

Credit Markets

Credit Default Swaps

Credit Default Swaps and the "Empty Creditor" Theory

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The financial crisis which has swept across the world over the last couple of years has highlighted many issues which until recently were largely unknown or ignored as benign. One of those concerns the potential conflicts between creditors holding credit default swaps (CDS) and the struggling companies that these derivatives reference.

Credit Default Swaps

A CDS is a transaction in which one party pays a premium to another party to assume the credit risk relating to a third party or reference entity. If certain events occur, such as the insolvency of the reference entity, the party who has bought the credit protection receives an agreed sum from the counterparty. Although the protection buyer needs not have any economic exposure to the reference entity over which it is buying credit protection, it may, and where it does, it hedges its economic exposure towards its own debtor. Herein lies the root of one potentially significant conflict. There is a general assumption that the creditors of a company want it to succeed, as the repayment of capital and interest is more probable in a successful, operating

company. But the use of CDS challenges this assumption. The CDS enables the credit risk to be transferred from the creditor to the counterparty, whilst the creditor retains the rights attaching to a traditional debt arrangement. This often includes the right to enforce covenants which give a certain degree of control by the creditor over the affairs of the debtor and, in the case of insolvency, powers given by law to participate in recovery or liquidation processes.

Debt Decoupling

The capacity for a CDS to reduce or cancel a creditor's economic exposure whilst preserving the legal rights, and status during insolvency, of a creditor is referred to as "debt decoupling."

Debt decoupling is not in itself a bad thing. It brings capital adequacy and financial advantages to the creditor and spreads credit risk. But it has been suggested that a creditor who hedges his credit exposure to a struggling debtor might be uninterested in participating in a debt restructuring or corporate recovery plan, hence the coined

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phrase: "empty creditor." Worse, the creditor who has bought credit protection over its debtors is suspected of wanting them to fail rather than restructure and survive, manipulating for the company to take the route of bankruptcy rather than debt restructuring.

This is not a new criticism, and it has been levelled at derivatives of all types before, because they intrinsically carry the moral stigma that they can be used to generate a benefit from something bad happening to others (run on currencies, *etc.*). For CDS, the fact that a CDS buyer need not be insuring himself against the default of a bond or loan that he actually owns makes it worse in the eyes of the public – betting on the creditworthiness of a company without having any actual exposure to it. CDS (particularly "naked" ones) are often contrasted with insurance. It is interesting to remember that insurance was not itself always looked upon favourably from a moral point of view but has become a completely acceptable way of managing risk. Speculative behaviour tends to attract more criticism in periods of hardship and recent history has linked CDS with several highly publicised corporate failures such as that of insurer AIG in 2008.

Next Steps

More important for the future is to better understand the dynamics behind CDS and to integrate them into corporate life. It is argued that empty creditors complicate the task of companies seeking to restructure their debt or the insolvency process of failing companies. This is a valid concern

and examples are given of companies which have been confronted to difficult or uncooperative hedged creditors in their debt restructurings. However, the idea that the interests of (some of) the creditors of a company in difficulty may not be aligned with its own is not novel as the jurisprudence suggests and should not come as a surprise. The real novelty of the past few years is the increasing use of CDSs and the greater number of potential situations of conflict which comes with it. How to deal with these in a fair and orderly fashion has not yet been fully thought through and addressed and pointing the finger at CDS does not provide the answer. The principles of company reorganisations and rescue arrangements need to evolve to take account of this growing phenomenon where the beneficiaries of the typical rights attaching to traditional debt arrangements may not have an active interest in a restructuring or rescue process.

The issue has already been widely discussed in journals and in the public arena by politicians and commentators and has been argued in courtrooms. So far, the dominant proposals have centred on disclosure and restrictions as the Chairman of the Commodity Futures Trading Commission (CFTC) Gary Gensler evoked in March 2010.¹ The idea is to require CDS-protected creditors of bankrupt companies to disclose their positions and give bankruptcy judges the power to restrict their participation in bankruptcy proceedings. This is not, however, an entirely new remedy. Insolvency laws in some countries already have the tools for this. Concepts of "ulterior motive" or "bad faith" may be used by the

courts in certain jurisdictions to exclude a creditor from a vote on a rescue plan. The jurisprudence has applied this in the past to diverse scenarios such as someone wanting a company to fail in order to favour his own competing business, for instance. Where available, the courts could use their discretion on a case-by-case basis to decide which empty creditor interests to discount and parliaments could entrench those rights in countries where they do not yet exist.

Is this, however, a fair way of dealing with this issue? Is it fair that the empty creditor interests should be simply cast aside, especially if this results in large portions of creditors being left outside of the restructuring process? This is a rather blunt way of dealing with the problem – reactive rather than proactive, and mostly moralising. In the future, companies themselves might consider that these issues ought to be addressed from the outset by introducing new terms in their indebtedness or their inter-creditor arrangements: a new tier of hedged creditors with different rights or weighted voting rights. Or maybe finding ways of transferring the interests of the empty creditors to those whose interests are aligned with those of the distressed company, for instance the credit protection seller who is at risk from the reference entity's failure? A sort of "skin-in-the-game"

argument, so that those who stand to lose have the standing to decide.

This approach would raise its own conceptual and practical issues: the motivations of the protection buyer to accept this, the timing of the transfer and re-transfer of rights, adjustments to the protection premium due, how to reconcile the leverage of the CDS with the nominal debt position held by the creditor, *etc.* There is nothing easy about finding the right balance but it is worth exploring new solutions which are neither coercive nor judgmental. The sophistication that derivatives in general and CDS in particular bring should be embraced rather than rejected.

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ⁱ Keynote Address, OTC Derivatives Reform, Markit's Outlook for OTC Derivatives Markets Conference – Speech by Gary Gensler, CFTC, 9 March 2010