Credit Derivatives Developments

September 2016

The Aftermath of the 2014 ISDA Credit Derivatives Definitions

1. Introduction

In 2014 substantial changes were made to the credit derivatives market through the publication of the 2014 ISDA Credit Derivatives Definitions[1] (the **2014 Definitions**) and implemented (a) for some, but not all, existing credit derivatives contracts through the ISDA 2014 Credit Derivatives Definitions Protocol[2] (the **2014 Protocol**) with effect from 6 October 2014[3] (the **2014 Definitions Implementation Date**) and (b) for future credit derivatives contracts to varying degrees from the 2014 Definitions Implementation Date.

Box 1: Main Changes effected by 2014 Definitions

- New Governmental Intervention Credit Event
- Changes to Restructuring Credit Event, including Bond exchange, Eurozone-related provisions and Auction bucket changes
- New Asset Package Delivery provisions
- Split senior/subordinated CDSs for financial Reference Entities
- Successor changes (including Universal Successor, Steps Plan and Standard Reference Obligation)
- New definition of Outstanding Principal Balance
- Qualifying Guarantee changes

These changes primarily focused on circumstances where credit derivatives had led to odd results in the past. Box 1 sets out a high-level list of the main changes. In many cases, sellers of protection were reluctant to incorporate certain changes because they were seen to be too buyer-friendly and led to increased moral hazard risks. This has led to increased divergences in credit derivatives market standards worldwide.

Since the 2014 Definitions Implementation Date, there have been a number of interesting events, determinations by Credit Derivatives Determinations Committees[4] (**DCs**) and developments that should be borne in mind by market participants for future matters. This briefing starts by giving an overview of Credit Events and Successor determinations made since the 2014 Definitions Implementation Date, before going on to look at the specific details around the most interesting or important events, which are often heavily fact-specific. This briefing also considers some of the other developments affecting the credit derivatives industry, in particular the European Commission antitrust investigations and changes made to the DC Rules, before touching briefly on progress on the Standard Reference Obligation and Package Observable Bond identifications.

Note that a number of DC determinations referred to in this briefing were based on the 2003 ISDA Credit Derivatives Definitions as supplemented by the July 2009 Supplement (together the **Updated 2003 Definitions**). In addition, IHS Inc. (**IHS**) and Markit Ltd. merged

[1] Published on 21 February 2014. ISDA stands for the International Swaps and Derivatives Association, Inc.

[2] Published on 21 August 2014, then amended on 8 September 2014 and 20 October 2015 and supplemented on 15 September 2014.

[3] The original intention had been to start on 22 September 2014, which was the first business day after the usual 20 September roll date for CDSs, but various difficulties led to the postponement. Some market participants did, however, trade under the 2014 Definitions from 22 September 2014.

[4] There are five DCs, one for each of these regions: Americas; EMEA; Japan; Asia ex-Japan; and Australia/New Zealand. We refer to the DCs generally as the relevant DC making the particular determination. See "DC Determinations and Rules" below for more details.

on 12 July 2016 to form a new entity called IHS Markit Ltd. (**IHS Markit**), but this briefing uses the definition **Markit** to mean both the pre-merger entity Markit Ltd. for pre-12 July 2016 actions and the same part of the business in IHS Markit for subsequent actions (e.g. the Article 9 commitments described in section 11 given by Markit will cover subsequent actions by IHS Markit).

The focus of this briefing is on over-the-counter (**OTC**) credit default swaps (**CDSs**), though many of the principles apply equally to other forms of credit derivatives such as credit linked notes or synthetic collateralised debt obligations (generically referred to as **CLNs** when in securitised format). CLNs in particular often reference Auction Final Prices, but depending on how they are drafted there might be times when they cannot use a particular Auction Final Price (e.g. if they refer to Auctions under the Updated 2003 Definitions but an Auction is only held under the 2014 Definitions).

Because many of the events affecting CDSs described in this briefing were triggered by specific aspects of debt restructuring negotiations, insolvency laws and other laws/practices in the United States (the **US**), the European Union (the **EU**) and the United Kingdom (the **UK**), in several places this briefing goes into some detail about the specific laws/practices and things to watch out for under CDSs and in debt restructuring negotiations.

Capitalised terms used but not defined in this briefing have the meaning ascribed to them in the relevant market standard documents, which could be (a) the Updated 2003 Definitions or the 2014 Definitions, as applicable to the relevant facts, (b) the 2014 Protocol, (c) the relevant Auction Settlement Terms, (d) the DC Rules or (e) specific iTraxx/CDX Standard Terms Supplements. When referring to Transaction Types, we have omitted references to "Standard" (e.g. references to "European Corporate" cover both European Corporate and Standard European Corporate).

2. Salient events

Since the 2014 Definitions Implementation Date, there have been[5] 14 DC Resolutions that a Credit Event had occurred, of which only two did not result in at least one Auction[6], 8 DC Resolutions that a Credit Event had not occurred, 20 DC Resolutions determining a Successor (only two resulted in more than one Successor[7]) and 13 DC Resolutions that there was no Successor. There have been DC Resolutions on various other topics as well, such as lists of Standard Reference Obligations or Package Observable Bonds, as well as a number of requests to convene DCs that were rejected for lack of Publicly Available Information (for Credit Events) or Best Available Information/Eligible Information[8] (for Successor determinations).

There have been two issues that went to External Review, namely the CEOC and Novo Banco questions, which is significant as only one question had been decided by External Review before the 2014 Definitions Implementation Date, being that for Cemex S.A.B. de C.V. in 2009[9].

For the Credit Events that resulted in one or more Auctions, Figure 1 below shows the relevant Auction Final Prices and the triggering Credit Event:

[5] Where there have been DC Resolutions on the same event under both the Updated 2003 Definitions and the 2014 Definitions and the outcome was the same, they have been counted as a single DC Resolution here.

[6] These two are (a) the Abengoa Bankruptcy Credit Event under the Updated 2003 Definitions only (an Auction was held for the Abengoa Failure to Pay Credit Event under the 2014 Definitions) and (b) The State Export-Import Bank of Ukraine Restructuring Credit Event. Note also that no DC Resolution was made for the CEOC LCDSs as the process for LCDSs is different and pre-dates the Big Bang changes of 2009.

[7] These two are (a) for Windstream Services under the 2014 Definitions only and (b) for MGM Resorts International.

[8] Best Available Information is the term used in the Updated 2003 Definitions, whereas Eligible Information is the term used in the 2014 Definitions.

[9] The issue in SEAT Pagine Gialle S.p.A. had been referred to External Review in 2011, but that was abandoned when a subsequent Failure to Pay Credit Event clearly occurred.

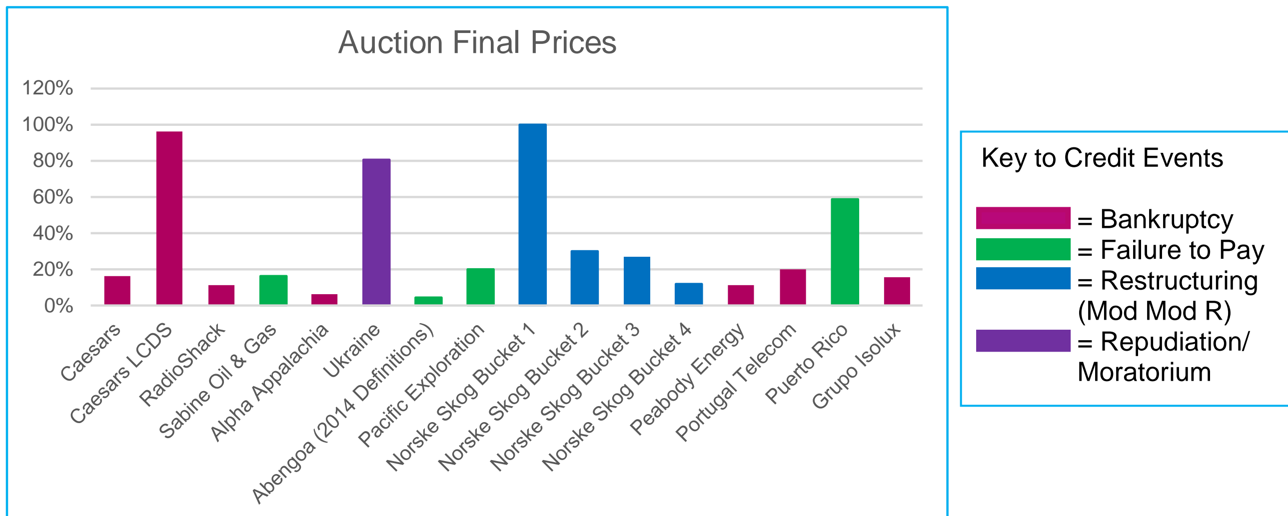


Figure 1 – Graph showing the Auction Final Prices for the Auctions that have taken place since the 2014 Definitions Implementation Date (data source: Creditex/Markit website for Credit Event fixings)

Most of the DC Resolutions since the 2014 Definitions Implementation Date have been made by the Americas DC and the EMEA DC, with the most common Transaction Types being North American Corporate and European Corporate. Figure 2 shows the breakdown by DC and Transaction Type:

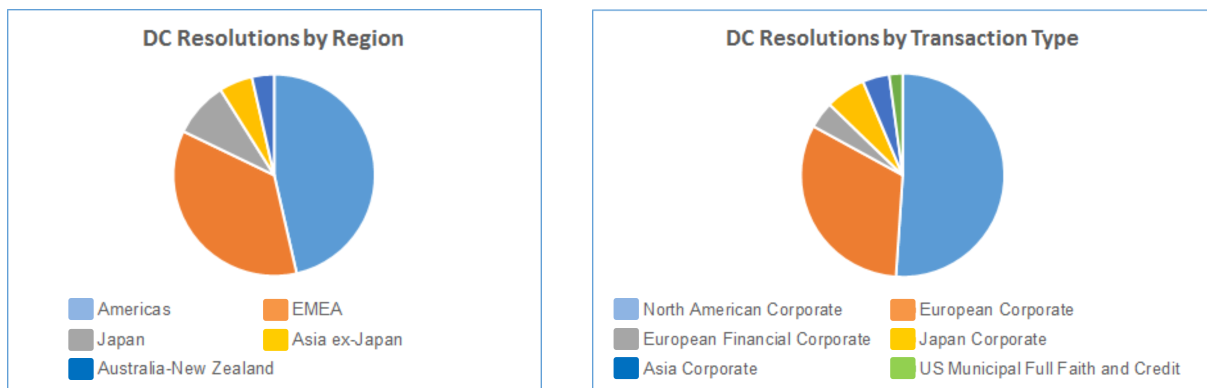


Figure 2 – Charts showing DC Resolutions made since the 2014 Definitions Implementation Date by DC and Transaction Type[10]

For the purpose of this briefing, these significant events after the 2014 Protocol Implementation Date have been broadly grouped together into the following categories by the most significant question considered (for example, Abengoa had questions around both Bankruptcy and Failure to Pay Credit Events, but the former was more informative so it is in the non-US Bankruptcy Credit Events section): (a) US Bankruptcy Credit Events; (b) non-US Bankruptcy Credit Events; (c) Repudiation/Moratorium Credit Events; (d) Governmental Intervention Credit Events; (e) Restructuring Credit Events; (f) US Municipal Reference Entities; (g) other Failure to Pay Credit Events; and (h) Successor determinations.

3. US Bankruptcy Credit Events

The US Chapter 11[11] bankruptcy protection procedure remains the most common Credit Event trigger for CDSs worldwide. All of the US Bankruptcy Credit Events since the 2014 Protocol Implementation Date

[10] DC Resolutions on the same question for the Updated 2003 Definitions and the 2014 Definitions have been counted as a single DC Resolution, even where the outcome was different. Multiple requests on the same question have been counted as a single DC Resolution. Any questions that were rejected have not been counted on the basis that they did not lead to a DC Resolution. Different questions on the same Reference Entity have been counted separately (e.g. Novo Banco led to two European Financial Corporate DC Resolutions: one for the Governmental Intervention query (despite there being two such queries); and one for the Successor query, and as the Restructuring Credit Event query had been rejected it was ignored).

were triggered by Chapter 11 filings. As the events below show, a Chapter 11 filing is often coupled with pre-packaged (or pre-negotiated) debt restructurings to create a streamlined process for restructuring the debt and exiting the Chapter 11 procedure as quickly as possible. Using the Chapter 11 filing as a Bankruptcy Credit Event trigger can have the benefit of removing CDS holders from the equation when a vote is being put to bondholders/lenders to restructure their debt (the CEOC and RadioShack events are examples of pre-packaged bankruptcy procedures), which is sometimes referred to as "flushing out" bondholders/lenders with CDS positions – the idea is that the CDSs are triggered and settled before any voting takes place on proposed restructurings, so that the interests of all remaining bondholders/lenders are aligned and thereby making it easier to reach the required voting thresholds[12]. However, pre-packaged Chapter 11 filings are not always successful (e.g. the CEOC case).

It should be noted that Restructuring is not usually a Credit Event for North American Corporate Transaction Types[13], so many debt restructurings that might otherwise have been structured to trigger a Restructuring Credit Event without involving any insolvency filing that could trigger a Bankruptcy Credit Event are now often structured so as to trigger a Bankruptcy Credit Event. Much depends on the CDS positions of major bondholders/lenders.

3.1 *Caesars Entertainment Operating Company (CEOC)*

The first Credit Event to be considered by a DC following the 2014 Definitions Implementation Date was that for Caesars Entertainment Operating Company, Inc.[14] (**CEOC**). Caesars Entertainment Corporation (**Caesars**) is a US casino operator and CEOC was its largest operating subsidiary. The Caesars group was known to be in financial difficulties[15] and both Caesars and CEOC were excluded from the 2014 Protocol[16], so even though the DC determinations came after the 2014 Definitions Implementation Date they were based on Updated 2003 Definitions.

On 15 December 2014, CEOC made a payment under certain subordinated notes[17] (the **Second Lien Notes**) that represented a portion of the amortising principal amount and accrued interest thereon that was due that day. However, it did not make a separate payment of the interest on the remaining Second Lien Notes, based on the standard strategy of delaying payments that are subject to a grace period for as long as possible[18]. Nonetheless, the Americas DC was asked to consider whether that constituted a Failure to Pay Credit Event on the basis that, on construction of the indenture for the Second Lien Notes, no grace period should apply to the interest payment.

At the DC meeting, there were 5 Yes votes and 10 No votes, so the question was put to External Review. On 9 February 2015, the three members of the External Review Panel came to a unanimous decision that a Failure to Pay Credit Event had not occurred, and a day later they published their reasoning that a 30-day grace period applied to the interest payment so no Failure to Pay Credit Event had yet occurred. The

---

[11] This is chapter 11 of the US Bankruptcy Code, which is itself Title 11 of the US Code.

[12] Considerable academic attention is being paid to these issues now, particularly since Professors Hu and Black coined the expression "empty creditor" to describe bondholders/lenders who have acquired default protection using CDSs. ISDA commissioned an academic review of the empirical academic literature, and the findings were published in "Single-name Credit Default Swaps: A Review of the Empirical Academic Literature" by Christopher L. Culp, Andria van der Merwe and Bettina J. Stärkle in September 2016.

[13] Although the ISDA Physical Settlement Matrix states that Mod R applies if Restructuring is specified as applicable in the Confirmation, in practice it rarely is.

[14] The Caesars group has a quite a complex debt history. In 2005, Harrah's Entertainment, Inc. acquired Caesars Entertainment, Inc., and the group has had a number of debt restructurings since then. Harrah's Entertainment, Inc. was renamed Caesars Entertainment Corporation in November 2010.

[15] It was in advanced negotiations with debtholders to restructure its debts.

[16] Caesars and CEOC were both specified in the Excluded Reference Entity List, though no DC Resolutions relate to the former.

[17] 10% Second-Priority Senior Secured Notes due 2015 (CUSIPs 413627BA7 and 413627BB5) and 10% Second-Priority Senior Secured Notes due 2018 (CUSIPs 413627BC3, 413627BD1 and U24658AM5) issued under an indenture dated 24 December 2008.

[18] See the External Review Panel's Decision and Analysis published on 10 February 2015 for details, particularly item 6. The payment of the portion of principal and accrued interest thereon was not subject to a grace period, although s.1.12(iii) of the Updated 2003 Definitions would have applied the minimum three Grace Period Business Day provision to CDSs.

External Review Panel did say that the indenture had been poorly drafted, which is one of the most common reasons for uncertainty about the occurrence or non-occurrence of Credit Events generally[19].

On 15 January 2015, CEOC filed for Chapter 11 bankruptcy protection[20] as the first step for implementing its plan to restructure its debt under a pre-packaged Chapter 11 plan of reorganisation supported by more than 80% of its first-lien noteholders[21]. An application was also made for the approval of debtor-in-possession financing (see section 3.3 below for an explanation of what debtor-in-possession financing is). The Chapter 11 filing clearly constituted a Bankruptcy Credit Event, but the Auction had to be postponed until after a decision had been reached by the External Review Committee on the Potential Failure to Pay question. This was necessary in case some CDSs had matured after the Potential Failure to Pay but before the Bankruptcy[22] (many news articles published around the time suggesting that one party had bought substantial amounts of naked CDS protection expiring on 20 December 2014[23]).

As is now standard where Auctions are held on Reference Entities that are undergoing debt restructurings, the Final List of Deliverable Obligations excluded any bonds where the holders had agreed to a lock-up under a restructuring agreement[24] (the **CEOC Restructuring Support Agreement**). The lock-up meant that bondholders could not transfer the bonds they held to third parties unless those third parties had signed up, or were willing to sign up, to the CEOC Restructuring Support Agreement, which as a rule is not permissible under CDSs or into Representative Auction-Settled Transactions (**RASTs**) following Auctions (an unusual exception to this rule occurred in the IC Finance Auction described in section 4.3 below). Consequently, any bondholders who were fully hedged under CDSs but had signed the CEOC Restructuring Support Agreement bore basis risk equal to the difference between the Auction Final Price and the price they eventually realised for the bonds following the debt restructuring.

The Auction took place on 19 February 2015 and settlement of the RASTs took place a few days later.

A Bankruptcy Credit Event was also triggered under loan-only credit default swaps (**LCDS**) referencing CEOC. LCDSs relate to syndicated secured loans rather than the types of loans that are deliverable under normal CDSs, and were popular during the leveraged buyout boom of 2006/7 but their use has fallen away considerably since the financial crisis.

LCDSs were not covered by the 2014 Protocol or the Big Bang/Small Bang[25] changes of 2009, but have the concept of Auctions built into their documents from the outset[26]. However, they do not have the concepts of DC Resolutions hardwired in, so parties usually sign up to a bilateral Uniform Settlement Agreement[27] to agree the settlement dates and apply the Auction Final Price. The Credit Event triggers for US LCDS are the same as for CDSs on North American Corporates[28] (i.e. failing to pay amounts under a bond can still

[19] A classic example was the internal loan from SEAT Pagine Gialle S.p.A. to its financing subsidiary Lighthouse International Co., S.A., which was the subject of a Potential Failure to Pay query in November 2011.

[20] Case No. 15-01145 in US Bankruptcy Court for the Northern District of Illinois. Caesars and certain other group entities were not part of the Chapter 11 filing.

