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COMMENT

EMPTY CREDITOR SYNDROME AND VIVISEPULTURE: PREVENTING CREDIT-DEFAULT-SWAP HOLDERS FROM PUSHING COMPANIES INTO PREMATURE GRAVES BY REFUSING TO NEGOTIATE RESTRUCTURINGS

INTRODUCTION

Our financial industry faced nearly unparalleled distress in 2008.¹ Numerous banking and insurance institutions whose names were synonymous with the triumph of American capitalism—e.g., Lehman Brothers² and AIG³—either filed for bankruptcy or were bailed out by

¹ See Magnifico, *USA Was 3 hrs Away from Economic, Political Collapse in September 2008*, DAILY KOS (Feb. 9, 2009, 8:58 PM), <http://www.dailykos.com/story/2009/02/09/695504/-USA-was-3-hrs-away-from-Economic,-Political-Collapse-in-September-2008?detail=hide> (“According to Rep. Paul Kanjorski (D) (PA–11), in mid-September of 2008, the United States of America came just three hours away from the collapse of the entire economy. In a span of 2 hours, \$550 billion was drawn out of money market accounts in an electronic run on the banks.”).

² See CNBC with Wires, *Lehman Brothers Files For Bankruptcy, Scrambles to Sell Key Business*, CNBC (Sept. 15, 2008), http://www.cnbc.com/id/26708143/Lehman_Brothers_Files_For_Bankruptcy_Scrambles_to_Sell_Key_Business (discussing the Lehman Brothers bankruptcy).

³ Matthew Karnitschnig, Deborah Solomon, Liam Plevin, & Jon E. Hilsenrath, *U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. JOURNAL at A1 (Sept. 16, 2008), <http://online.wsj.com/article/SB122156561931242905.html> (discussing the federal government’s bailout of AIG).

the federal government to prevent their failure. Meanwhile, competitors bought out other stalwarts facing potential bankruptcies.⁴

In 2012, the distress has not entirely subsided, and the financial industry continues to recover.⁵ More troubling, however, is the effect the financial industry's collapse has had on the broader economy.⁶ Between January 2008 and February 2010, the United States lost 8.8 million jobs.⁷ Simultaneously, the unemployment rate ballooned from roughly five percent to nearly ten percent.⁸ Unsurprisingly, business bankruptcies increased throughout the country over a similar timeframe.⁹

⁴ JP Morgan Chase bought Bear Stearns, see Andrew Ross Sorkin, *JP Morgan Pays \$2 a Share for Bear Stearns*, N.Y. TIMES, Mar. 17, 2008, at A1, available at <http://www.nytimes.com/2008/03/17/business/17bear.html>, and Washington Mutual, see Robin Sidel, David Enrich, & Dan Fitzpatrick, *WaMu Is Seized, Sold off to J.P. Morgan, in Largest Failure in U.S. Banking History*, WALL ST. J., Sept. 26, 2008, at A1, available at <http://online.wsj.com/article/SB122238415586576687.html>, while Bank of America bought Meryl Lynch. See Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill Sold*, N.Y. TIMES, Sept. 14, 2008, at A1, available at <http://www.nytimes.com/2008/09/15/business/15lehman.html> (discussing the sale of Merrill Lynch and the pending bankruptcy of Lehman Brothers).

⁵ See, e.g., *Goldman Sachs Group, Inc. (The) (GS)*, YAHOO! FINANCE (Feb. 13, 2012, 7:59 PM), <http://finance.yahoo.com/echarts?s=GS+Interactive#chart1:symbol=gs;range=5y;indicator=volume;charttype=line;crosshair=on;ohlvalues=0;logscale=on;source=undefined> (Goldman Sachs' stock traded at more than \$230.00 per share in October 2008, while in February 2012 it has traded around \$120.00 per share); *Bank of America Corporation Com (BAC)*, YAHOO! FINANCE (Feb. 13, 2012, 7:59 PM), <http://finance.yahoo.com/echarts?s=BAC+Interactive#chart1:symbol=bac;range=5y;indicator=volume;charttype=line;crosshair=on;ohlvalues=0;logscale=on;source=undefined> (Bank of America Corporation's stock went from more than \$50.00 per share to under \$10.00 over the same time period); *Citigroup, Inc. Common Stock (C)*, YAHOO! FINANCE (Feb. 13, 2012, 7:59 PM), <http://finance.yahoo.com/echarts?s=C+Interactive#symbol=C;range=5y> (Citigroup's stock went from roughly \$140.00 per share to about \$35.00 per share over the same time period).

⁶ See Howard Wial, Siddharth Kulkarni, & Richard Shearer, *MetroMonitor: Tracking Economic Recession and Recovery in America's 100 Largest Metropolitan Areas*, METROPOLITAN POLICY PROGRAM AT THE BROOKINGS INSTITUTION, available at http://www.brookings.edu/~media/Files/Programs/Metro/metro_monitor/2011_12_metro_monitor/1215_metro_monitor.pdf (discussing the general economic impact).

⁷ Annalyn Cenky, *Will Obama Break Even on Jobs?*, CNN MONEY (Jan. 11, 2012, 8:44 AM), http://money.cnn.com/2012/01/11/news/economy/obama_jobs_record/index.htm.

⁸ *Unemployment Rate – Not Seasonally Adjusted*, GOOGLE: PUBLIC DATA (Feb. 10, 2012),

http://www.google.com/publicdata/explore?ds=z1ebjpgk2654c1_&met_y=unemployment_rate&idm=country:US&fdim_y=seasonality:S&dl=en&hl=en&q=unemployment+statistics#!ctype=&l&strail=false&bcs=d&nselm=h&met_y=unemployment_rate&fdim_y=seasonality:U&scale_y=lin&ind_y=false&rdim=country&idm=country:US&ifdim=country&tstart=1200200400000&tend=1268456400000&hl=en&dl=en.

⁹ In 2007, there were 28,332 business bankruptcy filings, while in 2008–2010, there were 43,546; 60,837; and 56,282 respectively. *Annual Business and Non-business Filings by Year (1980–2011)*, AMERICAN BANKRUPTCY INSTITUTE (last visited Feb. 13, 2012, 10:38 PM), <http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&CONTENTID=63164&TEMPLATE=/CM/ContentDisplay.cfm>.

Many pundits have argued that a “housing bubble” caused this collapse.¹⁰ Academic research offers the same conclusion but with additional insight into why and how the decline of property values could lead to catastrophic results for the broader economy.¹¹ One of the more nuanced observations points to the role of complex financial instruments in exacerbating the economic decline.¹² This observation led government officials to enact regulations that could prevent this economic chaos from reoccurring.¹³ The result was the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”).¹⁴ Dodd-Frank’s drafters focused, in part, on the regulation of sophisticated financial instruments because of their direct relationship to the turmoil.¹⁵ One such financial instrument was the credit default swap.¹⁶

A credit default swap is a contract under which the seller agrees to pay the purchaser if a negative event befalls a debt instrument; in return, the purchaser agrees to pay the seller a percentage of the payout either up front or over time.¹⁷ Credit default swaps played an integral role in the system-wide collapse of the financial markets,¹⁸ as

¹⁰ See, e.g., Alan Greenspan, *The Fed Didn’t Cause the Housing Bubble*, WALL ST. J., Mar. 11, 2009, at A15, available at, <http://online.wsj.com/article/SB123672965066989281.html> (discussing the housing bubble and its potential origins); Steven Gjerstad and Vernon L. Smith, *From Bubble to Depression?*, WALL ST. J., Apr. 6, 2009, at A15, available at <http://online.wsj.com/article/SB123897612802791281.html> (discussing historical bubbles, including the housing bubble). *But see* Casey B. Mulligan, *Was it Really a Bubble?*, ECONOMIX (May 5, 2010, 2:53 PM), <http://economix.blogs.nytimes.com/2010/05/05/what-it-really-a-bubble/> (questioning whether a bubble actually existed and arguing the housing bubble was a response to market fundamentals).

¹¹ See, e.g., Robert Hatch, *Reforming the Murky Depths of Wall Street: Putting the Spotlight on Security and Exchange Commission’s Regulatory Proposal Concerning Dark Pools of Liquidity*, 78 GEO. WASH. L. REV. 1032, 1040 (2010) (discussing the development and impact of dark liquidity trading); Thomas J. Schoenbaum, *Saving the Global Financial System: International Financial Reforms and United States Financial Reform, Will They Do The Job?*, 43 NO. 1 UCC L. J. ART. 3, 4 (2010) (discussing the causes of the financial crises).

¹² See, e.g., MICHAEL M. LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE* 62 (2011) (discussing, generally, the role of derivatives in the financial turmoil).

¹³ The Dodd-Frank Wall Street Reform and Consumer Protection Act, which Congress passed in 2009, claims “[t]o provide for financial regulatory reform, to protect consumers and investors . . .” H.R. 4173, 111th Con. (1st Sess. 2010).

¹⁴ *Id.*

¹⁵ See *id.* (Dodd-Frank also aims “to regulate the over-the-counter derivatives market”).

¹⁶ *Id.*

¹⁷ For an in-depth discussion of credit default swaps, see *infra* Part I.A.

¹⁸ See Yves Smith, *So Why Hasn’t the Credit Default Swap Casino Been Shut Down*, NAKED CAPITALISM (Mar. 1, 2010), <http://www.nakedcapitalism.com/2010/03/so-why-hasnt-the-credit-default-swaps-casino-been-shut-down.html> (“Credit default swaps played a much more central role in the financial crisis than is widely understood.”); Jessie Westbrook & David Scheer, *Credit Swaps Must Be Regulated Now, SEC’s Cox Says (Update4)*, BLOOMBERG (Sept. 23, 2008, 5:03 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ajXNMd45_cio (“U.S. Securities and Exchange Commission Chairman Christopher Cox said Congress should ‘immediately’

they tied the fate of large amounts of capital to shaky debt instruments and intertwined the risks of massive financial institutions.¹⁹

Although Dodd-Frank's regulation of credit default swaps may succeed in stemming some of the systemic risk that these derivative financial instruments create, the statute does not prevent credit-default-swap holders from forcing companies into bankruptcies that otherwise would not occur. Specifically, under current law, parties who invest in a company's debt and who have also purchased a credit default swap on that investment have incentive to resist that company's attempts to restructure its debt in order to avoid bankruptcy, even when a restructuring would be beneficial to other creditors and the economy at large. In an effort to rectify this inefficient outcome, this Comment proposes a rule that Congress should adopt to improve the efficacy of its credit-default-swap regulation.

