iHeart and Other Unconventional CDS Credit Events

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This Article examines unconventional credit default swap (CDS) credit event determinations and offers suggestions for amendments to CDS contracts that address unconventional CDS credit events.

This Article:

- Presents three recent **credit default swap** (CDS) **credit event** determinations, including the iHeartCommunications credit event, which may appear inconsistent with the spirit of the protections for which CDS contracts were designed.
- Discusses the similarities and differences between the three credit events.
- Concludes with suggested amendments to standard CDS contracts that parties may consider to address "unconventional" credit events such as these.

The iHeart Case

On December 27, 2016, the ISDA Americas Determinations Committee (DC) announced that the election by iHeartCommunications Inc. (iHeart) not to repay at maturity the principal balance of certain 5.50% senior notes due December 15, 2016 (2016 Notes) held by one of its subsidiaries constituted a “failure to pay” under ISDA’s 2014 Credit Derivatives Definitions (the Definitions) that govern interpretation of CDS contracts. As a consequence, **credit protection buyers** of CDS contracts on the senior unsecured debt of iHeart were entitled to collect on their contracts.

Background

iHeart and its parent, iHeart Media Inc., were highly leveraged with approximately $20 billion in outstanding debt. The iHeart entities were engaged in a variety of activities to restructure their debt. Among other things, iHeart arranged for its wholly owned subsidiary Clear Channel Holdings Inc. to purchase $57.1 million of the 2016 Notes. At the maturity of the 2016 Notes in December 2016, iHeart repaid all amounts outstanding on the 2016 Notes except those held by Clear Channel. The purpose of this was to avoid a **springing lien** in favor of certain creditors over assets of iHeart, which would have been triggered had all of the 2016 Notes been retired.

Standard & Poor's (S&P) indicated that it viewed the non-repayment on the 2016 Notes to the subsidiary as a default and downgraded:

- iHeart to “selective default.”
- The 2016 Notes to a “D” rating.

While seemingly negative, the ratings changes actually bolstered the position of iHeart with respect to the outstanding 2016 Notes held by its subsidiary. iHeart also took affirmative steps to ensure that the 2016 Notes held

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by its subsidiary would be viewed as outstanding, including seeking a declaratory judgment in the District Court of Bexar County, Texas, to that effect.

Clear Channel agreed to forbear from exercising remedies under the 2016 Notes against iHeart, but reserved the right to claim the unpaid principal amount of the 2016 Notes in the future. While the failure to repay the 2016 Notes held by Clear Channel was clearly a payment default, it did not **cross-default** other debt in the iHeart capital structure because the amount was below the $100 million cross-default threshold in the other indebtedness documents.

The actions of iHeart reverberated through the CDS market, as parties disagreed as to whether iHeart's failure to pay on the 2016 Notes held by its subsidiary constituted a failure-to-pay credit event under the Definitions.

The CDS Settlement Process

Under the standard ISDA terms for CDS contracts, when a failure to pay or other credit event (as defined in the Definitions) occurs with respect to the **reference entity**, a credit **protection seller** must pay to its protection buyer an amount equal to the percentage decline in the value, compared to **par**, of the "cheapest to deliver" qualifying debt obligation of the reference entity (the **reference obligation**) that may be delivered in satisfaction of the contract, multiplied by the **notional amount** specified in the CDS contract (see Practice Notes, Credit Derivatives: Overview (US) and Credit Derivatives: Overview (US): ISDA's Big Bang: CDS Determinations Committees).

The determination of whether a credit event occurred is made by the DC (which consists of buy- and sell-side members) for the region in which the contracts were written. Any market participant may request a determination, but only alleged credit events occurring within the 60 days preceding the request will be taken into account. If the DC finds that a credit event has occurred, it also decides whether to hold an auction to determine market value of obligations of the reference entity that qualify to be submitted in exchange for a payment under the CDS contract if **physical settlement** were applicable (**deliverable obligation**) and the terms under which the auction will be conducted (see Practice Note, The Auction Settlement and Restructuring Supplement to the 2003 ISDA Credit Derivatives Definitions).

