BY INDIRECTIONS FIND DIRECTIONS OUT: CREDIT DEFAULT SWAPS AND THE HOVNANIAN EXCHANGE OFFER

Date: 1 June 2018

U.S. Finance and Investment Management Alert

By: Anthony R.G. Nolan, Han (Hilda) Li

The recently completed exchange offer for K. Hovnanian Enterprises' 8% 2019 senior notes has roiled the world of credit default swaps ("CDS"); some observers have gone so far as to call it an existential problem for CDS. At least one lawsuit has been filed, and ISDA and the CFTC have expressed concern about market manipulation.[1] This issue has distinct implications for corporate issuers of debt, protection sellers, and protection buyers. As Tolstoy might have put it best if he were writing about financial markets rather than unrequited love, "all happy market players are alike; each unhappy market player is unhappy in its own way depending on its place in the market."

This article will briefly describe the issues posed by this situation at the intersection of corporate finance and CDS and will highlight implications for those who may be affected by it in their different ways.[2]

THE HOVNANIAN REORGANIZATION AND THE BACKSTOP COMMITMENTS

On December 28, 2017, Hovnanian Enterprises, Inc. (the "Company") and its wholly owned subsidiary K. Hovnanian Enterprises, Inc. ("K. Hovnanian"; together with the Company, "Hovnanian") commenced an offer to exchange K. Hovnanian's 8% senior notes due 2019 (the "8% 2019 Notes") for a combination of cash, new eight-year 13.5% unsecured notes (the "13.5% 2026 New Notes") and new 22-year 5% unsecured notes (the "5% 2040 New Notes"). Hovnanian also announced the redemption in full of all $132.5 million of 7% notes due in 2019 (the "7% 2019 Notes"). In conjunction with this exchange offer, Hovnanian solicited consents to eliminate the restrictions on its ability to purchase, repurchase, redeem, acquire, or retire for value various tranches and maturities of its indebtedness.

GSO Partners ("GSO") agreed to tender up to $170 million of its $236 million holding of 8% 2019 Notes into the exchange offer and had also agreed to provide Hovnanian a 5% unsecured facility to allow the company to redeem the 7% 2019 Notes and up to $80 million of 8% 2019 Notes not tendered in this exchange offer. Hovnanian agreed to cause its wholly owned subsidiary Sunrise Trails to purchase $26 million of the tendered 8% 2019 Notes for cash and to use that cash to fund the cash portion of the exchange offer. Hovnanian also agreed to covenant in the 5% 2040 New Notes indenture that it would default on interest payments owed to Sunrise Trail on its 8% 2019 Notes commencing on May 1, 2018. Hovnanian disclosed all of the above in its 1934 Act filings. Hovnanian does not appear to have disclosed that GSO owned $333 million of CDS credit protection against a Hovnanian debt default.[3] When the grace period ends for the interest payment default on the 8% 2019 Notes,

©2005-2024 K&L Gates LLP. All Rights Reserved.

the ISDA's DC will almost certainly be asked to decide whether the payment default triggered a credit event for CDS referencing Hovnanian debt. Perhaps more importantly, it will also be asked to decide whether to list the 5% 2040 New Notes as the deliverable obligations for the CDS auction. This is important because some observers expect the 5% 2040 New Notes to trade at 50 cents on the dollar, while the other Hovnanian debt is trading at or above par and the 13.5% 2026 New Notes are expected to trade above par. If the 5% 2040 New Notes are deliverable obligations in a CDS auction following a credit event on Hovnanian CDS, credit protection in purchasers on Hovnanian debt will stand to reap a windfall while those who sold credit protection on Hovnanian debt will likely incur corresponding losses.

CDS MARKET IMPLICATIONS

The Hovnanian debt restructuring has stoked concern about the integrity of the CDS market because of two issues in particular. First, whether the interest default covenant in the 5% 2040 New Notes indenture represented an effort to use a selective default to "manufacture" a credit event on CDS referencing Hovnanian debt. Second, whether the 5% 2040 New Notes (with nonmarket terms arguably designed to ensure they would trade well below par) were artificially created in order to present a very low value deliverable obligation as "cheapest to deliver," and thus increase the payout to CDS protection buyers.

Put another way, if payment defaults and "cheapest to deliver" bonds can be manufactured at will, it will be extraordinarily difficult, if not impossible, to price or value credit protection accurately in the $10 trillion CDS market, just as it would be impractical for insurance companies to price property insurance if property owners were permitted to destroy the insured assets to collect an insurance recovery and could affect the amount of the insurance coverage by manipulating market valuation. This uncertainty is the crux of the concern that leads some to characterize this situation as "existential."

On April 11, 2018, the ISDA board of directors expressed a concern that narrowly tailored defaults that are designed to result in CDS payments that do not reflect the creditworthiness of the underlying corporate borrower (the reference entity in the CDS), could negatively impact the efficiency, reliability, and fairness of the overall CDS market.[4] Although the CFTC and the ISDA announcement did not mention Hovnanian, it is widely accepted that they are reacting to this particular situation. (Interestingly, the Securities Exchange Act ("SEC") has been silent on this issue.)

