NOTE

Unraveling Credit Default Swaps–Engineered Transactions and Their Impacts

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Introduction

The proliferation of credit default swap ("CDS") contracts prior to the financial crisis drew the attention of scholars, regulators, and the public.[1] In simplistic terms, credit default swaps enable contracting parties to tailor their exposure to credit risk.[2] Credit default swaps occur when the "protection seller" agrees to compensate the "protection buyer" in the event the debt issuer—the "reference entity" or "underlying"—experiences a credit event.[3] Credit events are "contractually defined performance triggers that determine

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1. Roshanthi Dias, The Rise and Fall of Credit Default Swaps: An Empirical Investigation of Global Banks and Non-Bank Financial Institutions (2013) (Ph.D. dissertation, Swinburne University of Technology) (on file with Research Bank), https://researchbank.swinburne.edu.au/file/c45db566-b9db-4aac-b522-6d68dd512710/1/Roshanthi%20Dias%20Thesis.pdf [https://perma.cc/V92S-8URA].

2. Gina-Gail Fletcher, *Engineered Credit Default Swaps: Innovative or Manipulative?*, 94 N.Y.U. L. Rev. 1073, 1081 (2019) ("a CDS is an insurance-like financial contract").

3. *Id.* at 1082.

whether a protection buyer is entitled to compensation."[4] The term "credit event" can include events other than outright nonpayment.[5] For example, the parties to a CDS contract may define a credit event as having occurred when the reference entity experiences "a credit rating downgrade."[6] In that case, the protection buyer in the CDS derivatives contract will be entitled to compensation if the reference entity experiences a credit rating downgrade. If the reference entity does not experience a credit rating downgrade, the protection seller will profit off the premiums collected during the life of the CDS contract.[7] The function and structure of CDS contracts therefore can allow creditors to place a sufficiently large bet against their own loans or bonds to profit from the failure of the debtor.[8] For creditors that are "net short," the debtor's failure provides them with a payoff that can offset a loss on the underlying investment.[9]

In 2019, ISDA circulated proposed changes to the standard CDS contracts, while the SEC, CFTC, and FCA released a joint statement on opportunistic strategies in CDS markets.[10] The statement acknowledged the danger of manufactured defaults, expressing that they negatively affect the integrity, confidence, and reputation of CDS markets.[11] Failing to announce any direct actions, these agencies implicitly delegated the problem to ISDA to solve.[12] This paper seeks to (1) illustrate exactly what harms are created by engineered transactions, (2) identify which forms of engineered transactions are the most harmful, and (3) provide reasonable solutions to the problem of engineered transactions that are narrowly tailored in addressing those specific harms.

I. The Issue with Engineered CDS Transactions

Engineered CDS transactions are transactions that occur when a "CDS counterparty (or group working together) takes affirmative steps to guarantee that its CDS position is profitable."[13] If the counterparty is a protection buyer, a credit event must trigger their payoff for their CDS position to be profitable a payoff must be triggered by a credit event.[14] Therefore, a counterparty engaging in an engineered CDS transaction would take action to ensure the CDS

4. *Id.* at 1083.
5. Oskari Juurikkala, *Financial Engineering Meets Legal Alchemy: Decoding the Mystery of Credit Default Swaps*, 19 Fordham J. Corp & Fin. L. 425, 430 (2014).
6. *See* Fletcher, *supra* note 2, at 1082.
7. *See id.* at 1083.
8. *See* Vincent S.J. Buccola et al., *The Myth of Creditor Sabotage*, 87 Univ. Chi. L. Rev. 2029, 2031 (2020).
9. *Id.*
10. M. Konrad Borowicz, *Contracts as Regulation: The ISDA Master Agreement*, 16 Cap. Mkt. L. J. 72, 88 (2021).
11. *Id.*
12. *Id.*
13. Fletcher, *supra* note 2, at 1093.
14. *See id. See also* Juurikkala, *supra* note 5, at 430 (noting that a credit event can be something other than outright nonpayment).

payoff is triggered.[15] Conversely, a counterparty acting as a protection seller would make preventative measures to ensure the CDS payoff is not triggered.[16]

Accordingly, engineered transactions consist of parties utilizing their resources to sway the outcome of a CDS contract in favor of their positions to increase the contract's profitability.[17] Given that engineered CDS transactions are most profitable in the case of financially distressed or near-distressed issuers, this essay aims to identify the strategies employed by parties engaged in engineered CDS transactions and the potential harm caused by their use.

A. Methods of Engineering CDS Transactions

The first tactic creditors can employ to engineer a transaction is to force a default through "workout frustration."[18] Workout frustration occurs when a net-short activist creditor ("saboteur") forces a payment default and liquidation, or a bankruptcy filing, by acquiring a substantial amount of the target debtor's bonds and refusing to tender them in any exchange.[19] If the saboteur holds a large enough position, it has the power to discourage other bondholders from accepting diminished claims.[20] Moreover, a saboteur holding a large enough participation has the ability to take advantage of a minimum-participation threshold for exchange offers and "scuttle" any exchange offers based on that threshold.[21]

