

CHAPTER 3

Credit Derivatives and the Resolution of Financial Distress

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INTRODUCTION

Following at least a decade of adjustment, chapter 11 of the United States Bankruptcy Code seems to have stabilized around a relatively efficient system that has become the starting point for discussion of corporate reorganization around the world (Jacoby, 2006). When corporations the size of Global Crossing or Kmart can reorganize in less than two years, with total professional costs of less than 1 percent of assets, complaints about the expense or delay associated with chapter 11 seem outdated and unformed (LoPucki and Doherty, 2007). Instead, all indications are that chapter 11 as currently practiced is a relatively efficient and cheap means of redeploying a bankruptcy firm's assets.

The combination of low interest rates and plentiful liquidity has meant that only a few large companies have filed for chapter 11 relief in the past few years. However, at the very moment that the United States appears headed for a new round of large chapter 11 cases, chapter 11 is changing again. With the growth of credit derivatives, corporate

reorganization threatens to become much more complex. The advent of credit derivatives could well mean that the present efficiency of chapter 11, which many trace to secured creditors' increased sophistication within chapter 11, may be coming to a quick end. Furthermore, the effects of these new instruments could extend to the "shadow" period before chapter 11.

The growth of credit derivatives could well impede the negotiation of workouts, as well as prenegotiated or prepackaged bankruptcy plans, inasmuch as the party with the real risk of loss will often be unknown. Similarly, credit derivatives may ultimately discourage out-of-court restructurings or at least place artificial time limits on the length of such negotiations while simultaneously increasing the incidence of involuntary bankruptcy filings. In general, creditors may no longer behave in predictable ways; previously unheard of creditors may appear on the scene, demanding a voice in the proceedings, and the debtor's true stakeholders may be subject to dispute.

Does this support calls for legislative intervention in the credit derivative markets? Hardly, but as the remainder of this chapter explains, in coming years the changing nature of chapter 11 will present new challenges for bankruptcy judges and the professionals who negotiate reorganizations. For those in other jurisdictions, contemplating chapter 11-like systems of their own, one of the main concerns here is that a key feature of chapter 11 is its ability to change along with the changing financial markets.

CHAPTER 11 TODAY

As is well known, the key features of chapter 11 are creditor voting and debtor control. Formally, the Bankruptcy Code provides that two thirds of claims (by amount) in a class must vote to approve a plan and, in addition, that a flat majority (by head count) in a class must also vote in favor of the plan. Poised against the creditor's voting power is the debtor's exclusive right to propose a reorganization plan, at least at the outset of the case. Beyond these formal powers, the parties have an array of informal powers, like the debtor's ability to threaten liquidation under chapter 7, which mandates the appointment of a trustee and the piecemeal liquidation of the debtor, and the creditors' ability to seek the appointment of a trustee or examiners.

Finding an appropriate balance of debtor and creditor power, and thus ensuring an efficient reorganization, has been a key concern of American corporate reorganization since the late nineteenth century (Lubben, 2004). However, in recent years, creditors, especially secured creditors, have had increasing input into the crucial decisions that face a financially distressed company. Often using the powers that come to them as post-petition lenders under the Bankruptcy Code, senior creditors now prevent the kind of elongated cases that came to typify American corporate reorganization in the 1980s (Baird and Rasmussen, 2002). Indeed, while many academic commentators, especially in finance, seem to suppose that bankruptcy practice is static, modern chapter 11 practice features the frequent replacement of managers by outside restructuring experts and the going concern sales of companies that fail to reorganize on the senior lender's timetable. These lenders understand how to use their power in chapter 11, and the bankruptcy courts, especially in key jurisdictions like Delaware, New York, and Chicago, are inclined to defer to agreements reached in out-of-court bargaining among the parties and their sophisticated professionals (Skeel, 2003). While it can be argued that the pendulum has swung too far in the direction of lender control, it is beyond debate that today's chapter 11 is decidedly centered on senior creditor control (Lubben, 2005; Westbrook, 2005).

CREDIT DERIVATIVES AND THE PREBANKRUPTCY PERIOD

The most important credit derivative instrument is the credit default swap, also known as a *single-name* credit default swap. This type of swap is a contract covering the risk that a specified debtor defaults. One party (the *protection seller*) acquires the credit risk associated with a debt or class of debts in exchange for an annual fee from the other counterparty (the *protection buyer*). The debtor on the referenced obligation is not a party to the swap and in most cases is unaware of the transaction.

