Opportunistic Credit Default Swap Strategies

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A Practice Note detailing opportunistic credit default swap (CDS) strategies in the context of refinancings and restructurings that utilize techniques including voluntary failure-to-pay credit events, succession events, and orphan CDS. Among others, this Note discusses the iHeartCommunications case, Hovnanian Enterprises, and the McClatchy and Sears cases.

The credit default swap (CDS) market has seen an increase in activism and the evolution of creative refinancing and restructuring strategies intended to achieve particular outcomes for the CDS. These refinancing and restructuring strategies include options for both CDS credit protection buyers as well as CDS credit protection sellers.

A number of issuers in financial distress and their investors have used unconventional refinancing and restructuring strategies that capitalize on CDS contracts that have been written on the issuer, as reference entity, to achieve a specific economic outcome. The CDS market has also created a parallel source of financing for reference entities, where both the CDS protection buyers and sellers can engage with reference entities and offer economic incentives in exchange for cooperation that enhances their CDS positions.

In particular, this Note:

- Discusses three CDS credit event determinations, iHeart Communications Inc. (iHeart), Codere SA (Codere), and MBIA Insurance Corporation (MBIA), which may appear inconsistent with the spirit of the protections for which CDS contracts were designed (see iHeart, Codere, and MBIA: The CDS Protection Buyer and Unconventional Credit Events).
- Addresses the CDS-related structuring in K. Hovnanian Enterprises, Inc. (Hovnanian), and the legal issues involved in the Hovnanian litigation (see The Hovnanian Enterprises Restructuring).
- Provides an analysis of the state of the CDS market following these unconventional credit events, the viability of these strategies moving forward, and the possible implications for the CDS market of their proliferation (see Unconventional Credit Events and Implications for the CDS Market).
- Suggests amendments to standard CDS contracts that parties may consider to address these "unconventional" credit events (see Suggested Amendments to Standard Terms of ISDA CDS Contracts).
- Discusses the basic principles of succession events and orphan CDS (see The CDS Protection Seller and Opportunistic CDS Strategies).
- Examines two recent cases, McClatchy and Sears, in which the strategies of succession events and orphan CDS played a role, at least initially (see The McClatchy Refinancing and The Sears Refinancing).
- Provides an analysis of the state of the CDS market in the wake of opportunistic strategies such as succession events and orphan CDS (see Implications of CDS Protection Seller Strategies).

This Note is entitled "Unconventional Credit Default Swap (CDS) Financing Strategies" on the Practical Law Finance website.

For details on credit derivatives generally, including an explanation of CDS mechanics, see Practice Note, Credit Derivatives: Overview (US) (0-386-8130).

UNCONVENTIONAL CDS CREDIT EVENTS

These strategies take various forms but most commonly involve the triggering of credit protection payments under the CDS contract pursuant to the occurrence of a failure-to-pay credit event. The ensuing monetization of the CDS contracts for the benefit of the CDS credit protection buyers enables these parties to extend financing to the reference entity on more favorable terms. At the same time, the relatively low failure-to-pay threshold in the standard CDS contract of $1 million enables most CDS contracts to be triggered without also triggering cross-defaults in other debt instruments in the reference entity's capital structure.

Failure-to-pay credit events of this type are considered "unconventional" because they result from voluntary, rather than unavoidable, payment defaults.

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.

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 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.

Throughout the CDS market, 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) (0-386-8130) and Credit Derivatives: Overview (US): ISDA's Big Bang: CDS Determinations Committees (0-386-8130)).

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 are 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 (the deliverable obligation) that qualify to be submitted in exchange for a payment under a CDS contract in which physical settlement is applicable and the terms under which the auction will be conducted (see Practice Note, Understanding the Auction Settlement and Restructuring Supplement to the 2003® ISDA Credit Derivatives Definitions (8-508-0969)).

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:

- 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 no extended 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 ON iHEART

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

- 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 can 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 has important implications for the CDS market and other permutations of unconventional credit events. 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.

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 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 world of unconventional CDS, credit events may also encourage market participants that 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.

Despite 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 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, clarifying 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 illustrates the velocity of new concepts in the CDS market, particularly with respect to unconventional 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.

