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Merrill Lynch Ruling Impacts CDS Agreements

In *Merrill Lynch Int'l, Merrill Lynch & Co. v. XL Capital Assurance Inc., XLCA Admin LLC*, Judge Jed S. Rakoff of the United States District Court for the Southern District of New York determined that a credit protection buyer had not repudiated its contractual obligations under a credit default swap ("CDS") agreement, thereby permitting the credit protection seller to terminate the CDS, because the protection buyer had neither breached the terms of the CDS nor rendered its performance of the terms impossible. This case is significant because it demonstrates that a court will enforce the often technical wording of a CDS contract rather than allow a CDS provider to exercise termination rights based on a prospective inconsistency with a CDS with a third party.

Background

The case was based on a dispute over seven Collateralized Debt Obligation ("CDO") CDS agreements entered into by Merrill Lynch International ("MLI") as the credit protection buyer and XL Capital Assurance Corporation ("*XLCA*") as the credit protection seller to provide credit protection in connection with the Class A-2 note tranche that MLI owned in seven separate CDOs. As part of the Class A-2 note tranche CDS agreements, MLI gave XLCA controlling class rights over both the Class A-1 note tranches and Class A-2 note tranches that it owned in the seven CDOs; these rights were explicitly defined in the CDS as "the failure . . . to exercise any Voting Rights . . . solely in accordance with the written instructions of XLCA." Subsequent to entering into these CDS agreements with XLCA, MLI entered into six new CDS agreements with MBIA Insurance Corporation (the "MBIA CDS Agreements") that provided credit protection in connection with the Class A-1 note tranches in six of the same seven CDOs. As part of the MBIA CDS Agreements, MLI gave MBIA Insurance Corporation ("MBIA") the same voting rights over the Class A-1 note tranches that MLI had previously given XLCA over the same tranches. MBIA expressly acknowledged the possibility that MLI could enter into CDS containing conflicting voting rights and that in the event MLI failed to comply with MBIA's instructions, MBIA's only remedy would be to terminate the MBIA CDS Agreements by declaring an additional termination event (an "Additional Termination Event").

On February 22, 2008, XLCA sent six termination notices with respect to the six CDOs covered by the MBIA CDS Agreements, claiming that MLI had repudiated its contractual obligations under the six CDS agreements and that XLCA was entitled to terminate its CDS agreements by declaring an Additional Termination Event. On the same date, XLCA sent a notice requesting confirmation that MLI did not enter into any agreement or understanding with a third party with respect to the controlling voting rights on any or all of the Class A-1 note tranche or Class A-2 note tranche of the seventh CDO.

On February 29, 2008, MLI responded to XLCA's six termination notices by claiming that an Additional Termination Event was not triggered because MLI had not failed to exercise voting rights in accordance with instructions from XLCA nor had it exercised any voting rights without the consent of XLCA.

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Response

After a further exchange of letters, on March 19, 2008, MLI filed suit requesting that the court make a declaration that XLCA must remain bound by the XLCA CDS agreements. During the case, MLI made a motion for summary judgment, arguing that it was clear from the face of the CDS agreements that MLI had not anticipatorily breached or repudiated any of the six CDS agreements with XLCA in which voting rights allegedly overlapped with the MBIA CDS Agreements. (XLCA conceded that MLI had not breached any of the CDS agreements; no written instructions as to voting rights having been given). MLI further argued that it had not failed to provide adequate assurance with regards to the seventh CDS. Judge Rakoff agreed with MLI's contentions.

The Court's Analysis

The court held, with respect to the six CDS agreements, that MLI had not anticipatorily breached the agreements. The court found that an anticipatory breach could not occur simply by (i) MLI entering an agreement with MBIA entitling it to a declaration of an Additional Termination Event if MLI did not follow MBIA's instructions or (ii) a public announcement by third parties that MLI intended to vote on matters regarding the six CDOs in accordance with instructions from MBIA. Noting that "MLI's contract with XLCA does not, as XLCA represents, grant controlling class voting rights unconditionally to XLCA," the court held that under the "plain language" of XLCA's CDS, "XLCA grants MLI protection in the case of default, and MLI grants XLCA control (via the exercise of voting rights) over certain factors affecting the risk of default—but if MLI chooses not to cede control (i.e., refuses to vote in accordance with XLCA's wishes), it thereby relinquishes XLCA's protection" by triggering an Additional Termination Event, which would also require MLI to pay XLCA certain make-whole amounts.

The court further stated that an anticipatory breach could not occur under these circumstances because even though MLI entered into an agreement with MBIA, MLI could still opt to follow XLCA's instructions. The court explained that when comparing the plain language of the MBIA CDS agreements and XLCA CDS agreements there was no overlap in priority of voting rights. The MBIA CDS agreements provide that MLI must "exercise all voting rights . . . only at the discretion of [MBIA] . . . subject to Section 9(b)." Section 9(b) provides that if MLI does not obey MBIA's instructions because they are in conflict with other obligations, MBIA is merely entitled to an Additional Termination Event. The court further explained that the absence of similar language in the XLCA CDS agreements suggests that, if anything, it was MLI's intention to give XLCA higher priority voting rights as it entitled MLI to decline to follow instructions from MBIA in order to uphold its obligations to XLCA. Thus, the court reasoned that XLCA had no grounds upon which to issue the termination notices with respect to the six CDS agreements.

The court further held that adequate assurance is a concept that only applies to the UCC sale of goods and other limited circumstances. The court chose not to extend adequate assurance to the instant case.

Prospective Impact

This case provides an interesting development for the credit protection market because it clarifies the scope of conduct that will not constitute an anticipatory breach or repudiation of a CDS agreement. As a result of this precedent, it is likely that an attempted termination of a CDS agreement by a credit protection seller due to statements or behavior by a credit protection buyer that may appear to demonstrate a credit protection buyer's intention not to follow the credit protection seller's instructions in the future will not be upheld by a court, provided performance with such instructions has not been rendered impossible. Conversely, if a credit protection buyer breaches the agreement by actually failing to follow instructions received from a credit protection seller, then it is likely that an attempted termination of a CDS agreement by a credit protection seller would be upheld by a court.

This case may have already had an impact on the remediation strategies that credit protection sellers employ in connection with problematic credit default swap agreements. Shortly after the opinion in this case was handed down, XLCA and MLI entered into a settlement agreement for a lump sum payment by XLCA to MLI in exchange for termination of the credit default swap agreements. (*See* "SCA-Merrill Deal May Set Tone on Bond Insurance Pacts," *Wall Street Journal*, July 29, 2008). Several other monoline financial guarantors who have been unable to terminate credit default swap agreements on other grounds have begun to follow suit by negotiating similar settlement agreements. *Id*. With options limited for termination, settlement agreements may become more prevalent to clear problematic credit default swap agreements from a firm's portfolio or to avoid insolvency for firms who are party to a significant number of credit default swap agreements affected by the current credit crisis in the capital markets.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work. Visit us at www.dechert.com/finance&realestate.

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