

Manhattan Federal Court Enforces ‘Clear’ Terms of Credit Default Swap Contract

By

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On November 5, 2008, Judge Barbara Jones of the Southern District of New York issued an important decision in a case involving a credit default swap (CDS), finding that Citibank N.A. (Citibank)—the credit protection buyer under the CDS—was entitled to certain payments from the credit protection seller, VCG Special Opportunities Master Fund Limited (VCG), and granting Citibank judgment on the pleadings. The decision in VCG Special Opportunities Fund v. Citibank, N.A., Docket No. 08-CV-01563, reinforces the likelihood that courts will strictly construe CDS agreements and uphold them as a matter of law.

CDS contracts are derivative instruments by which financial institutions and other businesses manage their exposure to credit risk. In a CDS contract, a credit protection seller agrees with a credit protection buyer to assume certain specified default risks in respect of a particular “reference obligation”. The risks specified in the CDS are taken by the protection seller in exchange for periodic payments from the protection buyer. If a defined “credit event” occurs, the protection seller becomes obligated to make a payment or payments to the protection buyer. CDS contracts frequently require the protection seller to post collateral upon the occurrence of designated events, and may also require the protection buyer to post collateral in certain circumstances.

In 2006 Citibank and VCG entered into a CDS contract under which Citibank purchased protection on reference obligations consisting of Class B Notes issued by Millstone III CDO Ltd. III-A (the “Millstone CDO”). Citibank agreed to make periodic fixed payments of 5.50% per annum on the initial face amount of the Class B Notes. VCG, in turn, agreed to pay Citibank an amount designated as the “Floating Payment Amount” upon the occurrence of certain specified events, referred to among CDS parties as “credit events.” The CDS contract also included provisions under which Citibank was entitled to demand additional collateral from VCG in the event of a downward movement in the daily mark-to-market value of the Millstone CDO. According to the complaint,¹ Citibank began making margin calls in August 2007 and made a total of four margin calls, all met by VCG. In total, VCG provided \$9,960,277.78 in collateral on a credit risk of \$10,000,000.

On January 9, 2008, Citibank informed VCG that a credit event—defined in the CDS contract as an “Implied Writedown”—had occurred, giving rise to VCG’s obligation to pay Citibank the Floating Payment Amount as calculated by Citibank. VCG denied that such an event had occurred and refused to pay the Floating Payment Amount. Citibank subsequently issued a Notice of Default and Early Termination stating that Citibank intended to close out the CDS transaction based upon VCG’s failure to pay the Floating Payment Amount. VCG then commenced the lawsuit against Citibank seeking, among other relief, a declaratory judgment that the margin calls were inconsistent with the CDS contract and that a credit event had not occurred. In addition, VCG sought rescission of the contract and return of the collateral, arguing

that VCG did not knowingly assume the risk that it would be subject to requests for collateral. VCG also alleged that Citibank had breached the contract and an implied covenant of good faith and fair dealing both by requesting excessive collateral and by prematurely demanding the Floating Payment Amount.² Citibank counterclaimed and moved for judgment on the pleadings, arguing that it was entitled to the Floating Payment Amount.

The court ruled in favor of Citibank on all grounds. The court first examined whether a credit event had occurred. Citibank argued that one of the defined credit events—an “Implied Writedown”—had occurred in respect of the reference obligations (the Class B Notes) because securities owned by the Millstone CDO (which had been pledged to secure the Class B Notes) had decreased in value. In a strained reading of the CDS contract, VCG argued that a provision relating to “Written-Down Securities” referred to the Class B Notes rather than the securities owned by the Millstone CDO and thus prevented Citibank’s determination of an Implied Writedown. After analyzing the CDS contract and the indenture for the Millstone CDO, the court concluded that the Implied Writedown provision referred to collateralized assets *held by* the CDO and not to the notes *issued by* the CDO. Accordingly, the court found that Citibank’s determination that a credit event in the form of an Implied Writedown had occurred was proper and that Citibank was entitled to judgment on the pleadings on that issue.

