§ 9:1 General Review of Systemic Risk

The credit crisis resulting in the collapse of Lehman Brothers in September 2008 has led to intense scrutiny of over-the-counter (OTC) derivative transactions, such as those described in this book. Numerous proposals by foreign and U.S. regulators have been proposed to deal with the perceived systemic risk posed by OTC derivatives, and the United States adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) in the summer of 2010 which, among other regulatory reforms of the financial services industry, regulates OTC derivative transactions. ¹

As we have discussed throughout this book, the systemic risk that concerns regulators is the counterparty exposure risk that each party to a derivative transaction has to the other party in the transaction. Counterparty exposure risk is essentially the risk that a party to a derivative transaction will not perform its obligations. Given the numerous OTC derivative transactions executed globally among a multiple of counterparties, global systemic risk is created directly as a result of the multiplication of this counterparty exposure risk. The failure of a major derivative participant to perform on its derivative transactions in turn increases the risk that other parties will be unable to perform on their derivative transactions. For

¹ H.R. 4173, 111th Cong. (2010).
example, if one party based in the United States enters into two offsetting derivative transactions with one party located in Europe and another located in Asia, and the party in Europe fails to perform its obligations to the U.S. party, the U.S. party, in turn, may be unable to perform on its offsetting derivative transaction with the Asian party.

As we have discussed throughout this book, there are many legal risk mitigation techniques that parties can utilize to reduce counterparty risk exposure and, in turn, systemic risk through the use of payment netting, collateral arrangements, and close-out netting in derivatives documentation. The effectiveness of these risk mitigation techniques was tested in the Lehman Brothers insolvency proceedings. Lehman Brothers Holdings Inc. and its subsidiaries (“Lehman”) were major participants in the OTC derivatives market. While many Lehman counterparties suffered significant losses due to the insolvency proceedings, the close-out netting process effected by Lehman’s counterparties mitigated the losses suffered by these parties. See Chapter 8 for a review of best practices recommendations to mitigate counterparty exposure risk.

Nevertheless, the Lehman Brothers insolvency proceedings and the credit crisis of 2008 have led to many proposals by both foreign and U.S. regulators for greater regulation of, and transparency in, OTC derivative transactions. These events and their cumulative effect have led to a wide range of efforts by countries and global regulators to overhaul the current regime of financial regulations relating to OTC derivatives, and to impose broad regulatory authority over OTC derivatives and other financial instruments that were believed to be a major cause of the financial crisis. With passage of the Dodd-Frank Act, the United States became the first country to enact significant legislation relating to the regulation of OTC derivatives.

Moreover, the Lehman Brothers insolvency proceedings continue to establish new precedents in the OTC derivatives market that may impact future practices. We have discussed several of the court cases and motions pending before the Lehman bankruptcy court that could result in significant changes in the current market practices of the OTC derivatives markets.

This chapter will briefly examine the Dodd-Frank Act and the pending Lehman motions and court cases that may significantly impact OTC derivative transactions in the future.

§ 9:2 Dodd-Frank Act and OTC Derivatives

In July 2010, the United States enacted the Dodd-Frank Act, which substantially amends and alters the regulation of financial services in the United States. Within the Dodd-Frank Act, the Wall Street
Transparency and Accountability Act\(^2\) contains sweeping new proposals for the regulation of the OTC derivatives market in the United States. (A copy of the Wall Street Transparency and Accountability Act is attached as Appendix C.)

The Dodd-Frank Act delegates authority to the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) to regulate OTC derivatives and requires these agencies to issue new regulations relating to OTC derivatives. At the time of this publication, neither the SEC nor the CFTC have issued these highly anticipated new regulations, but release of these proposed regulations is expected by early 2011.

The main principles relating to OTC derivatives under the Dodd-Frank Act include the following:

**Regulators**—The SEC will have exclusive jurisdiction to enact regulations over all “security-based swap” transactions, while the CFTC will have exclusive jurisdiction to enact regulations over all other swap transactions. While the SEC has always asserted jurisdiction over swap transactions relating to securities, such as equity swaps, its exclusive role as regulator of “security-based swap” transactions under the Dodd-Frank Act provides express legislative authority for this role. Security-based swap transactions will include all equity swaps, as well as credit default swaps, and will be regulated by the SEC. Interest rate swaps, commodities swaps and FX swaps will be regulated by the CFTC.

