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Corporate Distress, Credit Default Swaps, and Defaults: Information and Traditional, Contingent, and Empty Creditors

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CORPORATE DISTRESS, CREDIT DEFAULT SWAPS, AND DEFAULTS: INFORMATION AND TRADITIONAL, CONTINGENT, AND EMPTY CREDITORS*

Henry T. C. Hu[**]

ABSTRACT

Federal securities law seeks to ensure the quality and quantity of information that corporations make publicly available. Informational asymmetries associated with companies in financial distress, but not in bankruptcy, have received little attention. This Article explores some important asymmetries in this context that are curious in their origin, nature, and impact. The asymmetries are especially curious because of the impact of a world with credit default swaps (CDS) and CDS-driven debt "decoupling."

The Article explores two categories of asymmetries. The first relates to information on the company itself. Here, the Article suggests there is fresh evidence for the belief that troubled companies may prove lax in securities law compliance and for the existing "final period" explanation for such laxity. The Article also offers two new explanations: one based on the requirements for class action certification in Rule 10b-5 litigation and the other based on uncertainties as to private enforceability of "Management's Discussion and Analysis" disclosure requirements.

Building on the existing analytical framework for decoupling, the Article also examines a less obvious category of asymmetries: "extra-company" informational asymmetries flowing from the CDS and CDS-driven debt decoupling activities of third parties. Such third-party activities can be determinative of a company's prospects, but reliable public information on the presence, nature, and magnitude of such activities tends to be scant. Here, even the company itself, not just investors, may not have the requisite information, including information on the highly counterintuitive and unusually complex incentives that such third parties may have. Unlike traditional creditors, "empty creditors with a negative economic ownership" as well as certain other buyers of CDS protection can have strong incentives to intentionally cause corporations to go bankrupt even when bankruptcy would make little sense. Such third parties may profit not only from actual

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** Professor Hu holds the Allan Shivers Chair in the Law of Banking and Finance, University of Texas Law School. This Article is based partly on my presentations at the University of Texas Law School conference in honor of Jay Westbrook (Feb. 3, 2018) and the Brooklyn Law School symposium on "The Market for Corporate Control in the Zone of Insolvency" (Mar. 2, 2018). Roughly similar versions are appearing in the anticipated *Festschrift* volume and this corporate control symposium issue. I have benefited much from the comments of conference/symposium participants and the assistance of Michael Davis, Jacob McDonald, Vaughn Miller, Scott Vdoviak, Alicia Vesely, Helen Xiang, and Lei Zhang.

defaults on financial covenants—at just the right times—but also from artificially manufacturing "faux" defaults or seizing on real, but largely technical, defaults. The Article examines such CDS and "net short" creditor matters through the lens of four examples. The three most important and recent of these examples have not previously been considered in the academic literature: Norske Skog (a Norwegian lumber company) (involving Blue Crest and GSO Capital Partners), Hovnanian (an American home builder) (involving GSO Capital Partners), and Windstream Services (an American telecommunications company) (involving Aurelius).

INTRODUCTION

Financially troubled companies, endemic to our economic system, are likely to become more pervasive. Since October 1, 1979, more than a thousand large public companies became so distressed that they ended up in bankruptcy.[1] In 2016, the average Standard & Poor's credit rating for U.S. corporate debt fell to junk levels.[2] In April 2018, the International Monetary Fund reported that the U.S. market for leveraged loans had reached almost $1 trillion[3] and that two-thirds of loans extended in 2017 were rated "B" or lower.[4] In May 2018, Moody's stated that a prolonged environment of low growth and low interest rates has caused "striking changes in nonfinancial corporate credit quality."[5] Such deterioration in credit quality leaves corporations especially vulnerable as interest rates return to normal.

The task of protecting debt and equity investors in companies in danger of bankruptcy will thus be increasingly important. The academic literature has largely focused on the role of substantive corporate law in doing so, in particular the doctrine of "duty shifting" present in the substantive law of many states. Under this doctrine, when a corporation is sufficiently distressed—but not bankrupt (and thus not subject to the alternate mandates of federal bankruptcy law)—management must shift its focus from the interests of shareholders to the interests of bondholders or the enterprise as a whole. A vast academic literature is devoted to this doctrine, including a work that I co-authored with Jay Westbrook.[6]

1. *See A Window on the World of Big-Case Bankruptcy*, UCLA-LOPUCKI BANKRUPTCY RESEARCH DATABASE, http://lopucki.law.ucla.edu/ (last updated Aug. 2018).

2. Patrick Gillespie, *Junk Territory: U.S. Corporate Debt Ratings Near 15-Year Low*, CNN MONEY (Mar. 24, 2016), http://money.cnn.com/2016/03/24/investing/us-corporate-debt-rating-junk-15-year-low/index.html.

3. INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: A BUMPY ROAD AHEAD 12 (2018).

4. *Id.* at 15.

5. Jeff Cox, *Moody's Warns of 'Particularly Large' Wave of Junk Bond Defaults Ahead*, CNBC: CORP. BONDS (May 25, 2018), http://www.cnbc.com/2018/05/25/moodys-warns-of-particularly-large-wave-of-junk-bond-defaults.html.

6. Henry T. C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321, 1340 (2007). By mid-2006, over 150 law review articles had cited the

In contrast, the role of disclosure with respect to such troubled, non-bankrupt companies has received little academic attention.[7] This Article explores some important informational asymmetries in this context, and which are curious in their origin, nature, and impact. Disclosure matters for companies that are already in bankruptcy are different and extensively discussed elsewhere.[8]

This Article explores two types of asymmetry that undermine the robust informational base needed by investors in such troubled companies. The first type is simple and direct: asymmetry with respect to information about the company itself that the company does not fully convey to investors. This Article suggests that there is fresh evidence for the belief that troubled companies may prove lax in securities law compliance and for a longstanding explanation for such laxity. In addition, the Article offers two new explanations rooted in securities law developments.

Building on the existing analytical framework for decoupling, the Article also examines a less obvious category of asymmetries: "extra-company" informational asymmetries flowing from credit default swaps (CDS) and CDS-driven "debt decoupling" activities of third parties.[9] Such third-party activities can be determinative of a company's prospects, but reliable public information on the presence, nature, and magnitude of such activities tend to be scant. Here, even the company itself, not just investors, may not have the requisite information. This Article largely examines such CDS and debt decoupling matters through the lens of four examples, the three most important and recent of which have not previously been considered in the academic literature.

Part I centers on information about the troubled company itself. Troubled corporations can be lax in securities compliance. (*Part I(A)*). Woody Allen

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seminal 1991 duty shifting case, *Credit Lyonnais Nederland, N.V. v. Pathe Commc'ns Corp.*, No. Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

7. The earliest academic work that deals in a material way with the disclosure aspects of distressed but not bankrupt companies appears to be Richard H. Mendales, *Looking Under the Rock: Disclosure of Bankruptcy Issues Under the Securities Laws*, 57 OHIO ST. L. J. 731 (1996). More recent academic works in this space do not try to offer an integrated overview but instead center on particular situations, such as the "final period" incentive pattern discussed in Part I(B).

8. A company in bankruptcy is generally subject to two disclosure regimes, one under federal bankruptcy law and one under federal securities law. As to federal securities law, an "SEC-lite" disclosure regime is sometimes available. *See, e.g.*, Application of the Reporting Provisions of the Securities Exchange Act of 1934 to Issuers Which Have Ceased or Severely Curtailed Their Operations, Exchange Act Release No. 9660, 1972 WL 121308 (June 30, 1972); David J. Barton, *SEC Disclosure, Filing Requirements for Public Companies in Chapter 11*, J. CORP. RENEWAL, Jan. 2009, at 1. As to works on disclosure matters for companies in bankruptcy, *see, e.g.*, Kelli A. Alces, *Limiting the SEC's Role in Bankruptcy*, 18 AM. BANKR. INST. L. REV. 631 (2010); Dennis F. McNally, *Relaxed SEC Reporting Requirements for Domestic Companies in Bankruptcy*, 26 CAL. BANKR. J. 324 (2003); 7 COLLIER ON BANKRUPTCY ¶ 1125.02 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011).

9. *See* Part II.

said, "[s]howing up is 80 percent of life."[10] Fresh evidence, found in an unexpected source, suggests that many troubled companies simply do not show up: they do not even bother to file the required Securities and Exchange Commission (SEC) periodic documents. Moreover, when they do show up, a surprising number embarrass themselves with misrepresentations.

The Article then turns to a longstanding explanation for the laxity and offers two new ones. After briefly setting forth the existing "final period" explanation, the Article refers to new empirical work from an unlikely source that is consistent with the underlying intuition. (*Part I(B)*). The Article then shows how two aspects of current securities law, by lessening the threat of private enforcement, can also contribute to laxity. First, requirements for class action certification in Rule 10b-5 litigation are more difficult to meet in the troubled company context. (*Part I(C)*). Second, recent cases have created uncertainty as to private enforceability of an important disclosure item—the "Management's Discussion and Analysis" (MD&A)—of particular salience to troubled companies. (*Part I(D)*).

Part II centers on extra-company informational asymmetries flowing from CDS and CDS-driven debt decoupling activities of third parties. The highly counterintuitive and unusually complex incentives that such third parties may have can be determinative of the ultimate change in control: bankruptcy. But even the company itself, not just investors, may not have reliable and timely information on the presence, nature, and magnitude of such activities and incentives. Unlike traditional creditors, "empty creditors with a negative economic ownership" as well as certain other buyers of CDS protection can have strong incentives to intentionally cause corporations to go bankrupt even when bankruptcy would make little sense. Such third parties may profit not only from actual defaults on financial covenants—at just the right times—but also from manufacturing "faux" defaults or seizing on real, but largely technical, defaults. The Article begins consideration of such CDS and net short creditor matters with a brief overview of the existing analytical framework for decoupling, a framework that addresses the impact on corporations of third-party CDS activities and associated terminology such as "empty creditors" and "empty creditors with a negative economic ownership." (*Part II(A)*).