First, this Comment outlines the basics of the credit default swap, discusses the relationship between the credit-default-swap market and the financial crisis of 2008, and describes the way Dodd-Frank addresses the systemic problems that credit default swaps cause. Next, it explains that Congress's pre- and post-Dodd-Frank regulation of credit default swaps has already led to bankruptcies that otherwise would not have occurred and will continue to do so. Finally, it proposes a rule that solves this problem: Congress should allow the seller of a credit default swap to refuse to make a payout to a purchaser that does not negotiate a restructuring with the debt issuer underlying the swap.

I. CREDIT DEFAULT SWAPS: THE BASICS

A. *What Is a Credit Default Swap?*

Conceived in the aftermath of Drexel Burnham Lambert's²⁰ creation of collateralized debt obligations²¹ in the late 1980s,²² a

grant authority to regulate credit-default swaps amid concern the bets are fueling the global financial crisis.”).

Also, consider the role that credit default swaps may have or are having in economies throughout the world. See, e.g., Abigail Moses, *Credit Default Swaps on Greek, Portuguese Government Bonds Jump to Records*, BLOOMBERG (Apr. 26, 2011, 4:50 AM), <http://www.bloomberg.com/news/2011-04-26/credit-default-swaps-on-greek-portuguese-government-bonds-jump-to-records.html>.

¹⁹ See *infra* Part I.C.

²⁰ Ironically, this investment firm filed for bankruptcy in 1990. Kurt Eichenwald, *THE*

credit default swap is a “promise[] to make a specified payment in the event a particular debt instrument experiences an event of default, such as a payment default or if the issuer files for bankruptcy protection.”²³ In other words, credit default swaps are “derivative instruments that seek to mitigate the risk of failure of a security through purchase of insurance against the occurrence of such event.”²⁴ For example, suppose Sara purchases Company X’s bonds but is worried that X may be unable to repay her according to the terms of her investment. She could turn to a third party who, for a price, will guarantee her a return by agreeing to pay her if X fails to do so.²⁵ The contract between Sara and the third party is a credit default swap.

To purchase a credit default swap, the buyer makes “a single upfront payment, or possibly a series of payments, in exchange for the counterparty’s obligation to make . . . [a] payment that is contingent upon the occurrence of any one of a specified set of possible credit events.”²⁶ In this way, the instruments are similar to insurance systems we have in society.²⁷ Consider Ben’s purchase of car insurance against the possibility of damage or theft. Ben pays the insurance company a monthly payment, and the insurance company assumes the risk of catastrophic damage to the car by promising to pay Ben if such a catastrophic event occurs. When the buyer of a

COLLAPSE OF DREXEL BURNHAM LAMBERT; Drexel, Symbol of Wall St. Era, is Dismantling; Bankruptcy Filed, N.Y. TIMES: ARCHIVES, Feb. 14, 1990, at A1, available at <http://www.nytimes.com/1990/02/14/business/collapse-drexel-burnham-lambert-drexel-symbol-wall-st-era-dismantling-bankruptcy.html?pagewanted=all&src=pm>.

²³ “Collateralized debt obligations, or CDOs, are created by banks that pool together otherwise unrelated debt-instruments, like bonds, and then sell shares of that pool to investors.” *Collateralized Debt Obligations*, N.Y. TIMES: TIMES TOPICS (Oct. 19, 2011), <http://topics.nytimes.com/topics/reference/timestopics/subjects/c/collateralized-debt-obligations/index.html>.

²⁴ P.M. Vasudev, *Default Swaps and Director Oversight: Lessons from AIG*, 35 J. CORP. L. 757, 760 (2010).

²⁵ John D. Finnerty & Kishlaya Pathak, *A Review of Recent Derivatives Litigation*, 16 FORDHAM J. CORP. & FIN. L. 73, 88 (2011). The event triggering the payment from the third party to the individual does not necessarily have to be default. Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity*, 48 HARV. J. ON LEGIS. 49, 52 (2011) (Credit Default Swaps “may also protect against debt restructuring or credit rating downgrade”).

²⁶ William T. Coleman, Jr., *A Brief History of Banking and Investment Regulation in the US and a Challenge to Remain the Greatest Nation in the World*, 99 KY. L.J. 1, 4 (2010).

²⁷ For a variation of this simple example, see Kress *supra* note 23 at 52; see also Alex Blumberg, *Unregulated Credit Default Swaps Led to Weakness*, NPR (Oct. 31, 2008), <http://www.npr.org/templates/story/story.php?storyId=96395271&ft=1&f=94427042> (explaining the basic principles of a default credit swap).

²⁸ Finnerty & Pathak, *supra*, note 23 at 88.

²⁹ See Coleman, Jr., *supra* note 24, at 4 (claiming that “[e]ssentially, a credit default swap is a life insurance policy on a security”).

credit default swap also owns the investment on which the instrument is based, the swap operates as insurance.

Not all credit default swaps, however, serve the traditional insurance function.²⁸ Instead, investors who do not own a debt instrument²⁹—e.g., bonds, or notes—but believe that the institution issuing the debt will face some type of crisis in the future buy credit default swaps from third parties for “protection” against that crisis.³⁰ Imagine Tim taking out “insurance” on Ben’s car—without having any ownership stake in the vehicle—because he believes someone will soon steal it.³¹ Effectively, investors pay third parties monthly premiums or up-front payments with the hope that a credit event befalls the debt instrument, leaving the investor with a large payout from his credit default swap. When investors use swaps in this manner, it is easy to view them as speculators³² or gamblers.³³

B. The Benefits of Credit Default Swaps

From a macroeconomic viewpoint, the credit-default-swap market provides two main benefits to the broader economy. First, credit

²⁸ See Michael Lewis & David Einhorn, *How to Repair a Broken Financial World*, N.Y. TIMES, Jan. 3, 2009, at WK9, available at http://www.nytimes.com/2009/01/04/opinion/04lewiseinhornb.html?_r=1&pagewanted=all (explaining that we can “[c]all [credit default swaps] insurance if you like, but it’s not the insurance most people know”).

²⁹ See Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 679 (2010) (“There is no requirement that one actually own the underlying credit instrument in order to purchase a credit default swap.”).

³⁰ See Kress, *supra* note 23, at 53 (“[T]he majority of the [credit-default-swap] market is now comprised of so-called ‘naked’ [credit default swaps] that enable protection buyers to bet against the credit quality of assets they do not own.”).

³¹ For a similar explanation, see Blumberg, *supra* note 25 (“Let’s say there’s a guy named Frank and he has a life insurance policy. When he dies, the beneficiary gets a million dollars. Now imagine a whole bunch of other people saying, ‘I want a million dollars if he dies, too.’ And so they take out life insurance policies on Frank.”); Lewis & Einhorn, *supra* note 28 (“It’s more like buying fire insurance on your neighbor’s house.”).

³² Vasudev, *supra* note 22, at 764 (“Thus, multiple swaps for CDOs complete the transition of default swaps from their conception as hedges against risk into instruments of pure financial speculation.”); Nathaniel G. Dutt, *Current United States Credit Default Swap Regulatory Initiatives: A New World Standard or Just a Ploy?*, 16 ILSA J. INT’L & COMP. L. 169, 209–210 (2009) (discussing the speculative nature of the credit-default-swap market); Kress, *supra* note 23, at 52 (“Market participants use [credit default swaps] in a variety of ways, including hedging and speculation.”).

Although an investor may still be hedging against other bets he has in the market, his use of the credit default swap without any equity in the underlying asset is, effectively, “the buying . . . of something with the expectation of profiting from price fluctuations,” in this case the value of the asset decreasing to a level that causes the credit default swap to trigger. BLACK’S LAW DICTIONARY 1435 (8th ed. 2004).

³³ Andrew M. Kulpa, *Minimal Deterrence: The Market Impact, Legal Fallout, and Impending Regulation of Credit Default Swaps*, 5 J.L. ECON. & POL’Y 293, 298 (2009) (“[Credit-default-swap] agreements also resemble gambling or gaming contracts. However, gaming contracts, much like insurance contracts, face strict governmental oversight.”).

default swaps allow investors and creditors to hedge against risk by permitting them to “offset[] their exposure to the risk of loss that is inherent in lending arrangements such as credit facilities or the acquisition of debt securities.”³⁴ More specifically:

Credit default swaps separate the risk of loss that a creditor faces upon entering into a debt investment and redistributes the risk among the creditor and its credit default swap counterparties. As a result of the redistribution, risk is not concentrated in the same manner that risk is concentrated between a single borrower and a single lender engaged in a traditional credit arrangement.³⁵

In addition to benefiting investors and creditors, this risk-shifting helps the broader financial market because, “[i]f derivative contracts allow an agent such as a producer to hedge the risk of cash market price fluctuations[,] this may reduce the risk premium that the produce[r] will apply in making investment decisions.”³⁶ Such a reduction decreases producers’ cost of production and, therefore, may lead to lower prices for consumers.³⁷

Second, the credit-default-swap market assists the broader economy by acting as a pricing mechanism “by giving an incentive to agents to become better forecasters of market conditions in the future.”³⁸ The market helps “allocat[e] resources to the most valuable uses”³⁹ because, “if in the future there will be an increase in demand that will lead to a price increase, then [market participants] who buy derivatives contracts . . . will bid up their prices in anticipation of that demand increase.”⁴⁰ Thus, producers of financial instruments are better able to understand what to produce, for whom, and at what price.⁴¹

³⁴ Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167, 199 (2011).

³⁵ *Id.* at 200 (citation omitted).

³⁶ Ronald W. Anderson, *Credit Default Swaps: What Are the Social Benefits and Costs?*, BANQUE DE FRANCE FINANCIAL STABILITY REVIEW, No. 14, July 2010 at 1, 2, available at http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financier/e/etude01_rsf_1007.pdf.

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*; cf. Floyd Norris, *The Naked Truth on Credit-Default Swaps*, N.Y. TIMES, May 21, 2010, at B1 (“To most on Wall Street, the answer is obvious: let markets function. My buying that insurance will probably drive up the price, and serve as a market indication that people are worried about the credit, which is good because it gives a warning to others.”).

⁴¹ See Anderson, *supra* note 36, at 2.

