



Credit Default Swaps: Exploring the Controversy

Litigation and Bankruptcy

Thursday, November 20, 2008

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Presenters

John Ray

Workout specialist at Avidity Partners and Chairman of Enron Creditors Recovery Corporation

Judge Robert E. Grossman

Sitting U.S. Bankruptcy Judge

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Partner at Crowell & Moring; experienced civil litigator

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Partner at Crowell & Moring; former Department of Justice attorney and Enron Task Force member

Credit Default Swaps – What are they?

- » Private contract
- » Not insurance
- » ISDA Master Agreement (same as interest rate swap Master Agreement)
 - 1992
 - 2002
 - Requires Schedule A for specifics of trade
- » No provision for arbitration in contract
- » Warren Buffet: “Financial Instruments of Mass Destruction”

Credit Default Swaps – What are they?

- » Unregulated
- » Opaque
- » No central clearing exchange until November 14, 2008 announcement
 - Several likely exchange applicants – NYSE, ICE, CBT
- » Counterparty risk aggravated by:
 - Size of market - \$33 Trillion to \$68 Trillion (double or multiple counted)
 - \$340 Billion – AIG alone
 - Lack of information
 - Fear
 - Leverage

Litigation Over CDS's

» Forums

- **State Court** – Supreme New York County
 - *UBS A.G. v. Paramax* (December 2007)
 - *CDO Plus v. Wachovia* (November 2007)
- **Federal Court** – New York
 - *Eternity Global Master Fund Limited v. Morgan Guaranty Trust Company*, 375 F.2d 168 (2d Cir.2004)
 - *Deutsche Bank AG v. AmBac Credit Products LLC*, 2006 WL 1867497 (S.D.N.Y. January 2006)
 - *Aon v. Societe Generale*, 476 F.3d 90 (02/15/07)

Litigation Over CDS's

» Forums

– Federal Court – New York

- *Aon v. Societe Generale*, 476 F.3d 90 (02/15/07)
- *Ursa Minor Ltd v. Aon Financial Products, Inc.*, 2000 WL 1010278, aff'd, April 11, 2001 (2d Cir.), 7 Fed Appx. 129, 2001 WL 363515
- *Merrill Lynch Int'l v. XL Capital Assurance, Inc.* (declaratory relief over voting rights transfer as a Termination Event), 564 F. Supp. 2d 298 (S.D.N.Y.)

No arbitrations under ISDA Master Agreement or FINRA Rules

2002 ISDA Master Agreement provides for New York law and forum
-- § 13(b)(i)(1) depending on the law chosen in the Schedule A

1992 Master Agreement, § 13(b)(1)

Issues Litigated So Far

- » Counterparty Disputes over:
 - Termination Events – *Merrill Lynch Int'l v. XL Capital*
 - Credit Events – *Aon v. Societe Generale*
 - Collateral Demands – *VCG Special Opportunities Master Fund Limited v. Citibank, N.A.*, 06 Civ 01563 (February 2008) (S.D.N.Y.)
 - Margin Demands – *UBS A.G. v. Paramax*

Issues Litigated So Far

» Securities Claims

- Failure to Disclose Risks – *In re AIG Securities Lit.*, 08 Civ 4472
- Termination Settlement Amounts (mark to market vs. actual loss)
- “Manufactured” Credit Event (by action taken by CDS buyer of protection)
- “Composition” definition § 4(c) ISDA Credit Derivatives Definition

Issues Litigated So Far

- » Likely Future Disputes
 - Entitlement to Termination
 - Terms of Transaction (valuation)
 - Suitability
 - Disclosure
 - Under common law
 - Under '34 Act

Issues Litigated So Far

» Preparation for Litigation

- Check completeness of documentation
- Check collateral calculation and location
- Identify relevant documents
- Evaluate counterparty's contractual motivation
- Evaluate form of settlement in CDS (i.e., physical or cash)
- Evaluate valuation methodology
- Check ISDA protocols
- Draft advance notices

Issues Litigated So Far

» Lessons

- Courts treat each CDS as a stand alone contract
 - Not as part of a hedge (Aon)
 - Without regard to related contracts, including insurance (MLI)
 - Not as insurance or reinsurance
 - Not as a aleatory contract

Bankruptcy Issues

- » If Debtor holds collateral on CDS, is collateral “property of debtor”?
- » If Creditor holds collateral on CDS, is collateral “property of debtor”?

Government Investigations

- » SDNY – NY Attorney General
- » SEC
- » Federal Reserve
- » CFTC
- » Others?

Hypothetical for Discussion

- » “A” sells credit insurance to “B” related to “X” bond defaults. “B” physically settles by delivering “X” bond but the bond is subject to subordination because of “A’s” conduct.

Hypothetical for Discussion

- » Dealer sells credit “A” related to “X” bond and hedges it with a buy side transaction with “B”. As “X” bond deteriorates in value B posts collateral to Dealer who then goes into bankruptcy. Does “A” have rights to the collateral posted by “B” to Dealer?

Hypothetical for Discussion

- » In example 2 above, what about the collateral posted by Dealer to A – is this property of the debtor? If Dealer files for bankruptcy there can be no closing of the contract or posting of collateral without violating the automatic stay. Is the closing a post petition transaction?

Hypothetical for Discussion

- » “A” buys protection from “B”. “X” bond goes into default and “B” refuses to honor settlement because it alleges “A” misrepresented some aspect of the trade – either the condition of the asset or its value.

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Litigation and Bankruptcy

Q&A Session

Credit Default Swaps: Exploring the Controversy

Three Part Series Sponsored by Crowell & Moring

Upcoming:

Credit Default Swaps: Exploring the Controversy
Market Forces, Litigation, Regulation, Accounting & Tax

New York Seminar – **Thursday, December 11, 2008**

Grand Hyatt New York Hotel – 1:30pm Registration; 5pm Cocktail Reception

Registration – email customerservice@bvrresources.com or call (503) 291-7963

Guest speakers include:

Robert Pickel, Executive Director and Chief Executive Officer, International Swaps and Derivatives Association (ISDA)

Anthony Saunders, John M. Schiff Professor of Finance and Chairman, Department of Finance, Stern School of Business, New York University

Bala Dharan, Ph.D., CPA, Visiting Professor of Accounting, Harvard Law School; Vice President in the financial accounting and valuation practice, CRA International, Inc.

Stephan Kuppenheimer, Chief Executive Officer, FSI Capital

Steven Halterman, National Office Director, PricewaterhouseCoopers; former Director of Derivatives and Financial Instruments, Metropolitan Life Insurance Company

Chester S. Spatt, Kenneth B. and Pamela R. Dunn Professor of Finance and Director, Center for Financial Markets, Tepper School of Business, Carnegie Mellon University; former Chief Economist and Director, Office of Economic Analysis, U.S. Securities and Exchange Commission

About Crowell & Moring

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