Can Arbitration be the Answer to Resolving Manufactured Credit Event Disputes?

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I. Introduction

In recent years, financial institutions have developed several innovative derivative products. These products are typically born out of an unmet need in the financial marketplace. Credit derivatives, for example, were created in order to let financial clients mitigate credit risk.[1] A well-known type of credit derivative is the credit default swap ("CDS"), a privately held, negotiable bilateral contract that allows a lender to transfer the credit risk of a borrower to a third party.[2] In return for periodic premium payments, a buyer of CDS protection is entitled to a large one-time payout if the underlying reference entity triggers a "credit event."[3] Since the inception of CDS in the early 1990's, their use and popularity has grown tremendously.[4] The total gross notional amount of outstanding CDS as of the second quarter of 2019 was approximately $9.4 trillion.[5]

In recent years, companies have been increasingly forced into litigation by highly sophisticated investors who, incentivized by large profits tied to CDS positions, scrutinize a firm's credit documents in order to force or "manufacture" a corporate default or other credit

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[1] James Chen, *Credit Derivative*, INVESTOPEDIA (Apr. 20, 2019), https://www.investopedia.com/terms/c/creditderivative.asp.

[2] *Id.*

[3] Patrick Augustin, Marti G. Subrahmanyam, Dragon Y. Tang, & Sarah Q. Yang, *Credit Default Swaps: Past, Present, and Future*, 8 ANN. REV. FIN. ECON. 175 (2016).

[4] *The credit default swap market: what a difference a decade makes*, BIS Q. R., https://www.bis.org/publ/qtrpdf/r_qt1806b.htm (last visited Feb. 26, 2020).

[5] *Global CDS Market Study*, ISDA, https://www.isda.org/a/JUPTE/Global-CDS-Market-Study.pdf (last visited Oct. 28, 2019).

event. In many cases, some borrowers in response to those credit events have even been compelled to file for bankruptcy.[6]

Realizing that manufactured credit events have become a cause for concern, industry associations and finance lawyers have proposed various credit agreement amendments or clauses that have attempted to make it more difficult for CDS buyers to force an otherwise financially sound firm into bankruptcy.[7] Some commentators have suggested that these amendments and proposals still leave open many loopholes. To reduce the scrutiny and economic costs that manufactured credit events have been accused of producing, this article proposes that a mandatory arbitration clause in corporate credit documents could be utilized to promote an alternative dispute resolution mechanism in lieu of litigation.

II. Background

a. Current Oversight

The International Swaps and Derivatives Association ("ISDA") was created to address the challenges that the derivatives market posed to financial institutions.[8] The goal of ISDA is to help reduce counterparty risk and increase transparency by providing some form of standardization and oversight.[9] The main tool that ISDA uses in this regard is the ISDA Master Agreement ("Master Agreement").[10] The Master Agreement "delineates the obligations of

[6] Mary Childs, *Windstream Blames Bankruptcy on Hedge Fund Aurelius and CDS Market*, BARRON'S, (Feb. 25, 2019) https://www.barrons.com/articles/windstream-files-for-bankruptcy-calls-for-credit-default-swap-regulation-51551133206.

[7] *Indenture Restrictions Applicable to "Net Short" Investors and Related Provisions*, CAHILL GORDON & REINDEL LLP, (Aug. 9, 2019), https://www.cahill.com/publications/firm-memoranda/2019-08-09-indenture-restrictions-applicable-to-net-short-investors-and-related-provisions.

[8] Gordon Scott, *International Swaps and Derivatives Association (ISDA)*, INVESTOPEDIA (Aug. 27, 2019), https://www.investopedia.com/terms/i/isda.asp.

[9] *Id*.

