A TANGLED WEB: CAN ARBITRATION BE THE ANSWER TO RESOLVING MANUFACTURED CREDIT EVENT DISPUTES?

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I. Introduction

Derivatives are financial contracts whose value is derived from, or reliant upon, another asset.[1] Perhaps the most popular derivatives for retail investors are stock options,[2] whose value is derived from the price of an underlying equity.[3] In recent years, financial institutions have developed several innovative derivative products. These products are typically born out of an unmet need in the financial marketplace. Credit derivatives, for example, were created in order to let financial clients mitigate credit risk.[4] A well-known type of credit derivative is the credit default swap ("CDS"), a privately held, negotiable bilateral contract that allows a lender to transfer the credit risk of a borrower to a third party.[5] Since the inception of the credit default swap in the early 1990's, its use and popularity has grown tremendously.[6] As of the second quarter of

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1 *Derivatives*, Off. Comptroller Currency, https://www.occ.treas.gov/topics/supervision-and-examination/capital-markets/financial-markets/derivatives/index-derivatives.html (last visited Feb. 26, 2020).

2 Dan Freed, *Retail Investors Flock to Derivatives for Income and Safety*, TheStreet (Oct. 30, 2014, 8:43 AM), https://www.thestreet.com/story/12933148/1/retail-investors-flock-to-derivatives-for-income-and-safety.html.

3 James Chen, *Equity Derivative*, Investopedia (Apr. 20, 2019), https://www.investopedia.com/terms/e/equity_derivative.asp.

4 James Chen, *Credit Derivative*, Investopedia (May 31, 2019), https://www.investopedia.com/terms/c/creditderivative.asp.

5 Justin Kuepper, *Credit Default Swap Definition*, Investopedia (Sept. 29, 2020), https://www.investopedia.com/terms/c/creditdefaultswap.asp.

6 Iñaki Aldasoro & Torsten Ehlers, *The Credit Default Swap Market: What a Difference a Decade Makes*, BIS Q. Rev. (June 5, 2018), https://www.bis.org/publ/qtrpdf/r_qt1806b.htm.

2019, the total gross national amount of outstanding CDSs was approximately $9.4 trillion.[7]

In recent years, companies have been increasingly forced into litigation by highly sophisticated investors who, incentivized by large profits tied to CDS positions, scrutinize a firm's credit documents, in order to force or "manufacture" a default or other credit event. In response to those credit events, many borrowers have had to file for bankruptcy.[8] Although bankruptcy reorganization can be an efficient process, achieving a mutually beneficial outcome for both debtors and creditors, it can often erode value through large payments to professionals such as bankers, lawyers, and consultants, as well as cause other negative externalities.[9]

Realizing that manufactured credit events have become a cause for concern, industry associations and finance lawyers have proposed various credit agreement amendments and clauses in an attempt to make it more difficult for CDS buyers to force an otherwise financially sound firm into bankruptcy.[10] Some commentators have suggested that these amendments and proposals still leave open many loopholes. To reduce the scrutiny and economic costs that manufactured credit events have been accused of producing, a mandatory arbitration clause in corporate credit documents should be utilized to promote an alternative dispute resolution mechanism in lieu of litigation.

Part II of this Note will examine the history and discuss the functionality of the global credit markets, credit default swaps, and manufactured credit events. It will also highlight several recent cases involving manufactured credit events. Part III will discuss the criticism surrounding manufactured credit events, provide current solutions, and outline the benefits and drawbacks of arbitration. Part IV will explore the possibility of using arbitration, in lieu of litigation, in cases involving manufactured credit events and will explore potential arbitration clauses and procedures that could instead be utilized.

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7 *Global Credit Default Swaps Market Study*, ISDA (Sept. 2019) https://www.isda.org/a/JUPTE/Global-CDS-Market-Study.pdf.

8 Mary Childs, *Windstream Blames Bankruptcy on Hedge Fund Aurelius and CDS Market*, BARRON'S (Feb. 26, 2019, 9:37 AM), https://www.barrons.com/articles/windstream-files-for-bankruptcy-calls-for-credit-default-swap-regulation-51551133206.

9 Efraim Benmelech et al., *The Agglomeration of Bankruptcy*, 32 REV. FIN. STUD. 2541, 2573 (2018).

10 *Indenture Restrictions Applicable to "Net Short" Investors and Related Provisions*, CAHILL GORDON & REINDEL LLP (Aug. 9, 2019), https://www.cahill.com/publications/firm-memoranda/2019-08-09-indenture-restrictions-applicable-to-net-short-investors-and-related-provisions.

II. Background

To analyze manufactured credit events, it is important to start with a high-level overview of both credit default swaps and the broader credit markets, in general.

A. *Function of Global Credit Markets*

Retail investors are often surprised to learn that the domestic debt market, which includes both bonds and loans, is larger than the domestic stock market.[11] Although bonds and loans are both forms of debt capital, they differ in several key respects.

Bonds are highly tradeable, unsecured loans that a bond purchaser, or "bondholder," conveys to the bond issuer.[12] The price of a bond reflects the value of the fixed-income stream that it pays to the bondholder and it is usually inversely related to interest rates.[13] In addition, the price of a debt instrument is typically correlated to the performance, or "credit risk," of the issuer, which is the risk of nonpayment of scheduled interest or principal payments.[14] As a company's business fundamentals weaken, the company's credit risk usually increases, and the market price of its debt falls.[15] For example, if a company announces that holiday sales of an important product have declined, its bonds could potentially fall in value, as debtholders will likely believe that the risk of the company going into financial distress has increased.

The main difference between a secured loan and an unsecured bond is that a secured loan is typically a senior secured obligation that has a lien on some form of collateral, such as the real or intellectual property of a company.[16] In addition, the periodic interest

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11 Steven Melendez, *Bond Market Size vs. Stock Market Size*, Zacks (Mar. 6, 2019), https://finance.zacks.com/bond-market-size-vs-stock-market-size-5863.html.

12 Christina Majaski, *Unsecured vs. Secured Debts: What's the Difference?*, Investopedia (Aug. 30, 2020), https://www.investopedia.com/ask/answers/110614/what-difference-between-secured-and-unsecured-debts.asp.

13 Nick K. Lioudis, *The Inverse Relationship Between Interest Rates and Bond Prices*, Investopedia (Oct. 8, 2020), https://www.investopedia.com/ask/answers/why-interest-rates-have-inverse-relationship-bond-prices/.

14 *Credit Concepts: Duration*, Cion Invs., https://www.cioninvestments.com/insights/credit-concepts-duration/ (last visited Oct. 28, 2019).

15 *Credit Investing: A Primer on Debt Investments*, Cion Invs., https://www.cioninvestments.com/insights/credit-investing-a-primer/ (last visited Oct. 28, 2019).

16 Majaski, *supra* note 12.

payments that loans pay may be determined by a floating, as opposed to fixed, interest rate that is set at some spread above a benchmark rate, such as the London Interbank Offering Rate ("LIBOR") or the Secured Overnight Financing Rate ("SOFR").[17] Loans are typically held on the original bank's balance sheet that extended the loan or syndicated to other large, sophisticated financial buyers. In contrast, bonds, if publicly registered, may usually be easily traded between retail investors.[18]

To protect against issuer-specific credit risk, credit derivatives provide lenders and other debtholders an insurance-like function, which is meant to offset any decreases in the value of their bond or loan holdings. There are various types of credit derivatives, but CDSs dominate the market and constitute the building blocks for most credit derivative structures.[19]

B. *Overview of Credit Default Swaps*

1. History

Credit default swaps were initially developed in order to fulfill an unmet need between a lending institution and its borrower client. In 1989, the *Exxon Valdez*, a large oil tanker traveling from Alaska to California, accidently struck a reef and spilled over ten million gallons of crude oil into Alaska's Prince William Sound.[20] Although no human lives were lost, the Valdez oil spill caused major environmental, economic, and wildlife damage to the local area.[21] As a result, the tanker's owner, Exxon, was forced to pay approximately $2 billion in cleanup costs and an additional $1.8 billion in habitat restoration and personal damages.[22] Exxon asked J.P. Morgan, its banker, for a multi-billion-dollar credit line so that it could cover any potential litigation costs arising from the tragic

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[17] Daniel Kurt, *Secured Overnight Financing Rate (SOFR)*, INVESTOPEDIA (Oct. 15, 2020), https://www.investopedia.com/secured-overnight-financing-rate-sofr-4683954.