The second method involves litigation; the saboteur can identify a covenant violation that is difficult to cure and sue the debtor in order to expedite repayment obligations (hereinafter "litigation default sabotage").[22] Under this strategy, the creditor is attempting to create a scenario where the debtor's illiquidity will make it unable to fulfill its financial obligations.[23] The debtor's accelerated obligation to repay a class of securities often constitutes a default on others, and a majority—if not all—of a company's debt may become due instantly.[24] In the case of leveraged firms, this scenario can lead to bankruptcy.[25] Importantly, this can constitute a credit event.[26] However, litigation default sabotage is likely only successful in cases where a saboteur has acquired an outright majority of at least one tranche of the targeted company's debt.[27] Moreover, litigation default sabotage will likely be a costly and lengthy process. First, bankruptcy is an expensive process that is typically more expensive than an agreement made outside of court.[28] Second, litigation itself is time

15. Fletcher, *supra* note 2, at 1075.
16. *Id.*
17. *See id.*
18. *See* Buccola et al., *supra* note 8, at 2045.
19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.* at 2046.
23. *See id.*
24. *Id.* at 2047.
25. *Id.*
26. *See* Fletcher, *supra* note 2, at 1082.
27. *See* Buccola et al., *supra* note 8, at 2047.
28. *Id.* at 2061.

consuming, and the resources required to undergo the process likely make this strategy less desirable than workout frustration.[29]

Additionally, CDS traders may manufacture default.[30] In the case of manufactured default, a CDS protection buyer offers the issuer financing on more favorable terms than the markets could provide.[31] In exchange for favorable financing, the issuer agrees to trigger a credit event under the terms of the CDS contract.[32] For example, the issuer may trigger a credit event by defaulting entirely upon outstanding debt.[33] Conversely, the issuer may only "technically" default by making a late payment on outstanding debt.[34] Regardless, the key component to manufacturing default is that the issuer is consciously deciding to not pay their debt obligations as a condition of their favorable financing agreement.[35] The key distinction between manufactured defaults and the previously discussed methods stems from the explicit cooperation of the issuer itself. This distinction is highly important given that the cooperation process extends beyond a CDS counterparty to the issuer, consequently ensuring a desired outcome on the CDS contract.[36]

On the other hand, financially distressed issuers can avoid default by collaborating with a CDS protection seller.[37] The protection seller is incentivized to engage in this form of collaboration as it can avoid an impending default until the credit protection it sold has expired.[38] Helping the issuer avoid default can be profitable for the protection seller if it earned more in premiums than necessary to keep the issuer solvent, or faces greater potential liabilities from the issuers default than would be covered by its collected premiums.[39] Accordingly, helping the issuer avoid default will either help by ensuring the protection seller's CDS contract is profitable or minimizing the losses on the CDS position.[40] Again, the crucial element of avoiding default is the agreement between the issuer and a CDS counterparty to cooperate and avoid a default.

Finally, CDS traders may also take actions to negate a default.[41] In such cases, the CDS protection seller offers financing to the issuer to restructure its debts, an action which shifts the issuer's debts off its own balance sheets and on to those of a subsidiary or affiliate.[42] The act of shifting the issuer's debt to a subsidiary or affiliate removes all outstanding debts from the issuer, and the CDS protection seller is guaranteed to retain the profits made on selling

29. *See id.* at 2060 (noting in footnote 101 that the relevant maneuvers require time-consuming litigation).
30. *See* Fletcher, *supra* note 2, at 1094.
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id. See also* Juurikkala, *supra* note 5, at 430 (noting that a credit event can include terms other than outright nonpayment).
35. Fletcher, *supra* note 2, at 1094.
36. *Infra* Section I.B.1.
37. Fletcher, *supra* note 2, at 1098.
38. *Id.*
39. *Id.* at 1099.
40. *Id.*
41. *Id* at 1101.
42. *Id.*

protection.[43] Again, the key distinction in the case of negating default in comparison to litigation default sabotage and saboteur transactions is the explicit cooperation between the issuer and a CDS counterparty to take action to shift or remove debts and negate a default.

Engineered transactions can be bifurcated into two categories: sabotage and collaboration transactions. Sabotage transactions are those where one counterparty takes specific actions against the issuer to generate a credit event in their favor. Collaboration transactions are those where a counterparty and the issuer collaborate with one another to generate a credit event. The crucial difference between these two forms of engineered transactions relies upon whether the engineering involves a collaborative process, or if it is a single actor. Throughout the rest of this paper, it will become clear that this distinction is highly important when addressing the potential harms of engineered CDS transactions and potential remedies for those harms.[44]

B. The Impact of Engineered CDS Transactions

The social impact of any given form of trading can be unveiled through a two-step process of first assessing the effect of the type of trading on market liquidity and price accuracy, then the trading's effect on social goals which relate to trading.[45]

1. The Effect of Engineered CDS Transactions on Price Accuracy

Price accuracy typically references the accuracy with which the market price of an issuer's security predicts the issuer's future cash flows.[46] Broadly, an accurate security price helps to reveal managers that perform poorly and improve the effectiveness of share price compensation schemes, threats of hostile takeovers, and activist hedge fund pressures as incentives for better managerial-decision making.[47] Moreover, an accurate security price tends to impute a greater sense of fairness on the part of investors, likely due to outcomes being more consistent with their expectations when purchasing a share.[48]

However, these functions do not apply in the case of credit default swaps. Rather, in the case of credit default swaps specifically, "the price of the CDS reflects the likelihood of an issuer's default as a result of its financial condition."[49] Engineered CDS transactions are alleged to diminish the pricing efficiency of the markets by affecting the reliability of the CDS spread as an indicator of the issuer's risk of default.[50] In non-engineered CDS transactions, creditors, and counterparties can attempt to determine an issuer's likelihood of default based

43. *Id.*
44. *Infra* Section I.B.
45. Merritt B. Fox et al., *Stock Market Manipulation and Its Regulation*, 35 YALE J. ON REG. 67, 82 (2018).
46. *Id.* at 83.
47. *Id.*
48. *Id.*
49. Fletcher, *supra* note 2, at 1109.
50. *Id.*

off the price of the CDS.[51] However, in engineered transactions, this is not always the case.