[10] James Chen, *ISDA Master Agreement*, INVESTOPEDIA, https://www.investopedia.com/terms/i/isda-master-agreement.asp (last visited Oct. 28 2019).

parties, defines what constitutes a credit event, and details procedures for early termination and transfer of CDS contracts."[11]

Assessing whether a default or credit event has occurred isn't as straightforward as it seems and has caused aggressive litigation between CDS counterparties (see *Solus Alt. Asset Mgmt. LP v. GSO Capital Partners L.P.*).[12] These disagreements compelled ISDA to establish a "Determinations Committee" to make binding decisions on credit event occurrence.[13] Some say that ISDA, by using a textualist approach to its rules and regulations, has made its decisions with "little regard for the negative effects that arise from strict application."[14]

b. Manufactured Credit Events

In June of 2019, the heads of the Securities & Exchange Commission ("SEC"), Commodities Futures Trading Commission ("CFTC") and the UK's Financial Conduct Authority issued the following joint statement regarding manufactured credit events:

> "The continued pursuit of various opportunistic strategies in the credit derivatives markets, including but not limited to those that have been referred to as "manufactured credit events," may adversely affect the integrity, confidence and reputation of the credit derivatives markets, as well as markets more generally. These opportunistic strategies raise various issues under securities, derivatives, conduct and antifraud laws, as well as public policy concerns."[15]

A manufactured credit event occurs when a CDS protection buyer entices, persuades or otherwise forces a company to default or trigger a credit event so that the investor will receive the large one-time credit default payment associated with their CDS.[16] According to the CFTC,

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[11] Gina-Gail S. Fletcher, *Engineered Credit Default Swaps: Innovative or Manipulative?*, 94 NYU L. REV. 1073 (2019).

[12] *Solus Alternative Asset Mgmt. LP v. GSO Capital Partners L.P.,* 2018 WL 620490, at *1 (S.D.N.Y. Jan. 29, 2018)

[13] Fletcher, *supra* note 11.

[14] *Id*.

[15] Todd P. Zerega & Shekida (Anna) Smith-Sandy, *U.S. and UK Regulators Make Joint Commitment to Combat "Manufactured Credit Events" in CDS Market*, THE DERIVATIVES AND REPO REP. (Aug. 6 2019), https://www.derivativesandreporeport.com/2019/08/u-s-and-uk-regulators-make-joint-commitment-to-combat-manufactured-credit-events-in-cds-market/.

[16] *Id*.

there have been approximately fourteen manufactured credit events over the past three years.[17] Net short debt activism is the latest form of manufactured credit event strategy in which an investor simultaneously purchases a small debt position in a reference company, establishes a large short position through CDS and then uses the contractual rights associated with their debt position to take legal action against the company.[18] Commentators have described net short debt activists as using their position to drive otherwise solvent companies into bankruptcy over minor technical defaults.[19]

c. Recent Examples of Manufactured Credit Events

Several recent examples of manufactured credit events illustrate how savvy investors have been able to persuade companies to take or be subject to certain corporate actions that are beneficial to the investor but may not be in the best long-term interests of the company.

i. Hovnanian

In 2017, with a large amount of debt about to mature, Hovnanian Enterprises ("Hovnanian") started to seek new sources of capital and began negotiating with GSO Capital Partners ("GSO"), the debt investing unit of Blackstone.[20] Before negotiating with Hovnanian, GSO purchased approximately $330 million in CDS that referenced the company's existing bonds.[21] After establishing this CDS position, GSO then approached Hovnanian and proposed a

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[17] Mary Childs, *Why Hedge Funds Could Find It Harder to Push Companies Into Default*, BARRON'S (Aug. 2, 2019 2:44PM), https://www.barrons.com/articles/hedge-funds-could-find-it-harder-to-push-companies-into-default-51564771477.

[18] Joshua A. Feltman, Emil A. Kleinhaus, and John R. Sobolewski, *The Rise of the Net-Short Debt Activist,* HARV. L. SCH. FOR. ON CORP. GOV. (Aug. 7, 2018) https://corpgov.law.harvard.edu/2018/08/07/the-rise-of-the-net-short-debt-activist/.

[19] *Net Short Lender Disenfranchisement: Is the New Anti-CDS Vaccine Safe and Effective?*, MILBANK CLIENT ALERT (Jun., 11 2019), https://www.milbank.com/images/content/1/1/v2/116063/Client-Alert-6.11.19-Net-Short-Lender-Disenfranchisement.pdf.