The Article then examines four significant real-world examples of such matters. The first example (Radio Shack) shows the impact of a CDS *seller* being, in effect, a contingent creditor of the pertinent company and taking steps consistent with this status. The second example (Norske Skog) shows how certain empty creditors can have exceptionally complex, dynamic, counterintuitive, and certain difficult-to-detect incentive patterns. The third example (Hovnanian) shows a CDS *purchaser* seeking to create what can be described as a "faux" default: an artificially manufactured covenant default

10. YALE BOOK OF QUOTATIONS 17 (Fred R. Schapiro ed., 2006).

that, *benefits* the pertinent company and extracts funds from the CDS *seller*. The final, perhaps most consequential, example (Windstream Services) involves an alleged empty creditor with negative economic ownership that might be seizing on what some observers view as a real, but largely technical default, in order to cause financial distress, if not bankruptcy, to a going concern. (*Part II(B)*).

This Article is a brief work consistent with the space constraints of the anticipated *Festschrift* volume and this symposium issue. It is meant as an initial, exploratory foray. It is not intended to identify all factors undermining the informational base associated with troubled companies and, apart from a few ideas mentioned in passing in the Windstream discussion and in the Conclusion, does not explicitly address the matter of solutions.[11]

I. INFORMATIONAL ASYMMETRIES AS TO THE COMPANY

A. OVERVIEW: THE ROBUST INFORMATIONAL BASE AND TROUBLED COMPANY LAXITY IN COMPLIANCE

With the usual public company, disclosure and market forces animated by disclosure play crucial roles in protecting investors. The SEC's core goal has always been to ensure a robust informational base that investors can use in their decision-making and that can help deter managerial misbehavior.[12] In the 1970s, the efficient market hypothesis (EMH) provided a social science foundation for the disclosure philosophy.[13] An efficient market supported by good information would facilitate the market for corporate control. The stock price would reflect lazy and incompetent management, and a low stock price would encourage changes in control.[14]

Many troubled corporations do not bother to even facially comply with federal securities disclosure requirements. In Woody Allen terms, many don't show up. New evidence, found in a current working paper on the entirely different matter of forum shopping, suggests the significance of this issue. Jared Ellias compiled a dataset consisting of all large companies that

11. As an example of the former, the Article does not deal with the lack of public clarity as to whether management has come to the legal conclusion that its duty had shifted to the interests of creditors or the enterprise. As another example, the Article leaves aside the contours of the disclosure requirements in the MD&A context and elsewhere. In particular, the uncertainties in the "duty to correct" and "duty to update" can result in material information not being made available in advance of the next periodic report. As to this "interim nondisclosure" issue, *see generally* Bruce Mendelsohn & Jesse Brush, *The Duties to Correct and Update: A Web of Conflicting Case Law and Principles*, 43 SEC. REG. L.J. 67 (2015); Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675 (1998).

12. *See, e.g.*, Henry T. C. Hu, *Efficient Markets and the Law: A Predictable Past and an Uncertain Future*, 4 ANN. REV. FIN. ECON. 179, 180–81 (2012).

13. *Id.* at 181.

14. *Id.* at 200.

filed for bankruptcy reorganization between 2001 and 2012 with debt that traded in public or private markets and for which prices could be observed.[15]

The vast majority of the 285 firms that filed for bankruptcy in Delaware, the Southern District of New York, and other jurisdictions were public companies (i.e., subject to SEC disclosure requirements): 83%, 86%, and 89%, respectively.[16] But in the year preceding bankruptcy, only a minority of the companies continued to comply with SEC disclosure requirements: 35%, 39%, and 36%, respectively.[17]

There is also evidence of laxity when troubled companies not in bankruptcy do show up. Deloitte identified 519 public companies with assets of at least $100 million that filed for Chapter 11 between January 1, 2000 and December 31, 2005.[18] Deloitte looked at SEC final "Accounting and Auditing Enforcement Releases" (AAERs) that alleged financial statement fraud that occurred *before* the bankruptcy filings, apart from releases that dealt solely with auditors.[19]

Deloitte found, first, that the bankrupt companies were three times more likely than comparable non-bankrupt companies to have been issued such AAERs.[20] Of the 519 companies that filed, 9% were issued AAERs for such pre-bankruptcy behavior versus 3% for companies that had not. Second, companies that were issued AAERs for such pre-bankruptcy behavior were more than twice as likely to file bankruptcy as those not issued one.[21]

Finally, *post-bankruptcy* attitudes to disclosure compliance may be reflective of *pre-bankruptcy* attitudes. One practitioner noted, for instance, that companies in Chapter 11 "often comply . . . only very loosely" with SEC periodic disclosure requirements.[22]

B. EXPLANATIONS FOR LAXITY: THE FINAL PERIOD PROBLEM

With healthy corporations, managements have strong incentives to cause their corporations to comply fully with SEC disclosure requirements. Such transparency may help increase the stock price and contribute to continuing access to the capital markets. The value of the executives' stock options and

15. Jared A. Ellias, *What Drives Bankruptcy Forum Shopping? Evidence from Market Data*, J. LEGAL STUD. (forthcoming 2018) (manuscript at 7), *available at* http://ssrn.com/abstract=2795824.
16. *Id.* at 17.
17. *Id*.
18. DELOITTE FORENSIC CTR., TEN THINGS ABOUT BANKRUPTCY AND FRAUD: A REVIEW OF BANKRUPTCY FILINGS 2 (2008).
19. *Id.* at 3.
20. *Id*. at 5.
21. *Id.* at 2. Admittedly, the Deloitte figures can be explained in other ways. For instance, they may reflect the SEC's finding it easier to target companies that have filed for bankruptcy, even with respect to pre-bankruptcy disclosures.
22. Barton, *supra* note 8, at 1.

securities holdings would tend to be enhanced, as would their human capital from reputational effects.[23]

People can do surprising things on their final day of work. Janet Yellen, on her last day as the Chair of the Federal Reserve Board, effectively ousted four of the directors at Wells Fargo.[24] On his last day as President, in what the *New York Times* characterized as "a shocking abuse of presidential power," Bill Clinton pardoned Marc Rich, a fugitive financier.[25]

To the extent that existing literature addresses SEC compliance at troubled corporations not in bankruptcy, it focuses on the managerial final period problem. Jennifer Arlen and William Carney posited a model that predicted that fraud on the market generally occurs when agents fear they are in their last period of employment, and found empirical evidence that such frauds generally result from last period agency costs.[26] They suggest that when a firm is ailing, a manager's expectations of future employment no longer serve as a constraint.[27] Building on Arlen and Carney, Mitu Gulati states that a variety of nonlegal sanctions serve to police disclosure in all but a small subset of cases, and that these cases are composed primarily of situations in which management perceives itself to be facing the final period of its managerial life.[28] These situations include takeovers and bankruptcy.[29]

At the time of those articles, there was sparse empirical evidence of CEO career and compensation changes arising from bankruptcies. The first study, published in 2016, suggests that the intuitions expressed in the earlier articles were well-founded. Analyzing 322 Chapter 11 filings in the period from 1996 to 2007 by large public U.S. companies, the authors found that 86% of the CEOs left the firm (voluntarily or otherwise) within the year of filing and that only about one-third of the incumbent CEOs either left for a new executive position or remained CEO of the restructured firm after emergence from bankruptcy.[30]

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23. Such factors would not apply if, for instance, a leveraged buyout was afoot.

24. *See, e.g.*, John Heltman, *Fed Drops Hammer on Wells Fargo as Four Board Members Ousted*, AM. BANKER (Feb. 2, 2018), https://www.americanbanker.com/news/fed-drops-hammer-on-wells-fargo-as-four-board-members-fired; Letter from Elizabeth Warren, U.S. Senator, to Janet Yellen, Chair, Fed. Reserve Bd. of Governors (July 28, 2017) (on file with U.S. Senate), https://www.warren.senate.gov/files/documents/2017-7-28_Wells_Fargo_Fed_letter.pdf.

25. Opinion, *An Indefensible Pardon*, N.Y. TIMES (Jan. 24, 2001), https://www.nytimes.com/2001/01/24/opinion/an-indefensible-pardon.html.

26. Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 691 (1992).

27. *Id.* at 702.

28. Gulati, *supra* note 11, at 736.

29. *Id.*

30. B. Espen Eckbo, Karin S. Thorburn & Wei Wang, *How Costly is Corporate Bankruptcy for the CEO?*, 121 J. FIN. ECON. 210, 211 (2016).

C. EXPLANATIONS FOR LAXITY: THE REQUIREMENTS FOR CLASS CERTIFICATION IN RULE 10B-5 ACTIONS

The threat of class actions under Rule 10b-5,[31] the central antifraud provision of securities law, is a key incentive for companies to provide fulsome and accurate information. The requirements that plaintiffs must meet to bring class actions have the effect of reducing this threat for troubled corporations.

