Fordham Law Review

Volume 80 | Issue 3 Article 17

December 2011

Swapped Disincentives: Will Clearinghouses Mitigate the Unintended Effects of the Bankruptcy Code's Swap Exemptions?

Timothy P.W. Sullivan

COMMENT

SWAPPED DISINCENTIVES: WILL CLEARINGHOUSES MITIGATE THE UNINTENDED EFFECTS OF THE BANKRUPTCY CODE'S SWAP EXEMPTIONS?

*Timothy P.W. Sullivan**

The Bankruptcy Code contains exemptions for swap agreements that allow creditors to seize collateral, to terminate their contract, and to net obligations once the debtor files for bankruptcy. By privileging this class of creditors, these provisions reduce incentives to monitor counterparty risk, and thus magnified losses experienced during the recent financial crisis. Congress overlooked this role of the Bankruptcy Code in destabilizing the financial system. Instead, its response was to require that all swaps be traded through a clearinghouse. This failure to address one of the contributing factors to the swap market's collapse should be worrisome, as a clearinghouse's traditional risk management devices likely cannot prevent a similar crisis in the future. Nonetheless, under the proper conditions, a clearinghouse theoretically has greater incentives to monitor counterparty risk than its individual members, thereby strengthening market discipline and financial stability. In order to realize this incentive structure, certain regulatory measures are necessary, namely heightened disclosure requirements and strict governance rules designed to preserve the independence of the clearinghouse's board from its members.

TABLE OF CONTENTS

* J.D. Candidate, Fordham University School of Law; B.A. in Economics, Vanderbilt University. The author would like to thank Richard S. Carnell for his truly invaluable comments and thoughts. Gratitude is also owed to Sara Elizabeth Marcus, Susan Block-Lieb, and Richard Squire for the original idea to focus on clearinghouses. This Comment is dedicated to the author's parents.

INTRODUCTION

In 1997, credit default swaps (CDSs) were still relatively exotic financial instruments, trading at a volume of around $180 billion.[1] The next decade saw an explosion in their use, with approximately $34.422 trillion trading in 2006, and $62.173 trillion in 2007.[2] Many lauded this development, both as "a major advance in risk management for all financial intermediaries," and for providing "a market-based reading of the risks of companies that is not available from any other source and that can be of major assistance to regulators, as well as investors and creditors."[3]

This growth was accompanied by a privileged status in the Bankruptcy Code (Code), as Congress believed it necessary to contain systemic risk in the event of a large institution's insolvency. Its reasoning, eventually applied to all swap agreements, was fairly straightforward: rather than waiting for a lengthy bankruptcy proceeding to share assets with other creditors, a cash-strapped swap party could now immediately seize collateral and terminate its contract with the debtor.[4] By permitting these actions, privileged status would help to maintain liquidity precisely when the financial system needed it most.[5] However, this systemic elixir came packaged with an unforeseen side effect: because creditors became more concerned with the debtor's ability to post collateral than to repay the underlying debt, these provisions ultimately reduced private market

1. Mike Jakola, *Credit Default Swap Index Options: Evaluating the Viability of a New Product for the CBOE*, FIN. INSTS. & MKT. RESEARCH CTR., KELLOGG SCH. OF MGMT. 3 (June 2, 2006), http://www.kellogg.northwestern.edu/research/fimrc/papers/jakola.pdf.

2. *ISDA Market Survey*, INT'L SWAPS & DERIVATIVES ASS'N (2010), http://www.isda.org/statistics/pdf/ISDA-Market-Survey-annual-data.pdf.

3. Peter J. Wallison, *Everything You Wanted to Know About Credit Default Swaps—But Were Never Told*, AM. ENTER. INST. FOR PUB. POLICY RESEARCH 10 (Dec. 2008), http://www.aei.org/docLib/20090107_12DecFSOg.pdf.

4. *See infra* Part II.C.

5. *See infra* Part II.C.

incentives to monitor counterparty risk.[6] In response to the perceived security of these contracts, one financial analyst noted that "[d]ue to these credit enhancements, market participants commonly view interest rate swaps as free of counterparty default risk."[7]

This distortion to market discipline lay dormant until 2008, when Bear Stearns—with nearly a quarter of its assets subject to the Code's privileged status—suffered a bank run.[8] AIG Financial Products (AIG), with $400 billion in credit default swap exposure and a mere $100 billion in equity, required a federal bailout not long thereafter.[9] In a recent article, Professor Mark J. Roe argues that if the Code's priority treatment of these instruments had been narrower, these firms would have been "less financially central and less interconnected. They would likely have had less super-priority debt. The financial system would have been more resilient."[10] As the dust from the credit crisis begins to settle, these provisions of the Code exempting swaps from the normal rules of bankruptcy appear to be an important yet overlooked culprit in destabilizing the financial system.

Despite their loss-magnifying effects, these exemptions were not addressed in the recent Dodd-Frank Wall Street Reform and Consumer Protection Act[11] (Dodd-Frank). Instead, Congress's response was to require that all swaps be guaranteed by clearinghouses.[12] The so-called "clearing mandate" came to be regarded as one of Dodd-Frank's "most notable provisions affecting the OTC derivatives market,"[13] and even considered by some to be its "biggest win of all."[14] But will Congress's decision to opt for the clearing mandate instead of limiting the Code's exemptions merely shift these disincentives from banks to clearinghouses? Or is there something inherent in the structure of a clearinghouse which can induce more diligent assessment of counterparty risk? And if the answer to this latter question is "yes," are there specific regulatory oversights necessary to preserve that integrity?

This Comment seeks to address each of these questions. To be certain, it may be optimal to limit particular swap exemptions and thereby target the root cause of these disincentives, as some scholars have advocated. However, it is important to survey the capacity of clearinghouses to bolster market discipline in the event that Congress either fails to or delays in addressing that issue. This is especially true because, having recently

---

6. *See infra* Part II.D.

7. Michael Johannes & Suresh Sundaresan, *The Impact of Collateralization on Swap Rates*, 62 J. FIN. 383, 383 (2007).

8. Mark J. Roe, *The Derivatives Players' Payment Priorities as Financial Crisis Accelerator* 63 STAN. L. REV. 539, 552 (2011).

9. *Id.* at 550; *see infra* notes 52–55 and accompany text.

10. *Id.* at 542.

11. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

12. *See id.* § 723(a), 124 Stat. at 1675–81.

13. David S. Huntington, *Summary of Dodd-Frank Financial Regulation Legislation*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (July 7, 2010, 9:15 AM), http://blogs.law.harvard.edu/corpgov/2010/07/07/summary-of-dodd-frank-financial-regulation-legislation/.

14. Matt Taibbi, *Wall Street's Big Win*, ROLLING STONE, Aug. 6, 2010, at 57.

passed Dodd-Frank, Congress may lack a political constituency for reform until the next crisis event.[15]

Part I provides a necessary background for understanding the issues at hand. It begins by orienting the reader with a brief explanation of derivatives. Next, it discusses swaps—a particular class of derivatives not only at the heart of the recent financial crisis, but also subject to certain exemptions from the Bankruptcy Code's normal rules. Finally, it provides a primer on the business of clearing, and discusses Congress's theoretical justifications for the clearing mandate as a response to the recent failure of the swap market.

Part II introduces the Code's exemptions for swaps, and the role they played in the recent financial crisis. It begins by exploring the central justification for the Code, and three bedrock rules which further that justification. It then outlines in detail each of the provisions which exempt swaps from these principles of bankruptcy law. Next, it discusses Congress's justifications for passing these exemptions. Finally, it explains how these provisions reduce market discipline by weakening incentives to hedge against counterparty risk.

Part III explores how a clearinghouse might strengthen market discipline, and thus restore stability to the swap market. It begins by explaining which basic elements of a clearinghouse, and similarly those often extolled by commentators, are not capable of preventing a future AIG-type failure. It then focuses on how a clearinghouse would theoretically have greater incentives to monitor counterparty risk than its individual members. Finally, building upon this framework, it highlights several key issues that regulators should focus on to ensure that clearinghouses do in fact engage in more rigorous market discipline.

I. THE BASICS OF BILATERAL AND CLEARED SWAP MARKETS

This part presents a financial and historical context for the legal issues discussed later in this Comment. It begins by providing a background in the financial instruments that are generally subject to the Code's exemptions, as well as the clearing mandate. In particular, it describes each class of instruments and outlines their uses in the financial system. Additionally, this section places its emphasis on one particular type of swap—the credit default swap—because of its central role in the financial crisis. Finally, it discusses the clearing mandate as a direct policy response to the failure of the swap market.

A. What Is a Derivative?

Stated in the most abstract terms, a derivative is a financial agreement with an economic value dictated by a specified variable,[16] sometimes

15. *See infra* note 188 and accompanying text.

16. *See* Bernard J. Karol, *Regulation of Financial Derivatives: An Overview of Derivatives as Risk Management Tools*, 1 STAN. J.L. BUS. & FIN. 195, 195 (1995) (defining derivatives as "contracts or securities whose values depend on (or 'derive' from) the prices

referred to as the "underlying."[17] Other important features include the notional amount and the outstanding notional amount. The notional amount refers to the number of units of "underlying" specified in the contract.[18] The outstanding notional amount is the "notional amount multiplied by the contract price per unit of underlying."[19]

To illustrate, consider the following example of a derivative with which many readers may be familiar: an options contract.[20] A, the purchaser of the option, pays a specified amount to B, the seller, in consideration for the right (but not obligation) to buy five pounds of hops at $100 per pound. Here, the notional amount is five, the contract price per unit of underlying is $100, and the outstanding notional amount is $500. It is important to see how the value of this option will be "derived" from the current market price of hops (the variable). Consider that the option will only be valuable to A if the current market price of hops is higher than $100 per pound. In that case, A will exercise its option and purchase the hops from B for less than it would have paid on the open market. If, however, the price of hops is below $100 per pound, then the option is worthless to A.

Why might A enter into such an agreement? Derivatives can be used for two essential purposes: hedging against risk and speculating.[21] To illustrate, let us continue with the example of an options contract. Assume that A is a small, local brewer. Because a principal ingredient in beer is hops,[22] brewers are particularly sensitive to changes in their market price. A spike in their price, perhaps owing to a drought in areas where hops are grown (as occurred in 2007[23]), could therefore lead to disastrous consequences for brewers without financial protection.[24] A could insure against this risk by entering into an options contract with B, a hops producer, giving A the right to purchase a certain quantity at a fixed price. A has now insulated himself from price fluctuations by shifting that risk to B.[25]

---

of underlying assets"); *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act, § 610(a)(3), 124 Stat. at 1612 (defining a derivative as "any transaction that . . . is based, in whole or in part, on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities, securities, currencies, interest or other rates, indices, or other assets").

17. *See* Norman Menachem Feder, *Deconstructing Over-the-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677, 681. Feder notes that "[u]nderlyings can be anything that interests markets: cash instruments, like stocks and bonds; tangibles, like commodities; or intangibles, like interest rates, currency rates, stock market indices, and credit quality." *Id.*

18. *See id.* at 683.

19. *Id.* at 683–84.

20. *See* Karol, *supra* note 16, at 195 (defining an "option").

