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Outrageous Fortune: Making Money by Engineering Defaults

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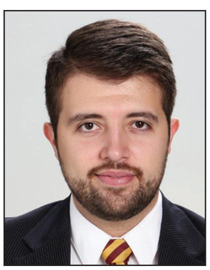

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Historically, lenders have obtained protection against borrower default through loan agreements. These agreements are vigorously negotiated and carefully crafted to protect against an array of borrower acts and omissions. The advent of credit-default swaps (CDS) in the 1980s introduced an instrument for sophisticated investors to hedge investment risk and bet on a borrower's default risk.

A CDS works like insurance. It is a contract between two parties whereby one party sells protection to a buyer. The buyer pays a premium to the seller, who agrees to reimburse the buyer if a credit event occurs with respect to the reference entity. A credit event might occur when a reference entity misses an interest payment, restructures its debt or files for bankruptcy. The Determinations Committee of the International Swaps and Derivatives Association (ISDA) decides whether an act or omission constitutes a credit event. If a credit event has occurred, ISDA conducts an auction to determine the market price of the reference entity's "cheapest-to-deliver" outstanding debt. The difference between the debt's par value and the auction price is the amount that the CDS seller pays the CDS buyer.

Academics have written extensively about the "empty creditor" problem created by a CDS: A creditor has less incentive to work out a loan if it is insured against a borrower default.[1] However, what if a debtor, creditor or third party is *incentivized* to trigger a default?

Scenario One

Former avocado farmers open an avocado brokerage and distribution business ("AvoCo"). Their plan is to buy avocados directly from farmers and sell them to customers at a profit. AvoCo borrows $10 million from a lender to purchase a distribution center, necessary equipment and excess inventory (avocados). The loan is due in five years, and the terms are attractive to the borrower. The lender's collateral includes substantially all of AvoCo's assets.

The business is highly successful at first. It generates plenty of excess cash, which is used to buy another distribution center and additional equipment. Then tragedy strikes: A plague destroys most of the world's avocado supply, and avocado prices soar. AvoCo's inventory is quickly diminished, and the business is unable to procure the volume of avocados needed to sustain operations.

Unfortunately, AvoCo's loan is due in 12 months, and the operators do not have the funds to pay the principal and need to refinance. The existing lender is willing to amend and extend the loan, but at a materially higher interest rate plus exorbitant fees. The amended loan would strain AvoCo's finances, and the operators are unsure they will be able to make the required payments.

A sophisticated investor learns of AvoCo's woes and believes that it can make substantial profits while lowering AvoCo's financing cost. The investor will purchase a 12-month AvoCo CDS contract that will trigger if AvoCo files for bankruptcy or misses an interest payment. The CDS seller charges a $1 million annual premium.

The investor approaches AvoCo with more attractive terms than those offered by the current lender. However, there is just one catch: The investor's loan is contingent on AvoCo missing an interest payment on the current loan. Once AvoCo misses the payment, the CDS will trigger, resulting in a payment to the investor, then the investor will fund the new loan. Assuming that the value of AvoCo

1 *See* Henry T. C. Hu and Bernard Black, "Equity and Debt Decoupling and Empty Voting II: Importance and Extensions," 156 *U. Pa. L. Rev.* 625, 728 (2008) (introducing "empty creditor" concept); *see also In re Washington Mut. Inc.*, 419 B.R. 271, 280 (Bankr. D. Del. 2009) (collecting related secondary authority).

debt decreases from $10 million to below $9 million, the investor will profit on the CDS. The money from the CDS trade can then be used to help finance AvoCo.

A Comparison

In 2017, GSO Capital Partners proposed a similar deal to Hovnanian Enterprises Inc., a large U.S. residential construction firm facing liquidity struggles. Hovnanian determined that the terms offered by GSO — which included long-term financing at rates below those offered by other sources and a requirement that it misses an interest payment on an intercompany note to trigger a credit event — were favorable and pursued the refinancing.

The CDS seller to GSO, Solus Alternative Asset Management LP, sued. It claimed that GSO had engineered a "sham default" and "embarked on a fraudulent scheme with Hovnanian to pervert the normal operation of the CDS market."[2] Solus immediately moved to enjoin the transaction, claiming that it would suffer "massive and irreversible harm" if the trade was allowed to proceed.[3] Solus also argued that the trade would cause irreparable "public harm" by causing a cascade of similar transactions that would existentially threaten the CDS market.[4]

Hon. Laura Taylor Swain of the Southern District of New York denied the injunction motion. The effect of the transaction was "essentially economic," and the plaintiff could be compensated monetarily to remedy any harm it suffered.[5] Nor was there any irreparable public harm. Judge Swain stated:

> [T]he allegedly threatened community of CDS market participants, consisting of CDS traders and dealers, is a relatively insular and sophisticated subset of the public. CDS market participants are empowered, through ISDA membership and participation in its governance mechanisms, to create rules to mitigate engineered-transaction-related risks through changes to ISDA documentation, policies, and procedures; the allegedly anticipated harm is thus neither inevitable nor irreparable.[6]

The parties settled before going to trial. Solus agreed to dismiss the lawsuit and pay an undisclosed amount to GSO, who in return agreed to allow Hovnanian to make its interest payment and not trigger the CDS.[7]

This form of engineered default is arguably a net positive. It allows a stressed company to obtain less-expensive financing that staves off a more serious credit event like bankruptcy and might provide a bridge to financial stability. The CDS seller is undoubtedly harmed, but as a sophisticated entity with access to the same information as the CDS buyer, sellers should also be able to price CDS to account for any engineered-default risk — a conclusion that seemed to inform Judge Swain's analysis in *Solus v. GSO*.

