Feature

KEY POINTS

- In recent times, distressed corporate borrowers have become better informed about and advised on how credit derivatives might impact a planned debt restructuring and also how the structure and timing of such a restructuring can affect the value and utility of credit derivatives entered into by their creditors. This information has allowed distressed corporate borrowers to be more strategic in the planning of the restructuring of their debt.
- Regulators in the UK and the US are now focussed on the potential for the integrity of the global market for credit derivatives to be undermined by strategic co-operative behaviour between distressed corporate borrowers and stakeholders who have bought or sold credit protection.
- Amendments made to the standard terms of credit derivative contracts in response to this regulatory attention goes some way to clarifying the intended operation of these highly complex instruments, but careful analysis of such terms will continue to be necessary for distressed corporate borrowers looking to have the greatest influence on their creditors' behaviour during a workout.

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The influence of credit derivatives on corporate debt restructuring

In this article Jeremy Green considers some of the novel issues arising from the presence of credit derivatives in corporate debt restructuring for distressed companies, buyers and sellers of protection, their respective advisers and regulators and policy makers.

By the end of the first half of 2008, the global credit derivatives market was at an all-time high, with a notional value of US$68trn.[1] At the time, with signs of an imminent global financial and economic crisis becoming clearer by the day, I asked the question, "Should the presence of protection purchased under a credit derivative be expected to alter the behaviour of traditional bank lenders towards their distressed corporate borrowers?".[2] The tentative answer at the time was as follows:

> "When credit derivatives have been written on entities that subsequently encounter financial distress, and the buyers of protection under those derivatives are lenders to the distressed entity, the distressed entity that approaches its lenders to discuss restructuring its finances may well find that all is not what it seems at the negotiation table. A lender which previously may have been relied upon to have a keen interest in seeing the distressed entity restored to health may have altogether different motivations and may approach any negotiated restructuring with an eye on the terms of its credit derivative to ensure that the terms of any standstill or restructuring agreement satisfy the necessary conditions to trigger a credit event and the payment of a settlement amount …"[3]

Since then, the historic events of the intervening years and the global regulatory and industry responses to them have resulted in significant changes to the way in which credit derivative transactions are documented, traded, cleared, and settled. These changes – and, in particular, the standardisation of the terms of credit derivative contracts, which has facilitated the use of portfolio compression techniques and central counterparty clearing of credit derivatives[4] – have resulted in the notional value of the credit derivatives market contracting to US$8trn as at the end of 2018.[5]

However, the change in the structure, operation and size of the credit derivatives market has not made this question less relevant. Rather, this sustained period of corporate financial distress has provided numerous illustrations of the operation of credit derivatives in the restructuring process, many of which have stimulated considerable academic, journalistic, and regulatory interest in – and commentary on – the impact of credit derivatives on corporate debt restructuring. Much of this commentary has focussed on either individual events that have produced what the commentator appears to regard as a curious outcome, or on conduct of the kind that Andrew Bailey, the chief executive officer of the Financial Conduct Authority (FCA), has referred to as being on "the wrong side of the line".[6]

It is little surprise that the FCA is interested in credit derivatives – after all, credit derivatives will often fall within the ambit of the English insider dealing and European market abuse regimes, particularly where the reference entity has securities which are traded, or admitted to trading on a relevant European market or platform[7] – or that the FCA holds the view that "manufactured credit events may in certain circumstances constitute market abuse".[8]

So concerned have the FCA and the international regulatory community become about so-called "manufactured" or "engineered" credit events[9] that, in June 2019, the leaders of the FCA, the Commodity Futures Trading Commission (CFTC), and the Securities and Exchange Commission (SEC) issued a joint statement warning that "opportunistic strategies in the credit derivatives markets … may adversely affect the integrity, confidence, and reputation of the credit derivatives markets … [and] raise various issues under securities, derivatives, conduct and antifraud laws, as well as public policy concerns".[10]

In response to this heightened press and regulatory scrutiny, the International Swaps and Derivatives Association, Inc (ISDA) recently published amendments to the standard terms of credit derivative transactions designed to address what ISDA refers to as "narrowly tailored" credit events. Primarily, narrowly tailored credit events are agreements by the company to default on certain of its debts or otherwise conduct itself in a manner that is designed to trigger a credit event under credit derivative contracts while minimising the impact of such default or behaviour on the company itself.[11]

