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Credit Default Swaps and the Bankrupt Counterparty — Entering the Undiscovered Country

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The credit default swap ("CDS") has never been tested in bankruptcy proceedings on any significant scale, particularly under recent amendments to the Bankruptcy Code. In part, this is because the CDS market is a very recent phenomenon. CDS market participants also make considerable efforts to avoid holding a credit default swap where the counterparty has gone into bankruptcy. But with the deterioration of the credit markets since mid-2007, the bailouts of Bear Stearns, Fannie Mae, and Freddie Mac, and most recently the bankruptcy of Lehman Brothers and the federal takeover of AIG, CDS market participants will confront counterparty bankruptcy and a variety of issues of first impression.

The Credit Default Swap Market

A credit default swap is a contract between two parties, whereby the credit protection buyer makes periodic payments to the credit protection seller in exchange for the right to a payoff if there is a default or other defined "credit event" on the part of a "reference entity". The reference entity can be a corporation, a government, or a financial obligation such as an asset-backed security. A credit default swap can have multiple reference entities (a "basket CDS"), or can have a market index as a reference entity (an "index CDS"). There are numerous other variations of the CDS. Fundamentally, however, a protection seller accepts the credit risk of the reference entity or entities in exchange for a premium.

Credit default swaps are generally documented using industry standard derivative master agreements and standard CDS terms, such as the International Swaps and Derivatives Association ("ISDA") 2002 Master Agreement and Credit Derivative Standard Terms.[1] While many credit default swaps are "vanilla" instruments based on

[1] The 2002 ISDA Master Agreement is the most recent master agreement promulgated by the ISDA and is discussed herein for illustrative purposes. The previous master agreement, the 1992 Master Agreement, is still in use. While the issues arising under the 1992 Master Agreement are similar, differences in contract language must be taken into account.

standard contracts, the standard agreements are flexible, and some CDS contracts contain unique terms or features. These are known as "bespoke" swaps.

The credit default swap market has doubled in size for each of the past five years. By 2008, outstanding CDS contracts had a combined value on payoff of more than $60 trillion, and a market value of more than $2 trillion.[2] A variety of institutions both buy and sell credit default swaps, including banks, hedge funds, insurers, mutual funds, pension funds, and corporations.[3] At the center of the CDS universe are the dealers, large banks such as JPMorgan Chase, Citibank and Morgan Stanley, and a number of European banks. After the initial CDS contract is established, there is a secondary market for CDS. Selling a CDS requires the agreement of both original parties, called a "novation," and, although recent developments have improved the process, it can be somewhat cumbersome operationally.[4]

Because a protection seller is at risk should the reference entity suffer a credit event, and because there are no regulatory requirements for protection sellers to meet regarding creditworthiness or reserves, a protection buyer must make sure the protection seller is able to pay.[5] Likewise, the protection seller must make sure it has the resources to pay claims. Various risk management strategies are used. Protection sellers can balance risk by purchasing mirror CDS contracts. For example, by buying a protection contract that would pay off upon the credit event, a party can fund a payment it would make as a protection seller on the other side. Using this approach, large dealers generally maintain a "balanced book", offsetting risks on one side with protection on the other.[6]

Protection buyers facing the risk that the seller will be unable to pay can insist on appropriate collateral. Collateral arrangements are generally established through a standardized collateral agreement such as the ISDA's Credit Support Annex. The amount of collateral for a CDS contract is typically based on some portion of the notional exposure. Under standard arrangements, as the protection buyer's exposure to the counterparty increases beyond a certain threshold, the counterparty has to post collateral to offset the risk. The terms of the collateral, including the thresholds at which additional collateral is required, what is acceptable collateral, how it is valued, and how it may be used by the secured party vary widely. About two-thirds of CDS

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[2] Moody's Investors Service, *Credit Default Swaps, Market, Systemic, and Individual Firm Risks in Perspective* (May 2008) at 1.

[3] Darrell Duffie, *Innovations in Credit Risk Transfer: Implications for Financial Stability*, Bank for International Settlements Working Paper No. 255 (July 2008) at 5.

[4] Moody's Investors Service, *supra* note 1, at 22.

[5] David Evans, *Hedge Funds in Swaps Face Peril with Rising Junk Bond Defaults*, Bloomberg (May 20, 2008) at 2.

[6] Moody's Investors Service, *supra* note 1, at 7.

exposure is subject to some form of collateral agreement.[7] This, obviously, leaves some exposure unprotected.