First, in the cases of engineered CDS transactions where collaboration is involved, i.e., manufactured default, avoiding default, and negating default ("collaboration transactions"), informational asymmetries regarding the nature of the CDS prohibit both the non-collaborating CDS counterparty, creditors, and the market from reaping the informational benefits of the CDS price.[52] Take, for example, a non-collaborating counterparty entering into a CDS contract with a collaborating counterparty who has the goal of manufacturing an issuer's default to provide valuable financing to an issuer. The non-collaborating counterparty, who would be the protection seller in this instance, agreed to provide compensation to the collaborating counterparty—the protection buyer—based off their ex-ante analysis of the issuer's default risk. The collaborating counterparty benefits from the information asymmetry in its contract with the non-collaborator, negotiating the CDS contract knowing it will reap the benefit of default in the long run. However, the non-collaborating counterparty analyzed the issuer's risk of default prior to entering into the CDS contract, likely determining the likelihood of default to be below that of reality. Accordingly, the non-collaborating counterparty has been stripped of its ability to engage in educated and informed CDS contracting because the price of the CDS contract is no longer representative of the issuer's financial condition, "despite there being no fundamental change to the issuer's" actual creditworthiness.[53]

Similar effects can be arguably seen in the case of workout frustration and litigation default sabotage ("saboteur transactions"), as well. Here, as with collaboration transactions, one party entering into the CDS contract is unaware of the strategy employed by their CDS counterparty. For example, one party is likely unaware that their counterparty plans to attempt workout frustration once entering into the CDS contract. The risk of default is, arguably, higher in cases where one party actively employs tactics to coerce an issuer's default than when such efforts are not undertaken. However, the distinguishing factor between saboteur transactions and collaboration transactions is the information asymmetry lies only between the two CDS counterparties, not between the non-collaborating counterparty and both the issuer and collaborating counterparty. Specifically, in the case of collaboration transactions, one party is unaware of the agreement between the issuer and its counterparty to take action that will favor the counterparty's CDS position. Conversely, a saboteur only knows its plans to manipulate issuer for the benefit of its position in the CDS contract. This raises the question of whether saboteur transactions have the same effect on CDS market information as collaboration transactions.

A typical CDS contract plays a speculative game, based on each party's own calculus of the underlying's default risk. Under the condition of no arbitrage opportunity existing, theoretically, the value of a CDS can be derived using a risk-neutral valuation principle, where the present value of the premium

51. *See id.*
52. *See id.*
53. *Id.*

payment in a risk-neutral world equals the value of protection the protection buyer can receive if the credit event occurs.[54] To ensure no arbitrage opportunity exists, the two values should be equalized.[55] Widely accepted to be absent from financial markets, arbitrage opportunities are investment strategies that guarantee a positive payoff without the possibility of negative payoff, and with no net investment.[56]

In collaboration transactions, arbitrage opportunity exists for the protection buyer. Consider a case of manufactured default. In the case of manufactured default, the protection buyer has first ensured a positive payoff because it has formed an agreement with the issuer for the issuer to default to generate a credit event for a payout. Because the protection buyer has collaborated with the issuer, the protection buyer has reaped the benefits of a positive payoff without possibility of negative payoff. Moreover, assuming the negotiation of default occurs prior to the point where the protection buyer's premium payments are equal to that of the settlement amount (the difference between par value of bond and auction-established settlement price of the bond),[57] the protection buyer has avoided net investment in this scenario. The presence of this arbitrage opportunity consequently suggests that the collaboration process of collaboration transactions obscures the true value of the CDS contract.[58]

Of course, this analysis forgoes discussion of negotiation issues that may arise between the issuer and its creditors in collaborating with a CDS counterparty in a financing arrangement.[59] First, creditors are inherently at a risk of loss if the collaborating CDS counterparty creates a default that destroys the issuer's value.[60] Therefore, disclosure of an engineered CDS transaction with the agreement to default could incentivize creditors to provide additional financing to avoid loss from that agreement. Accordingly, those creditors themselves act as alternative sources of liquidity.[61]

However, these caveats depend squarely upon disclosure of the engineered CDS transaction to creditors. Generally, "the primary source[s] of a debtor's obligation to creditors" are found under contract law.[62] Typically, the loan agreement or contract governing a creditor/debtor relationship includes covenants for the debtor to ensure it remains creditworthy and can include provisions requiring mandatory disclosure ex-ante.[63]

Moreover, fraudulent transfer laws exist to protect creditors by allowing ex-post nullification of transfers deemed actually, or constructively, fraudulent.[64]

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54. Haibin Zhu, *An Empirical Comparison of Credit Spreads Between the Bond Market and the Credit Default Swap Market* 3-4 (Bank for Int'l Settlements, Working Papers No. 160, 2004).