The iHeart Determination

In December 2016, the ISDA Americas DC, which had jurisdiction over the iHeart CDS, announced that it would consider a request for a credit event determination with respect to iHeart and the 2016 Notes. The DC publicized its decision that a failure-to-pay credit event had indeed occurred and established February 2, 2017 as the iHeart auction date. The auction was held, establishing a market price of 35.50 cents on the dollar for a deliverable obligation that was deliverable in settlement of open iHeart CDS contracts. As a result, approximately $154 million changed hands in settlement of the iHeart CDS contracts.

Market participants took opposite positions over whether a failure to pay had occurred because of iHeart's non-repayment of the 2016 Notes held by its subsidiary. Proponents of a failure-to-pay determination emphasized a literal application of the Definitions. The fact that the 2016 Notes held by the subsidiary were outstanding under the terms of the indenture was not contested. The 2016 Notes represented borrowed money and therefore constituted "obligations"; iHeart's failure to pay under the 2016 Notes was just that, a failure to pay on an outstanding obligation. Proponents downplayed the agreement of Clear Channel to forbear from exercising remedies against iHeart arguing instead that:

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- The indenture had not been amended.
- In the past the DC had ignored forbearance agreements in deciding that a failure to pay had occurred.

Opponents of a failure-to-pay determination stressed Clear Channel's forbearance and maintained that it constituted an amendment-in-fact of the indenture. Opponents drew an analogy to a case in the NY courts, *LaSalle Bank NA* (2002), in which the court declined to find a default following an implied waiver in the contract. That situation was readily distinguishable from iHeart, however, primarily because Clear Channel did not waive any rights or remedies against its parent. It had merely agreed to a temporary stay of enforcement while reserving its rights to pursue remedies against iHeart in the future.

The DC sided with the proponents, adopting a literal approach to the Definitions, reasoning that:

- Under the terms of the Definitions, a failure to pay occurs three business days after non-repayment, absent any contractually extended grace period. The 2016 Note indenture provided for no such grace period.
- Under the 2016 Note indenture, all interest and principal payments were “due and payable” on the maturity date of the 2016 Notes.
- There was no agreement between the parties modifying or deferring the maturity date.
- The payments owed by iHeart to Clear Channel constituted “obligations” for purposes of the Definitions.

Therefore, the DC concluded that a failure-to-pay credit event occurred with respect to iHeart under the 2016 Notes on December 20, 2016, the third business day following the maturity date of the 2016 Notes.

Observations

From an equitable perspective, and from the perspective of a protection seller, the decision of the DC could appear unjustified since:

- iHeart had the ability to fully pay the remaining amount due on the 2016 Notes, but chose not to do so.
- All notes held by market participants were repaid.
- The issuer joined with a wholly owned subsidiary to keep a relatively small portion of the 2016 Notes outstanding for purposes that were ancillary to the credit itself.

It could be argued that requiring protection sellers to make good on their commitments in these circumstances was inconsistent with the spirit of the CDS contracts. The DC nonetheless looked only to the literal terms of the contracts, and in its view the plain meaning of those provisions compelled the conclusion that a failure to pay had occurred, and protection sellers were therefore required to perform.

The decision of the DC to restrict their interpretation of the Definitions to their literal terms and ignore potentially applicable policy considerations has an understandable rationale. The markets require certainty in the enforcement of CDS contracts, and importing policy consideration into the calculus would inject a measure of uncertainty and imprecision.

The iHeart determination therefore has important implications for the CDS market and other permutations of nonconventional credit events that may arise in the future. Nonetheless, there is a lingering sense that the paradigm may be shifting in the world of CDS, where credit events can be created that are not indicative of the fundamental credit-unworthiness of a reference entity.

