about access to nonpublic information should be alleviated by the presence of firewalls maintained by banks. On the “private side” of the bank are the credit portfolio and workout groups who would have access to nonpublic information about a Reference Entity including its financial difficulties. On the other side of the bank are the traders who participate in the credit derivatives market. Yet various insurance and fund management companies have complained that the lending departments are informing traders of problems with their borrowers before this information has been made public. Henny Sender, *Big Insurers, Fund Managers Claim Barriers Between Lending, Trading Staffs Were Breached*, WALL ST. J., Dec. 26, 2002, at C1. Anecdotally, certain banking officials indicate that the credit derivatives market often moves first in anticipation of the announcement of negative information about a Reference Entity.

¹⁵¹ See *Hudson Soft Co., Ltd. v. Credit Suisse First Boston Corp., et al.*, Civil Action No. 02-CV-5768, first amended class action complaint filed (S.D.N.Y. Sept. 29, 2002).

Citigroup Inc. and several other defendants sold these notes that were linked to the creditworthiness of Enron with full knowledge of its true financial condition. The lead plaintiff, Hudson Soft Co., Ltd., is a Japanese software company that bought Y500,000,000 of these notes. According to the amended complaint, CSFB and Citibank entered into these transactions in order to transfer the risk associated with its loans to Enron at a time when they had knowledge that it was only a matter of time before Enron declared bankruptcy.

Quite a few protection sellers have developed into more sophisticated participants in the credit derivatives market. These protection sellers can and do require banks to retain some exposure.¹⁵² One difficulty with this approach is that this retention requires direct contracting with the party holding the reference obligation. The transaction costs of this could become quite substantial and would be impractical for non-dealers. Another difficulty is that the influx of new participants in the credit derivatives markets provides protection buyers with a new set of less sophisticated participants with which to enter into transactions. In the words of an in-house lawyer at a prominent insurance protection seller, there is a “constant game of catch up” for protection sellers.¹⁵³ Since there is an unlimited supply of new entrants to the market, there is a limited ability of protection sellers as a group to drive the market.

B. What Can Be Done to Address This Issue?

The extent of the systemic effect of these incentives problems and difficulties in addressing them is difficult to discern. Yet it is this broader effect that should be of utmost concern. What follows is a list of several ideas for ways to begin to address these issues.

¹⁵² This could be done on a contractual basis. The terms of any contract requiring exposure retention would have to be drafted carefully to ensure that the protection buyer was not still able to offload their exposure in another manner.

¹⁵³ Interview (see author for details).

1. Lessons to Be Learned From Similar Financial Products?

One obvious place to look for answers is at how participants with similar economic products combat these types of difficulties. Yet a close analysis shows the inherent difficulties with such a comparison given the uniqueness of credit derivatives. Credit derivatives are very similar economically to financial guarantees and sureties. The proposed Basel Accord, for example, provides identical treatment for capital regulatory relief for financial guarantees and credit derivatives.¹⁵⁴ However, there are some important differences between credit derivatives and other credit risk mitigation techniques. A guarantee is a promise by an insurance company to assume responsibility for fulfilling the obligations of a principal in the event of a default by this principal. A surety bond is similar to a guarantee, with the most important difference being that the bond is usually obtained by the principal and pledged to the obligor as a performance guarantee. There are some important reasons why these products do not evenly match up. An important distinction is the directness of the relationships with the principal (Reference Entity). A protection seller never enters into a relationship with the Reference Entity. This is very different from a surety or a guarantee, where the relationship between the “protection seller” and the “Reference Entity” is directly contractual.¹⁵⁵ Insurance more closely resembles credit

¹⁵⁴ In the initial proposal for Basel II, the major difference in treatment came in the form of a “w” factor. For guarantees from a sovereign, central bank, or a bank, “w” would be zero. For all other types of guarantees, “w” would be 0.15 (the same as for all credit derivatives). The IRB advanced approach treats all guarantees and credit derivatives the same because “they share the same economic effect.” The market response to this differential treatment was extremely critical. In particular, ISDA questioned the rationale for the legal charge, and why such a legal charge would apply to credit derivatives but not to “less standardized” and “less liquid” guarantees. Despite their economic equivalence, Basel II would only require the 15% “w” factor for credit derivatives but not for guarantees (from sovereigns, central banks, or banks). This was seen as particularly troubling given that guarantees have less standardized contracts and a more illiquid market. The Basel Committee responded fairly quickly to these concerns and announced removal of the “w” factor from treatment of credit derivatives in September 2001. *See* BASEL COMMITTEE ON BANKING SUPERVISION, BASEL COMMITTEE NEWSLETTER NO. 2, Sept. 2001.

