

## **INSURANCE AND CREDIT DEFAULT SWAPS: SHOULD LIKE THINGS BE TREATED ALIKE?\***

*Arthur Kimball-Stanley\*\**

### ABSTRACT

This article focuses on the potential moral hazards created by the use of credit default swaps (“CDS”) and argues that perhaps such swaps should be regulated as analogous to regular insurance regimes. The author discusses academic mischaracterization of the issue, including arguments that CDS is not the same as insurance, and refutes this mischaracterization by comparing original rationales for regulating insurance with moral hazards created by the use of this credit risk management practice. Several specific examples are provided to illustrate this argument, including that of investment banks, scholarship on insurance contracts, control, regulatory value, and the issues of risk that underlie both regimes. Finally, the author asserts that, given the similarities and risks involved in CDS as compared to traditional insurance, regulation possibilities should be investigated.

“...[L]egal rule and economic principle are but the concavity and convexity of the single lens of general policy. To ignore this fact is to chance the invidious probability that legal rules will calcify and become divorced from basic social values.”<sup>1</sup>

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\* Editor’s Note: This student note was written in February and March 2008, during the relatively early period of what has become a financial crisis of historical proportions. Since that time, the credit default swap market has received significant attention from regulators, including insurance regulators. This note does not discuss the newfound interest of insurance regulators in the credit default swap market because when it was written such interest seemed a remote possibility. Given the extent to which the credit default swap market has changed, much of the argument made by the author can be considered anachronistic. The note remains as originally conceived to show how much the regulatory culture and consequently the regulatory landscape has changed in that short space of time.

\*\* J.D. Candidate, Boston College Law School, 2010. I would like to thank Professors Thomas E. Baker, John Day, Thomas Morawetz, and Sanchin Pandya from the University of Connecticut School of Law for their guidance.

<sup>1</sup> Bertram Harnett & John V. Thornton, *Insurable Interest in Property: A Socio-Economic Reevaluation of A Legal Concept*, 48 COLUM. L. REV. 1162, 1162 (1948) (citations omitted).

## INTRODUCTION

Recent scholarship and journalism on the use of credit default swaps (“CDS”) provide evidence that these financial products create moral hazard similar to that created during the early history of insurance contracts. The insurable interest and indemnity doctrines, as well as other principles of insurance, created to mitigate moral hazard, provide guidance in dealing with the moral hazard CDS trading may create.

Compare the following hypotheticals:

An 18th century speculator buys insurance on a British cargo ship in which he has no interest. The speculator then sends a message to his cousin in Paris, asking the cousin to inform the French fleet of the ship’s schedule. A French frigate uses the information to sink the British vessel. The speculator collects on his insurance contract. To mitigate this danger, the insured interest doctrine was created to keep the speculator from profiting on his insurance contract.

A 21st century hedge fund manager buys millions of dollars in CDSs that will pay off only if company (x) declares bankruptcy. The hedge fund manager then organizes the short-term purchase of creditor voting rights as the embattled company (x) attempts to borrow money to avert Chapter 11. The hedge fund votes against allowing further borrowing and company (x) is forced to declare bankruptcy. The CDS bet pays off and the hedge fund manager finds herself with a substantial return.

In terms of the moral hazard to be averted, the second hypothetical is no different from the first as both create new risk through contract. Both hypotheticals effectively illustrate the moral hazard created by risk distribution contracts and why mitigation through the insurable interest and indemnity doctrines is necessary. The growth of risk management products in the financial industry over the last few decades, in particular the emergence of a multi-trillion dollar CDS market, merits a reexamination of the purposes and the history of the insurable interest and indemnity doctrines.

Since the market’s inception little more than a decade ago, CDS traders and their attorneys have worked hard to distinguish their new financial product from insurance to avoid stringent regulatory insurance regimes

operated throughout the United States and in the United Kingdom.<sup>2</sup> Applying the insurable interest doctrine to CDSs requires reevaluating the chief arguments for treating these contracts differently from traditional insurance.

The focus of this reevaluation is not whether CDSs are insurance, as that misstates the problem, but whether CDS trading results in moral hazard typical of insurance contracts. This paper argues that attempts to distinguish CDSs from insurance on the basis of regulation rather than on the resultant risks are mischaracterizations of the issue. Instead, this paper argues that CDSs create moral hazard similar to insurance such that policy-makers should consider whether CDS should be regulated like insurance.<sup>3</sup>

Part one of this paper defines CDSs and discusses the arguments that attempt to show CDSs are not insurance as well as the stakes involved in making those arguments a success. Part two identifies evidence of morally hazardous uses of CDSs and compares that evidence to the original rationale for instituting early insurance regulations such as the insurable interest and indemnity doctrines. Part Three analyzes the arguments used to differentiate CDSs and insurance in light of this evidence. The conclusion addresses the need for further research regarding the moral hazard created by CDSs, and argues that insurance regulators should examine the costs and benefits of their decision not to regulate CDSs.

## I. THE PRODUCT

CDS contracts are used to manage credit risk. They are among the most popular credit derivative products traded today, having grown into a multitrillion-dollar business in less than a decade.<sup>4</sup> In June of 2007 over

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<sup>2</sup> See HELENE RAINELLI & ISABELLE HUALT, OLD RISK, NEW MARKET: CONSTRUCTING THE OVER-THE-COUNTER FINANCIAL MARKET FOR CREDIT DERIVATIVES, 16, (Multilevel Governance Workshop Papers 2007), available at <http://www2.warwick.ac.uk/fac/soc/csgr/activitiesnews/conferences/gmorgan/papers/>; Paul C. Harding, A PRACTICAL GUIDE TO THE 2003 ISDA CREDIT DERIVATIVES DEFINITIONS 19 (Euromoney Institutional Investor Plc 2004); Robert F. Schwartz, *Risk Distribution In the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 13 FORDHAM J. CORP. & FIN. L. 167, 190 (2007).

<sup>3</sup> This paper does not explore the policy implications inherent in the determination that CDS and insurance are innately alike.

<sup>4</sup> Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 409-10 (2007); Rick Hyman & Amit Trehan, *Credit Default Swaps: What You Need to Know Now*, THE SECURED LENDER, 26 (2007); See *Deutsche Bank AG v.*

\$42 trillion in outstanding CDS contracts were recorded by the Bank for International Settlements.<sup>5</sup> Originally designed to meet the needs of bondholders who did not want to resort to traditional forms of credit enhancement, these contracts have grown into a freely traded, liquid market all their own.<sup>6</sup> This market, commonly referred to as the over the counter (“OTC”) derivatives market, is free from regulation or disclosure rules.<sup>7</sup> The International Swaps and Derivatives Association (“ISDA”) does, however, attempt to standardize CDS contracts and help buyers and sellers manage transactions.<sup>8</sup>

#### A. CDS DEFINED

A CDS contract allows a buyer to purchase credit protection with respect to one or more referenced entities from a seller. The two parties agree that the seller will pay a certain amount to the buyer upon the occurrence of a “credit event” with respect to the referenced entity or entities—usually some kind of debt obligation such as a bond—in exchange for the purchase price of the contract.<sup>9</sup> The agreement allows the

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Ambac Credit Prods., LLC, No. 04 CIV. 5594(DLC), 2006 WL 1867497, at \*2 (S.D.N.Y. July 6, 2006) for a brief discussion of the history and use of credit default swaps.

<sup>5</sup> Bank for International Settlements, Credit Defaults Swaps Market Notational amounts outstanding at end December 2007, *available at* <http://www.bis.org/statistics/otceder/dt21.pdf>.

<sup>6</sup> Hyman, *supra* note 4 at 20, 22. The authors refer to letters of credit, guarantees and financial guarantee insurance as more traditional forms of credit enhancement; *See also* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1020-1023 (2007).