21. *See* Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123, 125 (2010).

22. Tom Bowers, *Trouble Brewing: Price of Hops Hits Home*, SPOKESMAN-REVIEW (Jan. 9, 2008), http://www.spokesmanreview.com/tools/story_pf.asp?ID=226938.

23. *Id.* (noting a resultant six-fold increase in the price of hops, in some instances).

24. *Id.* (predicting the failure of small, local brewers).

25. Feder, *supra* note 17, at 683 ("Importantly, derivatives do not eliminate underlying risk; they only reposition it.").

However, this simple options contract could also be used by A to speculate on the price of hops.[26] Assume that A, now a speculator, has a gut feeling that the Hallertau region of Bavaria[27] will soon experience uncharacteristically low rainfall. In order to capitalize on this prescience, it might purchase an option from B, a hops grower. When the drought does in fact come, there will be a shortage of hops, driving up the price. A can now exercise its option and resell those hops in the market for a large windfall. Moreover, if A believed that there would be a robust growing season and a consequent surplus of hops, it could have also speculated by *selling* options. Assuming A was right and the price did fall below that fixed in the contract, then the option would expire unexercised and A would walk away with a profit from the sale of the option. Thus, parties are capable of speculating on both sides of the transaction.[28]

B. What Is a Swap?

The International Swaps and Derivatives Association defines a "swap" as "[a] derivative where two counterparties exchange streams of cashflows with each other. These streams are known as the legs of the swap and are calculated by reference to a notional amount."[29] This definition will become clearer after reviewing the five most important types of swap agreements below.

Interest rate swaps allow a party to exchange variable interest rate payments for fixed interest rate payments.[30] Why would a company enter into such an agreement? Norman Feder explains its benefits as follows:

> Company A owes $10 million at a floating rate of interest—LIBOR plus 1%—and would like to rearrange its obligation to a fixed rate to give it greater predictability. The company can swap its payment obligations with Bank B. Company A will periodically pay to Bank B a fixed rate of interest—11%—on a notional amount of $10 million, and Bank B will pay to Company A on the same schedule the periodic payments of LIBOR plus 1% on the same notional amount . . . . This neutralizes Company A's market risk in LIBO rates. If Bank B lends money at floating interest rates, the transaction ensures an interest rate spread between what the bank pays and what it obtains.[31]

Thus, Bank A gets greater predictability in the form of a fixed rate liability, and Bank B gets a premium for taking on a variable interest rate. This will

---

26. A speculator buys or sells something so as to profit off of changes in its price, rather than to insure against an underlying risk. *See* BLACK'S LAW DICTIONARY 1529 (9th ed. 2009).

27. The Hallertau region of Bavaria is a famous region for growing hops. *See* MICHAEL JACKSON, ULTIMATE BEER 15 (1998).

28. The practical difference is that the seller is taking a short position on the underlying variable (he is betting that prices will fall), whereas the buyer is taking a long position (he is betting that prices will increase).

29. *Glossary*, INT'L SWAPS & DERIVATIVES ASS'N, http://www2.isda.org/functional-areas/research/Glossary (last visited Nov. 16, 2011).

30. *See* Karol, *supra* note 16, at 200.

31. Feder, *supra* note 17, at 702–03.

be a particularly important risk management tool for Bank A if, like many banks, it has fixed rate assets: the swap allows it to shield itself from the risk that the interest rate on its liabilities will increase, eventually exceeding that of its assets.[32] With $364.378 trillion in notional amount outstanding as of the second half of 2010, interest rate swaps are by far the most significant type of swap.[33]

A currency swap is an "agreement to swap specified payment obligations denominated in one currency for specified payment obligations denominated in a different currency."[34] This allows parties to secure a steady flow of money in a desired currency, mitigating currency risk arising out of volatile foreign exchange markets. Ruth W. Ainslie explains a common use of these instruments:

> A very typical situation is a U.S. corporation that has a subsidiary in Europe and has revenues from Europe. The corporation is going to have Euro cash flow coming in. Now, in the United States, it has to pay its bondholders, and servicing its bondholders is always going to be in dollars. So the corporation will swap those European revenues with a swap counterparty, and get dollars. The dollars then go to the bondholders and the corporation has matched those risks.[35]

If the U.S. corporation had not done so and the euro subsequently collapsed, then income from its subsidiary would buy far fewer dollars on a foreign exchange market. It could therefore find itself struggling to pay off its dollar denominated debt. In the second half of 2010, currency swaps had $19.271 trillion in notional amount outstanding.[36]

Commodity swaps involve the exchange of a fixed payment for a payment based upon the market price of a commodity.[37] This enables both purchasers and sellers of goods to eliminate the risk of price volatility. To illustrate, let us return to our hypothetical brewer. In order to hedge against the risk of an increase in the price of hops, he can agree to pay a bank a fixed amount, in return for the market price of hops multiplied by the notional amount. He can then use these payments to purchase the amount needed to meet production. As of the second half of 2010, there were $1.781 trillion notional amount outstanding in commodity forwards and swaps.[38]

Equity swaps involve the exchange of a payment based upon a specified equity index, share, or basket of shares, for either another payment based

---

32. *See* Wallison, *supra* note 3, at 4.

33. *OTC Derivatives Market Activity in the Second Half of 2010*, BANK FOR INT'L SETTLEMENTS 8 (2011), http://www.bis.org/publ/otc_hy1105.pdf [hereinafter *BIS Report*].

34. BLACK'S LAW DICTIONARY, *supra* note 26, at 1585.

35. Ruth W. Ainslie, *Industry Perspective*, 5 FORDHAM J. CORP. & FIN. L. 14, 15–16 (2000).

36. *See BIS Report*, *supra* note 33, at 8.

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

38. *See BIS Report*, *supra* note 33, at 8.

upon equity prices, or a payment based upon a fixed notional amount.[39] This allows parties to hedge against the risk of equity price volatility. At the end of 2010, equity-linked forwards and swaps constituted $1.828 trillion in notional amount outstanding.[40]

A credit default swap "is nothing more than a contract in which one party (the protection seller) agrees to reimburse another party (the protection buyer) against a default on a financial obligation by a third party (the reference entity)."[41] Thus, the protection buyer has effectively purchased "insurance" against the risk of default on that obligation.[42] Because the issuer of protection is now legally obligated to pay its counterparty for loss on the underlying financial obligation, it may itself wish to purchase protection for all or a part of the notional amount it insured. It can do so by entering into another CDS with a different party, making the original issuer the new protection buyer. The new protection seller may in turn wish to insure himself, and so on. In this scenario, risks of default can be transferred and spread across many different parties, a process known in financial jargon as a "daisy chain."[43] As of the end of 2010, there were $29.898 trillion notional amount outstanding in credit default swaps, making them second only to interest rate swaps in terms of volume.[44]

By operation of the CDS daisy chain, multiple financial institutions are able to mutually reduce their credit risks via diversification.[45] Peter J. Wallison illustrates by using the example of a bank which has made a corporate loan to an oil manufacturer. A drop in oil prices may reduce the creditworthiness of the manufacturer, increasing the risk of default. In order to hedge against this risk, the bank would prefer exposure to assets with either uncorrelated or negatively correlated risks (as the risk of one increases, the risk of the other either is unaffected or decreases, respectively). The bank can do so via a two-step process. First, it can purchase protection on the corporate loan from a CDS dealer, who in turn seeks protection from an insurance company. An insurance company is an ideal choice, as exposure to the oil industry could provide much-needed diversification to its primarily commercial real estate-based portfolio. Next, the original bank issues CDS protection to a hedge fund on a loan made to auto dealers, a negatively correlated risk to the oil industry.[46] As a result of this series of CDS transactions, both the bank and the insurance company have balanced their portfolios and decreased their own credit risk. Thus, CDSs can be an extraordinarily valuable risk management tool.[47]

---

39. *See* Feder, *supra* note 17, at 706.

40. *See BIS Report*, *supra* note 33, at 8.

41. *See* Wallison, *supra* note 3, at 3. Thus, the performance of the financial obligation is the underlying variable from which the value of the CDS is derived.

42. *Id.*

43. *Id.*

44. *See BIS Report*, *supra* note 33, at 8.

45. *See* Wallison, *supra* note 3, at 6.

46. As oil becomes more expensive, demand for cars decreases, and vice versa.

47. In addition to this hedging function, CDSs are frequently used for speculation—just like any other derivative. Michael Greenberger, *Out of the Black Hole: Regulatory Reform*

It is helpful briefly to highlight how these CDS transactions are structured. As Wallison notes, "The CDS market is a dealer market, so transactions take place through dealers, over the counter rather than on an exchange."[48] Thus, derivatives are negotiated bilaterally in accordance with parties' particular needs, as opposed to on an exchange, which requires a much higher degree of standardization.[49] The seller of protection is typically required to post collateral to secure its performance.[50] Additionally, the contract will often contain a provision which requires the posting of additional collateral if a materially adverse event should occur, such as a decline in the credit rating of the reference entity, or the counterparty to the CDS agreement itself.[51] The price of the CDS is dictated by the creditworthiness of the underlying reference entity.[52] If the risk of default increases, then sellers of protection will demand higher premium payments—known as the CDS's spread—to compensate for this additional risk.[53] If the risk of default decreases, then buyers can bargain for a lower cost of protection.

CDSs were a principal device for insuring investments in the subprime mortgage market.[54] Although the securitization process is beyond the scope of this Comment, it will suffice to note that the process worked by offering protection on mortgage-backed securities, which were in turn secured by home mortgages.[55] From the perspective of issuers of

of the Over-the-Counter Derivatives Market, ROOSEVELT INST. 101 (2009), http://www.rooseveltinstitute.org/sites/all/files/OTC%20Derivatives.pdf. To illustrate, in 2008 three in every four CDSs were "naked," that is, not insuring against the default of an underlying loan owned by a party to the swap agreement. *See id.* This practice would have been illegal under state insurance law as insuring someone else's risk. *See id.*

48. Wallison, *supra* note 3, at 3. Precisely why these transactions have tended to take place over-the-counter (OTC) rather than on an exchange is a fascinating question. *See, e.g.*, Karol, *supra* note 16, at 199 (listing the primary benefits of OTC products as providing confidentiality, avoiding position limits and margin requirements, and allowing for customization); Wallace C. Turbeville, *Derivatives Clearinghouses in the Era of Financial Reform*, ROOSEVELT INST., 8 (Oct. 24, 2010), http://www.rooseveltinstitute.org/sites/all/files/wallace_clearinghouse.pdf (noting that financial institutions can utilize a line of credit in lieu of collateral, which is "much more lucrative than straightforward corporate lending," and that the line of credit is not reported in the same manner as direct lending, and thus end users' balance sheets appear more healthy). Prior to the enactment of the Commodity Futures Modernization Act of 2000, codified at 7 U.S.C. § 1 (2006), some types of derivatives were required to be traded on exchanges overseen by the Commodity Futures Trading Commission. *See* Greenberger, *supra* note 47, at 99–100.

49. *See* Karol, *supra* note 16, at 199.

50. Wallison, *supra* note 3, at 3. Under certain circumstances, buyers of protection may also have to post collateral to ensure they continue to make premium payments. *Id.*

51. *Id.* at 3, 7.

