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Insolvency & Restructuring
Securities Litigation
Financial Services Regulation
March 26, 2008

Client Alert

Lawsuit Challenges Termination of Insured Credit Default Swaps

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In a lawsuit filed in New York federal court on March 19, 2008, Merrill Lynch International ("MLI"), an affiliate of the investment banking firm Merrill Lynch & Co. Inc., alleges that bond insurer XL Capital Assurance Inc. ("XL") wrongfully terminated a series of insured credit default swap agreements based on XL's claim that MLI repudiated the agreements by assigning voting rights with respect to the insured reference securities to a third party. MLI commenced the lawsuit to obtain a declaratory judgment that the swap agreements remain binding and enforceable against XL and that MLI did not repudiate them. In effect, MLI seeks a ruling that XL's purported terminations are invalid.[1]

The transfer of voting and other control rights is common under insured credit default swaps, and a violation of such rights could provide a financial guaranty insurance company with a basis to claim that its guaranty obligations are terminated. In light of the current state of the financial markets and securities linked to sub-prime mortgages, parties to insured credit default swaps with financial guaranty insurance companies should review their contractual obligations to determine whether they have acted in ways that might give rise to assertions that the insurance is terminated, and should centralize their notice and reporting functions to know immediately if any such claims are being asserted by their financial guaranty counterparties.

Insured Credit Default Swaps

Insured credit default swaps are a common form of credit protection used in the financial markets. They combine a credit default swap with a financial guaranty insurance policy to provide credit protection against

1 *Merrill Lynch International v. XL Capital Assurance Inc., et al.*, Case No. 08-02893 (S.D.N.Y.).

defaults in the payment of principal and interest on designated securities or other debt instruments. In an insured credit default swap transaction, a seller of credit protection (usually a bond insurer) issues a financial guaranty insurance policy to secure the obligations of a special purpose subsidiary that has entered into a credit default swap with a counterparty that is buying protection against specified default risks associated with certain securities.

The form of the transaction at issue in the lawsuit is often called a "transformer."[2] A financial guaranty insurance company or its holding company forms a special purpose subsidiary (the "CDS Subsidiary"). The CDS Subsidiary enters into a credit default swap with a counterparty that owns interests in underlying securities. The transaction is evidenced by standard ISDA documentation using standard ISDA terminology.[3] Under the credit default swap, the counterparty, as the "Fixed Rate Payer," pays the CDS Subsidiary periodically an amount based upon a percentage of a notional amount of the securities. In insurance terminology, the fixed payment on an insured credit default swap is analogous to the premium paid under an insurance policy.

The CDS Subsidiary is the "Floating Rate Payer" under the credit default swap and is obligated to make payments to the counterparty only upon the occurrence of a "credit event"—e.g., a default in the payment of principal or interest on the underlying securities. In insurance terminology, the floating payment on an insured credit default swap is analogous to the payment of a claim under an insurance policy.

The CDS Subsidiary usually has little or no assets of its own, so its affiliate, the financial guaranty insurer, issues a policy to insure and guaranty the CDS Subsidiary's payment obligation upon a credit event. The credit protection buyer and swap counterparty to the CDS Subsidiary is the beneficiary and holder of the financial guaranty policy.

Voting Rights

A common feature of insured credit default swaps is the transfer of voting and other control rights with respect to the underlying securities from the credit protection buyer, which holds the rights by virtue of owning the securities, to the credit protection seller (the insurer through its CDS Subsidiary) that would otherwise be vulnerable to actions taken by the credit protection buyer with respect to the securities.

In most cases, as is apparently the case in the agreements between MLI and XL, voting rights are effectively transferred in a contractual provision that gives the insurer's CDS Subsidiary the right to terminate the swap if the counterparty fails to exercise voting rights in accordance with the instructions of the CDS Subsidiary.