<sup>7</sup> PHILIP M. JOHNSON & THOMAS L. HAZEN, DERIVATIVES REGULATION § 1.02[2][E] (Aspen Publishers 2004); The Commodity Futures Modernization Act of 2000 (CFMA) in most cases completely bars and in some cases severely limits regulation of the Over-The Counter Derivatives Market. Neither the Securities and Exchange Commission nor the Commodities Futures Trading Commission have jurisdiction to regulate OTC CDS trading. In recent months, regulators have examined the possibility of changing this regime. Such methods have been resisted by the ISDA. At the time of this writing, there seems to be a stringent effort to create a clearinghouse for CDS trading. The hope is that a clearinghouse service would eliminate many of the structural problems created by the Over-The-Counter CDS market. This paper does not examine those structural market risks. *See* Commodity Futures Modernization Act of 2000 §1(a)(5), 7 U.S.C.A. §1 (2000).

<sup>8</sup> *See generally* About ISDA, <http://www.isda.org/>.

<sup>9</sup> Deutsche Bank AG v. AMBAC Credit Prods., LLC, No. 04 CIV. 5594(DLC), 2006 WL 1867497, at \*2 (S.D.N.Y. July 6, 2006); Robert D. Aicher et al., *Credit Enhancement: Letters of Credit, Guaranties, Insurance and Swaps (The Clash of Cultures)*, 59 BUS. LAW. 897, 954-55 (2004).

buyer to hedge the risk associated with owning a reference entity that might suffer a credit event such as bankruptcy or default.<sup>10</sup>

University of San Diego School of Law Professor Frank Partnoy offers the following example regarding the typical use of CDS contracts: A bank lends \$10 million to company (y). The bank then enters into a \$10 million dollar CDS with a third party to protect itself in case company (y) defaults on the loan. If company (y) defaults, the bank executes its CDS, and recoups the loss. If company (y) does not default payment for the CDS reduces the profit accordingly. The seller of the CDS purchased by the bank determines the price of the contract by evaluating the likelihood of the company's defaulting on the loan.<sup>11</sup>

A CDS contract can be settled physically or with cash. In a physical settlement the CDS buyer delivers to the seller one of the obligations of the reference entity upon which the CDS contract is based in exchange for the payout amount.<sup>12</sup> CDS contracts may specify a certain obligation of a reference entity or may accept delivery of any obligation issued by the reference entity.<sup>13</sup> Alternatively, in a cash settlement the buyer exchanges the value of a specific defaulted obligation for a predetermined payout amount.<sup>14</sup>

The chief difference between CDSs and insurance is that the buyer of a CDS contract need not own or have any relationship with the reference entity's obligation.<sup>15</sup> Unlike insurance, CDSs can be and are often used for speculation and arbitrage.<sup>16</sup> These trades are intended to make the CDS market liquid.<sup>17</sup>

CDS contracts provide a number of benefits to capital markets. As discussed above, the primary benefit is that they allow investors to hedge or reduce their risk. In 2005, Federal Reserve Chairman Alan Greenspan reminded the Federal Reserve Bank of Chicago's Conference on Bank Structure that CDS contracts were one of the reasons banks had been able to shrug off the losses of the 2000 downturn relatively easily.<sup>18</sup> The ability

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<sup>10</sup> *Id.*

<sup>11</sup> Partnoy & Skeel, *supra* note 6, at 1021-22.

<sup>12</sup> Harding, *supra* note 2, at 134.

<sup>13</sup> David Z. Nirenberg & Richard J. Hoffman, *Are Credit Default Swaps Insurance?*, 3 DERIVATIVES REP. 7, 14 (2001).

<sup>14</sup> Harding, *supra* note 2, at 134.

<sup>15</sup> Aicher et. al., *supra* note 9, at 955.

<sup>16</sup> Partnoy & Skeel, *supra* note 6, at 1022; Schwartz, *supra* note 2, at 190.

<sup>17</sup> Partnoy & Skeel, *supra* note 6, at 1022.

<sup>18</sup> Alan Greenspan, Chairman, Fed. Reserve Bd., Risk Transfer and Financial Stability, Remarks to the Federal Reserve Bank of Chicago's Forty-first Annual Conference

to hedge risk using CDSs also injects liquidity into the markets by making investors more comfortable in taking on risk. Finally, the pricing of CDS contracts and the result of the spread created by the buying and selling of CDSs, creates new information helpful in evaluating securities.<sup>19</sup>

These advantages, however, come at a price. The last several years are illustrative of how CDS contracts, in Partnoy's words, might create incentives to destroy value by allowing profit to be born from loss.

#### B. THE ARGUMENT THAT CDS ARE NOT INSURANCE

Black's Law Dictionary defines insurance as "[a] contract by which one party undertakes to indemnify another party...against the risk of loss, damage or liability arising from the occurrence of some specified contingency."<sup>20</sup> This basic definition by itself, is not dispositive of what should be considered insurance. It is important to note that there is no consensus regarding the definition of insurance. Some scholars argue that a short definition of insurance is inherently misleading.<sup>21</sup> However, simplicity has its merits. For example, the argument in favor of treating CDS like insurance is simple: that for the purpose of insurance regulation, contracts that create similar moral hazard as traditional insurance should be treated as insurance.

The literature arguing that CDSs should not be considered insurance is limited but influential. It has allowed the market for CDSs to remain regulation-free. In an opinion commissioned by the ISDA, Robin Potts QC, an English barrister, argued what has become the basis for not treating CDSs as insurance.<sup>22</sup> The so-called "Potts opinion" concluded that credit derivatives should not be characterized as insurance contracts because they are structured to pay out on the occurrence of a default or other credit event, irrespective of whether the buyer suffers a loss.<sup>23</sup> Breaking down this point further, Potts wrote that CDSs "plainly differ from contracts of insurance" because "the payment obligation is not conditional on the

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on Bank Structure (May 5, 2005), <http://www.federalreserve.gov/Boarddocs/Speeches/2005/20050505/default.htm>.

<sup>19</sup> Partnoy & Skeel, *supra* note 6, at 1026-27.

<sup>20</sup> BLACK'S LAW DICTIONARY 814 (8th ed. 2004).

<sup>21</sup> See 1 ERIC MILLS HOLMES & MARK S. RHODES, HOLMES'S APPLEMAN ON INSURANCE § 1.4 (2d ed. 1996).

<sup>22</sup> Opinion by Robin Potts QC, Erskine Chambers, prepared for the Int'l Swaps & Derivatives Ass'n (24 June 1997) (on file with author)

<sup>23</sup> *Id.* at 2-3.

payee's sustaining a loss or having a risk of loss."<sup>24</sup> The contract is thus not one which seeks to protect an insurable interest on the part of the payee. "His rights do not depend on the existence of any insurable interest."<sup>25</sup>

According to Potts, these are substantial differences that justify the dissimilar treatment of CDSs and insurance. Potts's reasoning was premised on the British common law which defines an insurance policy as "a contract to indemnify the insured in respect of some interest which he has against the perils which he contemplates it will be liable to."<sup>26</sup> Despite acknowledging "the economic effect of certain credit derivatives can be similar to the economic effect of a contract of insurance," Potts concluded that CDS contracts are not insurance because the contracts lacked an insurable interest requirement and indemnity requirement.<sup>27</sup>

ISDA attorneys, scholars and regulators in both the United Kingdom and the United States have used Potts' argument, or similar reasoning ever since. In 2000, an opinion from the New York Department of Insurance, responding to an inquiry as to whether CDSs constituted insurance, stated "[i]ndemnification of loss is an essential indicia of an insurance contract which courts have relied upon in the analysis of whether a particular agreement is an insurance contract under New York law. Absent such a contractual provision the instrument is not an insurance contract."<sup>28</sup>

Scholarship has also developed in support of the disparate treatment of CDSs and insurance. In "Are Credit Default Swaps Insurance?," authors David Z. Nirenberg and Richard J. Hoffman concluded that though there were similarities between CDSs and insurance, the objectives of the financial products were sufficiently distinct to justify differential treatment.<sup>29</sup> They applied three insurance tests set forth in Holmes' *Appleman on Insurance Law and Practice*.<sup>30</sup> Holmes' tests are: (1) whether the contract constitutes the transfer of risk ("Substantial Control Test"); (2) whether that transfer is the dominant feature of the contract ("Principle Object Test"); and (3) whether it is in the public interest to regulate the contract as insurance ("Regulatory Value Test").<sup>31</sup>

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<sup>24</sup> *Id.* at 7.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 4-5, (citing *Wilson v. Jones*, (1867) 2 Exch. Div. 150).