52. *See id.*

53. *See* VIRAL ACHARYA ET AL., RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM (2009). When the creditworthiness of the reference entity changes after the CDS has been executed, one of the parties will be getting a windfall, known as being "in the money"; if the creditworthiness increases, then the buyer is paying more for protection than he could purchase on the open market, known as being "out of the money." *See* Wallison, *supra* note 3, at 3.

54. *See* Greenberger, *supra* note 47, at 100.

55. *See id.*

protection such as AIG, CDSs were viewed as a cheap source of additional revenue, with little to no risk of payouts.[56] This business model proved to be catastrophically misplaced as the real estate market collapsed in 2007. In September 2008, AIG's credit rating was downgraded due to its large CDS exposure, triggering concerns over the insurer's creditworthiness.[57] As a response, counterparties began demanding collateral en masse as CDS spreads sky-rocketed.[58] Eventually, AIG was no longer able to meet these collateral calls, prompting an $85 billion government bailout shortly thereafter.[59] This sequence of events was a primary factor in motivating Congress to require all swaps to be cleared as part of Dodd-Frank.[60] The next section discusses the function of clearing and precisely why its proponents believe so strongly that it might prevent a similar collapse in the future.

C. The Business of Clearing

The essential purpose of a clearinghouse is to shield its members from counterparty risk.[61] Clearinghouses enter into bilateral contracts with the parties on both sides of a swap transaction, acting as a "middleman" who buys the financial product from one party and sells it to another. Consequently, the clearinghouse itself bears the costs of a party's default, rather than its members.

As an initial matter, it is important to note that this organization does not eliminate any risk per se.[62] On the contrary, "[f]rom the perspective of market participants, the credit risk of the [clearinghouse] is substituted for the credit risk of the other participants."[63] A clearinghouse, just like an individual firm in a bilateral transaction, might be managed poorly or experience a series of unfortunate events, causing it to become insolvent and default on its obligations. But if the structure of a clearinghouse does not itself eliminate any risk, then why do its proponents favor it?

---

56. *See id*. at 101.

57. *AIG Hit with Downgrades to Debt Ratings*, CBS NEWS (Sept. 16, 2008), http://www.cbsnews.com/stories/2008/09/16/business/main4452015.shtml.

58. *U.S. Announces $85 Billion Bailout of AIG*, CBS NEWS (Sept. 16, 2008), http://www.cbsnews.com/stories/2008/09/16/business/main4453942.shtml.

59. *See id*.

60. *See, e.g.*, S. REP. NO. 111-176, pt. 2, at 29–31 (2010) (discussing AIG's failure as a basis for the clearing mandate).

61. Kirsi Ripatti, *Central Counterparty Clearing: Constructing a Framework for Evaluation of Risks and Benefits* 9 (Bank of Finland Discussion Papers, Dec. 30, 2004), *available at* http://129.3.20.41/eps/fin/papers/0508/0508021.pdf.

62. Turbeville, *supra* note 48, at 2 ("The first thing to know about clearing is that it does not eliminate any risk. In fact, it *concentrates* the credit risk inherent in derivatives transactions." (emphasis added)).

63. Ripatti, *supra* note 61, at 9; *Credit Default Swaps, Clearinghouses, and Exchanges* 3 (Council on Foreign Relations, Squam Lake Working Group on Financial Regulation Paper, July 2009), http://i.cfr.org/content/publications/attachments/Squam_Lake_Working_Paper5.pdf [hereinafter *Squam Lake Working Paper*] ("Once the swap is cleared, the original counterparties are insulated from direct exposure to each other's default, and rely instead on the performance of the clearinghouse.").

The answer lies in the fact that clearinghouses theoretically offer efficiency gains and possess tools enabling them to limit potential losses.[64] First, centralization of transaction processing and risk management offers substantial efficiency gains.[65] "[H]igh-volume, developed markets," such as the United States, typically benefit from delegating these tasks to a central, specialized institution.[66] For example, "the internationalisation of securities trading, the introduction of new electronic platforms and the switch to order-driven anonymous trading systems in national stock exchanges have made it increasingly impossible for trading parties to control counterparty risk themselves."[67] Thus, it may be inefficient, if not impracticable, for individual firms to monitor the creditworthiness of each of their counterparties.[68] Many believe that these informational deficiencies had systemic consequences during the most recent financial crisis: "Lack of transparency in the massive OTC market intensified systemic fears during the crisis about interrelated derivatives exposures from counterparty risk. These counterparty risk concerns played an important role in freezing up credit markets around the failures of Bear Stearns, AIG, and Lehman Brothers."[69] A similar, although more mundane, concern is that clearinghouses "generally offer straight-through processing facilities aimed at reducing back-office bottlenecks"[70] that have been observed at dealer firms.[71]

Second, the ability to multilaterally net exposures by offsetting position values ("netting") is a primary benefit of clearinghouses.[72] Netting essentially means that claims can be offset against liabilities, resulting in one "net" liability.[73] Let us first consider the benefits of bilateral netting. Assume that A owes B $50, and B owes A $100. If A defaulted on its obligation to B, netting would allow B to offset this claim against its liability to A, resulting in one net liability of $50. Therefore, B has limited its loss in the event of the default. This device has been widely adopted by OTC derivatives dealers.[74]

---

64. *See* Ripatti, *supra* note 61, at 16 ("The primary force behind the creation of [clearinghouses] is the economic interest of capital market participants in lowering the market-side risks and costs of post-trade processing.").

65. *OTC Derivatives: Settlement Procedures and Counterparty Risk Management*, BANK FOR INT'L SETTLEMENTS 26 (1998), http://www.bis.org/publ/ecsc08.htm [hereinafter *Counterparty Risk Management*].

66. Ripatti, *supra* note 61, at 13.

67. *Id.* at 17.

68. *See id.* at 19 ("This does not mean that [clearinghouses] eliminate counterparty credit risk; they rather manage and redistribute it far more efficiently than market participants could do in isolation.").

69. S. REP. NO. 111-176, pt. 2, at 30 (2010).

70. *See* Ripatti, *supra* note 61, at 18.

71. *See generally Counterparty Risk Management*, *supra* note 65 (discussing deficiencies in the settlement and risk management processes of individual dealer firms).

72. *Squam Lake Working Paper*, *supra* note 63, at 3.

73. *Counterparty Risk Management*, *supra* note 65, at 37 ("In effect, multilateral netting allows the clearing members to offset their net liabilities to some members against their net claims on other members.").

74. *See id.* at 2.

The benefits of bilateral netting are limited to situations where claims are against—and liabilities are owed to—the same party. Multilateral netting, by contrast, allows for exposures to one party to be offset against exposures to a different party.[75] To illustrate its advantages, consider the following hypothetical from the Squam Lake Working Group on Financial Regulation:

> Suppose, to pick an ideal example, that Dealer A has an exposure on credit derivatives to Dealer B of $ 1 billion, before considering collateral. That is, if Dealer B fails, then A would lose $ 1 billion. Likewise, B has an exposure to Dealer C of $ 1 billion, and C has an exposure to A of $ 1 billion. Without a clearinghouse, default by A, B, or C leads to a loss of $ 1 billion. With clearing, however, the positive and negative exposures of each counterparty cancel, and each poses no risk to anyone, including the clearinghouse.[76]

In other words, because the clearinghouse is a counterparty to all trades, it can offset its claim against a defaulting clearing member with any amount still owed to that clearing member. As a practical matter, this means that the clearinghouse is fully repaid to the extent of that offset amount. Thus, multilateral netting can result in fewer overall losses.[77]

Additionally, the advantages of bilateral netting are "limited by systems constraints, such as incomplete systems integration, that make it difficult for dealers to calculate and administer net payments."[78] Clearinghouses could offer a solution to this problem by institutionalizing settlement procedures and risk management. Just how effective can netting be? One study found that bilateral netting provisions decreased total credit exposure by 20 to 60 percent.[79] For reasons discussed above, one would expect these benefits to be greater if netting occurred through a central clearinghouse.

---

75. *Squam Lake Working Paper*, *supra* note 63, at 3.

76. *Id.*

77. This raises important questions: how many clearinghouses should there be, and how many different types of contracts should they clear? Commentators note that if there are many clearinghouses clearing a limited number of contracts, then the benefits of multilateral netting will be minimal. *See Counterparty Risk Management*, *supra* note 65, at 6; *Squam Lake Working Paper*, *supra* note 63, at 4 ("[I]mportant opportunities to net offsetting credit default swaps may be lost if clearing is scattered across several institutions."). *But see* Turbeville, *supra* note 48, at 14 (noting that if clearinghouses were also forced to clear products with "unpredictable illiquidity and volatility" and management systems did not work properly, then "the consequences could be even worse"). Thus, the optimal size of a clearinghouse is itself a crucial question.

78. *Counterparty Risk Management*, *supra* note 65, at 2.

79. *Id.* at 2. However, the study proceeded to note the limits of bilateral netting as a risk management device:

> Despite the widespread use of bilateral netting, OTC derivatives have become a significant source of credit exposures between the global financial institutions that are the largest dealers. Consequently, if a major global financial institution were to fail, losses to other dealers on OTC derivatives would be a potential channel for the transmission of systemic disturbances.

Id. at 5. This report was written in 1998, one decade before these concerns were eventually realized.

An additional benefit of netting is that it can promote liquidity. Members would only be required to post collateral on their net, as opposed to gross, exposures.[80] The Squam Lake Working Group on Financial Regulation notes that as a result, "clearinghouses reduce . . . the demand for collateral, a precious resource, especially during a financial crisis."[81] In other words, netting might be able to ease liquidity pressures by allowing for more efficient use of collateral.

Third, some commentators have asserted that clearinghouses employ methods and systems for managing counterparty risk that are superior to those used by dealers.[82] To understand this assertion, it is necessary first to explore the nature of counterparty risk in the swap market, and how the tools used by clearinghouses manage those risks.

The practical consequence of a counterparty default is that a clearinghouse must go out onto the market and purchase a replacement contract.[83] In so doing, the clearinghouse stands to suffer a loss if the price of the contract is now higher than the original purchase price.[84] The risk of this loss is referred to as "mark-to-market risk."[85] Clearinghouses protect against these losses by requiring members to post collateral, or "margin" in clearing jargon.[86] In particular, a clearinghouse uses two different devices: maintenance margins and initial margins.[87]

---

80. *See Squam Lake Working Paper*, *supra* note 63, at 3.

81. *Id.*; *see also Counterparty Risk Management*, *supra* note 65, at 38 (noting that multilateral netting of derivatives could promote liquidity); Turbeville, *supra* note 48, at 2 ("There are certain netting benefits that require less cash margin than bi-lateral transactions that are subject to full collateralization of credit risks.").

82. *See, e.g.*, Turbeville, *supra* note 48, at 2 ("Clearinghouses manage credit risk using proven methods and systems which are uniform and virtually always superior to that which can be achieved by individual trading firms.").