**Clearance of OTC Derivatives**—The Dodd-Frank Act requires that OTC swap transactions be cleared through a central clearinghouse unless it is exempt from clearance. The clearinghouses would be regulated by and registered with the CFTC and/or the SEC. By clearing transactions on central clearinghouses, regulators believe that counterparty exposure risk would be negated because the clearinghouses would guarantee performance of the transactions. Furthermore, under the Dodd-Frank Act, new regulations will be issued by the CFTC and the SEC to encourage the use of standardized derivatives and thus utilization of central clearing organizations through higher capital and margin requirements for non-cleared derivative OTC transactions.

In determining what would be cleared or not, each class of swaps, group of swaps or individual swap transactions would be reviewed by the SEC or the CFTC, as applicable. The SEC or the CFTC would then determine whether the swaps, class of swaps, or group of swaps would be subject to clearing on a clearinghouse. Under the Dodd-Frank Act, the SEC and the CFTC must consider the following factors in determining whether a particular swap, class of swaps or group of swaps are cleared or not:

\[\text{Id. Section 701 et seq.}\]

(Durham, Rel. #2, 11/10)
(i) the liquidity and outstanding notional amount of such swaps;

(ii) the availability of infrastructure support for the clearing of such swaps;

(iii) the systemic risk mitigation that would be achieved in clearing such swaps;

(iv) the impact on competition for clearing such swaps; and

(v) the existence of reasonable legal certainty in the treatment of swap counterparty positions, funds and property in the event of an insolvency of a derivatives clearinghouse.

To encourage transparency, the central clearinghouses would also be required to publicly disclose the contractual terms of the swaps settled at such organizations, as well as daily settlement prices, volume and open interest for derivative contracts cleared through such organizations.

Key Swap Definitions—The Dodd-Frank Act creates categories for swap transactions and swap participants. These key categories and definitions under Dodd-Frank are as follows:

**SECURITY-BASED SWAP** means any agreement, contract, or transaction that—

(i) is a swap, as that term is defined under section 1a of the commodity Exchange Act (without regard to paragraph (47)(b)(x) of such section); and

(ii) is based on—

(I) an index that is a narrow-based security index, including any interest therein or on the value thereof;

(II) a single security or loan, including any interest therein or on the value thereof; or

(III) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer.

(B) RULE OF CONSTRUCTION REGARDING MASTER AGREEMENTS.—The term ‘security-based swap’ shall be construed to include a master agreement that provides for an agreement, contract, or transaction that is a security-based swap pursuant to subparagraph (A), together with all supplements to any such master agreement, without regard to whether the master agreement contains an agreement, contract, or
transaction that is not a security-based swap pursuant to subparagraph (A).

(C) EXCLUSIONS.—The term ‘security-based swap’ does not include any agreement, contract, or transaction that meets the definition of a security-based swap only because such agreement, contract, or transaction references, is based upon, or settles through the transfer, delivery, or receipt of an exempted security under paragraph (12), as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security as defined in paragraph (29) as in effect on the date of enactment of the Futures Trading Act of 1982), unless such agreement, contract, or transaction is of the character of, or is commonly known in the trade as a put, call, or other option.

(D) MIXED SWAP.—The term ‘security-based swap’ includes any agreement, contract, or transaction that is as described in subparagraph (A) and also is based on the value of 1 or more interest or other rates, currencies, commodities, instruments or indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence (other than an event described in subparagraph (A)(ii)(III)).

(E) RULE OF CONSTRUCTION REGARDING USE OF THE TERM INDEX.—The term ‘index’ means an index or group of securities, including any interest therein or based on the value thereof.

**MAJOR SECURITY-BASED SWAP PARTICIPANT** means any person:

(i) who is not a security-based swap dealer; and

(ii) (I) who maintains a substantial position in security-based swaps for any of the major security-based categories, as such categories are determined by the Commission, excluding both positions held for hedging or mitigating commercial risk and positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

[II] whose outstanding security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or
that is a financial entity that:

(aa) is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and

(bb) maintains a substantial position in outstanding security-based swaps in any major security-based swap category, as such categories are determined by the Commission.

(B) DEFINITION OF SUBSTANTIAL POSITION.—For purposes of subparagraph (a), the Commission shall define, by rule or regulation, the term ‘substantial position’ at the threshold that the Commission determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States. In setting the definition under this subparagraph, the Commission shall consider the person’s relative position in uncleared as opposed to cleared security-based swaps and may take into consideration the value and quality of collateral held against counterparty exposures.

