Credit Default Swaps in Bankruptcy Proceedings under US Law

A Legal Perspective
Schriften zum Insolvenzrecht

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Nomos
Credit derivatives amount to a multi-trillion-dollar component of capital markets and thus constitute one of today’s most widely traded financial devices. Notwithstanding their impact on the stability of global finance, such tools can no longer be excluded from the context of bankruptcy proceedings. It rather seems reasonable to assume that their presence in liquidation as well as reorganization proceedings will only increase.

To safeguard the fair and equitable distribution of the debtor’s assets as well as the successful confirmation of reorganization plans with all the social and economic consequences entailed, it is essential to review the potential legal inconsistencies that can occur from the presence of undisclosed credit derivative positions in bankruptcy proceedings to subsequently implement new provisions that can adequately protect all parties involved, according to the legal principles and provisions of bankruptcy law.

The present thesis means to contribute some thoughts on the foregoing issue, in the hope of supporting the initiation of a dialogue towards that direction.

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Credit default swaps (CDS) are bilateral agreements under which one party agrees to transfer to the counterparty the credit risk of an entity with regard to a designated debt obligation of such entity. If the transferred credit risk materializes, e.g. if the referenced entity files for bankruptcy, the credit risk assignor is entitled to payment, equal in value to the losses noted on the referenced debt obligation due to the referenced entity’s default. The actual amount of payment is determined by the specifics of each CDS agreement and varies accordingly, with higher losses always reflecting higher CDS revenues.

The risk assignor does not have to hold ownership of the referenced debt obligation to enter into a CDS agreement; if it does, such ownership may be preserved after settlement of the CDS agreement, depending on the appointed way of settlement. Should the risk assignor retain ownership of the referenced obligation post settlement, it will also preserve its right to pursue a claim as a creditor in the referenced entity’s bankruptcy proceeding.

The presence of credit default swap positions in bankruptcy proceedings has been thoroughly examined in previous research\(^1\). The particular feature that captured the attention of various economic scholars is that such positions are typically short positions. A credit risk assignor who is also a creditor in the referenced entity’s bankruptcy proceeding, preserves a right to payment on account of its bankruptcy claim, i.e. the debt obligation referenced under the CDS agreement, against the credit risk assignee. Because higher losses reflect higher CDS payments, it can reasonably be assumed that said creditor will have an interest to minimize rather than maximize the bankruptcy estate’s value. Economists argued that CDS short positions can compromise the successful outcome of reorganizations for exactly that reason. The applicable rules set out in Chapter 11 of the US Bankruptcy Code (USBC) are based on the premise that, notwithstanding the adversity of creditors’ economic interests, they will always

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share the common incentive to maximize the value of the debtor’s assets, for maximizing the value of the estate means maximizing the value of the expected recovery on creditors’ claims. Since CDS positions break such premise – so the argument – they deprive reorganization proceedings of their ultimate safety net warranting the successful adoption of a fair and equitable reorganization plan; what is more, such positions remain undisclosed. Creditors with a short position incentive can thus not be identified.

Economists therefore argued that a requirement to disclose such CDS positions should be introduced in reorganization proceedings. Indeed, the adversities caused by the creation of short positions in reorganization bankruptcies have been recognized\(^2\) to an extent that enabled the introduction of a disclosure obligation by the 2011 amendments of Bankruptcy Rule 2019, limited to reorganization and municipal bankruptcy proceedings and applicable to groups or committees of creditors only. Albeit definitely a step towards the right direction, the disclosure obligation introduced by the 2011 amendments remains somewhat limited, particularly in lieu of the fact that participation in creditor groups or committees follows on purely voluntary grounds. In other words, creditors cannot be obliged to participate in creditor groups or committees and thus also not obliged to disclose their CDS position. The question that inevitably occurs is whether the introduction of a disclosure requirement that is limited to the previously indicated extent, suffices to combat the adverse effects that can be caused by undisclosed CDS positions, not only in reorganization and municipal but also in liquidation proceedings.

The present thesis attempts to provide an answer to this very question, but contrary to previous research essays a different approach: it examines the legal inconsistencies that can occur from individual, undisclosed CDS positions in bankruptcy proceedings and reviews whether such potential inconsistencies are imminent enough to justify the introduction of an ex-

\(^2\) The American Bankruptcy Institute report of 2014 studying the reform of Chapter 11USBC also confirms the potential problems that could arise from the creation of, \textit{inter alia}, CDS short positions in reorganizations, suggesting that any potential issues within that context could be best resolved by bankruptcy courts on a case-by-case basis under the good faith requirement imposed on creditors rejecting a reorganization plan pursuant to the relevant section 1126 (e) of the US Bankruptcy Code (Bankruptcy Code). See American Bankruptcy Institute Report 2012-2014, pp. 268-69.
panded disclosure obligation, applicable to individual creditors as well as liquidation proceedings.

Since CDS agreements are inherently diverse and the specifics of each bankruptcy case vary, the present thesis does not attempt to evidence an *a priori* inconsistency regarding all CDS creditor positions, but rather distinctively examines each CDS position that could be encountered in bankruptcy proceedings and reviews the possible inconsistencies that *can* occur in this regard. Concretely, the present thesis reviews possible inconsistencies with the equal treatment principle as well as some of the principal provisions of Chapter 11 USBC.

To that end, the present study ensues the following structure. Part one provides a general overview on credit derivatives. Part two introduces the key elements of CDS transactions and identifies those creditor positions that can arise therefrom in bankruptcy proceedings.

Part three reviews the consistency of previous positions with the equal treatment principle. Within that context, part three firstly elaborates the applicable provisions to substantially similar creditor positions, i.e. creditor positions that preserve the right of receiving payment on their bankruptcy claim by a third party, who is not the bankruptcy debtor or from a source other than the bankruptcy estate, to subsequently review whether the *de facto* exemption granted to CDS positions due to lack of disclosure, is consistent with the equal treatment principle.

Part four examines the consistency of undisclosed CDS positions with the provisions regarding the classification of creditor claims, associated voting rights as well as the legitimate acceptance and confirmation of a reorganization plan, set out in Chapter 11 of the US Bankruptcy Code.

A more detailed structural description is separately indicated at the outset of each part.

The author concludes with a discussion of the findings resulting from the present study that exhibit the need to impose expanded disclosure requirements on CDS creditor positions in bankruptcy proceedings.
Credit default swaps (CDS) are bilateral agreements, under which one party (the CDS buyer) agrees to transfer to the counterparty (the CDS seller) the credit risk of a third party (the reference entity) with regard to one or more underlying debt obligations (the reference obligation) of the reference entity. In exchange for assuming the reference entity’s credit risk, the CDS seller receives payments in form of a premium from the CDS buyer. If the reference entity defaults on a reference obligation specified under the CDS, the CDS buyer has the right to trigger payment of an amount equal to the losses noted on the reference obligation upon the reference entity’s default, payable by the CDS seller.

Credit default swaps fall within the broad category of credit derivatives because they specifically relate to credit risk as opposed to derivatives relating to other types of risk, e.g. currency risk or other types of underlying assets, e.g. oil, energy etc.

The first part of the present thesis aims at providing a principal background on credit derivatives and their innovative features as well as the terms and conditions currently covering the vast majority of credit derivative transactions. It furthermore elaborates on the legal aspects of credit derivative transactions and briefly addresses derivatives regulation introduced in the United States after the financial crisis of 2008.

The general overview on credit derivatives provided under this part is essential for the appreciation of the more specific features embedded in those credit default swaps that constitute the object of the present study.

The discussion on the legal aspects of credit derivative transactions means to contribute some thoughts to the debate on whether the legal status of credit derivatives is akin to that of an insurance policy. The current regulatory framework applicable to credit derivatives in the US is briefly introduced for the sake of completeness.

The chapters of this part are structured as follows. The first chapter introduces derivatives in general. It provides a brief historical background on their fundamental concept and indicates the innovative features adhered to such concept during the financial innovation period of the 1980s. It concludes with a discussion on the distinctive and innovative features inherent in modern derivative products. The first chapter furthermore indicates the
broader categories of derivatives as well as the most frequently traded types thereof. Credit derivatives are included in the relevant category of derivatives that relate to credit risk. Depending on the context, the author makes use of both terms ‘derivatives’ and ‘credit derivatives’. For the sake of clarity, please note that former refers to all derivatives including credit derivatives whereas latter refers to credit derivatives only.

In its second part, the first chapter provides an overview of the documentation covering the vast majority of credit derivative transactions. Such documentation is of particular importance because it is subsequently used as the template documentation for the purposes of the present thesis.

The second chapter of this part contributes some thoughts to the discussion on the legal status of credit derivatives and briefly introduces the current regulatory framework applicable to derivatives in the US.
Chapter 1: A Background on Credit Derivatives and their Documentation

A. An introduction to derivatives in general

I. The fundamental concept of derivatives, financial innovation and the distinctive feature of modern financial derivatives

The modern notion associated with the term ‘derivative’ will in most cases refer to the emergence of financial derivatives in the early 1980s. Even so, the very fundamental concept of such term antedates the advent of modern financial derivatives by several centuries. Historical finds suggest that derivative type-like contracts can be traced back to the Hammurabi Age in Babylon\(^3\) and ancient Japan\(^4\). References to derivative contracts were also found in ancient Greek scriptures\(^5\).

In modern history the first derivatives (re) emerged towards the mid-19\(^{th}\) century in big commodity markets as such of Frankfurt, London, Chicago and New York bearing the form of organized futures exchanges on agricultural commodities\(^6\). As commerce trends developed from trading in wheat and cotton to trading in bonds and stocks and from using risk

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5 Scalcione, *The Derivatives Revolution: A Trapped Innovation and a Blueprint for Regulatory Reform*, p.3 noting that in 640 BC Thales from Miletus bought exclusive contracting rights to use all public olive presses in the future for a fairly low price following a prediction that harvest of olives would be untypically large that year. His prediction paid off. When the time came and farmers were seeking olive presses due to the high harvest, he resold his previously acquired rights at a much higher price.
6 Ibid., p.4; See also Schaede, "Forwards and Futures in Tokugawa-Period Japan: A New Perspective on the Dojima Rice Market", p.487; See also Timothy E. Lynch, "Derivatives: A Twenty-First Century Understanding" *Loyola University Chicago*
evaluation methods based on intuitive weather forecasts to complex electronic formula assessing risk opportunity, financial innovation devised those intricate and arcane financial products known as financial derivatives today.

If we look back to the historic roots of what is today known as a financial derivative contract, we will find the rationale of its primary creation. It is the need to reduce uncertainty of future events, something that modern finance calls risk management.

The urge to predict the future has always been dormant in human nature. Predicting the future means finding a way to predict the most probable occurrence of events. Socrates defined the word probable (εικός in ancient Greek) as likeness to truth. Mathematicians and later economists used numbers and identified relevant variables to calculate probability but—albeit quite successfully so—were not able to escape the likeness to truth impasse: It might be possible to determine the most likely occurrence of events based on their past frequency but the actual occurrence of events will always remain unforeseeable. In his work *A Treatise on Probability* (1921), John Maynard Keynes asserts that probability theory is of little concern when it comes to real life situations, particularly because it is based on nothing more than mathematical frequencies of past occurrences. Keynes noted with regard to what he called uncertain knowledge: ‘the sense in which I am using the term [uncertain knowledge] is that in which prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention...About these matters, there is no scientific basis on which to form any calculable probability whatsoever. We simply do not know!’

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7 Shmuel Sambursky, "On the Possible and Probable in Ancient Greece " *Osiris* 12 (1956): pp.35-48. Likeness to truth is not truth. Even more so in ancient Greece where truth was only what could be proved by logic. In lieu of the insistent seek of truth distinguishing that historical period, truth almost stood in direct contrast to probability. It is therefore that in ancient Greece probability was considered but never accredited as a potential device to determine action.

8 One only needs to consider that the laws of probability is one of the most powerful devices available to risk management.

Keynes’s notion of the ‘uncertain knowledge’ suggests: Since you cannot predict the future you need more than calculable probability to determine it; you need action\(^{10}\).

This concept introduces the need to formulate preventive action against potential losses accruing from uncertain events of the future; or action to establish or maximize potential profitability.

Formulating such action by means of a bilateral contract under which countervailing rights and obligations associated with an underlying asset of value are established to take effect upon the occurrence of a future event or on a specific date in the future constitutes the very fundamental basis of all derivatives. The specifics of each derivative vary according to the needs of the aspired transaction. This is why derivatives are inherently diverse. But dissecting the features of every derivative -even the most complex ones- unveils that all derivatives share the same fundament from early antiquity to what has been recorded as the financial revolution of the 20\(^{th}\) century.

The question that inevitably occurs is why modern financial derivatives are described as novel, innovative products that revolutionized finance, if their concept has been around for millennia. Evidently, it was not the fundamental concept of derivatives financial innovation captured, but rather their utilization potential.

If we go back to the concept of reducing risk by means of bilateral agreements, we will find that one party will gain if such risk materializes while the counterparty will gain if such risk does not materialize. In that sense, one party speculates for risk materialization and the other against it. Risk management always involves a certain degree of speculation. If the primary objective is risk mitigation, speculation remains an inevitable consequence; but speculation generates fair yield potential if considered discretely.

Supposed that parties of a derivative contract diversified their positions by entering into multiple derivative contracts with third parties covering countervailing positions; and supposed that they furthermore referenced underlying assets they did not own diversely speculating on potential prof-

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10 This is why Keynes firmly believed that a degree of government intervention is necessary for maintaining economic efficiency and why he had little patience with laissez faire theorists claiming they were capable to predict that markets would always turn to economic efficiency if they were only left alone to take their natural course.
its or losses. If speculation becomes the parties’ primary objective, promising investment opportunities erupt. In other words, risk is a great commodity to trade in; and financial innovation made it possible.

Commoditizing risk was the innovative element of financial derivatives introduced into the markets during the 1980s. Investment banks were not in search of new insurance policies; they were widely available even before the emergence of financial derivatives. They wished for a device that would enable the isolation and liquidation of risk so that it could be traded separately\(^\text{11}\) and found that derivatives embedded the structures necessary to serve that objective.

The aforementioned observation can best be illustrated on the basis of credit derivatives, i.e. derivatives that deal with credit risk as opposed to other types of risk, e.g. currency or interest rate risk.

Before the emergence of credit derivatives, investors wishing to invest in the credit risk of a reference entity inevitably had to acquire a financial obligation issued by such entity, e.g. a bond, and all associated risk types assembled therein, e.g. interest rate risk, liquidation risk, currency risk etc. The discrete investment in credit risk was therefore not possible for two reasons. Firstly, because investing in the credit risk inherent in a debt obligation required the acquisition of such obligation and secondly because the credit risk inherent in such obligation could not be isolated from the residual risk types assembled therein.

Credit derivatives solved this problem. Firstly, they enable investors to buy credit derivatives for debt obligations they do not hold. In that sense, if an investor wishes to invest in the credit risk of a corporate bond, it may acquire a credit derivative on such bond rather than acquiring the bond itself. Secondly, credit derivatives enable the isolation of credit risk from the bundle of risks assembled in the underlying financial obligation so that an investor can discretely invest in credit risk\(^\text{12}\). The mechanics are sim-

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\(^{11}\) Initially, banks were looking for a way to extend more credit to entities albeit having exhausted the limits of their credit exposure to such entities. Being able to sell credit risk separately to other banks made further credit extension possible. See Brendan Sapien, "Financial Weapons of Mass Distraction : From Bucket Shops to Credit Default Swaps" *Southern California Interdisciplinary Law Journal* 19(2010): p.421.

\(^{12}\) Edmund Parker, *Credit Derivatives: Documenting and Understanding Credit Derivative Products* (Globe Business Publishing Ltd 2007), pp.8-9; See also Vinod Kothari, *Credit Derivatives and Structured Credit Trading* (John Wiley & Sons
ple, credit derivatives specify solely events related to credit risk as events triggering payment under the respective credit derivative agreement.

To make investment in credit risk ultimately possible, credit derivatives had to further feature a structure to enable credit risk liquidation. Credit risk is the risk that the issuer of a financial obligation might default on its payment or go bankrupt. If such risk materializes, a particular lump sum will accrue reflecting the losses on the underlying financial obligation due to such default or bankruptcy. This lump sum constitutes the payable amount under a credit derivative contract. In that sense, credit derivatives feature a certain hedging factor, because the party transferring the credit risk to the counterparty of the credit derivative is technically paid for the losses occurring from a credit default event, if such event occurs.

Prevailing literature on credit derivatives describes the aforementioned feature as the hedging characteristic of credit derivatives.\textsuperscript{13} This is why the parties of credit derivative transactions are frequently referred to as the ‘protection buyer’ or ‘protection seller’ depending on whether they transfer or assume credit risk. Credit derivatives are subsequently divided into ‘speculative derivatives’ when the buyer does not hold the underlying obligation and ‘non-speculative derivatives hedging credit risk’ where the buyer owes such obligation.\textsuperscript{14}

The author disagrees with that approach. Pursuant to the view represented in the present thesis, credit derivatives are credit risk investment devices and the hedging factor they entail is the inevitable consequence of credit risk liquidation. In other words, credit risk can only be liquidated on the basis of the accrued losses noted on a financial obligation due to the default of its issuer; and the hedging factor inherent in credit derivatives is

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(Asia) Pte.Ltd 2009), pp.3-4 and Norman Menachem Feder, "Deconstructing Over-the-Counter Derivatives " \textit{Columbia Business Law Review} 2015, no. 2 (2002): p. 682. It is worth noting at this point that isolating any kind of risk from the bundle of other associated risks inherent in an obligation is never entirely possible. For instance, the risk of default of the counterparty can never be isolated; also market risk will always be inherent in transactions to a certain extent as will be demonstrated below. But isolation of credit risk still works for the purposes of risk commoditization.


14 \textit{Id.}
\end{flushleft}
consequently not a discrete feature but rather linked to the necessity of credit risk liquidation.

The author therefore believes that the terms ‘protection buyer’ and ‘protection seller’ are inaccurate. The ‘protection buyer’ is rather the credit risk assignor and the ‘protection seller’ accordingly the risk assignee.\textsuperscript{15}

The author furthermore is of the view that the distinction between speculative and non-speculative credit derivatives is misleading. Naturally a CDS buyer, who enters into a credit derivative agreement referencing an underlying debt obligation it has no ownership of, cannot be considered to have entered such agreement for hedging purposes; however the mere fact that a CDS buyer holds the underlying debt obligation is not necessarily evidencing its intention to hedge the associated credit risk. Firstly, because even a holder of a debt obligation can acquire a higher amount of credit risk than that inherent in such obligation. A CDS buyer can, e.g., hold bonds in value of sum x and nevertheless acquire a credit derivative referencing a higher sum on the same bond value owned by the CDS buyer. Secondly, whether the CDS buyer is using the credit derivative for speculative purposes or not cannot be determined pursuant to one specific credit derivative transaction but rather occurs from such buyer’s overall credit derivative activity. A CDS buyer can pursue an overall investment strategy by holding multiple or countervailing credit derivative positions referencing the same underlying debt obligations it holds ownership of; and in certain cases the hedging of certain debt obligations might even be part of such strategy, particularly in a financial environment of short positions and distressed debt investment. The overall strategy of investors is not an available assessment tool, because investment strategies and portfolios are usually kept highly confidential. The author is therefore of the opinion that the factor of whether the CDS buyer is the holder of the reference obligation in a credit derivative transaction cannot appropriately serve the task of determining whether speculation is the primary objective of such transaction.

The author accordingly believes that credit derivatives cannot be divided into speculative and non-speculative derivatives. All credit derivatives are credit risk investment devices and as such always entail a speculative factor. The degree of such speculation will depend on the degree of specu-

\textsuperscript{15} Please note that the present thesis nevertheless uses the terms ‘CDS buyer’ and ‘CDS seller’ to avoid confusion.
lation inherent in the adopted investment strategy itself, i.e. on whether the CDS buyer wishes to pursue less risky or more aggressive investment strategies. Credit derivatives make both options and various options in between available to any investor.

Investing in credit risk rather than hedging credit risk being the distinctive feature of credit derivatives is best evidenced against the backdrop of their structure. Credit derivatives are highly flexible, so that they can be tailored to fit any aspired investment strategy. They furthermore operate independently from the underpinned debt obligation or ownership thereof. The underlying debt obligation merely serves the purposes of a reference basis for payment calculation should the assumed credit risk materialize, i.e. become liquid. This is further evidenced by the fact that reference obligations must not necessarily be individually specified; it suffices to indicate a broad category of reference obligations or a category thereof resembling certain characteristics.

Another indication can be observed in the flexible utilization potential of credit derivatives; discrete credit derivative types can be freely combined with each other in more complex credit derivative transactions or embedded in securitization devices by means of which they can be converted into saleable commodities.

Finally, a strong indication regarding the investing character of credit derivatives occurs from the absence of any indemnification requirements or clauses adhered to their payment; to satisfy the conditions to payment under a credit derivative agreement, the CDS buyer solely needs to demonstrate the occurrence of a default event affecting the designated reference obligations or categories thereof rather than provide evidence on suffered losses due to such default event. This is why the credit risk assignor must not necessarily own the designated reference obligation to receive payment on account of such obligation under a credit derivative agreement.

The foregoing being noted, one has to clarify that an investor is not prevented from using credit derivatives for hedging purposes only; this is theoretically always an option. It does however not resemble the distinctive feature of credit derivatives, but is rather a possibility that is not and cannot be excluded from credit derivative transactions.

This is further confirmed by empirical evidence; at least to the extent such evidence is publicly available. For instance, right before the financial crisis of 2008, the notional amount of credit derivative transactions was found to be ten times greater than the notional amount of the associated
underlying obligations\textsuperscript{16} and in certain cases even higher\textsuperscript{17}. Moreover, by taking a look at the major credit derivatives dealers that created the credit derivatives market\textsuperscript{18} we know today, one will find that the vast majority thereof consists of investment banks and hedge funds\textsuperscript{19}, i.e. institutions assigned with the task to develop and execute profitable investment strategies.

Finally, the market for credit derivatives virtually exploded shortly after their emergence. This clearly indicates active investment unless someone can be convinced of the vast majority of Wall Street’s investment banks at that time suddenly being over-proportionately keen to safeguard their exposed debt. Credit derivatives being more investment than hedging devices, is further demonstrated by the clear preference noted on privately traded credit derivatives in the face of exchange traded credit derivatives. Whereas former are bespoke agreements, latter are rather standardized contracts, ill-suited for investment purposes.

The issue of whether credit derivatives are credit risk insurances in nature or rather credit risk investment devices will be elaborated further below, in the discussion on the legal status of credit derivatives. It suffices to note conclusively at this point that pursuant to the views expressed in the present thesis, credit derivatives are not innovative devices that better serve protection against credit risk but rather devices that facilitated the innovative aspect of discrete credit risk investment.


\textsuperscript{17} Prior to the bankruptcy of the former largest US automotive parts manufacturer Delphi Corporation in October 2005, the analogy between the notional value of credit derivatives issued on its debt and that of its actual underlying debt was nearly 13:1. See Fitch Ratings, “Delphi, Credit Derivatives, and Bond Trading Behavior After a Bankruptcy Filing” (November 28, 2005), available at www.fitchratings.com.

\textsuperscript{18} Parker, \textit{Credit Derivatives: Documenting and Understanding Credit Derivative Products}, pp. 13-14.

\textsuperscript{19} It is important to note at this point that (despite their conferred term) hedge funds are not institutions that hedge credit risk. Rather, hedge funds are institutions that are contracted by investors with the task to handle their investment portfolio. In other words, hedge funds are financial investment institutions. Contrary to their name, hedge funds are known for their aggressive investment strategies.
A broad classification of derivatives

1. The absence of a clear definition

Finding a definition applicable to all types of credit derivatives defies the notion of an easy task. Credit derivatives are highly diverse, complex and furthermore individually tailored products\(^\text{20}\). Moreover, novel types of credit derivatives keep erupting continuously.

To date, there is no clear legal definition of credit derivatives. Economists described credit derivatives as financial instruments transferring credit risk whose payoffs derive from the value of an underlying asset\(^\text{21}\), or more precisely ‘whose payoffs are linked in some way to a change in quality of an issuer or issuers [of an underlying asset]’\(^\text{22}\). None of these descriptions can however adequately serve the purpose of a legal definition or even a definition per se for they merely describe one of the assembled elements embedded in credit derivatives. Furthermore, the underlying-asset-element is inherent in various financial instruments including non-credit derivative products.

Notably, even derivatives regulation introduced in the United States and the European Union does not formulate a legal definition thereof. The recently enforced EC Directive 2014/65 (MiFID II)\(^\text{23}\) exhibits a list of the financial instruments falling within its scope and merely itemizes (among

\(^{20}\) This applies to credit derivative contracts that are traded over-the-counter. Credit derivative contracts traded via stock exchanges or clearing houses are subject to standardized terms. For a more detailed description on this subject see below, chapter one, A II-1.


\(^{22}\) Partnoy, "The Promise and Perils of Credit Derivatives ", p.1021. For a more detailed discussion on the definition of derivatives see Lynch, "Derivatives: A Twenty-First Century Understanding ". Lynch comes to the conclusion that derivatives are bilateral contracts in which the payoffs to and from each counterparty depend on the outcome of one or more extrinsic, future, uncertain events and/or metrics and in which each counterparty expects such outcome to be opposite to that expected by the other counterparty; For a legal discussion on the definition of credit derivatives see Scalcione, The Derivatives Revolution: A Trapped Innovation and a Blueprint for Regulatory Reform, pp.149-55.

other financial instruments, e.g. transferable securitization devices) the most commonly known derivative types (options, futures, swaps, forwards) and subsequently establishes some of their characteristics, e.g. the nature of their underlying obligations, the conditions of their payment etc.\textsuperscript{24}. The US Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) adopts a similar approach\textsuperscript{25}.

Notwithstanding its importance, the matter of a legal definition for derivatives amounts to the volume of a separate study and shall therefore not be discussed any further\textsuperscript{26}. The following sections provide the reader with a description of the broadest categories of derivatives as well as the most commonly traded derivative types to enable a better understanding thereof. The objective is to conclude the present chapter by illustrating some of the numerous features embedded in the most basic derivative transactions and by no means to provide an exhaustive list of all currently available derivative products.

2. Principal categories of derivatives

a. Exchange traded, cleared and over-the-counter derivatives

Derivatives can be traded via a registered exchange platform, through clearing houses or privately. Depending on how they are traded they are classified into exchange traded, cleared, or over-the-counter (OTC) derivatives respectively.

Exchange traded or listed derivatives are openly executed in organized exchange markets and limited to standardized contracts. The counterparty

\footnotesize{\textsuperscript{24} MiFID II, Section C of Annex I. The initial form of such list was already introduced by Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments (MiFID I), OJ L 145, 30.4.2004, p.1.}

\footnotesize{\textsuperscript{25} Dodd-Frank Wall Street Reform and Consumer Protection Act, Title VII, Section 721, subsection 47, Pub. L. No. 111-203, 124 Stat. 1376 (2010). The difference is that the Dodd-Frank Act separates swaps from futures, forwards, options on futures and other derivatives based on securities.}

\footnotesize{\textsuperscript{26} A working definition for derivatives is eminently important within the context of establishing efficient derivatives regulation. For legislators to detect the statutory limitations that need to be imposed on derivatives trading, they must first establish what derivative products are.
A. An introduction to derivatives in general

of listed derivatives is the exchange’s clearing house. Their distinctive characteristics are that they are publicly disclosed and limited, i.e. parties are not permitted to deviate from the terms of the applicable standardized contract.

Cleared derivatives are traded through clearing houses. Similarly to exchange traded derivative contracts, the counterparty is the clearing house. The terms and conditions of cleared derivative contracts involve a high degree of standardization and are registered with the clearing house.

OTC derivatives are privately negotiated contracts between two parties and therefore not subject to any standardized terms requirement. They can be tailored to fit the individual needs of their parties. As privately negotiated agreements, OTC derivatives do not have to be listed or registered and remain undisclosed.

Unfunded derivatives are those types of credit derivatives under which the party acquiring the credit risk makes no upfront payment to cover its potential future liabilities. In an unfunded credit derivative, payment only takes place if the credit risk materializes, i.e. if a credit event occurs. Unfunded derivatives include single name credit default swaps, basket credit default swaps, credit default swaps on asset-backed securities, index trades, credit spread options and swaptions.

Funded derivatives are those types of derivatives under which the party acquiring the credit risk makes an advanced payment to cover its potential future liabilities. For instance, in a funded credit derivative transaction, the party assuming the credit risk can purchase a debt obligation issued by a special purpose vehicle (SPV) or a financial institution and invest the accrued proceeds in highly rated securities. The dividends of such investment can subsequently be used to fund potential payment under a –in most cases unfunded - credit derivative agreement, such as a credit default swap. Funded credit derivatives include credit-linked notes, synthetic col-

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27 In an effort to mitigate the adverse effects of OTC credit derivatives noted during the 2008 financial crisis, regulation introduced in the US and the EU prohibits the over-the-counter trade of certain credit derivatives. Yet, the vast majority of OTC credit derivatives fall outside the scope of such prohibition. This matter is addressed in more detail below under chapter 2-B.

28 Parker, *Credit Derivatives: Documenting and Understanding Credit Derivative Products*, p.27; See also Kothari, *Credit Derivatives and Structured Credit Trading*, p.15.

29 This mechanism is frequently referred to as ‘collateralization’. See Parker, *Credit Derivatives: Documenting and Understanding Credit Derivative Products*, p.27.
lateral debt obligations, synthetic constant proportion portfolio insurance transactions and constant proportion debt obligations.

c. Categorization on the basis of associated risk types

Derivatives can further be categorized pursuant to the risk type they cover. As already indicated, credit derivatives are those derivatives linked to the credit risk of a reference entity, i.e. a debtor’s default. Such default is specified as a ‘credit event’ and broadly includes a failure to pay, the restructuring of the underlying obligation or the debtor’s bankruptcy. The countervailing rights and obligations embedded in a credit derivative are triggered only if such specified credit event occurs within the time period corresponding to the credit derivative’s term.

The same principle is applied to derivatives that cover other types of risk, e.g. interest rate risk, currency risk etc. Such derivatives can accordingly be classified as interest rate derivatives, currency derivatives etc.

3. Basic types of derivatives

The basic types of derivatives can broadly be divided into options, futures and forwards, swaps and swaptions. The present subsection shall provide a brief overview of the above derivative types.

a. Options

An option confers upon its buyer the right, but not the obligation, to either purchase or sell an underlying asset in the future at a pre-agreed price set at the outset of the option. Options are termed call options if they confer purchasing rights and put options if they confer selling rights. The underlying asset can inter alia be a security, commodity or rate. The option buyer pays a premium to the option seller for the acquisition of the option right. Such right expires on a pre-agreed date set at the outset of the option. Depending on their underlying asset, options can further be divided into bond options, currency options, equity options etc.

Within the context of credit derivatives, i.e. those derivatives relating to credit risk, the most commonly known options are credit spread options. A
credit spread option confers upon its buyer the right to sell an underlying asset to the option seller at a pre-determined price set at the outset of the option if the spread of the underlying asset, i.e. the difference between its bid and the ask price, reaches a certain pre-determined number.

b. Futures and Forwards

Futures and forwards establish an obligation to deliver an underlying asset on a pre-agreed date in the future at a pre-agreed price set at the outset of the future or forward. Essentially, they work a lot like options with the difference that futures and forwards establish an obligation that must be fulfilled on the pre-set date. Futures are standardized contracts traded via registered stock exchange platforms whereas forwards are privately negotiated, i.e. traded over-the-counter.

The obligation to deliver the underlying asset is flexible as it is not obligatorily limited to the physical delivery of the asset but can also be cash settled, i.e. by conducting a payment equal to the difference between the set price and the applicable price upon such obligation’s maturity.

c. Swaps

In their very basic form, swaps enable parties to exchange cash flows of an underlying asset, either periodically or on a set date. For instance, parties can enter into a currency swap agreement and agree to exchange payments in specific currencies on pre-agreed dates for a pre-agreed period of time. Or they could enter into an interest swap agreement and exchange different types of interest rate payments accrued on a notional amount, e.g. floating interest rates against fixed interest rates or vice versa.

Credit default swaps are formally included in the swap-type derivative category although certain opposite views support that credit default swaps feature a closer resemblance to futures rather than swaps.

d. Swaptions

A swaption is a credit derivative agreement combining both a swap and an option transaction. The swaption buyer acquires the right, but not the obli-
gation, to enter into a swap with the swaption seller. The swaption seller will in such case be obliged to either purchase or sell credit risk protection at the pre-agreed price set at the outset of the swaption.

B. The International Swaps and Derivatives Association and its documentation on unfunded OTC credit derivatives

The vast majority of credit derivative transactions are conducted over-the-counter, i.e. privately. The parties to OTC credit derivative agreements are therefore not restricted in the selection of applicable terms to their agreement; they are permitted to tailor each term to fit their particular requests. This is considered the greatest benefit of OTC credit derivatives.

Nevertheless, for a novel market to be developed and for market participants to enjoy some degree of security in their transactions, standardization of some extent is indispensable, at least with regard to the set of applicable terms credit derivative participants can select from. This was the first task envisaged in the mid-1980s by the group of investment banks keen to build a credit derivatives market. To that end, representatives of the largest investment banks at that time founded today’s most dominant international derivative trade association: The International Swaps and Derivatives Association (ISDA).

ISDA conferred upon its first task the significance it deserved and provided the credit derivatives industry with a working framework of standardized documentation. In the decades following its establishment, ISDA issued sets of terms and conditions, associated agreement templates

30 To date, ISDA is home to over 850 member institutions from 68 countries. As stated on ISDA’s website, such members ‘comprise of a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers.’ See ISDA statement, available at http://www2.isda.org/about-isda/.
31 ISDA’s first board director stated in an interview in 1997 ‘the market would never have developed to the degree it has without standardized documentation. Credit officers at some point would have shut down the business without it.’ See ISDA’s 20th Anniversary Report, p.12, available at http://www.isda.org/anniversary/pdf/isda.pdf.
and related documents virtually covering all separate categories and types of credit derivative products. ISDA documentation is continuously revised and updated to better fit novel challenges encountered by credit derivative dealers. It further continuously documents newly emerging credit derivative products as soon as a settled market practice can be recorded.