MLI v. XL

According to the lawsuit, MLI and XL are parties to several insured credit default swaps structured as bond transformers. In each transaction, the CDS Subsidiary of XL has the right to terminate the swap upon MLI's failure to exercise voting rights in the underlying securities solely in accordance with the written instructions of the CDS Subsidiary. MLI alleges that, following a publication by Standard & Poor's stating that another bond insurer, MBIA, Inc., sold credit protection on some of the same underlying securities and is the sole controlling party with respect to those securities, XL took the position that by granting voting and control rights to

[2] *See "The Bond 'Transformers,'"* The Wall Street Journal Online, Jan. 30, 2008, available at *http://online.wsj.com/article/SB120165349019826957.html?mod=rss_Money_and_Investing*.

[3] ISDA is the International Swaps and Derivatives Association. *See www.isda.org*. for more information about the organization and the use of its industry standard documentation.

a third party, MLI repudiated its contracts with XL and that XL therefore had the right to terminate the contracts. XL sent notices to MLI asserting that MLI's repudiation gave XL the right to terminate the contracts. In addition, XL demanded that MLI confirm that it had not entered into any other agreement with regard to the voting rights with respect to the underlying securities.

MLI responded to the repudiation notices by denying that it has acted in any way that would prevent it from exercising voting rights in accordance with XL's instructions pursuant to the contracts. MLI did not, however, confirm to XL that it had not entered into any other agreement concerning the voting rights. XL then sent a notice acknowledging that it had no proof that MLI had entered into any other agreements, but that because MLI did not confirm this in response to XL's prior notice, XL viewed MLI's failure to respond as evidence that MLI had, in fact, given the voting rights to a third party in repudiation of its contracts with XL. Moreover, XL stated that it considered MLI's repudiation to be final and that XL was therefore exercising its right to terminate the insured credit default swaps.

As noted, the lawsuit was commenced on March 19, 2008, and a defendant like XL ordinarily has 20 days from the date it is served with the summons and complaint to file its response. In a story published on March 21, 2008, in *The New York Times* online edition, XL reportedly stated that it terminated the MLI contracts "because Merrill had given important rights promised to it under the contracts to at least one other party."[4]

Recommendations to Credit Protection Buyers

Because the assignment of voting and other control rights is common in insured credit default swaps, the assertions made by XL may be echoed by other financial guaranty insurance companies hoping to limit their exposure to risky securities. In order to avoid or prepare for such allegations, counterparties should review their contracts to determine:

- The scope of their obligations with respect to voting and other control rights. The XL-MLI contracts apparently provided for termination if MLI failed to exercise voting rights "solely" in accordance with instructions from XL's CDS Subsidiary. Voting rights provisions in other insured credit default swaps may be more or less restrictive, and counterparties should know the scope of their obligations.

- Whether the counterparty has taken any voting or other control actions under insured securities and, if so, whether it did so in compliance with the control provisions of its contracts.

- Whether the notice provisions under the contracts are adequate to give the counterparty timely notice of claims. The counterparty should, if necessary, centralize notice and reporting functions to make sure the appropriate personnel are made aware of any assertions by insurers that the counterparty has not complied with voting provisions. It is likely that the contracts were entered into at a time when markets were less volatile and the notice provisions seemed less important to the overall trade. Now that markets are less stable and insurers, like other parties, are reporting losses, counterparties should centralize their notice and reporting functions, including, if necessary, sending notices to the other parties to its insured credit default swaps amending or supplementing notice names and addresses to be certain that relevant information is delivered in a timely manner to those who need to know.

4 See "Insurer Gives Its Reasons for Severing Merrill Pacts," The New York Times Online, March 21, 2008, available at *http://www.nytimes.com/2008/03/21/business/21merrill.html?ex=1363752000&en=a6739b8ee27c6a82&ei=5088&partner=rssnyt&emc=rss*

Live Links

"*The Bond 'Transformers,'"* The Wall Street Journal Online, Jan. 30, 2008

International Swaps and Derivatives Association

"Insurer Gives Its Reasons for Severing Merrill Pacts," The New York Times Online, March 21, 2008

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