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DERIVATIVES AND REHYPOTHECATION FAILURE IT'S 3:00 p.m., DO YOU KNOW WHERE YOUR COLLATERAL IS?[1]

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 The title is taken from a pamphlet dealing with the risks in the hold in custody repo market published in 1985 by the Federal Reserve Bank of New York entitled "It's 8:00 a.m., Do You Know Where Your Collateral Is?".

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INTRODUCTION

A borrower would probably be alarmed to learn that its lender had an unrestricted right to use and sell the collateral that the borrower had pledged to secure its borrowings. Borrowers typically believe that a lender should safeguard and protect collateral pledged to it, not use the collateral for its own gain. Yet in the derivatives market, it has become increasingly common for secured parties to insist upon such unrestricted use of pledged collateral.

The derivatives industry is a huge financial market measured in trillions of dollars. When negotiating a derivative transaction (a “transaction”), the parties to the agreement often agree that the party with the resulting payment obligation under the transaction (the "pledgor") is required to pledge or post

collateral ("posted collateral") to the other party (the "secured party"), to secure its payment obligation. Participants in the industry currently pledge billions of dollars in collateral to each other.

Unlike a typical loan transaction, however, it is often unclear at the inception of a transaction who will be the pledgor and who will be the secured party, and therefore each party may be required at some point to assume this pledge obligation.

As part of an agreement to pledge collateral, dealers, banks and other financial institutions participating in the derivatives market aggressively seek (and insist upon) the right to use posted collateral pledged to them.[2] This right to use posted collateral is commonly referred to as a "right of rehypothecation." The right of rehypothecation in this paper refers to the right of a secured party to sell, pledge, rehypothecate, assign, invest, use, commingle or otherwise dispose of posted collateral.

Although a secured party would most typically use the posted collateral by transferring it to another party (a "third party") in a repurchase transaction, the posted collateral could be used for almost any other purpose, including use as collateral for the secured party's own borrowing. As billions of dollars of

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[2] This article will only discuss the consequences of rehypothecation with respect to secured parties that are subject to the U.S. Bankruptcy Code or Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"). A discussion with respect to secured parties such as insurance companies and government sponsored enterprises that are not covered by these provisions is beyond the scope of this article.

collateral are posted in derivative transactions, many pledgors have become concerned about the legal risks involved in granting a right of rehypothecation.

Rehypothecation in the derivatives area has created a new risk for a pledgor. By granting the right of rehypothecation, the pledgor faces the possibility that a secured party may fail (or be unable) to return the posted collateral to it after the pledgor has fulfilled its payment obligations under a derivative transaction. This will be referred to as "rehypothecation failure." If rehypothecation failure occurs, the pledgor may end up paying twice with respect to the same obligation: First, when pledging collateral that may not be returned to it, and, second, when it meets its contractual payment obligations under the transaction.

Rehypothecation failure represents a unique scenario that is typically not a concern in a more customary secured transaction context. Typically, a secured transaction is structured to protect the secured party against the possibility that the pledgor will not meet its payment obligation. Rehypothecation failure, on the other hand, concerns the possibility that the secured party will fail to return posted collateral after the pledgor has met its obligations.

Because of the bilateral nature of the collateral arrangements, it is often unknown at the inception of the transaction which party will be the secured party and which will

be the pledgor. This creates the atypical situation in which the pledgor may be more credit-worthy than the secured party.

Loss from rehypothecation failure can be minimized through a pledgor's right to setoff its payment obligation to the secured party against the posted collateral. The pledgor, however, would probably be an unsecured creditor with respect to any collateral that it was unable to setoff (i.e. any excess of collateral value over its payment obligation). In addition, it is also possible that the pledgor may not be able to setoff the obligation without a court's or trustee's permission in the event of the insolvency or bankruptcy of the secured party.

This article will begin with a discussion of derivative transactions and the derivatives industry in general, focusing in particular on transactions involving interest rate swaps. This part will discuss the credit risks that participants experience when they enter into interest rate swap transactions (as well as other kinds of derivative transactions). Then, this article will discuss the efforts made by participants to require counterparties to collateralize their possible payment obligations.

Part II will discuss the practice of rehypothecation and describe why secured parties are so insistent on having that right to rehypothecate collateral. It will then discuss the statutory provisions that normally prevent its exercise without the consent of the pledgor.

Part III will focus primarily on the risks assumed by a pledgor with respect to its posted collateral if the secured party becomes insolvent or bankrupt after it has rehypothecated the posted collateral. It will describe the remedies available to the pledgor against both the secured party and the transferee of the posted collateral. Part III will conclude that the greatest risk occurs in the event that the secured party becomes overcollateralized with respect to the pledgor's obligation to it.

Finally, Part IV will argue that a participant should resist consenting to rehypothecation, or should at a minimum, be compensated by its counterparty for assuming the risk of rehypothecation failure. In the event that a participant does consent, Part IV will suggest some precautions that a pledgor can take to minimize the risks of rehypothecation. In addition, this part will discuss possible legislative changes that could be made to minimize the risks of rehypothecation.

I. Derivative Transactions

Although the spectacular losses suffered by some participants in the derivatives industry has given some participants pause, the derivatives market continues to develop and expand. In particular, the number of transactions in the over-the-counter derivative market continues to grow at an ever increasing rate. As the market has grown, participants have

become more concerned about the counterparty credit risks associated with these transactions.

A. Nature of Derivative Transactions

The term derivative transaction includes a wide variety of financial transactions. Transactions range in complexity from "plain vanilla" interest rate swaps to more complex transactions involving equities and commodities.

1. Derivatives in General

The derivatives market has expanded and evolved over the last two decades.[3] Although the term derivative has become overused,[4] it is typically defined as "a financial contract whose value depends on the values of one or more underlying assets or indexes of asset values."[5] In a typical transaction, parties contractually agree to exchange payments based upon the

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[3] For a general description and discussion of the derivatives market, *see generally* S. Das, Swap & Derivative Financing - The Global Reference to Products, Pricing, Applications and Markets 3-36 (1993).

[4] *Misuse of the World "Derivatives" Continues*, Swaps Monitor, Apr. 25, 1994, at 7 ("The word 'derivatives' seems to get attached particularly to any transaction which lost money or which is deemed to be risky.").

[5] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, & Office of the Comptroller of the Currency, Derivative Product Activities of Commercial Banks: Joint Study Conducted in Response to Questions Posed by Senator Riegle on Derivative Products 2(Jan. 27, 1993) [hereinafter "Joint Study"]; U.S. General Account Office, Financial Derivatives: Actions Needed to Protect the Financial System 24 (May 1994)(same) [hereinafter "GAO Report"]; Group of Thirty Global Derivatives Study Group, Derivatives: Practices and Principles 28-29 (July 21, 1993) (same) [hereinafter "Group of Thirty"]

change in the value or performance of an index or asset. The change in the underlying index or asset is then typically multiplied by an agreed upon amount, commonly referred to as the notional amount,[6] to determine the total that must be paid by one party to the other.

In the early 1980s, transactions typically only involved swapping interest rate risk.[7] Parties now, however, enter into various forms of transactions based on changes in the value of currencies, equity securities and commodities.[8] It is estimated that the notional amount outstanding as of the first half of 1996 for interest rate swaps, currency swaps and interest rate options alone was over $21 trillion.[9]

A derivative can be either a customized or a standardized contract. Standardized contracts are typically traded over an exchange and cleared through a clearinghouse.[10] A huge market

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[6] The parties do not actually ever exchange the notional amount, but instead use it as an amount to base the calculations of their payment obligations. Joint Study, *supra* note *5*, at 8 (discussion of notional amount).

[7] Das, *supra* note 3, at 18-19.

[8] GAO Report, *supra* note *5*, at 24 (assets include "stocks, bonds, physical commodities, such as wheat, oil and lumber"); E. Baecher, Swaps and the Derivatives Market, in The Handbook of Derivatives & Synthetics 114-16 (R.A. Klein & J. Lederman eds., 1994)(discussing broad categories of derivative market products).

[9] International Swaps and Derivatives Association, Inc., News Release: ISDA's Midyear 1996 Market Survey Finds Double-Digit Growth in Swaps Activity, Nov. 13, 1996, at 1 ("The ISDA survey's figures aggregate data that 80 ISDA members around the world submitted on a confidential basis to Arthur Andersen.").

[10] Joint Study, supra note 5, at 4 ("Exchange-traded contracts are (continued...)

has developed, however, in transactions that are customized by large commercial banks, investment banks and similar financial institutions.[11] This is commonly referred to as the "over-the-counter" market (the "OTC market").[12] In the OTC market, large financial institutions structure various kinds of customized derivative instruments for their customers.[13] This article will focus primarily on transactions entered into in the OTC market, although the general principles regarding rehypothecation should be applicable to standardized contracts as well.

2. Purpose of Derivative Transactions

Participants enter into derivative transactions primarily for three reasons. First, derivative instruments are commonly used to hedge or reduce various kinds of risks in a particular business.[14] For example, a participant through a swap

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[10](...continued)
standardized as to maturity, contract size, and delivery terms").

[11] *Id.* ("OTC markets involve customized derivative products in which the parties negotiate all details of the transactions or agree to certain simplifying market conventions"). For a general discussion of the development of the derivatives industry, see Das, *supra* note 3, at 14-30.

[12] *See* B. S. Derringer, *Swaps, Banks and Capital: An Analysis of Swap Risks and a Critical Assessment of the Base Accord's Treatment of Swaps*, 16 U. Pa. J. Int'l Bus. L. 259, 271 n53 280(1995) (discussion of OTC Market); A.R. Waldman, Comment: *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance into the Abyss*, 43 Am. U.L. Rev. 1023, 1033 (1994) ("Today's players in the OTC derivatives market consist primarily of corporations, governmental entities, financial institutions, and institutional investors.").

[13] Joint Study, *supra* note 5, at 4.

[14] GAO Report, *supra* note 5, at 25. Group of Thirty, *supra* note 5, at (continued...)

transaction may be able to convert its obligation to pay a variable interest rate into an obligation to pay a fixed rate. Through the swap transaction, a participant has minimized the risk that it will be subject to an interest rate change above the fixed rate.[15] This is particularly important for businesses attempting to match their fixed-rate assets to variable-rate liabilities.[16]

Second, some participants speculate in the market by attempting to take advantage of changes in market rates or prices through derivatives.[17] Some major dealers also earn significant fees through serving as a dealer or middleman in the process.[18]

Finally, some participants attempt to obtain more desirable financing terms through their use of derivatives or to change the

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[14](...continued)
36-37. A. Kuprianov, *The Role of Interest Rate Swaps in Corporate Finance*, Federal Reserve Bank of Richmond Economic Quarterly, Summer 1994, at 53-58 (discussing hedging through interest rate swaps); J.L. Motes, *A Primer on the Trade and Regulation of Derivative Instruments*, 49 SMU L. Rev. 579, 585-87 (1996)(same).

[15] Waldman, *supra* note 12, at 1028.

[16] C. D. Olander & C. L. Spell, *Interest Rate Swaps: Status Under Federal Tax and Securities Laws*, 45 Md. L. Rev. 21, 23 (1986).

[17] GAO Report, *supra* note 5, at 25; Group of Thirty, *supra* note 5, at 43; Joint Study, *supra* note 5, at 7 ("trading profits").

[18] Banks and investment firms also had $5 billion in revenue from their swap dealings in 1994. T. C. Hagamam, *Derivatives and the Banks*, Mgmt. Acct., June 1, 1995, at 16 (quoting Swaps Monitor); *See* Darringer, supra note 12, at 275("[s]waps account for a growing share of revenues and profits for banks and securities firms"); Joint Study, *supra* note 5, at 6 (firms "expect to generate income from transaction fees, bid-offer spreads, and their own trading positions").

asset mix in their portfolios.[19] Counterparties that borrow money (particularly at a variable rate) often enter into interest rate swaps to minimize their interest costs. For example, a borrower with a poor credit rating typically is able to borrow more readily on a variable rate than on a fixed rate. However, the borrower can effectively convert a variable rate loan into fixed rate financing by entering into a derivative transaction.[20]

3. Interest Rate Swaps

Although derivatives can be structured in a variety of different ways and be based on any number of indices, one of the most common types of transaction is generally referred to as an "interest rate swap".[21] Interest rate swaps provide a useful example to demonstrate the possibilities and problems of rehypothecation failure for virtually all types of derivative transactions.[22]

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[19] GAO Report, *supra* note 5, at 25; Group of Thirty, *supra* note 5 , at 34-35. *See also* Kuprianov, *supra* note 14 at 53-58 (discussion of lowering finance costs through derivatives).

[20] Darringer, *supra* note 12, at 268; S.K. Henderson & J.A.M.N. Price, Currency and Interest Rate Swaps vii (1984).

[21] Joint Study, *supra* note 5, at 5 (listing interest rate contracts).

[22] See Darringer, *supra* note 12, at 275 n71 ("Although swaps come in numerous forms, the underlying analysis of the risks each type of swap entails is substantially similar.").

The first real use of interest rate swap agreements began in the late 1970s.[23] Estimates place the outstanding notional principal amount for interest rate swaps at $15.584 trillion at the end of the first six months of 1996.[24] As a comparison, the notional amount outstanding as of December 31, 1995 was $12.811 trillion.[25]

A typical interest rate swap is a transaction in which parties agree to exchange payments based on fixed and variable interest rates.[26] In a common scenario, a participant may be able to borrow more inexpensively at a variable interest rate than a fixed interest rate. However, the participant may prefer to pay a fixed rate for business reasons. The counterparty to the transaction may have the opposite problem. The counterparty is able to borrow more cheaply on a fixed basis, but would prefer

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[23] *See* R. Romano, *A Thumbnail Sketch of Derivative Securities and their Regulation*, 55 Md. L. Rev. 1, 51 (1996); S. Das, *supra* note 3, at 15 (discussion of history of swap development); *A Brief History of Derivatives*, The Economist, Feb. 10, 1996, at 6 ("It is not the idea that is new, it is the volume."); N. Saber, Interest Rate Swaps: Valuation, Trading and Processing (1994) (discussion of development of interest rate market).

[24] ISDA News Release, *supra* note 9, at 2. For an overall discussion of the size of the derivatives market, see generally Das, *supra* note 3, at 4-11. Official statistics, however, may actually underestimate the true size of the market. *Confused by Rival Estimates of Market Size? Here's Why*, Swaps Monitor, Oct. 11, 1993, at 4 (discussion of problems of gathering accurate data).

[25] ISDA News Release, *supra* note 9, at 5 (chart of swaps outstandings).

[26] *See* Olander & Spell, *supra* note 16, at 29-33 (comprehensive discussion of mechanics of interest rate swaps); *see also* Baecher, *supra* note 8, at 114-16 (general discussion and description of interest rate swaps); R. J. Rendleman, How Risks are Shared in Interest Rate Swaps (same).

to pay a variable rate, perhaps because the resulting interest cost would better match its business assets or resources.[27]

In this situation, the parties agree to swap payment obligations based upon a specified notional amount.[28] For example, assume that one participant ("Party A") has borrowed $10 million at the fixed rate of 10%. The second participant ("Party B") has also borrowed $10 million at a variable rate equal to the prime rate plus 2%. Assuming that the prime rate at the date of borrowing equaled 8%, Party B's initial rate would also be 10%.

By entering into a swap, Party A agrees to make a payment to Party B equal to Party B's interest payment and Party B agrees to make a payment equal to Party A's interest payment. For example, if the prime rate rose to 10%, on the date of payment (assuming annual payments), Party A would be obligated to make a payment to Party B equal to $1.2 million. Party B would be obligated to make a payment to Party A in the amount of $1 million. Typically the terms of the swap agreement require that the payments be made on the same day and be netted against each other. In our example, Party A would make a $200,000 payment to Party B.

Because Party A's obligation to Party B is variable, Party B is concerned whether Party A will be able to meet its obligation. For example, if the prime rate had risen to 18%, Party A's payment to Party B would be equal to $2 million (20% of the

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[27] *See* GAO Report, *supra* note 5, at 5 (example of bank using an interest rate swap).

[28] Saber, *supra* note 23, at 4 (example of interest rate swap).

notional amount). Party B has only budgeted a payment of $10 million to its lender, anticipating that Party A will make up the difference with its payment. Of course, Party B is still obligated to make its payment to its lender, whether or not Party A performs under the swap transaction.

At the date of entering into an interest rate swap, the parties may have roughly equivalent payment amounts. As in the above examples, the interest rates upon which the transaction is based are probably equal.[29] As interest rates fluctuate, however, one of the participants will end up making a payment to the other party.

As interest rates continue to fluctuate it is also possible that the obligation to make a payment may vary between the parties.[30] For example, interest rates fluctuated as much as 10 percent during a one year period in the early 1980s.[31]

In such a volatile interest rate environment, it is realistic to assume that the obligations to make payments under an interest rate swap agreement may change rapidly and

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[29] E.M. Remolona et al., *Risk Management by Structured Derivative Product Companies*, Econ. Pol. Rev., April 1996, at 17 ("The typical swap transaction will have a zero value at origination, but market movements will in short order lead to gains for one of the counterparties and losses for the other."); Saber, *supra* note 23, at 83 (same); Joint Study, *supra* note 5, at 13 (same).

[30] J. H. Levie & D. J. Yeres, *Mark-to-Market Arrangements*, New York L. J., April 7, 1994, at 5 ("If the swap is for a long term the roles of debtor and secured party will probably shuttle back and forth between the parties.").