For private plaintiffs to bring a lawsuit under 10b-5, the plaintiffs must, among other things, establish reliance. For a class to be certified, a court must conclude that "common" questions of fact or law predominate over particular questions pertaining to individual plaintiffs. Requiring proof of individualized reliance on a misstatement or omission from each member of the proposed class would make it impossible to satisfy this requirement.[32]

Rule 10b-5 class actions became possible when courts effectively did an end-run around the reliance requirement. In particular, the Supreme Court adopted the "fraud-on-the-market" doctrine in *Basic v. Levinson*.[33] Under this doctrine, rooted in the EMH, there was no need for individualized proof of reliance. Instead, there would be a rebuttable presumption that the plaintiffs had relied: after all, "in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business."[34]

Critically, to invoke the presumption, the plaintiff must show that the shares involved were traded in an informationally efficient market. The leading case of *Cammer v. Bloom*[35] set out five factors to consider:

(1) the average weekly trading volume of the shares;

(2) the number of securities analysts following and reporting on the company's stock;

(3) the number of market makers and arbitrageurs;

(4) the company's entitlement to use a Form S-3 registration statement for public offerings; and

(5) empirical facts showing responsiveness to unexpected events and financial releases.[36]

Additionally, whether a security is traded on an organized exchange has sometimes been a factor. One court, after citing the *Cammer* factors, noted the relevance of securities being traded in "national secondary markets such as the New York Stock Exchange."[37] Some courts have concluded as a matter

31. 17 C.F.R. § 240.10b-5 (2018).
32. Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2407–08 (2014).
33. Basic Inc. v. Levinson, 485 U.S. 224, 224 (1988).
34. *Id.* at 241 (quoting Peil v. Speiser, 806 F.2d 1154, 1160 (3d Cir. 1986)).
35. Cammer v. Boom, 711 F. Supp. 1264, 1286–87 (D.N.J. 1989).
36. *Id.*; *see* Freeman v. Laventhol & Horwath, 915 F.2d 193, 199 (6th Cir. 1990) (summarizing the *Cammer* factors).
37. *Freeman*, 915 F.2d at 199.

of law that stocks trading in an over-the-counter market do not trade in an efficient market.[38]

The foregoing factors reduce the chances of class action certification with troubled corporations. First, many of these factors correlate with firm size: in general, larger firms are more likely to have higher weekly share trading volume, greater numbers of securities analysts, and greater numbers of market makers. Empirical studies suggest that analyst coverage increases with firm size.[39] One fund manager interested in small company stocks estimated that about 15% of companies he held had no sell-side analyst coverage.[40] In 2017, Reuters estimated that the number of companies in the Russell 2000 benchmark for small cap stocks without formal attention from Wall Street research firms increased 30% over the preceding three years.[41]

The emphasis on size has a disparate impact on investors seeking class certification in troubled companies. Larger firms tend to be more stable financially. Among other reasons, larger firms tend to be more diversified, have greater market power, and better access to capital markets.[42] Empirical academic studies consistently show the importance of firm size in predicting the likelihood of default.[43] An industry participant noted in 2015 that only fifty-seven of the Standard & Poor's 500 (an index of large company stocks) were considered non-investment grade, and that companies rated at junk-grade levels tend to be small.[44]

Second, a number of the *Cammer* considerations relate to financial health. The right to use an S-3 registration statement is such a factor. One

38. *See* Victor E. Schwartz & Christopher E. Appel, *Rebutting the Fraud on the Market Presumption in Securities Fraud Class Actions:* Halliburton II *Opens the Door*, 5 MICH. BUS. & ENTREPRENEURIAL L. REV. 33, 51 (2016).

39. *See, e.g.*, Lihong Liang, Edward J. Riedl & Ramgopal Venkataraman, *The Determinants of Analyst-Firm Pairings*, 27 J. ACCT. & PUB. POLICY 277, 278–79 (2008); Huai-Chun Lo, *Do Firm Size Influence Financial Analyst Research Reports and Subsequent Stock Performance*, 6 ACCT. & FIN. RES. 181, 181 (2017).

40. David Randall, *Funds Target 'Unknown' Stocks as Wall Street Cuts Analyst Jobs*, REUTERS, Aug. 7, 2017, https://www.reuters.com/article/us-usa-funds-research/funds-target-unknown-stocks-as-wall-street-cuts-analyst-jobs-idUSKBN1AN221.

41. *Id.*

42. Panayiotis Theodossiou, Emel Kahya, Reza Saidi & George Philippatos, *Financial Distress and Corporate Acquisitions: Further Empirical Evidence*, 23 J. BUS. FIN. & ACCT. 699, 704 (1996).

43. *See, e.g.*, James A. Ohlson, *Financial Ratios and the Probabilistic Prediction of Bankruptcy*, 18 J. ACCT. RES. 109, 110 (1980) (using a sample of U.S. firms and stating that the firm size was one of four factors found statistically significant in affecting the probability of failure); Julie Fitzpatrick & Joseph P. Ogden, *The Detection and Dynamics of Financial Distress*, 11 INT'L REV. FIN. 87, 87 (2011) (using a sample of U.S. firms and finding that firm size was the most important of six variables examined in forecasting five-year failure); Clive Lennox, *Identifying Failing Companies: A Re-evaluation of the Logit, Probit and DA Approaches*, 51 J. ECON. & BUS. 347, 347 (1999) (studying a sample of UK-listed companies and finding company size among the most important determinants of bankruptcy).

44. Sam Ro, *There's Not Much Junk in the S&P 500*, BUS. INSIDER (Oct. 20, 2015), https://www.businessinsider.com/speculative-grade-companies-in-the-sp-500-2015-10 (quoting Barclays' Jonathan Glionna).

requirement for using the S-3 is that neither the company nor any of its subsidiaries have, within a specified period: (a) failed to pay any dividend or sinking fund installment on preferred stock; or (b) defaulted on any debt or any rental on long-term leases, which defaults in the aggregate are material.[45] Trading on an organized stock exchange such as the New York Stock Exchange or NASDAQ is another financial health-related factor. Both such exchanges rely on a variety of financial metrics with respect to initial listings.[46]

Third, as noted, many troubled companies do not even file the requisite periodic SEC documents. If a company is not doing so, the cost for a securities analyst to follow the company would rise, thus discouraging coverage. Moreover, the company would not be entitled to use an S-3 registration statement. One S-3 requirement is that the company has filed in a timely manner all required Securities Exchange Act of 1934 (Exchange Act) reports.[47]

This failure to file creates a problem extending beyond the particular factors a judge considers. The basis for the *Basic* "fraud-on-the-market" theory is that the information provided to the market is, in effect, processed by the market as an unpaid agent of the investor.[48] If *no* information is being provided (at least in SEC periodic reports), a foundational assumption of *Basic* is missing.

This has an ironic result. A company, by failing to file SEC periodic reports, reduces the chances of a securities class action being brought against it. *Not* showing up can have rewards.

D. EXPLANATIONS FOR LAXITY: NEW UNCERTAINTIES AS TO ENFORCEMENT OF THE "MD&A"

For all public corporations, the MD&A section of the quarterly Form 10-Q and annual Form 10-K[49] is widely considered to be the primary form of narrative disclosure that is reviewed, together with financial statements, for investment decision-making.[50] Because of the substantive content required,

45. 17 C.F.R. § 239.13(a)(4) (2018).

46. PRICEWATERHOUSECOOPERS, LISTING IN THE US: A GUIDE TO A LISTING OF EQUITY SECURITIES ON NASDAQ AND NYSE 6–8 (2012), https://www.pwc.com/ua/en/services/capital-markets/assets/listing-in-the-us-ua-en.pdf.

47. 17 C.F.R. § 239.13(a)(3)(ii) (2018).

48. Basic Inc. v. Levinson, 485 U.S. 224, 244 (1988) (citing *In re* LTV Sec. Litig., 88 F.R.D. 134, 143 (N.D. Tex. 1980)).

49. The MD&A is set out as Item 303 of Regulation S-K. 17 C.F.R. § 229.303 (2018). As to the disclosure items required by Forms 10-Q and 10-K, see Regulation S-K, 17 C.F.R. § 229.10 *et seq.* (2018).

50. *See* Orin E. Barran et al., *MD&A Quality as Measured by the SEC and Analysts' Earnings Forecasts*, 16 CONTEMP. ACCT. RES. 75, 80 (1999) (noting "a growing body of evidence suggests that the SEC and users of financial reports view the MD&A as particularly important . . . ."); Bernd Hüfner, *The SEC's MD&A: Does it Meet the Informational Demands of Investors? A Conceptual Evaluation*, 59 SCHMALENBACH BUS. REV. 58, 58–59 (2007) (noting how, of all disclosure items

the MD&A addresses matters with particular resonance for troubled corporations. Uncertainties that have recently become manifest on the private enforceability of the MD&A, most notably in the Ninth Circuit, undermine the robustness of the informational base for troubled companies.

The SEC has stated that:

> The MD&A requirements are intended to provide, in one section of a filing, material historical and prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future.[51]

The MD&A is expressly "intended to give the investor an opportunity to look at the company through the eyes of management."[52] The MD&A requires disclosure of, for instance, "known trends or any known demands, commitments, events or uncertainties" reasonably likely to result in the company's liquidity changing materially and "known material trends, favorable or unfavorable" in the company's capital resources.[53] More generally, the MD&A "shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition."[54]

The MD&A is thus seemingly tailor-made to the needs of investors in troubled corporations.[55] Empirical evidence is consistent with this. Using a sample of 354 firms that filed for bankruptcy between 1995 and 2012, a study found that both the management's explicit mentions in the MD&A that the firm may be unable to continue as a going concern, as well as the MD&A's

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in the annual report, sell-side financial analysts in the U.S. most frequently use the MD&A when preparing their reports).

51. Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Act Release No. 6835, Exchange Act Release No. 26,831, Investment Company Act Release No. 16,961, 54 Fed. Reg. 22,427, 22,428 (May 24, 1989).

52. Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release No. 6711, Exchange Act Release No. 24,356, 52 Fed. Reg. 13,715, 13,717 (Apr. 24, 1987).

53. 17 C.F.R. § 229.303(a)(1)–(2)(2018).