If the reference obligation goes into default, the protection buyer receives a payment meant to compensate it for its losses. More specifically, the protection seller's payment obligation is triggered by the occurrence of a "credit event" with regard to a specified class of obligations incurred by the reference entity. Commonly used credit events include

bankruptcy,¹ failure to pay,² and restructuring.³ The bankruptcy trigger includes both traditional chapter 7–style bankruptcy as well as chapter 11.

In the North American and European corporate markets these events typically must occur with respect to “borrowed money”—effectively any obligation owed to a voluntary creditor of the reference entity or its subsidiaries, assuming the parent guaranteed the subsidiaries’ obligations, in excess of the \$1 million and \$10 million limitations built into the definitions of failure to pay and restructuring, respectively.

Most often the swap will call for *physical settlement* upon the occurrence of a credit event, meaning that the buyer will deliver a defaulted bond to the seller in exchange for payment of the full face value of the bond. The types of obligations that can be delivered to settle the swap are typically set forth in the documentation, although market practice does tend to give the protection buyer a choice within a range of debt instruments. This gives rise to the so-called cheapest-to-deliver option in a triggered swap, namely, the ability of a buyer to maximize recovery under the swap by purchasing the least valuable debt instrument that will satisfy the contractual provisions of the swap. In the North American and European corporate markets, swaps regularly allow for the delivery of any bond or loan issued by the reference entity, provided that, among other things, the obligation is not subordinated, i.e., not bearer paper with a maturity of less than 30 years from the settlement date.

Given these terms, credit derivatives may ultimately discourage out-of-court restructurings or at least place artificial time limits on the length of such negotiations while simultaneously increasing the incidence of involuntary bankruptcy filings. More generally, they may create perverse

¹ 2003 ISDA Credit Derivative Definitions, Section 4.2.

² 2003 ISDA Credit Derivative Definitions, Section 4.5. *Failure to pay* is defined, in part, as the failure of the reference entity to make payments in an aggregate amount of not less than the payment requirement. *Payment requirement* is a term that the parties can define; otherwise, it defaults to obligations of at least \$1 million. See 2003 ISDA Credit Derivative Definitions, Section 4.8(d).

³ 2003 ISDA Credit Derivative Definitions, Section 4.7. The restructuring must relate to debt in excess of the default requirement, which is set at \$10 million unless the parties agree otherwise. 2003 ISDA Credit Derivative Definitions, Section 4.8(a). The definition of *restructuring* is not uniform among jurisdictions; for example, in the North American corporate market the definition is usually modified—and thus referred to as *modified restructuring*—by electing additional limitations on the maturity and transferability of the debt that can be delivered under the swap. 2003 ISDA Credit Derivative Definitions, Section 2.32.

incentives for parties to prefer outcomes that maximize the value of their swap position as opposed to the underlying investment in the debtor.

Credit default swaps often have a relatively short duration, and they expire without value to the protection buyer if no credit event occurs before maturity. Thus, as maturity dates approach on outstanding credit default swaps, protected creditors will have an increasing disincentive to work with the debtor on the terms of a restructuring arrangement that might not be announced or consummated until after the creditors' swaps have terminated. More generally, the protection buyer faces the risk that any workout could extend the underlying debt obligation beyond the duration of the swap.

Creditors will have every incentive to trigger the swap by filing an involuntary bankruptcy petition against the debtor, illustrating the important point that *bankruptcy* is the one credit event that can be controlled by many credit buyers. Moreover, the push to remove restructuring triggers from swaps in the North American market might solve the problem of how to interpret these clauses, but it will generate increased incentives to push the company into chapter 11, as the protection buyer will receive no protection benefits from agreeing to an out-of-court workout.

The increased incidence of credit risk transfer will also exacerbate creditor conflicts.

Restructuring agreements, including prepackaged chapter 11 plans, are most often negotiated with the debtor's largest creditors and then submitted to all creditors for consideration. However, the largest creditors are presumably the creditors most likely to have hedged their default risk. While it was undoubtedly always true that big bondholders are unlike small bondholders, the growth of credit derivatives may swell this gap, as large bondholders now agree to riskier reorganization plans or other similar terms that result solely from the downside protection these large bondholders have by virtue of their swap positions.

