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CDS Markets

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THE INFLUENCE OF CDS ON THE RESTRUCTURING PROCESS

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WHAT IS A CREDIT DEFAULT SWAP?

- A Credit Default Swap (or “CDS”) is a mechanism whereby a party can purchase credit protection for a specified amount of time against a default or other Credit Event at a Reference Entity
- There are two parties to a CDS contract:
 - CDS buyer – the party who purchases credit protection from a CDS seller in exchange for periodic premium payments
 - CDS seller – the party who, in exchange for the periodic premium payments, agrees to make a payment to the CDS buyer following the occurrence of a Credit Event
- CDS contracts can be written for different durations (*i.e.*, 6 months, 1 year, 5 years) and the price is generally lower for short term protection than long term protection
- Cost of CDS (known as the CDS spread) reflects the likelihood of a default of the Reference Entity before the CDS end date, and the expected recovery on the underlying instrument

* Note, there are a variety of different types of CDS, including single-name CDS, index CDS, loan-only CDS (LCDS), and credit-linked notes. The discussion in this presentation is particular to single-name CDS.



WHAT GOVERNS CDS?

- The International Swaps and Derivatives Association ("ISDA") is a trade organization of participants in the market for over-the-counter derivatives
 - Membership consists of derivatives dealers, service providers and end users
- CDS contracts tend to be written using standard ISDA documents (Master Agreement, Schedules, confirmations), and are governed by the ISDA definitions applicable to the contract (2003, 2009 Supplement and 2014)
 - North America has a standardized convention - Standard North American Corporate ("SNAC") CDS trades
 - Section 11.1(b)(iii) of ISDA definitions expressly permits CDS parties to act in a self-interested manner (including by engaging with issuers against whom the CDS contract is written), even if doing so impacts the CDS price or gives rise to a Credit Event
- SEC has jurisdiction over single-name CDS contracts as they may constitute a security-based swap
- CFTC has jurisdiction only over CDS indexes, but is acting aggressively on single name CDS

3



KEY CDS TERMS

- Reference Entity – issuer of the debt that forms the basis of the underlying CDS
- Obligation – any obligation of the Reference Entity for borrowed money
- Reference Obligation – designated debt obligation upon which the CDS is based, typically an unsecured obligation of the Reference Entity
- Deliverable Obligation – a debt obligation issued or guaranteed (subject to certain limitations) by the Reference Entity, which is *pari* or senior to the Reference Obligation and meets the characteristics necessary to be deliverable into a CDS auction
 - The aggregate of CDS bought and sold on a Reference Entity is often a multiple of the Deliverable Obligations / Obligations

4

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CDS FROM THE BUYER'S PERSPECTIVE

- CDS often used by buyers as a hedge against their long position in a Reference Entity's debt and in that context can be viewed as similar to insurance
- Can also be used to establish a synthetic short position with respect to a Reference Entity's debt
- There is no requirement that CDS buyers own Deliverable Obligations to purchase CDS protection
- Buyer is "short" the Reference Entity

5

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CDS FROM THE SELLER'S PERSPECTIVE

- CDS used for liquidity, especially where CDS is more liquid than the underlying bonds
- CDS used to get credit exposure to the Reference Entity without having to outlay the capital associated with buying bonds
- CDS may provide better yields to seller than those of the underlying bonds
- Seller typically does not own Deliverable Obligations
- Seller is actually "long" the Reference Entity

6



HOW IS CDS TRIGGERED?

- CDS is triggered upon the occurrence of a Credit Event by the Reference Entity or with respect to a Reference Obligation
- Credit Events can include:
 - Bankruptcy of the Reference Entity
 - A default in payment by the Reference Entity in respect of its borrowed (*i.e.*, not trade) obligations
 - Out-of-court reorganization or restructuring
 - Note: Not available for CDS under SNAC
- The determination as to whether a Credit Event has occurred is made by the ISDA Determinations Committee in response to requests for such determinations made by market participants
- With recent “unconventional” CDS transactions, ISDA Determination Committee has been asked to respond to numerous “interpretive” questions
- ISDA Determinations Committee is a non-judicial entity
- CDS market depends on reliability and speed of decisions

7



HOW IS CDS SETTLED?