It is essential to clarify at this point that ISDA documentation on credit derivative transactions is but one available framework to credit derivative dealers. ISDA is a private trade association and its documentation is therefore not legally binding, nor should it be. That being noted, ISDA documentation almost reaches the status of a legally binding framework, in the sense that it is applied to virtually all OTC credit derivative transactions.

In absence of an actual legally binding framework regulating the terms and conditions embedded in credit derivative agreements, parties thereto are at liberty to select the available framework they want their transaction adhered to and ISDA documentation seems to be the vast majority’s preference. This may not be surprising if one considers that all major credit derivative dealers are ISDA members. Howsoever, the fact that ISDA documentation covers the vast majority of credit derivative transactions is the reason it has been selected as the template documentation for the purposes of the present study.

The following sections shall firstly introduce the International Swaps and Derivatives Association and subsequently elaborate on its relevant documentation.

I. The International Swaps and Derivatives Association and its background

ISDA was established in New York City, in March 1985, some years after one of Wall Street’s largest investment banks of the time, Salomon

32 For instance, the 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring CDS Protocol was released to deal with certain transaction-specific challenges that occurred after certain major credit events. Similarly, the release of the most recent ISDA documentation, the 2014 ISDA Credit Derivative Definitions was ISDA’s response to bail in regulation introduced after the global financial crisis allowing for government intervention in the banking sector in a way not captured by precedent ISDA documentation.

33 ISDA’s 20th Anniversary Report, p.12.
Brothers, issued the first over-the-counter swap. ISDA’s founding members were Salomon Brothers and nine further banks representing the major swap dealers at that time: Bankers Trust, Citicorp, First Boston Corporation, Goldman Sachs, Kleinwort Benson, Merrill Lynch, Morgan Guaranty, Morgan Stanley and Shearson Lehman Brothers. Holding membership of all major Wall Street commercial, investment and merchant banks of the time, ISDA has been a powerful lobby force from as early as its very foundation.

Beyond its task to supply the OTC derivatives industry with standardized documentation, was to assure immunity against the restrictive securities laws of the time. The essential policy issue at stake during the late 1980s and early 1990s in the United States was whether the recent over-the-counter swap transactions fell within the scope of the Commodity Exchange Act, which included various restrictions and most importantly exchange trading requirements. In fact, OTC swap transactions at that time would have been prohibited if the provisions of the Commodity Exchange Act were declared applicable. ISDA’s lobbying efforts pursued the twofold argument that officials were unable to understand swaps and thus incapable of regulating them without compromising market efficiency and economic growth and that Wall Street was well able to self-regulate. The clear victory for the derivatives industry came when the Commodity Exchange Act was amended to exclude OTC swap transactions from its provisions.

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34 ISDA was initially established as the International Swaps Dealers Association and subsequently changed its name to International Swaps and Derivatives Association in 1993. See ISDA’s 20th Anniversary Report, p.10.
35 The term swaps is sometimes used over the term derivatives in the present section, because swaps were the first credit derivatives traded in the markets of that time.
36 ISDA’s 20th Anniversary Report, p.12.
37 Indeed, the successful enforceability of OTC credit derivative products was highly doubtful in lieu of the restrictive regulation of the time applicable to securities. The importance of this issue as well as ISDA’s active role in pursuing a solution is highlighted by the following statement of one of ISDA’s former executive directors and chief executives: ‘Relationships with government, regulators and supervisors around the world have become a laser point of ISDA’s focus in its 20-year history. Fostering those relations and working to ensure understanding of the issues and each other is about as important as any of the work that ISDA does.’ See ISDA’s Anniversary Report, Preamble.
modity Futures Modernization Act (CFMA) of 2000\textsuperscript{41} was passed by US Congress.

The CFMA was undoubtedly a milestone in the development of unregulated OTC credit derivative markets as it excluded virtually all OTC credit derivatives from the scope of the Commodity Exchange Act and the supervision of the Commodity Futures Trading and the Securities Exchange Commissions\textsuperscript{42}. The passing of the CFMA was solemnly attributed to ISDA’s successful policy efforts\textsuperscript{43}. It is worth noting conclusively that the issue of regulating OTC derivatives was not addressed again until after the financial crisis of 2008.

To date, ISDA has expanded its membership. As stated on ISDA’s website ‘In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, interme-

\textsuperscript{42} Id. §§ 103, 120 (codified at 7 U.S.C. §§ 2(h), 25(a) (4) (2001)).
\textsuperscript{43} ISDA’s chairman in 2005 noted in an interview with Risk magazine with regard to the Commodity Futures Trading Commission’s efforts to regulate OTC derivatives that it was particularly because of such efforts that it needed to be said that the ‘CFMA [Commodity Futures Modernization Act of December 2000, providing legal certainty to the OTC derivatives markets], which involved significant work by many people in the industry to get across the finishing line, is a highlight in ISDA’s life.’. A former chairman of ISDA added that ‘to be precise, it was 12 years of negotiation and two pieces of legislation and policy statements and regulations.... And many visits to commissioners.’ ISDA chairman concluded by stating that ‘The comparative advantage that the industry has is our use of technology, our Master Agreement architecture and the regulatory framework that exists for swaps as a result of what we’ve done – swaps aren’t futures, swaps aren’t securities for the most part, and it’s easier for us to innovate.’, ISDA’s 20\textsuperscript{th} Anniversary Report, p.10. It is worth noting, that the explanatory reference to the CFMA included in the interview, namely that it provided legal certainty to OTC derivatives markets, would have been more accurate if it had clarified that such legal certainty was provided to the OTC derivatives markets participants with regard to the enforceability of their derivatives contracts. For the CFMA surely did not contribute to the legal certainty of OTC derivatives markets as demonstrated by the various scandals and big economic losses involving OTC derivatives following its passage and eventually by the global financial crisis of 2008. See also Partnoy, Infectious Greed: How Deceit and Risk Corrupted the Financial Markets, p.295 on how ISDA’s most active lobbyist was heavily involved in the drafting process of the CFMA.
diaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers.’

Furthermore, ISDA frequently provides its expertise to English and US courts in cases involving derivatives transactions. Such expertise are delivered by means of *amicus curiae* briefs advising courts on significant cases involving OTC derivative transactions. ISDA has published following announcement on its website with regard to *amicus curiae* briefs:

‘ISDA’s amicus program is another important way that we fulfill our commitment to advocacy on behalf of the industry. ISDA files amicus briefs, known as “friend of the court” briefs, in court cases around the world that raise important policy issues that impact the over the counter derivatives market and market participants. Because of ISDA’s role in the development of derivatives markets, ISDA is uniquely well positioned to address issues of general importance to the industry. For example, ISDA has filed numerous briefs addressing the interpretation of the safe harbor provisions in the Bankruptcy Code as well as defending ISDA documentation provisions. ISDA’s amicus program continues to actively monitor litigations that may impact the OTC derivatives market or market participants and we welcome member suggestions for possible participation in cases.’

It is hard to not be oblivious of the fact that notwithstanding its indispensable contribution to the development of the OTC derivatives markets and its unique expertise, ISDA is but a private trade association and not a regulatory body authorized with the regulation, supervision and arbitration of OTC derivative transactions.

II. The structure of ISDA’s documentation on unfunded credit derivatives

ISDA’s documentation covers the vast majority of OTC credit derivative transactions. Parties to such transactions can either choose to follow ISDA’s standardized documentation or arbitrarily amend it to fit their indi-

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45 It might be worth noting at this point that ISDA’s master agreements suggest that exclusive jurisdiction over derivative transactions should be given to English and US courts. Evidently, parties are at liberty to confer jurisdiction to courts of another country, but nevertheless strongly advised by ISDA to do so with due care as ISDA master agreements have not been prepared with a view of being enforceable under other jurisdictions.
46 Available at http://www2.isda.org/functional-areas/legal-and-documentation/amicus-briefs/.
individual needs. ISDA documentation follows a particular structure to provide the degree of standardization necessary for transaction security while conferring upon the parties of such transaction the flexibility to amend or deviate from such standardization.

ISDA documentation is divided into agreement templates and documents embedding terms and conditions applicable to such agreements. Former include *inter alia* the master agreements and associated schedules, confirmation agreements and additional provisions agreements, latter the ISDA credit derivative definitions.

ISDA makes two master agreements available to OTC credit derivative dealers: The 1992 Master Agreement and the 2002 Master Agreement. The master agreements are standardized and provide the terms of the basic transaction. Parties can amend such agreements for the purposes of their individual transaction by incorporating respective deviations into the schedule, which is attached to the selected master agreement.

Confirmation agreements are agreement templates adapted to the product-specific terms of each credit derivative transaction. Depending on the specific transaction, parties will use the associated confirmation agreement template, in which they will specify the applicable transaction terms and furthermore designate the applicable ISDA credit derivative definitions as well as the associated amendments thereto or deviations therefrom. If parties wish for further amendments not envisaged by the confirmation agreement template they can incorporate such amendments by means of additional provisions agreements that are further attached and referred to in the confirmation agreement.

The amendments to and deviations from standard documentation will *inter alia* depend on the type of each transaction but also on the specific features of the selected reference entities and underlying obligations. ISDA’s documentation is variously adapted to specific transaction types and subsequently follows a broadest-to-the-narrowest structural system.

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47 Two ISDA credit derivatives definitions are currently available, the 2003 and 2014 ISDA Credit Derivatives Definitions.

48 For instance, the confirmation agreement template for a single name credit default swap transaction is attached to the 2003 and 2014 ISDA Credit Derivatives Definitions as Exhibit A. To date, most but not all credit derivative products have separate confirmation agreement templates. If parties enter into a credit derivative transaction lacking a separate confirmation agreement, they will select the closest available confirmation agreement and amend it accordingly to serve the purposes of their transaction.
credit derivatives definitions and the basic confirmation agreement templates relate to the broadest categories of reference entities and underlying obligations and the subsequent additional provisions agreements relate to the narrowest types of reference entities and underlying obligations.

The following paragraphs separately describe the abovementioned ISDA documentation in further detail.

III. Master agreements and associated schedules

ISDA issued two master agreements, the 1992 Master Agreement and the 2002 Master Agreement. Parties intending to enter into an OTC credit derivative transaction can select either. The 2002 Master Agreement is an updated form of the 1992 Master Agreement\(^49\). Nevertheless, OTC credit derivative dealers retain almost exclusive preference for the 1992 Master Agreement. The 1992 Master Agreement shall therefore constitute the master agreement template for the purposes of the present section.

The 1992 Master Agreement is standardized and includes the general terms of the overall transaction notwithstanding its type and specific features. Such terms relate to the interpretation of applicable terms, the basic obligations of the parties, representation related matters, general agreements relating to the overall transaction, events of default and termination events of the overall transaction, early termination events of the overall transaction, transferability of the overall transaction agreement, the applicable currency, miscellaneous provisions, provisions on the governing law and jurisdiction as well as definitions of relevant terms\(^50\).

Attached to the master agreement is a pre-printed form of a schedule (the Schedule to the Master Agreement) making various amending choices available to the parties entering the master agreement\(^51\). The parties can choose which master agreement provisions shall or shall not apply to their transaction and to which party of the transaction; they can furthermore modify master agreement provisions or add additional provisions to better serve the purposes of their transaction.

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49 The 2002 Master Agreement includes certain variation and additions particularly regarding closeout payments, set-off and *force majeure* related matters.
51 *Id.*
This system is fairly efficient. Parties at the outset of an OTC credit derivative transaction are provided with the standard market terms included in the master agreement to commence their negotiations and can incorporate the respective amendments fitting their final agreement into the attached schedule. Eventually, the master agreement, as amended by the schedule will be the valid contract documenting the respective overall OTC transaction.

IV. Confirmation agreements and additional provisions agreements

1. Confirmation agreements

Once the parties have concluded a master agreement and settled the terms of the associated schedule, they confirm their master agreement by entering into a confirmation agreement\(^{52}\). The confirmation agreement is adapted to product-specific transactions. It designates the details of each specific transaction, such as the reference entity, the underlying obligation, settlement method, the applicable master agreement, as amended by the attached schedule etc.\(^ {53}\). The parties further indicate which credit derivative definitions shall apply to their transaction and designate respective amendments or deviations. Similarly to the process applying to the master agreement and the associated schedule, the selected credit derivatives definitions constitute the standard market terms applicable to the related transaction and provide a starting reference for parties’ negotiations. Once the parties have agreed on the specific terms applicable to their transaction they incorporate the respective amendments to or deviations from the credit derivatives definitions in their confirmation agreement.

The confirmation agreement carries the form of a letter that is extended by the proposing party to the confirming party. Once the confirming party signs and returns the confirmation agreement to the proposing party, the respective credit derivative transaction becomes effective.

Templates of confirmation agreements are constantly produced by ISDA for new credit derivative products as soon as their affiliated business practice settles. Confirmation agreement templates for credit derivatives issued by ISDA so far are adapted to \textit{inter alia} single name, first-to-de-

\(^{52}\) Introductory paragraph of the 1992 ISDA Master Agreement.

\(^{53}\) See, for instance, 2003 and 2014 ISDA Credit Derivatives Definitions, Exhibit A.
fault and contingent credit default swaps, transactions entailing US municipal reference entities and credit default swaps on asset backed securities.

2. Additional provisions agreements

ISDA’s credit derivatives definitions and confirmation agreement templates regard the broadest categories of reference entities and underlying obligations. But certain reference entities and underlying obligations can exhibit more particular features. The same applies to more particular OTC credit derivative transactions. Parties to such transactions are therefore conferred the option to undertake further amendments by means of additional provisions agreements. In an additional provisions agreement, the parties can designate additional provisions and settlement and transfer variations for the purposes of their transaction. The additional provisions agreement is included in the introductory paragraph of the respective confirmation agreement by reference.

ISDA issued various additional provisions agreement templates and continuously does so when a specific transaction product demonstrates sufficient trading volume.

One of the most important additional provisions document templates issued by ISDA was the 2005 matrix supplement\(^\text{54}\). The 2005 matrix supplement introduced a credit derivatives physical settlement matrix\(^\text{55}\) and was incorporated into the 2003 ISDA Credit Derivative Definitions by including a new Article XI. The credit derivative physical settlement matrix was declared applicable to certain reference entities designated in physically settled transactions\(^\text{56}\).

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\(^{54}\) See www.isda.org.

\(^{55}\) Credit derivative agreements can be either cash or physically settled. Latter means that one party delivers to the counterparty the defaulted underlying obligation if the assumed risk materializes.

\(^{56}\) See www.isda.org.
V. ISDA Credit Derivatives Definitions

1. The 2003 ISDA Credit Derivatives Definitions

The 2003 ISDA Credit Derivative Definitions (2003 ISDA Definitions) are applicable to OTC credit derivative transactions that are documented by either the 1992 or 2002 ISDA Master Agreement. As indicated previously, parties to such transactions can amend or deviate from the 2003 ISDA Credit Derivative Definitions by designating respective amendments or deviations in their confirmation agreement and/or their additional provisions agreement.

The 2003 ISDA Definitions include a set of terms and conditions covering virtually every feature of an OTC credit derivative transaction: the designation of a reference entity and underlying obligation, settlement conditions, available credit events, available settlement methods and associated terms, calculation of settlement payments and fee payments, terms related to cash and physical settlement, additional representations or agreements and novation provisions.

The 2003 ISDA Definitions were drafted on the basis of a single name credit default swap transaction and have therefore been selected as the documentation template for the purposes of the present thesis.

2. The 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions

The 2009 ISDA Credit Derivatives Determinations Committees, Auction Settlement and Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions (2009 Supplement) was a response to certain

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58 2003 ISDA Definitions, Introduction.

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practical difficulties OTC credit derivative participants faced in the past with regard to the physical settlement of certain credit derivative transactions. The physical settlement of a credit derivative transaction requires the delivery of the defaulted underlying obligation. Holders of ‘naked’ OTC credit derivatives, i.e. holders not owning the underlying obligation\textsuperscript{60}, therefore had to buy a deliverable obligation to physically settle their transaction upon the occurrence of a credit event.

The problem arose due to the high number of naked OTC credit derivative transactions. Right before the financial crisis of 2008, the notional amount of credit derivative transactions was found to be ten times greater than the notional amount of the associated underlying obligations\textsuperscript{61}. Inevitably, some major credit events resulted into a disproportionately high demand for underlying obligations inflating their prices to such extent that the overall recovery payment amount of related OTC credit derivative transactions fell below any reasonable expectation.

The credit event of Delphi Corporation, the former largest US automotive parts manufacturer, in October 2005, was one of those major credit events\textsuperscript{62}. Prior to Delphi’s bankruptcy, the analogy between the notional value of OTC credit derivatives issued on its debt and that of its actual underlying debt was nearly 13:1\textsuperscript{63}. Consequently, when Delphi filed a bankruptcy petition, prices on its debt skyrocketed and parties of naked OTC credit derivative transactions suddenly faced the cost of market risk.

ISDA’s first response was to issue cash settlement protocols applicable to specific major credit events\textsuperscript{64} allowing for cash settlement instead of physical settlement by means of a complex auction process. In 2009, it


\textsuperscript{63} Id.

published the Big Bang Protocol\textsuperscript{65} and the Small Bang Protocol\textsuperscript{66}, former covering credit events other than restructuring and latter applicable to restructuring credit events. Those Protocols were embedded in the 2009 Supplement. The 2009 Supplement was subsequently incorporated into the 2003 ISDA Definitions by means of a new Article XII establishing the terms and conditions relating to auction settlements and the indication of the necessary amendments to the residual terms of the 2003 ISDA Definitions accruing from the introduction of the new auction settlement method.

Pursuant to the relative amendments introduced by the 2009 Supplement, protocol covered transactions, i.e. transactions covered by associated ISDA protocols, initially set out to physical settlement can be cash settled by means of the established auction process.

3. The 2014 ISDA Credit Derivative Definitions

Similarly to the 2009 Supplement, the 2014 ISDA Credit Derivative Definitions (2014 ISDA Definitions)\textsuperscript{67} were issued to combat certain difficulties that arose due to certain market developments that had not been envisaged by the 2003 ISDA Definitions.

In February 2013, the Dutch government nationalized its fourth largest bank, SNS Reaal and expropriated all of SNS Reaal’s subordinated bonds as part of a government bail-in\textsuperscript{68}. Expropriation, albeit incurring signifi-

\begin{itemize}
  \item Bail-in provisions require bondholders of a bank to participate in the financial recovery of such bank if necessary. On nationalization of SNS Reaal see ‘SNS Na-
\end{itemize}
cant losses for OTC credit derivative parties, was not covered by any of the available credit events under the 2003 Definitions. It could neither be considered a bankruptcy credit event since SNS Reaal was not insolvent, nor a failure to pay credit event since there was no payment default. The closest credit event that could apply was restructuring, but expropriation was hard to justify since there were no reductions in interest or principal or postponement or deferral, change in ranking or currency as provided by the 2003 ISDA Definitions. ISDA solved that problem by nevertheless declaring a restructuring credit event on the facts. The consequences for the OTC credit derivative industry were not severe, because SNS Reaal was not a widely traded reference entity. But when it became apparent that the proposed EU Bank Recovery and Resolution Directive, inter alia conferring EU governments the power to implement mandatory debt exchanges for senior and subordinated bondholders and establishing a bail-in of at least 8% of a bank’s liability as a prerequisite to any government bail-out, was about to enter into force, it was clear that the SNS Reaal bail-in would not be a sui generis case.

ISDA’s response was to issue the 2014 Credit Derivative Definitions (2014 ISDA Definitions). The 2014 ISDA Definitions constitute an amended version of the 2003 ISDA Definitions, as amended by the 2009 Supplement. The amendments included in the 2014 ISDA Definitions regard mostly credit events involving government interventions and restructurings as well as sovereign reference entities. They do therefore not provide the appropriate template documentation for the purposes of the present thesis. Nevertheless, the amendments introduced by the 2014 Definitions are too important to be left out completely. The following paragraphs shall thus provide a brief overview of the three most essential amendments introduced by the 2014 ISDA Definitions.


tion Credit Event (GI credit event). The GI credit event covers government bail-ins. It can be triggered in situations where a restructuring and resolution law or regulation resulting from governmental authority action or announcement applies to reference entities making certain binding changes to the underlying obligations of such entities. Such changes include reductions, deferrals in principal or interest, subordination of reference obligations, expropriations, transfers, obligatory cancellations, conversions, exchanges and other analogous events.

Furthermore, the 2014 ISDA Definitions introduce the concept of Financial Reference Entity Terms. The Financial Reference Entity Terms apply to reference entities that are financial institutions and to restructuring or GI credit events if referenced in the confirmation agreement of the respective transaction. Essentially, this concept amends the provision of the 2003 ISDA Definitions pursuant to which a restructuring credit event triggering payment on underlying subordinated debt obligations issued by a reference entity also triggers payment on underlying non-subordinated debt obligations issued by the same reference entity. This was one of the complexities noted during the SNS Reaal credit event, where due to the abovementioned provision included in the 2003 ISDA Definitions, all OTC credit derivative transactions designating SNS Reaal as a reference entity were triggered, notwithstanding the fact that only SNS Reaal’s subordinated bonds were expropriated. Pursuant to the new 2014 ISDA Definitions, this provision no longer applies, if parties choose to apply the Financial Reference Entity Terms. Such terms provide that a restructuring or GI credit event affecting subordinated debt reference obligations does not trigger payment of OTC credit derivatives issued on the same reference entity referencing non-subordinated debt.

Another factor that seems to have become apparent to ISDA is that, after a government bail-in or sovereign debt restructuring, deliverable underlying obligations might no longer exist in the same form. In such case, valuation of a deliverable obligation in a physically settled OTC credit derivative transaction would become significantly difficult even by means of an auction process. To combat such potential controversies, the 2014 ISDA Definitions established a new set of provisions, the Asset Packaged

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71 2014 ISDA Credit Derivatives Definitions, Section 4.8.
72 2014 ISDA Credit Derivatives Definitions, Section 3.6 (b) and (c).
73 This complexity became apparent during the SNS Reaal credit event where bonds were expropriated. But its consequences were limited because SNS Reaal was not
Delivery provisions applicable to sovereign and financial institution reference entities\(^\text{74}\). Pursuant to the new provisions, deliverable obligations\(^\text{75}\) that existed immediately prior to a GI or restructuring credit event shall be substituted by those obligations that result from the occurrence of such credit event. The resulting obligations shall constitute eligible obligations for transaction settlement purposes even if they typically do not fulfill respective deliverable obligation criteria\(^\text{76}\).

As already indicated, the 2014 ISDA Definitions are beyond the scope of the present thesis and will therefore not be elaborated in further detail. It is worth noting conclusively that even though the abovementioned amendments form but a part of the recent 2014 ISDA Definitions they evidence that the OTC credit derivatives industry is adequately equipped to deal with the aftermath developments of the global financial crisis. To date, both the 2003 and 2014 ISDA Definitions are available to parties entering into an OTC credit derivative transaction.

\(^{74}\) 2014 ISDA Credit Derivatives Definitions, Section 8.9.

\(^{75}\) Deliverable obligations within the present context refer to the obligations that can be delivered to the counterparty in a physically settled OTC credit derivative transaction.

\(^{76}\) 2014 ISDA Credit Derivatives Definitions, Sections 3.2 (d) and 3.3.
Chapter 2: Legal Aspects of Credit Derivatives

A. A comment on the legal status of credit derivatives

The legal status of credit derivatives has been highly debated among legal and economic scholars. This debate seems to result into the following two opposite views. The first view sees credit derivatives as insurance agreements and thus supports that they should fall within the scope of insurance law; the second view sees credit derivatives as non-insurance agreements and accordingly finds they are rightfully not subjected to the provisions of insurance law. The latter view suggests that credit derivatives should, at the most, be cleared instead of traded over-the-counter in some cases. Current US regulation applicable to credit derivative transactions seems to be more convinced of the second view, as will be demonstrated in the next subchapter.

The author is of the opinion that credit derivatives are indeed not insurance agreements but - contrary to the suggestion of the prevailing literature supporting that view - finds that this by no means constitutes a ground for less regulation but rather an inducement to contemplate whether credit derivatives should be subjected to additional regulatory requirements.

Prior to the elaboration of the aforementioned opinion represented herein, it is essential to distinguish credit derivatives from insurance policies.

The insurance policies featuring the closest resemblance to credit derivatives are financial guaranty insurances. Financial guaranty insurances are agreements under which the insurer undertakes the obligation to


pay the insured for the non-payment of principal and interest of a debt obligation, typically bonds, when such payment becomes due. The insured pays a premium to the insurer in return for the acquired protection.

Financial guaranty insurances emerged in the early 1970s. They were created by a small group of specialized insurance companies, the first of which was the American Municipal Bond Assurance Corporation. Prior to the mid-1980s, financial guaranty insurances were essentially treated as regular insurances and thus subjected to US insurance law.

In 1986, the National Association of Insurance Commissioners (NAIC) issued the Financial Guaranty Insurance Model Act (NAIC Model Act), which sets out financial guaranty insurance as a separate and distinct line of insurance. The concern was that financial guaranty insurances bear large and concentrated risks of loss for insurers; their separation from other lines of insurance intended to limit such risks to the financial guaranty policy line so as to not jeopardize insurance companies’ liquidity with regard to other lines of insurance. Financial guaranty insurers are therefore frequently referred to as ‘monoline insurers’.

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80 Id.
81 In 1944 the Supreme Court held in United States v. South-Eastern Underwriters Association, that Congress could regulate insurance transactions that were truly interstate; Congress subsequently enacted the McCarran-Ferguson Act (15 U.S.C. § 1011), which provided that the laws of the several states should control the insurance business. The McCarran-Ferguson Act thus confers upon states the power to regulate the insurance industry. See McCarran-Ferguson Act (15 U.S.C. § 1011, Pub. L. 114-38). See also United States v. South-Eastern Underwriters Association, 322 U.S. 533, L. Ed., 88 L Ed. 1440, 64 S. Ct. 1162 (1944). To date, states regulate insurances within their jurisdiction and the relative insurance statutes override federal law except of certain portions of federal law mostly dealing with peripherals of the insurance industry, e.g. federal tax laws.
83 NAIC Model Act § 2.
The NAIC Model Act defines financial guaranty insurance to include surety bonds, insurance policies, indemnity contracts and any guaranty similar to the foregoing, pursuant to which loss is payable upon proof of occurrence of financial loss to the insured as a result of specified events, such as the debtor’s default to pay principal or interest on a financial obligation when due. Pursuant to the provisions of the NAIC Model Act, an insurer may only issue financial guaranty insurance if it is licensed as a ‘financial guaranty insurance corporation’. Moreover, a financial guaranty insurer is not permitted to have more than one percent of its assets invested in a single entity and must comply with specified capital requirements. The NAIC Model Act further limits the financial obligations that may be insured under financial guaranty insurances to certain types of bonds or other substantially similar financial obligations.

Insurers issuing policies on financial guaranty insurance are otherwise subject to the provisions applicable to property and casualty insurers under the insurance law of each state so long as latter provisions are not inconsistent with the provisions set out under the NAIC Model Law.

Financial guaranty insurances are, like all insurance policies, hedging devices. They enable the insured to purchase protection against potential losses of the future. The NAIC Model Law therefore establishes, as any other insurance law, that the insurer must be licensed to issue insurance policies and comply with minimum capital requirements as well as limit its exposure to single insured entities.

Insured on the other hand are required to prove that they suffered financial loss as a result of the specified events under the financial guaranty insurance, to be entitled to payment. Such indemnity clause aims at restricting the insurance’s payment to the actual loss the insured suffered and prevent the insured from yielding any profit by means of its insurance policy.

85 Khan, "Credit Enhancement: Letters of Credit, Guaranties, Insurance and Swaps (The Clash of Cultures) ", p.923.
86 NAIC Model Act § 1 (A) (1) (a)-(f) (1986).
87 See Id. § 2 (A).
88 See Id. § 2 (A) (5).
89 See Id. §§ 2 (B) and 4 (A).
90 See Id. § 4 (B).
91 See Id. § 8. Naturally this section applies only where such state has adopted similar regulation to the NAIC Model Act. Alternatively, financial guaranty insurances are regulated solely pursuant to the provisions established under state insurance law.
Subrogation clauses typically included in insurance policies furthermore prevent the insured from receiving any payment beyond compensation for its actual losses. Subrogation clauses confer upon the insurer the right to subrogate the insured in its claim against the principal obligor if the insurer funded such claim under the associated insurance policy.

Subrogation clauses generally apply to sureties, who conducted payment for the debt of a principal obligor. In In re Enron Corp. the court discussed the concept of subrogation. The finding of the court reads in pertinent part as follows:

‘New York courts have long recognized and enforced the doctrine of subrogation. "Subrogation" means "the substitution of one person in the place of another [as] to a lawful claim, demand or right, so that he who is substituted succeeds to the rights of the other [as] to the debt or claim, and its rights, remedies, or securities." "The right of subrogation … is founded upon the facts and circumstances of a particular case and upon principles of natural justice …" It is a "creature of equity, and 'is enforced solely for the purpose of accomplishing the ends of substantial justice."92.

In Commercial Union Ins. Co. v. Minnesota Sch. Bd. Ass'n the court held specifically with regard to subrogation rights in insurance policies:

‘Subrogation is the substitution of an insurer to the rights of the insured. "The insurer stands in the shoes of the insured and acquires all of the rights the insured may have against a third party." [citation omitted]. Minnesota recognizes both equitable and conventional subrogation. Equitable subrogation is derived from common law and places "the charge where it ought to rest, by compelling the payment of the debt by him who ought in equity to pay it." [quotation omitted]. Conventional subrogation is contractual and a product of an agreement between the insured and the insurer. Where the rights of the parties are not governed by the terms of the policy, then the rules of equitable subrogation control. Because subrogation is equitable in origin, even when the right is contractual in nature, the terms of the subrogation are governed by equitable principles, unless the contract explicitly provides otherwise.’93.

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Subrogation clauses do not limit the subrogation rights of the insurer to the insured’s claim against the principal obligor, but can extend such rights to virtually any party that is responsible to pay for the losses accrued to the insured, the subrogee insurer paid for. This issue was addressed in *Medica, Inc. v. Atlantic Mut. Ins. Co.*[^94]. The issue at stake involved a health insurer, who paid medical benefits to its insured that were injured on property owned by several churches and subsequently asserted conventional subrogation rights against the churches' liability insurer for medical expenses paid to its insured[^95]. The Court of Appeal interpreted the policy language included in the respective contractual subrogation clause to mean that the health insurer could subrogate ‘*only against an entity that is legally responsible for all of an injured member's injuries.*[^96]’ The US Supreme Court reversed this finding and held that the Court of Appeal’s interpretation of the aforementioned policy language was too narrow[^97]. The Supreme Court found that such clause must be interpreted to include ‘*any party responsible for payment of medical expenses incurred as a result of [the insured’s suffered] injuries*[^98] and accordingly ruled that the health insurer in question was entitled to subrogation rights against the liability carrier[^99].

It results so far, that an insured under a financial guaranty insurance is – after the insurer conducted payment under such insurance- precluded from asserting any rights to payment regarding the same default event from the principal obligor or any other party responsible to make payments for the same loss, e.g. another insurer. The insurer subrogates the insured in its aforementioned rights to payment, so long as the insurer has conducted payment to protect its interests and has not acted as a volunteer[^100] and paid the full amount for which it bears secondary liability[^101]. Latter require-

[^95]: See *Id.*
[^96]: *Id.*
[^98]: See *Id.*
[^99]: See *Id.*, 79.
ment restricts subrogation rights to those parties that paid a debt for which they were secondarily liable rather than a debt of their own.\(^\text{102}\)

The limitation of the insured to receiving solely compensation for its suffered losses and no payment beyond such ceiling is the decisive element that distinguishes a hedging device from credit derivatives. Because credit derivatives are investment rather than hedging agreements the aforementioned element is absent in credit derivative transactions, including transactions where the CDS buyer owes the underlying debt obligation. For even in latter transactions the CDS buyer is not required to have suffered losses from the principal obligor’s default nor precluded from asserting any rights to payment it holds against the principal obligor after receiving payment under the credit derivative; the CDS buyer is furthermore entitled to encash payment for the same default under as many credit derivative agreements it might have acquired.

Thus, the primary intention of credit derivatives is not to indemnify the CDS buyer for any losses but rather to enable such party to yield profit if its credit risk investment pays off. Preventing an insured party from yielding profit under an insurance policy is on the other hand precisely what insurance policies aim for.

Because credit derivatives enable investing in credit risk and such risk can only be liquidated by means of calculating the accrued losses of the defaulted obligor on a debt obligation, credit derivatives entail some elements identical to those included in financial guaranty insurances. Such are, e.g., the payment of a premium, the specification of the underlying debt obligation and the principal obligor’s default being the event triggering payment. Still, calculation of the payable amount under a credit derivative is different from the calculation of the amount payable under an insurance policy, because former aims at liquidating the acquired credit risk rather than calculating any suffered losses. It is therefore that calculation under a credit derivative agreement is based on dissecting the decrease in the defaulted obligation’s market price, i.e. the difference between its market value after the occurrence of the issuer’s default and the par value of such obligation against the backdrop of the amount specified in the credit derivative agreement. Payment under financial guaranty insurances on the other hand includes the principal and interest of a debt

\(^{\text{102}}\) For a more detailed discussion on primary versus secondary liability of sureties including insurers see Part 3, Chapter 6.
obligation that were not conducted to the insured by the issuer when due against the backdrop of the insured’s suffered losses.