Early Signs of Stressed Counterparties

As the subprime mortgage market fell apart in late 2007 and early 2008, many financial products, particularly mortgage-backed securities, were downgraded. The price of credit default swaps on these products increased. Pursuant to their collateral agreements, many protection buyers were able to insist on additional collateral protection. In some cases, the collateral demanded represented a significant portion of the counterparty's assets. Unsurprisingly, counterparties have carefully evaluated, and in some cases challenged, protection buyers' right to such additional collateral amounts. This tension has generated several recent lawsuits:

- *CDO Plus Master Fund Ltd. v. Wachovia Bank, N.A.*, 07-11078 (S.D.N.Y. Dec. 7, 2007) (dispute over demand for collateral on $10,000,000 protection on collateralized debt obligations).

- *VCG Special Opportunities Master Fund Ltd. v. Citibank, N.A.*, 08-1563 (S.D.N.Y. Feb. 14, 2008) (same).

- *UBS AG v. Paramax Capital Int'l, No. 07604233* (N.Y. Sup. Ct. Dec. 26, 2007) (dispute over demand for $33 million additional capital from hedge fund for protection on collateralized debt obligations).

Given that the collateral disputes erupting in the courts so far likely represent only a small fraction of the stressed counterparties, and given recent developments, an increase in counterparty bankruptcy appears probable.

Termination of Credit Default Swaps upon Counterparty Bankruptcy

Under the terms of most credit default swaps, when one of the parties enters bankruptcy, the non-bankrupt party may terminate the swap. For example, under § 5(a)(vii) of the 2002 ISDA Master Agreement, bankruptcy is defined as an "Event of Default" giving the non-bankrupt party the right to terminate. If the "Automatic Early Termination" provision of the Master Agreement is made applicable, termination occurs automatically at a time immediately preceding the institution of the bankruptcy proceeding. *Id.* at ¶ 6(a).

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[7] ISDA Margin Survey 2008 at 10.

The next step, pursuant to the termination provisions in typical credit default swaps, is that the non-defaulting party calculates a termination value or "Close-out Amount" reflecting certain allowed categories of damages arising from the termination. As part of this calculation, the non-defaulting party may net losses against other derivative agreements entered into under the same master agreement with the bankrupt counterparty and set off losses against collateral.

The termination provisions in credit default swap contracts enjoy special treatment under the Bankruptcy Code, and particularly under amendments made in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which clarified the treatment of credit default swaps and other derivative contracts.[8] For example, although the "termination on bankruptcy" clause in the standard master agreement would ordinarily be considered an unenforceable *ipso facto* clause, the 2005 amendments make clear that such termination and liquidation provisions are enforceable.[9]

The non-bankrupt counterparty is specifically permitted to offset any claim against collateral it holds, without restraint by the automatic stay or other provisions of bankruptcy law.[10] It is also entitled to net any claim with gains or losses from other terminated derivative contracts it has with the bankrupt party pursuant to a master agreement with a netting provision, like the ISDA 2002 Master Agreement.[11]

The exercise of a right to liquidate, terminate, or accelerate a swap agreement on bankruptcy may not be avoided by a bankruptcy trustee.[12] With the exception of actual fraud, certain transfers made in connection with swap agreements are not subject to bankruptcy avoidance powers.[13] Moreover, the Code specifies that a swap participant or financial participant that receives a transfer in connection with a swap agreement "takes for value to the extent to the transfer."[14] Likewise, a master netting agreement participant takes for value.[15]

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[8] A credit default swap is a "swap agreement" under the Code. 11 U.S.C. § 101(53B)(A).

[9] 11 U.S.C. §§ 560, 561(a).

[10] 11 U.S.C. §§ 362(b)(17), 560.

[11] 11 U.S.C. §§ 362(b)(27); 561(a).

[12] 11 U.S.C. §§ 560, 561.

[13] 11 U.S.C. § 546(g). Note that § 546(g) references pre-petition transfers. Avoidance of certain post-petition transfers is permitted by § 549, which does not explicitly exempt swap agreements. However § 549(a) does exempt transfers "authorized under this title or by the court". Sections 362(b)(17) and (b)(27) authorize setoffs, to the extent the automatic stay is made inapplicable, against collateral and pursuant to netting agreements in connection with swap agreements.

[14] 11 U.S.C. § 548(d)(2)(D).

[15] 11 U.S.C. § 548(d)(2)(E).

In effect, the Bankruptcy Code permits many of the contractual mechanisms limiting counterparty exposure to operate without interference. In particular, the damages due to the non-bankrupt counterparty may be altered without regard to the bankruptcy process by the operation of netting and collateral agreements. After application of collateral and netting agreements, the damages left constitute a pre-petition claim subject to allowance or disallowance.[16]

Determining the Size of the Claim in Bankruptcy

Both the 2002 ISDA Master Agreement and the Bankruptcy Code provide rules for the calculation of the damages resulting from termination of a credit default swap. Neither, however, provides more than a general framework.