THE HOVNANIAN ENTERPRISES RESTRUCTURING

Hovnanian is a large construction firm that builds and sells residential properties. On February 1, 2018, Hovnanian closed a series of transactions (collectively, the exchange offer) to restructure and refinance some of its debt that was to mature in 2019, with significant financing provided by GSO Capital Partners L.P. (GSO). One component of these transactions involved the tender of $170 million of Hovnanian's 8% senior notes due November 2019 (the 2019 Notes) in exchange for $155 million in cash, $90.6 million of new 13.5% unsecured notes due 2026 (the New 2026 Notes), and $90.1 million of new 5% unsecured notes due 2040 (the New 2040 Notes).

In addition, GSO agreed to provide Hovnanian a 5% term loan in the amount of $132.5 million maturing in 2027 (with an additional $80 million available as a delayed draw) to refinance certain other debt, and a $125 million revolving facility available to refinance Hovnanian's existing $75 million secured term loan and for general corporate purposes.

As part of the exchange offer, Hovnanian subsidiary K. Hovnanian at Sunrise Trail III (Sunrise) agreed to purchase and maintain outstanding $26 million of the 2019 Notes tendered in the proposed exchange.

An intentional trigger of a failure-to-pay credit event was built into the indentures for the New 2026 Notes and the New 2040 Notes, which prohibited Hovnanian from making the interest payment due on the 2019 Notes held by Sunrise on the following interest payment date in May 2018. A default on the May 2018 interest payment under the 2019 Notes in the amount of $1.04 million could have resulted in a failure-to-pay credit event determination by the ISDA® Credit Derivatives Determinations Committee (ISDA DC) This would have entitled CDS protection buyers to receive credit protection payments under their Hovnanian CDS contracts. However, following a settlement between CDS market participants, no such determination was made.

COMPARISON TO CODERE AND iHEART

The Hovnanian restructuring incorporated elements of both Codere and iHeart. The transaction was analogous to Codere because Hovnanian's agreement to default under the 2019 Notes held by Sunrise was apparently designed, in part, to draw value from the CDS market that would have been used, indirectly, to provide value to Hovnanian through favorable financing terms obtained from GSO. As in iHeart, the interest payment that would have been missed was not on an obligation owed to third-party investors, but rather to an affiliate of the reference entity.

However, unlike both Codere and, to a certain extent, iHeart, Hovnanian was not a distressed entity, considering the prices of its publicly traded debt obligations. However, Hovnanian had made clear that it faced a significant and relatively urgent need to refinance the 2019 Notes, and, due to certain restrictions in its other debt obligations, was unable to fund the refinancing with otherwise available cash. To obtain financing at more favorable rates than would typically have been available to it in the market, Hovnanian therefore turned to a more complex refinancing strategy with GSO, central to which was the triggering of a CDS credit event.

The Hovnanian restructuring also injected an entirely new component with the issuance of the New 2040 Notes. These notes provide long-term flexibility to Hovnanian, among other benefits. With a relatively low 5% rate of interest and extended maturity, the New 2040 Notes became the obligation in Hovnanian's capital structure trading at the lowest level and payments on the CDS contracts would therefore have been expected to be based primarily on the trading price of the New 2040 Notes.

The trading price of the New 2040 Notes at the time of the occurrence of the planned credit event would likely have had the effect of increasing the return to CDS protection buyers on their CDS contracts, generating value for GSO through its CDS positions. Some of the value received by GSO would then have been passed on to Hovnanian in the form of the favorable financing terms it receives from GSO.

GSO ultimately settled with CDS protection sellers (including Solus) and agreed to permit Hovnanian to make the payment on its remaining 2019 notes, presumably in exchange for a payment from CDS protection sellers.

THE SOLUS ACTION

As with any bilateral market, the economic benefit this transaction presented for Hovnanian and, presumably, GSO created a converse loss for CDS protection sellers. One CDS protection seller, Solus Alternate Asset Management LP, filed a complaint against both GSO and Hovnanian in New York federal district court. The Solus complaint alleged that Solus would suffer monetary losses if the ISDA DC determined that a failure-to-pay credit event occurred following Hovnanian's planned May 2018 interest payment default under the 2019 Notes. Solus also suggested that the transaction could result in irreparable harm to the CDS market generally.

Solus initially sought an injunction against Hovnanian and GSO to block the exchange offer, but Judge Laura Taylor Swain of the federal district court for the Southern District of New York (SDNY) denied Solus' request (Solus Alt. Asset Mgmt. LP v. GSO Capital Partners L.P., No. 18 CV 232-LTS-BCM (SDNY January 29, 2018)), citing the availability to Solus of monetary damages and the ability of ISDA to craft solutions addressing problems in the CDS market generally. With the denial of the requested injunction, the Solus action transitioned to a traditional litigation proceeding. The complaint alleged a number of causes of action against GSO and Hovnanian, including market manipulation, disclosure, tortious interference.