[21] CEOC had proposed to split itself into two, one part to hold its real estate and the other to run its casinos and resorts. However, the bankruptcy examiner effectively blocked the proposal on the grounds that it involved giving up valuable claims against its parent companies to the detriment of its general creditors (the bankruptcy examiner's findings are not themselves legally binding, but could be a guide to how any litigation actions would turn out).

[22] Grace Period Extension did not apply to CDSs on CEOC. As a general point, where Grace Period Extension does not apply, a bondholder or lender buying CDS protection should ensure that the CDS Scheduled Termination Date occurs on or after the applicable grace period or deemed grace period of the relevant bond or loan expires.

[23] One example is "Contested Caesars Swaps Payout Set for Panel Decision" by Sridhar Natarajan, available online at http://www.bloomberg.com/news/articles/2015-02-06/contested-caesars-swaps-payments-set-to-be-decided-by-isda-panel.

[24] Under the Third Amended & Restated Restructuring Support and Forbearance Agreement dated 13 January 2015 between CEOC and certain creditors, among others. This was further amended on 31 July 2015.

[25] The Big Bang and Small Bang changes of 2009 are discussed briefly at the start of section 12 below.

[26] The US LCDS Confirmations and LCDX Standard Terms Supplements refer to a Market Settlement Mechanism, which is effectively the Auction, and there are LCDS Auction Rules available on the Markit website at http://www.markit.com/Documentation/Product/LCDX.

[27] The one for CEOC was published on 13 February 2015 and is available through the ISDA DC LCDS Management website at http://dc.isda.org/lcds-management/.

[28] The only Credit Events are Bankruptcy and Failure to Pay (no Restructuring (Mod R)), and the Obligation Category is Borrowed Money with no Obligation Characteristics. By contrast, the Credit Event triggers for European LCDSs and iTraxx LevX differ from those for CDSs on European Corporates because, although the Credit Events are the same (Bankruptcy, Failure to Pay and Restructuring (Mod Mod R)), the Obligations for European LCDSs and iTraxx LevX are Reference Obligations Only rather than any Borrowed Money.

trigger an LCDS Failure to Pay Credit Event), but for settlement the Deliverable Obligation Category is Loan and there is an additional Deliverable Obligation Characteristic of Syndicated Secured.

CEOC had been in several series of the LCDX index[29], so it was a significant Reference Entity. The CEOC LCDS Auction Settlement Terms list the Deliverable Obligations[30] rather than having them in a separate Final List. They include a standard provision stating that the Loans were only deliverable if not subject to a lock-up, though in this case there were two possible lock-up arrangements to watch out for [31].

The Chapter 11 plan of reorganisation did not go as smoothly as hoped. On 31 July 2015, the CEOC Restructuring Support Agreement was amended again[32]. On 4 April 2016, CEOC filed an amended plan of reorganisation with the US Bankruptcy Court, and the hearing has been scheduled for 17 January 2017. This whole debt restructuring saga is a clear example of how pre-packaged Chapter 11 plans of reorganisation do not always go as smoothly as hoped[33].

3.2 *RadioShack*

The circumstances around the RadioShack Corporation (**RadioShack**) CDSs provide an important guide to some of the controversial issues that are sometimes involved with distressed debt situations.

RadioShack is a US chain of electronics stores. On 10 December 2013, it entered into[34]: (a) asset based lending (**ABL**) agreements relating to a US$ 535 million revolving credit facility (the **ABL Facility**) and a US$ 50 million term loan (the **ABL Term Loan** and, together with the ABL Facility, the **ABL Loans**) with a lending syndicate led by General Electric Capital Corporation, which were secured by a first priority lien over current assets and a second priority lien over certain fixed assets, intellectual property and shares; and (b) agreements relating to a US$ 250 million term loan with a lending syndicate led by Salus Capital Partners, LLP, with a first priority lien over certain fixed assets, intellectual property and shares and a second priority lien over current assets (the **SCP Term Loan**). The security for the ABL Loans and the SCP Term Loan are therefore described as crossing liens.

On 3 October 2014, the original lenders under the ABL Facility transferred their rights and obligations to General Retail Holdings L.P. and General Retail Funding LLC, both of whom were affiliates of the hedge fund Standard General L.P. (**Standard General**). Later in October 2015, the ABL Facility was restructured into: (i) a US$ 275 million revolving loan facility, amounts under which could not be re-borrowed once repaid (the **ABL Term Out Loan**); (ii) a US$ 120 million letter of credit facility; and (iii) a US$140 million revolving credit facility. The aggregate of these amounts was US$ 535 million, the same as the amount that was available under the ABL Facility. The ABL Term Loan was unaffected.

The ABL Term Out Loan in particular led to controversies. The October 2014 restructuring of the ABL Facility was made at a time when RadioShack was negotiating with its other creditors who were blocking a store closure plan. Much of the commitment for the ABL Term Out Loan came from hedge funds who had sold substantial amounts of CDS protection on RadioShack that matured on 20 December 2014. It has been reported in a number of news items that this investment might not have been forthcoming from those hedge funds had they not had the significant CDS positions[35], which is an interesting contrast to the usual allegations that CDSs help force companies into insolvency (albeit by no means the only such example). However, given that the ABL Facility already existed and the ABL Term Out Loan did not enable RadioShack to borrow more than it could have done before, it is a weak argument on the facts.

---

29 LCDX.NA Series 14 to 21.

30 There were five Deliverable Obligations: the Term B-4-B Loan; the Term B-5-B Loan; the Term B-6-B Loan; the Term B-7-B Loan; and the Revolving Facility relating to Extended Maturity Revolving Facility Commitments.

31 The two lock-up agreements referred to: (i) the Third Amended & Restated Restructuring Support and Forbearance Agreement dated 13 January 2015 that also applied for the CDS Auction; and (ii) a First Lien Bank Lender Agreement entered into by certain beneficial holders of CEOC first lien bank debt.

32 Fourth Amended and Restated Restructuring Support and Forbearance Agreement dated 31 July 2015.

33 A particularly good example of a smooth one was that for General Motors in 2009.

34 Form 8-K filing dated 10 December 2013.

35 There are several articles on this point, see for example "RadioShack Kept Alive by $25 Billion of Swaps Side Bets" by Jodi Xu Klein on 18 December 2014, published on Bloomberg.

On 4 December 2014, the Americas DC was asked to consider if a Failure to Pay Credit Event had occurred under the SCP Term Loan. The question put to the DC was unusually detailed and contained this statement (*emphasis added*):

> "There is a concern which has been expressed in the market that the actions taken in connection with the Recapitalization Agreement, Loan Sale Agreement (each as defined in the Notice of Default), and related agreements (together defined as the "Standard General Transactions"), which form the basis of the breaches of the Credit Agreement underlying the acceleration of the Obligations, were structured with a purpose to manipulate the CDS market (i.e., to avoid triggering CDS contracts with a termination date of December 20, 2014), and that but for the Standard General Transactions, the Reference Entity would have already filed for bankruptcy protection. If that is the case, a determination that a Failure to Pay credit event occurred on December 4, 2014 would be *not only the correct finding based on the facts, it is the conclusion that would uphold the integrity and efficacy of the credit protection provided by the CDS market*.
>
> … If the Determinations Committee is unable to make a determination in respect of this question due to the lack of public information, the Determinations Committee should accept this question and await additional information to become public to make its determination, with that determination being effective as of the date hereof."

RadioShack had filed a report[36] with the US Securities and Exchange Commission stating that it had "received a notice of default and acceleration … asserting that events of default have occurred and are continuing" under the relevant credit facility. If acceleration had occurred, the lack of a grace period in the loan would have resulted in the minimum three Grace Period Business Days grace period applying for the purpose of CDSs, which would have resulted in a Failure to Pay Credit Event occurring on 4 December 2014. One of the other items filed with the DC was the notice of default and acceleration itself, possibly submitted by a lender who had acquired a significant long CDS position and therefore wanted a Credit Event to occur.

However, based on the Publicly Available Information, there was nothing to suggest that acceleration had actually occurred, so the DC Resolved that no Credit Event had occurred.

RadioShack eventually filed for Chapter 11 bankruptcy protection[37] on 5 February 2015 as part of a pre-packaged plan to sell a large number of stores to its largest shareholder Standard General (the purchase was carried out through its new subsidiary General Wireless Inc.), with some of those stores continuing to bear the RadioShack name but most of them being co-branded with Sprint, and enter into a US$ 285 debtor-in-possession financing (see section 3.3 below for an explanation of what debtor-in-possession financing is). The remaining US stores were closed, though some RadioShack stores were not included in the Chapter 11 filing, particularly those operated by its Mexican subsidiary and those that were part of its Asian operations).

This was the first Credit Event to lead to decisions made on CDSs incorporating the 2014 Definitions. In particular, there was a single Auction held to settle CDSs referencing the Updated 2003 Definitions and CDSs referencing the 2014 Definitions on the basis that the Deliverable Obligations were the same under both[38], but the DC noted that would not always be the case. This is important to note because the Auction Settlement Terms state[39] that the Auction Covered Transactions for a particular Auction are those credit derivatives whose "Deliverable Obligation Provisions are identical to one set of the Deliverable Obligation Terms determined by the relevant Convened DC to be applicable to the Auction", which arguably is not the case for CDSs based on the Updated 2003 Definitions or the 2014 Definitions as the former contains the Deliverable Obligation Characteristic of Not Contingent and the latter does not (it has been absorbed to a

---

[36] Form 8-K filing dated 2 December 2014.

[37] Case No. 15-10197 in US Bankruptcy Court for the District of Delaware.

[38] In fact there was only one Deliverable Obligation on the Final List, which was the 6.75% Senior Notes due 2019 (CUSIP: 750438AE3).

[39] This extract is from limb (d) of the definition of Covered Non-Swaption Transaction, which is one of the two components of the definition of Auction Covered Transaction.

degree into the new definition of Outstanding Principal Balance) and there are other subtle differences as well. However, the DC seems to have taken the sensible broader view that if the Deliverable Obligations are the same for different CDSs then they can be settled under the same Auction, even if their Deliverable Obligation Provisions differ slightly, and amended the Auction Settlement Terms to reflect this[40]. This has the particular benefit of reducing the number of Auctions and increasing liquidity in the Auctions held.

There has been litigation in relation to the RadioShack bankruptcy: (a) RadioShack's unsecured creditors brought an action[41] against Standard General and Wells Fargo Bank N.A. (among others), alleging that they contrived a corrupt scheme to delay RadioShack's entry into bankruptcy for a few months to enable Standard General to take over RadioShack at a reduced price, which caused significant losses for the unsecured creditors; and (b) RadioShack's senior secured lenders brought an action[42] against RadioShack and its affiliates alleging that the October 2014 loan needed their prior approval and resulted in them losing first lien rights. The claims against Standard General and Wells Fargo for the former have been settled and the latter was dismissed with prejudice[43] on 11 May 2016.

3.3 *Alpha Appalachia*

Alpha Natural Resources, Inc. (**ANR**) and its subsidiary Alpha Appalachia Holdings, Inc. (**Alpha Appalachia**, formerly called Massey Energy Company (**Massey**)) are coal mining companies that filed for Chapter 11 bankruptcy protection[44] on 3 August 2015 to reduce existing debt and give effect to a debtor-in-possession (**DIP**) financing from existing creditors[45]. That particular DIP financing showed the ongoing support of its secured creditors. DIP financings are regularly used in US corporate restructurings to provide financing to distressed companies during Chapter 11 or other bankruptcy processes, with the DIP financing debt ranking above the company's existing debt and the debtor remaining in charge of the company (c.f. a UK administration where an administrator, which is usually an accounting firm, is appointed to run the company). DIP financings should be contrasted with: (a) other forms of rescue financings, where finance is provided to a company in administration or some other insolvency procedure but the debtor is not in "possession" (e.g. in a UK administration, the relevant administrator takes over the running of the company); and (b) exit financings, where debt is incurred when the company emerges from Chapter 11 or other bankruptcy reorganisation procedure.

The Americas DC swiftly determined that a Bankruptcy Credit Event had occurred in respect of Alpha Appalachia. There was only one Deliverable Obligation in the Auction, which was a series of convertible bonds[46] (the **Convertible Bonds**). The Auction had to be postponed because an interim order[47] published on 5 August 2015 by the US Bankruptcy Court (the **NOL Order**) required 28 days' notice to be given to ANR prior to any transfers of ANR equity securities, which was broadly defined to include options and convertible securities and consequently included the Convertible Bonds. However, BNP Paribas (which eventually submitted the largest volume of Deliverable Obligations to sell in the first stage of the Auction) filed a limited objection on the grounds that the conversion period for the Convertible Bonds had expired, so they were effectively just debt securities. The US Bankruptcy Court agreed and carved the Convertible Bonds out of the final NOL Order, so in end the Auction went ahead on 17 September 2015 without any hitches.

---

[40] This amendment was not made directly to the Auction Settlement Terms, instead it was made in the Determinations Committee Decision dated 2 March 2015.

[41] *Official Committee of Unsecured Creditors of RadioShack Corp. v. Soohyung Kim*, 15-00652, U.S. District Court, Northern District of Texas (Fort Worth). Details are available at https://consumermediallc.files.wordpress.com/2015/09/shack_lawsuit0815.pdf.

[42] *In re RS LEGACY CORPORATION, et al.* (Case No. 15-10197).

[43] Judge Shannon's Opinion and Order dated 11 May 2016 sets out a detailed background of the facts and is available at http://www.deb.uscourts.gov/sites/default/files/opinions/judge-brendan-l.shannon/shack-salus-opinion-and-order.pdf.

[44] Case No. 15-33896 (KRH) United States Bankruptcy Court for the Eastern District of Virginia, Richmond Division.

[45] Arranged by Citigroup and driven by a group of first and second lien lenders.

[46] 3.25% Convertible Senior Notes due 1 August 2015 (CUSIP: 576203AJ2). These were originally convertible into Massey shares, but following ANR's acquisition of Massey were amended so that they became convertible into ANR shares instead. The conversion rights expired unexercised on 31 July 2015, so they effectively became straight debt.

[47] The case is *In re Alpha Natural Resources, Inc., et al.*, Case No. 15-33896 (KRH) in the US Bankruptcy Court for the Eastern District of Virginia. ANR and its affiliates filed a motion for the order prohibiting transfers of equity securities to ensure that they could benefit from "net operating losses", which is why it is referred to as the NOL Order.

The Auction itself highlighted an interesting feature of the two-stage process. The Initial Market Midpoint based on bids and offers from the Participating Bidders was 14.125%, but because the Open Interest to sell was high at USD 47.638 million compared to the bids placed in the second stage of the Auction, the Auction Final Price was considerably lower at 6%.

The ANR preliminary Plan of Reorganization was filed on 8 March 2016. The final Plan of Reorganization was approved by the US Bankruptcy Court on 7 July 2016, subject to certain contingencies. The Plan of Reorganization involved selling certain coal assets to Contura Energy, Inc., which was a new company formed by a group of ANR and Alpha Appalachia's first lien lenders, in return for debt forgiveness. The ANR group exited Chapter 11 on 26 July 2016.

3.4 *Peabody Energy*

Peabody Energy Corporation (**Peabody Energy**) is the world's largest private sector coal mining company. Following some significant acquisitions in Australia in 2011, falling coal prices left it in financial difficulties and it filed for Chapter 11 bankruptcy protection[48] on 13 April 2016, near the end of a 30-day grace period for bond interest payments that it was unable to make. Peabody Energy's Australian operations (Macarthur Coal) were not included in the Chapter 11 filing.

The Americas DC Resolved that a Bankruptcy Credit Event had occurred on 13 April 2016 and an Auction was held on 4 May 2016, a slightly shorter timetable than usual (though in fact shortening the timetable is probably more common now than following the standard timetable). Five series of bonds were deliverable into the Auction and there were no particular difficulties.

On 17 May 2016, a US$ 800 million DIP financing was approved. Peabody Energy has not yet exited Chapter 11.

4. Non-US Bankruptcy Credit Events

There have been four events relating to Bankruptcy Credit Events on non-US Reference Entities since the 2014 Definitions Implementation Date that flag important issues to watch out for, three of which (Abengoa, PTIF and IC Finance) highlight a seemingly innocuous modification made to the Bankruptcy definition in the 2014 Definitions that is having a surprisingly significant effect. All four relate to the European Corporate Transaction Type, though for one (PTIF) the trigger was a Brazilian insolvency filing.

Most jurisdictions do not have insolvency regimes that are as flexible and powerful (or indeed as debtor-friendly) as the US Chapter 11 regime, so there are few attempts to effect debt restructurings using a streamlined insolvency procedure. That said, the UK administration regime[49] is increasingly being used to effect pre-packaged administration sales on similar lines to those being done under Chapter 11 in the US, though there are still comparatively few examples affecting CDSs[50].

DIP financings are less common outside the US and Canada. European countries in particular have historically been more creditor-friendly jurisdictions than most others, so did not like arrangements that could prejudice the interests of existing creditors, but in recent years have been softening their stance[51]. The UK administration process permits DIP financings to the extent that the payments can be treated as "expenses" of the administration[52], thereby ranking above existing unsecured creditors, but in practice DIP financings have never factored as part of UK administrations, which is one reason why so few UK

---

[48] Case No. 16-42529-399 in US Bankruptcy Court for Eastern Missouri.

[49] Governed by the Insolvency Act 1986 as amended by the Enterprise Act 2002.

[50] The first such example triggering a CDS was probably that for Hellas Telecommunications (Luxembourg) II, a financing subsidiary of the Greek telecoms company Wind Hellas. Hellas II moved its "centre of main interests" from Luxembourg to the UK in order to use the UK administration regime.

[51] For example, French law used to regard DIP financings as *soutien abusif*, but article L.650-1 of the French Code of Commerce now permits DIP financings (subject to certain limited exceptions).

[52] The UK administration provisions are set out in Insolvency Act 1986 Schedule B1. The provision on expenses is in para. 99(3).

administrations result in the company continuing as a going concern[53]. A number of other European countries have amended their insolvency laws in recent years to permit DIP financings (e.g. Germany, Italy, Spain), and the UK may well be making similar changes soon[54]. In Asia, Japan is the only country where there have been DIP financings to any degree, but even there they have not been particularly popular.

4.1 *Abengoa*

Abengoa, S.A. (**Abengoa**) is a Spanish conglomerate that filed for relief under Article 5bis of the Spanish insolvency law[55] on 27 November 2015. The following extract from a publication by the EMEA DC[56] explains more about it, and was critical for determining whether a Credit Event had occurred:

> "In circumstances where the relevant debtor has entered into restructuring negotiations with its creditors, Article 5bis allows the debtor to request from the court a three-month grace period (plus another month) in order to conclude those negotiations and to attempt to resolve its financial difficulties informally with its creditors. This is the so-called "Article 5bis communication" (the procedure is also referred to as *preconcurso*). The debtor need not be insolvent at the time it files an Article 5bis communication, though it must at least be in a period of financial difficulty with a risk of insolvency in the near future. The filing of an Article 5 bis communication is merely acknowledged by the relevant court clerk."