However, critics contend that these engineered defaults simply take advantage of loopholes within CDS contracts, damage the integrity of the CDS market and amount to market manipulation. These transactions threaten to transform a CDS from primarily a hedging instrument into an elaborate means of gambling with a tenuous connection to the financial health of the reference entity.

Moreover, the benefit of temporarily staving off bankruptcy should not be overstated. Perpetuating the life of an unhealthy company is not a good unto itself.[8] If attractive CDS financing only temporarily delays a bankruptcy filing, the benefit of this financing arguably does not outweigh the harm to other parties-in-interest. The real winner seems to be the CDS buyer, who obtains a potentially massive windfall from exploiting a technicality.

> **As demonstrated by *Windstream*, parties should be wary of complex transactions structured to avoid triggering covenants in credit agreements. Even if other creditors consent to or express indifference toward a proposed transaction, it might be open to attack by sophisticated investors.**

Scenario Two

Shortly after the investor's loan is funded, the avocado supply stabilizes and business begins booming. After a few years, AvoCo decides to go public and issues stocks and bonds.

AvoCo's management wants to generate extra cash by selling AvoCo's real estate holdings, but the indenture associated with the publicly traded bonds is not allowed. AvoCo structures and executes a sale-leaseback transaction that management believes will technically avoid violating the indenture.

A few years after the sale-leaseback transaction, a hedge fund reads the AvoCo bond indenture and believes that the transaction violated the indenture. The hedge fund purchases $10 million of CDS protection with a $1 million annual premium payment. The reference entity is AvoCo, and a "credit event" is defined as a bankruptcy filing or missed interest payment. The hedge fund then purchases 2 million AvoCo bonds at $0.70 on the dollar or a total of $1.4 million. The hedge fund successfully asserts that AvoCo violated the bonds' indenture by selling its real estate assets. Consequently, the bonds' outstanding principal and accrued interest is immediately due and payable. AvoCo does not have the money to repay the outstanding principal and files for bankruptcy, which triggers the CDS payment to the hedge fund.

The hedge fund delivers the bonds for the ISDA auction. They sell for $0.70 on the dollar, so the hedge fund receives $1.4 million from the sale of its bonds. No profit is made from the sale of the bonds (excluding accrued interest). However, they also receive a payment for the CDS they own

2 Complaint ¶¶ 4, 8-9, *Solus Alternative Asset Mgmt. LP v. GSO Capital Partners LP*, No. 18-cv-232 (S.D.N.Y. Jan. 11, 2018), Dkt. 1.
3 Mem. Supp. Mot. Prelim. Inj. at 3, *Solus v. GSO*, Dkt. 6.
4 *See id.* at 11, 25.
5 *Solus Alternative Asset Mgmt. LP v. GSO Capital Partners LP*, No. 18-cv-232, 2018 WL 620490, at *6 (S.D.N.Y. Jan. 29, 2018).
6 *Id.*
7 Andrew Scurria, "Blackstone Stands Down on Hovnanian Swaps Wager," *Wall St. J.*, May 30, 2018, *available at* wsj.com/articles/blackstone-stands-down-on-hovnanian-swaps-wager-1527722945 (unless otherwise specified, all links in this article were last visited on April 25, 2019).

8 *See, e.g., In re TOUSA Inc.*, 680 F.3d 1298, 1311 (11th Cir. 2012) ("A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." (citation omitted)).

for $1 (par) minus $0.70, which equals $0.30. Assuming that one premium payment was made, the hedge fund realizes $2 million in profit: ($0.30 x $10 million) - $1 million.

A Comparison

Aurelius Capital Master Ltd. engaged in a series of similar transactions with respect to Windstream Services LLC, which (with its affiliates) provides telecommunications services throughout the U.S. In 2013, Windstream issued a series of senior unsecured notes in an aggregate principal amount of $700 million due in 2023 (the "2023 notes"). The bond indenture precluded Windstream from engaging in certain transactions.

In 2015, Windstream transferred various corporate assets to a newly created real estate investment trust in exchange for all of the subsidiary's common stock, $1.035 billion in cash and $2.5 billion in debt (the "2015 transaction"). In 2017, Aurelius began purchasing 2023 notes, and market participants believed that the firm built a large CDS position as well.[9] Aurelius subsequently contended that Windstream had engaged in a prohibited sale-leaseback transaction, declared an event of default under the indenture, and directed the indenture trustee to file suit. Aurelius was not involved in the 2015 transaction, but it effectively engineered the credit event by exploiting a technical covenant breach that was not challenged by existing noteholders.