<sup>27</sup> *Id.* at 7, 10.

<sup>28</sup> Re: Credit Default Option Facility, (NY Dept. of Ins. Gen. Counsel June 16, 2000).

<sup>29</sup> Nirenberg & Hoffman, *supra* note 14, at 16.

<sup>30</sup> HOLMES & RHODES, *supra* note 21, at § 1.4.

<sup>31</sup> Nirenberg & Hoffman, *supra* note 14, at 11-12.

Based on this analysis, the authors posited: “[t]o facilitate a determination that a particular credit default swap is not insurance, the transaction should be structured so that payment to the protection buyer is not contingent on the protection buyer suffering a loss.”<sup>32</sup> In other words, the authors recommended that CDS trades be structured so that they do not perform the same function as insurance.

Most recently, a Fordham Journal of Corporate and Financial Law article argued in favor of the dissimilar treatment of CDSs and insurance.<sup>33</sup> The article argued that “CDS[s] are capital market products” and not insurance.<sup>34</sup> In support of this theory, the author Robert F. Schwartz, outlined six propositions, at least one of which applies to any CDS trade.<sup>35</sup> The propositions are:

- 1) [w]here a party enters into a contract for contingent recovery possessing no economic interest in protecting the covered property from loss or damage, the contract is not insurance;...
- 2) [w]hen the contract for recovery fails to reference property that the purchasing party has economic incentive to protect from loss or damage, the contract is not insurance;...
- 3) [w]hen recovery under a contract can be had without substantiating any actual loss or damage the contract is not insurance;...
- 4) [w]here a party can recover under a contract an amount that exceeds expenses caused by loss or damage, the contract is not insurance;...
- 5) [w]here a contract for recovery allows physical settlement, the contract is not insurance;...
- 6) [w]here a contract for recovery provides for cross-payment netting under a master agreement, the contract is not insurance.<sup>36</sup>

Failure of one proposition is dispositive of the analysis; meaning the CDS contract involved is insurance.<sup>37</sup>

The premise of these arguments is that the insurable interest and indemnity doctrines are defining characteristics of insurance contracts. This premise is incorrect. These doctrines are policy responses to the moral hazard that insurance contracts create. Though they have become defining

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<sup>32</sup> *Id.* at 16.

<sup>33</sup> *See* Schwartz, *supra* note 2, at 174.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 200-01.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

characteristics of insurance in some contexts, distinguishing CDSs from insurance using these requirements is disingenuous and circuitous. Such reasoning fails to consider the origins of the doctrines and does not utilize the appropriate legal framework for evaluating the benefits and costs of the CDS market.

To date, there has been little work discussing the problems with the arguments used to distinguish CDSs from insurance. University of North Carolina Law Professor Thomas Lee Hazen identified the similarity between early insurance contracts and certain derivatives in a paper published in 2005. He wrote:

The insurable interest doctrine attempts to provide a basis for drawing the line with respect to insurance contracts that the law will tolerate. It is an imperfect measure at best. A significant problem is whether the insurance limitation is really meaningful without a comparable control of derivatives contracts? The derivatives markets may now offer a way around the insurable interest requirement, unless courts treat the contract in question as insurance rather than as a derivative investment. If the insurable interest requirement remains justifiable for insurance contracts, then there may be good reason to close the gap with respect to parallel derivatives transactions created by the [Commodities Futures Modernization Act of 2000]. It would appear appropriate to either rethink the insurable interest doctrine or attempt to import something comparable into derivatives regulation.<sup>38</sup>

Hazen's argument succinctly highlights the illogical distinction between CDSs and insurance, and the potential adverse consequences it may have. This article elaborates on the consequences of the double standard currently applied to CDSs and traditional insurance, and emphasizes the flaws of arguments against treating CDSs as insurance.<sup>39</sup>

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<sup>38</sup> Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 426 (2005).

<sup>39</sup> *Id.*

## C. THE IMPORTANCE OF A DISTINCTION

The National Association of Insurance Commissioners<sup>40</sup> (“NAIC”) published a Draft White Paper in 2003 arguing that weather derivatives should be treated similarly to insurance contracts.<sup>41</sup> The study noted that businesses that accept risk transfers for a fee are generally known as insurers and the fee paid by the entity seeking to transfer risk is comparable to an insurance premium.<sup>42</sup> The same reasoning arguably applies to CDSs, where coverage in the event of a default is traded in exchange for an upfront payment.

The NAIC noted: “These weather derivatives and other ‘non-insurance’ products are primarily temperature protection coverages (heating and cooling degree days) that appear to be disguised as ‘non-insurance’ products to avoid being classified and regulated as insurance products. In fact, there is evidence that the promoters of these products go to great lengths to be sure that the energy companies involved do not use terms that naturally describe what is taking place—namely the transfer of risk from a business to another professional risk taker.”<sup>43</sup>

The ISDA quickly responded to the draft white paper in a letter to the NAIC.<sup>44</sup> The letter argued that because weather derivatives do not require a party to have an insurable interest they are not insurance.<sup>45</sup> The ISDA did not analyze whether weather derivatives or other derivative products, such as CDSs, create sufficient moral hazard to necessitate requiring the application of the insurable interest or indemnity doctrines. The ISDA’s letter also stated that the “Draft White Paper’s logic could extend to a broad array of derivatives and would create substantial and disruptive regulatory uncertainty.”<sup>46</sup> Such concerns are frequently expressed by the ISDA.

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<sup>40</sup> National Association of Insurance Commissioners, About the NAIC (2008), [http://www.naic.org/index\\_about.htm](http://www.naic.org/index_about.htm). The National Association of Insurance Commissioners is the organization of insurance regulators for all 50 of the United States, Washington D.C., and five United States territories.

<sup>41</sup> PROP. AND CAS. INS. COMM., WEATHER FINANCIAL INSTRUMENTS (TEMPERATURE): INSURANCE OR CAPITAL MARKET PRODUCTS? (Nat’l Ass’n of Ins. Comm’rs Draft White Paper, Sept. 2, 2003).

<sup>42</sup> *Id.* The NAIC included all contracts used to hedge or protect against weather related risk in defining weather derivatives.

<sup>43</sup> *Id.*

<sup>44</sup> Letter from Robert G. Pickel, Executive Dir. and CEO, ISDA, to Ernst N. Csiszar, President, NAIC and Robert Esson, Senior Manager, Global Ins. Mkts., NAIC (Feb. 23, 2004) (on file with author).

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 2.

In 2006, the ISDA sent a similar letter to the United Kingdom's Law Commission addressing the commission reevaluation of British insurance law. The letter concluded by stating:

There is a range of possible outcomes to such a review. If the outcome is seen as differing materially from the current market consensus view, it could create very considerable uncertainty and damage the [credit derivatives] market itself. Conversely, if the outcome is not seen as differing materially from the current market consensus, its value will be low.

