

The Next Wave

DEVELOPMENTS IN CREDIT DEFAULT SWAP LITIGATION

By Alan H. Scheiner

The Credit Default Swap (CDS), an arcane and relatively novel instrument of institutional finance, recently gained notoriety as the apparent cause of the near collapse of American International Group, Inc. (AIG). AIG's downfall and bailout, involving up to \$170 billion in federal funds, testifies to the importance of these credit derivatives.

The CDS market, which arose only in the 1990s, is shockingly large. A survey of members conducted by the International Swaps & Derivatives Association, Inc. (ISDA) reported that the CDS market had a notional value, meaning the face value amount of all potential payouts, of \$54.6 trillion as of mid-2008. For comparison, the gross domestic product of the United States in 2008 has been estimated by the Bureau of Economic Analysis at \$14.28 trillion. The immense size of the CDS market—combined with a continuing environment of financial distress—seems destined to produce a wave of CDS litigation over the next several years.

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A CDS is a promise by the seller of the CDS to pay a fixed amount to the buyer of the CDS upon the occurrence of a "Credit Event," a term defined by each particular swap agreement. Although some states are proposing to regulate CDSs as insurance, one feature that distinguishes the CDS from bond insurance is that the buyer of credit protection need not—and often does not—own the underlying obligation that is the subject of the CDS. And the Credit Event payment may be keyed to a change in the financial condition of a debtor, such as a lowered credit rating or bankruptcy filing, rather than a default on a specific debt.

This article examines some of the recent legal developments in CDS litigation, for hints of what the future holds. CDS litigation has so far been rare. But the handful of reported CDS decisions show that CDS litigation will be as complex and varied as the instruments themselves. Some cautionary signposts already appear on the road ahead.

- First, CDS participants must take care that they do not unintentionally waive their rights. For example, a CDS seller may wish to temporarily accommodate, because of other business relationships with a counterparty, what

it believes are unreasonable demands for collateral. But a recent decision holds that payment of a CDS collateral call could waive any objections to the amount paid.

- Second, CDS buyers must take all actions necessary to establish that a Credit Event occurred before the termination date of the CDS. A delay of just one day could mean the difference between collecting the full value of a CDS contract, or zero.

- Third, CDS buyers should anticipate and meet all the procedural deadlines controlling settlement of the CDS. Failure to do so can result in complete forfeiture of the buyer's bought-and-paid-for rights to credit protection.

General Structure of CDS Agreements

CDS contracts can be difficult to interpret because they are written using a terminology peculiar to credit derivatives, and are subject to innumerable variations in the particulars of their crucial terms. Easing that difficulty (somewhat), all CDS contracts share a common structure based upon the standard master agreement and definitions published by the ISDA. Note, however, that CDS contracts continue to evolve, including the

recent opening of a central counterparty clearinghouse.

Typically, the parties to a CDS enter into a master agreement that governs all their individual CDSs. For each swap, a confirmation, which can modify the terms of the master agreement, is issued setting forth the basic terms of the swap. Each confirmation will typically define a “reference entity” (the debtor that is the subject of the swap), a “reference obligation” (an instrument or security that is the subject of the swap), a termination date, the types of Credit Event that will trigger payment, the payments to be made

Support Annex. CDS collateral calls were pivotal in the troubles of AIG.

The trigger to the payout on a CDS—the Credit Event—is an adverse event concerning the reference entity or the reference obligation. Regarding the entity, it may be a bankruptcy filing, significant default, and/or a credit rating downgrade. Regarding the obligation, it may be a failure to pay, any event of default, a write-down, or a credit rating downgrade. The definitions of a Credit Event are limited only by the ingenuity of the CDS counterparties. The CDS will have a termination date before which the Credit

procedures set forth in the ISDA Credit Support Annex can lead to waiver of any objections to margin call amounts. A failure to make all appropriate demands can lead to a failure to establish a Credit Event requiring payment under the CDS. Counterparties must timely follow settlement procedures, or may forfeit their rights to collect under the CDS. Each of these developments is discussed in detail below.

Waiver of Margin Disputes

In a pair of recent lawsuits in the federal court in the Southern District of New York, VCG Special Opportunities Master Fund, Ltd. (VCG), a hedge fund of approximately \$50 million in assets and a CDS seller, sued Citibank, N.A. and Wachovia Bank, N.A., CDS buyers, raising similar claims against each bank. VCG alleged that both banks had bought CDS contracts from VCG, each covering a different CDO for the amount of \$10 million, and that each had made unwarranted and bad faith demands for additional credit support, i.e., margin calls.

Although the two claims involve distinct transactions, the substance of the two suits is identical: VCG claimed that no margin calls were permitted under its CDS contracts, and therefore all the margin calls were unwarranted. In the Citibank case, VCG alleged that Citibank demanded nearly the face value of the CDS of \$10 million as collateral. In the Wachovia case, VCG claimed that at one point the bank demanded more than the face value of the CDS as collateral, requiring \$10.4 million against a CDS covering a \$10 million mortgage-backed CDO.