¹⁵⁵ There is an interesting common law principle from the law of suretyship that would be quite useful in increasing the role that protection sellers play in the negotiation process. Under suretyship law, the obligor and the principal cannot amend the underlying contract without the consent of the obligee.

derivatives because neither the protection seller nor the insurance provider has a contractual relationship with the Reference Entity. However, unlike credit default swaps, the insured party can only trigger reimbursement under the insurance policy after the occurrence of an actual loss. By comparison, credit derivatives can be triggered as soon as a Credit Event occurs. In addition, the insurer's role ends after loss reimbursement, unlike protection sellers, which will hold the underlying obligation after a physically settled credit default swap is triggered.

Some credit derivatives market participants point to the very differences between credit derivatives and these other products as one of their attractive features. Their separateness and their uniformity through the use of the ISDA Definitions are partially responsible for the tremendous growth of this market. As one official at a protection buyer points out, the very beauty of credit derivatives is that they are separate and independent products.¹⁵⁶ Allowing a protection seller to assume a role in the negotiations with a Reference Entity would be inconsistent with this fundamental principle. This sentiment is quite prevalent within the community of protection buyers and casts doubt on the willingness of these banks to allow protection sellers to participate in negotiations with a Reference Entity.

2. London Approach

The London Approach is a striking example of how informal collective action can ensure that all participants cooperate to reach a result that is in the best interests of the troubled debtor and its creditors. Developed by the Bank of England, the London Approach provides general guidance to help banks and other creditors respond when a company is experiencing serious financial difficulties.¹⁵⁷ The Bank of England created this policy for London bankers to follow

¹⁵⁶ See *supra* note 138.

¹⁵⁷ See Pen Kent, *Corporate Workouts – A UK Perspective*, INT'L INSOLVENCY REV. (1997), at *9.

in the aftermath of several recessions in the 1970s and 1980s. The London Approach is an informal, flexible framework that is not binding on its participants. Yet through the assistance of the Bank of England, this policy came into prominence in the 1990s as a means for dealing with troubled debtors on the brink of insolvency.

There are several key features to this approach.¹⁵⁸ Lenders are encouraged to remain supportive and open to non-statutory resolutions. This is intended to keep creditors from appointing a receiver. Decisions about the long-term future of the distressed debtor are to be made on the basis of comprehensive information that is shared among all the parties. This process will generally involve an independent review of the company's current status. In addition, any decisions about whether, and on what terms, the creditors will give the company a "financial lifeline" will be made collectively. A lead bank may be designated to coordinate this process. Claims with seniority are recognized and all creditors in a single category are treated equally. Lastly, new financing may be provided as part of this process if necessary.

The heart of this approach is premised upon making orderly and well-informed decisions. There are certain issues that arise under the London Approach. As mentioned above, these guidelines are non-binding. There is also a unanimity requirement. As a result, any creditor can holdout from this process and seek independent action. The approach does not establish a formal moratorium. These elements suggest that an important aspect to this approach is the role of the Bank of England. According to a former official at the Bank of England, the bank played a significant role in encouraging banks to participate in this framework.¹⁵⁹ Without an institution

¹⁵⁸ *Id.*; Peter Brierley & Gertjan Vlieghe, *Corporate Workouts, the London Approach and Financial Stability*, FIN. STABILITY REV., Nov. 1999, at 168-183.

¹⁵⁹ See *Kent*, *supra* note 157. One interesting question to consider is to the long-term vitality of the London Approach in light of the restructuring in the United Kingdom. Now that the Financial Services Authority conducts the regulatory oversight that was previously under the Bank of England, it is questionable whether the Bank will have the same level of influence over the actions of banks.

with the stature and influence of the Bank of England supporting this process, it would be difficult to imagine this mechanism leading to any type of sustainable success.¹⁶⁰

The Bank of England has raised its concern with the effect that various efforts such as debt trading and credit derivatives will have on banks and their willingness to participate in these types of informal workouts. One of the underlying principles behind the London Approach is the importance of long-term relationships between lenders and borrowers. As these parties move towards more transactional-based borrowing, it is questionable whether their willingness to participate in such an informal process will continue. In addition, with the increasing variety of the types of financings used by debtors, more parties such as bondholders and insurance companies need to be included in this process. Whether such an informal system would work with an increasing size of groups also remains questionable.

The International Federation of Insolvency Professionals (“INSOL”) published a “Statement of Principles for Multi-Creditor Workouts” in 2000. These principles are consistent with the London Approach and are intended to extend this systemic framework to multi-creditor workouts.¹⁶¹ The eight principles (or statements of best practices) include: creditor cooperation during a standstill period to provide an opportunity for obtaining and evaluating information on the debtor and to formulate and assess proposals for resolving the debtor’s financial difficulties; creditors refraining from taking any steps during the standstill period to enforce their claims; and coordination through the appointment of a committee. The report specifically addresses the increasing use of credit derivatives and credit insurance. The drafters suggest that the other

¹⁶⁰ Other countries, particularly Asian emerging markets, have developed a comparable system to the London Approach. This is most likely used as a substitute to a step towards creating an effective insolvency law. The London Approach could be viewed as a first step before insolvency laws have been enacted.