[31] G. Hanwekc & B. Shull, Interest Rate Volatility 5 (1996)(figure showing fluctuations of the prime rate).

dramatically from one party to the other.[32] Furthermore, the possibility that the payment obligation may shift between the participants in a derivative transaction is also likely with respect to other transactions outside of the interest rate swap area.[33]

4. The Documentation of Derivative Transactions

The documentation of transactions in the OTC market has largely become standardized.[34] The International Swaps and Derivatives Association ("ISDA") has developed standardized agreements for these transactions, which has enabled the market to reduce the transaction costs associated with individually negotiating every transaction between the participant and the opposing party (the "counterparty").[35] The more common types of documents include the Master Agreement, the Confirmation, and Credit Support Documents.

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[32] J. A. Gluck, Measuring and Controlling the Credit Risk of Derivatives, in Derivative Risk and Responsibility 121-22 (R.A. Klein & J. Lederman eds. 1996) ("Perhaps uniquely among financial assets, a swap can be an asset one day and a liability the next.").

[33] *Id.* at 122 ("Unlike bond contracts, (nonoption) derivative transactions are at least partially symmetric in that they may pose credit risk to either party."); Joint Study, *supra* note 5, at 15 ("the bilateral nature of OTC derivative transactions . . . can lead to significant credit exposure").

[34] B.L. Crino & P. Dondanville, *Pay Attention to Swap Contracts*, Corp. Cashflow Mag., Aug. 1995, at 30 (general discussion of ISDA swap documentation).

[35] M. Uffy, Wall Street & Technology 34 (Feb. 1993) (discussion of role of ISDA); *Industry Organizations*, Futures, Jan 1. 1993, at 117 (summary of ISDA organization).

The Master Agreement, developed by ISDA, documents the overall terms of the relationship (other than a transaction's payment terms) between the two parties.[36] The standard form of Master Agreement developed by ISDA provides for representations between the parties, covenants, events of default and other important contractual considerations.[37]

The Confirmation documents the payment terms of the transaction, detailing the amount and the timing of each payment to be made by each participant.[38] ISDA has developed common standard definitions that are used to document the individual trades and transactions between the counterparties.[39]

Credit Support Documents are typically a security agreement or a guarantee or both, and provide a participant with greater

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[36] For a comprehensive discussion of the Master Agreement, *see* ISDA, User's Guide to the 1992 Master Agreements (1993) [hereinafter "User's Guide"].

[37] 90% of the notional amount of interest rate swaps entered into between dealers were documented using a Master Agreement. G30 Resurveys Dealers, Swaps Monitor 9 (Dec. 12, 1994); T.K. Patton, Corp. Cashflow Mag., Aug. 1995, at 16 ("Most swaps are written with an ISDA agreement"); R. Rice, *Business and the Law: A question of Standards*, Fin. Times 20 (Nov. 22, 1994) (discussion of ISDA's effort to standardize documentation); D. M. Forster, Comment: *Standard Swap Agreements Don't Insulate Users From Risk*, The American Banker 20 (June 13, 1994) (discussion of issues in using a Master Agreement); ISDA Issues Standard Form For Derivatives Deals, BC Cycle, June 7, 1994 at 77 (master agreements are "widely used in global over-the-counter derivatives activity").

[38] *See* User's Guide, *supra* note 36, at 3-4 (discussion of confirmations and definitional booklets); A. Piscitello, Operation Risk, in Derivatives Risk and Responsibility 516 (R.A. Klein & J. Lederman eds., 1996) (discussion of role of confirmations).

[39] 1991 ISDA Definitions; 1994 ISDA Equity Definitions; ISDA Commodity Definitions.

assurance that the other party will perform.[40] ISDA has developed a standardized security agreement referred to as the Credit Support Annex (the "ISDA Annex") that governs the pledging of collateral (including the right of rehypothecation) to secure a party's obligations to make payments under a Master Agreement.[41] The ISDA Annex consists of seven pages of standard language with an additional paragraph that can be modified to customize the agreement for certain key points of negotiation.[42]

B. Credit Risk

As the derivatives industry grows, participants have become concerned about the possibility that some counterparties will default on their obligations under the transactions. In an effort to minimize these risks, participants have typically required that counterparties provide collateral that can be used to satisfy the counterparty's obligations in the event that it defaults.

1. Generally

A party that enters into a derivative transaction assumes not only the risk that it has negotiated a "bad" transaction and

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[40] ISDA 1992 Master Agreement, section 14 (definition of "Credit Support Document").

[41] For a more complete discussion of the ISDA Annex, *see* ISDA, User's Guide to Paragraph 13 of the 1994 Credit Support Annex (Bilateral Form) (1994) [hereinafter "Annex Guide"].

[42] *News in Brief*, Int'l Sec. Reg. Rep., June 14, 1994, at 1.

may be required to make payments to the other party under the transaction's terms, but also that even if it has negotiated a "good" transaction, the other party may fail to perform.[43] This risk of the failure to perform is typically referred to as "credit risk".[44]

Credit risk is particularly troubling for participants in the OTC market because there is no clearinghouse arrangement to mitigate it.[45] In a clearinghouse arrangement such as the New York Stock Exchange or the Chicago Board of Trade, credit risk is

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[43] S. S. Cohen, *Financial Services Regulation: A Mid-Decade Review: Colloquium: The Challenge of Derivatives*, 63 Fordham L. Rev. 1993, 2011 (1995)(identifying credit risk as one of thirteen risks in the derivative area).

[44] Joint Study, *supra* note 5, at 12; GAO Report, *supra* note 5, at 52 ("the possibility of financial loss resulting from a counterparty's failure to meet its financial obligations"); Waldman, *supra* note 12, at 1023 ("The 'credit risk' in an OTC derivative transaction is the risk that the participant will default on contractual obligations to a counterparty, resulting in loss."). In understanding credit risk, it is important however, to distinguish credit risk from "systemic risk", the risk that the failure of a major participant in the market could lead to a domino effect affecting the entire market. *See* Joint Study, *supra* note 5, at 23 (discussion of aggregation or interconnection risk); Waldman, *supra* note 12, at 1047 (discussion of systemic risk). Although a party may be unable to control systemic risk, it does have the ability to minimize its credit risk through carefully selecting its counterparts or by requiring collateral.

[45] Romano, *supra* note 23, at 51. "For exchange-traded products, there is a central clearinghouse that stands as a guarantee to all buyers and sellers that their trades will be consummated, regardless of counterparty default. Because OTC derivatives participants deal directly with each other without the benefit of an exchange clearinghouse, counterparties must rely on each others's credit for assurance that contractual obligations will be met." Waldman, *supra* note 12, at 1047-48; J. W. Markham, *"Confederate Bonds," "General Custer", and the Regulation of Derivative Financial Instruments*, 25 Seton Hall L. Rev. 1, 60-64 (1994) (discussion of a clearinghouse for derivatives).

minimized.[46] Although some participants have envisioned some sort of clearinghouse arrangement such as a collateral depository, the industry appears to be several years away from the creation of a clearinghouse for use with swap transactions done in the OTC market.[47]

Credit risk is typically measured in the derivatives area by determining the replacement cost of the swap transaction should the counterparty default.[48] In other words, how much would a new participant require to assume the obligations of the defaulting party in the transaction.[49] This amount is measured by determining the present value of the net cash flows that the new participant expects it will have to pay during the life of the

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[46] Darringer, *supra* note 12, at 271 n.55 (discussion of role of clearinghouse); Das, *supra* note 3, at 1193-97 (discussion of mechanics of swap clearinghouse).

[47] Gluck, *supra* note 32, at 156-57 (discussion of proposed collateral depository for swaps by Chicago Mercantile Exchange); *Phillps Urges Adoption of Bilateral Netting Plan to Promote Enforceability*, Daily Rep. For Executives (BNA) No. at A48, (Mar. 14, 1994) (Federal Reserve Governor Phillps views the creation of a clearinghouse for swaps as "the next logical development").

[48] Joint Study, *supra* note 5, at 9 ("the replacement cost or the positive market value (if any) of the swap is the preferred measure for assessing the amount of credit exposure if the counterparty to the agreement defaults"). For a discussion of the calculation of replacement cost, see Waldman, *supra* note 12, at 1048. For a discussion regarding modeling credit risk in the derivatives area, see Saber, *supra* Note 23, at 83-93 (1994).

[49] This is the underlying concept of "Market Quotation" in the Master Agreement. Market Quotation is the method of calculating the amount to be paid by the parties to the Master Agreement upon its termination caused, for example, by a payment default. ISDA Master Agreement, § 14 (definition of Market Quotation); User's Guide, *supra* note 36, at 24-26.

contract.[50] If there were a severe move in interest rates, this could be potentially millions (or many millions) of dollars.

It was estimated a few years ago that the credit risk on an aggregate market basis for all participants in the derivative market was approximately $170 billion.[51] Other studies estimate that the aggregate credit risk for a participant with respect to its swap transactions was approximately equal to one to three percent of the notional amount[52] of the swaps it has outstanding.[53] Historically, however, the actual number and

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[50] Waldman, *supra* note 12, at 1048; *see also* Joint Study, *supra* note 5, at 9; F. E. Meigs, *Managing the Credit Risk of Interest Rate Swaps*, 77 Journal of Commercial Lending 11 (1995) ("The amount of the credit risk can be measured [for an interest rate swap] using the present values of net cash flows given specific interest rate assumptions."); M. P. Jamroz, *The Net Capital Rule*, 47 Bus. Law. 863, 901 (1992) (determining replacement cost).

[51] C. Cummings, *Regulators Seen Pulling Together Series, American Banker*, April 5, 1993 (quoting David W. Mullins, vice chairman of the Federal Reserve Board); *see also* D. Casserley & G. Wilson, *Demystifying Derivatives*, Bank Mgmt., May 1, 1994, at 40 (credit risk assumed by U.S. banks in their derivative activity estimated at 2.4% of their combined equity); M. Levinson, *Sorry, No Crisis Here*, Newsweek, Apr. 25, 1994, at 40, 42 ("Merrill Lynch held derivatives with a face value of $891 billion at the end of 1993, but it would have lost less than $7 billion had every one of its trading partners gone out of business.").

[52] The amount at risk is not the notional amount but rather the cost to replace the transaction if the counterparty defaults. B. J. Karol, *Symposium: Regulation of Financial Derivatives: An Overview of Derivatives as Risk Management Tools*, 1 Stan. J.L. Bus. 195, 204 (1995).

[53] Patton, *supra* note 37, at 17; D. Hart, 77 Journal of Commercial Lending 17 (Feb. 1995); *OTC Derivatives Risk Overstated, Says ISDA*, Financial Times, Aug. 1, 1995, at 24 (results of Arthur Andersen study); Arthur Andersen & Co., S.C., ISDA Default Survey, at 4, Dec. 31, 1991. What particularly troubles regulators and some counterparties is that the actual amount of credit risk may be underestimated. The Federal Reserve Board in particular worries that current methods of measuring credit risk may underestimate the true credit risk underlying a particular financial instrument. *See* J. Connor, *Study Faults Risk Analysis of Derivatives*, Wall St. J., Sept. 26, 1994, at B12B; *G30 Survey Reveals Wealth of Detail*, Swaps Monitor, April 11, 1994, at

(continued...)

amount of defaults in swap transactions, appears to be very small.[54]

Participants tend to evaluate the possibility of a counterparty defaulting in a derivative transaction in the same manner that they would evaluate the risk of lending to that counterparty.[55] For example, participants look to the credit rating of a counterparty as an indication of the risk of the counterparty defaulting as it would do in assessing the risk that a borrower will default on a loan.[56]

2. Reluctance to do Unsecured Derivative Transactions

Participants have become more sensitive to credit risk as they have become more sophisticated with respect to derivative

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[53](...continued)
9-12 (survey of how dealers measure credit risk).

[54] *Bank Data Indicate Very High Counterparty Credit Quality*, Swaps Monitor, June 6, 1994, at 1 ("the amount of OTC derivatives that are past due by 90 days or more is tiny by contrast with the $104 billion replacement cost of all these dealers' OTC derivatives."); *But see* M. Liebowitz, *Will the ISDA Default Study Impress the Regulators,* Investment Dealers Digest, Aug. 3, 1992, at 3 (critique of ISDA figures).

[55] *See* Joint Study, *supra* note 5, at 12 ("[credit risk] can be evaluated and controlled through traditional methods of assessing the credit-worthiness of a counterparty."); *see also* C.J. Loomis, *The Risk That Won't Go Away*, Fortune, March 7, 1994, at 40 ("Yes, every dealer worth the name carefully polices the credit quality of its counterparties and sets limits on how much business it will do with each."); House Banking Committee Minority Staff, Report on Financial Derivatives (Part 2) 40-41 (Nov. 1993). Debt ratings, however, may not be as helpful as they are in lending situations. Moody's Investors Service, Global Credit Research, Derivatives Risk: A Growing Credit Concern 3 (April 1994).

[56] Gluck, *supra* note 32, at 125-27 (discussion of role of credit ratings in measuring credit risk).

transactions. This sensitivity is due to the increasing size of the derivative market, the volatility of derivative transactions, the number of lower credit-quality counterparties, and the highly publicized failures that have occurred in the derivatives area.

As explained above, the derivative market is now measured in notional amounts of trillions of dollars.[57] In particularly large transactions, a participant may end up owing the other party tens of millions of dollars.[58] It also appears that the market (as well as the accompanying credit risk) will only continue to grow as participants become more reliant upon derivative transactions and as different types of transactions are developed.[59]

Participants have also become more concerned with credit risk as transactions become more volatile. This increased volatility can result in risk positions changing "in a matter of seconds."[60] These concerns have increased lately due to the longer maturities involved in some derivative transactions.[61]

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[57] *See* text at *supra* notes 5-6.

[58] D. Hendricks, *Netting Agreements and the Credit Exposure of OTC Derivative Portfolios*, Federal Reserve Bank of New York Quarterly Review, March 22, 1994, at 7 (discussion of OTC derivative credit risk).

[59] *See* text at *supra* notes 8-10.

[60] Moody's Investors, *supra* note 55, at 4 ("risk positions can be rapidly changed in a matter of seconds").

[61] For example, "a $100 million one-year swap may have less risk than a $20 million seven-year swap". Meigs, *supra* note 50, at 11. *See also* L. Rahl, What Makes a Good OTC Counterparty?, in The Handbook of Derivatives & Synthetics 331 (R.A. Klein & J. Lederman eds. 1994) (discussion of the factors that affect credit risk).

The increasing maturities have led to increased volatility in the instruments, making credit risk harder to determine and to monitor.[62] Longer maturities are also problematic because a counterparty's credit quality can deteriorate over an extended period of time.[63] Accordingly, as the maturities involved in derivatives become longer, the credit quality of the counterparty becomes more important.[64]

Participants initially insisted on entering into derivative transactions only with the most credit-worthy of counterparties because of credit risk concerns.[65] This has become more difficult, however, because of the decreasing number of highly rated counterparties.[66] Although derivative dealers in

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[62] Remolona et al., *supra* note 29, at 17 ("The size of the potential credit exposure of a derivatives contract will depend on the volatility of the underlying asset and on the time horizon being considered.").

[63] Loomis, *supra* note 55, at 40 ("but within the span of a five- or ten- year derivative contract, a counterparty's creditworthiness can deteriorate substantially."); Darringer, *supra* note 12, at 276 (example of credit rating deterioration and subsequent defaults on swap agreements by Olympia & York).

[64] *Taming the Derivatives Beast*, The Economist, May 23, 1992, at 81 (importance of watching long-term credit risk).

[65] Ramono, *supra* note 23, at 51 ("swap market participants therefore tend to have the very highest credit ratings."); T. Corrigan, *Salomon sets up triple-A Rated Derivatives Unit*, The Financial Times, Feb. 9, 1993, at * ("many potential clients are unwilling to deal with institutions rated less than double A"); W. B. Crawford, Jr., *In Swaption World It Has to Be AAA*, Chi. Trib. Feb. 20, 1994, at C1; Gluck, *supra* note 32, at 66 (discussing dealing only with highly rated counterparties); M. Peltz, *Wall Street's Triple-A for Effort*, Institutional Investor, May 1993, at 89 (participants are demanding collateral upon downgrade of their counterparty).

[66] *Triple-A Vehicles Provoke Suspicion Among Users*, Euromoney, March 1994, at 58 ("The shrinking universe of triple-A banks cannot satisfy demand for the top credit rating among derivatives' users").

particular have attempted to improve their attractiveness as a counterparty through the creation of so-called "triple-A" rated subsidiaries, this still has not eliminated the demand for more credit-worthy counterparties.[67]

In addition, less credit-worthy participants want to access the derivative market in spite of their lower credit ratings.[68] Even highly rated participants have an incentive to do business with lower rated counterparties because of the fees that can be earned in the transactions.[69]

Even though the majority of the major defaults under derivative transactions have been dealt with successfully,[70] it is generally recognized that a default by a large financial institution is a realistic possibility.[71] The bankruptcy in 1990

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[67] *See* Romano, supra note 23, at 62 ("Securities firms devised [AAA subsidiaries] in order to compete with the better capitalized banks, which, unlike securities firms, have the highest credit ratings. A high credit rating is essential because, as has been emphasized, counterparty creditworthiness is a key market consideration."). However, not all counterparties are necessarily satisfied that these special purpose entities merit a AAA rating. *Triple-A Vehicles, supra note *, at* 58; Summary of *Triple-A Structures*, 8 Swaps Monitor (No. 20) 7-11 (July 24, 1995) (summary of nine triple-A entities). These entities, however, have not been as successful as their sponsors would have hoped. Remolona, et al., *supra* note *, at 17.

