

# **Coming Valuation Problems of Mortgage-Backed Securities & Credit Default Swaps in Bankruptcy**

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## **I Introduction**

These are unprecedented times. Financial firms have reported losses and write-downs on debt securities approaching half a trillion dollars to date since the breakdown of the subprime mortgage market in 2007.<sup>1</sup> At the center of the storm is both the failure of the market for mortgage-backed securities and the nontransparent and unregulated credit default swaps that have exacerbated the systemic risk. The hemorrhaging of the value in mortgage-backed securities has now inflicted the global credit markets toppling pillars of Wall Street, fundamentally changing investment banking as it had heretofore been known, and raising fears of the worst economic collapse since the Great Depression.<sup>2</sup>

As part of its initial response, the United States government has enacted the Emergency Economic Stabilization Act of 2008 (Pub. L. 110-343) (the “Act”) which aims, in part, to revitalize the market for mortgage-backed securities by enabling the Secretary of the Treasury to purchase up to \$700 billion worth of “troubled assets” through the Troubled Asset Relief Program (“TARP”). TARP is therefore aimed at doing what the market had previously failed to do, set an appropriate price for these securities. Treasury Secretary Henry Paulson, and the other principal authors of the “bailout,” did not set forth in the Act the procedures that will be used to value the assets purchased under TARP. However, the Act does call for the prompt and detailed disclosure of such procedures once they have been established.

But even massive government intervention cannot piece back together working markets overnight. In the meantime, mortgage-backed securities and other “bad debt”

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<sup>1</sup> See *JP Morgan Plan to Write Down \$1.5 Billion in Mortgage-Backed Securities*, INT’L HERALD TRIB., Aug. 12, 2008, available at <http://www.iht.com/articles/2008/08/12/business/12jpm.php>.

<sup>2</sup> See, e.g., Julie Creswell & Ben White, *Wall Street, R.I.P.: The End of an Era, Even at Goldman*, N.Y. TIMES, Sept. 27, 2008, available at <http://www.nytimes.com/2008/09/28/business/28lloyd.html>.

will be subjected to the scrutiny of bankruptcy courts that will be charged with valuing these assets in a number of circumstances.<sup>3</sup> This presentation discusses how bankruptcy courts may approach these thorny valuation questions.

## **II. Mortgage-Backed Securities and Their Valuation**

A mortgage-backed security is a debt instrument collateralized by the principal and interest payments on a pool of mortgage loans. Most of these pooled mortgages were “subprime” obligations. The market for these securities expanded rapidly as investors calculated that a substantially sized pool of risky mortgages could be divided into slices or tranches permitting investment grade ratings for the senior tranches. Low interest rates for much of the past decade combined with rising housing prices to cause a flood of liquidity into the market for mortgage-backed securities, raising the market to several trillion dollars in size. A major flaw in this financing device was that the underwriting assumptions were faulty. Default rates for mortgages were calculated at historical levels, but historically mortgage loan underwriting had never included such a large pool of non-credit worthy borrowers.

Mortgage-backed securities were priced according to factors including (i) the type of mortgage and their outstanding principal balances (“OPB”); (ii) the default risk, ascertainable in part by payment histories (see above); (iii) the applicable interest rate for each mortgage; and (iv) the prepayment risk. Prepayment of a loan is termed a risk to the security because most mortgages can be repaid without penalty resulting in a loss of expected future interest payments. Furthermore, prepayment risk is closely related to interest rates because many mortgage holders will prepay to refinance their mortgages in

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<sup>3</sup> See, e.g., Harold S. Novikoff, *Valuation Issues in Chapter 11 Cases*, SM014 ALI-ABA 185 (Mar. 2007).

order to take advantage of lower rates. The asset's value would also be dependent on its level of subordination to other tranches of debt from the pooled mortgages.

With a robust market for mortgage-backed securities, and the continuing appreciation of house prices created by the liquidity that had poured into the housing market, valuation was less of a concern in pricing the securities. Complex models could be constructed centering around the above-listed information but also incorporating factors such as demographic data, new construction starts, etc. With robust trading taking place, these models could be tested against actual market trends, albeit trends that were heavily affected by the speculative bubble in the mortgage market.<sup>4</sup>

However, starting with the deterioration of the subprime mortgage market in 2007, the mortgage-backed security market began to contract. The interdependencies between mortgage originators and the secondary market began to take its toll. As the secondary market became saturated and large banks and financial institutions began to raise the credit criteria for purchasing pools of mortgage debt, loan originators were no longer able to facilitate homebuyers' easy access to credit. This resulted in the freezing up and decline of home prices, which in turn further constricted the secondary mortgage market.