54. *Id.* § 229.303(a) (Instruction 3 to paragraph 303(a)).

55. Certain narrative disclosures can arise for troubled companies from Financial Accounting Standards Board (FASB) requirements. Notably, the FASB now requires company management to perform its own independent "going concern" evaluation, separate from the longstanding obligations on this matter on the part of outside auditors. FIN. ACCT. STANDARDS BD., FASB ACCOUNTING STANDARDS CODIFICATION, ACCOUNTING STANDARDS UPDATE NO. 2014-15, PRESENTATION OF FINANCIAL STATEMENTS – GOING CONCERN (SUBTOPIC 205-04), DISCLOSURE OF UNCERTAINTIES ABOUT AN ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN, 205-40-50-12, at 10 (2014).

overall linguistic tone, provided significant explanatory power in predicting whether a firm would cease as a going concern.[56]

However, recent U.S. Court of Appeals cases have introduced uncertainty as to a key issue: whether the omission of information required under the MD&A gives rise to liability under Section 10(b) and Rule 10b-5 thereunder.[57] In cases in 2015 and 2016, the Second Circuit held that an omission can give rise to such liability.[58] But in 2014, the Ninth Circuit held that "Item 303 does not create a duty to disclose for purposes of Section 10(b) and Rule 10b-5."[59] The Second and Ninth Circuits together handle more federal securities law cases than the rest of the circuits combined.[60] The U.S. Supreme Court granted certiorari to resolve this split in the circuits.[61] But this was not to be: the Supreme Court announced on October 17, 2017 that the parties would settle.[62]

The failure of the Supreme Court to adopt the Second Circuit approach undermines compliance with the MD&A. The Acting Solicitor General, in his amicus brief, suggested that the Ninth Circuit approach would exempt from Section 10(b) liability "conduct that is clearly fraudulent," preventing defrauded investors from obtaining compensation, and would prevent the SEC from obtaining various sanctions available under Section 10(b) but not available under other securities law provisions.[63] With troubled companies, this impact becomes especially significant: the substantive content in the MD&A is particularly salient, and, as noted earlier, troubled companies appear to be lax in SEC compliance to begin with. What ameliorates this

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56. William J. Mayew, Mani Sethusraman & Mohan Venkatachalam, *MD&A Disclosure and the Firm's Ability to Continue as a Going Concern*, 90 ACCT. REV. 1621, 1621–22, 1627 (2015). On August 24, 2014 (i.e., after the period covered by the study), the FASB issued Accounting Standards Update No. 2014-15, which requires management to assess a company's ability to continue as a going concern and related disclosures in certain circumstances. DAGHAN OR ET AL., GOING CONCERN: FASB DEFINES MANAGEMENT'S GOING CONCERN ASSESSMENT AND DISCLOSURE RESPONSIBILITIES, PRICEWATERHOUSECOOPERS 1 (2014), http://www.legalexecutiveinstitute.com/wp-content/uploads/2016/09/25.-PwC-us2014-07-going-concern.pdf.

57. *See* Brief for the United States as Amicus Curiae Supporting Respondents at I, Leidos Inc. v. Ind. Pub. Ret. Sys., 137 S. Ct. 1395 (2017, (No. 16-581).

58. Ind. Pub. Ret. Sys. v. SAIC, Inc., 818 F.3d 85, 94 (2d Cir. 2016); Stratte McClure v. Morgan Stanley, 776 F.3d 94, 101 (2d Cir. 2015).

59. *In re* NVIDIA Corp. Sec. Litig., 768 F.3d 1046, 1054 (9th Cir. 2014) (citing Oran v. Stafford, 226 F.3d 275, 288 (3d Cir. 2000)).

60. Monica Loseman et al., *2017 Year-End Securities Litigation Update*, GIBSON DUNN 17 (Feb. 1, 2018), https://www.gibsondunn.com/wp-content/uploads/2018/02/2017-year-end-securities-litigation-update.pdf.

61. *See* Leidos, Inc. v. Ind. Pub. Ret. Sys., 137 S. Ct. 1395, 1396 (2017).

62. Order, Leidos, Inc. v. Ind. Pub. Ret. Sys., 138 S. Ct. 369 (2017) (staying proceedings pending settlement); Order, Leidos, Inc. v. Ind. Pub. Ret. Sys., 138 S. Ct. 2670 (2018) (dismissing writ of certiorari for mutual agreement of the parties).

63. Brief for the United States as Amicus Curiae Supporting Respondents, *supra* note 57, at 32. *But see* Joseph A. Grundfest, *Ask Me No Questions and I Will Tell You No Lies: The Insignificance of Leidos Before the United States Supreme Court* 5 (Stanford Law Sch. and Rock Ctr. for Corp. Governance, Stanford Univ., Working Paper Series No. 229, 2017) (2017), http://www.ssrn.com/abstract=3043990.

situation somewhat is that many companies, as a matter of prudence, may assume the possibility of MD&A liability. This is because, in many situations, plaintiffs will have the flexibility to bring MD&A claims in the Second Circuit.[64]

II. EXTRA-COMPANY INFORMATIONAL ASYMMETRIES: CDS AND DEBT DECOUPLING

A. OVERVIEW

The fate of a company has traditionally depended largely on company-specific issues and the regulatory environment it operates in. Not surprisingly, SEC disclosure requirements thus focus on such matters as the quality and integrity of company management, the competitiveness of its goods and services, its access to financing, and its regulatory environment. The fate of a troubled company, however, does not necessarily flow largely from such "company-specific" matters. For instance, in modern capital markets, CDS and other "debt decoupling" activities on the part of third parties may be critical to the company's survival. "Extra-company" informational asymmetries flowing from such financial innovations are necessarily important as well.

The exploration of such extra-company informational asymmetries begins with a brief summary of the analytical framework for decoupling. *(Part II(B))*. This is followed by a close examination of four recent examples where such third-party activities appear to have significant impact. *(Part II(C))*.

B. DEBT DECOUPLING AND PUBLIC INFORMATION

Classic conceptions of "debt" and "equity" are clearly understood. Ownership of debt conveys a package of economic rights (to receive payment of principal and interest), contractual control rights (to enforce, waive, or modify the debt contract), other legal rights (including rights in bankruptcy), and sometimes disclosure obligations. Similarly, ownership of equity conveys a package of economic rights, voting rights, and other rights, as well as disclosure and other obligations.

These classic conceptions assume that the elements of these packages of rights and obligations are normally "bundled" together. With debt, the holder's contractual control rights (such as in a loan agreement) are linked to the holder's economic rights to interest and principal. With equity, the

64. As to the grounds on which plaintiffs may be able to bring claims in the Second Circuit, *see, e.g.*, Edward J. Fuhr, Scott H. Kimpel & Johnathon E. Schronce, *Client Alert*, *Supreme Court Will Not Consider Leidos Case After Apparent Settlement*, HUNTON & WILLIAMS 2 (Oct. 17, 2017), https://www.hunton.com/images/content/3/3/v2/33768/supreme-court-will-not-consider-leidos-case.pdf.

holder's voting rights are usually linked to the holder's economic interest: the familiar "one share, one vote" is an example.

These foundational conceptions no longer hold. Today, through the use of derivatives and other means, debt holders and equity holders can, if they wish, easily separate components of these packages. Sophisticated, lightly regulated hedge funds have been especially active in this arena. And, importantly from the standpoint of this Article, often the activities can occur without any public disclosure. Within the analytical framework that Bernard Black and I introduced in 2006 and refined and extended in a series of articles that I sole- or co-authored through 2015, the term "decoupling" was coined to refer to this separation.[65]

It is decoupling on the debt side and associated derivatives such as CDS, that are particularly pertinent to distressed corporations.[66] Notwithstanding the new reality made possible by debt decoupling and CDSs, law and contracting practice generally assume an immutable link between the debt holder's control rights and its economic interest. That is, both law and credit agreements are predicated on the creditor's being interested in keeping a solvent firm out of bankruptcy and (intercreditor conflicts aside) in maximizing the value of an insolvent firm.

Today, this can prove dangerously naïve. This Article is narrowly focused on decoupling related to troubled companies that are not in bankruptcy. And for simplicity, I focus on CDS-based techniques for decoupling.

Debt decoupling and CDSs have made "debt governance" perhaps less efficient and definitely more opaque and complex. This is especially so when there are hidden parties or when there are counterintuitive incentive patterns.

Consider, for instance, one technique for becoming what the framework refers to as an "empty creditor." A creditor holds the shaky debt of a troubled company and has the formal contractual control rights set out in the credit

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65. The initial decoupling article was Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 SO. CAL. L. REV. 811, 816 (2006). Among the subsequent articles are: Henry T. C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343, 343 (2007); Hu & Westbrook, *supra* note 6, at 1330, 1401–02; Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625 (2008) [hereinafter Hu & Black, *Penn-Debt and Equity Decoupling*]; Henry T. C. Hu & Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk*, 14 EUR. FIN. MGMT. 663 (2008) [hereinafter Hu & Black, *EFM − Debt, Equity, and Hybrid Decoupling*]; and Henry T. C. Hu, *Financial Innovation and Governance Mechanisms: The Evolution of Decoupling and Transparency*, 70 BUS. LAW. 347 (2015) [hereinafter Hu, *Financial Innovation and Governance Mechanisms*].

For a brief 2015 summary of the analytical framework for decoupling (debt, equity, and hybrid), *see* Hu, *Financial Innovation and Governance Mechanisms*, at 350–81.

66. For a more detailed analysis of debt decoupling than is set out in this Article and discussion of the closely related phenomenon of "hybrid decoupling," *see, e.g.*, Hu & Black, *EFM − Debt, Equity, and Hybrid Decoupling*, *supra* note 65, at 679–94.

agreement, including the protections provided by various affirmative and negative covenants.