The mere fact that a CDS buyer could theoretically limit its benefits under a credit derivative to the amount of its suffered losses and thus enter into a credit derivative transaction for hedging purposes only, does not qualify credit derivatives to be hedging devices. Rather, the general transactional structure embedded in credit derivatives is of relevance and such structure is laid out in a way that enables the CDS buyer to yield payment when certain credit risks materialize, i.e. to invest in credit risk. It is therefore that principal insurance elements such as indemnity or subrogation clauses are absent from credit derivative transactions and why parties, who do not hold the underlying debt obligation, can acquire credit derivative agreements referencing such obligations. It is further also pursuant to the aforementioned reason that payment under credit derivatives is based on the losses noted on the underlying obligation and not the losses suffered by the CDS buyer. Accordingly, the CDS buyer needs to merely demonstrate the principal obligor’s default rather than its suffered losses to receive payment under a credit derivative agreement.

If the aforementioned analysis were applied to the question of whether credit derivatives should be subjected to the requirements of insurance law, it would return a partially negative response. Within the context of insurance law, investment, i.e. aspiring profitable revenues, is the opposed pole of hedging. This is why insurance law deprives the insured from any rights that could yield any payment beyond the insured’s losses, i.e. profit. If credit derivatives were subjected to the same requirement, they would no longer be credit derivatives; they would become insurance policies. Accurately put, credit derivatives would have to be prohibited if they fell within the scope of insurance law.

The author is of the view that credit derivatives should be assessed discretely as the devices they are in order to establish the appropriate regulatory requirements they should be subjected to rather than evaluated against the backdrop of insurance law. Evidently, this matter amounts to the volume of a separate thesis. Moreover, the regulation of credit derivatives outside bankruptcy law defies the scope of the present thesis that examines certain credit derivative positions in bankruptcy proceedings. The following paragraphs therefore merely provide some thoughts concluding the present comment on the legal status of credit derivatives.

Following the foregoing approach pursuant to which credit derivatives are credit risk investment agreements utilizing certain transactional me-
mechanics embedded in insurances for the purposes of credit risk liquidation, it occurs that the relative requirements of insurance law covering such mechanics would have to be included accordingly in any regulation applicable to credit derivatives. Such requirements would, e.g., be the requirement that the issuer of a credit derivative would have to be licensed or subjected to minimal capital requirements or exposure limitations to a single entity.

In addition to the aforementioned insurance elements, regulators would have to contemplate the benefits and perils that could arise from credit risk investment and regulate credit derivatives accordingly. For instance, the Securities Exchange Act of 1934 regulates officers, directors, and principal shareholders in an attempt to maintain fair and honest markets and furthermore establishes rules to ensure that informational needs of investors are adequately met\textsuperscript{103}. A similar approach should be adopted within the context of regulating credit derivatives.

A starting point occurs from the lessons to be learnt from past corporate scandals involving credit derivatives as well as within the context of the global financial crisis in 2008.

For instance, handling a large credit derivative exposure requires a high degree of sophistication as well as certain equipment. It might be less complicated to handle outstanding credit derivatives sporadically, but managing a large credit derivative portfolio would require the ability to develop mathematical risk models and risk control procedures. Moreover, credit derivatives require sophisticated evaluation and pricing methods to serve the purposes of a good investment. Dealers, who expose themselves to large credit derivative activities without acquiring the necessary sophistication, jeopardize large losses. Such losses were noted on various corporations during the 1990s. For instance, Metallgesellschaft AG lost over $1 billion on oil derivatives in 1993\textsuperscript{104}.

\textsuperscript{103} Securities laws actually provide a parallel example within the context of this section; in a sense securitization did to debt what credit derivatives did to credit risk. An investor wishing to invest in a corporation does not have to acquire shares or extend a direct loan to such corporation; it can buy one of the bonds issued by that corporation. Bonds are securities marketed on secondary markets and not based on any relationship between the issuer and the investors. The regulatory needs that arise within the context of bonds are thus not the same with those arising within the context of shares or loans.

\textsuperscript{104} Scalcione, \textit{The Derivatives Revolution: A Trapped Innovation and a Blueprint for Regulatory Reform} p.179.
The Enron Corp. bankruptcy in 2001 furthermore illustrates how giant derivative dealers can emerge in an unregulated and unlimited derivatives market and the associated perils upon such giants’ default. Enron Corp. was a rather small company involved in the energy business in the early 1980s. Towards the early 1990s, it started trading in energy derivatives. Its derivatives business expanded to a point that conferred Enron Corp. the reputation of having created the market of energy derivatives. In 2000, Enron reported an annual revenue of $150 billion and was considered the world’s largest gas and electric market maker; in 2001 it filed a Chapter 11 bankruptcy petition. It is known today, that this mystic default was associated with Enron’s massive debt disguise scandal. Nevertheless, its sudden default and the induced market consequences reflect the shortcomings of unregulated credit derivative markets from a public interest point of view.

Similarly, the systemic risk entailed in the over-exposure of financial giants to credit derivatives was evidenced by the default of Lehman Brothers Holding Inc. following the bail out of several large investment banks in 2008.

Conclusively, it should be noted that a regulatory approach towards credit derivatives that includes applicable insurance law requirements and furthermore establishes the necessary statutory requirements within the context of credit risk investment, does not compromise the interests of those investors, who wish to enter into a credit derivative agreement for pure hedging purposes. To the contrary, the aforesaid approach would increase protection for such investors; but it would furthermore safeguard financial stability avoiding replication of meltdowns, similar to those noted during the global financial crisis of 2008.

B. An introduction to derivatives regulation in the United States

In July 2010 the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was signed into law. Title VII Wall Street Transparency and Accountability of the Dodd-Frank Act reforms the regul-

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105 Id., p. 186.
106 Id.
latory framework of OTC derivatives\textsuperscript{108}. Effectively, Title VII does not introduce a new regulatory framework but is rather based on the already existing framework established by the Commodity Exchange Act\textsuperscript{109} and the Securities and Exchange Act of 1934\textsuperscript{110}. Title VII therefore mostly includes detailed amendments to the aforegoing acts rather than discrete rules\textsuperscript{111}.

The Dodd-Frank Act was supposed to be comprehensive regulation of derivatives that had threatened the entire financial system\textsuperscript{112}; nevertheless it is a highly complex and complicated piece of law severely criticized with regard to its effectiveness.

As indicated previously, the regulation of derivatives is beyond the scope of this thesis. The present section therefore merely serves the purpose of a brief introduction thereof.

Title VII of the Dodd-Frank Act does not provide a definition of credit derivatives; rather it includes a broad list of ‘swaps’ defining latter to include the most commonly known derivatives and excluding futures, forwards and derivatives based on securities, which are regulated separately\textsuperscript{113}. The supervision of swaps is left to the Commodity Futures Trading Commission (CFTC).

\footnotesize{108} Dodd-Frank Act, Title VII, sections 701-774.
\footnotesize{110} Securities and Exchange Act, 15 U.C.C., 78 ff.
\footnotesize{113} Dodd-Frank Act, Title VII, section 721 (46).
Broadly speaking and subject to exceptions, Title VII imposes on “Swap Dealers”\textsuperscript{114} and “Major Swap Participants”\textsuperscript{115} registration requirements\textsuperscript{116} and subjects certain OTC derivatives to central clearing\textsuperscript{117} and trading on a type of derivatives market venue, similar to an exchange but with reduced regulatory requirements\textsuperscript{118}.

“Swap Dealers” and “Major Swap Participants” are required to register under the Commodity Exchange Act and perform recordkeeping and reporting duties. Section 731 establishes that it is unlawful for any person to act as a “Swap Dealer” or “Major Swap Participant” unless such person is registered with the CFTC.

In defining the term “Swap Dealer”, section 721 attempts to draft the profile of a professional swap user. In relevant part, it provides the following definition of a “Swap Dealer”: ‘any person who (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps’\textsuperscript{119}.

The definition of swap dealers is highly abstract. Rather than establishing a clear set of objective rules to determine those swap participants that must be subjected to regulation, the aforementioned section essentially leaves such determination to the CFTC. Furthermore, section 721 provides that dealers may be designated as swap dealers for a single type, class or category of swaps or activities and not be a swap dealer for other types, classes or categories of swaps or activities\textsuperscript{120}. This essentially creates a regulatory regime for specific derivative products and swap dealers while leaving others less regulated or even unregulated.

The term “Major Swap Participant” is defined as ‘any person who is not a swap dealer; and (i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding....positions held for hedging or mitigating commercial risk....(ii) whose outstanding swaps create substantial counterparty exposure that

\begin{itemize}
  \item \textsuperscript{114} Dodd-Frank Act, Title VII, section 721 (47).
  \item \textsuperscript{115} Dodd-Frank Act, Title VII, section 721 (33).
  \item \textsuperscript{116} Dodd-Frank Act, Title VII, section 727.
  \item \textsuperscript{117} Dodd-Frank Act, Title VII, section 723.
  \item \textsuperscript{118} Dodd-Frank Act, Title VII, section 733.
  \item \textsuperscript{119} Dodd-Frank Act, Title VII, section 721 (47).
  \item \textsuperscript{120} Dodd-Frank Act, Title VII, section 721 (49).
\end{itemize}
could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (iii)(I) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and (II) maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission.\textsuperscript{121}

The aforementioned definition of “Major Swap Participants” seems to attempt placing swap dealers with large derivatives positions and sizable derivatives trading creating substantial counterparty exposure under federal regulation. Similarly to the statutory language defining “Swap Dealers”, however, the afore-cited provision includes vague terms that are not clearly defined. “Major Swap Participants” are supposed to be participants maintaining ‘a substantial position’ in swaps. Such position shall define whether participants and the derivatives they trade are subject to regulation under the Dodd-Frank Act; yet the term substantial is not defined. Also, the aforementioned provision excludes derivatives positions held by major participants for hedging or mitigating commercial risk from its scope, without defining the term ‘commercial risk’. It is furthermore questionable whether not regulating ‘substantial’ derivatives positions hedging ‘commercial risk’ would have no adverse effects on the stability of financial markets; after all insurance policies are subject to strict regulation and supervision for a reason. Besides, as already discussed in previous part, the distinction between speculative and hedging derivatives is in its fundamental basis highly questionable\textsuperscript{122}.

Title VII of the Dodd-Frank Act furthermore attempts to improve transparency of derivatives trading and price discovery by requiring, under certain circumstances, OTC derivatives to be centrally cleared by supervised clearing houses\textsuperscript{123} and be traded on CFTC regulated markets for derivatives, which are somewhat similar to exchanges but subject to reduced regulatory requirements, referred to as ‘swap execution facilities’\textsuperscript{124}.

Mandatory clearing does not apply to swaps where one of the counterparties is not a financial entity and the swap is used to hedge or mitigate

\begin{flushleft}
\textsuperscript{121} Dodd-Frank Act, Title VII, section 721 (33). \\
\textsuperscript{122} Part one, chapter 2-A. \\
\textsuperscript{123} Dodd-Frank Act, Title VII, section 723. \\
\textsuperscript{124} Dodd-Frank Act, Title VII, section 733. 
\end{flushleft}
commercial risk. Also in this case, the determination of whether a swap issued by a non-financial entity is subject to mandatory clearing is left to the CFTC.

Pursuant to section 733 of Title VII, a person may operate a facility for trading and processing swaps only if it is registered as a swap execution facility with the CFTC. The CFTC is further authorized to promulgate rules to define those swaps that can be executed on a swap execution facility.

The above set of rules demonstrates the structural framework of the Dodd-Frank Act. It essentially determines that an entity carrying out an activity in swaps that is either professional or sizable, must register with the CFTC. Upon its registration, such entity and its swap activity are subjected to the rules of the Dodd-Frank Act and to any subsequent regulation issued by the CFTC. The Dodd-Frank Act, however, fails to define professional and sizable entities as well as swap activities and thereby firstly creates legal uncertainty as to which swaps and entities are subject to regulation and which are excluded and on what grounds and secondly increases government-industry partnership, which has sincerely jeopardized the adoption of effective regulation promoting financial stability in the past.

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125 Dodd-Frank Act, Title VII, section 723.
126 Albeit a bit better defined compared to section 721, the term ‘financial entity’ is still highly abstract. See Dodd-Frank Act, Title VII, section 723.
Credit default swaps are bilateral agreements, under which one party transfers to the counterparty the credit risk of an underlying reference entity on one, or more of its debt obligations. If the underlying reference entity defaults on such payment obligations or files for bankruptcy, payment under the credit default swap can be triggered.

If the CDS buyer is a creditor of the reference entity, i.e. if it holds ownership of the referenced debt obligation, such creditor will be entitled to file a claim on account of such debt obligation in the bankruptcy proceeding of the reference entity, should latter file a bankruptcy petition. Because such filing would constitute a bankruptcy credit event triggering payment under the CDS agreement, the foregoing creditor will, shortly after the commencement of the bankruptcy proceeding, receive payment on its bankruptcy claim under the CDS, notwithstanding its right to payment accruing from the same claim in the reference entity’s bankruptcy proceeding. Since payment received under a CDS is currently not subject to any disclosure obligation, such contribution is most likely to remain silent during the course of the reference entity’s bankruptcy proceeding. It will consequently not be encountered when determining a CDS buyer-creditor’s payment share to be covered by funds of the bankruptcy debtor’s estate. Examining the legal consistency of such circumstance with the legal provisions of US Bankruptcy Law and the *pari passu* principle constitutes the primary objective of the present study.

The first step in this regard, and evidently the first challenge too, is to identify the relevant CDS creditor positions to be examined. One of the distinctive characteristics of CDS agreements is that they are individually tailored products, i.e. the specific terms applicable to each transaction vary according to the individual needs of their parties and special features of

128 This statement is based on the fallback provisions determining the time of payment under a single name CDS agreement under the 2003 ISDA Definitions. This issue is elaborated in more detail below.
each transaction type. There are consequently numerous types of CDS transactions and even within similar transactions the specific terms and conditions can still vary. The present thesis solves this problem by selecting the most basic type of all CDS transactions: single name credit default swaps. This selection serves a twofold purpose. It firstly enables the better understanding of those CDS features that are of importance for the elaboration of this thesis’ hypothesis, because the underpinning transaction is limited to its very basic and therefore less complex form; and it secondly facilitates the broadest applicability of the findings resulting from the present study, because single name CDS agreements represent the basic transaction embedded in most of the more complex CDS products. Moreover, single name CDS are to date the most frequently traded credit derivative products.

In order to identify the object of this thesis, the present part firstly explains single name CDS transactions under the applicable ISDA documentation. It subsequently elaborates on the terms of payment of a single name CDS agreement after the occurrence of a bankruptcy credit event with the ultimate view of identifying the creditor positions that arise after settlement of the aforegoing agreement. Eventually, the present part specifies those CDS positions that will be examined in the subsequent parts three and four.

To that end, the chapters of this part are structured as follows. Chapter three illustrates the key elements of single name CDS transactions and the general terms applicable under the 2003 ISDA Definitions.

Chapter four elaborates in detail the terms of payment embedded in the 2003 ISDA Definitions, putting particular emphasis on identifying the reference obligation on account of which payment will take place under the single name CDS, its applicable settlement method and the key dates regarding the evaluation of the reference obligation, the calculation of the settlement payment as well as the termination of the CDS after payment is

129 Parker, *Credit Derivatives: Documenting and Understanding Credit Derivative Products*, p. 27, p.371; Kothari, *Credit Derivatives and Structured Credit Trading*, p.81.

130 As already indicated under Part One, the documentation issued by the International Swaps and Derivatives Association (ISDA) has been selected as the template documentation for the purposes of the present thesis, because it covers virtually all CDS transactions and thus rendered the status of standard documentation applicable to CDS transactions.
conducted. Latter is particularly important within the context of CDS positions in the reference entity’s bankruptcy proceeding, because it indicates the point of time in the bankruptcy proceeding, at which creditors with a CDS position will receive payment on account of their bankruptcy claim under their CDS agreement.

Chapter five of this part categorizes the different CDS positions that can accrue from the settlement of single name CDS agreements and fall within the scope of the present thesis.
Chapter 3: The Structure of Single Name Credit Default Swap Transactions

Single name credit default swaps are unfunded credit derivatives that are traded over-the-counter\(^\text{131}\). They are called ‘single name’ because they specify only one reference entity as opposed to other credit default swaps that reference more than one entity, such as for instance basket credit default swaps. Henceforth, the term credit default swaps (CDS) shall –if not otherwise specified- refer to single name credit default swaps.

The following sections to the present chapter shall firstly illustrate the basic elements of a CDS transaction and subsequently elaborate on the general terms applicable to such transactions under the 2003 ISDA Definitions\(^\text{132}\).

A. Defining the key elements of a single name credit default swap transaction

A credit default swap is a bilateral contract, under which one party (the CDS buyer\(^\text{133}\)) agrees to transfer to the counterparty (the CDS seller) the

\(^{131}\) As already indicated under Part One, the Dodd-Frank Act subjects certain CDS transactions and participants to trading in standardized swaps markets rather than over-the-counter. The vast majority of CDS transactions is nevertheless still traded over-the-counter as the Dodd-Frank Act excludes from its scope CDS transactions that are not professional or sizeable as well as those that are concluded primarily ‘for hedging purposes’.

\(^{132}\) As indicated in the first part of the present thesis, the 2003 ISDA Definitions are adapted to single name CDS transactions and therefore constitute an appropriate framework for their documentation.

\(^{133}\) The following should be noted here for the sake of clarity: The vast majority of the literature on CDS uses the terms ‘protection buyer’ and ‘protection seller’ to refer to the buyer and seller of a CDS. Yet, such terms are not always accurate. Not all parties transferring the risk of a reference entity by means of a credit derivative contract seek to acquire protection against such credit risk. This is best demonstrated by the fact that a respectable number of credit derivative agreements and particularly CDS agreements reference obligations that are not owned by the party transferring the associated credit risk. It would therefore be more
credit risk of a third party (the reference entity) with regard to one or more underlying obligations (the reference obligation) of the reference entity. In exchange for assuming the reference entity’s credit risk, the CDS seller receives payments in form of a premium from the CDS buyer. If the reference entity defaults on a reference obligation specified under the CDS, the CDS buyer has the right to trigger payment of an amount equal to the losses noted on the reference obligation due to the reference entity’s default, payable by the CDS seller.

The parties

The parties to a CDS contract are the CDS buyer and the CDS seller. The CDS buyer agrees to transfer the credit risk associated with a reference entity’s obligation to the CDS seller who agrees to assume such risk against the payment of a fee.

It is worth noting here that it is not uncommon for CDS dealers to diversely take buyer and seller positions in multiple CDS transactions referencing the same entity and reference obligation or obligations. It should also be kept in mind that the CDS buyer must not necessarily own the reference obligation designated in the CSD agreement to receive payment thereunder.

The reference obligation

The reference obligation constitutes the underlying obligation of the CDS agreement. It can be a loan, bond, borrowed money or any other payment obligation of the reference entity. The parties may agree to designate in their confirmation agreement a single obligation only, a category of obligations or a category of obligations that fulfill certain pre-determined characteristics. The reference obligation further constitutes the basis for the calculation of both the payment fee payable to the CDS seller and the settlement amount payable to the CDS buyer.

precise to use the term ‘risk assignor’ as opposed to the term ‘protection buyer’ and respectively the term ‘risk assignee’ as opposed to ‘protection seller’. To avoid confusion, the present thesis makes use of the terms ‘CDS seller’ and ‘CDS buyer’.
The reference entity

The reference entity is the entity the credit risk of which is subject to the CDS transaction. The reference entity is the issuer of the reference obligation and its default on such obligation is the primary condition for payment under the CDS agreement to be triggered. As already indicated, credit default swaps that are not single name credit default swaps can designate more than one reference entities.

Fixed rate payment

The fixed rate payment, also termed ‘fixed amount’\(^ {134}\), is the amount paid by the CDS buyer to the CDS seller for assuming the credit risk of the reference entity. The fixed rate payment is calculated on the basis of the notional value of the CDS and represents the credit risk quality of the reference entity. It is usually expressed in terms of percent or basis points.

The parties determine in their confirmation agreement the dates on which the fixed amount is set and the dates on which payment thereof must be conducted. Usually payment of the fixed amount takes place once per year unless parties agree otherwise.

Floating rate payment

The floating rate payment is the amount of payment the seller pays to the buyer if and after one of the pre-agreed credit risks materializes. This amount will either be a cash settlement amount or a physical settlement amount depending on which settlement method the parties agree upon. The floating rate payment is calculated on the basis of the floating rate payer calculation amount, which is specified in the confirmation agreement between the parties and further represents the notional amount of the CDS.

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\(^{134}\) ISDA 2003 Credit Derivatives Definitions, Exhibit A.
The calculation agent

The calculation agent is an agent appointed by the parties and assigned *inter alia* with the task to conduct all necessary calculations for the settlement of the CDS agreement pursuant to the relevant specifications designated in the confirmation agreement. Such calculations essentially involve the determination of the reference obligation’s market price after the occurrence of a credit event and the determination of the settlement amount, i.e. the payment amount the CDS seller must conduct to the CDS buyer.

The calculation agent is designated in the confirmation agreement between the parties and can be one of the parties to the CDS transaction or a third party.
Credit events

Credit events specify the credit risks of a reference entity that can be transferred to the CDS seller under a CDS. The 2003 ISDA Definitions make available the following credit events to parties of a CDS transaction: bankruptcy of the reference entity, the reference entity’s failure to pay, acceleration of the reference obligation, default on the reference obligation\(^{135}\), the repudiation or declaration of a moratorium over some or all reference obligations and the restructuring of the reference obligation\(^{136}\).

The parties to a CDS specify in their confirmation agreement which of the above credit events is applicable to their transaction. Parties can further agree to designate credit events not envisaged by ISDA.

If one of the pre-agreed credit events occurs, both parties have the right to trigger payment under the CDS agreement.

Settlement methods and notification requirements

After the occurrence of a credit event, either party of the underlying CDS agreement can trigger its payment. Payment under a CDS agreement can follow a physical settlement method, a cash settlement method or be cash settled by means of an auction.

The mere occurrence of a credit event is not sufficient for payment to take place. The party intending to trigger payment needs to fulfill the notification requirements applicable to the designated settlement method. Only after the applicable conditions are fulfilled, is the CDS seller obliged to pay the CDS buyer the settlement amount.

The separate settlement methods and associated notification requirements applicable under the 2003 ISDA Definitions shall be addressed in greater detail below.

\(^{135}\) Default on an obligation that is not a failure to pay or due to acceleration can exist where a default occurred notwithstanding if or when acceleration on the reference obligation has been declared.

\(^{136}\) See 2003 ISDA Definitions, Article IX. Please also note that the 2014 ISDA Definitions further include as a separate credit event restructurings resulting from government intervention.
Key dates summarized

This subsection brings together the key elements embedded in the settlement process of a CDS agreement and summarizes the associated key dates as follows.

The date on which the parties to the CDS transaction enter into an agreement is the trade date of the transaction. Such transaction becomes effective on the date both parties are provided with a signed copy of all associated agreements confirming the CDS transaction, i.e. the master
agreement and the confirmation agreement. The confirmation agreement designates the scheduled termination date of the CDS transaction, i.e. the date on which the CDS agreement documenting such transaction expires if no credit event occurs or if a credit event occurs but is triggered by neither party.

If a credit event occurs prior to or on the scheduled termination date, the notifying party has 14 calendar days to deliver a credit event notice and a notice of publicly available information and, where the CDS agreement is physically settled, a physical settlement notice designating the reference obligation to be delivered to the counterparty. This 14-calendar day period is the notice delivery period. If the notifying party fails to meet the conditions to settlement as described above, the latest within the foregoing time period, it will not be able to trigger a credit event and the single name CDS transaction will be considered terminated on the scheduled termination date.

The date on which the credit event notice, notice of publicly available information and, where applicable, notice of physical settlement become effective, i.e. are received by the counterparty, is the event determination date. After the event determination date, the price of the relevant reference obligation is evaluated and the cash or physical settlement amount is calculated. Once such valuation is concluded and the payable settlement amount is set, the CDS seller must conduct payment of the respective amount to the CDS buyer. The date on which such payment takes place is considered the termination date of the CDS contract and concludes the related transaction.
The general terms of a single name credit default swap transaction under the 2003 ISDA Credit Derivatives Definitions

After having provided a general overview of the basic elements assembling a CDS transaction in previous section, the present section focuses on the general terms applicable to such transaction under the 2003 ISDA Definitions.

A brief reminder on the principal structure documenting a CDS transaction might be useful at this point. Parties intending to enter into an ISDA documented CDS transaction will firstly conclude a master agreement to establish the general terms of their overall transaction. To confirm such transaction, parties will further enter into a confirmation agreement. A template form of a confirmation agreement for CDS transactions is included in Exhibit A of the 2003 ISDA Definitions. It is drafted in form of a letter extended from one party to the counterparty of the CDS transaction.

In the introductory paragraph of the confirmation agreement, the parties will specify that they are entering into a CDS transaction and designate that the 2003 ISDA Definitions shall be incorporated into their confirmation agreement. Following the reference to the 2003 ISDA Definitions is a clause indicating that in case of an inconsistency between the confirmation agreement and the ISDA Definitions, the latter shall govern.
agreement and the 2003 ISDA Definitions, the former shall prevail. The confirmation agreement consists of six further paragraphs that specify the terms of the CDS transaction.

The first paragraph provides the general information of the transaction; it designates the CDS seller, the CDS buyer, the reference entity, the reference obligation, the calculation agent and the city it performs its duties from etc. It further determines the cornerstone dates of the transaction, such as the date on which the parties enter into the transaction (trade day), the date on which such transaction become effective (effective day) and the date it ends (scheduled termination date).

The second paragraph specifies the fixed amount payment, i.e. the payment conducted by the CDS buyer. It indicates its amount and further specifies on which dates such amount is payable as well as its last payment date.

The third paragraph determines the specifics of the floating rate payment, i.e. the payment conducted by the CDS seller upon the occurrence of a credit event. It specifies the floating rate calculation amount, which represents the notional value of the CDS transaction and provides the basis upon which the potentially accrued settlement amount shall be calculated. In this paragraph, the parties further specify the conditions to settlement, the applicable reference obligation or obligations or categories thereof and the applicable credit events.

The fourth paragraph indicates the settlement method applicable to the CDS transaction and further indicates the specifics of its technical process. It also identifies the deliverable obligations in case the parties choose to physically settle their transaction.

Finally, paragraphs five and six provide contact and account details of the parties and information of the offices they are acting through for the purposes of the relative CDS transaction. The closing section of the confirmation agreement requires the confirming party to execute and return the confirmation agreement to the proposing party in order to confirm its consent to be bound by the terms of the confirmation agreement.

The 2003 ISDA Definitions set out the provisions applicable to the CDS transaction as designated and, or amended under the confirmation agreement. The 2003 ISDA Definitions include twelve articles. Articles I

137 By means of this clause, parties to the CDS transaction can make effective any amendment to or deviation from the 2003 ISDA Definitions specified in their confirmation agreement.
and II provide the general definitions and terms relating to a CDS transaction. More specifically, Article I provides a definition for each term included in the CDS confirmation agreement. Article II sets out the general terms of the CDS transaction, e.g. terms relating to the determination of a successor to the reference entity, the general mechanics of payments, certain general provisions with regard to reference obligations etc.

Articles III – VIII deal with the payment obligations of the parties and the associated conditions. They establish the applicable rules on the determination of fixed rate payments, floating rate payments, the conditions to settlement and the specifics of each available settlement method. These more specific terms shall be elaborately addressed in the next chapter.

Articles IX and X of the 2003 ISDA Definitions set out the terms applicable to additional representations and agreements of the parties and to novation related issues respectively.

Article XI includes the physical settlement matrix as incorporated into the 2003 ISDA Definitions by the 2005 matrix supplement. Article XII sets out the terms and conditions applicable to CDS transactions that are subject to an auction settlement and was incorporated into the 2003 ISDA Definitions by means of the 2009 Supplement.

The present section concludes the elaboration on the general terms applicable to a CDS transaction for the purposes of the present thesis. The following chapter examines the more specific terms regarding the settlement of a CDS agreement after the occurrence of a bankruptcy credit event.
Chapter 4: Terms of Payment under a Single Name CDS Agreement and its Termination after the Occurrence of a Bankruptcy Credit Event under the 2003 ISDA Definitions

The present chapter provides a detailed elaboration on the terms of payment and the termination of a CDS agreement under the 2003 ISDA Definitions after the occurrence of a bankruptcy credit event. Its ultimate objective is to crystalize the position of a CDS buyer, who, after the reference entity’s bankruptcy, will receive payment on the reference obligation under the CDS agreement while preserving the right to pursue a claim on account of the same reference obligation in the reference entity’s bankruptcy proceeding.

Because a CDS buyer will only be a creditor in the reference obligation’s bankruptcy proceeding if it retains ownership of the foregoing reference obligation, the present section gives particular emphasis on the terms related to the cash settlement of CDS agreements, i.e. that settlement method enabling the CDS buyer to retain ownership of the reference obligation post settlement as opposed to the physical settlement method where the CDS buyer is typically obliged to deliver the defaulted obligation to the CDS seller in order to receive post settlement payment.

A. Identifying the reference obligation

Identifying the reference obligation is one of the key elements in CDS transactions. Any reference entity can and most likely will have numerous obligations extending from letters of credit, bonds and loans to payment of paper bills.

The parties to a CDS transaction will thus have to determine in their confirmation agreement which obligation, or category of obligations or category of obligations fulfilling certain criteria will be covered by their CDS agreement. Article II of the 2003 ISDA Definitions provides a framework to assist parties in the selection of the reference obligations underlying their CDS transaction.
Article II, section 2.19(a) of the 2003 ISDA Definitions sets out obligation categories parties can elect from. Those include payment obligations, i.e. any future, present or contingent obligation to pay money, any obligation to repay borrowed money, referencing obligations only, i.e. obligations specifically referenced in the relevant confirmation agreement of the CDS transaction, any bond, note or debt security obligation, any obligation arising from a loan or other credit agreement and any obligation that is either a loan or a bond. Some obligation categories, e.g. payment obligations are very broad whereas others, e.g. a reference obligation only are narrow.

The parties to a CDS transaction will choose the reference obligation category that better fits their individual investment strategy. For instance, a party would elect a reference obligation only or an obligation that is a bond or loan in cases where the parties’ investment interests rely on a transaction to be more tailor-made, e.g. because it physically holds specific obligations issued by the reference entity. Broader categories on the other hand would be more appealing to cover less tailor-made investment interests, since more obligations fit into a broader scope of credit risk transfer.

Another method to limit the number of obligations covered under a single name CDS is further suggested under Article II, section 2.19(b). Section 2.19 sets out seven obligation characteristics subjected to the parties’ election. The parties may reference in their confirmation agreement obligations with more than one obligation characteristic as long as they are not contradictory.

Pursuant to section 2.19 (b), elected obligations can be characterized by not being subordinated, not being owed primarily to sovereigns or supranational organizations, not being payable in the reference entity’s home country currency, not been governed by the reference entity’s home jurisdiction and not being issued domestically\(^{138}\). Reference obligations can be furthermore characterized by being payable in a currency specified in the confirmation agreement, or by being listed, quoted or ordinarily purchased and sold on an exchange\(^ {139}\).

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\(^{138}\) This characteristic would limit the reference obligations to those issued and offered for sale outside the market of the reference entity’s home country.

\(^{139}\) The characteristic of being listed, quoted or exchange traded includes only reference obligations that are bonds. See Article II, Section 2.21 (a) of the 2003 ISDA Definitions.
It results from the above that reference obligations satisfying the characteristics and falling within the categories established under the 2003 ISDA Definitions can with no argument be allowed claims in the reference entity’s bankruptcy proceeding after the occurrence of a bankruptcy credit event. The only prerequisites would be that the CDS buyer is the holder of the relative reference obligation and further retains ownership thereof after the CDS agreement is settled. This is the case in all cash settled CDS agreements where the CDS buyer owns the reference obligation as will be demonstrated below.

B. The credit event of bankruptcy and the settlement conditions to be satisfied before payment

I. The credit event of bankruptcy

One of the credit events covered by ISDA’s documentation is the credit event of bankruptcy. Article IV, Section 4.2 (d) of the 2003 ISDA Definitions establishes the applicable definition of the term bankruptcy. This definition includes the filing of a bankruptcy petition. Section 4.2 (d) quotes in relevant part:

‘…. [“Bankruptcy” means a Reference Entity] institutes or has instituted against it a proceeding seeking a judgment of insolvency or bankruptcy or any other relieve under any bankruptcy or insolvency law or other similar law affecting creditor’s rights, or a petition is presented for its winding-up or liquidation, and, in the case of any such proceeding or petition instituted or presented against it, such proceeding or petition (i) results in a judgment of insolvency or bankruptcy or an order of an entry of relief or the making of the order for its winding-up or liquidation or (ii) is not dismissed, discharged, stayed or restrained in each case within thirty days of the institution or presentation thereof.’

It occurs that the objective of the above-cited provision is to determine a bankruptcy credit event as objectively as possible and further keep its scope broad enough to include bankruptcy events under as many different jurisdictions as possible. The filing of a petition resulting into the commencement of a reference entity’s bankruptcy proceeding under chapter 7 or Chapter 11 of the US Bankruptcy Code (USBC) clearly falls within the scope of Article IV, Section 4.2 (d) of the 2003 ISDA Definitions. Consequently, if a reference entity or one of its creditors file a valid USBC chapter 7 or Chapter 11 bankruptcy petition, payment on the CDS transaction...
can be triggered, provided that the credit event of bankruptcy is indicated as an applicable credit event under the associated confirmation agreement and the otherwise associated settlement conditions are fulfilled.

II. Conditions to settlement

As already indicated, the mere occurrence of a credit event does not suffice to trigger payment under a CDS agreement. Pursuant to Article III, section 3.1 of the 2003 ISDA Definitions, the parties must further fulfill certain conditions to settlement depending on the applicable settlement method of their CDS transaction.