This led to careful consideration of s.4.2(d) of the Updated 2003 Definitions and the 2014 Definitions, which were different because of a seemingly innocuous move of the word "similar" when the 2014 Definitions were being drafted. The difference is shown below (the red strike-through wording is in the Updated 2003 Definitions, whereas the blue wording is in the 2014 Definitions):

> ""Bankruptcy" means ~~a~~ the Reference Entity … (d) institutes or has instituted against it a proceeding seeking a judgment of insolvency or bankruptcy or any other similar relief under any bankruptcy or insolvency law or other ~~similar~~ law affecting creditors' rights, …"

This subtle difference meant that under the 2014 Definitions, the DC determined[57] that the Article 5bis relief was not "relief" that was "similar" to "a judgment of insolvency or bankruptcy" and so no Credit Event had occurred, but under the Updated 2003 Definitions it constituted "relief" that was "similar" to "any other relief under any bankruptcy or insolvency law". In particular, the DC said:

> "The effect of the filing is for the Reference Entity to avail itself of the Article 5bis court protection, providing some relief for certain of its assets or, as the case may be, from certain of its creditors. However, the relief granted is predominantly in respect of certain assets. Further, it is by virtue of a suspension of enforcement of claims and security; filing an Article 5bis communication does not suspend payment obligations, and prevents neither acceleration of obligations nor the bringing of a claim. The relief under Article 5bis is also limited in time to three months (plus one month)."

The DC went on to contrast Article 5bis with an actual declaration of insolvency under Spanish insolvency law (*concurso*) as well as the French *sauvegarde* proceedings that the DC had previously found triggered a Bankruptcy Credit Event for Thomson in 2009.

However, the fact that a Bankruptcy Credit Event occurred under the Updated 2003 Definitions but not the 2014 Definitions did not cause any particular issues in the Abengoa case as a Failure to Pay Credit Event clearly occurred on 2 December 2015 triggering settlement of CDSs incorporating the 2014 Definitions as

[53] There had been calls for super-priority financing arrangements to be included as part of the Enterprise Act 2002 changes to UK administrations, but these were rejected by the House of Lords. The UK administration process is led by the administrator, usually an accounting firm, who assumes control and is not usually in a position to be able to maintain the day-to-day work of the company in administration.

[54] On 25 May 2016, the UK Insolvency Service launched a consultation of corporate insolvencies in "A Review of the Corporate Insolvency Framework: A consultation on options for reform" covering "rescue finance" generally, including DIP financings. The consultation closed on 6 July 2016 and official feedback is awaited.

[55] Article 5bis of the Spanish Law 22/2003 of 9 July 2009 on insolvency (Ley 22/2003 de 9 de julio, Concursal), as amended

[56] EMEA DC Meeting Statement 8 December 2015.

[57] The decision was not unanimous as one DC Member voted No on the Updated 2003 Definitions and one DC Member voted Yes on the 2014 Definitions.

well. One interesting point to note about the Auction was that the Deliverable Obligations under the Updated 2003 Definitions and the 2014 Definitions were different, so the DC resolved to hold an Auction under the 2014 Definitions only.

4.2 *PTIF*

The facts around PTIF highlight two of the issues we have already touched on in this briefing, namely: (i) the narrower scope of the amended Bankruptcy definition in the 2014 Definitions; and (ii) difficulties with negotiating restructurings because some bonds are held by investors with CDS positions.

Portugal Telecom International Finance B.V. (**PTIF**) was the PT Portugal SGPS SA (**Portugal Telecom**) financing subsidiary that was the main Reference Entity in CDSs. On 2 October 2013, Portugal Telecom and the Brazilian telecommunications company Oi S.A. (**Oi**) announced that they would merge, and a rather complex corporate structure resulted during 2014. Oi was not itself a significant Reference Entity in the CDS market.

In June 2015, Oi sold Portugal Telecom and its operations in Portugal to Altice Group, but retained PTIF as a subsidiary because of the financing provided.

On 23 October 2015, Oi and LetterOne Holdings S.A. entered into a seven-month exclusivity period to discuss a merger between Oi and TIM Participações S.A., which is the Brazilian subsidiary of Telecom Italia Mobile, and a cash injection into Oi. However, the merger talks collapsed in February 2016. Consequently, on 25 April 2016, Oi announced[58] that it had entered into discussions with a group of *ad hoc* bondholders to potentially restructure its debts. There have been reports[59] that some bonds were held by people with CDS positions who were trying to push Oi into triggering a Credit Event, though we have not been able to find out any details of those positions and the restructuring options discussed. There was litigation[60] in in The Netherlands where one bondholder sought to prevent Oi Brasil Coöperatif UA from transferring funds or making loans to its parent company, which was ostensibly to ensure that the money would be available for repaying the PTIF bonds, but there has been speculation that CDS positions were involved. The judge rule against it though.

Attempts were made to construct an exchange offer that would be acceptable to bondholders and effect an out-of-court restructuring[61], but these were not successful. We do not know whether bondholders with CDS positions were ultimately responsible for the failure.

On 20 June 2016, Oi and its subsidiaries (including PTIF) filed for judicial reorganisation (*recuperação judicial*) of the Oi group under Brazilian law[62] (**RJ**) and a request was put to ISDA to convene a DC to consider whether this constituted a Bankruptcy Credit Event for CDSs referencing PTIF. The EMEA DC consulted local Brazilian counsel to find out exactly how the RJ procedure worked and what its effect was, and published a very helpful statement about it[63]. An extract is set out below:

> "RJ is an in-court proceeding which allows a debtor to request an automatic stay and/or injunctions against its creditors for a 180-day period (subject to extension in limited circumstances) in order for the debtor to negotiate with, and submit a reorganisation plan (an RJ plan) to, such creditors. Creditors or third parties cannot make a filing to commence RJ in respect of a debtor (although they can challenge a court decision to commence RJ). A debtor remains in RJ for two years after the court ratification of any RJ plan that has been approved by the creditors (the general creditors' meeting for such approval should be held within 150 days of the commencement of the RJ process).

---

[58] "Material Fact: Oi S.A. Announces Certain Material Information Regarding its Capital Structure" dated 25 April 2016.

[59] See for example "Oi's Vexing Credit Mess: How to Deal With $14.2 Billion of Swaps" by Cristiane Lucchesi on 20 April 2016, available at http://www.bloomberg.com/news/articles/2016-04-19/oi-s-vexing-credit-mess-how-to-deal-with-14-2-billion-of-swaps.

[60] See for example "Judge Said to Let Oi Borrow from Unit in a Blow to Aurelius" by Jodi Xu Klein, Cristiane Lucchesi and Paula Sambo dated 7 May 2016.

[61] See for example "UPDATE 2 – Bonds of Brazil phone carrier Oi jump on debt exchange terms" by Guillermo Parra-Bernal and Ana Mano on 17 June 2016: http://www.cnbc.com/2016/06/17/reuters-america-update-2-bonds-of-brazil-phone-carrier-oi-jump-on-debt-exchange-terms.html.

[62] Specifically Article 51 of Brazilian Federal Law No. 11,101 dated 9 February 2015, as amended.

[63] EMEA DC Meeting Statement 1 July 2016.

…

RJ is akin to a debtor-in-possession proceeding and so the management of the debtor continues to operate the business and deal with its contracts and assets although this is now conducted under the supervision of the court and the court-appointed judicial administrator (see below). In general, the duties of the managers do not change during RJ. The debtor may not, without the authorisation of the court, dispose of or encumber any items or rights of its permanent assets (other than those listed in the approved RJ plan) following the date on which the RJ request is filed. The management may be removed by the court during RJ in certain limited circumstances (e.g. unjustifiably decapitalising the debtor or entering into transactions that are detrimental to its regular operations)."

Although it was clearly a Bankruptcy Credit Event under the Updated 2003 Definitions (and indeed, this same question had been considered on the earlier OGX Petróleo e Gás Participações S.A. Bankruptcy Credit Event), it was less clear whether it did under the 2014 Definitions. The analysis of the RJ showed that it provided less protection for the filing company and its group than a US Chapter 11 bankruptcy protection procedure[64], but more protection than the Spanish Article 5bis relief (*preconcurso*) considered in the Abengoa case described above. The EMEA DC felt that "the relief granted by RJ is sufficiently similar in effect to that of a judgment of insolvency or bankruptcy", noting in particular:

- ***Automatic stay:*** RJ provides for an automatic stay (albeit temporary) providing relief for all of its assets and from all of its creditors, despite certain exceptions.
- ***Payment relief:*** The debtor does not have to satisfy its payment obligations until the RJ plan is approved, despite creditors still being able to accelerate the debt on any default.
- ***Debt restructurings:*** The RJ plan may provide for debt extensions, haircuts and interest rate changes. It is adopted through the approval by a majority of each statutory class of creditors, which binds dissenting or non-voting creditors, and in some cases the court can bind dissenting creditors even if the approval thresholds have not been met.

A number of differences were noted between the Brazilian RJ and the Spanish *preconcurso*, such as *preconcurso* (a) still permitting payments by the debtor during the grace period, (b) the automatic stay only providing for relief for certain assets and from certain creditors, (c) the automatic stay only lasting for three months plus a possible one-month-extension, (d) requiring the consent of all the relevant classes affected (no cram-down procedure was available under which the court could impose the changes on non-consenting bondholders/lenders), (e) having less court involvement and (f) not permitting as many amendments.

The end result was that a Bankruptcy Credit Event was determined to have occurred under the 2014 Definitions as well as under the Updated 2003 Definitions.

There were seven bonds deliverable into the Auction, all of which were directly issued by PTIF (although at least one was issued by another entity and then PTIF was substituted as the issuer) and guaranteed by Oi. One of these bonds[65] (**Deliverable Obligation Number 1**) was due to mature on 26 July 2016, shortly after the Auction was due to take place on 21 July 2016, so the Auction Settlement Terms had provisions stating that if it was specified in the relevant Notice of Physical Settlement or NOPS Amendment Notice and was converted into something else then the resulting Deliverable Obligation Number 1 Asset Package could be delivered instead and would be treated as having the same currency and Outstanding Principal Balance that it had before. However, it could only be deliverable if the relevant Notice of Physical Settlement or NOPS Amendment Notice were delivered prior to the date on which Deliverable Obligation Number 1 is

[64] EMEA DC Meeting Statement 1 July 2016 extract: "upon closer examination of the effect of the RJ, the DC was of the view that RJ offered significantly less protection to a debtor compared to Chapter 11 (for instance, with respect to the length of the moratorium, the unambiguous prohibition of "ipso facto" clauses and on the exercise of set-off rights, and the applicability of anti-avoidance rules)".

[65] EUR 400,000,000 6.25% Notes due 2016 issued by PTIF (PT Portugal had been the original issuer, but was substituted on 2 June 2015) and guaranteed by Oi S.A. (ISIN: PTPTCYOM0008).

redeemed in full[66], which prevents the free option inherent in seeing what is coming out of it and comparing to the Auction Final Price, and the Auction Date was brought forward to reduce the likelihood of this happening. The DC published a helpful statement[67] confirming that this was done to ensure that the CDS buyer of protection would not be worse off than he would have been had the CDS been physically settled.

Unlike the Norske Skog situation described in section 20 below, PTIF did not repay the Deliverable Obligation Number 1 as scheduled and the Deliverable Obligation Number 1 Asset Package provisions did not apply in practice. However, it is a good example of the DC managing the Auction process to ensure that it went ahead smoothly if certain potential events occurred, which ties in with the points discussed in section 12 about the DCs taking actions to improve confidence in how CDSs work.

Oi is still in the RJ procedure and, as far as we are aware, the PTIF bonds have not yet been restructured.

4.3 *Isolux Corsán Finance (IC Finance)*

Grupo Isolux Corsán, S.A. (**Isolux Corsán**) is a Spanish international construction company that specialises in constructing and maintaining large infrastructure projects. Its Dutch financing subsidiary Grupo Isolux Corsán Finance B.V. (**IC Finance**) was the main Reference Entity in CDSs, and had a single series of bonds outstanding[68] (the **IC Finance Bonds**).

Isolux Corsán and its subsidiaries had been in negotiations with their creditors about restructuring their debt, then on 14 July 2016 it launched a consent solicitation (the **IC Finance Consent Solicitation**) to the holders of the IC Finance Bonds asking them to (a) sign up to a restructuring agreement dated 13 July 2016 that contained standard lock-up provisions providing that they could not transfer to other people unless they had also entered into the restructuring agreement or were willing to do so (such holders defined as **Compromised Creditors**) and (b) vote in favour of the amendments set out in the restructuring agreement. A detailed procedure was set out in the IFC Consent Solicitation, and eventually followed. On 26 July 2016, Isolux Corsán announced that the IC Finance Consent Solicitation was approved by almost 90% of the holders of the IC Finance Bonds, well above the 75% threshold required by the Spanish *homologation* insolvency regime.

On 28 July 2016, IC Finance filed for a suspension of payments (*surseance van betaling*) under Dutch law[69] (a **Dutch Moratorium**). Isolux Corsán and the other Spanish group companies that guaranteed IC Finance's debt, along with IC Finance itself, made Chapter 15 filings in the US on 29 July 2016 (Chapter 15 is to do with jurisdiction and is available when the main insolvency proceedings are outside the US but there are affected assets in the US).

The EMEA DC consulted Dutch lawyers and published a detailed statement[70] confirming that a Dutch Moratorium protects debtors from its unsecured, non-preferential creditors by imposing a court ordered standstill, provided that there is "a reasonable prospect of the debtor being able to satisfy its liabilities and obligations", with partial payment being sufficient for this. The DC found that the Dutch Moratorium provides relief that is sufficiently similar in effect to a judgment of insolvency or bankruptcy, finding that it provided better protection than both the *preconcurso* and RJ proceedings analysed in the Abengoa and PTIF cases (see sections 4.1 and 4.2 above). The DC also found that the appointment of the court-appointed administrator was similar to the insolvency officials described in limb (f) of the Bankruptcy definition. Consequently, a Bankruptcy Credit Event was determined to have occurred under both ss.4.2(d) and (f) of both the Updated 2003 Definitions and the 2014 Definitions.

Only one Deliverable Obligation was deliverable in the Auction, namely the IC Finance Bonds. However, as noted above, all the holders of the IC Finance Bonds were Compromised Creditors. Ordinarily,

66 In the definition of Representative Auction-Settled Transaction at limb (h)(iii).
67 See the publication "Explanatory note re: modifications to RAST settlement provisions". The change itself is explicitly permitted under DC Rule 3.2(d) second paragraph.
68 EUR 850,000,000 6.625% Senior Notes due 2021 issued by Grupo Isolux Corsán Finance B.V. and guaranteed by four separate guarantors (ISINs: XS1046702293 (Reg S) and XS1046702616 (Rule 144A)).
69 Pursuant to Article 214 of the Dutch Bankruptcy Act (*Faillissementswet*).
70 EMEA DC Meeting Statement 5 August 2016.

Compromised Creditors would not be able to participate in an Auction. However, possibly because of the shortage of Deliverable Obligations, in this particular Auction the DC decided Compromised Creditors should be allowed to take part, provided that they could locate Participating Bidders who were willing to enter into the restructuring agreement[71].

In the first stage of the Auction, there were only two offers by Participating Bidders and no bids. Although the Open Interest to sell was comparatively high at EUR 56.9 million compared to the bids in the second stage of the Auction, there were enough bids for small volumes to ensure that the Auction Final Price at 15.75% was not too far below the Initial Market Midpoint of 18.625%.

As is now common where debt restructurings are taking place, the Auction process was accelerated (in particular, the settlement period following the Auction Date was shortened) to ensure that it was completed before the restructuring plan was due to be implemented. This is another good example of the DC managing the Auction process to ensure it gives a fair result.

4.4 *ONO Finance*

The facts around the ONO Finance II Public Limited Company (**ONO Finance**) potential Bankruptcy Credit Event are useful to note as they illustrate some important considerations the relevant DC makes when interpreting the Bankruptcy definition.

Grupo Corporativo Ono, S.A. (**Grupo Ono**) is a Spanish company that provides integrated television and telecommunications services in Spain. 100% of Grupo Ono's share capital was acquired by Vodafone Group Plc (**Vodafone**) on 23 July 2014. However, Grupo Ono's financing subsidiary ONO Finance (an Irish company) was the main Reference Entity in CDS markets, and it retained its debt.

ONO Finance was eventually wound up following a special resolution passed by its shareholders on 22 October 2015. It was a voluntary winding-up that involved the appointment of a liquidator. The EMEA DC was asked to consider whether this constituted a Bankruptcy Credit Event. In particular, they had to consider whether it fell within the carve-out in parentheses below[72] (the deleted wording is in the Updated 2003 Definitions):

> ""Bankruptcy" means ~~a~~ the Reference Entity … (e) has a resolution passed for its winding-up~~, official management~~ or liquidation (other than pursuant to a consolidation, amalgamation or merger)".

It was clear that Vodafone had acquired Grupo Ono, which constitutes a "consolidation, amalgamation or merger" of those two entities, but it was less clear that the actual winding-up over a year later was itself a result of the such merger. The DC had to investigate the facts carefully[73], and found (a) Vodafone had commenced a tender offer on 30 July 2014 to the holders of the ONO Finance bonds (as required by the change of control provisions in them), though only a portion of the bonds were tendered, and (b) the remaining bonds were subsequently redeemed by ONO Finance on 15 January 2015 pursuant to the issuer call option in them. This led the DC to conclude that Vodafone had made a very deliberate attempt to redeem the bonds as soon as the takeover had concluded, so there was no reason to believe that the redemptions and subsequent winding-up of ONO Finance were not connected to the merger, despite the fact that the winding-up took place over a year after the merger.

Consequently, the DC felt that the carve-out did apply, so determined that no Bankruptcy Credit Event had occurred on ONO Finance. They contrasted it with the facts in ABB International Finance Limited which no longer had any obligations outstanding and as a result was wound up in 2014, but there was no "consolidation, amalgamation or merger" involved and so it was determined to be a Bankruptcy Credit Event[74].

---

[71] The details are set out in EMEA DC Statement 19 August 2016.

[72] This is s.4.2(e) of both the Updated 2003 Definitions and the 2014 Definitions.

[73] See EMEA DC Meeting Statement 6 November 2015.

[74] There were some other interesting issues here too. Because there were no Deliverable Obligations, it was not possible to hold an Auction or settle CDSs. However, for tranched iTraxx CDSs referencing ABB International Finance Limited, although it was removed from the relevant index, no Settled Entity Notional Amount could be determined and the Outstanding Swap Notional

The DC also resolved that the appointment of a liquidator did not trigger another limb[75] of the definition of Bankruptcy on the basis that the reference to a "provisional liquidator" in such limb refers to entities appointed in an insolvent winding-up, rather than a solvent winding-up as for ONO Finance.

Some of the general principles worth bearing in mind when construing the Bankruptcy provisions are:

- ***Carve-out broadly interpreted:*** The carve-out for "a consolidation, amalgamation or merger" should be construed broadly under both the 2014 Definitions and the Updated 2003 Definitions (i.e. for the Reference Entity's group as a whole, rather than the specific Reference Entity), whereas a narrow interpretation of the same wording is required under the ISDA Master Agreement. This means the fact that Vodafone acquired Grupo Ono rather than ONO Finance did not prevent it from constituting "a consolidation, amalgamation or merger" for ONO Finance.

  The rationale for this is that some form of credit impairment should be involved in CDSs and events in one group company can affect others, whereas for swap counterparties the concern is the specific counterparty.

