Feature

KEY POINTS

- Recent "Failure to Pay" events have been controversial because they were not a reflection of the Reference Entities' true ability to pay.
- Many market participants are dismayed at the ease with which a Reference Entity is able to manufacture a "Failure to Pay" and outraged at the alleged ulterior motives underlying the event.
- A credit default swap (CDS) party-initiated Failure to Pay (a Manufactured Failure to Pay) should be treated differently from a more traditional Failure to Pay (which is Reference Entity-initiated).
- The current Failure to Pay Definition should be refined by requiring that the Obligation on which the Reference Entity fails to make the payment must be an Obligation held by a party other than an Affiliate of the Reference Entity.
- Adding Restructuring-like safeguards will also protect against a Manufactured Failure to Pay.
- The distinction between the two types of Failure to Pay Credit Events lies in whether the Reference Entity has covenanted to default on an Obligation in connection with, or such default has been made a condition to, other transactions between the Reference Entity or its Affiliates and third parties.

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"Failure to Pay" needs a restructuring

In this article, Julia Lu and Richard Lee explore some options to amend "Failure to Pay" to protect against manufactured CDS credit events.

> "Things should be made as simple as possible, but not simpler." Albert Einstein

At least one Credit Event[1] under a credit default swap (CDS) was supposed to be simple. It is known as "Failure to Pay". The test is objective, easily verifiable, and generally not subject to varying interpretations.[2] The length of the Failure to Pay Definition, as compared to the "Bankruptcy" or "Restructuring" Definition, reflects that view. "Failure to Pay" remained in its original form even when the Definitions underwent substantial overhaul in 2014. Much to its dismay, the CDS market has learned that "Failure to Pay" is not simple after all, and the Definition has become the focus of recent controversies that threaten the very existence of the CDS product.

This article examines the Definitions of "Failure to Pay" and "Restructuring" and the likely cause of recent controversies and explores some options to amend "Failure to Pay" to include safeguards to minimise the risk of moral hazards. Any amendments must preserve the reasonable expectations of protection buyers hedging credit exposure with CDS while closing the door to using CDS to obtain a windfall or other similar gaming behaviour.

That balancing would require treating a CDS party-initiated Failure to Pay (which will be referred to as the Manufactured Failure to Pay in this article) differently from a more traditional Failure to Pay (which will be referred to as the Reference Entity-initiated Failure to Pay).[3] The current Failure to Pay Definition is generally adequate for Reference Entity-initiated Failure to Pay, and this article suggests making only one modification – requiring that the defaulted Obligation be held by parties other than an Affiliate of the Reference Entity – in order to further minimise the Reference Entity's ability to cause a Failure to Pay Credit Event when no debt holder would experience a loss.

On the other hand, the risks of moral hazard inherent in a Manufactured Failure to Pay are similar to those in a Restructuring. This article suggests adding Restructuring-like safeguards to protect against a Manufactured Failure to Pay. Those additional safeguards are not appropriate for a Reference Entity-initiated Failure to Pay because they would make a traditional Failure to Pay substantially more difficult to trigger, thereby compromising the reasonable expectations of a protection buyer.

If the two types of Failure to Pay Credit Events are to have different consequences under a CDS, then the most critical question will be how to distinguish them definitionally. This article proposes that the distinguishing factors should be whether or not the Reference Entity has *covenanted* to default in connection with, or the default has been made a *condition* to, other transactions between the Reference Entity or its Affiliates and other parties, or other arrangements are made which would have a similar effect. In a Manufactured Credit Event those factors would be present as the agreement to default would be inextricably linked to another transaction under which a third party (likely a CDS party) would provide some valuable consideration in exchange for the benefit arising from the Failure to Pay.

THE EXISTING "FAILURE TO PAY" AND "RESTRUCTURING" CREDIT EVENTS

"Failure to Pay" is defined in the Definitions as:

> "[A]fter the expiration of any applicable Grace Period (after the satisfaction of any conditions precedent to the commencement of such Grace Period), the failure by the Reference Entity to make, when and where due, any payments in an aggregate amount of not less than the Payment Requirement under one or more Obligations, in accordance with the terms of such Obligations at the time of such failure."[4]

The "Obligation" for this purpose means a Borrowed Money Obligation, the scope of which is rarely disputed. It makes no difference to whom the payment obligation is owed, or who is holding the Obligation.

