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Introduction

In a corporate collapse, a creditor of a distressed company has an economic interest in identifying the preferred way in which its return is maximised. Typically, this may involve the acceptance by a financier of waivers of defaults, extensions of time, and on occasions, and the release of part of the outstanding indebtedness or a conversion of the debt into equity. This mechanism breaks down if a holder of a debt lacks that economic interest in maximising the recovery of its outstanding indebtedness.

The severance of exposure from ownership of a debt may arise in a number of ways. A financier may have sold down its debt to a third party even though that financier may remain the lender of record; or a financier may have entered into a participation arrangement with a third party such that in the event of default, that financier looks to its participant for recovery rather than to the distressed entity. More recently, it is equally likely that a financier may have entered into a credit default swap (CDS) with a third party.

Up until the latest credit crisis, the role of financiers had been evolving with many focusing on the origination and syndication of corporate loans rather than holding them to maturity. The ability to originate and syndicate depended on an ongoing relationship between the financier and its borrower. If a bank sold a loan which it has originated, this might damage that relationship. If, however, the financier purchased a CDS, it may reduce its exposure to its borrower and at the same time, retain the loan on its books thereby maintaining the relationship with that borrower.

A CDS arrangement may encompass all or a part of that financier's exposure to a borrower. In effect, the buying of protection under a CDS operates as a form of credit insurance, even though as a matter of law, it is quite distinct from insurance[1]. In the first two types of protection mentioned above, the lender of record is usually required to act on the instructions of the economic owner of the debt or of the entity which ultimately bears the risk of loss. In the case of a CDS, the seller of protection usually has little input into the way in which a buyer of protection deals with the borrower. At the same time, the lender of record that is fully covered by a CDS may have little incentive to participate in a workout.

In its survey of the risks associated with private equity, the Financial Services Authority in the United Kingdom noted that the diversity in debt ownership, whilst spreading exposure, resulted in 'increased complexity in managing a corporate restructuring, or default workout, involving a large number and variety of investors.'[2] There have also been suggestions that

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1 *Aeon Fin Prods, Inc, v. Société Generale,* 476 F. 3d 90 96 (2d Cir. 2007) (noting that credit default swaps differ significantly from insurance contracts as "they 'do not and are not meant to indemnify the buyer of protection against loss'" but
"'[r]ather allow parties to 'hedge' risk by buying and selling risks at different prices and with varying degrees of correlation'") (citations omitted).

2 *Private equity: a Discussion of Risk and Regulatory Engagement'.* (Feedback Statement 07/03), Financial Services Authority, (June 2007) at 22 (FSA Survey).

the INSOL Approach'[3] for negotiating a workout is no longer suitable where there is such a diversity of investors.

This paper analyses the typical single named CDS and then considers whether the holding of credit protection by financiers poses additional risks for effecting a workout.

Description of a Credit Derivative

A "derivative" is a contract between two parties where the value of the contract is determined by reference to an external circumstance. Thus derivatives have been used to hedge (or speculate on) risks in connection with interest rates, currency exchange rates and the price of commodities. Since the mid 1990s, the external circumstances that are the subject of derivatives have expanded to cover hedging of and trading in credit risk. CDSs have accounted for much of the development in the use of derivatives by market players.[4]

A CDS should be distinguished from a portfolio credit default swap, a collateralised debt obligation and a credit linked note even though such instruments may have an economic function similar to a CDS. A description of these other forms of instrument is set out in the Appendix.

The majority of CDSs are effected by dealers in the over-the-counter market. The contracts are usually recorded in standard form documentation published by the International Swaps and Derivatives Association, Inc. ('ISDA').

The standard documentation consists of:

- an ISDA 'Master Agreement' (the 'master agreement'), which particularises matters such as events of default, representations and warranties, covenants, liquidated damages, and choice of law;
- a 'Schedule' to the master agreement, which modifies the master agreement to reflect the specific requirements of the parties;
- a 'Confirmation' (the 'confirmation') which stipulates the economic terms of each individual transaction, and incorporates by reference not only the master agreement but also any definitions referable to the subject matter of the derivative;
- In the case of a CDS, the '2003 ISDA Credit Derivatives Definitions' (the 'credit definitions'), which are of particular importance; and
- 'Credit Support Documents' where the contracting parties have differing credit quality and security is required.

A typical single name CDS may be represented diagrammatically as follows: [5]

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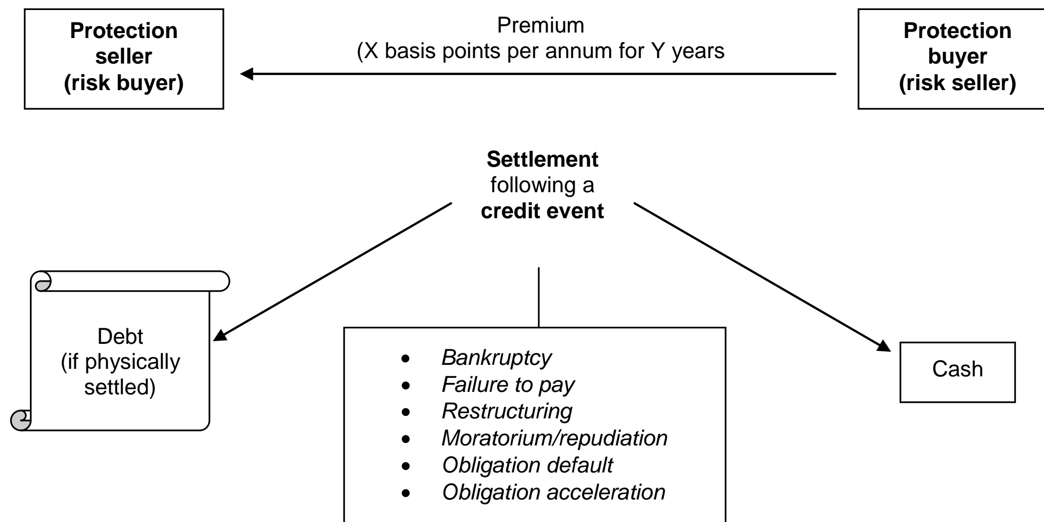
[3] See *Statement of Principles for A Global Approach to Multi-Creditor Workouts,* (INSOL International, October 2000). The principles represent best practice for multi-creditor workouts and are broadly consistent with the so called 'London Rules.'

[4] David Yeres, *An Overview of the Uses of and Issues Surrounding Credit Derivatives, in Nuts & Bolts of Financial Products 2007,* at 529,531 (PLI Corp. Law & Practice, Course Handbook Series No B-10870, 2007) ('The International Swaps and Derivatives Association, Inc…estimates that the notional value of credit default swaps grew alone by 52% during the first half of 2006 to reach a notional value of over US$ 26 trillion. This is up from US$ 2.60 trillion in 2003').

[5] Taken from *Credit Derivatives in Restructurings a Guidance Booklet* (INSOL INTERNATIONAL, September 2006) (INSOL Guide). This booklet is an excellent introduction to the issues which arise in this area.



As illustrated in the above diagram, one party (the 'protection buyer') will pay another (the 'protection seller') for assuming the risk on a specified principal amount (the 'notional amount') of debt (the 'reference obligation')[6]. of a specified entity (the 'reference entity')[7]. during a specified period (the 'tenor').