- ***Determination not limited by clear proof or time:*** The DC Resolved that the winding-up over a year after the "consolidation, amalgamation or merger" was connected to it despite some difficulty in connecting it.

- ***Substance rather than wording:*** All the relevant terms have been interpreted in the standard legal way to look at the substance behind what is being done rather than the words/names used (e.g. the appointment of a liquidator not triggering a Bankruptcy Credit Event under s.4.2(f) of the Updated 2003 Definitions/2014 Definitions as it is not a insolvency procedure).

5. Repudiation/Moratorium Credit Events

There have been two recent Credit Events involving Ukrainian entities that are worth mentioning: (a) the Restructuring (Old R) Credit Event for The State Export-Import Bank of Ukraine, which is discussed in section 7.1 below; and (b) the Repudiation/Moratorium Credit Event for the Republic of Ukraine (**Ukraine**).

The first (and so far only) Repudiation/Moratorium Credit Event determined by any DC is that for Ukraine. There are a number of interesting features about the process that make it worth going into in some detail.

CDSs referencing Ukraine fell under the Transaction Type "Emerging European & Middle Eastern Sovereign". Most Sovereign Reference Entities were excluded from the 2014 Protocol because of the significant pricing impact of the new provisions, especially the Asset Package Delivery provisions. However, because liquidity in emerging markets CDSs is quite low, the market was concerned about decreasing liquidity even further if the market was bifurcated (i.e. existing CDSs remaining under the Updated 2003 Definitions, with new CDSs under the 2014 Definitions). Consequently, they decided to include emerging markets CDSs in the 2014 Protocol but disapply the Asset Package Delivery provisions by using the 2014 Sovereign No Asset Package Delivery Supplement[76].

On 27 August 2015, the Ministry of Finance of Ukraine published a factsheet stating that there would be a "technical suspension" of certain Ukraine debt during its proposed debt restructuring programme. However, the DC said[77]:

> "Although this appeared to be an announcement that Ukraine would suspend its payments under such Obligations, the EMEA DC felt that the proper construction of the announcement was that any such suspension was conditional on the debt restructuring programme proceeding. Accordingly,

Amount could not be reduced as a result (i.e. the buyer of protection might be continuing to pay for protection that was no longer relevant).

[75] This is s.4.2(f) of both the Updated 2003 Definitions and the 2014 Definitions.

[76] This was published by ISDA on 15 September 2014 and works by saying that there are no Package Observable Bonds for the relevant Reference Entity.

[77] EMEA DC Meeting Statement 2 October 2015.

when Ukraine promulgated the legislation pursuant to which the Cabinet of Ministers of Ukraine were instructed to procure the restructuring of certain Obligations of Ukraine, at that point the DC were of the view that such suspension of payments ceased to be conditional and that such official promulgation constituted *a de facto declaration of a moratorium by an authorised officer or Governmental Authority with respect to one or more Obligations in an aggregate amount not less than the Default Requirement*."

The relevant legislation was passed on 19 September 2015, so that was determined to be the date of the Potential Repudiation/Moratorium, despite the request to the DC to consider the question being made a day earlier.

The occurrence of a Repudiation/Moratorium depends on a Failure to Pay or a Restructuring also occurring, albeit disregarding any Payment Requirement or Default Requirement. The benefit of the Repudiation/Moratorium is that the occurrence of the Credit Event is effectively backdated to the date of the Potential Repudiation/Moratorium.

One particular Ukraine bond[78] was expected to trigger a Failure to Pay. Its scheduled maturity date was 23 September 2015 and it had a ten day grace period that expired at midnight on Saturday 3 October 2015. Since Ukraine was working with its bondholders to establish an exchange offer and consent solicitation process on a tight timeline, the DC took the unusual step of determining (on Friday 2 October 2015) that a Repudiation/Moratorium occurred prior to it actually occurring (as well as publishing the Final List of Deliverable Obligations[79]), but making it subject to the condition precedent that a holder of the bond confirms it is a holder and has not received the redemption payment due on or before Sunday 4 October 2015. That confirmation was duly received and the date on which the Repudiation/Moratorium Credit Event occurred was determined to be 4 October 2015.

The Auction was substantially accelerated to take place on 6 October 2015, with a number of bespoke changes being made to the Auction Settlement Terms including: (a) inserting a new definition of NOPS Cut-off Time[80] (i.e. not just referring to the Notice of Physical Settlement Date); (b) changing "firm quotations" to "tradeable firm quotations"; and (c) inserting the following bespoke provision:

"By delivering a Notice of Physical Settlement or a NOPS Amendment Notice, Buyer is deemed to represent that (i) it holds, or has a reasonable expectation of receiving, the Outstanding Amount of each Deliverable Obligation specified therein, and (ii) accordingly it will be able to deliver such Outstanding Amount of each such Deliverable Obligation within the relevant Physical Settlement Period."

The purpose of accelerating the Auction was to enable recipients of Ukraine bonds under Representative Auction-Settled Transactions to receive the bonds in time to take part in the exchange offer and consent solicitation if they wanted to. Any bonds whose holders had agreed to take part in the exchange offer and consent solicitation process prior to the Auction could not be delivered into the Auction.

The last observation to be made here is that the Auction Settlement Terms stated that if "Bond or Loan" was specified as the Deliverable Obligation Category in the documents for a transaction, then that transaction would not constitute an Auction Covered Transaction. The Deliverable Obligation Category for Emerging European & Middle Eastern Sovereign is Bond, so that statement makes sense, though we do not know if there were any Loans that were actually deliverable; if there were, then this is clearly the right approach as the Deliverable Obligations would be different, but if there were not, then it seems a rather strict interpretation given that the Deliverable Obligations would be exactly the same.

---

[78] USD 500,000,000 6.875% Notes due 2015 (ISINs: XS0543783434 (Reg S) and US603674AB86 (Rule 144A).

[79] The DC had previously determined that it would hold an Auction if a Credit Event occurred, and accelerate the Auction process, as set out in the DC Meeting Statements published on 28 September 2015 and 30 September 2015.

[80] This was defined as: (a) for a Customer Buy RAST, 10:00 a.m. Relevant City Time; (b) for an Auction RAST, 12:00 p.m. Relevant City Time; and (c) for a Customer Sell RAST, 2:00 p.m. Relevant City Time.

To enable CDSs on Ukraine to start trading again: (a) new Additional Provisions[81] for Ukraine were published that specify Excluded Obligations and Excluded Deliverable Obligations as any Bonds issued on or before 1 November 2015; and (b) Asset Package Delivery now applies (i.e. the 2014 Sovereign No Asset Package Delivery Supplement does not apply).

6. Governmental Intervention Credit Events

Banco Espírito Santo (**BES**) was a Portuguese bank that was in financial difficulties. On 3 August 2014 (i.e. before the 2014 Definitions Implementation Date), the Bank of Portugal in its capacity as Portuguese Regulation Authority transferred all the senior obligations of BES to a new bank called Novo Banco (wholly-owned by the Portuguese Resolution Fund), which was to be the "good bank" and BES the "bad bank" (i.e. Novo Banco became the obligor of those senior obligations instead of BES).

As more than 75% of the Relevant Obligations of BES were transferred to Novo Banco, the Successor for all CDSs referencing BES was Novo Banco, regardless of whether those CDSs related to senior or subordinated debt. Novo Banco did not have any subordinated debt, so the subordinated CDSs referencing Novo Banco were effectively orphaned in that only Novo Banco senior obligations would be deliverable. This is what had also happened with Bankia S.A. and led to splitting senior and subordinated CDSs in the 2014 Definitions for entities where "Financial Reference Entity Terms" is specified to be applicable[82], so although it was too late to help with the BES case (the BES transfer to Novo Banco occurred after the 2014 Definitions were published but before the 2014 Definitions Implementation Date) it should not happen with them again. However, there are numerous banks in jurisdictions where CDSs will not reference "Financial Reference Entity Terms", so this is still a risk to be aware of for those.

In this briefing, we are more interested in what happened next. The Bank of Portugal was looking for a buyer for Novo Banco to try to recover as much of the cost of bailing out BES as possible, but was not getting much interest at the price it wanted. On 29 December 2015, the Bank of Portugal transferred five series the Novo Banco senior bonds back to BES (the **Returned Bonds**). These Returned Bonds were the bonds predominantly held by banks and institutional investors, and the aim appears to have been to try to increase the value of Novo Banco without harming the interests of domestic retail investors who hold many of the remaining bonds in Novo Banco.

Consequently, holders of Returned Bonds suffered substantial losses as the value of those Returned Bonds fell sharply, as shown in Table 1 below:

Returned Bonds	ISIN	Price (%) 28/12/15	Price (%) 30/12/15	Price (%) 12/01/16
EUR 81,400,000 6.875% Notes due 2016	PTBEQBOM0010	99	15	13
EUR 87,000,000 6.90% Notes due 2024	PTBENIOM0016	93	14	13
EUR 500,000,000 4.75% Notes due 2018	PTBENJOM0015	94	16	12
EUR 750,000,000 4% Notes due 2019	PTBENKOM0012	92	15	13
EUR 750,000,000 2.625% Notes due 2017	PTBEQKOM0019	94	15	12

Table 1 – Table showing how the prices of the five Returned Bonds changed after being transferred back from Novo Banco to BES (data source: Bloomberg and Written Materials in Support of the Yes Position published on 5 February 2016)

[81] Additional Provisions for the Republic of Ukraine: Excluded Obligations and Excluded Deliverable Obligations published on 11 April 2016.

[82] The Financial Transaction Types for which Financial Reference Entity Terms apply are European Financial Corporate, European Coco Financial Corporate, Australia Financial Corporate, New Zealand Financial Corporate, Japan Financial Corporate, Singapore Financial Corporate and Asia Financial Corporate.

Figure 3 shows how the prices of the Returned Bonds moved over time (the prices of all five series plummeted on 29 December 2015, and started to match each other almost exactly so they are on top of each other in the graph after then), and comparing with the price of another senior unsecured bond that was retained by Novo Banco[83].

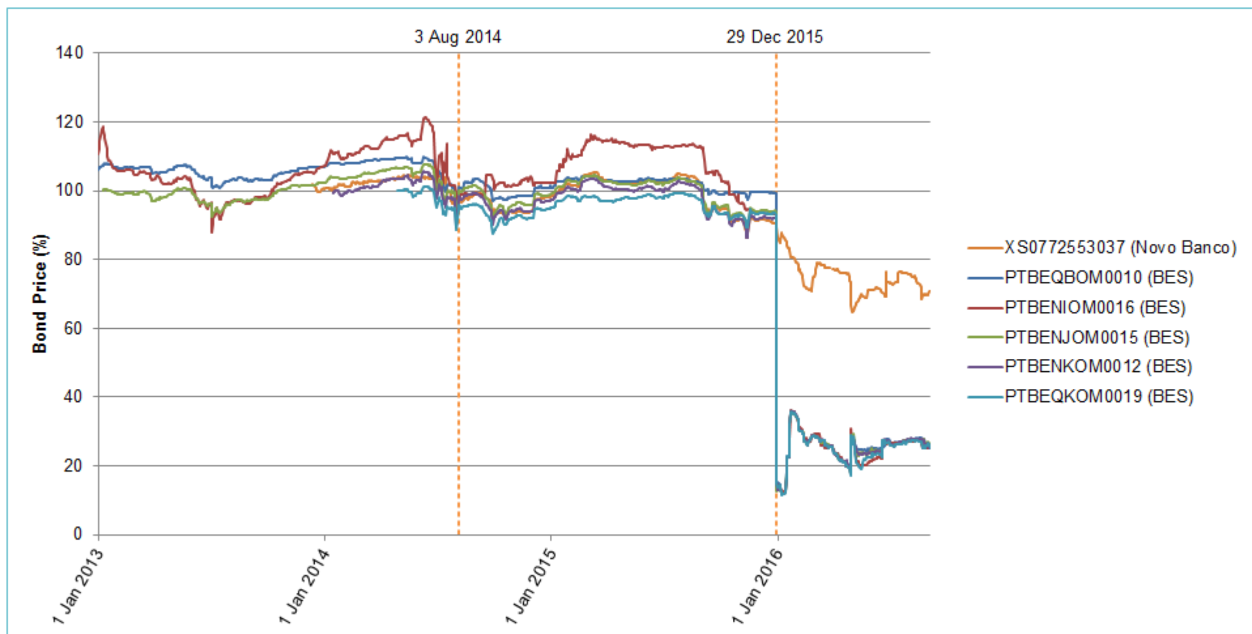


Figure 3 – Graph showing how the prices of the five Returned Bonds changed over time in comparison to one of the bonds that stayed with Novo Banco (data source: Bloomberg on 2 September 2016)

As the Returned Bonds represented less than 25% of the Relevant Obligations of Novo Banco, the EMEA DC Resolved[84] that there was no Successor for the purpose of CDSs (see section 10.6 below for more about this analysis). Any holders of Returned Bonds who had bought CDS protection therefore found themselves without the protection they thought they had, unless they could argue that a Governmental Intervention Credit Event had occurred. Two separate requests[85] were made to the DC to consider whether this constituted a Governmental Intervention, one of which in particular contained a four page explanation of why the submitter felt a Governmental Intervention Credit Event had occurred and that failing to find that one had occurred would "further diminish CDS's efficacy as a hedging tool and erode confidence in the product".

This was the first test of the Governmental Intervention Credit Event since it was introduced in the 2014 Definitions. It is well known that changing the obligor of an Obligation does not of itself trigger a Restructuring Credit Event as it does not fall within any of the limbs[86] of a Restructuring Credit Event[87], and although some additional limbs[88] had been introduced for Governmental Intervention, none of them obviously covered the facts in hand.

The DC was split on the point, with 4 Yes votes and 11 No votes, so it was referred to External Review. It was the first EMEA External Review to go ahead, and the third overall.

The Yes Position tried to argue that this change in obligor should fall within ss.4.8(iii) or (iv) of the 2014 Definitions, which are:

"(iii) a mandatory cancellation, conversion or exchange; or

83 EUR 750,000,000 5% Notes due 2019 (ISIN: XS0772553037).
84 See EMEA DC Statement 3 March 2016, which contains a detailed analysis of what the Relevant Obligations were and concluding that the Returned Obligations constituted no more than 20.1% of the Relevant Obligations.
85 One on 30 December 2015 and the other on 7 January 2015. The extract is from the latter one.
86 In ss. 4.7(a)(i) to (v) of the Updated 2003 Definitions and the 2014 Definitions.
87 On 30 December 2015, a question was put to the DC asking it to consider whether a Restructuring Credit Event had occurred, but that question was rejected just two business days later.
88 One was removed, namely a change in currency to a currency that is not one of the permitted currencies.

(iv) any event which has an analogous effect to any of the events specified in Sections 4.8(a)(i) to (iii)."

The External Review Panel unanimously decided that no Governmental Intervention Credit Event had occurred. They concluded that a transfer did not amount to a "conversion" or an "exchange", and that the omission of the word "transfer" in ss.4.8(iii) and (iv) must have been deliberate. Trying to construe the wording in s.4.8(iv) as a broad catch-all was not appropriate.

It should be noted that the overall fact pattern of BES transferring senior obligations to Novo Banco and then transferring some back to BES is more like a use of the bridge institution tool in the EU Bank Resolution and Recovery Directive[89] (**BRRD**) rather than a bail-in tool, and is likely to be used again in future. Note that bridge institutions are intended to be temporary solutions; BRRD requires[90] any bridge institution to be sold no later than two years after the last transfer of debt from an institution under resolution to that bridge institution.

It is worth mentioning in passing that litigation actions have been made against Bank of Portugal for its actions. We will not dwell on these in any detail as they are not directly relevant for the CDS positions, but two are worth mentioning briefly here as they may shape how such governmental actions are done in future. On 5 April 2016, various institutional investors launched claims on the basis of violating the equitable treatment of creditors and discriminating on grounds of nationality. These actions are ongoing and may take years to be resolved. On 28 April 2016, Bank of America Merrill Lynch obtained a provisional injunction preventing the transfer of the bonds it held from Novo Banco to BES (and leading to a spike in the prices of the Returned Bonds as shown in Figure 3), but that decision was reversed following a challenge from the Bank of Portugal. BES has now had its banking licence withdrawn and is in liquidation.

7. Restructuring Credit Events

As is commonly the case, issues around Restructuring Credit Events have proved to be among the more problematic ones the DC has had to consider. There have only been two Restructuring Credit Events since the 2014 Definitions Implementation Date, in particular the Mod Mod R one for Norske Skog that highlights some tricky legal and practical issues regularly involved. There has also been a DC Resolution that an event did not amount to a Restructuring Credit Event on the basis that there was no deterioration in creditworthiness (Sharp), yet the facts are very similar to those for The State Export-Import Bank of Ukraine where a Restructuring Credit Event did occur.

A common feature of Restructuring Credit Events is the need to get the consent of a sufficient percentage of the holders of a particular series of bonds or loans that can bind the entire series. If there are many bondholders/lenders with CDS positions, they might be inclined to vote against particular proposals that adversely affect their CDS positions. In some cases, the relevant Reference Entity might be tempted to remove bondholders/lenders with CDS positions by triggering a Credit Event prior to the restructuring proposal (sometimes referred to as "flushing out" bondholders/lenders with CDS positions), which could be done by: (a) triggering a Bankruptcy Credit Event, which is often done under Chapter 11; (b) triggering a Failure to Pay Credit Event, which has been done before but not in any of the examples since the 2014 Definitions Implementation Date; or (c) triggering a Restructuring Credit Event through a different issue of bonds/loans from those that are held by bondholders/lenders with CDS positions, but that did not happen in these specific examples.

7.1 *The State Export-Import Bank of Ukraine*

Joint Stock Company "The State Export-Import Bank of Ukraine" (**Ukreximbank**) is one of Ukraine's largest state-owned banks. On 27 April 2015, the maturity of a particular issue of Ukreximbank loan participation

---

[89] Directive 2014/59/EC establishing a framework for the recovery and resolution of credit institutions and investment firms. The bridging institution tool provisions are set out in BRRD Articles 41 and 42. The bail-in tool provisions are set out in BRRD Articles 43 to 55.

[90] BRRD Art. 41(5).

notes[91] (the "**LPNs**") was extended by three months following an extraordinary resolution of the holders of the LPNs. However, there was some doubt whether this extension resulted from a deterioration in creditworthiness, but the EMEA DC decided that it did (14 Yes votes, 1 No vote) and consequently a Restructuring (Old R) Credit Event was determined to have occurred. This should be contrasted with the decision for Sharp Corporation discussed in section 7.3 below, where a similar short maturity extension occurred but the DC determined that there was no deterioration in creditworthiness.

No Auctions were held for the Ukreximbank Credit Event, most likely because there were insufficient CDSs outstanding.

As it turned out, there was a further restructuring on 7 July 2015 pursuant to a successful consent solicitation[92] (the maturity date of the LPNs was extended by seven years, along with an increased coupon, amortisation provisions and various other changes, and similar changes were made to other loan participation notes maturing in 2016[93] and 2018[94]) followed an actual exchange of the amended LPNs into new loan participation notes that reflected the revised terms[95] on 20 July 2015, but no-one asked ISDA to convene a DC to consider if another Restructuring Credit Event had occurred (mostly likely because no CDSs were then outstanding, though there may have been CDSs outstanding that were bilaterally triggered).

