UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SOLUS ALTERNATIVE ASSET MANAGEMENT LP, Plaintiff, -against- GSO CAPITAL PARTNERS L.P., HOVNANIAN ENTERPRISES, INC., K. HOVNANIAN ENTERPRISES, INC., K. HOVNANIAN AT SUNRISE TRAIL III, LLC, ARA K. HOVNANIAN, and J. LARRY SORSBY, Defendants.	**No. 18 Civ. 232 (LTS) (BCM)** **SUPPLEMENTAL DECLARATION OF ROBERT PICKEL**

I, ROBERT PICKEL, do hereby declare under penalty of perjury:

1. I was employed for 17 years by the International Swaps and Derivatives Association, Inc. ("ISDA"), the global trade association for the over-the-counter derivatives business, including as its General Counsel (1997-2001), Chief Executive Officer (2001-2009, 2012-2014) and Executive Vice Chairman (2009-2012).

2. Prior to joining ISDA, I worked as an Associate in the Corporate Department at Cravath, Swaine & Moore in New York from 1984 through 1991, where I did substantial work for ISDA. I hold a law degree from New York University School of Law, which I graduated from in 1984.

3. In my roles at ISDA, I was intensively engaged in the full range of issues affecting the derivatives business and the global financial markets, including representing ISDA before numerous legislative and regulatory bodies, on topics concerning the integrity of the derivatives and financial markets. I have extensive, specialized knowledge of the role of credit default swaps ("CDS") in modern credit markets and the operation of the market for CDS.

4. In my roles at ISDA, I was also responsible for overseeing the continued development of ISDA documentation, including standard form documentation governing CDS. Among other projects, I was responsible for overseeing the drafting of the 1999 ISDA Credit Derivatives Definitions (the "1999 Definitions") in my role as General Counsel. I was also involved in the drafting of the 1997 Confirmation of OTC Credit Swap Transaction Single Reference Entity Non-Sovereign (the "1997 Long Form")—which was the predecessor to the 1999 Definitions—as well as various efforts to update the 1999 Definitions, such as the 2003 ISDA Credit Derivatives Definitions (the "2003 Definitions") and the 2014 ISDA Credit Derivatives Definitions (the "2014 Definitions").

5. I respectfully submit this Declaration in support of Solus Alternative Asset Management LP's Motion for a Preliminary Injunction. I am fully familiar with all matters set forth in this Declaration, based on my own personal knowledge and information and documents that I have reviewed in preparing this Declaration.

6. I understand that Solus Alternative Asset Management LP ("Solus" or "Plaintiff") has initiated a lawsuit against Defendants Hovnanian Enterprises, Inc. ("Hovnanian Enterprises"), K. Hovnanian Enterprises, Inc. ("K. Hovnanian"), and K. Hovnanian at Sunrise Trail III, LLC ("Sunrise Trail," and together with Hovnanian Enterprises and K. Hovnanian, "Hovnanian"), Ara K. Hovnanian and J. Larry Sorsby (the "Individual Defendants"), and GSO Capital Partners L.P. ("GSO" and together with Hovnanian and the Individual Defendants, the "Defendants") in connection with CDS on debt issued by Hovnanian Defendants.

7. I have been retained by counsel for Solus as an expert in this matter. I am being compensated at a rate of $900 per hour for my consulting work on this matter. My compensation

is not dependent upon the results of my analyses or the substance of my testimony, and is not contingent upon any outcome in this matter.

8. I have reviewed the Complaint in this action, the Securities and Exchange Commission ("SEC") Form 8-K filed by Hovnanian Enterprises (the "Transaction 8-K") on December 28, 2017, the Refinancing Transaction presentation slides attached as Exhibit 99.5 to the Transaction 8-K, as well as the transcript of the January 11, 2018 court conference in this case.

9. There is an underlying assumption in CDS trades that the companies ("reference entities") that issue the debt securities referenced in CDS trades will endeavor whenever financially possible to make good on their obligations and avoid payment defaults. In addition to the expectation that companies will seek to comply with their contractual debt obligations, avoiding defaults is also a matter of self-interest as defaults can cause cross-defaults and reputational damage that can make it more difficult (or expensive) for issuers to access the capital markets. While companies may ultimately elect to default on obligations when they become insolvent and seek the protections of the bankruptcy laws, a company will generally look to avoid bankruptcy until it is inevitable or the benefits and protections of bankruptcy outweigh the cost and reputational concerns.

