

**IMPORTANT DECISION IN  
CREDIT DEFAULT SWAP LITIGATION**

Willkie Farr & Gallagher LLP obtained, on behalf of a credit protection seller, an important decision<sup>1</sup> from the New York State Supreme Court that clarifies what constitutes effective notice of a credit event and on whom the burden of providing adequate notice belongs. This decision provides valuable judicial clarity to the settlement of certain credit default swaps.

A copy of the *Oasis* decision can be obtained by clicking [here](#).<sup>2</sup>

**EXAMINATION OF THE OASIS CASE*****Summary***

The dispute in question was whether Merrill Lynch International as credit protection seller (the “Seller”) defaulted on the settlement of a credit default swap (“CDS”) with DKR Soundshore Oasis Holding Fund Ltd. as credit protection buyer (the “Buyer”).<sup>3</sup> The court ruled that:

- the Buyer’s notice failed to provide in reasonable detail the facts relevant to determining whether a credit event had occurred;
- the ISDA Definitions place the burden upon the Buyer to provide adequate notice; and
- the Seller has no duty to investigate the existence of a credit event based upon an inadequate notice that lacks the necessary facts.

The case also raised, but did not address, whether a refinancing of the Reference Obligation constituted a restructuring of the Reference Obligation.

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<sup>1</sup> The case, *DKR Soundshore Oasis Holding Fund Ltd. v. Merrill Lynch International and Merrill Lynch & Co., Inc.*, No. 650327/09, was argued before Judge Barbara R. Kapnick of the Supreme Court of the State of New York, New York County Commercial Division. Willkie’s victory is profiled in the *Am Law Litigation Daily* in a feature article entitled “Willkie Wins for Merrill Lynch in Credit Default Swap Dispute with Hedge Fund” (4/15/2010). The case was handled by partners Richard Bernstein and Mary Eaton, and associates David Gise, Emma Deacon, and Melissa Yang.

<sup>2</sup> [http://www.willkie.com/files/tbl\\_s10News/FileUpload44/13554/Memorandum%20of%20Law.pdf](http://www.willkie.com/files/tbl_s10News/FileUpload44/13554/Memorandum%20of%20Law.pdf)

<sup>3</sup> The Buyer and Seller were parties to an International Swaps and Derivatives Association, Inc. (“ISDA”) Master Agreement dated July 26, 2007 and a Confirmation Agreement dated October 29, 2007 relating to Urban Corporation (“Urban”), a public Japanese company, as the reference entity (the “Reference Entity”), and certain reference obligations (the “Reference Obligations”). Originally the CDS was between Riviera Holdings as protection buyer (the “Original Buyer”) and Deutsche Bank AG as protection seller (the “Original Seller”) but was novated to the current Buyer and Seller on June 12, 2008.

### ***The CDS Terms***

The CDS contained common terms. Pursuant to the CDS, the Seller had sold 1.5 billion JPY worth of protection to the Buyer that would be settled if (a) among others, a restructuring Credit Event (as discussed below) occurred within a specific time frame; and (b) the Buyer delivered a certain specified Notice (as discussed below) of such Credit Event to the Seller.

A restructuring Credit Event was defined in the CDS, in part, as a postponement or deferral of the payment of principal or interest on unsubordinated debt of the Reference Entity totaling no less than 1 billion JPY (the “Default Requirement”), in a form binding on all holders of such debt, occurring after the effective date of the swap but on or before May 23, 2008 (the “Termination Date”).

The notice requirements of the CDS provided that the Buyer must deliver to the Seller, no later than June 6, 2008:

- (i) a Credit Event Notice (the “Credit Notice”) indicating that a restructuring Credit Event had occurred, including “a description in reasonable detail of the facts relevant to the determination that a Credit Event ha[d] occurred”; and
- (ii) a Notice of Publicly Available Information (“NPAI” and together with the Credit Notice, the “Notice”) that “reasonably confirm[ed]...facts relevant to a determination that the Credit Event...described in [the] Credit Event Notice...ha[d] occurred” on or before the Termination Date.

### ***Notice Provided, Payment Demanded***

On June 6, 2008 the Original Buyer sent to the Original Seller a combined Credit Notice and NPAI, stating that “a Restructuring Credit Event occurred with respect to Urban Corporation during the period between March 2008 to May 2008.” The Original Buyer also provided an affidavit from an employee thereof, stating that the employee “had learned from a Deputy President of Urban that Urban had sought to restructure obligations in excess of one billion JPY, and that it had been successful, except with respect to its debts to two banks, one of which Urban had had to repay in full, and the other of which Urban had repaid in part” and further stating that Urban “had successfully persuaded nearly all of its creditor banks holding obligations in excess of JPY 1,000,000,000 to extend the scheduled loan maturity” for such obligations.