(C) SCOPE OF DESIGNATION.—For purposes of subparagraph (A), a person may be designated as a major security-based swap participant for 1 or more categories of security-based swaps without being classified as a major security-based swap participant for all classes of security-based swaps.

SECURITY-BASED SWAP DEALER means any person who:

(i) holds themselves out as a dealer in security-based swaps;

(ii) makes a market in security-based swaps;

(iii) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or

(iv) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security-based swaps.

(B) DESIGNATION BY TYPE OR CLASS.—A person may be designated as a security-based swap dealer for a single type or single class or category of security-based swap or activities and considered not to be a security-based swap dealer for other types, classes, or categories of security-based swaps or activities.

(C) EXCEPTION.—The term “security-based swap dealer” does not include a person that enters into security-based swaps for such person’s own account, either individually or in a fiduciary capacity, but not as a part of regular business.
(D) **DE MINIMIS EXCEPTION.**—The Commission shall exempt from designation as a security-based swap dealer an entity that engages in a de minimis quantity of security-based swap dealing in connection with transactions with or on behalf of its customers. The Commission shall promulgate regulations to establish factors with respect to the making of determination to exempt.

**SWAP** means any agreement, contract, or transaction:

(i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interest or property of any kind;

(ii) that provides for any purchase, sale payment, or delivery [other than a dividend on an equity security] that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence;

(iii) that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interest or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset [including any enterprise or investment pool] or liability that incorporates the financial risk so transferred, including any agreement, contract, or transaction commonly known as:

   [I] an interest rate swap;
   [II] a rate floor;
   [III] a rate cap;
   [IV] a rate collar;
   [V] a cross-currency rate swap;
   [VI] a basis swap;
   [VII] a currency swap;
   [VIII] a foreign exchange swap;
   [IX] a total return swap;
   [X] an equity index swap;
an equity swap;

(XII) a debt index swap;

(XIII) a debt swap;

(XIV) a credit spread;

(XV) a credit default swap;

(XVI) a credit swap;

(XVII) a weather swap;

(XVIII) an energy swap;

(XIX) a metal swap;

(XX) an agricultural swap;

(XXI) an emissions swap; and

(XXII) a commodity swap;

(iv) that is an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap;

(v) including any security-based swap agreement which meets the definition of ‘swap agreement’ as defined in section 206A of the Gramm-Leach-Bliley Act [15 U.S.C. 78c note] of which a material term is based on the price, yield, value or volatility of any security or any group of index of securities, or any interest therein; or

(vi) that is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v).

MAJOR SWAP PARTICIPANTS means any person who is not a swap dealer and:

(i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding:

(I) positions held for hedging or mitigating commercial risk; and

(II) positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraph (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 [29 U.S.C. 1002] for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;

(ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or

§ 9:2 TERMINATING DERIVATIVE TRANSACTIONS
(iii) (I) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and

(II) maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission.

**SWAP DEALER** means any person who:

(A) **IN GENERAL.**—The term ‘swap dealer’ means any person who:

(i) holds itself out as a dealer in swaps;

(ii) makes a market in swaps;

(iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps,

provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer.

(B) **INCLUSION.**—A person may be designated as a swap dealer for a single type or single class or category of swap or activities and considered not to be a swap dealer for other types, classes, or categories of swaps or activities.

(C) **EXCEPTION.**—The term ‘swap dealer’ does not include a person that enters into swaps for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.

(D) **DE MINIMIS EXCEPTION.**—The Commission shall exempt from designation as a swap dealer an entity that engages in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers. The Commission shall promulgate regulations to establish factors with respect to the making of this determination to exempt.

**Categorization of Swap Counterparties**—Different regulations will apply to swap dealers, security-based swap dealers, major security-based swap participants, and major swap participants than to other end-users of derivative transactions. Swap dealers will be subject to a more robust regulatory regime and higher capital requirements than major swap participants who will in turn be subject to a more robust regulatory regime and higher capital requirements than
an entity that is not classified as either a swap dealer or a major swap participant.

The legislative definition of swap dealer is broad enough to encompass entities that would not normally be viewed as swap dealers, such as hedge funds or large corporate end users. Only forthcoming SEC and CFTC regulations will determine whether these types of entities will be classified as swap dealers.