10. In assessing the price of a CDS, the typical analysis by a CDS investor is to take a view on the probability of default ("PD") of the reference entity and the likely loss given default ("LGD"). In CDS contracts, the LGD is generally assumed to be a fixed percentage of par value of the reference entity's indebtedness, generally around 60% of par, implying a 40% recovery rate. Hence, PD, the probability of an entity's default, is the most significant factor driving CDS

pricing. At any point in time, a CDS investor's view of PD will be a function of three considerations:

a. An assessment of the specific financial performance and business strategy and plans of the reference entity (this is the most significant factor);

b. The prospects for the industry that the reference entity is a part of (for example, a well-run coal company still faces headwinds by virtue of it being a coal company); and

c. General trends in the economy and markets in which the reference entity is active (for example, a company active in Venezuela has a different credit risk profile than a company active in France).

11. Each of the three considerations above is, to varying degrees, quantifiable, and an investor can make an assessment as to whether the price it is quoted to buy or sell CDS is cheap or expensive in light of analyzing these factors.

12. Based on my review of the Transaction 8-K, Hovnanian is intentionally defaulting on payments for the purpose of triggering a "failure to pay" credit event. Of the unsecured notes tendered in the exchange (a significant portion of which are owned by GSO), Sunrise Trail will purchase $26 million (the "Purchased Notes") with full knowledge that Hovnanian has no intention to pay, and is contractually prohibited from paying, interest on those Purchased Notes prior to their stated maturity. The amount of interest that would be owed by K. Hovnanian on these notes at the next payment date is $1.04 million—just barely over the $1 million threshold for failed payments to qualify as "failure to pay" credit events. This amount does not appear to be a coincidence, and serves to highlight the transparently manufactured nature of this default.

13. Additionally, based on my review of the Transaction 8-K and the Complaint, Hovnanian is also issuing a 5% bond with a 22 year maturity—significantly off-market terms for Hovnanian—that analysts believe will trade well below par at issuance. This bond appears to be designed to artificially increase GSO's recovery on its CDS positions. Following the occurrence of a credit event, the amount of money that protection sellers are required to pay protection buyers is determined by an auction run by ISDA. Market participants submit qualifying debt obligations of the reference entity into the auction, and the obligation that yields the lowest price—referred to as the "cheapest-to-deliver" obligation—generally sets the recovery on the CDS. For a simplified example, if the cheapest-to-deliver bond clears the auction at 20 cents on the dollar, then CDS protection sellers are required to pay out 80 cents on the dollar on their CDS. If the 5% bond is the cheapest-to-deliver obligation, it will increase the amount that protection sellers are required to pay protection buyers such as GSO.

14. The effect on CDS pricing of the prospect of a manufactured failure to pay, such as the one at issue here, is impossible to quantify. If manufactured defaults proliferate, it is my belief that the ability to price CDS will be irredeemably undermined.

15. The market impact in this case is magnified by the fact that Hovnanian is a constituent in several versions of the CDX High Yield Index.[1] The CDX High Yield Index is an index comprised of CDS referencing "one hundred (100) liquid North American entities with high yield credit ratings that trade in the CDS market." Markit CDX High Yield & Markit CDX Investment Grade Index Rules (Markit N. Am. Aug. 2016).[2] By trading CDS that reference the CDX High Yield Index, parties agree that they have entered into separate credit derivative

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[1] For example, K Hovnanian Enterprises, Inc. is a component of the most recent version of the CDX High Yield Index, CDX.NA.HY.29. *See* Index Annex, CDX.NA.HY.29 (Sept. 20, 2017), <http://www.markit.com/Company/Files/DownloadFiles?CMSID=c7e83a6adf3b46f5b7f95eac2f6d2b5d>.

[2] <http://www.markit.com/Company/Files/DownloadFiles?CMSID=1ec08990b6814532ad075e242b34160d>.

transactions in respect of each component of the Index. CDX Untranched Transactions Standard Terms Supplement (Int'l Swaps & Derivatives Ass'n & Markit N. Am. Sept. 22, 2014).[3] Through their CDX High Yield Index positions, numerous market participants will be impacted by this manufactured default.

16. After a manufactured failure to pay by Hovnanian, the impaired ability to price CDS properly may lead participants to withdraw from the market, depriving the credit markets of a major avenue for distributing and diversifying risk exposure. The consequent loss of market liquidity will make it harder, perhaps impossible, for lenders and others with credit exposures to hedge those exposures. This amounts to an existential threat to the CDS market with ramifications beyond the CDS market.

17. Reliable pricing is essential not only for buyers and sellers of CDS, but it is also useful for reference entities and lenders. A company whose name is actively traded in the CDS market can look to its CDS spread as an assessment by sophisticated market participants of its financial performance and business strategy. For many companies, the CDS spread is a better assessment than equity prices because the CDS market is an institutional market. For lenders, the CDS price is useful information in deciding whether to extend credit to an entity, how much to extend, and at what interest rate.