Complicating the resulting valuation issue was Statement of Financial Accounting Standards No. 157, Fair Value Measurements ("FAS 157"). Promulgated by the Financial Accounting Standards Board for statements as of November 2007, FAS 157 requires companies to determine publicly the value of assets and liabilities according to the price that would be paid for them in an orderly transaction between market

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<sup>4</sup> See, e.g., Jeffrey J. Szafran, *Valuation of Mortgage-Backed Securities & Collateralized Debt Obligations: More Art Than Science*, SN084 ALI-ABA 685 (May 2008).

participants. FAS 157 also requires companies to distinguish between three levels of inputs for their valuations: (i) Level 1 inputs are “quoted prices in active markets for identical assets or liabilities”; (ii) Level 2 inputs are “inputs other than quoted prices included within Level 1 that are observable for the asset or liability”; and (iii) Level 3 inputs are “unobservable inputs for the asset or liability.”<sup>5</sup>

With the market for mortgage-backed securities collapsing in mid and late 2008, large banks and financial institutions were forced to list the value of their holdings as “unobservable” Level 3’s and suffer huge write-downs from the purchase price. For example, Morgan Stanley reported that 7.4% of the firm’s assets were Level 3 as early as the end of the third quarter of 2007, and had to write down \$3.7 billion in the first two months of the fourth quarter because of the declining subprime market.<sup>6</sup>

Where once mortgage-backed securities were valued according to their OPB, type, default risk, interest rate and prepayment risk, they are increasingly valued according to the current depressed market for these assets. The value of FAS 157 and whether or not it should be suspended are issues discussed at length elsewhere. When bankruptcy courts are presented with valuation issues involving mortgage-backed securities, both model-based and FAS 157-driven valuations will likely be presented for consideration by advocates for different interested parties.

### **III. Credit Default Swaps and Their Valuation**

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<sup>5</sup> See, e.g., David B.H. Martin & Lindsay Kitzinger, *Disclosure Implications of Fair Value Accounting & the Subprime Mortgage Crisis*, SP018 ALI-ABA 223 (July 2008).

<sup>6</sup> See Yalman Onaran & Christine Harper, *Goldman Held Bigger Level 3 Share Than Citi, Merrill*, BLOOMBERG, Nov. 12, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601109&sid=aEpBVhRfNTfU&refer=exclusive>.

A credit default swap is an unregulated, so-called over-the-counter contractual agreement between two parties whereby a protection-buyer pays premiums to a protection-seller in exchange for the protection-seller's promised performance in the event of a reference entity's credit event, such as a default.<sup>7</sup> Credit default swaps usually are written on standardized forms established by the International Swaps and Derivatives Association, Inc. (ISDA). After such a swap is executed, it can be traded on secondary markets. These markets are also unregulated and have precipitated doubts concerning their ability to appropriately value the risk associated with these arrangements.<sup>8</sup>

Credit default swaps can be used to hedge the protection-buyer's exposure, but they can also be used to speculate on a third party's credit events (speculators, of course, can also hedge their positions causing further market leverage). In the case of speculation, credit default swaps act to amplify the effect of a credit event. With the notional amount currently outstanding in the market for default swaps skyrocketing over the last years to the astronomical level of \$54.6 trillion, and the agreements themselves having an estimated value of \$2 trillion, this amplification rose to a systemic risk in September 2008.<sup>9</sup>

Upon a credit event with respect to the reference entity, the protection-seller is liable for the default payment to the protection-buyer as established by the contract. In addition, the protection-buyer will either have to transmit the reference obligation to the

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<sup>7</sup> Credit default swaps come in a wide variety of forms, some have multiple reference entities (basket swaps), some are pegged to market indexes (index swaps).

<sup>8</sup> Warren Buffet famously criticized credit default swaps, other swaps such as interest rate swaps and other derivatives as "financial weapons of mass destruction" due to their lack of transparency. See Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, available at <http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html?partner=rssnyt&emc=rss>.