Additionally, each of these four categories will apply to particular classes of derivative transactions identified by the SEC and the CFTC. For example, a hedge fund could be classified as a “swap dealer” for FX derivative transactions and a “major security-based swap participant” for equity derivative transactions, but not fit into any of these four categories for commodity derivative transactions or fixed income derivatives.

Swap Depositories—Even if a swap is deemed by the SEC or the CFTC to be a non-cleared swap that will be executed outside of the clearinghouses, all relevant data regarding the non-cleared swap transactions must be submitted to specially designated swap depositories. At the time of this publication, there are no swap depositories.

The information that must be submitted to a swap repository includes:

(i) any information necessary to identify and value the transaction, including the spread and the LIBOR rate;
(ii) the date and time of execution;
(iii) all information from which the price of the transaction is derived;
(iv) whether the transaction has been accepted for clearing by a clearinghouse;
(v) any amendments to the transaction; and
(vi) the final confirmation for the transaction.

The swap repositories, once established, will be required to make their records publicly available in “real time.” However, the identities of the parties to swap transactions will be kept confidential, although the regulators will have access to all information. Additionally, other rules exempting “real time” information reporting will be enacted by the SEC and the CFTC to exclude “large notional swap transactions” from the real time requirements of public access.

§ 9:3 Implications of Dodd-Frank Act

One of the key implications of the Dodd-Frank Act in terminating derivative transactions will be the different regime that will apply in
terminating swaps cleared on a central clearinghouse and terminating swaps that are not so cleared. As a result, the close out process in terminating swap transactions will differ in the future between swaps that are cleared on a central clearinghouse and those that are not. Presumably, swaps that are not cleared through a central clearinghouse will retain the same substantive close-out netting process that is described in this book.

Another key issue arising under the Dodd-Frank Act for OTC derivative transactions is how Dodd-Frank will impact close-out netting. One of the provisions of the Dodd-Frank Act establishes a new liquidation regime for “financial companies.” Under these provisions, the Secretary of the Treasury has the authority to appoint the Federal Deposit Insurance Corporation (FDIC) as the receiver for “financial companies” in certain circumstances. Banks and insurance companies are clearly contemplated to be “financial companies” for the purposes of these provisions. Non-bank financial companies may also be included if they are deemed to be engaged in primarily financial activities. However, for such a determination to be made, at least 85% of the total consolidated revenues of a company must be attributable to financial activities.

The scope of this new liquidation proceeding and the procedural steps for its implementation are beyond the scope of this book, but assuming a financial company has been designated as being subject to this new liquidation authority and such company is in danger of default, the Secretary of the Treasury may appoint the FDIC as a receiver after completing various procedural steps. The question is then how would the appointment of the FDIC impact any existing OTC derivatives to which such financial company is a party.

Under this new insolvency regime, OTC derivatives would constitute qualified financial contracts that can still be closed-out and netted in spite of the appointment of the FDIC as a receiver. However, a one-business day stay would apply even to qualified financial contracts such as derivative transactions. During this one-business day grace period, the FDIC would have the power to transfer all of the derivative transactions of one single counterparty to a third party. If the FDIC exercises this authority, the derivative contracts may not be terminated unless another independent event of default has occurred. Accordingly, under this new insolvency procedure, a one-business day stay would apply to the termination of derivative contracts, whereas under the Bankruptcy Code, no such stay applies.

The FDIC would also have the power to repudiate derivative contracts, and damages would be calculated on the date of repudiation instead of the date on which the FDIC is appointed as receiver. The FDIC is not permitted to set aside any security interest that a party may have with a company under FDIC receivership, so a secured
derivative transaction could not be made unsecured by the FDIC. The FDIC generally recognizes set-off rights arising under state law.

At the time of this publication, it is uncertain as to how this new insolvency regime will interact with existing insolvency regimes. Further regulations and studies by relevant governmental agencies should clarify some of the outstanding questions relating to this new insolvency proceeding, particularly which parties will be subject to it. For OTC derivative parties, this new regime only heightens the need for adequate security and collateral arrangements to secure derivative transactions and mitigate counterparty risk exposure since the FDIC has no power to overturn security arrangements. Set-off rights should also be drafted into all derivatives documentation. In fact, all the legal risk mitigation procedures that have been discussed in this book should continue to be utilized, notwithstanding the additional measure of uncertainty that has been added to the close-out netting process by these new insolvency provisions in the Dodd-Frank Act.

