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Mark Swantek

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A BRAVE NEW WORLD: CREDIT DEFAULT SWAPS AND “VOLUNTARY” DEBT EXCHANGES

MARK A. SWANTEK*

“[T]he over-the-counter derivatives market is the San Andreas Fault of our financial system. The interconnection of the so-called ‘too-big-to-fail’ firms and the OTC derivatives are a cocktail that may force the taxpayer to drink from disaster again in the future.”¹

I. INTRODUCTION

A financial crisis struck America in 2008,² which became the first truly global economic disaster.³ The downward spiral started with the bursting of a housing bubble in the United States, but has directly affected every economy.⁴ Some of America’s largest

* Mark A. Swantek is a January 2013 graduate of The John Marshall Law School. He would like to give special thanks to Professor Karen Halverson-Cross for her help in selecting a topic as well as all of her guidance throughout law school. Mark would also like to thank his mother, Kathleen Swantek, for her endless and selfless support. He can be reached at mark.swantek@gmail.com.

1. *Credit Default Swaps on Gov’t Debt: Potential Implications of the Greek Debt Crisis Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov’t Sponsored Enterprises of the H. Comm. on Fin. Servs.* 111 Cong. 10 (2010) (statement of Robert Johnson, Dir. of Global Fin., Roosevelt Inst.).

2. See generally *The Financial Crisis: A Timeline of Events and Policy Actions*, FED. RES. BANK OF ST. LOUIS <http://timeline.stlouisfed.org/pdf/CrisisTimeline.pdf> [hereinafter *Fed. Timeline*] (providing an overview of the subprime mortgage financial crisis).

3. Saule T. Omarova, *The New Crisis for the New Century: Some Observations on the “Big-Picture” Lessons of the Global Financial Crisis of 2008*, 13 N.C. BANKING INST. 157, 158 (2009).

4. *Id.* Professor Omarova explains that:

The industrialized countries, including the United States, the European Union, and Japan, have suffered the bulk of the direct losses from the rapid decline in the value of mortgage-backed and other asset-backed securities, excessive leveraging of financial investments, and failure or near-failure of the world’s largest financial institutions. China, Russia, Brazil, and other emerging market economies suffered the secondary effects of the stock market decline and credit shock in the industrialized world, as the demand for their exports contracted severely and foreign investors withdrew massive amounts of capital.

Id. For further discussion on the global effects of the 2008 financial crisis, see

and most iconic businesses came to the brink of collapse or indeed failed.⁵ Credit default swaps (“CDS” or “CDSs”) played some role in the collapse of AIG and Lehman Brothers, and critics heavily scrutinized their use of these financial instruments, bringing them to the national spotlight.⁶

The effects of the crisis have caused the world economy to stall.⁷ Specifically, Greece is riddled with debt that has sent—and continues to send—waves of uncertainty through global markets.⁸ European sovereign debt creates a new forum to discuss and analyze CDS use and the interpretation of their terms.

The first part of this Comment introduces the basics of the international financial regulatory regimes that gave birth to credit derivatives. It then outlines the mechanics of CDS use and surveys the Greek sovereign debt crisis. The second part looks at the legal application of CDS contracts, specifically a recent shift to a strict and narrow interpretation of the terms. Then, this Comment proposes that this shift is overly restrictive and detracts from a fundamental use of CDSs. The “brave new world” of a debt stricken Europe and a fear of derivatives should not abrogate the utility of CDSs.⁹

generally DICK K. NANTO ET AL., THE U.S. FINANCIAL CRISIS: THE GLOBAL DIMENSION WITH IMPLICATIONS FOR U.S. POLICY, (Congressional Research Service ed., Nov. 10, 2008), available at <http://fpc.state.gov/documents/organization/115947.pdf>.

5. Press Release, Board of Governors of the Federal Reserve System, (Mar. 14, 2008) <http://www.federalreserve.gov/newsevents/press/monetary/20080314a.htm>; see also *Fed. Timeline*, *supra* note 2, at 4 (explaining that J.P. Morgan Chase & Co. purchased Bear Sterns Cos. with financing provided by the Federal Reserve Bank of New York). Bank of America Corp. bought Merrill Lynch & Co. (without government assistance). *Id.* at 7. Lehman Brothers Holdings, Inc. filed for Chapter 11 bankruptcy protection. *Id.* The US government purchased a significant equity stake in American International Group Inc. (“AIG”) to prevent its collapse. *Id.* at 8, 10, 12, 20.

6. Rene M. Stulz, *Credit Default Swaps and the Credit Crisis*, 24 J. ECON. PERSPECTIVES 1, 73-92 (2010).

7. See *Timeline: Euro Zone Debt Crisis*, REUTERS (Jun 10, 2010, 10:24 AM), <http://www.reuters.com/article/2010/06/10/us-eurozone-events-idUSTRE6593G320100610> (charting various noteworthy events of the extended economic crisis).

8. *Id.*; see also discussion *infra* Part 0 (summarizing some of Greece’s sovereign debt issues and the attempts at curing the crisis).

9. ALDOUS HUXLEY, BRAVE NEW WORLD (1932). This is a dystopian novel that portrays a one-state futuristic world that is highly mechanized. The title is ironic as the civilization in the book is shocking and undesirable. The novel is seen as a foreboding critique of the industrial revolution and over-mechanization of society. The characters living in this twisted world think it is a utopia; however, the reader, as an outsider, sees the true pitfalls.

II. BACKGROUND

This section introduces CDSs from a historical and mechanical perspective, then gives an overview of the devolution of the Greek economy and the role of CDSs in bailout negotiations.

A. *Basel and the Birth of Credit Derivatives*

In their simplest form, banks are in the business of lending and borrowing money, incurring losses when a borrower defaults.¹⁰ To ensure that a wave of unexpected losses does not put a bank into bankruptcy, a bank must ensure it has reserves to cover unexpected losses.¹¹ Reserve capital, as it is known, promotes bank stability, but also decreases funds available for investment, thereby lowering banks' ability to profit.¹²

In 1976, the Bank for International Settlements organized a standing committee of the central bank governors of the G-10 countries.¹³ This committee sought to facilitate cooperation between major economies in forming fundamental banking standards.¹⁴ In late 1987, the committee agreed upon a "capital measurement" system known as the Basel Capital Accord ("Basel Accords").¹⁵ This system created a method for assessing the adequacy of capital with specific regard to credit risk.¹⁶ In short, the Basel Accords mandated that banks maintain a capital reserve

10. Sandra Rutova & Tim Volkheimer, *Revisiting the Basel Accords: Lessons Learned from the Credit Crisis*, 19 U. MIAMI BUS. L. REV. 83, 84 (2011).

11. *Id.*

12. *Id.* at 84-85.

13. See *History of the Basel Committee and Its Membership*, BASEL COMMITTEE ON BANKING SUPERVISION (Aug. 2009), <http://www.bis.org/bcbs/history.pdf> [hereinafter *History of Basel*] (outlining the history of the Basel regulatory regime). Members of the Group of Ten (G-10) include Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. *Members and Partners*, OECD, <http://www.oecd.org/about/membersandpartners> (last visited Aug. 29, 2012).

14. *History of Basel*, *supra* note 13, at 1.

15. *International Convergence of Capital Measurement and Capital Standards*, BASLE COMMITTEE ON BANKING SUPERVISION (July 1988), available at <http://www.bis.org/publ/bcbs04a.pdf> [hereinafter *Basel I*] (both "Basel" and "Basle" are appropriate spellings); see also HAL S. SCOTT, *INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION* 414 (17th ed. 2010) (explaining the Basel agreements and the implications on financial institutions).

16. See Rutova & Volkheimer, *supra* note 10, at 85-86 (noting that the aim of the regulation was to "strengthen the stability of the international banking system and to remove competitive advantages among banks").

equaling at least eight percent of its risk-weighted assets.¹⁷

Capital is a term of art has no uniform definition. The United States requires at least half of a bank's mandatory capital be equity.¹⁸ This mandate caused banks and bank holding companies to create hybrid instruments that are sufficiently similar to equity to qualify as Tier I capital.¹⁹ Tier II capital is more residual.²⁰

A fundamental aspect of the Basel Accords, *inter alia*, was the imposition of risk-weighting.²¹ The purpose is that assets with lower credit-risk will require less capital to be held in reserve.²² Banks, then, will multiply the face dollar amount of an asset by the appropriate risk-weight percentage to determine how much reserve capital is required.²³ The US rules set out four categories of assets and assign a percentage to each.²⁴ Category 1, the zero

17. *Basel I*, *supra* note 15, at 14. This requirement came into effect in 1992. *Id.*

18. *See Federal Reserve System, Capital Adequacy Guidelines for State Member Banks, Risk-Based Measure*, 12 C.F.R. § 208, App. A, II.-III. (2007) (stating that in the US, "qualifying capital" is divided into two "tiers" and charting out the different risk weights assigned to various assets). The first tier consists of common shareholders' equity (cash), which must make up at least half of the firm's capital (four percent of weighted-risk assets); and other low-risk, high-liquidity assets. *Id.* at II.A.1. Tier II consists of supplementary capital, which is less liquid and more speculative. *Id.* at II.A.2.

19. *See* SCOTT, *supra* note 15, at 418-19 (identifying that banks search for hybrid instruments and noting that there can be hotly contested debates as to which tier to classify certain instruments).