And, so, it seems, for now at least, that part of the solution to what regulators regard as potentially abusive market conduct is an industry-led, contractual amendment to the standard terms of credit derivative contracts. This is clearly no panacea for the broader issues of market integrity (as the FCA, SEC and CFTC noted in their joint statement on 19 September 2019[12]), but it serves as a useful reminder that the terms of the credit derivative are critical. It should not be forgotten that a credit derivative is, fundamentally, just another privately negotiated, bilateral contract, which provides for certain pre-defined consequences of the occurrence of certain pre-defined events. The determination of whether the contractual criteria have been met for the occurrence of a credit event or the necessary conditions have been met for settlement to occur under a credit derivative contract is necessarily an objective one to be determined in accordance with the terms of that contract. As ISDA stated:

> "Whether any specific … arrangements meet the definition of a credit event under the ISDA Credit Derivatives Definitions will be determined by one of five regional Credit Derivatives Determinations Committees (DCs) …. Under the DC rules, a determination can only be made based on publicly available information submitted to the DC. This information is then analyzed against the criteria for credit events within the ISDA Credit Derivatives Definitions to determine whether a credit event has occurred. The credit event determination process does not allow the DC to make subjective decisions, or to consider the intent or good faith of the parties that put in place the arrangements leading to a potential credit event. This ensures the process is objective and predictable, and decisions can be made quickly."[13]

However, the terms of credit derivative contracts are spread across an amalgam of many documents and are highly technical and intended to be capable of application in myriad factual circumstances. It has been said that "… one of the major barriers to new entrants in the [credit derivatives] market is the required level of expertise. Despite attempts to simplify [credit derivatives] … it necessarily remains relatively more complex than cash bonds … [A] detailed understanding of the contractual terms relating to credit events and the relationship with underlying reference entities is essential, and the product can provide pitfalls for the unversed".[14]

Interestingly, in the debate over the propriety of the conduct of participants in the credit derivatives market and in arriving at a contractual solution, little has been said by commentators or regulators about one seemingly relevant contractual term of every credit derivative contract. Section 11.1(b)(iii) of the 2014 ISDA Credit Derivatives Definitions records an agreement that the buyer and seller of protection are deemed to have made with each other, which reads as follows (with emphasis added):

> "Buyer and Seller shall each be deemed to agree with the other that … each party and its Affiliates … may deal in the Reference Obligation, each Obligation, each Deliverable Obligation and each Underlying Obligation and may … generally engage in any kind of commercial or investment banking or other business with, the Reference Entity … [or] any Affiliate of the Reference Entity … and *may act (**but is not obliged to act**) with respect to such business in the same manner as each of them would if such Credit Derivative Transaction did not exist, regardless of whether any such action might have an adverse effect on the Reference Entity … or the position of the other party to such Credit Derivative Transaction* or otherwise (including, without limitation, any action which might constitute or give rise to a Credit Event) … "

This provision makes clear that a party to a credit derivative transaction is not obliged to deal with the reference entity in the same way as it would have done had it not entered into the credit derivative transaction, even if to do so would have an adverse effect on the reference entity or the other party. That is, for example, the buyer of protection does not owe to the seller of protection a duty to behave (in its dealings with the reference entity) as the buyer would have done had it been an unhedged creditor of the reference entity. Rather, the buyer can act in connection with the restructuring of the reference entity with one eye on the protection it has bought and in doing so may act in a manner that is ultimately adverse to the seller. However, a question arises as to how far a party to a credit derivative transaction can go in its dealings with the reference entity with a view to triggering (or to avoiding triggering) a payment under that transaction.

The recent amendments made by ISDA to the failure to pay credit event make clear that such credit events are intended to be triggered only where the payment default directly or indirectly results from, or results in, a deterioration in the creditworthiness or financial condition of the reference entity.[15] Substantially the same standard applies to the restructuring credit event.[16] However, it is an open question as to whether s 11.1(b)(iii) of the 2014 ISDA Credit Derivatives Definitions might excuse a buyer under a credit derivative who reaches an agreement with a distressed reference entity to manufacture a credit event in order to benefit from the protection provided by the derivative contract. It is likely to depend upon the circumstances as a whole. By way of example, in the context of a *bona fide* restructuring, one can see arguments in favour of defending an agreement reached by the distressed reference entity and a creditor who has bought protection under a credit derivative pursuant to which the reference entity agrees to take a legitimate course of action in its restructuring plans, which would also trigger a credit event, in order to secure that creditor's support for the restructuring plans of the company or the provision of a new line of credit to the corporate group that would be otherwise unavailable and the absence of which would threaten the viability of the group and its business as a whole.