In its statement, the ISDA board observed that the credit event determination process does not allow the DC to make subjective decisions or to consider the intent or good faith of the parties that put in place the arrangements leading to a potential credit event, and that the solution may be to amend the DC rules or the credit derivatives definitions. Consistent with that view, on April 20, 2018, the DC rejected consideration of a request to consider whether the DC rules provide the DC with "discretionary authority" pursuant to which the DC "may exclude an obligation as a deliverable obligation, even if it otherwise meets the deliverable obligation terms, when the DC determines that inclusion of the obligation would produce an artificially low auction final price."[5]

On April 24, 2018, CFTC Chairman Giancarlo stated publicly that manufactured credit events may constitute market manipulation and may severely damage the integrity of the CDS markets, including markets for CDS index products, and the financial industry's use of CDS valuations to assess the health of CDS reference entities.[6]

©2005-2024 K&L Gates LLP. All Rights Reserved.

Claims of market manipulation involving CDS are not new. Often they have involved a manufactured credit event, such as a restructuring or a narrowly missed balloon payment that effectively leaves bondholders whole except for a couple of days' interest but creates a technical event of default. After the development of the pay-as-you-go form of CDS that referenced asset-backed securities in 2004, there were several instances where controlling class investors in securitizations would use CDS to take outsize short positions on the tranches they held or on assets of the securitization, and use their voting power in the securitization to cause an event of default in order to trigger a credit event on the CDS, benefitting to the extent the gain on the CDS was larger than the loss on the cash position. It was generally difficult in those cases to prove manipulation. What appears to be novel is the creation of a new security that is intended to have a low trading price in order to have a deliverable obligation that provides a significant credit protection payment.

These and other issues are being tested in ongoing litigation. On February 1, 2018, Solus Asset Management ("Solus") filed a complaint against GSO and Hovnanian and certain of their control persons in the federal district court for the Southern District of New York, amended in April. GSO and Hovnanian have moved to dismiss the case; a hearing on that motion has been scheduled for July 11. Solus complaint includes allegations of securities fraud, both in respect to Hovnanian's debt and with regard to GSO's CDS positions and tortious interference with Solus's own CDS contracts as well as a claim for breach of the 8% 2019 Notes indenture. Solus also requests a declaratory judgment that Sunrise Trails waived the interest payment default on the 8% 2019 Notes, which would remove the triggering event for a CDS credit event. Interestingly, Solus does not claim violations of the antifraud provisions of the Commodity Exchange Act; presumably this is because all of the relevant Hovnanian CDS transactions reference a single name or a narrow-based index.[7]

Key issues in this litigation likely include whether the CDS aspect of the transactions described above was in connection with the purchase or sale of a security, whether uneconomic trading for an ulterior purpose is sufficient for a Section 10(b) violation, whether CDS protection sellers have incurred damages before the DC has made a determination, whether Hovnanian or GSO had a duty to disclose GSO's short CDS positions, whether Hovnanian's disclosure about the restructuring and the consent solicitation was materially incorrect or misleading, how concepts such as reliance and scienter apply in the CDS market, whether tortious interference in contract can arise from an action that changes the outcome of an existing CDS contract but that does not affect the entry into the contract, and whether a prepackaged event of default gives rise to enforceable remedies.

On May 30, 2018, Solus announced a settlement with Hovnanian and GSO under which GSO consents to amend the 5% 2040 New Notes indenture to allow Hovnanian to cure the "default" under the 8% 2019 Notes, which Hovnanian did cure on the same day. GSO has also agreed not to support any future failure to pay events affecting Hovnanian. Luckily for Hovnanian, the settlement won't impact the benefits it receives from the financing transactions with GSO. A stipulation was filed on the following day to dismiss the Hovnanian litigation "with prejudice."[8]

CONSIDERATIONS FOR ISSUERS AND CDS TRADERS

The Hovnanian exchange offer has important implications for those who may be directly or indirectly exposed to corporate credits in cash form or through CDS.

©2005-2024 K&L Gates LLP. All Rights Reserved.

For issuers of corporate debt, the strategy described above, although perhaps hard to duplicate given the recent litigation development, may nevertheless represent another lever that increases their ability to obtain favorable borrowing terms and realize significant reductions in debt funding costs. The emerging positions of regulators and the evolving litigation will be material to the risks and benefits to an issuer of doing so. Normally, a debt issuer is not required to disclose the potential impact of a transaction on CDS markets. In the future, it may be important to address questions of materiality in disclosure regarding all aspects of a debt restructuring and to consider whether or not the issuer has a duty to disclose impacts of transactions on technically unrelated markets where it has no contractual privity. These will be affected by factors such as whether the issuer plays in its own CDS. An understanding of these dynamics and related legal issues may also be material to a determination whether a debt restructuring is likely to succeed.[9] CDS traders may be affected in various ways by the outcome of the Hovnanian DC process and the ongoing litigation. Going forward, as the ISDA board has indicated that the issues unearthed by the Hovnanian exchange offer may require a change to the ISDA, CDS documentation, or DC rules, the technical aspects of amendments of the 2016 Credit Derivatives Definitions or the DC rules may be increasingly important to the economics of CDS trading on corporate names. This may also be relevant to litigation involving CDS.

