A QUESTION OF DEFINITION

THE STANDARDISED DOCUMENTATION OF CREDIT DERIVATIVES TRANSACTIONS IS STILL EVOLVING. **CHRIS ALLEN** AND **MATTHEW DENING** OF BAKER & MCKENZIE REVIEW THE ISSUES THAT ARE PARTICULARLY RELEVANT TO THE CORPORATE TREASURER'S USE OF CREDIT DEFAULT SWAPS.

The market in credit derivatives continues to grow rapidly, and the volatility of credit spreads has encouraged the market in the use of credit default swaps (CDS). CDS are increasingly being used as a tool for hedging credit exposure under trade and leasing receivables, and also as a potentially high-yield investment alternative to taking positions in conventional debt instruments.

Just as the market in CDS and other types of credit derivative is growing, so the documentation of such products continues to evolve. Since the publication of a 'long-form' confirmation by the International Swaps and Derivatives Association, Inc. (ISDA) in 1998, ISDA has published two definitions booklets and a series of supplements in a bid to both standardise the documentary treatment of vanilla products and, at the same time, address market concerns over the response to various corporate and sovereign defaults under those definitions. Since 20 June 2003, the 2003 ISDA Credit Derivatives Definitions (the '2003 Definitions') have been largely adopted in the market as a documentary basis for CDS transactions. These are already subject to a supplement, the May 2003 Supplement, which revises a number of their terms.

Differing responses in the US and Europe to a number of corporate and sovereign defaults, plus an expanding market in trading the basis between the spreads on credit and the spread over swaps in underlying debt (as opposed merely to using the CDS as a form of hedge), increase the complexity and diversity of the documentary developments. The following are just a selection of the issues that remain under the spotlight, being either sources of recent documentary development or issues of particular relevance to the corporate treasurer's use of CDS.

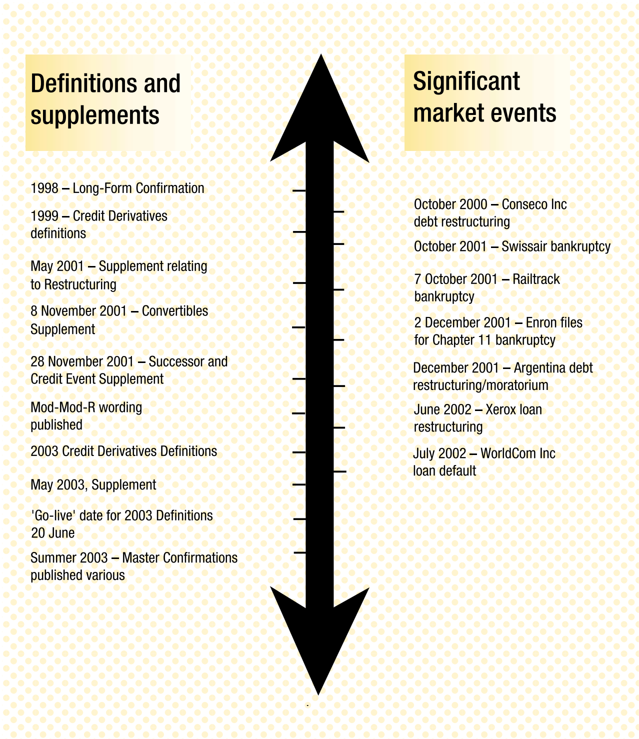
QUALIFYING GUARANTEES. Under a CDS, the instrument or source of exposure that a protection buyer may be looking to hedge is defined by the term 'obligation'. In broad terms, this obligation may be a direct or indirect obligation of the reference entity (being the debt issuer or a trade debtor in respect of whom a buyer typically has a credit exposure). One question that has been considered recently is the scope of the 'indirect' obligations that the terms of a CDS should cover.

Under the 1999 ISDA Credit Derivatives Definitions (the '1999 Definitions'), the definition of the term 'obligation' covered a reference entity's direct obligations, but also certain indirect obligations that were caught by the following wording: "any obligation of a reference entity (whether as principal or surety or otherwise)...". Under the 2003 Definitions the concept of 'surety' was dropped in favour of a new concept of 'qualifying guarantees'.

Accordingly, the term 'obligation' now extends to a reference entity's direct obligations, as well as its obligations as the provider of a 'qualifying guarantee'. This definition is broadly drafted and covers guarantee arrangements that are evidenced by a written instrument, under which a reference entity irrevocably agrees to pay all amounts due under an obligation for which another party is the primary obligor. However, the definition contains the following three qualifications, which scale back its scope:

- The guarantee cannot be subordinated to any of the unsubordinated 'borrowed money' obligations of the underlying obligor (ie, the party whose obligations have been guaranteed). (This qualification is reversed in the May 2003 Supplement, which contains no such requirement regarding subordination).