By contrast, "Restructuring" has a much longer definition, and, in summary, is only triggered when a qualifying event, such as an extension of maturity, reduction of principal or interest, subordination or redenomination of currency (outside of a specified list), occurs:

- with respect to an Obligation which is a Multiple Holder Obligation;
- in relation to an aggregate amount of no less than the Default Requirement;[5]
- in a form that binds all Holders; and
- directly or indirectly as a result of the deterioration of the creditworthiness or financial condition of the Reference Entity.

A "Multiple Holder Obligation" is an Obligation which is held, at the time of the event, by more than three holders unaffiliated with each other.[6] The requirement that the event is a result of the "deterioration of the creditworthiness or financial condition of the Reference Entity" has historically generated debate, and sometimes criticism, because it is somewhat subjective. Yet in practice, of the over 30 requests to the ISDA Credit Derivatives Determinations Committees to determine whether or not a Restructuring Credit Event has occurred, only two were found to have failed to constitute a Restructuring for failure to meet the "deterioration of the creditworthiness or financial condition" test.[7]

Additional limitations on Deliverable Obligations, known as "Mod R" or "Mod Mod R", may apply to a Restructuring Credit Event, but not to Failure to Pay or other Credit Events. One such limitation is on the maturity of the Obligation that may be delivered – if an Obligation is issued in connection with the Restructuring and would otherwise meet the Deliverable Obligation Category and Deliverable Obligation Characteristics, it may not be deliverable into the CDS following a Restructuring Credit Event if the final maturity is later than the applicable maturity limitation date. This maturity limitation was designed to prevent the long-dated bonds issued in a Restructuring from being deliverable into a CDS, because the delivery would mean a windfall to the protection buyer.

CONTROVERSIAL FAILURE TO PAY CREDIT EVENTS

Until recently Failure to Pay has been the more straight-forward Credit Event with simple and objective tests. In the last few years, a number of purported failure to pay events have prompted heated debates over whether the events *should* constitute a Failure to Pay Credit Event, even if they have technically met the requirements of the Definition. Recent Failure to Pay events have been controversial because they were not a reflection of the Reference Entities' true *ability* to pay. Many market participants are dismayed at the ease with which a Reference Entity is able to manufacture a Failure to Pay and outraged at the alleged ulterior motives underlying the event. The market is therefore interested in solutions to "fix" the Definition to eliminate incentives for gamesmanship in future events.[8] This article represents an independent view of the likely causes of these events and proposes an alternative approach to address the issue.

> Recent Failure to Pay events have been controversial because they were not a reflection of the Reference Entities' true *ability* to pay.

Low Cost to Reference Entity

The conventional wisdom that it is financially costly for a Reference Entity to fail to pay its debt obligations is not always accurate. The direct cost of a Failure to Pay may be low because a Reference Entity may selectively default on the debt held by an Affiliate without upsetting the creditor community or necessitating costly negotiations of forbearance or waivers. The knock-on costs of a Failure to Pay may also be low as long as the payment default can be isolated without triggering a cross-default under other debt obligations of the Reference Entity or its Affiliates.

In December 2016, iHeartCommunications, Inc. failed to repay $57.1m principal amount of its senior notes held by a wholly-owned subsidiary. The Reference Entity needed this amount of the senior notes to remain outstanding after the maturity date in order to avoid triggering a "springing lien" provision in its other debt documents. The thresholds for cross-default in the company's indentures and credit agreements were higher than $57.1m, thus none was triggered.

Much of the CDS market was surprised to learn that a Failure to Pay had, indeed, occurred upon iHeartCommunications' selective non-payment of debt obligations held by its Affiliate, notwithstanding its apparent *ability* to pay. Because there are little direct or knock-on costs for a Reference Entity to withhold payment under these circumstances, Failure to Pay would seem a rational choice for the Reference Entity so long as any appreciable benefit is attainable.

Substantial Benefits to Reference Entity

Reference Entities often do reap substantial benefits from a Failure to Pay Credit Event. For one thing, a Credit Event would lead to the settlement and termination of all outstanding CDS, thereby eliminating a device by which debt holders can hedge their credit exposure, and through which their incentives may be skewed. This is preferable for the Reference Entity because debt holders without an ongoing hedge make more straight-forward negotiating counterparties.