[68] Corrigan, *supra* note 65, at x ("Salomon, like a number of US banks with single A ratings, has been struggling to maintain its market share against triple A rated entitles like Morgan Guaranty and Union Bank of Switzerland.").

[69] *See* text at *supra* notes 17-18.

[70] *See* Darringer, *supra* note 12, at 293 (summary of major swap defaults).

[71] Markham, *supra* note 45, at 46 ("there are concerns that a large default by a large trader could impose substantial losses").

of Drexel Burnham Lambert,[72] an active participant in the derivatives market, heightened awareness of the importance of counterparty credit risk.[73] Other large financial losses in the area are also examples of the reality of credit risk in the derivatives market.[74]

C. Collateral and Derivative Transactions

As participants are confronted with the growing problem of credit risk, they have struggled to develop practical solutions to minimize that risk. Although there are a variety of other possible methods to reduce credit risk, the most practical and common method is to require a counterparty to post collateral under certain circumstances. Requiring collateral to be pledged does not completely eliminate credit risk, but may provide a sufficient reduction of risk whereas the secured party may be more willing to enter into a transaction with a less credit-worthy counterparty than it would otherwise have been.

1. Generally

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[72] *Id.* at 50 n.203.

[73] Remolona, *supra* note 29, at 17.

[74] S. Webb et al., *A Royal Mess: Britain's Barings PLC Bets on Derivatives*, Wall St. J., Date, at A1 (summary of Barings PLC collapse); *see also* N. Bray & L. Ingrassia, *Losses at Barings Grow to 1.24 Billion*, Wall St. J., Feb. 28, 1995, at A3 (possible losses of creditors of Barings); S. Lubman & J. Emshwiller, Wall St J., Jan. 18, 1995, at A1 (summary of Orange County losses); P. Jorion, Big Bets Gone Bad, Derivatives and Bankruptcy in Orange County (1996) (same); C. Cummings, *Regulators Seen Pulling Together Series*, American Banker, April 5, 1993, at * (quoting David W. Mullins, vice chairman of the Federal).

Although the pledging of collateral is not a new practice in the derivatives area, it is becoming increasingly important.[75] Both dealers and customers are beginning to insist on collateralization of derivative transactions:

> The posting of collateral has been around for a decade, ever since the thrift industry began using swaps. However, in recent years the emphasis has moved away from dealers protecting themselves from customers. Today, the emphasis of collateral arrangements is on dealers protecting themselves from each other, and on end-users protecting themselves from dealers.[76]

There appears to be a general perception in the market place that pledging collateral is the best means of reducing credit risk.[77]

In 1996, it was estimated that there was approximately $40 to $60 billion of collateral posted to secure derivative transactions.[78] Some commentators estimate that literally all

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[75] *Collateral Usage Continues to Grow, But Standards remain elusive*, Swaps Monitor, Nov. 22, 1993, at 1.

[76] Id. *See also* Joint Study, *supra* note 5, at 15 ("Counterparties routinely reduce exposures to weakening institutions by . . . requiring margin to reduce risk"). Historically, derivatives transactions have not typically been secured. W. Glasgall & B. Javetski, *Swap Fever: Big Money, Big Risks*, Bus. Wk., June 1, 1992, at 102, 103 (derivative transactions are "unsecured and exposed to ever-more-volatile interest-rate, currency and futures markets").

[77] P. Thompson, *Learning Curve, Collateralization Agreements*, Derivatives Wk., July 10, 1995, at 10 ("Collateralizing transactions with counterparties allows credit risk to be quantified and nullified"); Miegs, *supra* note 50, at 11; *Bank Regulators Offer a Way to Reduce the Capital Requirement for Derivatives*, 8 Swaps Monitor (No. 23) at 3, Sept. 11, 1995 ("To date, the market has decided that collateral is the superior means of reducing credit risk and economizing on capital"); S. McGee, *"Plain Vanilla" Derivatives Can Also Be Poison*, Wall St. J., Mar. 20, 1995, at C* (parties are reducing counterparty credit risk by requiring collateral).

[78] *The Size of the Collateral Pool Remains Difficult to Quantify*, Swaps Monitor, April 8, 1996 (estimate from panelists at the 1996 ISDA annual conference). This is in comparison to an estimate of $10 billion in 1994. L. (continued...)

derivative transactions will eventually be secured by collateral.[79] Parties appear to be looking to collateral as an important part of the terms of a derivative transaction, regardless of a counterparty's credit rating.[80] As could be anticipated, collateral is also permitting less credit-worthy customers in particular to participate in the derivatives market.[81]

Parties have also begun to insist on collateralization for bank regulatory reasons.[82] Certain financial institutions are able to reduce the capital that they are required to hold against

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[78](...continued)
Lorber, *Collateralization Nixes World Bank Swap Bizx for Foreign Banks*, Derivatives Wk., Aug. 1994, at 1.

[79] *Collateral Usage Continues to Grow*, *supra note* 75, at 5 ("Some dealers expect that, within a few years, all trades between professionals will be collateralized."); Gluck, *supra* note *, at 146-47 (discussion of use of collateral); A. Ratcliffe, *U.S. OTC market Seen Looking to Collateralize Swaps*, Reuters, Nov. 3, 1994, available in Lexis, World Library, Txtlne File.

[80] M. Peltz, *Wall Street's triple-A for Effort*, Institutional Investor, May 1993, at B9 ("To some derivatives investors, however, what counts is not a credit rating but collateral"); *Collateral Usage Continues to Grow, supra note* 75, at 1 ("[even] triple-A banks are entering into collateral arrangements").

[81] P. Thompson, *supra note* 77, at 10 (collateralization allows highly rated counterparties "to trade with counterparties that do not meet their typically high counterparty credit rating criteria."); Romano, *supra* note 23, at 51 ("low credit counterparties typically must post collateral or provide other security guaranteeing payment in order to participate in the market.").

[82] *See Risk-Based Capital Standards: Derivative Transactions*, 60 Fed. Reg. 46,172 (1995) (to be codified at 12 C.F.R. pts. 3, 208, 225, 325 (proposed Sept 5, 1995). For a discussion of the rules, see M. T. Cowhig, & S. A. Misra, *Derivatives*, 15 Ann. Rev. Banking L. 28 (1996); *see also Fed Rules Benefit Collateralized Deals, But Banks Lobby for Other Changes*, 8 Swaps Monitor (No. 5) 1 (Dec. 26, 1994)("this provision is likely to spur growth in the use of collateral for counterparties").

certain derivative transactions if their derivative transaction exposure is collateralized.[83]

2. Agreements to Collateralize Credit Risk

Participants typically provide for the pledging of collateral by entering into a security agreement. The security agreement provides that a pledgor will deliver collateral to the secured party under the circumstances set forth in the agreement. Although the security agreement could require just one of the parties of the transaction to pledge collateral, they are typically bilateral in nature.

Parties originally developed their own form of security agreement to use in the derivatives area. Although these agreements generally served their purposes, they tended to be highly stylized and led to delays as parties negotiated the agreement's terms.

The negotiation process and associated transaction costs have been reduced by ISDA's development of the ISDA Annex, a form of security agreement.[84] This article assumes that the parties

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[83] *Risk-Based Capital, supra* note 82; *Fed Rules Benefit Collateralized Deals, supra note* 82, at 1 (summary of rules). *US Bank Regulators Have Different Policies On Collateral*, 8 Swaps Monitor (No. 23) pg #, Sept. 11, 1995 (discussion of use of collateralization to reduce capital requirements).

[84] D. Suetens, *Collateralization and the ISDA Credit Support ISDA Annex*, 14 Int'l Fin. L. Rev. 15 (Aug. 1995). ISDA has drafted not only an ISDA Annex for use with New York law, but also agreements for English and Japanese law. K. Tyson-Quah, *Cross-Border Securities Collateralization Made Easy*, Butterworths J. of Int'l Banking and Fin. L., April 1996, at 183 n.5.

to the transaction have elected to use the ISDA Annex in order to simplify the discussion of rehypothecation.[85]

The ISDA Annex and other security agreements in the derivatives area are typically bilateral in nature.[86] This is because it is often difficult to determine at the inception of the transaction which party will have the payment obligation to the other and, indeed, because the determination (and the size of the payment obligation) will vary over the life of the transaction.[87] In other words, these agreements impose a duty on either party to pledge collateral, depending upon who has a current payment obligation under the transaction.

Under these security agreements, a party is typically required to pledge or transfer collateral to the other party in the event that its obligation to the other party (commonly referred to as its "exposure"[88]) exceeds a certain amount. This amount is referred to as the party's "threshold" in the ISDA Annex.[89] Depending upon the credit quality of the counterparty,

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[85] Although the non-ISDA Annex forms can be stylistically quite different, the problems of rehypothecation should be the same regardless of the particular form used.

[86] *Collateral Usage Continues to Grow, supra note* 75, at 4 ("Among dealers and banks, collateral agreements are now almost entirely bilateral, meaning that both sides could potentially be required to post collateral.").

[87] *See* text at *infra* notes 29-33.

[88] ISDA Annex, ¶12 (definition of exposure) For a discussion of "exposure" in the ISDA Annex, *see* Annex Guide, *supra* note 41, at 6; A. C. Gooch & L. B. Klein, Documentation for Derivatives: Credit Support Supplement 8, 20, 30, 54 (1995).

[89] With respect to the use of thresholds in the ISDA Annex, see ISDA (continued...)

the threshold could be fixed at an amount ranging anywhere from zero to a large sum, depending upon the party's credit rating. Under the ISDA Annex, either party may have an obligation to pledge collateral depending upon how the underlying index moves with respect to the transaction.

Literally any collateral can be pledged to secure an obligation under the ISDA Annex; however, the larger dealers in derivative transactions typically prefer that U.S. government securities be pledged.[90] This is because the securities are highly liquid and carry the highest possible credit rating.[91] Second, they can be easily valued.[92] And finally, they can be easily transferred because they are held in book entry form on the records of Federal Reserve banks.[93]

II. Rehypothecation and the Uniform Commercial Code

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[89](...continued)
Annex, ¶¶ 3, 13(b)(iv)(B). For a discussion of thresholds in the ISDA Annex, see Annex Guide, *supra* note 41, at 5-6, 8-9; Gooch & Klein, *supra* note 88, at 9, 59, 67.

[90] Miegs, *supra* note 50, at 11 ("The securities are usually U.S. government and agency issues"); *Collateral Usage Continues to Grow, supra note* 75, at 4 ("The most common types of collateral are Treasuries, agency securities and cash."); Das, *supra* note 3, at 1143 ("The basic types of collateral utilized are government securities and marketable mortgage backed securities . . .").

[91] M. Stigum, The Repo and Reverse Repo Markets 15 (1989).

[92] *Id.*

[93] *See* 31 C.F.R. Part 306, Subpart O (1996) (securities maintained in the form of an entry in the records of the Federal Reserve Banks).

As the swap industry matures, rehypothecation has become more common. Parties typically insist on the right of rehypothecation because they intend to transfer the posted collateral pursuant to a repurchase transaction. Therefore, it is important for pledgors to understand the rights that they are surrendering before they permit rehypothecation.

A. Rehypothecation Rights

The ISDA Annex expressly provides that the parties may elect the rights that they want to grant to the other party with respect to the collateral that they pledge. In particular, the ISDA Annex permits the secured party to rehypothecate posted collateral.

The ISDA Annex provides that, if the parties elect, a secured party may

> "sell, pledge, rehypothecate, assign, invest, use, commingle or otherwise dispose of, or otherwise use in its business any posted collateral it holds, free from any claim of right of any nature whatsoever of the pledgor, including any equity or right of redemption by the pledgor."[94]

As explained earlier, this article will use the term "rehypothecation" both as defined in the dictionary[95] as well as

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[94] ISDA Annex, ¶6(c)(i).

[95] Black's Law Dictionary defines rehypothecation in particular as the right "[t]o pledge to another . . . collateral which have been already pledged; e.g. a broker may pledge securities pledged to him by a customer (under e.g. a margin account) to finance his borrowings from a bank." Black's Law Dictionary 1287 (6th ed. 1990).

to refer to all of the other rights granted under the ISDA Annex as described in this paragraph.

Non-ISDA Annexes often have similar language, giving the secured party the right to rehypothecate posted collateral. The following is a typical example of a clause in a non-ISDA Annex, granting the right of rehypothecation:

> The secured party shall have the right at any time to transfer any posted collateral pursuant to a repurchase agreement with a third party, free of any right of redemption or other right of the pledgor in such collateral and without any obligation of the pledgee to substitute for deposit hereunder or otherwise maintain equivalent collateral; provided, however, that such transfer shall be subject to the secured party's obligation to pay and return collateral to the pledgor upon the pledgor's satisfaction of its obligations to the secured party as required under the agreement.

The parties may be as expansive or restrictive as they desire when drafting these rehypothecation provisions.[96]

Some form of rehypothecation has long existed in the securities industry; however, rehypothecation rights are typically not granted to a lender in other borrowing situations. This is most likely because the collateral is not in a form suitable to be rehypothecated. For example, it would be difficult, if not impossible, to rehypothecate collateral in the

[96] As opposed to the ISDA Annex, this example limits a secured party's right to use the posted collateral only in repurchase transactions.

form of real property, equipment or inventory.[97] On the other hand, securities are uniquely suited for rehypothecation.[98]

In the securities industry, it has long been a practice to require a customer of a brokerage firm to permit the firm to hypothecate and rehypothecate securities held in that customer's account.[99] This most typically occurs with respect to the securities held in a customer's margin account at a stock brokerage firm.[100] The securities industry's experience in this area, however, is probably not transferable to the derivatives area.

First, the rehypothecation of securities held in margin accounts is subject to comprehensive regulation by the U.S. Securities and Exchange Commission[101] and self regulation by the

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[97] This is because the borrower is either using this type of collateral or intends to sell it. *See* R.D. Henson, Secured Transactions Under the Uniform Commercial Code 62-97 (1979)(perfection by filing versus possession).

[98] For a discussion of the use of posted collateral in repurchase transactions, see text at *infra* notes 111-115.

[99] B. Clark, The Law of Secured Transactions Under the Uniform Commercial Code 7-93 (1993); J.D. Downes & J.E. Goodman, Barron's Finance & Investment Handbook (4th Ed. 1995) (definition of margin account and margin agreement).

[100] For an example of a sample provision providing for rehypothecation in a stock brokerage account agreement, see Howe Barnes Investments, Inc. Brokerage Services Account Agreement 5 (Revised December 1, 1995) http://secap1.com/How_phtml/signup/sig.html.

[101] 15 U.S.C. § 78h(b) (1990)(restrictions on hypothecating customers securities); 17 C.F.R. §§ 240.8c-1, 240.15c2-1 (hypothecation of customers' securities).

various exchanges.[102] On the contrary, there is no regulation to protect a pledgor of securities in a derivative transaction when its securities are rehypothecated. Second, brokerage customers are also protected from the failure of their stock brokers[103] because a customer's brokerage account is probably insured by the Securities Investor Protection Corporation.[104] This insurance minimizes the risk of loss to a pledgor, but is not available in the derivatives area.[105]

B. Rehypothecation and Repurchase Transactions

With a general right of rehypothecation, a secured party may use the posted collateral for any purpose. However, the most common usage is transferring the posted collateral to third party in a repurchase transaction.

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[102] *See, e.g.*, *New York Stock Exchange Rule 402*, 2 New York Stock Exchange Guide (CCH) ¶ 2402 (hypothecation rule); *American Stock Exchange Rule 412*, 2 American Stock Exchange Guide (CCH) ¶ 9432 (unreasonable pledges prohibited); *NASD Rules of Fair Practice 19 and 20(b)*, NASD Securities Dealers Manual (CCH) ¶¶2169-170 (hypothecation of customers' securities).

[103] *See generally*, H.S. Bloomenthal, Securities and Federal Corporate Law § 12.17 (1995) (customer protection from brokerage failures).

[104] Securities Investors Protection Act of 1970, 15 U.S.C. §78aaa-111 (1986) (the "SIPA"). For a discussion of SIPA and SIPC, see generally M. Don and J. Wang, Stockbroker Liquidations Under the Securities Investor Protection Act and Their Impact on Securities Transfers, 12 Cardozo L. Rev. 509 (1990); Sowards & Mofsky, *The Securities Investor Protection Act of 1970*, 26 Bus. Law. 1271 (1971).

[105] The SIPA provides for the creation of the Securities Investors Protection Corporation (the "SIPC") and a fund to protect brokerage firm customers up to $500,000 for cash and securities held at the brokerage firm. 15 U.S.C. §78fff-3(a)(1). *See* M. Don and J. Wang, supra note 104, at 515; J. Downes & J.E. Goodman, Barron's Finance & Investment Handbook 574 (4th ed 1995)(discussion of Securities Investor Protection Corporation).

As participants have become more sophisticated, one of the most important rights that the secured party may negotiate for itself in the ISDA Annex is the right of rehypothecation.[106] This right of rehypothecation entitles a secured party to sell the posted collateral outright, lend the posted collateral in its securities lending business, or use it to secure its own borrowings.[107] However, most secured parties transfer posted collateral pursuant to a repurchase transaction.[108]

Repurchase transactions are "contracts involving the simultaneous sale and future repurchase of an asset, most often Treasury securities."[109] When using rehypothecated securities, the pledgor may "sell" the posted collateral to a third party who is unconnected with the original derivative transaction. In this

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[106] *Collateral Usage Continues to Grow, But Standards Remain Elusive*, Swaps Monitor, Nov. 22, 1993, at 4 ("The most important issue for many firms is that of 'use rights', or as lawyers say 'rehypothecation').