Analogous trading issues may arise in relation to equity transactions where there is a relation to total return swap transactions ("TRS"). Although the ISDA documentation and settlement mechanics and securities law concerns for TRS are different than those for CDS (including the need to consider whether the TRS gives rise to section 13 reporting obligations), certain principles described above may apply in some guise to the aggressive use of TRS in corporate restructuring transactions.

Entities who may seek to engage in similar transactions to those described above or who may feel themselves aggrieved by such transactions will have to be sensitive to the regulatory framework of CDS, including the antifraud provisions of the SEC and of the Commodity Exchange Act. The shifting law regarding market manipulation in CDS may be highly relevant to these market players.

Notes:

[1] ISDA, or the International Swaps and Derivatives Association, is the leading swaps market organization. The CFTC, or the Commodity Futures Trading Commission, is a principal regulator of swaps, including broad-based security based swaps.

[2] CDS are derivatives that permit counterparties to express long or short views on a reference entity's ability to pay its debts (that is, risk of bankruptcy or default). If a credit event occurs with respect to a reference obligation under a CDS, the protection buyer is entitled to receive a payout based on the deterioration in market value of a deliverable obligation of the reference entity. The most typical credit events are triggered by the reference entity's bankruptcy, its failure to pay on reference obligations indebtedness, or certain types of debt restructurings of reference obligations. All CDS are cash settled based on an auction of specified debt of the reference entity that satisfies the "cheapest to deliver" convention (the "deliverable obligation"). In order to address CDS settlement on a market-wide basis, CDS counterparties rely on ISDA's Determinations Committee ("DC") to decide whether a given event affecting debt of a reference entity has triggered a credit event under the CDS and to identify the deliverable obligations for valuation in the settlement auction. The DC process is initiated by requests from market participants that it take action and the DC rules mandate provide for iterative consultation with market participants if there is disagreement with a decision. The Americas DC consists of nine swap dealers and five nondealers

©2005-2024 K&L Gates LLP. All Rights Reserved.

(currently Alliance Bernstein, Citadel, Cyrus, Elliott, and PIMCO). For a dated but generally accurate description of the CDS auction settlement process and the role of the DC, please read the linked article: http://www.klgates.com/a-new-era-for-credit-default-swaps-03-13-2009/.

[3] Based on publicly available information, GSO amassed its large short CDS position in early 2017 because it believed Hovnanian would default on $700 million of indebtedness maturing later in that year. When Hovnanian successfully restructured that indebtedness, GSO's position lost its value. *Cf.* B. Arends, *Taking a Chance on Hovnanian Shares*, https://www.barrons.com/articles/taking-a-chance-on-hovnanian-shares-1518836290.

[4] *See ISDA Board Statement on Narrowly Tailored Credit Events*, (April 1, 2018), https://www.isda.org/a/6UmEE/ISDA-Board-Statement-on-Narrowly-Tailored-Credit-Events.pdf.

[5] For the ISDA DC Determination to reject this question, *see* https://dc.isda.org/cds/n-a/.

[6] *See Statement on Manufactured Credit Events by CFTC Divisions of Clearing and Risk, Market Oversight, and Swap Dealer and Intermediary Oversight*, (April 24, 2018), https://www.cftc.gov/PressRoom/SpeechesTestimony/divisionsstatement042418.

[7] Under the Dodd-Frank Act, CDS based on nine or fewer reference entities are "securities" and CDS that reference broader indices like the S&P 500 are "commodities." Entry into and early termination of a transaction may be regarded as the equivalent of a "purchase" or "sale" of a security under the SEC or analogous concepts under the Commodity Exchange Act.

[8] *See Stipulation of Dismissal with Prejudice*, https://reorg-research.com/pdf/1643101.pdf.

[9] For example, news reports speculate that the reason why Hovnanian offer to exchange $440 million outstanding 10% senior secured notes due 2022 and $400 million outstanding 10.5% senior secured notes due 2024 for newly issued 3% senior notes due 2047 did not satisfy the minimum exchange condition was that investors were concerned about liability concerns in light of the brouhaha that has surrounded the 8% 2019 Notes exchange offer.

KEY CONTACTS

ANTHONY R.G. NOLAN
PARTNER

NEW YORK
+1.212.536.4843
ANTHONY.NOLAN@KLGATES.COM

©2005-2024 K&L Gates LLP. All Rights Reserved.

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.

©2005-2024 K&L Gates LLP. All Rights Reserved.