The Solus Claims Against Hovnanian and GSO

Market Manipulation: Solus asserted that Hovnanian and GSO violated Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and related Rule 10b-5 by manipulating both the price of Solus' CDS contracts and of Hovnanian's outstanding bonds. Note that the single-name CDS at issue in this case are security-based swaps and therefore securities for purposes of the anti-fraud rules under the federal securities laws (see Practice Note, The Dodd-Frank Act: Application of US Securities Laws to Security-Based Swaps (6-532-2752)).

To establish market manipulation, Solus would have had to prove that GSO and Hovnanian engaged a fraudulent or deceptive course of conduct. Claims of market manipulation typically rest on the creation of a perception of market demand where none or a higher/lower level exists, or of pricing generated artificially by deceptive practices rather than free market forces. As such, this claim may have proven a challenge for Solus. The terms of the restructuring were disclosed, and their effects on the pricing for Hovnanian debt, and CDS contracts that reference the Hovnanian debt, were predicable based on the known features of those instruments.

Disclosure Claims: The Solus complaint made a further allegation under Section 10(b) and Rule 10b-5: that Hovnanian failed to properly disclose the CDS-related benefits of the exchange offer to GSO. As with its market manipulation claim, Solus encountered a relatively high bar. Even if Hovnanian had not expressly articulated the CDS-related rationale for the transaction, the market clearly understood them. With no harm and no undisclosed facts (as opposed to perceived motivations), it is difficult to see how this claim would have succeeded, other than perhaps to obtain some additional disclosures from the issuer.

Tortious Interference: Finally, Solus asserted a claim of tortious interference by Hovnanian and GSO with Solus' CDS contracts or (under Solus' amended complaint) its business relationships. Tortious interference has historically proven to be a difficult claim on which to succeed, as pursuing one's own economic interest is not tortious, notwithstanding that there may be an adverse consequential impact on contractual or business relationships of a third party. Particularly here, where the CDS contracts would have paid off only if the ISDA DC determined that a credit event had occurred in accordance with the terms of the contracts, it would seem difficult to establish that the defendants engaged in tortious conduct.

The settlement between GSO and CDS protection sellers also amounted to a settlement of the Solus litigation and these issues therefore remain undecided.

CDS MARKET INTEGRITY AFTER HOVNANIAN

In the newer model of CDS as opportunistic investment, CDS are used affirmatively as a source of capital for participating debtholders to supplement a refinancing package and thereby allow for more favorable terms to the issuer. Hovnanian is another link in the evolution of CDS contracts from a pure hedging or bespoke investment product to an opportunistic, standalone investment strategy.

This new restructuring technique, of course, rests on the backs of the CDS protections sellers like Solus, which has in effect argued that the proliferation of engineered failure-to-pay credit events risks damaging the CDS market to the point of collapse. In support of this, Solus' expert witness opined that CDS contracts become impossible to price where credit events can be engineered and that CDS contracts would cease to serve their beneficial risk-spreading function were engineered credit events permitted to persist. Solus argued further that this technique would ultimately result in the dissipation of liquidity in the CDS market. Solus further argued that ISDA, whose rules and procedures govern the CDS market, is not able to protect the markets against the adverse consequences of engineered credit events, as implied by its statement in relation to these events (see Unconventional Credit Events and Implications for the CDS Market). The SDNY court, at least on the motion for preliminary injunction, declined to enter this thicket.

ANALYZING THE SOLUS ARGUMENT: PRICING AND LIQUIDITY

GSO's expert argued against the Solus position. Engineered defaults, he observed, have been around for some time now – at least since Codere in 2013 – and they have not yet, and likely will not, threaten the viability of the CDS market. The reason is that the market is capable of embedding additional premium into pricing to reflect the risk of engineered, opportunistic credit events. Moreover, the enhanced risk-reward opportunities have attracted new participants that, to the contrary, have increased market depth.

Pricing

Pricing of a CDS contract reflects:

- The probability that a failure to pay will occur with respect to the reference entity, and
- The likely value of the CDS contract in the event a failure to pay does occur.