In some instances, a more direct benefit from a Failure to Pay may accrue to the Reference Entity as it may be able to avoid more dire financial consequences. This was the case with iHeartCommunications – if it had repaid the senior notes at maturity, the aggregate outstanding principal amount of the notes would have fallen below the amount below which a lien would have "sprung" on substantially all of its assets in favour of some of its existing creditors, thereby severely curtailing its ability to obtain additional financing.

In more controversial cases, a Reference Entity may obtain some otherwise-unavailable financing or other economic benefits by complying with a third party's demand to withhold payment. The first widely-known example of the so-called "manufactured default" was the 2013 Failure to Pay Credit Event of Codere S.A., a Spanish gaming company, which withheld payment on some of its existing debt until after the expiration of the grace period, satisfying a condition to financing provided by a hedge fund, GSO Capital Partners.[9]

More recently, Hovnanian Enterprises, Inc., a troubled homebuilder in dire need of financing, agreed to the demands of GSO to default on scheduled payments of its debt in exchange for such financing. Hovnanian also agreed to issue long-dated bonds designed to be Deliverable Obligations for CDS, thus amplifying the recovery by GSO as a CDS protection buyer. Litigation ensued when another hedge fund, Solus Alternative Asset Management, sought an injunction against the proposed restructuring.[10] The trial court declined to grant the preliminary injunction in part due to its belief that the problem could and should be solved by refining the rules applicable to a Failure to Pay Credit Event. Ultimately the parties settled.

Minimal immediate consequences to the instigator of a Failure to Pay

Other than attracting media attention, a CDS party, such as GSO, who instigates a Failure to Pay Credit Event does not seem to suffer any negative consequences. A New York court has held that the duty to act in good faith is not breached when a CDS party makes arrangements with third parties (such as the issuer of the Reference Obligation) to maximise its gain under the CDS.[11] To the extent an analogous reasoning is adopted for a Manufactured Failure to Pay scenario, this holding may have unfortunately left the market with a licence to continue to manufacture defaults in order to obtain a windfall under the CDS.

Since the *Good Hill* case, and particularly since the litigation involving Hovnanian, the ISDA Board has made a statement criticising manufactured Credit Events, noting that further amendments to the Definitions may be necessary.[12] A US regulator, the Commodities Futures Trading Commission, has also noted that these activities may constitute market manipulation.[13] For now, however, an instigator of a Failure to Pay Credit Event may still be able to enjoy the fruits of its gaming behaviour.

To prevent further gamesmanship arising from the unbounded use of manufactured defaults, the Definitions should be amended to reduce the risk of a manufactured default becoming a Failure to Pay Credit Event.

> Any changes to the rules must, first and foremost, do no harm and maintain consistency with the reasonable expectations of the CDS parties.

SAFEGUARDING THE FAILURE TO PAY CREDIT EVENT

Safeguarding "Failure to Pay" will not be simple. The current rules work well in the vast majority of cases because the rules are objective and the facts necessary for a determination are easily verifiable with Publicly Available Information. Any changes to the rules must, first and foremost, do no harm and maintain consistency with the reasonable expectations of the CDS parties.

It is therefore critical to differentiate a CDS party-initiated Failure to Pay, or Manufactured Failure to Pay (as in the case in *Hovnanian or Codere*), from a more traditional Reference Entity-initiated one, even in a case such as *iHeartCommunications*. With respect to the latter, current rules require only some minor modifications. Other safeguards analogous to Restructuring should be added to the former to minimise the risk of moral hazard. Some suggestions for necessary modifications and safeguards are discussed below, as well as an approach to differentiate the two.

Reference entity-Initiated Failure to Pay

To address issues arising from Reference Entity-initiated Failure to Pay, the current Failure to Pay Definition should be refined by requiring that the Obligation on which the Reference Entity fails to make the payment must be an Obligation held by a party other than an Affiliate of the Reference Entity. Allowing an Affiliate-held Obligation to trigger a Failure to Pay presents an inherent moral hazard that a Reference Entity may easily choose to default on that Obligation for reasons unrelated to its creditworthiness or ability to pay, contrary to the working presumption of the CDS market. In a situation such as *iHeartCommunications*' default, where the issuer *chose* to default on a payment, rather than being unable to pay, this refinement would enable CDS transactions to continue even when the Reference Entity has created a technical default. The protection buyer's expectation that a CDS would hedge its exposure to a default would not be frustrated under these circumstances because if the Reference Entity initiates a default on a debt obligation held only by its Affiliates, no other debt holder would suffer a loss which needs hedging.