The protection buyer pays the protection seller a premium, made up of a series of fixed payments made (typically, quarterly in arrears) and computed at a fixed rate per annum on the notional amount. In return, the protection seller agrees to pay all or, more usually, a certain portion of the notional amount upon the happening of one or other of the events particularised in the diagram (a 'credit event'). If a credit event does not occur during the term of the CDS, the protection buyer will not receive any payment at all from the protection seller.

In specifying the economic terms, the confirmation will include of the following:

- the notional amount;
- the reference entity;
- the reference obligation;
- the tenor;
- the premium; and
- the settlement method, which may either, be physical settlement or cash settlement.

After the occurrence of one of six credit events[8] described in the above diagram, either the protection buyer or the protection seller must deliver a 'Credit Event Notice' (the 'credit event notice') to the other, which describes the credit event and of its formal request to settle

[6] The obligations are typically confined to obligations to bondholders but may also include obligations under a guarantee.

[7] Single named CDSs may include provisions identifying a successor entity if the reference entity is subject to merger such that the cover continues in respect of the successor entity.

[8] It is common practice to select only three events: bankruptcy, failure to pay and restructuring; See paragraph 5.2 of the INSOL Guide infra note 5.

the CDS[9]. The mechanics of settlement depend on whether the confirmation for the CDS stipulates physical settlement or cash settlement.

In the physically settled CDS, the protection seller must pay to the protection buyer the notional amount in cash, in exchange for the buyer physically delivering a debt obligation to the protection seller (measured by principal amount or the fair market value of the reference obligation as at the date of the CDS).[10] The CDS will usually also require the contemporaneous delivery of a notice of publicly available information. This notice is required to cite information referable to the occurrence of the identified credit event as published in a recognised source[11].

In cash settled CDS, the protection seller pays the protection buyer the difference between (i) the original principal amount of the reference obligation (or its fair market value on the date of the CDS) and (ii) the market value[12] of the reference obligation after the credit event occurs. Alternatively, the parties may stipulate the price by reference to a formula which estimates the actual amount recoverable by the protection buyer in connection with the reference obligation.

Historically, a physically settled CDS was more common than a cash settled CDS[13]. The advantage of a physically settled CDS is that it does not necessitate the calculation of the value of the reference obligation after a credit event occurs - a time when the market for reference obligations may be distorted. However, the notional amount of CDSs for many reference obligations far exceeds the aggregate amount of reference obligations on issue. As a consequence, the market for reference obligations may be distorted after a credit event, as protection buyers of physically settled CDSs struggle to obtain sufficient amounts of the reference obligations to satisfy their delivery obligation.

In the collapse of the US reference entity Delphi, only $2 billion in reference obligations were on issue in the market and were available for delivery. Yet Delphi was referenced by $28 billion in notional amount. [14] Following the commencement of Delphi's bankruptcy, protection buyers scrambled to find the then relatively rare Delphi reference obligations. At

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9 *Practical Guide to 2003 Definitions* 99-100.

10 The confirmation usually stipulates the specific obligations of the reference entity which would satisfy the delivery obligation. Commonly, the delivery condition is satisfied by the delivery of any senior unsecured and unsubordinated loans in an agreed currency. In *Nomura International plc. v. Credit Suisse First Boston International,* [2003] 2 All ER (Com) 56, there was a dispute as to whether the delivery of convertible bonds satisfied the delivery obligation. The parties had stipulated a 'Non Contingent' delivery obligation. It was held that the delivery of conditional bonds convertible at the holder's option did not render the bonds contingent for the purposes of the credit definitions.

11 The confirmation would usually specify the source. It may also include information from a trustee, paying agent, fiscal agent or clearing agent. In *Deutsche Bank AG v. ANZ Banking Group Ltd*. 2000 WL 1151384 (QBD Comm. Ct) the provision of a news article confirming a late payment was held to have satisfied this requirement.

12 Quotes are obtained from dealers during a specified period following the occurrence of a credit event. However, other methods are evolving. See INSOL Guide infra note 5 at paragraph 5.7.

13 As at 2003/2004, it was estimated that approximately 86% of CDS were settled physically. See BBA *Credit Derivatives Report 2003/2004.* This percentage has probably diminished since 2004. For CDS referencing structured finance facilities, it is standard practice to select cash settlement because of the small issue size makes physical settlement difficult. See Moorad Choudhry, *Credit Derivatives and Structured Financial Products: Transforming the Debt Capital Markets,* Euromoney, Nov. 2004 at 2.

14 Compare the Marconi restructuring discussed below, where it was estimated that the market in Marconi swaps exceeded the $4 billion the company owed its creditors.

the same time, the price of Delphi notes increased to a price of 70% of par when the price had been 63% of par before the commencement of the bankruptcy proceedings[15].

By way of response to the difficulty in obtaining debt obligations to satisfy the physical settlement requirement, ISDA has promulgated a series of protocols[16] permitting the cash settlement of CDS which, as originally agreed, contemplated physical settlement. Parties may follow the ISDA procedure in adopting the protocol for an identified reference obligation and thereby mutually agree to amend their original contract. The take up rate of the protocols has been high[17].

If the parties select the restructuring credit event, they must also stipulate whether their deliverable obligation involves 'Full Restructuring', 'Modified Restructuring' or 'Modified Modified Restructuring'.

Under the first alternative, which applies in default of the selection of any other alternative, there is no restriction imposed on the maturity or transferability of obligations in order for them to be deliverable[18].

If notice is given of the occurrence of a restructuring credit event and if the parties have selected 'Modified Restructuring,'[19] then the deliverable obligation must have a final maturity date no later than the earliest of:

- 30 months after the scheduled termination date of the CDS;
- 30 months after the effective date of the restructuring; and
- the latest final maturity date of any restructured loan or bond,

and in the case of a loan be transferable to an 'Eligible Transferee'[20] without consent. If the deliverable obligation is a bond, then the bond must be transferable without restriction[21].

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[15] Quoted from Jay M. Goffman, Mark A. McDermott and Andrew Thau '*Distressed Investing: Selected Topics'* (an unpublished paper presented as seminar conducted by the American Bankruptcy Association in October 2007 at Georgetown University Law Center)('Goffman') at note 11.

[16] For example ISDA has published the following protocols in relation to index products: the *2005 CDS Index Protocol* (relating to Collins & Aikman Products Co., a US supplier of automotive parts and the *2005 Delta & Northwest CDS Protocol* (relating to Delta Airlines, Inc. and Northwest Airlines, Inc.). Further examples are available at www.isda.org.

[17] Goffman infra note 15 at 18.