<sup>9</sup> The ISDA reports "Surveys & Market Statistics" regularly at its website, <http://www.isda.org/> (providing data through mid-year 2008). For comparison, in the middle of 2004, the notional amount

protection-seller (physical settlement) or transmit a cash payment to the protection-seller usually equal to the reference obligation less its recovery value (cash settlement). The protection-buyer and protection-seller then “swap” positions with respect to the reference obligation upon the credit event.

The value of a default swap, therefore, is calculated according to such factors as (i) the premium paid by the protection-buyer; (ii) the remaining payments due; (iii) the default risk of the reference entity; and (iv) the availability of credit. As with mortgage-backed securities, complex models could be, and were, constructed to value these derivatives. With the market for default swaps already shaken,<sup>10</sup> and with a credit crisis globally that threatens untold credit events for an untold number of reference entities, the accuracy of these models and investor confidence in the clouded secondary market for default derivatives is at growing risk.

One of the complicating factors for many credit default swaps is that credit events giving rise to a right to payment for the protection-buyer from the protection-seller often are not tied to a monetary or payment default on the underlying mortgage pool vehicle or other reference obligation. Rather, if the vehicle suffers a ratings downgrade, a credit event occurs, triggering the protection-seller’s obligation to pay. This structure means that actions of credit rating agencies played a particularly significant role in creating credit events across a wide spectrum of credit default swaps.

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outstanding of credit default swaps was reported at only \$5.44 trillion. *See also* Moody’s Investors Service, *Credit Default Swaps: Market, Systemic, and Individual Firm Risks in Perspective* (May 2008).

<sup>10</sup> ISDA reports that after years of remarkable growth, the market for credit default swap contracted 12% as of the middle of 2008. Further contraction can be expected as credit markets remain restricted and default risks inflate.

Liquidity risk is also problematic for modeling the risk profile of complex financial instruments, a difficulty compounded by the fact that such models are constructed for and tested against the existing markets in which they operate.<sup>11</sup> For example, the collapse of Long-Term Capital Management (LTCM) in late 1990s was also premised in part on the failure of that fund's models to appreciate liquidity risk in the capital markets.<sup>12</sup> Today, however, the fear is that not just one fund or a select group of hedge funds will fail, but that such failure will be amplified by the myriad default swap positions maintained against such an event.<sup>13</sup> Because the counterparties to these swaps include large banks, insurance companies and brokerage firms, the risk of spiraling credit defaults has become systemic in the entire banking system.

In lieu of these real risks, there is growing pressure for oversight and regulation of the default swap market. On September 26, 2008, Christopher Cox, the Chairman of the Securities and Exchange Commission, issued a press release stating:

Unfortunately, as I reported to Congress this week, a massive hole [in regulation] remains: the approximately \$60 trillion credit default swap (CDS) market, which is regulated by no agency of government. Neither the SEC nor any regulator has authority even to require minimum disclosure. I urge Congress to take swift action to address this.<sup>14</sup>

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<sup>11</sup> See Kwamie Dunbar, *US Corporate Default Swap Valuation: The Market Liquidity Hypothesis and Autonomous Credit Risk*, UNIV. OF CONN. (Jan. 2007).

<sup>12</sup> See THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT, at 12, available at [www.treas.gov/press/releases/reports/hedfund.pdf](http://www.treas.gov/press/releases/reports/hedfund.pdf).

<sup>13</sup> Moody's Investors Service, *Credit Default Swaps: Market, Systemic, and Individual Firm Risks in Perspective*.

<sup>14</sup> Press Release, U.S. Securities and Exchange Commission, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), available at <http://www.sec.gov/news/press/2008/2008-230.htm>.

Calling for co-existent federal regulation, New York state also recently announced that it would begin to regulate the credit default swap market.<sup>15</sup> What the coming regulatory landscape for default swaps will ultimately be, however, remains to be determined. Suffice to say, times are changing.

#### **IV. The Emergency Economic Stabilization Act of 2008**

The passage of the Emergency Economic Stabilization Act of 2008 provided its own drama. On Wednesday, September 24, 2008, President George W. Bush addressed the nation stating the “entire economy is in danger” and urging that Congress pass the response proposed by Secretary Paulson. To assuage discomfort with the towering \$700 billion price tag, the president argued that the “government is the one institution with the patience and resources to buy these assets at their current low prices and hold them until markets return to normal.”<sup>16</sup>

Five days later, on Monday, September 29, 2008, the House of Representatives spurned the president and defeated Paulson’s revised proposal sending the Dow Jones Industrial Average plummeting 778 points. On Wednesday of that week, the Senate approved the legislation “sweetened” with earmarks and other concessions aimed at winning increased House support. A House revote approved the Act on Friday, October 3, 2008 and the president immediately signed it into law.<sup>17</sup>

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<sup>15</sup> Press Release, State of New York, Executive Chamber, Governor Paterson Announces Plan to Limit Harm to Markets from Damaging Speculation (Sept. 22, 2008), available at [www.ins.state.ny.us/press/2008/p0809224.pdf](http://www.ins.state.ny.us/press/2008/p0809224.pdf).