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Codere: A Precursor to iHeart

Codere SA operates betting parlors and race tracks in eight countries in Europe and Latin America. In 2013, it attempted to restructure about €1 billion of debt after posting losses over a number of consecutive quarters. GSO Capital Partners LP (GSO), a subsidiary of Blackstone Group LP, offered to lend money to Codere, reportedly conditioned on Codere refraining from making an interest payment on one of its credit obligations until after the applicable grace period. The condition resulted in a failure-to-pay credit event with respect to CDS credit protection that GSO had purchased on Codere as reference entity. The ISDA Americas Determinations Committee made a failure to pay determination and as a result, GSO reportedly received a $15.6 million payment from its protection seller in settlement of the CDS contract. This, of course, enhanced the returns on the loan that GSO made to Codere.

In Codere, a failure-to-pay credit event was triggered without crossing the cross-default thresholds in Codere's other debt documents. The parties were therefore able to take advantage of the CDS market without bringing down the capital structure of the reference entity as a whole. In Codere, the engineering of a failure-to-pay credit event enabled capital to be drawn from the credit protection sellers in the CDS market and injected as liquid cash into Codere, ultimately preventing further credit deterioration. iHeart could be seen as a natural progression of the technique pioneered in Codere. Whereas Codere involved cooperation between a reference entity and an unaffiliated lender, iHeart created a credit event, albeit for a wholly separate purpose, between itself and a wholly owned subsidiary, without the collaboration of any other market participant.

In this context it is not hard to imagine a situation in which an issuer or borrower attempts to obtain leverage over credit protection sellers in the CDS market by threatening to take unilateral action that could trigger a credit event. This could, of course, occur with the wider financial health of the company in mind (as witnessed in Codere) or could simply be used as a means to pressure certain bondholders or lenders into concessions.

MBIA: An Unsuccessful Takeoff on iHeart

iHeart and Codere were situations in which credit events were created despite the ability of a reference entity to pay the debt that triggered the event. But in the new world of nonconventional CDS, credit events may also encourage market participants who would profit from a credit event to aggressively advocate for one even where its occurrence is doubtful at best.

MBIA Insurance Corporation (MBIA), a monoline insurer and a wholly owned subsidiary of MBIA Inc., was obligated under insurance policies used to "wrap" or insure for credit or cash-flow purposes, certain notes issued by affiliates of Patriarch Partners LLC that came due in January 2017 (Zohar II notes). In December 2016 and January 2017, MBIA engaged in certain transactions to facilitate satisfaction of its payment obligations under the Zohar insurance policies that wrapped the Zohar II notes. With the proceeds of a financing and the acquisition of certain of the Zohar II notes as consideration for the sale of a subsidiary, MBIA was able to pay in full the amounts owed to third-party noteholders of the wrapped Zohar II notes at maturity. The various transactions were fully disclosed in Forms 8-K filed by MBIA Inc.

Notwithstanding the full disclosure, and the absence of any evidence of a failure to pay, unknown market participants alleged the occurrence of a credit event at MBIA and requested a determination of the ISDA Americas Determinations Committee. The request posited that the Zohar II notes acquired by MBIA should be presumed to remain outstanding and unpaid, absent proof that the insurer had fulfilled its obligation under the wrap and repaid

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amounts due under the notes. The parties submitting the request seemed to be seeking to leverage the decision of the Determinations Committee in iHeart.

In contrast to the situation at iHeart, however, the Zohar II notes were not held by a subsidiary of MBIA, but rather transferred to MBIA itself. **Offset** arrangements were also agreed upon between MBIA and the trustee for the Zohar II notes, which were appropriately documented, making it clear that all payment obligations on the Zohar II notes had been discharged in full. The DC had no difficulty finding that a credit event had not occurred.

The MBIA case nonetheless illustrates the velocity of new concepts in the CDS market, particularly with respect to nonconventional situations. The case may also serve as a lesson for issuers engaged in debt repurchases seeking to avoid the inconvenience and distractions of dealing with an alleged credit event to properly document and publicize retirement of the acquired debt.