[18] Long dated bonds may trade at a price considerably lower than short dated paper reflecting the market's opinion of the long term prospects of the reference entity. In the 2000 restructuring of Conseco in 2000 (involving a debt extension), this occurred allowing the protection buyer to deliver not loans (trading at 92% of par) but long term Conseco bonds trading at 66%-90% of par thereby delivering a windfall gain to the protection buyer. See further Goffman infra note 15 at 13.
The other alternatives discussed in the text were intended provide mechanisms for avoiding such an outcome. The first alternative is largely reflected in Section 2.32 of the credit definitions and gained the market title 'Modified Restructuring' and largely reflected US practice at the time rather than European practice. To bring US and European practice further into accord and because European bonds had a shorter term and contained more restrictive transfer restrictions than was the case with US bonds, the 'Modified Restructuring' option was further changed. The further alternative gained the market title 'Modified Modified Restructuring' and is reflected in Section 2.33 of the credit definitions. See further Chris Allen and Matthew Dening, *A Question of Definition*, The Treasurer, (November 2003) 19.

[19] For more detail see credit definitions Section 2.32. In Australia and New Zealand, it is the usual practice to adopt the 'Modified Restructuring 'alternative.

[20] credit definitions Section 2.32(f).

[21] credit definitions Section 2.20(b) (v) and Section 2.32(b).

If notice is given of the occurrence of a restructuring credit event and if the parties have selected 'Modified Modified Restructuring'[22], then the deliverable obligation must have a stated maturity no later than the later of:

- the termination of the CDS; and
- 60 months after the effective date of the restructuring (where there is a bond or loan) or 30 months after the effective date of the restructuring (in the case of all other deliverable obligations),

and be transferable to the protection seller without any requirement for consent (except for any consent of the obligor under the relevant loan documentation where such consent is not to be unreasonably withheld or delayed)[23]. This type of consent requirement is commonly seen in European loan documentation such as that used by the Loan Market Association.

In addition to modifying the requirements concerning term and consent, the class of persons to whom the obligation may be transferred is more specific and easier to satisfy.[24]

In the case of either 'Modified Restructuring' or 'Modified, Modified Restructuring,' the obligations to be delivered must be 'Multiple Holder Obligations'. That is, it is necessary that the obligations are held by no less that 4 unrelated entities and for at holders of at least 662/3% to consent to any changes in the loan documentation.[25]

The ISDA credit events[26]

In a CDS entered into outside the US, failure to pay, bankruptcy and restructuring constitute the usual risks which are covered. In the US, often the restructuring event may not be included.

(a) Failure to Pay

In the 'Multicurrency Term and Revolving Facilities Facility Agreement' published by the Asia Pacific Loan Market Association ('APLMA Agreement'), a failure to pay occurs if the borrower fails to pay any amount due under that document on the due date unless the borrower is given the option whereby the payment date may be extended because of administrative error or in some instances a disruption event[27].

By contrast, the ISDA Failure to Pay event[28], which is not identical, only arises if the borrower omits to effect payment on its due date (after taking into account any 'Grace Period' (a 'grace period')[29]) provided the amount is not less than a threshold amount (or $1 million if no amount is stipulated), and provided further the default relates to a specific obligation (commonly but not always 'Borrowed Money'[30]). Thus the quantum of the default sum in the APLMA Agreement may be less than the amount required for the ISDA failure to pay credit event while the grace period

[22] credit definitions Sections 2.33.
[23] In other words, the loan obligation does not have to be a 'Fully Transferable Obligation' (see credit definitions Section 2.33(b)) but need only be a 'Conditionally Transferable Obligation' (see credit definitions Section 2.33(b)).
[24] See credit definitions of 'Eligible Transferee' and 'Modified Eligible Transferee' in credit definitions Section 2.32(f) and Section 2.33(f) respectively.
[25] Ibid. Section 4.9.
[26] Ibid. Section 4.7.
[27] See for example APLMA Agreement clause 23.1.
[28] credit definitions Section 4.5.
[29] Ibid. Section 1.12(a).
[30] Ibid. Section 2.19.

in the latter document may be longer than that in the APLMA Agreement. For these reasons, the ISDA failure to pay credit event may not occur at all or may only occur at a point in time later than the occurrence of the non-payment event of default in the APLMA Agreement.

If a financier wishes to effect a workout, it is normally in its interests not to trigger a payment default. Because a payment default is one of the indicia of insolvency and because the directors of a borrower will have a justified concern about becoming personally liable for insolvent trading, a well advised financier without any credit protection would not want to trigger a payment default if it wished to avoid the resignation of those directors or the borrower going into voluntary administration. For these reasons, the failure to pay credit event may be of limited utility to a purchaser of a CDS, at least in the early stages of a workout[31].

(b) Bankruptcy

Likewise, the ISDA bankruptcy credit[32] event is not coterminous with the events in the APLMA Agreement dealing with insolvency and insolvency proceedings. In relation to the appointment of a liquidator, for example, the applicable clauses in the ISDA credit definitions and in the APLMA Agreement are engaged on the actual filing of court process unless the process is dismissed within an applicable grace period. In the ISDA bankruptcy credit event, the grace period is thirty days whilst in the APLMA Agreement could be for a shorter period.

The applicable provisions also cover the enforcement of a security by a secured creditor. In the ISDA credit definitions, the enforcement must extend to 'all or substantially all '[33]of the assets of the reference entity whilst in the APLMA Agreement, the enforcement needs to extend to assets having an aggregate monetary value.

The insolvency event of default is also engaged in the APLMA Agreement if the borrower or a member of the group of which it forms a part 'commences negotiations with one or more of its creditors with a view to rescheduling any of its indebtedness'[34]. There does not appear to be a similar provision in the ISDA credit definitions with the consequence that the insolvency event in the APLMA Agreement, in so far as it relates to a potential restructuring, may be engaged at an earlier point in time than would be the case with the former document.

There are thus differences as to the timing of the operation of the applicable clauses in each instrument. For present purposes, the fact that negotiation for a restructuring is an event of default in the APLMA Agreement but not in the ISDA credit definitions may mean that a 'restructuring' event of default in the former document is triggered at a much earlier point in time than would be the case in the ISDA credit definitions where the issue is addressed as part of the ISDA restructuring credit event.

The inability to issue a credit event notice under the ISDA credit definitions in these circumstances runs the risk for the holder of the CDS that its coverage may expire due to the effluxion of time notwithstanding that in substance an event is occurring which was intended to be protected by the CDS. This circumstance may advantage

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[31] In Marconi, the failure to pay credit event only occurred near the end of the restructuring.
[32] See credit definitions Section 4.2.
[33] Ibid.
[34] APLMA Agreement clause 23.6.

the protection seller and is a salutary reminder to ensure consistency between CDS and the underlying agreement.

For those uncovered or partially covered financiers seeking to develop a workout, the absence of such consistency could be used in the right circumstances as a lever to obtain co-operation from a recalcitrant financier holding a CDS.

(c) Restructuring

The ISDA restructuring credit event is particularly relevant in the context of an out-of-court work out and is addressed separately from the bankruptcy credit event. Other than as mentioned above, there is no equivalent clause in the APLMA Agreement.

In practice, the ISDA provision has proved to be very difficult to apply; so much so, that in order to achieve certainty, some counterparties may exclude altogether this circumstance from the list of credit events incorporated in the CDS.

The desire for certainty obtained by excluding that event is counterbalanced by the fact that the inclusion of the ISDA restructuring credit event permits banks to have full regulatory capital relief under Basle II. If a CDS does not contain the restructuring credit event, then only 60% of the amount of protection purchased will be recognised[35].