Pursuant to Article III, Section 3.2 (a) of the 2003 ISDA Definitions the settlement conditions applying to cash settled CDS transactions include the delivery of a credit event notice and, if specified in the confirmation agreement, the delivery of a notice of publicly available information. The same applies to physically settled CDS transactions with the additional requirement of delivering a notice of physical settlement.

Section 3.2 (b) of Article III further sets out how, when and by which party the above conditions must be satisfied. The confirmation agreement may specify the buyer\(^1\) and the seller\(^2\) or only the buyer to be entitled to trigger a credit event under the respective transaction. Such party (or parties) will be designated as *notifying parties* in the confirmation agreement. If the confirmation agreement does specify neither the buyer nor the seller, both parties are considered to be notifying parties\(^3\).

Regardless of which of the parties to the CDS agreement is entitled to trigger a credit event, it is in any case the notifying party, i.e. the party triggering such event, who has to satisfy the settlement conditions for the counterparty to perform its obligations under the respective CDS transaction.

\(^{140}\) Article I, section 1.9 of the 2003 ISDA Definitions.

\(^{141}\) Article I, section 1.20 of the 2003 ISDA Definitions. It might be hard to imagine why the CDS seller of a CDS transaction would want to trigger payment of the CDS. Nevertheless, depending on its overall investment strategy or the economic circumstances of a credit event, a CDS seller might have an interest to trigger payment to avoid potential additional costs.

\(^{142}\) Article III, section 3.2 (e) of the 2003 ISDA Definitions.
The following sub-sections elaborate on all separate settlement conditions to provide an overview of the process following the occurrence of a credit event.

1. Delivering a Credit Event Notice

Pursuant to Article III, Section 3.3 of the 2003 ISDA Definitions a credit event notice is an irrevocable notice delivered by the notifying party to the counterparty. The credit event notice must deliver the relevant facts of the credit event in reasonable detail. The delivery of the credit event notice must take place within the notice delivery period, i.e. within the time period extending from the effective date (effective date included) of the CDS transaction to fourteen calendar days (fourteenth calendar date included) after the scheduled termination date of the CDS transaction. Any delivery that has taken place until 4.00 p.m. (calculation agent city time) on a calculation agent city business day is considered effective on the same day. Any delivery taking place after 4.00 p.m. is considered effective as of the following calculation agent city business day.

Conclusively, if a credit event specified in the confirmation agreement occurs within the term of the CDS transaction, the notifying party has to deliver to the counterparty a credit event notice no later than fourteen business days after the scheduled termination date. A credit event notice template is provided under Exhibit B of the 2003 ISDA Definitions.

2. Notice of Publicly Available Information

If specified in the confirmation agreement, the notifying party must adhere to its credit event notice a notice of publicly available information. Pursuant to Article III, Section 3.6 of the 2003 ISDA Definitions, a notice of publicly available information is an irrevocable notice delivered by the notifying party to the counterparty and cites publicly available information confirming the occurrence of the credit event described in the credit event notice. Article III further defines the notion of publicly available information.
tion as information on the facts related to the determination of the credit event that is described in the credit event notice\textsuperscript{146}. Such information must furthermore be published in a specified number of public sources. Public sources are, if not otherwise specified in the confirmation agreement, the sources indicated in Article III, Section 3.7, e.g. The Financial Times or The Wall Street Journal and virtually any internationally recognized, published or electronically displayed news sources\textsuperscript{147}. Specified number of public sources means the number specified in the confirmation agreement and if no indication is made thereunder, two public sources\textsuperscript{148}.

The specifics of a publicly available information notice are incorporated into the credit event notice template exhibited in the 2003 ISDA Definitions\textsuperscript{149}.

3. Notice of Physical Settlement

If a CDS transaction is physically settled, the notifying party must, in addition to a credit event notice and notice of publicly available information, provide the counterparty with a notice of physical settlement\textsuperscript{150}. Such notice must be delivered within 30 calendar days (thirtieth day included) after the event determination date, i.e. the date on which the counterparty has received the credit event notice\textsuperscript{151}.

The notice of physical settlement must confirm the physical settlement of the CDS transaction and furthermore provide a detailed description of the deliverable obligation\textsuperscript{152}.

C. Payment under a CDS agreement

If an applicable credit event occurs and the notifying party timely satisfies the applicable conditions to settlement, both parties to the CDS transaction

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{146} Article III, Section 3.5 of the 2003 ISDA Definitions.
\item \textsuperscript{147} Article III, Section 3.7 of the 2003 ISDA Definitions.
\item \textsuperscript{148} Article III, Section 3.8 of the 2003 ISDA Definitions.
\item \textsuperscript{149} Exhibit B of the 2003 ISDA Definitions.
\item \textsuperscript{150} Article III, Section 3.2 of the 2003 ISDA Definitions.
\item \textsuperscript{151} Article III, Sections 3.2, 3.4 (ii) and Article I, Section 1.8 of the 2003 ISDA Definitions.
\item \textsuperscript{152} Article III, Section 3.4 of the 2003 ISDA Definitions.
\end{itemize}
\end{footnotesize}
must perform their respective obligations thereunder according to the applicable settlement method.  
There are three settlement methods applicable to ISDA documented CDS transactions; the physical settlement method, the cash settlement method and the settlement method by means of an auction. The following sections address each settlement method separately with particular emphasis on the cash settlement method.

I. Physical Settlement Method

Under a physically settled CDS transaction, the CDS seller agrees to buy the defaulted reference obligation at the price it would have bought it in absence of a credit event and the CDS buyer agrees to deliver such obligation to the CDS seller. The CDS buyer has 30 days after having satisfied the conditions to settlement to deliver a notice of physical settlement. As already indicated, the notice of physical settlement determines the actual deliverable obligations the CDS buyer will deliver on the physical settlement date according to the respective specifications in the confirmation agreement between the parties.

On the physical settlement day, the buyer delivers the determined deliverable obligation and the seller pays an amount equal to the par value of such obligation. The CDS transaction is thereby concluded, i.e. terminated.

It is worth noting at this point that where physical delivery of a defaulted obligation is not entirely possible by the time it becomes due, parties of a CDS transaction are permitted to deviate from their initial agreement to physically settle their transaction and partially cash settle their transaction. The conditions allowing for partial cash settlement of a CDS transaction and the applicable terms to partial cash settlement are dealt with in Article IX of the 2003 ISDA Definitions.

153 Article III, Section 3.1 of the 2003 ISDA Definitions.
154 Article VIII, Section 8.1 of the 2003 ISDA Definitions.
155 Article III, Section 3.2 of the 2003 ISDA Definitions.
156 Article III, Section 3.4 of the 2003 ISDA Definitions.
II. Cash Settlement Method

In cash settled CDS transactions the CDS seller pays to the CDS buyer the value of the accrued loss on the defaulted reference obligation after the occurrence of a credit event. For such value to be determined, an adequate price representing the value of the defaulted obligation after the credit event needs to be calculated. The determination of such price can be complex and highly dependent on appropriate timing. Particularly in case of a bankruptcy credit event, sufficient time must be provided to allow the price of the defaulted obligation to settle.

The following sub-sections will therefore elaborate on the mechanics and associated valuation dates of cash settled CDS transactions and furthermore provide an overview of the applicable key dates as set out under Article VII of the 2003 ISDA Definitions.

1. The mechanics of cash settlement

When the notifying party has satisfied the conditions to settlement, the calculation agent appointed in the confirmation agreement between the parties undertakes the obligation to make the arrangements for the determination of the reference obligation’s current market value.

To that end, the calculation agent will contract a specific number of dealers\footnote{Article VII, Section 7.15 of the 2003 ISDA Definitions.} on the valuation date or dates\footnote{Article VII, Section 7.8 of the 2003 ISDA Definitions.} and at the valuation time or times\footnote{Article VII, Section 7.14 of the 2003 ISDA Definitions.} with the task to provide quotations for the amount of each reference obligation specified in the confirmation agreement\footnote{Article VII, Section 7.7 of the 2003 ISDA Definitions.}. Such quotations are essentially quotations of the evaluated obligation’s market prices on the respective valuation dates and times.

Pursuant to Article VII, Section 7.15 of the 2003 ISDA Definitions, dealers are dealers in obligation of the type of obligation(s) for which quotations are to be obtained. The dealers are specified in the confirmation agreement. If the confirmation agreement includes no such specification the calculation agent must consult the parties for the appointment of dealers.

\footnotetext[157]{Article VII, Section 7.15 of the 2003 ISDA Definitions.}  
\footnotetext[158]{Article VII, Section 7.8 of the 2003 ISDA Definitions.}  
\footnotetext[159]{Article VII, Section 7.14 of the 2003 ISDA Definitions.}  
\footnotetext[160]{Article VII, Section 7.7 of the 2003 ISDA Definitions.}
The confirmation agreement designates the applicable methods to the acquisition of quotations made available to the parties of the CDS transaction\textsuperscript{161}. In particular, Article VII, section 7.9 of the 2003 ISDA Definitions sets out three methods for the acquisition of quotations: the request of bid quotations, offer quotations or bid and offer quotations, the calculation agent will average out. If the confirmation agreement does not specify a quotation method, the calculation agent will approach the dealers for bid quotations\textsuperscript{162}.

Accrued and unpaid interest rate payments on the respective obligation can be included in a quotation depending on the relative specification made under the confirmation agreement\textsuperscript{163}. If no specification has been made in this regard, the calculation agent will decide whether accrued unpaid interest is included after consulting the parties and the current practice regarding the respective reference obligation\textsuperscript{164}.

The confirmation agreement will further specify the amount of the reference obligation that shall be evaluated pursuant to the acquired quotations\textsuperscript{165}. Such amount is termed quotation amount. The confirmation agreement can either specify a defined amount or refer to a representative amount for the determination of the quotation amount\textsuperscript{166}. A representative amount is an amount that is representative for a single transaction in the relevant market and at the relevant time\textsuperscript{167}. If the parties have not made any specification in the confirmation agreement with respect to the applicable quotation amount, such amount is deemed to be the floating rate calculation amount\textsuperscript{168}.

Once the assigned dealers deliver the quotations on the specified quotation amount, the calculation agent will apply the valuation method specified in the confirmation agreement to set the final price of the reference obligation\textsuperscript{169}. The final price is a percentage that reflects the value of the reference obligation after the occurrence of the credit event compared to its par value. The valuation methods available to the parties are set out in

\textsuperscript{161} Article VII, Section 7.9 of the 2003 ISDA Definitions.
\textsuperscript{162} Id.
\textsuperscript{163} Article VII, Section 7.7 (c) of the 2003 ISDA Definitions.
\textsuperscript{164} Id.
\textsuperscript{165} Article VII, Section 7.12 of the 2003 ISDA Definitions.
\textsuperscript{166} Id.
\textsuperscript{167} Article VII, Section 7.16 of the 2003 ISDA Definitions.
\textsuperscript{168} Article VII, Section 7.10 of the 2003 ISDA Definitions.
\textsuperscript{169} Article VII, Section 7.4 of the 2003 ISDA Definitions.
Chapter 4: Terms of Payment under a Single Name CDS Agreement

Article VII, section 7.5 of the 2003 ISDA Definitions\textsuperscript{170}. Such methods are categorized pursuant to the number of reference obligations and the count of valuation dates referenced in the confirmation agreement and can include the highest, average or lowest quotations, i.e. market prices. The confirmation agreement indicates which prices, i.e. the highest or lowest price or a price in between, the calculation agent will use to calculate the final price of a reference obligation\textsuperscript{171}.

Once the final price is set, the calculation agent will multiply the notional amount of the CDS, i.e. the floating rate payer calculation amount, with the reference price\textsuperscript{172}, from which it will subtract the final price to determine the cash settlement amount\textsuperscript{173}.

**Figure 4: Cash Settlement Amount Calculation**

\[
\text{Cash Settlement Amount} = (\text{Notional Amount} \times \text{Reference Price}) - \text{Final Price}
\]

\textsuperscript{170} Section 7.5 provides the parties with the following valuation methods: the market valuation method and the highest valuation method for transactions specifying one reference obligation and a single valuation date, the average market valuation, the highest valuation and the average highest market valuation for transactions specifying one reference obligation and multiple valuation dates, the blended market and blended highest market valuation method for transactions referencing more than one obligation and specifying a single valuation date and the average blended market and the average blended highest valuation method for transactions referencing more than one obligation and specifying multiple valuation dates. If no specification regarding the applicable valuation method is indicated in the confirmation agreement the highest valuation method of each respective category applicable to one or more reference obligations and valuation dates is applicable.

\textsuperscript{171} Article VII, Sections 7.4, 7.5 and 7.6 of the 2003 ISDA Definitions.

\textsuperscript{172} The reference price is a percentage specified in the confirmation agreement and reflects the amount of the floating rate payer calculation amount used for the calculation of the cash settlement amount. If parties make no specification with regard to the reference price in their confirmation agreement the reference price is considered to be one hundred per cent. See Article II, Section 2.4 and Exhibit A, paragraph 1 of the 2003 ISDA Definitions. For the purposes of the present thesis the reference price will be considered to be one hundred per cent, i.e. to reflect the total floating rate payer calculation amount specified by the parties.

\textsuperscript{173} Article VII, Section 7.3 of the 2003 ISDA Definitions.
The calculation agent undertaking the obligation to calculate the cash settlement amount is further obliged to notify each party providing them with a written notice including the acquired quotations and the written calculation of the final price\textsuperscript{174}.

The parties may alternatively agree upon a fixed recovery CDS transaction, i.e. specify the cash settlement amount in their confirmation agreement\textsuperscript{175}.

The CDS seller must pay the cash settlement amount to the CDS buyer on the cash settlement date\textsuperscript{176}. The CDS transaction following a cash settlement method is thereby concluded\textsuperscript{177}.

2. Key dates and times of a cash settlement process

The present section summarizes the key dates of a cash settled CDS transaction to provide a conclusive overview of the cash settlement process. Such key dates are the event determination date, the applicable valuation dates and cash settlement date.

The event determination date, i.e. the date on which the notifying party has satisfied the conditions to settlement, initiates the cash settlement process. Immediately after the event determination date, the calculation agent will contract the specified dealers to obtain the appropriate quotations for the purposes of calculating the final price.

The date or dates on which the calculation agent will obtain such quotations constitute the applicable valuation dates. As such quotations can be obtained on one or more valuation dates, such dates are accordingly divided into the single valuation date and multiple valuation dates, both falling on a specified number of business days after the event determination date\textsuperscript{178}. The parties will specify in their confirmation agreement whether a single valuation date or multiple valuation dates are applicable to their CDS transaction as well as the number of business days following the event determination date such valuation dates fall after\textsuperscript{179}. If no specifica-
tion is indicated in the confirmation agreement a single valuation date is applicable falling five business days after the event determination date\textsuperscript{180}. The same number of business days also applies to multiple valuation dates where no number of business days is specified\textsuperscript{181}.

Quotations must furthermore be obtained at a specified time, termed the \textit{valuation time}. The applicable valuation time is specified in the confirmation agreement. If no relative specification is indicated in the confirmation agreement, the valuation time is deemed to be at 11.00 a.m. on the time zone of the reference entity’s principal trading market\textsuperscript{182}.

The overall valuation period can be concluded in a week pursuant to the fallback provisions established in the 2003 ISDA Definitions. Bespoke CDS agreements can nevertheless have valuation dates falling after a much higher number of business dates\textsuperscript{183}. This will depend on the nature of the CDS transactions as well as the intentions of the parties. For the purposes of the present thesis the valuation period will be determined pursuant to ISDA’s fallback of five business days.

Concluding the cash settlement process is the cash settlement date, i.e. the date on which the CDS seller must pay the cash settlement amount to the CDS buyer. If the confirmation agreement of the respective CDS transaction provides for a specific cash settlement amount, the cash settlement date is the fourth business day following the event determination date, unless the parties to the transaction have agreed otherwise in their confirmation agreement\textsuperscript{184}.

If the confirmation agreement does not specify a cash settlement amount, the cash settlement date is the fourth business day following the calculation of the final price, unless the parties to the transaction have agreed otherwise in their confirmation agreement\textsuperscript{185}.

The cash settlement date is the termination date of the CDS transaction\textsuperscript{186}.

\textsuperscript{180} Id.
\textsuperscript{181} Article VII, Section 7.8 (b) of the 2003 ISDA Definitions.
\textsuperscript{182} Article VII, Section 7.14 of the 2003 ISDA Definitions.
\textsuperscript{183} Some confirmation agreements specify valuation dates falling up to 140 New York, London or Tokyo business days after the event determination date. If this is the case the valuation period can last up to eight months. See Parker, \textit{Credit Derivatives: Documenting and Understanding Credit Derivative Products}, p.519.
\textsuperscript{184} Article VII, Section 7.2 (b) of the 2003 ISDA Definitions.
\textsuperscript{185} Article VII, Section 7.2 (a) of the 2003 ISDA Definitions.
\textsuperscript{186} Article VII, Section 7.2 of the 2003 ISDA Definitions.
III. Auction settlement

The auction settlement method was introduced by the 2009 Supplement and incorporated into the 2003 ISDA Definitions by means of an additional article, Article XII on Terms Relating to Auction Settlement and relevant amendments to the residual terms of the 2003 ISDA Definitions. The auction settlement method applies only to covered CDS transactions, i.e. those transactions that are subject to the 2009 Supplement, or the Big Bang and Small Bang Protocols and must furthermore be designated as the applicable settlement method in the associated confirmation agreement. After the occurrence of a credit event, ISDA announces if an auction settlement will be organized with regard to such credit event. If ISDA announces that no auction settlement will be organized, the parties will settle their transaction by means of the fallback settlement method, which will be either a cash or physical settlement method, established in their confirmation agreement.

If ISDA announces that an auction will be held, it establishes a Credit Derivatives Determination Committee (Determination Committee) appointed with the task to determine if a credit event has occurred. If the Determination Committee rules that a credit event has occurred, the parties to the respective CDS transaction will not have to satisfy any conditions to settlement, for such conditions will be deemed to be satisfied.

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188 Section 6.1 added to the 2003 ISDA Definitions via Section VI, paragraph 1 of the 2009 Supplements and Article XII and Sections 12.1, 12.11, 12.9 and 12.8 of the 2009 Supplements incorporated in the 2003 ISDA Definitions.
189 Section 1.8 (a) (ii) added to the 2003 ISDA Definitions via Section I, paragraph 2 of the 2009 Supplements and Section 12.1 of the 2009 Supplements incorporated in the 2003 ISDA Definitions.
190 Sections 1.8 (a) (i) and 6.4 added to the 2003 ISDA Definitions via Section I, paragraph 2 and Section VI, paragraph 3 of the 2009 Supplements respectively.
191 Section 1.22 added to the 2003 ISDA Definitions via Section I, paragraph 7 of the 2009 Supplements. The rules regarding determination committees are set out in the ‘Credit Derivatives Determinations Committees Rules’, which are published on ISDA's website (www.isda.org) from time to time and effective as amended from time to time. See Section 1.22 added to the 2003 ISDA Definitions via Section I, paragraph 7 of the 2009 Supplements.
automatically upon the Determination Committee’s resolution\textsuperscript{192}. An auction is subsequently organized by ISDA to determine the final price for the calculation of the \textit{auction settlement amount}\textsuperscript{193}. The technical details of the auction process are not relevant for the purposes of the present thesis and will therefore not be addressed hereunder\textsuperscript{194}. It suffices to note that the auction process cash settles the transaction as described in the previous section with the difference that the final price is not determined by means of market quotations but rather according to an auction of defaulted reference obligations. The formula for calculating the auction settlement amount pursuant to the auction final price is the same formula used in cash settled transactions.

The auction settlement date is the date on which the CDS seller pays the auction settlement amount to the CDS buyer\textsuperscript{195}. The auction settlement date is the sixth business day following the auction final price determination date, if not otherwise specified in the confirmation agreement between the parties\textsuperscript{196}. The auction settlement date terminates the CDS transaction\textsuperscript{197}.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{192} Section 3.2 added to the 2003 ISDA Definitions via Section III, paragraph 2 of the 2009 Supplements.
\item \textsuperscript{193} Article XII, Section 12.4 of the 2009 Supplements incorporated in the 2003 ISDA Definitions.
\item \textsuperscript{194} Such details covering an auction settlement process are set out in the ‘Credit Derivatives Auction Settlement Terms’, which are published on ISDA’s website (www.isda.org) from time to time and effective as amended from time to time. See Article XII, Section 12.8 of the 2009 Supplements incorporated in the 2003 ISDA Definitions.
\item \textsuperscript{195} Article XII, Section 12.1 of the 2009 Supplements incorporated in the 2003 ISDA Definitions.
\item \textsuperscript{196} Article XII, Section 12.3 of the 2009 Supplements incorporated in the 2003 ISDA Definitions.
\item \textsuperscript{197} \textit{Id.}
\end{itemize}
\end{footnotesize}
Chapter 5: Classification of Post-Settlement Creditor Positions

A. Post-settlement CDS positions relevant for the purposes of the present thesis

The present thesis deals with CDS positions that follow from the settlement of a CDS agreement in bankruptcy proceedings. Its scope does therefore not include any post settlement CDS position but solely those that leave the associated CDS buyer with a right to file a bankruptcy claim against the reference entity on account of the reference obligation subjected to settlement payment under the respective CDS agreement. The following paragraphs identify the relevant CDS positions for the purposes of the present thesis by setting out the characteristics accumulated therein.

Firstly, only CDS positions resulting from a settlement due to the occurrence of a bankruptcy credit event, i.e. due the reference entity’s filing of a valid petition to commence a bankruptcy proceeding under the Bankruptcy Code (USBC) are of interest.

Secondly, only CDS positions accruing from a CDS agreement where the CDS buyer is the holder of the reference obligation subjected to settlement payment are included in the scope of the present thesis. A CDS buyer who does not hold ownership of the reference obligation is of little interest since such buyer would not be a creditor in the reference entity’s bankruptcy proceeding.

Thirdly, the scope of the present thesis includes only CDS transactions where the CDS buyer retains ownership of the reference obligation subjected to settlement payment after the CDS seller has conducted such payment. This is typically the case when CDS agreements are cash settled, but it can also occur in auction settled or partially cash settled CDS agreements. Physically settled CDS agreements are excluded from the scope.

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198 It is worth noting at this point that after the introduction of the auction settlement method by means of the 2009 Supplement, physically settled CDS transactions are scarce in practice and mostly substituted by auction settled transactions. See Edmund Parker, 'Over-the-Counter Credit Derivatives' in Practical Derivatives: A Transactional Approach Second ed. (Globe Business Publishing Ltd. : O'Neill, Sian 2010), p.249.
of the present thesis, as they require the CDS buyer to deliver the defaulted reference obligation to the CDS seller.

Finally, the present thesis includes only CDS transactions with a set valuation period and cash settlement date not exceeding the early stages of the reference entity’s bankruptcy proceeding and in any case before such proceeding is concluded. Valuation periods and cash settlement dates will therefore be determined according to ISDA’s standard terms as set out in previous chapter.

The classification following in the next section includes those creditor positions that emerge from CDS agreements that fall within the scope established hereunder.

B. Classification of post-settlement creditor positions

Depending on the floating rate payer calculation amount specified by the parties to a cash settled CDS agreement and the decrease of the reference obligation’s market price after the reference entity’s bankruptcy, the CDS buyer can receive cash settlement payment of less, equal or higher value compared to the par value of the reference obligation subjected to such payment.

The par value of the reference obligation subjected to payment under the CDS agreement and any accrued but unpaid interest rate amount on such obligation reflect the value of the bankruptcy claim, the CDS buyer will be entitled to file as a creditor to the reference entity’s bankruptcy proceeding. The cash settlement payment reflects the amount of payment the CDS buyer received from the CDS seller on account of the reference obligation subjected to payment under the CDS agreement. The cash settlement payment can also include accrued but unpaid interest on the reference obligation subjected to payment depending on the relative agreement between the parties\(^\text{199}\).

The value of the cash settlement payment will depend on the amount of the notional value of the CDS agreement and will reflect the losses noted on the reference obligation after the occurrence of the credit event, with greater losses reflected in higher cash settlement payments. The value of

\(^{199}\) Article VII, Section 7.7 (c) of the 2003 ISDA Definitions.
the bankruptcy claim is the par value of the reference obligation subjected to payment under the CDS agreement and is therefore fixed.

Depending on whether the value of the cash settlement payment is below, equal to or exceeds the total value of the bankruptcy claim the CDS buyer is entitled to file against the reference entity, the CDS buyer can be a partially satisfied creditor, an empty creditor or a net short creditor respectively.\textsuperscript{200}

The following subsections cite three hypothetical cases to illustrate the above creditor positions emerging after payment of the cash settlement amount under a CDS agreement.

I. Partially satisfied creditor positions

A partially satisfied creditor is a creditor who received cash settlement payment that falls below the par value of the reference obligation subjected to such payment. In such case, the creditor will have received part of the total value of its bankruptcy claim against the reference entity from the CDS seller. The following hypothetical case illustrates a partially satisfied creditor position.

Supposed corporation C (CDS buyer) and bank B (CDS seller) enter into a CDS agreement specifying corporation D as the reference entity, any bond issued by D as the applicable reference obligation and an amount of $800,000 as the floating rate payer calculation amount. Supposed that D goes bankrupt and thus files a valid petition to commence a bankruptcy proceeding under the USBC. Supposed furthermore that C holds ownership of bonds issued by D amounting to a total value of $800,000. C decides to trigger a credit event and satisfies the conditions to settlement specified in the confirmation agreement. Upon the applicable valuation date, the calculation agent appointed by C and B determines that D’s bonds note a value of only 50% of their par value upon the declaration of D’s bankruptcy. The cash settlement amount is accordingly specified at

$400,000. C will have received from B half of the total value of its bankruptcy claim against D, which amounts to $800,000.

II. Empty creditor positions

An empty creditor is a creditor who received cash settlement payment equal to the par value of the reference obligation subjected to such payment. In such case, the creditor will have received the total value of its bankruptcy claim against the reference entity from the CDS seller.

Supposed that in our previous hypothetical, C holds D bonds of a total value of $800,000 but C and B agreed to specify an amount of $1,000,000 as the floating rate payer calculation amount; and supposed furthermore that the calculation agent appointed by C and B determined that D’s bonds only amount to 20% of their face value upon the declaration of D’s bankruptcy. The cash settlement payment would accordingly amount to $800,000. C would thus have received a payment from B covering the total value of its bankruptcy claim, which amounts to $800,000.

III. Net short creditor positions

A net short creditor position is the position of a creditor who received a cash settlement payment of a value exceeding the par value of the reference obligation subjected to such payment. A net short creditor therefore receives more than the total value of its bankruptcy claim against the reference entity from the CDS seller.

Supposed that in our previous hypothetical, the calculation agent appointed by C and B determined that D’s bonds only amounted to 10% of their face value after the declaration of D’s bankruptcy. The cash settlement amount would accordingly be set at a value of $900,000. C would therefore receive a payment from B exceeding the total value of its bankruptcy claim against D that amounts to only $800,000.
C. Partially satisfied, empty and net short creditor positions in bankruptcy proceedings

The previous sections illustrated emerging creditor positions after the cash settlement of a CDS agreement without taking into consideration any amount paid to such creditors under the reference entity’s bankruptcy proceeding. If latter payment is considered, partially satisfied creditor positions after payment of the cash settlement amount can become empty or net short creditor positions during the course of the reference entity’s bankruptcy proceeding. Empty creditor positions after payment of the cash settlement amount will automatically become net short creditor positions as soon as the creditor receives any payment under the bankruptcy proceeding of the reference entity whereas already net short creditor positions will note an even higher exceeding value to the total value of the creditor’s bankruptcy claim.

For instance, the creditor of the hypothetical case regarding partially satisfied creditors receives a cash settlement payment of $400,000 from the CDS seller B and has a bankruptcy claim of $800,000. If C is paid five dollars on the cent in D’s bankruptcy proceeding, C will have received a total of $800,000, which covers the total amount of its bankruptcy claim against D. If C was paid more than five dollars on the cent in D’s bankruptcy proceeding, C would have exceeded the total value of its bankruptcy claim against D.

The same applies to empty and net short creditors. In our previous hypothetical C was an empty creditor who received the total value of its bankruptcy claim against D, i.e. a cash settlement payment of $800,000. If C receives any payment under the bankruptcy proceeding of D, C will have exceeded the total value of its claim. Accordingly, in the hypothetical case illustrated under Section II, subsection 3, where C is already a net short creditor, any payment received under D’s bankruptcy proceeding will increase the amount exceeding the total value of C’s bankruptcy claim against D.

The Bankruptcy Code currently establishes no disclosure requirements with regard to individual creditors with partially satisfied, empty or net short CDS positions. Consequently, empty or net short creditor pos-

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201 Disclosure requirements with regard to CDS positions are currently only applicable to reorganization bankruptcies and municipality reorganizations (chapters 9
itions that can emerge during bankruptcy proceedings can be neither con-
trolled nor avoided and can therefore result into certain creditors receiving
payment on their bankruptcy claim in excess of the total value of such claim.

and 11 USBC) and to groups or committees of creditors only. Individual creditors
are excluded from any disclosure obligation. See Bankruptcy Rule 2009.
Subfindings

The second part of the present thesis demonstrated that a CDS buyer who retains ownership rights of the reference obligation, subjected to payment after the CDS agreement is settled, also retains the right to file a bankruptcy claim against the reference entity, amounting to the par value of such reference obligation.

The analysis under the final chapter of the present part demonstrated that the payment a CDS buyer receives under a CDS is not necessarily proportionate to the par value of the reference obligation subjected to such payment. A CDS buyer will, in some cases, receive cash settlement payment that falls below, or beyond the par value of such reference obligation.

Whereas this is less problematic within the context of CDS transactions, it can result into a more debatable situation within the context of the reference entity’s bankruptcy proceeding. The par value of the reference obligation subjected to payment under a CDS agreement reflects the value of the bankruptcy claim a CDS buyer, who retains ownership rights of such reference obligation, is entitled to file as a creditor to the reference entity’s bankruptcy proceeding. If the cash settlement payment is equal to or exceeds the value of the creditor’s bankruptcy claim, before such creditor receives payment on its bankruptcy claim, any payment received in the bankruptcy proceeding of the reference entity will exceed the total value of the creditor’s claim. The same could apply to cash settlement payment that falls below the par value of the reference obligation subjected to payment, depending on the amount of payment the creditor will receive on its bankruptcy claim.

In a forum such as that of a bankruptcy proceeding attempting to enable the fair, equitable and best-possible satisfaction of all creditor claims from a limited source of assets, the potentiality of certain creditors being able to achieve a revenue in excess of the total value of their bankruptcy claim is of legitimate dubiety, particularly in lieu of the fact that - due to the debtor’s limited assets - some creditors might receive much less than the total value of their claim or even no consideration at all.

The question of whether such circumstance can infringe the pari passu principle is examined in the following part of the present thesis.
Bankruptcy law is fundamentally an ancillary debt collection device\textsuperscript{202}. Debt collection outside bankruptcy law is mainly enabled through a lawsuit against the non-paying debtor resulting into a court judgment on the basis of which the creditor can ask the state to seize property of the debtor to satisfy its claim. This system works for individual creditor claims as long as the debtor is solvent. Less efficient outcomes occur, however, in cases where the debtor has multiple unpaid creditors and limited funds.

Non-bankruptcy debt collection laws inevitably operate on a first come-first serve basis because they apply to single creditors, who can arbitrarily file a lawsuit against the debtor, if latter defaults on its debt payment obligations. If the debtor is insolvent, its assets will be exhausted rapidly upon the first creditor lawsuits. This would ultimately lead to few creditors receiving full payment on their claims leaving a large number of creditors with no payment at all. Bankruptcy law was established to provide a more efficient solution to the problems that arise in cases where a debtor has too few assets to satisfy the total value of its debts.

One of the primary objectives of bankruptcy law therefore is to enable the fair and equitable satisfaction of all creditor claims to the best possibility of the debtor’s assets. One of the key principles of bankruptcy law within this context is the fair and equitable treatment of creditor claims, or else the \textit{pari passu} principle.

Fair and equitable treatment of claims does not mean identical treatment of claims. In fact, the distributional scheme provided by bankruptcy law, contains various exceptions to the premise of equality\textsuperscript{203}. For instance, priority is conferred to secured claim, i.e. claims secured by means


\textsuperscript{203} See, e.g., USBC § 507 on the priority of certain unsecured claims.
of leans or collaterals enforceable against the debtor’s property\textsuperscript{204}. Secured claims are entitled to full payment before any distribution is made to unsecured claims\textsuperscript{205}. Priority is further conferred to certain unsecured claims mainly due to (but not limited to) social policy issues\textsuperscript{206}.

Within the context of this ordering function embedded in the distributional process of bankruptcy law, the \textit{pari passu} principle ensures not the equal treatment of all claims but rather the equal treatment of equal claims, i.e. similarly situated claims. In that sense, secured claims can be afforded priority over unsecured claims but not over other secured claims. Similarly, certain types of unsecured claims can be conferred priority over others but within the same priority class, claims must be treated equally.

To establish whether the treatment of undisclosed CDS positions under the US Bankruptcy Code is consistent with the \textit{pari passu} principle, one has to therefore firstly examine the treatment conferred to similarly situated creditors.

To that end, chapter six of this part identifies those creditor positions that are substantially similar to CDS positions. Chapter seven subsequently elaborates on the applicable rules to such substantially similar creditor positions and compares such rules to the treatment afforded to undisclosed CDS positions.

Chapter eight demonstrates why and under which circumstances the treatment currently afforded to undisclosed CDS positions can result into an inconsistency with the \textit{pari passu} principle.

The present part concludes with a summary of the subfindings resulting from the aforegoing.