The probability-of-default calculation must now factor in the possibility that a reference entity will pursue a strategy involving an engineered default. Numerous factors enter into this assessment, including cross-default thresholds, acceleration terms, other provisions of the underlying debt, the financial condition of the reference entity, and its short- and long-term capital requirements, among others. According to the GSO expert, there appears no reason why the prospects for an engineered credit event cannot be modeled and priced. In addition, the highly specific fact pattern required to make a particular reference entity an attractive candidate for such strategies limits the universe of engineered credit events and can generally be identified through publicly available information.

Hovnanian introduced a new feature into the pricing calculus, which was absent in prior engineered credit events. Not only did Hovnanian commit to a failure to pay, it also agreed to issue a debt instrument that may trade below the market price for the issuer's existing debt obligations, and if so would therefore likely be the cheapest deliverable obligation for protection buyers to deliver upon the occurrence of a credit event. It would be this instrument that would primarily impact the payout under the CDS contracts in which Hovnanian was the reference entity, at levels that would likely be higher than they would have been absent this new obligation.

The risk to a CDS protection seller that a reference issuer might issue additional, lower priced obligations during the term of its CDS contract is not new. It is a risk that has been incorporated into the pricing for CDS contracts from the start. The risk is not unquantifiable, even with the advent of obligations specifically engineered to be the cheapest to deliver on the occurrence of a credit event.

To be viable, these engineered strategies require the auction at which the payout on the CDS contracts is established to land in a particular, and therefore somewhat predictable, range. CDS protection sellers therefore should be able to assess the risk of the Hovnanian strategy on a particular reference entity and price accordingly. As mentioned above, in many cases the availability of these strategies to a particular reference entity can be identified through diligence and, therefore, these risks can be assessed with some degree of accuracy.

Liquidity

GSO's expert also observed that CDS have evolved over the years from a pure hedging/default protection tool to an opportunity-seeking investment strategy. The influx of return-seeking market participants has deepened the CDS market and enhanced its liquidity. Multiplying the input variables for CDS contracts and increasing the uncertainty of outcomes should enhance the attractiveness of the CDS market to return-seeking investors.

The absence of market reaction to the Codere and iHeart cases appears to support this proposition. The CDS market to date has been undeterred by the engineered credit events showcased in iHeart and Codere. Hovnanian similarly appears to have had minimal impact on the CDS market, although the failure to pay did not actually occur and the analysis may change if a similar strategy giving rise to a failure-to-pay credit event does take place in the future.

THE CDS PROTECTION SELLER AND OPPORTUNISTIC CDS STRATEGIES

The CDS market has created a parallel source of financing for reference entities in which both CDS protection buyers and sellers can engage with reference entities, and offer economic incentives in exchange for cooperation that enhances their CDS positions. The restructuring option most readily available to CDS protection sellers is a migration of debt across a reference entity's affiliated group of companies, resulting in the creation of a succession event or a so-called orphan CDS.

This section addresses the basic principles of a succession event and orphan CDS strategies and also looks at two recent cases where those strategies may have played a role.

CDS PROTECTION SELLER STRATEGIES

Succession Event Strategy

In order to generate value for a CDS protection seller, all or some portion of the debt of the reference entity is assumed by one or more successor reference entities with a different credit profile. Under the ISDA 2014 Credit Derivatives Definitions (CDDs), a succession event would occur if at least 25% of the outstanding obligations at the existing reference entity are assumed by an affiliate. In circumstances where the related CDS contract then splits, creating two new CDS contracts with an equal portion of the notional amount allocated to each of the new CDS contracts: one with the initial reference entity as reference entity and one with the affiliate successor as reference entity (see infographic for a summary of post-succession event scenarios).

For the strategy to be effective, the successor(s) have to be more creditworthy, on a net basis, than the pre-succession reference entity. This would have the effect of narrowing the CDS spread in the aggregate for the CDS contract that references the successor entities.

Example: Long-dated unsecured debt trading significantly below par is transferred by a reference entity to an affiliate of the reference entity, leaving only secured debt trading around par at the reference entity. Assuming all the succession event requirements are satisfied, and both the initial reference entity and its affiliate are deemed successor reference entities, 50% of the notional amount of CDS protection would now reference an entity with only secured debt trading around par. Pre-succession, by comparison, 100% of the CDS protection referenced an entity with long-dated unsecured debt trading well below par. The spread on 50% of the CDS protection on the original reference entity should significantly narrow post-succession. If the spread on the CDS referencing the affiliate holding the unsecured debt does not drastically widen, the succession event would result in a substantial net gain for the CDS protection seller.