The key legal uncertainty under the Dodd-Frank Act for OTC derivatives is which derivative transactions must be cleared on a central clearinghouse. While there are already exchange-listed derivatives that parties can purchase through central clearinghouses, OTC derivatives provide a level of customization to parties that exchange-listed derivatives cannot.

Even a simple interest rate derivative transaction, the most plain vanilla OTC derivative transaction and one normally utilized solely for hedging purposes, is specifically tailored to the terms of the debt that a party wishes to hedge. A standardized derivative cannot be specifically tailored to the terms of the debt that a party wishes to hedge. The debt may contain amortization features or payment features that cannot be procured through an exchange-listed derivative. An exchange-listed derivative would not provide a completely efficient hedge to a party’s debt because the terms of the derivative could not be customized to the terms of the debt.

Furthermore, current accounting regulations require that derivatives be marked-to-market by derivative participants. Marking-to-market a derivative means that, on a quarterly basis, companies with derivative transactions must determine the current fair market value of each derivative transaction and post the gain or loss since the last quarter on their financial statements. This type of marking-to-market of derivative transactions increases earnings volatility. Major derivative participants, such as financial institutions, have no issues with marking-to-market their derivative positions, but companies that engage in derivative transactions solely for hedging purposes do not wish to suffer the earnings volatility that derivative transactions create.
For that reason, hedging transactions are subject to a hedging exception under the mark-to-market accounting rules, which require the derivative transaction be a fully effective hedge for the hedged obligation. This analysis of the effectiveness of a derivative transaction in hedging a hedged obligation, such as a debt financing, is time consuming, but requires that the derivative transaction be exactly tailored to the terms of the hedged obligation. For example, to avoid a marking-to-market of an interest rate swap that has been entered into to hedge a debt financing, the terms of the interest rate swap transaction must exactly match the terms of the debt financing or the interest rate swap will not be deemed fully effective and the ineffective portion must be marked-to-market.

As a result, corporate end-users who engage in derivative transactions purely for hedging purposes will face mark-to-market treatment of their derivative positions if they are required to purchase derivatives traded on a clearinghouse. Since the earnings volatility created by marking-to-market derivative positions is avoided by companies that do not engage in derivative transactions solely for hedging purposes, these companies may be forced to choose between not hedging their interest rate risk or FX currency risk or being required to mark-to-market their positions as financial institutions do. Without a concurrent change in U.S. accounting rules, moving “standardized” OTC derivatives such as interest rate swaps or FX currency swaps to a central clearinghouse may actually increase the financial risk profile of companies forced to choose between hedging their exposure to interest rate risk or FX currency risk and marking-to-market their derivative hedging transactions.

Additionally, the categorization of entities as swap dealers or major swap participants may also be a significant detriment to corporate end-users. Large corporations with foreign operations can easily fall within the legislative definition of “major swap participant” due to their FX hedging activities. If corporate end-users are subject to higher regulatory scrutiny, higher margin costs and capital reserve requirements as a result of engaging in pure hedging transactions, corporate end-users may decide to keep a portion of their risk unhedged to avoid falling within this regulatory scheme. During the debate over the Dodd-Frank Act, corporate end-users sought a hedging exception from this new regulatory regime, but were unsuccessful. It is now left to SEC and CFTC rule-making to determine whether and how these corporate end-users will be subject to this new regulatory scrutiny.
§ 9:4 Lehman Brothers Bankruptcy Developments

In addition to legislative developments, the ongoing bankruptcy proceedings of Lehman Brothers Holdings Inc. and its affiliates will continue to set new precedents in the OTC derivatives market by defining the close-out netting process, the valuation process for the termination of derivatives, and the applicability of the U.S. Bankruptcy Code (the Code) in derivative transactions.

For example, the Lehman Brothers bankruptcy proceedings have raised the issue of what constitutes the close-out netting process, which is considered in the context of synthetic collateralized debt obligation (CDO) transactions. (See discussion in section 7:6.)

In the Ballyrock ABS CDO 2007-1 Limited CDO transaction, the Lehman bankruptcy court will review a motion by a CDO counterparty to enjoin a trustee from subordinating the counterparty to the bondholders of the Ballyrock SPV due to termination of its credit default swap (CDS) transaction with the counterparty. (See discussion in section 7:6.1.) The court will be determining, among other questions, whether such subordination is an ipso facto clause, which is generally not permissible in bankruptcy, or is an integral part of the CDS transaction and allowed under an exemption to the automatic stay provisions of the Code. Applicability of bankruptcy rules to derivatives contracts and the close-out netting process will be tested in a situation when a CDS contract is intricately and carefully woven into the provisions of financing documents.