83. *Id.* at 1 (defining the credit risks in a derivatives trade as the risk that a replacement contract will be more expensive). As previously discussed, the clearinghouse is legally obligated to the non-defaulting party to perform the terms of the original contract. *See supra* notes 63–65 and accompanying text. Thus, if one party defaults, they must purchase a replacement so as to remain "balanced, with mirror image derivative transactions . . . at all times." Turbeville, *supra* note 48, at 10.

84. *Id.* at 5. This is because, unlike a real middleman who tries to sell his good at a premium, the price at which the clearinghouse purchases the financial instrument is (hopefully) the price at which it sells it. Thus, if the price of the replacement contract is higher than the original price, the clearinghouse is experiencing a loss by having essentially sold the contract at a discount.

85. *Id.* at 1.

86. *Id.* at 5.

87. *Id.* at 9; s*ee also Credit Default Swaps and Counterparty Risk*, EUR. CENT. BANK 52–53 (2009), *available at* http://www.ecb.int/pub/pdf/other/creditdefaultswapsandcounterpartyrisk2009en.pdf. Clearinghouses also maintain a default fund to protect against these losses, with members contributing funds based on their transaction volume. However, these default funds are generally inadequate to cover the sorts of systemic losses that occurred during the recent financial crisis. As an example, the Chicago Mercantile Exchange maintains a default fund of about $2 billion. By contrast, the average daily change in its risk is $3 billion (that is, the additional amount needed to cover losses), and has at times reached in excess of $18.5 billion. *Id.*

Maintenance margins are called as the price of the swap increases, thus covering mark-to-market risk. Wallace C. Turbeville describes the operation of maintenance margins as follows:

> As the price associated with a derivative moves so as to create clearing member credit risk to the clearinghouse, the amount of that risk has to be funded by the clearing member. If the price subsequently moves in the opposite direction, maintenance margin is reduced and the clearing member receives a credit. A clearing member is very likely to have some derivatives which move in its direction and some which move against it during any calculation period. These movements are netted and the required maintenance margin payment (or credit) is the netted amount.[88]

Maintenance margins are typically calculated on a daily basis, although intraday margins may be called if necessary.[89] So long as the deposited margin could keep up with price changes, the clearinghouse would be fully protected against any default, and it would experience no losses.[90]

However, this ideal situation is unlikely to occur. Maintenance margins are most likely based on the previous day's prices, which are unlikely to have remained the same.[91] Moreover, markets may react adversely to the member's default, further affecting prices.[92] The risk that prices have risen since the last call for maintenance margin is known as illiquidity/volatility risk.[93] Clearinghouses protect against it by requiring that parties post initial margin.[94] As one might have inferred, initial margin is the clearinghouse's estimate of price moves between the time when maintenance margin is posted and when the contract could hypothetically be replaced.[95] In the end, because initial margin is calculated based upon historical data, the ability of a clearinghouse to hedge this residual risk is dictated by the accuracy of past observations in predicting future price changes.[96]

How does this system compare to that employed by dealers in the bilateral, OTC market? In 1999, dealers with the most sophisticated systems collateralized only 10 to 30 percent of derivatives transactions.[97] A majority of those collateralization agreements provided for daily recalculation of exposure and collateral values, but as a practical matter "many call[ed] for collateral only weekly or monthly."[98] Although practices changed significantly over the following decade, still only 63

88. Turbeville, *supra* note 48, at 9.
89. *Id.*
90. *Id.* at 8. This assumption is addressed at greater length in Part III.
91. *Id.* at 10.
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.* at 11.
97. *Counterparty Risk Management*, *supra* note 65, at 22.
98. *Id.* at 23. The report noted that collateral calls "add to [dealers'] legal and operational risks." *Id.* In other words, it was burdensome to make and process these calls, and dealers were not always sure of the enforceability of terms providing for collateral calls, particularly in foreign jurisdictions and where the counterparty had entered bankruptcy.

percent of CDSs were collateralized by 2008.[99] It is perhaps for this reason that the staunchest proponents of clearing have asserted that clearinghouses will ensure capital adequacy if managed properly.[100] This contention is revisited in Part III.

Finally, as evidenced by the legislative record, Congress believed that cleared transactions would impose fewer external costs on the financial system than if agreements were negotiated bilaterally. In its report in support of the clearing mandate, the Senate Committee on Banking, Housing, and Urban Development noted that "[i]n the OTC market, margin requirements are set bilaterally and do not take account of the counterparty risk that each trade imposes on the rest of the system, thereby allowing systemically important exposures to build up without sufficient capital to mitigate associated risks."[101] Viral Acharya and Alberto Bisin specifically attribute this "counterparty risk externality"[102] to the opacity of the OTC market, which leaves parties unable to properly price default risk without adequate information regarding their counterparty's other positions.[103] Because a central clearing party records all of a party's trades, they are much better placed to price that risk, and require efficient levels of collateral.[104]

II. THE DESTABILIZING EFFECTS OF THE BANKRUPTCY CODE'S EXEMPTIONS FOR SWAPS

Thus far, this Comment has confined its inquiry to the basic uses of swaps in the financial system, and the accompanying risks of counterparty default. As noted above, those risks materialized during the recent financial crisis to create massive losses and prompt a federal bailout. This part introduces the following question: how, if at all, were these losses affected by a change in the underlying bankruptcy rules to which swaps are subject? To answer this question, it reviews scholarship showing how these rules decreased incentives to monitor counterparty risk in the bilateral OTC market, thereby increasing overexposure to weak, systemically important institutions such as AIG.

This part begins by exploring three of the bedrock principles of the Bankruptcy Code: the automatic stay, limits on preferential transfers, and

99. Wallison, *supra* note 3, at 7.

100. *See, e.g.*, Greenberger, *supra* note 47, at 105 (arguing that a "well capitalized and federally supervised" clearinghouse would act as "protection against a lack of creditworthiness of, and default by, OTC derivatives counterparties").

101. S. REP. NO. 111-176, pt. 2, at 33 (2010); *see also* ACHARYA ET AL., *supra* note 53 (same).

102. Acharya and Bisin define this as "the effect that the default risk on one contract will be increased if the counterparty agrees to the same contract with another agent because the second contract increases the probability that the counterparty will be unable to perform on the first one." *See* Viral Acharya & Alberto Bisin, *Counterparty Risk Externality: Centralized Versus Over-the-Counter Markets* 4 (June 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573355.

103. *See generally id.*

104. *See id.* at 5.

the invalidation of ipso facto clauses. The purpose of this discussion is to highlight the rules to which creditors are generally subject, so the reader can get a sense of precisely how and to what extent swap exemptions confer a privileged status. Next, it addresses the substance of the exemptions themselves, with an emphasis on their practical significance for swap participants. It then highlights some of the policy justifications for these provisions. Finally, it shows how bankruptcy privileges promote financial instability by reducing incentives to monitor counterparty risk.

A. The Bankruptcy Code's Normal Provisions

Professor Thomas H. Jackson once wrote: "The basic problem that bankruptcy law is designed to handle, both as a normative matter and as a positive matter, is that the system of individual creditor remedies may be bad for the creditors *as a group* when there are not enough assets to go around."[105] To illustrate Professor Jackson's insight, consider a world in which no bankruptcy law existed. If debtors remained solvent, every creditor would be paid in full. However, when a debtor had liabilities in excess of assets, at least some creditors would by necessity experience some loss. In such a regime, creditors would be paid on a first-come, first-served basis.[106] As a result, creditors acting out of rational self-interest would scramble to seize their share of the debtor's limited assets before nothing was left.[107]

However, for a number of reasons, this process might not be desirable from the perspective of creditors as a class. For example, the debtor's business might be worth more in one piece than the sum of its individual assets.[108] If creditors liquidated the business piece by piece, they would not be able to capture this additional value. Bankruptcy law is therefore a

---

105. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 10 (1986). In this sense, bankruptcy law seeks to solve a "tragedy of the commons," with the debtor's estate being the common pool and individual creditors as the "users" of that resource. *See id.* at 10–12.

106. *See id.* at 9.

107. *Id.* Professor Thomas H. Jackson analogizes this to concertgoers lining up to purchase tickets: "the people first in line get the best seats; those at the end of the line may get nothing at all." *Id.*

108. This attribute is known technically as "the surplus of a going-concern value over a liquidation value." *Id.* at 14. Professors Franklin R. Edwards and Edward R. Morrison discuss this point further:

> [Going-concern value] exists, however, only if the firm's assets are worth more to the firm than to outsiders. This asymmetry arises when assets are customized to meet a firm's idiosyncratic needs or the needs of firms in the same industry (examples include airplanes, railroad tracks, and brewery equipment). These specialized assets cannot be readily redeployed by other firms (if the assets are firm-specific) or by firms outside the industry (if they are industry-specific). As a result, plant, equipment, and other specialized assets are relatively illiquid: there are few buyers for the assets, and any potential buyers will value the assets significantly less than the seller does.

Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 111 (2005).

collectivized debt collection system that imposes rules on creditors so as to benefit this class in the aggregate.[109]

This section explores three of the Bankruptcy Code's bedrock rules that further this principal goal. In particular, it addresses the automatic stay,[110] the avoidance of preferential transfers,[111] and the invalidation of ipso facto clauses.[112] However, as will be seen later in this Part, the Code exempts creditors to swap agreements from each of these three rules. This privileges them vis-à-vis the debtor's other creditors, and likely causes them to monitor counterparty risk less rigorously.

1. The Automatic Stay

The automatic stay, codified at 11 U.S.C. § 362, acts as a "bar to all judicial and extrajudicial collection efforts against the debtor or the debtor's property."[113] It comes into effect upon the filing of a bankruptcy petition.[114] This rule serves an important function for creditor protection. As noted above, the debtor's estate presents a common resource problem. Allowing creditors to line up and dismember the debtor piece by piece would in many situations be undesirable from the perspective of creditors as a class.[115] The automatic stay directly prevents creditors from engaging in this sort of conduct.[116]

It is important to note that the automatic stay is also effective against secured creditors.[117] In other words, once the debtor files for bankruptcy, the automatic stay prevents the secured creditor from seizing its collateral. One might ask: if secured creditors already have priority in certain assets of the debtor—as swap participants do once their counterparties post collateral[118]—then why can they not promptly proceed against those assets to satisfy their claims? The answer lies in the fact that the collateral, although subject to a security interest, may be essential to the debtor's

109. *See* JACKSON, *supra* note 105, at 14. Professor Jackson notes that preserving "the aggregate value of the assets" is only the most "obvious reason" for a collectivized debt collection system; there are other significant benefits as well. *Id.* For example, creditors may prefer a guaranteed collection, even at a deficiency, rather than risk losing the race and getting paid nothing at all. *See id.* at 15. Moreover, such races for the debtor's assets can be wasteful in and of themselves. *See id.* at 16.

110. *See* 11 U.S.C. § 362(a) (2006).

111. *See id.* § 547(b).

112. *See id.* § 365(e)(1).

113. BLACK'S LAW DICTIONARY, *supra* note 26, at 1548.

114. *See* § 362(a) (noting that the petition itself "operates as a stay"); 3 COLLIER ON BANKRUPTCY ¶ 362.LH[3] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).

115. *See supra* notes 108–09 and accompanying text.

116. The legislative history of the automatic stay confirms this as an underlying policy justification: "Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of their claims in preference to and to the detriment of other creditors." H.R. REP. NO. 95-595, at 340 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6297.

