



# Alternative Investment Litigation Alert

## Developments in law related to alternative investments

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## Problems and Opportunities in the Credit Default Swap (CDS) Market

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The Lehman Brothers bankruptcy is a watershed event in the Credit Default Swap (CDS) market because it is the first large-scale credit event that will test the functioning of that market. As a result, systemic risk in that market has moved from possible to probable.

Lehman's bankruptcy affects the CDS market on two levels. First, the bankruptcy is a credit event on the CDS tied to Lehman's debt as a reference obligation. This credit event obligates the insuring party to make a payment to the party that purchased protection. This is the first time that a credit event has been triggered on a reference entity the size of Lehman, where there will likely be significant losses. Thus, those parties who have sold protection on Lehman's bonds will have a realized obligation to pay their counterparties. It is possible that one or more parties will default on their resulting obligations, resulting in a domino effect.

Second, because Lehman is a counterparty in the CDS market, its bankruptcy disrupts the functioning of that unregulated market. In those contracts where Lehman sold protection via CDS, there is substantial risk that Lehman will be unable to satisfy its obligations to its counterparties. In addition, where Lehman is a credit support provider, an event of default under the standard ISDA terms has likely already occurred. As a result, Lehman may be unable to honor its obligations on those CDS to purchasers of that protection (Lehman's counterparties).

In this turbulent market, CDS participants should consider the following.

- All market participants must evaluate their exposure to Lehman on two levels: (i) Do they hold CDS insuring against Lehman's default on its bonds, and, if so, are they buyers or sellers of such protection; and (ii) Is Lehman a counterparty to a CDS that they are holding?
- Participants should be examining their rights under each separately negotiated CDS, specifically with regard to collateral.
- The pressure on other CDS market participants—particularly sellers of protection—has increased dramatically, so there may be risk unrelated to Lehman.

- Volatility in the CDS market has increased dramatically, with the price to insure other participants (such as other investment banks) spiking upward. If another large participant in the CDS market fails, the CDS market may cease functioning with parties dishonoring obligations on CDS. In such an event, parties who have acted as “net insurers” on risk may try to renegotiate or exit such contracts and/or declare that the contracts are void (perhaps relying on *force majeure*).
- There may be disputes between the counterparties over control of the collateral where a counterparty is at risk for a bankruptcy or other default.
- The value of certain CDS contracts may decline as a result of the declining credit worthiness of the “insuring party”—and not by any change in the risk of default regarding the reference entity.
- Many hedge funds are major participants in the CDS market, both as “insurers” of credit risk and purchasers of protection. Due to their capital structure, and the right of investors to redeem capital, hedge funds can be more fragile than other market participants, and may suffer significant losses in any market disruption.
- It is possible that the U.S. federal government may have to step in as an intermediary to keep the market functioning, but participants should not rely on an intervention, and any intervention may not help current participants.
- Regulation in the alternative investment industry, and in the CDS market in particular, is all but a certainty. Even before the current market turmoil, both the Democratic Congress and the Republican Administration had proposed regulatory frameworks for these types of instruments. Given voter outcry over the use of taxpayer funds to bolster an unregulated industry, the question would appear to be when, not if, regulation will be promulgated and what it will look like.

Nixon Peabody’s Alternative Investment Litigation Team has the skills, experience and depth to handle matters from complex litigation resulting from fund failures to advice regarding asset management and protection. We welcome your questions and comments. If you need assistance on any matter, please call or e-mail Timothy W. Mungovan ([tmungovan@nixonpeabody.com](mailto:tmungovan@nixonpeabody.com) or 617-345-1334) or Jonathan Sablone ([jsablone@nixonpeabody.com](mailto:jsablone@nixonpeabody.com) or 617-345-1342 / 212-224-6395).