20. *Id.* Tier II capital includes including loan loss reserves and a capped amount of unrealized appreciation of certain equities and real estate. *Id.* at 418. For the official American capital guidelines, see 12 C.F.R. § 225, App. A (2007). Also, loan loss reserves are held to cover future unknown losses and not present losses. *Allowances for Loan and Lease Losses: Hearing Before the Subcomm. on Fin. Inst. and Consumer Credit of the H. Comm. on Banking and Fin. Serv.* 106 Cong. 1 (1999) (statement of Donna Tanoue, Chairman, FDIC), available at <http://archives.financialservices.house.gov/banking/61699tan.shtml>. It is added to a bank's portfolio when it becomes probable that a loan or group of loans will not be fully collected and the amount can be estimated. *Id.* Then, the institution is required to establish a reserve account and recognize a loss against current earnings. *Id.* This represents credit losses inherent in an institution's loan portfolio given the facts and circumstances as of the evaluation date.

21. *See* Rutova & Volkheimer, *supra* note 10, at 85-86 (noting that one of three "pillars" of the Accord was risk-weighting). The other two pillars are constituents of capital and a target standard ratio. *Id.*

22. *Id.* For example, the goal of the US codification of the Basel accords is to make regulatory capital requirements more sensitive to differences in risk profiles among banks. 12 C.F.R. § 208, app. A (2011).

23. *See* Rutova & Volkheimer, *supra* note 10, at 86-87; *see also* ANTULIO N. BOMFIM, UNDERSTANDING CREDIT DERIVATIVES AND RELATED INSTRUMENTS 32 (2005) (giving the formula: regulatory capital charge = $r \times .08 \times$ notional exposure).

24. *See generally* SCOTT, *supra* note 15, at 421-23 (outlining that the four percentages are zero, twenty, fifty, and one hundred percent).

percent class—meaning no capital requirement—consists of the safest devices such as cash, US Treasury bonds, and gold bullion.²⁵ On the other hand, the one-hundred percent class will require eight percent capital to offset credit risk.²⁶ Category 3 assets carry a fifty percent weight.²⁷ These assets include fully secured residential loans and revenue bonds from OECD governments.²⁸

The Basel Accord became final in 1992,²⁹ and the effects varied.³⁰ As the imposition of a reserve capital requirement effectively made certain types of behavior more expensive, the eight percent capital reserve requirement is a restriction.³¹ An obvious method to circumvent this and to free up more capital for investment (and profit) was to use certain risk-weighted assets to avoid the eight percent requirement.³² As mentioned above, banks could cut the capital requirement in half by putting residential mortgages and sovereign debt instruments on their books.³³

This paradigm gave birth to the use of credit derivatives.³⁴

25. 12 C.F.R. § 208, App. A; SCOTT, *supra* note 15, at 421.

26. SCOTT, *supra* note 15, at 422. These are the “riskiest” loans. Examples of these assets are private loans, long-term claims on non-OECD foreign banks, claims on non-OECD governments, and real estate and physical capital (plants and equipment, to name a few). *Id.* at 423.

27. *Id.* at 422.

28. *Id.* Its members include Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. *Id.* It is also worth noting that fully secured commercial loans carry a one hundred percent risk-weight, whereas residential loans carry a fifty percent risk-weight. *Id.*

29. *Id.* at 426.

30. *See id.* at 424 (noting the lots of money went into US government debt rather than private loans, effectively amounting to a credit crunch); Paul Atkinson, *The Basel Capital Adequacy Framework Should Be Reconsidered*, GROUPE D’ECONOMIE MONDIALE POLICY BRIEF 14 (October 2008), available at http://gem.sciences-po.fr/content/publications/pdf/Atkinson_BaselIII17112008.pdf (stating “it is obvious that two decades of practice have not matched the promise” of a sound and stable banking system).

31. *See* BOMFIM, *supra* note 23, at 33 (noting that “[h]olding too much capital in reserve is expensive—the bank would have to forego the income that the held capital could generate, for instance, if it were lent to prospective borrowers”).

32. *See id.* (stating “banks have taken measures to reduce their regulatory capital requirements while staying within the limits prescribed by bank regulators”).

33. *See* 12 C.F.R. § 208, App. A (specifying the risk-weights); *see also* BOMFIM, *supra* note 23, at 31-33 (outlining the various economic effects of the Basel Accord).

34. *See* Michael Phillips, *The Monster that Ate Wall Street*, NEWSWEEK (Sept. 26, 2008 8:00 PM), <http://www.thedailybeast.com/newsweek/2008/09/26/the-monster-that-ate-wall-street.html> (tracing the origins of CDSs).

A credit derivative is a financial contract whose value is derived from the value of debt obligations issued by one or more reference entities.³⁵ The “regulatory changes . . . spurred the development of tools for a more active management of risk and capital.”³⁶ Credit derivatives allowed a bank to isolate credit risk, protect against it, and reduce its “regulatory capital charge.”³⁷ These instruments exploded onto the financial scene, with gross notional amounts (or total debt insured) growing from below \$2 trillion in 2002 to nearly \$60 trillion in 2007.³⁸ Credit derivatives function to “help bring [banks’] regulatory capital requirements closer in line with their economic capital.”³⁹ This method of “regulatory capital management,” born by the Basel Accords, “played a significant role in the evolution of the credit derivatives market.”⁴⁰

B. Credit Default Swaps

A CDS is the predominant type of credit derivative.⁴¹ The metaphor most often used to describe a CDS is an insurance policy.⁴² One important difference, though, is that neither party to a CDS contract needs to own the referenced underlying entity, have an insurable interest, or suffer any loss.⁴³ These are called “naked” swaps.⁴⁴ CDSs, in financial jargon, are “financial

35. *Over-the-Counter Derivatives Before the Subcomm. on Securities, Insurance, and Investment, Comm. on Banking, Housing, and Urban Affairs, Board of Governors of the Federal Reserve System* (testimony of Patrick M. Parkinson, Dep. Dir., Div. Research and Statistics) (July 9, 2008), available at <http://www.federalreserve.gov/newsevents/testimony/parkinson20080709a.htm>. [hereinafter *Testimony of Patrick M. Parkinson*].

36. Christian Weistroffer, *Credit Default Swaps: Heading Towards a More Stable System*, DEUTSCHE BANK RESEARCH: CURRENT ISSUES, 5 (Dec. 21, 2009), available at http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD000000000252032.PDF.

37. See BOMFIM, *supra* note 23, at 34 (explaining that after buying protection for credit risk, the only remaining risk was that of the counterpart risk of the protection seller).

38. Weistroffer, *supra* note 36, at 1.

39. BOMFIM, *supra* note 23, at 5. The idea of “economic capital” is what a “prudent bank would want to hold in reserve given its overall credit risk exposure.” *Id.* at 33.

40. *Id.* at 34.

41. *Testimony of Patrick M. Parkinson, supra* note 35.

42. See LAURENT L. JACQUE, GLOBAL DERIVATIVE DEBACLES: FROM THEORY TO MALPRACTICE 279 (2010) (stating that “even though there may be some debate as to whether CDS are more akin to financial [instruments] than insurance products, it remains the CDS are closely related to traditional insurance products”).

43. See Weistroffer, *supra* note 36, at 4 (observing that underlying entities, for CDS purposes, are almost always corporate or sovereign borrowers).

44. See SCOTT, *supra* note 15, at 852 (addressing the various strategies a party may institute by assuming credit risk on assets without acquiring them).

instruments to hedge and trade credit risk.”⁴⁵ Legally, a CDS is a contract that guarantees payment if a “credit event” occurs in exchange for a premium payment.⁴⁶ The definition of a credit event, then, is critical to the contract.⁴⁷

1. *The Mechanics of Credit Default Swaps*

There are two sides to a CDS contract: the protection buyer and protection seller.⁴⁸ The protection buyer, who does not need to own the reference entity, makes regular payments to the protection seller.⁴⁹ This is the CDS premium.⁵⁰ In turn, the protection seller guarantees to “settle the contract,” or pay the protection buyer its incurred loss.⁵¹ Enumerated “credit events”

45. Weistroffer, *supra* note 36, at 3.

46. *See id.* at 4 (offering that payments are typically annual).

47. *Id.*

48. *Id.*

49. *Id.* 2008 market-share estimations show that 33% of protection sellers are banks in trading activities, 31% were hedge funds, 18% were monoline and other insurers, and 7% were banks in loan portfolio activities. *Id.* For protection buyers, 36% were banks in trading activities, 28% were hedge funds, 18% were banks in loan portfolio activities, and 6% were monoline and other insurers. *Id.* This data shows that the main CDS market participants are traders and hedge funds, with only a small portion going towards loan portfolios. *Id.* at 6, Figure 2, 3.

50. *Id.* at 4. The research states:

The CDS premium is calculated to cover the expected loss of the reference entity. There are two main parameters that determine the expected loss and hence the CDS premium: (i) The probability of default (PD), and (ii) the recovery rate (RR):

$$\text{CDS Premium} = \text{PD} * (1 - \text{RR})$$

Assuming a recover rate of zero, a 1% default probability translates into a 100 basis points annual premium. Although the premium is calculated on an annual basis, it is usually paid in quarterly terms. Thus, a protection buyer of a CDS contract with notional value of USD 10m (and an agreed premium of 100 basis points) has to pay a quarterly amount of USD 25,000 to insure against default of the reference entity.

Id.

