

“Decoupling” Issues in Bankruptcy

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In recent years, the structured credit markets have created derivative instruments in which economic rights can be decoupled from their governance rights. Decoupling is a term used to describe the separation of economic rights from voting rights in various instruments. More specifically, debt decoupling is “the unbundling of the economic rights, contractual control rights, and legal and other rights normally associated with debt, through credit derivatives and securitization [sic].”² The most common, and perhaps simplest, derivative instrument is the credit default swap (“CDS”). A CDS permits parties to hedge against credit risk by transferring the inherent risk of purchasing a credit instrument to another party. The rapid growth of the CDS market has caused many to question the unintended consequences CDSs have, or at least may have, on financially distressed companies.³ This article provides a basic understanding of the mechanics of a CDS and touches on several issues that a CDS creates in bankruptcy and in out-of-court workouts.

A Basic Credit Default Swap

The mechanics of a CDS are straightforward. Under a CDS, one party, called the protection buyer, pays a periodic (usually biannual or quarterly) fee to another party, called the protection seller, for a certain term, in exchange for protection against the occurrence of a credit event of a reference entity.⁴ If a credit event occurs for the referenced entity, the protection seller agrees to make the protection buyer whole (less fees paid to the protection seller) in accordance with the terms of the CDS. Fundamentally, this transaction is designed to transfer the risk of the occurrence of a credit event of the reference entity from the protection buyer to the protection seller.⁵

For example, suppose Debtor obtains a \$10 million loan from Bank. Bank, as the holder of the loan, is entitled to payment over time according to the terms of the loan; however, Bank also bears the risk that Debtor will default under the terms of the loan. Therefore, to hedge against that risk, Bank may seek to enter in to a CDS with another

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² Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications, Henry T.C. Hu and Bernard Black, *European Financial Management*, Vol. 14, No. 4, 2008, 663-709.

³ The CDS market notional amount in 2001 was approximately \$632 billion and was approximately \$62 trillion in 2007, according to the International Swaps and Derivatives Association.

⁴ CDS contracts are typically, but not always, based upon the International Swaps and Derivatives Association (“ISDA”) 2002 Master Agreement and Credit Derivative Standard Terms.

⁵ Of course, the protection buyer is assuming the risk that the protection seller can satisfy the obligation underlying the CDS upon the occurrence of a credit event of the reference entity. If the protection buyer is concerned about the protection seller’s ability to satisfy the CDS, the protection buyer may require that the protection seller secure the CDS with collateral.

party (which we will refer to as the Mystery Group) to protect itself from a default on the loan.

In such a CDS transaction, Bank is the protection buyer because it is purchasing protection in the event of Debtor's default on the loan.⁶ Mystery Group is known as the protection seller because it is selling the protection to Bank.⁷ Importantly, Debtor is not a party to the CDS and may be, and typically is, unaware of the transaction.⁸

In exchange for the protection, Bank will pay Mystery Group a fee based upon the spread of the CDS.⁹ The spread is based upon the probability of a default by Debtor – therefore, the higher the probability Debtor will default, the higher the annual fee Bank will pay to Mystery Group as part of the CDS. Bank will continue to pay this fee until the CDS contract expires by its terms or until a credit event occurs.

Typically, CDS contracts provide that bankruptcy of the Debtor, the restructuring of the Debtor or the Debtor's failure to pay in accordance with the underlying obligation, constitutes a credit event (although some CDSs exclude restructuring).¹⁰ Therefore, if Debtor becomes unable to pay its obligations under the loan from Bank, a credit event will occur which would permit Bank to recover from Mystery Group under the CDS.¹¹ If the parties choose a physical settlement after the occurrence of a credit event, Bank will need to deliver the note or bond representing the loan to Mystery Group, who will then pay the par/stated value of the underlying obligation. Alternatively, if the parties choose a cash settlement, Mystery Group will pay Bank the difference between the par/stated value of the obligation and its market price.¹² In our example with \$10 million in protection, if the underlying obligation were worth 12% upon a credit event, Mystery Group would have to pay Bank \$8.8 million (\$10 million x (100% - 12%)). As this example shows, a CDS is akin to an insurance policy protecting against the occurrence of a credit event.¹³

A CDS is an example of debt decoupling because the protection seller obtains the economic rights under the obligation, while the protection buyer maintains voting and all other rights. As is discussed below, this decoupling through a CDS changes the

⁶ See Credit Derivatives and the Future of Chapter 11, Stephen J. Lubben, *American Bankruptcy Law Journal*, Fall 2007, 81 Am. Bankr. L.J. 405, 411.