In the circumstances, we do not consider that it would be desirable to proceed with a review in this area. However, should the Commission decide to proceed regardless, then it will be critical to ensure that there is extensive consultation at every stage of the review in order to minimize the risks to the smooth operation of the market.<sup>47</sup>

CDS traders, as well as the derivative industry in general, have worked hard to keep government regulation from interfering with their market. The ISDA has been highly successful in standardizing derivative contracts and managing potential disputes that arise between parties to a trade.<sup>48</sup> Given that its members include some of the most powerful financial institutions in the world—J.P. Morgan Chase, Goldman Sachs, Citigroup<sup>49</sup>—it is unsurprising that the industry's efforts have been sufficient to keep government regulators at bay.<sup>50</sup>

Classifying CDSs as insurance has numerous and substantive consequences. CDS vendors would be required to obtain an insurance license. Further, those responsible for paying out upon the occurrence of a credit event would be subject to state insurance regulatory oversight regarding market operations and reserve requirements.<sup>51</sup> These requirements would complicate the current free market system in which

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<sup>47</sup> Letter from Richard Metcalfe, Senior Policy Dir., ISDA, to Peter Tyldesley, Law Comm'n, U.K. 2 (Apr. 18, 2006) (on file with author).

<sup>48</sup> See Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 HARV. NEGOT. L. REV. 211, 229-34 (2001).

<sup>49</sup> *ISDA Primary Members* (Jul. 18, 2008), <http://www.isda.org/membership/isdamemberslist.pdf>.

<sup>50</sup> See Flanagan, *supra* note 46, at 246.

<sup>51</sup> Nirenberg & Hoffman, *supra* note 14, at 8; PROP. AND CAS. INS. COMM., *supra* note 41.

CDSs are traded.<sup>52</sup> Interestingly, had regulation been implemented from the beginning, much of the current uncertainty regarding the American financial system could have been avoided.<sup>53</sup> This is because regulation would limit the amount of risk banks take on and state regulators would review CDS accounts to make sure sellers could meet their obligations.<sup>54</sup>

Some argue that much of the ISDA's work consists of convincing the world that derivatives' approach to risk is wholly different from anything that has come before and that in truth, there are few if any differences from decades and centuries old financial products, such as insurance, securities and commodities futures.<sup>55</sup> Such questions, however, are beyond the scope of this paper.

Interestingly, insurance companies have also argued against the classification of CDSs as insurance. In 2004, the Association of Financial Guarantee Insurers successfully lobbied New York State to create a statutory definition of CDSs.<sup>56</sup> An amendment to the New York state Insurance Laws that went into effect October 19, 2004 declared: "the making of [a] credit default swap does not constitute the doing of an insurance business."<sup>57</sup> The statute is hardly a convincing analysis of the legal issues involved in such a statement; but it is effective nonetheless.

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<sup>52</sup> Insurance companies generally keep more cash on their balance sheets than banks. For a study of the differences see Richard Herring & Til Schuermann, *Capital Regulation for Position Risk in Banks, Securities Firms, and Insurance Companies*, in CAPITAL ADEQUACY BEYOND BASEL: BANKING, SECURITIES, AND INSURANCE 15 (Hal S. Scott ed., Oxford University Press 2005). Overall, the problem is that capital adequacy requirements for insurance companies and banks are calculated differently. One financial commentator put it succinctly when he said: "a dollar of risk in banking is not the same thing as a dollar of risk in insurance." Martin Mayer, *THE FED: THE INSIDE STORY OF HOW THE WORLD'S MOST POWERFUL FINANCIAL INSTITUTION DRIVES THE MARKET* 302-303 (The Free Press 2001).

<sup>53</sup> See Jenny Anderson & Vikas Bajaj, *A Wall Street Domino Theory*, N.Y. TIMES, Mar. 15, 2008, at A1.; Gretchen Morgenson, *Arcane Market is Next to Face Big Credit Test*, N.Y. TIMES, Feb. 17, 2008, at A1.

<sup>54</sup> See Hazen, *supra* note 38, at 416.

<sup>55</sup> See HELENE RAINELLI & ISABELLE HUALT, *OLD RISK, NEW MARKET: CONSTRUCTING THE OVER-THE-COUNTER FINANCIAL MARKET FOR CREDIT DERIVATIVES*, 16, (Multilevel Governance Workshop Papers 2007).

<sup>56</sup> Letter from Bob Mackin, Executive Dir., Ass'n of Fin Guarantee Insurers, to George E. Pataki, Governor of the State of N.Y., (Jul. 15, 2004) (on file with author).

<sup>57</sup> N.Y. Ins. Law § 6901 (j-1) (2005 & Supp. 1 2008).

## II. THE PROBLEM

The following examples are illustrative of the moral hazard created by CDSs. This resulting moral hazard has the potential to create negative economic interests and destroy value.

### A. TOWER AUTOMOTIVE AND STRANGE BEHAVIOR

Truck frame supplier Tower Automotive's declaration of bankruptcy in 2005 may have been caused by speculators interested in profiting on CDS positions.<sup>58</sup> Unable to pass the rising costs of metals and other supplies onto car-makers, Tower fought the squeeze by turning to the credit markets for cash.<sup>59</sup> Hedge funds bought Tower's debt in May, 2004.<sup>60</sup> By November, Tower needed more money. The hedge funds refused to provide approval for the necessary new loans. Without the additional loans Tower was forced to file under Chapter 11 two months later.<sup>61</sup> Some bankers believe hedge funds purposely triggered the filing in order to collect on CDS positions.<sup>62</sup> The monetary gain for doing so exceeded any potential profits from the loans to Tower and therefore outweighed any incentive to maintain those loans.<sup>63</sup> "Many hedge funds play in a gray world," said Henry Miller, a restructuring advisor quoted in *The Journal* article, "[t]hey sometimes do things to make their positions worth more, which can cause difficulty for others."<sup>64</sup>

Tower supports the proposition that a lender with a credit derivative position may have an incentive to force a default, regardless of costs or the impact on the value of underlying assets.<sup>65</sup> Partnoy argues, that the lack of required disclosure in the derivatives market makes assessing the adverse impact of transactions difficult.<sup>66</sup>

Moreover, Professors Henry T.C. Hu and Bernard Black, both of the University of Texas School of Law, describe investment positions that

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<sup>58</sup> Henny Sender, *Hedge-Fund Lending to Distressed Firms Makes for Gray Rules and Rough Play*, WALL ST. J., July 18, 2005, at C-1.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> Partnoy & Skeel, *supra* note 6, at 1034-35.

<sup>66</sup> *Id.* at 1035.

increase in value if a reference entity's credit risk rises or suffers a credit event, as "negative economic ownership."<sup>67</sup> They argue that the use of CDSs in conjunction with derivatives that allow speculators to purchase the temporary use of rights that come with ownership of securities without buying those underlying securities may allow the pushing of a company into bankruptcy to trigger larger payoffs on CDS contracts.<sup>68</sup>

While Hu and Black acknowledge that lack of disclosure requirements in the CDS market makes it difficult to determine the extent to which this strategy is used, there is evidence that it is used.<sup>69</sup> For example, the market for CDSs referencing certain firms has at times been up to ten times larger than the dollar amount of underlying debt.<sup>70</sup> Moreover, CDS contracts have begun to require buyers to act in the interest of creditors. This change in contract language suggests, according to Black and Hu, that buyers were not previously acting in the interest of creditors and might not do so in the future. How this contract language is enforced without disclosure, however, remains unclear.<sup>71</sup> Further, Black and Hu cite conversations with bankruptcy judges who say they sometimes see strange courtroom behavior by creditors.<sup>72</sup> One judge "described a recent case wherein a junior creditor complained of too *high* a valuation being assigned to the bankruptcy estate, for reasons the creditor did not offer."<sup>73</sup>

#### B. SPURRING THE DECLINING HOUSING MARKET

CDSs might be partly responsible for inflaming the downturn in the national housing market. There is evidence to suggest that left unregulated these derivatives create a disincentive for mortgage service providers to work out new agreements with homeowners as an alternative to foreclosure.