51. *Id.* at 4. This is generally the difference between the face value of the underlying security and the amount that can be recovered from the underlying reference borrower (e.g., government that issued bond). *Id.* Settlement of a CDS contract occurs at the end of its life span when a credit event has triggered compensation payment. *Id.* Protection buyer and seller usually agree on a method of settlement up-front. *Id.* Physical settlement involves the protection buyer delivering the underlying bond in exchange for compensation. *Id.* Cash settlement obligates the protection seller to pay the buyer the difference between the bond value at the time of settlement and the bond's nominal value in cash. *Id.* An interesting hypothetical is if a naked protection buyer, i.e., one that does not own the underlying entity, sustains a credit event and the contract calls for physical delivery. *Id.* Theoretically, the protection buyer must then go purchase the underlying entity in the open market. This could potentially cause a run on certain bonds even though the borrower is somehow in default. *Id.*

relating to the underlying reference entity condition this obligation.⁵²

CDS contracts are “over-the-counter” (“OTC”) derivatives, meaning they are not bought and sold on regulated exchanges;⁵³ rather, they are private contracts between private parties.⁵⁴ Therefore, the parties must negotiate and agree upon their own terms.⁵⁵

The general provisions of these contracts have been standardized by the International Swaps and Derivatives Association (“ISDA”), a global financial trade association.⁵⁶

52. See JOÃO GARCIA & SERGE GOOSSENS, *THE ART OF CREDIT DERIVATIVES: DEMYSTIFYING THE BLACK SWAN* 22 (2010) (observing that an “important legal issue on a CDS contract is the precise definition of what is considered a *credit event*”) (emphasis in original).

53. See Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167, 172 (2011) (explaining that CDS and OTC transactions lack the formality of exchanges and that regulations might not require participants to register or record their transaction). Sometimes, this lack of formality is criticized as muddying the transactions as one cannot understand the counterparty risk at bar. *Id.* “Regulation of the OTC derivatives markets is often piecemeal and performed by the individual regulators of the parties, e.g. bank or securities firm regulators.” PAUL C. HARDING, *MASTERING THE ISDA MASTER AGREEMENT: A PRACTICAL GUIDE FOR NEGOTIATION* 3 (2002).

54. See Johnson, *supra* note 53, at 172 (noting that some commentators have described the OTC market as part of a “shadow banking system”); see generally Jerome A. Madden, *A Weapon of Mass Destruction Strikes: Credit Default Swaps Bring Down AIG and Lehman Brothers*, 5 BUS. L. BRIEF (AM. U.) 15, 16-18 (2008) (asserting that “the unregulated and opaque CDS market helped to fuel a ‘death spiral’ for these firms that, ironically, got into financial difficulty to begin with by improvidently entering into a large number of CDS contracts as an insufficiently capitalized insurer”). This has been the focus of much scrutiny in the wake of the 2008 subprime mortgage crash and the ensuing financial crisis. *Id.* Critics point to this lack of transparency as the cause of the systemic effects of the subprime crisis. *Id.* Lehman Bros. and AIG were protection sellers on many mortgage-backed securities. *Id.* When the real estate bubble burst, many of those obligations became due and those firms suffered staggering losses. Lehman Bros. also invested heavily in real estate, so this created a deadly couplet. *Id.* AIG sold protection to just about everyone. *Id.* As the bubble burst, many counter-parties to AIG’s various insurance products worried about AIG’s ability to pay its obligations, so they demanded AIG post more collateral. *Id.* Both of these firms over-leveraged their own bets, but this was masked by the private nature of OTC derivatives. *Id.* Following this theme, speculators were able to buy up CDS against Bear Stearns, Lehman, and AIG, betting that they would default on their obligations. *Id.* This created a downward pressure in the market. *Id.* Investors also began shorting their stocks, and then, to be colloquial, the rest is history. *Id.*

55. See HARDING, *supra* note 53, at 15 (introducing the basics of the ISDA documentation process). This is a complex process involving complicated negotiations regarding credit, legal, and tax issues. *Id.*

56. *About ISDA*, ISDA <http://www2.isda.org/about-isda/> (last visited Aug. 30, 2012).

Founded in 1985, ISDA focuses on making OTC derivatives markets safe and efficient.⁵⁷ It is comprised of over eight hundred members and works to enhance international derivatives use.⁵⁸ ISDA has a “Master Agreement” that serves as a standard form contract for CDSs.⁵⁹ The goal was to avoid disputes as to whether a credit event had actually occurred or how a contract should be settled.⁶⁰ ISDA works towards “the development and maintenance of a wide range of standard derivatives documentation, which facilitates the efficient documentation of transactions and promotes sound business practices.”⁶¹

Specifically with regard to credit derivatives, ISDA primarily works in documentation, public policy, market structure, market practices, and research.⁶² It has certain “Credit Derivatives Determinations Committees” (hereinafter known as “Determinations Committees” or “Committees”) in a variety of global marketplaces.⁶³ These Committees deliberate on issues involving the reference entity under the CDS contract and issues binding decisions.⁶⁴ ISDA only acts as a non-voting secretary to each Committee.⁶⁵ These Committees can resolve a credit event dispute where one party believes a credit event has occurred and the other does not.⁶⁶

57. *Id.*

58. *Id.* ISDA’s goals are to reduce counterparty credit risk, increase transparency, and improve the industry’s operational infrastructure. *Id.*

59. *See generally* HARDING, *supra* note 53, at 19 (noting that ISDA began to standardize market practice and documentation).

60. *See* Weistroffer, *supra* note 36, at 20.

61. *Recent Documents*, ISDA, <http://www2.isda.org/functional-areas/legal-and-documentation/recent-documents/> (last visited Aug. 30, 2012).

62. *Credit Derivatives/Credit Default Swaps*, ISDA, <http://www2.isda.org/asset-classes/credit-derivatives/> (last visited Aug. 30, 2012).

63. *About the Credit Determinations Committee*, ISDA, <http://www.isda.org/credit/> (last visited Aug. 30, 2012). The Determinations Committees operate according to a rather thorough set of rules. *Credit Derivatives Determinations Committee Rules*, ISDA, <http://www.isda.org/credit/revisedrules.html> (last visited Aug. 30, 2012). A Determinations Committee exists in the Americas, Asia (excluding Japan), Australia-New Zealand, Europe, and Japan. *About the Credit Determinations Committee*, ISDA <http://dc.isda.org/about-dc-committees/> (last visited Aug. 30, 2012).

64. *About the Credit Determinations Committee*, ISDA <http://dc.isda.org/about-dc-committees/> (last visited Aug. 30, 2012).

65. *Id.*

66. Credit Derivatives Determinations Committee Rules (July 11, 2011 Version) Rule 3.1(b), *available at* [http://www.isda.org/credit/docs/DC_Rules_\(July-11_2011\).pdf](http://www.isda.org/credit/docs/DC_Rules_(July-11_2011).pdf).

2. *The Gains from Trade of Credit Default Swaps*

CDSs have valuable roles in financial markets.⁶⁷ Broadly, they are risk management tools, trading instruments, and economic indicators.

a. Use in Business: Risk Management and Hedging

A hedge is the “use of two compensating or offsetting transactions to ensure a position of break even.”⁶⁸ CDSs are a complement to traditional hedging methods.⁶⁹ Rather than adjust the underlying loan portfolio, a protection buyer can manage its risk exposure with an arm’s length transaction.⁷⁰ Mechanically, a CDS allows a party to offset its exposure to the risk of loss that comes with lending agreements or debt securities.⁷¹ Reducing risk has two major benefits: first, it lessens the susceptibility to economic loss;⁷² second, the protection buyer may have more free capital to invest.⁷³ A CDS isolates the credit risk from an underlying bond and transfers it to another entity.⁷⁴ Moreover, banks that hold assets not easily bought and/or sold can protect against credit loss even though it cannot transfer the assets

67. See generally BOMFIM, *supra* note 23, at 70-72 (explaining the various functional utilities of CDSs).

68. BLACK’S LAW DICTIONARY 791 (9th ed. 2009). The definition further states that the purpose of a hedge is “to make advance arrangements to safeguard oneself from loss on an investment, speculation, or bet, as when a buyer of commodities insures against unfavorable price changes by buying in advance at a fixed rate for later delivery.” *Id.*

69. Weistroffer, *supra* note 36, at 8; see also Johnson, *supra* note 53, at 199 (adding that this is the most frequently cited benefit of CDSs).

70. See Weistroffer, *supra* note 36, at 8 (explaining that this is also helpful because it will avoid potentially offending a customer by questioning its creditworthiness).

71. See Johnson, *supra* note 53, at 199-200 (relating the use of CDSs in debt markets to traditional hedging methods from equity markets and suggesting that a CDS is “an instrument that completes credit markets because the instruments allow market participants to offset exposure to risk of loss”).

72. See *id.* (describing that CDS agreements offset the monetary risk a lender faces). For example, if a pension fund manager

agrees to lend fifty million dollars to an orange grove, she hopes that there will be great harvests each year that loan remains outstanding. If the pension fund manager enters into a [CDS] with a credible counterparty to cover 10 percent of the investment risk exposure, the pension fund manager offers five million dollars of her exposure to the risk that the orange grove may fail to repay its obligations.

Id. at 200.

73. See Weistroffer, *supra* note 36, at 8 (stating that with CDS protection, less capital will be committed to the loan).