On November 5, 2008, the claim against Citibank was dismissed by District Judge Barbara Jones in the Southern District of New York; the Wachovia case remains pending. The decision in *VCG v. Citibank, N.A.*, 08-CV-01563 (BSJ), 2008 WL 4809078 (S.D.N.Y. Nov. 5, 2008), currently on appeal, provides insight into the types of disputes to be

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by the buyer to the seller in exchange for the CDS (which may be fixed or variable), the payment to be made by the seller if there is a Credit Event, notice requirements, and settlement procedures.

The reference entity, a particular debtor, may be a corporation, other business entity, or a sovereign government or agency. The reference obligation could be of any sort, but is often a collateralized debt obligation (CDO), mortgage-backed security, bond, or other direct or indirect loan obligation.

Of central importance is any requirement of collateral, or margin, that must be posted by the seller of the CDS, and that may vary during the life of a CDS depending on credit rating changes (of the counterparty or reference entity), securities prices, and other market events. Thus, the cost to the seller of meeting its CDS obligations can increase over time, well before the CDS is required to be paid, and even if it is never required to be paid. When a CDS requires collateral (termed “credit support” by ISDA), that requirement is governed by the ISDA Credit Support Annex, the variables of which are modified by the parties in paragraph 13 of the Credit

Event must occur in order to trigger the payout. Occurrence of the Credit Event before termination will result in a payout and termination of the CDS contract.

CDS settlement procedures are standardized, for either “physical settlement” or “cash settlement.” All require a “Credit Event Notice,” which is followed by a “Notice of Intended Physical Settlement” if “physical settlement” is required. In that case, the buyer must deliver to the seller a specified security or class of securities (often the reference obligation or an equivalent). If cash settlement is permitted, the payout will be made according to a formula based on the difference between the face value and market value (if any) of the reference obligation.

Developing Issues in CDS Litigation

The few reported judicial decisions give guidance for the future, and indicate caution to CDS participants. One repeated theme is the failure to follow procedures set out in CDS documentation, leading to the complete forfeiture of rights under the CDS. With respect to margin disputes, a failure to follow the margin dispute resolution

expected regarding CDS contracts and some of the pitfalls facing litigants. The decision applied New York law.

VCG alleged that Citibank made a series of margin calls in 2007 that ultimately required VCG to post a total of \$9.96 million in collateral against a contingent payment of \$10 million. VCG claimed that the margin calls were without contractual basis because the original \$2 million in collateral posted on the contract—referred to as the “independent amount”—was the only collateral that was required. The CDS provided for “floating payments”—interim payments by VCG upon certain credit events less significant than a total default on the reference obligation—but VCG said those were the only interim payments permitted under the CDS and no variable margin payments could be required. Citibank, on the other hand, read the CDS to allow for margin calls based on variations in the market value of the CDO reference obligation.

The court held against VCG regarding the margin calls on two grounds. First, the court found that the parties’ Credit Support Annex to the master agreement allowed Citibank to request additional collateral based on its “exposure,” as measured by the gain or loss it would incur at any given time in replacing the CDS with an equivalent transaction. The court found nothing in the CDS confirmation to contradict that provision of the Credit Support Annex.

Unlike VCG, most parties to CDS contracts generally agree with their counterparties about whether their contracts permit margin calls at all, and are far more likely to disagree about the amount of the calls. For those participants, the second part of the court’s holding on margin calls is far more significant.

In that holding, the court found that VCG had *waived* any dispute regarding the margin calls on two grounds: (1) by paying the calls and continuing to accept payments from Citibank under the CDS and (2) by failing to invoke the dispute resolution procedure in the contract. VCG

claimed that it paid Citibank’s unreasonable demands because it feared that Citibank would declare a default and seize the collateral. The court held that that was an insufficient excuse. The court applied the basic rule that “where a party to an agreement has actual knowledge of another party’s breach and continues to perform under and accepts the benefits of the contract, such continuing performance constitutes a waiver of the breach.” Because VCG paid the margin calls while continuing to accept Citibank’s payments under the CDS (over a period from August to November 2007), the court found that VCG waived its objection to the margin calls.

In addition, the court held that the dispute resolution procedure contained in the parties’ Credit Support Annex to their master agreement was a mandatory prerequisite to suit. In other words, VCG waived its objection because it did not invoke the dispute resolution provisions pertaining to disputed margin calls. The court found that New York public policy favored strict enforcement of alternative dispute resolution agreements, and therefore “VCG cannot now challenge Citibank’s requests for additional collateral without having first vetted

the claim in the manner agreed upon in the CDS contract.” Thus, *VCG v. Citibank* is a strong caution to CDS parties to scrupulously follow dispute resolution procedures if they wish to preserve a margin call objection.

Definitions and Timing

The *VCG v. Citibank* decision also addressed a question of whether a “Floating Amount Event”—requiring an interim payment on the CDS—had occurred. Citibank had declared a Floating Amount Event on the basis of an “implied write-down” (as defined by the CDS documents) of the reference obligation, requiring an interim payment from VCG that VCG refused to make. As a result, Citibank terminated the CDS, foreclosed on the collateral, and sought to collect the remainder of the unpaid Floating Amount Payment.