However, say that this creditor has approached a derivatives dealer and has purchased protection against the default of that company under a CDS. Under the terms of a simple CDS, when a "credit event" (e.g., default on a debt obligation or bankruptcy) occurs with respect to the "reference entity" (e.g., that company), the seller of the CDS protection must, in effect, compensate the buyer of the CDS protection. The relationship of the CDS buyer to the CDS seller is roughly akin to the relationship of a homeowner to the insurance company that provides fire insurance on the home.

I coined the term "empty creditor" to refer to this kind of creditor.[67] That is, an empty creditor retains the control and other formal rights flowing from the credit agreement yet has partly or fully hedged its economic risk to the debtor.[68]

Highly counterintuitive incentive patterns can occur. For instance, what if that creditor has decoupled by buying a huge amount of CDS protection relative to the debt it holds? That is, what if the creditor had extended a $50,000,000 loan to a company but bought CDS protection naming that company as the reference entity in the amount of $200,000,000? This creditor may actually *benefit* from the company's filing for bankruptcy. After all, the payoff from the CDSs the creditor holds on the company's bankruptcy may well be greater than any loss that creditor suffers on its loan. In this circumstance, that creditor has negative exposure to a firm's credit risk. The creditor is over-hedged.

In 2008, the analytical framework for decoupling called such *over*-hedged empty creditors "empty creditors with negative economic ownership"; this year (2018), some practitioners appeared to refer to such persons as "net-short debt activists."[69] This extreme category of empty creditors would have incentives to use contractual control rights not to protect the value of their loans but, subject to reputational concerns and legal and other constraints, to harm the company, such as by helping grease the skids to bankruptcy.[70] In contrast, traditional creditors often waive breaches of the loan agreement, agree to out-of-court restructurings, and work with troubled

67. *See, e.g.*, Henry T. C. Hu, *'Empty Creditors' and the* Crisis, WALL ST. J. (Apr. 10, 2009), https://www.wsj.com/articles/SB123933166470307811 [hereinafter Hu, *Empty Creditors and the Crisis*] (on the origins of the term); Hu & Westbrook, *supra* note 6, at 1402 n. 310 (same).

68. *See, e.g.*, Hu & Black, *EFM – Debt, Equity, and Hybrid Decoupling*, *supra* note 65, at 680. A creditor need not rely on CDSs to hedge. For instance, a creditor can also hedge by being long one class of a company's debt, and short another. They can also hedge through strategies involving the company's common or preferred shares. *See id.* at 681, 683–86.

69. *Id.* at 682. As to a 2018 use of the term "net-short debt activist," *see* Joshua A. Feltman, Emil A. Kleinhaus, & John R. Sobolewski, *The Rise of the Net-Short Debt Activist*, WACHTELL, LIPTON, ROSEN & KATZ 1 (Aug. 1, 2018).

70. *See, e.g.*, *id.* at 679–86.

debtors in manifold other ways that would redound to the benefit of both the creditors and their debtors.

Even a creditor that does not have a negative economic interest would have lessened incentives to cooperate with a troubled debtor. For example, an empty creditor with merely zero economic interest would be indifferent as to whether the company survives.[71]

Neither the identity of the parties who buy or sell CDS protection as to a troubled company nor the net economic ownership, positive or negative, of such parties is, generally speaking, publicly available. This is notwithstanding the increased transparency of the CDS market as a result of the Dodd-Frank Act of 2010.

The Depository Trust & Clearing Corporation maintains a centralized electronic database for "virtually all CDS contracts outstanding in the global marketplace."[72] Access is restricted to derivatives dealers and other market participants, and subscribers can obtain data such as the gross notional and net notional amounts and trade volumes as to the CDS outstanding for particular companies.[73] However, no information is available on, say, any particular hedge fund's CDS holdings. Thus, as will be illustrated shortly, even such sophisticated parties would instead have to rely on market chatter and media reports to get a sense of what a hedge fund's CDS exposures to a company might be.

The scarcity of public information compromises not only debt governance but also the robustness of the informational base needed by investors. The informational deficiencies abound, involving both "hidden non-interest" and "hidden interest." If a creditor has decoupled and the troubled company or the capital markets are generally unaware of this, that creditor has a "hidden non-interest": that is, the creditor does not have the economic interest that the debtor and the capital markets think it has. Investors, the capital markets, and the troubled company itself would thus have an overly optimistic view as to the willingness of those creditors to help the company survive.

Where, unbeknownst to investors and capital markets, there are empty creditors with negative economic ownership, the gap between perception and reality may be especially large. Here, their misunderstandings of the incentives of the creditors do not involve questions of *degree*, but instead, the fundamental matter of *direction*.

71. *See, e.g.*, Hu, *Financial Innovation and Governance Mechanisms*, *supra* note 65, at 370–71.

72. *Trade Reporting Repository: Overview,* DEPOSITORY TRUST & CLEARING CORP., http://www.dtcc.com/derivatives-services/trade-information-warehouse/trade-reporting-repository.

73. Press Release, Depository Trust & Clearing Corp., TIW Market Reports Give Clients Insights into Global CDS Contracts: A Conversation with Chris Nardo, Director, DTCC Data Pro (Mar. 17, 2017), http://www.dtcc.com/news/2017/march/17/tiw-market-reports-give-clients-insights-into-global-cds-contracts.

There are additional informational deficiencies in debt governance that extend to a party that has no contractual relationship whatsoever with the troubled company: the CDS seller. The CDS seller is, in a very rough sense, a contingent creditor of the troubled company. That is, the CDS seller is exposed to the credit risk of the company. If the company goes bankrupt, that seller must pay up (to the CDS buyer).

This "hidden interest" that the CDS seller has in the troubled company can raise informational concerns for investors. The CDS seller only has a hidden interest in the troubled company until the maturity of the CDS. Under certain circumstances, the CDS seller may deem it worthwhile to become an actual creditor of the troubled company, not because of the CDS seller's optimism about the company, but because it wants to get the company through to the maturity of the CDS. An announcement by the company of new financing, unadorned by fulsome disclosure of the CDS seller's status as the new creditor, has the potential of sending an unduly positive message to investors.

One key takeaway of the foregoing from the standpoint of this Article can be summarized. The scarcity of public information as to the identity and interests of these hidden interests and hidden non-interests, and thus the possibility of counterintuitive incentives, undermines the robust informational base needed by investors, the capital markets, and troubled corporations themselves.

We now turn to some recent examples involving third-party CDSs and other debt decoupling behavior. These examples yield new insights as to the informational asymmetries now possible with troubled companies.

C. Illustrative Examples from 2008 Through 2018

From 2007 to 2008, when the term "empty creditor" was coined and debt decoupling was incorporated into the overall decoupling framework, the real-world evidence for debt decoupling was more limited than that for equity decoupling. Subsequently, far more such evidence became available. In a 2015 article, I showed that debt decoupling and the related "hybrid decoupling" phenomenon appeared to have played roles in, among other things, three of the iconic corporate disasters of the 2008 global financial crisis: American International Group (AIG), Chrysler, and General Motors.[74] For instance, Goldman Sachs's apparent status as an "empty creditor" of AIG might help explain its decision to ask for an additional \$1.5 billion in collateral from AIG, notwithstanding the possible impact on AIG's survival.[75] Five days later, AIG had to be bailed out.

74. *See* Hu, *Financial Innovation and Governance Mechanisms*, *supra* note 65, at 369–72.

75. This example was initially advanced in abbreviated form in Hu, *Empty Creditors and the Crisis*, *supra* note 67, and discussed in greater detail in Hu, *Financial Innovation and Governance Mechanisms*, *supra* note 65, at 370–71.

The Article turns now to closer examination of what are likely to be four recent examples:

(1) *RadioShack* (2014–2015): survival, at least as a temporary matter, due to financing arranged by Standard General, an alleged seller of CDS protection that would soon expire;
(2) *Norske Skog* (2016): survival, as least as a temporary matter, dependent on approval of an exchange offer (1) objected to by BlueCrest, an alleged *purchaser* of CDS protection, and (2) supported by GSO Capital Partners (GSO), an alleged *seller* of **short-term** CDS protection and alleged *purchaser* of **longer-term** CDS protection;
(3) *Hovnanian* (2017–2018): financing obtained at exceptionally favorable terms from GSO, an alleged buyer of CDS protection, in return for Hovnanian deliberately triggering a credit event by defaulting on certain debt held by its own subsidiary; and
(4) *Windstream Services* (2015−2018): an alleged empty creditor with negative economic ownership uses an alleged breach of a covenant in a bond indenture to cause a going concern to go into bankruptcy to the detriment of the company and the company's normal creditors.

1. *RadioShack* (2014–2015): CDS Seller as Contingent Creditor and Incentives to Keep Firm Out of Bankruptcy

In late 2014, RadioShack, an electronics retailer, was near bankruptcy.[76] But on October 3, 2014, RadioShack announced a financing plan that would stave off a filing and help it stock stores through the 2014 holiday season.[77] The new financing came from investors including Standard General LP, a hedge fund that was RadioShack's largest shareholder.[78] In spite of this new financing, RadioShack filed for bankruptcy on February 5, 2015.[79] Neither RadioShack's Form 8-K filed on October 6, 2014, nor the initial press reports mentioned any CDS-related matters.[80]

76. Drew FitzGerald & Matt Jarzemsky, *RadioShack Gets a Lifeline*, WALL ST. J., Oct. 4, 2014, at B3.

77. *See id.*; *see* RadioShack Corp., Current Report (Form 8-K) 2 (Oct. 6, 2014); Drew FitzGerald & Matt Jarzemsky, *Lifeline for RadioShack Only Buys a Little Time*, WALL ST. J., Oct. 6, 2014, at B3 [hereinafter FitzGerald & Jarzemsky, *Lifeline for RadioShack*].