7.2 *Norske Skog*

Norske Skogindustrier ASA (**Norske Skog**) is a Norwegian pulp and paper company. It was in financial difficulties and had lengthy discussions with its creditors about potential restructurings. As part of this process, it made various exchange offers involving a new indirectly-owned subsidiary called Norske Skog AS (the **NS Subsidiary**) that was due to issue a "qualified securitization financing" (**QSF**).

On 17 November 2015, Norske Skog made an exchange offer and consent solicitation to the holders of two series of notes, one maturing on 15 June 2016[96] (the **2016 Notes**) and the other maturing on 26 June 2017[97] (the **2017 Notes**). However, insufficient support was received from the holders of the 2016 Notes or the 2017 Notes.

On 5 January 2016, Norske Skog made a revised exchange offer and consent solicitation to the holders of the 2016 Notes and the 2017 Notes, expiring on 3 February 2016. The exchange offer terms offered on the 2016 Notes was significantly better than that offered on the 2017 Notes, which reflected the substantial time priority of the 2016 Notes, and had a required threshold of 90% compared to the 75% threshold for the 2017 Notes. Most importantly, the terms of the consent solicitation were less favourable than those of the exchange offer (a "coercive" consent solicitation), which is a common incentive to encourage bondholders to accept exchange offers generally[98].

Further adjustments were made to the terms of the exchange offer and consent solicitation on 4 February 2016, 24 February 2016 and 11 March 2016.

---

[91] US$ 750,000,000 8.375 per cent. Loan Participation Notes due 2015 issued by Biz Finance PLC (ISIN: XS0503737461).

[92] See the Ukreximbank statement "Noteholders Vote in Favour of Ukreximbank's Reprofiling Proposal" dated 8 July 2015 (http://cbonds.com/news/item/783019).

[93] US$ 125,000,000 Loan Participation Notes due 2016 issued by Biz Finance PLC (ISIN: XS0243733127).

[94] US$ 600,000,000 8.75% Loan Participation Notes due 2018 issued by Biz Finance PLC (ISIN: XS0877737287).

[95] US$ 750,000,000 9.625 per cent. Loan Participation Notes due 2022 (ISINs: XS1261825977 (Reg S) and XS1261826512 (Rule 144A)).

[96] EUR 121,421,000 outstanding of the 11.75% Senior Notes due 2016 issued by Norske Skog (ISINs: XS0636567710 (Reg S) and XS0636569922 (Rule 144A)).

[97] EUR 218,106,000 outstanding of the 7.00% Senior Notes due 2017 issued by Norske Skog (ISIN: XS0307552355).

[98] These forms of "coercive" exit consents are very common in the US. However, note that there is some doubt about their legality and effectiveness in the UK following the decision in *Assenagon Asset Management S.A. v Irish Bank Resolution Corporation (formerly Anglo Irish Bank Corporation Ltd)* [2012] EWHC 2090, though things were complicated by the fact that the appeal was withdrawn by the Anglo Irish liquidators. They should be contrasted with incentive payments, which have been found to be acceptable as non-consenting debtholders were not adversely affected: *Azevedo and Another v Importação, Exportação e Industria De Oleos Ltda and Others* [2012] EWHC 1849 (Comm.).

However, a litigation action[99] brought by senior secured bondholders in New York resulted in the court (a) issuing a temporary restraining order on 2 February 2016 preventing the closing of the latest exchange offer and (b) on 8 March 2016 denying the preliminary injunction against the exchange offer on the basis that there was no "irreparable harm" (and consequently lifting the restraining order) but stating that the proposed issue of notes by the NS Subsidiary (the **QSF Notes**) would breach covenants in the senior secured bonds. Interestingly, there were numerous allegations that CDS positions were affecting the voting[100], and one of the funds involved that was opposing the exchange offer took the unusual step of saying it did not have a CDS position[101].

Consequently, Norske Skog terminated the exchange offer for the 2016 Notes and revised[102] the exchange offer yet again for the 2017 Notes to remove the QSF Notes and make other changes, with the deadline being extended to 6 April 2016. About 76% of the 2017 Notes were validly tendered[103]. On 11 April 2016, the noteholders meeting for the 2017 Notes was held and resulted in:

- ***Exchange Offer:*** A holder of EUR 1,000[104] in principal amount of 2017 Notes who accepted the exchange offer received a package of:

  (a) EUR 468 in principal amount of new notes[105] maturing on 30 December 2026 issued by Norske Skog, which bear interest at 3.5% p.a. in cash and 3.5% p.a. by payment-in-kind (**PIK**);

  (b) EUR 362 in principal amount of new perpetual notes[106] issued by Norske Skog, which bear interest at 2% p.a. in cash; and

  (c) the right to subscribe in cash for EUR 68.77 of ordinary shares in Norske Skog at a price of NOK 2.24 per share.

- ***Consent Solicitation:*** The terms and conditions of the remaining 2017 Notes were amended with effect from 12 April 2016 to insert a redemption and mandatory exchange offer provision so that a holder thereof would be in exactly the same position as he would have been in had he accepted the exchange offer (i.e. a "drag-along" consent solicitation).

On 22 April 2016, the EMEA DC Resolved that a Restructuring Credit Event had occurred on 12 April 2016 and set out an impressively detailed statement[107] of their reasoning, which is consistent with their recent approach in the interests of greater transparency. The actual trigger of the Restructuring Credit Event was the amendment of the 2017 Notes that were not exchanged through the consent solicitation because the exchange offer did not bind the entire issue[108]. The DC stated that it was the insertion of the redemption and mandatory exchange offer that triggered the Restructuring Credit Event rather than the actual exercise of that provision, though the DC noted that it had been exercised immediately anyway[109].

Note also that Mod R and Mod Mod R are "optional" Credit Events in that the DC Credit Event Resolution is not itself sufficient to trigger settlement, a Notifying Party to the CDS still needs to notify the other party that

---

[99] *Citibank, N.A. v. Norske Skogindustrier ASA*, No. 16-cv-850, 2016 WL 1052888 (S.D.N.Y. Mar. 8, 2016).

[100] See ""No winners" in Norske Skog debt ruling" by Robert Smith, published on Reuters on 11 March 2016.

[101] See "BlueCrest Denies It Would Profit From Norske Skog Default" by Luca Casiraghi, published on Bloomberg on 1 March 2016.

[102] Norske Skog announcement titled "Norske Skogindustrier ASA Announces Extension Of and Amendments To Exchange Offer and Consent Solicitation for the EUR 218,106,000 7.00% Senior Notes due 2017 (ISIN: XS0307552355)" on 18 March 2016.

[103] Norske Skog announcement titled "Norske Skogindustrier ASA Announces Final Results of its Exchange Offer and Consent Solicitations" on 11 April 2016.

[104] These figures are used for ease of reference. It is not a realistic example as the minimum denominations were EUR 100,000.

[105] The 2026 Notes, which constituted Deliverable Obligations.

[106] EUR 79,000,000 2% Fixed Rate Notes due 2115 (ISINs: XS1394812918 (Reg S) and XS1394813213 (Rule 144A)). These bonds mature on 30 December 2115, so were effectively 100-year bonds rather than actually being perpetual.

[107] EMEA DC Meeting Statement 22 April 2016.

[108] This was the first exchange offer following the 2014 Definitions Implementation Date that could potentially have triggered a Restructuring Credit Event on its own, but the new wording that was added in s.4.7 of the 2014 Definitions: "(including, in each case, in respect of Bonds only, by way of an exchange)" did not apply because it did not affect the entire issue of 2017 Notes. Note also that because Norske Skog was not a financial institution (i.e. Financial Reference Entity Terms did not apply) or a Sovereign, the Asset Package Delivery provisions of the 2014 Definitions did not apply.

[109] Whether this is the right approach is debatable from a strict construction of the contract, but in practice it probably does not matter as the insertion of these clauses invariably involves them being triggered immediately. A similar thing happened with the Greece Restructuring Credit Event in 2012 when collective action clauses were inserted into the Greek domestic law bonds.

it wishes to trigger settlement (defined as a Triggered Transaction[110] in the DC Rules). ISDA published a notice from DTCC Deriv/SERV about the Triggered Transactions[111], which showed that most of the CDSs had moved to the 2014 Definitions but there were five CDSs, all in the 2.5-year maturity bucket, that were still using the Updated 2003 Definitions.

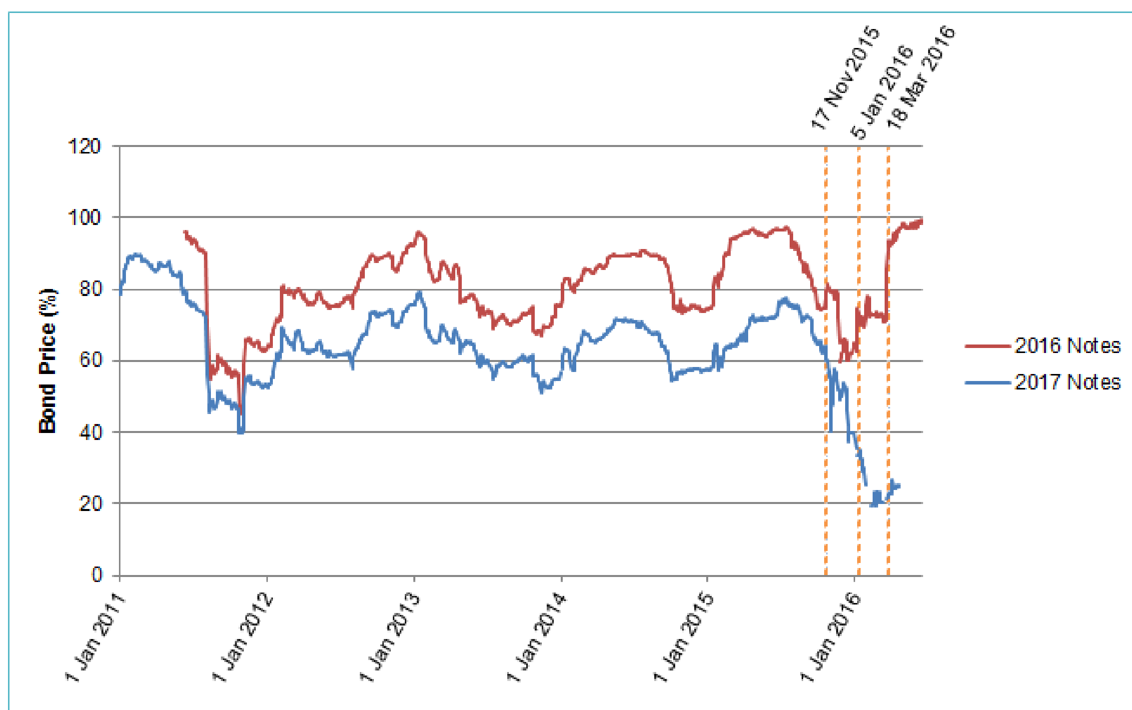


Figure 4 – Graph showing the prices of the 2016 Notes and the 2016 Notes (data source: Bloomberg on 2 September 2016)

Determining the Deliverable Obligations turned out to be unusually difficult, with different outcomes under the Updated 2003 Definitions and the 2014 Definitions. There were six series of bonds potentially deliverable: the 2016 Notes; EUR 290,000,000 11.75% Senior Secured Notes due 2019 issued by the NS Subsidiary and guaranteed by Norske Skog (among others)[112] (the **2019 Notes**); EUR 159,017,000 8.00% Senior Unsecured Notes due 2021 issued by Norske Skog Holding AS and guaranteed by Norske Skog[113] (among others) (the **2021 Notes**); USD 60,649,000 8.00% Senior Unsecured Notes due 2023 issued by the NS Subsidiary and guaranteed by Norske Skog (among others)[114] (the **2023 Notes**); EUR 114,200,000 3.500% cash / 3.500% PIK Senior Unsecured Notes due 2026 issued by Norske Skog[115] (the **2026 Notes**); and USD 200,000,000 7.125% Senior Unsecured Notes due 2033 issued by Norske Skog[116] (the **2033 Notes**).

The difficulty arose with the notes that were guaranteed by Norske Skog, namely the 2019 Notes, the 2021 Notes and the 2023 Notes (the **Guaranteed Notes**). The DC determined that the guarantees constituted a Qualifying Guarantee under the 2014 Definitions, but not the Updated 2003 Definitions, because they contained provisions in which the guarantees could be released (e.g. as a result of a transaction permitted by the covenants covering merger, consolidation and sale of assets). Under the Updated 2003 Definitions, a Qualifying Guarantee can only be discharged by payment[117], whereas under the 2014 Definitions, a

[110] DC Rule 3.4(a).
[111] "Deriv/SERV Norske Skogindustrier ASA Triggered Transaction Data" published on 13 June 2016.
[112] ISINs: XS1181663292 (Reg S) and XS1181663532 (Rule 144A).
[113] ISINs: XS1193909154 (Reg S) and XS1193907968 (Rule 144A).
[114] ISINs: USR59730AA00 (Reg S) and US65653AAA88 (Rule 144A).
[115] ISINs: XS1394812595 (Reg S) and XS1394812751 (Rule 144A).
[116] ISINs: USR80036AQ09 (Reg S) and US656533AC01 (Rule 144A).
[117] Under s.2.23(ii) of the Updated 2003 Definitions.

Qualifying Guarantee can be discharged by (among other things) way of a Permitted Transfer[118], which includes "a transfer to and the assumption by any single transferee of such Qualifying Guarantee".

The question also arose as to whether the Not Subordinated Deliverable Obligation Characteristic was satisfied for the Guaranteed Notes because of the terms of intercreditor agreement dated on or about 24 February 2015 (the **Intercreditor Agreement**). The DC was not able to get a copy of the Intercreditor Agreement, so based its analysis on a summary description contained in the listing particulars[119] for them. In particular, there was a summary of the waterfall that seemed inconsistent with the statement that the Guaranteed Bonds ranked *pari passu* (except on security, which is not relevant for the Updated 2003 Definitions or the 2014 Definitions[120] anyway), but the DC took the view that it was unclear drafting and the intention was for them to rank *pari passu*.

Consequently, each of the six series of notes were deliverable under the 2014 Definitions, but the three series of Guaranteed Notes were not deliverable under the Updated 2003 Definitions.

The Auction eventually took place on 22 June 2016, over two months after the Credit Event occurred. This was an unusually long gap, but was caused by issues with determining the Deliverable Obligations and in particular trying to find the Intercreditor Agreement. This was the first Mod Mod R Credit Event to take place following the 2014 Definitions Implementation Date, and is useful for highlighting the simplified procedure for determining Auction buckets. For example, under the 2014 Definitions the concept of the Enabling Obligation has been removed and the number of potential Auction buckets has been reduced, with any CDSs whose Scheduled Termination Dates fall beyond the 10-year Limitation Date expecting to resort to the Fallback Settlement Method. However, for the last point the DC took the view that Auction Settlement could apply for CDSs maturing on or after the maturity date of the last Deliverable Obligation to mature.

Appendix 1 sets out a diagram illustrating how the Deliverable Obligations and Triggered Transaction Data were used to determine the Auction buckets[121]. It is not particularly easy to understand the DC's reasoning for some parts though. The Designated Range of Scheduled Termination Dates is the definition the DCs use in Auction Settlement Terms to allocate CDSs by their Scheduled Termination Dates to particular Auction buckets in which particular Deliverable Obligations will be deliverable. Looking at the process under the 2014 Definitions and the Updated 2003 Definitions separately:

- ***2014 Definitions:*** The Triggered Transaction Data showed a number of CDSs under the 2014 Definitions were triggered: 430 Buyer-exercised in the 2.5-year bucket; 1,717 Buyer-exercised in the 5-year bucket; 43 Buyer-exercised in the 7.5-year bucket; and 180 Seller-exercised.

  Buyer-exercised: Auction Buckets 1 and 2 are straightforward as they correspond to the standard 2.5-year and 5-year Limitation Dates. Auction Bucket 3 is trickier as its Designated Range of Scheduled Termination Dates runs up to 29 December 2026 rather than the 7.5-year Limitation Date. The reasoning the DC gives for the latter is that there are no other Deliverable Obligations available between the 7.5-year Limitation Date and 29 December 2026, which makes some sense, though it is not obvious why they did not just keep the bucket corresponding to the 10-year Limitation Date as a separate bucket for which the Fallback Settlement Method applies and for which the Movement Option would be available rather than automatically allocating it to Auction Bucket 3. The DC may have taken into account the fact that there were no Triggered Transactions falling in the 10-year bucket, so there was no point allocating it separately. CDSs with Scheduled Termination Dates falling from 30 December 2026 to 14 October 2033 are subject to the Fallback Settlement Method. Note that CDSs maturing on or after 15 October 2033 can be Auction Settled in Auction Bucket 4, which is somewhat surprising as the Fallback Settlement Method generally applies after the 10-year

[118] Under ss.3.21(b)(ii) and 3.25 of the 2014 Definitions.
[119] The Guaranteed Notes were listed post-issue on the Luxembourg Stock Exchange under the listing particulars dated 14 July 2015.
[120] Pursuant to the definition of Subordination in s.2.19(b)(i)(B) of the Updated 2003 Definitions and s.3.13(b)(i)(B) of the 2014 Definitions.
[121] The DC published a helpful explanation of the rationale for the relevant Designated Range of Scheduled Termination Dates in the statement "Maturity Buckets for the Norske Skogindustrier ASA ("Norske Skog") Auction" dated 14 June 2016.

Limitation Date, but it does make sense as the all Deliverable Obligations would be deliverable into CDSs maturing on or after the last such Deliverable Obligation to mature[122].

Seller-exercised: All Deliverable Obligations are deliverable with Seller-exercised Restructuring Credit Events, so these are allocated to Auction Bucket 4.

- ***Updated 2003 Definitions:*** The Triggered Transaction Data showed only that five CDSs incorporating the Updated 2003 Definitions were triggered, all of which were in the 2.5-year bucket. As the Guaranteed Notes were not deliverable, the only buckets which had Deliverable Obligations in were the 2.5-year bucket, the 12.5-year bucket and the 20-year bucket. Consequently, all Buyer-exercised CDSs were allocated to Auction Bucket 1 and no Auctions were held for the 12.5-year and 20-year buckets (if these Auctions had been held, they would have been specifically for the Updated 2003 Definitions as their Deliverable Obligations were different from those under the 2014 Definitions).

  All Seller-exercised CDSs resorted to the Fallback Settlement Method. Because the Deliverable Obligations under the Updated 2003 Definitions were different from those under the 2014 Definitions, it was not possible to allocate them to Auction Bucket 4 for maturities falling on 15 October 2033 and beyond.

  As with the 2014 Definitions, it is not entirely clear why the 5-year, 7.5-year, 10-year and 15-year buckets were not kept as separate buckets for which the Movement Option could apply, but it seems likely that the DC felt this was not worthwhile as the Triggered Transactions only involved CDSs falling in the 2.5-year bucket.

One point to note here is that even though Fallback Settlement Method applies after the 10-year Limitation Date under the 2014 Definitions and the 20-year Limitation Date under the Updated 2003 Definitions, it is still possible to apply Auction Settlement for CDSs with a Scheduled Termination Date falling on or after the maturity date of the last Deliverable Obligation to mature. Consequently, it is possible to have up to five Auction buckets for Mod Mod R under the 2014 Definitions and up to eight Auction buckets for Mod Mod R under the Updated 2003 Definitions.

