

## Comment

### Empty Creditors and Debt Exchanges

Daniel Hemel†

*This Comment reviews recent proposals to address the “empty creditor” problem. The author argues that previous proposals would do little to reduce the risk that empty creditors will block debt-for-equity exchanges in order to collect credit default swap payments. The author presents an alternative approach that would limit the dangers of empty crediting by modifying the standardized language of swap agreements. Specifically, the author argues for widening the definition of “credit events” to encompass voluntary debt-for-equity exchanges that surpass a certain participation threshold. This reform would benefit the vast majority of credit protection buyers and sellers, while simultaneously reducing deadweight losses resulting from unnecessary bankruptcy filings.*

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#### Introduction

As its North American amusement parks prepared for the 2009 summer season, Six Flags, Inc. found itself on a financial rollercoaster ride that was anything but amusing. On April 17, Six Flags announced a debt-for-equity exchange offer that would allow its investors, who together held \$600 million of the company’s bonds, to swap these bonds for 85% of the company’s stock. Six Flags stipulated that it would only execute the exchange if holders of 95% of its outstanding obligations participated. For bondholders, the debt-for-equity swap seemed to present a last chance to salvage their investment because without the debt-for-equity exchange, Six

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† J.D. Yale Law School, expected 2012; M.Phil. Oxford University, 2009; A.B. Harvard College, 2007.

Flags would probably file for bankruptcy and the value of the bonds would plummet. The rating agency Fitch estimated that uninsured bondholders would end up with less than a 10% stake in a restructured Six Flags after Chapter 11 proceedings.<sup>1</sup> But although most bondholders favored the debt-for-equity deal, one “holdout” creditor—which the *Washington Post* identified as Fidelity Investments—stood in the way. The *Post* posited that Fidelity, which owned more than \$100 million of Six Flags bonds, had bought credit default swaps to insure itself against the possibility that the theme park operator would file for bankruptcy.<sup>2</sup> As *Newsweek* columnist Daniel Gross explained, “Since credit-default swaps are triggered by formal bankruptcy filings—and not necessarily by out-of-court restructuring deals—bondholders who purchased insurance may feel they have more to gain from a traumatic filing than from an out-of-court settlement.”<sup>3</sup> Ultimately, the debt-for-equity exchange fell short of the 95% participation threshold; Six Flags filed for Chapter 11 in June; and the credit default swaps purchased by anonymous investors were worth more than \$200 million.<sup>4</sup>

We may never know how much of those \$200 million in swaps were held by Fidelity, nor will we ever know for sure why Fidelity rejected Six Flags’ offer.<sup>5</sup> But if Fidelity declined the debt-for-equity offer in order to preserve the value of its credit default swaps, then Six Flags may be just one of the latest corporate victims of the “empty creditor” problem. “Empty creditors” are “creditors who have greater contractual or legal rights than underlying exposure.”<sup>6</sup> This imbalance becomes a public policy concern when empty creditors engage in “empty manipulation.”<sup>7</sup> For example, an investor might acquire \$100 million of Six Flags bonds while also entering into credit default swaps that will pay him *more* than \$100 million if Six Flags files for Chapter 11 protection. The investor would have an incentive to block any debt exchange that might avert Six Flags’ bankruptcy. Empty creditors have been accused of pushing a long list of companies into bankruptcy since the start of 2009, including

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1 *CDSs and Bankruptcy: No Empty Threat*, ECONOMIST, June 20, 2009, at 79, available at [http://www.economist.com/businessfinance/displaystory.cfm?story\\_id=13871164](http://www.economist.com/businessfinance/displaystory.cfm?story_id=13871164).

2 Michael S. Rosenwald, *Plagued by Debt, Six Flags Faces Its Own Wild Ride*, WASH. POST, Apr. 13, 2009, at A10.

3 Daniel Gross, *The Rise of the ‘Empty Creditor,’* NEWSWEEK, Apr. 21, 2009, <http://www.newsweek.com/id/194820>.

4 *Six Flags CDS Recover 14 Pct in Auction*, REUTERS, July 9, 2009, <http://uk.reuters.com/article/idUKN0948091720090709>.

5 Fidelity maintains a policy against commenting on “individual credits or companies.” Tim Arango, *Six Flags in Negotiations To Stave Off Chapter 11*, N.Y. TIMES, Mar. 14, 2009, at B3.