78. FitzGerald & Jarzemsky, *Lifeline for RadioShack*, *supra* note 77.

79. Phil Wahba, *RadioShack pulls the plug and files for bankruptcy*, FORTUNE (Feb. 5, 2015), http://fortune.com/2015/02/05/radioshack-bankruptcy-filing/.

80. *See* RadioShack Corp., Current Report (Form 8-K), *supra* note 77; FitzGerald & Jarzemsky, *RadioShack Gets a Lifeline*, *supra* note 76; FitzGerald & Jarzemsky, *Lifeline for RadioShack Only Buys a Little Time*, *supra* note 77.

Later press reports, however, suggested that much of the new financing came from hedge funds who had sold CDS protection.[81] In bankruptcy proceedings, the unsecured creditors alleged that those who provided the late 2014 financing had "reportedly sold" CDS protection, "betting that the company would not default on its bonds—at least not until December 20, 2014"—"[i]f the company defaulted before that date," the CDS sellers would have suffered "massive losses."[82] The 2014 financing, they alleged, allowed these investors to avoid having to pay out on their CDSs by "orchestrating when RadioShack would default."[83]

Standard General disputed the allegations of the unsecured creditors and dismissed them as "conspiracy theories" and a "red herring."[84] Indeed, Standard General noted that it had *bought* some CDS protection to hedge certain RadioShack bonds it held.[85]

Diligent RadioShack investors, on reading both the initial press reports and the Form 8-K relating to the new financing, would have assumed that traditional creditor incentives were animating the Standard General-arranged financing. If Standard General was indeed a CDS seller with CDS maturing on December 20, 2014 and investors knew of this additional "contingent creditor" status, investors might have assessed the implications of the new financing differently. Although later press reports mentioned the possible role of CDS sellers, the absence of verifiable quantitative information on the actual CDS positions of Standard General limited the value of those reports.

2. *Norske Skog* (2016): Time-Varying Incentives to Keeping Firm Out of Bankruptcy and Pushing Firms into Bankruptcy

RadioShack is a relatively simple tale involving allegations that, by virtue of their CDS positions, certain hedge funds had incentives to, and did

81. Jodi Xu Klein, *RadioShack Kept Alive by $25 Billion of Swaps Side Bets*, BLOOMBERG (Dec. 18, 2014), https://www.bloomberg.com/news/articles/2014-12-18/radioshack-kept-alive-by-25-billion-of-swaps-side-bets. *See also* Michael Aneiro, *What's Keeping Radio Shack Afloat? Credit Derivatives*, BARRON'S (Dec. 19, 2014), https://www.barrons.com/articles/whats-keeping-radio-shack-afloat-credit-derivatives-1419003199; Mike Kentz, *CDS allegations surround RadioShack*, REUTERS, Dec. 15, 2014, https://www.reuters.com/article/radioshack-cds-idUSL1N0TZ0V720141215?feedType=RSS&feedName=bondsNews.

82. Motion of Official Committee of Unsecured Creditors for an Order, Pursuant to Section 105(a) of the Bankruptcy Code, Bankruptcy Rule 2004, and Local Bankruptcy Rule 2004-1, Authorizing and Directing the Examination of the Debtors and Certain Third Parties at 12, *In re* RS Legacy Corp., Case 15-10197-BLS (Bankr. D. Del. Mar. 17, 2015), Doc. 304.

83. *Id.* at 12–13.

84. Preliminary Response of Standard General L.P. to Motion of Official Committee of Unsecured Creditors for an Order, Pursuant to Section 105(a) of the Bankruptcy Code, Bankruptcy Rule 2004, and Local Bankruptcy Rule 2004-1, Authorizing and Directing the Examination of the Debtors and Certain Third Parties at 6, *In re* RS Legacy Corp., Case 15-10197-BLS (Bankr. D. Del. Feb. 5, 2015), Doc. 503.

85. *Id.* at 4.

take steps to keep the firm *out of* bankruptcy—at least for a while. In contrast, Norske Skog is a complex and surprising saga.

In late 2015, the debt of Norske Skog, a troubled Norwegian paper company, reached "unacceptable" levels: €1 billion, the most immediate maturity being certain unsecured notes maturing in 2016 and 2017.[86] GSO, an affiliate of Blackstone (the world's largest private equity firm), and Cyrus Capital Partners (Cyrus) owned a large position in the unsecured notes, and Blackstone itself owned 11% of Norske Skog's equity.[87] Norske Skog sought approval for an exchange offer that would, among other things, effectively extend the maturity of the unsecured notes to 2019 and thus address immediate liquidity issues.[88] GSO and Cyrus backed the exchange offer. Holders of the secured debt, including the hedge fund BlueCrest, objected.[89]

Why would these two sets of creditors, GSO and Cyrus on the one hand, and the secured creditors on the other, take opposing positions on a transaction that would alleviate Norske Skog's urgent problems? There are grounds to believe that the answer may lie with the CDS positions of the key players.

GSO and Cyrus. Citibank, as trustee for the secured noteholders (including BlueCrest), sued Norske Skog to enjoin the exchange offer.[90] Relying on reporting by Bloomberg, Citibank alleged that GSO and Cyrus were not participating in the exchange offer "to ensure Norske's long-term economic viability."[91] Instead, Citibank alleged, two starkly different CDS-related motivations were at play: first, "**to avoid a large payout** to their counterparties under the credit default swaps if Norske does not default on its debts *in the short-term*"; and, second, to "**earn a large pay out** from their counterparties if Norske *eventually goes bankrupt*."[92] A BlueCrest trader filed a declaration stating that he believed GSO had a "large steepener trade," wherein GSO *sold* short-dated CDS protection but also *bought* long-dated

86. Press Release, Norske Skog Commc'ns & Pub. Aff., Norske Skog launches exchange offer to all holders of 2016 and 2017 notes (Nov. 17, 2015) (on file with Norske Skog), http://www.norskeskog.com/Show-news.aspx?Action=1&NewsId=258&M=NewsV2&PID=3264; Sally Bakewell, *Swaponomics II: Blackstone, BlueCrest and the Great Paper Caper*, BLOOMBERG (Feb. 19, 2016), https://www.bloomberg.com/news/articles/2016-02-19/swaponomics-ii-blackstone-bluecrest-and-the-great-paper-caper.

87. Gavin Jackson & Miles Johnson, *Hedge funds spar over Norske Skog debt restructuring*, FIN. TIMES (Feb. 25, 2016), https://www.ft.com/content/ea90717a-dbad-11e5-98fd-06d75973fe09.

88. *See* Press Release, Norske Skog Commc'ns & Pub. Aff., *supra* note 86.

89. Robert Smith, *"No winners" in Norske Skog debt ruling*, REUTERS, Mar. 11, 2016, https://www.reuters.com/article/norske-skogsind-restructuring/no-winners-in-norske-skog-debt-ruling-idUSL5N16I2CN.

90. *See* Amended Complaint for Declaratory and Injunctive Relief, Citibank, N.A. v. Norske Skogindustrier, ASA, No. 16–cv–850 (RJS) (S.D.N.Y. Mar. 7, 2016), Doc. No. 60.

91. *Id.* at ¶ 4; *see* Luca Casiraghi, *Why Blackstone Would Prop Up Troubled Paper Giant*, BLOOMBERG (Dec. 21, 2015), https://www.bloomberg.com/news/articles/2015-12-22/swap-o-nomics-why-blackstone-would-prop-up-troubled-paper-giant; *see also* Bakewell, *supra* note 86.

92. Amended Complaint for Declaratory and Injunctive Relief at 16, Citibank, N.A. v. Norske Skogindustrier ASA, No. 16–cv–850 (RJS) (S.D.N.Y. Mar. 7, 2016), Doc. No. 60 (emphasis added).

protection.[93] With these two different types of CDS positions, GSO would benefit from Norske staying alive for a few years but then defaulting.

BlueCrest. Norske's CEO claimed that the secured noteholders would benefit massively from the company's insolvency. He claimed that the secured notes' "principal investor" held a CDS short position "in the range of 120m-130m nominally."[94]

If the respective allegations on the part of both sides are to be believed, this Norske Skog situation is more complex and involves more counterintuitive behavior than RadioShack. First, while both RadioShack and Norske Skog allegedly had CDS market participants incentivized to see to the survival of the firm in the short-term, Norske Skog also had CDS market participants that would benefit from the destruction of the firm. In the terminology of the analytical framework, with Norske Skog, there were "empty creditors with negative economic ownership."

Second, the incentives of certain of the empty creditors with negative ownership are especially counterintuitive. BlueCrest was an empty creditor with negative economic ownership, both in the short-term and in the long-term. In contrast, by virtue of highly customized CDS positions, GSO would allegedly benefit *both* from the firm not going bankruptcy *in the short term* as well as from the firm going bankrupt *in the long-term*. Thus, GSO's immediate incentives were diametrically opposed to their incentives in the long-run. It is only with respect to the long-term that GSO was an empty creditor with negative economic ownership.