[18] Katerina Simons, *Why Do Banks Syndicate Loans?*, NEW ENGLAND ECON. REV. 45, 45 (1993).

[19] Dominic O'Kane, *Credit Derivatives Explained*, LEHMAN BROS. (Mar. 2001), http://investinginbonds.com/assets/files/LehmanCredDerivs.pdf.

[20] *Exxon Valdez Oil Spill*, HIST. (Mar. 9, 2018), https://www.history.com/topics/1980s/exxon-valdez-oil-spill.

[21] Susan Lyon & Daniel J. Weiss, *Oil Spills by the Numbers*, CTR. FOR AM. PROGRESS (Apr. 30, 2010), https://www.americanprogress.org/issues/green/news/2010/04/30/7620/oil-spills-by-the-numbers.

[22] *Exxon Valdez Oil Spill*, *supra* note 20.

spill.[23] At the time, J.P. Morgan reluctantly turned down Exxon, a longstanding client, because of regulatory rules restricting how much credit risk J.P. Morgan could have on its own balance sheet.[24] In 1994, Blythe Masters, a member of J.P. Morgan's swaps team, developed the idea that J.P. Morgan could extend the loan to Exxon if it could simultaneously offload the credit risk to a third party.[25] That idea afforded protection to J.P. Morgan because if Exxon ever defaulted on the loan, the third party—and not J.P. Morgan—would be responsible for any losses. In return, the third party would receive a generous periodic fee or "premium" payment from J.P. Morgan for a set amount of time. In this way, J.P. Morgan had effectively insured against the credit risk of Exxon and the modern credit default swap was born.[26]

Throughout the 1990's and early 2000's, the market for CDSs expanded rapidly as banks took advantage of the opportunity to offload their credit risk and increase lending.[27] By 2007, the CDS market had ballooned to an estimated $57.8 trillion in gross value.[28]

CDSs also played a prominent role in the leadup to the 2008 global financial crisis. In the early 2000's, a strong economy, low interest rates, and the advent of mortgage-backed securities all contributed to a housing bubble in the United States. As the market for mortgage-backed securities continued to grow, investors increasingly began to seek out ways to insure against any potential losses.[29] Major insurance companies, such as American International Group ("AIG"), capitalized on this opportunity and sold billions of dollars' worth of CDSs to subprime mortgage lenders and investors.[30] As subprime mortgages related to credit default swaps

[23] Joe Romm, *JP Morgan Invented Credit-Default Swaps to Give Exxon Credit Line for Valdez Liability*, THINKPROGRESS (May 26, 2010, 1:04 PM), https://thinkprogress.org/jp-morgan-invented-credit-default-swaps-to-give-exxon-credit-line-for-valdez-liability-dfe0333d25c7/.

[24] *Id.*

[25] John Lanchester, *Outsmarted*, NEW YORKER (June 1, 2009), https://www.newyorker.com/magazine/2009/06/01/outsmarted.

[26] Jim Jelter, *Exxon Valdez and the Birth of Credit Default Swaps*, MARKETWATCH (May 3, 2010, 7:08 PM), https://www.marketwatch.com/story/exxon-valdez-and-the-birth-of-credit-default-swaps-2010-05-03.

[27] Nathaniel G. Dutt, Note, *Current United States Credit Default Swap Regulatory Initiatives: A New World Standard or Just a Ploy?*, 16 ILSA J. INT'L & COMP. L. 169, 174 (2009).

[28] *Id.*

[29] Kimberly Amadeo, *The Causes of the Subprime Mortgage Crisis*, BALANCE (Sept. 17, 2020), https://www.thebalance.com/what-caused-the-subprime-mortgage-crisis-3305696.

[30] Kimberly Amadeo, *AIG Bailout, Cost, Timeline, Bonuses, Causes, Effects*, BALANCE (Sept. 17, 2020), https://www.thebalance.com/aig-bailout-cost-timeline-bonuses-causes-effects-3305693.

began to go into default, investors started to demand their cash "insurance" payouts from AIG. AIG and other firms could not cover all of these payout requests and as a result, many investors and financial institutions suffered significant losses.[31]

Although the misuse of CDSs was a major catalyst in the 2008 global financial crisis and the market for CDSs has since shrunk dramatically, interest in the product remains strong as sophisticated parties continue to use them to successfully mitigate credit risk.[32]

2. Functionality

In order to understand how a CDS transaction works, a simple example follows: Imagine a fictitious company known as XYZ Corp. ("*XYZ*" or the "Reference Entity"). If *Investor B* owns a large position in *XYZ's* bonds due in 2025 ("Reference Asset"), then *Investor B* can also purchase specific CDS contracts that reference *XYZ's* 2025 bonds as a form of insurance to protect against any decrease in their value. *Investor B* is known as the "protection buyer" and will be compensated if *XYZ* triggers the CDS contract under a pre-determined "credit event."[33] Credit events can occur under various scenarios.[34] The three most common credit events are bankruptcies, payment defaults, and debt restructuring.[35] This hypothetical CDS transaction is known as a "covered" CDS transaction because the investor seeks to protect or cover his underlying debt investment.[36] This is akin to *Investor B* purchasing homeowner's insurance and being compensated if his own house is destroyed in a subsequent fire (credit event). On the other side of the CDS transaction is *Investor S*, the "protection seller," who wants to receive the periodic fees or premium payments from *Investor B*. Although these fees can provide a stable source of income, *Investor S*, like an insurance company, bears the risk that it will have to make a large one-time payment to *Investor B* if *f* does

31 Amadeo, *supra* note 29.

32 Patrick Augustin et al., *Credit Default Swaps: Past, Present, and Future*, 8 ANN. REV. FIN. ECON. 175 (2016).

33 *Id.*

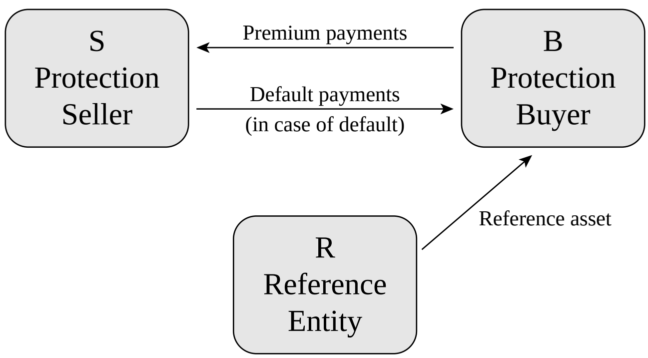
34 Carla Tardi, *Credit Event Definition*, INVESTOPEDIA (Aug. 5, 2020), https://www.investopedia.com/terms/credit-event.asp.

35 *Credit Event—Definition, Types of Credit Events, Examples*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/finance/credit-event/ (last visited Feb. 26, 2020).