[107] Meigs, *supra* note 50, at 103 n.5 ("Counterparties, especially non-banks, commonly want the right to rehypothecate the pledged securities, that is, lend these securities or pledge them to swaps or hedges of their own.").

[108] Tyson-Quah, *supra* note 84, at 183 n.5 (practices are widespread); Interview with Tom Lullo, vice president and legal counsel to The First National Bank of Chicago, November 25, 1996 (swap dealers customarily request the right of rehypothecation and use the rehypothecated posted collateral in repurchase transactions). The financial market involving repurchase transactions is one of the most important financial markets in the United States. M. Stigum, *supra* note 91, at 4.

[109] *See* Stigum, *supra* note 91, at 4. Stigum's book provides one of the most comprehensive discussions of repurchase transactions and the repurchase market; *see also* R. Lapper, *Clarifying a Complicated Subject/A Guide to Repurchase transactions*, Financial Times, Mar. 1, 1996, at II (general discussion of repurchase transactions). Repurchase transactions are most commonly entered into between large financial institutions on an institutional or wholesale basis such as U.S. government security dealers. Stigum, *supra* note 91, at 53-67.

scenario, the secured party would agree to buy the securities back for the same price that the secured party sold them for, plus an amount that compensates the third party for the use of its money.[110]

Although this article will focus primarily on a secured party's using the posted collateral in a repurchase transaction, the analysis will be relevant in other situations. As will be explained below, the pledgor will probably be in the same position with respect to rehypothecation failure, whether the secured party sold the posted collateral outright, used it in a repurchase transaction, or used the posted collateral as collateral for its own borrowings.

C. Motivation Behind Rehypothecation

The primary rationale driving rehypothecation appears to be that it provides dealers with an inexpensive source of financing through repurchase transactions. By obtaining the right to rehypothecate posted collateral through a repurchase transaction, a secured party opens up an additional inexpensive source of financing at little cost to itself.[111]

First, these arrangements will expand the inventory of securities available to the secured party for repurchase

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[110] Stigum, *supra* note 91, at 4.

[111] *Lesson One-the Safety Harness*, Euromoney, August 1995, at 38 ("After repo, CP is the company's cheapest source of funds."); Lapper, *supra* note *, at II ("a relatively cheap way of financing"); J.L. Schroeder, *Attachment and Perfection of Security Interests in Article 8 Collateral*, C664 A.L.I.-A.B.A. 177, 247 (1991).

transactions by including the pledged securities in addition to the secured party's own securities to include securities pledged to it. A secured party financing through a repurchase transaction can raise in the range of 98 cents for every dollar of posted collateral (in the form of government securities) available to it. Therefore, the right of rehypothecation gives the secured party the ability to raise substantially more financing than would otherwise be possible without rehypothecation.[112]

Second, the securities are transferred to the secured party to secure the pledgor's obligations. Thus, these securities are obtained at little or no cost to the secured party. A secured party is not obligated to pay the pledgor for the use of the posted collateral.

Although the ISDA Annex enables the secured party to pledge the securities to secure more traditional borrowing sources such as a secured loan from a financial institution, the legal significance given to the "sales" nature of repurchase transaction accounts for its popularity as a means of raising funds.

In particular, the sales nature of a repurchase transaction results in a lower funding cost to the secured party, as opposed to the cost of borrowing the money directly.[113] The lower funding

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[112] *Lesson One,* supra, note 111, at 37 ("Typically, a firm can raise 98 cents of borrowing for every $1 of treasury bonds it owns.").

[113] *Lesson One, supra* note 111, at 38 ("It also reflects the greater (continued...)

cost is available because for legal purposes, repurchase transactions are typically characterized as a sale, followed by a repurchase, of the security.[114] Alternatively, repurchase transactions have been characterized as a borrowing with the security serving as collateral.[115] In either case, however, the third party (purchasers of the securities) enjoys certain legal advantages that offer protection if the secured party (the seller of securities) finds itself in financial difficulty: the third party will be treated either as the outright owner of the rehypothecated posted collateral or as a secured party with respect to the posted collateral.[116] These protections result in lower funding costs for the secured party.[117]

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[113](...continued)
difficulty of seizing collateral in a bankruptcy than selling collateral posted with a repo lender".).

[114] J.L. Schroeder, *Repo Madness: The Characterization of Repurchase Agreements Under the Bankruptcy Code and the U.C.C.*, 46 Syracuse L. Rev. 999, 1023 (1996). For cases characterizing repurchase transactions as sales, *see* Resolution Trust Corp. v. Aetna Casualty & Sur. Co., 25 F.3d 570, 571-73 (7th Cir. 1994); Cohen v. Savings Bldg & Loan Co., 896 F.2d 54, 55 (3d Cir. 1990); Jonas v. Farmer Bros. Co., 145 B.R. 47, 53 (9th Cir. 1992); Cohen v. Army Moral Support Fund, 67 B.R. 557 (Bankr. D.N.J. 1986).

[115] Smith v. Mark Twain Nat'l Bank, 805 F.2d 278 (8th Cir. 1986); *See In re* Lombard-Wall, 23 B.R. 165, 166 (Bankr. S.D.N.Y. 1982). For a discussion of the debate, *see* Schroeder, *supra* note 114; W. F. Hagerty, Note, *Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repurchase Transactions as Separate Purchases and Sales of Securities*, 37 Vand. L. Rev. 401, 403-04 (1984); E. M. Osenton, Comment, *The Need for a Uniform Classification of Repurchase Agreements: Reconciling Investor Protection with Economic Reality*, 36 Am. U.L. Rev. 669, 669-70 (1987).

[116] For a discussion of the result of a contest between a third party and a pledgor with respect to the rehypothecated posted collateral, *see infra* text at notes 155-158.

[117] "A repurchase agreement may save approximately 25 basis points
(continued...)

The lower funding costs are largely attributable to the protections the third party enjoys in the event of the bankruptcy or insolvency of the secured party. The U.S. Bankruptcy Code (the "Code") and Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") permits the third party to liquidate the securities that it holds in a qualifying repurchase transaction, without being subject to the automatic stay or similar restrictions.[118]

More ominously for the pledgor, the advantages that a repurchase transaction provides to a third party mean that a dealer with access to securities may have an immediate source of liquidity in the event of legal or financial difficulty.[119] Because of the sales nature of a repurchase transaction and the

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[117](...continued)
(0.25 percent) off the overnight money market rate for lending. Thus the use of collateral inventory for repo finance can have significant implications for the balance sheet over time." Tyson Quoh, *supra* note 84, at 183 n.5; Stigum, *supra* note 91, at 58 ("the repo rate is usually shortly below the funds rate").

[118] Code Section 362(a) imposes, upon the filing of a bankruptcy petition, an automatic stay of, among other things, all actions commenced or which could have been commenced prior to the petition date and all actions to obtain property of the estate. 11 U.S.C. §362 (1996). Sections 362(b)(7) and 559 of the Code provide important remedies and protections for purchasers in repo transactions if the event the seller becomes bankrupt by excepting the liquidation of repurchase agreements from the automatic stay. *See* 11 U.S.C. §§ 362(b)(13), 555, 559(b); S. Mouy & E.J. Nalbantian, Make Sure You use the Right Repo Agreement 36-40 (May 1995) (discussion of remedies in bankruptcy situations).

Section 1821(e)(8) of FIRREA provides similar rights to a third party. *See* 12 U.S.C. § 1821(e)(8)(A) (rights under qualified financial contracts); *Id.* §1821(e)(8)(D) (repurchase agreements are qualified financial contracts).

[119] *Lesson One,* supra note 111, at 34 ("In the markets where it is available, such as government bonds, repo is the lowest-cost, most stable form of funding and has passed the test of all previous disasters.").

statutory protections that offset certain risks of bankruptcy or insolvency, a dealer may be able to find third parties willing to purchase securities from it in a repurchase transaction. However, the same third parties may have been unwilling to make a loan to the dealer on an unsecured basis. Therefore, it is not inconceivable that a secured party might require the right of rehypothecation be granted to it as insurance in the event of the secured party's own future difficulty, as opposed to any immediate desire to rehypothecate the posted collateral.

D. Pledgor Rights Under the UCC

When personal property is pledged, a pledgor is normally protected from rehypothecation failure by the Uniform Commercial Code (the "UCC"). In a derivatives transaction, however, the pledgor consents to rehypothecation, allowing the secured party to transfer the posted collateral to third parties. Thus, the pledgor is subjected to the risk that the secured party, if insolvent or bankrupt, will not have possession or control of the rehypothecated collateral.

1. UCC Prohibitions Against Rehypothecation

The UCC protects a pledgor from rehypothecation failure because it prevents (without the pledgor's permission) a secured party from rehypothecating posted collateral.[120] A pledgor of

[120] Article 9 of the UCC will generally govern the parties' rights with respect to rehypothecation. U.C.C. §9-101 official comment ("This (continued...)

securities, however, is typically required to grant the right of rehypothecation to the secured party free of any claim or right given by the UCC (including the right of redemption), exposing the pledgor to the possibility of rehypothecation failure.

UCC 9-207 generally requires the secured party to use reasonable care in the custody and preservation of collateral in his possession.[121] Such a duty generally precludes the secured party from rehypothecating posted collateral without the express

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[120](...continued)
Article sets out a comprehensive scheme for the regulation of security interests in personal property"). This is true even though the securities typically pledged in a derivatives transaction are primarily governed by Article 8. *See* U.C.C. §8-102(15) (1978)(definition of a security). The definition and scope of the new Article 8 is also similar to the 1978 version. U.C.C. §8-102(15)(1994).

This should be the case regardless of whether the applicable jurisdiction has adopted the new revised Article 8 (the "new Article 8"). *See* The American Law Institute & National Conference of Commissioners on Uniform State Laws, Revised Article 8. Investment Securities (With Conforming and Miscellaneous Amendments to Articles 1, 4, 5, 9, and 10) (1994). Since Article 8 was revised, 30 states have adopted the revision. National Conference of Commissioners of Uniform Laws, A Few Facts About Revised UCC Article 8 (1994) (March 1, 1997).

New York state, however, has not yet adopted the revision. For a discussion of the proposed Article 8 in New York, see The Committee on Uniform State Laws and The Banking Law Committee of the Association of the Bar of the City of New York, Report on Proposed Revisions to Article 8 of the New York Uniform Commercial Code, with Conforming and Miscellaneous Amendments to Articles 1, 5, 9 and 13 thereof as well as Conforming and Miscellaneous Amendments to Other Statutes to the Association of the Bar of the City of New York (Feb. 21, 1996).

Under the current unrevised Article 8, the UCC expressly looks to Article 9 with respect to the right of a party to safeguard and repledge collateral. U.C.C. §8-321(3)(b) (1994) ("The secured party has the rights and duties provided under Section 9-207, to the extent they are applicable"). Under the new Article 8, the rules regarding taking security interests in pledged collateral have been moved into Article 9 where these rights are setout. U.C.C. §9-115 (1994); American Law Institute, supra note 125, at 10 ("The revision returns to the pre-1978 structure in which the rules on security interests in investment securities are set out in Article 9, rather than in Article 8.").

[121] U.C.C. §9-207(1)(1994).

authorization of the pledgor. Without such authorization, the secured party would be guilty of conversion if it were to rehypothecate the posted collateral.[122]

Although the UCC permits a secured party to transfer posted collateral under limited circumstances, these transfers are typically done for reasons and purposes quite different from that of rehypothecation. Under the UCC, a secured party is generally permitted to transfer posted collateral in four situations.

First, a secured party is generally permitted to assign posted collateral in conjunction with the assignment of the obligation secured by the posted collateral. Second, a secured party is permitted to foreclose on collateral after a default by the pledgor. Third, a secured party may be required to transfer collateral as part of its duty to use reasonable care in the custody and preservation of the posted collateral. And finally, a secured party may repledge posted collateral under certain circumstances.

The first three situations have little resemblance in either form or purpose with respect to the right of rehypothecation. A secured party holding posted collateral is typically entitled to transfer the posted collateral in the event that the secured party were to assign the obligation secured by it.[123] For

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[122] Ocean Nat. Bank v. Diment, 462 A.2d 35, 36 (Me 1983); Anderson, Anderson on the Uniform Commercial Code § 9-207:41 (1993) ("No provision of the Code protects the pledgee under unauthorized rehypothecation from an action for conversion brought by the owner of the securities.").

[123] B. Clark, *supra* note 99, at xx ("There is no prohibition in (continued...)

example, a lender may sell its loan to another lender and would normally assign the posted collateral along with it. This is unlike rehypothecation, in which the posted collateral is transferred to a third party without transfer of the pledgor's underlying payment obligation.

In the second situation, section 9-501 permits a secured party to exercise its remedies to foreclose and sell the posted collateral after a default by the pledgor.[124] This right is exercisable only after the pledgor (as opposed to the secured party), has run into financial difficulties. The proceeds from the sale are also used to extinguish the pledgor's liability to the secured party.[125] This is not true in rehypothecation.

The third situation imposes a duty on the secured party to use reasonable care when holding the posted collateral. This duty may require a secured party to dispose of posted collateral that is declining in value.[126] Again, however, a required

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[123](...continued)
Article 9 against a secured party's assigning to another the debt instruments plus the collateral."); 72 C.J.S. § 41 *Assignment or Transfer of Debt or Pledge* (same under common law); Richey v. Venture Oil & Gas Corp., 346 So.2d 875 (La App. 1977), writ denied 350 So. 2d 891 (1977)(same); Sprenger v. Wishek First Nat. Bank, 206 N.W. 224, 53 N.D. 398 (1925) (same).

[124] U.C.C. §§ 9-501(1) (1994) (rights upon a default); U.C.C. §9-504 (1994) (secured party's rights to dispose of collateral after default).

[125] U.C.C. §9-504(b)(1994) ("proceeds shall be applied . . . to the satisfaction of indebtedness secured by the security interest").

[126] Anderson, *supra* note 122, at § 9-207:36; Tallahassee Bank v. Bryant, 271 So. 2d 190 (1972) (secured party should have exercised stock warrants); Grace v. Sterling, Grace & Co., 30 A.D.2d 61 (1968) (secured party should have converted convertible bonds into stock); Fidelity Bank & Trust Co. v. Production Metals Corp., 366 F.Supp. 613 (E.D. Pa 1973); Dubman v. North
(continued...)

"disposition" of posted collateral into another form of collateral is distinct from transferring posted collateral pursuant to a right of rehypothecation.

The fourth situation permits a secured party to repledge posted collateral and appears to resemble the right of rehypothecation. However, this statutory right does not provide the broad rights granted under a right of rehypothecation for use of posted collateral.

2. Repledge of Posted Collateral

The common law generally provides a right to secured parties to repledge posted collateral. Section 9-207(2)(e) also appears to provide a similar limited repledge right. This section provides that "unless otherwise agreed, . . . (e) the secured party may repledge the collateral upon terms which do not impair the debtor's right to redeem it." Read broadly, it could be argued that this right would permit a secured party to repledge posted collateral pursuant to a repurchase transaction.

Under this provision, a secured party would argue that a repurchase transaction was actually a secured loan. The secured party would assert it was only repledging the posted collateral to secure its loan from the third party as permitted by section

[126](...continued)
Shore Bank, 85 Wis.2d 819, 271 N.W.2d 148 (App. 1978); 279 N.W.2d 455 (Wis. 1978); FDIC v. Caliendo, 802 F.Supp. 575 (D.C. NH 1992).

9-207(2)(e).[127] It appears, however, that this section was intended to be much more limited.

The right to repledge collateral under 9-207(2)(e) is a codification of the previous common law.[128] Case law interpreting this provision holds that a secured party has the power to repledge posted collateral to a second lender to secure its own borrowing, but its borrowing must be smaller than that of the original pledgor.[129] In addition, the repledge should also not be for a longer time or for a type of obligation significantly different than the original pledge.[130]

The common law right is based on the ability of the secured party to use the pledgor's payment to him to satisfy his obligation to the third party, who is holding the repledged collateral. By paying off its obligation to the third party, the secured party could retrieve the repledged collateral from the third party and return it to the original pledgor.

For example, assume that the pledgor pledged collateral in the amount of $1,000 in exchange for the secured party lending it

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[127] *See* text at *supra* notes 113-117.

[128] Section 9-207 generally codifies rights and duties that a pledgor is held to at common law. U.C.C. §9-207, Comment 2 (1994) ("Subsection (2) states rules, which follow common law precedents, and which apply, unless there is agreement otherwise, in typical situations during the period while the secured party is in possession of the collateral."); *see also* Chittenden Trust Co. v. Marshall, 507 A.2d 965, 146 Vt. 543 (1986) (right to repledge under " common law, and implicitly under the Uniform Commercial Code").

[129] SEC v. H.L. Rodger & Bro., 444 F.2d 1077 (7th Cir. 1971); McRae v. Vogler, 272 Or. 230, 536 P.2d 509 (1975); 72 C.J.S. § 41 *Assignment or Transfer of Debt or Pledge* (19xx) (same).

[130] Restatement (Second) of Security § 23, comment (b)(1941).

$800. Further assume that the secured party then repledged the collateral to a third party in exchange for the third party lending it $700. The pledgor's right to the collateral should not be impaired under these facts. Upon the pledgor's payment of $800 to the secured party, the secured party will pay $700 to the third party and retrieve the repledged collateral, allowing him to then return it to the pledgor.