From this example alone it can be seen that, for a company in financial difficulty, credit derivatives present highly sensitive, complex and often novel issues and risks for the board and management of the company (and its advisers) to consider as part of the broader planning for the survival of the company. It is now quite commonplace for a distressed entity that is contemplating a restructuring of its debt to appoint not only insolvency, restructuring, financial, accounting, and tax advisers, but also advisers with expertise in credit derivatives. The situation is complicated further by the fact that a company facing a debt restructuring commonly will not have a clear (or, sometimes, any) insight into which of its creditors may have bought or sold protection under a credit derivative nor, therefore, how its creditors may be motivated to act in restructuring negotiations. It is not always apparent, for example, whether a holder of a company's bonds has bought credit protection as a partial hedge for its exposure under the bonds or whether such bondholder is not really a "true" bondholder at all, but an arbitrageur engaging in a basis trade whose only consideration is ensuring the safe and timely settlement of its credit derivative transaction. Equally, a white knight offering new money or some other rescue plan may be motivated by having sold protection under credit derivatives and, as a consequence, will be keen to extract from the company an agreement to terms of the restructuring that ensure that it can never be called for payment under those credit derivatives.

As a consequence, advice is now regularly sought as restructuring alternatives and rescue plans are unearthed and considered, so as to ensure the company understands the effect of each alternative on buyers and sellers of credit protection. It is becoming increasingly common for a well-advised distressed company to take this advice as part of its scenario planning, to put itself in the best position to successfully and lawfully negotiate with each class of its creditors.

In doing so, the first issue to be resolved is to determine which entity (or entities) in the group is the (or are a) reference entity on which credit protection may be bought and sold in the credit derivative market. If multiple group entities have issued debt, it may be the case that credit protection is only traded in the market on one or some of those entities. Equally, it may not matter if the reference entity on which credit protection trades has not issued any debt itself, as it is possible for a failure to pay or restructuring credit event to be triggered where the reference entity is a guarantor of debt issued by another group entity.[17] If the company's restructuring plans do not involve a reference entity on which credit protection is offered in the market, then it is unlikely that a credit event can be triggered.

If, for example, a company in financial distress is contemplating a scheme of arrangement under Pt 26 of the Companies Act 2006 in respect of a reference entity, the company will often wish to understand whether the proposed scheme will trigger a credit event. The initial filing with the court may not trigger a bankruptcy credit event (depending upon, perhaps, the nature of the orders sought from the court or the relief that the scheme may provide),[18] but it is certainly possible for such a scheme to trigger a credit event once the scheme has become effective. Whether in fact a scheme that has been sanctioned by the court and become effective will trigger a bankruptcy credit event will depend upon whether such a scheme can properly be regarded as a "general … scheme … with or for the benefit of its creditors generally".[19] This can be a very complicated question of fact. For example, a scheme that binds only one class of creditors may be unlikely to trigger a credit event, unless that scheme could be viewed as being for the benefit of creditors generally.

Even if the scheme of arrangement itself does not trigger a bankruptcy credit event, the effect of the scheme of arrangement could still trigger a credit event or may have other impacts on the credit derivatives that have been written in relation to the company. For example, if the effect of the scheme were to be that the terms of the bonds issued or guaranteed by the reference entity were to be amended so as to extend the maturity date of the bonds (and the scheme bound all holders of those bonds), this could trigger a restructuring credit event.[20] Similarly, care needs to be taken with any statements as to the reference entity's financial position that are included in the documents that are filed with the court, to ensure that a bankruptcy credit event is not inadvertently triggered by virtue of a written admission of an inability of the reference entity generally to pay its debts as they become due.[21]

Debt for equity swaps are another common restructuring tool that raises complex questions for all concerned in credit derivative transactions. For example, if the debt for equity swap is to be effected by the scheme itself, the redemption and cancellation of the bonds could trigger a restructuring credit event (as this would probably result in a reduction in the amount of principal payable at redemption), but (if the reference entity had no other deliverable obligations) would result in there being no obligations of the reference entity left in existence. This would have the result that credit derivative transactions written in respect of that reference entity would be left incapable of being settled and therefore worthless.[22] Such an outcome may be welcomed by sellers of protection, but buyers of protection could be expected to want the debt for equity swap managed so as to allow time for credit derivatives to settle prior to the exchange occurring.

