

Subprime Practice Group Advisory: Decision Supports Enforceability of Credit Default Swaps

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The United States District Court for the Southern District of New York recently issued a summary judgment decision that supports the enforceability of credit default swap obligations (“CDSs” or “swaps”) to pay principal and interest on defaulted collateralized debt obligations (“CDOs”) in the matter of *Merrill Lynch International v. XL Capital Assurance Inc., et al*, Case #: 1:08-cv-2893-JSR. The ruling is significant because of the substantial losses incurred by investors and financial institutions that were caused by CDO defaults, the use of CDSs to hedge or protect against such losses, and the anticipated growth of litigation with respect to both.

An inability to enforce swaps would sharply deepen the CDO-based financial crisis for investors and financial institutions, which hedged their CDO positions with swaps. The ruling stands for the proposition that unproven, speculative allegations of a breach of CDO control provisions, specifically, voting rights, will not survive summary judgment or relieve the issuers of credit protection of payment obligations on insured CDO default, absent proof of actual breach.

The subject swaps were purchased by plaintiff Merrill Lynch International (“Merrill Lynch” or “MLI”) from XL Capital Assurance Inc. (“XLCA”) to provide a \$3.1 billion payment guarantee to MLI by XLCA in the event of specified events of default with respect to principal and interest obligations of seven CDO trusts. Shortly after the swap agreements were signed and payments were made by Merrill Lynch to XLCA, in a letter motivated by what Merrill Lynch’s complaint describes as “buyer’s remorse,” XLCA claimed that Merrill Lynch breached its contractual obligations and declared itself free of its payment obligations under the swaps.

Specifically, XLCA alleged that Merrill Lynch breached the covenant to provide XLCA control rights by purportedly granting control of the CDO voting rights to another provider of credit protection with respect to higher level tranches of the same CDOs. XLCA purportedly did not issue any directive to Merrill Lynch to exercise voting rights with respect to the control covenants which it claims were breached.

Merrill Lynch denied that it had entered into any hedging agreement with any other counterparty that would preclude it from exercising voting rights controlled by XLCA. MLI claimed that XLCA improperly issued notices purporting to terminate the seven credit default swaps “without any basis and under a pretext based entirely on rank speculation.”

In a one-page ruling, the court granted Merrill Lynch’s summary judgment motion in all respects finding that Merrill Lynch had not repudiated its obligations under the seven credit default swaps with XLCA and that XLCA’s attempt to terminate those swaps was without effect. An opinion setting forth the reasons for the ruling will follow.

This case is a reminder that CDO credit protection issuers may allege breach of covenants to escape contractual obligations. CDS counterparties are advised to be acutely aware of and compliant with their covenant obligations and to respond carefully and with legal assistance to communications from CDS issuers with respect to such covenants and obligations.

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