Because none of the Deliverable Obligations had been restructured to extend their maturity dates, the new provisions in the 2014 Definitions about allocating to Auction buckets that their pre-restructuring maturity dates would have led to were not tested.

The spread of Auction Final Prices across the four Auction buckets was unusually large: 100% for Auction Bucket 1 (on basis of deemed delivery of redemption proceeds of the 2016 Notes); 29.625% for Auction Bucket 2; 27% for Auction Bucket 3; and 12% for Auction Bucket 4.

Auction Bucket 4 resulted in a lower Auction Final Price than expected. The Initial Market Midpoint was 20.625%, but the large Open Interest to sell of EUR 5.55 million compared to the small bids in the second stage of the Auction resulted in the Auction Final Price being considerably lower at 12%. Auction Bucket 2 had an Open Interest to sell of EUR 34.1 million, but that was not much compared to the bids in the second stage of the Auction and the Auction Final Price ended up exactly equal to the Initial Market Midpoint. Auction Bucket 3 had an Open Interest of zero, so the Auction Final Price equalled the Initial Market Midpoint.

One of the major drawbacks with Restructuring Credit Events needs to be highlighted here. If a person held the 2017 Notes and had purchased full CDS protection maturing after the 2017 Notes matured (after taking any grace period into account), he would nonetheless have suffered a substantial loss because (a) the 2017 Notes were exchanged for a package of bonds and share purchase rights that were worth considerably less than the principal amount of the 2017 Notes and (b) the CDS protection was worthless because the CDS is allocated to Auction Bucket 1 which has an Auction Final Price of 100%.

[122] The relevant provision is the Modified Restructuring Maturity Limitation Date definition set out in s.2.33(e) of the Updated 2003 Definitions and s.3.32(e) of the 2014 Definitions, particularly the second provision.

Finally, this is a suitable place to highlight one of the issues with back-to-back CDSs where a Restructuring Credit Event has been triggered. If a person has bought and sold CDS protection on the same Reference Entity and the terms are otherwise identical[123], then there is still residual risk for that person that the CDSs do not net out. For example, say that a person (the **Middle Party**) had bought and sold EUR 1,000 of protection on Norske Skog with Scheduled Termination Dates of 1 January 2018 (the **Long CDS** is the one he has bought protection under, the **Short CDS** is the one he has sold protection under). If the Middle Party delivered a Credit Event Notice under both CDSs, the Long CDS would be allocated to Auction Bucket 1 and the Short CDS would be allocated to Auction Bucket 4. Auction Bucket 1 had an Auction Final Price of 100% whereas Auction Bucket 4 had an Auction Final Price of 12%. Therefore, the Middle Party would receive EUR 1,000 x (100% - 100%) = EUR 0 under the Long CDS, but pays EUR 1,000 x (100% - 12%) = EUR 880 under the Short CDS.

This is a more extreme example than usual because Auction Final Prices of 100% or more are fairly infrequent, but there have been a few[124] and in any case the Auction Final Prices for longer-dated maturity buckets tends to be lower than those for shorter-dated maturity buckets. There is no obvious solution to this risk. If the Middle Party does not trigger the Long CDS, he might lose out on any amounts payable under it. The Exercise Cut-off Date is earlier[125] for Credit Event Notices delivered by the Seller than for those delivered by the Buyer, so under the Short CDS the Middle Party cannot wait until its counterparty as Buyer elects to trigger the Short CDS. In most cases, it might be best for the Middle Party to trigger the Long CDS and hope that the Seller triggers the Short CDS to ensure the two CDSs offset each other, though the risk is that the Short CDS is not triggered and remains outstanding (this might be better if no subsequent Credit Event occurs, but could be worse if a subsequent Credit Event occurs with a lower Auction Final Price).

It might be possible for the Middle Party to form a view about how the Auction Final Prices will turn out to make a profit, but on balance it would be safer to take part in a portfolio compression cycle prior to the Auction to avoid being put at risk of a loss in this situation. Interestingly, in the Norske Skog CDSs there were reports[126] that one hedge fund sold short-dated CDS protection and bought long-dated protection, so would have made a substantial profit this way if those reports are true.

7.3 *Sharp*

On 30 March 2016, the Japanese multinational electronics company Sharp Corporation (**Sharp**) agreed with the lenders of certain loans that the maturity date should be extended by a month from 31 March 2016 to 30 April 2016. On the same day, Sharp announced that it had agreed with Foxconn that it would issue new shares giving Foxconn 66% of the voting rights in Sharp in return for a cash infusion of JPY 389 billion[127].

The Japan DC Resolved[128] that the loan maturity date extension was not a Restructuring Credit Event (2 Yes votes, 13 No votes) on the grounds that, based on the information available, the short extension was thought to be part of a refinancing process rather than due to a deterioration in creditworthiness. This was despite Sharp reporting large losses, having off-balance sheet contingent liabilities (triggered by events such as restructurings and layoffs) and the Foxconn takeover being expected to lead to significant layoffs.

---

[123] The application of portfolio compression or tear-up services should result in such trades being cancelled out, but not all market participants take part in compression cycles.

[124] There have been two Auction Final Prices greater than 100%: 104.25% for the Northern Rock (Asset Management) plc Auction Bucket 1; and 105.75% for the Energy Future Intermediate Holding Company LLC and EFIH Finance Inc. Auction (two separate Reference Entities, but a single Auction as the Deliverable Obligations were the same for both). CDS Auction Settlement Amounts are generally floored at zero though (s.12.4(b) of the Updated 2003 Definitions and s.6.4(b) of the 2014 Definitions).

[125] See s.1.41(a)(i) of the 2014 Definitions and s.1.26(b)(i) of the Updated 2003 Definitions, which says the Exercise Cut-off Date is: (a) for Seller, two Relevant City Business Days after the Final List is published; and (b) for Buyer, five Relevant City Business Days after the Final List is published. Any Seller notice prevails over a corresponding Buyer notice.

[126] See "GSO's win-win on Norske Skog CDS" by David Wigan, 28 April 2016, published on IFR: http://www.ifre.com/gsos-win-win-on-norske-skog-cds/21245087.fullarticle. Even if the hedge fund had not bought longer-dated CDS protection, they seem to have held the 2016 Notes and sold short-dated CDS protection on it, so benefitted from the final outcome.

[127] See http://www.wsj.com/articles/foxconn-and-sharp-approve-3-5-billion-takeover-deal-1459326798.

[128] Determinations Committee Decision dated 23 May 2016.

Shortly before the extended termination date in April 2016, the interest rate on the loans was reduced and their maturity date was extended by another 10 years, though no-one asked the DC to consider if a Credit Event had occurred as it was presumably again done in connection with a Foxconn rescue deal.

These facts are significant as bank supported restructurings are more common in Japan than bankruptcies are, so similar issues are likely to arise again[129]. Lenders who have bought CDS protection could be at risk if their existing CDS protection expires before the relevant loan matures on its extended maturity date, though if a loan requires 100% lender consent then they would be in control of the process and could factor in the costs of extending their CDS protection into the price they agree for the amendment of the loan.

8. US Municipal Reference Entities

The Commonwealth of Puerto Rico (**Puerto Rico**) is the first US municipal Reference Entity in respect of which a DC has determined a Credit Event occurred. It is not entirely clear why previous US municipal defaults/restructurings have not led to Credit Events themselves, such as those on Detroit, Stockton (in California) and Jefferson County (in Alabama), but it has been suggested that this is because there were no CDSs outstanding on them hence no-one had an interest in the question to put to the DC.

US municipals are states, counties or local government authorities, which often issue bonds through one or more specific agencies. Bonds issued by US municipals differ from normal corporates and sovereigns in that they often distinguish where the money comes from to pay the obligations under the bonds. There are four main types of US municipal bonds:

- ***Full Faith and Credit Obligation Liability (also known as General Obligation Liability):*** These are backed by either (i) the "full faith and credit" of the relevant US municipal or (ii) ad valorem taxes required to be levied on all taxable property of the relevant US municipal. The 2012 ISDA U.S. Municipal Reference Entity Supplement[130] (the **Muni Supplement**) states that any Double-Barrel Obligation Liability, which is a liability that is both a Full Faith and Credit Obligation Liability and provides for other sources to be used to make payments, can be treated as a Full Faith and Credit Obligation Liability.

  To reference in CDSs, "Full Faith and Credit Obligation Liability" is specified as an additional Deliverable Obligation Characteristic.

- ***General Fund Obligation Liability:*** These are[131] backed by the general fund of the US municipal, but exclude any Moral Obligation Liability (described below). A General Fund Obligation Liability is quite rare and similar to a Full Faith and Credit Obligation Liability, except that it cannot be funded by increasing taxes and the fund is usually set up for a specific purpose (e.g. the ones issued by California to fund pension liabilities).

  To reference in CDSs, "General Fund Obligation Liability" is specified as an additional Obligation Characteristic and Deliverable Obligation Characteristic.

- ***Revenue Obligation Liability:*** These are[132] backed by "the same source of revenues as the Reference Obligation", and again excludes any Moral Obligation Liability.

  To reference in CDSs, "Revenue Obligation Liability" is specified as an additional Obligation Characteristic and Deliverable Obligation Characteristic.

[129] Japan seems to be a particularly tricky jurisdiction for carrying out debt restructurings. There have been a number of events that have led to the Japan DC to consider if a Credit Event has occurred, but have either been dismissed, rejected or taken years to be resolved. The Aiful Corporation saga around the Business Revitalisation ADR process is a case in point, which eventually led to a Restructuring Credit Event occurring in 2009.

[130] Published on 5 March 2012. This particular wording is paragraph II.7 of the Muni Supplement inserts a new s.2.19(b)(viii) into the Updated 2003 Definitions to define a Full Faith and Credit Obligation Liability.

[131] Paragraph II.8 of the Muni Supplement inserts a new s.2.19(b)(ix)(A) into the Updated 2003 Definitions to define a General Fund Obligation Liability.

[132] Paragraph II.8 of the Muni Supplement inserts a new s.2.19(b)(x) into the Updated 2003 Definitions to define a Revenue Obligation Liability.

- ***Moral Obligation Liability:*** These are liabilities that are[133] "contingent upon an appropriation being made by the governing body or other official of the" relevant US municipal. They are not referenced in CDSs on US municipals.

Full Faith and Credit Obligation Liability and Revenue Obligation Liability are the most common ones in use.

Note that CDSs referencing US municipals (**Muni CDSs**) specify Failure to Pay and Restructuring as the Credit Events. They do not reference Bankruptcy, even though there is a Chapter 9 bankruptcy protection regime available to some US municipals (it was used by Detroit, but was not available to Puerto Rico). That Chapter 9 procedure is harder to trigger (there are number of conditions that need to be satisfied before a Chapter 9 filing is made) and not as powerful as Chapter 11, as well as not being universally available, which we understand is why Bankruptcy is not included as a Credit Event in Muni CDSs.

The relevant Transaction Type for CDSs referencing Puerto Rico was "U.S. Municipal Full Faith and Credit". As Muni CDSs were excluded from the 2014 Protocol, the Updated 2003 Definitions were the relevant ones to use as supplemented by the Muni Supplement.

In August 2015, a Puerto Rican agency Public Finance Corporation failed to pay the full amounts due under certain bonds. However, these did not satisfy the "Full Faith and Credit Obligation Liability" Obligation Characteristic, so CDSs referencing Puerto Rico were not triggered.

On 1 July 2016, Puerto Rico failed to make a payment under certain bonds that did constitute a Full Faith and Credit Obligation Liability[134]. There was no explicit grace period, so the default minimum three Grace Period Business Days applied resulting in the Failure to Pay Credit Event occurring on 8 July 2016. The Muni Supplement modifies the standard Obligation Characteristics and Deliverable Obligation Characteristics, including amending the definition of Not Subordinated and inserting a requirement for Full Faith and Credit Obligation Liability, but there was nothing controversial about the Credit Event Resolution and the Americas DC issued a thorough statement explaining it[135].

The Auction process was more interesting. Because so few dealers trade CDSs referencing Puerto Rico, there were only six Participating Bidders in the Auction. Special rules for Auctions for Muni CDSs had been published in March 2012 (referred to as the "new Section 5 of the DC Rules (July 11, 2011 Version)") and not incorporated into the latest version of the general DC Rules for some reason, yet they still apply.

Puerto Rico has been in most series of the Markit MCDX index[136]. Revised versions of the relevant MCDX index series were published accordingly without Puerto Rico (often called re-versioning).

9. Other Failure to Pay Credit Events

This briefing has already considered two specific examples where Failure to Pay Credit Events occurred: Abengoa; and Puerto Rico. The other Failure to Pay Credit Events to have occurred since the 2014 Definitions Implementation Date were more straightforward. A short summary of these is set out in this section.

Note that although these Failure to Pay Credit Events are discussed separately from the Bankruptcy Credit Events above, in many cases the circumstances around them are similar in that there are often debt restructuring negotiations going on and the Failure to Pay might have simply have been the first Credit Event to occur, closely followed by a Bankruptcy Credit Event. Companies in financial difficulties have to

---

[133] Paragraph II.9 of the Muni Supplement inserts a new s.2.19(b)(ix)(B) into the Updated 2003 Definitions to define a Moral Obligation Liability.

[134] US$ 3.5 billion 8% General Obligation Bonds of 2014, Series A due 1 July 2035 (CUSIP: 74514LE86).

[135] Americas DC Meeting Statement 21 July 2016.

[136] MCDX.NA.10 to 21. It was not included in MCDX.NA.22, which rolled on 3 April 2014, following downgrades that meant two of the three rating agencies no longer gave it an investment grade rating (Markit MCDX Index Rule 1.2). The MCDX indices are unusual in that they roll on 3 April and 3 October of each year, rather than 20 March and 20 September of each year, though coupons are still paid on the standard payment dates of 20 March, 20 June, 20 September and 20 December of each year.

consider all their creditors, so even if they have enough to pay the immediate interest or principal due under a particular bond or loan, they might not be able to if it prejudices other bonds/loans.

9.1 *Sabine Oil & Gas*

Sabine Oil & Gas Corporation (**Sabine Oil & Gas**) entered into a forbearance agreement with the lenders under a revolving credit facility on 20 May 2015, which led to a Failure to Pay Credit Event occurring on 21 May 2015. Two questions were put to ISDA, one on Sabine Oil & Gas on 28 May 2015 and the other on its former name Forest Oil Corporation[137] on 29 May 2015, but the EMEA DC dismissed the second question and proceeded on the first question alone. There were just three series of bonds deliverable into the Auction, which took place on 23 June 2015.

Sabine Oil & Gas filed for Chapter 11 bankruptcy protection[138] on 15 July 2015 to facilitate a balance sheet restructuring. A DIP financing arrangement was then quickly put in place. Although the CDS trigger/settlement process could scarcely have been any simpler, by contrast the restructuring negotiations in Chapter 11 have been lengthy and fraught, involving a number of litigation matters, and it finally emerged from Chapter 11 on 11 August 2016.

9.2 *Pacific Exploration & Production*

Pacific Exploration & Production Corporation (**Pacific Exploration & Production**, formerly known as Pacific Rubiales Energy Corporation) is a Canadian petroleum and natural gas exploration and production company, but its focus is on South America (particularly Columbia and Peru) so CDSs on it trade under the Latin America Corporate BL Transaction Type. It missed an interest payment under certain bonds maturing in 2025[139] (the **2025 Bonds**) on 19 January 2016, and the 30 day grace period resulted in Failure to Pay Credit Event occurring on 18 February 2016. Note that 42% of the holders of the 2025 Bonds signed a forbearance agreement on 19 February 2016 agreeing to forbear from accelerating the 2025 Bonds until 31 March 2016 (a similar forbearance was given by a holders of other bonds and loans), but this did not prevent the Failure to Pay Credit Event from occurring.

The request was put to ISDA to convene a DC on 7 March 2016, which was an unusually long time after the Credit Event itself (albeit well within the 60 day period allowed). The Auction[140] took place on 6 April 2016 and only one bank putting in a Physical Settlement Request[141].

The forbearance was subsequently extended to 29 April 2016, and before that expired Pacific Exploration & Production and its affiliates applied for (and received) bankruptcy protection under the Canadian Companies' Creditors Arrangement Act (**CCAA**). A DIP Financing was put in place on 22 June 2016 and a “plan of compromise and arrangement” has been put forward to exit the CCAA in October 2016.

10. Successor Determinations

There have been a number of determinations made around Successors since the 2014 Definitions Implementation Date. Most of the questions put to the DCs have been pretty straightforward, either as sole Successor determinations or determining that there is no Successor (e.g. for simple renamings[142]), along with numerous query rejections on the basis of lack of Best Available Information/Eligible Information. However, there have also been some interesting outcomes discussed below.

---

137 Forest Oil Corporation and Sabine Oil & Gas LLC had merged in December 2014.

138 Case No. 15-11835 in US Bankruptcy Court for the Southern District of New York.

139 Under the US$ 750,000,000 5.625% Senior Notes due 2025 issued by Pacific Rubiales Energy and guaranteed by four other entities (ISINs: USC71058AF55 (Reg S) and US69480UAK34 (Rule 144A)).

140 There were 12 Yes votes and 3 No votes about whether to hold an Auction. It is not clear what the No voters were objecting to, but the perhaps felt that there was insufficient liquidity in the Deliverable Obligations to hold an Auction.

141 For a small amount of US$ 1.23 million in principal amount, despite there being a substantial principal amount of bonds available for delivery into the Auction. This was a rare example of CDS notionals on a Reference Entity being substantially less than the principal amount of Deliverable Obligations available.

142 Although renaming a Reference Entity does not involve a Successor determination, it is still important to ensure that Markit updates its systems with the new name.

Note that the 2014 Definitions removed the concept of a Succession Event for corporates (though Sovereign Succession Event has been inserted for Sovereigns, whereas the old definition of Succession Event did not apply to Sovereigns), so most of the questions were around whether a Succession Event had occurred under the Updated 2003 Definitions or whether a Succession Date has occurred under the 2014 Definitions, and in each case that one or more Successors is determined. For brevity, this briefing refers to Successor determinations to mean both of these.

10.1 *FIA Card Services*

FIA Card Services, National Association (**FIA**) merged with Bank of America, National Association (**BofA** on 1 December 2014 (FIA had previously been part of the BofA group). A request was put to the DC to consider whether a Successor should be determined, but it was found that FIA Card Services did not have any Relevant Obligations so there could not be a Successor. The CDSs had presumably become orphaned because FIA bonds/loans had matured before the CDSs did, but Bloomberg suggests the last FIA obligations were two bonds that matured in 2012 so it is not clear why CDSs were still outstanding.

In addition, Bank of America had to abstain from voting in the DC meetings under DC Rule 2.3(c) because it was involved in the matter and was effectively an Affected Reference Entity[143], despite not actually ending up as the Reference Entity.