Finally, it should be kept in mind that the present part considers only CDS positions accruing from cash settled CDS agreements where the CDS buyer retained ownership of the defaulted reference obligation and where payment is conducted pursuant to ISDA’s fallback provisions during the early stages of the bankruptcy proceeding and in any case before such proceeding is concluded. It is furthermore essential to clarify that the present part only considers creditors with a CDS position who have an unsecured

\textsuperscript{204} USBC § 506.
\textsuperscript{205} USBC § 725.
\textsuperscript{206} USBC § 507.
Part Three Reviewing the Consistency with the Pari Passu Principle

claim against the debtor; secured creditors with a CDS position are hence excluded from the scope of the present thesis²⁰⁷.

²⁰⁷ Secured creditors are excluded from the scope of the present thesis because they are paid out of the proceeds of their collateral and are subjected to special rules. See USBC §§ 506, 725.
Chapter 6: Substantially Similar Creditor Positions in Bankruptcy Proceedings - Creditors who Received Payment by a Party other than the Debtor or a Source other than the Debtor’s Estate

A. Creditors holding a personal security

The concept of hedging the risk of default in a transaction by establishing a contractual liability of a third party on the underlying obligation of such transaction is not a foreign concept. Creditors frequently use guaranties or other suretyship devices to that end. A guaranty is an agreement under which one party (the guarantor) agrees to pay for a claim the other party (the beneficiary) holds against a debtor (the principal obligor). The beneficiary preserves its right to collect payment from the principal obligor but may also rely on its contractual right under the guaranty agreement to collect payment from the guarantor if the principal obligor defaults on the underlying obligation. Whether or not the enforcement of payment under the guarantee is subject to any conditions precedent to such enforcement, such as exhausting efforts to collect from the principal obligor, will depend on the type of guaranty. If the principal obligor is insolvent or

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210 A guaranty of payment or absolute guaranty obliges the guarantor to pay in case the principal obligor defaults on the underlying obligation when payment thereunder becomes due without requiring the beneficiary to satisfy any further conditions. See, e.g., U.S. v. Vahlco Corp., 800 F.2d 462, 466 (5th Cir. 1986); Cox v.
files a bankruptcy petition, payment under the guarantee agreement will, in any case, be enforceable\(^{211}\). The beneficiary can thus receive payment under the guaranty agreement before, as well as after the commencement of the principal obligor’s bankruptcy proceeding. If the guarantor conducts payment under the guaranty, it preserves subrogation rights with regard to the beneficiary and has the right to seek contribution or reimbursement payment from the principal obligor for the amount paid.

A guarantor is not primarily liable on the underlying obligation but rather holds a secondary liability, i.e. its obligation depends on the existence of the primary obligation on the part of the principal obligor\(^{212}\). This means that a guarantor will not be liable to pay the beneficiary unless the primary obligor is liable to make such payment to the beneficiary\(^{213}\). Accordingly, the guarantor has the right to plead any defense available to the principal obligor if the beneficiary collected payment from the principal obligor\(^{214}\).

\(^{211}\) U.C.C. § 3-419(d) (ii) and Restatement (Third) of Suretyship and Guaranty § 15 (b) (2). It must be noted at this point that parties to a guaranty agreement are at liberty to agree that the principal obligor’s bankruptcy does not relieve the beneficiary from the obligation to first seek recovery from the principal obligor. See Restatement (Third) of Suretyship and Guaranty § 6 and Data Sales Co., Inc. v. Diamond Z Mfg., 205 Ariz. 594, 74 P.3d 268, 273–74 (Ct. App. Div. 1 2003).

\(^{212}\) See, e.g., Terwilliger v. Terwilliger, III, 206 F.3d 240, 246 (2d Cir. 2000); See also In re East Texas Steel Facilities, Inc., 117 B.R. 235, 241 (Bankr. N.D. Tex. 1990).

\(^{213}\) See, e.g., In re L&S Indus., Inc., 989 F.2d 929, 934 (7th Cir. 1993); Very v. Watkins, 64 U.S. (23 How.) 469, 16 L. Ed. 522 (1860); Grommes v. St. Paul Trust Co., 147 Ill. 634, 35 N.E. 820 (1893).

\(^{214}\) Id.
So far, it results that CDS agreements share certain features akin to the features embedded in guaranty agreements. CDS agreements also establish a liability on the part of the CDS seller that can be triggered upon the reference entity’s default, similarly to the liability of the guarantor. The liability of the CDS seller is however, in contrast to the liability of a guarantor, that of a primary nature. The CDS seller has a distinct, independent liability it assumes under the CDS agreement. In that sense, even if such liability might – in the case of a bankruptcy credit event- relate to the liability of the reference entity, as it can only be triggered upon the reference entity’s default, under no circumstances does it result therefrom. Guaranty agreements must therefore clearly be differentiated from CDS agreements, yet share a similarity to latter, that is substantial for the examination under the present chapter: They enable third party payment on the bankruptcy claim of their beneficiary against the principal obligor.

Not all suretyship devices establish a secondary liability of the surety. Letters of credit feature the characteristic of establishing a primary liability of the issuer. A letter of credit is an agreement under which the issuer of the letter of credit (issuer)\(^\text{215}\) makes the promise to pay the designated beneficiary (beneficiary)\(^\text{216}\) on behalf of a third party (the applicant)\(^\text{217}\) upon satisfaction of the conditions specified in the letter of credit\(^\text{218}\). The beneficiary can draw upon the letter of credit, i.e. receive payment from the issuer, if it otherwise satisfies the conditions specified therein, mainly including the presentation of certain documents. The issuer will accordingly either ‘honor’\(^\text{219}\) or ‘dishonor’\(^\text{220}\) the beneficiary’s draw request, i.e. either conduct, or not conduct payment under the letter of credit.

Letters of credit embed three separate commitments; the underlying agreement between the beneficiary and the applicant, the agreement between the beneficiary and the issuer representing the issuer’s promise to conduct reimbursement payment to the beneficiary pursuant to the conditions specified in the letter of credit and the credit letter itself establishing the liability of the issuer to honor drafts of payment by the beneficiary if latter abides by the conditions specified in the letter of credit.

\(^{215}\) U.C.C. § 5-102 (a) (9).
\(^{216}\) U.C.C. § 5-102 (a) (3).
\(^{217}\) U.C.C. § 5-102 (a) (2).
\(^{218}\) U.C.C. § 5-102 (a) (10) and § 5-104.
\(^{219}\) U.C.C. § 5-102 (a) (8).
\(^{220}\) U.C.C. § 5-102 (a) (5).
Typically, the issuer of a letter of credit is a bank and the applicant a customer of such bank. The bank extends a letter of credit to either help the applicant to enter into the underlying agreement with the beneficiary or to enter such agreement under more favorable economic terms. By means of the letter of credit the bank extends its creditworthiness to the applicant by substituting the applicant’s creditworthiness in the underlying transaction.

The bank is entitled to receive reimbursement payment from the applicant should it honor the beneficiary’s draw request; it further receives compensation in form of issuance fees.

Letters of credit are subject to Article 5 of the Uniform Commercial Code (UCC). Pursuant to Article 5, Section 103 (d), the rights and obligations of the issuer are ‘independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary’. The issuer therefore bears primary liability with regard to the performance of its obligations under the letter of credit. The issuer’s liability is not contingent upon the existence or performance of the underlying agreement between the beneficiary and the applicant. This is additionally asserted in Section 108 of Article 5 UCC explicitly citing that the issuer is not responsible ‘for the performance or nonperformance of the underlying contract, arrangement or transaction’. It therefore occurs that albeit letters of credit are issued to ensure that payment on the underlying agreement will be made, the liability of the issuer is not contingent upon the applicant’s default. In other words, a situation of default on the underlying agreement does not necessarily trigger the issuer’s liability in cases where the presentation of the required documents for payment by the beneficiary note any discrepancies to the exact terms specified in the letter of credit. In the reverse, the issuer will not be entitled to plead any defens-
es available to the applicant with regard to the underlying agreement to avoid payment under the letter of credit.

It further occurs from Article 5, Section 103 (d), that the liability of the issuer is further immune to any agreements between the parties involved in the letter of credit, i.e. the issuer, the beneficiary and the applicant. The issuer assumes a liability that is entirely autonomous and solely dependent on the terms of the letter of credit. The issuer’s primary liability is the characteristic of letters of credit and is commonly referred to as the ‘independence principle’ \(^{224}\). The independence principle distinguishes letters of credit from guaranty agreements \(^{225}\). Yet, the issuer of a letter of credit preserves a right to reimbursement for the payment conducted under such letter similarly to the rights preserved by the guarantor of a guaranty agreement.

The primary liability established under letters of credit resembles the liability of the CDS seller under a CDS agreement. The seller’s liability is also independent from the underlying obligation of the reference entity. But whereas the liability of the issuer of a letter of credit is not necessarily contingent upon the applicant’s default but rather upon the presentation of the designated documents, the CDS seller will – in the case of a bankruptcy credit event – always be liable to payment if the reference entity defaults. The conditions to settlement that need to be satisfied by the CDS buyer are merely a formality and will always trigger payment if timely satisfied; the discrepancies in the presentation of the requirements are not waived with the mutual consent of the beneficiary and the issuer. This fact has given rise to a certain criticism with regard to the effectiveness of letters of credit in cases where the applicant is insolvent, particularly in light of the fact that the issuer can reasonably be assumed to have strong incentives to avoid payment under a letter of credit since it will not be able to recover reimbursement payment from an insolvent applicant. The protection offered under a letter of credit is in that sense dubious in cases of insolvent applicants. For a detailed discussion on this issue see, e.g., Ronald J. Mann, "The Role of Letters of Credit in Payment Transactions," *Michigan Law Review* 98 (2000); Margaret L. Moses, "Letters of Credit and the Insolvent Applicant: A Recipe for Bad Faith Dishonor," *Alabama Law Review* 57(2005).

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\(^{224}\) See, e.g., *Ward Petroleum Corp. v. FDIC*, 903 F.2d 1297, 1299 (10th Cir. 1990).

essential requirement is the occurrence of the credit event itself, i.e. - within present context- the reference entity’s bankruptcy.

Another significant difference between letters of credit and CDS agreements is further reflected by the fact that the CDS seller is not entitled to any reimbursement from the reference entity upon payment under the CDS agreement.

Consequently, letters of credit must also be differentiated from CDS agreements, yet still – similarly to guaranty agreements - preserve a substantial similarity to latter: They enable payment on the beneficiary’s bankruptcy claim by a third, non-debtor party after the commencement of the bankruptcy proceeding.

Another suretyship device akin to the operational features of a CDS agreement is the financial guaranty insurance. Under financial guaranty insurances, the insurer undertakes the absolute, unconditional and irrevocable obligation to reimburse an insured for any default of principal and interest payment on an underlying debt obligation against payment of a premium. Upon payment, the insurer is typically subrogated to the claims of the insured to the extent of such payment226.

The transaction embedded in financial guaranty insurances resembles the mechanics of a CDS agreement the closest. However, liability of the insurer is not merely contingent upon the default of the obligor to the underlying debt obligation. It will also not be triggered upon the mere demonstration of such default, as is the case with CDS agreements. Financial guaranties are insurance policies and therefore subject to indemnity clauses. The insured would have to prove the extent of losses suffered from the obligor’s default before being entitled to receive payment. The insurer’s liability is furthermore not that of a primary nature since it is always contingent upon the liability of the principal obligor. Thus, similarly to the previous suretyship devices examined, financial guaranty insurances must be differentiated from CDS agreements, yet still retain a similarity regarding the state of the beneficiary creditor in the bankruptcy proceeding, as they allow for payment on the latter’s bankruptcy claim to be conducted by a third, non-debtor party.

226 For a more detailed discussion on financial guaranty insurances see part one, chapter 2-A.
B. Creditors holding a CDS agreement

Against the backdrop of the view that CDS agreements are more of a credit risk investment than hedging nature, the aspects that differentiate such agreements from the basic forms of suretyship devices examined herein, are all but surprising. They rather seem to substantiate a logical consequence: It is exactly because CDS agreements were not set out to hedge credit risk but rather to commoditize it, that they lack features like the establishment of a secondary liability contingent upon the liability of the principal obligor, or indemnity clauses. The author does therefore not suggest that CDS agreements are substantially similar to suretyship devices, but rather is of the view that it is the consequence of having received payment on their bankruptcy claim against the principal obligation, i.e. the bankruptcy debtor, from a third, non-debtor party, that puts CDS creditors and suretyship beneficiary creditors in a substantially similar position within the context of a bankruptcy proceeding.

The previous section illustrated that the basic categories of suretyship devices, albeit exhibiting diverse features with regard to the legal nature of the surety’s liability and the conditions precedent to payment under the surety share one common feature. They confer upon the beneficiary the right to receive payment on its claim against the principal obligation from a third, non-debtor party.

The same applies to CDS agreements. Certain features assembled in a CDS agreement are different from those assembled in suretyship devices, which is why CDS agreements do not fall within the scope of personal securities. Regardless, within the context of a bankruptcy proceeding, the buyer of a CDS agreement is also a beneficiary afforded the right to receive payment on its claim against the principal obligor, i.e. the reference entity, from a third, non-debtor party. Consequently, in a situation where the CDS buyer receives settlement payment from the CDS seller after asserting a bankruptcy claim as a creditor, it will be in the same position of a beneficiary of a guaranty agreement, or a letter of credit and of an insured under a financial guaranty insurance, who received payment after the commencement of the principal obligor’s bankruptcy proceeding from a contractual co-obligor. Whether the liability of the co-obligor is that of a primary or secondary nature might impact such co-obligor’s rights of subrogation in the bankruptcy proceeding but essentially leaves the substantial position of the beneficiary creditor unaltered; for such beneficiary obligor
will, in any case, have received payment on its claim from a party other than the debtor.

The same applies to CDS buyers who are creditors to the reference entity’s bankruptcy proceeding. The CDS seller is legally speaking no co-obligor and will not be subrogated to the bankruptcy claim of the CDS buyer, but this does not mean that the CDS buyer will not have received payment on account of such bankruptcy claim from the CDS seller. If we go back to the CDS positions identified in previous part, we will notice that a partially satisfied CDS creditor will have been paid a part of its bankruptcy claim’s value by the CDS seller, whereas an empty creditor will have been paid the entire value of its bankruptcy claim by the CDS seller, shortly after the commencement of the bankruptcy proceeding. Net short creditors receive payments that exceed the total value of their bankruptcy claim by means of their CDS agreement. Similarly thereto, a suretyship beneficiary will have received either partial or total payment of its bankruptcy claim by the co-obligor after the commencement of the bankruptcy proceeding. Naturally, since suretyship devices are supposed to hedge possible losses accruing from a possible default of the principal obligor, payments that exceed the total value of the principal claim are inconceivable.

The previous paragraphs conclude that, within the context of a bankruptcy proceeding, a CDS buyer comes into a substantially similar position to a beneficiary of a suretyship device, the moment it receives partial, total, or exceeding payment on its bankruptcy claim against the debtor from the CDS seller.

It should finally be noted that the fact that the CDS buyer pays a fee to acquire a right to payment from the CDS seller under the CDS agreement is also of little relevance in this regard. This is best evidenced by the fact that suretyship devices in form of insurance policies, such as financial guaranty insurances, also oblige the insured to conduct payment of a premium to be covered by the insurance. Moreover, payment for protection is inherent in all suretyship devices, even if not in form of a direct payment. Guaranties enable the principal obligor to achieve less burdensome economic terms on the underlying obligation and thus result in less favorable terms for the beneficiary. The same applies to letters of credit. The bank’s creditworthiness substitutes the applicant’s creditworthiness in the underlying transaction and thus results into more favorable transaction terms for the applicant and less favorable transaction terms for the beneficiary. Furthermore, the issuer of a letter of credit is also paid issuance fees.
So far, we can conclude that—within the context of a bankruptcy proceeding—a CDS creditor who received payment under a CDS agreement is in a substantially similar position to a beneficiary of a suretyship device. The obvious divergency between a CDS agreement and a suretyship device impacts the rights of the co-obligor and not the position of the beneficiary. Whereas a guarantor or insurer has subrogation, contribution and reimbursement rights against the principal obligor, a CDS seller is not entitled to assert any reimbursement or subrogation rights against the reference entity.

The co-obligor’s subrogation rights, albeit not altering the position of the beneficiary, carry a virtual consequence. Bankruptcy law protects non-bankruptcy rights as long as such rights do not impair the primary purpose, bankruptcy law was created to serve, i.e. the fair and equitable distribution of the debtor’s assets to all creditors. Bankruptcy law therefore also grants subrogation rights to co-obligors in the bankruptcy proceeding of the principal obligor. This inevitably results into the disclosure of payment received by beneficiaries, since co-obligors can reasonably be assumed to assert their subrogation rights in the bankruptcy proceeding to receive reimbursement from the principal obligor for payment conducted to the beneficiary. This is not the case with regard to payments received under a CDS agreement. Since the CDS seller has no subrogation rights and in absence of any disclosure requirements applicable to individual CDS buyers, any payment received by the CDS seller will be silent and remains undisclosed during the course of the bankruptcy proceeding. Consequently, partially satisfied, empty and net short CDS creditors will not be treated like creditors who received at least partial payment on their bankruptcy claim by a third, non-debtor party, but rather as any other creditor to the bankruptcy proceeding, who preserves a right to payment solely against the debtor.

To review whether such circumstance is consistent with the pari passu principle the next chapter elaborates on the applicable bankruptcy rules to beneficiaries of suretyship devices who received payment from a co-obligor as well as to creditors who received payment from a general partner debtor, who is not the bankruptcy debtor, or concurrent bankruptcy proceeding. These two final creditor positions captured by the USBC that include payments conducted by a party, other than the debtor or from a source, other than the bankruptcy estate are previously briefly indicated below.
Chapter 6: Substantially Similar Creditor Positions

C. Other creditor positions involving payments originating from a source other than the bankruptcy estate

Even if creditors with a CDS position are found not to be in a substantially similar position to beneficiary creditors with a suretyship position, former are still creditors who received payment on their bankruptcy claim from a source, other than the debtor’s estate.

Creditors who received payment on their bankruptcy claim by means of a suretyship are not the sole creditor positions that can be satisfied by means of non-debtor funds in a bankruptcy proceeding. The Bankruptcy Code recognizes two further situations that include distributions from sources other than the bankruptcy estate.

Section 508 USBC deals with situations that involve payment of creditors by general partners of the debtor, in liquidation cases of partnership debtors, where the general partner conducting payment is not a debtor in the liquidation case.

Similarly, section 1532 USBC handles equivalent situations that arise in reorganization cases, where a creditor has received payment with respect to its bankruptcy claim in a concurrent proceeding. This situation essentially involves payments received in foreign proceedings resulting from cross border bankruptcy cases.

The applicable bankruptcy rules to the aforementioned creditor positions will be elaborated in the following chapter.
Chapter 7: Applicable Bankruptcy Rules to Creditors who have Received Payment by a Non-Debtor Party or from a Source other than the Bankruptcy Estate

A. Rules applicable to creditors who have received partial or full payment by a co-obligor under Section 509 USBC

As already indicated in previous chapter, suretyship devices and insurance policies typically afford the co-obligor the right to subrogate the beneficiary, or insured in their claim against the principal obligor. Subrogation rights of co-obligors are imported into the bankruptcy proceeding of the principal obligor by means of sections 502 (e) and 509 USBC.

This occurs because bankruptcy law mainly leaves non-bankruptcy relationships between creditors or third parties and the debtor, as well as non-bankruptcy rights unaltered, unless a bankruptcy rule specifically provides otherwise, or an alteration is necessary to solve the particular problems bankruptcy law was created to solve. The Supreme Court introduced this principle into bankruptcy law the first time in 1979, in *Butner v. United States*. This principle is known as the *Butner* principle and has been renewed by the Supreme Court various times. To date, the *Butner* principle applies to virtually all bankruptcy cases.

Following the *Butner* principle, bankruptcy law preserves the co-obligor’s subrogation rights against the debtor to the extent of the payments conducted by the co-obligor to the beneficiary, albeit with certain limitations to make sure that its primary objective of fair and equitable distribution of the debtor’s assets to its creditors is not impaired.

Pursuant to the Bankruptcy Code, a co-obligor, who conducted payment to a beneficiary on behalf of the principal obligor, is entitled to seek revenues to the extent of such payment in the bankruptcy proceeding of the principal obligor in two mutually exclusive ways. It can either file a self-contained claim for reimbursement or contribution under section 502 (e)

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USBC or assert a right of subrogation to the claim of the beneficiary under section 509 USBC\(^\text{229}\).

Section 502 (e) USBC provides the applicable rules to the allowance or disallowance of claims for reimbursement or contribution. Pursuant to section 502 (e) (1), claims for reimbursement or contribution must be disallowed, if the claim of the beneficiary creditor against the estate is disallowed, if the claim for reimbursement or contribution is contingent as of the time of its allowance or disallowance and if the co-obligor requested subrogation to the rights of the beneficiary creditor under section 509 USBC\(^\text{230}\). According to section 502 (e) (2) a claim for reimbursement or contribution filed by a co-obligor shall be allowed or disallowed pursuant to the general provisions on the allowance and disallowance of claims established under section 502 the same as if such claim for reimbursement or contribution was fixed before the date of the bankruptcy filing\(^\text{231}\).

Alternatively to filing a claim for reimbursement or contribution, the co-obligor can choose to request subrogation to the rights of the beneficiary creditor under section 509 USBC for the payments it made to the beneficiary creditor. According to section 509 (a) USBC a co-obligor, who conducted payment to the beneficiary creditor is subrogated to the rights of such creditor to the extent of such payment. Section 509 (b) (1) USBC provides that subrogation rights shall not be granted where the co-obligor has filed a claim for reimbursement or contribution and such claim has

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\(^{229}\) Please note that sections 502 (e) and 509 USBC apply to ‘an entity that is liable with the debtor on, or that has secured such [beneficiary] creditor’s claim’. Pursuant to section 101 (15) the term ‘entity’ includes person, estate, trust, government unit and US trustee whereas ‘person’ includes individual, partnership and corporation as specified under section 101 (41). The present thesis refers to such entity as ‘the co-obligor’.

\(^{230}\) USBC § 502 (e) (1) (A), (B) and (C) respectively.

\(^{231}\) It should be noted at this point, that in liquidation cases creditors are required to file a proof of claim to get their claims allowed. See USBC § 501 and 502(a). Section 501 (d) provides that claims for reimbursement or contribution arising after the filing of the bankruptcy petition, can be filed under section 501 USBC the same as if they had arisen before the date of filing. In reorganization proceedings, a proof of claim is deemed filed under section 501 if it is included in the schedule the debtor (or trustee) submits to the court. A proof of claim must only be filed for claims that are listed as disputed, contingent or unliquidated. See USBC § 1111 (a). In such case, the creditor would have to file a proof of claim pursuant to Bankruptcy Rule 3003 (c) (2). A co-obligor would accordingly file a proof of claim pursuant to Bankruptcy Rule 3005 (a).
been either allowed or disallowed under section 502 USBC\(^232\), or subordinated under section 510 USBC\(^233\). Section 509 (b) (2) USBC further establishes that a co-obligor is not entitled to subrogation, if it received the consideration for the beneficiary creditor’s claim.

Thus, pursuant to sections 502 (e) and 509 USBC a co-obligor is entitled to exercise its rights for reimbursement and subrogation under a suretyship agreement in the bankruptcy proceeding of the principal obligor. It further follows that the co-obligor must make a choice between filing a claim for reimbursement or requesting subrogation to the beneficiary creditor’s rights in the bankruptcy proceeding\(^234\).

Section 509 (c) USBC clarifies, however, that in both cases, the claim of the codebtor is subordinated to the claim of the principal creditor until latter claim is paid in full either through payments conducted by the co-obligor or otherwise\(^235\). This means, that in cases where a co-obligor makes partial payments to the beneficiary creditor after the commencement of the principal obligor’s bankruptcy case, any claim of the co-obligor regarding such payments, notwithstanding if in form of a claim for reimbursement or contribution pursuant to section 502 (e) USBC or in form of a subrogation claim pursuant to section 509 USBC, will be subordinated to the principal creditor’s claim, until such claim is paid in full either by the co-obligor or otherwise. Accordingly, the beneficiary creditor has the right to pursue the total value of its bankruptcy claim notwithstanding

\(^{232}\) USBC § 509 (b) (1) (A) and (B) respectively.

\(^{233}\) USBC § 509 (b) (1) (C).


any partial postpetition payments received from the co-obligor, but only until the beneficiary creditor has received the total value of such claim regardless of the source of payment.

The principle behind the abovementioned provision is to fully protect the rights of the beneficiary creditor who has secured its claims by means of the contractual liability of a third party by preventing a situation in which the beneficiary creditor would have to compete with the co-obligor for the limited proceeds in the debtor’s estate, before the beneficiary creditor has received payment to fully satisfy its claim against the debtor. Section 509 (c) USBC explicitly indicates that such payment includes payments conducted by the co-obligor ‘or otherwise’. It is in that sense not relevant if the beneficiary creditor achieves full satisfaction on its claim by means of payments conducted under the suretyship device, the debtor’s estate or any other source. The essential factor is that at the end, the beneficiary creditor is paid in full, but not beyond the full value of its claim.

The full satisfaction of the beneficiary creditor is subject to two exceptions, both established through case law. The first exception occurs where the beneficiary creditor agrees with the co-obligor to settle for a reduced amount and thereby voluntarily waives its priority rights. This exception is however not absolute, for at least one court has held that even though the beneficiary creditor voluntarily agreed to settle for a reduced amount, the associated co-obligor claim was nevertheless subordinated pursuant to section 509 (c) until the full payment of the beneficiary creditor.

The second exception occurs where the co-obligor’s partial payments represent the full amount for which the co-obligor is liable under the associated suretyship agreement. In re Tri-Union the bankruptcy court held that subordinating a co-obligor’s claim where the co-obligor has fully funded its obligation would compromise the purpose of the claim allowance and priority provisions of the Bankruptcy Code, which is the equitable distribution of the debtor’s assets, because it would provide a windfall to beneficiary creditors who have partially secured claims at the

236 See Senate Report No. 95-989 on subsection 502 (e), adhered to USBC § 502.
expenses of the co-obligor. The court also suggested that subordinating a co-obligor claim that fully funds the co-obligor’s obligation would violate section 502 (e) (2) USBC that requires for postpetition co-obligor claims to be treated as if they were filed prepetition. A co-obligor claim for reimbursement of payment covering the full performance of the co-obligor’s liability filed prepetition could not be subordinated since the beneficiary creditor would not be entitled to file a claim including such payment. In that sense, the court found that a postpetition filing of a funded co-obligor claim should accordingly also not be subordinated because subordination to ensure equal treatment of prepetition and postpetition co-obligor claims pursuant to the provision established in section 502 (e) (2) USBC.

Notwithstanding the aforementioned provision, courts seem to be generally inclined to permit beneficiary creditors to pursue the full value of their claims notwithstanding partial payments received by co-obligors including third party securities. In Ivanhoe, the US Supreme Court found that a creditor, who had previously foreclosed a third party collateral on account of its unsecured bankruptcy claim, was nevertheless permitted to assert the full amount of its bankruptcy claim and not merely the residual deficiency after deduction of the proceeds accruing from the foreclosure to the debt, subject to the limitation, however, that said creditor would not receive more than the total value of its claim from all sources. Albeit the finding of the Supreme Court in Ivanhoe was strongly criticized for allowing creditors partially secured by means of non-debtor collaterals or third

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241 Ivanhoe Building & Loan Ass’n v. Orr, 295 U.S. 243, 244-45, 246, 247 (1935). The bankruptcy court had previously reduced Ivanhoe’s claim by deducting the proceeds of the foreclosure of the third party collateral and the Third Circuit affirmed. See Ivanhoe Building & Loan Ass’n v. Orr, 73 F.2d 609 (3d Cir. 1934) rev’d, 295 U.S. 243 (1935). The Supreme Court reversed that finding.
party codebtors to be disproportionately overcompensated\textsuperscript{242}, such finding was upheld in various subsequent cases\textsuperscript{243}.

Conclusively, we can note the following at this point. A creditor who has received partial payments by a co-obligor by means of a suretyship device after the commencement of the principal obligor’s bankruptcy proceeding is allowed to assert the full value of its claim, notwithstanding any partial payments, until its claim has been fully satisfied taking into consideration payments from all sources. The beneficiary’s claim will however be reduced to its residual amount by deducting partial payments conducted by the co-obligor, in cases where such partial payment reflects the full amount for which the co-obligor is liable under the associated surety agreement. The beneficiary creditor is under no circumstances allowed to receive or assert payment, notwithstanding its source, in excess of the total value of its claim against the debtor.

\textit{B. Rules applicable to creditors who received partial or full payment from a source other than the bankruptcy estate under sections 508 and 1532 USBC}

\textit{I. Rules applicable to creditors who received payment from a non-debtor general partner in a liquidation proceeding of a partnership debtor under section 508 USBC}

Section 508 USBC applies to liquidation cases of partnership debtors\textsuperscript{244}. Concretely, it applies to creditors, who received payment of or transfer of property on account of their bankruptcy claim against the partnership

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{242} See, e.g., Darrell Dunham, "Creditors' Claims in Bankruptcy: A Plea for Complete Adoption of the Bankruptcy Rule" \textit{American Bankruptcy Law Journal} 52 (1978); Kenneth N. Klee, "Bankruptcy and the Supreme Court" (Lexis-Nexis 2008), pp. 286, 455-57; Daniel J. Bussel, "Multiple Claims, Ivanhoe and Substantive Consolidation" \textit{American Bankruptcy Institute Law Review} 17 (2009).
\item \textsuperscript{244} See USBC § 508. Note also that pursuant to subsections 101 (13) and (41) USBC a partnership can be the debtor of a bankruptcy proceeding under the Bankruptcy Code.
\end{enumerate}
\end{footnotesize}
debtor from a non-debtor general partner and are not secured by a lien on the property of such non-debtor general partner\textsuperscript{245}. Section 508 USBC provides that in the aforementioned situation the beneficiary creditor is not permitted any dividends from the debtor’s estate until each creditor entitled to the same distribution share as the beneficiary creditor has received payment equal in value to the consideration the beneficiary creditor has received from the general partner.

A general partner of a partnership debtor is not entitled to a claim for reimbursement under section 502 (e) USBC against its own partnership; it would furthermore not be entitled to any subrogation rights under section 509 USBC, since, as a general partner of the debtor, it received consideration for the beneficiary creditor’s claim\textsuperscript{246}. Consequently, any payments conducted to the beneficiary creditor by a general partner would not be considered within the context of section 509 (c).

To avoid preferential treatment of the beneficiary creditor to the detriment of similarly situated creditors, section 508 establishes the restriction that the beneficiary creditor may not receive any consideration from the debtor’s estate, until all other creditors, who are entitled to the same distribution share have received payment equal in value to the consideration the beneficiary creditor has received from the general partner.

Contrary to section 509 (c) that confers upon the beneficiary creditor the right to assert the full value of its bankruptcy claim, notwithstanding any partial payments conducted by the co-obligor, until it receives payment amounting to the total value of such claim, section 508 USBC limits the beneficiary creditor to the amount of the payment received by the general partner until all the other creditors who are entitled to the same distribution share, receive the equal amount of payment.

The aforementioned restriction is reasonable, if one considers that the trustee of a partnership debtor has a claim against the non-debtor general partners of such partnership to the extent that they are personally liable, in cases where the creditors of the partnership debtor are not paid in full\textsuperscript{247}. The court can in such cases order the general partner not to dispose of property pending a determination of its obligations to the trustee to avoid competition between the trustee and creditors of the partnership, who

\textsuperscript{245} USBC § 508.
\textsuperscript{246} See USBC § 509 (b) (2).
\textsuperscript{247} See USBC § 723 (a) (b).
might attempt to seek payment from a general partner\textsuperscript{248}. Creditors, who have received payment of their bankruptcy claim from a general partner will therefore typically have received such payment before the commencement of the partnership debtor’s bankruptcy proceeding.

Prior to the 2005 Amendments to the Bankruptcy Code, section 508 USBC embedded two sections, former applying to creditors of reorganization cases, who received a payment or transfer of property with regard to their allowed claim from a foreign proceeding, latter establishing the same provisions section 508 currently establishes with regard to liquidation cases of partnership debtors. The 2005 Amendments introduced a new chapter 15 applicable to cross-border reorganization cases including a discrete provision, section 1532, dealing with creditors of reorganization cases, who received a payment from a foreign proceeding on their allowed claim. Former section 508 (a) USBC was therefore rendered superfluous and consequently repealed\textsuperscript{249}.

Section 1532 USBC is elaborated in the following subsection of the present thesis.

II. Rules applicable to creditors who received payment from a concurrent foreign reorganization proceeding under section 1532 USBC

The 2005 Amendment to the Bankruptcy Code introduced a new chapter 15 with the objective to incorporate into the Bankruptcy Code the Model Law on Cross-Border Insolvency of the United Nations Commission on International Trade Law (UNCITRAL)\textsuperscript{250}. The ultimate objective was to provide effective mechanisms to better deal with cross-border insolvency cases\textsuperscript{251}.

Chapter 15 USBC includes a separate section 1532 that deals with creditors, who have received payment on their allowed claims under a reorganization proceeding from a foreign proceeding. Pursuant to section 1532 USBC creditors, who are not secured and do not otherwise hold an interest

\textsuperscript{248} See USBC § 723 (b).
\textsuperscript{249} Pub. L. No. 109-8, § 802(d) (7) (A) (2005).
\textsuperscript{251} See Pub. L. No. 109-8, § 801 (2005) and USBC § 1501 (a) respectively.
in rem, and received payment with respect to their allowed claim under a reorganization proceeding from a foreign proceeding may not receive payment on the same claim from the debtor’s estate so long as the payment received by the other creditors of the same class is proportionately less than the payment already received by the beneficiary creditor.