⁷ See *Id.*

⁸ See *Id.*

⁹ See *Id.*

¹⁰ See Credit Derivatives and the Future of Chapter 11, Stephen J. Lubben, *American Bankruptcy Law Journal*, Fall 2007, 81 Am. Bankr. L.J. 405, 412.

¹¹ Note that many credit events are public information, and readily confirmable – e.g., the filing of a bankruptcy petition. Additionally, the recovery from the protection seller depends on the solvency of the protection seller. In effect, while the protection buyer is shorting the underlying obligation upon which the CDS is based, the protection buyer is gambling that the protection seller will be able to satisfy its obligations under the CDS upon a credit event of the reference entity (i.e., in the above example, the Debtor).

¹² “Today, most credit default swaps are settled through a cash payment by the credit protection seller to the protection buyer.” See Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications, Henry T.C. Hu and Bernard Black, *European Financial Management*, Vol. 14, No. 4, 2008, 663-709. at 680.

¹³ While credit default swaps may be akin to an insurance policy, they are not insurance policies for several reasons: (i) a CDS does not require the protection buyer to actually own the underlying security, and (ii) the protection buyer does not have to incur an actual loss.

traditional debtor-creditor relationship and often leaves Debtor confused by what appears to Debtor as the irrational actions of the creditor.

Implications of CDS on Distressed Companies

In a typical debtor-creditor relationship, a creditor's repayment depends upon the success of the debtor.¹⁴ Therefore, typical creditors have incentive to work with the debtor, extend repayment terms, waive default rates and do whatever it takes to keep the debtor afloat long enough to maximize the return to the creditor. Decoupling places debtors in the awkward position of not knowing the identity of the true creditor-in-interest. For example, if Debtor is aware that it will be unable to repay its obligation to Bank on the maturity date, Debtor will likely attempt to workout an extension with Bank. While in the typical debtor-creditor relationship, the creditor may be willing to discuss an accommodation for Debtor, in our situation, Bank may actually want to see Debtor fail; it might make more sense for Bank to try to force Debtor into bankruptcy (either alone or with others by filing an involuntary bankruptcy petition) so that it can trigger a credit event under the CDS and collect par value from Mystery Group.¹⁵

If a credit event occurs and is followed by a physical settlement, the protection buyer with whom Debtor has been negotiating will be replaced at the proverbial table by the protection seller, who will likely be completely unknown to Debtor. The protection seller may have a very different agenda from the protection buyer, which no doubt will cause undue chaos for Debtor.

In our hypothetical situation, the relationship of the expiration date of the CDS and the date of a potential credit event also will likely impact the behavior of Bank.¹⁶ The closer to the expiration date of the CDS, the more likely the protection buyer will want to see Debtor fail. These apparently irrational acts¹⁷, which are atypical to the traditional debtor-creditor relationship, are actually quite rational to Bank because upon the occurrence of the credit event, Bank will be paid in full by Mystery Group, and Debtor will be forced to deal with the consequences.

Within bankruptcy¹⁸, Bank's actions will likely continue to appear irrational to Debtor (and others) leaving Debtor clueless as to the motive behind these actions. Furthermore, within bankruptcy, Bank may gain an advantage over other creditors due to the apparent risk of loss Bank suffers. For example, bankruptcy law provides that a class

¹⁴ "Both loan contracts and bankruptcy laws are premised on the assumption that creditors are averse to downside risk, but otherwise have an economic interest in the company's success and will behave accordingly." Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications, Henry T.C. Hu and Bernard Black, *European Financial Management*, Vol. 14, No. 4, 2008, 663-709. at 683.

¹⁵ See 11 U.S.C. § 303(b) (providing the requirements for commencement of an involuntary bankruptcy case against a debtor).

¹⁶ "[R]ecall that credit default swaps are often relatively short term instruments that expire without value to the protection buyer if no credit event occurs before maturity." Credit Derivatives and the Future of Chapter 11, Stephen J. Lubben, *American Bankruptcy Law Journal*, Fall 2007, 81 Am. Bankr. L.J. 405, 427.

¹⁷ Since the debtor is generally unaware of the existence of a CDS transaction, what appears to be irrational from the debtor's perspective may be quite rational from the protection purchaser's perspective, and likely would seem rational to the reference entity if it had full information.