117. § 362(a)(5) (stating that the stay is applicable to "any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title").

118. *See* Lubben, *supra* note 21, at 126.

operations and thus its ability to reorganize. In other words, proceeding against the collateral creates an externality: "Removal of collateral benefits the secured creditor but harms other creditors by destroying firm value."[119] Absent the automatic stay, the secured creditor would ignore this external cost and proceed against the collateral anyway.[120] Therefore, the automatic stay as applied to secured creditors still benefits creditors as a class.

2. Avoidance of Preferential Transfers

Preferential transfers are payments made by an insolvent debtor to or for the benefit of a creditor *prior* to bankruptcy, enabling that creditor to receive more than it would have in the bankruptcy proceeding.[121] Section 547(b) of the Code gives the trustee in bankruptcy the power to avoid such transfers.[122] Note that the provision makes no reference to the creditor's or debtor's intent—only the transaction's effect upon other creditors is significant.[123]

The effect of a preferential payment is, of course, to benefit one particular creditor at the expense of the debtor's other creditors. Professor Jackson notes that, consequently, a preferential payment

> would not be in the collective interest of the creditors because it reintroduces the common pool problem. Preference law is best viewed as a solution to this replication of the common pool problem that results

---

119. Edwards & Morrison, *supra* note 108, at 107.

120. *See id.* at 17–18. Professor Jackson and Professor Douglas G. Baird further elaborate on this point:

> Individual diverse owners have a particular incentive to act against the collective interest in cases where, under nonbankruptcy law, some owners are entitled to be paid before others and where the available assets are insufficient to satisfy all those with rights to them. A fully secured creditor, for example, has the right to be paid before more junior creditors receive anything. Like any other person assured of full payment if the business were to stop, he will tend to favor an immediate liquidation, even in circumstances in which a sole owner would keep the assets together. As a senior debtholder he has nothing to gain from waiting and attempting to keep the firm intact, but he can do worse if the firm continues and its fortunes decline—a possibility that always exists in an uncertain world, whether the firm is solvent or insolvent, in or out of bankruptcy.

Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 106–07 (1984).

121. § 547(b) defines as preferential

> any transfer of an interest of the debtor in property—
> (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made . . . on or within 90 days before the date of the filing of the petition . . . (5) that enables such creditor to receive more than such creditor would receive if—(A) the case were a case under Chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

§ 547(b).

122. *Id.*

123. 5 COLLIER ON BANKRUPTCY, *supra* note 114, ¶ 547.03; *see also* Kenan v. Fort Worth Pipe Co., 792 F.2d 125, 127 (10th Cir. 1986) (noting that the basis for exceptions to § 547(b) is that such instances are not "deemed harmful to the debtor's estate").

> from strategic planning in the prebankruptcy period. Preference law, therefore, is essentially a transitional rule designed to prevent individual creditors from opting out of the collective proceeding once that event becomes likely. It is part of the attempt to ameliorate the effects of a common pool problem that justifies a collective proceeding in the first place.[124]

It is therefore necessary to keep bankruptcy a system of collectivized debt collection. Without it, creditors would be able to get in line ahead of others, leaving nothing for those late in the game.

3. Prohibition of Ipso Facto Clauses

An ipso facto clause stipulates the contractual effect of a party entering into bankruptcy.[125] These clauses typically allow a party to terminate a contract when its counterparty files for bankruptcy.[126] *In re Clerc Chemical Corp.*[127] provides a classic example of an ipso facto clause, as well as courts' hesitancy to enforce such clauses even before the Bankruptcy Code was enacted. In *Clerc Chemical*, Reilly Tar & Chemical Corporation leased property to Frederick D. Loeb.[128] The lease contained an ipso facto clause, providing:

> If the Lessee shall be adjudicated a bankrupt, file a voluntary petition in bankruptcy, make a general assignment for the benefit of creditors, or if a receiver of its properties and assets shall be appointed, then and in that event the Lessor shall have the option to terminate this lease . . . .[129]

Thereafter, Loeb assigned the lease to Clerc Chemical, a corporation he had formed.[130] Two years later Clerc Chemical filed a bankruptcy petition, and Reilly Tar & Chemical exercised its option to terminate the lease.[131]

Notwithstanding a clause that bound the assignee to the "terms, covenants, conditions and agreements" of the original lease, and the fact the assignee was the original lessee's own corporation, the court held that the ipso facto clause was not binding against Clerc Chemical.[132] The court began by noting that "[f]orfeitures are not favored either at law or in equity," and that "a provision for a forfeiture in a lease will be construed strictly in favor of the tenant."[133] It then proceeded to base its holding on the fact that there were no express words binding the assignee to the ipso facto clause.

---

124. JACKSON, *supra* note 105, at 125.

125. *See* BLACK'S LAW DICTIONARY, *supra* note 26, at 905 (defining an ipso facto clause as a "contract clause that specifies the consequences of a party's bankruptcy").

126. *See* 3 COLLIER ON BANKRUPTCY, *supra* note 114, ¶ 365.08[1].

127. 52 F. Supp. 109 (D.N.J. 1943).

128. *See id.* at 109.

129. *Id.*

130. *See id.*

131. *See id.*

132. *See id.* at 109–10.

133. *Id.* at 110 (quoting *In re* Larkey, 214 F. 867, 870 (D.N.J. 1914)). A forfeiture clause is a "contractual provision stating that, under certain circumstances, one party must forfeit something to the other." BLACK'S LAW DICTIONARY, *supra* note 26, at 722.

Clerc Chemical aptly demonstrates courts' distaste for enforcing ipso facto clauses because of their potential to cause forfeitures. Additionally, courts failed to enforce these clauses "in order to allow the trustee to make the most of any valuable asset in the estate."[134] Although *Clerc Chemical* did not explicitly invoke this latter justification, the facts of the case illustrate the underlying policy: if Clerc Chemical was permitted to stay on the property, they could have continued to do business and generated revenue to satisfy creditors' claims. With a forfeiture, it would have been entirely deprived of this opportunity.

Prior to the passage of the Bankruptcy Reform Act of 1978, such clauses were generally enforceable.[135] The Reform Act reversed this rule and codified cases like *Clerc Chemical*.[136] Stated simply, contractual provisions that provide for modification or termination of the contract in the event of insolvency,[137] bankruptcy,[138] or the appointment of a receiver or custodian[139] are void.

B. Provisions Exempting Derivatives

When the Bankruptcy Code was first enacted in 1978, it accorded special status to a narrow class of financial transactions and actors.[140] Over the next twenty-five years, Congress greatly expanded both the scope and number of these exemptions from the Code's ordinary provisions, eventually reaching swap agreements.[141] As noted above, the automatic stay, avoidance of preferential transfers, and the invalidation of ipso facto clauses operate by limiting the enforceability of certain contractual provisions when the debtor enters bankruptcy. The Code privileges swaps by exempting them from these limitations on creditor conduct.[142] Stated conversely, it accords these creditors much more freedom to contractually protect themselves from a debtor's insolvency.[143] Below is an overview of

134. 3 COLLIER ON BANKRUPTCY, *supra* note 114, ¶ 365.08; *see also* Yates Dev., Inc. v. Old Kings Interchange, Inc., 241 B.R. 247, 253 (Bankr. M.D. Fla. 1999) ("These termination clauses are invalidated because they deprive the Chapter 11 estate of valuable property rights, such as the opportunity to receive the benefits of a contract, at the very time the debtor and the estate may need these rights the most in order to further rehabilitation efforts.").

135. 3 COLLIER ON BANKRUPTCY, *supra* note 114, ¶ 365.08.

136. 11 U.S.C. § 365(e)(1) (2006).

137. *See* § 365(e)(1)(A).

138. *See* § 365(e)(1)(B).

139. *See* § 365(e)(1)(C).

140. *See* 11 U.S.C. § 764(c) (Supp. II 1979).

141. *See* Edwards & Morrison, *supra* note 108, at 96.

142. Roe, *supra* note 8, at 548 ("Bankruptcy sticklers may object to calling these *priority* provisions and they are formally correct . . . . The derivatives and repo benefits operate by exempting the bankrupt's derivatives- and repo-holding creditors from baseline rules . . . insulating them from typical creditor liability rules . . . and giving them more rights.").

143. *See* Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 645 (2005) ("These limits on counterparty rights, however, do not apply when the underlying contract is a financial contract and the counterparty is a

the relevant statutory provisions, and their significance for creditors. As will be seen, swap privileges essentially fall into three categories: rights to seize collateral, rights to setoff, and the avoidance of liability for preferential transfers.

Almost all swap agreements provide that the commencement of a bankruptcy proceeding constitutes an event of default, giving rise to certain remedial rights.[144] Of these, the Code protects the rights to liquidate, terminate, and accelerate the agreement, and the right to offset and net claims.[145] Furthermore, 11 U.S.C. § 362(b)(17) creates an exception to the automatic stay for exercise of contractual rights arising out of security and netting agreements.[146] Taken together, these provisions give parties to swap agreements a material advantage over the debtor's other creditors in the event of insolvency, increasing both the amount and timeliness of their recovery.

To illustrate, consider first secured creditor rights. As discussed previously in Part I.C, parties to swap agreements often make collateral calls in an effort to secure their counterparty's obligations, and that doing so creates a secured claim.[147] Normally, the automatic stay would prevent a secured creditor from foreclosing against its collateral once the debtor enters bankruptcy.[148] Sections 560 and 362(17) are exceptions to this rule, specifically providing that the rights of secured creditors to swap agreements are unaffected by the filing of a petition.[149] Because initiating a bankruptcy proceeding almost always constitutes an event of default in a swap agreement, the practical consequence is that the creditor can terminate an unfavorable contract with the debtor and immediately seize the posted collateral.[150]

Collier on Bankruptcy describes the right to setoff as follows:

> Setoff is a right of equitable origin designed to facilitate the adjustment of mutual obligations. Its central premise is an ancient one well-grounded in practical logic: If A is indebted to B, and B is likewise indebted to A, it

'protected party.' *Protected parties enjoy the same rights in bankruptcy as they do outside*." (emphasis added)); *see also* 5 COLLIER ON BANKRUPTCY, *supra* note 114, ¶ 560.04[2] (noting that termination and acceleration rights are furnished not by the Code itself, but by "a written agreement or other document, such as a customer agreement, master agreement or the terms and conditions printed on a confirmation of the transaction").

144. 5 COLLIER ON BANKRUPTCY, *supra* note 114, ¶ 560.04.

145. *See* 11 U.S.C. § 560 (2006); *see also* 5 COLLIER ON BANKRUPTCY, *supra* note 114, ¶ 560.04 .

146. 11 U.S.C. § 362(b)(17); *see also id.* § 362(b)(27) (giving similar privileges to "a master netting agreement participant"); *id.* § 362(o) (providing that these rights may not be stayed by "any order of a court or administrative agency in any proceeding under this title."). Collier on Bankruptcy explains the inclusion of § 362(o) as follows: "This provision was added by the 2005 Act to make clear that the protections afforded by section 362(b)(17) . . . cannot be circumvented by an injunction issued pursuant to section 105(a)." 5 COLLIER ON BANKRUPTCY, *supra* note 114, ¶ 560.05 n.7.

