SEPTEMBER 2020

European Credit Derivatives Outlook

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At a Glance

- Despite the magnitude of the COVID-19 crisis, there were relatively few Credit Events triggered and auctions held in 2Q/3Q of FY 2020.
- Recent Credit Events (Wirecard AG, Matalan) have added clarity to the circumstances under which European insolvency proceedings and restructurings (and corresponding proceedings for recognition under Chapter 15 of the U.S. Bankruptcy Code) will constitute "Bankruptcy" Credit Events under the most current version of the ISDA Credit Derivatives Definitions (the "**2014 Definitions**").*
- Increasing use by the EMEA Determinations Committee of explanatory written statements provides useful indications of future determinations, notwithstanding the fact that the Determinations Committees (EMEA and others) are not formally bound by precedent.
- Key factors in determining whether an insolvency proceeding or restructuring (and corresponding Chapter 15 recognition proceedings) will constitute "Bankruptcy" Credit Events under the 2014 Definitions are:
    1. the inclusion (or lack) of a stay of general application;
    2. the presence (or absence) of an administrator;
    3. the degree of court involvement;
    4. the extent to which the Reference Entity is required to satisfy maturing obligations during the proceeding;
    5. the relevant entity or entities which are the subject of the proceedings (and whether that entity is the Reference Entity).
- The EMEA Determinations Committee generally is willing to modify typical auction settlement terms to ensure a fair result. This may result in acceleration or delay of typical auction timelines.
- The introduction of the new "restructuring plan" procedure in the United Kingdom is unlikely in our view to significantly move the needle on Credit Event determinations, provided the debtor does not also invoke the new stand-alone moratorium.
- It is still too early to fully gauge the effects of the changes to the "Failure to Pay" Credit Event implemented by the 2019 Narrowly Tailored Credit Event Supplement to the 2014 Definitions (the "**NTCE Supplement**"). However, the increasing attention given by regulators both in the U.S. and Europe warrants taking the potential regulatory and reputational risks of narrowly tailored and/or manufactured Credit Events seriously.

* In this presentation, we focus on the 2014 Definitions, which govern most standard contracts currently traded. It should be noted that certain of the points discussed here are less relevant to the auction-updated ISDA 2003 Credit Derivatives Definitions (the "**2003 Definitions**"), which include a more permissive definition of the "Bankruptcy" Credit Event.

2019-2020 EMEA Credit Events[1] & Auctions

REFERENCE ENTITY	CREDIT EVENT	CREDIT EVENT DATE	AUCTION DATE	NOI/FINAL PRICE
PizzaExpress Financing 1 plc	Failure to Pay	2 September 2020	TBD	TBD
HEMA Bondco I B.V.	Failure to Pay	14 August 2020	8 September 2020	To sell: €4.4M Final Price: 68.5
Matalan Finance plc	Bankruptcy (Chapter 15 filing)	29 June 2020	15 September 2020	To sell: GBP11.5M Final Price: 36.5
Wirecard AG	Bankruptcy (opening of German preliminary insolvency proceedings)	25 June 2020	29 July 2020	To sell: €50.1M Final Price: 11
Thomas Cook Group plc	Failure to Pay	19 September 2019	30 October 2019	To sell: €171.7M Final price: 10.125
	Bankruptcy (court application by Reference Entity for English compulsory liquidation)	23 September 2019	N/A[2]	N/A
Steinhoff Europe AG	Failure to Pay	8 February 2019	25 September 2019	To buy: €8.4M Final price: 84
Top Gun Realisations 61 Limited (formerly, New Look Bondco I Limited)	Bankruptcy (shareholder resolution to wind up)	6 August 2019	Deemed 11 September 2019	Final price: Deemed 100[3]
Galapagos Holding SA	Failure to Pay	17 July 2019	7 August 2019	To sell: €14.4M Final price: 6.875
Rallye SA	Bankruptcy (opening of French *sauvegarde* proceedings)	23 May 2019	27 June 2019	To sell: €167.15M Final price: 12.5
New Look Senior Issuer plc	Failure to Pay	10 May 2019	5 June 2019	To sell: €58.8M Final price: 0[4]

1. Successor Events are not listed here, as they are not Credit Events. Sovereign Credit Events excluded. Additionally, this summary is limited to European contracts.
2. Although the Determinations Committee found that a "Bankruptcy" Credit Event occurred, it didn't require a separate auction as the "Failure to Pay" Credit Event already triggered trades governed by the 2014 Definitions. An additional "Bankruptcy" Credit Event (as a result of a Chapter 15 filing) also was found to have occurred with respect to the updated 2003 Definitions only.
3. The Determinations Committee authorized a "deemed" auction notwithstanding the fact that there were no Deliverable Obligations at market participants' request.
4. The open interest to sell exceeded the number of bids received at auction.