Orphan CDS Strategy

Another strategy for enhancing the position of CDS protection sellers is the creation of an orphan CDS. In this scenario, there is no succession event, but the debt of the reference entity is nonetheless eliminated. For example, an affiliate of a reference entity could issue debt with the proceeds provided to the reference entity. The reference entity would then use the proceeds to repay or otherwise retire its existing indebtedness.

In this scenario, the CDS protection seller is left with a CDS contract referencing an entity that cannot default (since it has no outstanding debt) or that is highly unlikely to default (if the amount of debt remaining at the reference entity were de minimis). As long as no additional debt is incurred by the reference entity, the CDS would remain an "orphan" – that is, a CDS written on a reference entity that has no (or de minimis) default risk. The protection seller would confidently collect its CDS premium from the protection buyer for the duration of the contract, with little or no risk of making a settlement payment. With the CDS spread substantially narrowing, the protection seller might also unwind its CDS position at a profit

These strategies, of course, require the cooperation of the reference entity. Particularly where a CDS protection seller has sold protection on a reference entity that has come under financial distress, a protection seller may be strongly motivated to offer economic incentives in exchange for cooperation in the creation of a favorable succession event or an orphan CDS. It may also be worthwhile for the protection seller to acquire a position in the debt of the reference entity, thereby affording it some input or influence over the restructuring process, where consent of its debtholders is required.

Cheapest-to-Deliver Obligations

One of the key components of the buy-side strategy in Hovnanian was the issuance of a low-coupon, long-dated note, potentially creating a cheapest-to-deliver debt security that would likely trade significantly below par. The result would be a CDS auction clearing well below par, and therefore a gain for CDS protection buyers (see The CDS Settlement Process for details on cheapest-to-deliver obligations).

CDS protection sellers can implement the same strategy in reverse, by providing financial incentives to induce the reference entity to retire its cheapest to-deliver debt. Even an issuer-repurchase program that may not wholly eliminate the cheapest-to-deliver debt could boost the value of the remaining outstanding debt, creating substantial gains for a protection seller.

Taking advantage of the features of the CDS contract in these ways enables CDS protection sellers to generate gains for their CDS positions. Such strategies could be observed in the early stages of both the McClatchy and Sears refinancings. Although these cases may or may not have been driven by CDS considerations, they illustrate how sell-side CDS strategies may be effectively implemented.

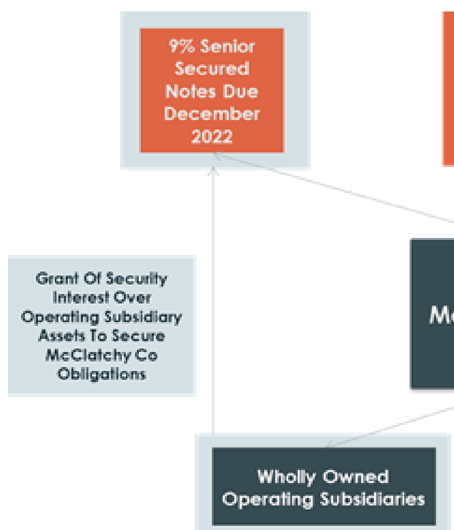
THE McCLATCHY REFINANCING

McClatchy Co. is a publisher of newspapers and online content and owns a number of widely distributed publications across the United States. Through Q1 2018, the company had approximately $800 million in debt outstanding and $1.5 billion in assets, a little under half of which was goodwill. McClatchy had been suffering losses for some time, and a sizable CDS market had developed on its name, reaching almost $500 million of net notional outstanding in March 2018.