The language of section 1532 USBC is identical to the language used in the equivalent article 32 of the UNCITRAL Model Law on Cross-Border Insolvency. According to the Guide Enactment and Interpretation of the UNCITRAL Model Law on Cross-Border Insolvency, article 32 ‘is intended to avoid situations in which a creditor might obtain more favorable treatment than the other creditors of the same class by obtaining payment of the same claim in insolvency proceedings in different jurisdictions.’

In that sense, section 1532 USBC is the counterpart of section 508 USC in reorganization cases similarly ensuring that a creditor, who received payment from a concurrent cross-border proceeding is not granted a privilege regarding its distribution rights to the detriment of the other creditors of the same class.

C. The single satisfaction rule or else the limitation to one’s full claim amount in bankruptcy

The ‘single satisfaction rule’ within the context of bankruptcy law is based on the principle of law and equity that a claimant is entitled to recover only once on account of a claim. In other words, once a claim has been satisfied with regard to all losses suffered by its holder no second claim for those same losses can be asserted.

The US Supreme Court directly imported this principle into bankruptcy proceedings in 1935 by means of its ruling in *Ivanhoe Building & Loan*.  

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252 See, UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation, Part one, Chapter V, Article 32, pp.15-16.
254 The specific term ‘single satisfaction rule’ was adapted to the term conferred by the scholar Daniel J. Bussel upon the limitation imposed on creditors who are able to assert the full value of their claims notwithstanding any partial payments received from non-debtor third parties, to never exceed the total value of their bankruptcy claim. See Bussel, "Multiple Claims, Ivanhoe and Substantive Consolidation", p.219.
Ass’n v. Orr (Ivanhoe)255. The question at stake was whether a creditor, who recovered a portion of the debt owed to him via foreclosure of a mortgage on property that was not part of the debtor’s estate was allowed to file a proof of claim for the full amount of the debt, or only for the residual balance occurring from the difference between the total value of the debt and the conducted partial payments. Interestingly, the creditor was denied the right to assert the full value of its claim at first and second instance256. The Supreme Court however reversed previous findings and ruled that the creditor was nevertheless able to assert the full value of its claim. The Supreme Court clarified that ‘however, the court additionally noted that the creditor was not able to collect and retain dividends which with the sum realized from the foreclosure should have more than made up that amount’257.

The Supreme Court’s decision in Ivanhoe was reiterated in numerous subsequent cases258. After the introduction of the Bankruptcy Code in 1978, the Ivanhoe decision establishing that a creditor need not deduct

256 Ivanhoe Building & Loan Ass’n v. Orr, 73 F.2d 609 (3d Cir. 1934) rev’d, 295 U.S. 243 (1935).
257 Id. This finding was essentially based on an ancient exception to the bankruptcy rule established by the Supreme Court pursuant to which, secured creditors were generally privileged to assert their claims independently from their mortgage so long as they did not receive total payment beyond the total value of their claim. The Supreme Court stated in Merrill v. National Bank of Jacksonville in this regard: The United States Supreme Court determined that the bankruptcy rule, which required a holder of collateral security to exhaust it and credit the proceeds on the claim, was not adopted for national banks by U.S. Rev. Stat. § 5236. The Court held that the secured creditor was entitled to prove and receive dividends upon face of his claim as it stood at time of the bank’s declaration of insolvency without first exhausting his collateral. However, the dividends ceased when the creditor’s claim was paid in full.’ see, Merrill v. National Bank of Jacksonville, 173 U.S. 131, 134 (U.S. 1899). See also Chem. Nat’l Bank v. Armstrong, 59 F. 372, 381-82 (6th Cir. 1893); Swarts v. Fourth Nat. Bank of St. Louis, 117 F. 1, 12 (8th Cir. 1902); In re N.Y. Commercial Co., 233 F. 906, 909-10 (2d Cir. 1916); Young v. Gordon (In re Foster Motor Car Co.), 219 F. 168, 171 (4th Cir. 1914); Mark v. Am. Brick Mfg., 84 A. 887, 888 (Del. Ch. 1912).
from its claim partial payments received from a non-debtor third party as long as such creditor does not exceed the total value of its claim, was considered incorporated\(^{259}\). The bankruptcy court in *In re Biaggio* noted in this regard:

\[\text{"The language from Ivanhoe \ldots is also binding precedent under the current Bankruptcy Code. The Supreme Court has stated "when Congress amends the bankruptcy laws, it does not write 'on a clean slate." [citations omitted]. Congress is presumed to have enacted the Bankruptcy Code of 1978 with an understanding of the holding of Ivanhoe, and to have intended to incorporate that holding into the Code, unless the language of the Code or its legislative history clearly provides otherwise."}^{260}\]

There is indeed no indication that Congress intended to overrule the holding in *Ivanhoe* in the provisions established in the current Bankruptcy Code. To the contrary, language and adhered legislative history of the Bankruptcy Code confirm the court’s finding in *In re Biaggio* that the language from *Ivanhoe* is also binding under the current Bankruptcy Code\(^{261}\).

The court in *In re Biaggio* concluded that ‘Ivanhoe adopts a rule to deal with the situation in which the defendant co-obligor is in bankruptcy and cannot pay his debts in full. Ivanhoe makes a choice as to how the claim of a creditor will be treated in bankruptcy proceedings if that creditor receives partial payment from a co-obligor of the debtor. Ivanhoe decides that the amount the creditor’s claim in the bankruptcy case is not affected by third-party payments, except to the extent payment from the debtor would produce a double recovery.’\(^ {262}\).

The single satisfaction rule of the *Ivanhoe* finding has been upheld in various cases and is a well-accepted rule applicable to bankruptcy proceedings\(^{263}\).

\(^{259}\) USBC § 509 (c).
\(^{260}\) *In re Biaggio*, 496 B.R. 600 (Bankr. N.D. Cal. 2012).
\(^{261}\) *In re Biaggio*, 496 B.R. 600, 603 (Bankr. N.D. Cal. 2012).
The single satisfaction rule was not only upheld within the context of section 509 (c) USBC. The Second Circuit Court of Appeals applied the single satisfaction principle in the *Delta Air Lines* case ruling over a first instance independent holding on section 502 (b) (2) USBC\(^{264}\). This case concerned the debtor’s request to disallow certain claims brought by equity owners with the argument that the same losses claimed by such equity owners had been previously satisfied through the discharge of overlapping claims asserted by other equity owners who acted on behalf of the former. The debtor argued that a single loss could only give rise to a single claim in bankruptcy. The Court of Appeals reversed the previous finding that upheld the debtor’s argument on the grounds of the agreed contractual language of the parties stating that ‘if [the debtor] contracted to pay duplicative claims, then it must pay both\(^{265}\) and on the ground that its decision to allow such claims still left said creditors with less than a hundred percent recovery on their losses thereby not violating the single satisfaction principle\(^{266}\). The court thus applied the single satisfaction rule without directly referencing *Ivanhoe* since it ruled on an independent claim based on section 502 (b) (2) USBC.

In conclusion of the present section, it can be noted that the ancient single satisfaction rule principle established by the US Supreme Court in 1935 is to date included in the Bankruptcy Code and furthermore a well-established principle of bankruptcy law. Thus, notwithstanding any conferred distribution rights to creditors in a bankruptcy proceeding, creditors may never recover more than the total value of their bankruptcy claim against the debtor.

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\(^{265}\) *Id.*, 57 (Bankr. S.D. N.Y. 2008).

\(^{266}\) *Id.*, 69-70 (Bankr. S.D. N.Y. 2008).
Chapter 8: Reviewing the De Facto Exemption Granted to Undisclosed CDS Positions from otherwise Applicable Bankruptcy Rules

A. The de facto exemption of creditors who have received payment under a CDS agreement from otherwise applicable rules as a consequence of non-disclosure

Section 509 (c) USBC applies to beneficiary creditors, who received partial payment on their bankruptcy claim from a co-obligor afforded a claim for reimbursement or contribution under section 502 (e) USBC or a subrogation right to the claim of the beneficiary creditor under section 509 USBC.

Albeit the broad phrasing included in the aforementioned sections, case law has established that they only apply to co-obligors who either preserve a right for reimbursement or contribution under non-bankruptcy law or are entitled to subrogation because their liability is that of a secondary nature, i.e. dependent on and therefore relieving the liability of the principal obligor.

Concretely, section 502 (e) applies to co-obligors preserving a right of reimbursement or contribution against the principal obligor. Bankruptcy courts established that such right is preserved where the co-obligor is ‘liable with the debtor’ on the underlying obligation267. This co-liability requirement is to be interpreted as requiring the claim arising from the underlying obligation that can be held against the co-obligor by means of a non-bankruptcy lawsuit, to be a claim for which the debtor could be liable, if the automatic stay268 had not applied by virtue of the debtor’s bankrupt-

268 USBC § 362.
In other words, the co-obligor and the debtor must bear a shared liability to the same party on the same claim. A similar principle applies to section 509 USBC. A co-obligor is afforded subrogation rights only where the co-obligor’s liability is secondary to the debtor’s liability, i.e. where in the eyes of the law the debtor is the party primarily liable for the debt paid by the co-obligor. Bankruptcy courts deny subrogation rights to co-obligors, who essentially pay for their own debt rather than the debt of the debtor on the grounds of section 509 (b) (2) USBC that prohibits subrogation where co-obligors received the consideration for the beneficiary creditor’s claim and pursuant to the principles of equitable subrogation law.

It follows from the foregoing requirements that guaranties and financial guaranty insurances clearly fall within the scope of section 509 USBC, since they establish a secondary liability of the guarantor or the insurer. Indeed, financial guaranty insurances are mostly involved in municipal reorganization cases because they are mostly issued on municipality debts. In another case, In re Covino, the bankruptcy court granted subrogation rights to an insurer, who had reimbursed an employer pursuant to

270 See e.g. Dant & Russell, Inc. v. Burlington N.R.R. Co., 951 F.2d 246 (9th Cir. 1991); Juniper Dev. Group v. Kahn, 993 F.2d 915, 28 C.B.C.2d 1545 (1st Cir. 1993); In re Chateaugay Corp., 29 C.B.C.2d 1, 5, 154 B.R. 416, 420 (S.D.N.Y. 1993); In re Allegheny Int’l, Inc., 126 B.R. 919 (W.D. Pa.); In re Harvard Indus., Inc., 153 B.R. 668 (Bankr. D. Del. 1993). It is worth noting at this point that section 502 (e) has also been applied to parties that were jointly liable under state and federal statutes and not by means of a contractual suretyship relationship. See, e.g., Syntex Corp. v. Charter Co., 862 F.2d 1500, 20 C.B.C.2d 915 (11th Cir. 1989); In re American Continental Corp., 119 B.R. 216 (D. Ariz. 1990).
273 Chapter 9 USBC. Pursuant to section 901 (a) USBC, § 509 applies to chapter 9 bankruptcy proceedings. On the participation of insurers in chapter 9 bankruptcy cases by means of section 509, see Henry C. Kevane, "Bond Insurers Become Active Participants in Chapter 9s," Journal of Corporate Renewal 24(2013): p.29.
an insurance policy for improper fund withdrawals conducted by its employee, in the employee’s subsequent bankruptcy proceeding\textsuperscript{274}.

Matters become more complicated with regard to co-obligors, who have conducted partial payments to the beneficiary creditor under letters of credits. As already indicated, letters of credit establish primary liability of the issuer. They do thus not fulfill the co-liability or secondary liability requirement from a strict legal point of view. Some courts have denied subrogation rights to issuers of letters of credit, notwithstanding the fact that they conducted partial payment to the beneficiary, on the ground of their primary liability.

In \textit{In re Hamada} the Ninth Circuit Court of Appeals held: ‘The key distinction between letters of credit and guarantees is that the issuer’s obligation under a letter of credit is primary whereas a guarantor’s obligation is secondary, the guarantor is only obligated to pay if the principal defaults on the debt the principal owes. A bank issuing a letter of credit, unlike a guarantor, is not obligated until after its customer fails to satisfy some obligation, and it is satisfying its own absolute and primary obligation to make payment rather than satisfying an obligation of its customer. Thus, as opposed to the guaranty given by a surety, in a letter of credit transaction the bank’s obligation under the letter of credit is independent of the underlying contract.’\textsuperscript{275}

Various other courts have arbitrated similar findings on the ground that letters of credit are distinguished by the independence principle and therefore establish primary and completely independent liability of the issuer, who consequently has no subrogation rights under section 509, since it is paying off its own debt\textsuperscript{276}.

\begin{footnotesize}
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\item \textsuperscript{275} \textit{Hamada v. Far E. Nat'l Bank}, 291 F.3d 645, 647 (9th Cir. Cal. 2002).
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Other courts have found to the contrary that despite the primary liability of the issuer, subrogation rights to the rights of the beneficiary creditor’s claim must nevertheless be granted because the issuer still pays or reduces the beneficiary creditor’s claim against the debtor’s estate and is thus in an analogous position to that of a guarantor\textsuperscript{277}. Courts have furthermore noted in this regard that not granting subrogation rights to an issuer who conducted payment to the beneficiary would unreasonably result into a windfall for the debtor\textsuperscript{278}.

So far the following can be concluded. Section 509 (c) USBC provides that partial payments do not preclude the right of beneficiary creditors to pursue the total value of their claim until its full satisfaction from all sources, unless the payment conducted represents the full amount for which the co-obligor is liable. Section 509 (c) USBC applies only where the co-obligor is granted a claim for reimbursement or contribution or the right to subrogate to the beneficiary creditor’s claim to the extent of the payment conducted by the co-obligor. This only occurs where the co-obligor is liable with the debtor, i.e. has a secondary liability with regard to the underlying claim and exceptionally in cases where the co-obligor’s liability is that of a primary nature but the payments made by the co-obligor nevertheless reduce the beneficiary creditor’s claim against the debtor’s estate.

It is clear that a CDS seller, who has conducted payment to the beneficiary creditor under a CDS agreement does not fall within the scope of sections 502 (e) or 509 USBC and would thus not be granted a claim for reimbursement or a right to subrogate the beneficiary creditor in its claim against the debtor’s estate. The liability of the CDS seller is independent and could not be held against the debtor. The vital question that occurs in this regard is the following: Should the beneficiary creditor be allowed a claim against the debtor’s estate despite the fact that it received payment on the same claim by a third party and in certain cases beyond the total


value of such claim, merely because the paying party has no reimbursement or subrogation rights against the debtor?

Applying the *pari passu* principle and the single satisfaction rule to the foregoing question would return a negative response. Pursuant to the foregoing principles, the treatment conferred upon a creditor with a CDS position would be similar to the treatment established under section 509(c) USBC permitting said creditor to assert the full amount of its claim but only until such claim is paid in full.

The Bankruptcy Code is otherwise silent on this matter. This is not surprising. For denying subrogation rights to a surety, notwithstanding the type of such surety, does usually not result into conferring upon the beneficiary creditor the right to receive payment beyond the total value of its claim. Within the context of a suretyship agreement, the paying co-obligor typically acquires all associated control rights over the debt obligation it pays for. This can be noted in all aforementioned suretyship devices. A guarantor conducting payment under a guaranty agreement is automatically subrogated to the beneficiary’s claim against the principal obligor and is furthermore afforded the right to seek reimbursement from the principal obligor to the extent of the guarantor’s payment. The same applies to financial guaranty insurances or other insurance policies that typically establish equivalent subrogation and reimbursement clauses to the benefit of the insurer. Even letters of credit grant the issuer reimbursement rights against the applicant to the extent of the payment conducted to the beneficiary despite the fact that the issuer’s liability is independent from the liability of the applicant.

CDS agreements, however, as all credit derivatives, embed a unique feature, which has been frequently described as ‘decoupling of interests’\(^{279}\). In a CDS transaction, the party conducting the payment on a debt is not necessarily the party assuming the associated control rights over such debt. In cash settled CDS agreements the CDS seller conducts payment on the defaulted reference obligation, yet the associated controlling rights on such obligation remain with the CDS buyer. Consequently, after the settlement of a CDS transaction, the party holding the economic interests on the underlying obligation is not necessarily the party holding the associated control rights on such obligation.

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\(^{279}\) Black, "Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications."
Sections 502 (e) and 509 of the Bankruptcy Code are founded on the premise that the party holding the economic interests on a debtor’s debt obligation, i.e. the party who conducted payment on such obligation also holds the associated control rights including the right to file a claim against the debtor to the extent of such conducted payment.

Regarding section 509 USBC, this observation is best confirmed by the fact that such section was explicitly found to apply to postpetition partial payments, firstly because of the wording of section 509 USBC referring to co-obligors who conducted payment to a ‘creditor’, i.e. an entity with a right to payment as of the petition date; and subsequently on the premise that in prepetition payments the co-obligor automatically assumes subrogation rights to the beneficiary creditor’s claim and therefore is a creditor with a discrete right to payment by the time the principal obligor files for bankruptcy.

In re May the bankruptcy court held in this regard: ‘11 U.S.C.S. § 509 provides only for the subrogation of "codebtors," e.g., guarantors, to the rights of "creditors." In order for a guarantor to exercise subrogation rights under § 509, the guarantor must pay the claim of a "creditor," an entity that has a right to payment as of the petition date. In other words,

280 USBC § 101 (10) (A).

281 See, e.g., Buckeye Union Ins. Co. v. Four Star Constr. Co. (In re Four Star Constr. Co.), 151 B.R. 817 (Bankr. N.D. Ohio 1993); Prim Capital Corp. v. May, 2006 Bankr. LEXIS 4196 (Bankr. N.D. Ohio, Aug. 14, 2006), aff’d, 368 B.R. 85, 2007 Bankr. LEXIS 2335 (B.A.P. 6th Cir. July 19, 2007); Leibowitz v. Hall (In re Hall), 477 B.R. 74, 82 (Bankr. N.D. Ill. 2012); In re Brodkey Bros., Inc., 2013 Bankr. LEXIS 4309 (Bankr. D. Neb. Oct. 15, 2013). Naturally, particular circumstances may arise in certain cases and courts could grant subrogation rights to a surety that conducted payment to the beneficiary prepetition. This occurred, for instance, in In re Big Idea Prods., where a surety secured a bond issued by the principal obligor and conducted partial payment to the beneficiary after the beneficiary obtained a judgment confirming its entitlement to payment, before the commencement of the principal obligor’s bankruptcy proceeding. However, the beneficiary’s favorable judgment and verdict was subsequently reversed. By the time the principal obligor filed a bankruptcy petition, the surety was not able to subrogate the beneficiary in its claim because the beneficiary no longer had a claim against the principal obligor pursuant to the reversing judgment. The court nevertheless granted the right to the surety to subrogate the principal obligor in its right of restitution pursuant to the aforementioned judgment and thus granted a bankruptcy claim to the surety on the grounds of its equitable subrogation rights. See Big Idea Liquidating Creditor Trust v. Safeco Ins. Co. of Am., 372 B.R. 388, 397 (Bankr. N.D. Ill. 2007).
the payment giving rise to the subrogation rights must be made postpetition. Otherwise, there is no creditor to whom the guarantor may be subrogated for purposes of § 509 because a prepetition payment extinguishes any right to payment that the original obligee would have had on the petition date. If a guarantor pays the original obligee prepetition, then the guarantor would pursue its claim against the debtor in its own right. The guarantor, for the purposes of the Bankruptcy Code, is now the creditor because the guarantor now has a "right to payment" as of the petition date, and subrogation under § 509 is not available. 282.

The court furthermore noted within the context of chapter 5 USBC: ‘That 11 U.S.C.S. § 509 applies only to postpetition payments to creditors by codebtors is further borne out by § 509's context. First, 11 U.S.C.S. § 509 must be read in conjunction with the other provisions of Subchapter I of Chapter 5. Those provisions, taken together, provide the framework for the difficult division of scarce assets among competing claimants. Specifically, 11 U.S.C.S. § 502(e) (1) provides: The court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that--(A) such creditor's claim against the estate is disallowed; (B) such claim for reimbursement or contribution is contingent; or (C) such entity asserts a right of subrogation to the rights of such creditor under 11 U.S.C.S. § 509. 11 U.S.C.S. § 502, the principal section governing allowance of claims, contemplates the operation of 11 U.S.C.S. § 509 only in those situations where an entity's claim against the debtor is premised on that entity's payment of a creditor in bankruptcy, i.e., a postpetition payment. 283.

The court finally concluded that ‘11 U.S.C.S. § 509 acts as a narrow, equitable backstop to ensure that a codebtor will receive some distribution (specifically the original creditor's distribution) from the debtor's estate if the codebtor pays a creditor's claim. When a guarantor makes its payment prepetition no such backstop is needed since the guarantor can proceed as a creditor in its own right under 11 U.S.C.S. §§ 501, 502.' 284.


284 Id., *12. This finding was further upheld in Diamantis v. Perfect Home LLC (In re Diamantis), 380 B.R. 838, 843-844 (Bankr. N.D. Ala. 2007).
The afore-cited ruling premises that the co-obligor assumes discrete control rights on the part of the obligation it pays for prepetition, which subsequently affords the co-obligor a discrete bankruptcy claim postpetition. It is therefore that section 509 USBC is mostly preoccupied with establishing whether a co-obligor indeed holds subrogation rights against the debtor or whether it mostly pays off debt obligations of its own. Such evaluation is not concerned with any potential indirect benefits that could be granted to the beneficiary creditor because it reasonably assumes that, one way or the other, the beneficiary creditor will not hold a bankruptcy claim against the debtor to the extent of the amount paid on such claim by the co-obligor. Consequently, the rights and limitations established with regard to the beneficiary creditor take into consideration solely postpetition partial payments conducted by the co-obligor because this is the only instance envisaged by section 509 USBC that would result into the beneficiary creditor obtaining twofold payments on account of its bankruptcy claim. Section 509 (c) USBC solves this situation by preserving the principal creditor’s right to assert the total value of its claim notwithstanding any partial payments to ensure that such creditor is not put in a more disadvantageous position than it would be in absence of the underlying suretyship agreement while limiting such rights to the total value of the beneficiary creditor’s bankruptcy claim considering payments originated from all sources.

The same premise applies to section 502 (e) USBC, albeit less directly. In contrast to section 509 USBC, section 502 (e) USBC affords the co-obligor with a discrete claim for reimbursement or contribution against the debtor. Such claim is treated as any other bankruptcy claim under section 502 USBC if conducted prepetition, notwithstanding the fact that it needs to comply with some additional requirements to be allowed, arising from the co-liability of the debtor inherent in such claim.

Regarding claims for reimbursement or contribution that became fixed postpetition, section 502 (e) (2) USBC provides that such claims shall be allowed or disallowed pursuant to the general provisions of section 502 USBC the same as if such claims had become fixed prepetition to permit a co-obligor who conducted postpetition payment to a beneficiary creditor to nevertheless file a valid claim in the principal obligor’s bankruptcy proceeding. On the premise that any twofold payments to the benefit of the

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285 See, USBC § 502 (e) (1) (A), (B) and (C).
principal creditor will occur only in postpetition payment situations, the provision establishing applicability of the same rights and limitations that apply to beneficiary creditors under section 509 USBC to beneficiary creditors under section 502 (e) USBC, is embedded in section 509 (c) USBC, which applies to postpetition payments only.

It therefore follows that both sections 502 (e) and 509 USBC, consider rights and limitation of rights of beneficiary creditors, where the co-obligor has conducted partial postpetition payments to such creditor on the premise that only in latter situations will the beneficiary party be a creditor in the principal obligor’s bankruptcy case.

CDS agreements break that premise by enabling the beneficiary party to preserve its control rights on the underlying reference obligation notwithstanding any partial or total payments conducted by the CDS seller on account of such obligation. This situation is reasonably not envisaged by sections 502 (e) or 509 that currently apply to suretyship transactions based on the premise that the paying party assumes the associated control rights over the underlying obligation it pays for. Beneficiary creditors under a CDS agreement are therefore de facto exempted from the limitation established under section 509 (c) that is otherwise applicable to all beneficiary creditors in the same position.

What can be concluded so far is that creditors with an undisclosed CDS position are not intentionally exempted from the scope of section 509 (c) USBC, but that such exemption is mainly circumstantial. In that sense, one can exclude the possibility that the Bankruptcy Code meant to create a windfall to creditors with a CDS position. Still, the question remains if it is justifiable to exempt beneficiary creditors from the provision established under section 509 (c) USBC merely due to that fact that the CDS seller has no reimbursement or subrogation rights against the debtor.

Since sections 502 (e) and 509 USBC can provide no further assistance as to whether a beneficiary creditor may be exempted from the limitation established in section 509 (c) USBC if it received payments on its bankruptcy claim from a third party who has no subrogation or reimbursement rights against the debtor, one has to examine how the Bankruptcy Code deals with non-debtor sources of recovery outside the scope of sections 502 (e) and 509 USBC, i.e. when such sources do not involve a co-obligor within the context of the aforesaid provisions.

As already indicated previously, the Bankruptcy Code envisages two further situations in which creditors might receive payment from a third
party source of recovery that does not fall within the scope of sections 502 (e) or 509 USBC.

The first applies to liquidation cases of a partnership debtor, where a general partner, who is not the debtor, conducts payment to one of the partnership debtor’s creditors. A general partner has no reimbursement rights against the debtor, i.e. the partnership, and is thus not entitled to a claim for reimbursement or contribution against the debtor under section 502 (e) USBC. Such co-obligor will also not be afforded the right to subrogate the beneficiary creditor in its claim against the debtor under section 509, because as the debtor’s general partner, it has received the consideration on such claim. The Bankruptcy Code prevents this situation from resulting into a windfall for beneficiary creditors, by establishing under section 508 USBC that where a creditor received payment on its bankruptcy claim by a general partner of a partnership debtor, who is not a debtor, such creditor shall not receive any payment from the debtor’s estate on account of such claim until ‘each of the other holders of claims on account of which such holders are entitled to share equally with such [beneficiary] creditor under this title has received payment under this title equal in value to the consideration received by such [beneficiary] creditor from such general partner.’ The Bankruptcy Code thereby directly applies the pari passu principle to avoid granting increased distribution rights to the beneficiary creditor to the detriment of the other similarly situated creditors.

The same principle applies accordingly to reorganization cases by virtue of section 1532 USBC in cases where creditors received payment by means of a concurrent bankruptcy proceeding. Pursuant to section 1532 USBC, such creditors ‘may not receive payment for the same claim in a case under any other chapter of this title regarding the debtor, so long as the payment to other creditors of the same class is proportionately less than the payment the creditor has already received.’

It results from the aforementioned provisions, that the Bankruptcy Code does not grant unlimited distribution rights to creditors who received payment from a third party source of recovery that does not fall within the scope of sections 502 (e) and 509 USBC. To the contrary, the Bankruptcy Code deprives beneficiary creditors of sections 508 and 1532 USBC of

286 See, USBC § 509 (b) (2).
287 See, USBC § 508.
any distribution right until all other similarly situated creditors receive payment of equal or at least equivalent value. In that sense, it cannot be argued that the Bankruptcy Code meant to confer unlimited distribution rights to beneficiary creditors who received payment from a third party that is not a co-obligor under sections 502 (e) and 509 USBC. The *de facto* exemption of creditors with a CDS position from section 509(c), as analyzed previously, can thus not be regarded as an approved or even intended exemption. Rather, creditors with a CDS provision currently not being subjected to similar limitations as those embedded in sections 508 and 1532 USBC occurs as a consequence of the non-disclosure of such positions.

As already indicated, individual creditors with a CDS position are not required to disclose such position in bankruptcy proceedings. The payment received by means of the CDS agreement thus passes unnoticed. The issue of whether such *de facto* exemption from otherwise applicable bankruptcy rules granted to creditors with an undisclosed CDS position is consistent with the *pari passu* principle is addressed in the following section.

**B. Reviewing the consistency of the *de facto* exemption granted to CDS creditor positions with the *pari passu* principle**

The principle of providing equal treatment to similarly situated creditors in a bankruptcy proceeding (*pari passu* principle) is one of the core principles of bankruptcy law. The UNCITRAL Legislative Guide on Insol-

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288 The only established disclosure requirements in this regard are imposed on creditor committees in chapter 9 USBC and Chapter 11 USBC cases pursuant to Bankruptcy Rule 2019.

vency Law (UNCITRAL Legislative Guide)\textsuperscript{290} identifies the above principle to reflect one of the key objectives of bankruptcy law\textsuperscript{291}. Indeed, one of the primary objectives of bankruptcy law is the fair and equitable distribution of the debtor’s assets among all creditors in the face of the inefficient and inequitable first come-first serve principle inherent in non-bankruptcy debt collection law.

One of the fundaments of the fair and equitable distribution of the debtor’s assets among all creditors is the fair and equitable treatment of creditors. That said, the \textit{pari passu} principle is not about treating creditors identically\textsuperscript{292}. As a matter of fact bankruptcy law treats creditors differently depending on the non-bankruptcy status of their claim. For instance, claims with an interest \textit{in rem} on the debtor’s property are conferred absolute priority over unsecured claims until their full recovery. Similarly, certain unsecured claims are given priority over others mainly following socioeconomic policies. The \textit{pari passu} principle rather ensures that the priority accorded to similarly situated creditors affects all creditors of such position in the same manner\textsuperscript{293}. In other words, pursuant to the \textit{pari passu} principle, creditors with similar rights must be treated equally and receive the same distribution rights in accordance with their relative ranking position and interests\textsuperscript{294}. Based on the aforementioned principle, bankruptcy law establishes a fair and equitable framework under which all creditors of an insolvent debtor receive the same chances to recover the highest possible amount of their claims against the debtor and the same rights within the type of their claim.

Albeit not indicated explicitly, the \textit{pari passu} principle is reflected in various provisions of the Bankruptcy Code dealing with the distribution

\begin{footnotes}
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\item[290] See UNCITRAL Legislative Guide on Insolvency Law (UNCITRAL Legislative Guide), available at https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf. The UNCITRAL Legislative Guide was a project entrusted to Working Group V of UNCITRAL with the objective to \textit{‘prepare a comprehensive statement of key objectives and core features for a strong insolvency regime’}, see UNCITRAL Legislative Guide, Preface. The ultimate objective of drafting the UNCITRAL Legislative Guide was thus to encourage and promote the adoption of strong bankruptcy law provisions in national bankruptcy law regimes.
\item[291] UNCITRAL Legislative Guide, p.11.
\item[292] UNCITRAL Legislative Guide, p.11.
\item[293] UNCITRAL Legislative Guide, pp.11-12.
\item[294] \textit{Id.}, p. 11.
\end{enumerate}
\end{footnotes}
B. Reviewing the de facto exemption granted to CDS creditors

rights of creditors\textsuperscript{295}. Section 726 (b) USBC, for instance, provides that in liquidation cases creditor claims shall be paid pro rata among claims of the same kind. Similarly, section 1123 USBC provides with regard to the distribution process in reorganization cases that the same treatment must be afforded to claims of the same class\textsuperscript{296}, i.e. to substantially similar claims\textsuperscript{297}.

Within the context of the aforegoing, the present section shall examine if the \textit{de facto} exemption granted to creditors with an undisclosed CDS position is consistent with such principle.

As already indicated in the previous chapter, the present thesis represents the view that creditors who have received postpetition payment on their bankruptcy claim from a CDS seller under a CDS agreement, are in a similar position to that of beneficiary creditors who received postpetition payment from a co-obligor under a suretyship agreement pursuant to sections 502 (e) and 509 USBC. Both creditor positions reflect a beneficiary creditor, who has received payment on its bankruptcy claim from a third non-debtor party by virtue of such third party’s contractual liability after the commencement of the bankruptcy case. The essential similarity is that both creditor positions receive twofold payment on account of the same claim.

This similarity is not waived by the fact that a creditor with a CDS position paid to the CDS seller fees in the form of premium payments during the term of the CDS agreement and prior to its settlement due to the debtor’s bankruptcy. As already demonstrated, section 509 USBC applies to suretyship devices, such as insurance policies that entail identical premium payment requirements.

The difference between creditors, who received payment by means of a CDS agreement and creditors who received payment by means of a suretyship device covered by sections 502 (e) and 509 USBC lies in the liability of the co-obligor. Whereas latter devices typically establish a secondary li-

\begin{footnotesize}
296 § USBC 1123 (a) (4).
297 § USBC 1122 (a).
\end{footnotesize}
ability of the related co-obligor\textsuperscript{298}, the liability of the CDS seller under a CDS agreement is always that of a primary nature. In other words, while co-obligors of suretyship devices that fall within the scope of sections 502 (e) and 509 USBC pay a debt obligation for which the debtor is primary liable, CDS sellers pay for their own debt obligation that merely coincides with the debtor’s obligation. CDS sellers do therefore not meet the requirements set out under sections 502 (e) and 509 USBC and are consequently not afforded a claim for reimbursement or contribution or subrogation rights in the debtor’s bankruptcy proceeding. Accordingly, beneficiary creditors under CDS agreements are not subjected to the limitations embedded in section 509(c) providing that partial payments do not preclude the right of beneficiary creditors to pursue the total value of their claim until its full satisfaction from all sources of payment, unless the payment conducted represents the full amount for which the co-obligor is liable.

Regardless, the fact that sellers of CDS agreements are entitled to neither reimbursement nor subrogation rights in the debtor’s bankruptcy proceeding does not alter the position of the associated beneficiary creditors in such proceeding; those creditors remain in a substantially similar position to that of creditors who received payment from a co-obligor bearing a secondary liability, the only difference is that latter creditors are subjected to the limitation of section 509 (c) USBC whereas former are not. If section 509 (c) USBC was applicable to partially satisfied CDS creditors, such creditors would be allowed a claim on the residual value of such claim after the deduction of the amount received by the CDS seller. This would occur, because a CDS seller is independently liable to conduct payment of the cash settlement amount under the CDS agreement. Regardless of whether such amount falls below the total value of the CDS buyer’s bankruptcy claim, which ultimately depends on the terms of each CDS agreement, it will always represent the full amount for which the CDS seller is liable.