36 Charles W. Murdock, *Credit Default Swaps: Dubious Instruments*, 3 HARV. BUS. L. REV. ONLINE 133, 136 (2013).

indeed trigger a credit event. In the case of a bankruptcy or financial restructuring, this one-time payment could be very large.

FIGURE 1: DIAGRAM OF A TYPICAL CDS TRANSACTION[37]



CDSs were initially developed as hedging products for lenders to offset potential losses, such as in the aforementioned case of J.P. Morgan and Exxon.[38] Today, a CDS contract functions more like a type of tradeable insurance policy.[39] In addition to a potential one-time credit default payment, the price of a CDS contract can fluctuate similarly to the price of a stock or bond.[40] The price of a CDS contract, also known as the "CDS spread," is quoted as a percentage, which is related to the expense of insuring a certain debt obligation of a specific company.[41] For example, if a CDS spread was 4.00%, then it would cost approximately $4.00 per annum to insure against $100 of the reference asset.[42] As the credit risk of a company goes up, so does the company's related CDS spread. Most CDS contracts are in the $10 to $20 million dollar size range, contain maturities of between one and ten years, and are traded

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37 MICHAIL ANTHROPELOS, A SHORT INTRODUCTION TO CREDIT DEFAULT SWAPS 1 (2010).

38 Andrew Beattie, *Hedging Basics: What is a Hedge?*, INVESTOPEDIA (June 25, 2019), https://www.investopedia.com/articles/optioninvestor/07/hedging-intro.asp.

39 Zhongmin Luo, *An Application of Data Science and Mathematics in Finance*, DATA SCI. CENT. BLOG (Nov. 21, 2018), https://www.datasciencecentral.com/profiles/blogs/an-application-of-data-science-and-mathematics-in-finance.

40 *Credit Default Swaps*, CFA INST., https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/2020/credit-default-swaps (last visited Feb. 26, 2020).

41 *Id.*

42 *Id.*

over the counter (not on a major exchange) with little regulatory oversight.[43]

In addition to using CDS for hedging purposes, strategic parties have begun to purchase CDS contracts with little to no holdings in the reference entity's debt. This is known as a "naked" CDS transaction,[44] which is analogous to *Investor B* taking out homeowner's insurance on his neighbor's house and receiving compensation if the neighbor's house is destroyed in a subsequent fire (credit event).[45] In this "naked" CDS scenario, *Investor B* is not protecting against any potential personal loss, but speculating on the risk of a third party.[46] The ability to speculate on a third party's credit quality without having any economic interest in the reference entity has led certain investors incentivized to see, and sometimes even force, a company to default on its own debt obligations.[47] Adding to this incentive is the fact that, as long as there are willing CDS protection buyers and sellers in the market, the volume of CDS contracts can greatly outweigh the entire value of the underlying debt instrument.[48] For instance, if *XYZ* only had $100 million worth of 2025 bonds outstanding, investors could still theoretically purchase over $1 billion in CDS protection on those same bonds.

3. Current Oversight

The International Swaps and Derivatives Association ("ISDA") was created to address the challenges that the derivatives market posed to financial institutions.[49] It is a trade organization that is made up of over 875 members from over 68 countries.[50] The goal of ISDA is to help reduce counterparty risk and increase

[43] Justin Kuepper, *Credit Default Swap (CDS) Definition*, INVESTOPEDIA (Sept. 29, 2020), https://www.investopedia.com/terms/c/creditdefaultswap.asp.

[44] Sam Jones, *The Benefits of Naked CDS*, FIN. TIMES (Mar. 2, 2010), https://ftalphaville.ft.com/2010/03/02/161556/the-benefits-of-naked-cds/.

[45] R. Matthew Darst & Ehraz Refayet, *Credit Default Swaps and Debt Contracts: Spillovers and Extensive Default Premium Choice*, FED. RSRV. (Apr. 19, 2016), https://www.federalreserve.gov/econresdata/feds/2016/files/2016042pap.pdf.

[46] Dutt, *supra* note 27, at 184–85.

[47] Fabien Carruzzo et al., Note, *Opportunistic Credit Default Swap (CDS) Financing Strategies*, PRAC. L. (2018), https://www.kramerlevin.com/images/content/4/9/v2/49130/Opportunistic-Credit-Default-Swap-Strategies-w-014-1708.pdf.

[48] Murdock, *supra* note 36.

[49] Gordon Scott, *International Swaps and Derivatives Association (ISDA)*, INVESTOPEDIA (Aug. 27, 2019), https://www.investopedia.com/terms/i/isda.asp.

[50] *Id.*

transparency by providing some form of standardization and oversight.[51]

The main tool that ISDA uses in this regard is the ISDA Master Agreement ("Master Agreement").[52] The Master Agreement "delineates the obligations of parties, defines what constitutes a credit event, and details procedures for early termination and transfer of CDS contracts."[53] The agreement also specifies the governing law or jurisdiction, typically the United Kingdom, Japan or New York State, that will apply to a potential dispute between counterparties.[54] In addition, parties can modify the default provisions of the Master Agreement by inserting amendments through a "schedule" document.[55]

Assessing whether a default or credit event has occurred is not as straightforward as it seems and is the cause of aggressive litigation between CDS counterparties.[56] These disagreements compelled ISDA to establish a "Determinations Committee" to make binding decisions on whether a credit event has occurred.[57] Some say that ISDA, by using a textualist approach to its rules and regulations, has made its decisions with "little regard for the negative effects that arise from strict application."[58]

C. *Manufactured Credit Events*

In June of 2019, the heads of the Securities & Exchange Commission ("SEC"), Commodities Futures Trading Commission ("CFTC") and the UK's Financial Conduct Authority issued the following joint statement regarding manufactured credit events:

> The continued pursuit of various opportunistic strategies in the credit derivatives markets, including but not limited to those that have been referred to as "manufactured credit events," may

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51 *Id.*

52 James Chen, *ISDA Master Agreement*, INVESTOPEDIA (Apr. 10, 2020), https://www.investopedia.com/terms/i/isda-master-agreement.asp.

53 Gina-Gail S. Fletcher, *Engineered Credit Default Swaps: Innovative or Manipulative?*, 94 N.Y.U. L. REV. 1073, 1090 (2019).

54 *ISDA Publishes French and Irish Law Master Agreements*, ISDA (July 3, 2018), https://www.isda.org/2018/07/03/isda-publishes-french-and-irish-law-master-agreements/.

55 *Schedule to the ISDA 2002 Master Agreement*, ISDA, https://www.isda.org/book/schedule-to-the-2002-isda-master-agreement/ (last visited Feb. 26, 2020).

56 Solus Alternative Asset Mgmt. LP v. GSO Capital Partners L.P., 2018 WL 620490, at *1 (S.D.N.Y. Jan. 29, 2018).

57 Fletcher, *supra* note 53, at 1091.

58 *Id.*

> adversely affect the integrity, confidence and reputation of the credit derivatives markets, as well as markets more generally. These opportunistic strategies raise various issues under securities, derivatives, conduct and antifraud laws, as well as public policy concerns.[59]

A manufactured credit event occurs when a CDS protection buyer entices, persuades, or otherwise forces a company to default or trigger a credit event so that the investor will receive the large one-time credit default payment associated with their CDS.[60] According to the CFTC, there have been approximately fourteen manufactured credit events over the past 2.5 years.[61] Net short debt activism is the latest form of manufactured credit event strategy in which an investor simultaneously purchases a small bond or loan position in a reference company, establishes a large short position through CDS, and then uses the contractual rights associated with their bonds or loans to take legal action against the company.[62] Commentators have described net short debt activists as using their position to drive otherwise solvent companies into bankruptcy over minor technical defaults.[63]

1. Recent Examples of Manufactured Credit Events

Several recent examples of manufactured credit events illustrate how savvy investors have been able to persuade companies to take or be subject to certain corporate actions that are beneficial to the investor but may not be in the best long-term interests of the company.