Defining the “Bankruptcy” Credit Event

European bankruptcies and restructurings continue to test the boundaries of the “Bankruptcy” Credit Event, particularly in the context of the 2014 Definitions.

This is in large part due to the multiplicity of restructuring regimes in the European Union and United Kingdom (in contrast to the single Chapter 11 process in the U.S.) and variegated approaches to Chapter 15 recognition proceedings in the U.S. Determining whether a given jurisdiction’s insolvency-like proceeding triggers a “Bankruptcy” Credit Event is challenging, owing to the absence of a single standard across the continent.

The definition of a “Bankruptcy” in the 2014 Definitions includes two triggers that are particularly relevant in the context of European bankruptcies and restructurings:

- the Reference Entity makes a general assignment, arrangement, scheme or composition with or for the benefit of its creditors generally, or such a general assignment, arrangement, scheme or composition becomes effective (Section 4.2(c)); or
- the Reference Entity institutes or has instituted against it a proceeding seeking a judgment of insolvency or bankruptcy or any other similar relief under any bankruptcy or insolvency law or other law affecting creditors' rights, or a petition is presented for its winding-up or liquidation, and, in the case of any such proceeding or petition instituted or presented against it, such proceeding or petition (i) results in a judgment of insolvency or bankruptcy or the entry of an order for relief or the making of an order for its winding-up or liquidation, or (ii) is not dismissed, discharged, stayed or restrained in each case within thirty calendar days of the institution or presentation thereof (Section 4.2(d)).

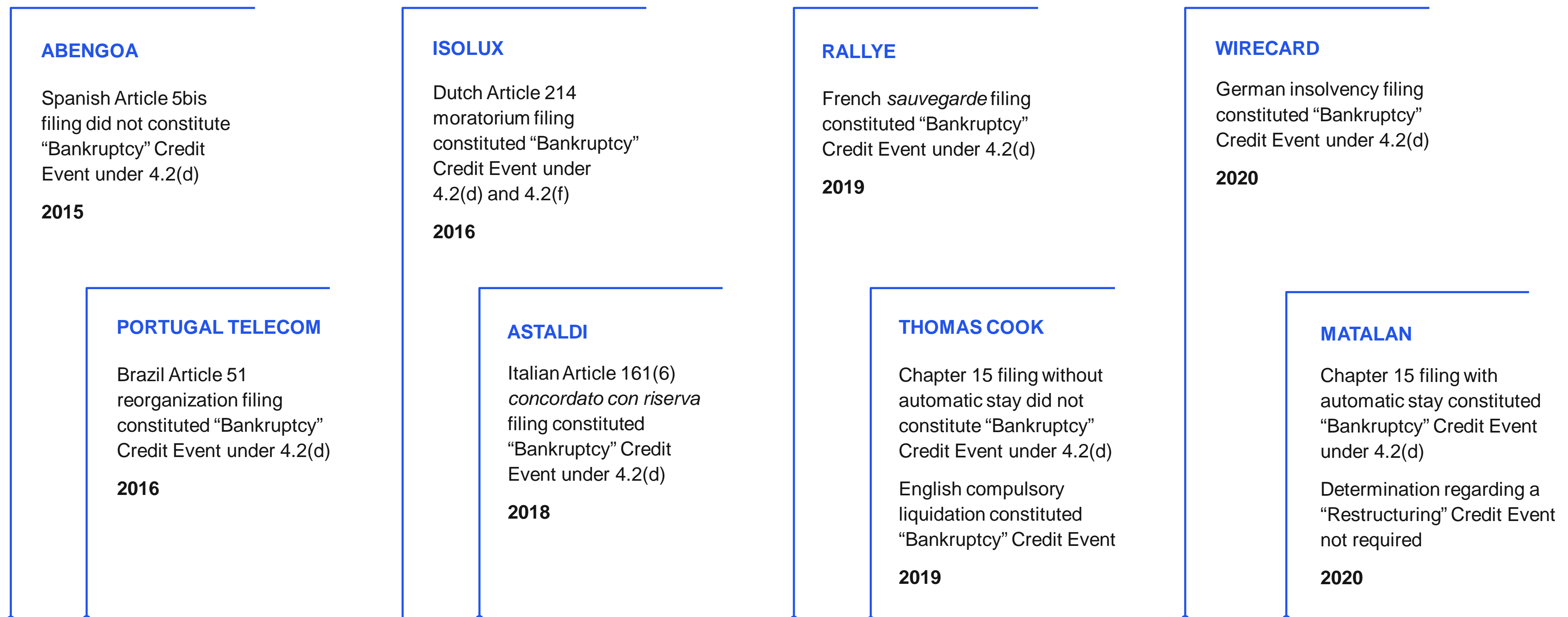
The EMEA Determinations Committee has recently been more active in publishing written explanations of their reasoning. Tracing through recent explanatory statements provides valuable insight. That said, it should be emphasized that the Determinations Committees are not bound by precedent, and so while previous decisions are instructive, they are not determinative.