FIGURE 1
CDS TIMELINE



'UNDER THE 2003 DEFINITIONS, THE CONCEPT OF SURETY WAS REPLACED BY A NEW CONCEPT OF QUALIFYING GUARANTEES'
CHRIS ALLEN

- Certain instruments are expressly excluded from the definition of a 'qualifying guarantee'. These are: surety bonds, financial guarantee insurance policies and letters of credit and equivalent legal arrangements.
- Arrangements whereby the reference entity's payment obligation can be discharged due to an event other than payment are excluded.

Furthermore, parties may elect to provide that only qualifying affiliate guarantees should qualify as indirect obligations. This restricts the scope of the definition to downstream affiliates only. For these purposes, a 'downstream affiliate' is an entity the majority of whose voting shares are held by the reference entity. By and large, the markets in European and Asian corporate credits have adopted 'all guarantees applicable' as their preferred standard. The US market has adopted a more restrictive approach, which extends to 'qualifying affiliate guarantees' only.

THE CREDIT EVENTS. Of all the credit events, restructuring has proved the most problematic and contentious. The definition of restructuring was first amended in the May 2001 Restructuring Supplement to the 1999 Definitions in order to clarify the scope of the 'subordination' limb of restructuring (namely, that only a contractual agreement to the subordination of debt constituted a credit event). The definition of restructuring was subsequently amended in the 28 November 2001 Supplement to the 1999 Definitions, relating to successor and credit events so as to provide that the re-denomination of obligations into the 'permitted currencies' (broadly, the major currencies) would not constitute a restructuring. Furthermore, with the publication of the 2003 Definitions, amendments were made to the language relating to obligation exchanges, which had proved controversial in the context of Argentina's debt restructuring[1].

TABLE 1

DEFINITIONS OF 'RESTRUCTURING'

	Old Restructuring under the 1999 Definitions	Full Restructuring under the 2003 Definitions	Mod-R - Restructuring Maturity Limitation and Fully Transferable Obligations	Mod-Mod-R Modified Restructuring Maturity Limitation and Conditionally Transferable Obligations
Maturity Limitation	No restructuring – specific limitation but maximum maturity limitation may still apply if so specified in the Deliverable Obligation characteristics	No restructuring – specific limitation but maximum maturity limitation may still apply if so specified in the Deliverable Obligation characteristics	The maturity date that is the earlier of (x) 30 months following the Restructuring Date[1] and (y) the latest final maturity date of any Restructured Bond or Loan[2]	The date that is the later of (x) the Scheduled Termination Date and (y) 60 months following the Restructuring Date in the case of a Bond or Loan, or 30 months following the Restructuring Date for other Deliverable Obligations[3]
Multiple Holder Obligation	None	Applicable[4]	Applicable	Applicable
Deliverable Obligations – Transferability	Note the Deliverable Obligations characteristic that may be specified	Note the Deliverable Obligations characteristic that may be specified	Must be Fully Transferable – no consent required	Obligation may be Conditionally Transferable (consent cannot be unreasonably withheld or delayed)[5]
Eligible Transferee[6]	Not applicable	Not applicable	Eligible transferee subject to minimum asset test of at least $500m	No minimum asset test

[1] Note that the Restructuring Date is not a defined term for Deliverable Obligations other than Bonds or Loans. [2] Note this is subject to a proviso that the Restructuring Maturity Limitation Date shall not be earlier than the Scheduled Termination Date and not later than 30 months after the Scheduled Termination Date. [3] Again, there is no definition of the Restructuring Date where the Deliverable Obligation is not a Bond or Loan. [4] Multiple Holder Obligation applies unless disapplied. Note, the application of the Multiple Holder provisions are amended where the terms of the May 2003 Supplement are applied to a transaction. [5] Bonds must still be fully transferable. [6] The Eligible Transferee is the person to whom the Restructured Deliverable Obligation must be capable of being delivered.

However, restructuring has proved controversial not only in relation to the definition of the credit event but also with regard to what a buyer can deliver under a physically settled CDS once a restructuring has occurred.

The first major catalyst to debate in this area arose in the light of the restructuring of the debt of the Indianapolis-based insurance company, Conseco Inc., in October 2000.

In this case, protection buyers under physical CDS looked to deliver to sellers the cheapest deliverable obligation available. This included long-dated restructured debt that was trading both significantly below par (as might be expected), but also significantly below the rate of other, nearer dated, debt. Largely as a consequence of Conseco, the market in US corporate credit embraced a concept referred to as Mod-R as the documentary starting point for CDS transactions. Mod-R, the main provisions of which are summarised in *Table 1*, imposed limitations on the range of restructured obligations that a buyer could deliver in accordance with its settlement obligations.