55. *Id.*

56. Philip H. Dybvig & Stephen A. Ross, *Arbitrage*, *in* FINANCE 57, 57 (John Eatwell et al. eds., 1989).

57. Fletcher, *supra* note 2, at 1083.

58. *See id.* at 1109.

59. *See* Buccola et al., *supra* note 8, at 2055.

60. *See id.*

61. *Id.* at 2056.

62. Steven L. Schwarz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 651 (1996).

63. *Id.*

64. *See id.*at 653. *See also* Uniform Fraudulent Transfer Act §§ 4(a)(1)-(2), 5(a)-(b).

Specifically, section 548(a)(1)(A) and (B) of the Bankruptcy code note that the transfer of the debtor's property, interest in property, or obligation incurred by the debtor can be "actual" fraud when the debtor acted with intent to defraud creditors, or constructively fraudulent when the debtor received less than the reasonably equivalent value for the property and was insolvent at the time of, or rendered insolvent by, the transfer.[65] A transfer under New York law includes every payment of money.[66] Thus, in the case of negating default, a creditor could potentially attempt to seek remedy when an issuer and CDS counterparty collaborate to create a credit event by providing financing shifting the issuer's debt obligations to a subsidiary. However, fraudulent conveyance laws limit creditors in some instances, noting that future creditors cannot void vulnerable transfers if the creditor knew or easily could have found out about them.[67] Additionally, a creditor could only seek remedy under these laws if the issuer subsequently enters into bankruptcy, negating the point of the collaboration transaction entirely. Furthermore, it is unclear as to whether seeking redress through fraudulence conveyance laws is applicable in this circumstance.

Additionally, a debtor-creditor relationship is not one of trust or reliance, and is consequently not covered under fiduciary duties.[68] Thus, commercial law limits a debtor's ex tempore obligations to a duty of good faith on lending relationships.[69] Specifically, implicit rules of conduct should be recognized if they arise from widespread courses of dealing in an industry or between specific parties.[70] Accordingly, a creditor's ability to intervene in an engineered CDS transaction is limited ex-ante to the disclosure made available, and its remedy is limited ex-post to fraudulent conveyance rules and litigation to remedy for a breach of the duty of good faith.[71] Consequently, creditors cannot easily prevent an issuer from engaging in a collaboration transaction without close monitoring of the issuer's activities or prohibiting them ex ante via contract.[72] Accordingly, arbitrage opportunity is not only present in collaboration transactions, but also poses a very real threat to creditors.

In the case of non-collaborative saboteur transactions, however, the protection buyer cannot guarantee a positive payoff. Consider a case of workout frustration. First, the saboteur refusing to tender bonds no matter how attractive the amount is simultaneously deals with one or a small group of arbitrageurs consolidating their positions to overcome the scenario.[73] Conversely, the saboteur could experience the other CDS counterparty entering into its own agreement to engineer a transaction to avoid or negate default. In short, there are significantly more variables at play in a saboteur transaction because the saboteur has not formed an agreement with the issuer. Consequently, the likelihood of arbitrage opportunity in these cases is significantly lower because

65. *See* 11 U.S.C. §§ 548(a)(1)(A)-(B).
66. *See* N.Y. Debt. & Cred. § 270 (McKinney).
67. Kupetz v. Wolf, 845 F.2d 842, 849-50 (9th Cir. 1988).
68. Schwarz, *supra* note 62, at 655.
69. *Id.* at 656.
70. *Id.* at 657.
71. *See id.* at 651-57.
72. *See* Cheryl W. Gray, *Creditors' Crucial Role in Corporate Governance*, 34 Fin. & Dev. 29 (June 1997).
73. *See* Buccola et al., *supra* note 8, at 2054.

there is no way to guarantee a payoff. Moreover, at least in the case of litigation default sabotage, the sheer financial cost of litigation—as well as its tendency to become lengthy before resolution is obtained—imputes that the likelihood of a net investment payoff is very low. Thus, saboteur transactions likely operate more in line with the assumed no-arbitrage principle due to the lack of confidence in the outcome of the saboteur's actions.[74] Accordingly, saboteur transactions may be less likely to substantially affect the pricing efficiency of markets in indicating an issuer's likelihood of default.[75]

2. *The Effect of Engineered CDS Transactions on Market Liquidity*

Liquidity is a multi-dimensional concept, generally relating to the size of a trade, the price at which it is accomplished, and the time it takes to accomplish said trade.[76] Generally, a larger sized purchase or sale, or a sale one that must accomplish expeditiously, will have a less desirable price.[77] However, a more liquid market can mitigate these tradeoffs.[78] A benefit of CDS contracts is that they enable investors to hedge their exposure to risk, which enhances the liquidity of the bond market.[79] Bondholders lower their credit risk through CDS contracts, which translates into more credit being available to other borrowers.[80] More investors become willing to lend credit due to CDSs' insurance-like functions.[81] Consequently, CDSs generally enhance market liquidity.[82] Importantly, any reduction in CDS market liquidity has the ability to increase the impact on overall market liquidity and price.