<sup>16</sup> *Transcript: Bush’s Speech*, INT’L HERALD TRIB., Sept. 25, 2008, available at <http://www.iht.com/bin/printfriendly.php?id=16463831>.

<sup>17</sup> See Christopher Stern & Laura Litvan, *Bank-Rescue Plan Wins Approval as House Reverses Vote*, BLOOMBERG, Oct. 3, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aTRUXZrt.eMY&refer=home>.

Soon after the bill was finally signed, Secretary Paulson announced that Neel Kashkari would lead TARP on an interim basis.<sup>18</sup> Kashkari had advised the Secretary on housing issues and was a former vice president at Goldman Sachs Group Inc., where Paulson had also worked. The leader of TARP now heads one of the largest sovereign wealth funds in the world.

The fund is charged with, among other things, buying distressed financial assets from U.S. financial institutions, and it has chosen to proceed by a “reverse auction” procedure whereby those institutions wishing to sell mortgage-backed securities and derivatives offer to sell them to the fund at particular prices. The results of these auctions will make a market, and thus set short term prices and values for the mortgage-backed securities and derivatives. This market, however, is artificial in some senses. If the Treasury as buyer accepts asking prices that are notionally too low, the seller-banks’ capital will be further impaired and the bank will be unable or reluctant to make new loans to third parties. If, on the other hand, the Treasury accepts asking prices that are notionally quite high, it risks depleting the fund’s cash without achieving the policy of recapitalizing banks and unfreezing the credit markets.

The Act is clearly not the only – or even the most significant – response the U.S. government or other world governments will take to the credit crises. Besides explicitly nationalizing Fannie Mae and Freddie Mac and injecting billions of dollars (on more than one occasion) into the world’s largest insurer A.I.G., the U.S. government has now represented its willingness to purchase the short term commercial paper of large businesses and even equity interests in major banks. However, it is the U.S.

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<sup>18</sup> See Rebecca Christie, *U.S. Treasury’s Kashkari to Lead Bank Bailout Office*, BLOOMBERG, Oct. 6, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601103&sid=ak5RqnboIhG0&refer=news>.

government's commitment to value and purchase problematic assets off the books of financial institutions which will directly affect court's valuation of these assets should their holders become the subject of bankruptcy proceedings.

The Act requires sweeping disclosure to accompany the sweeping powers it entrusts to the Treasury. Section 101 of the Act enables TARP "to purchase ... troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary." "Troubled assets" are defined as meaning both:

"(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and

(B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress."

Act § 3(9).<sup>19</sup> A credit default swap position is clearly a "financial instrument" that could be purchased under the program, although the likelihood of this actually happening is problematic.<sup>20</sup>

Both subsections to the definition of "troubled asset" provide that TARP is designed to "promote[] financial market stability." This is echoed in the stated purpose of the Act which is "to immediately provide authority and facilities that the Secretary of

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<sup>19</sup> A financial institution, from which trouble assets can be purchased, is also defined in broad terms under the Act meaning "any institution, including, but not limited to, any bank ... security broker or dealer, or insurance company ... but excluding any central bank of, or institution owned by, a foreign government." Act § 3(9).

<sup>20</sup> The broad definition of troubled assets also would permit TARP to purchase – as Treasury Paulson has suggested doing – an equity stake in large banks to help spur lending. However, this may trigger executive compensation limits and other corporate governance provisions under the Act. *See* Act § 111.

the Treasury can use to restore liquidity and stability to the financial system of the United States.” Act § 2(1). Even section 113, which seeks to minimize the long-term costs and maximize the benefit for taxpayers, provides that TARP can still take into account “the overall economic benefits of the program, including economic benefits due to improvements in economic activity and the availability of credit” in assessing the appropriate price for purchased assets.