Companies that fail to make interest payments on debt borrowings are typically in severe financial distress and could soon file for bankruptcy.[64] In the mid 2010's, homebuilders such as Hovnanian Enterprises ("Hovnanian") experienced declining sales as

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59 *Joint Statement on Opportunistic Strategies in the Credit Derivatives Market*, U.S. SEC. & EXCH. COMM'N (June 24, 2019), https://www.sec.gov/news/press-release/2019-106.

60 *Id.*

61 Mary Childs, *Why Hedge Funds Could Find it Harder to Push Companies into Default*, BARRON'S (Aug. 2, 2019, 2:44 PM), https://www.barrons.com/articles/hedge-funds-could-find-it-harder-to-push-companies-into-default-51564771477.

62 Joshua A. Feltman et al., *The Rise of the Net-Short Debt Activist*, HARVARD L. SCH. (Aug. 7, 2018), https://corpgov.law.harvard.edu/2018/08/07/the-rise-of-the-net-short-debt-activist/.

63 *Net Short Lender Disenfranchisement: Is the New Anti-CDS Vaccine Safe and Effective?*, MILBANK CLIENT ALERT (June 11, 2019), https://www.milbank.com/images/content/1/1/v2/116063/Client-Alert-6.11.19-Net-Short-Lender-Disenfranchisement.pdf.

64 Emma Orr, *PetroQuest Skips Interest Payment, Could Consider Bankruptcy*, BLOOMBERG (Sept. 2, 2016, 4:07 AM), https://www.bloombergquint.com/business/petroquest-skips-interest-payment-could-consider-bankruptcy.

the demand for new residential construction began to slow.[65] In 2018, with a large amount of debt about to mature, Hovnanian started to seek new sources of capital and began negotiating with GSO Capital Partners ("GSO"), the debt investing unit of Blackstone.[66] Before negotiating with Hovnanian, GSO purchased approximately $330 million in CDS that referenced the company's existing bonds.[67] After establishing this CDS position, GSO then approached Hovnanian and proposed a unique refinancing deal.[68] The GSO deal was attractive to Hovnanian in that it would help the company shore up its balance sheet; however, the deal was contingent upon Hovnanian skipping a small interest payment on a very specific bond that served as the reference asset for GSO's $330 million CDS position.[69] At the time, Hovnanian was not facing imminent bankruptcy and GSO's main objective in requiring Hovnanian to skip that interest payment was so that Hovnanian would trigger a credit event and GSO could profit off its related CDS position.[70] In bilateral markets such as the CDS market, any economic gain also results in a subsequent loss for a counterparty.[71] In the case of Hovnanian, Solus Alternative Asset Management ("Solus"), a New York hedge fund, had taken the other side of the transaction and had sold approximately $200 million in CDS contracts on Hovnanian as a protection seller. If Hovnanian were to accept GSO's deal and trigger a credit event by skipping a nominal interest payment, Solus would have been responsible for a very large one-time payment to GSO and other CDS protection buyers. Amid public outrage and a lawsuit filed by Solus that accused GSO of market manipulation, the refinancing deal was ultimately abandoned.[72]

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65 Fabien Carruzzo et al., *Unconventional CDS Credit Events: Hovnanian Enterprises*, KRAMER LEVIN NAFTALIS & FRANKEL LLP (Mar. 29, 2018), https://www.kramerlevin.com/en/perspectives-search/unconventional-cds-credit-events-hovnanian-enterprises.html#_ftn2.

66 *Id.*

67 Mary Childs, *Solus Made Money from that CDS Litigation*, BARRON'S (June 20, 2018), https://www.barrons.com/articles/solus-made-money-from-that-cds-litigation-1529514208.

68 *See* Solus Alt. Asset Mgmt. LP v. GSO Capital Partners L.P., 2018 WL 620490 (S.D.N.Y. Jan. 29, 2018).

69 Carruzzo et al., *supra* note 65.

70 Matt Levine, *Blackstone May Do its Cleverest CDS Trade Again*, BLOOMBERG (Nov. 17, 2017), https://www.bloomberg.com/opinion/articles/2017-11-17/blackstone-may-do-its-cleverest-cds-trade-again.

71 Carruzzo et al., *supra* note 65.

72 Andrew Scurria, *Blackstone Stands Down on Hovnanian Swaps Wager*, WALL ST. J. (May 30, 2018, 7:29 PM), https://www.wsj.com/articles/blackstone-stands-down-on-hovnanian-swaps-wager-1527722945.

Certain CDS transactions have even forced otherwise financially sound firms to file for bankruptcy. Windstream Communications ("Windstream") was a publicly traded network communications and cable operator based in Little Rock, Arkansas with approximately 14,000 employees.[73] In 2015, Windstream decided to spin-off certain copper wire and fiber optic cable assets into a separate, publicly traded company known as Uniti Group ("Uniti").[74] Concurrent with the spin-off, Windstream entered into a sale-leaseback agreement whereby Windstream agreed to lease from Uniti a number of the assets that it had previously owned.[75] Although the agreements governing certain Windstream's bonds included specific covenants restricting sale-leaseback transactions, many of Windstream's bondholders did not object to the transaction.[76] In 2017, two years after the successful Uniti spin-off, Aurelius Capital Management ("Aurelius"), a New York-based hedge fund founded by a former bankruptcy attorney, purchased Windstream bonds and began its own analysis.[77] It is widely believed that at the time of its Windstream bond investment, Aurelius had also purchased a large amount of CDS protection that would pay off if Windstream triggered a credit event.[78] Presumably incentivized by the large profits tied to a potential default payment, Aurelius subsequently revived the fact that the sale-leaseback covenant had been violated in order to assert that Windstream had indeed defaulted on its bonds over two years prior.[79] The Windstream case exemplifies how certain opportunistic investment strategies can result in negative repercussions for stakeholders beyond the sophisticated counterparties engaged in the CDS transaction.[80] Aurelius and Windstream eventually ended up in hostile litigation in order to determine whether there actually had been a credit default.[81]

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73 Mary Childs, *Windstream Dispute Highlights Aurelius' Role as a Hedge-Fund Debt Cop*, BARRON'S (Aug. 31, 2018, 5:23 PM), https://www.barrons.com/articles/windstream-dispute-highlights-aurelius-role-as-a-hedge-fund-debt-cop-1535750611.

74 Matt Levine, *Aurelius Wins Against Windstream*, BLOOMBERG (Feb. 19, 2019, 11:58 AM), https://www.bloomberg.com/opinion/articles/2019-02-19/aurelius-wins-against-windstream.

75 *Id.*

76 *Id.*

77 U.S. Bank Nat'l Ass'n v. Windstream Servs., LLC, 2019 WL 948120 (S.D.N.Y. Feb. 15, 2019).

78 Levine, *supra* note 74.

79 *Id.*

80 *Id.*

81 *Id.*

> The Windstream situation, regardless of how it is resolved, exemplifies the risks that net-short debt activism can pose to companies. Aurelius has publicly questioned Windstream's financial position and threatened Windstream with an outcome—defaults on its bond debt—that could cause significant damage to Windstream's other stakeholders, including other creditors, shareholders and employees. While short sellers in the equity markets might "talk down" a stock, they have no similar legal mechanism to inflict such wide-ranging harm on a target.[82]

In February of 2019, Judge Furman of the Southern District of New York ruled in favor of Aurelius and Windstream subsequently filed for bankruptcy protection.[83]

Another scenario has arisen in which bond or loan investors have attempted to block companies from engaging in friendly corporate actions under the premise that such action would decrease the value of their CDS positions. In the summer of 2019, United Kingdom-based travel firm Thomas Cook, which had been under enormous financial pressure, negotiated a restructuring and financing deal with the owner of ClubMed Resorts, Fosun International ("Fosun").[84] This rescue deal needed to be approved by Thomas Cook's debtholders who had also purchased large CDS positions in the company. Fearing that the rescue deal would not trigger a credit event, these CDS investors grouped together in order to block the Fosun deal.[85] With no Fosun-led rescue deal available, Thomas Cook ultimately entered into a liquidation proceeding.[86]

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82 Feltman et al., *supra* note 62.