¹⁸ Note that under BAPCPA, credit default swaps, like other swap agreements, are treated favorably. See e.g., 11 U.S.C. Sections 101(53B)(A), 362(b)(17), and 560.

of creditors votes in favor of a Chapter 11 plan if “at least two-thirds in amount and more than one-half in number” of the particular class vote in favor of the plan.¹⁹ Although Bank faces no risk of loss due to the CDS, bankruptcy law gives Bank the power to vote all \$10 million worth of its debt.²⁰ The protection of the CDS may make Bank likely to vote in favor of a risky plan that places other unprotected creditors at a greater risk of loss, or perhaps not to vote at all and possibly make it more difficult for the debtor to confirm its plan.²¹ That is, unprotected creditors may wrongfully be assuming that each creditor in the class to which they have been assigned for plan purposes are in the same situation, only to be ultimately surprised to see the way a protected creditor voted.

Another interesting issue in bankruptcy arises with the formation of the creditors committee.²² In a complex Chapter 11 bankruptcy case, the United States Trustee appoints a creditors committee promptly after the bankruptcy filing. Typically the committee consists of the seven largest unsecured claims against the debtor.²³ The committee has the authority to, among other things, perform an investigation of the debtor, and participate in formulation of a plan.²⁴ Without knowledge that a protected creditor has no incentive to act in the best interests of the estate as a whole, the United States Trustee may select a protected creditor to be a member of the committee, even though such a creditors exposure is significantly less than the other unsecured creditors and even though such a creditor may wish a different, if not contrary, result from the other unsecured creditors.

There can be no doubt that the lack of transparency of CDS transactions can only make it more difficult for a debtor to reorganize efficiently.

Disclosure

Bankruptcy is intended to be a transparent process. Chapter 11 debtors are required by the Bankruptcy Code to file reports and maintain records documenting the flow of money during a case.²⁵ Attorneys and professionals working for the debtor are required to disclose their compensation and apply for court approval before receiving payment during the case.²⁶ Additionally, every entity or committee that represents more than one creditor is required to file a notice in the bankruptcy case.²⁷ Each of these requirements is a part of the Bankruptcy Code and/or the Bankruptcy Rules because transparency is an important element of the bankruptcy process. The current ability of creditors to hedge their risk through CDS places the debtor and other creditors in an unfair position of not knowing with whom they are truly dealing and why they are behaving as they are. While those who would argue transparency is not critical because

¹⁹ 11 U.S.C. § 1126(c).

²⁰ See Credit Derivatives and the Future of Chapter 11, Stephen J. Lubben, American Bankruptcy Law Journal, Fall 2007, 81 Am. Bankr. L.J. 405, 428-29.

²¹ See Credit Derivatives and the Future of Chapter 11, Stephen J. Lubben, American Bankruptcy Law Journal, Fall 2007, 81 Am. Bankr. L.J. 405, 428-29.

²² See 11 U.S.C. § 1102.

²³ See 11 U.S.C. § 1102(b)(1).

²⁴ See 11 U.S.C. § 1103(c).

²⁵ See Fed. R. Bankr. P. 2015.

²⁶ See Fed. R. Bankr. P. 2016.

²⁷ See Fed. R. Bankr. P. 2019.

the settlement procedure takes place shortly after the occurrence of a credit event, it is in the early days of a bankruptcy proceeding that debtor-in-possession financing and, more currently, 363 sale issues are addressed, and thus, transparency is important from the beginning of the bankruptcy proceeding so that a debtor has a fair ability to reorganize.

In order to level the playing field, the Bankruptcy Code and/or Rules should be amended to require an additional disclosure: disclosure of any CDS (or other like instrument in which rights have been decoupled).²⁸ However, because it is likely that, due to cash settlements for CDS, the debtor and other creditors will never know of the CDS, the Code and/or Rules should also provide a penalty for failure to disclose. For example, failure to disclose could result in disallowance or subordination of a protected creditor's claim. This solution, while it is merely one small solution for the host of bankruptcy issues as a result of a CDS, will at least give the debtor and other creditors an understanding of why the protected creditor is behaving in a particular manner, and give them the ability to formulate an appropriate strategy to level the playing field so the debtor can have a fair chance at reorganizing.

²⁸ Interestingly, the Financial Accounting Standards Board has issued FAS 161 that will require, beginning November 15, 2008, the disclosure of, among other things, the nature, extent and fair value of derivatives, to improve the transparency of financial reporting. See FAS 161 (2008).