Manufactured Failure to Pay

For a Manufactured Failure to Pay, the current Definition should be modified to include the following additional safeguards against risks of moral hazard:

- First, the Obligation on which a Failure to Pay occurs must be a Multiple Holder Obligation.[14] This requirement, when used in the Restructuring Definition, serves to minimise the risk that one or two debt holders consensually agree with the Reference Entity to design a transaction which would trigger a Restructuring Credit Event. The same rationale applies to a Manufactured Failure to Pay. Requiring that the Obligation be held by more than three un-affiliated parties would deter a Manufactured Failure to Pay by substantially increasing the transaction cost of a Manufactured Failure to Pay to the Reference Entity (and indirectly the CDS party).

Biog box
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- Second, the payment default must apply to all holders of the Obligation *pro rata*. This requirement parallels the one under the Restructuring Definition that the event be "binding on all holders", and eliminates an easy way to circumvent the rules by selectively defaulting on payments to certain holders but not others.
- Third, a Manufactured Failure to Pay should not be triggered if "the occurrence of, agreement to or announcement of" the event "does not directly or indirectly result from a deterioration in the creditworthiness or financial condition of the Reference Entity". This, again, is consistent with the Restructuring Definition. The deterioration of creditworthiness or financial condition of the Reference Entity has always been an implicit assumption underlying Failure to Pay, because the market did not believe a Reference Entity would default on its payments other than as a result of such deterioration. With Manufactured Failure to Pay, however, that can no longer be assumed, and should be explicitly satisfied when considering a potential Manufactured Failure to Pay.
- Finally, any Deliverable Obligation must satisfy a maturity limitation analogous to the Restructuring Maturity Limitation Date or Modified Restructuring Maturity Limitation Date. Just like in the case of a Restructuring, a maturity limitation would serve to prevent the CDS party who instigates a Failure to Pay from further amplifying their gain by having a long-dated debt obligation issued to be a Deliverable Obligation.

Distinguishing two types of Failure to Pay

Distinguishing a Reference Entity-initiated Failure to Pay from a Manufactured Failure to Pay is critically important to the differentiated treatment approach suggested here. The key difference for this purpose is whether the default is the prerogative of the Reference Entity or a *quid pro quo* for some benefit provided by another party. Expressed in language that is more likely to appear in disclosure documents, the test should be whether or not the Reference Entity has *covenanted* to default in connection with, or the default has been made a *condition* to, other transactions between the Reference Entity or its Affiliates and other parties. In order to prevent rule-circumvention, this test should also include whether any other arrangement has been made which would achieve a similar result.

This test is objective and verifiable. No determination regarding the purpose, intent or motive of the Reference Entity or any other party is necessary. The facts necessary to establish a determination are likely easily ascertainable, and no judgment of morality, ethics or violation of law is inherently necessary in a determination. This test could therefore provide transparency and certainty to the market.

> The key difference … is whether the default is the prerogative of the Reference Entity or a *quid pro quo* for some benefit provided by another party.

There is plenty of Publicly Available Information about the circumstances surrounding the two known cases of Manufactured Failure to Pay, *Codere* and *Hovnanian*.[15] It is possible, however, that a future Manufactured Failure to Pay may occur to a Reference Entity that is not required to, and does not, make the relevant disclosure. It may therefore be prudent to widen the scope of information for this determination to Eligible Information, as already used in the context of determining Successors, which includes information that is not yet publicly available but can be made public without violating any law or contractual confidentiality restrictions.

CONCLUSION

CDS should be a product which enables market participants to hedge risks and express credit views, not one with which parties try to outsmart each other at the expense of the market and the vast majority of other participants. Recent trends suggest that some CDS parties may be taking the market in the wrong direction. While regulatory concerns may deter most parties from engaging in transactions that raise the specter of being manipulative, it is critically important for the Definitions to evolve to withstand an assault of questionable behaviours. The Failure to Pay Definition has been simple, but perhaps it is simpler than justified, and needs a restructuring now. ■

1 Capitalised terms used in this article are defined terms in the 2003 ISDA Credit Derivatives Definitions and the 2014 ISDA Credit Derivatives Definitions, unless otherwise noted. Those two sets of credit derivatives definitions are collectively referred to as the "Definitions".