Following trial, Hon. Jesse Furman of the Southern District of New York ruled that the 2015 transaction violated the indenture.[10] Windstream was unable to pay the principal and accrued interest due upon default, and it subsequently filed for chapter 11 protection.

Under § 510(c) of the Bankruptcy Code, a bankruptcy court may subordinate all or part of a claim "under principles of equitable subordination." This typically requires the following conditions to be satisfied: (1) the claimant must have engaged in inequitable conduct; (2) the misconduct must have caused injury to the debtor's creditors or conferred an unfair advantage on the claimant; and (3) such subordination would need to be consistent with the Code.[11] Even if a creditor's conduct is technically legal, sufficiently inequitable conduct can give rise to equitable subordination.[12] In addition, subordination travels with the claim, so selling or assigning a claim to an innocent third party should not affect a court's subordination analysis.[13]

Windstream and other interested parties have suggested that they might pursue claims for equitable subordination of the 2023 notes. Certain participants in the Windstream ISDA auction argued that equitable subordination was "highly credible" based on the substantial drop in the trading price of the 2023 notes after Aurelius purchased a controlling position and directed the indenture trustee to file a lawsuit against Windstream, while it simultaneously owned a large position in the Windstream CDS and intended to profit from Windstream's default at the expense of other parties.[14] While Judge Furman ruled in Aurelius's favor, his decision focused on the parties' compliance with the indenture rather than general equitable considerations, and it should not foreclose the possibility of equitable subordination in the bankruptcy court. The ultimate treatment of the 2023 notes remains to be seen.

An important issue might be the value of potentially equitably subordinated claims. Some auction participants asserted that the equitable subordination of the 2023 notes would cause their market price to fall to $0.[15] In most cases, including Windstream's, ISDA conducts the auctions prior to, or early in, a bankruptcy case. A holder of claims subject to potential equitable subordination and a CDS covering the reference entity could deliver its claims to the ISDA auction, where those claims would likely trade at a deep discount. The increased discount would trigger a larger payout under the CDS. The purchaser of the claims would effectively have "option value" to litigate those claims and extract at least nuisance value.

Conclusion

The forecast for engineered defaults is unclear. Although these transactions have been criticized on various grounds, the current guidance from the courts is too limited to draw definite conclusions about future court challenges.

ISDA is considering amending the definition of a "Failure to Pay Credit Event" to require a deterioration of the reference entity's creditworthiness.[16] While that might solve some problems, determination of a company's creditworthiness could be subjective and create uncertainty in the CDS market. Moreover, CDS buyers might use increasingly draconian tactics to ensure that a reference entity will default and cause the CDS contracts to be paid out.

Regardless of whether ISDA amends the underlying definitions of CDS contracts, management teams, investors and other parties should safeguard their positions from any damage that could be caused by engineered defaults. All parties should review the credit agreements and CDS contracts tied to the reference entity to ensure that the entity understands its default risk. As demonstrated by *Windstream*, parties should be wary of complex transactions structured to avoid triggering covenants in credit agreements. Even if other creditors consent to or express indifference toward a proposed transaction, it might be open to attack by sophisticated investors. Finally, management teams and investors should monitor the credit and CDS markets to look for early warning signs that an engineered default might be on the horizon. abi

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9 *See* ISDA Challenge Submission, Issue No. 2019022501 at 11 (March 11, 2019).

10 *U.S. Bank NA v. Windstream Servs. LLC*, No. 17-CV-7857, 2019 WL 948120, at *23 (S.D.N.Y. Feb. 15, 2019) ("This Court's ... sole task is to enforce the Indenture's plain terms.").

11 *See, e.g., In re Durango Georgia Paper Co.*, 539 B.R. 896, 901 (Bankr. S.D. Ga. 2015) (applying test for equitable subordination set forth in *In re Mobile Steel*, 563 F.2d 692 (5th Cir. 1977)); *In re LightSquared Inc.*, 511 B.R. 253, 346-52 (Bankr. S.D.N.Y. 2014) (same).

12 *See LightSquared* at 346 (Bankr. S.D.N.Y. 2014) (equitable subordination available "notwithstanding the apparent legal validity of a particular claim").

13 *See In re Metiom Inc.*, 301 B.R. 634, 643 (Bankr. S.D.N.Y. 2003) ("[A]ssignment should not, and does not, affect the debtor's rights vis-à-vis the claim."); *cf.*, *In re KB Toys Inc.*, 736 F.3d 247, 252 (3d Cir. 2013) ("[C]laims that are disallowable under § 502(d) must be disallowed no matter who holds them.").

14 *See* ISDA Challenge Submission at 11.

15 *See id.*

16 "Proposed Amendments to the 2014 ISDA Credit Derivatives Definitions Relating to Narrowly Tailored Credit Events," ISDA (March 6, 2019), *available at* isda.org/a/nyKME/20190306-NTCE-consultation-doc-complete.pdf.