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LITIGATION ALERT

CREDIT DEFAULT SWAPS: OVERVIEW OF RIGHTS AND OBLIGATIONS SURROUNDING CREDIT EVENTS AND EVENTS OF DEFAULT

Government takeovers, bankruptcies, mortgage defaults and the broadening credit crunch have contributed to major losses across the financial services industry. In particular, the approximately $55 trillion[1] market in credit default swaps (CDS)—many based on mortgage-backed securities—has contributed to the downfall of venerated financial institutions. The market for CDSs is drying up, as protection sellers have had to write down huge losses on CDS portfolios. Moreover, continuing Credit Events on CDSs means that literally trillions of dollars in CDS settlements are coming due. Market participants, including both CDS buyers and sellers, are concerned about what rights, obligations and litigation considerations arise under CDS agreements when a Credit Event[2] on the underlying reference entity or obligation is noticed, or when a counterparty asserts an Event of Default and attempts early termination of the agreement.

Following is a discussion—generally applicable to CDS agreements—of what actions a market participant should consider in evaluating defaults, determining contract rights and managing losses. Market participants should seek legal counsel for advice on specific agreements, as every agreement is different, and interpretation may depend on which version of the Master Agreement was chosen, as well as the Schedule, Annex, Definitions and Confirmations negotiated by the parties.[3] This article is not intended to provide legal advice and should not be relied upon as such.

[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* www.isda.org (follow "Surveys & Market Statistics" hyperlink; then follow "Summaries of Market Survey Results" hyperlink).
[2] Capitalized terms have the same meaning as set forth in the 2003 ISDA Credit Derivatives Definitions ("2003 Definitions").
[3] For background information on Credit Default Swaps see previous litigation alert – A Background on Credit Default Swaps.

EVALUATING DEFAULTS AND DETERMINING CONTRACTUAL RIGHTS AND OBLIGATIONS

One of the more serious questions of the unregulated CDS market is whether or not a protection seller currently assigned to pay out upon default of the reference entity or obligation has—or can raise—sufficient capital to do so. Market participants should seek to minimize losses and consider litigation risks and opportunities by immediately organizing and evaluating information on outstanding CDSs. As set forth in more detail below, market participants should: gather and index documentation on all CDSs; evaluate the risk of default of all parties and the reference entity and obligation; determine whether or not a Credit Event has already occurred; and determine whether or not an Event of Default has occurred. If a Credit Event or Event of Default has occurred, this article provides a brief overview of relevant rights and obligations.

First, market participants should gather and index information on all relevant transactions. The terms of a CDS are set forth in privately negotiated contracts.[4] Gather all relevant documentation, including Master Agreements; assignments and information on successors in interest, if any; Definitions; Schedules; Annexes; and Confirmations, as well as information on the reference entity or obligation. Determine who the current parties to each CDS agreement are: protection buyer, seller and any guarantors (called a "Credit Support Provider" under the Master Agreement). While Section 7 of the Master Agreement generally requires prior approval of assignments, parties should ensure that they know who the counterparty is and that all relevant paperwork is present. Finally, gather all correspondence, including e-mail, related to each transaction, as this correspondence may contain information relevant to a claim or defense should litigation ensue regarding the Credit Event, transaction or underlying reference entity or obligation. Securing relevant documentation will also be important should your firm become involved in any government investigation.

Second, evaluate the risk of default of both the underlying reference entity, as well as the counterparty for each Confirmation. Determine what, if any, collateral was posted. If the CDS **is not** collateralized, the agreement is only as valuable as the counterparty's creditworthiness. If the CDS **is** collateralized, find and secure the collateral. Determine how the collateral is currently held, *i.e.*, by the buyer or by the seller. If you hold the collateral, consider whether or not you can or should sell the collateral, and whether or not notice to the counterparty or other action is required before a sale.

Third, for each CDS transaction, determine whether or not a Credit Event has occurred on any of the underlying securities or with the reference entity that entitles a protection buyer to a settlement on the CDS agreement. Article IV of the 2003 ISDA Credit Derivatives Definitions ("2003 Definitions"), which is typically incorporated by reference into a CDS agreement, defines a Credit Event as "one or more of Bankruptcy, Failure to Pay, Obligation Acceleration, Obligation Default, Repudiation/Moratorium or Restructuring, as specified in the related Confirmation." The 2003

[4] 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. Confirmations set forth the economic terms of each separate transaction. Parties can customize the terms of a CDS agreement by, for example, negotiating which version of the Master Agreement to use (1992 or 2002), and by varying standard terms in the Schedule, Annex and Confirmation.