[20] Fabien Carruzzo, Stephen Zide & Daniel King, *Unconventional CDS Credit Events: Hovnanian Enterprises*, KRAMER LEVIN: PERSPECTIVES, https://www.kramerlevin.com/en/perspectives-search/unconventional-cds-credit-events-hovnanian-enterprises.html#_ftn2 (last visited Feb. 26, 2020).

[21] Mary Childs, *Solus Made Money From That CDS Litigation*, BARRON'S (June 20, 2018 1:03 PM), https://www.barrons.com/articles/solus-made-money-from-that-cds-litigation-1529514208.

unique refinancing deal.[22] The GSO deal, which was very attractive to Hovnanian and would help the company shore up its balance sheet, was contingent upon Hovnanian skipping a small interest payment on a very specific bond that served as the reference asset for GSO's $330 million CDS position.[23] At the time, Hovnanian was not facing imminent bankruptcy and GSO's main objective in requiring Hovnanian to skip that interest payment was so that Hovnanian would trigger a credit event and GSO could profit off its related CDS position.[24] If Hovnanian were to accept GSO's deal and trigger a credit event by skipping a nominal interest payment, the CDS protection seller, Solus Alternative Asset Management ("Solus"), would have been responsible for a very large one-time payout to GSO and other CDS protection buyers. Amid public criticism and a lawsuit filed by Solus that accused GSO of market manipulation, the refinancing deal was ultimately abandoned.[25]

ii. Windstream

Certain CDS transactions have even indirectly forced otherwise financially sound firms to file for bankruptcy. In 2015, Windstream Communications ("Windstream") decided to spin-off certain copper wire and fiber optic cable assets into a separate, publicly traded company that is now known as Uniti Group ("Uniti").[26] Concurrent with the spin-off, Windstream entered into a sale-leaseback agreement whereby Windstream agreed to lease from Uniti a number of the assets that it had previously owned.[27] Although the agreements governing certain of Windstream's bonds had included specific covenants restricting sale-leaseback transactions,

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[22] *See Solus Alt. Asset Mgmt. LP v. GSO Capital Partners L.P.*, 2018 WL 620490, (S.D.N.Y. Jan. 29, 2018).
[23] Carruzzo, et al., *supra* note 20.
[24] Matt Levine, *Blackstone May Do Its Cleverest CDS Trade Again*, BLOOMBERG OPINION (Nov. 17, 2017), https://www.bloomberg.com/opinion/articles/2017-11-17/blackstone-may-do-its-cleverest-cds-trade-again.
[25] Andrew Scurria, *Blackstone Stands Down on Hovnanian Swaps Wager*, WALL ST. J. (May 30, 2018 7:29 PM), https://www.wsj.com/articles/blackstone-stands-down-on-hovnanian-swaps-wager-1527722945.
[26] Matt Levine, *Aurelius Wins Against Windstream*, BLOOMBERG OPINION (Feb. 19, 2019 11:58 AM), https://www.bloomberg.com/opinion/articles/2019-02-19/aurelius-wins-against-windstream.
[27] *Id.*

many of Windstream's bondholders did not object to the transaction.[28] In 2017, two years after the successful Uniti spin-off, Aurelius Capital Management ("Aurelius"), a New York-based hedge fund founded by a former bankruptcy attorney, purchased Windstream bonds and began its own analysis.[29] It is widely believed that at the time of its Windstream bond investment, Aurelius had also purchased a large amount of CDS protection that would pay off if Windstream subsequently triggered a credit event.[30] Presumably incentivized by the large profits tied to a potential default payment, Aurelius subsequently revived the fact that the sale-leaseback covenant had been violated in order to assert that Windstream had indeed defaulted on its bonds over two years prior.[31] The *Windstream* case exemplifies how certain opportunistic investment strategies can result in negative repercussions for stakeholders beyond just the sophisticated counterparties engaged in the CDS transaction.[32] Aurelius and Windstream eventually ended up in hostile litigation in order to determine whether there actually had been a credit default.[33]

> "The Windstream situation, regardless of how it is resolved, exemplifies the risks that net-short debt activism can pose to companies. Aurelius has publicly questioned Windstream's financial position and threatened Windstream with an outcome—defaults on its bond debt—that could cause significant damage to Windstream's other stakeholders, including other creditors, shareholders and employees. While short sellers in the equity markets might "talk down" a stock, they have no similar legal mechanism to inflict such wide-ranging harm on a target."[34]