74. MOORAD CHOUDHRY, THE CREDIT DEFAULT SWAP BASIS 3 (2006). This makes it possible to separate the ownership and management of credit risk from the other features of ownership associated with that bond. *Id.*

themselves.⁷⁵ A CDS is practically used to transfer credit risk exposure to another party.⁷⁶

b. Use as a Trading Instrument

Recall that a protection buyer does not need to be exposed to the underlying risk.⁷⁷ In this sense, CDSs turn credit into an asset.⁷⁸ They attempt to isolate only the credit quality of the reference entity.⁷⁹ One who buys protection can sell it for a profit if there is a credit event or if it appears one is on the horizon.⁸⁰ Trading CDSs, then, is thought to increase liquidity by improving the chances of protection buyers or sellers finding a contract partner and enhancing pricing efficiency.⁸¹

c. Use as an Economic Indicator

The bond market is often looked at as a macroeconomic indicator.⁸² However, this is influenced by many other factors besides credit risk, notably interest rate risk and liquidity risk.⁸³ As noted above, CDSs allow credit risk to be isolated.⁸⁴ This isolation from other risk factors makes CDS spreads (the premium payment for default protection) a better indicator of market distress.⁸⁵ Furthermore, it may also digest market information more quickly than prices in other markets.⁸⁶ CDS spreads serve as an important source of information for private banks, central banks, supervisors, and international organizations because they effectively put a price on credit as an asset.⁸⁷

75. *Id.*

76. *Id.* at 9

77. *See* Weistroffer, *supra* note 36, at 8.

78. CHOUDHRY, *supra* note 74, at 3.

79. *See* BOMFIM, *supra* note 23, at 5 (stating “[c]redit derivatives potentially give market participants the ability to trade risks that were previously virtually untradeable because of poor liquidity”).

80. *Id.* at 9-10.

81. *See* Weistroffer, *supra* note 36, at 9 (offering the two-sided argument that trading improved the chances of buyers and sellers finding a contract party, but excessive trading may distort the pricing mechanism).

82. *See* BOMFIM, *supra* note 23, at 39-40 (2005) (noting that the price of credit derivatives reflects market sentiments).

83. *See* Weistroffer, *supra* note 36, at 9 (adding that bond spreads and CDS spreads are complementary as they synthesize similar information, albeit differently). CDS spreads tend to be more of a leading market indicator. *Id.*

84. *Id.* This is extremely valuable because isolating credit risk eliminates all other factors to give a more accurate analysis. *Id.*

85. *Id.*

86. *See* BOMFIM, *supra* note 23, at 40 (explaining that it is easier to enter into swap agreements than buy or sell certain instruments and therefore the swap markets reflect market information that may otherwise be hidden).

87. Weistroffer, *supra* note 36, at 9.

C. Big Bang of “The Brave New World”

The European Union became riddled with sovereign debt issues in the post-financial crisis world, many of these issues stemming from a Grecian crisis.⁸⁸ In the fall of 2009, the newly elected Greek government discovered a budget deficit that was twice what the exiting administration had disclosed.⁸⁹ Reacting to this disclosure and the government’s “crumbling finances,” the three major credit rating agencies downgraded their Greek debt ratings.⁹⁰ The Greek government, facing international political pressure and an uneasy bond market, passed wildly unpopular austerity measures.⁹¹ Greece then had the full attention of the bond markets and investors began to analyze every move, even focusing their attention on other indebted European economies to start what was a wild summer of 2010.⁹² Bond yields grew and the price to insure Greek debt reached record highs.⁹³ The interplay between the bond market and the CDS market continued to drive bond yields upward to nearly nine percent, leading the prime minister to describe his economy as “a sinking ship” and formally requested an international bailout.⁹⁴ Eventually, Greece received nearly \$1 trillion in emergency funding.⁹⁵ The turbulence did not subside, however, as the bond markets continued to puppeteer contentious political posturing and unleashed violent internal

88. Jan Ambrose & Joshua Buch, *The Greek and Irish near Sovereign Defaults: Similarities and Differences*, 40 No. 2 REAL ESTATE REV. J. ART 2 (2011) (stating that Greece, Ireland, Italy, Portugal, and Spain are all riddled with debt and are in bad economic shape).

89. Tayyab Mahmud, *Is It Greek or Déjà Vu All over Again?: Neoliberalism and Winners and Losers of International Debt Crises*, 42 LOY. U. CHI. L. J. 629, 639 (2011); *Timeline: Euro Zone Debt Crisis*, *supra* note 7.

90. Mahmud, *supra* note 89, at 639; David Jolly, *Moody’s Joins Others in Cutting Debt Rating on Greece*, N.Y. TIMES (Dec. 22, 2009), <http://www.nytimes.com/2009/12/23/business/global/23drachma.html>.

91. Mahmud, *supra* note 89, at 640-41; *Greek Parliament Passes New Austerity Budget*, BBC NEWS (Dec. 6, 2011, 6:49 PM), <http://www.bbc.co.uk/news/business-16062878>.

92. Mahmud, *supra* note 89, at 640; Landon Thomas Jr., *Under Siege in Europe*, N.Y. TIMES (Feb. 5, 2010), <http://www.nytimes.com/2010/02/06/business/global/08euro.html?pagewanted=all>.

93. *See id.* (calling speculators “bond vigilantes,” suggesting that these investors perpetuated unreasonable expectations to reform domestic policies, and commenting that demanding high interest rates on Greek bonds exacerbated the problem).

94. Mahmud, *supra* note 89, at 648; Niki Kitsantonis & Matthew Saltmarsh, *Greece, Out of Ideas, Requests Global Aid*, N.Y. TIMES (Apr. 23, 2010), <http://www.nytimes.com/2010/04/24/business/global/24drachma.html> (adding that investors “shunned the country’s bond offerings because of concern about its runaway debt”).

95. David Muir, *Markets Rebound After Europe’s Leaders Bail Out Greece*, ABC WORLD NEWS (May 10, 2010), <http://abcnews.go.com/WN/markets-rebound-european-leaders-bail-greece/story?id=10608764>.

opposition to the policies in Greece.⁹⁶

Moody's downgraded Greek debt to a "junk bond" in June 2010.⁹⁷ In January 2011, three major ratings agencies demoted Greek debt to "junk" status, and by June 2011, Moody's had moved Greece's credit rating even deeper into "junk" territory.⁹⁸ By June 13, 2011, Standard & Poor's downgraded Greek debt to the lowest credit rating in the world.⁹⁹ During this time span, more austerity measures went into place as the Greek populous continued to organize vehement opposition.¹⁰⁰

On July 21, 2011, European leaders agreed to a second Greek bailout package.¹⁰¹ The terms of this package marked a significant shift in sovereign debt policy.¹⁰² Traditionally, taxpayers paid for the entire bailout while investors in debt were largely made whole.¹⁰³ This time around, the terms of the rescue package included a contribution from private sector bondholders wherein they exchanged their bonds for ones with later maturation dates.¹⁰⁴

96. Matthew Saltmarsh, *Default Fears Return to European Debt*, N.Y. TIMES (Aug. 26, 2010), <http://query.nytimes.com/gst/fullpage.html?res=9503BEDC173BF935A1575BC0A9669D8B63>.

97. *Moody's Cuts Greek Rating to Junk*, REUTERS (June 14, 2010), <http://www.reuters.com/article/2010/06/14/us-greece-junkratings-moodys-idUSTRE65D46W20100614>. Interestingly enough, this downgrade did not affect the CDS market for Greek debt. *Id.* A senior currency analyst at BNP Paribas said "[w]e've been trading with this for a long time now and just the fact that the agencies finally recognize reality doesn't have too much impact." *Id.*

98. *TIMELINE-Greece's Debt Crisis*, REUTERS (Sept. 28, 2011), <http://www.reuters.com/article/2011/09/28/greece-economy-events-idUSL5E7KR2D120110928>.

99. *Id.*

100. *Id.*

101. Luke Baker & Julien Toyer, *Europe Agrees Sweeping New Action on Debt Crisis*, REUTERS (July 21, 2011), <http://www.reuters.com/article/2011/07/21/us-eurozone-idUSTRE76I5X620110721>.

102. Mahmud, *supra* note 89, at 650; Andrew E. Kramer, *The Euro in 2010 Feels Like the Ruble in 1998*, N.Y. TIMES (May 12, 2010), <http://www.nytimes.com/2010/05/12/business/global/12iht-ruble.html?dbk> (explaining that the first Greek bailout package paralleled similar efforts to bail out Russia in that the sovereign took on large loans in order to repay its obligations to investors).

103. *Id.*

104. Stephen Castle & Niki Kitsantonis, *Markets Lend Their Support to Rescue Plan*, N.Y. TIMES (July 22, 2011), <http://www.nytimes.com/2011/07/23/business/global/Reactions-to-the-Greece-Bailout-Plan.html>. The plan suggested that:

Banks and insurers will voluntarily swap their Greek bonds for longer maturities at lower interest rates to help Athens. Acknowledging that the swap scheme may lead to Greece being declared in selective default, Sarkozy said euro zone nations stood ready to protect Greek banks from the fallout, by providing credit guarantees if needed to ensure they can still obtain liquidity from the European Central Bank.

After the bailout was announced, the German Chancellor, Angela Merkel, stressed that any private sector involvement would be voluntary and not legally obligatory.¹⁰⁵ On this accord, ISDA released an opinion that since the exchange of debt is “expressly voluntary, it should not trigger CDS.”¹⁰⁶ The tentative terms of the deal force bankers to take a fifty percent reduction in the face value of their Greek bond holdings.¹⁰⁷ Chancellor Merkel used CDSs as a sword, telling bankers to “[a]ccept the 50 percent write-down . . . or bear the consequences of default.”¹⁰⁸ To rescue Greece, Chancellor Merkel threatened to trigger a “credit event” and place the blame solely on the bankers.¹⁰⁹ The terms of that deal, as it stood, did not trigger CDSs.¹¹⁰

Nevertheless, ISDA announced on March 9, 2012, that a restructuring credit event had occurred, triggering the swaps.¹¹¹ The Determinations Committee unanimously found that even though there had been a voluntary debt exchange, Greek

Baker & Toyer, supra note 101.