Definitions explain in detail all capitalized terms listed above. Each Confirmation must be reviewed because the parties can alter what constitutes a Credit Event.

If a Credit Event has occurred in the underlying reference entity or obligation, the parties would move toward settlement of the CDS. The following provides an overview of relevant contractual considerations.

Conditions to Settlement — If a Credit Event has occurred, parties should consult the Conditions to Settlement found in Article III of the 2003 Definitions and perform all applicable obligations. For example, typically, but not always, it is a protection buyer's obligation to send the protection seller a Notice of Credit Event. An example notice is provided as Exhibit B to the 2003 **Definitions.** A Notice of Credit Event must describe the Credit Event in "reasonable detail" and is generally based on publicly available information. A Credit Event Notice must be sent within the Notice Delivery Period as set forth in Section 1.9 of the 2003 Definitions. Other notices detailed in the Conditions of Settlement include the Notice of Publicly Available Information, and, where applicable, a Notice of Physical Settlement (in lieu of a cash settlement). The Notice of Publicly Available Information sets forth published information confirming the facts relied upon in noticing the Credit Event. Other requirements apply if the information is not based on publicly available information.

Settlement Methods — The Confirmation generally sets forth whether the settlement will be a Physical Settlement or a Cash Settlement. If the buyer elects a Cash Settlement, the seller pays the Cash Settlement Amount, as specified in the Confirmation, to the buyer on the Cash Settlement Date.[5] If no Cash Settlement Amount is specified in the Confirmation, Section 7.3 of the 2003 Definitions sets forth a formula for calculating the amount, which is equal to the greater of either zero or the Floating Rate Payer Calculation[6] multiplied by the Reference Price (specified in the Confirmation) minus the Final Price. The Final Price is determined using the Valuation Method specified in the Confirmation, as explained in Article VII of the 2003 Definitions. If a Physical Settlement has been noticed, the buyer must deliver the Deliverable Obligations specified in the Notice of Physical Settlement to the seller before the Physical Settlement Date, in exchange for a Physical Settlement Amount from the seller. The Physical Settlement Amount is equal to the Floating Rate Payer Calculation Amount multiplied by the Reference Price.

Auctions — Determine whether or not the ISDA is coordinating an auction to help set the market price for a particular defaulting reference entity or obligation. The ISDA Web site (www.isda.org) lists upcoming auctions, timelines, auction protocols and the instruments to which they apply, as well as what steps must be taken to participate in an auction and what steps must be taken to adhere to the auction protocol. While no room for negotiation exists if parties choose to adhere to an auction protocol, those parties that do not choose to adhere to an auction protocol must bilaterally settle all transactions with counterparties regarding the defaulting reference entity. Market participants should consult counsel regarding whether or not to participate and how to participate, as well as to ensure that they are versed in how the auction protocol may change any contractual remedies.

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[5] *See* Article VII on Terms Relating to Cash Settlement.
[6] The Seller is the Floating Rate Payer. Section 1.20, 2003 Definitions. The Floating Rate Payer Calculation should be specified in the Confirmation.

Litigation Risks and Opportunities — Litigation opportunities may exist for protection sellers to avoid payment, or to avoid some portion of payment, on CDS agreements where, for example, the process of settlement has not been followed, the valuation is at issue or where fraud or misrepresentation is involved. A protection seller should consider whether or not the claimed Credit Event has occurred, whether or not the relevant reference entity has defaulted and whether or not all Conditions to Settlement have been met, including the veracity and interpretation of publicly available information used to support the Credit Event.

Likewise, a protection buyer must assess its litigation risks and opportunities surrounding the same issues discussed above for protection sellers. A protection buyer may also need to file suit where a protection seller is not meeting its settlement obligations.

Possibilities for litigation include, for example—

- Breach of contract claims surrounding whether or not a Credit Event has occurred. *See, e.g., AON Financial Products, Inc. v. Societe Generale*, 476 F.3d 90 (2d Cir. 2007) (holding that failure to pay did not arise where reference entity described in the CDS was not the defaulting party); *Eternity Global Master Funds Ltd v. Morgan Guaranty Trust Co*., 375 F.3d 168 (2d Cir. 2004) (reversing dismissal of breach of contract claim based on ambiguity of whether or not the event at issue was a restructuring event).
- Breach of contract, fraud and misrepresentation claims surrounding whether or not all material information about the transaction that induced a party to enter the agreement was disclosed, including information about the counterparty, reference entity, obligation or collateral.
- Whether both the settlement amount and procedures have been correctly carried out. *See e.g., Deutsche Bank AG v. Ambac Credit Products, LLC*, No. 04-5594 (DLC), 2006 WL 1867497 (S.D.N.Y. July 6, 2006) (holding that defendant did not breach CDS by failing to pay for bonds—representing Deliverable Obligation in a physical settlement—where obligation to pay did arise based on buyer's failure to deliver the bonds within the time specified in the CDS agreement).