6 Henry T.C. Hu & Bernard Black, *Debt and Hybrid Decoupling: An Overview*, THE M&A LAW., Apr. 2008, at 5.

7 Kevin J. Coco, Note, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 COLUM. BUS. L. REV. 610, 613.

## Empty Creditors and Debt Exchanges

AbitibiBowater,<sup>8</sup> Chrysler,<sup>9</sup> CIT Group,<sup>10</sup> GM,<sup>11</sup> General Growth Properties,<sup>12</sup> and LyondellBasell.<sup>13</sup>

This Comment describes how U.S. securities law, financial innovation, and the actions of private sector self-regulators have given rise to the empty creditor phenomenon. It evaluates a series of recent proposals aimed at addressing the empty creditor problem. Finally, it presents an original proposal that would mitigate the risks generated by empty creditors while simultaneously reducing the cost of credit protection for all market participants. Under the status quo, investors who buy swaps to protect themselves against the risk of a specific company's default do not collect payments from swap sellers if the company and its creditors agree to a voluntary debt exchange. However, a slight change in the language of credit default swap agreements would enable swap buyers to collect payments from swap sellers when voluntary debt exchanges pass a sufficient participation threshold. Swap buyers would benefit from this change because their swaps would now serve as more comprehensive insurance arrangements; swap sellers would benefit because the amount they would have to pay after a voluntary debt exchange would often be less than the amount they would pay after a Chapter 11 filing; and corporate borrowers would benefit because they could restructure their debt without incurring massive and unnecessary costs in the bankruptcy process.

### I. The Problem of Empty Crediting

The most potent weapon in the empty creditor's arsenal is the credit default swap. A credit default swap is an agreement in which "one party (*protection buyer*) pays a periodic fee to another party (*protection seller*) in return for compensation for default (or similar *credit event*) by a *reference entity*."<sup>14</sup> In the above example, Fidelity would be the "protection buyer"; a bank, hedge fund, or insurer might be the "protection seller"; and Six Flags would be the "reference entity." The protection buyer does not necessarily

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<sup>8</sup> Michael J. de la Merced & Geraldine Fabrikant, *Newsprint Firm Tries To Revamp Debt To Avoid Bankruptcy*, N.Y. TIMES, Mar. 20, 2009, at B3.

<sup>9</sup> Tom Krisher, *Chrysler Debtholder Talks Pick Up Pace; GM Stalled*, ABC NEWS, Apr. 14, 2009, <http://abcnews.go.com/Business/wireStory?id=7332901>.

<sup>10</sup> Henry Sender, *CDS in the Spotlight in Goldman Purchase of CIT Debt*, FIN. TIMES, Oct. 4, 2009, at 20.

<sup>11</sup> Loren Steffy, *Credit-Default Swaps: Banking on Bankruptcy*, HOUSTON CHRON., July 22, 2009, at 1.

<sup>12</sup> *Id.*

<sup>13</sup> Caroline Salas & Shannon D. Harrington, *Darth Wall Street Thwarting Debtors with Credit Swaps (Update2)*, BLOOMBERG.COM, Mar. 5, 2009, <http://www.bloomberg.com/apps/news?pid=20601110&sid=aZjMculoat7U>.

<sup>14</sup> ISDA: CDS Marketplace: About the CDS Market, [http://www.isdacdsmarketplace.com/about\\_cds\\_market](http://www.isdacdsmarketplace.com/about_cds_market) (last visited Dec. 10, 2009).

own any debt obligations issued by the reference entity. Thus, credit default swaps enable investors to establish *negative* economic ownership in a reference entity's debt. In such cases, the investor stands to profit from the reference entity's default.