All parties agreed that an implied write-down constituted a Floating Amount Event, but they disagreed about whether an implied write-down occurred. Under the standard terms supplement incorporated by the CDS confirmation, there could be no implied write-down if the reference obligation itself expressly provided for write-downs. In fact, the reference

ADDITIONAL INFORMATION

- ▶ ISDA forms and definitions: www.isdadocs.org
- ▶ CDS market information, CLE courses: www.isda.org
- ▶ Related ABA committees: Committee on Derivatives and Futures Law of the Business Law Section, and ABA Committee on Regulation of Futures and Derivatives: www.abanet.org
- ▶ A CLE primer: search www.abanet.org for “An Introduction to Over-the-Counter Derivatives,” March 16, 2007, Business Law Spring Meeting.

CDO did permit write-downs on the collateral that secured the CDO, namely, mortgages. Citibank argued, however, and the court agreed, that the relevant write-down was not of the collateral securing the CDO, but of the CDO itself. Because the CDO did not provide for a write-down of the CDO itself, Citibank was free to find an implied write-down and demand a floating amount payment.

Not only the definition of payment triggers, but also the question of when they occur, can be crucial in the outcome of CDS litigation. The decision of the Second Circuit in February 2007, in *Aon Financial Products, Inc. v. Societe Generale*, 476 F.3d 90 (2d Cir. 2007), concerned whether the failure of an agency of the government of the Philippines to pay on certain bonds constituted a Credit Event under the CDS. A different court had already ruled that a different CDS, between

failed to take action that would have established that Credit Event before the expiration of the CDS. For a period of almost one month, Aon could have demanded payment from the Republic, which would have been refused, resulting in a Credit Event before the expiration of the CDS, but Aon did not make the demand in time. Thus, *Aon v. SG* is a caution to understand every event that might constitute a Credit Event, and to make all potentially relevant demands for payment or establish any other preconditions, before the expiration of the CDS.

Requirements for Settlement

Court decisions also indicate that notice provisions and procedural requirements for settlement of a CDS will be strictly enforced. In *Aon v. SG*, the Second Circuit noted that Aon had failed to provide the notice of a

obligations—required the following standard procedure for payment upon a Credit Event: (1) delivery of a Credit Event Notice; (2) within 30 days from the Credit Event Notice, delivery of a Notice of Intended Physical Settlement (NIPS); and (3) delivery of a qualified security (specified in the NIPS) by the number of days after the NIPS set by the original CDS confirmation, or, if the CDS confirmation is silent, based on the “current market practice” for settlement of the sale of a particular security. Failure by the buyer to meet any of these deadlines results in the forfeiture of any payment by the seller under the CDS.

Unfortunately, Deutsche Bank issued a timely Credit Event Notice and NIPS but it did not complete delivery of the securities for settlement until a month after the deadline the bank itself had set. Deutsche Bank argued, among other things, that because the CDS was a portfolio CDS (which did not automatically terminate upon the Credit Event for a single reference obligation), the bank was entitled to settle any particular obligation at any time before the overall termination date. The court found, however, that the parties intended the physical settlement dates on particular obligations to be different from the overall termination date on the entire portfolio. This decision is an example of how even basic questions concerning the operation of a CDS can be unclear, even to sophisticated market participants.

Conclusion

Given the volume of CDS contracts outstanding and the variety of their possible permutations, CDS litigation is likely to occupy litigants, lawyers, and judges for some time to come. Parties can minimize difficulties in CDS litigation by solidifying their understanding of key contract terms before litigation, and by strict adherence to dispute resolution, notice, and procedural requirements embedded in the CDS to avoid the unintended forfeiture of crucial rights. **BLT**

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Aon and a third party, made Aon liable for the face value of the defaulted bond. The question was whether Societe Generale (SG) was in turn liable to Aon for that amount, which Aon claimed it had covered by its CDS with SG.

In the court’s view, Aon was mistaken in believing that it had fully hedged its exposure to Philippine agency bonds. The decision turned on the definition of the reference entity, which was defined as the “Republic of the Philippines.” The court found that the Republic of the Philippines did not include the agency, hardly an intuitive result. Therefore, the default by the agency was not a default by the Republic of the Philippines, as required to constitute a Credit Event.

Ironically, the Republic of the Philippines did default on its statutory obligation to guarantee the debt of its agency, but unfortunately Aon

Credit Event and demand for payment as required by the CDS. Aon argued that a letter it issued to SG explaining its position on the CDS constituted a Credit Event Notice. However, the Second Circuit carefully parsed the letter, noting that it did not contain the term “Credit Event Notice,” and that the letter allowed for circumstances where payment would not be required. Therefore, the court held, it was not a Credit Event Notice, and none had ever been issued.

In a decision of the U.S. District Court of the Southern District of New York in 2006, Judge Denise Cote held, after a bench trial, that requirements for the timing of physical settlement would be strictly enforced. In *Deutsche Bank AG v. Ambac Credit Products, LLC*, 04 Civ. 5594 (DLC), 2006 WL 1867497 (S.D.N.Y. July 6, 2006), the CDS—which was a portfolio CDS covering numerous different