Further, the Act provides that “[b]efore the earlier of the end of the 2-business-day period beginning on the date of the first purchase of troubled assets ... or the end of the 45-day period beginning on the date of enactment of this Act, the Secretary shall publish program guidelines, including ... [m]ethods for pricing and valuing troubled assets.” Act § 101(d). Moreover, section 114 specifically calls for market transparency and provides that “the Secretary shall make available to the public, in electronic form, a description, amounts, and pricing of assets acquired under this Act, within 2 business days of purchase, trade, or other disposition.”

Additionally, section 105(a) of the Act states that every 30 days during the pendency of the program the Secretary shall provide to Congress “a detailed financial statement” including “the valuation or pricing method used for each transaction” during that period. Additional reports concerning “the pricing mechanism” for purchases are required every time commitments to purchase troubled assets reach an interval of \$50 billion. Act § 105(b).

With strict deadlines, it will not be long before the Treasury is required to publish its pricing guidelines. Importantly, the Act does not permit only one loose sketch of TARP’s valuation approach at the outset of the program. Instead, the comprehensive

disclosure required of the Treasury – after every purchase, after every 30 days, after every \$50 billion spent – will allow insight into how the TARP’s pricing calculations arise and change over time. Furthermore, as the program’s main goal is to foster market stability, it is hoped that the TARP will generate sophisticated and transparent pricing procedures which could become a model for other marketplace transactions, but as noted above, the policy goals of recapitalizing financial institutions and unfreezing credit markets are necessarily going to influence the prices paid for the troubled securities.

**V. Intersection of Mortgage-Backed Securities with Bankruptcy Law**

Some of the largest and most significant new debtors likely will bring with them portfolios of mortgaged-backed securities, the remaining value of which will have to be orderly distributed to creditors.<sup>21</sup> Bankruptcy courts will be charged with overseeing this process. Challenges to the valuation of these securities in many contexts are unavoidable.

Liquidation of assets always raises valuation concerns. What will be unprecedented in these circumstances, however, is how the federal courts will treat asset sales in a market driven by a single major buyer which is a creature of the federal government – TARP. The bankruptcy bar will have to determine how it will respond.

Three possibilities are: (i) bankruptcy courts could view TARP as simply another market participant; (ii) bankruptcy courts could view TARP as setting the floor of reasonable pricing for an asset; and (iii) bankruptcy courts could endeavor to utilize, to the extent practical, the same standards for valuing mortgage-backed securities as those published under the program.

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<sup>21</sup> See, e.g., *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y.) (JMP); *In re Washington Mutual, Inc.*, Case No. 08-12229 (Bankr. D. Del.) (MFW).

To put it another way, beyond arguing merely over the value of an asset to be liquidated, parties to a dispute may also argue over what approach a court should adopt with respect to TARP's role in the process. Prospective buyers may suggest that TARP should be viewed simply as any other market participant. One can argue that the court's sole role should be making sure the best willing buyer purchases the assets for the benefit of the estate.<sup>22</sup> On the other hand, because of TARP's policy goals of recapitalizing financial institutions through these asset purchases, it can also be argued that TARP's valuations are artificially high or low, depending on the circumstances.

## **VI. Intersection of Credit Default Swaps with Bankruptcy Law**

Bankruptcy courts will also be presented with challenges when confronted with credit default swaps on debtors' balance sheets. There are three basic ways in which a bankruptcy filing can affect the holder's position: (i) the reference entity could declare a triggering credit event on the swap; (ii) the protection-buyer could file for bankruptcy; or (iii) the protection-seller could file for bankruptcy. The likelihood of a default of the reference entity should have been researched by both the protection-buyer and the protection-seller as such risk is the primary factor in calculating the value of the swap. But even if there has been thorough research, modeling the risk profile of any reference entity is a tricky business.