83 *Windstream Holdings, Inc. Files for Voluntary Reorganization Under Chapter 11 of the U.S. Bankruptcy Code Following Judge Furman's Decision*, WINDSTREAM (Feb. 25, 2019), https://investor.windstream.com/news/news-details/2019/Windstream-Holdings-Inc-Files-for-Voluntary-Reorganization-Under-Chapter-11-of-the-US-Bankruptcy-Code-Following-Judge-Furmans-Decision/default.aspx.

84 *Thomas Cook to Sell Majority Stake to China's Fosun*, BBC (Aug. 28, 2019), https://www.bbc.com/news/business-49493876.

85 Katie Linsell, *Thomas Cook Rescue to be Challenged*, BLOOMBERG (Sept. 10, 2019, 7:15 AM), https://www.bloomberg.com/news/articles/2019-09-10/thomas-cook-rescue-under-challenge-from-hedge-funds-plan.

86 *Thomas Cook Enters Liquidation, Potentially Leaving Hundreds of Thousands Stranded on Holiday*, FR. 24 (Sept. 23, 2019, 11:05 AM), https://www.france24.com/en/20190923-united-kingdom-thomas-cook-group-travel-compulsory-liquidation-bankruptcy.

III. Discussion

Although the misuse of credit derivatives has certainly been associated with some noteworthy negative events such as the global financial crisis, many commentators have noted that credit derivatives such as CDS play an important role in the global financial system.[87] Proponents argue that the original function of CDS, the ability to successfully insure against credit risk, has increased overall lending to companies, municipalities and governments, which in turn has had a net positive impact on the economy.[88] On the other hand, skeptics have cited the outsized profit opportunities associated with specific financial derivatives such as CDS as indirectly leading to unnecessary bankruptcies, economic waste, and other negative consequences.[89] In order to balance the key advantages and disadvantages associated with these financial products, a neutral, fair, and informed dispute mechanism is needed.

A. *Manufactured Credit Event Criticism*

Market manipulation has been defined as "the interference with the free and fair operation of the market by engaging in transactions that create an artificial price."[90] Manufactured credit events have led observers to assert that certain CDS investors are "gaming the system to guarantee that they win."[91] In *Solus*, the plaintiff's main contention was that offering a below-market loan in exchange for Hovnanian triggering a credit event meant that GSO was technically engaging in market manipulation.[92] The plaintiff further testified that the CDS market "operates based on market participants' ability to accurately assess risk, which such

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87 Sean Campbell & Josh Gallin, *Risk Transfer Across Economic Sectors Using Credit Default Swaps*, Fed. Rsrv. (Sept. 3, 2014), https://www.federalreserve.gov/econresdata/notes/feds-notes/2014/risk-transfer-across-economic-sectors-using-credit-default-swaps-20140903.html.

88 *ISDA Publishes New Academic Paper on Single-Name CDS Market*, ISDA (Sept. 12, 2016), https://www.isda.org/2016/09/12/isda-publishes-new-academic-paper-on-single-name-cds-market/.

89 Floyd Norris, *Naked Truth on Default Swaps*, N.Y. Times (May 20, 2010), https://www.nytimes.com/2010/05/21/business/economy/21norris.html.

90 *What is Market Manipulation?*, Labaton Sucharow, https://www.secwhistlebloweradvocate.com/securities-laws/common-securities-violations/market-manipulation/ (last visited Oct. 28, 2019).

91 Fletcher, *supra* note 53.

92 *See* Solus Alt. Asset Mgmt. LP v. GSO Capital Partners L.P., 2018 WL 620490 (S.D.N.Y. Jan. 29, 2018).

participants do based on the working assumption that Reference Entities will endeavor to avoid default whenever possible to protect their reputations and their access to capital markets."[93] If net short investors can use legal action to guarantee that their CDS positions payout or a company can be incentivized to default on its own debt, then the ability for a counterparty to accurately assess credit risk could be diminished.[94]

If investors perceive manufactured credit events to be market manipulation, this could also decrease liquidity,[95] which would not only have repercussions for CDS counterparties, but also the wider credit markets utilizing CDS in an effort to offload credit risk.[96] Without the ability to offload credit risk, banks and other financial institutions would be reluctant to extend debt capital. This could possibly make borrowing more expensive for borrowers and deny financing to those who would have otherwise obtained it.

As was the case in both the Windstream and Thomas Cook examples, manufactured credit events can ultimately lead to an unnecessary bankruptcy. In a bankruptcy, a company can either be liquidated or restructured, and many employees may potentially lose their jobs.[97] "An unnecessary bankruptcy imposes deadweight losses on society as a whole"[98] and can result in a large amount of both direct and indirect costs. The direct costs of a bankruptcy include substantial fees that must be paid to professionals such as attorneys, bankers, and consultants.[99] Bankrupt firms typically employ these outside professionals in order to help them successfully restructure and reorganize the operations and capital structure of their company with a goal towards one day emerging from bankruptcy.[100] In addition, when a firm is in bankruptcy, a substantial amount of management's time and focus must be spent tending to

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93 *Id.*

94 Fletcher, *supra* note 53, at 1073.

95 *Id.* at 1113.

96 *Id.* at 1008, 1107.

97 Carron Armstrong, *What Happens When a Company Files Chapter 11 Bankruptcy?*, BALANCE CAREERS (Aug. 9, 2019), https://www.thebalancecareers.com/what-to-do-when-your-company-files-chapter-11-bankruptcy-316247.

98 Daniel Hemel, Comment, *Empty Creditors and Debt Exchanges*, 27 YALE J. ON REG. 159, 164 (2010).

99 *How Much Does A Chapter 11 Bankruptcy Cost? Why Is It So Expensive?*, AVVO, https://www.avvo.com/legal-guides/ugc/how-much-does-a-chapter-11-bankruptcy-cost-why-is-it-so-expensive (last visited Feb. 26, 2020).

100 Robert Shaftoe, *Role of Investment Banks in Corporate Restructuring*, AZCENTRAL, https://yourbusiness.azcentral.com/role-investment-banks-corporate-restructuring-27026.html (last visited Feb. 26, 2020).

bankruptcy-related matters instead of normal day-to-day business operations.[101] The distraction of having to oversee a bankruptcy proceeding can deprive certain business areas from much needed management attention and result in the deterioration of value.[102] There is also reputational risk associated with bankruptcy that could cause potential customers and clients to seek alternative vendors. For example, if there is discussion about a company filing for bankruptcy, some vendors, fearing non-payment, may actually impose higher costs and more restrictions on how they transact with the company.[103]

Bonds and loans are governed by contractual agreements (indentures or credit agreements) that set out the terms and other relevant information of the bond or loan.[104] Embedded in these documents is a list of covenants that may restrict certain actions of the company.[105] Covenants may vary but are often related to certain financial rules that a company must adhere to.[106] For example, a covenant can limit the total amount of debt that a company may issue, limit what corporate acquisitions may be made, or restrict dividend payouts.[107] Some argue that by allowing manufactured credit events to exist, investors are motivated to scrutinize debt documents, which benefits markets because it acts as a monitoring or policing mechanism by enforcing previously agreed upon covenants.[108] In addition, some argue that manufactured credit events should be allowed to occur because counterparties involved in CDS transactions are highly sophisticated investors who can price the risk associated with the potential for a forced default.[109]

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[101] Ben Branch, *The Costs of Bankruptcy: A Review*, 11 INT'L REV. OF FIN. ANALYSIS, 39, 43–44 (2002).