Empty CDS creditors, i.e. creditors who received a cash settlement amount of equal value to their bankruptcy claim from a CDS seller would pursuant to section 509 (c) USBC be precluded from exercising any distribution rights in the bankruptcy proceeding of the debtor, for their

\textsuperscript{298} Letters of credit are an exception, for they establish primary liability of the issuer. Issuers of letters of credit have nevertheless been granted subrogation rights under section 509 USBC.
bankruptcy claim would already have been paid in full by the CDS seller. Naturally, the same would apply to net short creditors, i.e. creditors who received a cash settlement amount exceeding the total value of their claim from the CDS seller.

Because of the de facto exemption from section 509 (c) USBC currently granted to creditors with a CDS positions USBC, such creditors are not subjected to the aforementioned limitations but rather conferred distribution rights in bankruptcy proceedings regardless of any additional consideration obtained, even where such consideration exceeds the total value of their bankruptcy claim. Creditors with an undisclosed CDS position therefore have a net advantage compared to those creditors, who are subjected to the limitation of section 509 (c) USBC, as they are afforded increased distribution rights on the debtor’s estate. Such privilege – even if circumstantially granted- is inconsistent with the pari passu principle that requires the equal treatment of similarly situated creditors.

At this point one could argue that aforegoing provisions are set out to either protect the beneficiary creditor, i.e. safeguarding that the beneficiary is not put in a disadvantageous position compared to the position it would be in absence of the suretyship agreement, or the co-obligor, i.e. preventing a windfall for the beneficiary at the co-obligor’s cost. Since CDS sellers are precluded from asserting any right in the bankruptcy proceeding of the reference entity, previous provisions would – in any case- not be applicable.

Following that argument, creditors with an undisclosed CDS position must be considered as creditors who received payment on their bankruptcy claim from a non-debtor party, who is not a co-obligor within the context of sections 502 (e) and 509 USBC, or a source other than the debtor’s estate.

The Bankruptcy Code envisages two situations of similar creditor positions. The first includes creditors, who in a liquidation proceeding of a partnership debtor received payment on their bankruptcy claim from a general non-debtor partner. Section 508 USBC provides that in those situations, beneficiary creditors are not conferred distribution rights beyond the payment received from the general partner until each creditor, who is entitled to the same share as the beneficiary creditor receives payment of equal value. The second situation involves similarly situated creditors in reorganization proceedings, who received payment on their bankruptcy claim from the bankruptcy estate of a foreign proceeding. Accordingly, section 1532 provides that said creditors are precluded from asserting any
distribution rights against the debtor’s estate so long as creditors of the same class received payment of proportionately less value.

The aforementioned provisions embedded in sections 508 and 1532 USBC are direct reflections of the *pari passu* principle. Notwithstanding any distribution rights of the beneficiary creditor with regard to non-debtor third parties or the estate of a foreign proceeding, received payments on account of such distribution rights are considered in bankruptcy proceedings and restrict the associated distribution rights of the beneficiary creditor to the amount of such payments, until all other similarly situated creditors receive equal or at least equivalent payment on their claims. In other words, bankruptcy law compromises the distribution rights of a creditor in the bankruptcy proceeding to avoid conferring preferential treatment to such creditor that could result into the detriment of similarly situated creditors.

Creditors who received payment on their bankruptcy claim from a non-debtor third party under a CDS agreement are currently not subjected to similar limitations under the Bankruptcy Code. Consequently, creditors with an undisclosed CDS position are granted an unjustified privilege compared to the creditors of sections 508 and 1532 USBC, because they are permitted distribution rights even after having received payment on their bankruptcy claim (even where such payment exceeds the total value of their claim), whereas latter creditors are deprived of their distribution rights in the equivalent situation until all other creditors with similar claims receive equal or equivalent consideration.

Accordingly, if the USBC provisions currently dealing with third party payments or payments from a source other than bankruptcy estate are brought together, CDS creditors would have to be subjected to the following rules:

Partially satisfied CDS creditors would either be entitled to pursue the total value or a reduced residual amount (after deducting the partial payment they received) of their claim until its full recovery, or be restricted to the amount of the partial payment conducted by the CDS seller, until all other similarly situated creditors received an amount of equal or equivalent value.

Empty or net short CDS creditors would be precluded from asserting any distribution rights in the bankruptcy proceeding.

Individual empty or net short creditor positions are currently not subjected to any restrictions since they remain undisclosed. This clearly results into an inconsistency with the *pari passu* principle on a twofold lev-
el; primarily with regard to the creditors that are subjected to the provisions of sections 502, 509, 508 and 1532 USBC and subsequently with regard to all other creditors of the bankruptcy case who might hold a lower ranking claim, e.g. equity holders, and thus be precluded from any recovery of their claim while a creditor with an undisclosed CDS position might have received payment satisfying or exceeding the total value of its claim.

Individual partially satisfied CDS creditors are similarly not subjected to any restrictions, including the recovery of ‘solely’ the total value of their bankruptcy claim, since partial payments conducted by the CDS seller are not disclosed. Notwithstanding the fact, that no universal, \textit{a priori} inconsistency can be established, since such inconsistency would depend on the specifics of each bankruptcy case, i.e. the value of recovery granted to a CDS creditor compared to the value of recovery granted to other similarly situated creditors, it can not be excluded either. In other words, the \textit{de facto} exemption of partially satisfied CDS creditors from otherwise applicable rules can, but does not necessarily have to result into an inconsistency with the \textit{pari passu} principle. Such possibility is however imminent enough to justify a disclosure obligation regarding the amount of the partial payment received.

It results so far that creditors who received payment on their bankruptcy claim under a CDS agreement should, pursuant to the \textit{pari passu} principle, be subjected to similar limitations as those embedded in section 509 (c) USBC or alternatively those embedded in sections 508 and 1532 USBC. Their \textit{de facto} exemption from such limitations and the absence of any equivalent limitations applicable to creditors with an undisclosed CDS position can result into an inconsistency with the \textit{pari passu} and hence impair one of the primary objectives of bankruptcy law, i.e. the fair and equitable distribution of the debtor’s assets among its creditors.

The foregoing analysis further concludes that due to foregoing reasons, the \textit{pari passu} principle renders the introduction of a disclosure requirement with regard to the amount of payment received by means of the CDS agreement, imperative.

An interesting question that arises with regard to the applicability of the limitations imposed on creditors holding a personal security to CDS creditors, is how to deal with the inevitable benefit that such limitations would confer upon the debtor of the bankruptcy case. As already indicated, the CDS seller holds no subrogation or reimbursement rights against the debtor. This peculiarity occurs due to the decoupling of the economic interests and associated control rights on the underlying debt obligation fa-
cilitated in CDS transactions. Whereas in other transactions the party paying for a debt obligation automatically assumes the associated control rights, e.g. reimbursement or subrogation rights, CDS transactions can leave the associated control rights with the party who receives the payment. Within the context of a bankruptcy proceeding, such decoupling of interests would inevitably create a windfall to the debtor, if the conducted payments to the beneficiary creditor limited its distribution rights against the debtor’s estate. The reason is evident. The payments received by the CDS buyer would limit the amount due on the debtor’s estate but in absence of any subrogation or reimbursement rights on behalf of the paying party, such party would not be able to recover its conducted payments; the created surplus would thus unduly increase the debtor’s estate.

What needs to be clarified at the outset of any subsequent argumentation is that the aforementioned question concerns the relationship between the debtor and the co-obligor rather than the rights conferred upon the beneficiary creditor. Beneficiary creditors of a CDS agreement cannot be conferred preferential treatment compared to the beneficiary creditors of suretyship agreements; such preferential treatment infringes the pari passu principle and impairs one of bankruptcy law’s primary objectives, which is the fair and equitable distribution of the debtor’s assets. Moreover, preventing a potential windfall to the debtor is no viable justification for shifting the burden of such prevention to the other creditors of the bankruptcy proceeding. In other words, avoiding a windfall to the debtor at the expenses of all of its creditors is highly inequitable within the context of a bankruptcy proceeding, which after all aims at ensuring the equitable and best possible satisfaction of all creditor claims.

The aforegoing question needs to be addressed within the context of the relationship between the debtor and the CDS seller. What needs to be examined concretely is whether the fact that the payment conducted by the CDS seller to the beneficiary creditor inevitably reduces the debtor’s outstanding debt to such creditor creates any equitable subrogation or reimbursement rights on behalf of the CDS seller.

Since the present thesis examines the rights and obligations of the CDS buyer in the reference entity’s bankruptcy proceeding, the issue of whether the CDS seller of a CDS agreement is entitled to any equitable subrogation or reimbursement rights in the reference entity’s bankruptcy proceeding falls beyond its scope, notwithstanding the fact that a sincere analysis of the aforegoing matter would amount to the volume of a separate thesis.
The aforementioned issue will therefore not be addressed any further. What is essential to note for the purposes of the present study is that the issue of whether the CDS seller holds any equitable subrogation or reimbursement rights against the debtor has and should not have any impact on the obligations of the beneficiary creditor in the associated bankruptcy proceeding; nor could it provide an acceptable justification to exempt the beneficiary creditor from otherwise applicable bankruptcy rules.

C. Reviewing the consistency of the de facto exemption granted to CDS creditor positions with the single satisfaction rule

As already indicated, pursuant to the single satisfaction rule, creditors may never assert more than the total value of their claim. Notwithstanding the circumstances, the single satisfaction rule applies to all creditors, who received payment by means of a third party non-debtor or its property; even in cases where courts have granted exaggerated rights to such creditors to not compromise their right to assert the full value of their claim notwithstanding any partial payments, the single satisfaction rule always dictated the ultimate limit, set at the full value of the associated bankruptcy claim against the debtor.\textsuperscript{299}

Because creditors with an undisclosed CDS position are not obligated to declare any payments received under their CDS agreement, such payments cannot be considered in the distribution of the debtor’s assets; said creditors can thus not be subjected to the limitation imposed by the single satisfaction rule.

Consequently, partially satisfied CDS positions can easily infringe the single satisfaction rule depending on the amount of payment received by the creditor holding such position.

In lieu of the fact that payment under a CDS agreement can be equal to the value of the CDS buyer’s bankruptcy claim or even of higher value depending on the terms of each CDS agreement, certain CDS positions will be empty, or net short, i.e. already fully satisfied or even overcompensated. In that case, any payment conducted to a creditor with an undisclosed

empty or net short CDS position from the debtor’s estate will be in breach of the single satisfaction rule.

The afore-explained inconsistency with the single satisfaction rule further results into creditors with an undisclosed CDS position to be granted increased distribution rights compared to all other creditors, who are prevented from recovering more than the total value of their claim notwithstanding the source of such recovery, and thus also leads to an inconsistency with the *pari passu* principle.
Subfindings

The analysis conducted under the present chapter concludes the following subfindings with regard to the *de facto* exemption granted to creditors with an undisclosed CDS position from rules that are otherwise applicable to creditors who received payment from a co-obligor or other non-debtor sources:

1. The *de facto* exemption of undisclosed empty or net short CDS creditors from section 509 (c) USBC as well as similar limitations to those applying to beneficiary creditors under sections 508 and 1532 USBC are inconsistent with the *pari passu* principle because former creditors are afforded increased distribution rights compared to latter.

2. The *pari passu* principle therefore renders the introduction of equivalent limitations applicable to empty and net short CDS creditors imperative and the introduction of a disclosure obligation indispensible.

3. The *de facto* exemption of undisclosed partially satisfied CDS creditor positions from the aforegoing limitations can result into an inconsistency with the *pari passu* principle, depending on the actual amount of CDS creditors’ recovered bankruptcy claim compared to the recovery amount of other similarly situated creditors. In order to safeguard compliance with the *pari passu* principle, partially satisfied CDS creditors must be obliged to disclose the amount of payment they received under their CDS agreement.

4. Exempting creditors with an undisclosed CDS position from otherwise applicable limitations can, in absence of any imposed disclosure requirements, further result into a breach of the single satisfaction rule:

   Partially satisfied CDS positions can easily infringe the single satisfaction rule, depending on the amount of payment received by the creditor holding such position from the debtor’s estate.

   Since empty and net short creditors are already fully satisfied or over-compensated, any payment right grated to such creditors against the debtor’s estate, will be in breach of the single satisfaction rule.
Chapter 11 USBC confers upon corporate debtors the opportunity to reorganize their business in the face of a piecemeal liquidation. To that end, a Chapter 11 debtor is afforded powerful devices such as the right to acquire new loans, the right to propose a reorganization plan and the right to continue the operation of its business through the reorganization procedure. The debtor is further afforded breathing room through the applicability of the automatic stay\textsuperscript{300}.

Congress and bankruptcy courts favor reorganization over liquidation to enable viable but financially troubled businesses to continue their business activity so as to maintain their going-concern value\textsuperscript{301}. The essential rationale behind such built-in bias favoring reorganization over liquidation is that in cases where the going concern value of a business is higher than its liquidation value, reorganizing such business over liquidating its assets piecemeal best benefits all parties involved; creditors of the debtor receive higher payment on their claims; the debtor’s employees preserve their employment positions, its suppliers their customer and shareholders might even be able to preserve part of their principal investment\textsuperscript{302}.

The US Supreme Court noted within the aforesaid context: ‘...the fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources\textsuperscript{303}.

In another case, the Supreme Court explained Congress’ rationale for qualifying reorganization as an alternative bankruptcy proceeding. The Supreme Court noted in this regard: ‘By permitting reorganization, Congress anticipated that the business would continue to provide jobs, to satisfy creditors’ claims, and to produce a return for its own-

\textsuperscript{300} USBC §§ 103, 362.
\textsuperscript{301} Janger, \textit{Understanding Bankruptcy}, p.709.
ers….Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if “sold for scrap”.  

In reorganization proceedings, the debtor is principally allowed to manage its estate and perform the duties and rights conferred upon the trustee in liquidation bankruptcies. The debtor is therefore referred to as the debtor-in-possession (DIP) in its capacity to act as the estate’s representative, subject to the powers and duties conferred upon a trustee. In that sense, the term ‘debtor-in-possession’ indicates the trustee in a reorganization case, who is also the debtor of the case, where no trustee has been appointed. The bankruptcy court will appoint a trustee or an examiner to conduct an investigation of the debtor only when needed.

The DIP preserves the exclusive right to file a reorganization plan for the first 120 days of the reorganization case. If the DIP does not file a reorganization plan within the afore-specified time period, or if such plan is not accepted within the first 180 days of the reorganization case, parties in interest may file a reorganization plan.

A reorganization plan must be accepted by the DIP’s creditors and confirmed by the bankruptcy court. To that end, Chapter 11 classifies creditor claims, establishes the conditions of the voting procedure and the voting rights conferred to each creditor as well as the conditions for the confirmation of the reorganization plan by the court.

The provisions establishing the requirements applicable to the classification of claims, creditors’ voting rights as well as the content of the plan are of essential importance because, notwithstanding any additional re-

305 Pursuant to section 1104 (a) USBC a trustee may be appointed by the bankruptcy court on request of any party in interest or the United States trustee ‘for cause’ or if the appointment of a trustee is in the interests of creditors, equity security holders and other interests of the estate. Section 1104 (a) (1) specifies ‘for cause’ to include fraud, dishonesty, incompetence, or gross management by current management of the business debtor before or after the commencement of the case.
306 USBC § 1107 (a).
307 USBC § 1101 (1). Consequently, whereas the Bankruptcy Code is drafted in terms of powers and duties of the ‘trustee’ as the estate’s representative, such terms refer to the DIP in reorganization cases, albeit not explicitly mentioned.
308 USBC § 1104.
309 USBC § 1121 (b).
310 USBC § 1121 (c) (1), (2), (3).
311 See USBC § 1122; §§ 1124, 1126 and §§ 1123, 1129 respectively.
quirements, only reorganization plans complying with the aforegoing provisions may be confirmed by the court\textsuperscript{312}.

Pursuant to section 1126 (a) USBC, ‘the holder of a claim or interest allowed under section 502 [USBC] may accept or reject a plan’. A sine \textit{qua non} precondition for creditors to participate in reorganization proceedings is therefore the allowance of their claim pursuant to the provisions of section 502 USBC\textsuperscript{313}.

Thus, within the context of reorganization cases, the allowance of a claim under section 502 serves a twofold purpose. Firstly, it determines the distribution rights of the claim holder as in any other type of proceeding and secondly confers upon the claim holder a voting right on the DIP’s reorganization plan.

So far, the present thesis examined the effects of creditors with an undisclosed CDS position within the context of their distribution rights. The present and final part of this thesis examines the effects of the foregoing creditor positions within the context of their conferred voting rights in reorganization cases and the legitimate acceptance and confirmation of a reorganization plan under the relevant provisions of Chapter 11 USBC.

To that end, the present part is structured as follows. Chapter nine examines the discrepancies that can occur from the non-disclosure of CDS positions within the context of the classification of claims pursuant to the provision of section 1122 (a) USBC that prohibits placement of claims that are not substantially similar into the same class. Emphasis is put on the criteria that are to be considered in determining which claims are substantially similar to each other. The second part of chapter nine examines, within the same context, the requirement to treat equally claims of the same class, embedded in section 1123 (4) USBC.

Chapter ten discusses the inconsistencies that can occur with regard to the provisions on the acceptance and confirmation of a reorganization plan. It furthermore elaborates on the disclosure requirements embedded in Bankruptcy Rule 2019, currently only applicable to groups of creditors or creditor committees.

\footnotesize
\begin{itemize}
\item \textsuperscript{312}See, USBC § 1129 (a) (1); see also USBC §§ 1123 (a) (1), 1124.
\item \textsuperscript{313}It is worth noting at this point that section 103 (a) provides that the provisions of chapters 1, 3 and 5 USBC apply to reorganization cases other than railroad reorganizations (USBC § 1161ff). The same provision applies to liquidation cases, family farmer or fisherman debtors under chapter 12 USBC and individual debtors under chapter 13 USBC.
\end{itemize}
The present part concludes with a summary of the findings resulting from the analysis provided under the present part, evidencing the imperative need to apply disclosure requirements to individual creditors with a CDS position in reorganizations.
Chapter 9: The Effects of Undisclosed CDS Positions on Sections 1122 (a) and 1123 (a) (4) USBC

A. Allowance of claims and voting rights in reorganization proceedings

Before looking at the effects of the de facto exemption granted to creditors with an undisclosed CDS position on sections 1122 (a) and 1123 (a) (4) USBC separately, this short section shall briefly explain the process of claims allowance in reorganization cases.

In a reorganization proceeding, claims are allowed under section 502 USBC\(^\text{314}\). Pursuant to section 502 (a) a claim shall be deemed allowed if a proof of claim is timely filed pursuant to the provisions of section 501 USBC\(^\text{315}\), unless a party in interest objects\(^\text{316}\). If a party in interest objects to the allowance of a claim, the bankruptcy court, after notice and a hearing, is obliged to determine the amount of such claim and subsequently allow such claim pursuant to the general requirements of section 502 USBC\(^\text{317}\). Claims are disallowed, notwithstanding whether any party in interest objected, pursuant to the specific grounds for disallowance established under section 502 USBC\(^\text{318}\). Grounds for disallowance include claims that are unenforceable against the debtor\(^\text{319}\), claims for unmatured interest\(^\text{320}\) etc.

Under section 1111 (a) USBC, claims in a reorganization proceeding are deemed filed under section 501, if such claims appear in the schedule filed by the DIP under section 521(a) (1) and are not scheduled as disputed, contingent or unliquidated\(^\text{321}\). If a claim is listed as disputed, contingent or unliquidated, the holder of such claim shall file a proof of claim under Bankruptcy Rule 3003 (c) (2), which is subsequently allowed or dis-

\(^{314}\) See, USBC §§ 103 (a).
\(^{315}\) See also Bankruptcy Rule 3001 on the content of proof of claims. Essentially, a proof of claim is a simple written statement setting forth the creditor’s claim and typically accompanied by documentation evidencing the validity of such claim.
\(^{316}\) See, USBC § 502 (a).
\(^{317}\) See, USBC § 502 (b).
\(^{318}\) See, USBC § 502 (b) (1)-(9), (d), (e) (1).
\(^{319}\) See, USBC § 502 (b) (1).
\(^{320}\) See, USBC § 502 (b) (2).
\(^{321}\) See, USBC § 1111 (a) and Bankruptcy Rule 3003 (b).
allowed pursuant to the relative provisions of section 502 USBC, as explained previously\(^{322}\).

Thus, a claim in a reorganization process is allowed or disallowed under section 502 as if it was filed under section 501, or if it is filed under Bankruptcy Rule 3003. The allowance of such claim under section 502 establishes the right of the creditor to accept or reject a proposed reorganization plan pursuant to the provisions of Chapter 11 USBC\(^{323}\).

Within the aforegoing context, a creditor with a CDS position is afforded voting rights on the DIP’s reorganization claim, if its claim is otherwise allowed under section 502 USBC. Since no disclosure requirements apply to individual creditors with a CDS position within reorganization or otherwise under the Bankruptcy Code\(^{324}\), such creditor would not have to disclose any payment received under its CDS agreement. The classification of its claim and any associated voting rights will therefore be determined on the basis of its claim regardless of any payment received on such claim from the CDS agreement. Consequently, even creditors with an empty or net short CDS position will be entitled to accept or reject a reorganization plan as long as their claim is allowed under section 502 USBC.

**B. The effects of the de facto exemption of creditors with an undisclosed CDS position from otherwise applicable bankruptcy rules on section 1122 (a) USBC**

For the purposes of accepting or rejecting a reorganization plan, creditor claims are classified. Pursuant to section 1122 (a) USBC, only ‘substan-
tially similar’ claims may be put into the same class\textsuperscript{325}. The aforegoing provision provides clearly that claims that are not substantially similar may not be placed in the same class; but it leaves several questions open to interpretation without providing any further guidance, such as whether all substantially similar claims must be placed in the same class, the circumstances under which substantially similar claims may be placed in different classes and whether the determination of ‘substantially similar’ claims is one of fact or law, or both depending on the circumstances of each reorganization case\textsuperscript{326}.

Bankruptcy courts have dealt with the aforementioned questions and developed various principles to provide- at times diverse- answers\textsuperscript{327}. For instance, case law has established in its vast majority that whereas the Bankruptcy Code requires all claims of a class to be substantially similar, it does not necessarily require all substantially similar claims to be placed in the same class\textsuperscript{328}. The separate classification of otherwise substantially similar claims therefore seems to not be generally prohibited as long as the reorganization plan articulates a reasonable justification for such separation and an attempt on behalf of the DIP to abuse such separate classification for the improper manipulation of the voting process can be reasonably

\begin{itemize}
\item \textsuperscript{325} Section 1122 (b) USBC authorizes, for administrative convenience, a separate class of unsecured claims that typically includes all claims of less than a relative small amount and claims that have been reduced to that amount with the creditor’s consent. Since section 1122(b) USBC applies to specific \textit{de minimis} claims only, it is not of relevance within the context of the present thesis and shall thus not be elaborated.
\item \textsuperscript{327} Mike Sigal; Eric Brunstad, "Competitive Choice Theory and the Unresolved Doctrines of Classification and Unfair Discrimination in Business Reorganizations under the Bankruptcy Code," \textit{The Business Lawyer} 55 (1999): pp. 1, 5 , 32-37 (indicating that courts have developed at least five different approaches regarding the classification of claims, injecting chaos into the case law).
\item \textsuperscript{328} \textit{In re Bryson Properties}, XVIII, 961 F.2d 496, 502 (4th Cir. 1992)
\end{itemize}
excluded\textsuperscript{329}. Still, some courts have prohibited separate classification of substantially similar claims regardless of the DIP’s motive\textsuperscript{330}.

Within the context of the present thesis it is not essential to determine whether substantially similar claims may be placed in different classes; what is rather of importance is the ground for determining the \textit{substantial similarity} of claims, i.e. whether claims are assessed based on their legal nature only or also against the backdrop of factual circumstances, e.g. the identity of the claim holder, its economic interests etc. In more specific terms, whether legally permissible classification of claims brought by creditors with an undisclosed CDS position should take into consideration the fact that a third party source for recovery is available or whether such claims should be classified solely on the basis of their legal nature, e.g. senior or subordinated, secured or unsecured.

The foregoing question of whether, within the context of section 1122 (a) USBC, \textit{substantial similarity} is determined only pursuant to the legal nature of claims, i.e. their rank of priority or also by taking into consideration factual circumstances is of particular importance for the purposes of the present thesis, for whereas former view would suggest that undisclosed CDS positions could be classified with claims of the same legal type notwithstanding any payments received from third party sources, latter would give ground to question whether third party considerations can be disregarded in the classification of claims for the purposes of Chapter 11 USBC.

Bankruptcy courts are divided in their interpretation with regard to the degree of flexibility embedded in section 1122 (a) USBC. One line of interpretation considers that section 1122 (a) is to be interpreted narrowly


\textsuperscript{330} See, e.g., \textit{In re Bloomingdale Partners}, 170 B.R. 984 (N.D. Ill. 1994).
and determines ‘substantially similar’ claims only based on their nature or legal attributes\textsuperscript{331}; another more flexible approach suggests that section 1122 (a) USBC does not establish any rigid standards for the classification of claims but confers broad discretion to courts with regard to propriety of classification\textsuperscript{332}. More recent cases adopted a more flexible approach towards the interpretation of ‘substantially similar’ claims, taking into consideration other factors but the legal nature and attributes of claims\textsuperscript{333}. In \textit{In re Light Squared}, the court found that ‘a claim reflects more than a dollar amount on a proof of claim; it reflects a bundle of rights and remedies that are wielded by the holder of the claim. Accordingly, both the nature of the claim and the identity of the claimant may be relevant in the context of separate classification.’\textsuperscript{334}.

The afore-illustrated division is rooted in the legislative history noted upon section 1122 (a) USBC\textsuperscript{335}. The adhered Senate Report indicates: ‘This section codifies current case law surrounding the classification of claims and equity securities. It requires classification based on the nature of the claims or interests classified, and permits inclusion of claims or interests in a particular class only if the claim or interest being included is substantially similar to the other claims or interests of the class.’\textsuperscript{336}

Pursuant to the Senate Report, the only exception to the aforementioned principle is the administrative convenience exception of section 1122 (b)

\textsuperscript{331} See, e.g., \textit{In re Sentinel Management Group, Inc.}, 398 B.R. 281 (Bankr. N.D. Ill. 2008) (“This determination should focus on the nature or legal attributes of the claims and not on the status or circumstances of the claimants.”); \textit{In re Quigley Co., Inc.}, 377 B.R. 110, 116 (Bankr. S.D.N.Y. 2007) (“Claims are similar if they have substantially similar rights to the debtor’s assets.”); \textit{In re Frascella Enters.}, 360 B.R. 435, 442 (Bankr. E.D. Pa. 2007) (“The similarity of claims is not judged by comparing creditor claims inter se. Rather, the question is whether the claims in a class have the same or similar legal status in relation to the assets of the debtor.”).

\textsuperscript{332} \textit{In re Jersey City Medical Center}, 817 F.2d 1055(3d Cir. 1987) (on chapter 9 US-BC); \textit{In re U.S. Truck Co., Inc.}, 800F.2d 581 (6th Cir. 1986).


\textsuperscript{334} \textit{In re Light Squared Inc.}, 513 B.R. 56, 84 (Bankr. S.D.N.Y. 2014).

\textsuperscript{335} Historical and Revision Notes, Pub. L. 95-989, Nov. 6, 1978, 92 Stat. 2631.

\textsuperscript{336} House Report, 406; S. REP. No.989, 95\textsuperscript{th} Cong. 2d session 118 (1978).
establishing that certain *de minimis* unsecured claims can be classified separately for administrative convenience.

The legislative history intended to codify the case law under former Bankruptcy Act into section 1122 (a) when it enacted the Bankruptcy Code in 1978. Complications arise due to the fact that the classification provisions of the predecessor Bankruptcy Act of 1898 were penned very differently from today’s section 1122 (a) USBC. Section 757 (1) of what constituted the analogous Chapter 11 USBC under the Bankruptcy Reform Act of 1898 permitted a plan to anticipate ‘provisions for treatment of unsecured debts on a parity one with the other, or for the division of such debts into classes and the treatment thereof in different ways’. The meanwhile ancient legislative history adhered to the precedent section 757 (1) of the Bankruptcy Reform Act of 1898 stated, in part, that said section considered the possibility of paying in full small claims or a settlement with the bank on terms different from the settlement with merchandise creditors, as long as classification is upon a reasonable basis.

It follows from the aforegoing that the analogous provision precedent section 1122 (a) anticipated a degree of fair flexibility in classifying similar claims either together or in different classes. The pre-Bankruptcy Code case law codified in the legislative history on section 1122 (a) USBC can therefore not reasonably be assumed to have established rigid standards limiting the classification of claims to a similarity in nature only, if read in its proper context. Following that line of reasoning it can forcefully be argued that since the language of section 1122 (a) USBC does not provide the same degree of flexibility as section 751 (1) of Bankruptcy Reform Act of 1898, such degree of flexibility should be left to the courts, particularly in lieu of the fact that a rigid interpretation of ‘substantially similar’ entirely disregarding any factual circumstances could in some
cases lead to controversial results within the context of the residual provisions of Chapter 11 USBC as will be demonstrated below.

The Court of Appeal in In re U.S. Truck Co. noted in this regard: ‘It is difficult to follow Congress’ instruction to apply the old case law to the new Code provision. The old case law comes from two different sources. Chapter XI was designed for small nonpublic businesses, did not permit the adjustment of a secured debt or of equity, and thus contained few investor-protection measures. The idea behind Chapter 11 of the Code was to combine the speed and flexibility of Chapter XI with some of the protection and remedial tools of Chapter X. Thus, Congress has incorporated, for purposes of interpreting section 1122, the case law from two provisions with different language, that were adopted for different purposes, and that have been interpreted to mean different things.’ 341

As already indicated, the crucial question that needs to be answered within the context of the present section, is whether a third party source of recovery is an applicable ground for determining the similarity of claims within the context of section 1122 (a) USBC.

This issue came up in In re Johnston 342. The Ninth Circuit Court of Appeals had to decide whether the bankruptcy court rightfully placed an unsecured creditor, who was partially secured by a third party’s collateral in its separate class and not in the same class of other unsecured creditors. Said creditor had filed a lawsuit against such third party to enable enforcement of its collateral. Upon the time the case was brought to the Court of Appeals said litigation was pending.

The Court of Appeal firstly indicated that bankruptcy judges must have discretionary power in classifying claims under 1122(a) USBC 343. The Court of Appeals ultimately confirmed the bankruptcy court’s finding inter alia because it found that unlike the other unsecured creditors, the aforementioned creditor was partially secured by third party collateral and because if successful in the pending litigation, such creditor could be fully paid before other unsecured creditors 344.

342 Steelcase Inc. v. Johnston (In re Johnston), 21 F.3d 323 (9th Cir. 1994).
343 Id., 327.
344 Id., 328.
The Court of Appeals in In re Loop \(^{345}\) interpreted In re Johnston as follows: ‘….the only factor in Johnston that seems at all relevant to either the bankruptcy court’s finding or the Ninth Circuit’s affirmance of substantial dissimilarity is that the creditor had a non-debtor source of repayment of the claim. The Ninth Circuit’s opinion emphasized the particular significance of this first factor when it stated: ”Steelcase, unlike other unsecured claimants, holds a partially secured interest in COS, thereby according Steelcase different status” than the other unsecured creditors.” [citation omitted]. It therefore appears that the holding of Johnston is that a claim that may be paid from a non-debtor source is not substantially similar to claims that lack such non-debtor source of repayment. Or, more accurately, the holding of Johnston appears to be that it is permissible for a bankruptcy court to find, as a matter of fact, that a non-debtor source of repayment of a claim renders it dissimilar from other claims lacking such source of repayment outside of the plan. \(^{346}\)

The bankruptcy court concluded that In re Johnston allows a court to consider whether the creditor has a non-debtor source for repayment of its claim in determining whether claims are or are not substantially similar and thus found that it was not restricted to considering the legal character of the claim as it relates to the assets of the debtor, i.e. its rank of priority in the distribution of the debtor’s assets, but could consider in its analysis other interests held by the creditor in question\(^{347}\). The court concluded that such flexible approach allows a reorganization plan to classify claims on some basis other than their rank of priority\(^{348}\).

The court eventually found that the existence of a third party source of payment, which unlike In re Johnston, was a cash source of payment pursuant to certain guarantee agreements, rendered the creditor’s claim dissimilar to other unsecured claims.

The 9th Circuit Bankruptcy Appellate Panel confirmed the court’s decision on the ground that notwithstanding any payment received from the estate the creditor was still able to receive full recovery from its guarantors; the court considered this to be a special circumstance that did not ap-

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\(^{345}\) In re Loop 76, LLC, 442 B.R. 713 (Bankr. D. Ariz. 2010).
\(^{346}\) Id., 717.
\(^{347}\) Id., 717-718.
\(^{348}\) Id., 719-720.
ply to any unsecured creditor thus according said creditor a different status. The 9th Circuit Court of Appeals subsequently affirmed this finding.

If the findings in *In re Johnston* and *In re Loop* were applied to the question as to whether claims held by creditors who received payment on such claims from a CDS agreement are substantially similar to other unsecured claims lacking any third party source of recovery, one would reason by analogy that former claims would have to be separately classified in their own class. Consequently, creditors with an undisclosed CDS position would have to be put in a class of creditors who also preserve a right to satisfy their claims through a third party source of recovery.

The foregoing court decisions anticipate the crucial factor in this regard. A creditor who has the right to receive payment on account of its bankruptcy claim from a third party source of recovery could be paid in full before any other creditor, who does not have the same right, receives any payment. Claims with a non-debtor source of recovery are therefore dissimilar from other claims, whose sole source of recovery is the distribution provided under the reorganization plan.

The foregoing interpretation is further confirmed within the context of section 1123 (a) (4) USBC, which provides that a reorganization plan must treat creditors of the same class equally. This requirement could not be applied in a class of creditors if certain creditors received payment before others.