10.2 *"la Caixa" Banking Foundation*

On 14 October 2014, Fundación Bancaria Caixa d'Estalvis I Pensions de Barcelona, "la Caixa" (**"la Caixa" Banking Foundation**) transferred all its bond obligations to a wholly-owned subsidiary called Criteria CaixaHolding, S.A. However, there was a question as to whether "la Caixa" Banking Foundation remained liable for those bonds under Spanish law, and the DC took advice from a Spanish law firm who[144] "on balance, concluded that liability under Article 80 of the Spanish Corporate Restructuring Act should not attach, contractually or at law, to" "la Caixa" Banking Foundation. Consequently, Criteria CaixaHolding, S.A. was determined to be the sole Successor.

10.3 *Iron Mountain*

On 20 January 2015, Iron Mountain Incorporated (which was the main CDS Reference Entity) merged with Iron Mountain REIT, Inc., with the former then ceasing to exist and the latter being renamed Iron Mountain Incorporated. The Americas DC unanimously Resolved that the remaining entity was the sole Successor for CDSs. This is not an especially interesting event, but very reassuring to see that the credit derivatives market is not being caught out by what happened with Unitymedia GmbH[145], which led to the concept of the Universal Successor in the 2014 Definitions that could be still determined more than 90 days after the date on which the succession became legally effective[146].

10.4 *Windstream Services*[147]

On 24 April 2015, the Windstream group effected a spin-off of certain communications assets into a new entity called Communications Sales & Leasing, Inc. (**CS&L**). The actual process was quite complex and involved the parent company Windstream Holdings, Inc. (**WH**) and Windstream Services, LLC (**WS**) both transferring certain assets to CS&L, which in turn issued (a) its shares to WH and (b) US$ 1.51 billion in notes, US$ 840 million in loans and US$ 1.035 billion in cash to WS.

---

143 Defined in DC Rule 2.1(d).

144 EMEA DC Statement 29 January 2015.

145 On 16 September 2010, Unitimedia GmbH merged with UPC Germany GmbH, with the former being dissolved and the latter being renamed Unitymedia GmbH. A request was eventually put to the DC on 2 April 2012 to ask if it should be treated as a name change rather than determining a Successor, but the DC said it could not and the look-back period prevented a Successor determination.

146 The term Succession Event Backstop Date is used in the Updated 2003 Definitions and the term Successor Backstop Date is used in the 2014 Definitions.

147 Note that the figures in this section may not be exactly correct as it has been difficult ascertaining exactly what the figures should be, but they are sufficient to illustrate the principles involved.

WS was the Reference Entity referenced by CDSs, and had about US$ 8 billion of bonds outstanding prior to the spin-off. After receiving the notes and loans mentioned above with aggregate principal amount US$ 2.35 billion, WS exchanged these with its existing bondholders to receive US$ 2.35 billion of such bonds in return (which it then cancelled). No entire series of such WS bonds were exchanged, so there was no question of a Restructuring Credit Event occurring.

A diagram illustrating the cash flows and deliveries involved in the spin-off is set out in Appendix 2.

The interesting outcome was that no Successor was determined under the Updated 2003 Definitions, but both WS and CS&L were Successors under the 2014 Definitions (i.e. CDSs referencing WS were split into two CDSs of equal notional amount, with one referencing WS and the other referencing CS&L). The rationale for this was that the 2014 Definitions take account of loans as well as bonds in an exchange of Relevant Obligations, whereas the Updated 2003 Definitions only take account of bonds[148] (the red strike-through wording is in the Updated 2003 Definitions, whereas the blue wording is in the 2014 Definitions):

> "For purposes of Section 2.2, "succeed" means, with respect to ~~a~~ the Reference Entity and its Relevant Obligations ~~(or, as applicable, obligations)~~, that ~~a party~~ an entity other than ~~such~~ the Reference Entity (i) assumes or becomes liable for such Relevant Obligations ~~(or, as applicable, obligations)~~ whether by operation of law or pursuant to any agreement (including, with respect to a Reference Entity that is a Sovereign, any protocol, treaty, convention, accord, entente, pact or other agreement), or (ii) issues Bonds or incurs Loans (the "Exchange Bonds or Loans") that are exchanged for Relevant Obligations, and in either case ~~such~~ the Reference Entity is ~~no longer an obligor (primarily or secondarily) or guarantor~~ not thereafter a direct obligor or a provider of a Relevant Guarantee with respect to such Relevant Obligations ~~(or obligations)~~ or such Exchange Bonds or Loans, as applicable. For purposes of Section 2.2, "succeeded" and "succession" shall be construed accordingly."

Limb (ii) is the relevant part. Under the Updated 2003 Definitions, the Relevant Obligations that were succeeded by CS&L comprised US$ 1.51 billion in Bonds, which was less than 25% of the US$ 8 billion of Relevant Obligations then outstanding and so no Successor was determined. However, under the 2014 Definitions, the Relevant Obligations that were succeeded by CS&L comprised US$ 2.35 in Exchange Bonds and Loans, which was more than 25% of the US$ 8 billion of Relevant Obligations then outstanding. As WS also remained the obligor for more than 25% of the Relevant Obligations, both WS and CS&L were determined to be Successors.

10.5 *DIRECTV*

On 18 May 2014, AT&T Inc. (**AT&T**) filed an Agreement and Plan of Merger with the US Securities and Exchange Commission that referred to its acquisition of DIRECTV Holdings LLC (**DIRECTV**), but it was almost two years later on 13 April 2016 when an Exchange Offer and Consent Solicitation by AT&T resulted in most of the DIRECTV debt being replaced with AT&T debt.

The Americas DC was asked to determine whether AT&T had become the sole Successor to DIRECTV Holdings LLC under both the Updated 2003 Definitions and the 2014 Definitions. Under the Updated 2003 Definitions, the requirement for a Succession Event meant that there had to be "an event such as a merger, consolidation, amalgamation, transfer of assets or liabilities, demerger, spin-off or other similar event in which one entity succeeds to the obligations of another entity, whether by operation of law or pursuant to any agreement". Despite the nearly two year gap between the Agreement and Plan of Merger and the Exchange Offer and Consent Solicitation becoming effective, the DC determined that the latter was connected with the relevant event, so AT&T was determined to be the sole Successor.

Under the 2014 Definitions, there is no longer a requirement for a Succession Event, so it was much more straightforward for the DC to Resolve that AT&T should be the sole Successor there.

[148] This is s.2.2(e) of the Updated 2003 Definitions and s.2.2(d) of the 2014 Definitions.

10.6 *Novo Banco*

The discussion around the potential Governmental Intervention Credit Event and the facts behind it are set out in section 6 above. The EMEA DC Resolved that there was no Successor as only 20.1% of the Relevant Obligations had been transferred by Novo Banco back to BES, which is less than the 25% needed to trigger a Successor determination.

However, the EMEA DC published a detailed analysis[149] of how it calculated the percentage of Relevant Obligations transferred, which flags a number of useful principles that would be relevant for future determinations of this type. Box 2 lists some of these relevant considerations.

Box 2: Useful Pointers for Calculating Percentage of Relevant Obligations Transferred

- Obligations held by the Reference Entity are not "outstanding"
- The principal amount of zero coupon bonds outstanding is their accreted amount
- The DC can wait for financial information to be published if it will show the data "as at" a relevant date
- The DC can contact the Reference Entity and others for more information or to confirm specific points (e.g. the form of any loans)
- The DC will make an informed decision based on best estimates

11. European Commission Antitrust Investigations

On 20 April 2011, the European Commission opened up antitrust investigation[150] into possible antitrust breaches by 16 banks and Markit about their actions in suppressing exchange trading of credit derivatives. These investigations were extended to include ISDA on 26 March 2013. One of these investigations focused in particular on refusals to licence use of Auction Final Prices and iTraxx/CDX indices.

The relevant EU antitrust provisions are set out in the Treaty on the Functioning of the European Union[151] (**TFEU**):

- *Article 101:* This prohibits anti-competitive agreements and concerted practices whose object is to prevent, restrict or distort competition within the EU.
- *Article 102:* This prohibits abuses of a dominant position in the EU or a substantial part of it.

The sanctions for breaches are set out in Council Regulation (EC) No 1/2003 on the implementation of the rules on competition (more commonly known as the **EU Antitrust Regulation**):

- *Article 7 Prohibition Declarations:* If the European Commission finds that there has been an infringement, it may require the entities involved to bring the infringement to an end and may impose "any behavioural or structural remedies which are proportionate to the infringement committed and necessary to bring the infringement effectively to an end".
- *Article 9 Commitment Decisions:* Where the entities involved voluntarily offer commitments to meet the European Commission's concerns, it may make those commitments legally binding on those entities. Any subsequent infringements may lead to penalties and sanctions.

It is not clear whether there was any real substance behind these antitrust investigations, but the main players in the credit derivatives industry are taking the opportunity to improve the general corporate governance of the industry. For example, the dealer banks have reduced their shareholdings in Markit (at the time of Markit's initial public offering (**IPO**) in 2014, the dealer banks owned 51% of the shares in Markit

---

[149] EMEA DC Statement 3 March 2016.

[150] Case COMP/AT.39745, whose details are on the European Commission website at http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=1_39745. There was an earlier investigation by the US Department of Justice, which did not lead to anything. There have also been a number of class actions in the US made by buy-siders, such as *In re Credit Default Swaps Antitrust Litigation*, 13-md-2476 (DLC).

[151] TFEU is also known as the Treaty of Lisbon. It was signed in 2007 and came into force in 2009. It replaced the Treaty of Rome that established the European Economic Community in 1957, which was in turn amended in 1992 by the Treaty of Maastricht to refer to the European Community (the Treaty of Maastricht also established the European Union, and has now become the Treaty on European Union).

in aggregate, but this fell significantly in 2015[152] and then in 2016 the merger between Markit and IHS left the dealer banks with an even more diluted stake[153]) and ISDA has put its DC Secretarial role out to tender[154]. On 29 April 2016, Markit and ISDA both proposed commitments to the European Commission pursuant to EU Antitrust Regulation Article 9, which led to the European Commission adopting an Article 9 Commitments Decision on 20 July 2016 that effectively makes the following points legally binding on Markit and ISDA:

- ***Dealer Banks Excluded from Licensing Decisions:*** ISDA and Markit will exclude the dealer banks from making or influencing any licensing decisions.
- ***Auction Final Price Licensing:*** ISDA will license the rights to use Auction Final Prices on fair, reasonable and non-discriminatory (**FRAND**) terms to any applicant for the purpose of exchange trading. Any such licence will be granted on a non-exclusive and non-transferable basis.
- ***iTraxx/CDX Licensing:*** Markit will license rights to the iTraxx and CDX indices on FRAND terms to any applicant for the purpose of creating and/or trading exchange traded financial products.

Some exchanges had already started trading in credit derivatives products based on Auction Final Prices and iTraxx/CDX indices. It remains to be seen whether they will be successful, or indeed seen as a viable alternative to OTC CDSs.

It is worth bearing potential antitrust issues in mind on future industry initiatives. While there have historically been relatively few antitrust investigations carried out in financial markets in the US[155] and the EU[156], there have been a number of recent high-profile investigations such as the LIBOR/EURIBOR investigations. Antitrust authorities have shown their willingness to investigate suspected infringements even years after the actions in question, and in the US in particular any findings of malpractice are likely to be followed by class action lawsuits.

12. DC Determinations and Rules

The DCs were set up in 2009 as part of the "Big Bang" process[157] to standardise the OTC credit derivatives market and make CDSs suitable for clearing. The DCs make decisions that are binding on standard CDSs, and ensure that all CDSs referencing the same Reference Entities are affected in the same way.

The establishment of the DCs was the most contentious part of Big Bang. Many market participants were concerned that if the major investment banks constituted the DCs, they would make decisions that suited them and not others. The end result was that the DCs each comprise 15 DC Voting Members, of whom ten are investment banks and five are buy-siders. Since major decisions, such as whether a Credit Event has occurred, require an 80% supermajority, the investment banks cannot pass such a DC Resolution without at least two of the buy-siders agreeing with them.

As it is, there have not been any instances where the investment banks have voted one way and the buy-siders have voted the other. All the situations in which votes have been split have involved some genuine legal or factual uncertainty. However, there have been some circumstances in which the DC Members have been accused of voting in accordance with their books (one particularly loud accusation was around SEAT Pagine Gialle S.p.A., but there were substantial legal uncertainties based on the facts there).

[152] The dealer banks were able to sell a quarter of their holdings in 2015, a year after the IPO.

[153] Immediately following the merger, 57% of the merged entity was owned by IHS shareholders and 43% by Markit shareholders.

[154] ISDA publication "ISDA Issues Invitation to Tender for Determinations Committees Secretary Role" of 3 May 2016. No subsequent announcements have yet been made.

[155] The US Department of Justice has carried out investigations into metals trading pricing and municipals bid rigging, as well as LIBOR manipulation.

[156] Economic Activity K.66.11 on Administration of Financial Markets is the category the European Commission uses. There is a list available of the actions in this area, but only one relates to antitrust (the others relate to mergers and state aid). The LIBOR/EURIBOR investigations are covered elsewhere.

[157] The main legal changes were made through (a) the March 2009 Supplement published on 12 March 2009 and associated Big Bang Protocol implemented on 8 April 2009 and (b) the July 2009 Supplement published on 14 July 2009 and associated Small Bang Protocol implemented on 27 July 2009. Various other standard industry changes were made in April 2009 as well, such as the introduction of standard coupons. This was all largely done to facilitate clearing.

The DCs have made some very welcome recent changes to the DC Rules on 20 January 2016 through the provisions around managing conflicts of interest and the addition of the representations in Schedule 6 (*DC Participant Representations*). The most significant points are discussed below:

12.1 *DC Participant Written Policies and/or Procedures*

A new definition[158] of DC Participant has been introduced as the relevant DC Member or CCP Member. The Standard Agreement under which each DC Participant acknowledges its rights and responsibilities under the DC Rules now needs to contain[159] the representations set out in DC Rules Schedule 6, including[160]:

> “The DC Participant represents to ISDA that the DC Participant has written policies and/or procedures reasonably designed to identify and manage conflicts of interest arising from its role as a DC Participant and the potential profits or losses from trading or holding economic positions in instruments whose price may be impacted by a DC Resolution.”

DC Resolutions must be “based on a commercially reasonable analysis of the information”[161].

There are additional provisions prohibiting discussions by Convened DC Members of Confidential Material outside DC Meetings when the duty of confidentiality still applies[162], with the exception of matters sent for External Review.

12.2 *Excluded Individuals*

A new term of Excluded Individuals has been introduced, which is a rather lengthy definition that essentially means[163] any people in business areas that trade credit derivatives or hold instruments whose prices are affected by credit derivatives:

> “An "**Excluded Individual**" means any individual who is part of a department, division, group, or personnel of a DC Participant or any of its affiliates, whether or not identified as such, that performs, or exercises authority over the performance of, any pricing (excluding price verification for risk management purposes), trading, sales, purchasing, marketing, advertising, solicitation, structuring, or brokerage activities (each such activity, a "**Business Activity**") on behalf of the DC Participant in respect of credit trading, credit derivatives trading or other business lines that enter into or hold instruments whose price may be impacted by a DC Resolution, such as hedging, lending, investing, advisory or similar functions (each such business line, a "**Relevant Business Line**"), provided that if a DC Participant determines that certain functions are part of a Relevant Business Line but are sufficiently independent of the Business Activities of that Relevant Business Line such that individuals fulfilling such functions would be able to act as DC Decision-makers or CCP DC Decision-makers, as relevant, without creating an unmanageable conflict of interest, then the written policies and/or procedures may permit such individuals to act as DC Decision-makers or CCP DC Decision-makers, as relevant, provided the DC Participant maintains a written record of the reasons for such determination.”

These Excluded Individuals cannot be DC Decision-makers.

Note that DC Decision-makers are still able to discuss matters with Excluded Individuals prior to any vote, but must do so in accordance with the relevant written policies and procedures and any regulatory or contractual requirements around handling material non-public information and Confidential Material[164].

12.3 *DC Secretary Written Policies and/or Procedures*

There are several changes to the DC Rules that apply to the DC Secretary, such as this one[165]:

---

[158] In the first paragraph of DC Rules Schedule 6.
[159] DC Rule 1.8(b).
[160] DC Rules Schedule 6 para. 1.
[161] DC Rules Schedule 6 para. 1(a).
[162] DC Rule 2.4(h). The definition of Confidential Material is set out in DC Rule 5.2(a).
[163] DC Rules Schedule 6 para. 1(b).
[164] DC Rules Schedule 6 para. 1(c).

"The DC Secretary shall have written policies or procedures or other mechanisms in place to provide for ongoing internal oversight of its compliance with the requirements of the Rules and any related policies and procedures. The DC Secretary shall also ensure that all staff of the DC Secretary involved in the work of the DC Secretary receive appropriate training on the relevant requirements of the Rules."

12.4 *Manipulation Allegations*

What is particularly striking about several of the questions put to the DCs since the 2014 Definitions Implementation Date is how many of them have alleged that the CDS market is being manipulated in some way, and that the relevant DC needs to determine a question in a particular way to preserve the integrity of the CDS market or ensure that CDSs work in the way intended.

The DCs have quite rightly decided that they cannot be swayed by such statements, they can only base their determinations on the wording of the CDS documents and the relevant facts. Any manipulation that occurs is a market abuse matter and therefore subject to the relevant market abuse laws/regulations. In any case, most of the vocal statements of market manipulation tend to have missed some important facts that mean that the relevant events do not constitute market manipulation at all.

13. Standard Reference Obligations and Package Observable Bonds

The 2014 Definitions introduced the concepts of Standard Reference Obligations (**SROs**) and Package Observable Bonds (**POBs**) for the first time. The former is intended to reduce possible mismatches across CDSs because CDSs that are otherwise identical might specify different Reference Obligations and potentially result in different Deliverable Obligations or Successor/Substitute Reference Obligation determinations[166]. The latter is needed by the new Asset Package Delivery provisions for Sovereigns.

Markit is both the SRO Administrator and the POB Administrator, and both the SRO List and the POB List are available on its website. The relevant DCs are responsible for selecting specific SROs and POBs though, and the rules for selecting them are set out in Schedules 4 and 5 of the DC Rules.

Although the SRO provisions are intended to apply to all CDSs, the take-up has been muted. At the time of writing, the latest version of the SRO List was dated 22 September 2016 and showed that the majority of SROs have been published for the EMEA region, with 110 SROs and 39 Prior Reference Obligations (**PROs**)[167]. 9 SROs and 1 PRO have been published for Japan and 9 SROs for Australia-New Zealand[168]. All of these SROs and PROs so far relate to Financial Transaction Types, mostly European Financial Corporate but also European Coco Financial Corporate, Japan Financial Corporate and Australia Financial Corporate. There are still some Financial Transaction Types for which no SROs have yet been published though: New Zealand Financial Corporate; Singapore Financial Corporate; and Asia Financial Corporate.

Somewhat surprisingly, there are no Identified Non-Conforming Reference Obligations (**INCROs**) or SROs with Deliverability Flaws on the current SRO List. Note that the Reference Obligation specified in CDSs has historically always been deliverable even if it did not satisfy the Deliverable Obligation Category or Characteristics[169], and this concept has been retained in SROs through Deliverability Flaws that are relevant for SROs that would not be deliverable if they were not specified as the SRO. It is important as any substitute can also have the same Deliverability Flaws. An INCRO is an SRO with one or more Deliverability Flaws.

---

[165] DC Rule 1(b).