147. *See* Lubben, *supra* note 21, at 126.

148. *See generally supra* Part II.A.

149. *See* §§ 362(b)(17), 560.

150. *See* Roe, *supra* note 8, at 548.

> makes sense simply to apply one debt in satisfaction of the other rather than require A and B to satisfy their mutual liabilities separately.[151]

Such is commonly used by swap participants to limit credit exposure in the form of bilateral netting, as noted in Part I.C. These rights are important to creditors for several reasons. First, setoff allows the creditor to avoid handing money over to the debtor that it otherwise would. Second, setoff effectively means that the creditor's claim is secured by its own debt: the creditor will be paid first out of the debtor's claim on it, up to the amount of that claim.[152] Thus, this priority enables it to recover more than the debtor's other creditors.[153]

Finally, in addition to the setoff and secured creditor rights discussed above, the Code also exempts parties to swap agreements from the avoidance of preferential transfers.[154] Consequently, the creditor can keep payments—and in particular, transfers of collateral—which the trustee could have otherwise voided if made 90 days prior to the filing of a petition.[155]

C. Justifications for the Code's Exemptions for Swaps

As Parts II.A–B have shown, the rules applicable to swaps deviate substantially from the Bankruptcy Code's normal provisions. These exemptions privilege one class of creditors to the eventual detriment of others. What justifications underlie such differential treatment? Congress essentially had two motives: the prevention of the debtor unfairly "cherry-picking" favorable contracts, and the promotion of financial stability. Each of these is discussed below. In addition, this section will address several criticisms of this latter argument, and note an alternative justification which has been proposed by scholars.

One of Congress's concerns was that if a creditor could not terminate and setoff multiple agreements, the debtor could unfairly choose which executory contracts[156] to perform and which to terminate pursuant to its

---

151. 5 COLLIER ON BANKRUPTCY, *supra* note 114, ¶ 553.01.

152. *See id.* ¶ 553.02 ("Indeed, a right of setoff has been described as 'security of the most perfect kind' precisely because the creditor holds the means of satisfying its claim through the extinguishment of its own debt." (quoting Boston Ins. Co. v. Nogg, 362 F.2d 111, 114 (2d Cir. 1966))).

153. *See id.*

154. *See* § 546(g); *see also* § 546(j) (granting similar privileges to transfers made pursuant to a master netting agreement). Constructively fraudulent transfers, otherwise avoidable pursuant to § 548(a)(1)(B), are also exempted. *See* § 546(g). Thus, the only payments not exempted are those made "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted." *See* § 548(a)(1)(A).

155. *See* 5 COLLIER ON BANKRUPTCY, *supra* note 114, ¶ 546.08.

156. Executory contracts are those "under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

avoidance powers in § 365.[157] The specific inequity arises out of the fact that the trustee could wait to see how the market performed before choosing whether to accept or reject a contract. *Collier on Bankruptcy* explains the concern that permitting the trustee to "play the markets with perfect hindsight in determining whether to assume or reject swap agreements seems to go far beyond the normal liquidation and reorganization policies of the Bankruptcy Code, and arguably amounts to affording the estate a windfall at the expense of other participants in the market."[158]

However, by far the most significant concern was thought to be the promotion of stability in financial markets.[159] Senator Grassley, when arguing for extension of these privileges to swap agreements, summarized the unifying purpose of these exemptions: "This amendment would go a long way toward ensuring that the failure of a participant will not unduly disrupt an extremely important financial market. The bill follows an approach that . . . is to minimize risk and dislocation to financial markets after a bankruptcy."[160] But how exactly could these provisions promote financial stability?

The House Report stated that "[t]he prompt liquidation of an insolvent's position is generally desirable to minimize the potentially massive losses and chain reaction of insolvencies that could occur if the market were to move sharply in the wrong direction."[161] In the event of a large institution's bankruptcy, the automatic stay would render its counterparties'

157. *See* H.R. REP. NO. 101-484, at 3 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 225 ("Concerns have been raised that under current bankruptcy law, termination and setoff of a swap agreement would be automatically stayed when one of the parties files a bankruptcy petition, whereupon the trustee, after indefinitely postponing termination of the swap agreement, could refuse setoff and unfairly "cherry pick" only the portions of the agreement advantageous to the debtor, while rejecting the portions unfavorable to the debtor.").

158. 5 COLLIER ON BANKRUPTCY, *supra* note 118, ¶ 560.01 n.4.

159. In fact, Congress and many commentators believed that cherrypicking might by itself destabilize the market. *See* 136 Cong. Rec. S7413, 7536 (June 6, 1990) (statement of Sen. Grassley) ("[T]here is the risk that a defaulting party or a trustee in bankruptcy could assume favorable swap transactions and reject unfavorable ones—so-called cherry picking—even though the swap contract calls for liquidation of these obligations by netting. The exposure created by these risks takes on special significance in a volatile market."); Morrison & Riegel, *supra* note 143, at 642 ("Losses from indefinite exposure to market movements and from cherrypicking could produce financial distress in the counterparty itself, forcing it to default on its own contracts with other parties. As one distressed party infects another, a domino effect could ensue, undermining the entire financial market.").

160. 136 Cong. Rec. at 7536. Senator Grassley noted in passing that swaps are a particularly valuable financial instrument to thrift organizations, who were at the time experiencing "severe financial pressure." *Id.* Thus, one can gather that the Savings and Loan Crisis (1986–95) was a motivating factor for passage of this legislation. Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC BANKING REV., Dec. 2000, at 26, 27, *available at* http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf. The value of swaps to a thrift organization arises out of the fact that it typically has assets with fixed rates of return (i.e. mortgages) and liabilities with variable interest rates. *See* 136 Cong. Rec. at 7536. This makes it particularly vulnerable to spikes in interest rates. *See id.* As noted above, interest rate swaps would allow them to hedge against this risk by "swapping" their variable interest rate liabilities for fixed rate liabilities.

161. H.R. REP. NO. 97-420, at 4 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 585.

claims illiquid, thus increasing the chance that they would themselves become unable to meet liabilities. Allowing creditors to immediately seize collateral would theoretically solve this problem.[162] Moreover, a subsequent House Report clarified the need to protect this particular class of creditors: "Because financial markets can change significantly in a matter of days, or even hours, a non-bankrupt party to ongoing securities and other financial transactions could face heavy losses unless the transactions are [resolved] promptly and with finality."[163] Thus, the reasoning was that financial markets merited special treatment because of their highly volatile nature.

Professors Franklin R. Edwards and Edward R. Morrison point to a number of deficiencies in these arguments. They note that swap participants are no more likely to become insolvent than any of the debtor's other creditors.[164] Thus, Congress's "volatility of financial markets" reasoning is too broad to adequately explain why certain creditors are privileged and others are not. They concede that a "chain of insolvencies" might be possible if creditors had failed to properly manage risk vis-à-vis the debtor.[165] But they respond that "the solution to this failure is better risk management by counterparties, not amendments to the Bankruptcy Code exempting derivatives counterparties from its automatic stay provisions. Or . . . the answer should be either better supervision or a regulatory structure that increases incentives to manage counterparty risk more effectively."[166] They also argue that these exemptions could exacerbate the situation by causing effects akin to a bank run.[167] In the end, they seem to suggest that, although ostensibly not misguided, these provisions rest on tenuous justifications and should "worry" those members of Congress who unwaveringly subscribe to the systemic risk argument.[168]

D. The Potential for Exemptions to Magnify Losses

Despite Congress's best intentions in enacting these exemptions, scholars have noted a number of unintended effects.[169] This Comment focuses on Professor Mark J. Roe's research showing that privileged status induces less rigorous market discipline, thereby magnifying the scale of a financial crisis.[170] Roe essentially argues that because of these privileges, swap participants are less exposed to loss in the event of default. Consequently,

162. *Cf.* Morrison & Riegel, *supra* note 143, at 642 ("Without these safe harbors, markets might suffer serious shocks—perhaps even a systemic liquidity crisis, causing markets to collapse—when debtors enter bankruptcy. Counterparties to financial contracts would find themselves subject to the automatic stay for extended periods. They would be unable to liquidate volatile contracts and thereby limit their exposure to market movements.").

163. H.R. REP. NO. 101-484, at 2 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 224.

164. Edwards & Morrison, *supra* note 108, at 101–02.

165. *See id.* at 102–03.

166. *Id.* at 103.

167. *See id.* at 101.

168. *See id.* at 122.

169. *See, e.g.*, Lubben, *supra* note 21; Edwards & Morrison, *supra* note 108.

170. *See generally* Roe, *supra* note 8.

they have less incentive to rigorously monitor their counterparty's creditworthiness and take steps to protect themselves when they perceive any increase in the risk of default.[171] This in turn gives weak counterparties access to inexpensive financing, increasing the magnitude of an eventual failure.

How exactly do reduced incentives to monitor counterparty risk magnify losses in a financial crisis? Roe argues that these privileges

> induc[e] stronger players to accept a higher, perhaps imprudently higher, level of derivatives and repo financing with weak counterparties. If they bore more risk of counterparty failure, they might demand better-capitalized counterparties. Or they would demand better counterparty portfolio information, so that they could better price that risk. They would charge the risky counterparty more and the sound one less. The weak counterparty would be incentivized to become financially stronger (so as to be charged less) and, at least to the extent prices rose, the parties would do less derivatives and repo business. The Code's superpriorities thereby undermine market discipline.[172]

Thus, the Code's privileges result in the debtor's and creditor's[173] overuse of these particular instruments, without sufficient capital backing.[174] This overexposure would have been lessened if creditors were incentivized to "contain the risk of counterparty failure."[175] In the end, it was AIG, Bear Stearns, and Lehman Brothers' large exposures to instruments protected by the Code, and lack of necessary capital reserves, which precipitated their collapses.[176]

Morrison and Edwards find a related effect on firms' incentive structure. They argue that, because derivatives can be used as a proxy for a loan, these exemptions may incentivize creditors to shift toward using swaps instead of loans as a financing device. This would occur when the debtor's creditworthiness declines, because the benefits of priority status start to outweigh the increased transaction costs.[177] Morrison and Edwards note that this shift is simply a form of rent-seeking—the act of increasing profits

171. *Id.* at 555.
172. *Id.*
173. Creditors could face insolvency if their exposure is so high that there is not enough collateral to cover their losses in the event of a default. This would have been precisely the case if the federal government had not stepped in to bail out AIG. *See* Wallison, *supra* note 3, at 7.
174. *See* Roe, *supra* note 8, at 555.
175. *Id.*
176. *See generally id.* at 550–54.
177. *See* Edwards & Morrison, *supra* note 108, at 120.

without actually producing any additional wealth[178]: creditors with these privileges recover more, leaving less for those who must wait their turn.[179]

Both Roe and Morrison and Edwards note that these parties do better in the event of counterparty insolvency, and both address different effects of this increased recovery on incentives. Roe focuses primarily on how swap privileges cause slackened efforts to contain counterparty risk, because creditors are essentially concerned with collateral rather than firm value. By contrast, Edwards and Morrison posit that increased riskiness can itself induce greater reliance on derivatives. Taken together, the two arguments suggest that a self-perpetuating process occurs whereby derivatives induce more precarious positions, and these more precarious positions in turn mean that creditors prefer to deal with the debtor only when protected by the Code's privileges.[180] Perhaps this theory could help to explain the exponential rise of derivatives in recent years, as well as some of the more outrageous positions taken prior to the crisis.[181]

Before continuing, it is worth noting one of the counterarguments to Roe's position. Because the debtor's other creditors are subject to the normal rules of bankruptcy, they recover less as a result of these privileges. Therefore, they should more diligently monitor that counterparty risk and contain losses in the event of default.[182] In particular, they should increase the cost of credit, or refuse to lend unless their counterparty acquired a sounder capital structure.[183] Both of these measures would make the financial system more stable.[184] However, these third parties lack either the incentives or the capacity to do so.[185] Consequently, the Code's exemptions give priority to those best positioned to monitor counterparty risk.