C. The Role of Credit Default Swaps in the Great Recession

Although credit default swaps may appear to be a rather harmless way for investors to make money, one of the United States' most famous investors, Warren Buffet, once described them as "financial weapons of mass destruction."⁴² At the heart of this ominous description is Buffet's understanding that credit default swaps produce systemic risk.⁴³ That systemic risk becomes apparent when one understands that numerous investors can purchase credit default swaps on the same type of investment or even the same investment itself.⁴⁴ For instance, consider the following hypothetical.

First, imagine that Investor L, who owns Company X's bonds, purchases a credit default swap from Insurance Firm Z to hedge against the risk that X will fail to make payment on those bonds. Under this deal, Z agrees to pay L \$1,000,000 if X fails to meet its obligations so long as L makes monthly payments to Z of \$1,000. Second, Insurance Firm Z, confident that X will not fail to make payments, strikes the same deal with Investors M and N. Third, Investor L, noticing that other investors believe that X may go bankrupt, originates her own credit default swap with a \$1,000,000 payout if X fails and sells it to Mutual Fund A. In return, A promises to pay L \$2,000 per month. Not to be outsmarted, Investors M and N also originate and sell credit default swaps to Mutual Funds B and C, respectively, for \$2,000 per month.⁴⁵

At this point, Mutual Funds A, B, and C hold credit default swaps protecting against X's bankruptcy that they purchased from Investors L, M, and N. L, M, and N also hold credit default swaps protecting against X's bankruptcy that they purchased from Insurance Firm Z. L, M, and N think that they have made out well: (1) they each are making \$2,000 per month from Mutual Fund A, B, or C, while only paying \$1,000 per month to Insurance Firm Z; and (2), even if Company X files for bankruptcy, they can each pay \$1,000,000 to

⁴² James B. Kelleher, *Buffet's "Time Bomb" Goes off on Wall Street*, REUTERS (Sep. 18, 2008, 1:42 PM), <http://www.reuters.com/article/2008/09/18/us-derivatives-credit-idUSN1837154020080918>.

⁴³ *Id.* ("When historians write about the current crisis, much of the blame will go to the slump in the housing and mortgage markets, which triggered the losses, layoffs[,] and liquidations sweeping the financial industry. But credit default swaps—complex derivatives originally designed to protect banks from deadbeat borrowers—are adding to the turmoil.")

⁴⁴ Johnson, *supra* note 34, at 212 ("During the recent financial crisis, investigations revealed that a concentration of significant financial institutions participated in the credit default swap market. This concentration of significant financial market participants contributed to systemic risk and moral hazard concerns.")

⁴⁵ This explanation stems from an example of a credit-default-swap market in Blumberg, *supra* note 25.

their respective Mutual-Fund counterparties with the \$1,000,000 that Z has agreed to pay them upon the occurrence of the same event.

Now, assume X files for bankruptcy. Theoretically, Z would pay \$1,000,000 to each of the Investors and those Investors in turn would pay \$1,000,000 to each of the Mutual Funds. But what if Z cannot afford to pay \$1,000,000 to the three Investors? The result is systemic destabilization, as investors across markets are injured—either the Investors or the Mutual Funds take the significant loss of \$1,000,000.⁴⁶

Sadly, this is not markedly different from what actually occurred when the housing market crashed in 2008.⁴⁷ Indeed, in 2007, the credit-default-swap market reached an “estimated . . . \$62.2 trillion,”⁴⁸ with many of the credit-default-swap contracts tied to financial instruments linked to home mortgages.⁴⁹ And, importantly, “investigations [have] revealed that a concentration of significant financial institutions participated in the credit default swap market.”⁵⁰ For instance, American International Group, Inc. (“AIG”), faced daunting financial obligations due to credit default swaps when property values rapidly declined:

The government rescued AIG . . . to prevent it from going bankrupt because it had promised a lot of money, which it didn't have, to people holding credit default swap agreements

⁴⁶ See *id.* (“Satyajit Das, a risk consultant with nearly 20 years of experience working with credit default swaps, says that netting works fine as long as everyone stays in business. ‘If the chain breaks down anywhere where one party does not actually honor their contracts, then the losses multiply rapidly,’ he says. ‘It links everybody together in this unholy chain and so what happens is if one party has a problem, then everybody else has a problem.’”).

⁴⁷ Vasudev, *supra* note 22, at 763–64 (citing Michael S. Gibson, *Credit Derivatives and Risk Management*, 92 FED. RESERVE BANK OF ATLANTA ECON. REV., no. 4, 2007 at 25, 39) (“[The amount of credit default swaps in the market], which is truly staggering, was most likely in excess of the underlying debt, which suggests the possibility of multiple swaps for the portfolios. In other words, a number of default swaps were issued for a single debt obligation. Michael Gibson has pointed out, ‘[a]s the credit derivative market has grown, it has become common for the notional amount of CDS outstanding referencing a particular issuer to be larger than the face value of the issuer's bonds outstanding.’ This fact clearly points towards multiple swaps for debt securities.”).

⁴⁸ Vasudev, *supra* note 22, at 763; see also *Clearing the Fog: Credit Derivatives Continue to Boom, But the Old Order Is Under Threat*, THE ECONOMIST (Apr. 17, 2008), http://www.economist.com/node/11060804?story_id=11060804 (“The overall market for over-the-counter derivatives shot up to \$455 trillion at the end of 2007. Some \$62 trillion of that were credit-default swaps (CDSs), whose supercharged growth continues in spite of the crunch.”).

⁴⁹ Andrea S. Kramer, Alton B. Harris, & Robert A. Anshel, *The New York State Insurance Department and Credit Default Swaps: Good Intentions, Bad Idea*, 22 J. OF TAX'N & REG. OF FIN. INST., no. 3, at 22, 22 n.1 (Jan./Feb. 2009); see also Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME (Mar. 17, 2008), <http://www.time.com/time/business/article/0,8599,1723152,00.html> (“[Credit default swaps] typically apply to municipal bonds, corporate debt and mortgage securities . . .”).

⁵⁰ Johnson, *supra* note 34, at 212.

with the company. ‘From recollection, I don’t believe the number got to \$500 billion, but it was certainly in totality around \$400 billion,’ sa[id] former CEO Martin Sullivan.⁵¹

Wells Fargo, through its purchase of Wachovia,⁵² also faced considerable credit-default-swap liability,⁵³ and “Bear Stearns, a top-ten actor in [credit default swaps], [was] rescued partly because of the fear of chaos if such a large counterparty [in the credit-default-swap market] were to fold.”⁵⁴ Likewise, Lehman Brothers’ former Chief Executive Officer, Richard Fuld, “blamed his firm’s collapse partly on ‘destabilizing’ forces including the escalating cost of swaps on the investment bank’s debt.”⁵⁵

In total, estimates suggest that credit default swap “strategies . . . contributed to \$1.82 trillion in write-downs and losses amid the worst financial crisis since the Great Depression.”⁵⁶ Given the sheer volume of the credit-default-swap market⁵⁷ and the dangers that exposure to it caused major financial institutions and our economy as a whole, an obvious question arises: Where were the regulations and regulators that “protect investors, maintain orderly markets and promote financial stability”?⁵⁸

⁵¹ Blumberg, *supra* note 25; *see also* Vasudev, *supra* note 22, at 775 (“AIG . . . estimated the subprime component in its default swap basket at \$61.4 billion. But the assistance provided by the federal government since September 2008 is reported to be over \$170 billion. This indicates that the loss in default swaps business went beyond the subprime exposure estimated by AIG.”) (citation omitted); George Soros, *One Way to Stop Bear Raids: Credit Default Swaps Need Much Stricter Regulation*, WALL ST. J., Mar. 24, 2009, at A17 (“AIG failed because it sold large amounts of credit default swaps (CDS) without properly offsetting or covering their positions.”).

⁵² Sara Lepro, *Wells Fargo Buys Wachovia for \$15.1 Billion*, ABC NEWS (Oct. 3, 2008), <http://abcnews.go.com/Business/SmartHome/story?id=5946486&page=1>.

⁵³ John Carney, *Wells Fargo’s Ticking Time Bomb: Credit Default Swaps On Commercial Mortgages*, BUSINESS INSIDER (Sep. 17, 2009, 1:41 PM), <http://www.businessinsider.com/john-carney-wells-fargos-ticking-time-bomb-credit-default-swaps-on-commercial-mortgages-2009-9>.

⁵⁴ THE ECONOMIST, *supra* note 48.

⁵⁵ Shannon D. Harrington & Christine Harper, *Wall Street Shrinks from Credit Default Swaps Before Rules Hit*, BLOOMBERG (Nov. 29, 2010, 12:00 AM), <http://www.bloomberg.com/news/2010-11-29/wall-street-shrinks-from-default-swaps-as-dodd-frank-rules-hit-speculators.html>.

⁵⁶ *Id.*; *see also* Morrissey, *supra* note 49 (“[T]he top 25 banks [held] more than \$13 trillion in credit default swaps . . . at the end of the third quarter of 2007 . . . JP Morgan Chase, Citibank, Bank of America and Wachovia were ranked among the top four most active . . .”).

⁵⁷ \$62.2 trillion is more than four times the annual gross domestic product of the United States. *World Factbook: United States*, <https://www.cia.gov/library/publications/the-world-factbook/geos/us.html> (last visited Mar. 30, 2012) (click on “Economy :: UNITED STATES”) (estimating that the United States’ gross domestic product for 2010 would be \$14.82 trillion).

⁵⁸ *Financial Regulation*, FINANCIAL TIMES LEXICON (last visited Mar. 30, 2012), <http://lexicon.ft.com/Term?term=financial-regulation>.

D. Dodd-Frank's Regulation of Credit Default Swap

Despite their similarity to insurance, the law did not regulate credit default swaps prior to Dodd-Frank to the same extent that it regulates the traditional insurance industry.⁵⁹ For instance, state law often mandates that insurance providers disclose financial information,⁶⁰ allow regulators and shareholders to inspect their “books and records,”⁶¹ and “require an insurer to maintain a specified amount of capital or surplus or reserves to meet liabilities.”⁶² In contrast, prior to Dodd-Frank, credit default swaps and the credit-default-swap market were generally unregulated.⁶³ Indeed, the federal rules governing credit default swaps were “the anti-fraud and anti-manipulation provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.”⁶⁴ The lack of regulation meant that participants in the credit-default-swap market traded the instrument in an “over-the-

⁵⁹ See State of New York Insurance Department, Office of General Counsel, Funding Agreement Securitizations (Apr. 18, 2000) <http://www.dfs.ny.gov/insurance/ogco2000/rg004181.htm> (the State of New York deciding not to consider credit default swaps as insurance contracts). But see State of New York Insurance Department, “Best practices” for Financial Guaranty Insurers, Circular Letter No. 19 (Sept. 22, 2008), http://www.dfs.ny.gov/insurance/circltr/2008/cl08_19.htm (reversing this policy).