105. Annika Breidhardt & Eric Kelsey, *Merkel Confident of Private Sector in Greek Bailout*, REUTERS (July 22, 2011), <http://www.reuters.com/article/2011/07/22/eurozone-merkel-banks-idUSB4E7IJ00Q20110722>.

Chancellor Merkel stated:

I believe there is a high probability that the numbers presents by the IIF on private sector involvement will be achieved . . . A voluntary contribution is a voluntary contribution and cannot be made legally obligatory. But there is trust in this contribution and similar past programmes add to this trust. And also there is an incentive for banks to get involved.

Id.

106. *Latest News: Greek Sovereign Debt Q&A (Update)*, ISDA (July 25, 2011), <http://www2.isda.org/news/greek-sovereign-debt-qampa-update>. The true voluntary nature is to be seen as ISDA notes that at the time of its statement, the agreement was simply a proposal. *Id.* To actually determine whether the action should trigger a CDS, a user must submit a proposal to the Determinations Committee. *Id.*

107. See Steven Erlanger & Stephen Castle, *Calling Bankers' Bluff, Merkel Won Europe a Debt Plan*, N.Y. TIMES (Oct. 27, 2011), http://www.nytimes.com/2011/10/28/world/europe/europe-in-accord-on-basics-of-plan-to-save-the-euro.html?_r=1&ref=global-home&pagewanted=all (reporting the details of the deal as well as Merkel's political maneuvering).

108. *Id.*

109. See *id.* (explaining the extraordinary fear of a “disorderly, involuntary default” and the prospect that a “credit event” would throw “world financial markets into turmoil, much as the collapse of Lehman Brothers did in the fall of 2008).

110. See Greek Sovereign Debt FAQ, ISDA, *available at* <http://www2.isda.org/greek-sovereign-cds/> (last updated March 19, 2012) (stating “the Eurozone proposal is voluntary and not binding on all bondholders. As such, it does not appear to be likely that the deal will trigger payments under existing CDS contracts”).

111. News Release, ISDA EMEA Determinations Committee: Restructuring Credit Event Has Occurred with Respect to the Hellenic Republic, ISDA (March 9, 2012), *available at* <http://www2.isda.org/greek-sovereign-cds/>.

lawmakers inserted certain provisions into its bonds that allowed them to strong-arm private investors into restructuring.¹¹² That specific action, according to ISDA, made the initially voluntary program not voluntary at all and therefore entitled protection buyers to a payout.¹¹³

CDSs are financial instruments that entitle the holder to a payout upon the occurrence of certain events. These bilateral contracts look to certain credit events to determine when a party owes its counterparty. However, recent developments in Greece have exposed the uncertainty that arises when a sovereign nation teeters on the verge of collapse, and an entire regional economy scrambles to keep it afloat.

III. DIFFERING SCOPES OF CDS CONTRACT INTERPRETATION

Generally, ISDA-documented CDSs consider a “credit event” to be one or more of the following: (1) bankruptcy,¹¹⁴ (2) failure to

112. See Katy Burne, *Greek CDS Triggered by Use of Collective-Action Clauses-ISDA Committee*, WALL ST. J. (March 9, 2012, 3:38 PM), <http://online.wsj.com/article/BT-CO-20120309-712280.html> (noting the country forced private creditors into its debt restructuring who didn’t want to accept the terms of the deal); see also Agustino Fontevicchia, *ISDA Says Greece in Default, CDS Will Trigger*, FORBES (March 9, 2012, 2:51 PM), <http://www.forbes.com/sites/afontevicchia/2012/03/09/on-greece-defaults-and-the-future-of-derivatives/> (adding that the collective action clauses effectively forced a seventy-four percent haircut on bondholders that held out of the voluntary plan).

113. *Id.*; Burne, *supra* note 112; see also Abigail Moses, *Greece Auction to Settle \$3.2 Billion of Credit-Default Swaps*, BLOOMBERG (March 18, 2012, 7:01 PM), <http://www.bloomberg.com/news/2012-03-19/greece-auction-to-settle-3-2-billion-of-credit-default-swaps.html> (proffering that triggering and settlement of the CDSs might actually have a positive effect on the struggling European bond market).

114. 1999 ISDA CREDIT DERIVATIVES DEFINITIONS § 4.2 [hereinafter 1999 DEFINITIONS]; 2003 ISDA CREDIT DERIVATIVES DEFINITIONS § 4.3 [hereinafter 2003 DEFINITIONS]. A commentator’s summary of this credit event:

Bankruptcy occurs when the Reference entity is: (a) dissolved; (b) becomes insolvent or admits it in writing; (c) makes a general assignment, arrangement or composition for the benefit of its creditors; (d) institutes or has instituted against it a proceeding seeking a judgment of insolvency, bankruptcy or another similar law affecting the rights of creditors, and such proceeding (i) results in such a judgment; or (ii) is not dismissed within 30 days; (e) has a resolution passed for its winding-up, official management or liquidation; (f) seeks or becomes subject to the appointment of a receiver or a similar officer; (g) has substantially all of its assets taken possession of by a secured creditor; (h) causes or is subject to any similar event; or (i) takes any action in furtherance, or consents to, any of the foregoing acts.

Pierre-Hugues Verdier, *Credit Derivatives and the Sovereign Debt Restructuring Process*, HARVARD L. SCHOOL INT’L FIN. SEMINAR, 50 n.141 (Apr. 27, 2004) available at <http://www.law.harvard.edu/programs/about/pifs/llm/sp27.pdf>.

pay,¹¹⁵ (3) obligation acceleration,¹¹⁶ (4) obligation default,¹¹⁷ (5) repudiation/moratorium,¹¹⁸ or (6) restructuring.¹¹⁹ Unfortunately,

115. 1999 DEFINITIONS § 4.4; 2003 DEFINITIONS § 4.4; *see also* Verdier, *supra* note 114, at 50 n.142 (quoting the Definitions and summarizing that an “Obligation Default occurs when one or more Obligations have become capable of being declared due and payable . . . as a result of . . . the occurrence of a default [or] event of default other . . . than a failure to make any required payment”).

116. 1999 DEFINITIONS § 4.3; 2003 DEFINITIONS § 4.3; *see also* Verdier, *supra* note 114, at 50 n.143 (noting the difference between Obligation Acceleration and Obligation Default is that “in addition to the obligations being capable of being declared due and payable, they have actually been so declared”).

117. *See* 1999 DEFINITIONS § 4.5 (stating that “after the expiration of any applicable (or deemed) grace period, the failure by a Reference Entity to make, when and where due, any payments in an aggregate amount of not less than the Payment Required under one or more Obligations”). The 2003 Definitions add “in accordance with the terms of such Obligations at the time of such failure.” 2003 DEFINITIONS § 4.5.

118. 1999 DEFINITIONS § 4.6. This occurs when

a Reference Entity of Governmental Authority (a) disaffirms, disclaims, repudiates or rejects, in whole or in part, or challenges the validity of, one or more Obligations in an aggregate amount of not less than the Default Requirement or (b) declares or imposes a moratorium, standstill or deferral, whether de facto or de jure, with respect to one or more Obligations in an aggregate amount of not less than the Default Requirement.

Id. The 2003 Definitions apply when the repudiation or moratorium is actually followed within sixty days by a Failure to Pay or Restructuring. 2003 DEFINITIONS § 4.6.

119. The 1999 Definitions state:

(a) “Restructuring” means that, with respect to one or more Obligations, including as a result of an Obligation Exchange, . . . any one or more of the following events occurs . . . and such event is not provided for under the terms of such Obligation . . .

(i) a reduction in the rate or amount of interest payable or the amount of scheduled interest accruals;

(ii) a reduction in the amount of principal or premium payable at maturity or at scheduled redemption dates;

(iii) a postponement or other deferral of a date or dates for either (A) the payment or accrual of interest or (B) the payment of principal or premium;

(iv) a change in the ranking in priority of payment of any Obligation, causing the Subordination of such Obligation; or

(v) any change in the currency or composition of any payment of interest or principal.

[. . .]

(b) Notwithstanding the provisions of Section 4.7(a), none of the following shall constitute a Restructuring:

[. . .]

(iii) the occurrence of . . . any of the events . . . in circumstances where such event does not directly or indirectly result from a deterioration in the creditworthiness or financial condition of the Reference Entity.

modern complex events such as the Greek crisis do not fit neatly under the definitions. The sovereign debt debacle in Greece and Europe is a new breed of financial crisis, but presents the recurring problem of defining an applicable credit event with regard to sovereign credit derivatives.¹²⁰ Despite all the aforementioned drama, CDSs on Greek debt were not triggered until the use of collective action clauses.¹²¹ To understand the

(c) If Obligation Exchange has occurred, the determination as to whether one of the [Restructuring] events . . . has occurred will be based on a comparison of the terms of the Obligation immediately before such Obligation Exchange and the terms of the resulting Obligation immediately following such Obligation Exchange.

[. . .]

1999 DEFINITIONS § 4.7; *see also id.* at § 4.9 (“Obligation Exchange’ means the mandatory transfer of . . . any securities, obligations, or assets to holders of Obligations in exchange for such Obligations”).