In short, negotiations on the event of bankruptcy can be expected to become increasingly complex and opaque (Skeel and Partnoy, 2007). In large part this is the result of the design of the credit protection markets, which expressly seek to allow banks and other lenders the ability to offload credit risk without alerting their customers of this fact and incurring the resulting reputation costs. However, this lack of transparency creates obvious and severe information asymmetries that may hinder pre-bankruptcy negotiation and planning, a serious problem after the 2005 amendments to the Bankruptcy Code make it increasingly difficult for a debtor to enter chapter 11 without such planning.

One likely response to this development is a return to coercive exchange offers, which may be used to force the “true” stakeholders of a firm to reveal themselves. Of course, this move might also further encourage involuntary bankruptcy petitions, with the attendant risk of an unplanned filing in an unfavorable jurisdiction.

CREDIT DERIVATIVES IN CHAPTER 11

The rapid growth of the credit derivatives market has recently led to supply-and-demand problems upon default. For example, after the recent chapter 11 filing of automotive parts manufacturer Delphi Automotive, \$2 billion of bonds were said to be in circulation when it filed for bankruptcy, but the notional amount of outstanding derivatives of more than \$20 billion initially had the explicable, although still strange, effect of driving up the market prices of the bonds just as Delphi filed for chapter 11. International Swaps and Derivatives Association (ISDA) has stepped in to mitigate this problem through a series of “protocols,” which were successfully deployed not only in the Delphi case but also in connection with other recent chapter 11 cases.

Essentially these protocols use an auction mechanism to set a price for the debtor’s bonds and then use that price to allow settlement of index credit default swaps without need for actual delivery of bonds. Removing index swaps from the mix reduces, but does not eliminate, the supply-and-demand effects on the bond markets. In the future it is expected that these problems will be solved by a move away from physical settlement of swaps, although the need for accurate, transparent markets in postdefault debt will remain if these swaps are to be settled.

If we assume that postdefault bond markets will return to a state of pretty good efficiency, the growth of credit default swaps and other credit protection represents a conundrum for chapter 11. In such a market a hedged senior creditor loses its ability to arbitrage, and its recovery in the chapter 11 case becomes essentially fixed. No matter what the lender does, they will not expect to alter their recovery in chapter 11 sufficiently to receive more or less than what the swap will pay them. Participation would simply mean incurring the positive costs of participation. Even if we assume that bond markets are somewhat inefficient, the protection buyer would have to assume a degree of inefficiency sufficient to clear their participation costs.

To the extent that recent commentators correctly identify senior creditor control as the lynchpin of a newly efficient chapter 11 process,

any trend toward creditor passivity threatens to undermine the very basis of this putative reform. If we assume that the most concentrated creditors are the creditors most likely to hedge their positions, the growth of credit derivatives could plainly reverse the trend toward creditor control. More generally, if large creditors disengage from the chapter 11 process, the only check on debtor, shareholder, and management overreaching will be the bankruptcy court. The risk of a return to the debtor-controlled chapter 11 cases of the 1980s looms large.

Exceptions to this analysis exist, of course, because of the so-called cheapest-to-deliver option and the potential that the protection buyer has superior information about the reference debtor, a reasonable possibility in this example because the buyer is also a bank lender. However, this seems to be a rather slim basis for assuming that senior lender behavior in chapter 11 is not about to change dramatically.

Additionally, it is not clear that many protection sellers have any interest or desire to participate in chapter 11 cases. For example, some hedge funds purportedly sell credit protection as an easy way to generate income from the periodic fees paid by the seller. They likely have little interest in the underlying debt, and thus, even if they could take the place of senior lenders, it is not clear they will do so. More to the point, most hedge funds and private equity firms have no more experience with chapter 11 than the bank lenders of the late 1970s and early 1980s.