Finally, in recent times, the question of the use of lock-up agreements has been given some attention in the context of credit derivatives and corporate debt restructuring. It is quite commonplace for a distressed corporate to require its creditors to sign a contract, which restricts its creditors from selling or otherwise disposing of the debt that the creditor holds (other than to a transferee who agrees to be bound by the same restriction), pending implementation of the agreed restructuring. The question that arises in this context is whether the debt that is held by creditors who sign such a lock-up is capable of being delivered as part of the settlement of a credit derivative transaction. That is, can such a bond be a "Deliverable Obligation"? This question arises because, in order for bonds to be eligible for delivery as part of the settlement of a standard European corporate credit derivative transaction, such bonds must be "Transferable", which means they must be "transferable to institutional investors *without any contractual*, statutory or regulatory *restriction*".[23] Thus, the question becomes: is the lock-up agreement a contractual restriction that makes the bonds incapable of transfer to institutional investors?

The better view seems to be that an agreement between holders of bonds that would be otherwise "Transferable" ought not to be viewed as a contractual restriction on the transfer of bonds; rather, the definition of "Transferable" arguably is intended to exclude bonds that have transfer restrictions housed within their contractual terms. Were this not to be the case, two bondholders owning only a very small percentage of the aggregate value of the bonds outstanding could, by agreement between them, convert the entire issuance of bonds into something that cannot be Deliverable Obligations. However, where the lock-up agreement is struck between the reference entity and a significant majority of its creditors who own bonds, this analysis feels somewhat more strained. In these circumstances, very few bonds may be capable of transfer, as the majority of bonds could be transferred only to a seller of protection who was prepared to become bound by the same restriction on transfer (and would find itself in turn unable to on-sell those bonds unless it could find a purchaser willing to become bound by that same restriction).

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The ISDA Credit Derivatives Determinations Committee has had to consider this issue on at least three occasions. On each occasion, the Determinations Committee published the final list of Deliverable Obligations including the bonds that were subject to the lock-up agreement, but noted that transferors of such bonds cannot oblige the seller of protection to adhere to the lock-up agreement or to accept such bonds as part of the settlement of a credit derivative transaction.[24] That is, the compromise seems to have been that the bonds were considered to be "Transferable" and "Deliverable Obligations", but that any bonds that were subject to a lock-up agreement may not be delivered as part of settlement of a credit derivative transaction unless the seller of protection was willing to be bound by the terms of the lock-up agreement.

Thus, it can be seen that credit derivatives remain at the heart of corporate debt restructuring and continue to present novel and challenging issues for reference entities, buyers and sellers of protection, their respective advisers, and the regulators and policy makers. It is clear from the last decade of experience that credit derivatives do affect the motivations of creditors, but also increasingly the actions of distressed corporate entities, who are now equipping themselves with equally sophisticated advisers and using their knowledge of the operation of credit derivatives to drive a hard bargain with their creditors in restructuring negotiations in an effort to achieve a more favourable outcome for the company. ■

1 Bank for International Settlements, 'OTC Derivatives Statistics at end-December 2018', 2 May 2019 https://www.bis.org/publ/otc_hy1905.htm

2 J Green, 'The impact of credit derivatives on corporate debt restructuring', (2008) 19 JBFLP 97.

3 Ibid.

4 A useful precis of the role of portfolio compression and central counterparty clearing in transforming the credit derivatives market during the period 2007 to 2017 can be found in I Aldasoro and T Ehlers, 'The credit default swap market: what a difference a decade makes', *BIS Quarterly Review*, June 2018 https://www.bis.org/publ/qtrpdf/r_qt1806b.htm

5 Bank for International Settlements, 'OTC Derivatives Statistics at end-December 2018', 2 May 2019 https://www.bis.org/publ/otc_hy1905.htm

6 'Engineered Defaults Are "Wrong Side of Line" FCA's Bailey Says', *Bloomberg News*, 12 July 2018 https://www.bloomberg.com/news/articles/2018-07-12/engineered-defaults-are-wrong-side-of-line-fca-s-bailey-says

7 See Pt V of the Criminal Justice Act 1993 and point 1 of Art 3(1) of Regulation (EU) No 596/2014 and point 8 of s C of Annex 1 of Directive 2014/65/EU.