In February of 2019, Judge Jesse M. Furman of the Southern District of New York ruled in favor of Aurelius and Windstream subsequently filed for bankruptcy protection.[35]

iii. Thomas Cook

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[28] *Id.*
[29] *U.S. Bank NA v. Windstream Servs. LLC,* No. 17-CV-7857, 2019 WL 948120, (S.D.N.Y. Feb. 15, 2019)
[30] Levine, *supra* note 26.
[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] Feltman, et al., *supra* note 18.
[35] *Windstream Holdings, Inc. Files for Voluntary Reorganization Under Chapter 11 of the U.S. Bankruptcy Code Following Judge Furman's Decision*, WINDSTREAM, (Feb. 25, 2019), https://investor.windstream.com/news/news-details/2019/Windstream-Holdings-Inc-Files-for-Voluntary-Reorganization-Under-Chapter-11-of-the-US-Bankruptcy-Code-Following-Judge-Furmans-Decision/default.aspx.

Another scenario has arisen where bond or loan investors have attempted to block companies from engaging in friendly corporate actions under the premise that such action would decrease the value of their CDS positions. In the summer of 2019, United Kingdom-based travel firm Thomas Cook, which had been under enormous financial pressure, negotiated a consensual restructuring and financing deal with the owner of ClubMed Resorts, Fosun International ("Fosun").[36] This rescue deal needed to be approved by Thomas Cook's debtholders who had also purchased large CDS positions in the company. Fearing that the rescue deal would not trigger a credit event, these CDS investors grouped together in order to block the Fosun deal.[37] With no Fosun-led rescue deal available, Thomas Cook ultimately entered into a liquidation proceeding.[38]

d. Manufactured Credit Event Criticism

Although the misuse of credit derivatives has certainly been associated with some noteworthy negative events, such as the global financial crisis, many commentators have noted that credit derivatives such as CDS actually play an important role in the global financial system.[39] Proponents argue that the original function of CDS, the ability to successfully insure against credit risk, has increased overall lending to companies, municipalities and governments which in turn has had a net positive impact on the economy.[40] On the other hand, skeptics have

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[36] *Thomas Cook to sell majority stake to China's Fosun*, BBC NEWS (Aug. 28, 2019), https://www.bbc.com/news/business-49493876.

[37] Katie Linsell, *Thomas Cook Rescue to Be Challenged*, BLOOMBERG (Sep. 10, 2019), https://www.bloomberg.com/news/articles/2019-09-10/thomas-cook-rescue-under-challenge-from-hedge-funds-plan.

[38] *Thomas Cook enters liquidation, potentially leaving hundreds of thousands stranded on holiday,* FRANCE 24 (Sep. 23, 2019), https://www.france24.com/en/20190923-united-kingdom-thomas-cook-group-travel-compulsory-liquidation-bankruptcy.

[39] Sean Campbell & Josh Gallin, *Risk Transfer Across Economic Sectors Using Credit Default Swaps,* FEDS NOTES (Sep. 3, 2014), https://www.federalreserve.gov/econresdata/notes/feds-notes/2014/risk-transfer-across-economic-sectors-using-credit-default-swaps-20140903.html.

[40] *ISDA Publishes New Academic Paper on Single-name CDS Market*, ISDA (Sep. 12, 2016), https://www.isda.org/2016/09/12/isda-publishes-new-academic-paper-on-single-name-cds-market/.

cited the outsized profit opportunities associated with specific financial derivatives such as CDS as indirectly leading to unnecessary bankruptcies, economic waste and other negative consequences.[41] In order to balance the key advantages and disadvantages associated with these financial products, a neutral, fair, and informed dispute mechanism, such as arbitration, is needed.