The 2003 Definitions state:

(a) “Restructuring” means that, with respect to one or more Obligations . . . , any one or more of the following events occurs *in a form that binds all holders of such Obligation*, is agreed between the Reference Entity or a Governmental Authority and *a sufficient number of holders of such Obligation to bind all holders of the Obligation* or is announced (or otherwise decreed) by a Reference Entity or a Governmental Authority *in a form that binds all holders of such Obligations*, and such event is not expressly provided for under the terms of such Obligation in effect as of the later of the Trade Date and the date as of which such Obligation is issued or incurred:

- (i) a reduction in the rate or amount of interest payable or the amount of scheduled interest accruals;
- (ii) a reduction in the amount of principal or premium payable at maturity or at scheduled redemption dates;
- (iii) a postponement or other deferral of a date or dates for either (A) the payment or accrual of interest or (B) the payment of principal or premium;
- (iv) a change in the ranking in priority of payment of any Obligation, causing the Subordination of such Obligation to any other Obligation;
- or
- (v) any change in the currency or composition of any payment of interest or principal to any currency which is not a permitted currency.

[. . .]

(b) Notwithstanding the provisions of Section 4.7(a), none of the following shall constitute a Restructuring:

[. . .]

- (iii) the occurrence of, agreement to or announcement of any of the events described in Section 4.7(a)(i) to (v) in circumstances where such event does not directly or indirectly result from a deterioration in the creditworthiness or financial condition of the Reference Entity.

2003 DEFINITIONS § 4.7 (emphasis added). These sections are the main focus of the analysis section of this Comment.

120. *See Verdier, supra* note 114, at 51 (noting that corporate entities usually fall under well-defined regimes).

121. *Burne, supra* note 112.

rationale, this section looks to a substance-over-form analysis of CDSs, then examines how a different approach to the same issues yields different results, and finally analyzes the language that required so much activity to finally trigger CDSs on Greek debt.

A. *Broad Analysis—Substance over Form*

In 2004, the Second Circuit of the United States Court of Appeals examined whether a credit event had occurred in regard to Argentinian sovereign bonds.¹²² It found that a “voluntary debt exchange,” in which a bondholder has the option of turning in their bonds for secured loans on terms less favorable than the original bond, could qualify as a restructuring credit event under the terms of the ISDA contract.¹²³

Plaintiff had an investment portfolio that included Argentinian sovereign bonds.¹²⁴ Argentina’s political and economic prospects had been rapidly deteriorating for some time,¹²⁵ so the plaintiff purchased CDSs from the defendant to offset its risk.¹²⁶ Upon announcement of the voluntary debt exchange program, the plaintiff contacted the defendant to settle the swaps, but defendant disputed that a “credit event” had occurred and refused to act.¹²⁷ Plaintiff filed a breach of contract action, alleging that the voluntary debt exchange constituted a credit event and triggered the defendant’s settlement obligations.¹²⁸

The court undertook to determine whether, as a matter of law, the voluntary debt exchange was a “restructuring credit event” covered by the contract.¹²⁹ The parties used the ISDA Master Agreement and incorporated the 1999 ISDA Credit Derivatives Definitions.¹³⁰ The court began its analysis of the ISDA contract by noting that interpretation should construe the agreement in accord with the parties’ intent.¹³¹ Ambiguous terms, however, must be examined along with extrinsic evidence to gather the correct and intended meaning.¹³²

122. *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y.*, 375 F.3d 168 (2d Cir. 2004).

123. *Id.* at 170.

124. *Id.* at 171-72.

125. *Id.* at 175.

126. *Id.*

127. *Id.*

128. *Id.* at 176.

129. *Id.* at 177.

130. *Id.* at 178.

131. *Id.* at 177-78.

132. *Id.* It added that ambiguities exist when a contractual term could suggest more than one meaning when viewed objectively by a reasonably intelligent person who has examined the context of the entire integrated agreement and who is cognizant of the customs, practices, uses, and terminology as generally understood in the particular trade or business. *Id.* at

In that case, the ambiguity was what exactly a “mandatory transfer” meant.¹³³ The official Argentine policy was voluntary and the defendant proffered that a voluntary exchange could not be a mandatory transfer. Plaintiff countered, however, contending that a mandatory transfer included any obligation exchange achieved by “economic coercion”¹³⁴ even if classified under the guise of voluntary participation.¹³⁵ The court accepted this argument, and explained that “from Argentina’s perspective, the exchange may have been voluntary in fact,”¹³⁶ but its “self-serving” characterization did not control.¹³⁷ Finally, the court drew an important distinction, noting the interpretation focuses solely on the government action.¹³⁸

On that note, the court pointed out that “the proper inquiry is whether the debt exchange caused a restructuring to occur with respect to *any* of the Argentine sovereign bonds.”¹³⁹ The Second Circuit stated that to be sure that a CDS has not been triggered, “it must be clear that none of the ‘events’ described in [the ISDA definitions] occurred with respect either to the participating obligations or to the nonparticipating obligations.”¹⁴⁰

Moving to the facts of that particular case, the court looked to the effect of the exchange program on both participating and nonparticipating obligations.¹⁴¹ Under the terms of the swap at issue, a restructuring credit event occurred upon “a postponement of payment on interest or principal.”¹⁴² The official bond exchange policy stated that instruments “whose total or partial original

178.

133. *Id.* at 174. Restructuring included an obligation exchange of the reference entity wherein the replacement entity has a reduced rate or amount of interest payable, a reduction in the principal or premium payable at maturity, a postponement or other deferral of a date or dates for either the payment or accrual of interest or the payment of principal or premium, a change in the ranking in priority of payment of any obligation causing the subordination of such obligation, or any change in the currency or composition of any payment of interest or principal. *Id.* at 180. An obligation exchange is a mandatory transfer of one set of obligations for another. *Id.*

134. *Id.* at 181. Plaintiff and the court used Black’s Law Dictionary, defining “economic coercion” as “conduct that constitutes improper use of economic power to compel another to submit to the wishes of one who wields it.” BLACK’S LAW DICTIONARY 252 (7th ed. 1999).

135. *Eternity*, 375 F.3d at 181.

136. *Id.* For example, the government debt may have had the intention to honor its debt obligations to nonparticipants without delay or deduction. *Id.*

137. *Id.*

138. *Id.* at 182. The court noted that with regard to credit events, whether the plaintiff actually owned sovereign bonds or participated in the exchange program was irrelevant. *Id.*

139. *Id.* (emphasis in original).

140. *Id.* at 183.

141. *Id.* at 182-83.

142. *Id.* at 182; 1999 DEFINITIONS § 4.7(a)(iii).

maturity is prior to December 31, 2010 shall receive secured loans that will extend the average life of the *Eligible Security* by 3 years.”¹⁴³ This caused the court to remand the case as it created a question of fact and the lower court had ruled that it was not a credit event.¹⁴⁴

Rather than present a definitive solution to current CDS issues, this case illustrates that the ISDA definitions can be ambiguous when governments use unconventional measures to solve sovereign debt issues. The Argentine government did not literally force the plaintiff to exchange his debt for a new obligation, but this was not dispositive and the broader intent of the parties and realities of the circumstances controlled the case. Legal tensions exist in these agreements: protection buyers want terms to be interpreted widely and take an active approach to look at the clear reality of a situation, whereas sellers want terms to be interpreted literally and narrowly.¹⁴⁵ ISDA exists somewhere in between, feeling pressures from both parties and attempting to uphold its mission.¹⁴⁶

B. Different Approaches—Different Results

ISDA refused to declare a restructuring credit event under this *Eternity* rationale in the Greek situation.¹⁴⁷ This signifies the shift from the substance-over-form approach towards a more restrictive analysis. This shows that different approaches yield different results. If an agreement incorporates the 1999 Definitions, a US court would likely follow the reasoning stated in *Eternity*,¹⁴⁸ and look to facts to determine whether the voluntary program is undercut by some economic coercion.¹⁴⁹ However, one

143. *Eternity*, 375 F.3d at 183 (emphasis in original).

144. *Id.*

145. Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 FORDHAM J. CORP. & FIN. L. 705, 777-78, 782 (2008).

146. *About ISDA*, *supra* note 56.

147. *Compare* Greek Sovereign Debt FAQ, *supra* note 110 (opining that the voluntary debt exchange would not trigger CDS obligations), *with* ISDA EMEA Determinations Committee: Restructuring Credit Event Has Occurred with Respect to The Hellenic Republic, *supra* note 111 (stating that the government mandate gave rise to CDS obligations).

148. *See Eternity*, 375 F.3d at 183 (proffering that voluntary exchange programs can be obligations if influenced through economic coercion).

149. *See* Charlemagne, *Selecting Default*, THE ECONOMIST (July 11, 2011, 11:48 PM), <http://www.economist.com/blogs/charlemagne/2011/07/contagion-euro-zone> (suggesting that this is due to the “contagion” effect of an actual Greek default in regard to countries such as Italy and Spain). Coercive rhetoric is also rampant in the official statements, for example on July 11, 2011, the

Ministers welcomed the decision by the IMF to disburse the latest tranche of financial assistance to Greece, as well as the *proposals from*

commentator argues this approach creates the scenario that ISDA hoped to avoid by standardizing its definitions—litigation and a lack of a clear idea of restructuring as it pertains to credit events.¹⁵⁰

The *Eternity* court’s stance embraced the spirit, over the letter of the contract.¹⁵¹ That spirit—the fundamental purpose of a sovereign CDS—aimed to help protect against the risk of loss associated with the deterioration of a reference entity’s creditworthiness.¹⁵² Indeed, *Eternity* argued that the “voluntary exchange” of bonds was really a “no-other-choice” exchange, and bondholders had no alternative but to participate in the swap.¹⁵³ Nevertheless, the 2003 Definitions refer to events that are agreed upon between the Governmental Authority and a sufficient number of holders of the obligation to bind all holders of the obligation.¹⁵⁴

This language appears to leave room for the same theory of economic coercion proffered in *Eternity*.¹⁵⁵ Plaintiff argued that “the bondholders effectively had a gun to [its] head” even though the plan had been labeled as voluntary.¹⁵⁶ Economic coercion, under this argument, is “conduct that constitutes improper use of economic power to compel another to submit to the wishes of one who wields it.”¹⁵⁷ ISDA was not willing to accept this argument,¹⁵⁸ consistently pointing to the “voluntary” nature of debt exchange and not pondering whether it was a Hobson’s choice.¹⁵⁹ Indeed, it

the private sector to voluntarily contribute to the financing of a second programme, building on the work already underway. The ECB confirmed its position, reaffirmed by its Governing Council last Thursday, that a credit event or selective default should be avoided.