In January 2008, Federal Reserve Chairman Benjamin S. Bernanke reported to the U.S. House of Representatives Committee on the Budget

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<sup>67</sup> Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 637, 731 (2008).

<sup>68</sup> See *id.* at 730-732. Such a practice is commonly referred to as "equity or debt decoupling" depending upon the relevant market. "Equity or debt decoupling" include the full range of rights and obligations typically associated with shareholder status, but reduce a shareholder's economic exposure. *Id.* at 631, 728.

<sup>69</sup> See *id.* at 732-33.

<sup>70</sup> *Id.* at 733 n.265.

<sup>71</sup> *Id.* at 733.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

that the housing market had declined significantly over the last two years and that the rates of foreclosures have added to an already elevated inventory of unsold homes.<sup>74</sup> “New home sales and housing starts have fallen by about half from their respective peaks,” he said.<sup>75</sup> The consequences of this market’s decline, Bernanke continued, would continue to be a drag on the overall economy.<sup>76</sup>

CDS contracts are often sold by the same banks that package and service mortgage-backed securities.<sup>77</sup> This means that the banks responsible for evaluating the need for and organizing mortgage modifications to prevent foreclosures are the same institutions that would

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<sup>74</sup> *The Economic Outlook: Hearing Before the H. Comm. on the Budget*, 110th Cong. 1 (2008) (testimony of Ben S. Bernanke, Chairman of the Federal Reserve), available at: <http://www.federalreserve.gov/newsevents/testimony/bernanke20080117a.htm>.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> Understanding the causes of this decline means understanding how the mortgage industry changed over the last several decades. Beginning in the early 1970s mortgage securitization allowed homebuyers access to the bond market and the deep pools of capital that came with such access. See Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2198-2202 (2007). Whereas once mortgagors dealt only with the bank that held their debt, securitization turned banks into mere service providers. This shift changed the outlook of banks servicing these mortgages. Instead of profiting on income from mortgages, banks increasingly profited from fees derived from selling mortgage-backed securities and other financial products related to those securities. Among the consequences of this change is the complication of a bank’s role as a mortgage service provider. Owning the debt allowed banks to modify mortgage contracts at will when payments were missed to prevent foreclosure. Such loan modifications are widely recognized as an important tool to keep economic downturns and the subsequent likelihood of late mortgage payments from turning a flood of foreclosures into a deluge that would speed a declining housing market. See Kurt Eggert, *Comment on Michael A. Stegman et al.’s “Preventive Servicing is Good for Business and Affordable Homeownership Policy”*: *What Prevents Loan Modifications?*, 18 HOUSING POL’Y DEBATE 279, 282, 284 (2007). Securitization of mortgages turned banks into trustees of mortgage-backed bonds, requiring approval from bondholders before mortgage adjustments, known as “workouts,” could be executed. The process of mortgage securitization also created such diversity in terms of ownership rights that getting requisite bondholder approval became impractical in many circumstances. At the same time, these workouts were not impossible. *Id.* at 287. Banks, acting as trustees, might still be inclined to make them if drops in housing prices became more than regional. A national drop in housing prices would defeat the risk mitigating effects of a bond backed by a geographically diverse group of mortgages and give a bank incentive to attempt to rescue the entire bond. *Id.* Depending on the precise terms of the Service and Pooling agreements that created the bonds, the calculus of whether or not to take the trouble to attempt adjustments begins with comparing the percentage of defaulting mortgages that are contributing to a bond’s revenue stream with the cost of an adjustment. See Hu & Black, *supra* note 66, at 730.

pay out a CDS contract in the event of foreclosure. Obviously, such a situation presents a significant conflict of interest for these banks.<sup>78</sup>

In June of 2007, Bear Stearns, a major trader of both CDS contracts and mortgage-backed securities, was accused of having such conflicting interests.<sup>79</sup> Hedge fund investors, like John Paulson, speculating on a drop in the housing market had purchased a large number of CDS contracts. These investors did not own any of the mortgage-backed securities to which the CDS contracts were tied.<sup>80</sup> Bear Stearns found that it would owe more in CDS payments than it would lose by making mortgage adjustments to prevent foreclosures and the resulting bond defaults. Despite the transaction costs of organizing such adjustments - which include seeking approval from large numbers of disparate investors with differing interests the bank began the process. CDS holders cried foul, accusing Bear Stearns of market manipulation.<sup>81</sup> The question, according to press reports, was what motivated Bear Stearns to renegotiate sub-prime loans and enter into what Paulson called “uneconomic transactions?”<sup>82</sup> Was the brokerage firm trying to keep homeowners in their houses or save itself from CDS losses?<sup>83</sup>

The consequences of the Bear Stearns incident could be dire, though they merit more research. Mortgage holders who might have been able to benefit from a mortgage reorganization with the bank lost that chance and watched their houses go into foreclosure. Sellers saw additional properties added to the glut of housing on the market, forcing prices further down. It is arguable that CDS contracts kept workouts, one of the potential failsafe mechanisms of the mortgage industry, from being executed.

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<sup>78</sup> See Eggert, *supra* note 76, at 290-91.

<sup>79</sup> See Gregory Zuckerman, Editorial, *Trader Made Billions on Subprime; John Paulson Bet Big on Drop in Housing Values; Greenspan Gets a New Gig, Soros Does Lunch*, WALL ST. J., Jan. 15, 2008, at A1; Saskia Scholtes, Editorial, *Fears Over Helping Hand for Mortgage Defaulters*, FIN. TIMES (London), May 31, 2007, at 1.

<sup>80</sup> Kate Kelly and Serena Ng, Editorial, *The Sure Bet Turns Bad: Funds Howl as Bear Stearns Buys Mortgages*, WALL ST. J., JUNE 7, 2007, at c3.

<sup>81</sup> Roddy Boyd, Editorial, *Hedge Fund Bearish on Sub-Prime Relief*, N.Y. Post, June 5, 2007, at [http://www.nypost.com/seven/06052007/business/hedge\\_fund\\_bear\\_ish\\_on\\_subprime\\_relief\\_business\\_roddy\\_boyd.htm](http://www.nypost.com/seven/06052007/business/hedge_fund_bear_ish_on_subprime_relief_business_roddy_boyd.htm).

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

## C. INVESTMENT BANKS: WINNING AND LOSING WITH CDSs

The banks themselves may be profiting by betting against their own securitized mortgages through CDS. Moreover, CDS might have contributed to the stunning collapse of one of Wall Street's most powerful investment banks.

In 2007, Goldman Sachs, another major trader of both CDS and mortgage-backed securities, made \$4 billion by betting that securities backed by home loans would fall in value.<sup>84</sup> While making these bets, Goldman was also underwriting bonds backed by these mortgages. Did Goldman keep churning out troubled bonds with the knowledge that it would profit from their decline in value using CDS?

In March of 2008, Bear Stearns finally succumbed to betting incorrectly on the housing market.<sup>85</sup> The firm's brokerage and hedge fund clients began withdrawing their accounts in droves as fear of Bear Stearns' lack of liquidity began to spread.<sup>86</sup> As a result, Bear Stearns, found itself in an increasingly precarious position.<sup>87</sup> The firm ended up agreeing to sell itself for \$2 (later raised to \$10) per share to J.P. Morgan Chase in a deal organized by the Federal Reserve.<sup>88</sup> Some traders speculate whether the clients withdrawing accounts from Bear Stearns used the CDS market to profit from the firm's demise.<sup>89</sup> A hedge fund betting heavily that Bear Stearns will fail has much less incentive to keep its business with Bear Stearns because withdrawing its business makes it more likely that its CDS will pay out.<sup>90</sup>

Some reports also suggested that certain Bear Stearns bond holders planned to vote against allowing J.P. Morgan Chase to buy the troubled

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<sup>84</sup> Kate Kelly, Editorial, *How Goldman Won Big on Mortgage Meltdown; A Team's Bearish Bets Netted Firm Billions; A Nudge from the CFO*, WALL ST. J., Dec. 14, 2007, at A1.