However, engineered CDS transactions are alleged to reduce the liquidity within the CDS market and generally reduce credit availability.[83] Ex ante, engineered CDS transactions reduce the number of traders in the market due to the previously discussed utility of CDS as a risk mitigation tool decreasing when certain engineered transactions occur.[84] Again, collaborative engineered CDS transactions have the effect of undermining the pricing efficiency of CDS markets because the market is unable to accurately price an issuer's risk of default.[85] An integral aspect of pricing efficiency is market liquidity, primarily regarding the presence of traders in the market with whom another trader may transact.[86] There is a symbiotic relationship between liquidity and pricing efficiency—if there are less traders in the market there is less liquidity.[87] Consequently, there is poor pricing efficiency.[88]

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74. *See* Zhu, *supra* note 54, at 3.
75. *See* Fletcher, *supra* note 2, at 1109.
76. Fox, *supra* note 45, at 84.
77. *Id.*
78. *Id.*
79. Fletcher, *supra* note 2, at 1116.
80. *Id.*
81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.* at 1113.
85. *Id.*
86. *Id.*
87. *See id.*
88. *Id.* (noting the symbiotic relationship between liquidity and pricing efficiency).

Traders exit the CDS market when collaboration transactions occur for a variety of reasons. First, the insurance-like functionality of CDS contracts is stripped due to the information arbitrage present in collaboration transactions.[89] Again, the CDS spread reflects the market consensus on the creditworthiness of the issuer and its risk of default.[90] In order to reap the benefits of using CDSs as a risk management tool, the integrity of the market pricing mechanism is of paramount importance.[91] When the integrity of the market pricing mechanism is adversely affected by the information asymmetry and arbitrage opportunity present in collaboration transactions, those seeking to use CDSs as a risk management tool can no longer effectively do so. Consequently, it is reasonable to anticipate that CDS counterparties seeking to utilize the insurance function of their contracts exit the CDS market in favor of other risk management methods. The exodus of these potential counterparties inherently reduces liquidity in the CDS market.[92]

However, CDS contracts are not solely used for insurance purposes; investors also use them as trading instruments.[93] Transactions aimed at generating profit for CDS traders through trading strategies are partly responsible for the liquidity of the CDS market.[94] In the absence of collaboration transactions, CDS traders can diversify their risk exposure in accordance with the preferences of their investors.[95] However, the possibility of collaboration CDS transactions makes a once reasonable investment unwise.[96] Rational investors could be less likely to invest in a CDS knowing that their counterparty may collaborate with the issuer to generate an outcome to their detriment.[97] Conversely, the investor themselves may begin collaboration discussions in an attempt to "get ahead" of their counterparty, potentially increasing the prevalence of collaboration transactions in the CDS market. Therefore, the negative externalities generated by collaboration transactions may proliferate, exacerbating the aforementioned problems.

On the other hand, the exodus of traders in the CDS market may be less significant in the case of sabotage transactions. First, as discussed previously, the pricing efficiency of CDS markets may not be as adversely affected in the case of saboteur transactions. Again, this is important since saboteur transactions contain significantly more contingencies that could prevent the engineered outcome from coming to fruition, thus arbitrage opportunity is not as significant. Accordingly, one could anticipate less of an exodus of traders from the market who seek to use CDSs' insurance functions to hedge their risk. These factors are also present in the case of CDSs used as trading instruments. Again, CDS traders likely exit the market when it becomes irrational to invest in a CDS knowing their counterparty can ensure an outcome that will be to

89. *Id.*
90. Nuray Terzi & Korkmaz Uluçaya, *The Role of Credit Default Swaps on Financial Market Stability*, 24 Procedia Soc. & Behavioral Sci. 983, 988 (2011).
91. *See* Fletcher, *supra* note 2, at 1109.
92. *Id.* at 1113.
93. *Id.*
94. Terzi & Ulçaya, *supra* note 90, at 988.
95. Fletcher, *supra* note 2, at 1113.
96. *Id.*
97. *Id.*

their detriment.[98] However, a trader may be less likely to exit the market if they are willing to take a bet that their counterparty will be unable to actualize its sabotage efforts.

3. Potential Social Issues Caused by Engineered Transactions

Although derivatives markets differ fundamentally from secondary equity markets in that the derivatives markets can be private and over the counter, some of the social goals related to secondary equity markets and their trading can be adopted in this instance. These social goals can be adopted as many directly relate to arguments in favor of engineered CDS transactions, specifically those that argue engineered CDS transactions are positive they provide financing to distressed companies that may otherwise not be available.[99]

A potential argument in favor of collaboration transactions is that the collaboration process is favorable to a distressed issuer as it provides an alternative form of financing the issuer may otherwise be unable to acquire.[100] However, in addition to the negative effects this may have on CDS market liquidity and pricing efficiency, there are serious concerns regarding efficient capital allocation. Again, in collaboration transactions, a financially distressed issuer seeks to raise capital by generating a credit event that will cause a payout for the collaborating counterparty.[101] In return, the collaborating counterparty will provide financing to the distressed issuer.[102] However, this process doesn't necessarily promote the efficient allocation of capital in the economy.

