October 15, 2008)

LITIGATION ALERT

BACKGROUND ON CREDIT DEFAULT SWAPS

Tensions are rising in the financial industry over increasing terminations and defaults on over-the-counter (OTC) derivatives, or credit default swaps (CDSs). With large investment banks seeking Chapter 11 protection, government bailouts, the takeover of Fannie Mae and Freddie Mac, and the tightening credit market, the approximately $55 trillion market in credit default swaps, many based on mortgage-backed securities, is facing difficult circumstances.[1] The sheer size of the market—and the number of speculators in the market—means that trouble in the CDS market has implications for market failure beyond the subprime mortgage market. As trillions of dollars in CDS settlements are likely to become due, both protection buyers and sellers are wondering where the cash will come from and how to manage losses.

CDS BASICS

Before the current credit crisis, many people were unaware of these financial instruments.[2] Beginning in the 1990s, large investors in such securities as corporate debt, municipal bonds or, more recently, asset-backed securities such as collateralized debt obligations (CDOs), started to use CDSs to hedge against losses on these investments. A CDS is akin to insurance against an investment loss, whereby the entity seeking to hedge its loss, the protection buyer, pays a premium over time to a protection seller to reimburse it for the value of covered loss in its investment should a specified Credit Event[3] occur, such as a default or bankruptcy of the reference entity or obligation.[4] Buyers take a risk, however, regarding whether the protection seller will be able to pay out upon a Credit Event. Trades on CDSs are unregulated. Only regulated entities, such as banks (as opposed to investment banks and hedge funds), are required to set aside reserves to cover potential CDS payouts.

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[1] The International Swaps and Derivatives Association, Inc. (ISDA) 2008 mid-year market survey states that, in the first half of 2008, the notional amount of credit default swaps was $54.6 trillion. *See* http://isda.org/statistics/recent.html (follow "Surveys & Market Statistics" hyperlink; then follow "Summaries of Market Survey Results" hyperlink).

[2] *See, e.g.*, Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME, Mar. 17, 2008, available at http://www.time.com/time/business/article/0,8599,1723152,00.html.

[3] Capitalized terms have the same meaning as set forth in the 2003 ISDA Credit Derivatives Definitions ("2003 Definitions"), available at http://www.isda.org/publications/isdacredit-deri-def-sup-comm.html#isdacrd.

[4] *See* ISDA's Product Descriptions and Frequently Asked Questions No. 24, available at http://isda.org/educat/faqs.html (follow "Education" hyperlink; then follow "Product Descriptions and FAQs" hyperlink).

Premiums on corporate debt are calculated from basis points, which typically represent how much it will cost to insure $10 million of debt over a five-year period. Basis points can vary based on the perceived risk of default, based on factors such as the reference entities' credit rating. For example, Reuters reported on October 3, 2008, that Wachovia's five-year credit default swaps fell to 249 basis points. This means that it costs $249,000 a year for five years to protect $10 million in Wachovia debt. Because the basis points fell, it means that the risk to insure Wachovia's debt had gone down as well.

When the economy is doing well, protection sellers earn money without substantial investment cost by collecting buyer premiums. Sellers can also enter into an offsetting hedge to protect against losses. Both sides, buyers and sellers, can trade their interests in the CDS. Also, many CDSs are collateralized, meaning that the buyer puts up either the referenced bonds or some other collateral as security. In the event of default of the underlying reference entity, and depending on what Settlement Method is specified in the Confirmation, the protection buyer can either deliver the agreed-upon Deliverable Obligation to the seller in exchange for a Physical Settlement Amount (Physical Settlement), or accept a payout as specified in the Confirmation for a Cash Settlement.[5]

In addition to traditional protection buyers and sellers that have a stake in the reference entity or obligation, the secondary CDS market has rapidly expanded in recent years, with speculators betting on whether a particular reference entity will succeed or fail. The value of these CDS agreements depends entirely on the creditworthiness of the reference entity upon which the parties are speculating.

CDS CONTRACTS

The terms of a CDS are set forth in privately negotiated contracts. Most trades are made pursuant to a Master Agreement, compiled and published by the ISDA, an industry trade association made up of major players in the OTC derivatives market. The Master Agreement sets forth the legal and credit relationship between the parties: an umbrella agreement that will be incorporated into separate transactions between the parties called Confirmations. The economic terms of each separate transaction are set forth on the Confirmation. Use of the ISDA Master Agreement and other form documents is intended to create consistency and to reduce risk involved in derivative transactions. Parties can customize the terms of a CDS agreement by negotiating which version of the Master Agreement to use (1992 or 2002 for CDS agreements) and varying standard terms in the Schedule, Annexes and the Confirmation. Typically the 2003 ISDA Credit Derivatives Definitions is incorporated by reference into a CDS agreement.

CDS DEFAULTS

With major financial institutions defaulting on a massive scale, either as the reference entity or as counterparty to a CDS agreement, there are two types of defaults that concern market participants.

The first type of default, called a Credit Event, involves a default of the underlying reference obligation or entity. A Credit Event occurs if, for example, the CDS agreement insured the performance of a reference entity, and the reference entity files for bankruptcy. Credit Events are detailed in Article IV of the 2003 Definitions and in the parties' negotiated Confirmation. If a Credit Event occurs, and the Conditions of Settlement are met, the protection seller must pay out the insured amount.[6]

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[5] *See generally*, Articles VI – VIII on Settlements in the 2003 Definitions.
[6] *See* Article III on Conditions of Settlement and Article IV on Credit Events in the 2003 Definitions.

The second type of default, called an Event of Default, occurs when one of the counterparties to the CDS agreement defaults by, for example, filing for bankruptcy. Section 5 of the ISDA Master Agreement sets forth Events of Default and Termination Events whereby a counterparty can set an Early Termination Date for a CDS agreement. The Master Agreement also sets forth a method to calculate close-out of the CDS agreement upon an Event of Default.

CONCLUSION

The problem in the current market is the number of defaults occurring simultaneously by reference entities and counterparties. Many protection sellers that must pay out on CDS agreements may not be able to raise sufficient capital to do so. Litigation over fraud and misrepresentation involved in valuation of the underlying collateral or reference entity is likely to increase in an attempt to stave off large payouts. Because CDSs are not regulated, the primary cause of action in any litigation involving a CDS is a breach of contract claim regarding the interpretation and enforcement of the parties' relevant agreements. Market participants should consult legal counsel regarding payouts, close-outs and litigation alternatives.

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