¹⁶¹ See Neil Cooper, *Introduction, The INSOL International Statement of Principles for a Global Approach to Multicreditor Workouts*, 2002 ANN. SURV. OF BANKR. LAW 295 (2002).

parties of interest created through these financial products must be involved for any workout proposal to succeed.¹⁶²

3. Who Are the Protection Sellers?

One of the difficulties in even considering ways to increase the role of protection sellers is ascertaining their identity. Dealers serve as the counterparty that both protection buyers and sellers deal with when they enter into credit default swaps. As a result, the triggering of a default under a credit default swap resembles the game of “musical chairs” after the protection buyer initiates physical settlement. The Deliverable Obligation will pass from one party to the next before it ultimately lands in the hands of the protection seller. In order to get a better sense of who these protection sellers are, the Basel Committee and appropriate regulatory agencies should undertake a comprehensive survey of who participates in credit derivatives markets. The British Bankers Association currently conducts the most comprehensive survey of the credit derivatives market. Although this report is very informative, its reach is limited to known, large participants and the information it collects is quite general. This information gathering must be extended to capture the Hudson Softs who are entering the credit derivatives markets in increasing numbers and the extent to which these new participants are holding this risk.

These identification problems can be alleviated through the use of an informal mechanism such as the London Approach. Despite being unknown the Reference Entity and possibly to the protection buyer, all protection sellers will know that they have sold protection on that Reference Entity. Once this informal process begins, these protection sellers would be able

¹⁶² See INTERNATIONAL FEDERATION OF INSOLVENCY PROFESSIONALS (INSOL) INTERNATIONAL, STATEMENT OF PRINCIPLES FOR A GLOBAL APPROACH TO MULTICREDITOR WORKOUTS 7-8 (2000).

to identify themselves rather than waiting for the opposite to occur after the credit default swap is triggered.

4. Exposure Retention

As the credit derivatives markets continues to grow, the opportunities for protection buyers to transfer large exposures will increase. This attaches a greater need for protection sellers to insist that protection buyers retain a significant portion of their underlying exposure. Such a result does not eliminate the potential role for protection sellers, but it does suggest a way of countering the moral hazard concern.

5. The Role of ISDA

Although all current indications suggest that ISDA has done an excellent job responding to market uncertainty through its standardized documentation, one should question whether a private organization comprised of market participants will remain the best organization for dealing with disputes. The use of credit protection and its effect on market participants suggests broader implications for other participants who are not a part of to this organization. We must also consider whether the public will ultimately bear some of the risk and the costs of the use of credit derivatives. If so, we should consider whether there is a regulatory body that is a more appropriate representative of the public interest and can provide a policing mechanism. Given the increasing size of credit derivatives, their lack of regulation should not escape consideration. In the meantime, however, ISDA is probably the entity best able to implement some of these suggestions.

6. A Comprehensive Approach

At a minimum, banks that hold credit protection should be required to disclose the extent to which they have transferred their exposure. The Basel Committee and appropriate regulatory bodies including the Federal Reserve and the Financial Services Authority should undertake a comprehensive study to identify the parties to these transactions. In addition, I would suggest implementing a more comprehensive way to deal with the incentives problem created when banks enter into credit derivatives transactions to hedge this exposure. This approach should be based on the same principles as the London Approach. The most important aspects of this framework should be disclosure of credit protection and information sharing among the various creditors. A lead bank, preferably one that has a significant long-term relationship with the distressed Reference Entity and has retained a significant level of exposure, should coordinate this process. Protection sellers should identify themselves as early as possible to facilitate their awareness and approval, if needed, to an ultimate restructuring or a similar result.

In addition, I would recommend that ISDA consider adding a premature triggering option in its standardized credit derivatives documentation. This option would serve a function similar to that of debt trading whereby protection buyers who wish to exit the negotiation procession and protection sellers who wish to assume a more formalized negotiating role can agree to such an option. To avoid manipulation designed to maximize pricing gains, both parties would be required to exercise the option. The mechanics of this option could be identical to that of any other feature of the Definitions. Any party desirous of including this option would select this feature when entering into the credit default swap. If a counterparty wished to exercise the option, it could send a notice to the other party. The recipient would have the opportunity to decide whether to accept, and therefore, trigger settlement.

V. CONCLUSION

Ultimately, what these ideas are designed to suggest are ways to improve transparency, identify parties with interests, and isolate the problems presented by the incentives problems created once banks buy credit protection. This paper is designed to raise issues that have yet to be considered on a broad scale. These suggestions are merely a starting point. One of the most important lessons that should be derived from the very brief history of credit derivatives is that legal and regulatory issues should be analyzed on a regular basis to meet the needs of market participants as they arise. The current level of documentation and regulatory treatment of credit derivatives should be seen as an admirable starting point, but not as the answer to all the questions surrounding their ever-increasing usage.

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