Importantly, credit default swap contracts can cover "credit events" *other* than bankruptcy. The International Swaps and Derivatives Association (ISDA), a private sector trade association, has crafted a Master Agreement that governs most credit default swap transactions. Under the Master Agreement, the parties to a swap can elect to include "restructuring" as a credit event that will trigger a payout from the protection seller. ISDA's 1999 Credit Derivatives Definitions attempted to specify the meaning of "restructuring," but market participants disagreed as to whether "restructuring" included voluntary debt exchanges.<sup>15</sup> After the Argentine government announced a "voluntary debt exchange" in November 2001, JPMorgan Chase, which had sold credit default swaps linked to Argentine debt, refused to make payments to swap buyers.<sup>16</sup> The bank claimed that a voluntary debt exchange did not qualify as a credit event under the ISDA Master Agreement.<sup>17</sup> Eternity Global Master Fund, which had purchased Argentina credit default swaps from JPMorgan Chase in October 2001, adopted a conflicting interpretation of the Master Agreement and sued for breach of contract.<sup>18</sup> While the case was pending, ISDA issued a new set of credit derivatives definitions clarifying that restructuring would only qualify as a credit event if it occurred "in a form that binds all holders" of the reference entity's debt obligations.<sup>19</sup> Thus a "voluntary debt exchange will not trigger a credit event . . . under up-to-date definitions."<sup>20</sup>

U.S. securities law makes it extremely difficult for companies to restructure their debt "in a form that binds all holders." The Trust Indenture Act of 1939 prohibits corporate borrowers from modifying

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15 Compare JEFFREY S. TOLK, UNDERSTANDING THE RISKS IN CREDIT DEFAULT SWAPS 8 (2001), available at <http://www.securitization.net/pdf/MoodysSyntheticCDORisks.pdf> ("Under the current ISDA definition, a 'credit event' can be triggered if the lender voluntarily agreed to the restructuring (so long as it is the direct or indirect result of credit deterioration)."), with Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co., No. 02 Civ. 1312, 2002 U.S. Dist. LEXIS 20706, at \*10 (S.D.N.Y. Oct. 29, 2002) (noting—though ultimately rejecting—the defendant's argument that "because this was a voluntary exchange . . . a Restructuring Credit Event did not occur").

16 See *Eternity Global Master Fund*, 2002 U.S. Dist. LEXIS 20706, at \*4-6.

17 See *id.* at \*6.

18 See *id.* at \*5-7. In June 2003, a federal district judge ruled that "because the 'voluntary debt exchange' did not meet the ISDA Definitions for a 'Restructuring Credit Event,' Eternity's claim for breach of contract fails as a matter of law." *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co.*, No. 02 Civ. 1312, 2003 U.S. Dist. LEXIS 12351, at \*17 (S.D.N.Y. June 4, 2003), *rev'd in part*, 375 F.3d 168, 190 (2d Cir. 2004) (holding that the definition of "credit event" under the 1999 Master Agreement "cannot be found unambiguous on the basis of the pleadings alone").

19 INT'L SWAPS & DERIVATIVES ASS'N, 2003 CREDIT DERIVATIVES DEFINITIONS § 4.7(a) (2003) (on file with The Yale Journal on Regulation).

20 Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How To Approach the Interpretation of Credit Events*, 13 FORDHAM J. CORP. & FIN. L. 705, 791 (2008).

provisions relating to the principal, interest, and maturity of a debt security without the consent of the bondholder.<sup>21</sup> Distressed debtors can still pursue *voluntary* debt-for-equity exchanges, but in a voluntary exchange, each creditor has an incentive to “free ride.” As Enrica Detragiache and Paolo G. Garella explain, “[C]reditors who refuse to write down their claims cannot be prevented from receiving a higher repayment rate if the firm remains in business.”<sup>22</sup> For this reason, distressed debtors frequently stipulate that the debt-for-equity exchange will take effect only if the offer is accepted “[b]y a sufficient percentage (usually 90% or more) of relevant creditor claims.”<sup>23</sup> On the one hand, a high participation threshold means that any creditor with a substantial stake in the distressed company’s debt obligations can block the exchange from occurring. On the other hand, the high threshold reduces the incentive to free ride.

In the introductory example, Six Flags set the participation threshold at 95%, which meant that Fidelity’s \$100 million bondholding constituted a blocking stake. As long as Fidelity refused to participate in the exchange, Six Flags had no legal remedy except to reduce the participation threshold<sup>24</sup> or to file for bankruptcy. Fidelity would have had an incentive to block the debt-for-equity swap if the notional value of its credit protection on Six Flags exceeded the face value of its direct debt holdings. But the 2003 ISDA Credit Derivatives Definitions might have motivated Fidelity to reject the debt-for-equity exchange even if the fund’s net exposure to Six Flags’ debt were neutral instead of negative. Imagine, for the sake of argument, that Fidelity’s stake in Six Flags was perfectly hedged: for every bond Fidelity owned, it had bought credit protection for the same amount as the bond’s face value. Under the debt-for-equity exchange, a Six Flags bond with a face value of \$1000 could be exchanged for common stock with a market price of approximately \$300. Imagine, further, that if Six Flags declared bankruptcy, the value of the bond would fall to \$40 (a figure in line with Fitch’s estimates).<sup>25</sup> If Six Flags defaulted,

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21 Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77ppp(b) (2006).