Application of ISDA restructuring credit event definition

Section 4.7 of the credit definitions nominates the following circumstances as credit events in relation to an identified obligation provided that the relevant credit event was not contemplated expressly under the terms of the underlying facility documentation when it was originally executed or at the date the parties enter into the CDS (the 'trade date')[36]:

(i). reduction in interest rate or in the amount of interest payable;

(ii). reduction in the amount of principal payable at maturity or its other due date;

(iii). postponement or deferral of the repayment date for principal or interest;

(iv). change in the ranking of the priority of a payment obligation which results in the subordination of that obligation; and

(v). change in the currency of payment except where the replacement currency is approved[37]under the documentation.

The above events, which are regular features of a workout, must result from an agreement between the reference entity and a certain number (as to which see further below) of holders of the reference obligation so as to bind all holders of that reference obligation.

The following conditions precedent must also be satisfied:

(A) the reference obligation must be of a certain type as particularised in the confirmation.

In particular, the reference obligation may encompass any payment obligation whatsoever, including certain obligations under a guarantee. It may also be limited

35 Australian Prudential Standard 112 at 43 published by the Australian Prudential Regulation Authority.
36 credit definitions Section 1.5.
37 Ibid. Section 4.7(a) (iv).

to a particular payment obligation in respect of borrowed money only, or any other nominated form of obligation. Furthermore the obligation may need to satisfy certain other characteristics identified in the confirmation which, for example, may stipulate that the obligation be unsubordinated, listed or in a particular currency[38];

(B) *the obligation must be for an amount of not less than US$10 million or its equivalent in another acceptable currency[39]; and*

(C) *the obligation must be a 'Multiple Holder Obligation'. As mentioned above, this means that the obligation must be held by at least 4 unrelated holders where the documentation requires at least 66 2/3% to consent to the restructuring[40].*

The current version of the credit definitions is a modification of the 1999 credit definitions. These modifications arose as an attempt to address the problems in construing the definitions, but have not succeeded in removing all of them.

Continuing Problems with ISDA restructuring credit event definition

The following problems still remain with the restructuring credit event definition.

(a) Timing of Occurrence

An initial issue is the precise identification of the point in time at which a credit event occurs. Section 4.7(a) of the credit definitions requires that the restructuring circumstance arises either from an agreement between the reference entity and the requisite number of holders of the reference obligation, or that the restructuring is announced by the reference entity, so as to bind all holders of the reference obligation. The latter event would occur more often in the restructuring of sovereign debt.

A typical workout commences with some form of notification by the reference entity of a potential inability to meet a payment obligation or of a potential event which could trigger a future acceleration of a debt obligation. The financiers would then meet with representatives of the reference entity, and either waive the breach or potential breach, or seek to negotiate changes to the documentation. The changes may include changes in the reference entity's current business plans and senior personnel and may also involve significant asset sales.

Pending finalisation of the restructuring, the financiers may enter into a standstill agreement with the reference entity and the corporate group of which it may form part. The standstill agreement may contain temporary waivers of breaches of any terms of the documentation or extensions of time for the satisfaction of any payment obligation under the documentation.

For the purposes of section 4.7 of the credit definitions, when is the 'agreement' reached between the reference entity and the requisite number of holders of the reference obligation? Does it encompass the series of arrangements (some of which may be informal or which may not bind all holders of the reference obligation[41]) which may precede the execution of a formal restructuring agreement?

[38] Ibid. Section 2.14 (definitions of 'Obligations') and Section 2.19.
[39] Ibid. Section 4.7(a) and Section 4.8(a) and definition of 'Default Requirement'.
[40] Ibid. Section 4.9.
[41] This assumes the 'Multiple Holder Obligation' option is applicable. See Section 4.9 of the credit definitions.

These circumstances arose for consideration in the workout of Marconi Corporation,[42] during the period commencing in September 2001 to April 2003, at which time the restructuring was effected by means of a creditors' scheme of arrangement under the English equivalent of Part 5.1 of the Australian Corporations Act.

One of the issues in the Marconi workout was whether a press release announcing a proposal for a non binding debt swap, involving the surrender of debt in return for a replacement of debt with cash, bonds and equity, constituted a restructuring credit event[43]. Under the current definitions, a press announcement of itself would appear to be insufficient to trigger the restructuring credit event, since any restructuring must bind all holders of the reference obligation. The initial restructuring proposal in Marconi only bound holders who voluntarily decided to take advantage of the debt swap.

In the end, the initial voluntary proposal was abandoned and the restructuring was effected by the scheme of arrangement which contained a clear trigger for the restructuring credit event. Even then, there was an issue whether the restructuring credit event was triggered upon publication of the scheme document advising of the details of the creditors' scheme or (as seems more likely as a matter of law) upon the making of the final court order approving the scheme.

While supporting the restructuring in principle, the holders of CDSs still wished to retain and access the benefit of those contracts. Further, over the many months of negotiations, it was still unclear whether a credit event had occurred. As matters turned out, there was very little time between the date at which a credit event had actually occurred and the voting on the restructuring proposals, for delivery of bank debt to the CDS providers.

(b) Debt Extension

A debt extension would constitute a debt deferral within Section 4.7(a) (iii) of the credit definitions. Again, issues arise concerning the scope of this provision.

On occasions, some but not all lenders will agree to a deferral. The non-consenting creditors often temporise and fail to commit themselves either way.

Whilst this may raise problems for the directors of the distressed entity, it also creates problems for the purchaser of the credit protection. For the purposes of the definition is one able to argue that this category of indecisive lender has agreed by its conduct to the deferral or that it is estopped from later asserting the right in a manner inconsistent with those holders who have agreed? Would those circumstances amount to a deferral agreed to by all holders? These issues may be of vital importance to a buyer of credit protection especially if the deferral extends the repayment date beyond the tenor of the CDS and the period of uncertainty extends right up to the expiration of the tenor of the CDS.

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[42] See further 'Marconi reveals shortcomings of credit swap documents' (October 2002). 21 *IFLR* 3; Nicholas Frome & Claude Brown, 'Lessons from the Marconi Restructuring', (September 2003) 22 *IFLR 19;* Martin Hughes, 'Derivatives must deal with Restructuring Quandary', (December 2003) 22 *IFLR* 17.

[43] In part, the argument that a restructuring credit event had occurred also relied on the following subparagraph (i) in the 1999 version of the credit definitions:'…[the taking of any] action in furtherance of , or indicating its consent to, approval of, or acquiescence in, any of the foregoing acts.' This subparagraph has been deleted from the 2003 credit definitions

(c) Debt Exchange

Whilst the issue of debt replacement and whether this amounts to a restructuring credit event was not fully resolved in Marconi, in *Eternity Global Master Fund Limited v Morgan Guaranty Trust Company of New York* this matter did receive judicial consideration in the context of the 2001 Argentine debt crisis[44].

In that case, Eternity entered into a CDS with a Morgan entity referencing Argentine debt. Subsequently, Argentina offered the holders of the debt an exchange facility whereby holders could voluntarily offer their bonds in return for secured loans having an increased term, but with a lower interest rate. Argentina was free to accept or reject the offers[45]. The surrendered bonds were to be held by a trustee of a trust the sole beneficiary of which was Argentina. The Argentine Government had also announced that the 'restructured loans held domestically'[46] would have highest priority for payment.