<sup>85</sup> Robin Sidel et al., Editorial, *The Week That Shook Wall Street: Inside the Demise of Bear Stearns*, WALL ST. J., Mar. 18, 2008, at A1.

<sup>86</sup> *Id.* See Zuckerman, *supra* note 78, at A1.

<sup>87</sup> See Sidel et al., *supra* note 82, at A1; Zuckerman, *supra* note 78, at A1.

<sup>88</sup> Sidel et al., *supra* note 82, at A1; Matthew Karnitschnig & David Enrich, Editorial, *Bear's Run-up Sets the Stage for Epic Clash; Speculators Ignite Rally, Driving Shares Up 23%; Disbelief on Deal Price*, WALL ST. J., Mar. 19, 2008, at C1; Andrew Ross Sorkin, Editorial, *JP Morgan Raises Bid for Bear Stearns to \$10 per share*, N.Y. Times, March 24, 2008.

<sup>89</sup> Gregory Zuckerman, Editorial, *Hedge Funds, Once a Windfall, Contribute to Bear's Downfall*, WALL ST. J., Mar. 17, 2008, at C1.

<sup>90</sup> *Id.*

firm, electing bankruptcy instead in order to allow CDS bets to pay off.<sup>91</sup> Why attempt to salvage value when what might be lost to bankruptcy is less than what will be gained from CDSs as a result of bankruptcy?

#### D. MORAL HAZARD AND INSURANCE DOCTRINE

Whether bankruptcies or foreclosures, the potential activities described in section C all deal with what economists call moral hazard. Moral hazard can be defined as activity that reduces incentives to protect against loss or minimize the cost of a loss.<sup>92</sup> Financial products that transfer wealth in the event of a loss give the buyer an incentive to bring about that loss, often in spite of the societal costs. A CDS potentially creates such an incentive or moral hazard since it creates awards when bad things –such as bankruptcies or foreclosures- happen. One way to think about developing policies to deal with that moral hazard is to evaluate the earliest methods. Those methods are found in the history of insurance law.

The doctrine of insurable interest invalidates insurance contracts in which buyers have no interest in the insured entity. It was created to counter moral hazard. The preamble of England’s Marine Insurance Act of

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<sup>91</sup> Karnitschnig & Enrich, *supra* note 85, at C1.

<sup>92</sup> TOM BAKER, INSURANCE LAW AND POLICY 4 (Wolters Kluwer ed., Aspen Publishers 2d ed. 1959 (2008)). Moral hazard is a term and an idea that grew out of the insurance business. *See generally* Tom Baker, *On the Genealogy of Moral Hazard*, 75 Tex. L. Rev. 237 (1996). To price insurance contracts, insurers borrowed probability theory used to determine the complicated odds of the dice game known in 18th century England as “Hazard.” They applied this theory to vital statistics such as births, marriages, suicide, fires, storms, murder, sickness and calamity at sea. Similarly to predicting the outcome of a game of “Hazard,” the laws of large numbers allowed insurers to predict on the aggregate how often a ship would sink, a duke would die, or a house would be destroyed. The knowledge allowed insurers to sell their product at a price that would allow them to honor their commitments to customers, turn a profit and not go broke (at least most of the time). *See id.* at 245, 247. Former University of Connecticut School of Law Professor Tom Baker adds writes that fire insurers distinguished among physical hazards in two senses of the word. “There were hazards that caused fires (for example, lightning, short circuits, spontaneous combustion),” he wrote, “and there were hazards that affected the probability or magnitude of loss by fire (for example, the type of construction or use of a building).” *Id.* at 248. Later, Baker continues, insurers began using the term “moral” to distinguish both of these types of “hazard” from incentive that caused amoral behavior resulting in loss. *Id.* at 248. “[F]raud and interested carelessness were moral hazards that caused losses,” Baker explains, while “[b]ad character or habits, financial embarrassment, poor business practices and over-insurance were moral hazards that increased the probability of loss.” *Id.* at 248-249.

1746, which first codified the insurable interest requirement for the 18th century British Empire, lists the concerns of the legislators that passed it. It reads:

“WHEREAS, it hath been found by experience, that the making assurances, interest or no interest, or without further proof of interest than the policy, hath been productive of many pernicious practices, whereby great numbers of ships, with their cargoes, have either been fraudulently lost and destroyed, or taken by the enemy in time of war; and such assurances have encouraged the exportation of wooll, and the carrying on many other prohibited and clandestine trades, which by means of such assurances have been concealed, and the parties concerned secured from loss, as well to the diminution of the publick revenue, as to the great detriment of fair traders...”<sup>93</sup>

Eighteenth Century British law is to a large extent the father of American common law and the doctrine of insurable interest is no exception. Nearly every state in the United States has codified insurable interest rules.<sup>94</sup> However, precise requirements of the doctrine often vary from state to state.<sup>95</sup>

Closely related to the insured interest doctrine is the principle of indemnity. Some argue that indemnity is an outgrowth of the insured

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<sup>93</sup> Marine Insurance Act, 1746, 19 Geo. 2, c. 37 (Eng.).

<sup>94</sup> CHRISTOPHER S. ARMSTRONG, AMERICA’S QUEST FOR A PROPER CONCEPT OF “INSURABLE INTEREST”: THE PERILS OF IGNORING THE IMPLICATIONS 3, (2002), [http://www.rmstrnglaw.com/publications/Americas\\_%20Quest.pdf](http://www.rmstrnglaw.com/publications/Americas_%20Quest.pdf).

<sup>95</sup> *Id.*

There are two basic theories used to articulate the insured interest doctrine: the legal interest test and the factual expectancy test. American courts have generally recognized contract rights, property rights or legal liability to be insurable. See ROBERT H. JERRY & DOUGLAS R. RICHMOND, UNDERSTANDING INSURANCE LAW 283 (LexisNexis 2007). Property rights of any nature and quality will usually meet the requirement. In evaluating insurable interest based on contractual rights, courts usually look for the possibility of economic loss resulting from a contractual breach. Those subject to liability in the event of property damage or tort are also considered to have an insurable interest. *Id.* at 284-287.

The factual expectancy test is arguably a more generous test of an insured interest. The test simply inquires into whether the purchaser of insurance can expect a loss if the insured reference entity ceases to exist or expects a profit if the insured entity continues to exist. *Id.* at 289.

interest doctrine.<sup>96</sup> Insurance aims to do nothing more than reimburse. The principle of indemnity merely states that a contract for insured property cannot return to the buyer more than his interest in that property is worth. If a buyer of insurance could collect more than the property is worth, that additional amount would not be based on an insurable interest and the moral hazard doctrine attempts to avert that which would not be fully mitigated.<sup>97</sup>

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<sup>96</sup> Daniel Dumas, *Insurable Interest in Property Insurance Law*, 18 R.D.U.S. 407, 423 (1988); HOLMES & RHODES, *supra* note 21, at § 3.1 (“The indemnity principle is dependent upon and interconnected with the doctrine of insurable interest.”).

<sup>97</sup> Jerry & Richmond, *supra* note 92, at 277.

The extent to which insurance doctrine focuses on insurable interest or indemnity differs from jurisdiction to jurisdiction and country to country. The United Kingdom’s Law Commission, a statutory independent body created by Parliament to review the law and recommend reform, is currently reevaluating whether the insured interest doctrine is useful considering that the indemnity doctrine serves a similar purpose. *See* The Law Comm. & The Scot. Law Comm., *Insurable Interest, Issue Paper 4* (2008), (available at [http://www.lawcom.gov.uk/docs/Insurance\\_Contract\\_Law\\_Issues\\_Paper\\_4.pdf](http://www.lawcom.gov.uk/docs/Insurance_Contract_Law_Issues_Paper_4.pdf)).