22 Enrica Detragiache & Paolo G. Garella, *Debt Restructuring with Multiple Creditors and the Role of Exchange Offers*, 5 J. FIN. INTERMEDIATION 305, 307 (1996).

23 Edward I. Altman & Brenda Karlin, *The Re-Emergence of Distressed Exchanges in Corporate Restructurings*, 5 J. CREDIT RISK 43, 43 (2009).

24 Six Flags could have tried to circumvent the holdout problem by lowering the participation threshold. However, a lower participation threshold decreases the probability that any one bondholder will be “pivotal” to the success of the debt exchange. Any individual bondholder’s incentive to participate in the debt exchange decreases as his or her chance of being “pivotal” decreases. Thus, by lowering the participation *threshold*, Six Flags might have likewise lowered the participation *rate*. On the relationship between participation thresholds and the probability of successful debt exchanges, see Ulrich Hege, *Workouts, Court-Supervised Reorganization and the Choice Between Private and Public Debt*, 9 J. CORP. FIN. 233 (2003).

25 The tender offer would allow Six Flags creditors to exchange \$1000 in bond principal for approximately 19 shares of common stock following a 1-for-100 reverse stock split. See Press Release, Six Flags, Inc., Six Flags Announces Debt for Equity Exchange Offer for Certain of Its Debt

Fidelity could collect a \$960 swap payout and sell the bond for \$40. By contrast, if Fidelity agreed to the debt-for-equity exchange, it could not collect on its credit default swaps and would be left with stock worth only \$300.

There might be nothing intrinsically immoral about Fidelity's behavior if it purchased \$100 million in credit protection on Six Flags and rejected a debt-for-equity exchange. As Daniel Gross writes, "You can't blame empty creditors for wanting to see companies in which they hold debt go bankrupt. They had the foresight to purchase insurance on their investments."<sup>26</sup> Empty crediting is less defensible in cases where empty creditors establish *negative* net exposures to the reference entity's debt and then try to push the reference entity into default by filing an involuntary bankruptcy petition.<sup>27</sup>

In either case, an unnecessary bankruptcy imposes deadweight losses on society as a whole. These losses stem from the *direct* costs of bankruptcy (such as fees for attorneys, accountants, consultants, and expert witnesses), as well as *indirect* costs. The "stigma of Chapter 11 in the marketplace" may lead potential customers and counterparties to avoid transactions with a company during and after its reorganization.<sup>28</sup> Time-consuming bankruptcy proceedings may divert the attention of corporate managers away from the day-to-day operation of the firm. According to econometric estimates, the total bankruptcy-related costs borne by a firm and its claimholders range from 12.7% to 20.5% of the firm's pre-bankruptcy assets.<sup>29</sup>

## II. Previous Proposals To Address the Empty Creditor Problem

Several scholars have presented plans that would address the empty creditor problem in the corporate bankruptcy process. Under Chapter 11

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Securities (Apr. 17, 2009), <http://www.prnewswire.com/news-releases/six-flags-announces-debt-for-equity-exchange-offer-for-certain-of-its-debt-securities-61857582.html>. Six Flags stock traded at \$0.17 (that is, \$17 with the reverse split) for the week following the announcement of the tender offer. See Yahoo! Finance, Historical Prices for Six Flags, Inc., <http://finance.yahoo.com/q?s=SIXFQ.OB> (last visited Dec. 6, 2009) (follow the link for Historical Prices and select April 20-24, 2009). Thus, the exchange would leave uninsured bondholders with slightly more than a \$300 equity stake in the company for every \$1000 of bond principal. Fitch estimated that uninsured bondholders would be left with less than a 10% equity stake after bankruptcy, compared to an 85% stake in the exchange. See *CDSs and Bankruptcy: No Empty Threat*, *supra* note 1. Using these estimates, the value of the bonds in bankruptcy would equal \$38 ( $(\$17 \times 19 \times 10\%) / 85\% = \$38$ ).