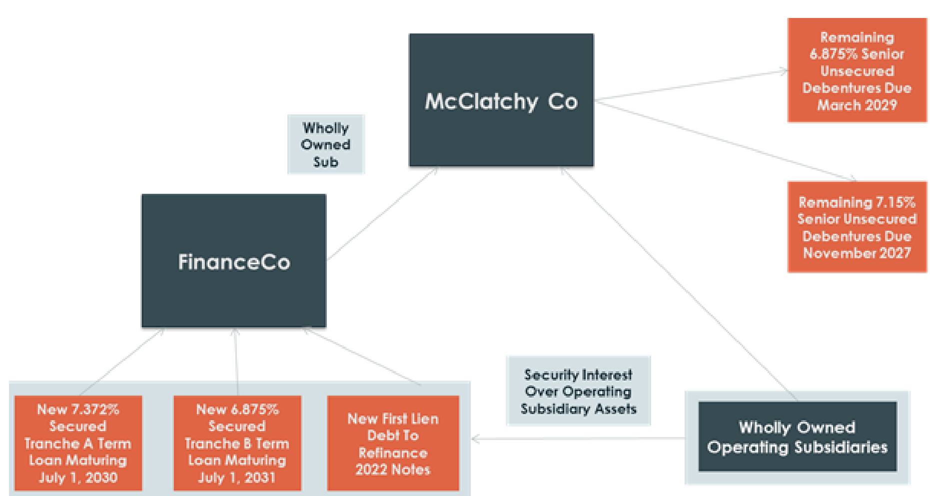
McClatchy's outstanding debt obligations at the time of the proposed restructuring consisted of $344 million of 9% secured notes due 2022 (2022 Notes), $89 million of 7.150% unsecured debentures due 2027 and $276 million of 6.875% unsecured debentures due 2029. The 2027 and 2029 debentures appeared to be held almost entirely by Chatham Asset Management, so McClatchy's CDS contracts were priced more in line with the 2022 Notes. Chatham also appeared to be a seller of CDS protection on McClatchy.

On April 26, 2018, McClatchy announced a refinancing sponsored by Chatham in which Chatham would provide McClatchy with $418.5 million in new secured term loans, on the condition that the new financing was incurred at a new entity (New FinanceCo), and the proceeds of the new term loans would be used to repurchase the 2027 and 2029 debentures held by Chatham. It was also announced that, as a condition to the term loan refinancing, the 2022 Notes would also be refinanced with the issuance by New FinanceCo of new first lien debt.

McClatchy Co. Pre-Refinancing:



McClatchy Co. Post-Refinancing:



Succession Events and Orphan CDS

As per the initial proposal, there would have been no succession event under the proposed McClatchy restructuring, because New FinanceCo would not have assumed debt issued by McClatchy or exchanged its debt for debt issued by McClatchy. Rather, the existing debt at McClatchy would have been repaid with the proceeds of the New FinanceCo debt. From a practical standpoint, the result would have been the same either way: The refinancing would leave the McClatchy parent company with substantially less debt. But from a CDS perspective, the difference is substantial:

- The risk of McClatchy defaulting on its own debt would have been materially reduced, seemingly resulting in the creation of an orphan CDS; and
- The CDS contracts on McClatchy could have become difficult to settle due to the relatively small amount of debt remaining at the reference entity.

As the market learned of the proposed refinancing, the CDS spread narrowed dramatically, quickly losing almost 70% of the value of protection. This indicated that the market had internalized the possibility of an orphan CDS.

Subordination and Deliverable Obligations

As disclosed in subsequent public filings, McClatchy altered the restructuring such that McClatchy would guarantee the debt issued by New FinanceCo, so the possibility of an orphan CDS was removed. Under the second proposed refinancing, McClatchy would guarantee both the New FinanceCo term loans and its new first lien debt, with the former being guaranteed on a subordinated basis.

Assuming the remaining debentures at McClatchy were ultimately retired, the subordinated guarantee may not have been considered a deliverable obligation for purposes of the settlement of the McClatchy CDS contract. However, the guarantee on a senior basis of the New FinanceCo first lien debt should be taken into account for settlement purposes, precluding the creation of an orphan CDS.

Despite the subsequent clarification of the structure of the McClatchy refinancing, the spread for the CDS contracts on McClatchy did not return to its prior levels. This may be a function of the market pricing in the subordination of the guarantee of the term loans, which may be fully disregarded for purposes of settling the CDS contracts. The only remaining deliverable obligation for CDS settlement purposes would have been the New FinanceCo guaranteed first lien debt.

In any event, as a result of the refinancing, Chatham would have had a more valuable book of CDS positions. It would have also enjoyed flexibility to sell out of the new term loans that it proposed to extend to McClatchy without negatively impacting the value of its CDS contracts. For McClatchy, the upside was the ability to slightly de-lever and push out maturities of key obligations by three years without significantly increasing its costs of funding.