On July 2, 2008 the Buyer delivered to the Seller a Notice of Physical Settlement, demanding that the Seller settle the transaction and pay 1.5 billion JPY by August 15, 2008. The Seller advised the Buyer that it had no obligation to pay, as the Buyer had failed to provide the required Notice within the required time frame.

### ***Suit Brought, Disagreement on Sufficiency of Notice***

On June 5, 2009 the Buyer brought suit against the Seller for breach of contract due to failure to pay under the CDS. The Seller argued that it had no obligation to pay because the Notice was deficient due to, among other things, failure to provide in reasonable detail the facts relevant to

determining that a Credit Event had occurred, including (i) whether the dollar amount of Reference Obligations successfully restructured by the Reference Entity equaled or exceeded the Default Requirement of 1 billion JPY, and (ii) whether such restructurings occurred prior to the Termination Date, May 28, 2008.

***The Ruling***

The Court agreed with the Seller's position that the Notice was substantively deficient and the Seller was thus not obligated to pay.

***Ambiguous Notice Is Insufficient.*** The Court correctly ruled that vague notice that merely raises a question as to whether a credit event has occurred is insufficient:

“To be sure, the ISDA Definitions specify that only reasonable notice needs to be given of a Credit Event, and that Publicly Available Information supplied need only reasonably confirm that the Credit Event described in the Notice occurred. However, by failing to specify either the date of the Credit Event upon which Riviera was relying, or the sum of the obligations that Urban had actually restructured, both the Notice, and the NPAI, do no more than pointedly raise a question as to whether the events that they purport to report had, in fact, taken place.”<sup>4</sup>

***Buyer's Burden to Provide Adequate Notice.*** The Court correctly ruled that the ISDA Definitions impose the burden upon the Buyer to provide adequate notice:

“[T]he ISDA Definitions place the burden of providing a Notice that complies with specific requirements squarely upon the Buyer. To accept plaintiff's argument that a Notice that fails to comply with those requirements is, nonetheless, adequate, because it gives the Seller a basis upon which to investigate whether a Credit Event occurred prior to the expiration of the Contract Term, would constitute a substantial modification of the Agreement, and it is well settled that courts ‘may not ‘by construction add or excise terms, nor distort the meaning of those used and thereby make a new contract for the parties under the guise of interpreting the writing’ (citation omitted)’ ”.<sup>5</sup>

***No Duty To Investigate Inadequate Notice.*** What may be the most important holding from the *Oasis* decision is the proposition that a protection seller does not have a duty to investigate the existence of a credit event after receiving a vague and inadequate notice.<sup>6</sup> The Court correctly concludes that imposing such a duty upon a Seller would be a substantial modification to the

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<sup>4</sup> *DKR Soundshore Oasis Holding Fund Ltd. v. Merrill Lynch International and Merrill Lynch & Co., Inc.*, No. 650327/2009 (Supreme Court of the State of New York, September 4, 2009) (Decision/Order)

<sup>5</sup> *Id.*

<sup>6</sup> See the immediately preceding quotation.

terms of the CDS by making “a new contract for the parties under the guise of interpreting the writing.” Stated differently, the plain language of the ISDA Definitions and the terms of the CDS will be enforced.

## CONCLUSION

The ruling in *Oasis* affirms the enforceability of globally used defined terms published by ISDA that many market participants take for granted. This decision also affirms the public policy benefits of the efficient settlement of credit default swaps among counterparties without the need for investigation. The *Oasis* decision is also consistent with ISDA’s efforts over the last few years to encourage clarity and certainty among derivative products and standardized CDS documentation, such as the “Big Bang” protocol published by ISDA last spring.<sup>7</sup>

The Court did not need to address a potentially important question for certain older over-the-counter credit default swaps that specify restructuring as a credit event.<sup>8</sup> The Court stated “[f]or the purposes of this decision, it is unnecessary to determine whether [the Reference Entity’s] agreements with certain banks to modify the terms of its debts to those banks constituted a restructuring, or as defendants argue, merely a refinancing.” This issue may be a source of future disputes among counterparties.

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<sup>7</sup> As of April 8, 2009, many market participants agreed to begin trading in accordance with the “Big Bang” protocol (and related subsequent protocols) that introduced standardized trading terms for CDSs.

<sup>8</sup> Restructuring is less commonly included as a credit event in CDSs today.