Fourth, for each Master Agreement, determine whether or not a counterparty or guarantor has defaulted such that early termination of the CDS is an option. Soaring Credit Events necessarily implicate the ability of protection sellers to fulfill mounting payout obligations. If a counterparty defaults—called an Event of Default—the non-defaulting party can terminate the agreement early.[7] Considerations for early termination of a CDS include the following—

Evaluate Event of Default — Section 5 of the Master Agreement sets forth what constitutes an Event of Default by a counterparty or guarantor. An Event of Default occurs, for example, when either party, or a Credit Support Provider (a guarantor) for either party, fails to make a scheduled payment without curing,

[7] Other circumstances which are not detailed herein, called Termination Events, also provide a basis for early termination. A Termination Event occurs when, without action by a party or guarantor, the agreement, payment obligation or compliance in some other aspect of the CDS becomes illegal after entering into the transaction, certain tax events occur, additional events added by the parties in the Schedule or Confirmation occur, or a Force Majeure precludes performance (added in the 2002 Master Agreement). *See* Section 5(b) of the Master Agreement.

breaches a technical or substantive obligation under the CDS agreement, repudiates or rejects the CDS agreement, misrepresents material information underlying the agreement, defaults on a specified transaction, becomes insolvent or files for bankruptcy, or merges with another entity that does not assume all obligations. *See* Master Agreement Section 5(a).

If a counterparty files for bankruptcy, it is an immediate Event of Default upon which early termination of the CDS can be based. Filing for bankruptcy protection typically stays all actions against a debtor in order to preserve assets of the estate. However, pursuant to 11 U.S.C. § 362(b)(17), swap agreements are exempt from the automatic stay provisions. This means that the non-defaulting party can enforce its termination rights against a debtor based on the bankruptcy filing. A non-defaulting party should promptly decide whether or not to terminate CDSs with the debtor to avoid waiver of this right through delay.

If no default has yet occurred, evaluate the risk of default by each counterparty. Review all publicly known information regarding the solvency of the party, including credit rating and outlook. Also, take the opportunity to correct any documentation deficiency. Market participants may want to consider altering the terms of all of its Master Agreements or Confirmations using an ISDA protocol. Protocols allow a party to change contract terms across contracts by submitting an Adherence Letter to the ISDA. Counterparties must agree to the protocol, as well, for the contract to be effectively amended. A novation can be used on a bilateral basis to alter specific agreements.

Evaluate Early Termination Option — If an Event of Default has occurred, the non-defaulting party must first determine whether or not early termination is discretionary or automatic by reviewing the Schedule to the Master Agreement for an Automatic Early Termination provision. In agreements where an Automatic Early Termination applies, no discretion obtains, and all outstanding transactions under the Master Agreement have an Early Termination Date effective immediately upon an Event of Default for most occurrences as set forth in Section 6(a).

If termination is not automatic, the non-defaulting party should carefully consider the nature of any default, the defaulting party's ability to cure, the net of outstanding transactions, the ability to replace the current protection, and the value of any posted collateral, before deciding whether or not to terminate a CDS agreement.

For example, by the time an Event of Default occurs, assignments may have occurred on both sides of the original CDS agreement. Protection buyers must be confident in the ability of the current assignee to pay out upon a Credit Event. Further, in many instances, the parties will have many outstanding transactions between them: some that favor the buyer and others that favor the seller. Because a non-defaulting party cannot choose which transactions to terminate, if the net of all outstanding transactions favors the seller, a non-defaulting buyer may not want to terminate.

Note that Section 11 of the Master Agreement provides that the non-defaulting party will be indemnified for "reasonable out-of-pocket expenses, including legal fees, execution fees and Stamp Tax" incurred in enforcing the CDS and protecting its rights in an early termination situation.