Eternity argued that the restructuring credit event had been triggered because the announcement effectively subordinated the original bonds to the restructured loans. It further argued that, during the holding of the surrendered bonds in the trust, the bonds would not be enforced because 'Argentina's role as both beneficiary and obligor on the trust assets suspended…any enforceable legal obligation created by those debt instruments'[47] . Morgan argued that in substance, the terms of the surrendered bonds had not changed and that there was no subordination.

Ultimately the court decided that in part these were matters of fact and remitted the case back to the trial judge for further consideration.

Despite the failure to resolve the matter, the voluntary debt exchange proposals in each of Marconi and Argentina may provide some scope for future action in a workout if it is desired to avoid the triggering of the credit event.[48]

More recently, the 2008 voluntary debt exchanges in respect of the English mortgage lender RecCap and the Canadian timber manufacturer, Tembac also raised questions as to whether the restructuring credit event in CDSs were triggered for referenced obligations of each of those companies. In each of those cases, the bondholders were offered the option of surrendering voluntarily the bonds which they held. Commercially, the bondholders argued that they had no choice but to surrender their original bonds and accept the exchange since they would be effectively subordinated if they failed to do so. On this basis they argued that, in substance, the exchange was not voluntary. The argument failed because the exchange was not effected under any binding agreement[49].

[44] *Eternity Global Master Fund Limited Morgan Guaranty Trust Company of New York and JP Morgan Chase Bank* (2004) 375 F.3d 168.('Eternity Global').

[45] One issue no longer relevant and arising out of the 1999 credit definitions was whether there was an 'Obligation Exchange' (…'the mandatory transfer …of any securities in exchange for such Obligations'. This concept of 'Obligation Exchange' was deleted in the 2003 credit definitions.

[46] *Eternity* infra note 44 at 185.

[47] Ibid, at 184.

[48] However, as occurred in Marconi, the price of support for a partially covered financier may well be to trigger the credit event which in Marconi clearly happened on the final court order approving of the scheme of arrangement.

[49] See The Financial Times (May 21, 2008) on www.debtwire.com.

All three examples referred to above serve to reinforce the need for an anterior agreement which satisfies the definition of 'Multiple Holder Obligation' before the restructuring credit event is engaged.

(d) Prepayment

A workout may involve a prepayment of a liability by a reference entity in circumstances where the reference entity is not necessarily insolvent. A protection purchaser under a CDS may object to such an outcome on the basis that the prepayment of the relevant reference obligation prior to its due date would render worthless the CDS for which the protection purchaser had paid a significant premium. The prepayment may be associated with major asset sales or changes in business operations requiring the consent of lenders. As a condition to consenting to the prepayment, and even though the prepayment may not trigger the restructuring credit event, a lender with CDS protection in connection with its exposure may require the value of the CDS to be maintained.

Such an issue arose when in 2006 Avis prepaid all of its outstanding bonds thereby wiping out its CDS reference obligation. After extensive negotiations with investors in Avis' referenced CDSs, a separate senior note issue in 2007 by Avis' subsidiary, Avis Budget Car Rental, was guaranteed by Avis for a fee of US$14 million paid to Avis by institutional investors. The previously orphaned CDSs leapt in value[50].

(e) Reference entity

When drafting the terms of the CDS, it is necessary to be precise about the identity of the reference entity. Confusion may arise in the structuring of a workout if there are misunderstandings concerning the identity of the reference entity.

The decision in *Aon Financial Products v Societe Generale*[51] illustrates how these problems can arise. That case concerned two different CDSs. In the first CDS (the Bear Stearns CDS), Aon sold credit protection to Bear Stearns in respect of a reference entity wholly owned by the Republic of the Philippines, being the Government Service Insurance System (GSIS), in respect of certain obligations of GSIS under a surety bond executed in favour of Bear Stearns as security for a loan facility provided by the latter company.

In turn, Aon entered into a second CDS with Societe Generale as protection seller and naming the Republic of the Philippines as the reference entity (the Societe Generale CDS).

A dispute arose as to whether the refusal of GSIS to pay under the bond constituted a credit event under the Bear Stearns CDS (this was resolved affirmatively in separate litigation). A separate dispute, the subject of the reported decision, then arose as to whether this circumstance also constituted a credit event under the Societe Generale CDS. Despite the specific wording of the second CDS, it was held that the default of GSIS under the Bear Stearns CDS constituted a credit event under the Societe Generale CDS since GSIS' liability under the surety bond was guaranteed by the Republic of the Philippines such that GSIS' default was in substance equivalent to a default by the Philippines. The decision at first instance

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[50] See the Treasurer (March 2007) at 17. The reconstruction of the Gus Plc group was also structured to avoid rendering its CDS Reference obligations worthless. See The Treasurer (January/February 2007) at 34.

[51] 2005 WL 427535 (S.D.N.Y.).

has since been reversed on appeal[52]. Nevertheless, the case illustrates the importance of not overlooking the need for careful drafting in the description of the reference entity.

The restructuring credit event has been labelled the 'soft' credit event because, although its occurrence may signify deterioration in the credit ranking of a reference entity, it is not necessarily followed by a failure to pay or bankruptcy[53]. However, the 'softness' of the clause is increased if it is never triggered in the first place.

Do the restructuring credit events pose a risk to Workouts?

Workouts occur where each of the debtor and its financiers opt for an informal out of court procedure to resolve issues faced by an entity experiencing financial difficulties. The assessment of the practical impact of a CDS on a workout is not capable of a straightforward answer. It is difficult to obtain detailed knowledge on such matters, as workouts are conducted largely in private, and holders of credit protection are usually unwilling to share with fellow syndicate members, let alone outsiders, information concerning the tactics which they will use to maximise their recovery from the distressed entity. Furthermore, the impact may be manifested in a subtle or indirect fashion.

Writing in 2006, the authors of the *INSOL* Guid*e*[54]assessed the position in the then more benign economic times as follows:

> "…[I]t appears that credit market participants have seen no evidence to date that the presence of CDS protection has caused an otherwise viable restructuring to fail, though there have been instances where problems have been encountered."[55]

Nevertheless, there is sufficient evidence that the existence of CDS protection among a syndicate can make the workout more difficult, not least because the triggering of a CDS, which calls for physical settlement, results in changes in the financiers involved in the workout thereby destabilising the whole process.

It should also be emphasised that these issues are not new and may arise apart from the holding of a CDS. A financier who has the benefit of traditional credit insurance, or who has entered into a participation arrangement with a third party, may approach the matter in a similar way, albeit with possibly more direction from the participant than is the case typically with a holder of a CDS. Then again, financiers lending at differing levels within a corporate group or in differing amounts may assert a special claim to priority, or adopt a blocking position, so as to maximise their recovery or be taken out completely.

Yet, where the distressed entity is a reference entity or a member of a group which includes a reference entity, the existence of a CDS with respect to the reference entity does give rise to a special set of problems for each of the distressed entity, covered and uncovered members of the syndicate, as well as for syndicate members who are exposed to the distressed entity in an additional capacity such as being a seller of credit protection.