<sup>26</sup> Gross, *supra* note 3.

<sup>27</sup> See Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405 (2007).

<sup>28</sup> Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067, 1070-72 (1984).

<sup>29</sup> Ben Branch, *The Costs of Bankruptcy: A Review*, 11 INT'L REV. FIN. ANALYSIS 39, 54 (2002).

of the Bankruptcy Code, a creditor can block a debtor's restructuring plan if the creditor holds one-half in number or one-third in amount of the claims in a particular class.<sup>30</sup> Kevin Coco suggests that any creditor with a blocking stake should have to disclose its hedges.<sup>31</sup> Henry Hu and Bernard Black go one step further and contemplate the possibility that disclosure alone might be insufficient: "[V]oting rights in bankruptcy may need to be based on net economic ownership instead of gross ownership of debt."<sup>32</sup> Patrick Fleming points out that section 1126(e) of the Bankruptcy Code enables courts to disenfranchise creditors whose acceptance or rejection of a Chapter 11 restructuring plan is "not in good faith."<sup>33</sup>

However, these modifications would not necessarily alter the incentives of "empty creditors" in pre-bankruptcy restructuring situations, where the moral hazard is most severe.<sup>34</sup> After a large company defaults on its debt, ISDA coordinates with a pair of firms—Creditex Group Inc. and Markit Group Ltd.—to stage a "Credit Event Fixing." A panel of seven derivatives dealers submits bids on the reference entity's debt obligations; the results of the auction establish the settlement price of outstanding credit default swaps.<sup>35</sup> Protection sellers pay protection buyers the difference between the face value of the debt obligation and the market price set at the auction.<sup>36</sup> For example, eleven days after GM's Chapter 11 filing, the automaker's unsecured bonds were auctioned off at 12.5 cents on the dollar, which meant that protection sellers owed protection buyers 87.5 cents on the dollar.<sup>37</sup> Auction settlement has become standard practice in the credit derivatives market since the ISDA "Big Bang" Protocol of April 2009, when more than two thousand parties announced that they would adhere to auction settlement procedures in settling swap

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30 11 U.S.C. § 1126(c) (2006). This ability to block a restructuring is subject to certain complications, such as cramdown. See 11 U.S.C. § 1129(b).

31 Coco, *supra* note 7, at 650.

32 Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 735 (2008).

33 Importantly, the "good faith" requirement applies to the acceptance or rejection of restructuring plans in bankruptcy, not restructuring plans pre-bankruptcy. Patrick D. Fleming, *Credit Derivatives Can Create a Financial Incentive for Creditors To Destroy a Chapter 11 Debtor: Section 1126(e) and Section 105(a) Provide a Solution*, 17 AM. BANKR. INST. L. REV. 189, 189 (2009).

34 "Credit default swaps create a moral hazard problem only before Chapter 11 begins and then in its immediate aftermath." Douglas G. Baird & Robert K. Rasmussen, *Anti-Bankruptcy*, 119 YALE L.J. 648, 683 (2010).

35 Creditex Group Inc. and Markit Group Ltd., Credit Event Fixings, <http://www.creditfixings.com/information/affiliations/fixings.html> (last visited Oct. 27, 2009).

36 Creditex Group Inc. and Markit Group Ltd., Credit Event Auction Primer, [http://www.creditfixings.com/information/affiliations/fixings/auctions/docs/credit\\_event\\_auction\\_primer.pdf](http://www.creditfixings.com/information/affiliations/fixings/auctions/docs/credit_event_auction_primer.pdf) (last visited Oct. 27, 2009).