In an 1876 decision, the United States Supreme Court dealt with the argument that a pledgor's rights were impaired with respect to the repledged collateral because there was no assurance that upon payment to the secured party, the secured party would then return the repledged collateral.[131] The Court found that a pledgor's rights to the collateral were not impaired because the pledgor could pay his obligation to the second lender, obligating the second lender to return the posted collateral under the pledgor's equity of redemption.[132] In an action by the original secured party against the pledgor for payment of the obligation, the pledgor's defense rests on payment to the second lender.[133]

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[131] Talty v. Freedman's Savings and Trust Company, 93 U.S. 321 (1876).

[132] Talty, 93 U.S. 321; Bradley v. Perkins, 78 Ill. 169 (1876); Belden v. Perkins, 78 Ill. 449 (1875); Restatement (Second) of Security §23, comment (b)(1941).

[133] Section 9-207(2)(e) has also been held to be applicable to a situation in which a lender transfers an obligation to another lender. The court held that the lender would be permitted to also transfer the collateral securing the obligation without being guilty of conversion. Security Savings Ass'n v. Clifton, 755 S.W.2d 925 (Tex. Ct. App. 1988). This, however, is not the meaning given to this concept by the common law.

Although Section 9-207(2)(e) allows the secured party to repledge collateral, the requirement that the repledge of collateral not impair the right of redemption means that this exception does not apply to a rehypothecation by a secured party involving a repurchase transaction.[134] Section 9-506 of the UCC provides the pledgor the statutory right to redeem the collateral pledged by him by "tendering fulfillment of all obligations secured by the collateral,"[135] provided that the secured party hasn't already disposed of the collateral as permitted by the UCC.[136] A secured party would be liable for conversion in the event that it failed to permit a pledgor to exercise its right of redemption.[137]

When the secured party transfers posted collateral in a repurchase transaction, it does impair the pledgor's right of redemption. This is because in a repurchase transaction, the seller of the security actually transfers title to the third

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[134] For a discussion of the application of the right of redemption, *see* text at *infra* notes 142-154.

[135] U.C.C. §9-506 (1994); *see also* Hillcrest State Bank v. Bankers Leasing Corp., 544 S.W.2d 727 (Tex. Ct. App. 1976).

[136] Section 9-506 provides that the debtor does not have a right of redemption in the event that (i) the secured party has disposed of the collateral under 9-504 after a default or (ii) the secured party has retained the collateral in satisfaction of the obligation under 9-505. U.C.C. §9-506 (1994).

[137] Mann v. United Missouri Bank, 689 S.W.2d 830 (Mo. Ct. App. 1985); Clark v. General Motors Acceptance Corp., 185 Ga App 130, 363 S.E.2d 813 (Ga. Ct. App. 1987).

party "free and clear" as opposed to merely granting a security interest.[138]

In describing the distinction between a secured loan and a repurchase transaction, one commentator has described the possible impairment to the pledgor's right of redemption in a repurchase transaction as opposed to a repledge:

> The power to repledge is also distinguishable from the power to sell and be personally liable to return a like item. In a repledge, the secured party can still re-obtain the exact collateral because the repledge must not interfere with the original pledge. An outright sale of the collateral, in lieu of a pledge, would surely violate the debtor's [i.e. pledgor's] property right.[139]

An outright sale of the posted collateral as occurs in the repurchase transactions impairs the pledgor's right of redemption because the contractual rights with respect to the transferred collateral run only between the secured party and the third party.[140]

This interpretation would probably be supported by the insolvency and bankruptcy provisions governing repurchase transactions. In the event of the bankruptcy of a secured party,

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[138] Schroeder, *supra* note 114, at 1020-1033 (discussing the differences between repurchase transactions and secured lending).

[139] Schroeder, *supra* note 114, at 1023.

[140] See Ocean National Bank of Kennebunk v. Diment, 462 A.2d 35 (Me 1983) (holding that 9-207(2)(e) inapplicable to "outright relinquishment" of posted collateral).

a party to a repurchase transaction with the secured party should have the right to retain the rehypothecated posted collateral.[141]

3. UCC Protections and Insolvency of Secured Party

The importance of the UCC prohibitions against rehypothecation can best be illustrated by testing a pledgor's rights to the return of its collateral upon the insolvency or bankruptcy of the secured party. Assuming that the pledgor has not consented to rehypothecation, a pledgor should be able to redeem the collateral it posted upon satisfying its obligation to the secured party, regardless of whether the secured party is solvent or insolvent.

Upon the posting of collateral to the secured party by the pledgor, the secured party is obligated to hold and preserve the collateral.[142] Assuming that the secured party has not transferred the collateral in violation of the UCC, the secured party should still be holding the posted collateral that was pledged prior to the time of its insolvency or bankruptcy.[143]

Upon the pledgor's satisfaction of its obligations to the secured party, the pledgor should normally be able to redeem the

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[141] *See supra* notes 113-118.

[142] U.C.C. §9-207(1) (1994).

[143] A discussion of other possible issues that might affect a pledgor's right to the return of the collateral such as issues regarding the segregation of collateral, fungibility or other identification issues, or the possibility of administrative error or loss is beyond the scope of this Article. These potential issues, however, would probably affect the pledgor independent of whether the pledgor had consented to rehypothecation.

collateral that it had pledged to it.[144] Assuming that the secured party were solvent, the pledgor would probably be able to redeem the collateral regardless of whether it had consented to rehypothecation. Even if the rehypothecated posted collateral were not in the secured party's possession, a solvent secured party could either require the rehypothecated posted collateral, or it could purchase equivalent collateral in the market. The secured party could then return this collateral to the pledgor.

However, if the secured party were insolvent or bankrupt, the pledgor's right to redeem the posted collateral becomes more important. This is because the insolvent secured party (or the trustee or receiver of the secured party) should still be in possession of the posted collateral.[145] Upon satisfying its obligation to the insolvent secured party, the pledger should be able to exercise its right of redemption and retrieve its posted collateral.[146]

The right of redemption should protect the pledgor regardless of whether the secured party is bankrupt or insolvent. The U.S. Bankruptcy Code (the "Code") provides that the "estate is comprised of all the . . . legal or equitable interests of the

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[144] *See* discussion of the right of redemption at *supra* text accompanying notes 134-137.

[145] It is again necessary to assume that the secured party has not violated the UCC by transferring the posted collateral.

[146] *See* text accompanying *supra* notes 134--137 (discussion of right of redemption).

debtor in property as of the commencement of the bankruptcy case."[147]

The bankrupt secured party's rights in the posted collateral are limited to the right to foreclose or retain the posted collateral in the event that the pledgor fails to meet its obligations under the transaction. If the pledgor meets its obligations to the secured party, the pledgor's rights in the posted collateral should be respected and the posted collateral will be returned to the pledgor.[148]

In understanding a pledgor's rights to the estate of the bankrupt secured party, it is important to distinguish the right of redemption from the rights of the estate's creditors. A creditor of the estate will only have a claim against those assets in the estate.[149] To the extent that the pledgor is able to extinguish the estate's rights in the posted collateral by meeting its payment obligation and exercising its right of

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[147] 11 U.S.C. §541(a)(1) (West 1995). *See also In re* Yeary, 55 F.2d 504, 508 (10th Cir. 1995); *In re* Harrison, 987 F.2d 677, 681 (10 Cr. 1993); *See* United States Fidelity & Guar. Co. v. Housak, 184 B.R. 494 (E.D. Va. 1995).

[148] Unfortunately, there appears to be no case law in which a pledgor's right to redeem collateral has permitted the pledgor to redeem posted collateral held by the bankrupt's estate. *Cf.* B. Clark, *supra* note 99, at 4-205 (discussion of bankrupt debtor's right of redemption); In re Carroll, 7 B.R. 907 (Bankr. D. Ariz. 1981) (debtor's right to redeem).

[149] *See* 11 U.S.C. §§ 541 (definition of property of the estate); 502 (claims against estate) (1996).

redemption, the estate and the estate's creditors would have no right to the posted collateral.[150]

A pledgor should have a similar right to redeem posted collateral held by an insolvent (as well as solvent) financial institution that is subject to FIRREA. FIRREA provides that when the Federal Deposit Insurance Corporation (the "FDIC") is appointed receiver for an insolvent insured depository institution, it "succeeds to all rights, titles, powers and privileges of the insured depository institution."[151]

Although FIRREA does not discuss what these rights entail, the U.S. Supreme Court has held that, "except where some provision in the extensive framework of FIRREA provides otherwise," the receiver is in the same position as was the depository institution prior to the insolvency.[152]

It would appear, therefore, that with respect to a receivership under FIRREA, the rights of the FDIC and the insolvent financial depository on any posted collateral would be governed by state law (i.e. the UCC). Accordingly, if a pledgor meets all of its obligations with respect to its obligation to the insolvent secured party and exercises its right of

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[150] Arguably, however, there could be more than one pledgor attempting to redeem the same posted collateral. This would assume, however, that the secured party had transferred posted collateral in violation of UCC § 9-207, resulting in a smaller pool of posted collateral than was originally pledged.

[151] 12 U.S.C. § 1821(d)(2)(A)(West 1995).

[152] O'Melveny & Meyers v. FDIC, 114 S.Ct. 2048, 2054 (1994); *see also* Barnhill v. Johnson, 112 S.Ct. 1386, 1389 (1992) (stating, the context of a bankruptcy case "[i]n the absence of any controlling federal law, 'property' and "interests in property' are creatures of state law").

redemption, the receiver or insolvent institution should be required to return the posted collateral to the pledgor.[153]

The rights of a pledgor that has not consented to rehypothecation should be weighed against the rights of a pledgor that has consented. By permitting rehypothecation and waiving its right of redemption, a pledgor risks the possibility that the secured party will not have the posted collateral in its possession, nor would it have the wherewithal to repurchase it or obtain equivalent collateral.

For example, assume that two pledgors have pledged collateral to a secured party, with only one pledgor consenting to rehypothecation (and waiving its right of redemption as required by the ISDA Annex). Assume further that prior to becoming insolvent, the secured party has only rehypothecated the posted collateral of the consenting pledgor. Finally, assume that both pledgors attempt to redeem their posted collateral after the secured party has become insolvent and is unable to repurchase the rehypothecated posted collateral.

Although both pledgors have a contractual right to the return of their posted collateral, only the nonconsenting pledgor has restricted the secured party from rehypothecating its collateral and has not waived its right of redemption. Under UCC section 9-506, the nonconsenting pledgor should be able to redeem its collateral from the insolvent secured party.

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[153] Unfortunately, there also appears to be no case law in which a pledgor's right to redeem collateral has permitted the pledgor to redeem posted collateral held by an insolvent financial institution.

The nonconsenting pledgor will need to pursue other remedies to recover its posted collateral.[154] By consenting to rehypothecation and waiving its right of redemption, the pledgor implicitly assumed the risk that the secured party would be unable to return the rehypothecated posted collateral. It would be inequitable to entitle the consenting pledgor to a share of the remaining posted collateral when it had waived the protections provided it by the UCC.

4. Waiving the Right of Redemption

There is a question as to whether a pledgor can grant a right of rehypothecation free of its right of redemption under the UCC. Section 9-501 expressly (and Section 9-506 implicitly) prohibits a pledgor from waiving or varying its right of redemption prior to defaulting on its obligation to the secured party.[155] This reading also has support in the case law.[156]

It could be argued that a pledgor is not waiving its right of redemption in the ISDA Annex. The ISDA Annex never requires the pledgor to waive its right of redemption; rather it instead requires the pledgor to permit the secured party to transfer the

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[154] *See* Part III.

[155] However, Section 9-501 does permit the parties to agree to the standards by which the fulfillment of the right of redemption is to be measured. Although U.C.C. 1-102(3) does permit contracting parties to vary the terms of the U.C.C., this would appear to be expressly prevented by Section 9-501. U.C.C. §9-501 (1994).

[156] Indianapolis Morris Plan Corp. v. Karlen, 28 N.Y.2d 30, 35-36, 319 N.Y.S.2d 831, 834-35 (1971). Under the common law, Justice Cardozo appears to have permitted such a waiver. *See* Wood v. Fisk, 215, N.Y. 233 (N.Y. 1915); For a discussion of this problem, see Schroeder, *supra* note 111, at 246.

posted collateral free of this right. The right of redemption would still apply when the posted collateral is returned by the third party to the secured party. This distinction, however, would appear to be one of semantics as opposed to one of legality.[157]

The ambiguity suggests a practical problem for counterparties seeking legal opinions with respect to the enforceability of the ISDA Annex. Assuming that the right of redemption cannot be waived prior to default of the pledgor, it calls into question whether a legal opinion could be given affirming the enforceability of a clause permitting rehypothecation.

III. Legal Consequences of Rehypothecation Failure

Although rehypothecation failure presents additional risks to a pledgor, the pledgor has several contractual and non-UCC legal remedies to minimize the risk that it may have to make a payment to the secured party to meet its obligations and will be unable to receive its posted collateral. Although it is doubtful that the pledgor would have any remedy against a third party holding the posted collateral, the pledgor should have a right to setoff the amount that it owes the secured party against the posted collateral.

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[157] *See* Gooch & Klein, *supra* note 88, at 35 (discussing waiver right of redemption).

In analyzing the legal consequences of rehypothecation failure, it will be assumed in this part that the secured party has become insolvent or bankrupt after rehypothecating the posted collateral. In addition, it will be assumed that the secured party does not have the wherewithal to repurchase the rehypothecated posted collateral. For the same reasons as discussed above, it is unlikely that rehypothecation failure would occur if the secured party is solvent. This is because a solvent secured party could either repurchase the rehypothecated collateral or could purchase equivalent collateral.

A. Remedies Against the Third Party

It is unlikely that the pledgor would have any remedy against the third party to whom the posted collateral was transferred, regardless of whether such transfer was made outright to such party through a sale, through a repurchase transaction, or through a pledge to secure other borrowing. This is because the pledgor, by permitting rehypothecation and allowing the secured party to transfer the posted collateral to a third party, has effectively subordinated its rights in the posted collateral to that of the third party.

The third party could be holding the posted collateral under several circumstances. First, the secured party may have transferred title outright to the third party in a sales transaction. Second, and more likely, the third party could be holding the posted collateral pursuant to a repurchase

transaction. Typically, if the secured party failed to repurchase the posted collateral, the third party would simply retain it.[158] Finally, the third party may have foreclosed on the posted collateral (or be waiting to foreclose), if the secured party has defaulted under a lending transaction with the third party.

By affirmatively giving the secured party the right to transfer or sell the posted collateral, combined with waiving its right of redemption to the posted collateral, the pledgor has in substance subordinated its rights in the posted collateral to the third party. By contractually permitting the secured party to transfer the posted collateral to the third party, the pledgor has placed itself in a junior position to the third party. In fact, the third party probably has relied upon this implied subordination before permitting the secured party to transfer the posted collateral to it as part of the transaction.[159]

If the rehypothecation of the posted collateral consisted of an outright sale or a repurchase transaction to a third party, the pledgor would not have a remedy against the third party because the third party would now have title to the posted collateral. Paragraph 6(c) of the ISDA Annex specifically gives a secured party the right to sell (i.e. transfer title to) the

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[158] *See* text at *infra* notes 144-154 (describing the rights of a third party in a repurchase agreement under the Bankruptcy Code and FIRREA).

[159] The ISDA Annex expressly requires the pledgor to transfer the posted collateral free from any right or equity of redemption. See text at supra note 94.

posted collateral. Under the UCC, the third party acquires all rights the secured party had with respect to the posted collateral.[160]

If the third party were holding the posted collateral as security for its own claim against the secured party,[161] it is probable that the pledgor's claim would be junior to that of the third party. This is because the pledgor does not have even a security interest in the posted collateral that would entitle it to some kind of lien priority over the third party. The pledgor is the party giving the security interest to the secured party, as opposed to the party receiving it. Therefore, at best, the pledgor has a contractual right only against the secured party for return of the posted collateral, with this contractual right probably subordinate to the third party's in the posted collateral.

B. Remedies against the Secured Party

Although the pledgor may consent to rehypothecation, it does not waive its contractual right to the return of the posted collateral from the secured party. The secured party is still

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[160] Under the revised Article 8, the pledgor would appear to have no remedy against the third party. See U.C.C. §8-503(e) (1994). A similar rule also exists under the current unrevised Article 8. U.C.C. §8-302(a) (1994) ("[U]pon delivery of a . . . security to a purchaser, the purchaser acquires all the rights in the security that the transferor had or had power to transfer.").

[161] This could also be the situation in the event that a repurchase transaction was characterized as a secured lending. *See* text at *infra* notes 113-117.

obligated to return the posted collateral, whether or not it has been rehypothecated. As explained above, however, the normal statutory right to redeem the posted collateral is waived.

1. Damages

The pledgor would have a claim for damages in the event that the secured party fails to meet its contractual obligations to return the posted collateral after the pledgor has fulfilled its obligations under the transaction. The ISDA Annex provides that the pledgor is entitled to exercise "all rights and remedies available to a pledgor under applicable law with respect to the posted collateral."[162] Presumably, this would entitle the pledgor to sue for contractual damages. If the pledgor satisfies its obligations to the secured party but does not receive back the posted collateral, the damages would probably equal the fair market value of the unreturned posted collateral.

Although the pledgor will have a claim for damages against the secured party, the pledgor still faces the difficulty of collecting the damages, particularly if the secured party is insolvent or bankrupt. Because the pledgor's claim for damages is not secured by collateral, the pledgor would probably be classified as an unsecured creditor, competing with the rest of the unsecured general creditors for the remaining assets of the bankrupt estate.