- Upon a triggering event, a CDS seller must either pay par to the CDS buyer in exchange for a particular Deliverable Obligation (*i.e.*, physical settlement) or pay the CDS buyer the difference between par and the price determined for Deliverable Obligations of the Reference Entity through an “auction” process (*i.e.*, auction settlement)
 - Following the so-called “big bang” protocol of 2009, most CDS is cash settled following an auction, though physical delivery is still an option
- Participants can also “settle” their CDS exposure by hedging their trade and either buying or selling CDS at a price that locks in their gains or losses

8

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AUCTION MECHANICS OVERVIEW

- CDS auction procedures are established for each auction pursuant to standardized guidelines published by ISDA
 - Standardized guidelines govern the majority of processes
 - Specific procedures for each auction are described in an addendum

9

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CDS AUCTION PROCESS STEPS

- Step 1: Dealer Submissions
 - 10 Dealers initially submit Initial Market Submissions to the DTC
 - Spread must be less than or equal to 2 pts apart
 - Bids and offers are stated for a pre-specified quotation amount of usually \$2mm or \$5mm
- Step 2: Determination of Initial Market Midpoint ("IMM")
 - Sort initial bids (descending order) and offers (ascending order)
 - Identify tradeable (matched bid price exceeds offer price) and non-tradeable markets (matched offer price exceeds bid price)
 - Identify "best half" of non-tradeable market bids and offers
 - Take the average of all the "best half" non-tradeable market bids and offers

10



CDS AUCTION PROCESS STEPS CON'T.

- Step 3: Determination of Open Interest
 - At the time Dealers submit their Initial Market Submissions, they also may submit Physical Settlement Requests (from both Dealer and customers) that indicate the amount of Deliverable Obligations requested to be bought or sold at the final auction price
 - Requests for physical settlement must (i) not be greater than the customer's CDS ownership; and (ii) be consistent with CDS position (e.g., if sold, CDS can only seek to buy bonds)
 - Open Interest is the difference between buy and sell Physical Settlement Requests
 - If Physical Settlement Sell Requests > Physical Settlement Buy Requests, the excess constitutes Open Interest to Sell
 - If Physical Settlement Buy Requests > Physical Settlement Sell Requests, the excess constitutes Open Interest to Buy
- Step 4: Submission of Limit Orders
 - Once the direction (sell/buy) and amount of Open Interest are determined, limit orders on the opposite side of the Open Interest are accepted from different sources to fill the Open Interests

11



CDS AUCTION PROCESS STEPS CON'T.

- Step 5: Determination of Final Auction Price
 - Open Interest to Sell
 - Open Interest to sell will be filled with limit buy orders beginning with the highest bid first, and then moving to the next remaining highest bid, until either:
 - (1) full amount of Open Interest has been matched, in which case the lowest matched bid will be the final auction price; or
 - (2) all of the limit buy orders have been matched and there is still Open Interest remaining, in which case the final auction price will be zero
 - Open Interest to Buy
 - Open Interest to buy will be filled with limit sell orders beginning with the lowest offer first, and then moving to the next remaining offer, until either:
 - (1) full amount of Open Interest has been matched, in which case the highest matched offer will be the final auction price; or
 - (2) all of the limit sell orders have been matched and there is still Open Interest, in which case the final auction price will be greater of (x) par and (y) highest limit offer received

12

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- When the notional amount of CDS exceeds the Reference Obligation, CDS participants have incentive to participate in transactions to maximize potential CDS profits or losses
- From a policy perspective, this can have both advantages and disadvantages for Reference Entities
 - Advantage: Reference Entities who can control when CDS is triggered have the ability to negotiate with both CDS buyers and sellers to obtain best terms for a refinancing/restructuring
 - Disadvantage: Difficult to effect consensual restructuring where holders are hoping/waiting for payout upon triggering a CDS event
 - “Clearing out” the CDS with a strategic trigger eliminates this disadvantage

13

STROOCK**STRATEGIC/UNCONVENTIONAL CDS ISSUES
CON'T.**

- Types of Unique CDS Situations:
 - Orphan/Small Deliverable Obligation CDS
 - Sears/McClatchy
 - Strategic Defaults
 - Codere/iHeart/Hovnanian
 - Prosecuting past defaults
 - Windstream