18. If the reliability of CDS prices is called into question because of uncertainty about the possibility of manufactured credit events, with adverse effects on the CDS market generally, the damage will be felt well beyond the CDS market. CDS prices are also relied on in the areas of credit valuation adjustment (which affects derivatives pricing and pricing of other financial products) and accounting (where credit and debt valuation adjustments rely on CDS prices). Banks use CDS to offset credit exposures for their regulatory capital calculations. With greater

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[3] <http://www.markit.com/Company/Files/DownloadFiles?CMSID=6902f2aa972046e3b6bfbe6afe769f18>.

pricing uncertainty, credit spreads, particularly for high-yield and distressed borrowers, are likely to increase as sellers of protection price in the prospect of greater use of manufactured defaults. Lenders looking to buy protection must factor in those hedging costs in their lending decisions, and without a well-functioning CDS market they will be less able to quantify and distribute risk.

19. Since executing my original declaration on January 10, 2018, I have reviewed the transcript of the initial conference before Judge Swain in this matter, which was held on January 11, 2018. I wish to address three comments made during that conference by counsel for Hovnanian and GSO.

20. *First*, counsel for Hovnanian informed the court that "in the CDS world, the ISDA contracts, which [are] a template contract, actually allow[] for the parties to engage in commercial activities, even ones that lead to payment on the ISDA contracts." Conf. Tr. 24:2-6. That is true as far as it goes, but I do not believe that the intent of the 2014 Definitions (or any predecessor ISDA CDS documentation) was to permit protection buyers to provide financing to a reference entity that is conditioned on that reference entity's agreement to trigger a failure to pay credit event on outstanding CDS.

21. I suspect that Hovnanian's counsel is referring to Section 11.1(b)(iii) of the 2014 Definitions (a true and correct copy of which is attached hereto in excerpted form as Exhibit A), which states that each party to a CDS:

> [M]ay, where permitted … make loans or otherwise extend credit to, and generally engage in any kind of commercial or investment banking or other business with, the Reference Entity … and may act (but is not obliged to act) with respect to such business in the same manner as each of them would if such Credit Derivative Transaction did not exist, regardless of whether any such action might have an adverse effect on the Reference Entity … (including, without limitation, any action which might constitute or give rise to a Credit Event).

22. Section 11.1(b)(iii) in the 2014 Definitions carried over in substantially the same form Section 9.1(b)(iii) in the 2003 Definitions (a true and correct copy of which is attached

hereto in excerpted form as Exhibit B), which in turn carried over in substantially the same form Section 9.1(b)(iii) in the 1999 Definitions (a true and correct copy of which is attached hereto in excerpted form as Exhibit C) and Section 7(b)(ii)(C) in the 1997 Long Form Confirmation (a true and correct copy of which is attached hereto in excerpted form as Exhibit D), and I am not aware of any intent on ISDA's part to change the purpose or operation of the provision. The provision was intended to ensure that protection buyers and sellers who had other commercial, investment banking or business relationships with a reference entity would not be required to alter the nature of that relationship, or act in a different way with respect to that relationship, in light of their CDS.

23. This purpose is clearly reflected in the draft User's Guide to the 1999 Definitions prepared by ISDA but never published in final form (a true and correct copy of which is attached hereto in excerpted form as Exhibit E), which explains Section 9.1(b)(iii) as follows:

> **(iii) Freedom to Deal and Conduct Business.** This agreement between the parties confirms each party's understanding that entering into a Credit Derivative Transaction does not in any way limit the ability of either party to engage in any kind of business with a Reference Entity …. ***Such business may be conducted in the same manner as if the Credit Derivative Transaction did not exist and completely without regard to the terms of the Credit Derivative Transaction***. The fact that such business may involve relationships (such as a lending relationship) that could give rise to a Credit Event under the Credit Derivative Transaction is irrelevant.

24. Derivatives dealers that had established lending relationships with reference entities wanted to ensure that their CDS counterparties could not cry foul if the dealer's commercial lending department—which was entirely separate and distinct from their CDS market-making business—took some action in the ordinary course of its relationship with the reference entity that resulted in a credit event. As the bold italicized sentence in the above quote makes clear, the purpose was to ensure that the commercial lending department could act "***as if the Credit Derivative Transaction did not exist and completely without regard to the terms of***

the Credit Derivative Transaction." That is not what GSO is doing in this case. On the contrary, based on the materials I have reviewed, it is clear that the lending arm and the CDS trading arm of GSO are acting in concert. More specifically, the lending arm is offering financing with terms that are designed to (1) induce Hovnanian to default, thereby triggering a credit event under Hovnanian CDS, and (2) increase GSO's recovery in the subsequent ISDA auction. Neither the 1999 Definitions nor subsequent formulations, including the 2014 Definitions contemplated this type of coordinated conduct.