Observations

Based on the precedent of iHeart, Codere, and MBIA, practitioners may consider modifying the terms governing standard CDS contracts to limit the ability of reference entities and market participants to engineer credit events not reflective of issuer creditworthiness.

On the one hand, it is common for protection buyers to acquire CDS contracts without any exposure to the underlying reference obligations, and indeed the notional amount of CDS contracts often exceeds by orders of magnitude the principal amounts of the corresponding deliverable debt obligations. Viewed from this perspective, a CDS contract is simply another financial tool that may be used unconventionally.

On the other hand, modern-day CDS contracts have their roots in hedges against default on borrowed money that still create corresponding market expectations. If so-called credit-event engineering becomes widespread, protection sellers could be deterred from writing contracts unless they are adequately compensated for the risk, adversely affecting the orderly functioning of the CDS markets.

Suggested Amendments

On the theory that engineered credit events frustrate market expectations and therefore should be constrained, the following amendments to the standard terms of ISDA-regulated CDS contracts may be considered:

- Express exclusion of debt owned by affiliates from the definition of "obligations" taken into account for the purposes of credit events. This is already done for purposes of "succession event" determinations (see Practice Note, Introduction to the 2014 ISDA Credit Derivatives Definitions: Successor Provisions).
- An increase in the threshold amount, the nonpayment of which gives rise to a credit event. To preserve the utility of a failure to pay, the threshold could be fixed at a percentage of outstanding indebtedness held by nonaffiliates of the reference entity, that should be lower than the lowest cross-default trigger in other indebtedness of the reference entity. Otherwise, the failure to pay could trigger an acceleration of all the reference entity's debt, which could in turn, trigger a Bankruptcy credit event.
- Inclusion of a term requiring a failure to pay to impact a defined number of holders, similar to the agreement of multiple holders required for a restructuring credit event (see Practice Note, The 2014 ISDA Credit Derivatives Definitions: key differences between the 2003 and 2014 ISDA Credit Derivatives Definitions: Changes to Article IV from the Updated 2003 Definitions: Section 4.7 (Restructuring)). This could be coupled with a

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requirement that the impacted holders must hold a certain amount or percentage of the outstanding debt, perhaps varying based on the total amount of outstanding debt of the reference entity.

- Removal of failure to pay as a credit event in certain markets and/or regions, perhaps coupled with the introduction of a voluntary restructuring credit event to mitigate the impact of the removal. However, abandoning failure to pay as a credit event will have negative implications for debtholders using CDS to hedge a particular debt obligation as the CDS contract would no longer be tailored to the risk they are exposed to by holding the debt. This may also have negative capital implications for banks using CDS to mitigate risks on their books.

The efficacy of each of these modifications, individually or in combination, in deterring an “engineered” credit event would depend on the circumstances of the reference entity, the amount and dispersion of the debt of the reference entity, and the language agreed by the parties. Of course, these changes would affect pricing of the contract as well, and the pool or protection sellers could be limited for such a contract.

Effecting the Amendments

Such amendments to CDS contracts could be effected via a protocol to which CDS market participants would adhere. The amendments, however, would likely affect the value of outstanding CDS trades. It is unlikely, therefore, that market participants who are net buyers of CDS protection would be willing to adhere to the amendments without being compensated for the reduction in value of their contracts.

Another approach would be to create an additional type of CDS contract that would trade with the amended terms. Such an approach might be better received by market participants, but it would have the consequence of splitting the market by certain names into two buckets, trading at different prices. This would be an undesirable outcome for a CDS market that has become thinner over the years and is in no need of fragmentation.

Concluding Observations

Nonconventional credit events in the CDS markets may be here to stay, unless constrained by contractual changes in the market. Whether such constraints are desirable may be a matter of perspective, but there are no doubt some market participants who believe that certain recently witnessed credit events are inconsistent with market expectations and could be harmful to the orderly functioning of the CDS markets. However, implementing corrective changes will likely to be a challenge, both because a one-size-fits-all approach may not work, and because the structure of the CDS market creates resistance to change.

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