As was the case in both the *Windstream* and Thomas Cook examples, manufactured credit events can ultimately lead to an unnecessary bankruptcy. In a bankruptcy, a company can be liquidated or restructured, and many employees may potentially lose their jobs.[42] "An unnecessary bankruptcy imposes deadweight losses on society as a whole"[43] and can result in a large amount of both direct and indirect costs. In addition, when a firm is in bankruptcy a substantial amount of management's time and focus must be spent tending to bankruptcy-related matters instead of normal day-to-day business operations.[44] The distraction of having to oversee a bankruptcy proceeding can deprive certain business areas from much needed management attention and result in the deterioration of value.[45]

Others argue that by allowing manufactured credit events to exist, investors are motivated to scrutinize debt documents which in turn is good for markets because it acts as a monitoring or policing mechanism by enforcing previously agreed upon covenants.[46] In addition, some commentators have said that manufactured credit events should be allowed to occur because

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[41] Floyd Norris, *Naked Truth on Default Swaps*, N.Y. TIMES (May 21, 2010), https://www.nytimes.com/2010/05/21/business/economy/21norris.html

[42] Carron Armstrong, *What Happens When a Company Files Chapter 11 Bankruptcy?*, THE BALANCE (Aug. 9, 2019), https://www.thebalancecareers.com/what-to-do-when-your-company-files-chapter-11-bankruptcy-316247

[43] Daniel Hemel, *Empty Creditors and Debt Exchanges*, 27 YALE J. ON REG. 159, 160–61 (2010).

[44] Ben Branch, *The Costs of Bankruptcy a Review*, 11 INT'L REV. OF FIN. ANALYSIS, 39 (2002).

[45] *Id*.

[46] Mary Childs, *Windstream Dispute Highlights Aurelius' Role as a Hedge-Fund Debt Cop*, BARRON'S (Aug. 31, 2018 5:23 PM), https://www.barrons.com/articles/windstream-dispute-highlights-aurelius-role-as-a-hedge-fund-debt-cop-1535750611.

counterparties involved in CDS transactions are highly sophisticated investors who can price the risk associated with the potential for a forced default.[47]

e. Current Solutions for Manufactured Credit Event Disputes

In response to manufactured credit events, corporate issuers have sought to develop and insert contractual provisions into their debt documents to limit the abilities of potential net short debt investors.[48] However, as recently noted in the *New York Law Journal*, "provisions addressing these issues are far from uniform, are by no means widely accepted and are a work in process."[49]

i. Net Short Lender Provisions

A recent solution that has been introduced to the market is the net short lender provision.[50] This provision first attempts to identify which investors qualify as "net short" by describing a specific formula that must be applied in calculating an investor's long and short debt and credit derivative positions.[51] The provision then goes on to apply certain restrictions to net short lenders such as taking away their voting rights or blocking their submitted notices of default.[52] More onerous net short lender provisions have even included clauses that force a net short lender to transfer its long debt position to a third party.[53]

Although the net short lender provision is a positive development, it still leaves open many potential loopholes. First, creative net short lenders can possibly use separate subsidiaries and affiliates to hold their long and short positions in order to avoid the net short restriction and

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[47] Fletcher, *supra* note 11.
[48] Cahill, *supra* note 7.
[49] Matthew Roose, Alyson Gal, Andrew Glantz & Jill Kalish Levy, *CDS 'Net Short' Holder Market Developments*, LAW.COM, https://www.law.com/newyorklawjournal/2019/09/20/cds-net-short-holder-market-developments/?slreturn=20200123135933 (last visited Feb. 26, 2020)
[50] *Supra* note 19.
[51] *Id*.
[52] *Id*.
[53] *Id*.

not raise any red flags.[54] Second, the formulas that are used to calculate the defined "net short" amount could potentially be subject to dispute as many investors (especially large financial institutions with multiple divisions) might have short debt positions that were entered into as a result of normal day-to-day activity or inadvertently acquired in the course of the purchase of a portfolio of debt instruments.[55] Finally, net short lender provisions only seek to protect against potential notices of default and don't provide protections against other opportunistic CDS strategies such as blocking consensual restructurings, accepting rescue capital or merging with or selling to another company, in each case depriving the company an avenue to avoid filing for bankruptcy.