14

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PROPOSED AMENDMENTS TO ISDA CREDIT DERIVATIVES DEFINITIONS

- A group of CDS participants recently proposed an amendment to the ISDA definitions to limit the ability to conduct a “strategic” default
- The proposed change would require that a failure to pay Credit Event would only be triggered where the failure to pay resulted from a deterioration in creditworthiness or financial condition of the Reference Entity
 - Contemplates rebuttable presumption that the failure to pay was caused by deterioration in Reference Entity’s creditworthiness

15

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CASE STUDIES

Sears

- Initially, smaller Deliverable Obligations than CDS written on Reference Entity (SRAC)
 - Results in theoretical control of final CDS auction price by CDS sellers by creation of residual open interest to buy or short squeeze, both of which drive price to par
- Intercompany notes (MTN’s) issued by Reference Entity (SRAC) could constitute Deliverable Obligations
- Debtor-held MTN’s auctioned in chapter 11 for value even though case recovery would be *de minimis*
 - CDS buyers wanted more Deliverable Obligations to help drive CDS auction price down
- MTNs held by non-debtor subs of Debtors not sold/auctioned
- Sale of Debtor-held MTNs to primary CDS seller plus restriction on sale of any other MTNs; netted real value for the Debtors’ estates
- CDS buyers objected to approval of sale based on lack of transparency and potentially more value to estate
- Bankruptcy Court authorized new bids in the context of revised sale approval hearing
- CDS buyers and primary CDS seller settled issues
- Original sale of MTNs approved with no new bid proposed

16

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CASE STUDIES

McClatchy

- Distressed print media company
- Owners of Reference Obligations and equity of McClatchy also sold CDS on McClatchy
- Reference Obligations of Reference Entity were to be repaid with proceeds of loan from Newco backed by CDS sellers
- Reference Entity would no longer have Deliverable Obligations, resulting in an orphaning of CDS (CDS Reference Entity with no Reference Obligations)
- Equity owner/debt holder/CDS buyer would collect premiums on sold CDS with no risk of payout
- CDS buyers stepped in and offered McClatchy less expensive financing to maintain CDS
- Odd result of troubled company receiving better than market refinancing when access to capital was limited/non-existent

17

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CASE STUDIES

Codere

- Troubled European online gaming company
- Agreed with CDS buyer to miss payment on term loan to trigger CDS
- CDS buyer underwrote refinancing of term loan once CDS was triggered
- “Costs” of refinancing loan on troubled company essentially absorbed by CDS buyer due to collection on CDS payout

18



CASE STUDIES

iHeart

- Subsidiary of troubled media company purchased notes of parent/issuer prior to maturity
- Issuer repaid third party held notes, but not subsidiary held notes
- Issuer was required to secure other debt if balance of remaining "legacy" notes fell below \$500 million
- Amount of debt purchased by subsidiary and not paid at maturity was enough to keep legacy note balance just above \$500 million
- Non-payment of subsidiary held notes at maturity triggered CDS but was below cross-default threshold
- Major debt holders negotiating with iHeart were also CDS buyers and were indifferent to whether iHeart defaulted/filed for bankruptcy
- Result of subsidiary default/triggering of CDS without defaulting other debt "cleared out" CDS and removed indifference of debt holders
- iHeart launched exchange offer to major debt holders shortly after CDS removed
- iHeart filed for chapter 11 with deal in place

19



CASE STUDIES

Hovnanian

- Non-distressed homebuilder
- CDS buyer who also owned a large amount of debt of the issuer sponsored a refinancing of near term-maturing debt
- Refinancing debt package included a note with a below market interest rate and long maturity, which was likely to depress the CDS auction price
- Refinancing required issuer subsidiary to take ownership of issuer notes and default on them to trigger CDS
- Subsidiary held notes were small enough to avoid cross-defaults
- CDS seller sued to block refinancing transactions, but court denied injunction
- Hovnanian obtained low cost, long term financing
- CDS ultimately was not triggered as a result of undisclosed settlement

20

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CASE STUDIES

Windstream

- Non-distressed telecom company
- Alleged CDS buyer and owner of notes sued company alleging default related to prior sale-leaseback transaction
- After lengthy litigation, court ruled in favor of alleged CDS buyer and Windstream filed for chapter 11
- CDS was triggered and efforts to block participation in the auction by CDS buyer failed
- Threats to attempt to equitably subordinate claims of alleged CDS buyer have been made

21