2 Occasionally, the effect of a Reference Entity's non-payment is subject to debate. That was the case in the December 2014 default by Caesars Entertainment Operating Company, Inc. on some payments due on its bonds. See written materials submitted by Richards Kibbe & Orbe LLP, on behalf of an ISDA member, to the ISDA External Review Panel for further details. https://www.cdsdeterminationscommittees.org/documents/2015/02/submission-to-external-review-panel-on-behalf-of-no-position.pdf.

3 Consistent with the Definitions, "Reference Entity" as used in this article refers to either the Reference Entity under the CDS or the issuer of the debt obligation, if the Reference Entity is the provider of a Qualifying Guarantee (including a Qualifying Affiliate Guarantee), as the case may be. The Multiple Holders Obligation requirement applies to some CDS categories, most notably Standard European corporates, but does not apply to other categories such as Emerging European or Latin America corporates.

4 The applicable Grace Period is either the grace period provided in the underlying debt documents, or a three-business day period supplied by the Definitions. The Payment Requirement is $1,000,000.

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5 The Default Requirement is $10,000,000.

6 The Definitions also specify other requirements which are not relevant for the purposes of this article.

7 Those determinations of "no Restructuring" (both related to Japanese corporate names) can be found at https://www.cdsdeterminationscommittees.org/cds/sharp-corporation/, and https://www.cdsdeterminationscommittees.org/cds/aiful-corporation-5/.

8 On 6 March 2019, ISDA published proposed amendments to the Definitions to address the issues relating to narrowly-tailored failure to pay.

9 Codere Group Press Release, https://www.grupocodere.com/en/press-room/news/press-release-interest-payment/press-releasee-17-september-2013/ (2013). See *also* Levine, *Blackstone Made Money on Credit Default Swaps with this One Weird Trick*, *Bloomberg*, https://www.bloomberg.com/opinion/articles/2013-12-05/blackstone-made-money-on-credit-default-swaps-with-this-one-weird-trick (2013); Johnson & Smith, *The Mystery Trader Who Roiled Wall Street*, *Financial Times*, https://www.ft.com/content/5e23e516-5cdc-11e8-ad91-e01af256df68 (2018).

10 See Lu & Plotko, 'The Hazards of Hovnanian: Key Take-Aways from the *Solus v. GSO-Hovnanian* Preliminary Injunction Ruling' https://www.rkollp.com/assets/htmldocuments/2.8.18%20Hovnanian.pdf (2018).

11 See Lu, 'Aggressive, But in Good Faith; and Other Lessons Learned from the *Good Hill* Case', https://www.rkollp.com/assets/htmldocuments/1.26.17%20Good%20Hill%20Case.pdf (2017).

12 ISDA Board Statement on Narrowly Tailored Credit Events, https://www.isda.org/2018/04/11/isda-board-statement-on-narrowly-tailored-credit-events/ (2018).

13 CFTC Statement on Manufactured Credit Events, https://www.cftc.gov/PressRoom/SpeechesTestimony/divisionsstatement042418 (2018).

14 Only limb (i) of the Multiple Holders Obligation is relevant here, as limb (ii) explicitly only applies to Restructuring.

15 See *Solus Alternative Management LP v GSO Capital Partners L.P., Hovnanian Enterprises, Inc. et. al.*, Case No 18-CV00232-LTS-BCM, Docket No 69 (2018).

Further Reading:

- CDS Governmental Intervention payment triggers: when can you rely on them? (2016) 5 JIBFL 299B.
- The imperfect hedge: bail-in risk and CDS contracts (2012) 2 JIBFL 95.
- LexisPSL: Banking & Finance: Practice Notes: Credit derivatives – credit events.

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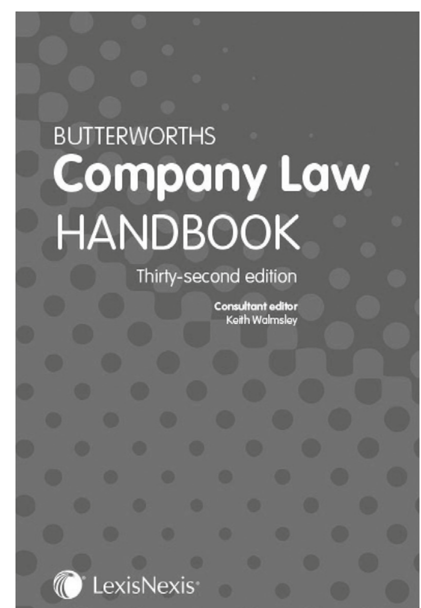

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