The court also determined that Citibank’s requests for collateral were appropriate. VCG had argued that the collateral demands (which were based upon provisions in a part of the CDS contract called the Credit Support Annex) were inconsistent with another part of the CDS contract, a Confirmation Letter, which did not specifically require collateral payments based on changes in the mark-to-market value of the reference obligations. The court rejected this argument, finding that the Confirmation Letter clearly stated that the “Transaction shall be subject to the Credit Support Annex.”

In opposing Citibank’s motion for judgment on the pleadings, VCG also argued that Citibank’s calculation of the Floating Payment Amount was not conducted in a commercially reasonable manner. The court rejected VCG’s argument on the grounds that, while VCG’s complaint alleged that Citibank failed to calculate *collateral demands* in a commercially reasonable manner, VCG did not challenge Citibank’s calculation of the *Floating Payment Amount* until VCG filed its opposition to Citibank’s motion. The court held that raising an argument for the first time in motion papers is an improper method to allege facts not included in the complaint.

Significantly, the court also found that VCG had waived its argument that Citigroup’s allegedly improper collateral demands breached the contract because VCG had repeatedly posted the requested collateral and had also continued to accept Citibank’s periodic contractual payments. The court noted that the Credit Support Annex contained a dispute resolution provision for disagreements with respect to required collateral, and suggested that VCG should have pursued those dispute resolution procedures prior to bringing an action against Citibank. The court’s reasoning suggests that if VCG had wanted to challenge the collateral requests, it should have done so before delivering collateral and should have exhausted the dispute resolution procedures in the contract.

The court rejected VCG’s claim for rescission, which was based on VCG’s assertion that it did not know it would be required to post collateral based on the mark-to-market value of the

reference obligations. Noting that a contract could only be rescinded for a unilateral mistake where enforcement of the contract would be unconscionable and the mistake was material and made despite the exercise of ordinary care, the court found that rescission was not appropriate in this case where the mistake was due to VCG's negligence. The court found that the collateral requirements were "clear" in the contract, and that VCG had acted negligently. The "instant case presents a circumstance where VCG, a sophisticated hedge fund, simply failed to review the terms of the parties' agreement."

The court dismissed VCG's remaining claims as well. The court found that the claim for breach of an implied covenant of good faith and fair dealing—based on an allegation that Citibank had abused its discretion by making unjustified collateral demands and improper calculations—had been waived because VCG had posted the requested collateral, had relied on Citibank's calculation of the Floating Payment Amount in VCG's own papers, and had not made any specific allegations adducing "arbitrary or irrational" conduct in Citibank's performance of its duties as the Calculation Agent. The court also dismissed VCG's unjust enrichment and conversion claims, finding they were duplicative of the breach of contract claim.

The *VCG v. Citibank* decision is an important decision for the derivatives market generally, and for CDS parties in particular, as it demonstrates important lessons:

First, courts are willing to enforce CDS contracts based on the terms of the contracts themselves without looking outside the documents to determine the party's intent, knowledge at the time of formation, or hedging strategies. This is consistent with the Second Circuit Court of Appeals' decision in *Aon Corporation v. Société Générale*, 476 F.3d 90 (2d Cir. 2007).

Second, to the extent that a CDS contract contains dispute resolution procedures, a party that objects to the other party's calculation but does not invoke the contractual procedures prior to commencing legal action may risk waiving the objection.

Third, the decision reinforces the courts' general aversion to granting rescission based on "unilateral mistake" where a sophisticated party enters into a CDS contract, which means parties must carefully review and fully understand their CDS contracts before executing them.

¹ Complaint in *VCG Special Opportunities Fund v. Citibank, N.A.*, Docket No. 08-CV-01563 (BSJ) (S.D.N.Y. February 14, 2008).

² VCG also brought claims for unjust enrichment and conversion.