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Derivative Securities In the Credit Crisis

Is all fair without market value?

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RECENT MONTHS have seen a wave of litigation spawned by the so-called “credit crisis.” Actions between financial institutions regarding the “failure” of transactions involving derivative securities, such as credit

default swaps or mortgage-backed securities, are of particular note and the focus of this writing.¹

At the core of some of the more interesting lawsuits is a default declaration of some sort, which generally stems from an assertion that the value of the security at issue has declined to or below a point that triggers margin obligations or early termination rights. Complaints have begun to invoke a variety of theories for recovery or relief. Generally, parties seeking to avoid enforcement of the instruments have struggled to find viable legal theories other than claims of fact-specific “fraud-in-the-inducement.” Other theories may be available, and it will be important to watch the lawsuits as they move forward in the next few months.

Many core legal principles about valuation flow from an assumption that the price of a security reflects its fair market value. There is an assumption—or at least a presumption—that the capital markets are efficient and that the observed price of a security reflects all publicly available information. For example, the fraud-on-the-market doctrine absolves individual investors bringing a 10b-5 claim from having to prove personal reliance on specific, allegedly false statements in purchase or sale decisions, thereby paving the way for class action adjudication of such disputes. See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). Damages analyses

in securities litigation similarly proceed from the view that price reactions upon a news announcement reflect the “value” of that announcement.

Over-the-counter (OTC) derivatives are generally not traded on a public exchange, but are instead creatures of private contract. In contrast to an exchange-traded stock, the value of an OTC derivative contract cannot be determined by reference to a closing price on an exchange. Indeed, OTC derivatives may not trade at all after their initial creation. How then should such instruments be valued in the litigation context? Is “mark to market” valuation legitimate in the context of a liquidity crisis such as the markets recently witnessed? What legal principles govern whether it is appropriate to use such valuations to determine the propriety of a margin call, the magnitude of margin owed, or appropriate termination values?

Instruments

Preliminarily, it is useful to review the basic characteristics of these instruments in order to understand what impacts their value.

First, credit default swaps. A credit default swap (CDS) is a contract between two parties pursuant to which they trade the credit risk of a third. In its simplest structure, the buyer pays a premium to the seller in exchange for which the seller agrees to insure against the risk that a reference third party will default on its debt. A CDS can be used to reduce or hedge a party’s exposure to third-party corporate debt (i.e., by buying default insurance). CDSs can also be used by speculators to bet against the financial fortunes of the reference third party (i.e., by buying a CDS as a “naked” trade).² The CDS market, which is unregulated and largely lacking in transparency, was recently reported to be as large as \$62 trillion.³

Mortgage-backed securities (MBS) are multi-tranche securities collateralized by a pool of mortgages (or cash flows from those mortgages), including fixed rate mortgages, floating rate mortgages, conforming and nonconforming residential mortgages, commercial mortgages, mortgages on multifamily dwellings, and Alt-A and so-called subprime credit.⁴ The holder of an MBS is paid pursuant to a contractually specified waterfall. The risks associated with an MBS are myriad, including prepayment risk, interest rate risk,

duration risk, counterparty risk and complexity or structure risk. Because there is no active, transparent market for many kinds of MBS, valuation of those for which there is not a market indicator turns on the choice of a valuation model, the assumptions on which it is built and the data inputs used, all of which are subject to substantial question in times of market stress.

Trades between counterparties that involve CDSs and MBS are generally documented pursuant to the industry standard Master Agreement of the International Swaps and Derivatives Association (the “ISDA Master Agreement”) or the Master Repurchase Agreement of the Bond Market Association (the “Master Repurchase Agreement” and collectively with the ISDA Master Agreement, the “Master Agreements”).⁵

Litigation Exposure

Recent months have seen substantial hedge fund losses and in some cases hedge fund failures precipitated by counterparty margin calls on leveraged trades involving CDSs and MBS (or other asset-backed securities (ABS)).⁶ Most of the ensuing litigation has focused on fraud in the inducement or other common law theories aimed at unwinding or reforming the trades that precipitated the failure. While valid as abstract legal theories, such arguments will be hard to prove up as courts are generally loath to release parties from contracts. The argument of the complaining institution can almost always be characterized—whether fairly or not—as “sour grapes” over a trade that went against it. Every trade has a winner and loser and courts are not in the business of absolving trading counterparties of bad bets.