In reviewing the current status of the insurable interest and indemnity doctrine it is important not to mistake the changes regarding life insurance as changes that affect insurance in general. Many jurisdictions have done away with the insurable interest doctrine as necessary for collecting on a life insurance policy. *See* Annotation, *Validity of assignment of life insurance policy to one who has no insurable interest in insured* 30 A.L.R 2d 1310, 1333. This change allows holders of life insurance to sell their policies before their death, allowing them to unlock much of the value they have paid into the policy. 30 A.L.R 2d at 1339-1340. The creation of a secondary market for life insurance contracts has been deemed legal. *See* BAKER, *supra* note 89, at 235-246. Also deemed legal is the controversial practice of employers taking out life insurance contracts on employees. *Id.* at 238-239. Courts evaluating this practice have ruled that the employers have an insurable interest in the lives of those who work for them. *Id.* at 238-239. Australia abandoned the insurable interest requirement for life insurance policies altogether in 1995 stating that the doctrine as a defense against moral hazard no longer holds sway. *See* The Law Comm. at 53-54.

Many of these changes are due to the differences between life insurance and other types of insurance. Life insurance is often not considered an indemnity contract because of the difficulty in valuing human life. HOLMES & RHODES, *supra* note 21. Moreover, courts deemed the public interest in allowing life insurance policy-holders to collect on their contracts before death to meet their needs in life outweighed the moral hazard of a buyer of the policy profiting through murder. *See* 30 A.L. R. 2d at 1333, 1339.

One recent argument against the insurable interest doctrine focuses on its use by insurers to invalidate contracts. *See* Jacob Loshin, *Insurance Law’s Hapless Busybody: A Case Against the Insurable Interest Requirement*, 117 YALE L.J. 475, 479 (2007). This scholar argues that the insured interest doctrine harms consumers who rely on contracts they believe are valid but are later found void by courts using a definition for the doctrine that is “erratic, ambiguous and inconsistent.” *Id.* at 487. The author argues that doing away with a legal insurable interest requirement would create more incentive for insurance companies to

Another insurance doctrine that might also be considered an outgrowth of the insurable interest and indemnity doctrines is subrogation. This doctrine seeks to avoid unjust enrichment on the part of the insured by substituting the insurer in place of the insured in regard to some claim or right the insured has against a third party regarding the insured's loss.<sup>98</sup> When an insurer asserts a subrogation right he is viewed as "standing in the shoes" of the insured.<sup>99</sup> Application of the doctrine bars the insured from filing a claim on a loss and then seeking compensation on that loss through other means, such as a tort suit.<sup>100</sup>

These doctrines still serve as legal efforts to ensure that insurance helps cushion the effects of existing risks and does not create new risks. If applied to CDSs, they would prevent the creation of the negative economic interests discussed and eliminate the potential profit from the destruction of value.

### III. FAILING TO MAKE A CONVINCING DISTINCTION

Given the similarities between CDSs and traditional insurance and the context with which the insurable interest and indemnity principles are applied, it is appropriate to reevaluate the arguments that CDSs are not insurance contracts.

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investigate potential moral hazard and not write policies for buyers who are likely deliberately to bring about the event insured against. *Id.* at 506-508.

It is also important to remember that the origins of insurable interest are also closely related to the 18th and 19th century legislative aversion to gambling in Anglo-Saxon countries and the insurance business' interest in separating itself from gaming activities. The history is sufficient to argue - as some of the sources referenced above do - that preventing gambling was the chief aim of the implementation of insurable interest as a legal doctrine. For the purposes of this discussion, gambling is considered to be part of the group of moral hazard that the doctrine seeks to avoid. However, given the changes in much of society's views on gambling it is arguable that the premises on which insurable interest is based is no longer valid. *See Dumais, supra* note 93 at 410-417.

Despite the ways in which the insurable interest and indemnity doctrines have evolved in certain parts of the world and criticisms of them, they are both alive and well as legal principles that discourage the destruction of value in order to collect on a property insurance contract.

<sup>98</sup> HOLMES & RHODES, *supra* note 21, §3.1 at 334.

<sup>99</sup> *Id.*

<sup>100</sup> *Id.* at 335-36.

## A. SCHWARTZ' ARGUMENT

Schwartz' propositions apply the same reasoning applied in the Potts' opinion and the advisory letter issued by the New York Department of Insurance.<sup>101</sup> Therefore, challenging Schwartz' propositions should also serve to challenge Potts and the New York Department of Insurance's analysis.

First, Schwartz argues that "[w]here a party enters a contract for contingent recovery possessing no economic interest in protecting the covered property from loss or damage, the contract is not insurance."<sup>102</sup> Thus, according to Schwartz, CDSs should not be labeled insurance because there is no insurable or economic interest requirement with respect to CDS contracts.<sup>103</sup> Insurance contracts, however, did not always require that the buyer possess an insurable or economic interest in protecting the covered property. Rather, the legislative and judicial intent in requiring insurable interest is to limit the moral hazard insurance contracts create.<sup>104</sup> A CDS creates the same kind of moral hazard and therefore should possibly be regulate as insurance. Using Schwartz' reasoning, insurance contracts before the adoption of the insurable interest requirement were not insurance contracts. Therefore Schwartz' first proposition does not prove CDS are not insurance.

Secondly, Schwartz argues that "[w]hen the contract for recovery fails to reference property that the purchasing party has economic incentive to protect from loss or damage, the contract is not insurance."<sup>105</sup> Similar to the first proposition, Schwartz's second proposition also seeks to define insurance using the insured interest doctrine. Schwartz acknowledges in discussing the second proposition that the insured interest doctrine is intended to mitigate moral hazard.<sup>106</sup> CDSs allow buyers to speculate, according to Schwartz, whether or not they bear any risk related to the reference entity and consequently are not insurance.<sup>107</sup> This feature of CDSs distinguishes it from insurance only in the sense that modern insurance law prevents using insurance contracts to create a negative economic interest in a given entity. As discussed in the preceding

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<sup>101</sup> See Schwartz, *supra* note 2 at 200; see also *supra* text accompanying notes 21, 27.

<sup>102</sup> Schwartz, *supra* note 2, at 200.

<sup>103</sup> See *id.* at 189.

<sup>104</sup> Jerry & Richmond, *supra* note 92, at 276.

<sup>105</sup> Schwartz, *supra* note 2, at 200.

<sup>106</sup> See *id.* at 190.

<sup>107</sup> *Id.*

paragraph, this is simply a difference in how two types of contracts are regulated as opposed to a difference in the contracts themselves. Given the evidence that CDSs create moral hazard similar to early insurance contracts, policy makers should consider applying the same regulation to CDSs as applied to insurance.

Third, Schwartz argues that “[w]hen recovery under a contract can be had without substantiating any actual loss or damage the contract is not insurance.”<sup>108</sup> Therefore, according to Schwartz, a CDS is not insurance because a credit event triggering a payout to a CDS buyer does not have to constitute a loss on the part of the buyer.<sup>109</sup> The indemnity doctrine was instituted to prevent using an insurance contract to create a negative economic interest in the insured entity. CDSs not being subject to this requirement does not mean CDSs are not insurance. It only means CDSs are not regulated the same way as a standard insurance contract.

Fourth, Schwartz argues that where the party can recover an amount that exceeds expenses caused by loss or damage, the contract is not insurance.<sup>110</sup> CDSs allow a buyer to recoup, upon the occurrence of a credit event, amounts that bear little or no relationship to the buyer’s loss. Consequently, Schwartz argues CDSs are not insurance.<sup>111</sup> Again, this argument uses the indemnity doctrine to define insurance when indemnity is merely a form of regulation restraining the use of insurance.