For an explanation of why credit default swaps are not treated like insurance, see *Credit Default Swap Regulation Overview*, KRAMER LEVIN (Nov. 2008), http://www.kramerlevin.com/files/Publication/8c676a8c-c444-4091-827b-008b78feaa15/Presentation/PublicationAttachment/f31d02c5-7ce3-4ea6-9fa7-02b2ac07d509/5361_Alert_CDSwaps_v7.pdf (“The conclusion that [credit default swaps] are not insurance contracts is based upon the fact that the buyer of credit protection under a [credit default swap] need not suffer any loss nor provide any evidence of any loss with respect to the relevant reference entity or obligation to receive payment from seller.”).

⁶⁰ 1 COUCH ON INS. § 2:24 (3d ed. 2009) (“In order to facilitate governmental control of insurers, and in some instances to make information available to the stockholders, members, or policyholders of insurers, or to the public at large, statutes provide for the filing of specified information with a government officer or commission. Such information may consist of a classification of risks and premium rates, policy forms, annual business transaction reports, or current financial condition. Statutes may require the publication of annual statements in daily papers designated by the insurance commissioners, making reports to the comptroller, or for returns to the insurance commissioner.”) (citations omitted).

⁶¹ *Id.* § 2:25.

⁶² *Id.* § 2:27.

⁶³ Letter from Timothy F. Geithner, United States Secretary of the Treasury, to Harry Reid, United States Senator (May 13, 2009), available at <http://online.wsj.com/public/resources/documents/OTCletter20090513.pdf> (writing that the credit-default-swap market, among others, before Dodd Frank “[were] largely excluded or exempted from regulation”); see also Dutt, *supra* note 32, at 186 (“The current state of CDS market regulation in the United States is quite limited.”).

⁶⁴ KRAMER LEVIN, *supra* note 59, at 1; see also Kramer, Harris, & Anshel, *supra* note 49 at 26 (“As a result of the [Commodity Futures Modernization Act in 2000], [credit default swaps] and other [over-the-counter] derivative contracts [were] not subject to any federal regulation.”).

counter”⁶⁵ fashion, where “participants . . . transacted . . . bilaterally without the facilitation of an exchange.”⁶⁶

The use of an over-the-counter market and the non-regulation of credit default swaps in general created economic problems. First, the presence of an exchange forces “buyers and sellers [to] choose from standardized listed products, and [ensures that] counterparties rarely interact directly, relying instead on the exchange to facilitate contract settlement.”⁶⁷ Without the stabilizing force an exchange provides, traders in the credit-default-swap market “independently negotiate[d] terms and settle[d] contracts,”⁶⁸ which exposed those parties to the risk of “less transparency than [they would otherwise have in] exchange-based markets.”⁶⁹ As a result, there were “complicat[ions] in risk management and regulation of [over-the-counter] products.”⁷⁰

A lack of transparency caused uncertainty within the market because participants were unaware of the maneuvers, positions, or relative stability of their counterparties,⁷¹ which led to a second problem: the fact that market participants were counterparties to each other “creat[ed] a daisy chain of systemic risk throughout the financial system.”⁷² This was troublesome because “market participants [were] unable to discern how much contingent exposure their counterparties ha[d] to other market participants.”⁷³ Because the counterparties in the pre-2008 over-the-counter market were predominately major institutions—e.g., AIG, Wachovia, Wells Fargo, Lehman Brothers, and Bear Stearns—systemic risk was high.⁷⁴

⁶⁵ Kress, *supra* note 23, at 54; *see also* Johnson, *supra* note 34, at 195 (“In the years leading to the financial crisis, credit default swap agreements traded in the OTC market . . .”).

⁶⁶ Kress, *supra* note 23, at 54; *see also* Johnson, *supra* note 34, at 195 (writing that, in the over-the-counter market, “counterparties engage[] directly, transacting with one another without the services or public disclosures involved in trading securities on an exchange or other formal trading platform”).

⁶⁷ Kress, *supra* note 23, at 54; *see also* Johnson, *supra* note 34, at 196 (“[Over-the-counter] markets historically lacked . . . regulatory oversight.”).

⁶⁸ Kress, *supra* note 23, at 54.

⁶⁹ *Id.* at 54–55.

⁷⁰ *Id.* at 55.

⁷¹ Johnson, *supra* note 34, at 196 (quoting *Fin. Crisis Inquiry Comm’n: The Role of Derivatives in the Financial Crisis* 3 (July 1, 2010) (statement of Gary Gensler, Chairman, Commodity Futures Trading Comm’n), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0701-Gensler.pdf) (“[T]he lack of transparency in the OTC market resulted in market participants being ‘unable to adequately judge the risks they were assuming.’”).

⁷² William Spencer Topham, *Re-Regulating “Financial Weapons of Mass Destruction,” Observations on Repealing the Commodity Futures Modernization Act and Future Derivative Regulation*, 47 WILLAMETTE L. REV. 133, 137 (2010).

⁷³ Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 243 (2009) (citations omitted).

⁷⁴ Even after the brunt of the financial crisis passed, a small number of firms continue to dominate the credit-default-swap market. David M. Katz, *Five Firms Hold 80% of Derivatives*

As such, some commentators called for Congress to completely ban market participants' ability to purchase credit default swaps without having an interest in the debt instrument underlying the swap.⁷⁵ While Congress chose not to transform the market in such a stark way,⁷⁶ “[Dodd-Frank] will drastically change the regulation of trading of derivatives instruments in the United States”⁷⁷ because it made substantial modifications to the regulatory treatment of the credit-default-swap market.⁷⁸

Dodd-Frank's specific section dealing with credit default swaps and other derivatives, is entitled “Prohibition against Federal Government bailouts of swaps entities,”⁷⁹ which suggests that Congress recognized derivatives' injurious effects over the past few years. Dodd-Frank takes the previously unregulated market for credit default swaps and grants two bodies—the Securities and Exchange Commission and Commodity Futures Trading Commission—regulatory powers over the instrument.⁸⁰ And “[p]robably the most significant change made by [Dodd-Frank]” is the requirement that credit-default-swap contracts be “traded on an exchange (or swap-execution facility) and cleared by a clearing organization.”⁸¹ Further,

Risk, Fitch Report Finds, CFO.COM (July 24, 2009), <http://www.cfo.com/article.cfm/14113089/?f=rsspage> (“About 80% of the derivative assets and liabilities carried on the balance sheets of 100 companies reviewed by Fitch were held by five banks: JP Morgan Chase, Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley. Those five banks also account for more than 96% of the companies' exposure to credit derivatives.”).

⁷⁵ See, e.g., Soros, *supra* note 51 (“Only those who own the underlying bonds ought to be allowed to buy them.”); Rolfe Winkler, *Credit Default Swaps Should Be Regulated As Insurance*, MYNEWMARKETS.COM (Aug. 3, 2009), <http://www.mynewmarkets.com/articles/102605/credit-default-swaps-should-be-regulated-as-insurance> (suggesting the government “[r]egulate [credit default swaps] as insurance”); Smith, *supra* note 18 (“[C]entral clearing and/or putting [credit default swaps] on exchanges are inadequate remedies.”).

⁷⁶ See Lawrence D. Hui & Mary Kuan, *Legal Update: Impact of Dodd-Frank Wall Street Reform and Consumer Protection Act on Derivatives Trading*, KLEINBERG, KAPLAN, WOLFF & COHEN, 6 (Aug. 2010), http://www.kkwc.com/library_cat/uf_Impact_of_Dodd-Frank_Wall_St_Reform.pdf (“The Dodd-Frank Act . . . provid[es] that states may not regulate swaps as insurance.”).

⁷⁷ *Id.* at 1; see also Eileen Bannon & Yoo-Keyong Kwon, *Derivatives Regulation Under Dodd-Frank: Potential Implications for Insurance Products and Companies*, DEWEY & LEBOEUF, 1 (Mar. 17, 2011), http://www.deweyleboeuf.com/~media/Files/attorneyarticles/2011/20110317_DerivativesRegulation.ashx (“Title VII of [Dodd-Frank] accomplishes a sweeping reform of the previously largely unregulated derivatives market.”).

⁷⁸ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, §§ 721–54, 124 Stat. 1376, 1641–1754 (2010) (codified in scattered sections of 7 & 15 U.S.C.).

⁷⁹ § 716, 124 Stat. at 1648.

⁸⁰ Hui & Kuan, *supra* note 76, at 2.

⁸¹ *Id.* at 3; see also Kress, *supra* note 23, at 61 (“[Dodd Frank] calls for [credit default swaps] to be traded through centralized counterparties, or clearinghouses.”); Daniel Waldman &

“dealers” of credit default swaps will now be subject to “comprehensive registration requirements, as well as capital and margin requirements, and rules governing business conduct and record keeping.”⁸² Finally, “[d]ealers that are banks will be subject to capital and margin requirements set by their banking regulators.”⁸³

These rules addressed numerous areas of concern regarding the credit-default-swap market. First, by placing credit default swaps into exchanges, “[c]ounterparty risk is [now] diffused through [the] central clearinghouse.”⁸⁴ Essentially, the “[central clearinghouse] acts as a middleman: the original, bilateral contract is replaced by two separate contracts, one each between the original parties and the [clearinghouse].”⁸⁵ This brings forth “[t]he potential benefit[] . . . [of] transparency and much lower transaction costs,”⁸⁶ because participants on both sides of trades will have a better understanding of the prices of similar contracts and the types of different contracts made by other market participants.⁸⁷

Second, “the clearing corporation essentially guarantees the derivatives contracts for each side of the trade and requires all of its members to post sufficient margin so as to safeguard the clearing of the trades,”⁸⁸ which is vital because, as some commentators contend, “[t]he most critical role for regulation is to make sure that the sellers of risk have the capital to support their bets.”⁸⁹ Ultimately, clearinghouses “reduce systemic risk by netting offsetting exposures and mutualizing counterparty risk among all of their members.”⁹⁰

Ahmad Hajj, *Dodd-Frank Wall Street Reform and Consumer Protection Act to Significantly Impact Derivatives Trading of Banks*, ARNOLD & PORTER LLP, 1 (July 2010), http://www.arnoldporter.com/resources/documents/Advisory--Dodd-Frank%20Wall%20Street%20Reform%20and%20Consumer%20Protection%20Act_071410.pdf (“Participants in derivatives trades could also be required to clear many or all of their swaps through a central clearing house.”).