The effect was to provide a greater degree of comfort to the protection seller in relation to the nature and value of the restructured obligation that represents the buyer's cheapest deliverable obligation available. However, the market is divided on the restructuring issue. The market in European names initially retained a preference for trading under what might broadly be described as Old-R (ie, restructuring with only limited amendments). One of the reasons for this relates to the fact that CDS transactions that do not include restructuring, or which include it in a modified form, have not always received favourable regulatory capital treatment.

Early in 2003 a revised approach to restructuring (again, principally in relation to what could constitute deliverable obligations rather than the definition of the event itself) emerged; it was briefly referred to as Mod-Mod-R. Mod-Mod-R, which in essence appears in the 2003 Definitions as the 'Modified Restructuring Maturity Limitation and Conditionally Transferable Obligation', sought to bring the US and European markets back in line with an approach to the deliverable obligations which, to a certain extent, can be seen as a compromise between Old-R and Mod-R on the restructuring maturity limitation issue.

Since the publication of the 2003 Definitions, the market in European names has taken up Mod-Mod-R as its documentary standard. The Japanese market, adopting a slightly different position again, has not traditionally been keen to embrace either form of modified restructuring, and indeed often does not include restructuring at all. It may be that the market in CDS without restructuring will develop more generally amid concerns, among others, that modified restructuring has been consistently over-priced in the market.

MULTIPLE HOLDER OBLIGATIONS. It came as little surprise when, in the May 2001 Restructuring Supplement to the 1999 Definitions, ISDA published language dealing with the issue of multiple holder obligations. This language, which is directly relevant to a company hedging trade receivables owed to it or credit risk on income derived from any other form of bilateral contract such as a vendor finance agreement, seeks to address the 'moral hazard' associated with a party to such bilateral arrangement agreeing to a restructuring of an obligation while being a protection buyer under a CDS written on those obligations. Clearly, an example where this could be problematic might be where a vendor financier buys protection on its customer under a CDS, agrees a 'soft' restructuring of the terms of the credit facility, and then calls for payment under the CDS.

It is worth bearing in mind the proviso to the definition of restructuring that provides that 'restructurings' which do not, directly or indirectly, lead to a deterioration in the credit worthiness or financial condition of the reference entity, do not constitute credit events.

Nonetheless, the moral hazard associated with such bilateral arrangements is clear to see, and the multiple holder obligation language seeks to address the problem by imposing the following two conditions on the obligations that qualify for a restructuring.

- The obligation, at the time of the restructuring, must be held by more than three non-affiliate holders.
- Under the terms of the obligation being 'restructured', at least 66 and two thirds of its holders must be required to consent to the event constituting the restructuring.

One of the difficulties this raises is that the second proviso does not simply require that a majority of holders of an obligation agree to its restructuring, but rather that under the terms of the obligation, a two thirds majority are required to agree. As a consequence, even if 100% of the holders of an obligation agree to its restructuring, the obligation in question will fall outside the scope of a CDS (for the purposes of a restructuring only) if under its terms it could have been restructured with less than two thirds of its holders consenting. So, for example, a meeting of holders of an obligation that is quorate with a 75% attendance, and which then requires a 75% approval for a restructuring, is not going to satisfy the multiple holder obligation criteria even if, in fact, over two thirds of holders in total agree to the restructuring.

Where incorporated, the May 2003 Supplement addressed this issue by deeming the two thirds consent requirement satisfied. This is an important point to consider for end investors looking to hedge receivables or other bilaterally derived payment flows.

'OF ALL THE CREDIT EVENTS, RESTRUCTURING HAS PROVED THE MOST PROBLEMATIC AND CONTENTIOUS' MATTHEW DENING

In particular, users should note that the multiple holder obligation language (but without the deeming provision of the supplement) will automatically apply to any CDS under the 2003 Definitions, unless disapplied. As a consequence, any hedge of a bilateral obligation will not be triggered on a restructuring unless the language is disapplied or amended.

As a practical matter, it may be that a party to a hedge takes the view that either a restructuring of a bilateral arrangement is unlikely to occur or is at least likely to be within its control. In addition, the multiple holder obligation language only applies to a restructuring. Any subsequent failure to pay will be covered as a credit event in the normal way. Nonetheless, any corporate hedging its credit exposure in respect of trade receivables owed to it should bear in mind the way in which a multiple holder obligation works.