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[162] ISDA Annex, ¶8(b)(i).

2. Right to Setoff

If the pledgor has not yet fulfilled its obligations under the derivative transaction, the pledgor should have the right to setoff its obligations against the value of any posted collateral held by the secured party. A right of setoff should enable the pledgor to avoid the situation of making a payment to the defaulting secured party without the assurance that the posted collateral will be returned to it after it has made the payment.

Setoff is a common law remedy "grounded on the absurdity of making A pay B when B owes A".[163] Setoff is generally understood as "a canceling out of mutual debts and credits,"[164] thus permitting a debtor to satisfy its debt to a creditor by offsetting it against an amount owed by the creditor to the debtor.[165] The remedy appears to have originated in an effort to

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[163] Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528 (1913). For a review of the common law remedy of setoff as developed in England the U.S. colonies, see W.H. Loyd, *The Development of Set-Off*, 64 U. Pa. L. Rev. 541 (1916); S. J. Keene, *Article 9's Setoff Exclusion: The Conflict Between a Bank's Right of Setoff and a Holder of a Perfected Security Interest*, 27 UCC L.J. 115, 117-23 (1994); Comment, *Automatic Extinction of Cross-Demands: Compensation From Rome to California*, 53 Cal. L. Rev. 224 (1965).

[164] B.L. Zaretsky, *Setoff Strategies for Collecting Troubled Loans*, 9 Commercial Lending Rev. 31, 31 (1994) ("When a debtor owes money to a creditor and the creditor owes money to the debtor, the parties can set off the obligations instead of exchanging payments.").

[165] For a general discussion of setoff, see B. Clark, *supra* note 99, at 1.08[9][c], L. Kalevitch, *Setoff and Bankruptcy*, 41 Clev. St. L. Rev. 599 (1993); J. Tassel, *Banker's Right of Setoff-Banker Beware*, 34 Okla. L. Rev. 40 (1981); D.L. Greene, *Deposit Accounts as Bank Loan Collateral Beyond Setoff to Perfection--The Common Law is Alive and Well*, 39 Drake L. Rev. 259 (1990);

avoid multiple lawsuits and to ensure fairness.[166] Although developed at common law, the remedy of setoff has been codified both in Federal and in state law.

The drafters of the ISDA Annex recognized the importance of the setoff right for a pledgor. Under the ISDA Annex, upon the occurrence of the bankruptcy or insolvency of the secured party,[167] the secured party is "obligated to immediately transfer all posted collateral . . . to the pledgor" whether or not the pledgor has satisfied its obligations to the secured party.[168] In the event the secured party fails to transfer the posted collateral to the pledgor, the pledgor is permitted to "set-off" any amounts payable by the pledgor to the secured party.[169]

The ISDA Annex, therefore, expressly provides the pledgor a contractual right to set off any amounts that it owes to the secured party against any posted collateral that the secured party has failed to return after becoming insolvent or bankrupt.[170] This right of setoff in the ISDA Annex should be

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[166] *See* Loyd, *supra* note 163, at 546, 562.

[167] The insolvency or bankruptcy of the secured party would be considered to be an Event of Default (as defined in the Master Agreement) under the ISDA Annex. ISDA Annex, ¶8(b).

[168] ISDA Annex, ¶8(b)(iii).

[169] ISDA Annex, ¶8(b)(iv)(A).

[170] [T]he Pledgor may: (A) Set-off any amounts payable by the Pledgor with respect to any Obligations posted against any Posted Collateral or the Cash Equivalent of any Posted Collateral held by the Secured Party (or any obligation of the Secured Party to transfer that Posted Collateral).
ISDA Annex, ¶8(b)(iv).

recognized under applicable state law, U.S. Bankruptcy law, and FIRREA.

a. U.S. Bankruptcy Code

Participants entering into transactions with counterparties subject to the U.S. Bankruptcy Code ("the Code") have always been concerned about their setoff rights when their counterparty declares bankruptcy.[171] A bankrupt secured party will generally be governed by the Code,[172] unless it is a domestic insurance company, bank, thrift or credit union or a foreign insurance company, bank thrift or credit union engaged in business in the United States.[173] Congress has modified the Code to extend protections to creditors in swap transactions not enjoyed by many other types of creditors.

The legislative history surrounding these modifications summarizes many of the earlier concerns for parties dealing with bankrupt counterparties:

> Concerns have been raised that under current bankruptcy law, termination and setoff of a swap agreement would be automatically stayed when one of the parties files a bankruptcy petition, whereupon the trustee, after indefinitely postponing termination of the swap agreement, could refuse setoff and unfairly "cherry pick" only the portions of the agreement advantageous

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[171] For a general discussion of setoff and the U.S. Bankruptcy Code, see Kalevitch, *supra* note 162, at 599 (1993).

[172] 11 U.S.C. § 101 et. seq. (1994).

[173] 11 U.S.C. § 109(b). For a general discussion of the area, see S. Grosshandler, L. Kalembka & K. Parker, Memorandum regarding Securities, Forward and Commodity Contracts and Repurchase and Swap Agreements under U.S. Insolvency Laws (May 1, 1996).

to the debtor, while rejecting the portions unfavorable to the debtor.[174]

The ability of a trustee to assume or reject an executory swap contract was of particular concern.[175]

Although the legislation has succeeded in minimizing the majority of these concerns,[176] there is still some ambiguity as to whether these provisions protect a pledgor who has previously pledged collateral to a now bankrupt secured party.[177]

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[174] Bankruptcy: Swap Agreements and Forward Contracts, House Report No. 101-484 (May 14, 1990), 4 U.S. Code & Cong. & Admin. News 223 (1990); *see also* Bankruptcy Treatment of Swap Agreements and Forward Contracts, H.R. Rep. No. 484, 101st Cong., 2d Sess. 1, reprinted in 1990 U.S. Code Cong. & Admin. News 223 (discussion of uncertainties); J. C. Dugan, *Derivatives: Netting, Insolvency, and End Users*, 112 Banking L.J. 638 (1995) (discussion of legal risks for a participant in bankruptcy without swap friendly provisions); Scot Tucker, *Interest Rate Swaps and the 1990 Amendments to the United States Bankruptcy Code: A Measure of Certainty Within Swap Market Contracts*, 1991 Utah L. Rev. 581 (same).

[175] *Interest Swap: Hearings on S. 396 Before the Subcomm. On Courts and Admin. Practice of the Senate Comm. On the Judiciary*, 101st Cong., 1st Sess. 22-31 (1989) (statement of Mark C. Brickell, Chairman, ISDA); *Id.* at 56-59 (statement of John J. Jerome); id. 51 (1989); Cunningham & Rogers, *The Status of Swap Agreements in Bankruptcy, in Interest Rate and Currency Swaps 1989*, 638 P.L.I. 203, 218-22 (1989); Rogers, *Interest Rate and Currency Swaps and Related Transactions, in The Swap Market in 1990*, 689 P.L.I. 7, 18 (1990).

[176] For a general discussion of the treatment of derivatives under the U.S. Bankruptcy Code, see Cravath, Swaine & Moore, Memorandum of Law for the International Swaps and Derivatives Association, Over-the-Counter Derivatives Transactions: Netting Under the U.S. Bankruptcy Code, FIRREA, and FDICIA (June 22, 1993); M. J. Bienenstock, Derivatives under the Bankruptcy Code, 721 PLI/Comm 11 (Sept. 7-8, 1995); Moody's Investors Service, Global Credit Research, The Status of Swap Agreements Under the U.S. Bankruptcy Code (June 1994) (general discussion); Moody's Investors Service, Derivatives Claims Under the U.S. Bankruptcy Code: Implications for Counterparty Ratings (Oct. 1994); J. C. Dugan, *supra* note 171 (same); Tucker, *supra* note 171, at 581.

[177] A pledgor may also want to consider the common law doctrine of recoupment if setoff appears unlikely. M. J. Bienenstock, Derivatives under the Bankruptcy Code, 721 PLI/Comm 11 (Sept. 7-8, 1995) (discussion of recoupment).

The Code has been amended several times to afford different treatment to "swap agreements" and "swap participants" than normally afforded to other commercial contracts and creditors.[178] The Code defines "swap agreement" broadly to include various types of derivative transactions.[179] In addition, a swap agreement is defined to include a "master agreement" relating to the various transactions "together with all supplements."[180] A swap participant is a party that had entered into a swap agreement prior to the bankruptcy of the secured party.

Section 362. Typically, a creditor is subject to the automatic stay with respect to the setoff of any debt owed to the debtor against any claim against the debtor.[181] The automatic stay prevents creditors from exercising their rights to setoff without the approval of the bankruptcy court. The Code, however, provides an express exemption from the automatic stay to permit a swap participant to setoff any mutual obligations with a bankrupt

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[178] ISDA & Public Securities Association, Financial Transactions in Insolvency, Reducing Legal Risk Through Legislative Reform (April 2, 1996) 4.

[179] Section 101 of the U.S. Bankruptcy Code defines a swap agreement as

> "an agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interests rate option ,forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreements, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing)"

11 U.S.C. §101(53(B)(A).

[180] *Id.*

[181] 11 U.S.C. §362 (a)(7) (West 1994).

counterparty arising under a swap agreement and to use any collateral to satisfy amounts due from the bankrupt party.[182]

If applicable, Section 362 would prove important to a pledgor in assuring that it could net or setoff any payment amount under the swap transaction against any collateral it had pledged without being subject to the automatic stay. Reliance upon Section 362 however, could prove problematic for a pledgor dealing with a bankrupt secured party.

Initially, Section 362 appears to have been drafted for the more typical situation in which the nonbankrupt party is the secured party, and the secured party is trying to setoff a payment owed to it against collateral that a bankrupt pledgor has pledged to it.[183] In this situation, Section 362 expressly provides that a secured party may setoff amounts owed to it against collateral that a bankrupt pledgor has pledged to it.

There is, however, no express provision in Section 362 that permits a nonbankrupt pledgor to setoff collateral that it has

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[182] *Id.* §362(b)(17). This exception to the automatic stay under the Bankruptcy Code provides that

> the filing of a petition . . . does not operate as a stay. . . of the setoff by a swap participant, or any mutual debt and claim under or in connection with any swap agreement that constitutes the setoff of a claim against the debtor for any payment due from the debtor under or in connection with any swap agreement against any payment due to the debtor from the swap participant under or in connection with any swap agreement or against cash, securities or other property of the debtor held by or due from such swap participant to guarantee, secure or settle any swap agreement.

[183] This situation is much more common because typically a secured party would be less likely to go bankrupt than the pledgor. This is the reason that the secured party has insisted on collateral.

pledged against payments owed to the bankrupt secured party. Because the provision expressly deals with setoff against collateral, and arguably not in the context of a bankrupt secured party and nonbankrupt pledgor; a court may conclude that Congress did not intend to provide similar relief to a nonbankrupt pledgor.[184]

The ambiguity further results from whether an obligation to return collateral is the same as, or equivalent to, the "payment due" language found in Section 362(b)(17). For example, does the payment due language suggest that the payment must relate to financial terms (as opposed to the collateral terms) of the derivative transaction? Or, does the "payment" language suggest that it must be an obligation to pay cash? If that were the case, would the obligation to return cash collateral be different from the obligation to return collateral in the form of government securities?

In interpreting similar language with respect to the repurchase transaction provisions of the Code,[185] the bankruptcy

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[184] The legislative history is not very helpful. It only refers to collateral pledged by a bankrupt debtor who has a payment obligation to its counterparty:

> The new paragraph [17] also permits the swap participant to use any collateral previously pledged by the debtor to guarantee, secure or settle swap agreement.

H.R. Rep. No. 484, 101st Cong., 2nd Sess. 226-27 (1990). Even though the language in the House's bill was eventually adopted, similar language was also proposed by the Senate. *See* Swap Agreements and Forward Contracts, S. Rep. No. 101-285 at 16 (May 14, 1990).

[185] *See* text at *supra* notes 118.

courts have struggled with a similarly ambiguous situation. In the repurchase transaction area, courts have broadly construed the term "settlement payment" to include not only the payment of cash, but also a transfer of securities.[186] Arguably, the "any payment due" language would also include the bankrupt secured party's obligation to transfer the posted collateral to the pledgor.[187]

Another way to reconcile the right of setoff for the pledgor with the "payment due" language is found in the remedy section of the ISDA Annex. The ISDA Annex provides that the pledgor may set off any amount that it owes against either "the posted collateral or the cash equivalent of any posted collateral held by the secured party."[188] The pledgor would therefore be entitled to setoff its obligation against a cash payment amount that would represent a "payment due" that the secured party would theoretically be required to make to the pledgor.

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[186] *In re* Cormark, 971 F.2d 322 (9th Cir. 1992) ("a settlement payment clearly includes a transfer of securities that completes a securities transaction."); Bevill, Bresler & Schulman v. Spencer Savings & Loan Association, 896 F.2d 54 (3rd Cir. 1990) (adopting a broad interpretation of 'settlement payment'); Bevill, Bresler & Schulman v. Spencer Savings & Loan Association, 878 F.2d 742 (3rd Cir. 1989)("it is clear that 'settlement payment' does not only mean payment of cash to the dealer by the purchaser, but also encompasses transfer of the purchased securities to the purchaser from the dealer."); *In re* Hamilton Taft & Company, 176 B.R. 895 (N.D. Cal. 1995)(same); *cf.* Kaiser Steel Corp v. Charles Schwab & Co., 913 F.2d 846 (10th Cir. 1990 (similar definition for purposes of 11 USC 741(8)); *In re* David, 193 B.R. 935 (1996) (same).

[187] Although the language in Section 362 is very similar for both the repurchase exemption and the swap exemption, the repurchase exemption language in 362(b)(7) does not contain the "property of the debtor" language in 362(b)(17).

[188] ISDA Annex, ¶8(b)(iv)(a).

From a policy perspective, there would appear to be little rationale to limit the reach of Section 362. First, permitting a pledgor to setoff its payment obligation against posted collateral would appear to limit the systemic risk that concerned Congress in the event of the bankruptcy of the secured party.[189] Requiring it to make a payment when it had already posted collateral would only magnify the financial pressure on a pledgor in the event of the bankruptcy of the secured party, contributing to systemic risk.

Second, it is unclear intuitively why a secured party should be permitted to setoff the payment obligation of a pledgor to it against posted collateral while a pledgor could not offset its obligation to make a payment against collateral that it had posted. Because of the bilateral nature of the ISDA Annex,[190] either party could potentially be a pledgor and could be at risk in the event of the bankruptcy of the secured party.

Section 560. Section 560 of the Code recognizes a party's contractual right to net or offset termination values and payment amounts under a swap agreement without being subject to the automatic stay or similar provisions.[191] Section 560 should

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189 *See supra* note 44 for a discussion of systemic risk.

190 *See* text at *supra* notes 86--87.

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> The exercise of any contractual right of any swap participant to cause the termination of a swap agreement because of condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection
>
> (continued...)

be helpful in that the ISDA Annex provides a pledgor with a contractual right of setoff.[192]

It is unclear, however, whether Section 560 would be applicable to a nonbankrupt pledgor attempting to setoff its payment obligation against posted collateral. First, as opposed to Section 362, Section 560 deals strictly with offsets of "termination values" and "payment amounts," and does not by its terms extend its protections to setoffs against collateral. It may be more difficult to convince a bankruptcy court that Section 560 encompasses a setoff involving collateral.

Second, similar to Section 362, Section 560 permits the setoff against any "payment amounts" without elaborating as to the meaning of that term. A court would be faced with the same concerns regarding the meaning of "payment amounts" as it would have had in Section 362 with respect to the "payment due" language. The same policy arguments, however, made with respect to Section 362 regarding the phrase "payment amount," could also be made with respect to Section 560 to interpret Section 560 to encompass setoffs by pledgors.

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[191](...continued)
with any swap agreement shall be not strayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title. As used in this section, the term "contractual right" includes a right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.

11 U.S.C. § 560 (1994).

[192] *See* text at *infra* notes 188.

Setoff Rights under Applicable State Law. Assuming that Sections 362(b)(17) and 560 of the Bankruptcy Code are inapplicable, the Bankruptcy Code may still recognize a setoff right of the pledgor under applicable state law, although the pledgor would be subject to the automatic stay and the concerns surrounding it.[193]

Section 553 of the U.S. Bankruptcy Code provides that the Code does not affect "any right of a creditor to offset a mutual debt owing" to the debtor that arose before the bankruptcy filing occurred.[194] Assuming that it would be permissible under state law setoff provisions, the pledgor's right to setoff its obligation to the secured party against the posted collateral should be respected in bankruptcy.[195]

Initially, the obligation of the pledgor to fulfill its obligations to the secured party and the secured party's

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[193] *See* 48th Street Steakhouse, Inc. v. Rockefeller Group, Inc., 835 F.2d 427, 430 (2nd Cir. 1987), *cert. denied*, 485 U.S. 1035 (1989) (party should apply to bankruptcy court for the return of property in the possession of a debtor); *In re* Atlantic Business and Community Corp., 901 F.2d 325, 327 (3rd Cir. 1990) *(a* possessory interest in real property is within the ambit of the estate and, thus, within the protection of the automatic stay).