In Lehman Brothers Special Financing, Inc. v. U.S. Bank National Association, the Lehman bankruptcy court will examine the subordination clauses in a variety of U.S. synthetic CDO transactions and whether such clauses constitute a preferential transfer that violates the automatic stay under the Code. This decision will have far-reaching implications for structured derivative transactions and is likely to be appealed whatever the outcome.

In the Dante Multi Issuer Secured Obligation Programme, which is yet another Lehman Brothers synthetic CDO case, the Federal District Court in New York and the Supreme Court of the United Kingdom will be considering the applicability of U.S. insolvency law to the enforceability of a subordination provision when one of the parties to the documentation is in U.S. bankruptcy proceedings, even though U.K. law was the governing law of the relevant transaction documents. A court decision in this case would impact other synthetic CDO transactions of Lehman Brothers in Europe, as well as other structured transactions that rely on derivative contracts.

and non-structured transactions, and could possibly affect the ratings and market value of such transactions.

In addition to these synthetic CDO transactions, the Lehman Brothers motions as to the termination of its open derivative contracts and as to effecting an alternative dispute resolution for all of its derivative contracts raise a multitude of issues for counterparties.

In one of its outstanding motions, Lehman Brothers is seeking to terminate or assign its open derivative contracts that have not been terminated by its counterparties. (See discussion in sections 7:7 and 7:7.1.) Arguably, most of such open derivative contracts are out-of-the-money for the counterparties. Under this motion, counterparties would effectively have a choice of either terminating their derivative transactions and paying Lehman Brothers an early termination amount calculated by Lehman Brothers, or accepting a transfer of the derivative transactions to a third party that is not of their choosing and facing the credit exposure to that third party which may totally change the credit risk profile of the transactions. However, a transfer to a new counterparty would present an opportunity for counterparties to receive a return of their collateral posted with Lehman Brothers. It is still questionable whether such transfers are feasible, given the complexity of OTC derivatives and the due diligence that alternative counterparties would need to conduct while being required to pay Lehman Brothers the “fair market value” of the swap transaction.

This motion was resolved in part by the order dated December 16, 2008 (the “Derivatives Procedures Order”), which established procedures for (i) the assumption and assignment of derivative contracts that have not been validly terminated, and (ii) the termination and settlement of claims for derivative contracts terminated by Lehman Brothers. [A copy of this Order is attached as Appendix B-2.] The Derivatives Procedures Order, however, did not resolve all objections filed by various counterparties (the “Remaining Objectors”) to the relief requested in this motion. In this regard, a second hearing with respect to issues raised by the Remaining Objectors was held in January 2009. At the conclusion of this hearing, the bankruptcy court overruled a number of the objections raised by the Remaining Objectors and entered a supplemental order (the “Supplemental Order”), which provided that the Derivatives Procedures Order was applicable to certain of the Remaining Objectors and adjourned for a later hearing date the determination of whether the Derivative Procedures Order is applicable to the balance of the Remaining Objectors (the “Remaining Derivative Contracts”). [The Supplemental Order is attached as Appendix B-3.] On September 29, 2009, the court entered an additional order that makes the previous procedures orders applicable to certain of the unresolved objectors. A hearing with respect to these Remaining Derivative Contracts was scheduled for December 2009
and May 2010, but both hearings were further postponed. (A copy of this Supplemental Order is attached as Appendix B-8.)

§ 9:5 Conclusion

At the time of publication of this book, it is uncertain what the OTC derivatives landscape will be in the future under the Dodd-Frank Act. New regulations to be released by the SEC and the CFTC will determine the regulatory landscape of OTC derivative transactions. Moreover, the new insolvency regime for financial companies under Dodd-Frank, as well as precedents set by the Lehman Brothers bankruptcy proceedings may require parties to derivative transactions to implement changes in the close-out netting process.

The credit crisis of 2008 illustrated the potential for systemic risk in OTC derivative transactions. However, as we have tried to demonstrate in this book, proper risk mitigation techniques can be utilized to reduce or eliminate counterparty exposure risk. The reduction or elimination of counterparty exposure risk in turn reduces the systemic risk posed by OTC derivatives. Regardless of the outcome of the legislative proposals, parties to derivative transactions should consider implementing appropriate risk mitigation techniques in their OTC derivative transactions.