Necessary to the argument that engineered transactions provide funding to distressed issuers that cannot otherwise be obtained is the fact that the distressed issuer in question could not acquire debt or equity financing. Corporate debt overhang occurs when a corporation cannot afford to take on new debt and all earnings are put toward paying off existing debt.[103] Once the value of a firm's debt exceeds its payoff, the firm cannot raise additional funds to finance projects with a positive net present value and potential debtors cannot accurately evaluate a company's investment opportunities.[104] Moreover, potential equity holders are averse to financing projects whose benefits accrue only to existing debt holders because all revenues are utilized toward paying off debt.[105] Thus, debt overhang limits investment into distressed corporations. Accordingly, both investors and debt financers likely have refused to provide capital to the issuer because the issuer is distressed and cannot meet many of its

98. *See id.*
99. *See id.* at 1105.
100. *Id.* at 1076 ("Some commentators consider engineered transactions positive – they allow distressed companies to access favorable and much-needed funding, thereby increasing liquidity in the credit markets).
101. *See id.* at 1094.
102. *Id.*
103. Kristian Blickle & João A.C. Santos, *The Costs of Corporate Debt Overhang*, Fed. Reserve Bank N.Y. & Nova Sch. Bus. & Econ. 2 (July 16, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3708502 [https://perma.cc/XR9C-TRF4].
104. *Id.*
105. *Id.*

financial obligations.[106] Implicitly, the market has decided that it is inefficient to continue to finance the distressed company, instead prioritizing corporations that can maximize the value of financing and generate positive externalities in, among other things, the form of revenue, profits for shareholders, or innovation. Engineered transactions thus circumvent the market's assessment regarding the true value of placing financing into the distressed issuer.

II. How Can Collaboration Transactions be Prevented?

Before action can be taken to address the previously discussed harms that engineered transactions may pose, it is important to clarify exactly which transactions need addressing. In the case of collaboration transactions, the collaborating counterparty and distressed issuer have circumvented market participants to provide financing in a manner that generates negative externalities. Specifically, collaboration transactions reap the benefits of information asymmetries, exploit arbitrage opportunity, negatively affect pricing efficiency, and decrease liquidity in the CDS market. Moreover, collaboration transactions strip CDS contracts of their insurance-like protections, decrease trader confidence to the point of exit from derivatives market, and have the potential to create harm to CDS markets.

Non-collaborative saboteur transactions, on the other hand, do not hold such significant power over these factors. Specifically, the variables involved in saboteur transactions—namely financing, bargaining, and time constraints—act as barriers to success.[107] Specifically, a saboteur is likely to find its actions unprofitable to the point where they cease, or never begin, attempting to manipulate the issuer.[108] Consequently, those very same barriers protect CDS markets from saboteur transactions imposing the same effects as collaboration transactions. Additionally, attempting to control the actions of a sole counterparty creditor in a CDS contract proves difficult.[109] Given that saboteur transactions do not pose as significant of a risk to CDS markets, proposed solutions to this problem should target the collaborative process innate to collaboration transactions.

The International Swaps and Derivatives Association ("ISDA") was established in 1985 and acts as the trade association of the global derivatives industry.[110] ISDA promotes greater informational efficiency in derivatives markets in a variety of ways, but its specialized legal documentation for use in derivatives trades notably removed the costs of designing, drafting, and negotiating derivatives contracts.[111] ISDA has consequently provided contractual

106. *See* CFI Team, *Distressed Debt*, Corp. Fin. Inst. (Jan. 13, 2023), https://corporatefinanceinstitute.com/resources/fixed-income/what-is-distressed-debt/ [https://perma.cc/C9NR-3MEA].

107. Buccola et al., *supra* note 8, at 2081.

108. *Id.*

109. *See id.* at 2081-83.

110. Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, 91 N.Y.U. L. Rev. 1104, 1152 (2016).

111. *Id.*

standardization both through the standardized master agreements and the statutory frameworks that ensure effective enforcement of those contracts.[112]

The ISDA 2002 Master Agreement ("Master Agreement") is the standardized contract typically used by participants in the derivatives market.[113] The Master Agreement seeks to address both market problems, such as systemic risk or market integrity, and transactional problems, such as transaction costs.[114] Because the Master Agreement is unique in seeking to address both market and transactional problems, the document seemingly serves a regulatory function within the OTC derivatives market.[115] Indeed, since its inception, the Master Agreement increasingly incorporated regulatory elements, including the various information obligations under the Dodd Frank Act.[116] Robert Pickel, the former CEO of ISDA, even noted in a series of published articles that the Global Financial Crisis cemented a shift from a transactional to a regulatory paradigm.[117]

A crucial structural feature of ISDA's contracts is that they are modular.[118] "Modular" refers to a "contractual architecture comprising a multiplicity of elements."[119] In the case of modular contractual architecture, each element is designed to perform a specific function.[120] For example, in the case of CDSs, the transaction would be governed by the 2014 Credit Derivatives Definitions, which are governed by the Master Agreement.[121]

Certain provisions within the Master Agreement assume a regulatory function. For example, the close-out netting provision was designed to address systemic risk.[122] Additionally, some modular elements are more "regulatory" in nature than others due to the costliness and difficulty found in the modification process.[123] For example, credit support documentation, confirmations, and certain provisions of the Master Agreement that can be modified through the Schedule are not "regulatory" in the sense that they can all be easily modified.[124] Conversely, credit definitions, amendment protocols, and non-easily modified provisions of the MA are regulatory in the sense that ISDA has determined there is a limit to deviation from those terms, and that the limit is set by

112. *Id.*
113. M. Konrad Borowicz, *Contracts as Regulation: the ISDA Master Agreement*, 16 Cap. Mkt. L. J. 72, 73 (2021).
114. *Id.*
115. *See id.* (noting the article's purpose is to identify the Master Agreement's regulatory properties and that it is unusual for a contract to address market problems, but the shift to including elements from the Dodd Frank Act cemented the move toward the regulatory paradigm).
116. *Id.* at 74.
117. *Id.* (citing RG Pickel, Catastrophes, Punk Eek and Hopeful Monsters: A New Species of Financial Contract, 12 Cap. Mkt. L. J. 299 (2017)).
118. *Id.* at 77.
119. *Id.*
120. *Id.*
121. *Id.*
122. *Id.* at 80.
123. *Id.* at 77.
124. *Id.* at 78 (naming these non-regulatory provisions "relational").

the *market*—not the counterparties—with the help of ISDA as the predominant derivatives industry association.[125]

Given that some aspects of the Master Agreement assume a regulatory function, or were designed with regulatory intent, these areas could provide a form of control over collaboration transactions.[126] ISDA must look within the 2014 Credit Derivatives Definitions to identify areas where potential additions to or removal of language can achieve a regulatory effect.