Notwithstanding the potential destabilizing effects of the Code's exemptions for derivatives contracts, these exemptions are not addressed in

178. Gordon Tullock, *The Fundamentals of Rent-Seeking*, 1 LOCKE LUMINARY NO. 2 (1998), *available at* http://www.thelockeinstitute.org/journals/luminary_v1_n2_p2.html (noting that, from an efficiency perspective, the essential problem with rent-seeking is that the resources entities expend in seeking such rents constitutes waste). The *Economist* describes rent-seeking in more accessible terms: "Cutting yourself a bigger slice of the cake rather than making the cake bigger." *Economics A-Z*, ECONOMIST http://www.economist.com/economics-a-to-z/r#node-21529810 (last visited Nov. 16, 2011).

179. Edwards & Morrison, *supra* note 108, at 121. Professors Morrison and Edwards further note that exemptions may eventually "alter the debt structure of firms towards a greater reliance on derivatives by favoring derivatives counterparties over other creditors." *Id.*

180. Roe also notes this potential for a "self-reinforcing engine" to occur. Roe, *supra* note 8, at 559.

181. *See id.* at 556. For an example of one such transaction, see *infra* note 200.

182. *See* Roe, *supra* note 8, at 556.

183. *See id.*

184. *See id.* at 555.

185. *See id.* Roe analyzed the risk-monitoring capabilities of four creditor categories: commercial paper holders, insurance premium payers, depositors, and the United States government, who becomes a creditor in the event of a bailout. *See id.* at 557–59. He concluded that none of these creditors are particularly capable of demanding sounder counter-parties ex ante.

Dodd-Frank, nor have they garnered much attention amongst reformers more generally. Moreover, although investors may now be acutely aware of derivatives' riskiness, the exemptions still constitute remaining structural flaws in the ways those risks are assessed. Thus, it is of the utmost importance that actions be taken to address the unintended effects of the Code's privileged status provisions, whether by outright repeal or otherwise.

At the end of his article, Roe briefly addresses the potential impact of the clearing mandate.[186] Specifically, he states that "it's unclear whether the exchange would itself be properly incentivized to handle counterparty risk."[187] Part III addresses precisely this issue. This is a particularly relevant inquiry because, with the passage of Dodd-Frank, there is no longer the same political expediency so necessary to effectuate financial reform.[188] Thus, the clearing mandate may be the best opportunity to bolster market discipline, and prevent another crisis event.

III. THE POTENTIAL FOR DODD-FRANK'S CLEARINGHOUSE MANDATE TO RESTORE STABILITY TO THE SWAP MARKET

The questions addressed by this part include whether the clearinghouse structure could provide greater incentives to monitor counterparty risk, and if so, what regulatory controls might be necessary to ensure that limits on losses are in fact put into place. These inquiries are essential because, as argued below, clearinghouses' traditional risk management tools are not likely to prevent a systemic event. Thus, clearinghouses are in danger of falling victim to the same unintended effects of the Bankruptcy Code that magnified losses in the recent financial crisis. Nonetheless, this part argues that a clearinghouse would theoretically have greater incentives to monitor counterparty risk. Finally, it addresses some of the steps regulators should take to ensure that clearinghouses are exercising greater market discipline.

A. Traditional Clearinghouse Risk Management Devices Are Not Likely Capable of Preventing Another Systemic Event

A clearinghouse's primary risk management devices likely would not have prevented the systemic losses experienced during the recent financial crisis. The purpose of margining is to ensure an amount of collateral is called sufficient to cover any losses from replacement of the contract on the open market.[189] Stated simply, so long as margining can keep up with the costs of replacing the trade, then the clearinghouse is adequately protected

186. *See* Roe, *supra* note 8, at 586–87.

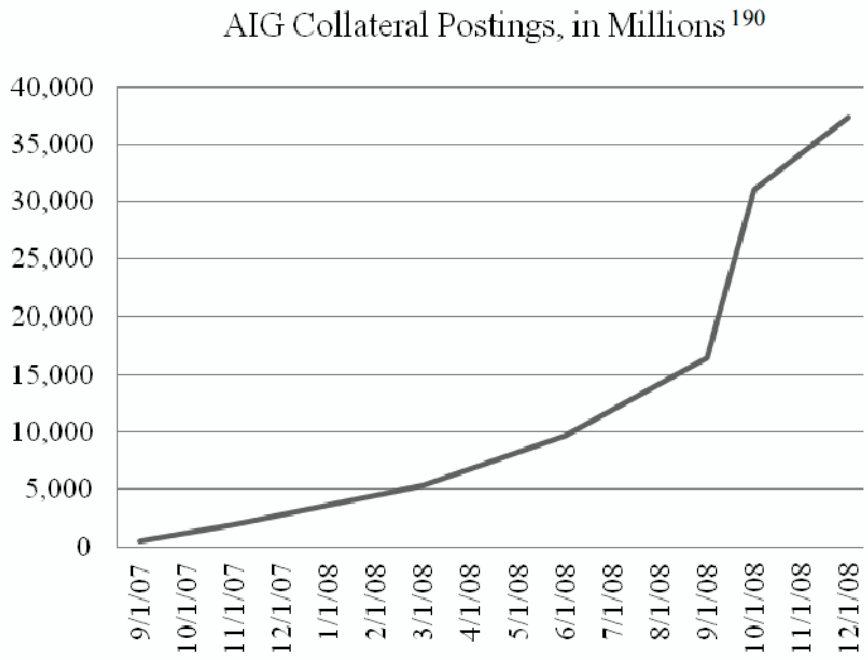
187. *Id.*

188. The absence of a political constituency for reform owes to the fact that policymakers suffer from powerful reputational disincentives to enact regulatory reforms. Consequently, they will only do so if continued regulatory forbearance is so ostensibly misguided as to harm their political careers. *See* EDWARD J. KANE, THE S & L INSURANCE MESS: HOW DID IT HAPPEN? 68 (1989) (documenting this phenomenon in the context of the Savings and Loan Crisis).

189. *See supra* notes 83–86 and accompanying text.

from any losses arising out of counterparty default. If it does not, then the clearinghouse itself faces insolvency.

It seems unlikely that a clearinghouse would be able to make adequate collateral calls if it were highly exposed to a systemically important institution. Consider the extraordinary speed and volume of collateral calls made against AIG during the recent financial crisis:



AIG simply had insufficient capital reserves to meet collateral calls on its CDS positions as they rapidly came due. Conceptually, this means that AIG was unable to post the amount of collateral which its counterparties deemed necessary to protect themselves from its default. The simple feature of trades being executed through a centralized clearing party, rather than bilaterally, does not alter this fundamental problem of capital inadequacy. True, a clearinghouse's collateral calls would have been more systematic and thorough, but that does not change the fact that deals are largely collateralized as the market worsens, not ex ante. Moreover, a clearinghouse's use of initial margins is unlikely to have made much of a difference either: it seems entirely unrealistic that it could accurately

190. *See* Paul Kiel, *AIG's Spiral Downward: A Timeline*, PROPUBLICA (Nov. 14, 2008), http://www.propublica.org/article/article-aigs-downward-spiral-1114. A similar trend occurred in CDS spreads. *See, e.g.*, Hayne Leland, *Structural Models and the Credit Crisis* (July 8, 2009), http://haas.berkeley.edu/groups/finance/CHINA7.pdf. Thus to the extent that a clearinghouse would have based its collateral calls on mark-to-market risk instead of credit rating downgrades, AIG still would have been unlikely to meet those collateral calls.

predict the amount of collateral it would need to replace agreements during a crisis event. In other words, the illiquidity/volatility risk on which initial margins are based would be too difficult to calculate. Thus, if a clearinghouse was already overexposed to a systemically important institution, it is highly unlikely that its system of margining could have adequately protected it from default.

One might argue that multilateral netting would simultaneously limit credit exposure and drastically reduce the need for collateral. This would soften the blow of a counterparty's failure on the clearinghouse and its members. To illustrate, they might point to the fact that during Lehman Brothers' bankruptcy proceedings, its counterparties presented $400 billion in CDSs for settlement, but after netting, only $6 billion actually "changed hands."[191] Although this argument seems powerful, the actual value of multilateral netting is highly uncertain.[192] In particular, commentators note that a large number of clearinghouses could substantially dampen its benefits.[193]

What about the contention that clearinghouses would have prevented the problem of overexposure ex ante by requiring higher initial margin? In its defense of the clearing mandate, the Senate Committee on Banking, Housing, and Urban Affairs cited the IMF for the proposition that "[p]utting nearly all derivatives through clearinghouses, with tough margin rules, could do away with most of the under-collateralization."[194] Given the extraordinary shortage of collateral experienced during the recent financial crisis, this contention seems appealing. However, it dodges the fundamental issue of whether a clearinghouse is better incentivized to hedge against counterparty risk. After all, tougher collateral requirements in the bilateral market, induced by rigorous market discipline, also could have solved the under-collateralization problem.

This concern over incentives is far from academic. Some have warned that the market for clearing might become too competitive, with clearinghouses consequently lowering membership eligibility standards in order to capture greater market share. Wallace C. Turbeville notes that "[c]ompetition among clearinghouses is intense. Their revenues are driven by volume of contracts cleared. There is a strong incentive to exceed the boundaries of prudent risk management in order to succeed against the competitors."[195] Thus, clearinghouses might eschew higher collateral

191. ACHARYA ET AL., *supra* note 53. In addition, clearinghouse failures have proven themselves to be very rare occurrences. *See* Ripatti, *supra* note 61, at 16–20. Recent examples include the Caisse de Liquidation in 1973, the Kuala Lumpur Commodity Clearing House in 1983, and the Hong Kong Futures Guarantee Corporation in 1987. *Id.* at 24. This may not be much comfort, though, given that the recent financial crisis could itself be described as an extraordinary event.

192. *See* Mark Roe, *Derivatives Clearinghouses Are No Magic Bullet*, WALL ST. J., May 6, 2010, at A19.

193. *See, e.g.*, *Squam Lake Working Paper*, *supra* note 63, at 4.