The greater complexities associated with Norske Skog render even more pressing investors' need for quantitative data on the CDS positions of the key players. Yet, as with RadioShack, the true CDS positions were unclear. BlueCrest claimed that there had been "materially incorrect statements" regarding its CDS positions.[95] Norske's counsel stated that the secured creditors' group that included BlueCrest had been unwilling to disclose their CDS positions.[96] As for the details of GSO's positions, it is notable that even Citibank, a major derivatives dealer, had to rely on Bloomberg stories.[97]

We may never find out the true CDS positions of these key players. A March 2016 court ruling effectively precluded the exchange offer, and

93. *See* Supplemental Declaration of Deniz Akgul in Support of Plaintiff's Request for a Preliminary Injunction at Ex. A, 3, Citibank, N.A. v. Norske Skogindustrier ASA, No. 16–cv–850 (RJS) (S.D.N.Y. Feb. 26, 2016), Doc. No. 52-1; Smith, *"No winners," supra* note 89; *see also* David Wigan & Robert Smith, *GSO's win-win on Norske Skog CDS*, REUTERS, Apr. 28, 2016, https://www.reuters.com/article/norske-skog-cds-idUSL5N17V5TX [hereinafter Supplemental Declaration of Deniz Akgul].

94. Smith, *"No winners," supra* note 89.

95. Supplemental Declaration of Deniz Akgul, *supra* note 93, at ¶ 5.

96. *See id.* at Ex. A, 6.

97. *See* Amended Complaint, *supra* note 90, at 4, 16.

Citibank's case settled before trial.[98] GSO and Cyrus then altered their plans to provide the needed liquidity for Norske Skog.[99] In June 2016, the CDS protection that GSO sold settled and in December 2017, Norske Skog filed for bankruptcy.[100]

3. *Hovnanian* (2017–2018): Incentives to Create a Faux Default

RadioShack and Norske Skog involved the complex, counterintuitive, and opaque incentives flowing from key debtholders' CDS positions. Investors in both companies may not have had sufficient information to understand such incentives and assess how such incentives could affect the companies' fates. The Hovnanian situation also involved GSO and the unique incentives created by CDSs. However, while the behavior in Hovnanian certainly has long-term implications for the viability of the CDS market and the pocketbooks of the specific CDS players involved, the behavior has almost nothing to do with the fates of companies or, indeed, anything else in the real world. Because of this, the discussion will be very brief as to Hovnanian.

Beginning in early 2017, GSO purchased $333 million of CDS protection on the debt of Hovnanian, a home builder.[101] At that time, there was a material risk that Hovnanian would not be able to repay its debt, and if that had come to pass, GSO stood to gain. However, Hovnanian's financial prospects began to improve in the first half of 2017 and by the end of July, GSO was likely to face large losses on its CDSs.

GSO allegedly saw a way out. Since Hovnanian's new-found health was such that it was unlikely to default on its obligations, GSO could try to "manufacture" a default that, as a purely technical matter, would trigger a "failure-to-pay" credit event payout on GSO's CDSs. GSO and Hovnanian struck a deal. GSO would provide below market financing to Hovnanian if

98. Citibank, N.A. v. Norske Skogindustrier ASA, No. 16–cv–850 (RJS), 2016 WL 1052888 (S.D.N.Y. Mar. 8, 2016); Smith, *"No winners," supra* note 89.

99. *See* Robert Smith, *GSO and Cyrus help Norske Skog get round debt exchange block*, REUTERS, Mar. 21, 2016, https://de.reuters.com/article/norske-skog-restructuring-idUKL5N16T3SZ; Press Release, Norske Skog Commc'ns & Pub. Aff., Norske Skog launches amended exchange offer; equity and liquidity initiatives; trading update and outlook (Mar. 18, 2016) (on file with Norske Skog), http://www.norskeskog.com/files/filer/Arkiv/PR/201603/1996060_5.html; Press Release, Norske Skog Commc'ns & Pub. Aff., Norske Skog – successful participation level for the 2017 exchange offer (Apr. 6, 2016) (on file with Norske Skog), http://www.norskeskog.com/files/filer/Arkiv/PR/201604/2001252_5.html.

100. Miles Johnson & Robert Smith, *The mystery trader who roiled Wall Street*, FIN. TIMES (June 4, 2018), https://www.ft.com/content/5e23e516-5cdc-11e8-ad91-e01af256df68.

101. Amended Complaint at 2, Solus Alt. Asset Mgmt. LP v. GSO Capital Partners L.P., No. 18 CV 232-LTS-BCM (S.D.N.Y. Feb. 1, 2018), Doc. No. 75; Declaration of J. Larry Sorsby in Opposition to Plaintiff's Motion for Preliminary Injunction at Ex. 13, Solus Alt. Asset Mgmt. LP v. GSO Capital Partners L.P., No. 18 CV 232-LTS-BCM (S.D.N.Y. Jan. 22, 2018), Doc. No. 43-13 (letter from Harrison Denman of White & Case on behalf of an ad hoc group of investment funds that had sold Hovnanian CDSs, sent to J. Larry Sorsby CFO of K. Hovnanian Enterprises on November 11, 2017).

Hovnanian would default on an interest payment on $26 million of debt held by a Hovnanian subsidiary.

This was, in effect, a faux default. This manufactured default did not cause any financial distress for Hovnanian. No outside creditor of Hovnanian would be affected. It was a win-win for Hovnanian and GSO: below-market financing for the former and a CDS payout for the latter.

This win-win gaming of the literal terms of the CDSs would come at the expense of the CDS sellers. Solus Alternative Asset Management, one such seller, sued, but the court refused to grant a preliminary injunction.[102] Regulators, the International Swaps and Derivatives Association, and outside observers expressed concern at the threat such gaming behavior may pose to the integrity and viability of the CDS market. On May 30, 2018, the manufactured default was called off after GSO and Solus settled.[103]

4. *Windstream Services* (2015–2018): Incentives to Use a Possible Technical Default to Cause Financial Distress

Windstream Holdings (Holdings) is a publicly traded company, and its only asset was its equity interest in Windstream Services (Windstream), a telecommunications company based in Arkansas. In April 2015, Windstream spun off Uniti Group (Uniti), a wholly-owned subsidiary.

This spin-off involved Windstream contributing substantial assets to Uniti in return for Uniti securities and cash.[104] In connection with the spin-off, Holdings and Uniti entered into a lease transaction whereby Holdings leased a large portion of the assets that Windstream contributed to Uniti.[105] This occurred notwithstanding the possible applicability of a covenant prohibiting certain sale-and-leaseback transactions in the indenture of certain senior notes issued by Windstream.[106]

For two years, no one complained about the spin-off and lease. But on September 21, 2017, Aurelius Capital Master (Aurelius), the largest holder of the senior notes, privately sent Windstream a notice of default alleging that these 2015 transactions were impermissible under the indenture. In October 2017, after being sued by Windstream in Delaware Chancery Court, the indenture trustee filed suit in the Southern District of New York against

102. Memorandum Opinion and Order Denying Motion for Preliminary Injunction, Solus Alt. Asset Mgmt. LP v. GSO Capital Partners L.P., No. 18 CV 232-LTS-BCM (S.D.N.Y. Jan. 29, 2018), Doc. No. 69.

103. Joe Rennison, *'Manufactured' credit default called off after legal challenge*, FIN. TIMES (May 30, 2018), https://www.ft.com/content/c184dd72-6457-11e8-90c2-9563a0613e56.

104. Windstream Services, LLC's Corrected Proposed Findings of Fact and Conclusions of Law, at 1, 2, 5, 6, No. 17-cv-7857 (JMF) (S.D.N.Y. June 18, 2018) [hereinafter Windstream FF+CL].

105. Counterclaim Defendant and Counterclaim Plaintiff Aurelius Capital Master, Ltd.'s Proposed Findings of Fact and Conclusions of Law, at 1, No. 17-cv-07857 (JMF) (S.D.N.Y. June 21, 2018) [hereinafter Aurelius FF+CL].

106. Plaintiff-Counterclaim Defendant U.S. Bank Nat. Ass'n Proposed Findings of Fact & Conclusions of Law (Corrected), at 11–12, No. 17-cv-07857 (JMF) (S.D.N.Y. June 15, 2018).

Windstream on the same grounds. Rather than litigating the question of whether the transactions violated the indenture, Windstream announced a series of exchange offers and consent solicitations that Aurelius believed were designed to obtain a waiver of the Aurelius-noticed default.[107]

Why did Aurelius initiate action against Windstream over an alleged covenant breach that occurred two years earlier? If the court agrees that a covenant breach occurred, the decision could trigger cross-defaults on an estimated $5.7 billion in debt, and Windstream may have to file for bankruptcy.[108] As the secured notes' largest holder, this would seem to be against Aurelius's economic interest.

But Aurelius is likely not a traditional creditor and has very different incentives. According to Windstream, Windstream became aware in the summer of 2017 that an unknown hedge fund was acquiring a substantial position in its notes, with the intent to call a default. It soon learned from industry sources that the unknown fund was Aurelius and that Aurelius intended to characterize the 2015 transactions as a violation of the indenture's sale-and-leaseback covenant.[109]

Critically, Windstream claims that Aurelius had "also acquired a sizable position in CDS on Windstream's debt.[110] Windstream proffered the testimony of Michiel McCarty, the head of a boutique investment bank as follows:

> McCarty will testify that Aurelius's conduct was not consistent with how a typical economic creditor of [Windstream] would behave. Aurelius's conduct appears calculated to *reduce* the prospects of payment in full at maturity. Aurelius's conduct would only be economically rational if it profits more from its CDS position if [Windstream] defaults than if [Windstream] successfully pays off the bond at maturity, creating an incentive for Aurelius to destroy value to other noteholders.[111]

Similarly, Windstream suggests that Aurelius's October 24, and 20, 2017 letters urging other Windstream noteholders to reject Windstream's consent solicitations and exchange offers should have, but did not, acknowledge Aurelius's skewed incentives.[112] For instance, Windstream stated:

> While the October 24 Letter characterized Aurelius as a 'Windstream Noteholder,' it neglected to inform that market of the material information

107. Aurelius FF+CL, *supra* note 105, at 1–2.

108. Katia Porzecanski, Dan Wilchins & Allison McNeely, *Citadel-Led Creditor Group Agrees to Windstream Debt Swap*, BLOOMBERG (Jul. 26, 2018), https://www.bloomberg.com/news/articles/2018-07-26/citadel-led-creditor-group-said-to-agree-to-windstream-debt-swap.

