CDS derivatives are blamed for role in bankruptcy filings
By Henny Sender in New York
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Credit default swaps, the derivatives instruments that have figured prominently in the global financial crisis, are now being blamed for playing a role in two bankruptcy filings this week.

Bankers and lawyers involved in restructuring efforts say they are concerned some lenders to troubled companies, such as newsprint producer AbitibiBowater and mall owner General Growth Properties, stand to benefit from a default because they also hold default swaps, which entitle them to payments in such events.

"We have seen CDS becoming a significant factor" when negotiations on out-of-court restructurings fail, said Alan Kornberg, the partner in charge of the bankruptcy practice at Paul, Weiss, Rifkind, Wharton & Rice, speaking generally. "We used to talk about the practice theoretically but now we see cases where it is hard to get lenders to agree to tender or to compromise and then you find out that these holdouts had significant CDS protection."

AbitibiBowater

, which filed for bankruptcy protection yesterday, ran into trouble as the dire state of the newspaper industry eroded its cash flow and left it unable to service its debt load. It sought to persuade debt holders to exchange bonds due in August for new debt with longer dated maturity and higher yields, but failed to do so as creditors squabbled.

Such exchange offers require the support of a significant number of lenders, 97 per cent in the case of bondholders in this case. But those who withhold support often have powerful incentives to do so, either because they hope to be made whole or because they are seeking to force a filing that would trigger payments under their credit protection agreements, bankers and lawyers say.

Some creditors, including Citigroup, which held a small exposure to AbitibiBowater, hedged themselves in the CDS market, meaning their economic interest in the deal was different to lenders who had not bought credit insurance, according to people familiar with the matter. Citigroup declined to comment.

Lawyers say CDS holdings were also a factor in the default and filing for Chapter 11 protection of General Growth Properties this week. Restructuring advisers expect many more such cases involving so-called fallen angels, or firms originally investment grade, since CDS was widely sold on such names.

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