37 Shannon D. Harrington, *GM Bonds Valued at 12.5 Cents To Settle Credit-Default Swaps*, BLOOMBERG.COM, June 12, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aZGopZRF4xcg>.

contracts.<sup>38</sup> Once an auction settlement has taken place, the reference entity's empty creditors no longer have an incentive to destroy economic value because the settlement price of outstanding credit derivatives is set in stone.<sup>39</sup>

Conceivably, investors may be less likely to engage in empty manipulation if they know that their hedges will be publicized in bankruptcy proceedings. Investors may incur "reputational risk" if they engage in empty manipulation and are caught red-handed.<sup>40</sup> For example, news reports cited Citigroup as an empty creditor to AbitibiBowater when the pulp and paper manufacturer sought to restructure its debt in early 2009.<sup>41</sup> Initially, Citigroup was a holdout in restructuring talks, but it agreed to a voluntary debt exchange after receiving negative publicity for its stance.<sup>42</sup> However, the "reputational risk" disincentive is not a panacea to the problems posed by empty creditors. For one thing, empty creditors may avoid disclosure requirements in the Chapter 11 process by liquidating their debt holdings immediately after the reference entity files for bankruptcy. Although the above proposals might make the Chapter 11 process run more smoothly, they would not reduce the incidence of Chapter 11 filings in the first place.

George Soros has suggested a more radical solution to the empty creditor problem. He would outlaw "naked" credit default swaps (that is, agreements in which the protection buyer does not own the underlying debt obligation that he or she is insuring).<sup>43</sup> Although Soros has not fleshed out the details of his proposal, one possibility is that an investor would have to hold one dollar of a reference entity's debt obligations for every dollar of swap protection that the investor purchases. This would prevent investors from establishing negative net exposure to a reference entity's debt. But in the previous example, Fidelity would have had an incentive to reject Six Flags' offer even if the investment fund were "fully clothed." The Soros proposal would prevent Fidelity from maintaining a

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38 Press Release, Int'l Swap & Derivatives Ass'n, ISDA Announces Successful Implementation of 'Big Bang' CDS Protocol (Apr. 8, 2009), <http://www.isda.org/press/press040809.html>.

39 Empty creditors still may have a perverse incentive to reduce the value of a reference entity during the days that elapse between the Chapter 11 filing and the settlement auction. Baird & Rasmussen, *supra* note 34, at 683. However, this hazard might be mitigated if creditors sped up the swap settlement process so that credit event fixings occurred a few days—instead of a few weeks—after a Chapter 11 filing. Janis Sarra, *Credit Derivatives, Market Design, Creating Fairness and Sustainability* 12-16 (Network for Sustainable Fin. Mkts.: Consultation, Paper No. 1, 2009), available at [http://www.sustainablefinancialmarkets.net/wp-content/uploads/2009/02/sarra-credit-derivatives\\_20jan091.pdf](http://www.sustainablefinancialmarkets.net/wp-content/uploads/2009/02/sarra-credit-derivatives_20jan091.pdf).

40 Hu & Black, *supra* note 32, at 694.

41 de la Merced & Fabrikant, *supra* note 8.

42 Michael J. de la Merced, *Newsprint Maker Said To Be Making Progress on Debt*, N.Y. TIMES, Mar. 27, 2009, at B2.

43 George Soros, *One Way To Stop Bear Raids*, WALL ST. J., Mar. 24, 2009, at A17.



*negative* net exposure to Six Flags' debt, but the same problem would arise if Fidelity had a *neutral* net exposure to the reference entity. If it were perfectly hedged, or in other words, if it were neither betting *on* nor *against* Six Flags' bankruptcy, Fidelity still would reject a debt-for-equity exchange that would give it less than the face value of Six Flags bonds. As long as credit default swaps do not compensate protection buyers in non-binding debt-for-equity exchanges, empty creditors with neutral net exposures will continue to have an incentive to block voluntary workouts.

### III. Redefining "Restructuring"

As mentioned in Part I, credit default swap contracts can include "credit events" *other* than bankruptcy. When the Basel Committee on Banking Supervision was crafting its New Capital Accord, supervisors considered a rule that would recognize credit default swaps for regulatory capital purposes *only* if the swaps specified "restructuring" as a credit event. ISDA raised concerns that if the Basel Committee went ahead with the restructuring requirement, "end-investors will choose to pull back from the credit derivatives market, reducing liquidity."<sup>44</sup> But it is not clear why the inclusion of restructuring as a credit event would deter protection buyers *or* protection sellers from participating in the market. Indeed, a broad definition of "restructuring" that encompasses voluntary debt exchanges may attract *more* participants to the derivatives market while also mitigating the risks generated by empty creditors.