Damages Under the Bankruptcy Code The 2005 amendments added § 562, which specifies that damages from the termination of a swap transaction should be measured as of the date of termination. By implication, § 562 also requires that damages be measured by reference to "commercially reasonable determinants of value" as of that date.[17] Legislative history suggests the references to "commercially reasonable determinants of value" are intended to reflect state law standards.[18] If there are no commercially reasonable determinants of value on the date of termination, § 562 requires that the earliest subsequent date on which there is a commercially reasonable determinant of value be used. If a subsequent date is used, and one of the parties objects, § 562 assigns to the objecting party the burden of proving that there were no commercially reasonable determinants of value on that date.[19]

Damages Under the 2002 ISDA Master Agreement The standard derivative contract promulgated by ISDA furnishes some additional guidance on damages calculation. Upon termination, the 2002 ISDA Master Agreement provides that a "Close-out Amount" is calculated and paid to the party owed it. As a general matter, the components of the "Close-out Amount" include:

- The cost incurred in replacing, or in providing the economic equivalent of, the material terms of the terminated transactions, and,

- The loss or cost incurred in connection with terminating, liquidating, or re-establishing any hedge related to a terminated transaction.

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16 11 U.S.C. § 502(g)(2).

17 11 U.S.C. § 562(b).

18 "The references to commercially reasonable are intended to reflect existing state law standards relating to a creditor's actions in determining damages." H.R. Rep. No. 109-31 at 134-135 (2005).

19 11 U.S.C. § 562(c).

Calculation of this amount is made by the non-defaulting party and must be made in good faith and with "commercially reasonable procedures in order to produce a commercially reasonable result". The primary, but not exclusive, method contemplated for determining replacement cost is the solicitation of quotations from the market.[20] The "as of" date is "the date or dates following the [termination date] as would be commercially reasonable."[21] This is largely congruent with § 562, but puts less emphasis on using the first subsequent date upon which a commercially reasonable value is available.

Taking into account both the Code and the 2002 ISDA Master Agreement, the broad legal principles shaping calculation of the damages claim are "commercial reasonableness" and "good faith". State law defines commercial reasonableness for a creditor most clearly in the context of realization of value on collateral, such as the sale of property securing a loan.[22] Although bringing such standards to bear on the calculation of damages and the solicitation of quotes for valuation purposes is complex, case law suggests the timeliness and thoroughness of the process would be paramount concerns. The question arises, also, whether an extraordinary valuation, even if the result of a seemingly reasonable process, could be commercially "unreasonable" in substance.

"Good faith" in the performance of a contract has been given a variety of interpretations in the courts. The Uniform Commercial Code defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing".[23] While overlapping the concept of commercial reasonableness, this definition more clearly rules out subterfuge or deception. Some courts have defined good faith to include an implied promise not to act arbitrarily or irrationally in exercising discretion where a contract contemplates the exercise of discretion.[24] The duty of good faith, however, is not without limit, and no obligation inconsistent with other terms of the contract can be implied.

Practically, because a court will focus its good faith and commercial reasonableness inquiry on the process by which a damages claim is calculated, a party should document the steps it takes to arrive at the amount of that claim. This would include, but not be limited to, documentation of how quotes for replacement

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[20] *See* 2002 ISDA Master Agreement § 14 (definition of Close-out Amount). Both the 1992 ISDA Master Agreement and the 1994 ISDA Credit Support Agreement, governing collateral calls, contain more specific methodologies under which a specified number of quotes are obtained, and the arithmetic average of the quotes is used.

[21] *Id.*

[22] See U.C.C. § 9-610(c) ("commercially reasonable" disposition of collateral); U.C.C. § 9-607(c) ("commercially reasonable" collection and enforcement).

[23] U.C.C. § 1-201(b)(20).

[24] *See, e.g.*, *Dalton v. Educational Testing Serv.*, 663 N.E.2d 289, 389 (N.Y. 1995).

transactions were solicited and responded to, or how, in the absence of such quotes, a damages amount was calculated.

Potential Damages Complications in Counterparty Bankruptcy

While the calculation of a damages claim in an ideal case may be straightforward, in the face of an actual bankrupt counterparty, numerous complications can and will arise. These issues have rarely been addressed by courts, particularly in the context of credit default swaps. A few examples are set out below.