⁸² Hui & Kuan, *supra* note 76, at 4–5; *see also* Waldman & Hajj, *supra* note 81, at 1 (“Banks that fit within the Act’s definition of ‘swap dealer’ or ‘major swap participant’ (MSP) would be subject to new requirements that could include: registration, capital and margin, reporting and record-keeping, as well as new business conduct standards.”).

⁸³ Hui & Kuan, *supra* note 76, at 5.

⁸⁴ *Id.* at 3.

⁸⁵ Kress, *supra* note 23, at 61.

⁸⁶ THE ECONOMIST, *supra* note 48.

⁸⁷ *See* Dutt, *supra* note 32, at 195 (“A centralized clearinghouse for [credit default swaps] transactions would reduce counterparty and systemic risks and increase market transparency and liquidity.”).

⁸⁸ *See* Hui & Kuan, *supra* note 76, at 3.

⁸⁹ Lewis & Einhorn, *supra* note 28, at WK10.

⁹⁰ Kress, *supra* note 23, at 61; *see also* Dutt, *supra* note 32, at 195 (“The clearinghouse will reduce counterparty risk by becoming the counterparty to every [credit-default-swap] transaction.”).

These regulations, however, do not address all of the problems credit default swaps create. Namely, these regulations fail to prevent unnecessary bankruptcies brought on by credit default swaps, which is the focus of this Comment.

II. EMPTY CREDITOR SYNDROME: HOW AND WHY CREDIT-DEFAULT-SWAP HOLDERS CAUSE UNNECESSARY BANKRUPTCIES

Despite taking important steps to reduce the systemic risk that credit default swaps cause, Dodd-Frank did not address an important risk that credit default swaps create: the potential that swap holders “may prefer to force [a] company into bankruptcy, rather than agree to a restructuring, because the bankruptcy filing will trigger a contractual payoff.”⁹¹ Although this may seem counterintuitive, a simple illustration shows how this works in theory.

Remember that Investor L owns Company X’s bonds and that she also purchased a credit default swap to hedge against the possibility that X would be unable to fulfill its obligations on those bonds. Next, assume that X is teetering on the edge of bankruptcy and hopes to restructure its debt to ensure that it can continue to operate. This restructuring, however, would require L to accept less than the full amount that X owes her from the bonds. In this scenario, L may prefer to receive the payout from her credit default swap rather than agree to the restructuring, a preference that could force X into bankruptcy.⁹² Indeed, if L is a rational actor, she will prefer X to fail. Moreover, if L is acting on behalf of other investors—if she manages a hedge fund, for instance—she may have a fiduciary obligation to

⁹¹ Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 732 (2008) [hereinafter Hu & Black, *Empty Voting II*]; see also Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 427 (2007) (“[C]redit derivatives may ultimately discourage out-of-court restructurings”); cf. Johnson, *supra* note 34, at 209 (citation omitted) (“Credit default swaps allow market participants to share the risk of a borrower’s default. Therefore, when a lender purchases a credit default swap to offset its exposure if the reference entity defaults, the lender may have diminished incentives to assist the issuer of the debt that is the underlying asset in the credit default swap agreement.”).

⁹² Professors Hu and Black use the following example: “Suppose, for example, that a hedge fund, bank, or other investor holds \$200 million of a company’s bonds, but is also long a \$500 million notional amount in credit default swaps on this debt.” Hu & Black, *Empty Voting II*, *supra* note 91, at 731–32. It is also important to note that, even if Investor L had purchased the same amount of protection against default that he was owed under the bond payment, or even somewhat less, L might still prefer bankruptcy because of the inherent costs involved in bankruptcy proceedings. Cf. Caroline Salas & Shannon D. Harrington, *Darth Wall Street Thwarting Debtors with Credit Default Swaps*, BLOOMBERG (Mar. 5, 2009, 1:03 PM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aZjMcuIoat7U&refer=home> (“Say you’ve lent \$100 million to a company and you had bought \$100 million in credit-default swaps,” said Henry Hu, a law professor at the University of Texas in Austin. “In that circumstance, the creditor really doesn’t care whether or not the company goes under.”).

prefer X's bankruptcy.⁹³ This phenomenon—"where a lender who has bought protection on an underlying loan, bond or credit exposure may have an incentive to put the reference entity into bankruptcy or Chapter 11"⁹⁴—is called "empty creditor syndrome."⁹⁵

Empty creditor syndrome begins with the understanding that "a traditional conception of debt ownership includes a standard package of economic rights (principally principal and interest payments), control rights, default rights, and other rights and obligations under contractual covenants, federal bankruptcy law, and, to a limited extent, state corporate law."⁹⁶ When a creditor purchases a credit default swap providing a payout if the company he invests in defaults on its obligation, the creditor hedges its risk in the original debt transaction.⁹⁷ Despite this hedge, the creditor retains full voting rights in bankruptcy. As one commentator notes:

A creditor who has partly or fully hedged through a credit default swap nevertheless retains full contractual rights under the loan agreement or bond indenture, and full voting rights in bankruptcy. In contrast, the holder of the long side of the credit default swap bears default risk, but has no control rights.⁹⁸

Because creditors who hold credit default swaps on the debt they have provided are not saddled with the same economic concerns as other individuals or entities who share that control, they may have "incentives to vote against the interests of other shareholders."⁹⁹

⁹³ This assumes the companies only duty is to maximize return to its investors.

⁹⁴ Satyajit Das, *Credit Default Swaps—Financial Innovation or Financial Dysfunction?*, BANQUE DE FRANCE FIN. STABILITY REV., July 2010, at 45, 50, available at http://www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Revue_de_la_stabilite_financiere/etude06_rsf_1007.pdf.

⁹⁵ *Id.*; see also Henry T.C. Hu, Op-Ed., 'Empty Creditors' and the Crisis, WALL ST. J., Apr. 10, 2009, at A13 ("Thus the 'empty creditor': someone (or institution) who may have the contractual control but, by simultaneously holding credit default swaps, little or no economic exposure if the debt goes bad. Indeed, if a creditor holds enough credit default swaps, he may simultaneously have control rights and incentives to cause the debtor firm's value to fall. And if bankruptcy occurs, the empty creditor may undermine proper reorganization, especially if his interests (or non-interests) are not fully disclosed to the bankruptcy court.").

⁹⁶ Hu & Black, *Empty Voting II*, *supra* note 91, at 728.

⁹⁷ See *id.* ("One simple way for a creditor to hedge involves a credit default swap.").

⁹⁸ *Id.* at 730–31; see also Henry T. C. Hu & Bernard Black, *Debt and Hybrid Decoupling: An Overview*, M & A LAWYER, Aug. 2008 at 1 (confirming the decoupling of rights of the creditors debtors in relationship to credit default swaps) [hereinafter Hu & Black, *Debt and Hybrid Decoupling: An Overview*].

⁹⁹ Hu & Black, *Empty Voting II*, *supra* note 91, at 731.

Importantly, these “creditor[s] might prefer that the company fail, and hence oppose an out-of-court restructuring.”¹⁰⁰

Unfortunately, empty creditor syndrome is not simply a theoretical problem.¹⁰¹ Take, for example, Six Flags’ bankruptcy in 2009.¹⁰² Roughly, one month prior to filing, Six Flags attempted to stave off financial ruin with a “debt-for-equity exchange” offer that would have allowed bondholders to exchange their debt for an equity position in the company.¹⁰³ To complete the deal, Six Flags required that “95% of its outstanding [debt holders] participate[]” in the exchange.¹⁰⁴ For the majority of Six Flags’ bondholders, this deal made sense, as their investments would lose considerable value if the company filed for bankruptcy.¹⁰⁵ Indeed, “most bondholders favored” Six Flags’ offer.¹⁰⁶

The same may not have been true, however, for one of the company’s major bondholders: Fidelity Investments. Fidelity “had bought credit default swaps to insure itself against the possibility that [Six Flags] would file for bankruptcy.”¹⁰⁷ Additionally, Fidelity’s debt holdings constituted a “blocking stake,” meaning that, if “[it] refused to participate in the exchange, Six Flags had no legal remedy except to reduce the participation threshold or to file for bankruptcy.”¹⁰⁸ Within one month of its debt-for-equity offer, Six Flags failed to garner enough bondholder support for the restructuring, and the company filed for Chapter 11 protection.¹⁰⁹

¹⁰⁰ Henry T. C. Hu & Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EURO. FIN. MAN. 663, 682 (2008) [hereinafter Hu & Black, *Governance and Systemic Risk*].

¹⁰¹ George Washington, *Guest Post: Credit Default Swaps—Love ‘Em, Ban ‘Em, or Tax ‘Em?*, NAKED CAPITALISM (Sept. 30, 2009, 1:06 AM), <http://www.nakedcapitalism.com/2009/09/guest-post-credit-default-swaps-love-em-ban-em-or-tax-em.html> (“And don’t forget that credit default swap counterparties drive company after company into bankruptcy, and that—once a company the counterparties are [sic] betting against goes bankrupt—the counterparties cut in line in front of all of the bankruptcy creditors to get paid.”).

¹⁰² Michael J. De La Merced, *Six Flags Files for Bankruptcy*, N.Y. TIMES (June 13, 2009, 11:26 AM), <http://dealbook.nytimes.com/2009/06/13/six-flags-files-for-bankruptcy/>.

¹⁰³ Daniel Hemel, Comment, *Empty Creditors and Debt Exchanges*, 27 YALE J. ON REG. 159, 159 (2010).

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* at 159–160.

¹⁰⁶ *Id.* at 160.

¹⁰⁷ *Id.* (citing Michael S. Rosenwald, *Plagued by Debt, Six Flags Faces Its Own Wild Ride*, WASH. POST, Apr. 13, 2009, at A10).

¹⁰⁸ *Id.* at 163 (citation omitted).