Somewhat more optimistically, it may be that protection sellers will aggregate large blocks of a reference debtor's bonds and thus represent a new source of creditor control in chapter 11. If smaller bondholders begin to use the swap settlement process as a market for exiting defaulted positions (a distinct possibility if supply and demand effects continue to drive up prices), there could be a mitigating trend at work in large chapter 11 cases. Furthermore, the possibility of reduced intraclass conflicts among bondholders, some of whom have bought at par and some of whom have bought in through the high yield markets, would be an unambiguous good in chapter 11 negotiations.

Likewise, the increasing transferability of bank loans may also moderate the problems of creditor passivity, inasmuch as the protection seller is more likely to be directly subrogated to the rights of the original creditor if that creditor's claim can be used to settle a swap. In this way, the increased transferability of claims might provide a market solution for the problem of creditor passivity. Of course, as the credit default swaps market continues to expand, other creditors with transfer restrictions on

their claims, such as trade creditors and contract creditors, might counteract this correction.

The implications for increased creditor passivity for chapter 11 are manifold. Most obviously, the loss of senior lender control in chapter 11 could result in a power vacuum that returns corporate reorganization to the debtor-controlled days of the past. However, this seems unlikely, given the academic vitriol directed against lingering cases like Eastern Airlines (Lubben, 2005). The 2005 amendments to the Bankruptcy Code, particularly those that limit the debtor's time in chapter 11, can be seen as Congress' fix for the problems of cases like Eastern—albeit about 10 years too late.

Perhaps the bigger difficulty that may well arise as a result of senior creditor passivity turns on the tremendous growth in second lien lending in the United States (Baird and Rasmussen, 2006). The relationship between the senior and second lender is set forth in a detailed intercreditor agreement, which typically provides for the second lien holders' consent to a wide variety of senior lender decisions, such as allowing the use of the lenders' cash during chapter 11. This senior lender control may become problematic if the lender ceases to have any real economic interest in the debtor. The second lender may have an option to buy out the senior lender, but it may not be alerted to the need to exercise this option until the senior lender has made key decisions in the chapter 11 case.

In addition, the potential turnover in the debtor's debt holders, moving from a mix of buyers with varying incentives to a pool of speculative buyers, may reduce intraclass conflicts, but it will also increase the overall risk tolerance of the creditors voting on the debtor's plan. While not necessarily a bad thing, this could lead to riskier plans and, consequently, higher refiling rates.

Whether repeated chapter 11 cases are suboptimal is the subject of much debate (Lubben, 2007). It is plausible that two short chapter 11 cases might be preferable to a single, protracted chapter 11 case, which may have greater indirect costs. The real issue is one of disclosure: If chapter 11 plans increasingly become more speculative, driven by either the increasing detachment of creditors or the aggregation of debt in the hands of speculators, both in turn driven by the spread of credit default swaps, courts will have to ensure that the remaining creditors understand the plan under consideration and the risk the plans entails. Of course, this assumes that the bankruptcy courts are themselves able to fully digest the increasingly complex terms contained in modern reorganization plans.

The biggest risk to chapter 11 comes from the risk that the debtor's business will decline beyond the point of rescue while the parties debate, and litigate, the issues of who gets to participate in the debtor's reorganization and who gets to make key decisions during the reorganization. Recent disclosures that swaps may have been assigned without needed consents present one obvious point for litigation—to determine the identity of the debtor's stakeholders.

Debates about the enforceability of intercreditor agreements, the interpretation of terms of swaps, the conduct of ISDA settlement protocols, and the settlement of swaps that do not require physical delivery also may be points of contention. It is not clear that the bankruptcy court would have jurisdiction to hear these disputes, which largely involve nondebtor parties, yet the failure to resolve these issues quickly could leave the debtor unable to reorganize. These problems could be further compounded if the debtor's chapter 11 filing causes follow-on insolvencies of financial institutions, which fail as a result of their exposure to the debtor.

CONCLUSION

Overall, it seems probable that credit default swaps will alter the current chapter 11 landscape, especially in the larger cases where the most common recent trend is senior lenders leading the debtor through a reorganization largely designed by that lender. Instead, these creditors may lose their incentives to engage in such active participation, thus ceding the field to speculative debt buyers or, much less optimistically, the debtor's management. In either case the potential for riskier plans that seek to maximize the debtor's value will be the likely result. Courts should be aware of this potential, but they should not necessarily seek to stop it, as it is uncertain that this result is less desirable than the other likely option for a distressed firm: liquidation.

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