[166] Markit had already started publishing the Preferred Reference Obligation that market participants should use, largely based on which the most common Reference Obligation in use for the relevant Reference Entity is, but mismatches were still common.

[167] PROs are essentially SROs that have matured but which have not yet been replaced, but the PROs are relevant for determining the seniority and Deliverability Flaws of any SROs identified later. See s.3.13(b)(i)(C) of the 2014 Definitions.

[168] The nine SROs for Australia-New Zealand approved by the ANZ DC, but have not yet made it on to the SRO List as they are currently in the market consultation period for challenges.

[169] One example is the Lighthouse International Co., S.A. bonds that were deliverable into CDSs on SEAT Pagine Gialle S.p.A. CDSs, but only if those Lighthouse bonds were specified as the Reference Obligation (they benefitted from a guarantee from SEAT Pagine that did not constitute a Qualifying Guarantee).

So far, there have been surprisingly few SROs published. The intention of the DCs was to focus on the most popular names by trading volumes and then stagger the introduction of the SROs (the EMEA SRO List has been updated several times to add SROs for new Reference Entities), but there are clearly many missing and it is odd not to see any at all published by the Americas and Asia ex-Japan DCs. It is possible that the time and cost of identifying and agreeing SROs is deterring a more widespread identification of SROs.

POBs are relevant for Sovereigns where Asset Package Delivery is to apply[170], but so far there have only been three POBs published, all for Greece. They were published on 7 April 2015 at a time when there was considerable concern over a possible second Credit Event on Greece, so it is possible that the DCs are planning to focus on publishing POBs only when Credit Events are imminent. If no POBs are available when a Credit Event occurs, settlement still occurs in the usual way but without the benefit of the Asset Package Delivery provisions.

14. Conclusions

CDSs and other forms of credit derivatives continue to be a hugely popular hedging tool, but are also continuing to be used for speculative purposes. Although the 2014 Definitions were designed to remove many of the uncertainties around certain Credit Event and Successor determinations, it is clear that there are still numerous circumstances in which a bondholder or lender with CDS protection might find that corporate events (particularly debt restructurings or governmental actions) result in hedging mismatches. However, allegations published by a vocal minority asserting that CDSs do not work or that the CDS market is rigged are clearly incorrect.

14.1 *Debt Restructurings*

The presence of bondholders/lenders with CDS positions continues to have a significant effect on corporate debt restructurings. The main issue is that their interests are usually not aligned with bondholders/lenders who do not have CDS positions and, as a result, it is often difficult to get them to vote in favour of particular proposals. Furthermore, these bondholders/lenders with CDS positions may have either: (a) bought CDS protection on a notional amount up to the principal amount of the bonds/loans held, which serves as a hedge against credit spread risk or default risk under the bonds/loans; (b) bought CDS protection on a notional amount greater than the principal amount of the bonds/loans held, which makes them overall short the Reference Entity's credit risk; or (c) sold CDS protection, which results in them being even more long the Reference Entity's credit risk. It is virtually impossible to find out what CDS positions are held by bondholders/lenders as they are so secretive about them (their fear is that other market participants might be able to exploit their CDS positions if they know about them), making it very different to come up with debt restructuring proposals that suit everyone.

Corporate debt restructurings are sometimes implemented in ways that try to minimise the potential disruption caused by such bondholders/lenders who have purchased CDS protection on their holdings, mainly by triggering a Credit Event and settling the CDSs before a vote on the restructuring is held. There are risks with this approach though, particularly if it takes longer than anticipated to effect the debt restructuring and CDSs start to be traded on the relevant entity again before the voting takes place.

The US Chapter 11 process provides a particularly neat way round this problem, and pre-packaged Chapter 11 plans of reorganisation are regularly used (CEOC and RadioShack are examples in this briefing). However, as the events in CEOC show, these pre-packaged Chapter 11 plans of reorganisation are not always successful.

[170] In general, all Sovereigns except for those in emerging markets (i.e. for the Transaction Types Emerging European & Middle Eastern Sovereign and Latin America Sovereign, for which the 2014 Sovereign No Asset Package Delivery Supplement applies) because of the concerns over bifurcated markets reducing liquidity. Note that emerging market Sovereigns that have suffered a Credit Event since the 2014 Definitions Implementation Date (i.e. Argentina and Ukraine) are now trading with Asset Package Delivery provisions applicable.

The position is often more complex in Europe and Asia, largely because their insolvency/restructuring laws are more creditor-friendly, but it is often still possible to find ways around problematic bondholders/lenders who have CDS positions. Although the Norske Skog restructuring had its problems with dissenting creditors who reportedly had CDS positions, it was not felt to be necessary to try to remove them by triggering a Credit Event prior to the exchange offer and consent solicitation on the 2017 Notes.

14.2 *2014 Definitions*

Most of the major changes introduced by the 2014 Definitions have yet to be tested in practice (e.g. the Asset Package Delivery provisions). The most significant points to arise so far have been:

- ***Bankruptcy:*** The most surprising impact came from the restriction of the Bankruptcy Credit Event in s.4.2(d) of the Updated 2003 Definitions/2014 Definitions, which led to a Credit Event occurring on Abengoa under the Updated 2003 Definitions but not under the 2014 Definitions. However, that did not have much of an impact in practice as a Failure to Pay Credit Event occurred soon after under the 2014 Definitions. It is a point that needs to be monitored and discussed with local counsel when looking at potential restructurings though, particularly by reference to the guidance the EMEA DC published in the PTIF Bankruptcy Credit Event.

  It is also important to note that the relevant insolvency law triggering the Bankruptcy Credit Event may not necessarily be that of the jurisdiction where the Reference Entity is incorporated; it could potentially be that of a parent company or other jurisdictions where insolvency courts can be involved (e.g. because significant assets are held in that jurisdiction).

- ***Governmental Intervention:*** The only governmental action that might have triggered the new Governmental Credit Event was in the Novo Banco case, but it did not based on the facts. It is clear that there are actions governments can take that adversely affect bondholders/lenders, but do not trigger Governmental Intervention Credit Events.

- ***Restructuring:*** The Norske Skog events highlighted a number of difficulties with Restructuring Credit Events, including: (a) difficulties with establishing acceptable exchange offers in the first place; (b) hedging mismatches where a bondholder holding the specific bond that was restructured and having full default risk CDS protection suffered significant losses; and (c) significant price differences across the Auction buckets. Many of the specific changes made by the 2014 Definitions to the Mod Mod R provisions were not tested.

- ***Qualifying Guarantees:*** Following the Norske Skog events, the new broader definition of Qualifying Guarantee that permits guarantee releases where the guarantee is transferred to a single entity who assumes responsibility for it has led to three bonds with guarantees being deliverable under the 2014 Definitions that were not deliverable under the Updated 2003 Definitions. This was the desired result and shows that these changes in the 2014 Definitions were effective.

- ***Successors:*** The changes made to the Successor provisions in the 2014 Definitions has led to different outcomes in limited circumstances from the Updated 2003 Definitions (e.g. Windstream Services), but there has not been anything controversial and the changes were more logical under the 2014 Definitions. It is still the case that debt restructurings can lead to bondholders/lenders with CDS protection find that their bonds/loans reference different entities than their CDSs reference; it all turns on the facts.

14.3 *Other Events*

A number of other important events occurred, but which were not under the 2014 Definitions. In particular:

- ***Repudiation/Moratorium:*** The first Repudiation/Moratorium Credit Event that a DC has determined occurred for Ukraine. The DC determined that a Potential Repudiation/Moratorium occurred when the relevant law was passed, not when a prior announcement was made. The relatively slow process leading up to an actual Repudiation/Moratorium was highlighted when the DC made a

number of determinations conditional on the relevant events occurring, including an extreme Auction acceleration.

- ***US Municipal Reference Entities:*** The first Credit Event on a US Municipal Reference Entity occurred with the Failure to Pay triggered by Puerto Rico. There were no particular difficulties in triggering and settling affected CDSs.

14.4 *DCs and Auctions*

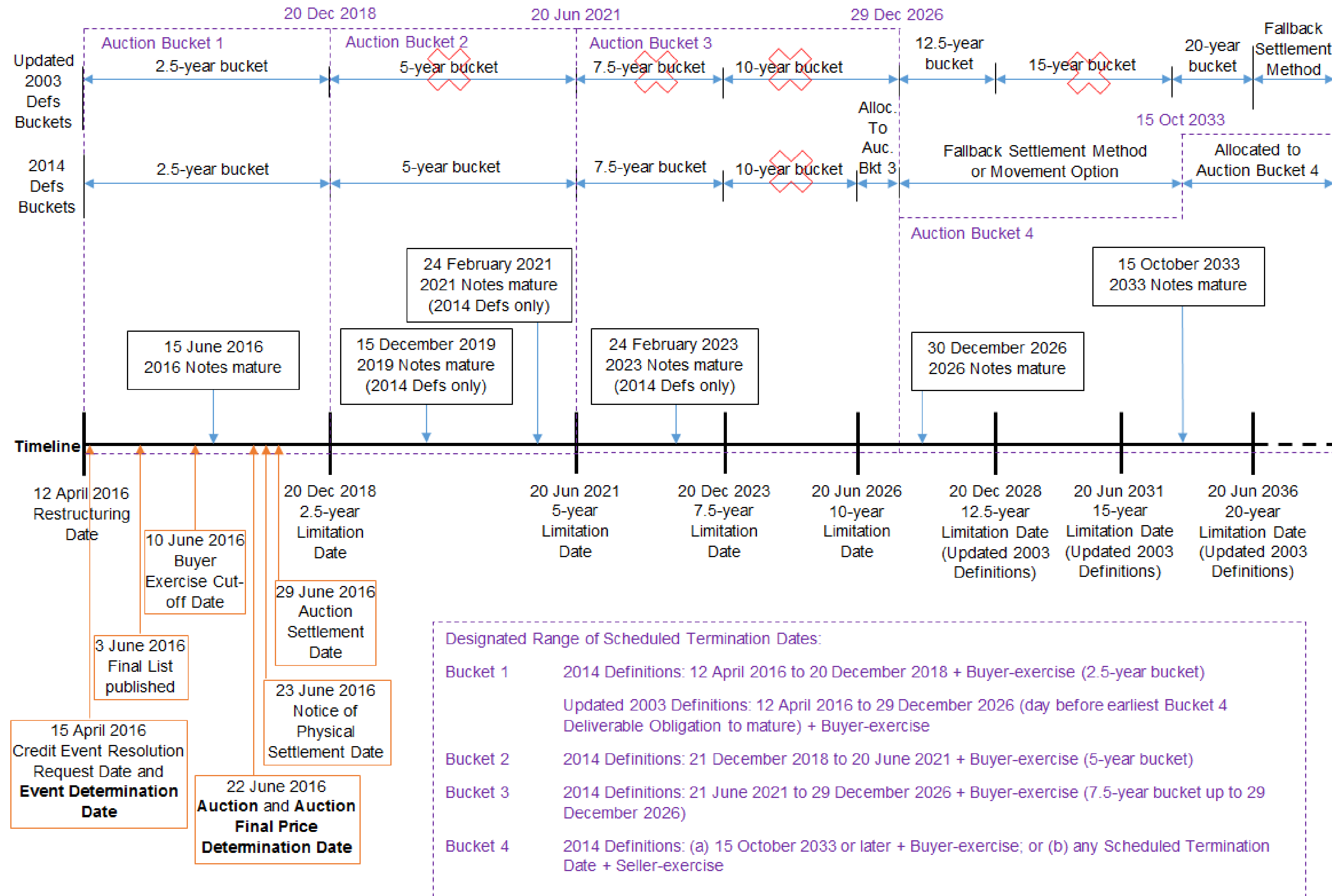
DCs have continued to manage Auction processes in way that improve their chances of producing fair and meaningful outcomes and to ensure that they tie in with timings for debt restructurings (e.g. so that Auctions are settled in time for the buyers in the Auction to receive the relevant Deliverable Obligations in time to exercise any voting rights thereunder in the debt restructuring process). A single Auction has regularly been held to settle CDSs under both the Updated 2003 Definitions and the 2014 Definitions, but only where their Deliverable Obligations are identical.

The most encouraging developments in the past couple of years have been the publication by the DCs of detailed reasons for their decisions and extending the DC Rules to address possible conflicts of interest, which are greatly improving transparency and making the market less open to accusations of misbehaviour. These changes should improve confidence in the CDS market as a whole.

14.5 *Industry Developments*

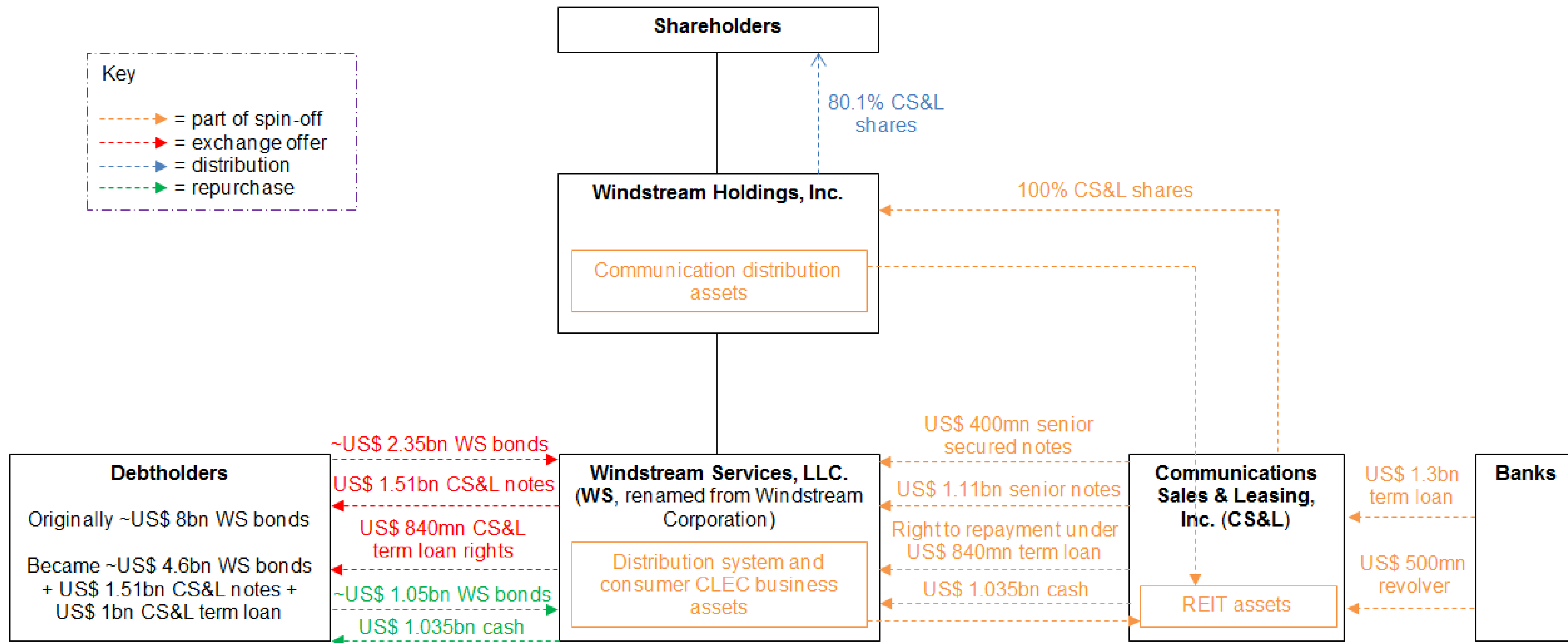
There have been important structural changes in the industry, particularly those resulting from commitments made by Markit and ISDA following the EU antitrust investigations. Markit and ISDA are required to licence out rights to iTraxx/CDX and Auction Final Prices for use by exchange trading platforms on fair, reasonable and non-discriminatory terms, and the dealer banks cannot make or influence such licensing decisions. Some exchange trading platforms already make use of such licences (which pre-date the Markit and ISDA commitments), though it remains to be seen whether they will be successful or seen as a viable alternative to OTC CDSs

Appendix 1
Diagram Illustrating Norske Skog Auction Buckets



Appendix 2
Diagram of Windstream Spin-off

The figures below are approximate and in some cases may not be exactly correct, but they are sufficient to illustrate the point.



Simmons & Simmons Contacts

Simon McKnight
Partner, Hong Kong

☎ +852 2583 8268
simon.mcknight@simmons-simmons.com

Jason Valoti
Partner, Singapore

☎ +65 6831 5610
jason.valoti@simmons-simmons.com

David Roylance
Partner, London

☎ +44 20 7825 4942
david.roylance@simmons-simmons.com

Alan Davies
Partner, London

☎ +44 20 7825 4113
alan.davies@simmons-simmons.com

Sean Bulmer
Partner, London

☎ +44 20 7825 3100
sean.bulmer@simmons-simmons.com

Paul Browne
Partner, London

☎ +44 20 7825 3946
paul.browne@simmons-simmons.com

David Toole
Partner, London

☎ +44 20 7825 3338
david.toole@simmons-simmons.com

Eucharia Bragg
Managing Associate, London

☎ +44 20 7825 4120
eucharia.bragg@simmons-simmons.com

Penny Miller
Partner, London

☎ +44 20 7825 3532
penny.miller@simmons-simmons.com

Allan Yip
Partner, London

☎ +44 20 7825 3626
allan.yip@simmons-simmons.com

Craig Bisson
Partner, London

☎ +44 20 7825 4691
craig.bisson@simmons-simmons.com

Rezah Stegeman
Partner, Amsterdam

☎ + 31 20 722 2333
rezah.stegeman@simmons-simmons.com

Asdrig Bourmayan
Counsel, Paris

☎ +33 1 5329 1658
asdrig.bourmayan@simmons-simmons.com

Alfredo de Lorenzo
Partner, Madrid

☎ +34 91 426 2643
alfredo.delorenzo@simmons-simmons.com

Thomas Scharfenberg
Partner, Frankfurt

☎ +49 69 907 454 60
thomas.scharfenberg@simmons-simmons.com

Michael Dodson
Partner, Bristol

☎ +44 20 7825 5547
michael.dodson@simmons-simmons.com

elexica.com is the award winning online legal resource of Simmons & Simmons

© Simmons & Simmons LLP 2016. All rights reserved, and all moral rights are asserted and reserved.
This document is for general guidance only. It does not contain definitive advice. SIMMONS & SIMMONS and S&S are registered trade marks of Simmons & Simmons LLP.

Simmons & Simmons is an international legal practice carried on by Simmons & Simmons LLP and its affiliated practices. Accordingly, references to Simmons & Simmons mean Simmons & Simmons LLP and the other partnerships and other entities or practices authorised to use the name “Simmons & Simmons” or one or more of those practices as the context requires. The word “partner” refers to a member of Simmons & Simmons LLP or an employee or consultant with equivalent standing and qualifications or to an individual with equivalent status in one of Simmons & Simmons LLP’s affiliated practices. For further information on the international entities and practices, refer to simmons-simmons.com/legalresp.

Simmons & Simmons LLP is a limited liability partnership registered in England &Wales with number OC352713 and with its registered office at CityPoint, One Ropemaker Street, London EC2Y 9SS. It is authorised and regulated by the Solicitors Regulation Authority.

A list of members and other partners together with their professional qualifications is available for inspection at the above address.