ii. Default Statute of Limitations

Historically, under New York law,[56] the applicable statute of limitations for a notice of default has been six years.[57] In *Windstream*, the sale-leaseback transaction that Aurelius scrutinized had occurred over two years prior to the litigation and had been assumed to have been accepted by the company's bondholders.[58] To deter this type of behavior, credit agreement provisions have been adopted by the market in order to limit the time in which a debtholder can assert a claim.[59] These provisions shorten the statute of limitations to around two years to deter potential activists from seeking out strategic litigation opportunities.[60] A potential drawback of this provision is that two years may not be enough time for a good-faith, neutral debtholder to

[54] *Locke Lord QuickStudy: Credit Markets Seek to Limit the Influence of Net Short Lenders*, LOCKE LORD, https://www.lockelord.com/newsandevents/publications/2019/08/net-short-lenders (last visited Feb. 26, 2020).
[55] Todd Koretzy, Anti-net short provisions in syndicated credit facilities, ALLEN & OVERY (Sep. 3, 2019), https://www.allenovery.com/en-gb/global/news-and-insights/publications/anti-net-short-provisions-in-syndicated-credit-facilities.
[56] See N.Y. C.P.L.R. 213(2) (McKinney 2019).
[57] Cahill, *supra* note 7.
[58] *U.S. Bank NA v. Windstream Servs. LLC, No. 17-CV-7857, 2019 WL 948120, (S.D.N.Y. Feb. 15, 2019)*
[59] Cahill, *supra* note 7.
[60] *Id*.

assert a real, non-opportunistic default.[61] For instance, a good faith debtholder may only learn of a material breach of a certain covenant months after it was initially disclosed due to it being buried in the footnotes of a company's required financial forms. If the statute of limitations were to be reduced to two years, then this hypothetical debtholder might not be able to appropriately assert a default.[62]

iii. ISDA Amendments

In March of 2019, ISDA published proposed amendments to its 2014 ISDA Credit Derivatives Definitions in order to address the issue of manufactured credit events.[63] The primary solution that ISDA proposed was to include a "credit deterioration" requirement under the definition of a failure to pay credit event. This proposed amendment was developed to deter net short activists by making sure that only actual financially distressed companies could trigger CDS contracts under a failure to pay credit event.[64] The ISDA Amendments, which have yet to be adopted, don't consider other opportunistic credit strategies such as those that were present in *Windstream* and Thomas Cook.

III. Analysis

a. Opportunity for Arbitration in Manufactured Credit Event Disputes

In May of 2019, the former CEO of ISDA testified that:

> "ISDA mechanisms would be insufficient to confront the threat of cleverly engineered defaults because CDS market participants and the ISDA Determinations Committee require the certainty of a bright-line rule, and that prohibiting engineered defaults would require a subjective inquiry into a Reference Entity's intent when defaulting"[65]

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[61] *Id*.
[62] *Id*.
[63] *May 2019: ISDA's Proposed Rules Aimed At Manufactured Defaults*, JD SUPRA (Jun. 12, 2019), https://www.jdsupra.com/legalnews/may-2019-isda-s-proposed-rules-aimed-at-39033/.
[64] *Id*.
[65] *See Solus Alt. Asset Mgmt. LP v. GSO Capital Partners L.P., 2018 WL 620490, (S.D.N.Y. Jan. 29, 2018).*

As new mechanisms are being proposed to remove the threat of manufactured credit events, loopholes and workarounds are being developed. The difficult task of balancing the benefits of CDS to provide greater liquidity and resilience to the credit markets while at the same time reducing their negative consequences, such as erosion of value, requires a neutral dispute resolution method.

In recent years, there has been a significant increase in the popularity of using arbitration as an effective tool in the financial sector.[66] Arbitration is "a method of dispute resolution by a privately-constituted tribunal typically made up of one or three arbitrators, which culminates in an arbitral award that binds the parties."[67] The fact that arbitration awards are binding on the parties means that arbitration, unlike mediation, can serve as a complete alternative to costly litigation.[68] Although arbitration costs can vary based on complexity, the main expenses are related to filing fees and the arbitrators' hourly fees.[69]

i. Benefits of Arbitration

There are many benefits to having borrowers and CDS market participants use arbitration instead of litigation in order to resolve disputes. For one, the arbitration agreement could specify a neutral forum in which both sides agree to arbitrate their matter, thus removing certain concerns that the parties may have of jurisdiction related bias.[70] In addition, the fact that arbitration allows the existence and details of the dispute to remain confidential would be very

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[66] *ISDA publishes a new edition of its Arbitration Guide*, ALLEN & OVERY (Dec. 17, 2018), http://www.allenovery.com/publications/en-gb/Pages/ISDA-publishes-new-edition-of-arbitration-guide.aspx.