8 Financial Conduct Authority, 'Newsletter on market conduct and transaction reporting issues', *Market Watch* No. 58 (December 2018) at p 7.

9 Manufactured or engineered credit events commonly involve a creditor, who has bought (or sold) credit protection against a company's default, entering into restructuring arrangements with that distressed company such that the company will deliberately default or otherwise conduct itself in a way that is designed to ensure that such credit protection is (or is not) triggered for the benefit of that creditor.

10 Financial Conduct Authority, 'Joint statement on opportunistic strategies in the credit derivatives markets', 24 June 2019 https://www.fca.org.uk/news/statements/joint-statement-opportunistic-strategies-credit-derivatives-markets

11 See the 2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions (published on 15 July 2019) https://www.isda.org/book/2019-narrowly-tailored-credit-event-supplement-to-the-2014-isda-credit-derivatives-definitions/

12 Financial Conduct Authority, 'Update to June 2019 join statement on opportunistic strategies in the credit derivatives market', 19 September 2019 https://www.fca.org.uk/news/statements/update-june-2019-joint-statement-opportunistic-strategies-credit-derivatives-market

13 International Swaps and Derivatives Association, Inc., 'ISDA Board Statement on Narrowly Tailored Credit Events', 11 April 2018 https://www.isda.org/2018/04/11/isda-board-statement-on-narrowly-tailored-credit-events/

14 International Capital Markets Association, 'The European Corporate Single Name Credit Default Swap Market', February 2018 at p 42 https://www.icmagroup.org/assets/documents/Regulatory/Secondary-markets/The-European-Corporate-Single-Name-Credit-Default-Swap-Market-250518.pdf

15 See the amendments to s 4.5 of the 2014 ISDA Credit Derivatives Definitions made by the 2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions (published on 15 July 2019) https://www.isda.org/book/2019-narrowly-tailored-credit-event-supplement-to-the-2014-isda-credit-derivatives-definitions/

16 Section 4.7(b)(iv) of the 2014 ISDA Credit Derivatives Definitions.

17 A failure to pay or a restructuring credit event are events in respect of an "Obligation" of the reference entity "either directly or as a provider of a Relevant Guarantee": see s 3.1 of the 2014 ISDA Credit Derivatives Definitions.

18 This is because s 4.2(c) of the 2014 ISDA Credit Derivatives Definitions requires the reference entity to "make a … general scheme … or such a scheme becomes effective", neither of which could be said to have occurred merely as a result of having filed the necessary scheme documents with the court. However, it is plausible that the filing of a scheme could trigger a bankruptcy credit event under s 4.2.(d) of the 2014 ISDA Credit Derivatives Definitions if, for example, the sanctioning of the scheme would provide the reference entity with protection from its creditors similar to that which it would obtain in an insolvency.

19 Section 4.2(c) of the 2014 ISDA Credit Derivatives Definitions. Although, there may be other limbs of the definition of the bankruptcy credit event to consider as well.

20 Section 4.7(a)(iii)(B) of the 2014 ISDA Credit Derivatives Definitions.

21 Section 4.2(b) of the 2014 ISDA Credit Derivatives Definitions.

22 Although the outcome may be different if the reference entity is a financial institution.

23 Section 3.14(b)(iv) of the 2014 ISDA Credit Derivatives Definitions.

24 See the New Look Senior Issuer plc – Final List (3 June 2019) https://www.cdsdeterminationscommittees.org/documents/2019/06/new-look-senior-issuer-plc-final-list-deliverable-obligations.pdf; Noble Group Limited – Final List (18 April 2018) http://www.cdsdeterminationscommittees.org/documents/2018/04/noble-final-list.xls; Grupo Isolux Corsan Finance B.V. – Final List (18 August 2016, as updated on 19/8/16) https://www.cdsdeterminationscommittees.org/documents/2016/08/isolux-final-list.pdf