¹⁰⁹ See Johnson, *supra* note 34, at 209 (“[S]ome posit that the recent bankruptcies at automakers General Motors Company and Chrysler LLC demonstrate the need to evaluate carefully traditional assumptions about creditors’ intentions and presumed responses to a distressed debtor.”); Hemel, *supra* note 103, at 161 (citing Tom Krisher, *Chrysler Debtholder Talks Pick Up Pace; GM Stalled*, ABC NEWS (Apr. 15, 2009), <http://abcnews.go.com/Business/wireStory?id=7332901> and Loren Steffy, *Credit-Default Swaps: Banking on Bankruptcy*, HOUSTON CHRON., July 22, 2009, at 1).

Importantly, Six Flags' bankruptcy is not an isolated incident. Indeed, a number of bankruptcies during the past few years have involved empty creditors.¹¹⁰ For instance, commentators have pointed to the "corporate bankruptcies of Canadian newsprint producer AbitibiBowater Inc. and U.S. shopping center developer General Growth Properties Inc." as instances where "credit default swaps became an actual bankruptcy catalyst."¹¹¹ Others believe that credit-default-swap holders drove General Motors Co.'s and Chrysler LLC's bankruptcies.¹¹² Likewise, creditors may have pushed LyondellBasell Industries, a chemical company traded on the New York Stock Exchange that filed for bankruptcy in 2009,¹¹³ toward failure.¹¹⁴ And, although neither situation ended in bankruptcy, some contend that "Ford Motor Co. [was being] pushed toward bankruptcy by bondholders trying to profit from credit default swaps that protect against losses on their high-yield debt,"¹¹⁵ while others believe that "YRC Worldwide . . . , one of the largest trucking companies in the United States," faced the same pressure.¹¹⁶ Likewise, some argue that, in the time leading up to the federal bailout, "Goldman Sachs was . . . an empty creditor of AIG."¹¹⁷

As both theory and practice show, parties in the credit-default-swap market may have incentives that run counter to those of other creditors¹¹⁸ and, more importantly, to those of the broader

¹¹⁰ Samuel M. Kidder, Comment, *What's Your Position? Amending the Bankruptcy Disclosure Rules to Keep Pace with Financial Innovation*, 58 UCLA L. REV. 803, 807 (2011) ("There is anecdotal evidence of net short [sic] creditors refusing to participate in out-of-court workout agreements . . .").

¹¹¹ Martin Hutchinson, *Ban Credit Default Swaps? These Corporate Bankruptcies Show We Should*, CONTRARIAN PROFITS (Apr. 23, 2009), <http://www.contrarianprofits.com/articles/ban-credit-default-swaps-these-corporate-bankruptcies-show-we-should/15849>.

¹¹² See Hemel, *supra* note 103, at 159–161. With respect to General Motors in particular, see Daniel Gross, *Why GM Might Go Bankrupt*, SLATE (May 12, 2009, 3:46 PM), http://www.slate.com/articles/business/moneybox/2009/05/why_gm_may_go_bankrupt.html.

¹¹³ Ana Campoy & Marie Beaudette, *Lyondell's U.S. Arm in Chapter 11: Dutch Chemical Maker Struggled With Heavy Debt from 2007 Acquisition*, WALL ST. J. (Jan. 6, 2009, 7:45 AM), <http://online.wsj.com/article/SB123127968554958711.html>.

¹¹⁴ See Hemel, *supra* note 103, at 160–161.

¹¹⁵ Salas & Harrington, *supra* note 92.

¹¹⁶ See Kidder, *supra* note 110, at 808–809.

¹¹⁷ Hu, *'Empty Creditors' and the Crisis*, *supra* note 95.

¹¹⁸ Norris, *supra* note 40 ("There is another, little noticed, possible impact of credit-default swaps. They can undermine bankruptcy laws. Normally, a creditor wants to keep a company out of bankruptcy if there is a decent chance it can survive. If it does go broke, the creditor wants to maximize the value of the company anyway, so that more will be available to pay creditors. But what happens if a major creditor, who might even control one class of bonds, has a much larger position in credit-default swaps? Will he not have interests directly at odds with those of other creditors, since he will do better if the company ends up with less to pay its creditors? Might that creditor seek to, and perhaps be able to, sabotage the company's best hopes for revival?").

economy.¹¹⁹ “The toll that business failure exacts on dependent constituencies goes beyond job loss and creditor recovery statistics. The closing of a failed business may produce shock waves that reverberate throughout the local, regional or national economy.”¹²⁰ Given the United States’ recent emergence from a long-lasting recession, the negative effects of bankruptcies on the economy at large,¹²¹ and the trillions of dollars of credit default swaps currently in circulation,¹²² Congress should address empty creditor syndrome as it relates to failed restructurings and premature bankruptcies.¹²³

III. COMBATING EMPTY CREDITOR SYNDROME

Ultimately, “the lifeblood of corporate reorganizations is and always has been negotiation. Creating the optimal environment for facilitating such negotiation is the principal business of those who shape the law.”¹²⁴ Perhaps in recognition of this general principle, typical “financial covenants, especially in bank loan agreements, are often written fairly strictly, to provide an early warning of financial trouble and an opportunity for renegotiation.”¹²⁵ Because of credit default swaps, however, the tendency to favor negotiation of debt terms when a debtor is facing temporary financial stress may be dissipating.¹²⁶ Indeed, if Investor L is better off having Company X bankrupt (regardless of whether X can recover from its difficult financial position in the future) and L has the chance to ensure that X will indeed go bankrupt, why would L even consider sitting down at the negotiating table to discuss a restructuring?

¹¹⁹ Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75, 75 (1995) (“Business failure negatively affects a broad range of interests.”).

¹²⁰ *Id.* at 76.

¹²¹ *Id.*; see also Hu & Black, *Governance and Systemic Risk*, *supra* note 100, at 690–693 (discussing that empty creditors are also a source of systemic risk for the economy at large.).

¹²² Lewis and Einhorn, *supra* note 28 (“There are [still] tens of trillions of dollars in [credit-default-swap] contracts between big financial firms.”); Gretchen Morgenson, *It’s Time for Swaps to Lose Their Swagger*, N.Y. TIMES, Feb. 27, 2010, at BU2 (“[T]he Bank for International Settlements, [found that] credit default swaps with a face value of \$36 trillion were outstanding in the second quarter of 2009.”).

¹²³ Although outside the scope of this Comment, future research may consider how creditors’ ability to institute bankruptcy proceedings relates to empty creditor syndrome. See Lubben, *supra* note 91, at 427 (“Creditors will have every incentive to trigger the swap by filing an involuntary bankruptcy petition against the debtor, illustrating the important point that ‘bankruptcy’ is the one credit event that can be controlled by credit buyers.”); see also Hemel, *supra* note 103, at 164 (citing Lubben for the same proposition).

¹²⁴ Baird & Rasmussen, *supra* note 29, at 699.

¹²⁵ Hu & Black, *Debt and Hybrid Decoupling: An Overview*, *supra* note 98, at 8.

¹²⁶ See *supra* Part II (discussing stresses on creditors).

A few commentators have discussed this issue. In particular, one commentator's proposal offers a clever starting point for addressing the specific problem this Comment focuses on: preventing credit-default-swap holders from forcing companies into bankruptcy by refusing to engage in restructuring negotiations.¹²⁷ To truly combat this phenomenon, however, Congress should take a stronger stand.

A. Other Commentators' Consideration of Empty Creditor Syndrome

To date, legal academics have paid little attention to the relationship between empty creditor syndrome and corporate bankruptcies.¹²⁸ The majority of those who have commented on this issue have focused on how credit-default-swap holders affect companies after those companies have already filed for bankruptcy.¹²⁹ Their regulatory recommendations address the post-bankruptcy environment and encourage the disclosure of credit-default-swap positions.¹³⁰ For instance, one commentator calls for bankruptcy law to "require *any* party seeking to be heard in [a bankruptcy] case to file an accompanying verified statement setting forth its disclosable economic interests," including credit default swaps, under Rule 2019 of the Federal Rules of Bankruptcy Procedure.¹³¹ Another calls for "[t]he Bankruptcy Code" to generally "incorporate a system that mandates disclosures of short positions in the debtor's equity or debt, derivatives or other third party contracts that reduce or eliminate an investor's economic risk, as well as interest in major competitors of the debtor."¹³²

Similarly, law professors Henry T.C. Hu and Bernard Black, who have written extensively on empty creditor syndrome, argue that disclosure "should become a routine part of bankruptcy proceedings."¹³³ Additionally, Professors Hu and Black add to the general call for more disclosure by asserting that:

¹²⁷ See generally Hemel, *supra* note 103.

¹²⁸ Kidder, *supra* note 110, at 805 ("As the credit derivatives market is a relatively recent and complex phenomenon, its potential implications in the bankruptcy context have received only limited scholarly attention.")

¹²⁹ See, e.g., Lubben, *supra* note 91 (discussing, generally, how credit default swaps can impact reorganizations).

¹³⁰ See Hemel, *supra* note 103, at 164–67 (surveying previous scholarly solutions to the empty creditor problem).

¹³¹ Kidder, *supra* note 110, at 839.

¹³² Kevin J. Coco, Note, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 COLUM. BUS. L. REV. 610, 649 (2008); see also Lubben, *supra* note 91, at 427 (proclaiming that more disclosure may be necessary to prevent the negative effects).

¹³³ Hu & Black, *Empty Voting II*, *supra* note 91, at 734; see also Hu & Black, *Governance and Systemic Risk*, *supra* note 100, at 684 (arguing for the same).

Debt contracts may need to adjust to the new world of hedged interests, voting rights in bankruptcy may need to be based on net economic ownership instead of gross ownership of debt, and the extra complexities in devising sensible voting rules may provide support for proposals to rely more on auctions.¹³⁴

While Congress's adoption of these proposals may improve the efficiency of Chapter 11—a laudable goal in its own right¹³⁵—“[c]redit default swaps create a moral hazard problem [both] before the Chapter 11 begins and in its immediate aftermath.”¹³⁶ Thus, to adopt truly meaningful regulatory change, Congress must address the pre-bankruptcy effects empty creditor syndrome has on companies.