[102] *Id.*

[103] Catherine Curan, *Sparks Fly in Barneys Fire Sale: As Luxury Retailer Races to Find a Buyer, Vendors Fear Getting Left Behind*, CRAINS N.Y. BUS. (Oct. 7, 2019, 3:44 PM), https://www.crainsnewyork.com/retail-apparel/barneys-races-find-buyer-vendors-fear-getting-left-behind.

[104] Julia Kagan, *Credit Agreement*, INVESTOPEDIA (Oct. 21, 2019), https://www.investopedia.com/terms/c/creditagreement.asp.

[105] Adam Hayes, *Covenant*, INVESTOPEDIA (Feb. 10, 2020), https://www.investopedia.com/terms/c/covenant.asp.

[106] *Id.*

[107] *What are Debt Covenants*?, CORP. FIN. INST. https://corporatefinanceinstitute.com/resources/knowledge/finance/debt-covenants/ (last visited Feb. 26, 2020).

[108] Childs, *supra* note 73.

[109] Fletcher, *supra* note 53, at 1103–07.

B. *Current Solutions for Manufactured Credit Event Disputes*

In response to manufactured credit events, corporate issuers have recently sought to develop and insert contractual provisions into their debt documents to limit the abilities of potential net short debt investors.[110] However, as recently noted in the *New York Law Journal*, "provisions addressing these issues are far from uniform, are by no means widely accepted and are a work in process."[111]

1. Net Short Lender Provisions

A recent solution that has been introduced to the market is the net short lender provision.[112] This provision first attempts to identify which investors qualify as "net short" by describing a specific formula that must be applied in calculating an investor's long and short debt and credit derivative positions.[113] Then, the provision applies certain restrictions to net short lenders such as taking away their voting rights or blocking their submitted notices of default.[114] More onerous net short lender provisions have even included clauses that force a net short lender to transfer its long debt position to a third party.[115] In July of 2019, Avis Budget Car Rental ("Avis Budget") opted to include a net short lender provision in the bond indenture governing its 5.75% Senior Notes due in 2027.

> "Net Short" means, with respect to a Holder or beneficial owner, as of a date of determination, either (i) the value of its Short Derivative Instruments exceeds the sum of (x) the value of its Notes plus (y) the value of its Long Derivative Instruments as of such date of determination or (ii) it is reasonably expected that such would have been the case were a Failure to Pay or Bankruptcy Credit Event (each as defined in the 2014 ISDA Credit Derivatives Definitions) to have occurred with respect to

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110 *Indenture Restrictions Applicable to "Net Short" Investors and Related Provisions*, *supra* note 10.

111 Matthew Roose et al., *CDS 'Net Short' Holder Market Developments*, LAW.COM, https://www.law.com/newyorklawjournal/2019/09/20/cds-net-short-holder-market-developments/?slreturn=20200123135933 (last visited Feb. 26, 2020).

112 *Net Short Lender Disenfranchisement: Is the New Anti-CDS Vaccine Safe and Effective*, *supra* note 63.

113 *Id.*

114 *Id.*

115 *Id.*

> the Company or any Guarantor immediately prior to such date of determination.[116]

In the Default and Remedies clause of its bond indenture, Avis Budget further provides that any notice of default submitted to the company must be accompanied by a written certification that the debtholder does not qualify as net short.[117]

Although the net short lender provision is a positive development, it still leaves open many potential loopholes. First, creative net short lenders can possibly use separate subsidiaries and affiliates to hold their long and short positions in order to avoid the net short restriction without raising any red flags.[118] Second, the formulas used to calculate the defined "net short" amount could potentially be subject to dispute, as many investors (especially large financial institutions with multiple divisions) might have short debt positions that were entered into as a result of normal day-to-day activity or inadvertently acquired in the course of the purchase of a portfolio of debt instruments.[119] Finally, net short lender provisions, as in the case of Avis Budget, only seek to protect against potential notices of default and don't provide protections against other opportunistic CDS strategies such as blocking consensual restructurings, accepting rescue capital or merging with or selling to another company, in each case depriving the company an avenue to avoid filing for bankruptcy.

2. Default Statute of Limitations

Historically, under New York law,[120] the applicable statute of limitations for a notice of default has been six years.[121] In *Windstream*, the sale-leaseback transaction that Aurelius scrutinized occurred over two years prior to the litigation and was assumed to have been accepted by the company's bondholders.[122] To deter this type of behavior, credit agreement provisions have been

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116 Avis Budget Grp., Quarterly Report (Form 10-Q) (June 30, 2019).

117 *Id.*

118 *Credit Markets Seek to Limit the Influence of Net Short Lenders*, LOCKE LORD, https://www.lockelord.com/newsandevents/publications/2019/08/net-short-lenders (last visited Feb. 26, 2020).

119 Todd Koretzy, *Anti-Net Short Provisions in Syndicated Credit Facilities*, ALLEN & OVERY (Sept. 3, 2019), https://www.allenovery.com/en-gb/global/news-and-insights/publications/anti-net-short-provisions-in-syndicated-credit-facilities.

120 *See* N.Y. C.P.L.R. § 213 (2015).

121 *Indenture Restrictions Applicable to "Net Short" Investors and Related Provisions*, *supra* note 10.

122 U.S. Bank Nat'l Ass'n v. Windstream Servs., LLC, 2019 WL 948120 (S.D.N.Y. Feb. 15, 2019).

adopted by the market in order to limit the time in which a debtholder can assert a claim.[123] These provisions shorten the statute of limitations to approximately two years in order to deter potential activists from seeking strategic litigation opportunities.[124] A potential drawback of this provision is that two years may not be enough time for a good faith, neutral debtholder to assert a real, non-opportunistic default.[125] For instance, a good faith debtholder may only learn of a material breach of a certain covenant months after it was initially disclosed because it was buried in the footnotes of a company's required financial forms. If the statute of limitations were to be reduced to two years, then this hypothetical debtholder might not be able to appropriately assert a default.[126]

3. ISDA Amendments

In March 2019, ISDA published proposed amendments to its 2014 ISDA Credit Derivatives Definitions in order to address the issue of manufactured credit events.[127] The primary solution that ISDA proposed was to include a "credit deterioration" requirement under the definition of a failure to pay credit event. This proposed amendment was developed to deter net short activists by making sure that only actual financially distressed companies could trigger CDS contracts under a failure to pay credit event.[128] The ISDA Amendments, which have yet to be adopted, do not consider other opportunistic credit strategies such as those that were present in the Windstream and Thomas Cook cases. In the Windstream and Thomas Cook scenarios, the CDS trigger never involved a failure to pay credit event, but instead relied upon other actions, namely litigating a sale-leaseback transaction (Windstream) and blocking a consensual restructuring (Thomas Cook).

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123 *Indenture Restrictions Applicable to "Net Short" Investors and Related Provisions*, *supra* note 10.

124 *Id.*

125 *Id.*

126 *Id.*

127 Quinn et al., *May 2019: ISDA's Proposed Rules Aimed at Manufactured Defaults*, JD SUPRA (June 12, 2019), https://www.jdsupra.com/legalnews/may-2019-isda-s-proposed-rules-aimed-at-39033/.