Consider again the case of Fidelity and Six Flags. Imagine, for the sake of argument, that in the absence of a debt-for-equity exchange, there was a 75% probability that Six Flags would declare bankruptcy. Thus, the expected value of a Six Flags bond would be \$280.<sup>45</sup> An unhedged creditor would accept the debt-for-equity exchange because the deal would leave it with securities worth \$300, which is more than the expected value of a Six Flags bond. But under the existing ISDA Credit Derivatives Definitions (which exclude voluntary restructurings), no swap payment would be triggered by a debt-for-equity exchange. Fidelity would have an incentive to reject the exchange offer (in which case it is insured for the full \$1000 face value) instead of accepting the securities worth \$300.

Now imagine that credit default swaps on the reference entity's debt included voluntary restructuring as a credit event. The voluntary

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44 Letter from Robert Pickel, Executive Dir. & Chief Executive Officer, Int'l Swaps & Derivatives Ass'n, and Sir Adam Ridley, Dir. Gen., London Inv. Banking Ass'n, to Norah Barger, Chair, Credit Risk Mitigation Subgroup, Basel Comm. on Banking Supervision (Oct. 2, 2002), available at [http://www.isda.org/c\\_and\\_a/pdf/Letter-on-restruct-CRM-Subgroup2oct.pdf](http://www.isda.org/c_and_a/pdf/Letter-on-restruct-CRM-Subgroup2oct.pdf).

45 The creditor would have a one-in-four chance of recovering the \$1000 face value of the bond and a three-in-four chance of recovering only \$40. Assume that the credit default swap is in its final period, so the protection buyer has no more quarterly payments to make to the protection seller.

restructuring would have to surpass some threshold level of participation—perhaps 50% or 75%—to qualify. An investor who sold \$1000 of Six Flags swaps to Fidelity would know that his or her expected liability—in the absence of a debt-for-equity exchange—would be \$720. If a debt-for-equity exchange occurred, the protection seller would pay Fidelity the difference between the face value of the Six Flags' notes and the market price of the swapped shares (\$700). Fidelity could then liquidate its shares for \$300 and break even on the deal; it would therefore have no incentive to block the debt-for-equity exchange. Alternatively, it could hold on to the bonds, but it would no longer have an outstanding hedge and thus would have the same (value-maximizing) incentives as other creditors. Meanwhile, the new definition of credit events would leave the protection seller better off because its payout to Fidelity following the debt-for-equity exchange would be less than its expected loss in the absence of such an exchange. Since the interests of the protection seller and those of "full creditors" would be aligned, the protection seller could be (reasonably) confident that the debt exchange would only occur under circumstances that reduced its expected payout.

The only market participant who loses from the inclusion of voluntary restructuring as a credit event is the speculator whose hedges *exceed* his direct exposure, assuming that the speculator is betting on (and perhaps pushing for) the reference entity to file for bankruptcy. The proposal presented in this Comment would make such a "sabotage" strategy enormously expensive to execute. If ISDA redefines "restructuring" to include voluntary debt-for-equity exchanges that garner 75% participation, then a speculator would need to acquire 25% of the reference entity's outstanding debt obligations to amass a blocking stake. A distressed debtor's bonds will trade at a deep discount as the firm teeters on the brink of bankruptcy, but credit default swaps linked to the firm's debt will trade at a premium. In March 2009, an investor could have paid 20.5 cents on the dollar for Six Flags bonds and 71 cents on the dollar for credit default swaps linked to Six Flags' debt.<sup>46</sup> If Six Flags had \$600 million in outstanding debt obligations, then a blocking stake (that is, 25% of outstanding debt obligations) would have cost approximately \$137 million to acquire and insure.<sup>47</sup> If ISDA redefines restructuring to include exchanges that garner majority (50%) rather than supermajority participation, then it would cost \$275 million to acquire and insure a blocking stake. Under such circumstances, only a small number of financial institutions with access to large quantities of cash could execute a

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46 See Salas & Harrington, *supra* note 13.

47 In this scenario, a speculator would have to hold Six Flags bonds with a face value of \$150 million to wield a blocking stake. It would cost \$30.75 million to acquire the bonds (at 20.5 cents on the dollar) and an additional \$106.5 million to insure the bonds (at 71 cents on the dollar).