One commentator, Daniel Hemel, has written on this specific issue.¹³⁷ To begin, Hemel notes that disclosure requirements, such as those that advocates of post-bankruptcy reform propose, “would not necessarily alter the incentives ‘empty creditors’ in pre-bankruptcy restructuring situations.”¹³⁸ Second, he contends that, by changing the language that credit-default-swap agreements typically use, we can accomplish the goal of altering these incentives to preclude credit-default-swap holders from causing unnecessary bankruptcies.¹³⁹ Currently, “[t]he International Swaps and Derivatives Association (ISDA), a private sector trade association, has crafted a Master Agreement that governs most credit default swap[s].”¹⁴⁰ Hemel proposes that the ISDA Master Agreement include “a broad definition of ‘restructuring’” as one of the events that compels a seller of credit default swaps to pay purchasers.¹⁴¹ Under Hemel's proposed language, a restructuring would require credit-default-swap sellers to pay the swapholder the difference between the face value of the holder's stake in the asset being restructured and the value in what the holder owns after the restructuring.¹⁴² Currently, restructurings, such

¹³⁴ Hu & Black, *Empty Voting II*, *supra* note 91, at 735; *see also* Hu & Black, *Governance and Systemic Risk*, *supra* note 100, at 684 (arguing for the same).

¹³⁵ After all, “[v]oting by empty creditors in bankruptcy can lead to less efficient decisions on liquidation versus continuation, or on post-reorganisation capital structures.” Hu & Black, *Governance and Systemic Risk*, *supra* note 100, at 684.

¹³⁶ Baird & Rasmussen, *supra* note 29, at 683.

¹³⁷ Hemel, *supra* note 103.

¹³⁸ *Id.* at 165 (citing Baird & Rasmussen, *supra* note 29, at 683).

¹³⁹ *Id.* at 161.

¹⁴⁰ *Id.* at 162.

¹⁴¹ *Id.* at 167.

¹⁴² *Id.* at 168.

as debt exchanges, do not fall under credit-default-swaps standard language for default, as found in the ISDA Master Agreement.¹⁴³

If future participants in the credit-default-swap market make the contractual changes that Hemel proposes, it is clear that the agreements will remove the incentive for credit-default-swap holders to force companies into bankruptcy by refusing to negotiate during restructurings.¹⁴⁴ Consider our old friends Investor L, Company X, and Insurance Firm Z. Initially, Z sold L a credit default swap insuring L's investment in X's bonds. Now assume that the agreement between L and Z also requires Z to pay L if X restructures its debt-equity ratio. What if X, on the verge of bankruptcy, offers its debtholders a debt-for-equity exchange to strengthen itself moving forward?

Presumably, the present market value of the equity that Investor L and Company X's other bondholders would receive will be less than the face value of the bonds they own. For example, assume that L's bonds have an aggregate face value of \$1,000,000, but, if she accepts X's proposed exchange, her equity stake will be worth only \$500,000. Under the old credit-default-swap agreements, L would rather receive the \$1,000,000 payout from Insurance Firm Z than stock worth \$500,000. But, under the new terms that Hemel proposes, L is indifferent. If L accepts X's restructuring offer, Z must pay her \$500,000—the difference between the \$1,000,000 face value of the bonds and the \$500,000 present market value of the equity stake in X. After Z's payment and X's restructuring, L will have \$500,000 in cash and a \$500,000 equity stake in X. Thus, L ends up with the same amount of value she would have had if X went bankrupt. At the point when L had to decide whether to participate in the restructuring, she no longer had an incentive to force the company into bankruptcy.¹⁴⁵

B. Congress Should Ensure That Credit-Default-Swap Contracts Remove the Incentive for Credit-Default-Swap Holders to Force Companies into Early Bankruptcies

Hemel's proposed change to the contractual language that parties use in the credit-default-swap market accomplishes the goal of preventing credit-default-swap holders from forcing companies into bankruptcy by removing the holders' incentives to do so. But, to

¹⁴³ *Id.* at 162 (citing Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 *FORDHAM J. CORP. & FIN. L.* 705, 791 (2008)).

¹⁴⁴ *Id.* at 167–69 (outlining his proposed changes).

¹⁴⁵ *See id.* at 167–68 (exploring another hypothetical to explain this point).

accomplish this, Hemel called for the “[ISDA], a private sector trade association,”¹⁴⁶ to change the definition of default in its standard credit-default-swap agreement voluntarily.¹⁴⁷ The effectiveness of his proposal, therefore, relies on two uncertain contingencies.

First, the ISDA must voluntarily make the change that Hemel proposes to its Master Agreement. This seems unlikely given the ISDA’s response to a lawsuit that turned on whether, under the ISDA Master Agreement, a company’s restructuring constituted a credit event requiring the credit-default-swap issuer to pay the purchaser.¹⁴⁸ During the case, the “ISDA issued a new set of credit derivatives definitions” that established that “a ‘voluntary debt exchange [would] not trigger a credit event.’”¹⁴⁹ Additionally, when “the Basel Committee on Banking Supervision . . . considered a rule that would recognize credit default swaps for regulatory capital purposes only if the swaps specified ‘restructuring’ as a credit event[,] . . . ISDA raised concerns”¹⁵⁰

Even if the ISDA changes course and voluntarily makes this change, a second contingency comes into play: will the parties to credit default swaps continue to utilize the ISDA Master Agreement without amending the new definition of credit event? It seems unlikely that they will. By adding “restructurings” to the list of events that trigger the credit-default-swap seller’s obligation to pay, the holder increases the overall number of ways that a seller may have to make payment. Thus, by including “restructuring,” the purchaser has increased the likelihood that the seller will be required to make payment on the swap. If a seller recognizes that he is more likely to have to make payment later, he will charge more for the swap upfront.

Some might argue that sellers could begin requiring this language as a prerequisite for even being willing to offer credit default swaps. This makes sense at first (consider that Insurance Firm Z is better off paying \$500,000 rather than \$1,000,000). As AIG’s actions leading up to our recent financial crisis show, however, credit-default-swap sellers may not be that prudent.¹⁵¹ Or, in a more likely scenario, sellers have simply balanced the value of being able to offer a cheaper product against the probability that it will result in more costly

¹⁴⁶ Hemel, *supra* note 103, at 162.

¹⁴⁷ *Id.* at 167–68.

¹⁴⁸ *Id.* at 162 (citing *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co.*, No. 02 Civ. 1312, 2002 U.S. Dist. LEXIS 20706 (S.D.N.Y. Oct. 29, 2002)).

¹⁴⁹ *Id.* (citing Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How To Approach the Interpretation of Credit Events*, 13 *FORDHAM J. CORP. & FIN. L.* 705, 791 (2008)).

¹⁵⁰ *Id.* at 166.

¹⁵¹ See *supra* Part I.B–C.

payouts and determined that offering credit default swaps without including this language is advantageous to them. This implies that the current issuers of credit default swaps are miscalculating the risks involved to them with empty creditor syndrome (higher than necessary payouts). After all, it is likely that credit-default-swap sellers have probably considered these scenarios before this Comment, and yet they have not required this language in their offerings. It is not surprising, though, given their inability to accurately evaluate risk in the past.¹⁵²

Knowing this, purchasers are also unlikely to demand this change. After all, why would purchasers voluntarily demand language that increases their contracts' cost? They would not, especially when one realizes that they are indifferent between the protection offered by the old language and the new language. Indeed, Investor L, as a rational actor, should not care whether she receives \$1,000,000 cash or \$500,000 in cash and \$500,000 worth of equity in Company X.¹⁵³ L, therefore, will not pay more to receive the latter by requiring that the credit-default-swap agreement include restructuring as a triggering event.

Admittedly, the uncertainty of this second contingency could be eliminated if the parties are forced to include this language. Hemel addresses this question by pointing to the fact that, because credit default swaps will be “mov[ing] toward a clearinghouse system,”¹⁵⁴ under Dodd-Frank,¹⁵⁵ “opportunities to construct customized contracts will diminish.”¹⁵⁶ This is true, Hemel contends, because clearinghouses may require that credit-default-swap agreements follow the ISDA Master Agreement.¹⁵⁷ At present, however, Dodd-Frank and the SEC's subsequent rules have not required clearinghouses to compel market participants to use the ISDA Master Agreement.¹⁵⁸

¹⁵² See *supra* Part I.B–C.

¹⁵³ The value of the equity is, after all, a cash equivalent.

¹⁵⁴ Hemel, *supra* note 103, at 169.

¹⁵⁵ See *supra* Part I.D.

¹⁵⁶ Hemel, *supra* note 103, at 169.

¹⁵⁷ See *id.* (“The one clearinghouse that is up-and-running in the United States, ICE Trust, applies the ISDA Master Agreement—with a small number of exceptions—to all swaps that it clears.”).

¹⁵⁸ Dodd-Frank makes no mention of the ISDA, let alone mandating that clearinghouses require market participants follow its Master Agreement. See H.R. 4173, 111th Cong. (2010) (making no mention of the ISDA). Likewise, the SEC, which has regulatory power over “security-based swap agreements, such as credit default swaps,” has not addressed the issue. See *Derivatives*, U.S. SECURITIES AND EXCHANGE COMMISSION, (Dec. 30, 2011), <http://www.sec.gov/spotlight/dodd-frank/derivatives.shtml> (outlining and linking to the rule proposals the SEC has made “[a]s of the end of 2011”) (quotations omitted).

Furthermore, even if the credit-default-swap market entirely moves to clearinghouses, it is counterintuitive to assume that all clearinghouses will require this definition in every credit-default-swap agreement. Although “[t]he one clearinghouse that is up-and-running in the United States, ICE Trust, applies the ISDA Master Agreement—with a small number of exceptions—to all swaps that it clears,”¹⁵⁹ it is highly probable that more clearinghouses will emerge as the whole credit-default-swap market moves to clearinghouses. And new clearinghouses may be unlikely to compel parties to abide by the ISDA Master Agreement. After all, a clearinghouse is simply interested in ensuring that the purchasers of the swaps make the required payments and, when an event that triggers an obligation for a seller to make a payout, the seller does so.¹⁶⁰ Adding to the kinds of events that can trigger such an obligation for the seller may complicate this role because it introduces another type of event, the occurrence of which the parties may disagree about. Even if some clearinghouses do require that restructurings count as a triggering event, it is unlikely that all will because demand probably exists for the parties to develop their credit-default-swap contracts freely as they have been in the over-the-counter market.

Despite the analysis above, there remains another way that Congress could ensure that the parties adopt the changes that Hemel proposes: it could mandate that parties engaging in credit default swaps do so. Unfortunately, this will be politically challenging. Should the federal government be mandating specific contractual terms? Even if it theoretically should, will politicians have the political will to do so? If the political will exists, then Congress should mandate that a restructuring constitutes an event triggering the seller’s obligation to make payment to the purchaser in a credit-default-swap agreement.