As a footnote to the issue of CDS written on bilateral obligations, the question might arise as to how the buyer will satisfy the publicly available information condition to settlement (if applicable) being – in all likelihood – the sole source of information relating to a credit event. Buyers in such circumstances need to consider whether the terms of any agreement establishing an obligation with a customer that is a reference entity include confidentiality provisions or other terms that will prevent the buyer from publishing details of any credit event. Many buyers would not want to have to issue proceedings in order to establish an alternative source of the information in the form of, for example, court filings. As a practical matter, it may be that the protection buyer, although using the CDS as a means of hedging exposure to a specific obligation, may prefer to wait until a reference entity defaults on its obligations in the market generally (which is likely to generate sources of publicly available information) before calling for settlement under such CDS.

CREDIT EVENTS AND THE OBLIGATION CATEGORY. It is generally the case that a CDS written on a US or European corporate name will only include bankruptcy, failure to pay and a form of restructuring. Obligation acceleration was dropped from standard corporate CDS transactions on European names as a 'soft' credit event in April 2002. It is generally accepted that protection buyers lose relatively little protection because of the omission on the basis that, once accelerated, sums due under an obligation are thereby likely to become immediately due and payable, thus presenting the possibility of a failure to pay.

However, a buyer looking to hedge its exposure to a reference entity in respect of particular obligations may need to consider the acceptability of 'borrowed money' (the standard approach), rather than 'payment', as the applicable obligation category. Clearly, where the protection buyer is using the CDS to hedge exposure to an obligation that does not relate to borrowed money, specifying borrowed money as the obligation category increases the potential basis risk between the protection afforded by a CDS and the buyer's exposure to the underlying obligation.

NON-CONTINGENCY AND DELIVERABLE OBLIGATIONS. Under the 2003 Definitions, 'not contingent' is no longer available as a standard obligation characteristic, ie, as a qualifying feature of an obligation covered by the CDS. However, it does remain as a deliverable obligation characteristic. This is a logical development, since the question of an obligation's being subject to a 'contingency' is clearly material to its potential value (and therefore relevant to the parties to a physically settled CDS), but is not so obviously relevant to the 'credit' of the obligation or reference entity.

The question of interpreting the 'not contingent' characteristic has proved controversial, with CSFB and Nomura litigating the issue of the eligibility as deliverable obligations of certain vanilla convertibles issued by Railtrack plc following Railtrack's default in 2001. While the issues raised in this case have been dealt with, to a great extent, in the supplement relating to Convertible, Exchangeable or Accreting Obligations, which ISDA published on 9 November 2001 (and carried through to the 2003 Definitions), interpreting the characteristic in the context of agreements relating to vendor finance is less clear. Parties should bear in mind that the market standard approach to deliverable obligations on a US or European corporate name typically specifies 'not contingent' as an applicable characteristic. The appropriateness of this for bespoke hedges should be considered carefully and must, for obvious reasons, be reconciled with the terms of the obligation being hedged.

A standard corporate CDS would also typically specify bond or loan as the deliverable obligation category. Clearly, such an approach may well be inappropriate where a buyer is hedging exposure to the credit risk associated with trade debts which are owed to it, where the reference entity does not have debt generally available in the market. More generally, where a CDS is used to hedge specific bilateral exposure, and the CDS is subject to physical settlement, the buyer needs to take care to ensure that the obligation being hedged is capable of being delivered as a deliverable obligation under its own terms, irrespective of whether the 'not contingent' deliverable obligation characteristic applies. For example, deliverable obligations that are subject to rights of set-off are not eligible for delivery to the seller under Section 8.2 of the 2003 Definitions[2]. A physically settled CDS where the buyer is short a deliverable obligation is clearly of little value if the buyer cannot source a deliverable obligation after a credit event.

OTHER DEVELOPMENTS. The 2003 Definitions have seen a range of other issues introduced into the negotiation and documentation of CDS. For example, there are new buy-in procedures for bonds and alternative settlement procedures for loans, which potentially create problems in terms of finality when realising termination dates under a CDS. Recent language that ISDA has published seeks to address these problems by imposing limits on the period for which the alternative settlement procedures can run post-physical settlement date before a termination date is imposed.

Furthermore, difficulties in applying the successor provisions to the demerger of Six Continents also suggest that the identification of successors to reference entities following consolidations, demergers and spin-offs remains problematic. This, among a range of issues, is likely to prove a source of continued discussion and debate notwithstanding the publication of the 2003 Definitions.

Matthew Dening is a Partner and Chris Allen is an Associate, both at Baker & McKenzie in London.
matthew.dening@bakernet.com
chris.allen@bakernet.com
www.bakernet.com

Notes

[1] For example, see the recent litigation between Eternity Global Master Funds Ltd v. Morgan Guaranty Trust Co. of New York and JPMorgan Chase Bank.

[2] Even where the deliverable obligation is a reference obligation with no applicable deliverable obligation characteristics.