“Statement by the Eurogroup”, available at http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/123601.pdf (emphasis added).

150. Kim, *supra* note 145, at 781.

151. See *Eternity*, 375 F.3d at 181 (stating that “[a] proper interpretation of the CDS contracts must be drawn from the contract language and . . . from other indicia of the parties’ intent”).

152. See Brief and Special Appendix for Plaintiff-Appellant at 4, *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y.*, 375 F.3d 168 (2d Cir. 2004) (No. 03-7652) (stating *Eternity* “developed strategies . . . to offset the risk that a financial crisis in the sovereign debt of a foreign country would ruin [the reference entity]”).

153. See *id.* at 46-47 (adding that bondholders “effectively had ‘a gun to their head’ and not participating in the program was in effect ‘to shoot themselves dead’”).

154. 2003 DEFINITIONS § 4.7(a).

155. Brief for *Eternity*, *supra* note 152, at 46.

156. *Id.*

157. *Eternity*, 375 F.3d at 181; BLACK’S LAW DICTIONARY, *supra* note 134, at 252.

158. See *Greek Sovereign Debt FAQ*, *supra* note 110 (making no reference to any possibility of a coercive nature to the program).

159. Hobson’s choice is a philosophical theory that is the illusion of a free-

was not until Greek lawmakers imposed binding requirements on all bondholders that ISDA determined a restricting credit event had occurred.

C. A Narrow Analysis—Strict and Literal

At times, ISDA tweaks its credit derivatives definitions in an attempt to provide clarity and understanding.¹⁶⁰ Even in the *Eternity* decision, the investment fund used a “User’s Guide” draft to the ISDA published 1999 Definitions to further support a broad interpretation of the contract.¹⁶¹ ISDA released some commentaries and supplements to the 1999 Definitions,¹⁶² but ultimately abandoned “repairing” the 1999 Definitions in favor of producing new 2003 Definitions.¹⁶³ The updates, however, appeared to be primarily revised with regard to corporate bonds rather than sovereign debt,¹⁶⁴ although some changes were made due to the Argentina case.¹⁶⁵

will decision, but it is really a choice with no alternative. *See generally* I.N.S. v. Chada 462 U.S. 919, 968 (1983) (White, J., dissenting) (stating that whether Congress should delegate rulemaking authority to executive agencies or undertake “the hopeless task of writing laws with the requisite specificity to cover endless special circumstances across the entire policy landscape” was a Hobson’s choice); *Monell v. Dep’t of Soc. Serv. of City of N.Y.*, 436 U.S. 658, 679 (1978) (describing a Hobson’s choice between keeping the peace or paying civil damages).

160. *See Guide to ISDA Publications*, ISDA 18-19 (2011), <http://www.isda.org/publications/pdf/pubguide.pdf>, and *ISDA Bookstore – Credit Derivatives Definitions, Supplements and Commentaries* (Oct. 21, 2011), <http://www.isda.org/publications/isdacredit-deri-def-sup-comm.aspx> (listing the main credit derivative publications).

161. *See Eternity*, 375 F.3d at 182 (offering that the commentary clarified the reference to mandatory transfer rather than restricted it and therefore an optional exchange can constitute a Restructuring). However, it was never formally promulgated. *See also* Allen & Overy, *An Introduction to the Documentation of OTC Derivatives*, 3-4 (May 2002), http://www.isda.org/educat/pdf/documentation_of_derivatives.pdf (describing the process of multiple commentaries, supplements, and updated definitions).

162. *Restructuring Supplement to the 1999 ISDA Credit Derivatives Definitions*, ISDA (May 2001), http://www.isda.org/c_and_a/pdf/Restructuring_Supplement.pdf; *Commentary on Restructuring Supplement*, ISDA (2001), http://www.isda.org/whatsnew/pdf/Commentary_on_Restructuring.pdf.

163. *See A Retrospective of ISDA’s Activities in 2002*, ISDA at 8 (Jan. 2003), http://www.isda.org/www/retrospective_2002_master.pdf (outlining briefly the developments in credit derivatives and touching on the new features of the 2003 Definitions).

164. *See id.* (stating that improvements came from loophole exposed by a corporate default and these “major tests of the market have been instrumental in defining this new document”); *see also* BOMFIN, *supra* note 23, at 21 (adding “[i]n practice, however, the vast majority of [credit derivatives] reportedly reference non-sovereign entities”).

165. *See* News Release, ISDA, ISDA Publishes 2003 ISDA Credit Derivatives Definitions (Feb. 11, 2003), *available at* <http://www.isda.org/>

Still, though, the 2003 Definitions restrict what constitutes a restructuring by removing the reference to an “Obligation Exchange.”¹⁶⁶ Narrowing the terms protects the interests of protection sellers, but also aims to uphold the integrity of the markets.¹⁶⁷ Furthermore, this strict interpretation might reduce moral hazard by avoiding situations where the buyer will have the incentive and capacity to precipitate a credit event.¹⁶⁸ Under the narrow 2003 Definitions, it appears that a reluctant minority of creditors cannot trigger a restructuring credit event.¹⁶⁹ A “voluntary” exchange will not trigger a credit event unless all holders tender their obligations, and even then some commentators have suggested it would not trigger a credit event.¹⁷⁰ That *de jure* argument concludes that if somehow every bondholder individually agreed to a restructuring, it would not constitute a credit event because it would lack any necessary coercive elements.¹⁷¹ Nevertheless, it is impractical and impossible for every bondholder to participate, rendering a literal reading of this definition nearly useless.¹⁷²

Commentators that argue voluntary exchanges are not a credit event under the 2003 Definitions also note that this theory reflects “market practice.”¹⁷³ The reason for apparent industry “preference for excluding voluntary restructurings is that if there

whatsnew/press021103.html (noting that “[t]he new provisions address major challenges that have shaped the course of the credit derivatives business”).

166. See Verdier, *supra* note 114, at 65 (noting that the ruling in *Eternity* was not repudiated by ISDA in the 2003 Definitions).

167. See *id.* 53-55 (arguing that a broad definition would allow protection buyers to trigger the swap “opportunistically”). That commentator suggested that a protection buyer could get the full payment for the reference amount, even if a true credit event did not occur, which might be much higher than the market value of the obligations. *Id.* at 54. He refers to this as “free protection against market risk for the protection buyer.” *Id.*

168. *Id.*; see also Paul Krugman, *Appeasing the Bond Gods*, N.Y. TIMES (August 19, 2010), <http://www.nytimes.com/2010/08/20/opinion/20krugman.html> (arguing that some economic policy is made to appease bond investors who have coercive power to drive up borrowing costs of governments by driving bond prices downward).

169. Kim, *supra* note 145, at 791; see also Verdier, *supra* note 114, at 71 (noting that with a collective action clause, nonparticipants could not trigger the obligation under the 2003 Definitions).

170. See Verdier, *supra* note 114, at 71 (suggesting that all creditors individually agreeing to a voluntary exchange restructuring would not have any coercive elements and thus would not be binding as contemplated by the definitions).

171. *Id.*

172. *Id.*; Kim, *supra* note 145, at 791.

173. See Verdier, *supra* note 114, at 71 (adding that many participants were satisfied with the district court’s ruling in *Eternity* before the circuit court reversed and applied its economic coercion theory).

were credit events, protection buyers might have reduced incentives to negotiate the best possible arrangement.¹⁷⁴ That would leave a possibility that after settlement of the swaps, the protection seller is left with excessively devalued obligations.¹⁷⁵ Moreover, certainty and objectivity are paramount to credit event analysis, and a narrow, literal reading helps to further that.¹⁷⁶ Following this thinking, any analogical interpretation of these events after the fact should be avoided.¹⁷⁷

While advocates of a narrow reading contend it promotes the best settlement, the converse stance contends that this prolongs the crisis because a more effective remedy could have been crafted but for policymakers' insistence on avoiding the stain of a "credit event."¹⁷⁸ However, before the Determinations Committee's decision in March 2012, many holders of Greek CDSs did not give up, still hoping for a default.¹⁷⁹ The "voluntary" solution to the Greek Debt crisis did not trigger CDSs, regardless of how much coercive pressure existed, because it was not "in a form that binds all holders."¹⁸⁰ Indeed, the Determinations Committee needed governmental action to make the financial haircuts binding on all bondholders to satisfy the contractual language, and was unwilling to accept the argument that economic coercion could result from an agreement between "a sufficient number of holders . . . to bind all holders."¹⁸¹

CDSs are complex instruments that only become more complicated when their payment is contingent upon an ever-evolving global economic crisis. The Greek sovereign debt crisis has provided an example of the difficulties in determining whether a triggering event has occurred. Previously, courts embraced a theory of economic coercion that would allow a "voluntary" agreement to trigger CDSs. The current CDS regime has removed the words "obligation exchange" from its definitions. This has shifted the paradigm to a more literal approach and swaps will not be triggered if a program is voluntary in name only.