128 *Id.*

C. *Opportunity for Arbitration in Manufactured Credit Event Disputes*

In May 2019, the former CEO of ISDA testified the following:

> ISDA mechanisms would be insufficient to confront the threat of cleverly engineered defaults because CDS market participants and the ISDA Determinations Committee require the certainty of a bright-line rule, and that prohibiting engineered defaults would require a subjective inquiry into a Reference Entity's intent when defaulting.[129]

As new mechanisms are being proposed to remove the threat of manufactured credit events, loopholes and workarounds are also being developed. The difficult task of balancing the benefits of CDS to provide greater liquidity and resilience to the credit markets, while at the same time reducing their negative consequences such as erosion of value, requires a neutral dispute resolution method.

In recent years, there has been a significant increase in the popularity of using arbitration as an effective tool in the financial sector.[130] Arbitration is "a method of dispute resolution by a privately-constituted tribunal typically made up of one or three arbitrators, which culminates in an arbitral award that binds the parties."[131] The fact that arbitration awards are binding on the parties means that arbitration, unlike mediation, can serve as a complete alternative to costly litigation.[132] Although arbitration costs can vary based on complexity, the main expenses are related to filing fees and the arbitrators' hourly fees.[133]

An arbitration procedure is usually agreed to by entering into a contract that contains an arbitration agreement.[134] Arbitration agreements can include few or many details relating to how the

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129 *See* Solus Alt. Asset Mgmt. LP v. GSO Capital Partners L.P., 2018 WL 620490 (S.D.N.Y. Jan. 29, 2018).

130 James Freeman, *ISDA Publishes a New Edition of its Arbitration Guide*, ALLEN & OVERY (Dec. 17, 2018), http://www.allenovery.com/publications/en-gb/Pages/ISDA-publishes-new-edition-of-arbitration-guide.aspx.

131 *2013 ISDA Arbitration Guide*, ISDA (2013), https://www.isda.org/a/6JDDE/isda-arbitration-guide-final-09-09-13.pdf.

132 *Id.*

133 Jean Murray, *Learn How the Arbitration Process Works*, BALANCE SMALL BUS. (Dec. 10, 2019), https://www.thebalancesmb.com/what-is-the-arbitration-process-how-does-arbitration-work-397420.

134 *Id.*

signed parties agree to arbitrate, instead of litigating, specific disputes in the future.[135]

1. Benefits of Arbitration

There are many benefits to having borrowers and CDS market participants use arbitration instead of litigation in order to resolve disputes. For one, the arbitration agreement could specify a neutral forum in which both sides agree to arbitrate their matter, thus removing certain concerns that the parties may have of jurisdiction related bias.[136] In addition, the fact that arbitration allows the existence and details of the dispute to remain confidential is attractive to a variety of investors who do not want their reputation publicly harmed or the markets to be influenced by papers filed with a court.[137] Another important benefit that arbitration can provide is the ability of arbitration agreements to specify that arbitrators be experts in a certain field, a very integral aspect to resolving disputes as complex as manufactured credit events. Perhaps the greatest benefit of having mandatory arbitration in manufactured credit event disputes is its ability to provide a standardized dispute resolution mechanism. As addressed prior, if investors lose faith in credit derivatives by believing that some players "game the market," then demand for CDSs will fall and the wider credit markets could suffer. Standardization, by raising investor confidence, could allow markets to continue to benefit from the many positive aspects of credit derivatives, while also increasing efficiency and reducing transaction costs.[138]

2. Potential Drawbacks of Arbitration

Although arbitration in complex credit derivative disputes is a possible solution, there are several drawbacks that need mentioning. For one, arbitration typically lacks a comprehensive discovery process and relies on the experience of the arbitrators to provide

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135 Katie Shonk, *What is an Arbitration Agreement?*, HARVARD L. SCH., https://www.pon.harvard.edu/daily/conflict-resolution/what-is-an-arbitration-agreement/.

136 Bahar Hatami Alamdari, *The Emerging Popularity of International Arbitration in the Banking and Financial Sector—Is This a Fashionable Trend or a Viable Replacement?*, UNIV. LONDON (Apr. 27, 2016), https://sas-space.sas.ac.uk/6401/1/Hatami%20Alamdari%2C%20Bahar.pdf.

137 *Litigation or Arbitration: How Best to Resolve Cross-Border Disputes in the Financial Sector?*, LATHAM & WATKINS (July 8, 2013), https://www.lw.com/thoughtLeadership/LW-arbitration-primer-financial-sector.

138 Enzo Scannella, *Transaction Costs, Standardization and Modularity in Credit Risk Transfer Market*, 1 INT'L. J. ECON. & BUS. MODELING 21, 25–28 (2010).

guidance on streamlined procedures.[139] In addition, arbitration typically disfavors summary judgment or summary disposition even when there are only legal and not any material facts in dispute.[140] Finally, the inability to appeal (except in cases of proven arbitrator bias) has sometimes turned parties away from choosing arbitration as the preferred method to resolve their disputes.[141]

IV. Proposal

The various proposals and amendments that have been introduced in order to combat the negative consequences of certain opportunistic CDS strategies often utilize bright-line rules in order to deal with one aspect of a manufactured credit event, while failing to consider other consequences. In addition, "preventing all future loophole-exploitation" is nearly impossible as sophisticated investors will create new and innovative ways in order to profit.[142]

Incorporating a standardized mandatory arbitration clause in corporate debt documents that is applicable to a wide net of debtholders could reduce value erosion and negative externalities, provide a mutually beneficial solution for all parties, and abolish the need for a subjective inquiry into a reference entity's intent when defaulting.

A. *Mandatory Arbitration Clause in Credit Documents*

In recent years, an increasing number of parties have turned to arbitration, instead of litigation, to resolve disputes related to complex financial transactions.[143] In 2013, ISDA published its original arbitration guide that set forth guidance on how parties to a derivatives contract could structure arbitration provisions.[144] The model

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139 Jean Murray, *The Benefits and Drawbacks of Arbitration*, Balance Small Bus. (July 22, 2019), https://www.thebalancesmb.com/what-are-the-benefits-and-drawbacks-of-arbitration-398535.

140 *Summary Judgment*, Legal Info. Inst., https://www.law.cornell.edu/wex/summary_judgment (last visited Feb. 20, 2020).

141 Murray, *supra* note 139.

142 Childs, *supra* note 61.

143 Scannella, *supra* note 138.

144 *Developments in Financial Services Arbitration: Revision of the ISDA Arbitration Guide*, Hogan Lovells (Dec. 18, 2018), https://www.hoganlovells.com/~/media/hogan-lovells/pdf/2018/2018_12_18_developments_in_financial_services_arbitration.pdf

clauses included in this arbitration guide relate to jurisdiction and governing law.[145] Although the ISDA Master Agreement helps protect buyers and sellers structure how they will resolve disputes related to their trade, it does little to protect the Reference Entity from net short debt activists. In 2012, the Panel of Recognized International Market Experts ("P.R.I.M.E.") was launched "to help resolve, and assist judicial systems in the resolution of disputes concerning complex financial products."[146] P.R.I.M.E. offers dispute resolution services, including arbitration, through a network of the world's most renowned financial markets experts.[147] There are several key advantages to utilizing P.R.I.M.E. in a manufactured credit event dispute. The panel of experts that P.R.I.M.E. can provide is extremely impressive and includes notable academics, lawyers, and even financial market experts such as Blythe Masters, the original developer of the credit default swap.[148] Another advantage of the P.R.I.M.E. Finance Rules is that the "arbitral tribunal may, at the request of a party, grant interim measures if it finds that it has *prima facie* jurisdiction to decide the claim."[149] This would be incredibly beneficial for reference companies as it gives them the ability to ask the arbitral tribunal for interim measures such as injunctions in order to delay opportunistic CDS investors from forcing an unnecessary bankruptcy.