25. *Second*, counsel for Hovnanian informed the court that the type of engineered default at issue here has "happened twice before in the iHeart transaction and the Codere transaction from 2014 and 2016. This is the third time it's happening." Conf. Tr. 24:13-15. This argument was reiterated by counsel for GSO, who stated: "The iHeart transaction … occurred over a year ago, very similar in its parameters to this one. You have a credit event between a parent and an affiliate, and it was found that it was a credit event." Conf. Tr. 32:17-21.

26. The court can consider for itself the various differences between the proposed GSO/Hovnanian transaction and the Codere and iHeart transactions. It is my view that market participants were unsettled by the Codere and iHeart transactions, but hoped that they were one-off situations based on the unique circumstances of each case. As I have stated above, it is the proliferation of manufactured defaults that would undermine the CDS market. The GSO/Hovnanian transaction provides a template for buyers of protection to manufacture failure to pay credit events and structure loans to artificially maximize CDS settlement amounts. Any buyer of CDS protection could seek to induce any healthy company to trigger a failure to pay credit event, and to issue debt that is custom-designed to drive up CDS recoveries in an ISDA

auction. If this transaction is allowed to proceed, and ultimately generates a substantial windfall for GSO, there is no reason to believe that it will not be replicated by GSO again or by other CDS protection buyers. As explained above, if this were to happen, it could threaten the continued viability of the CDS market.

27. *Third*, counsel for Hovnanian stated that "if the CDS market does not want to have these types of technical defaults, either the ISDA determinations committee can determine it's not a failure to pay event or the ISDA contract … can be modified." Conf. Tr. 24:19-22. Neither of these solutions is likely to be an appropriate way to address the problem. The CDS market desires certainty, speed and precision in the determination of credit events. Accordingly, the ISDA Determinations Committee (the "DC") has historically not taken the motive or intent behind a transaction into account when determining whether a credit event has occurred. Nor does it have the adjudicative capacity to properly address these issues in most cases because, among other reasons, unlike a court, it is limited to consideration of "public" material and does not have the means of compelling the provision of evidence or taking of testimony from relevant entities, including the reference entity who is not even a party to the CDS contract. The DC is also poorly situated to evaluate as part of a credit event determination whether a transaction leading to a failure to pay contravenes federal securities laws or other legal restrictions because it is intended to deceive or defraud market participants. Moreover, even if the DC were to begin considering motive and intent or violations of external legal obligations, it would inject a measure of uncertainty and imprecision into the process that would run counter to the DC's goal of establishing "bright line" rules to guide its determinations.

28. Thus, if the DC were presented with the question of whether a payment default by Hovnanian in the context of the present transaction constitutes a failure to pay credit event, I

believe it would find itself in a Catch-22 dilemma in which it could either: (a) stand by its historical practice of ignoring motive and intent, which would risk being misinterpreted as validating conduct that creates existential risk to the CDS market; or (b) depart from its historical practice and find that no credit event has occurred on the basis of GSO's and Hovnanian's intent to engineer the payment failure, which would inject a type of consideration into the credit event determination process that the DC is often not well situated to make, undermining the goals of certainty and predictability it strives to foster. I believe that either decision carries a risk of causing significant harm to the CDS market.

29. The same types of risks would also arise if ISDA sought to address concerns about the conduct of GSO and Hovnanian through amending the 2014 Definitions to exclude "intentional" failures to pay. For example, interpreting when a payment failure is "intentional" would itself invite a host of complicated distinctions—because almost every payment failure is volitional in at least some respects. An intent exclusion would force the DC to engage in the very types of "intent" based determinations that, as I describe above, it has historically sought to avoid, and which it is ill-suited to delve into. But that does not mean that participants in the CDS market believe that transactions such as the one between GSO and Hovnanian should simply be tolerated as "the price of doing business."

30. For the reasons stated, it is my view that ISDA would find it hard to address the questions of manufactured defaults and intent and still provide the certainty and "bright line" of a clearly discernable credit event. A better result would be recognition by the court that the CDS business is premised on the financial success or failure of reference entities in the execution of their business strategies, without the risk of CDS market participants inducing defaults by issuers with sufficient resources to pay their debts.

I declare under penalty of perjury that the foregoing is true and correct.

Executed in New York, New York on January 16, 2018.

By:

Robert Pickel