Framed in that manner—and it will almost always be possible to characterize the debate that way—such arguments seem unlikely to succeed. It is perhaps worth noting that the Master Agreements generally include jury trial waivers, but not arbitration provisions. “Jury risk” is thus typically not an issue in these cases.

It is equally unlikely, though, that litigation will come to a halt. What other arguments might be made? It is a virtual certainty that future litigation will surround the validity of margin calls on highly leveraged trades and resultant liquidations and close-out valuations. While the Master Agreements

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provide a mechanism for determining trade values in contested situations, they do not foreclose—and indeed may be characterized to permit—arguments relevant to the current circumstance. Specifically, the valuation provisions of the Master Agreements—whether Market Quotation, Loss or the newly adopted Close-out Amount provision—may be susceptible of an argument that they presuppose the existence of a market or at least readily observable inputs into a mark to model valuation.⁷

Some will argue that much of the recent “devaluation” in CDSs, MBS and other ABS stemmed from a decline in market liquidity rather than a change in their expected future cash flows, or what might be called, at least by some, “fundamental value” as might, for instance, be precipitated by a change in the yield curve.⁸ The market for these securities effectively dried up. With no market, many of these assets were valued and reflected as so-called Level 3 assets on the books of dealers,⁹ precisely because no actual trades were being done and the data inputs necessary to value them were not observable in a market.¹⁰

If a court were to find that the contractually specified valuation provisions are dependent upon the existence of a market—or at least the ability to observe the necessary data inputs in the market—it follows that many current mark to market valuations do not meet these requirements. Use of such valuations, one could then argue, is a breach of the governing contract.¹¹ It seems likely that courts would then require a commercially reasonable valuation, a contractual term that could exist either expressly or by implication. The amorphous nature of this concept could lead to litigation as debtors challenge actions on that ground alone.¹²

Conclusion

These uncertainties in valuation measurements are likely to lead to litigation challenging the validity of default declarations and margin calls (which are dependent upon legitimate, good faith valuations).¹³ If default declarations can be successfully challenged either under the express terms of the governing documents, or under more general standards of commercial reasonableness, it is likely that some challenges will also invoke common law doctrines of economic duress and other theories of lender liability in which one party to the trade alleges that its counterparty sought to create pressure that would allow it to buy assets at distressed prices. These tend to be difficult theories to prove, but if they survive summary judgment they will create risk for creditors.



1. See, e.g., Gretchen Morgenson, “First Comes the Swap. Then It’s the Knives,” N.Y. Times, June 1, 2008.

2. Buying CDSs for speculative purposes is an economic equivalent of shorting the corporate debt of the reference party. Operational issues often prevent the taking of such a direct short position.

Conversely, selling a CDS is the economic equivalent of taking a long position in the corporate debt of the reference party. While there are no operational constraints on such a long position, the size of the corporate debt market is limited in scope. In contrast, the size of the derivatives market is essentially unconstrained.

3. Gretchen Morgenson, “First Comes the Swap. Then It’s the Knives,” (reporting that the nominal value of swaps outstanding is now \$62 trillion). Given the size of the underlying debt market, it is reasonable to assume that a substantial amount

of that total is comprised of “naked” trades, rather than those purchased as insurance.

The collapse of Bear Stearns brought the risks and rewards of the CDS market into sharp focus. Market participants who purchased CDSs on Bear Stearns as a purely speculative position—i.e., a bet that Bear Stearns would default on its debt obligations—saw any mark to market gains on those positions wiped out when JPMorgan assumed the underlying debt obligations. The lack of transparency in the CDS market is such that one cannot know who took such positions and who took the other side, but it seems safe to assume that hedge funds or other investment vehicles had a substantial percentage of the Bear Stearns short bet, and dealer counterparties, perhaps even JPMorgan itself, had the other side of the trade. To the extent hedge funds reported net asset value (NAV) based on the CDS mark to market gains, which must later have been reversed, the potential exists for conflict. This is so because both investor redemption prices and manager fees are typically determined based on reported NAV, which current investors might argue was “inflated” based on mark to market pricing. See *In re Bayou Group, LLC*, 362 B.R. 624 (Bankr. SDNY 2007) (investor redemptions made prior to the revelation of fraud challenged as a fraudulent conveyance).