However, CDS positions remain undisclosed to anyone but the creditor holding such position. The factor of a non-debtor source of recovery can therefore not be considered in their classification. Consequently, the possibility of placing creditors with a CDS position in an inappropriate creditor class cannot be excluded. Such circumstance would not only be inconsistent with section 1122 USBC, but would furthermore nullify co-related provisions that are based on the premise that only substantially similar claims are placed in the same class, as will be demonstrated in the subsequent sections of this part.

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350 *Wells Fargo Bank, NA v. Loop 76, LLC (In re Loop 76, LLC)*, 578 Fed. Appx. 644 (9th Cir. 2014).
C. The effects on the applicability of the equal treatment requirement under section 1123 (a) (4) USBC

As already indicated, pursuant to section 1129 (a) USBC, bankruptcy courts are only permitted to confirm proposed reorganization plans that comply with the applicable provisions of Chapter 11 USBC. One of the core provisions of Chapter 11 USBC in this regard is section 1123 USBC.

Section 1123 USBC sets out the general requirements a reorganization plan must fulfill to be permissible. The first requirement established under section 1123 USBC is that a reorganization plan must designate classes of claims pursuant to section 1122 USBC. The previous section illustrated that creditors with an undisclosed CDS position cannot always be appropriately classified pursuant to section 1122 USBC because the factor that such positions maintain a third party source of recovery is not disclosed. Placing a creditor who received partial or even full payment within the same class of creditors who have not received any payment, would per se already constitute a violation of the requirement established under section 1122 USBC that only substantially similar claims may be placed in the same class.

Furthermore, section 1123 (a) (4) provides that each claim of a particular class must be treated equally under a reorganization plan unless a creditor voluntarily accepts less favorable treatment. It is evident that such requirement would be violated in cases where some creditors have received full or partial payment from a third party source of recovery whereas others have not. A reorganization plan could not possibly treat claims of a particular class equally under the aforesaid circumstances.

Moreover, section 1123 (a) (4) is directly related to section 1122 (a). It requires all claims of a particular class to be treated the same under the

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351 USBC § 1123 (a) (1). Pursuant to section 1123 (a) (1) USBC, certain priority claims are excluded from the classification requirement. Such priority claims are second priority administrative expenses (USBC § 507 (a) (2)), third priority post-petition claims (USBC § 507 (3)) and eighth priority tax claims (USBC § 507 (a) (8)). The former two types of priority claims are excepted because section 1129 (a) (9) (A) requires that such claims are cash paid in full on the reorganization plan’s effective date unless such requirement is waived by a particular creditor. In that sense there is no need to classify priority claims of the aforesaid type since their treatment is mandated and they do not vote as a class. Eighth priority tax claims are similarly excluded because the conditions of their payment are treated separately (USBC § 362 (b) (9) (D); § 511; § 1129 (a) (9) (C)).
premise of section 1122 (a), which determines that only substantially similar claims may be put within the same class. In that sense, the aforegoing sections establish two separate but substantially related requirements\textsuperscript{352}. Section 1123 (a) (4) cannot be applied if section 1122 (a) is not applied first. If proper classification cannot take place, then the same treatment of claims of the same class requirement cannot be applied either. In that sense, if the non-disclosure of a CDS position results into an impermissible classification of the associated claim under section 1122 USBC, section 1123 (a) (4) USBC is deprived from any possible ground of applicability.

According to section 1129 (a) USBC, the requirements of sections 1122 and 1123 (a) (4) USBC must be met for reorganization plans to be confirmed. Classifying an individual claim within a class of different claims therefore renders the associated reorganization plan legally impermissible.

The aforegoing paradox cannot always be avoided so long as CDS positions remain undisclosed. The introduction of appropriated disclosure requirements applicable to individual creditor claims and not merely to creditor committees\textsuperscript{353} is therefore imperative, albeit not a panacea for any legal inconsistency accruing from CDS positions in reorganizations. It is however a \textit{sine qua non} condition for any recovery thereof.


\textsuperscript{353} See Bankruptcy Rule 2019.
Chapter 10: The Effects on the Plan Voting and Plan Confirmation Provisions under Chapter 11 USBC and Bankruptcy Rule 2019

A. Determining the state of impairment of silently satisfied claims for the purposes of Chapter 11USBC

As already indicated at the outset of the present part, a proposed reorganization plan must be accepted by the DIP’s creditors in order to be confirmed by the bankruptcy court\textsuperscript{354}.

Section 1126 USBC provides that any creditor who has an allowed claim pursuant to section 502 (a) USBC may accept or reject a reorganization plan\textsuperscript{355}. Section 1126 USBC further provides that creditor classes that are not ‘impaired’ by the plan are deemed to have accepted such plan whereas creditor classes that do not receive any consideration are deemed to have rejected such plan\textsuperscript{356}. Within this context, section 1123 USBC, establishing the permissible content of a reorganization plan, provides that latter must specify those creditor classes that are not impaired by the plan as well as the treatment conferred upon all impaired creditor classes\textsuperscript{357}.

The status of impairment is thus of major practical and legal importance to the confirmation of a reorganization plan. Section 1124 USBC defines the circumstances under which a class of claims is considered ‘impaired’ for the purposes of Chapter 11 reorganizations.

In principle, a class of claims is considered to be impaired under a reorganization plan unless the plan does not alter the legal, equitable and contractual rights of the claim holder or cures defaults, reinstates the maturity of claims or compensates the claim holder for any damages and does not

\textsuperscript{354} Section 1129 (b) provides that under certain circumstances and subject to certain requirements a reorganization plan may be confirmed even where not accepted by all creditor classes.

\textsuperscript{355} USBC § 1126 (a).

\textsuperscript{356} See USBC § 1126 (f) and (g) respectively.

\textsuperscript{357} See USBC § 1123 (a), (2) and (3) respectively.
otherwise impair the rights of the claim holders with respect to each claim of such class\textsuperscript{358}.

Bankruptcy courts have adopted a broad interpretation of the term ‘impairment’. Case law has generally established that even the smallest alterations confer voting rights upon their holders even if the value of such rights is enhanced. The bankruptcy court in \textit{In re Union} held in this regard: ‘Impairment’ is a term of art and includes virtually any alteration of a claimant’s rights ... even where a creditor’s rights are improved by a plan. \textsuperscript{359}.

Section 1124 (2) USBC clearly states that a plan is considered to leave a class unimpaired, if it cures any default that occurred before or after the commencement of the bankruptcy claim. The cash settlement payment received by a creditor with a CDS position under a CDS agreement is by definition curing any default noted on the reference obligation, i.e. the bankruptcy claim of such creditor, due to the debtor’s bankruptcy. Such default is cured with mathematical precision as demonstrated under part two of the present thesis.

Another discrepancy with regard to the notion of impairment under section 1124 USBC is that such impairment is assessed on a class level rather than upon individual claims. Since classes must consist of similar claims pursuant to section 1122 USBC and each claim of a particular class must be treated equally pursuant to section 1123 (a) (4) USBC, assessing impairment on a class level is only reasonable. However, the non-disclosure of payments received through third party sources in the case of undisclosed CDS positions renders such assessment unfeasible; for how could section 1124 USBC be applied on a class including impaired and unimpaired claims.

In lieu of the fact that pursuant to section 1126 USBC only impaired classes are afforded voting rights in the acceptance of a reorganization plan, placing a creditor with an unimpaired claim in a class of impaired

\textsuperscript{358} USBC § 1124 (1), (2).

B. The effects on the confirmation of a reorganization plan

Section 1129 reflects the ultimate statutory objective of Chapter 11 USBC: the confirmation of a reorganization plan. Within this context, section 1129 USBC establishes a minimum standard of requirements, a reorganization plan must fulfill to be confirmed by the bankruptcy court. Section 1129 (a) USBC establishes the minimum requirements of a consensual plan confirmation whereas section 1129 (b) USBC deals with the non-consensual confirmation of a plan commonly referred to as a ‘cram down’.

The present section elaborates on the possible effects of undisclosed CDS positions on both a consensual plan confirmation and a plan cram down.

Section 1124 (a) USBC includes sixteen paragraphs each of which establishes a separate requirement that needs to be fulfilled for the court to be able to confirm a reorganization plan. The first paragraph of section 1124 (a) requires the plan to comply with the applicable provisions of Chapter 11 USBC. The legislative history noted upon the foregoing section, suggests that the applicable provisions referred to under this paragraph concern the internal structure and drafting of the plan, i.e. the provisions established under sections 1122 and 1123 USBC on the classification of claims and the permissible minimum standards with regard to the

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360 The first judicial use of the phrase ‘cram down’ appears in New England Coal & Coke Co. v. Rutland R. Co., 143 F.2d 179, 189 (2d Cir. 1944), in which the court simply quoted a law review article making use of such phrase. Courts appear to use ‘cramdown’, ‘cram down’ and ‘cram-down’ interchangeably. See Collier on Bankruptcy, 16th ed., P 1129.03.
content of a reorganization plan accordingly\textsuperscript{361}. Bankruptcy courts have therefore refused to confirm plans that did not comply with section 1123 (a) USBC\textsuperscript{362} or failed to apply the standards of classification as set out under section 1122 USBC\textsuperscript{363}.

That noted, section 1129 (a) (1) USBC nevertheless provides the grounds for denial of confirmation, if the proposed reorganization plan contradicts bankruptcy law provisions outside Chapter 11 USBC, for instance, by selectively overriding and attempting to nullify important provisions of bankruptcy law\textsuperscript{364}. To some extent courts have recognized the complexity involved in the confirmation of a reorganization plan and developed the notion of ‘harmless error’ to mean that a technical non-compliance with bankruptcy law provisions that do not significantly affect creditor rights, shall not prevent confirmation of a plan\textsuperscript{365}.

The previous chapter indicated the potential non-compliances of individual undisclosed CDS positions with sections 1122 (a) and 1123 (1) and (4) USBC. Due to the non-disclosure of received payments under the CDS agreement, individual creditors with CDS positions could be impermiss-


\textsuperscript{363} Bustop Shelters of Louisville, Inc. v. Classic Homes, Inc., 914 F.2d 810 (6th Cir. 1990); In re Holywell Corp., 913 F.2d 873, 24 C.B.C.2d 69 (11th Cir. 1990).


\textsuperscript{365} See Kane v. John-Manville Corp., 843 F. 2d 636, 648 (2d Cir. 1988) (‘Where Code violations are so insubstantial that they constitute harmless error, they do not warrant overturning an entire plan of reorganization under section 1129 (a) (1).’); See also Colorado Mountain Express v. Aspen Limousine Servs. (In re Aspen Limousine Servs., Inc.), 193 B.R. 325 (D. Colo. 1996).
bly classified within a class of substantially different claims, which would not only be inconsistent with section 1122 (a) USBC, but would furthermore infringe the equal treatment requirement embedded in section 1123 (a) (4) as well as the provision of section 1123 (a) (1) that a plan is required to designate classes of claims pursuant to section 1122 USBC. Following that line of reasoning, a reorganization plan providing impermissible classification of individual creditors with CDS positions could not be confirmed pursuant to section 1129 (a) USBC. Yet, in absence of any disclosure requirements applicable to individual creditors with a CDS position, the foregoing inconsistencies would most likely pass unnoticed and inevitably result into the confirmation of some reorganization plans, notwithstanding their non-compliance with section 1129 (a) USBC.

Section 1129 (a) (8) (A) USBC furthermore provides that each class of creditors must have accepted the proposed reorganization plan, unless such class is not impaired under the plan\textsuperscript{366}.

The previous chapter of the present part illustrated the possible effects of individual, undisclosed CDS positions on the determination of the impairment of a class of creditors. Due to the fact that the impairment status of individual creditors with an undisclosed CDS position cannot always be determined, a reorganization plan cannot always correctly identify impaired classes. Consequently, satisfaction of the acceptance requirement embedded in the foregoing section cannot always be assessed properly.

At an individual creditor level, section 1129 (a) (7) USBC establishes the so-called best interest test. The best interest test provides individual creditors of an impaired class with the safeguard that they will receive a property value\textsuperscript{367} of no less than they would receive in a liquidation proceeding. With that safety net in place, bankruptcy law assumes that anything above the value that could be achieved in a liquidation proceeding on each individual claim of an impaired class is subject to negotiation and should be allocated to a group vote to achieve the best possible outcome for all parties involved rather than to a vote subject to individual demand. Pursuant to the rule established by the best interest test, each impaired

\begin{footnotesize}
\textsuperscript{366} USBC § 1129 (a) (8) (B); See also §§ 1124, 1126 (f).
\textsuperscript{367} Section 1129 (a) (7), (8) and section 1129 (b) use the term ‘property in value’ to refer to a creditors receipt under the proposed plan. In this context ‘property’ can mean cash, notes, stocks, personal property, real property or pretty much anything of value. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 413 (1977), reprinted in App. Pt. 4(d) (i) infra.
\end{footnotesize}
class is considered to have accepted the plan if it has indeed accepted it or if its creditors receive under the proposed plan, property of no less value than the property they would have received in a liquidation proceeding. In that sense, the aforegoing provision establishes a fair and equitable balance between individual creditor rights and the best interest of the majority of creditors.

The best interest test cannot apply to creditors with an undisclosed CDS position, because in assessing whether the amount received by the reorganization plan reflects the amount such creditor would receive in a liquidation proceeding, the court cannot take into consideration the payment such creditors received under their CDS agreement. The court is thus in no position to properly determine whether such creditor’s overall recovery is less than its recovery under a liquidation proceeding. This can result into the non-confirmation of a reorganization plan despite its factual compliance with the best interest rule, even where said creditor is fully satisfied or has received an amount beyond the total value of its claim.

Ironically, section 1129 (b) allows for the confirmation of a reorganization plan over the non-acceptance of an impaired class, or classes, under certain conditions, to specifically avoid situations where a permissible plan cannot be confirmed solely due to the unreasonable opposition of an impaired creditor class. The Bankruptcy Code therefore provides the possibility of a cram down to avoid that successful reorganization be compromised due to individual creditor wishes.

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368 George M. Treister; Ronald J. Trost; Leon S. Forman; Kenneth N. Klee; Richard B. Levin, *Fundamentals of Bankruptcy Law* 6th ed. (American Law Institute-American Bar Association 2006), p. 495; See also generally Kenneth N. Klee, "All You Ever Wanted to Know about Cram Down Under the New Bankruptcy Code," *American Bankruptcy Law Journal* 53 (1979). Another reason for the cram down introduced by section 1129 (b) is of practical nature, given the fact that according to section 1126 (g) creditor classes not receiving any payment under a plan are considered to not have accepted such plan without the need of a formal voting. In lieu of section 1129 (a) (8) that requires acceptance of impaired classes for the consensual confirmation of a plan, a plan that eliminates a junior class could not be confirmed in absence of section 1129(b).

369 The Bankruptcy Code generally anticipates that not all reorganization plans will be confirmed by all creditors’ consensus. The first indication is embedded in the majority rule contained under section 1126 (c) USBC according to which an established class majority meeting the standards of such section can achieve acceptance of a plan over the dissenting class minority. In a similar context, section 1129 (b) foresees the possibility to cram down a plan on dissenting impaired
Section 1129 (b) permits non-consensual plan confirmation if the plan complies with all requirements of section 1129 (a) except paragraph (8), i.e. the acceptance requirement of all impaired classes, if non-consensual confirmation is expressly requested by the proponent of the plan and if the proponent of the plan demonstrates that the plan does not unfairly discriminate against dissenting classes and is ‘fair and equitable’ with regard to the non-accepting classes.

The requirement to not discriminate unfairly against dissenting creditor classes can be considered as a countervailing pole to the equal treatment requirement of individual creditors of the same class embedded in section 1123 (a) (4) USBC. While latter considers the rights of individual creditors within the same class, former establishes a form of equitable treatment requirement between separate creditor classes.

The proponent of such plan must furthermore demonstrate that the plan is ‘fair and equitable’ with respect to each impaired dissenting class\(^{370}\). Sections 1129 (b) (2) (A) and (B) USBC provide certain requirements that render a reorganization plan ‘fair and equitable’, whereas former apply to secured and latter to unsecured claims. The requirements listed under the foregoing sections are not exhaustive but rather indicative of a ‘fair and equitable’ reorganization plan; still a plan needs to be in conformity with said requirements to qualify for nonconsensual confirmation\(^{371}\).

Essentially, pursuant to the requirements established under section 1129 (b) (2) USBC, ‘fair and equitable’ can be interpreted to reflect two key factors: the absolute priority rule and the rule that no creditor be paid more than it is owed\(^{372}\).

The absolute priority rule establishes the precedence of creditors to the debtor’s assets under a reorganization plan\(^{373}\). If read in conjunction, subsections 1129 (b) (2) (A) and (B) establish the following priority rules:

- Secured creditors must have received the total value of their secured claims, before unsecured creditors can receive any payment under the creditor classes if adequate protection to the interests of such creditor classes is provided.

\(^{370}\) Section 1129 (b) (1) USBC.

\(^{371}\) 1129 (b) (2) USCB.

\(^{372}\) Collier on Bankruptcy, 16th ed., P 1129.03 [4] [a].

\(^{373}\) The absolute priority rule was firstly named and explained by Judge Douglas in *Case v. Los Angeles Lumber Co.* See *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106,115,117, 60S CT.1, 7, 8, 84 L.Ed.110,119,121 (1939).
plan. If unsecured creditors also receive the full value of their allowed claim then junior classes may receive payment. This will not always be possible given the debtor’s limited assets, so section 1129 (b) (2) (ii) provides the alternative. If unsecured impaired dissenting creditor classes are not paid the full amount of their allowed claim, a plan can be nevertheless non-consensually confirmed provided that under such plan no junior class receives any payment. In that sense, the absolute priority rule does not require that unsecured creditors are always paid in full under the cram down plan but rather establishes that in cases where the debtor’s assets are exhausted before unsecured creditors are paid in full under a plan, such plan does not violate the absolute priority rule as long as no junior class receives any payment; the absolute priority rule thereby ensures that the payment such unsecured class received is the maximum payment the estate permitted

The followed scheme determining the precedence of creditor claims in reorganization cases can thus be summarized as follows: Secured creditors must be paid the total value of their secured claim, then unsecured creditors must be paid in full, if the value of the estate permits full payment; if full payment of unsecured claim is not possible, all the residual assets of the estate, if there are any, are distributed among unsecured creditors. Only if unsecured creditors are paid the full amount of their allowed claim, can equity holders receive property on their equity claim.

The second component of the ‘fair and equitable’ requirement is the rule that no creditor receives more under a reorganization plan than the full value of its claim. Once a creditor has received or retained payment equal to the value of its claim, it may receive no more. It is worth noting at this point that this very rule essentially prohibiting any creditor to receive payment beyond the full value of its claim in reorganization cases, was expressly indicated in precedent versions of section 1129 (b) (2) USC-BC and subsequently deleted. The House Report noted upon section 1129

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374 This alternative applies only to unsecured creditors; secured creditor must be paid their secured claims in full before any junior class, including unsecured creditor classes can receive property under the plan.

B. The effects on the confirmation of a reorganization plan

(b) (2) USBC however clearly states that the reason for such omission by the House Amendment was ‘to avoid statutory complexity and because they would undoubtedly be found by a court to be fundamental to “fair and equitable treatment” of a dissenting class’\(^{376}\). The House Report further states that ‘a dissenting class should be assured that no senior class receives more than 100% of the amount of its claims’\(^{377}\) and concludes by stating that ‘while that requirement was explicitly included in the House bill, deletion is intended to be one of style and not one of substance’\(^{378}\).

It results from the foregoing that the second component of the ‘fair and equitable’ requirement resembles the principle embedded in the single satisfaction rule. The difference is that former applies to classes of creditors rather than individual creditor positions. Such difference can be attributed to the fact that in Chapter 11 cases, the assets of the estate are distributed among creditor classes rather than individual creditors\(^{379}\). The equal treatment of individual creditors within the same class is furthermore safeguarded by the equal treatment requirement embedded in section 1123 (a) (4) USBC. In that sense, if a creditor of a class received full payment while the other creditors of the same class did not, the associated cram down plan would be impermissible because it would not comply with section 1129 (a) USBC, which requires a plan to comply with all Chapter 11 provisions to qualify for confirmation\(^{380}\).

Nevertheless, the rule that no creditor class receives more than the full value of its claims bears analogy to individual creditors not being allowed to receive more than the total value of their claim. Creditors who have re-
Chapter 10: The Effects on the Plan Voting and Confirmation Procedure of Ch.11

eceived full payment of their claim under a CDS agreement therefore infringe the principle of the aforegoing rule in reorganizations.

C. Disclosure requirements under Bankruptcy Rule 2019

The Federal Rule of Bankruptcy Procedure 2019 (Rule 2019) is part of the disclosure scheme of the Bankruptcy Code. It applies only to Chapter 9 and Chapter 11 of the Bankruptcy Code, because the participation of creditors in such cases is more significant. Furthermore, since the DIP subrogates the trustee in its powers and duties, there is no trustee to act in the creditors’ interests. The need for policing creditor groups and their representatives is therefore greater than in other relief chapters of the Bankruptcy Code.

Rule 2019 provides that every group or committee or entity representing multiple creditors must file disclosures of ‘disclosable economic interests’ that are relevant to the bankruptcy case in which they are appearing. In 2011, Rule 2009 was substantially amended to expand the scope of its coverage and the content of its disclosure requirements.

The 2011 amendments added a new subsection to Rule 2019, which defines ‘disclosable economic interest’ as follows: “‘Disclosable economic interest’ is a broad term meant to encompass almost any interest that can be held. It means any claim, interest, pledge, lien, option, participation, derivative instrument or any other right or derivative right that gives the holder an economic interest in a debtor that is affected by the value, acquisition or disposition of the claim or interest. It extends to puts, calls, swaps, straddles and other sophisticated investments in a debtor.”

The 2011 Advisory Committee Note to Rule 2019 indicates that the foregoing definition is intended ‘to be sufficiently broad to cover any economic interest that could affect the legal and strategic positions a stakeholder takes in a Chapter 9 or Chapter 11 case. A disclosable economic interest extends beyond claims and interests owned by a stakeholder and includes, among other types of holdings, short positions, credit default swaps, and total return swaps.’

381 Bankruptcy Rule 2009 (a) (1).
Albeit definitely a step towards the right direction, Rule 2019 applies only to creditor groups, committees or entities representing multiple creditors. Pursuant to section 1102 USBC the United States Trustee appoints a committee of creditors holding unsecured claims that consist of those creditors who are willing to serve and hold the seven largest claims against the debtor\textsuperscript{383}. The disclosure requirements imposed on CDS positions pursuant to Rule 2019 therefore only apply to creditors that are members of creditor committees.

Since creditors cannot be forced to participate in a committee, the foregoing disclosure requirements will only be applicable to those creditors who are willing to disclose payments received under CDS agreements.

The present part has however demonstrated that imposing a disclosure obligation on individual creditors with a CDS position is imperative. For the legal inconsistencies that can be caused by the non-disclosure of individual CDS positions, would compromise virtually all key provisions of chapter 11 USBC that are vital to the acceptance and confirmation of fair and equitable reorganization plans, which is the ultimate objective of any reorganization case.

\textsuperscript{383} See USBC § 1122 (a) (1) and (b) (1) respectively.
Subfindings

The present part reviewed the possible effects of undisclosed CDS positions on reorganization proceedings from a legal point of view, i.e. their impact on the applicability and their consistency with the rules of law embedded in the essential provisions of Chapter 11 USBC. More specifically, the present part examined the legal results accruing from the circumstance that third party payments conducted to individual CDS creditors by means of the underlying CDS agreement, can currently not be considered during the process of a Chapter 11 proceeding.

Generally, the following can be noted with regard to the (non) consideration of third party payments in reorganizations:

1. Third party sources of recovery affect the determination of the similarity of claims within the context of section 1122 (a) USBC, for they afford their beneficiary claim holder the possibility of receiving full payment on its claim before claim holders lacking a third party source of recovery receive any payment at all; such possibility suffices to put former creditors in a substantially different position to latter. Thus, safeguarding compliance with sections 1122 (a) USBC and 1123 (a) (4) USBC, exacts the consideration of available third party sources of recovery.

2. Third party sources of recovery are further relevant for the determination of a creditor’s state of impairment and relevant voting rights pursuant to section 1126 USBC. They must also be considered within the context of the absolute priority rule and the rule that no creditor is allowed to receive payment beyond the total value of its claim (1129 (b) (2) USBC) as well as with regard to the best interest test (1129 (a) (7) USBC).

When applied to empty or net short CDS positions the foregoing findings return the following results:

1. Pursuant to the provisions embedded in sections 1122 and 1123 USBC as well as established case law, already fully or over-proportionately satisfied creditors cannot be classified within a class of creditors who have not received any payment on their claims. Placing former creditors within the same class with latter creditors, would inevitably result into an inconsistency with the foregoing provisions.

2. Pursuant to section 1126 USBC as well as established case law, already fully or over-proportionately satisfied creditors may not be con-
ferred any voting rights. Furthermore, granting any distribution rights to such creditors would compromise the provision of section 1129 (b) (2) that establishes the limitation of any recovery amount to the total value of each creditor’s claim.

Any inconsistency with the aforegoing provisions precludes the lawful confirmation of a reorganization plan pursuant to section 1129 (a) USBC. It is therefore essential to disclose any empty or net short creditor position resulting from the settlement of CDS agreements.

Matters are less clear with regard to partially satisfied CDS positions. In fact, it is neither feasible nor correct to attempt an a priori universal determination regarding the inconsistency of such CDS positions with sections 1122, 1123, 1126 and 1129 USBC; this is to be attributed to the fact that - notwithstanding the adversity of CDS positions - such inconsistency also strongly depends on the treatment conferred upon the residual creditors of the case. What is rather of importance is to ensure that appropriate assessment can take place on a case by case basis. In the author’s view, the present part evidenced that partially satisfied CDS positions need to be reviewed as to their consistency with aforegoing provisions for the following reasons:

1. Even though partially satisfied creditors have not recovered the total value of their claim, they still covered a part thereof. Placing them within a class of creditors who lack third party sources of recovery, could easily result into a situation where former creditors reach the total value of their claim whereas latter creditors do not. Notwithstanding the question whether aforegoing creditors could permissibly be placed within the same class, previous situation would compromise compliance with section 1123 (a) (4) USBC that requires all claims of the same class to be treated equally.

2. Disregarded partial payments conducted to creditors with a CDS position can further compromise the absolute priority rule (section 1129 (b) (2) USBC) and the best interest test (section 1129 (a) (7) USBC), for neither can be assessed properly if such payments are not taken into account. Furthermore, an already partially satisfied CDS creditor may – depending on the amount granted by the reorganization plan- exceed the total value of its claim infringing the rule embedded in section 1129 (b) (2) USBC that no creditor is allowed payment that would return a higher revenue than the total value of its bankruptcy claim.

Since section 1129 (a) requires compliance with aforegoing provisions for the confirmation of a reorganization plan and since such compliance
cannot always be guaranteed with regard to partially satisfied CDS positions, the author is of the view that latter CDS positions should also be subjected to disclosure requirements. For only if partial payments are declared, can they be considered; and only if they are considered, can compliance with sections 1122, 1123, 1126 and 1129 USBC be warranted.

Conclusive Notes

The present part explained in detail the effects that can be caused by individual creditors with undisclosed CDS positions on the principal provisions of Chapter 11 USBC and concluded that the non-disclosure of the foregoing positions could compromise the core provisions of Chapter 11 USBC that were drafted to ensure the confirmation of a fair and equitable reorganization plan for all parties involved or, at least, for the vast majority thereof.

The most sincere consequence accruing from undisclosed CDS positions is that they allow creditors who have already recovered the full amount or even an amount exceeding the total value of their bankruptcy claim through received payment under their CDS agreement, to nevertheless be conferred distribution and payment rights in a reorganization proceeding. Due to the absence of any disclosure requirement applicable to individual CDS positions, creditors holding such positions will be treated as if they had not recovered any payment on account of their bankruptcy claim.

By lacking essential information regarding third party payments conducted to partially satisfied creditors, the DIP as well as bankruptcy courts will furthermore not always be able to ensure compliance with some of the key provisions of Chapter 11 USBC. The view represented herein therefore suggests that the disclosure obligation embedded in Bankruptcy Rule 2019 should be extended to individual CDS creditor positions.
Conclusion

The present thesis examined the consistency of individual CDS creditor positions with the *pari passu* principle and the principal provisions of Chapter 11 USBC. The study object within this context encompassed CDS positions accruing from cash settled CDS agreements, where the CDS buyer retains ownership of the reference obligation. As demonstrated under part two, the cash settlement payment of a CDS agreement can create partially satisfied, empty and net short creditor positions in bankruptcy proceedings. The distinctive characteristic of such creditor positions is that the creditor has received payment on account of its bankruptcy claim that covers its value in part or fully under a CDS agreement. In certain cases such payment can even exceed the total value of the creditor’s bankruptcy claim.

Part three of the present thesis elaborated the reasons supporting the view that - within the context of bankruptcy proceedings - the foregoing creditors are in a substantially similar position to those creditors who have received payment on account of their bankruptcy claim from a non-debtor co-obligor or a third non-debtor party.

Whereas the Bankruptcy Code imposes limitations on latter creditor positions with regard to their distribution rights taking into consideration received payments, creditors with a CDS position are left with unlimited distribution rights mainly due to the reason that any received payment under their CDS agreement remains undisclosed.

This results into empty and net short creditors being able to recover more than the total value of their claims. The same applies to those partially satisfied creditors, who receive an amount of recovery that, when considered in accumulation to the amount of payment received under the CDS agreement, exceeds the total value of their bankruptcy claim.

Granting distribution rights to certain creditors beyond the total value of their bankruptcy claim, however, is firstly inconsistent with the *pari passu* principle, for pursuant to the previously indicated rules, other creditors who received third-party payment are strictly limited to the total value of their claim; and secondly also infringes the single satisfaction rule that dictates that under no circumstances are creditors to be afforded any distribution rights beyond the total value of their claim.
To safeguard compliance with the *pari passu* principle and the single satisfaction rule, empty or net short creditors must be deprived of any distribution right against the debtor’s estate, whereas partially satisfied creditors must be afforded distribution rights that, when considered in conjunction with received CDS payments, are limited to the total value of their claim. For previous rules to apply, CDS creditors must disclose the amount of payment received under their CDS agreement.

Part four of the present thesis examined the legal results accruing from the circumstance that third party payments conducted to individual CDS creditors by means of a CDS agreement, can currently not be considered during the process of a Chapter 11 proceeding.

The analysis conducted under part four, returned the following findings with regard to empty and net short creditor positions in reorganizations:

1. Pursuant to the provisions embedded in sections 1122 and 1123 USBC as well as established case law, already fully or over-proportionately satisfied creditors cannot be classified within a class of creditors who have not received any payment on their claims. Placing former creditors within the same class with latter creditors, would inevitably result into an inconsistency with the foregoing provisions.

2. Pursuant to section 1126 USBC as well as established case law, already fully or over-proportionately satisfied creditors may not be conferred any voting rights. Furthermore, granting any distribution rights to such creditors would compromise the provision of section 1129 (b) (2) that establishes the limitation of any recovery amount to the total value of each creditor’s claim.

Since any inconsistency with the foregoing provisions would preclude the lawful confirmation of a reorganization plan pursuant to section 1129 (a) USBC, it is essential to disclose any empty or net short creditor position resulting from the settlement of CDS agreements.

Even though an inconsistency with sections 1122, 1123, 1126 and 1129 USBC cannot be as clearly determined with regard to partially satisfied creditors, it cannot be excluded either. Partially satisfied creditors might not have recovered the total value of their claim, but they still covered a part thereof. Placing them within a class of creditors who lack third party sources of recovery, could easily result into a situation where former creditors reach the total value of their claim whereas latter creditors do not. Notwithstanding the question whether foregoing creditors could permissibly be placed within the same class, previous situation would compro-
mise compliance with section 1123 (a) (4) USBC that requires all claims of the same class to be treated equally.

Furthermore, disregarded partial payments conducted to creditors with a CDS position can compromise the absolute priority rule (section 1129 (b) (2) USBC) and the best interest test (section 1129 (a) (7) USBC), for neither can be assessed properly if partial payments are not taken into account.

It is further important to keep in mind, that an already partially satisfied CDS creditor may – depending on the amount granted by the reorganization plan- exceed the total value of its claim infringing the rule embedded in section 1129 (b) (2) USBC that no creditor is allowed payment that would return a higher revenue than the total value of its bankruptcy claim.

It is therefore essential to ensure that appropriate assessment can take place on a case by case basis. Since section 1129 (a) requires compliance with aforegoing provisions for the confirmation of a reorganization plan and since such compliance cannot always be guaranteed with regard to partially satisfied CDS positions, the author is of the view that latter CDS positions should also be subjected to disclosure requirements. For only if partial payments are declared, can compliance with sections 1122, 1123, 1126 and 1129 USBC be warranted.

The author is of the view that due to the aforegoing reasons, the scope of Bankruptcy Rule 2019 should be extended to liquidation proceedings as well as individual creditor positions. Disclosing a CDS position does not necessarily mean to restrict such position. The analysis of the present study demonstrated that distribution rights conferred upon certain partially satisfied creditors might be found to be in consistency with the pari passu principle and the single satisfaction rule. The findings elaborated herein rather suggest that the disclosure of CDS positions is important when it comes to safeguarding compliance with the pari passu principle and the single satisfaction rule.

Credit default swaps currently amount to a multi-trillion-dollar component of capital markets. It can therefore reasonably be assumed that their presence in bankruptcy proceedings will increase. Notwithstanding the adverse effects caused in reorganizations by the presence of CDS short position from an economic point of view, the potential legal inconsistencies that can occur must not be disregarded. To exclude the possibility of legal inconsistencies caused by undisclosed CDS positions, the disclosure obligation of Bankruptcy Rule 2019 has to be extended to cover liquidation proceedings as well as to apply to individual CDS creditors. For only then,
can bankruptcy law serve its primary objective which, after all, is the fair and equitable distribution of the debtor’s assets.
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