“sabotage” strategy that would topple a major corporate borrower.<sup>48</sup> The proposal presented in this Comment would not *eliminate* the sabotage risk, but it would dramatically limit the number of market actors who could pose such a risk.

In theory, protection sellers can modify the terms of swap agreements to shield themselves from the risk that their counterparty is an empty creditor who seeks to destroy value at the reference-entity firm. According to Hu and Black, “[S]ome credit default swap contracts now include customized terms which require the protection buyer, if it is also a creditor, to act in the interests of other creditors.”<sup>49</sup> Moreover, derivatives market participants might modify the ISDA Master Agreement to extend the definition of “credit events” so as to include voluntary restructuring. But these “customized terms” are only feasible when credit default swaps are traded on a bilateral basis. As the market in single-name swaps moves toward a clearinghouse system,<sup>50</sup> opportunities to construct customized contracts will diminish. The one clearinghouse that is up-and-running in the United States, ICE Trust, applies the ISDA Master Agreement—with a small number of exceptions—to all swaps that it clears.<sup>51</sup> Legislation approved by the House Financial Services Committee and supported by the Obama Administration would require derivatives dealers to trade most credit default swaps through a clearinghouse rather than on a bilateral basis.<sup>52</sup> Even if market participants want to amend the ISDA definitions to include voluntary restructuring as a credit event, new federal rules for over-the-counter derivatives might prevent such modifications.

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48 Potentially, a mid-sized hedge fund still could acquire a blocking state in a small firm’s outstanding obligations and “sabotage” a debt-for-equity exchange. However, there is not a liquid market in single-name swaps that list small firms as reference entities, so a saboteur would have trouble finding a protection seller to serve as a counterparty for swaps linked to a small firm’s debt. More than 96% of single-name swap contracts processed by the Depository Trust & Clearing Corporation reference one of 1000 entities. See Depository Trust & Clearing Corporation, Trade Information Warehouse Data, Table 6: Top 1000 Reference Entities (Gross and Net Notional), [http://www.dtcc.com/products/derivserv/data\\_table\\_i.php?id=table6\\_current](http://www.dtcc.com/products/derivserv/data_table_i.php?id=table6_current) (last visited Oct. 27, 2009). As long as the market for single-name swaps linked to small firms’ debt remains relatively illiquid, these smaller borrowers will be less vulnerable to the empty creditor problem.

49 Henry T.C. Hu & Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 EUR. FIN. MGMT. 663, 682 (2008).

50 IntercontinentalExchange has announced that it expects to receive regulatory approval to clear single-name swaps in October 2009. Press Release, IntercontinentalExchange, ICE Crosses \$3 Trillion Mark in Cleared CDS Transactions (Oct. 5, 2009), <http://ir.theice.com/releasedetail.cfm?ReleaseID=413610>.

51 ICE TRUST, CLEARING RULES 78 (2009).

52 Dawn Kopecki, *House Panel Approves Measure Regulating Derivatives*, BLOOMBERG.COM, Oct. 15, 2009, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aHJppkG6rQDU>.

## Conclusion

The current financial crisis has illustrated the dangers of credit derivatives—and, specifically, the scope of the “empty creditor” problem. Ironically, post-crisis regulatory reform might *exacerbate* that problem by entrenching ISDA’s current narrow definition of “credit events.” However, lawmakers and regulators have an opportunity to avert this outcome by requiring that swaps linked to publicly issued corporate bonds include restructuring as a credit event. Under this proposal, fully hedged creditors would no longer have an incentive to block debt-for-equity exchanges because they would now be able to collect swap payouts once the exchanges passed a participation threshold. Protection sellers would benefit because debt-for-equity exchanges would allow them to settle swaps for less than the losses that they would expect to incur if the reference entity defaulted. Some reference entities would gain a new lease on life, and society as a whole would reap rewards by avoiding the deadweight losses associated with unnecessary bankruptcies.

The list of firms that have fallen victim to “empty creditors” may never be known for certain. It is impossible to determine whether, for example, Six Flags succumbed to empty creditors or if it simply collapsed under the sheer weight of its debt. The same is true for AbitibiBowater, Chrysler, CIT, General Growth, GM, and LyondellBasell. But regardless of which firms do or do not belong on this list, an expanded definition of credit events in swap contracts may reduce the risk that this list will grow longer.