In the wake of Bear Stearns’ collapse, a group of dealers active in the CDS market are working with the Clearing Corporation based in Chicago to establish a central clearinghouse for CDSs. As reported, the participant banks would jointly bear any dealer counterparty risk. Thus, if one participant dealer were to fail, its obligations would be shared in some manner by the remaining dealers. (Presumably JPMorgan assumed Bear Stearns’ CDS liabilities in connection with its purchase of Bear Stearns’ assets, but absent such a transaction its CDS counterparties would have had little to show for the premiums paid.)

4. Where the collateral securing MBS is comprised of conforming, prime credit mortgages, it is typically guaranteed by a government-sponsored entity—Fannie Mae, Freddie Mac or Ginnie Mae—such that default risk has not historically been an issue. However, much of the MBS market is now comprised of underlying credit that is not accompanied by such guarantees (e.g., non-conforming mortgages, Alt-A and subprime credit). This so-called “private label” market raises a host of new risks and resultant valuation issues. The private institutions that securitized this paper—typically dealers or banks—generally sought to “overcollateralize” the senior tranches, the principal on which was then insured by “monoline” insurers that had historically confined their activities to the municipal bond market. These tranches often received AAA ratings, while providing a premium to other AAA paper. The default risk on the underlying collateral is thus more serious inasmuch as there is no government backstop. Additionally, the credit of the insurer itself comes into play. Moreover, recent market events demonstrate a need for any valuation model to account not only for borrower default risk, but also for a devaluation of the housing market itself.

Asset-backed securities (ABS) follow the same basic structure as MBS—and carry many of the same types of risk—but are backed by non-mortgage collateral, including student loans, credit card debt, car loans, home equity loans, corporate bonds or corporate loans. ABS may also be backed by levels of other ABS, each in turn dependent on an underlying pool of assets (or cash flows from such a pool). ABS values must factor in a default risk not always present in MBS valuations.

5. The Master Agreements dictate the basic terms of the overall trading relationship, while the economic terms of any given trade are documented in the trade confirmation. Among other things, the Master Agreements generally provide for haircut percentages, margin posting requirements, events of default (including NAV requirements) and the valuation methodology to be used in a disputed situation.

6. Tom Cahill and Katherine Burton, “Hedge Funds Reel From Margin Calls Even on Treasuries,” Bloomberg, March 10, 2008 at 5:47 p.m. (reporting that since Feb. 15, 2008, at least six hedge funds, with a combined total of \$5.4 billion under management, have been forced to liquidate or sell assets due to margin calls by lenders).

7. For instance, the Market Quotation provision of the 1996 ISDA Master Agreement requires quotations that “have the effect of preserving the economic equivalent of any payment or delivery (whether the underlying obligation was absolute or contingent and assuming the satisfaction of each applicable condition precedent) by the parties under Section 2(a)(i) in respect of such Terminated Transaction or group of Terminated Transactions that would, but for the occurrence of the relevant Early Termination Date, have been required after that date.” ISDA Master Agreement at §14. Notably, the provision does not permit the imposition of discounts for failure of a condition precedent, nor does it expressly contemplate discounts to reflect a reduction in market liquidity. Rather, the provision arguably contemplates the preservation of any future payment stream. See also *Peregrine Fixed Income Ltd. (In Liquidation) v. Robinson Dept. Store Public Co. Ltd.*, [2000] Lloyd’s Rep. Bank. 304, ¶39, 2000 WL 1027115 (U.K. Com. Ct. 2000) (commercial reasonableness of a Market Quotation must be measured against loss measure of valuation or the nominal economic value of the trades).