At the general level, the behaviour of financiers may be analysed by reference to:

- disclosure issues;

[52] *Aeon Financial Products Inc.v Societe Generale* infra note 1.
[53] N McPherson, H Remeza and D Kung, *Demystifying Restructuring Credit Events* (Credit-Suisse First Boston, 2003) at 2.
[54] Infra note 5.
[55] Ibid. 22 at 8.11.

- the existence of disparate economic interests and motivations among financiers; and
- syndicate stability and competence.

Disclosure Issues

A facility agreement usually contains a clause requiring the borrower to disclose to the financier information relating to its financial condition[56], but it is not the practice to impose a reciprocal clause on a financier[57] requiring that financier to disclose to the borrower whether it holds CDS protection, or has otherwise reduced its economic exposure to the borrower, such as by means of a participation arrangement. Some respondents to the FSA Survey identified the difficulty in identifying the true investors for the purposes of participating in the restructuring as a 'key risk'[58].

In crafting a workout proposal acceptable to all parties, an understanding of the stakeholders who bear the ultimate economic exposure is fundamental. A seemingly irrational response from a syndicate member (such as the desire to trigger an event of default under the facility agreement) may be understandable if it is known that the financier is fully covered by a CDS. In the latter case, those propounding the workout may be more effective if they recognise the issue and are able to deal directly with the protection seller under the CDS.

It may well be that the price of obtaining the consent of all syndicate members is the structuring of the workout in such a way that (as happened in the Marconi workout), it triggers the right for the protection buyer to issue a credit event notice under the CDS. In that situation, it would be beneficial to identify the protection seller who will inherit the financier's exposure if the CDS contemplates physical settlement.

Disclosure is also an issue when a financier has a direct exposure through its lending desk and an indirect exposure through its trading desk. It may have the latter capacity as a protection seller to another financier of the distressed entity. Because of insider trading rules, neither division of the financier may be aware of the other's exposure to the same entity, and it is not inconceivable that each division may take a different attitude to the terms of any proposed workout. It is also conceivable that the attitude of one division may change once it learns of that financier's aggregate exposure to the distressed entity or to the group of which it may form a part.

It has been suggested that current market practice does not support disclosure in this situation and that the practice is unlikely to change because of financiers' reluctance to disclose the existence of credit protection to their borrower and because of confidentiality requirements imposed either at general law or by contract. The confidentiality issue may also include reluctance by financiers to disclose the techniques which they may use to manage their various credit exposures.

In this writer's experience, the relationship between a borrower and its financier assumes a secondary position when the borrower is in financial difficulties. By that stage, different teams with the financial institution usually take over the management of the matter and the desire to maximise recovery predominates over any desire to have a fruitful ongoing commercial relationship with the borrower.

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[56] See for example clause 20 in the APLMA Agreement.

[57] The Association of Corporate Treasurers suggests that with respect to single name credit derivatives, such a clause should be inserted into loan documentation and be operative following the notification of an event of default. See *Syndicated loan facilities: non-bank lenders and the influence of credit derivatives: current issues and opportunities for Borrowers (Part 2),* published by that UK association in July 2007.

[58] FSA Survey infra note 2 at 22.

If and to the extent confidentiality is an issue, it is suggested that it may be managed either by a form of limited disclosure (such as the disclosure of the fact of the existence of credit protection if not of the actual terms of the protection if not the precise terms of the CDS), or by obtaining the requisite consent of the protection seller. Whist it is acknowledged that financiers do not currently disclose the existence of credit protection in the analogous situations where they may have credit insurance or the benefit of a participation arrangement, in this writer's opinion there is also a strong case which can be made for disclosure in those cases as well in order that there is a clear and early identification of all relevant stakeholders and their respective motivations.

Disparate Economic Interests and Motivations among Financiers

General Comments

The disparate economic interests of financiers may generate differing responses and motivations amongst financiers. A partially covered financier is more likely to support a workout and allocate resources (in terms of management time and serving on steering committees) to promote a result which will maximise its recovery.

In contrast, a fully covered financier may perceive that there is no benefit in supporting a workout, and the associated management time which that task entails[59], and may adopt a stand which will facilitate the ability to serve a credit event notice under the CDS at a time most convenient to itself. Such a financier may act in such a way so as to trigger an event of default under the facility agreement or temporise, on the basis that the ability to deliver a credit event notice under the CDS at the latest point in time possible will maximise its recovery. This tactic may render decision-making within the syndicate impossible and paralyse the processes and steps associated with the workout.

Furthermore, one model of behaviour suggests that a fully covered financier will have little or no economic incentive to participate in a workout unless that financier has superior information as to the prospects of the reference entity or unless the financier is able to use the ‘cheapest to deliver’ option to satisfy its delivery obligation. Such a model assumes that the fully covered and satisfied financier will only remain involved, even if it has received full payment from the seller of the credit protection, where it perceives the prospect of a satisfactory return from the reference entity and where it has retained its original debt because of its ability to satisfy its delivery obligation by finding, for example, long dated debt selling at a deep discount[60] or cash settlement.

Mr Jeremy Green[61] has also perceptively analysed this issue from the perspective of the extent or duration of the CDS cover and the method of settlement and has reached a conclusion.

If a financier is able to obtain payment under the CDS and at the same time still retain is underlying debt obligation (either because the financier is able to use the cheapest to deliver obligation or because the CDS calls for cash settlement), a financier has a prospect of obtaining a windfall if it is able to maximise the value of the underlying debt obligation. In

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[59] For a US perspective, see Stephen J. Lubben ‘*Credit Derivatives & the Future of Chapter 11*’ (2008) 81 Am. Banker. L. J. 405.(‘Lubben’)

[60] Note that this model ‘assumes that the cost of the debt used to settle the CDS and the ultimate recovery on the creditor’s claim will be identical, at least on average’. Quoted from Goffman infra note 15 at note 89.It is also noted that the ‘assumption may overestimate the efficiency of markets in distressed debt and derivatives’. See further Lubben infra note 58 at 425.

[61] Jeremy Green, *The Impact of Credit Derivatives on Corporate Debt Restructuring* (unpublished paper 2007 which was awarded first prize in the BFSLA Essay Competition of that year). (‘Green’)

these circumstances, Mr Green concludes that a financier would be likely to support any workout because of the prospect of the windfall gain.

With respect to the extent or duration of the CDS, he concludes (correctly in this writer's opinion) that the holder of a CDS would be unlikely to agree to any restructuring proposal if it involved a debt extension beyond the term of the CDS with the consequence that the financier would then be uncovered especially where the cost of extended protection may have increased due to the distressed circumstances of the debtor.

As to the method of settlement: if physical settlement is contemplated and there is no restriction on the transferability of the underlying debt, he concludes that the financier can be expected to exit at the earliest available opportunity and that prior to exiting the facility, the financier will be concerned to ensure that the terms of the underlying debt are not changed in such a way as to render it incapable of satisfying a delivery obligation under the CDS.

The existence of CDSs may also mean that a large cohort of protection sellers end up holding the debt. When such sellers provided credit protection, it is likely that they were motivated in so doing solely by the fee income generated by the sales rather than by any real consideration of the underlying debt. In the US, it has been noted that there is a real question as to whether protection sellers have either the motivation or the skills to participate in a workout[62].