B. *Placement of Arbitration Clause*

For arbitration procedures to be binding between reference entities and net short debt activists, the arbitration clause should be placed in the contract or document that would apply to the widest range of potential opportunistic credit investors. For many companies, this would be the indenture governing its bonds or credit agreement related to its loans.[150] As with the net short lender pro-

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145 2013 ISDA Arbitration Guide, *supra* note 131.

146 *See About us*, P.R.I.M.E. FIN., https://primefinancedisputes.org/page/about-us (last visited Feb. 20, 2020).

147 *Id.*

148 *See Expert Resume of Blythe Masters*, P.R.I.M.E. FIN., https://primefinancedisputes.org/expert/blythe-masters (last visited Feb. 20, 2020).

149 Daniella Strik, *Launch of P.R.I.M.E. Finance Arbitration Rules: Dispute Resolution in Global Financial Markets*, KLUWER ARB. BLOG (Jan. 17, 2012), http://arbitrationblog.kluwerarbitration.com/2012/01/17/launch-of-p-r-i-m-e-finance-arbitration-rules-dispute-resolution-in-global-financial-markets/.

150 James Chen, *Indenture*, INVESTOPEDIA (Mar. 4, 2020), https://www.investopedia.com/terms/i/indenture.asp.

vision, a mandatory arbitration clause could also successfully be inserted into a corporate credit agreement or bond indenture. As net short activists are utilizing the rights associated with their nominal long debt positions to assert defaults and other credit events, their actions are governed by the language in the underlying bond indenture or credit agreement.[151] This mandatory arbitration clause would include the essential details of arbitration such as parties' consent, scope of arbitration and the finality of the arbitration award.[152]

C. *Arbitration Clause Example*

In order to increase market acceptance and decrease the risk of debtholders pushing back against the provision for being too onerous, the mandatory arbitration clause could be specifically tailored to apply only to disputes related to manufactured credit events. For instance, "Credit Event Dispute" could be a defined term in the credit agreement that only covers disputes relating to manufactured credit events. This would leave other disputes between the borrower and lender unaffected by the arbitration clause.

FIGURE 2: HYPOTHETICAL ARBITRATION CLAUSE

Section 1.1 Arbitration

(a) Any dispute, controversy or claim arising out of or relating to this contract, or the breach, termination or invalidity thereof ("Credit Event Dispute"), shall be resolved by arbitration administered by the Panel of Recognised International Market Experts (together with its successors and assigns, "P.R.I.M.E.") in accordance with the P.R.I.M.E. Finance Arbitration Rules ("Arbitration Rules"). For the purposes of this arbitration provision only, the term "parties" shall include any parent corporation, subsidiary or affiliate of the Bank involved in the servicing, management or administration of any obligation described or evidenced by this Agreement in addition to any subsequent purchasers of any obligation described or evidenced by this Agreement.

151 *Id.*

152 Alamdari, *supra* note 136.

(b) At the request of any party to this Agreement, any Claim shall be resolved by binding arbitration in accordance with the Federal Arbitration Act (Title 9, U.S. Code) (the "Arbitration Act"). The Arbitration Act will apply even though this Loan Agreement provides that it is governed by the law of a specified state. The arbitration will take place on an individual basis without resort to any form of class action.

(c) Arbitration proceedings will be determined in accordance with the Arbitration Act, the then-current rules and procedures for P.R.I.M.E. and the terms of this Section. In the event of any inconsistency, the terms of this paragraph shall control. If P.R.I.M.E. is unwilling or unable to (i) serve as the provider of arbitration or (ii) enforce any provision of this arbitration clause, any party to this Agreement may substitute another arbitration organization with similar procedures to serve as the provider of arbitration.

(d) The arbitration shall be administered by P.R.I.M.E. and conducted in English in New York, New York. All Claims shall be decided by a majority decision of three arbitrators and these arbitrators shall be selected from P.R.I.M.E. Finance's list of approved arbitrators. Each party shall appoint one arbitrator from P.R.I.M.E. Finance's list of approved arbitrators, and the third arbitrator who shall be the Chairman shall be selected in line with article 9(1) of the P.R.I.M.E. Finance Arbitration Rules. All arbitration hearings shall commence within ninety (90) days of the demand for arbitration and close within ninety (90) days of commencement and the award of the arbitrator(s) shall be issued within thirty (30) days of the close of the hearing.

(e) Where necessary, the Secretary-General of the Permanent Court of Arbitration shall act as the appointing authority and shall appoint from P.R.I.M.E. Finance's list of approved arbitrators, to which list the parties herewith agree as the basis for the appointment of the arbitrators.

(f) Any final decision of the arbitral panel may be enforced by any court of competent jurisdiction.

(g) Except as may be required by law, neither a party nor the arbitrators may disclose the existence, content, or results of any arbitration hereunder without the prior written consent of the parties hereto. The expenses of the arbitration shall be borne proportionately by the parties hereto, provided that each party shall pay for and bear the cost of its own experts, gathering of evidence and counsel's fees, except that in the discretion of the

> arbitrators, any award may include the cost of the party's counsel fees if the arbitrators expressly determine that the party against whom such award is entered has caused the dispute, controversy or claim to be submitted to arbitration as a dilatory tactic or that such matter is frivolous. The arbitrators shall have the authority to grant any interim or emergency relief, including an injunction, if necessary to preserve the status quo or avoid irreparable injury.

D. *Hypothetical Arbitration Procedure*

It is important to understand how an arbitration procedure could potentially work in a manufactured credit event dispute. In a hypothetical scenario, if a Reference Entity believes that a debtholder is utilizing its contractual debt rights to trigger a much larger credit derivatives payout, the Reference Entity will be able to demand that the dispute be referred to arbitration by providing a notice to P.R.I.M.E.[153] This notice will identify the parties, claims, relief or remedy sought, in addition to other relevant information.[154] After demanding arbitration, the dispute can move forward and into arbitration proceedings which will be governed by the P.R.I.M.E. Finance Rules.[155] The P.R.I.M.E. Finance Rules contain procedural information, including the arbitrators' selection process, the timing of the arbitration, the rules of evidence and the types of experts that can be utilized.[156] In a hypothetical case where an opportunistic debtholder is utilizing a small technical default to push a reference entity into bankruptcy, the arbitration panel may ultimately decide that a one-time cash settlement may be a better option. This cash settlement, even if large, would save the company from all of the negative consequences of engaging in protracted litigation and possibly filing for bankruptcy.

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153 *P.R.I.M.E. Finance Arbitration and Mediation Rules*, P.R.I.M.E. FIN. 21 (Feb. 26. 2016), https://primefinancedisputes.org/files/2017-01/prime-arbitration-and-mediation-rules-v1801171c.pdf.

154 *Id.* at 22.

155 *Id.* at 33.

156 *Id.* at 26, 33, 46.

V. Conclusion

The introduction of new financial products has brought with it several investors who continuously seek clever ways to profit from them. Sometimes these products may have—whether benignly intended or not—unfair and inappropriate adverse consequences on the company's other creditors, employees, shareholders, and other stakeholders, as well as yielding negative effects on our economy and society. In order to mitigate or avoid the negative consequences that these transactions can cause, an effective alternative dispute resolution mechanism is needed. Although more research into this topic is warranted, mandatory arbitration agreements, inserted into corporate debt documents, could potentially be a step in the right direction.