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Angeliki Mavridou

Credit Default Swaps in Bankruptcy Proceedings under US Law

A Legal Perspective

Nomos

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Preamble

Credit derivatives amount to a multi-trillion-dollar component of capital markets and thus constitute one of today's most widely traded financial devices. Notwithstanding their impact on the stability of global finance, such tools can no longer be excluded from the context of bankruptcy proceedings. It rather seems reasonable to assume that their presence in liquidation as well as reorganization proceedings will only increase.

To safeguard the fair and equitable distribution of the debtor's assets as well as the successful confirmation of reorganization plans with all the social and economic consequences entailed, it is essential to review the potential legal inconsistencies that can occur from the presence of undisclosed credit derivative positions in bankruptcy proceedings to subsequently implement new provisions that can adequately protect all parties involved, according to the legal principles and provisions of bankruptcy law.

The present thesis means to contribute some thoughts on the aforegoing issue, in the hope of supporting the initiation of a dialogue towards that direction.

I would firstly like to thank my advisor Professor Christoph Paulus for his valuable support, his critical view and his assistance during this entire process. I furthermore want to thank my second corrector Professor Lars Klöhn for his support and his helpful remarks.

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My warmest gratitude goes to my friends and family, who have provided me with their support from the very beginning to the very end of this process. I particularly thank my beloved grandparents Konstantin and Angelina Mavridou, my parents Dimitra Siokou and Vassilios Mavridis and my friend Vassilis Kiosses, MD, PhD.

Berlin, 5 November 2017 Angeliki Mavridou

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Introduction

Credit default swaps (CDS) are bilateral agreements under which one party agrees to transfer to the counterparty the credit risk of an entity with regard to a designated debt obligation of such entity. If the transferred credit risk materializes, e.g. if the referenced entity files for bankruptcy, the credit risk assignor is entitled to payment, equal in value to the losses noted on the referenced debt obligation due to the referenced entity's default. The actual amount of payment is determined by the specifics of each CDS agreement and varies accordingly, with higher losses always reflecting higher CDS revenues.

The risk assignor does not have to hold ownership of the referenced debt obligation to enter into a CDS agreement; if it does, such ownership may be preserved after settlement of the CDS agreement, depending on the appointed way of settlement. Should the risk assignor retain ownership of the referenced obligation post settlement, it will also preserve its right to pursue a claim as a creditor in the referenced entity's bankruptcy proceeding.

The presence of credit default swap positions in bankruptcy proceedings has been thoroughly examined in previous research[1]. The particular feature that captured the attention of various economic scholars is that such positions are typically short positions. A credit risk assignor who is also a creditor in the referenced entity's bankruptcy proceeding, preserves a right to payment on account of its bankruptcy claim, i.e. the debt obligation referenced under the CDS agreement, against the credit risk assignee. Because higher losses reflect higher CDS payments, it can reasonably be assumed that said creditor will have an interest to minimize rather than maximize the bankruptcy estate's value. Economists argued that CDS short positions can compromise the successful outcome of reorganizations for exactly that reason. The applicable rules set out in Chapter 11 of the US Bankruptcy Code (USBC) are based on the premise that, notwithstanding the adversity of creditors' economic interests, they will always

1 See, e.g. Douglas G. Baird; Robert K. Rasmussen, "Antibankruptcy" *The Yale Law Journal* 119 (2010); Robert K. Rasmussen; Douglas Baird "The End of Bankruptcy" *Stanford Law Review* 55(2003).

share the common incentive to maximize the value of the debtor's assets, for maximizing the value of the estate means maximizing the value of the expected recovery on creditors' claims. Since CDS positions break such premise – so the argument – they deprive reorganization proceedings of their ultimate safety net warranting the successful adoption of a fair and equitable reorganization plan; what is more, such positions remain undisclosed. Creditors with a short position incentive can thus not be identified.

Economists therefore argued that a requirement to disclose such CDS positions should be introduced in reorganization proceedings. Indeed, the adversities caused by the creation of short positions in reorganization bankruptcies have been recognized[2] to an extent that enabled the introduction of a disclosure obligation by the 2011 amendments of Bankruptcy Rule 2019, limited to reorganization and municipal bankruptcy proceedings and applicable to groups or committees of creditors only. Albeit definitely a step towards the right direction, the disclosure obligation introduced by the 2011 amendments remains somewhat limited, particularly in lieu of the fact that participation in creditor groups or committees follows on purely voluntary grounds. In other words, creditors cannot be obliged to participate in creditor groups or committees and thus also not obliged to disclose their CDS position. The question that inevitably occurs is whether the introduction of a disclosure requirement that is limited to the previously indicated extent, suffices to combat the adverse effects that can be caused by undisclosed CDS positions, not only in reorganization and municipal but also in liquidation proceedings.