It is unclear whether the McClatchy refinancing was designed to impact the CDS market, or whether the impact was an unintended collateral effect. Nonetheless, the interplay of the economics of the refinancing and its effect on the CDS market cannot be overlooked. With or without the orphan CDS, McClatchy would have received better-than-market refinancing terms in a transaction that seemingly resulted in a creditor realizing a significant windfall on CDS protection it has sold.

McClatchy and Chatham subsequently announced a third iteration of the refinancing transaction whereby McClatchy would issue the refinanced debt, rather than New FinanceCo. This revision eliminated the impact on CDS protection buyers and appears largely driven by CDS protection buyers committing to providing some of the refinancing.

THE SEARS REFINANCING

Sears has been in well-documented financial difficulty for some time. For the past several years, the CDS market has traded on the assumption that a default on Sears debt is almost inevitable.

On April 23, 2018, Sears announced a refinancing proposal from ESL Investments Inc. ESL has been involved with Sears for a number of years both as a significant and even controlling shareholder — it has two seats on the board, one of which is the Sears CEO — and as a creditor.

The proposed refinancing includes:

- A purchase of certain Sears real estate by ESL, and an assumption by ESL of approximately $1.2 billion of the debt secured by that real estate, with Sears continuing to operate its stores under a sale-leaseback arrangement with ESL.
- An exchange by ESL of $600 million second lien debt for equity in Sears.
- A purchase by ESL of the Kenmore brand and related business units for $500 million.

The proposal required that the proceeds of the refinancing be used by Sears to tender for certain long-dated unsecured bonds issued by its subsidiary, Sears Roebuck Acceptance Corp. (the reference entity for Sears CDS purposes), at a discount to par, reflecting then-current trading prices.

Bond Rally and CDS Spread

Following the announcement, Sears unsecured bonds traded up to around 70 cents on the dollar, approximately double the trading price for the bonds prior to the announcement. With the jump in bond prices came the narrowing of CDS spreads. From a CDS perspective, a Sears default appeared less likely in the short term, and the cheapest-to-deliver obligation traded at a far smaller discount to par.

In the short term, the proposal resulted in a significant price swing that favored CDS protection sellers with the retirement of the Sears unsecured bonds also presenting the opportunity to keep the market for Sears CDS, at least for some time, in a seller-friendly state.

As with McClatchy, the impact on the CDS market may not have been a motivating factor in the Sears refinancing. However, the Sears situation illustrates how a sponsor that is long on the reference entity via CDS protection may be incentivized to make certain arrangements with a reference entity that favor its CDS positions. CDS protection buyers should therefore be wary of reference entities in which investors both have substantial degrees of control or influence and have also sold significant CDS protection.

IMPLICATIONS OF CDS PROTECTION SELLER STRATEGIES

The McClatchy and Sears cases provide road maps for opportunistic strategies available to CDS protection sellers as a counterweight to the strategies available to CDS protection buyers. By moving the price of the cheapest-to-deliver obligation and driving the probability of default, both CDS protection buyers and sellers can generate substantial gains on their CDS investments, using a portion of the economic benefits to incentivize the cooperation of the reference entity.

One can envision a situation in which CDS protection buyers and sellers compete with CDS strategies on a reference entity, with the prevailing party being the one that can generate economics justifying the better financing package for the reference entity.

As discussed above regarding Hovnanian, questions have been raised regarding the viability of the CDS product if these opportunistic strategies proliferate. Both ISDA and the CFTC have stated that they were looking into such strategies and how they comport with existing rules and regulations (see Regulatory and Market Response to Unconventional CDS Credit Events). It remains unclear whether the market has an appetite for changes or, indeed, whether the regulators can get ahead of sophisticated market participants and their creative strategies without undermining the utility of the CDS markets they are trying to protect.

Also, the market has now likely come to the realization that CDS is not simply an arena reserved for parties hedging commercial relationships or taking passive investment exposure. It is clearly also frequented by investors actively using CDS as well as other investment products such as equity and debt securities to achieve specific outcomes with respect to their holdings in a particular reference entity. In that worldview, both regulators and participants may have to contend for the foreseeable future with the presence of peer activism in the CDS market.

REGULATORY AND MARKET RESPONSE TO UNCONVENTIONAL CDS CREDIT EVENTS

While there have been a few well-publicized engineered credit events, and others have been proposed, the actual number of cases in which engineered credit events have materialized have been relatively few and the universe of possible cases appears also limited.