The Close-out Valuation provision of the 2002 ISDA Master Agreement provides that valuation may take account of, among

other things, “information consisting of relevant market data... including, without limitation, relevant rates, prices, yields, yield curves, volatilities, spreads, correlations or other relevant market data in the relevant market.” ISDA Master Agreement (definition of “Close-out Amount”). The definition goes on to caution against use of such data in circumstances where “the Determining Party reasonably believes that such quotations or relevant market data are not readily available or would produce a result that would not satisfy those standards [of commercial reasonableness].” Id.

8. Parties might also argue that illiquidity risk of the magnitude recently witnessed in the markets was not contemplated at the time of the transaction and should not be the basis for a default in a circumstance in which the fundamentals on the trade—the expected future cash flows—have not changed (or where those changes are acceptably valued). While such arguments could be advanced under theories of economic frustration of purpose, economic duress or force majeure, they suffer from the same potential difficulty as fraud in the inducement or reformation arguments: courts are reluctant to rewrite contracts. While some may argue that a “cooling off” period during times of illiquidity and loss of confidence is wise economic policy—witness the four-day “bank holiday” imposed by Franklin Delano Roosevelt on March 5, 1933 (the day after he took office)—it is possible for parties to contract for such protection and absent their having done so, courts may be reluctant to provide it.

9. Statement of Financial Accounting Standards (SFAS) 157 provides for so-called “fair value measurements” in reporting the value of financial assets. SFAS provides for three levels of valuation: Level 1 assets are those whose price is readily observable in an active market (e.g., exchange-traded stocks); Level 2 assets are those for which all the inputs significant to valuation are either directly or indirectly observable in the market; and Level 3 assets are those for which there is neither an observable price nor readily observable inputs to valuation.

10. See, e.g., Form 10-Q of The Goldman Sachs Group Inc. for the Fiscal Quarter Ended Feb. 29, 2008, reporting almost \$25 billion of MBS and other ABS as Level 3 assets.

11. The parties might also argue that margin calls based on such valuations constitute an improper post hoc attempt to increase the haircuts specified by the governing contracts.

12. A requirement of commercial reasonableness has many sources. First, it can be found in the express terms of the Master Agreements themselves. See, e.g., Paragraph 4(b)(i) of Annex V to the Master Repurchase Agreement (requiring that any sale of securities subject to the agreement be done “in a recognized market (or otherwise in a commercially reasonable manner) at such prices as the nondefaulting party may reasonably deem satisfactory”). Second, Article 9 of the UCC imposes a commercial reasonableness requirement. Third, “[i]mplicit in all contracts is a covenant of good faith and fair dealing in the course of contract performance.” *Dalton v. Educ. Testing Serv.*, 87 NY2d 384, 389 (1994). See also *The High Risk Opportunities HUB Fund Ltd. v. Credit Lyonnais and Societe Generale*, Index No. 600229/00 (Sup. Ct. New York Co., July 6, 2005) at 14 (finding that Credit Lyonnais “failed to obtain adequate market quotations in good faith pursuant to section 14 of the Master Agreement because it interfered with the Market-makers’ independence in valuing the NDFs as of the termination date.”).

13. These issues also give rise to the potential for a liquidity “mismatch.” While there may be significant arguments to be advanced in connection with margin calls and associated default notices along the lines outlined above, it is important to remember that hedge funds typically permit investor withdrawals on a quarterly basis. See Gregory Zuckerman, “Shakeout Roils Hedge-Fund World,” Wall St. J., June 17, 2008 at A1. To the extent such funds witness a decline in new investment in combination with a “run on the bank”—i.e., substantial redemption notices—their inability to liquidate positions at prices that reflect the intrinsic value of the trades may be problematic. As Federal Reserve Chairman Bernanke recently observed, “‘fire sales’ forced by sharp increases in investors’ liquidity preference can drive asset prices below their fundamental value, at significant cost to the financial system and to the economy.” Speech of Federal Reserve Chairman Ben S. Bernanke at the Federal Reserve Bank of Atlanta Financial Markets Conference, Sea Island, Ga. (May 13, 2008). Hedge funds might consider providing for the possibility of this circumstance in their constituent documents.