It stands to reason, however, that this is an implausible outcome. Accordingly, this Comment proposes an alternative solution: Congress should allow a credit-default-swap seller to refuse to make payment because of a bankruptcy if, prior to that bankruptcy, the holder does not accept a restructuring offer.¹⁶¹ Congress should adopt this solution because it will solve the empty creditor problem, and it is more pragmatic politically. Allowing credit-default-swap sellers to

¹⁵⁹ Hemel, *supra* note 103, at 169.

¹⁶⁰ See Hui & Kuan, *supra* note 76, at 3 (discussing the clearing of derivatives contracts).

¹⁶¹ There are many specifics to actually crafting legislation to this effect, *e.g.*, how do we want to define “restructuring offer”? And who has the burden of proving that the holder refused a restructuring offer? These issues are beyond the scope of this Comment, but future commentators should address them.

refuse to make payment because of purchasers' self-interested insistence on bankruptcy eliminates the financial incentive for holders to force companies into bankruptcy.

Imagine Company X offers Investor L a debt-for-equity exchange with this rule in place. Assuming that the parties are operating under the typical credit-default-swap agreement, L has two options: (1) accept the offer and receive equity worth half of the face value of his bonds, or (2) refuse the offer and hope that X does not go bankrupt. Assume further that the debt-for-equity exchange would have allowed X to avoid bankruptcy. If X does file for bankruptcy, Insurance Firm Z need not make the \$1,000,000 credit-default-swap payout. Because the value of bankrupt X's bonds are likely to be less than the equity stake that L could have received in the debt-for-equity deal, this regulation forces L to always take restructuring deals that a company it invests in offers. Some will argue that this is unfair. But this Comment's proposed rule should not prevent the parties from contracting in a way that allows the credit-default-swap holder to receive payment upon accepting the restructuring agreement. In other words, Congress should permit the parties to adopt the type of contract Hemel advocates for: a deal under which the seller agrees to pay the purchaser the difference between the value of the purchaser's debt/equity holding after a restructuring and the amount the purchaser would have received under the agreement if the underlying debt provider had filed for bankruptcy.

If the parties do craft this type of agreement, credit-default-swap purchasers will protect themselves against the loss associated with accepting the restructuring deal. This is the type of beneficial hedging that we want from credit default swaps, but this type of contract will also protect the companies issuing the underlying debt from unnecessary bankruptcies.¹⁶² In effect, then, this Comment's proposal protects companies, yet it allows credit-default-swap sellers and purchasers to contract in a way that preserves the benefits credit default swaps provide the market.

After Congress adopts this Comment's proposed rule, credit-default-swap purchasers will bargain for the type of contract Hemel proposes to protect themselves. Either way, credit-default-swap sellers are better off. First, they are better off because they can avoid a large payout if the holder forces the underlying company into bankruptcy, assuming the parties do not adopt the type of contract Hemel proposes. Second, even if the parties do adopt the type of contract Hemel proposes, a seller would still be better off because "its

¹⁶² See *supra* Part III.B.

payout” from a restructuring “would be less than its expected loss in the absence of such an exchange.”¹⁶³

Moreover, under this Comment’s rule, credit-default-swap holders will no longer have an economic incentive to refuse to engage in restructurings because they will end up with nothing if they do. Likewise, credit-default-swap purchasers no longer have the incentive under this proposed rule if the parties adopt the contract Hemel proposes because the purchaser is indifferent to the company’s bankruptcy.¹⁶⁴ If the credit-default-swap purchasers documented the contract Hemel proposes, they are not particularly worse off, as their only loss is paying more for the swap than they otherwise would. And this makes sense because they are the parties benefitting from empty creditor syndrome.

Most importantly, the economy at large is better off as it avoids the negative externalities associated with corporate bankruptcy.¹⁶⁵ Some might argue that this could be a bad outcome because companies in this situation might be better off in bankruptcy rather than restructuring. If this were true, then the boards and officers of those companies, in line with their fiduciary duties to shareholders, would be required to file for bankruptcy in the first place. Furthermore, even if the companies do end up filing for bankruptcy later, investors can still fall back on their credit-default-swap agreements to protect them. If, for instance, Investor L’s \$500,000 post-exchange equity stake in Company X becomes worthless a few months later because X still files for bankruptcy, L can look to Insurance Firm Z for that value under their credit-default-swap agreement.

Another concern that might arise from this Comment’s rule, and under the type of contract Hemel proposes more generally, is whether either causes restructurings that would not otherwise occur. This stems from a belief that, because credit-default-swap holders will always either (1) be indifferent to—under a Hemel contract—or (2) prefer to—under this Comment’s proposed rule alone—restructure, even if it does not make economic sense. Under this perspective, if a company offering a restructuring knows that its debtholders have credit-default-swap agreements, it may try to force through a restructuring that is not necessary to prevent bankruptcy, which will

¹⁶³ Hemel, *supra* note 103, at 168.

¹⁶⁴ See *supra* Part III.A.

¹⁶⁵ See Hemel, *supra* note 103, at 164 (“[A]n unnecessary bankruptcy causes deadweight loss on society as a whole.”); see also Yves Smith, *Musings on Credit Default Swaps*, NAKED CAPITALISM (Apr. 28, 2009), <http://www.nakedcapitalism.com/2009/04/musings-on-credit-default-swaps.html> (“[N]egotiations can keep companies out of [bankruptcy], and are also necessary for Chapter 11 to succeed. And if a restructurings fail, more job losses result. This too is a toll on the real economy.”).

naturally harm the credit-default-swap purchasers. Likewise, a credit-default-swap seller would be troubled by this because, under a Hemel contract, it would have to make payment for an unnecessary restructuring.

This concern is overblown, however, because it generally takes more than one debtholder to accomplish a restructuring. For example, in Six Flags' bankruptcy, the company required 95 percent of its bondholders to agree to the debt-for-equity swap.¹⁶⁶ Thus, even if one large bondholder—such as Fidelity in Six Flags' case or Investor L in our ongoing example—approves a restructuring, it will still be contingent upon independent debtholders agreeing to the deal. Presumably, the other debt holders will only accept a restructuring if it is truly in the best interest of the creditors as a whole.¹⁶⁷ In this way, “the interests of the protection seller and those of ‘full creditors’ would be aligned,” meaning that “seller could be (reasonably) confident that the debt exchange would only occur under circumstances that reduced its expected payout.”¹⁶⁸

If this fact does not offer enough security against the inefficient outcome,¹⁶⁹ credit-default-swap sellers can contract around this problem. For example, they could require that a credit-default-swap holder who is approached by an underlying company about a restructuring notify the seller. The seller could then ensure that the holder only accept a restructuring that is necessary by requiring that the holder obtain the seller's approval or even that the holder allow the seller to negotiate the restructuring on its behalf. The holder should not have a problem with this because, under this proposed rule and a contract following Hemel's proposal, he is hedged whether the company takes the restructuring or not. Thus, this Comment's proposed rule would not encourage unnecessary restructurings to the detriment of credit-default-swap sellers.

As this subsection shows, adopting this Comment's rule. Additionally, it avoids the problem that Hemel's proposal suffers from: relying on voluntary compliance by parties that completely misinterpreted the risk these derivatives pose in recent years.¹⁷⁰ And,

¹⁶⁶ Hemel, *supra* note 103, at 159.

¹⁶⁷ It is possible that all of the debtholders will own credit default swaps, which would make this point moot. This does not, however, seem likely, as not all debtholders will be able to afford credit default swaps.

¹⁶⁸ *Id.* at 168.

¹⁶⁹ This also applies if all of the debtholders own credit default swaps, or at least if enough of them to accept the restructuring do.

¹⁷⁰ As noted earlier, “[a]bout 80% of the derivative assets and liabilities carried on the balance sheets of 100 companies reviewed by Fitch were held by five banks: JP Morgan Chase, Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley. Those five banks also

most importantly, it accomplishes the goal this Comment started off with: preventing credit-default-swap holders from pushing companies into premature bankruptcy by refusing to engage in restructuring negotiations.

CONCLUSION

While “[t]he ultimate impact of the Dodd-Frank Bill on the derivatives market will depend in large part on the regulations that the [Commodities Futures Trading Commission] and [Securities Exchange Commission] promulgate,”¹⁷¹ Congress’s decision not to address the risk that credit-default-swap owners might have an incentive to encourage, or force, companies into bankruptcy was a mistake. Because we can “no longer . . . rel[y] on” the “assumption . . . that creditors generally want to keep a solvent firm out of bankruptcy,”¹⁷² Congress’s error leaves the regulation of credit default swaps lacking. As Congress considers ways to increase the efficacy of Dodd-Frank, it should recognize that an adjustment to the regulation of the credit-default-swap market to include a protection against empty creditor syndrome would be valuable for our economy. Adopting this Comment’s rule would be a wise start.

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account for more than 96% of the companies’ exposure to credit derivatives.” Katz, *supra* note 74. Under the Troubled Asset Relief Program, the federal government provided each of these financial institutions with “bailout” funds. Matthew Ericson, Elaine He, & Amy Schoenfeld, *Tracking the \$700 Billion Bailout*, N.Y. TIMES BUSINESS (last visited Mar. 3, 2012, 10:38 PM), http://www.nytimes.com/packages/html/national/200904_CREDITCRISIS/recipients.html.

¹⁷¹ See Hui & Kuan, *supra* note 76, at 6.

¹⁷² *The Role of Credit Derivatives in the U.S. Economy: Hearing Before the House Comm. on Agriculture*, 110th Cong. 46 (Oct. 15, 2008) (statement of Henry T. C. Hu: “Credit Default Swaps and the Financial Crisis: ‘Interconnectedness’ and Beyond”); see also Daniel Gross, *The Scary Rise of the “Empty Creditor”*, SLATE (Apr. 21, 2009, 3:01 PM), http://www.slate.com/articles/business/moneybox/2009/04/the_scary_rise_of_the_empty_creditor.html (“[I]f a lender or creditor believes it can profit more from a complete failure—i.e., if it has an insurance policy that pays off only in the event of utter devastation—that creditor might be more inclined to push a company toward bankruptcy. And thanks to the financial innovations of recent years—the rampant use of hedging and credit-default swaps, the ability of investors to purchase insurance on debt—that’s exactly what seems to be happening. Creditors are acting to protect their economic self-interest by encouraging companies to destroy themselves.”).

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