Noticing An Event of Default — If a non-defaulting party decides to terminate a CDS, it must provide notice regarding the Event of Default and set an Early Termination Date. Pursuant to Section 6(a) of the Master Agreement, the non-defaulting party "may, by not more than 20 days notice to the Defaulting Party specifying the relevant Event of Default, designate a day not earlier than the day such notice is effective as an Early Termination Date in respect of all outstanding Transactions." Although the decision to terminate may be discretionary, if the non-defaulting party chooses to terminate it cannot pick and choose which transactions to terminate—all outstanding transactions under the relevant Master Agreement will be terminated if an Early Termination Date is noticed.

Calculating the Early Termination Amount — After noticing an Event of Default and Early Termination Date, the parties move forward to close out all transactions under the Master Agreement.

As soon as possible following the Early Termination Date, each party must make any calculations regarding close-out set forth in Section 6(e) of the Master Agreement and provide the other party with a statement. As set forth in Section 6(d)(i) of the 2002 Master Agreement, the statement must show calculations in reasonable detail and set forth any market date or quotations used in the calculation, specify the Early Termination Amount and provide information regarding where the payment is to be made.

Section 6(e) of the Master Agreement sets forth options for calculating payments on early termination. In the 1992 Master Agreement, the parties had several options for calculating the Early Termination Amount. If the parties did not specify which option to use in the Schedule, Section 6(e) calls for parties to use the Market Quotation measure and the Second Method. Section 6(e) of the 2002 Master Agreement sets forth a single method for calculating the close-out that is similar to the 1992 default option. The 2002 ISDA User Guide explains that this change reflects market participants' need for flexibility. The ISDA encourages market participants to change all CDS agreements to incorporate the close-out method set forth in the 2002 Master Agreement.

Under the 2002 Master Agreement, the non-defaulting party must use commercially reasonable procedures to calculate the close-out amount before the Early Termination Date (if reasonable). Considerations for this calculation include the cost to replace the swap, relevant market data and internal data an entity uses to value such swaps. Unpaid amounts owed to the non-defaulting party, and unpaid amounts owed to the defaulting party are then netted out of the close-out amount to obtain the Early Termination Amount. Parties must also take into account any collateral for the CDS when determining this amount. If the number is positive, the non-defaulting party would seek to collect; if it is negative, the non-defaulting party would need to pay this amount to the other party on the date specified. Interest must also be paid on unpaid amounts as set forth in Section 9(h).

The Early Termination Amount should reflect the cost to replace protection from another seller if it favors the buyer. Likewise, if the net value favors the seller, the close-out amount should reflect the seller's cost to enter an equivalent CDS with another buyer.

Litigation Risks and Opportunities — Parties seeking to preserve the CDS or to minimize Early Termination Amounts can seek relief in the courts. For example, this past summer, Merrill Lynch won a declaratory judgment against XL Capital's attempts to terminate a series of CDSs based on alleged impairment of XL's voting rights. *Merrill Lynch Int'l v. XL Capital Assurance Inc.*, 564 F. Supp. 2d 298 (S.D.N.Y. 2008) (holding XL Capital was not entitled to terminate CDSs based on voting rights, where plaintiffs' subsequent obligations did not impair XL's voting rights as claimed). Merrill Lynch claimed that XL manufactured the voting rights issue as a means to early termination. In that case, the court agreed with Merrill Lynch that the purported basis for termination had not occurred.

With regard to the termination itself, parties to a CDS seeking to either terminate or defend against termination should consider all options regarding whether or not an Event of Default has occurred. As the Merrill Lynch case demonstrates, defaults can be based on a breach of the CDS agreement and not just failure to pay or insolvency. Where breach of the agreement is at issue, all contractual defenses are fair game in defending termination. Parties should also consider whether or not the termination procedure is or has been technically and substantively followed, including calculation of the Early Termination Amount, and any potential fraud or misrepresentation claims.

CONCLUSION

Both buyers and sellers of protection should consolidate information on all CDS agreements and evaluate the risk of default by both reference entities and counterparties. Should a Credit Event or Event of Default occur, both parties have rights and obligations in settling or terminating a CDS pursuant to their agreements. Parties should consult legal counsel in order to establish and maximize recovery on CDSs, evaluate litigation risks and opportunities, and to minimize any potential losses.

AKIN GUMP
STRAUSS HAUER & FELD LLP

akingump.com

CONTACT INFORMATION

If you have questions regarding this alert, please contact—

Anthony T. Pierce .... 202.887.4411 ....apierce@akingump.com..................... Washington, D.C.
Mary A. House .... 202.887.4143 ....mhouse@akingump.com.................... Washington, D.C.