194. S. REP. NO. 111-176, pt. 2, at 31 (2010).

195. Turbeville, *supra* note 48, at 12; *see also Squam Lake Working Paper*, *supra* note 63, at 3–4 ("In the fight for market share, they may compete by lowering their operating

requirements in pursuit of greater revenue, just like participants in the bilateral market. The crucial question is precisely why we should entrust clearinghouses, instead of the bilateral market, with the decision-making power over collateralization; it is too tenuous to assert categorically that clearinghouses would have required more collateral a priori.

B. Because a Clearinghouse Would Bear More Risk of Default, It Would Be Better Incentivized to Monitor Counterparty Risk

As the above analysis shows, there is strong reason to doubt that a clearinghouse's risk management tools would adequately limit its own losses during a systemic event, at least of the type experienced in 2008. Thus, the essential problem explored in Part II.D, and as articulated by Roe, remains: the Code reduces incentives to monitor counterparty risk by privileging this class of creditors. The only difference is that it is now a clearinghouse, rather than its individual member firms, which might fail to limit losses of counterparty default ex ante as a result of privileged status. But are there reasons to believe that a clearinghouse might actually be more incentivized to do so?

Theoretically, yes. There are several possible reasons. The first relates to the fact that a clearinghouse would bear greater losses from a counterparty's default.[196] Without a clearinghouse, risks are spread across different firms, who have presumably diversified against them to some degree. Moreover, the possibility of uncollateralized losses may appear too remote to merit much attention, especially where that counterparty has a high credit rating, and the prevailing market attitude at the time is one of optimism.

However, as noted in Part I.C., a clearing structure essentially *concentrates* counterparty risk in the clearinghouse. As a result, it would bear greater losses in the event of a large institution's default, and more importantly, those losses would appear less remote: it would not be diversified (especially where it was only clearing a limited class of derivatives), and presumably its monitoring activities would be much more focused on a particular class of instruments.[197] In other words, because clearinghouses bear greater losses from default, it appears quite plausible that the clearing structure would reduce the external risks that transactions impose on the financial system. Consequently, the clearinghouse would be better incentivized to price risk accurately.

---

standards, demanding less collateral from their customers, and requiring less capital from their members.").

196. The countervailing concern is that, in this way, the clearing mandate actually *creates* institutions that are too big to fail. *See* Roe, *supra* note 192.

197. *But see* S. REP. NO. 111-176, pt. 11, at 241 (2010) (suggesting that "specialized dealers in bilateral markets can monitor and manage the risks of complex, illiquid derivatives contracts and complex, opaque counterparties more effectively than all-purpose clearinghouses that are designed to clear standardized liquid contracts among clearing members").

Second, bankruptcy privileges have provided so great a sense of security that firms entirely ignored the potential for collateral calls to bring down counterparties with large, correlated derivatives positions. Although one might instead attribute this "rational ignorance" to the highly opaque nature of the OTC market,[198] one could just as easily argue that this observed lack of transparency was itself caused, at least in part, by the Code's exemptions: as Roe notes, if parties had borne more risk, they would have demanded more information about their counterparties' holdings.[199] At the very least, it seems as if the Code's privileges combined with the highly opaque nature of the OTC derivatives market to leave parties completely blinded to the *actual* risk of loss from a counterparty's default. Perhaps this could explain the logic behind some of the more baffling positions, such as where VCG Special Opportunities Master Fund Limited issued $20 million in CDO protection to Wachovia and Citibank, or in other words, 40 percent of the fund's capital on these two contracts alone.[200]

Regardless of its causes, this sense of security would have been entirely irrational for a clearinghouse. Because of its system of margining, one large swing in the market could result in crippling liability for its counterparty on the mark-to-market risk of its swap portfolio.[201] In other words, the clearinghouse would know that its own margining might destroy such a thinly capitalized and undiversified firm.

Third, an individual firm may very well recognize the risk that its counterparty is too thinly capitalized to meet all of its collateral calls. However, the firm might also believe that it could contractually protect itself from being too late in line. As previously noted, the swap participant's game is essentially to call for collateral before the counterparty defaults.[202] If they do so, then they can foreclose against that collateral once the debtor files for bankruptcy and apply the funds towards the purchase of a replacement contract. Individual firms may believe that their bankruptcy exemptions are sufficient to minimize counterparty risk, so long as they "jump in line" in front of the debtor's other privileged creditors, thus fully collateralizing their losses. For example, they could try to do so by demanding collateral earlier, or by including a broader range of triggering events for collateral calls in the swap agreement. This view might appear particularly sensible where other firms are generally not diligent in making collateral calls, as was indeed the case before the crisis.[203]

198. *See id.* at 30 ("Had information been more readily available to regulators and counterparties about the scope of AIGFP's credit default swap positions, regulators and market participants might have detected the systemic implications of AIGFP's book.").

199. Roe, *supra* note 8, at 555.

200. *See* Kevin LaCroix, *Credit Default Swaps: The Newest Subprime Litigation Front*, D&O DIARY (Mar. 5, 2008), http://www.dandodiary.com/2008/03/articles/subprime-litigation/credit-default-swaps-the-newest-subprime-litigation-front/.

201. *See supra* notes 88–90 and accompanying text.

202. *See supra* notes 83–87 and accompanying text.

203. *See supra* notes 97–99 and accompanying text.

By contrast, a clearinghouse could not believe that it would win a race to be first in margining. This is because a shift toward clearing would subject all cleared trades to mandatory, systematic collateral calls. Although a clearinghouse margins daily, and if necessary, intraday, it seems hard to imagine that it would want to invest costly resources in securing an early place in line. The more sensible solution is to limit the risk of losses from counterparty default ex ante.

If clearinghouses do have greater incentives to limit counterparty risk, then how could they go about doing so? Dodd-Frank expressly requires the imposition of membership eligibility standards.[204] Under this statutory authority, clearinghouses could require members to maintain capital adequacy for its swap positions. If this were too costly, then members would simply use fewer derivatives. Thus, these membership requirements could directly address the issue at hand: limiting losses arising out of counterparty default ex ante.

In order for clearinghouses to set membership requirements accurately, there must be rigorous disclosure of a firm's *aggregate* swap positions. Otherwise a firm could spread a large, undiversified swap position across many different clearinghouses, and create the illusion of financial health. As noted above, this was one of the major problems in the bilateral OTC market prior to the crisis.[205] Without adequate disclosure, transactions between a clearinghouse and its members might create the same risk externalities that were observed prior to the recent financial crisis.

One of the most salient reasons for doubting that clearinghouses will have a different set of incentives is that virtually all of the key players in the derivatives market prior to the financial crisis have recently entered the clearing business.[206] If this is the case, one might wonder: why would these firms have any different incentives as central clearing parties than as dealers in the OTC market?[207] A related concern is the potential influence of a clearinghouse's members over management, a scenario the Department of Justice likened to the "three or five largest airlines controlling all landing rights at every U.S. airport."[208] This could result in a push for lower margin requirements and more lax eligibility standards, which would entirely undermine the potential for the clearinghouse to contain counterparty risk ex ante.

---

204. *See* Pub. L. No. 111-203, § 725(c), 124 Stat. 1376, 1688 (2010).

205. *See supra* notes 101–03 and accompanying text.

206. *See* Mike Taylor, *Bank of America Gets Into the Derivatives Clearing Business*, N.Y. OBSERVER (Sept. 23, 2010), http://www.observer.com/2010/wall-street/bank-america-gets-derivatives-clearing-business (noting that Bank of America, Citigroup, Deutsche Bank, JP Morgan Chase, and Goldman Sachs have all entered the derivatives clearing business).

207. As of 2010, "[t]he largest fourteen derivatives dealers . . . [hold] 82 percent of interest rate derivatives, 90 percent of credit default swaps, and 86 percent of equity derivatives." David Mengle, *Concentration of OTC Derivatives Among Major Dealers*, INT'L SWAPS & DERIVATIVES ASS'N (2010), http://www.isda.org/researchnotes/pdf/ConcentrationRN_4-10.pdf.

208. Ben Protess, *Justice Department Seeks Tougher Derivatives Rules*, N.Y. TIMES DEALBOOK (Dec. 30, 2010, 12:44 PM), http://dealbook.nytimes.com/2010/12/30/justice-tells-regulators-to-beef-up-derivatives-rules/; *see also* Turbeville, *supra* note 48, at 12–13.

Regulators should be acutely aware of this tendency, and promulgate robust prophylactic rules insuring that each clearinghouse's board is not conflicted with respect to managing the clearinghouse's financial health. In response to these concerns, and pursuant to requirements of Dodd-Frank, the Commodities Futures Trading Commission has proposed rules that would limit members' ownership stakes and require boards to be composed of outside directors.[209] The Securities and Exchange Commission is currently seeking comments on similar proposed rules.[210] Commentators have proposed additional governance requirements as well. For example, Wallace C. Turbeville has advocated that

> [a]t a minimum, the public's interest should be represented by membership on the risk committees of major clearinghouses. Regulatory representation, or representation by other public interest organization, would legitimize the process as long as resources and expertise were provided to challenge decisions such as which derivatives are cleared and which are not.[211]

Of course, only experience will demonstrate which measures are sufficient. Additional regulations might be needed if clearinghouses are not proving independent enough to manage counterparty risk prudently.

CONCLUSION

Swaps are highly useful financial instruments which have been developed to hedge against a broad spectrum of business risks, from credit to currency, interest rate to commodity price volatility. When used appropriately, they allow institutions to manage those risks more efficiently, creating overall wealth gains. The explosion in their use should come as no surprise.

However, the recent financial crisis has caused market participants to seriously reevaluate the proper role of these instruments in the economy. Similarly, policymakers should reexamine the various legal reforms which were enacted to facilitate their widespread use. In particular, recent scholarship has shown that the original justifications for the Bankruptcy Code's exemptions for derivatives may be misplaced.[212] If anything, these exemptions likely facilitated the very crisis event that they were enacted to prevent by reducing incentives to monitor counterparty risk.

Fortunately, provisions of Dodd-Frank may present an important opportunity to strengthen market discipline. The purpose of this Comment is to show which aspects of clearinghouses might be able to mitigate these unintended effects of the Code's swap exemptions, and which most likely will not. Moreover, it highlights some of the key issues that regulators should focus on to ensure that clearinghouses are better incentivized to

209. Turbeville, *supra* note 48, at 13.

210. *See SEC Proposes Voting Caps for Derivatives Clearing*, FINANCIAL NEWS (Oct. 14, 2010), http://www.efinancialnews.com/story/2010-10-14/sec-clearing-caps.

211. *See* Turbeville, *supra* note 48, at 13.

212. *See supra* notes 164–68, 169–80 and accompanying text.

prevent the next AIG-type failure. In particular, regulators should mandate standards regarding disclosure of aggregate swap positions to clearinghouses, and promulgate strict governance rules designed to preserve the board's independence from its members.

This feature of clearinghouses should not chill debate over the continuing prudence of the Bankruptcy Code's swap exemptions. On the contrary, this priority status constitutes a remaining structural flaw in the way market participants assess counterparty risk. Moreover, this Comment has attempted to show that much of the enthusiasm for the clearing mandate may be considerably premature. But if the coming years demonstrate that there is no political constituency for directly addressing these issues, clearinghouses just may be our financial system's greatest hope for restoring stability to the swap markets.