[194] 11 U.S.C. § 553. For a discussion of Section 553, see Kalevitch, *supra* note 162 (generally); Freeman, *Setoff Under the New Bankruptcy Code: The Effect on Bankers*, 97 Banking L.J. 484 (1980); C. Hammon, Note, Setoff in Bankruptcy: Is the Creditor Preferred or secured, 50 Colo. L. Rev. 511 (1979); P. T. Lacy, *Setoff and the Principle of Creditor Equality*, 43 S.C. L. Rev. 951 (1992); J. C. McCoid, *Setoff: Why Bankruptcy Priority*, 75 Va. L. Rev. 15 (1989).

[195] "Section 553 does not create any new right of setoff where none existed under nonbankruptcy law, but merely recognizes the existence of the doctrine and puts some additional restrictions on its exercise. . . Thus, the Code looks to state law to determine the right of setoff." *In re* Anton, 146 B.R. 509 (E.D.N.Y. 1992).

obligation to return the posted collateral should meet the mutuality test under Section 553. Both obligations come from the same contract and relate to the same transactions. Case law has found that obligations in analogous situations satisfy both the requirement that there be a debt and that the debt be mutual.[196]

It is probable that New York law would be applicable in the event of a bankruptcy of a second party.[197] Both the Master Agreement and the ISDA Annex standard language are governed by New York law (although English law could also be chosen).[198] For purposes of the discussion of setoff here, it will be assumed that New York law will be applicable.[199]

Section 151 of the New York Debtor and Creditor Law provides a statutory right of setoff under certain conditions.[200] This

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[196] *See In re* Bevill, Bresler & Schulman Asset Management Corporation, 896 F.2d 54, 59 (3rd Cir. 1990) (failure to deliver securities considered to be mutual debt).

[197] For comprehensive discussion of setoff rights under the New York statute, see D.P. Cunningham & E.H. Kahil, Memorandum for ISDA's Board of Director from Cravath, Swaine & Moore, Setoff Rights in Swap Agreements under New York and U.S. Law (April 15, 1991).

[198] User Guide, *supra* note 36, at 33 ("The 1992 Agreements contemplate a choice between English law and the laws of the State of New York); ISDA Annex 1 ("ISDA Agreement subject to New York Law Only").

[199] Gooch & Klein, *supra* note 88, at 3-6 ("The Connection Between the Area and New York Law").

[200] Every debtor shall have the right upon:

(a) the filing of a petition under any of the provisions of the federal bankruptcy act or amendments thereto or the commencement of any proceeding under any foreign bankruptcy, insolvency, debtor relief or other similar statute or body of law, by or against a creditor;
(b) the making of an assignment by a creditor for the benefit of

(continued...)

statute permits a creditor, upon the filing of a bankruptcy petition by the debtor, to setoff "indebtedness" owed to the debtor against any "amount" owed by the debtor to the creditor. A pledgor should qualify for relief under this provision because the secured party has filed for bankruptcy.[201]

Although Section 151 does not provide a definition for the term "indebtedness," there have been several attempts by the

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[200](...continued)

its creditors;

(c) the application for the appointment, or the appointment, of any receiver of, or of any of the property of a creditor;

(d) the issuance of any execution against any of the property of creditor;

(e) the issuance of a subpoena or order, in supplementary proceedings, against or with respect to any of the property of a creditor; or

(f) the issuance of a warrant of attachment against any of the property of a creditor,

to set off and apply against any indebtedness, whether matured or unmatured, of such creditor to such debtor, any amount owing from such debtor to such creditor, at or at any time after, the happening of any of the above mentioned events, and the aforesaid right of set off may be exercised by such debtor against such creditor or against any trustee in bankruptcy, debtor in possession, assignee for the benefit of creditors, or against anyone else claiming through or against such creditor or such trustee in bankruptcy, debtor in possession, assignee for the benefit of creditors, receivers, or execution, judgement, or attachment creditor, notwithstanding the fact that such right of set off shall not have been exercised by such a debtor prior to the making, filing or issuance, or service upon such debtor of, or of notice of, any such petition; assignment for the benefit of creditors; appointment or application for the for the appointment of a receiver; or issuance of execution, subpoena or order or warrant.

N.Y. Debt & Cred. Law § 151.

[201] Section 151 expressly applies in the event that the secured party files "a petition under any of the provisions of the federal bankruptcy act." N.Y. Debt. & Cred. Law § 151(a) (McKinney 1990). The right to invoke a right of setoff with respect to occurrences of events of default not specifically enumerated in Section 151 has also been recognized. *See* Edwards V. Sterling Nat. Bank & Trust Co., 5 F. Supp. 925 (S.D.N.Y. 1934).

judiciary to do so. Indebtedness is generally defined under section 151 by the courts as "the condition of being in debt and debt is generally defined as a fixed and certain obligation."[202] This is in opposition to a contingent obligation which is not "indebtedness" under Section 151.[203]

It is clear that the obligation to return the posted collateral has become fixed and matured under the ISDA Annex upon the bankruptcy of the secured party.[204] The contractual obligation to return the posted collateral should also constitute "indebtedness" of the secured party under the New York setoff statute. The secured party has a contractual duty under the ISDA Annex to return the posted collateral "or the *cash equivalent* of any posted collateral"[205] to the pledgor upon the secured party's bankruptcy or insolvency.

Although there is little case law with respect to the pledgor's situation under New York law, the situation would seem

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[202] Trojan Hardware Company v. Bonaquisti Construction Corporation, 141 A.D. 2d 278, 534 N.Y.S.2d 789 (S.Ct. 1988); *see also* United States v. New York, New Haven & Hartford R.R. Co., 276 F.2d 525, 530, *cert. denied*, 362 U.S. 961(19xx). The New York Supreme Court has further defined a debt as "a certain obligation to pay a sum of money or another thing of value, either at the present time or in the future. An obligation, in contrast, is a legally enforceable duty to perform or forbear. Michaels v. Chemical Bank, Misc.2d 74, 441 N.Y.S.2d 638 (Sup. Ct. 1981).

[203] Trojan Hardware Co., Inc. v. Bonacquisti Const. Corp., 278, 534 N.Y.S.2d 789 (3 Dept. 1988);

[204] Paragraph 8(b)(iii) of the ISDA Annex provides that the secured party is obligated to return the posted collateral upon the occurrence of an Event of Default (such as a bankruptcy) with respect to it.

[205] ISDA Annex, paragraph 8(b)(iv)(a).

to meet both the letter and intent of the New York setoff statute.

b. Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA")

Participants transacting business with counterparties subject to FIRREA should enjoy many of the same protections that they have with respect to debtors subject to the U.S. Bankruptcy Code. Even if they do not qualify for these same protections, however, a creditor of an insolvent financial institution should still be able to exercise its setoff rights.

Participants in the derivatives market had many of the same concerns with respect to federal law governing the insolvency of financial institutions as they had with respect to debtors governed by the Code.[206] In enacting FIRREA, Congress attempted to replicate many of the same swap protections given to parties transacting business with Code debtors as those contracting with non-Code debtors such as federally insured financial institutions subject to FIRREA.[207] FIRREA covers almost all financial institutions such as banks and savings institutions.[208]

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[206] "While prior to the enactment of FIRREA several efforts were made to address the concerns of counterparties to insured institutions, the comfort received was . . . not statute or regulation, and it did not address many areas of concern." *See* W. Eccard & S. Grosshandler, *Qualified Financial Contracts with FDIC-Insured Banks and Thrifts*, 7 Review of Banking & Financial Services 49, 50 (April 10, 1991).

[207] Pub. L. No. 101-73, 103 Stat. 183 (1989).

[208] For a general discussion of the treatment of insolvent financial institutions, see Dugan, *supra* note 174, at 638 n4 (1995).

In general, FIRREA provides that a party shall not be stayed or prevented from exercising its rights under a "qualified financial contract", including "any right under any security agreement" relating to such contract.[209] A qualified financial contract is defined, among other things, broadly as a "swap agreement".[210]

To the extent that the security agreements related to a qualified financial contract provide a remedy of setoff for the pledgor, the right to exercise that remedy should be protected.[211] FIRREA should therefore recognize a pledgor's right to setoff its obligation to an insolvent secured party against the posted collateral. As opposed to the Code, the FIRREA language does not restrict the right of setoff to a particular situation.[212]

Although unlikely, it is possible that a court could find the above discussed FIRREA provisions to be inapplicable to

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[209] 11 U.S.C. § 1821(e)(8)(a)(i), (ii) (1994). For a discussion of qualified financial contracts, see Eccard & Grosshandler, *supra* note 203, at 49.

[210] 11 U.S.C. § 1821(e)(8)(D)(i) (1994). Swap agreement is defined as "any agreement, including the terms and conditions incorporated by reference in any such agreement, which is a rate swap agreement, basis swap, commodity swap, forward rate agreement, interest rate future, interest rate option purchased, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreements, currency future, or currency option purchased or any other similar agreement". *Id.* § 1821(e)(8)(D)(vi).

[211] The legislative history also does not put any limitation on a Pledgor's setoff rights. See H. Rep. No. 101-54(I), at 331 101st Cong., 1st Sess. At 331 (1989), reprinted in U.S. Code & Cong. & Admin. News 127 (1989) ("counterparties to certain Financial Contracts, as defined, including . . . swap agreements, may exercise their . . . setoff rights under such contracts and related security agreements").

[212] *See supra* notes 209.

setoffs by pledgors against rehypothecated posted collateral.[213] A pledgor should still, however, have the setoff rights it would normally have enjoyed even without FIRREA.

Both Federal banking regulators and the courts have recognized a right of setoff for creditors of insolvent financial institutions. The FDIC expressly recognizes the right of setoff[214] and has formulated the requisites that must be satisfied before it will recognize a setoff against an insolvent financial institution.[215]

> To be a legal offset, the debts between the bank and the depositor or other creditor must be contractual, mutual and existing at the time the bank is closed. Contractual means that the creditor must owe the financial institution . . . whereas the institution must owe the same individual for deposits or other contractual obligations.[216]

Although there are no examples from the FDIC with respect to a rehypothecation situation, the recognition that "contractual obligations" can be offset suggest that the pledgor should be able to offset its payment obligation against the posted collateral, assuming that mutuality exists and setoff is not against a state's banking law.

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[213] Because of the breadth of the language in Section 1821(e)(8)(a)(i), a court might attempt to limit it to what it believes was Congress's intent, which conceivably might not meet the pledgors situation.

[214] FDIC Interpretive Letter No. 91-11, reprinted in 1 Fed. Dep. Ins. Corp., Law, Regulations and Related Acts 4527 (Feb. 5, 1991).

[215] *See* FDIC-DAS Claims Procedures Manual - Volume 1, 4-142 (Mar. 2, 1994).

[216] *Id.*

Courts also generally recognize a creditor's right to offset an obligation against the obligation of an insolvent financial institution. The U.S. Supreme Court in *Scott v. Armstrong*[217] recognized such a setoff right at the turn of century.[218] Other courts have also recognized such right with respect to both a national bank[219] and a state bank.[220] However, the pledgor would still need to meet the general elements of setoff and such setoff rights would need to be permissible under applicable state law.[221]

Similar to the general right of setoff under the Code, however, in the event that the FIRREA swap provisions did not apply, the pledgor would still have to receive the approval from the insolvent financial institution's trustee prior to exercising its setoff right. This would leave the pledgor subject to the same concerns that participants had prior to the passage of swap provisions in FIRREA.[222]

3. Overcollateralization and Rehypothecation Failure

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[217] 146 U.S. 499 (1892).

[218] *Id.* (insolvent national bank); *see also* 7 Michie on Banks and Banking, ch. 5, § 240 (1989).

[219] Grady Properties Co. v. FDIC, 927 F.2d 528 (10th Cir. 1991) (recognizing right of setoff but not finding mutuality); FDIC v. Texarkana National Bank, 268-69 (5th Cir. 1989); Seattle-First National Bank v. FDIC, 619 F. Supp. 1351 (D.C. Okla. 1985).

[220] FDIC v. De Jesus Velez, 678 F.2d 371 (1st Cir. 1982) (recognizing right of setoff but not finding mutuality).

[221] FDIC v. Miller, 659 F. Supp. 388 (D.C. Kans. 1987).

[222] *See* text at *supra* notes 206.

Although the right of setoff provides a pledgor with important protections, the pledgor may still be at risk if the value of the posted collateral exceeds its payment obligations to the secured party. The right of setoff enables the pledgor to recover the value of the posted collateral, but only to the extent of its obligation to the secured party. Any posted collateral in excess of the pledgor's obligation could not be indirectly recovered through the pledgor's setoff.

For example, in the event that the pledgor had pledged $15 million in collateral to the secured party, but only had an obligation to the secured party of $10 million, it would be unable to setoff the remaining $5 million. The pledgor would probably become an unsecured general creditor of an insolvent or bankrupt secured party for such an excess.[223]

A secured party may become overcollateralized under several situations. One situation is that the secured party has insisted on being overcollateralized due to the poor credit quality of the pledgor. The secured party may have sufficient leverage in the negotiations to require the pledgor to pledge not only collateral sufficient to secure its obligation, but also an additional amount to protect against either a rapid increase in the

[223] Levie & Yeres, *supra* note 30, at 5 ("should for any reason the collateral value exceed the obligation, . . . the debtor might actually become an unsecured creditor of the secured party").

pledgor's obligation or a rapid decrease in the value of the posted collateral.[224]

Another possible situation could occur in the event that the derivative transaction were to move rapidly against the secured party. For example, if interest rates were to move rapidly in an interest rate swap transaction, the secured party could end up being obligated to make a payment to the pledgor.[225] Until the secured party returns the posted collateral, the secured party is overcollateralized.

Finally, the pledgor may become overcollateralized in the event that the secured party fails to meet its obligation to transfer the posted collateral as contractually required. It is possible that a secured party may be unable to honor the redemption request because the secured party has rehypothecated (i.e. sold or transferred) the posted collateral as part of a repurchase transaction and the secured party does not have the means or funds to repurchase the posted collateral or its equivalent.[226] This situation is most likely to occur when the secured party becomes financially troubled.

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[224] The ISDA Annex refers to this amount as the Independent Amount. ISDA Annex, ¶12 (definition of Independent Amount).

[225] *See supra* notes 32-33.

[226] J.D. Cohn, *The Basics of Collateralization of Derivatives, Swaps and Other Derivatives in 1995*, 892 PLI/Corp. 101 (May 22-23 1995) ("Mark-to-market turns to pledgor's benefit before pledgor learns that secured party is not returning collateral. Pledgor loses the opportunity to terminate while still owing a value comparable to that of the collateral posted. The collateral may be lost or subject to conflicting claims.").

The pledgor would probably be treated as an unsecured creditor with respect to the un-setoff rehypothecated collateral upon the insolvency or bankruptcy of the secured party under both FIRREA and the Code.[227] As explained above, the pledgor has no security interest with respect to the rehypothecated collateral.[228] In the event that it was unable to setoff the entire amount of the posted collateral owed to it, it would only have a contractual claim to damages against the secured party. Damage claims of this nature would typically be considered an unsecured claims under both FIRREA and the Code.[229]

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[227] D. Suetens, *supra* note 84, at 15-16 ("when the secured party is put under receivership or falls into bankruptcy, the pledgor will not have the certainty that the posted collateral will be returned because it will be regarded as a general creditor and no longer as a pledgor."); M. J. Bienenstock, *Derivatives under the Bankruptcy Code*, 721 PLI/Comm 11 (Sept. 7-8, 1995)("If a financial institution pledges margin to a counterparty pursuant to a security agreement authorizing rehypothecation and the counterparty thereafter files a petition for relief under the Bankruptcy Code, unless the proceeds of a financial institution's margin are segregated and identifiable, a financial institution may only have an unsecured claim for the value of the pledged margin").

[228] *See* text at *supra* note 161.

[229] Regardless of whether the contract was considered to be executory or nonexecutory under Section 365 of the U.S. Bankruptcy Code, the pledgor would be considered to be a general unsecured creditor with respect to damages suffered under the contract. See NLRB v. Bildisco and Bildisco, 465 U.S. 513, 531 (1984) (an executory contract); In re Gardinier, 831 F.2d 974, 976 n2 (nonexecutory contract). Under FIRREA, the pledgor would also be an unsecured creditor. See 12 U.S.C. §1821(e) (repudiation of contracts under FIRREA).

IV. Reducing the Legal Risks of Rehypothecation Failure

Participants should generally resist a request to consent to rehypothecation. If a participant does consent, however, there are several practical ways that the legal risks of rehypothecation failure can be reduced. The first approach would require the right of rehypothecation to terminate upon the occurrence of certain conditions. The second would require the pledgor to negotiate provisions in the ISDA Annex to reduce the risk of overcollateralizing its obligation to the secured party. The final approach would be to liberalize the setoff provisions with respect to swap agreements in the Code.

A. Resisting Rehypothecation

A participant should recognize that it will assume several unique legal risks by consenting to rehypothecation. As shown above, there is a general paucity of legal authority in the derivatives area with respect to how a bankruptcy court or the FDIC would deal with many of the unanswered issues posed by rehypothecation failure. In the event that a participant consents to rehypothecation, it should insist on being compensated in some manner for assuming these risks.