Fifth, Schwartz argues that where a contract for recovery allows physical settlement, the contract is not insurance.<sup>112</sup> While insurance contracts usually result in the insurer paying the insured a cash amount based on the loss, parties to a CDS contract can designate either cash or physical settlement.<sup>113</sup> The possibility of physical settlement, where the obligation provided by the buyer to the seller in exchange for the payout amount is different from the reference obligation, would not be allowed in a standard insurance contract.<sup>114</sup> By collecting on an insurance contract, the insured often hands over to the insurance company any right attached to the entity he or she had insured. This transfer of rights is called

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<sup>108</sup> *Id.* at 200.

<sup>109</sup> *See id.* at 193.

<sup>110</sup> *Id.* at 200-01.

<sup>111</sup> Schwartz, *supra* note 2, at 193.

<sup>112</sup> *Id.* at 200-01.

<sup>113</sup> *Id.* at 194.

<sup>114</sup> *Id.* at 195.

subrogation.<sup>115</sup> This difference means CDS cannot be defined as insurance, according to Schwartz.<sup>116</sup> Again, Schwartz has identified a distinction in the contract's legal treatment and not in the contract's effects. If a CDS contract creates similar effects as an insurance contract that is not subject to subrogation, then policy-makers must assess whether subrogation should apply to CDSs.

Sixth, Schwartz argues that where a contract for recovery provides for cross-payment netting under a master agreement, the contract is not insurance.<sup>117</sup> Under the ISDA Master Agreement, CDS trades between accounts can be netted, meaning that instead of working through each transaction, market participants can settle the net balance outstanding between them.<sup>118</sup> This aspect of the CDS market is merely a testament to the success of the ISDA in organizing consensus among its members. An insurance company might be able to achieve the same result if it deducted premiums owed by an insured on one policy from the amount the insured was scheduled to collect from a different policy. This last characteristic identified by Schwartz simply describes the manner in which an insurance exchange, unencumbered by the insured interest, indemnity or subrogation doctrines, might organize itself to achieve maximum efficiency. It is hardly a characteristic distinguishing CDS from insurance.

#### B. NIRENBERG AND HOFFMAN'S ARGUMENT

The analysis presented by Nirenberg and Hoffman, presents a more subtle argument. It utilizes Holmes' three tests; (1) Substantial Control; (2) Principal Object; and (3) Regulatory Value to determine whether CDS should be classified as insurance.<sup>119</sup>

Under the Substantial Control Test, insurance is any contract by which one contracting party (the insurer) for a valuable consideration (the premium) given by the other party (the insured) assumes the other party's fortuitous risk of loss or liability and then distributes the risk or liability

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<sup>115</sup> See Subrogation Administration, What Subrogation?, <http://www.subrogation.com/what/main.html> (last visited Oct. 4, 2008).

<sup>116</sup> Schwartz, *supra* note 2, at 201; See Subrogation Administration, What Subrogation?, <http://www.subrogation.com/what/main.html> (last visited Oct. 4, 2008).

<sup>117</sup> *Id.* at 200-01.

<sup>118</sup> *Id.* at 195-96.

<sup>119</sup> See *infra* text accompanying notes 103-107.

among a similarly situated group of parties pursuant to the same distribution plan.<sup>120</sup>

Applying this standard to CDSs, there is a contract (the CDS agreement) by which one contracting party (the seller) for valuable consideration (the contracted payment obligation) tendered by the other party (the buyer) assumes the other party's risk of loss or liability (the reference security becoming substantially devalued or worthless).<sup>121</sup> But, they continue, whether the risk of loss or liability is fortuitous depends on the facts and circumstances of the transaction.<sup>122</sup> Similarly, they argue, distribution of the risk by the CDS seller among buyers does occur, but not always.<sup>123</sup> Nirenberg and Hoffman conclude that CDSs being deemed insurance based on the substantial control test depends on the circumstances of the particular transaction.<sup>124</sup>

The Principle Object Test inquires whether the elements of risk transference and distribution of a fortuitous insured event are central to and a relatively significant feature of the commercial transaction.<sup>125</sup> Nirenberg and Hoffman again find that this determination varies between CDS transactions as one buyer might be buying to hedge risk, meaning he is buying insurance, whereas another might be buying to speculate, meaning he is not buying insurance.<sup>126</sup>

The Regulatory Value Test inquires whether a particular commercial transaction should be regulated in the public interest.<sup>127</sup> More specifically, the test makes the following inquiries: 1) What is the private interest sought to be protected in the commercial transaction? 2) Who is the party assuming the risk transferred and is the protected interest indigenous to that party? 3) Is the protected interest indigenous to the state and all its interests? 4) Does the value of the indigenous interest invoke the purposes and policies of state insurance regulation for all its citizens?<sup>128</sup>

Nirenberg and Hoffman provide a similar answer to the first two inquiries as Potts and Schwartz. They reason that because CDSs do conform to the requirements of the insurable interest and indemnity doctrines they

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<sup>120</sup> Nirenberg & Hoffman, *supra* note 14, at 11; HOLMES & RHODES, *supra* note 21, at § 1.4.

<sup>121</sup> Nirenberg & Hoffman, *supra* note 14, at 12.

<sup>122</sup> *Id.* at 10, 12.

<sup>123</sup> *Id.* at 12.

<sup>124</sup> *Id.* at 10, 12.

<sup>125</sup> *Id.* at 11; HOLMES & RHODES, *supra* note 21, at § 1.4.

<sup>126</sup> Nirenberg & Hoffman, *supra* note 14, at 12-13.

<sup>127</sup> HOLMES & RHODES, *supra* note 21, at § 1.4.

<sup>128</sup> *Id.*

are not insurance.<sup>129</sup> As argued above, this analysis is faulty as it distinguishes CDS from insurance based on its purpose rather its effects. In evaluating the second two inquiries, Nirenberg and Hoffman assume that CDSs “affect neither the health nor the safety of the public, nor any other interest indigenous to the state or its citizens.”<sup>130</sup> As discussed in part two of this paper, there is evidence that CDSs create negative economic interests that give CDS buyers incentive to destroy value in the economy. Policy-makers decided to check similar incentives created by early insurance contracts and should think about doing so with regard to CDSs.

### CONCLUSION

Arguments against recognizing CDSs as insurance fail to recognize the moral hazard created by CDSs. These arguments disregard the purpose of the insured interest and indemnity doctrines. Therefore, the differential treatment of CDSs and insurance merits review by policy-makers.

The moral hazard created by CDSs described above might only be potential. Dispositive evidence showing speculators destroy value to profit on CDS speculation has not been found. However, analysis of the issue is difficult due to a lack of disclosure requirements in the OTC derivatives market, through which CDSs are traded. Some argue that simply creating more disclosure rules would mitigate any potential moral hazard.<sup>131</sup> An alternative or supplemental measure might be the application of an insurable interest or indemnity requirement.

Given the similarities between an old problem (moral hazard in the early insurance market) and a potential new one (moral hazard in CDS markets), policy-makers must analyze the consequences of classifying CDSs as insurance for regulatory purposes. There are some strong arguments regarding the benefits of CDSs and the dangers of government regulation.<sup>132</sup> Given the immense size of the CDS market more research is needed. Moreover, given the similarities between CDSs and insurance, more emphasis should be placed on studying insurance law and policy in evaluating the future of CDSs.

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<sup>129</sup> Nirenberg & Hoffman, *supra* note 14, at 13-14.

<sup>130</sup> Nirenberg & Hoffman, *supra* note 14, at 15.

<sup>131</sup> Hu & Black, *supra* note 66, at 682 - 684.

<sup>132</sup> See Greenspan, *supra* note 19.