Similar sentiments have been expressed in the FSA survey which, in summarising the results of the survey, noted that newer participants such as hedge funds and distressed debt funds 'were less motivated to manage long term relationships with issuers [and] …may be motivated to push for a short-term strategy which would maximise their returns but act against the long term sustainability of the underlying firm.'[63]

A steering committee of creditors is often formed to facilitate a workout. That committee acts as a conduit for conveying information to the other creditors concerning the structuring and prospects of a satisfactory workout. In performing this role, a member of a steering committee may owe fiduciary duties to the other creditors who often rely on the committee's superior knowledge and recommendations. If a member of the steering committee were covered by a CDS, there is a potential for a conflict of duty and interest to arise. It may be in the interests of the majority of creditors for the steering committee to support a long term workout in circumstances where the duration of the workout may extend beyond the tenor of the CDS held by a member of the steering committee. As consequence the member may have an incentive not to support the workout. The prospect of such a conflict arising could well mean that able and experienced workout specialists may refuse to become members of steering committees. Indeed, there may be real difficulties in forming such a committee at all[64].

In Marconi, it has already been noted that holders of CDSs did make the workout more difficult. On the other hand, it has also been argued[65] that in supporting a workout plan, a holder of a CDS may take a cavalier or unrealistic approach in the knowledge that it would be protected in any event, if the failure results in subsequent insolvency proceedings in respect of which the creditor is fully protected.

[62] Lubben infra note 37 at 426.
[63] FSA Survey infra note 2 at 22.
[64] Goffman infra note 38 at 16.
[65] Ibid.

It has also been suggested that the holding of a CDS could increase the number of cases in which a creditor might commence proceedings to wind up a reference entity. In the absence of an undertaking not to institute winding up proceedings[66], a creditor has full control as to whether or not it will wind up a reference entity and as to the timing of commencement of those proceedings. As a related matter, it has also been suggested that a group of creditors might purchase credit protection on a reference entity and use a small claim to commence such proceedings. In this way, it has been suggested that some creditors may seek to profit by commencing winding up proceedings.[67]

Documentary Considerations

Apart from general statements concerning risk and possible creditor behaviour, it is difficult to provide a precise analysis as to whether the holding of a CDS increases the risks of a workout failing. As mentioned earlier, these issues are not new where a lender has obtained other forms of credit protection such as credit insurance. It is also worth recalling that not all CDSs are identical and that caution should be exercised when making generalisations.

The difficulties associated with the construction and operation of the restructuring credit event has been discussed above. It is here that an appreciation of the precise wording of the credit events assumes a particular importance. Because the triggering of that event, amongst other matters, requires an actual agreement between the borrower and its financiers and because often it is necessary to obtain the consent of 66 2/3% of financiers if not all financiers to obtain such agreement, in practice there would appear to be real practical difficulties for a financier seeking to rely on the restructuring credit event.

The failure to pay and bankruptcy events thus assume a greater importance in this situation. A modification of a failure to pay clause often requires the unanimous consent of financiers if the failure is to be waived. It is not inconceivable that a financier holding credit protection will withhold its consent noting that even if some banks agree on a bilateral basis not to take action, the failure to pay may trigger the bankruptcy event (such as the appointment of a voluntary administrator by the directors of the borrower) because of, as mentioned above, the fear of the directors of the borrower that they may incur personal liability for insolvent trading unless the failure to pay is avoided by changing the contractual date for payment. In this fashion, the failure to pay credit event assumes the greater importance because it would usually precede the bankruptcy credit event

It has been suggested by Mr Green[68] that institutional banks (as distinct from hedge funds or debt traders) have an interest in the ongoing existence of the borrower and that their institutional relationship with the borrower would reduce the likelihood of their acting in such a fashion.

In current times of large financial institutions experiencing shortages of capital and the expense of having to provide capital for distressed borrowers, there is no real certainty that institutional banks will act on the basis of historical relationships or the desire for the ongoing maintenance of such a relationship. Furthermore, early in the workout the institution may have sold its debt to a debt trader with CDS protection. Such traders are

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[66] In Australia, it is not clear whether such covenants are enforceable in any event. See *Community Development Pty Ltd v Engwirda Construction Co* (1969) 120 CLR 455 at 460. See also *A Best Floor Sanding Pty Ltd v Skyer Australia Pty Ltd* (1969) VSC 170. Cf. *TBGL Enterprises Ltd v Bellcap* (1996) 14 ACLC 205 and *Colt Telecom Group Plc* [2002] EWHC 2815.

[67] Goffman infra note at 15. There have been suggestions that the US Bankruptcy Code be amended so as to require creditors commencing winding up proceedings to disclose any credit derivative positions so that the court is made aware of any all the circumstances surrounding the commencement of insolvency proceedings prematurely or in bad faith.

[68] Green infra note 60.

often motivated only by the desire to exit the defaulting facility at a price higher than their original entry price.

More controversially, it has also been suggested by Mr S Frith (by analogy to principles derived from insurance law) that a protection buyer is subject to a duty of good faith to act in such a way so as to avoid the deliberate occurrence of a credit event thereby enabling a call to be made under its CDS[69]. In support of this view, Mr Frith relies on Section 9.1(b)(iii) of the credit definitions and, in particular, the requirement that for so long as a party has an obligation under a CDS that each party '…may act with respect to such business in the same manner as each of them would if such Credit Derivative Transaction did not exist'. Mr Frith construes these words as enabling a party to conduct its business activities only the basis that the CDS did not exist. The writer respectfully agrees with Mr Green[70] that this construction involves a reading into a permissive clause an implication inconsistent with the natural and ordinary meaning of the provision. Moreover, such a reading ignores the distinction between an insurance contract and the rights conferred under a CDS[71].

Syndicate Stability and Competence

There has been significant growth in distressed debt trading over the last decade. It has been suggested that the existence of CDSs may increase the amount of debt trading in relation to the debt of distressed borrowers. It is unclear whether the increase in rate is a result of the holding of CDSs referencing the traded debt and which require physical settlement or if this has occurred independently of any CDS holding. In any event, changes in the composition of a syndicate do destabilise a syndicate and may well render the effective resolution of the workout more difficult especially if active members of the workout team change policy and decide to cut their losses and run.

Although it is difficult to obtain actual information on this issue, it may be concluded intuitively that CDSs may have contributed to the increase in the rate of debt trading. This conclusion must be qualified if and to the extent that the consent of the borrower is required in relation to any transfer of the underlying debt. This depends on the stage as at which the transfer may be made. For example, in the APLMA Agreement, the borrower's consent is not required for a transfer after the occurrence of an event of default[72]. Thus whilst it may be true to conclude that the need for borrower consent may impose some form of control over debt transfers, the control may fall away as the workout proceeds either because the provision ceases to be applicable or because the provision is removed as a condition to the granting of any waivers which are required during the workout.

Debt traders (which would include hedge funds) tend to be passive investors in distressed borrowers and many lack the desire or skill to become involved actively in the administration of the workout. In large measure, the reluctance is attributable to the need for debt traders to retain the ability to on-sell their debt if they see an opportunity to do so. If the debt trader or hedge fund took an active role in any workout, this may give the trader to non public information which they may not want because this may limit their ability to freely trade the debt in the future without a proper disclosure which they be prevented from making because of either obligations of confidentiality or concerns about a potential liability for insider trading.