In 2019, ISDA published proposed amendments to the 2014 Credit Derivatives Definitions regarding arrangements with corporations that cause credit events resulting in settlements of CDS contracts while having minimal impacts on the corporations, called narrowly tailored credit events ("NCTEs").[127] If adopted, the amendments would require a subjective determination that a credit event based off a failure to pay resulted from or in a deterioration in the financial condition or creditworthiness of the issuer.[128] Section 4.5 would be amended to include the qualification that "[i]f 'Credit Deterioration Requirement' is specified as applicable in the related Confirmation, then . . . it shall not constitute a Failure to Pay if such failure does not directly or indirectly either result from, or result in, a deterioration in the creditworthiness or financial condition of the Reference Entity."

However, section 11.1(b)(iii) of the 2014 Credit Derivatives Definitions includes a "self-interest" provision.[129] The self-interest provision allows the parties to participate in transactions involving the underlying referenced asset.[130] Significantly, the parties are allowed to engage in "any action which might constitute or give rise to a [c]redit [e]vent."[131] Moreover, the outdated 2003 Credit Derivatives Definitions Section 9.1(b)(iii) notes that each party and its affiliates and the calculation agent may generally engage in any kind of commercial, banking, or other business with a reference entity or affiliate of such, regardless of whether the action may have an adverse effect on the position of the counterparty to the transaction.[132] Specifically, section 9.1(b)(ii) notes that this business may include, without limitation, any action which might constitute or give rise to a credit event.[133] Accordingly, both past and present versions of the ISDA Credit Derivatives Definitions explicitly provide that any counterparty may deal with an issuer in business that may give rise to, or constitute, a credit event.[134] Consequently, collaboration transactions are explicitly permitted within the contractual guidelines of CDS transactions.[135]

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125. *Id.* 77-78.

126. *See id.* at 73. *See also* Robert G. Pickel, *Catastrophes, Punk Eek and Hopeful Monsters: A New Species of Financial Contract*, 12 Cap. Mkt. L. J. 299 (2017).

127. Donna Parisi et al., *ISDA Proposes Amendments to the 2014 ISFA Credit Derivatives Definitions Relating to Narrowly Tailored Credit Events*, Shearman & Sterling Perspectives (Apr. 11, 2019), https://www.shearman.com/en/perspectives/2019/04/isda-proposes-amendments-to-the-2014-isda-credit-derivatives-definitions.

128. *Id.*

129. *See* Borowicz, *supra* note 113, at 80.

130. *Id.*

131. *Id.*

132. ISDA 2003 C.D. § 9.1(b)(iii).

133. ISDA 2003 C.D. § 9.1(b)(ii).

134. *See id. See also* Borowicz, *supra* note 113, at 80.

135. *See* Borowicz, *supra* note 113, at 80.

There are several ways in which ISDA can impose limitations on the ability of CDS counterparties to engage in collaboration transactions with issuers.

First, ISDA could completely remove the language from sections 9.1(b)(ii) and 11.1(b)(iii) that permits parties to engage in transactions involving the underlying referenced asset. However, doing so could be overly broad in that it would encompass actions that do not generate the same negative externalities as collaboration transactions. For example, a CDS counterparty could engage in commercial activity with a public issuer by simply purchasing many of its products or services. First, the act of purchasing many products or services is not a form of collaboration, and thus does not necessarily provide greater arbitrage opportunity or increase information asymmetries significantly. As discussed previously, the arbitrage opportunity and information asymmetries increase due to the collaborative process between the issuer and a counterparty. Therefore, although a large influx of cash into the issuer could help the issuer meet its financial obligations and avoid triggering a credit event, this act is more akin to sabotage transactions in that the variables present prohibit the counterparty from being able to manipulate the CDS agreement in its favor.

In addressing collaboration transactions specifically, ISDA must ensure it does not make amendments that are overbroad at risk of regulating behavior that could increase market liquidity or create positive economic externalities. Accordingly, the language that should be targeted to eradicate collaboration transactions is the parenthetical qualification at the end of §§ 9.1(b)(iii) and 11.1(b)(iii), "including, without limitation, any action which might constitute or give rise to a [c]redit [e]vent."[136] This language should be removed entirely and replaced with a qualification that counterparties may *not* engage in any action that may constitute, give rise to, avoid, or negate a credit event. Moreover, given that sections IX and XI of the 2003 and 2014 Credit Derivatives Definitions are regarding representations, ISDA should additionally consider adding a representation that the party has not collaborated or communicated with the issuer in the CDS transaction about the CDS contract and the nature of the counterparty's position, or entered into a contract with the issuer for some benefit connected to the CDS transaction. Adding this language to newly amended Credit Derivatives Definitions would make it a breach of contract for a counterparty to enter into a collaboration agreement with the issuer and provide remedy through enforcement action for a counterparty experiencing loss due to a collaboration transaction.