The present thesis attempts to provide an answer to this very question, but contrary to previous research essays a different approach: it examines the legal inconsistencies that can occur from individual, undisclosed CDS positions in bankruptcy proceedings and reviews whether such potential inconsistencies are imminent enough to justify the introduction of an ex-

2 The American Bankruptcy Institute report of 2014 studying the reform of Chapter 11USBC also confirms the potential problems that could arise from the creation of, *inter alia,* CDS short positions in reorganizations, suggesting that any potential issues within that context could be best resolved by bankruptcy courts on a case-by-case basis under the good faith requirement imposed on creditors rejecting a reorganization plan pursuant to the relevant section 1126 (e) of the US Bankruptcy Code (Bankruptcy Code). See American Bankruptcy Institute Report 2012-2014, pp. 268-69.

panded disclosure obligation, applicable to individual creditors as well as liquidation proceedings.

Since CDS agreements are inherently diverse and the specifics of each bankruptcy case vary, the present thesis does not attempt to evidence an *a priori* inconsistency regarding all CDS creditor positions, but rather distinctively examines each CDS position that could be encountered in bankruptcy proceedings and reviews the possible inconsistencies that *can* occur in this regard. Concretely, the present thesis reviews possible inconsistencies with the equal treatment principle as well as some of the principal provisions of Chapter 11USBC.

To that end, the present study ensues the following structure. Part one provides a general overview on credit derivatives. Part two introduces the key elements of CDS transactions and identifies those creditor positions that can arise therefrom in bankruptcy proceedings.

Part three reviews the consistency of previous positions with the equal treatment principle. Within that context, part three firstly elaborates the applicable provisions to substantially similar creditor positions, i.e. creditor positions that preserve the right of receiving payment on their bankruptcy claim by a third party, who is not the bankruptcy debtor or from a source other than the bankruptcy estate, to subsequently review whether the *de facto* exemption granted to CDS positions due to lack of disclosure, is consistent with the equal treatment principle.

Part four examines the consistency of undisclosed CDS positions with the provisions regarding the classification of creditor claims, associated voting rights as well as the legitimate acceptance and confirmation of a reorganization plan, set out in Chapter 11 of the US Bankruptcy Code.

A more detailed structural description is separately indicated at the outset of each part.

The author concludes with a discussion of the findings resulting from the present study that exhibit the need to impose expanded disclosure requirements on CDS creditor positions in bankruptcy proceedings.

Part One About (Credit) Derivatives

Credit default swaps (CDS) are bilateral agreements, under which one party (the CDS buyer) agrees to transfer to the counterparty (the CDS seller) the credit risk of a third party (the reference entity) with regard to one or more underlying debt obligations (the reference obligation) of the reference entity. In exchange for assuming the reference entity's credit risk, the CDS seller receives payments in form of a premium from the CDS buyer. If the reference entity defaults on a reference obligation specified under the CDS, the CDS buyer has the right to trigger payment of an amount equal to the losses noted on the reference obligation upon the reference entity's default, payable by the CDS seller.

Credit default swaps fall within the broad category of credit derivatives because they specifically relate to credit risk as opposed to derivatives relating to other types of risk, e.g. currency risk or other types of underlying assets, e.g. oil, energy etc.

The first part of the present thesis aims at providing a principal background on credit derivatives and their innovative features as well as the terms and conditions currently covering the vast majority of credit derivative transactions. It furthermore elaborates on the legal aspects of credit derivative transactions and briefly addresses derivatives regulation introduced in the United States after the financial crisis of 2008.

The general overview on credit derivatives provided under this part is essential for the appreciation of the more specific features embedded in those credit default swaps that constitute the object of the present study.

The discussion on the legal aspects of credit derivative transactions means to contribute some thoughts to the debate on whether the legal status of credit derivatives is akin to that of an insurance policy. The current regulatory framework applicable to credit derivatives in the US is briefly introduced for the sake of completeness.

The chapters of this part are structured as follows. The first chapter introduces derivatives in general. It provides a brief historical background on their fundamental concept and indicates the innovative features adhered to such concept during the financial innovation period of the 1980s. It concludes with a discussion on the distinctive and innovative features inherent in modern derivative products. The first chapter furthermore indicates the broadest categories of derivatives as well as the most frequently traded types thereof. Credit derivatives are included in the relevant category of derivatives that relate to credit risk. Depending on the context, the author makes use of both terms '*derivatives*' and '*credit derivatives*'. For the sake of clarity, please note that former refers to all derivatives including credit derivatives whereas latter refers to credit derivatives only.

In its second part, the first chapter provides an overview of the documentation covering the vast majority of credit derivative transactions. Such documentation is of particular importance because it is subsequently used as the template documentation for the purposes of the present thesis.

The second chapter of this part contributes some thoughts to the discussion on the legal status of credit derivatives and briefly introduces the current regulatory framework applicable to derivatives in the US.