Another reason for muted responses in the broader market may be that all instances of engineered credit events to date have involved entities under some degree of financial stress or distress. Codere's debt was trading at distressed levels in the secondary market, and, in the absence of the engineered failure-to-pay credit event, the company would likely have experienced near-term defaults. iHeart was highly leveraged, and its active pursuit of a restructuring, now in a bankruptcy context, indicates that its capital structure was unsustainable in the short-to-medium term. Similarly, Hovnanian was under financial pressure and at risk of a default absent a refinancing. The common thread in each of these situations is a credit event, albeit an unconventional one, driven by the ill health of the reference entity

The market appears willing to live with, and price in, the possibility of unconventional credit events for entities in financial distress, even where the debt markets have yet to fully reflect the difficulty.

The possibility exists that CDS protection buyers could seek to replicate their strategy with financially sound companies. That being said, the likelihood that a financially sound company would entertain such a strategy appears fairly low given that it would presumably have access to a number of less-complex financing alternatives not involving the relative uncertainty and the litigation, regulatory, and other risks implicated by unconventional credit events. Moreover, the ability to identify and create an obligation trading at a sufficient discount to par to make such a credit event strategy economically viable is more difficult with a financially sound reference entity, particularly given the maximum maturity limitations in the ISDA Credit Derivatives Definitions.

If the strategy is adopted by an entity not in need of a financial restructuring, this may put sufficient pressure on ISDA and the community of protection sellers generally for them to draw a line in the sand. Monetizing CDS in support of a restructuring may bend the rules of the CDS model, but at least it remains in the realm of financial reorganization. Monetization of a CDS contract through an engineered credit event without a capital structure under stress would cut CDS loose from its original moorings entirely. If such credit events were attempted, it is anyone's guess how the market would react, but a backlash could well reach Hovnanian-type deals as well.

ISDA and the CFTC have both weighed in and expressed their agreement with Solus' position, though no parties were mentioned in either statement.

On April 25, 2018, the CFTC issued a release stating that:

> "The CDS market functions based on the premise that firms referenced in CDS contracts seek to avoid defaults, and as a result, the instruments are priced based on the financial health of the reference entity. However, recent arrangements appear to involve intentional, or 'manufactured,' credit events that could call that premise into question. In a public statement dated 11 April, 2018, the International Swaps and Derivatives Association's (ISDA) board of directors criticised manufactured credit events, writing that they 'could negatively impact the efficiency, reliability, and fairness of the overall CDS market,' and ISDA's board indicated that it advised its staff 'to consult with market participants and advise the Board on whether … amendments to the ISDA Credit Derivatives Definitions should be considered' to address manufactured credit events.
>
> Manufactured credit events may constitute market manipulation and may severely damage the integrity of the CDS markets, including markets for CDS index products, and the financial industry's use of CDS valuations to assess the health of CDS reference entities. This would affect entities that the CFTC is responsible for overseeing, including dealers, traders, trading platforms, clearing houses, and market participants who rely on CDS to hedge risk. Market participants and their advisors are advised that in instances of manufactured credit events, the [CFTC] will carefully consider all available actions to help ensure market integrity and combat manipulation or fraud involving CDS, in coordination with our regulatory counterparts, when appropriate."

Given the settlement in Hovnanian, the attitude of the courts and regulators to the unconventional credit event strategy remains a grey area and is likely to remain that way until it is tested again.

While the ISDA initiative may bring market participants to the table, it remains to be seen if the ISDA Credit Derivatives Definitions can be effectively amended to prevent market participants from engineering unconventional credit events in the long term (see Suggested Amendments to Standard Terms of ISDA CDS Contracts). It is possible that a new CDS contract that incorporates amended definitions could bifurcate the liquidity in the CDS market into old (unamended) and new CDS contracts on the same reference entities.

The extension of engineered credit events to financially sound reference entities, if this were to happen, would undoubtedly apply even greater pressure on the CDS market. However, at least for now, engineered credit events are simply part of the market and, in the right circumstances, may be innovative source of refinancing capital.

While market participants are debating changes to the CDS contract with ISDA as part of ISDA's Credit Steering Committee, it is not clear that there is sufficient consensus on the horizon sufficient to drive ISDA to make such changes.

SUGGESTED AMENDMENTS TO STANDARD TERMS OF ISDA CDS CONTRACTS

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 (9-559-7165)).
- 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, Understanding 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) (1-580-3555)). This could be coupled with a 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 would 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 using 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 acting as 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.