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[69] See S Frith, *Derivatives Law and Practice* (Sweet and Maxwell) at paragraph 16-02 by analogy from the insurance decisions in *British and Foreign Marine Insurance v Gaunt* [1921] 2 AC 41 and *Beresford v Royal Insurance Co Ltd* [1938] 586.

[70] Green infra note 60.

[71] See *Aeon Products* infra note 1.

[72] APLMA Agreement clause 24.2.

Even if a debt trader wished to become involved in the workout, it has also been argued that the typical debt trader or hedge fund lacks the skills and resources to make an effective contribution to any workout. Despite these reservations, there have been some suggestions that some hedge funds may have an interest in becoming involved actively in a workout if they purchased debt as part of a strategy to own the distressed debtor.

At this stage, there is insufficient evidence to reach a conclusion on the last point but experience does suggest passivity rather than active involvement in workouts by both debt traders and hedge funds. As a consequence, there are general concerns that cases may arise where no institution wishes to get involved in a workout at all with the consequence that the only option that becomes viable is formal insolvency proceedings and the risk of reduced return which that option may generate.

Conclusion

The holding by a creditor of credit protection via a CDS referencing a distressed borrower together with the disparate economic interests of financiers and syndicate instability which those circumstances may generate, combine to add an additional complexity to a workout especially when there is lack of clarity as to who bears the economic risk of the insolvency.

To date, there have not been sufficient recent examples to establish whether or not holdings of CDSs referencing the distressed borrower are fatal to a successful workout, but the limited experience which exists does indicate that this has not been the case even though a successful work out may have been more difficult to achieve. Because of the very existence of the credit events and the commercial drive by some financiers to trigger the credit events, there is nevertheless some justification for concluding that the days of a pure workout based solely on mutual contractual undertakings between the stakeholders may have passed, and that in the future, the work out in conjunction with a formal insolvency proceeding such as voluntary administration may be more likely.

A workout involves the identification of the stakeholders who bear the economic risk in connection with the fate of the distressed borrower and the production of an outcome which accommodates those interests. In this writer's opinion, improved disclosure obligations will go a part of the way in resolving at least some of these issues. At the very least, this will enable the identification of the interests of the creditors and recognition of the need for the workout to accommodate those interests if the workout is to have any chance of success. The actual terms of a CDS, including its tenor, form part of the process of identification. In this connection, it is suggested tentatively that, because of the manner in which it is drafted, the reconstruction credit event is of less practical significance than the failure to pay and bankruptcy credit events.

Instability and a lack of cohesion within a syndicate may result from debt trading, whether or not attributable to the holding of a CDS. The resulting problem of potential instability within a syndicate, coupled with the lack of desire or skill by new holders of the underlying debt to participate in or effect a workout, do pose significant questions as to whether a workout, based solely on contract, has a viable future.

Appendix

Selected types of Credit Derivatives and other credit-linked products[73]

Portfolio credit default swap.[74] CDSs may be written on a portfolio of reference entities. The calling of a credit event with respect to any entity in the portfolio will require one or more protection payments to be made by the protection buyer to the protection seller (though in some portfolio CDSs, the aggregate amount of such payments as would otherwise be required must reach an agreed threshold before payment is actually made). During the term of the CDS, the aggregate notional amount of the CDS is reduced from time to time by the notional amount that relates to each reference entity that experiences a credit event.

Collateralised debt obligation (CDO). Collateralised debt obligations are secured credit-linked securities, usually issued by a special purpose vehicle that is sponsored by a financial institution. Among other things, CDO transactions are used by financial institutions often to comply with internal risk controls or regulatory capital requirements.

In a simple CDO transaction, the financial institution initially enters into a contract with the vehicle, under which the financial institution transfers to the vehicle exposures to a portfolio of debt obligations. The transfer may be accomplished:

(a) by a direct sale of such obligations from the financial institution to the vehicle for cash (in which case the transfer of credit risk and the resulting CDO transaction are referred to as a *cash* transfer and a *cash* CDO transaction, respectively); or

(b) by entering into a portfolio CDS under which the financial institution buys protection from the vehicle in respect of the credit risk of such obligations (in which case the transfer of credit risk and the resulting CDO transaction are referred to as a *synthetic* transfer and a *synthetic* CDO transaction respectively).

The vehicle then issues CDO debt securities to third parties, such securities being secured by (and recourse under which being limited to) the available collateral, i.e. payments to be received by the vehicle under the obligations in the portfolio (in the case of a cash transaction) or under the portfolio CDS (in the case of a synthetic transaction).

The proceeds of the sale of securities are applied by the vehicle to pay the purchase price of the portfolio (in a cash transaction), or to cover protection payments to be made under the portfolio CDS (in a synthetic transaction).

A payment default under an obligation in the portfolio or the calling of a credit event in respect of an obligation covered by the portfolio CDS (as the case may be) would result in a corresponding reduction in payments to the holders of the CDO securities, subject to any protection provided by over-collateralisation of the securities.[75]

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[73] Taken from the INSOL Guide infra note 5.

[74] The terminology used in respect of portfolio CDSs is analogous to that used in respect of single-name CDSs (for a description of which, see sections 4 and 5 above).

[75] In most CDO transactions, the principal amount of obligations in the collateral portfolio is larger than the principal amount of CDO securities secured by it. In addition, the vehicle may issue to the sponsoring financial institution subordinated debt securities or preferred shares to absorb initial loss amounts (if any) incurred under the portfolio before additional loss amounts are passed onto the purchasers of more "senior" CDO securities.

Credit-linked note. A credit-linked note is a debt instrument, the issuer's payment under which is contractually linked (and the purchaser's recourse under which is limited) to the credit and performance of another debt obligation or a portfolio of other debt obligations. Among other things, a credit-linked note allows its issuer to transfer the credit exposure associated with such an obligation or obligations to the purchaser of the note. The economic relationship between the issuer and purchaser of a credit-linked note is thus similar to that between the protection buyer and protection seller, respectively, under a portfolio CDS.

In a simple credit-linked note structure, an entity with credit exposure to a portfolio of debt obligations issues credit-linked notes in an aggregate principal amount up to the aggregate principal amount of the obligations in the portfolio,[76] and with a term to maturity that is no longer the longest term to maturity of any obligation in the portfolio. The terms of the notes also provide, among other things, that recourse by the holders of the notes is limited to the amounts paid from time to time by the obligors under the portfolio. Interest on the notes is paid from a combination of investment returns on proceeds of the sale of such notes and interest payments made under the obligations in the portfolio.

A payment default under an obligation in the portfolio would result in a corresponding reduction in the payments made to the holders of the credit-linked notes.[77]

[76] To provide a measure of protection to note purchasers, the principal amounts of credit-linked notes in most transactions are smaller than the principal amounts of obligations in the related portfolios.

[77] Such a reduction would be subject to the protection provided to the noteholders by the excess (if any) of the aggregate principal amount of obligations in the portfolio over the principal amount of the related credit-linked notes.