Even more important than assessing the likelihood of the occurrence of a credit event by the reference entity is the creditworthiness of the protection-seller, whose assets are liable to cover any such credit event. Because the market for default swaps is currently unregulated, however, there are no mandatory capitalization requirements for

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<sup>22</sup> See 11 U.S.C. § 363 (requiring highest and best price for asset sales).

swap participants. Further complicating matters is the fact that many swap counterparties have mortgage-backed securities of uncertain worth on their balance sheets.<sup>23</sup>

As noted above, market participants use credit default swaps to hedge, to speculate, and to hedge speculation. As such, upon a reference entity's credit event, there may be an insufficient deliverable obligation to complete physical settlement of the swap. However, even if the reference entity's credit event was a bankruptcy filing, the disputes concerning the protection-buyer and protection-seller will be resolved outside of the bankruptcy case of such reference entity because there is simply no privity to the debtor. Moreover, ISDA has become proficient in conducting auctions to settle the value of the deliverable reference obligation.<sup>24</sup>

A more pressing concern for bankruptcy courts is a default swap counterparty's filing. Swap agreements anticipate that a counterparty may file for protection under the Bankruptcy Code. Such an event constitutes that counterparty's default under the contract and gives rise to certain remedies for the non-defaulting party.<sup>25</sup> Like the exemptions provided with respect to securities contracts, § 560 of the Bankruptcy Code specifically protects the exercise of the contractual remedies provided to the non-defaulting swap counterparty. Specifically, upon the filing, § 560 permits the non-defaulting party "to cause the liquidation, termination or acceleration of one or more swap agreements ... or to offset or net out any termination values or payment amounts arising under or in connection with [the default]."

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<sup>23</sup> Indeed, under the uncertain market conditions currently prevailing, the London Interbank Offered Rate of interest exceeded the published prime rates of most banks during the week of October 5, 2008, demonstrating the uncertainty among banks as to who is creditworthy.

<sup>24</sup> For example, credit default swaps referencing obligations of Fannie Mae, Freddie Mac and Lehman Brothers were settled at auctions directed by ISDA. *See* <http://www.isda.org>.

<sup>25</sup> *See* 2002 Master Agreement § 5(a)(vii).

Additionally, § 562(a) of the Bankruptcy Code, added as part of the 2005 amendments, provides that if the debtor does reject or terminate the default swap, the resulting damages will be calculated “as of the earlier of – (1) the date of such rejection; or (2) the date or dates of such liquidation, termination or acceleration.” Importantly, § 562(b) states that “[i]f there are not any commercially reasonable determinants of value” when the swap is rejected, “damages shall be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value.” Section 562(c) provides that in the case of an objection, the party asserting there were no reasonable “determinants of value” available has the burden of establishing that fact. Section 562, however, reads as an invitation for counsel to raise valuation questions when default swaps are at issue.

Two form agreements issued by the ISDA have been widely used in the credit default swap market, the 1992 ISDA Master Agreement (the “1992 Form”) and the 2002 ISDA Master Agreement (the “2002 Form”). The 1992 Form allowed parties to choose remedies upon default. Parties could elect for damages to be calculated by Market Quotation where a defaulting party would be liable for the value quoted by dealers for the swap. Parties could also elect for damages to be calculated by Loss where a defaulting party would be liable for the injury suffered by the non-defaulting party. These remedies both were problematic in that the Market Quotation method could produce an unreasonable result if market conditions were strained and the Loss method was too subjective.

Under the 2002 Form, default remedies are calculated to determine the Close-out Amount. This amount is essentially the cost the non-defaulting party would incur in

replacing the terminated swap, but that calculation must employ “commercially reasonable procedures” and produce a “commercially reasonable result.” While the 2002 Form may have cured the over-subjectivity of the Loss method and the possible wide variances of the Market Quotation method, it could be found to have considerably complicated the valuation inquiry. Calculation of damages now minimally requires investigation of market conditions including how the market would respond to the particular creditworthiness of the non-defaulting party. Furthermore, as credit default swaps are traded and utilized in complex ways, such as with basket and index swaps and the use of default swaps to hedge precisely against other positions, obtaining an exact replication of the swap terminated by the bankruptcy filing upon which to base a damage claim may be so difficult as to raise its cost to a “commercially [un]reasonable result.”

As noted above, the credit default swap market will soon undergo a sea-change of new regulation. If the credit default swap in question utilizes either the Market Quotation method or the Close-out Amount method, valuing the bankruptcy claim of the non-defaulting party will require a familiarity with the new market and market conditions. Furthermore, regardless of what calculation method is employed, § 562 of the Bankruptcy Code may require courts to determine if the current market is capable of providing “commercially reasonable determinants of value.”

When a credit default swap counterparty files for bankruptcy, courts can expect to be forced into the complicated and changing marketplace for this uniquely dangerous derivative. Courts should endeavor to understand the policies behind the forming regulation concerning this market and amplify these policies as appropriate in their decisions to bolster the overall coherence of the regulatory framework.