As discussed above, a participant assumes certain legal risks from rehypothecation failure that would not be assumed if

it did not consent to rehypothecation.[230] If a participant does consent, and the secured party becomes bankrupt or insolvent, the pledgor's principal remedy (other than its claim as an unsecured creditor) is to setoff payment obligation to the secured party against the posted collateral.[231] Assuming that the court or receiver permits such a setoff, it is still subject to the risk that it will be unable to setoff the entire value of its posted collateral against its obligations to the secured party.[232]

A participant requesting rehypothecation may argue that rehypothecation (despite the legal risks) will benefit both parties. Theoretically, for example, both participants to a Master Agreement could rehypothecate the posted collateral in a repurchase transaction. However, it is likely, at least for a participant that is not a dealer or a large financial institution, that it will not have the same access, abilities and information to participate in the repurchase market as a dealer or large financial institution.[233]

A second argument often made in favor of rehypothecation is that a dealer or other financial institution will provide better terms to a consenting counterparty. This is because the dealer or other financial institution is able to obtain less expensive

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[230] *See supra* Part II(D).

[231] *See supra* Part III(B)(2).

[232] *See supra* Part III(B)(3).

[233] *See generally* Stigum, *supra* note 91, at 53-78 (general discussion of the repurchase market).

financing by rehypothecating the posted collateral.[234] It may prove difficult for a participant to quantify or specify just how much better the derivative transaction's terms are as a result of the counterparty consenting to rehypothecation. This is because a participant does not know at the inception of a derivative transaction just how much collateral will be pledged to it over the life of the transaction.[235]

A participant may discover that it will have to consent to rehypothecation if it wants to enter into derivative transactions with certain counterparties.[236] A participant, however, may be able to benefit from granting the consent if given in exchange for concessions on other issues, requesting better business terms, or including the suggested limitations on rehypothecation discussed below. By anticipating such a negotiation, a participant will be able to minimize the cost of rehypothecation failure.

B. Terminating the Right to Rehypothecate

Because the principal legal risk of rehypothecation occurs when a secured party becomes insolvent, the pledgor may want to consider making the secured party's right of rehypothecation

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[234] *See* text accompanying supra notes 113-117 (discussion of lower financing rates from repurchase transactions).

[235] *See* text accompanying supra notes 32-33 (discussion of uncertainty as to who will be required to pledge in a derivative transaction).

[236] *See supra* Part II(C) (discussion of motivations behind rehypothecation).

contingent upon the secured party's maintaining a certain credit rating, not being in default with respect to the transaction, or not having a specified condition occur with respect to it. If the secured party fails to meet any of these conditions, it would be required to stop rehypothecating posted collateral and reacquire any posted collateral that had already been rehypothecated.

A test based on the secured party's credit rating may prove useful in allowing a pledgor to protect its interests.[237] As the credit rating of the secured party begins to deteriorate, a right to terminate rehypothecation based on such deterioration reduces the risk of rehypothecation failure.[238] If the secured party were to cease rehypothecating prior to becoming bankrupt or insolvent (and assuming that it is able to reacquire the posted collateral prior to that occurring), the pledgor should be able to exercise its right of redemption with respect to the posted collateral.[239]

The occurrence of an "event of default" or "termination event" under the Master Agreement should also be a trigger for termination of the right of rehypothecation.[240] Although

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[237] Suetens, *supra* note 84, at 15-16 (rehypothecation an extra risk . . . for smaller swappers which are not able to continuously monitor the secured party's condition).

[238] For a discussion of credit ratings, *see supra* notes 55-56.

[239] For a discussion of the right of redemption, *see supra* note 134-137.

[240] The possible events of default under the master agreement include a failure to pay or deliver, a breach of a representation or covenant, a credit support default, a misrepresentation, a default under a specified

(continued...)

typically an "event of default" or "termination event" with respect to the secured party would result in the pledgor terminating the Master Agreement and the related derivative transactions, the pledgor may not want to exercise its termination rights.[241] By ending the right to rehypothecate, however, the pledgor would be in a much better position with respect to the posted collateral in the event that the secured party becomes bankrupt or insolvent.

Similar to the occurrence of an event of default or a termination, the occurrence of a specified condition as defined in the ISDA Annex is also an important early warning sign of problems that the secured party may be suffering. Specified conditions are the same as termination events under the Master Agreement.[242] Under the terms of the ISDA Annex, the occurrence of a specified condition permits the pledgor to exercise its

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[240](...continued)
transaction, a cross default, bankruptcy, or a merger without assumption. ISDA Master Agreement §5(a). The possible termination events include illegality, credit event upon merger, and other additional termination events. ISDA Master Agreement §5(b). For a discussion of the events of default and termination events, see ISDA, User's Guide to the 1992 ISDA Master Agreements (1993); A.C. Gooch & L.B. Klein, *Documentation for Derivatives* 59-70 (1993).

[241] For example, the pledgor may want to keep in place some of the transactions as hedges that it may not be able to replace if it were to terminate the Master Agreement.

[242] Specified conditions are designated in paragraph 13(d) of the ISDA Annex and include illegality, tax event, tax event upon merger, credit event upon merger and additional termination events. For a discussion of specified conditions, see Annex Guide, *supra* note 41, at 12-13; Gooch & Klein, *supra* note 88, at 10, 21, 41, 71.

rights and remedies under the ISDA Annex.[243] Again, even if the pledgor decides not to exercise its remedies upon its occurrence, the pledgor could still protect itself by terminating the secured party's right to rehypothecate.

Language in the ISDA Annex that would limit the secured party's right to rehypothecate under Section 6(c) might read as follows:

> The provisions of paragraph 6(c) shall apply for both parties; provided, however, that upon the occurrence of a Ratings Event, an Event of Default, a Termination Event or a Specified Condition with respect to the secured party (any such event, a "Trigger Event"), then (i) the provisions of Paragraph 6(c) shall not apply to such secured party for as long as such Trigger Event continues and (ii) such secured party shall reacquire any posted collateral not otherwise in its or its Custodian's possession.
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> "Ratings Event" means that the credit rating for the secured party's long term unsecured debt falls below A- by Standard & Poor's Ratings Services, a division of the McGraw-Hill Companies, Inc., or below A3 by Moody's Investors Service.

This language should help reduce the pledgor's risk that a secured party will not be in possession of the posted collateral if and when the secured party becomes insolvent or bankrupt.

C. Minimizing the Risk of Overcollateralization

A pledgor is most at risk with respect to its rehypothecated posted collateral when the secured party has become overcollateralized. There are several basic tactics that a pledgor can employ, however, to minimize that possibility.

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[243] ISDA Annex, ¶ 8(b).

1. Monitoring Overcollateralization

To avoid becoming overcollateralized, a pledgor should carefully monitor both its exposure and the fair market value of its posted collateral on a regular basis. This may require a pledgor to calculate its payment obligation and value the posted collateral on a regular basis.[244]

If the pledgor is not able to calculate its payment obligation or value its collateral,[245] it may be necessary to negotiate more frequent valuation dates with a more sophisticated counterparty.[246] However, a counterparty may be resistant to frequent Valuation Dates due to the time involved in making the calculations and notifying the pledgor.

2. Higher Thresholds

The most effective protection against the risks of rehypothecation failure is, of course, to never pledge collateral to the secured party. As a practical matter, this can be achieved by negotiating as large a threshold as possible with respect to when the pledgor will be required to pledge collateral. This may not be possible, however, for a

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[244] Piscitello, *supra* note 38, at 513-514 (discussion of risks of not properly monitoring collateral calculations and margin calls).

[245] Thompson, *supra* note 81, at 10 ("some counterparties lack the systems to accurately mark positions to market").

[246] For a discussion of Valuation Dates and calculations under the ISDA Annex, see Annex Guide, *supra* note 41, at 11; Gooch & Klein, *supra* note 88, at 10, 27, 69.

counterparty with less than a stellar credit rating. Even when a counterparty insists upon a pledge of collateral, any threshold amount that can be negotiated above zero will help to minimize the possibility that the secured party will become overcollateralized.

Under the ISDA Annex, a pledgor is required to pledge collateral to the extent that its exposure[247] to the secured party exceeds a negotiated threshold.[248] A secured party will typically not become overcollateralized under the ISDA Annex provided that the pledgor is only required to pledge collateral above the threshold amount, as opposed to an amount equal to its obligation to the secured party. The smaller the threshold, however, the greater the possibility that a secured party may become overcollateralized.

For example, assume that the pledgor is required to pledge collateral to the secured party when its exposure to the secured party exceeds the $5 million threshold. If the pledgor's exposure exceeds $6 million, the pledgor becomes obligated to pledge $1 million. It would require a significant change in either the value of the collateral or the exposure for a secured party to become overcollateralized under this scenario.[249]

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[247] For a discussion of exposure, *see* text at *supra* note 88.

[248] For a discussion of threshold, *see* text at *supra* note 89.

[249] For a discussion of the possibility of overcollateralization, *see* text at *supra* notes 223-229.

Under some security agreements, however, the pledgor is required to pledge the entire amount of its obligation to the secured party once the pledgor's exposure exceeds a certain amount. For example, if the threshold were $5 million, the pledgor is not required to pledge until its exposure exceeds $5 million. However, if the exposure increases to $6 million, the pledgor would be required to pledge $6 million. Under this scenario, it would be much more likely for the secured party to become overcollateralized with respect to the pledgor’s obligations to the secured party.

3. Custodians

Another possible solution to minimizing the risk of rehypothecation failure is to insist that a third party custodian hold any posted collateral. Custodians have proven helpful in other areas where parties have been concerned about the credit worthiness of the opposing contracting party. Although custodians are beginning to offer their services in the derivatives area, use of custodians still appears to be uncommon in the derivative area.

In the repurchase market, for example, purchasers of securities have suffered huge losses under “hold in custody” repurchase agreements (which permit the seller to retain possession of the securities) when a seller of the securities has

become bankrupt.[250] By not taking possession of the securities, the purchasers were [251] As a result, participants in repurchase transactions have come to insist on custodial arrangements with respect to the transfer of securities.[252]

Custodians would be helpful in minimizing rehypothecation risks for several reasons.[253] First, a custodian is a disinterested third party in control of the transfer of the collateral.[254] A custodian would remove the risk that a secured party will delay the transfer of collateral after the pledgor had requested its return. The custodian would not have the same incentives as a secured party to retain collateral in the event that the secured party became financially troubled.

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[250] N. Cohen, Survey of International Repo Markets (3) p. III (Mar. 1, 1996) (discussion of collapse of several repo participants); M. Stigum, *supra* note 91, at 196 (discussing fraud in dealer market).

[251] M. Stigum, *supra* note 91, at 196 (discussion of failure to take possession of collateral).

[252] F. Souder, *Using tri-party agreements*, Pension World, May 1991, at 38 ("Today, nearly all sophisticated investors [in the repo market] have heeded this lesson and have insisted that their custodial banks take possession of the collateral").

[253] *See* Gluck *supra* note 32, at 146-47 (discussing use of role of custodian swap transactions); Levie & Yeres, *supra* note 30, at 5 (suggesting need for custodians with respect to rehypothecation). Paragraph 13(b)(1) of the ISDA Annex provides the mechanics for using a custodian in conjunction with a derivative transaction. For admission of custodian under the ISDA Annex, *see* Gooch & Klein, *supra* note 88, at 33-34.

[254] *Cf.* L. Epstein, Caddy's Guide to Keeping Repos Out of the Rough, Corp. Cash Flow Mag., July 1991, at 43 ("'we like the extra safety of a third party acting in our interests on longer-term transactions--holding collateral'")

A custodian would also ensure that the collateral was being held in properly segregated accounts.[255] Documentation can also be drafted to further protect a party's right to the collateral in the event of a counterparty insolvency.[256] Secured parties, however, may be reluctant to use custodians due to liability concerns.[257]

A custodian could also be instructed to value the collateral that it holds on a daily basis.[258] This would help the pledgor to determine whether or not it is entitled to a return of collateral in the event that the exposure has changed. Frequent valuation would, however, be likely to increase the fees charged by the custodian.

A pledgor may want to become a party to the contractual agreement in order to assure that it is fully protected.[259] Unless it is a party to the agreement, it would be unable to enforce its rights under the contract on its own behalf.

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[255] *Cf.* B. Bollen, Survey of International Repo Markets, Financial Times, p VI (Mar. 1, 1996) (custodians safeguard securities in a segregated account in repo market).

[256] *Cf. id.*("Documentation is written to protect fully the cash investor's right to the collateral in the event of counterparty insolvency.").

[257] Suetens, *supra* note 84, at 15-16 implications for the secured party in using such a custodian should be stressed"), Gooch & Klein, *supra* note 88, at 34 (secured party should be liable for custodian's negligence).

[258] *Cf.* F. Souder, *Using tri-party agreements*, Pension World, May 1991, at 38 (use of custodians to value collateral in repurchase transactions).

[259] *See* Gooch & Klein, *supra* note 88, at 34 (tripartite custodian agreement would give pledgor rights).

As the posting of collateral has become more prevalent,[260] different parties have began to offer their services as custodians.[261] For example, parties such as Bankers Trust, Cedel and the Chicago Mercantile Exchange, have all begun offering their services as custodian.[262] Currently, however, there has been minimal use of their services.[263]

Although using a custodian may prove to be more costly,[264] a custodian will have the effect of minimizing the risk that arises for the pledgor when the secured party becomes overcollateralized, thus reducing its risk that a pledgor would become an unsecured creditor upon the insolvency or bankruptcy of the secured party.

C. Alternative Forms of Credit Support

A participant truly concerned about rehypothecation failure could minimize the risks by entering into other forms of credit support arrangements as opposed to posting collateral. By not

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[260] *See* text at *supra* notes 57--67.

[261] *At the Launch of the New Collateral Management Services Approaches, Cedel and the Merc are Seen as the Most Promising*, Swaps Monitor, April 22, 1996 (summary of the industry).

[262] *Id.* at 1-2.

[263] For example, Bankers Trust has only seven to nine customers, with $1.5 to $2 billion in collateral under management. *Id.* at 2.

[264] Bankers Trust is currently charging between $500 to $800 per month, plus a fee per deal. For example, it would cost approximately 1.2 to 1.9 basis points on a transaction with involving $50 million of collateral. *Id.* at 2. *Cf.* F. Souder, *Using Tri-Party Agreements*, Pension World (May 1991) (discussion of costs in using a custodian in repurchase market).

posting government securities as collateral, the pledgor may avoid rehypothecation failure.

A participant, for example, may want to consider such alternatives as providing for cash payments equal to mark to market exposure, termination of an agreement upon a credit downgrading or the obligation exceeding a certain amount, or swap insurance.[265] A participant may also want to consider providing a letter of credit instead of posting collateral.[266]

A participant, however, may find a counterparty reluctant to these collateral substitutes. There may be legal or business risks associated with using these types of collateral that exceed those risks with respect to rehypothecation failure.[267] The alternatives may also be inefficient and more expensive for the secured party than that involving the pledging of government securities.[268]

D. Amendments to the U.S. Bankruptcy Code

The legal risks for a pledgor doing business with a secured party subject to the Code could be reduced by making minor

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[265] *See* Darringer, *supra* note 12, at 280. A discussion of these other methods is beyond the scope of this article.

[266] *See* Gooch and Klein, *supra* note 88, at 65 (example of using an irrevocable letter of credit).

[267] For example, by using a letter of credit, the parties will have to discuss such issues as valuation, delivery and an acceptable issuer. *See* Gooch & Klein, *supra* note 88, at 65, 78-79.

[268] *See* text accompanying *supra* notes 90-93 (discussion of advantages of pledging government securities).

amendments to Section 362 of that statute. Currently, it is unclear how a bankruptcy court would deal with a setoff claim of a pledgor.

As explained above, the confusion in Section 362(a)(17) results from the concern that the obligation to return collateral to a pledgor is not expressly treated for setoff purposes as the obligation to make a cash payment required in the contract.[269]

Section 362(a)(17)of the Code should be amended to expressly clarify a pledgor's setoff rights in the event that a secured party becomes bankrupt. Section 362(a)(17) could be amended as follows:

> [T]he filing of a petition . . . does not operate as a stay . . ., of the setoff by a swap participant, of any mutual debt and claim under or in connection with any swap agreement that constitutes the setoff of a claim against the debtor for any payment due from the debtor (**or for any obligation of the debtor to transfer cash, securities or other property of the swap participant held by the debtor)** under or in connection with any swap agreement against any payment due to the debtor from the swap participant under or in connection with any swap agreement or against cash, securities or other property of the debtor held by or due from such swap participant to guarantee, secure or settle any swap agreement.[addition is underlined and bolded]

This would help clarify the pledgor's right to setoff its obligation to the secured party against any posted collateral.

Conclusion

Granting a right of rehypothecation has become a requirement to do business with certain counterparties in the derivatives

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[269] *See supra* notes 181-190.

area. By granting that right of rehypothecation, however, the pledgor faces certain legal risks if the secured party becomes bankrupt or insolvent after it has rehypothecated the pledgor's collateral.

Although the pledgor enjoys certain protections under the Code and FIRREA to setoff its obligations to the secured party against posted collateral, certain risks remain. In a bankruptcy situation, the pledgor faces the possibility that it will be subject to the automatic stay and will be unable to exercise its right of setoff. Worse, the pledgor risks the possibility that in the event that the secured party becomes overcollateralized with respect to the pledgor's obligation, the pledgor may become an unsecured creditor with respect to the excess.

Before consenting to rehypothecation, a participant should assure itself that it has benefited in some other way. In addition, although it is not possible to completely eliminate the legal risks of rehypothecation, a pledgor can take certain steps to protect itself from rehypothecation failure.

A participant may want to insist (as part of its consent) that the right to rehypothecate terminates upon the financial deterioration of the secured party and that the secured party does not become overcollateralized. Congress could also reduce some of the legal uncertainty with respect to a pledgor's rights of setoff by expanding the swap specific provisions to include a pledgor's setoff right against posted collateral in the U.S. Bankruptcy Code.