174. *Id.* at 72.

175. *Id.*

176. Kim, *supra* note 145, at 795.

177. *Id.*

178. The inference that seems to follow is that the voluntary debt exchange with a fifty percent haircut is the best solution, and would not have been reached if this type of agreement constitutes a credit event.

179. Gretchen Morgenson, *Sad Proof of Europe's Fallout*, N.Y. TIMES (Nov. 5, 2011), <http://www.nytimes.com/2011/11/06/business/in-mf-global-sad-proof-of-europes-fallout.html>.

180. 2003 DEFINITIONS § 4.7(a).

181. *Id.*; see also Burne, *supra* note 112 (stating the use of the collective action clauses made the debt exchange mandatory and satisfied the requirements of § 4.7(a)).

IV. PROPOSAL

Huxley's *Brave New World* paints the picture of a miserable social dynamic—but the citizens manage to cope. Likewise, Western Europe and the global economy will survive the sovereign debt crisis; however, what emerges may be a system nobody ever intended. In order to restore the balance between the substance of a CDS and the literal contractual language, this Comment proposes that ISDA embrace the *Eternity* theory of economic coercion. Specifically, the 2003 Definitions describe a circumstance where there is an agreement between “a Governmental Authority and a sufficient number of holders . . . to bind all holders of the obligation.”¹⁸² This is the language that should embrace the theory of Hobson's choice and give protection buyers the benefit of their bargain when situations like the Greek crisis occur, but before the government intervenes. This can be done by determining whether a voluntary exchange is driven by economic coercion, defined as an “improper use of economic power to compel another to submit to the wishes of one who wields it.”¹⁸³

This current use of CDSs may be creating hazardous market conditions by providing an illusory sense of protection.¹⁸⁴ In this brave new world of sovereign debt, “bond vigilantes” have made a practice of going after heavily indebted economies and driving the price down.¹⁸⁵ This happened to Greece, and after the tentative solution to the Greek crisis emerged, major concerns remained about other European economies with similar large debt burdens.¹⁸⁶ As such, bond prices in Italy, Portugal, Spain, and Ireland have taken hits and are the focal point of growing

182. 2003 DEFINITIONS § 4.7(a).

183. BLACK'S LAW DICTIONARY, *supra* note 68, at 294.

184. *See, e.g.*, Morgenson, *supra* note 179 (stating “the insurance that has been written on all this Greek debt will not cover investor losses generated by the 50 percent write-down—a disturbing consequence to those who thought they were buying insurance against that very risk”); *see also* Louise Story & Julie Creswell, *Debt Plan Could Deny Those Who Bet on Default*, N.Y. TIMES (Oct. 27, 2011), <http://www.nytimes.com/2011/10/28/business/global/debt-plan-could-deny-those-who-bet-on-default.html?ref=europe> (quoting a chief economist at a major international bank as saying “If a 50 percent notional haircut doesn't trigger an insurance contract on that debt, I mean what's going to trigger it? . . . If you bought protection and now all of a sudden, a 50 percent haircut is imposed on you and you don't get a payout on your insurance, that really casts a large doubt”).

185. *See* Krugman, *supra* note 168 (singling out “investors who would pull the plug on spendthrift governments, driving up their borrowing costs and precipitating a crisis”).

186. Nelson D. Schwartz & Eric Dash, *Gauging the Fallout of Another Rescue*, N.Y. TIMES (October 27, 2011), <http://www.nytimes.com/2011/10/28/business/gauging-the-fallout-of-another-rescue.html?ref=europe&pagewanted=all>.

unrest.¹⁸⁷

Now, it seems to be that an entity seeking to protect itself against loss by purchasing a sovereign CDS might find itself at the center of highly political and volatile negotiations and ultimately be pressured into accepting a similar type of loss that it originally hoped to hedge against.¹⁸⁸ In any event, it is an important purpose of the ISDA definitions to give a clear idea of restructuring as it pertains to credit events.¹⁸⁹ This promotes market efficiency and avoids wasteful litigation.¹⁹⁰ The narrow evolution of CDS interpretation, however, may have detracted from the underlying purpose and utility of CDSs on sovereign debt.

The voluntary debt exchange was intended to be the best-case scenario,¹⁹¹ but it left protection buyers without recourse, further hoping for a credit event,¹⁹² which eventually came because Greece had to force participation in the exchanges. Although some contend that the market prefers narrow interpretations,¹⁹³ some have begun to speak out against this position.¹⁹⁴ Those who sought to hedge have taken a significant loss on Greek debt and were without recourse until the government intervened.¹⁹⁵ This has led some to question the legitimacy of CDSs in this context.¹⁹⁶ If they do not hedge actual risk of loss, purchasers might reconsider entering these agreements.¹⁹⁷

Derivative markets perform an important economic function by enabling an efficient transfer of risk bearing from market participants least equipped to bear risk to market participants best equipped to bear risk.¹⁹⁸ Paradoxically, speculators give a free market valuation to these risks and enable protection seekers to readily hedge their risk, but also present a threat to distort

187. See Graham Bowley, *Interest Rates on Italian Bonds Rise to New Levels*, N.Y. TIMES (Nov. 7, 2011), <http://www.nytimes.com/2011/11/08/business/global/italy-bonds-push-higher.html> (noting that the rates at which Italy was being forced to sell its Bonds were reaching levels that forced Greece, Ireland, and Portugal to seek financial rescue).

188. Morgenson, *supra* note 179; Story & Creswell, *supra* note 184.

189. See Kim, *supra* note 145, at 781 (2008) (proffering that litigating disputes over the interpretation of Definitions is the exact scenario that ISDA hoped to prevent).

190. See *id.* (suggesting ISDA's promotion of a clear understanding hopes to prevent "litigation and hotly contested disputes").

191. Verdier, *supra* note 114, at 72.

192. See Story & Creswell, *supra* note 184 (noting the displeasure of some investors that the swaps were not triggered when the voluntary haircut first came out).

193. Verdier, *supra* note 114, at 72.

194. Morgenson, *supra* note 179.

195. Story & Creswell, *supra* note 183.

196. *Id.*

197. *Id.*

198. JACQUE, *supra* note 42, at 294.

price.¹⁹⁹ As it stands, though, these objectives are not being met. Risk is not being transferred because holders are still subject to significant loss under the narrow interpretation that allows coercive yet “voluntary” restructurings.²⁰⁰

Reading economic coercion into § 4.7(a) will help avoid mistakes made in the past. A seller’s hope that none of these instruments ever require a payout was exactly what led to the rapid insolvency of AIG in 2008.²⁰¹ This is critically important because “[f]ailings of the risk management function are at the core of the unsavory tales of derivative debacles.”²⁰² Market participants reacted to the triggering of Greek CDSs well, with an analyst calling it “a clear demonstration that there is a functioning hedging tool out there” and suggesting that there would be positive implications for European bond markets.²⁰³ Otherwise, this brave new world may have eliminated the possibility of a restructuring credit event from ever occurring but for the most drastic measures. The Greek scenario now stands for the method by which a sovereign restructures its debt and avoids triggering swaps. Widening § 4.7(a)’s interpretation to include economic coercion would further promote the functionality of CDSs as a tool to hedge against loss.

All in all, reliance on credit derivatives has added greater fear and uncertainty to this already-hectic saga, and the Greek case study reveals that CDSs may be falling short of their purpose and utility.²⁰⁴ Even before the Greek saga, CDS interpretation presented “thorny issues,”²⁰⁵ those of which become more apparent as the story unfolds. Furthermore, the tension between the *Eternity* opinion and ISDA’s 2003 Definitions will continue so long as the “voluntary debt exchange” solutions are the model for solving sovereign debt crises. This interpretational precedent has created a loophole that has the potential to undermine one of the fundamental benefits of CDSs.

199. *See id.* (offering that concentration of a derivative position in a small number of entities will distort the risk allocation process and potentially harm end-users).

200. *See* Story & Creswell, *supra* note 184 (describing that holders of bonds are taking significant losses on the face value of the debt).

201. *See* JACQUE, *supra* note 42, at 278-79 (explaining that AIG’s critical flaw was its overexposure to CDS and the lesson to learn from that meltdown is “there is no such thing as a free lunch”).

202. *Id.* at 281.

203. Moses, *supra* note 113.

204. *See* Baker & Toyer, *supra* note 101 (quoting Chancellor Merkel stressing the voluntary nature of the private participation while pushing hard for a viable solution to the crisis); Morgenson, *supra* note 179 (outlining how bondholders suffered a “disturbing consequence” when their bonds took a haircut but CDS obligations were not triggered).

205. Verdier, *supra* note 114, at 52.

V. CONCLUSION

The European sovereign debt crisis has shed new light on the use of CDSs. International finance has entered a new and uneasy era with sovereign debt crises. Credit default swaps are subtly trailing in the wake of these markets and the ongoing political debates of how to solve the regional issues. The industry groups that facilitate CDS use have squarely rejected a judicial doctrine embraced by American courts, but this appears to have been done at the expense of some utility of CDSs. To minimize the malicious influence of these instruments while maximizing their market utility, § 4.7(a) interpretation should be interpreted to include the theory of economic coercion and Hobson's choice.