109. Windstream FF+CL, *supra* note 104, at 14–15.

110. *Id.* at 15.

111. Windstream Services, LLC's Trial Witness List & Test. Summ. at 15, U.S. Bank Nat'l Ass'n v. Windstream Services, LLC, No. 17-07857-JMF-GWG (S.D.N.Y. Oct. 12, 2017), ECF No. 158-2.

112. Windstream FF+CL, *supra* note 104, at 28.

> about Aurelius's CDS position (giving Aurelius a short-position as to [Windstream]), and Aurelius's financial motives for disseminating the letter.[113]

The consent solicitations and exchange offers were successful.[114] The litigation, which was pending as of time of writing, will decide whether the 2015 transactions constituted a default under the indenture, and whether the subsequent exchange offers and consent solicitations violated the indenture.[115]

If Aurelius's CDS positions are as McCarty and Windstream claim, then Aurelius falls squarely within the decoupling framework's definition of "empty creditor with a negative economic ownership." The framework clarifies the Windstream situation in a number of ways.

First, most obviously, the framework helps explain Aurelius's behavior and how timely and granular information on the presence of empty creditors like Aurelius can be important to understanding the debtor's financial prospects. The incentives McCarty ascribes to Aurelius are precisely the counterintuitive incentives that the framework posited for such extreme empty creditors. In the two years following the 2015 transactions, not one of Windstream's other creditors had noticed a default, presumably because no other creditors were net short.

Windstream had limited information on any empty creditors in its midst. In the summer of 2017, Windstream was initially aware only that some unknown hedge fund was acquiring a position in its notes with the intent of calling a default. Afterwards, when it learned that Aurelius was the fund in question, Windstream appeared not to know the precise extent and nature of that fund's CDS positions. Windstream' CFO, Bob Gunderman, filed an affidavit that he "heard from market analysts that Aurelius had purchased [CDS] as to [Windstream], with respect to which Aurelius would profit if [Windstream] experienced an Event of Default."[116] The affidavit of Steve Cheeseman, a Citi investment banker who advised Windstream on the Aurelius crisis, stated that he "developed an understanding based on various sources of information, including conversations with market participants, that Aurelius . . . held a significant CDS position referencing Windstream."[117]

Second, Windstream might illustrate the framework's longstanding concern over the weaponization of "technical defaults" by empty creditors

113. *Id.* at 39–40.

114. *Id.* at 44.

115. Aurelius FF+CL, *supra* note 105, at 2–3.

116. Aurelius Obj. to Excerpts in the Direct Test. Aff. of Bob Gunderman at 2, U.S. Bank Nat'l Ass'n v. Windstream Services, LLC, No. 17-07857-JMF-GWG (S.D.N.Y. Oct. 12, 2017), ECF No. 187-3.

117. Aurelius Obj. to Excerpts in the Direct Test. Aff. of Stephen John Cheeseman at 3, U.S. Bank Nat'l Ass'n v. Windstream Services, LLC, No. 17-07857-JMF-GWG (S.D.N.Y. Oct. 12, 2017), ECF No. 187-4.

with a negative economic ownership.[118] A 2008 Hu and Black article pointed out that financial covenants are traditionally written on assumptions that creditors need protection in order to get repaid and that creditors thus care about the borrower's success.[119] We noted that, because of debt decoupling, some creditors will not care and, indeed, that some "may seek to use the 'technical default' provided by a covenant violation as leverage toward" the borrower's demise.[120] In terms of private ordering, debtor companies would be well-advised to craft financial covenants carefully, including recognizing the possibility of net short creditors.

Third, Windstream illustrates the need to determine whether empty creditors with a negative economic ownership should be entitled to exercise control rights under standard credit agreements, or if the agreements themselves should be drafted to expressly limit control rights for such creditors. In the *debt* decoupling context, the framework has raised the possibility of curbs on the contractual control rights of creditors who hold zero or negative economic interests in companies not in bankruptcy.[121] For companies in bankruptcy, the framework raised the prospect of forcing disclosure in bankruptcy proceedings of significant disparities between nominal debt holdings and actual economic exposure, and of courts overriding a creditor vote tainted by some creditors voting with little, no, or negative economic ownership.[122] Disclosures in this general spirit were mandated on December 1, 2011, when amendments to Rule 2019 of the Federal Rules of Bankruptcy Procedure became effective.[123]

In the *equity* decoupling context, the framework called for corporate law to disallow voting by empty voters with negative economic ownership.[124] In the 2012 TELUS case, the Supreme Court of British Columbia found that a hedge fund was an empty voter with a negative economic ownership under the Hu-Black analytic framework, and found that this status was relevant to the court's consideration of the hedge fund's objection to the company's proposed dual class recapitalization.[125]

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118. It is not necessary for the purposes of this Article to determine whether in fact the covenant breach alleged in Windstream should be characterized as merely involving a "technical default" with little consequence or should be characterized as involving something more substantial. The author does not take a position on this issue.

119. Hu & Black, *EFM−Debt, Equity, and Hybrid Decoupling*, *supra* note 65, at 685.

120. *See id.*

121. *See id.* at 685–86.

122. *Id.* at 684.

123. *See* FED. R. BANKR. P. 2019; Hu, *Financial Innovation and Governance Mechanisms*, *supra* note 65, at 372–73 (noting the impact of the subject parties being required to identify their "disclosable economic interests" under the new Rule).

124. Hu & Black, *Penn-Debt and Equity Decoupling*, *supra* note 65, at 701–03.

125. TELUS Corporation (Re), 2012 BCSC 1919, para. 342, 365, & 366 (2012); Hu, *Financial Innovation and Governance Mechanisms*, *supra* note 65, at 375–81. The author prepared the affidavit cited by the court as an expert to assist the court and not as an advocate for any party pursuant to the strict requirements of Rule 11-2(2) of the British Columbia Supreme Court.

Finally, the Windstream net short creditor situation shows that the presence of CDSs held by third parties can sometimes result in "real world" victims. The acceleration of $5.3 billion in debt from the Aurelius-noticed default and consequent bankruptcy would hurt the traditional creditors, the company itself, and the nearly 13,000 employees employed by the company and its subsidiaries.[126] This pattern also occurred with respect to the Norske Skog situation. This is in direct contrast to the Hovnanian situation. In Hovnanian, the only losers from the manufactured default were the CDS sellers. In fact, Hovnanian (and all of its stakeholders) actually benefited from the existence of third-party CDS activities.

CONCLUSION

This Article shows some key factors undermining the informational base needed by investors in distressed companies. It focuses on informational asymmetries that are curious in some way, those that in source, nature, or degree may be new or unfamiliar, including those that arise from new capital market developments. The impact of the true, faux, or technical defaults that can arise from third-party CDS activities and other debt decoupling may necessitate steps to better address certain "extra-company" information critical to investors.

Insufficient incentives contribute to the tendency of distressed-company managements to simply decline to file required SEC reports. The SEC has already shown itself willing to enact "bad boy" deterrents, including by way of the required biographical disclosures for directors and certain officers.[127] An incremental change, applicable to those who had served as, for instance, the chief executive officer or chief financial officer of a company that had failed to file required SEC reports, could be made to the required biographical information. If the CEO or CFO knows they will have to disclose such outright non-compliance failures in some future job, they may hesitate to shirk that responsibility. In certain more extreme cases involving laxity in SEC compliance, the SEC could seek to bar certain securities fraud defendants from serving as a director or officer of a public company, either permanently or for a specified period of time.

If the Supreme Court does not soon rule on the private enforceability of the MD&A requirements, the SEC could consider trying to move a few of the more "objective" aspects of the MD&A disclosure requirements to Form 8-K. No one, including the Ninth Circuit, disputes that Form 8-K omissions are actionable by private plaintiffs.[128]

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126. *See* Windstream FF+CL, *supra* note 104, at 1.

127. *See, e.g.*, Regulation S-K, 17 C.F.R. § 229.401(f) (Item 401) (requiring disclosure of various legal proceedings "that are material to an evaluation of the ability or integrity" of any person nominated to become a director or officer).

128. *See, e.g.*, *In re* Atossa Genetics Inc. Sec. Litig., 868 F.3d 784, 797 (9th Cir. 2017).

The extra-company information needs flowing from CDSs and the debt decoupling phenomenon pose real challenges. The absence of public information on the CDS positions of individual entities is one concern. But benefit/cost considerations aside, change in disclosure rules relating to derivatives positions of individual holders may prove difficult. For instance, unlike major foreign jurisdictions, the U.S. has yet to address the longstanding "hidden (morphable) ownership" problem relating to equity derivatives positions under Section 13(d) of the Exchange Act.[129]

An incremental, if less satisfying, alternative to systematic reform in this area might be to again look to Form 8-K. The SEC could add to the current list of occurrences triggering a Form 8-K filing. One trigger might be a troubled company's top management becoming aware of a major creditor having become an empty creditor with negative economic ownership, whether through CDSs or by other means.

Informational asymmetries can now materially hinder investor decision-making and market efficiency in the context of troubled companies not in bankruptcy. Addressing these asymmetries starts with a fuller understanding of how they arise. With today's debt-laden companies and the return of normal interest rates, opportunities to go further should not be missed.

129. *See* Hu, *Financial Innovation and Governance Mechanisms*, *supra* note 65, at 358–60, 366–69.