ISDA should alternatively consider imposing disclosure requirements on the parties to the CDS contract regarding any contracts or agreements with the issuer. Although critics of this method of reform argue that enhanced disclosure requirements may reduce debt-market liquidity and make borrowing more expensive, those arguments critique disclosure requirements in the context of sabotage transactions, not collaboration transactions.[137] Indeed, even critics of disclosure requirements admit that sound reasons for legal reform in the case of engineered transactions exist, but sabotage is not one of those

136. Borowicz, *supra* note 113, at 80. *See also* ISDA, *supra* note 132, at § 9.1(b)(iii).
137. *See* Buccola et al., *supra* note 8, at 2036.

reasons.[138] However, the ex-ante and ex-post consequences of collaboration transactions—decreased market liquidity, arbitrage opportunity, and pricing inefficiencies—may be those very sound reasons. Arguably, ISDA should respect the freedom of potential CDS counterparties to contract with others in the market. However, that freedom should come with the benefit of reduced information asymmetries in the CDS market so traders can, at the very least, make educated decisions. Potentially, this disclosure may mitigate any surprises to CDS traders and reduce trader exodus from the CDS market, restricting the ability of collaboration transactions to reduce market liquidity. Disclosure is an imperfect solution, however. In reality, because of the harm collaboration transactions create in CDS markets, ISDA should utilize its power to standardize CDS contracts to prohibit collaboration transactions entirely. Without imposing either of these strategies in combination with the proposed amendment to section 4.5 of the 2014 Credit Derivatives Definitions, section 4.5 may not address all forms of harmful collaboration transactions. First, the language of 4.5 notes that it is limited to instances where a credit deterioration requirement is applicable.[139] While this may target instances of manufactured default, two other forms of collaboration transactions—those where issuers and CDS parties collaborate to avoid or negate default—are not covered under this amendment. Although much of this paper primarily discussed manufactured defaults to illustrate the harms of collaboration transactions, engineered transactions to avoid or negate default still adversely affect the price accuracy and liquidity of CDS markets. Again, collaboration transactions affect the ability of the CDS market to accurately gauge an issuer's risk of default. A counterparty and issuer taking action to avoid or negate default is in conflict with the market's assessment of the risk of default, which subsequently can affect the liquidity of the CDS market in the form of market participants. Consequently, the proposed amendment to section 4.5 will is too narrow and will not protect the CDS market from harm through collaboration transactions.

Conclusion

In a world of full and complete information, information arbitrage doesn't exist.[140] However, the reality is that the CDS market does not operate within a risk-neutral bubble, and information asymmetries provide that parties to a CDS contract are unaware of whether their counterparty has obtained arbitrage opportunity by collaborating with the issuer. Although ISDA could treat both sabotage and collaboration transactions the same in that the act of manipulating the issuer through collaboration or hostile actions violates the no arbitrage principle inherent in CDS market theory, the better approach is to bifurcate these strategies into two payoff structures. Again, in the case of collaboration transactions, one counterparty is in possession of information they are positive will occur. This asymmetry is incredibly valuable in relation to the rest of

138. *Id.*
139. *See* Parisi et al., *supra* note 137.
140. *See* Dybvig & Ross, *supra* note 56, at 57.

market actors, generating negative externalities in the form of price accuracy and market liquidity. However, in sabotage transactions, all the counterparty is aware of is its own behavior – not the outcome. In short, the saboteur could still fail in its attempts to manufacture a default. The difference lies specifically within the nature of one-party holding information that the other party does not hold, thus ISDA should recognize this distinction in its attempts to remedy the issue of engineered transactions. It is vital that ISDA recognizes vulnerabilities in its contractual scheme that can adversely affect the CDS market. Specifically, ISDA must recognize that the true harm to CDS markets lies within the collaboration process between a CDS counterparty and an issuer.

Collaboration transactions—transactions where a CDS counterparty and issuer collaborate to create, avoid, or negate a default—specifically reduce CDS market liquidity by: (1) stripping a CDS contract of its insurance-like protections and disincentivizing their use for that purpose, and (2) decreasing trader confidence in CDS trading and consequently creating a market exodus. Moreover, the collaboration process widens information asymmetries and presents arbitrage opportunity. The presence of arbitrage opportunity adversely affects price accuracy in CDS markets because the market can no longer use the price of a CDS contract to gauge the likelihood of an issuer's default.

ISDA can address the problem of collaboration transactions by narrowly tailoring new amendments to new Credit Derivatives Definitions. Specifically, ISDA should seek to remove the parenthetical language from sections 9.1(b)(iii) and 11.1(b)(iii) that allow counterparties to engage with an issuer in a manner that can create or constitute a credit event. Additionally, ISDA should ensure it adds language to note that a party to a CDS contract cannot collaborate with an issuer to engage in activities that may constitute, prevent, or negate a credit event. Conversely, ISDA could consider imposing disclosure requirements regarding collaboration with an issuer to reduce information asymmetries in the CDS market. Any modification to the Credit Derivatives Definitions must be broad enough to cover all forms of collaboration transactions, while also ensuring it is not too broad as to stifle any productive activity within CDS markets.