<u>Scenario 1 — Simple Case</u> A protection buyer purchases a single "vanilla" credit default swap from a protection seller. The protection buyer does not require collateral from the seller. The protection seller goes into bankruptcy and, pursuant to a typical master agreement, the CDS is terminated. Upon termination, the protection buyer seeks market quotes for a replacement transaction and purchases a replacement. Subject to other contractual terms, the essential measure of the damages claim will be the replacement cost borne by the protection buyer.

<u>Scenario 2 — Complications in Obtaining Quotations</u> Consider Scenario 1, but posit the bankruptcy occurs in a period of general credit market turmoil, or during disruption of an industry sector that affects not only the now-bankrupt protection seller but the reference entity as well. Under such conditions it may be difficult to obtain market quotations for a replacement transaction. If quotes are obtained, the disruption may lead to replacement costs, and therefore damages, that are extremely high.[25] Such damages are likely to lead to disputes about the applicability and reasonableness of the quotations. If the terminated CDS was a complex bespoke transaction or basket swap, it may be difficult to find a party that is willing to enter into the transaction at any price. Measures of damages in the absence of market quotations are more theoretical and more likely to be disputed by a bankrupt counterparty facing a substantial damages claim.

Furthermore, even where quotes are obtained, disputes may arise as to the adequacy of the quotation process. Beyond the obligation of "good faith," the extent of efforts a non-defaulting party may be obligated to make to obtain quotes is not well defined. Although recently the credit default swap market has undergone some standardization and centralization, the process of obtaining quotes for credit default swaps can involve person-to-person negotiation, particularly if the swap is non-standard. Such a process invites disputes over what was communicated to parties from whom a quote was solicited. For example, a New York court recently found that a party soliciting quotes to determine replacement value for a derivative transaction did

[25] For example, credit default swap prices soared on the announcement that Lehman Brothers was entering bankruptcy. *See* Denis Maternovsky and Lester Pimentel, *Emerging-Market Bonds, Stocks, Currencies Sink as Lehman Fails*, Bloomberg (Sept. 15, 2008) at 1.

not act in good faith when it instructed quoting parties to consider certain risks. The difference in damages calculated by that party and the court's ultimate calculation was significant, approximately $40 million.[26]

Scenario 3 – Related Transaction If, in addition to the simple case set out in Scenario 1, the non-bankrupt protection buyer also entered into other transactions related to the CDS it had purchased from the now bankrupt protection seller, a new damages component may be applicable. As noted above, under some master agreements, a non-defaulting party may include as damages the loss or cost incurred in connection with its terminating, liquidating, or re-establishing any hedge "related to a terminated transaction".[27] For example, a CDS protection buyer facing a bankrupt counterparty may be permitted to include the amount it loses in terminating a mirror transaction in which it sold protection in the same amount on the same reference entities for the same period. But what if the corresponding hedge of the non-bankrupt party was not a perfect mirror? The hedge could, for example, be a basket or index swap. In such a case, more extensive adjustments to the trades on the other side would be required to balance the non-bankrupt party's position. Determining what adjustments to the balancing transactions were properly chargeable to the bankrupt counterparty would be complex. It could, moreover, become a point of dispute if the bankrupt counterparty believed the non-bankrupt party was making unrelated portfolio adjustments and charging it off to the bankrupt counterparty.

Scenario 4 – Recovery of Collateral or Netted Amounts Because of Disputed Valuation If, in addition to the simple transaction described in Scenario 1, the non-bankrupt protection buyer held collateral from the protection seller or had other open derivative positions with the protection seller, an additional layer of complexity would come into play. The party to a CDS transaction exercising its right to setoff against collateral or pursuant to a netting agreement must necessarily value its claim before exercising that right, a valuation that will occur prior to an adjudication of the claim in bankruptcy. For a variety of reasons, including those described above, that valuation might become a subject of dispute. In such circumstances, the bankruptcy trustee of the now bankrupt protection-seller could attempt to recover such collateral or netted funds from the non-bankrupt protection buyer.[28]

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[26] *High Risk Opportunities HUB Fund Ltd. v. Credit Lyonnais*, Index No. 600229/00 (Sup. Ct. N.Y. County July 6, 2005) (unpublished opinion).

[27] *See* 2002 ISDA Master Agreement § 14 (definition of Close-out Amount).

[28] The 2005 amendments did not change the bankruptcy trustee's right of turnover under 11 U.S.C. § 542, under which a trustee can, in some circumstances, seek return of collateral to the estate.

These scenarios are just a few of the many disputes likely to arise when credit default swaps are tested in bankruptcy. Given the complexities involved in calculating and litigating damages arising from termination of credit default swaps in bankruptcy, it is prudent to consult with knowledgeable financial and legal counsel to decide the best course of action.

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