[67] *2013 ISDA Arbitration Guide*, ISDA, https://www.isda.org/a/6JDDE/isda-arbitration-guide-final-09-09-13.pdf (last visited Feb 26, 2020).

[68] *Id*.

[69] Jean Murray, *Learn How the Arbitration Process Works*, THE BALANCE (Jun. 25, 2019), https://www.thebalancesmb.com/what-is-the-arbitration-process-how-does-arbitration-work-397420.

[70] Bahar Hatami Alamdari, *The emerging popularity of international arbitration in the banking and financial sector – Is this a fashionable trend or a viable replacement?*, UNIV. OF LONDON (2016), https://sas-space.sas.ac.uk/6401/1/Hatami%20Alamdari%2C%20Bahar.pdf.

attractive to a variety of investors who don't want their reputation publicly harmed or the markets to be influenced by papers filed with a court.[71] Another important benefit that arbitration can provide is the ability of arbitration agreements to specify that arbitrators be experts in a certain field, a very integral aspect to resolving disputes as complex as manufactured credit events. Perhaps the greatest benefit of having mandatory arbitration in manufactured credit event disputes is its ability to provide a standardized dispute resolution mechanism. If investors lose faith in credit derivatives by believing that some players "game the market," then demand for CDS will fall and the wider credit markets could suffer. Standardization, by raising investor confidence, could allow markets to continue to benefit from the many positive aspects of credit derivatives while also increasing efficiency and reducing transaction costs.[72]

ii. Potential Drawbacks of Arbitration

Although arbitration in complex credit derivative disputes is a possible solution, there are a few drawbacks that should be mentioned. For one, arbitration typically lacks a comprehensive discovery process and must rely on the experience of the arbitrators to provide guidance on streamlined procedures.[73] In addition, arbitration typically disfavors summary judgment or summary disposition even when there are only legal and not any material facts in dispute.[74] Finally, the inability to appeal (except in cases of proven arbitrator bias) has sometimes turned parties away from choosing arbitration as the preferred method to resolve their disputes.[75]

IV. Conclusion

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[71] *Litigation or Arbitration: How Best to Resolve Cross-Border Disputes in the Financial Sector?,* LATHAM & WATKINS CLIENT ALERT COMMENTARY (Jul. 8, 2013), https://www.lw.com/thoughtLeadership/LW-arbitration-primer-financial-sector.

[72] Enzo Scannella, *Transaction Costs, Standardization and Modularity in Credit Risk Transfer Market* (Oct. 1, 2010), 1 Int'l. J. Econ. Bus. Modeling, 21-28 (2010).

[73] Jean Murray, *The Benefits and Drawbacks of Arbitration*, THE BALANCE (Jul. 22, 2019), https://www.thebalancesmb.com/what-are-the-benefits-and-drawbacks-of-arbitration-398535.

[74] *Summary Judgment*, LEGAL INFORMATION INST., https://www.law.cornell.edu/wex/summary_judgment (last visited Feb. 20, 2020).

[75] Murray, *supra* note 73.

The various proposals and amendments that have been introduced in order to combat the negative consequences of certain opportunistic CDS strategies often utilize bright line rules in order to deal with one aspect of a manufactured credit event and fail to consider other consequences. In addition, "preventing all future loophole-exploitation" is nearly impossible as sophisticated investors will create new and innovative ways in order to profit.[76]

Incorporating a standardized mandatory arbitration clause in corporate debt documents that is applicable to a wide net of debtholders could reduce value erosion and negative externalities, provide a mutually beneficial solution for all parties and abolish the need for a subjective inquiry into a reference entity's intent when defaulting. Although more research into this topic is warranted, mandatory arbitration agreements inserted into corporate debt documents could potentially be an effective step in the right direction.

[76] Childs, *supra* note 17.