Defining the "Bankruptcy" Credit Event (cont.)

The key question in these cases from the perspective of the 2014 Definitions is whether the filing in question constitutes relief that is "similar" to a "judgment of insolvency or bankruptcy." Major factors include:

1. the inclusion (or lack) of a stay of general application;
2. the presence (or absence) of an administrator;
3. the degree of court involvement;
4. the extent to which the Reference Entity is required to satisfy maturing obligations during the proceeding;
5. the relevant entity or entities which are the subject of the proceedings (and whether that entity is the Reference Entity).

Impairment of creditors appears to be a key concern of the EMEA Determinations Committee.



Defining the “Bankruptcy” Credit Event (cont.)

Recent lessons include:

- The mere application for a court order convening a meeting of creditors under English law is not likely to trigger 4.2(c) (New Look).
- The mere filing of a scheme of arrangement under English law likely does not trigger 4.2(d) and would not generally be viewed as providing relief “similar to” a finding of “bankruptcy” or “insolvency” (Thomas Cook), though sanction of a scheme of arrangement could trigger 4.2(c). The analysis turns on whether the scheme constitutes the “making of a general assignment, arrangement, scheme or composition with or for the benefit of creditors generally”. This is a fact-specific inquiry that will take into account the debt and creditors impacted by the scheme.
- A Chapter 15 filing *without* an automatic stay will likely not trigger 4.2(d) and would not be viewed as providing relief “similar to” a finding of “bankruptcy” or “insolvency” (Thomas Cook), but a Chapter 15 filing *with* an automatic stay would likely trigger 4.2(d) (Tembec; Matalan).
- The appointment of an administrator under a Dutch Moratorium triggers 4.2(f) as well as 4.2(d) (Isolux), and so a proceeding with a similarly powerful administrator would also be expected to trigger 4.2(f).
- The appointment of an administrator pursuant to a German insolvency filing may trigger 4.2(f) (Wirecard), and the filing itself might trigger 4.2(b) (Wirecard) based on the fact that the proceeding is strictly an insolvency proceeding.

Failure to Pay as an Alternative Credit Event?

- European issuers of New York law-governed indebtedness – particularly indebtedness with an automatic acceleration feature – may obliquely trigger a "Failure to Pay" Credit Event by (a) launching a European restructuring or insolvency proceeding absent waiver/consent from the requisite noteholders (b) and/or filing for relief in the US.
- This is particularly relevant in the HY space, where a bankruptcy event of default is often coupled with an automatic acceleration feature (Chapter 11 creditors ideally want debt to become due and payable prior to or at the same time an issuer/guarantor makes a Chapter 11 filing).
- The "Failure to Pay" in this instance would be the issuer's failure to pay the accelerated amount after an acceleration.
- As the bankruptcy event of default in fixed income products tends to be broader than the definition of the "Bankruptcy" Credit Event under the 2014 Definitions, even proceedings that would not constitute a "Bankruptcy" Credit Event can set this fact pattern in motion.
- In Thomas Cook, the DC determined that a "Failure to Pay" Credit Event had occurred owing to the issuer's failure to pay an accelerated amount triggered by a Chapter 15 filing, even though the Chapter 15 filing had not on its own caused a "Bankruptcy" Credit Event under 4.2.
- Note that this fact pattern can reach across entities – a guarantor's application for relief could trigger an acceleration of indebtedness that could result in a "Failure to Pay" Credit Event.

Restructuring and Timing

> "When the CDS market moved towards Auction Settlement as the standard form of settlement rather than Physical Settlement, one of the guiding principles was that, so far as possible, market participants should not be prejudiced by the change."

DETERMINATIONS COMMITTEE, HEMA BONDCO I B.V.

- The interaction between CDS expiration dates, triggering events and restructuring plans requires careful analysis.
- Often, a restructuring will give rise to multiple Credit Events – both "hard" (e.g. "Bankruptcy" and "Failure to Pay") and "soft" (e.g., "Restructuring"). Understanding how the various Credit Events play out in terms of a restructuring timeline can be the difference in getting holdouts (such as basis holders) on-board.
- Basis holders will likely be particularly sensitive to restructuring plans that may undermine the deliverability of hedged assets into auction. For example, the extinguishment of deliverable obligations (e.g., in a debt-for-equity swap) can dramatically undermine the value of the CDS contract to protection buyers.

Recent lessons include:

- The EMEA Determinations Committee may be inclined and empowered in certain limited circumstances to accelerate the auction process or otherwise alter the standard auction settlement terms to ensure a fair result for CDS holders.
- This may entail accelerating the auction timeline to avoid write-downs that occur prior to the auction (Isolux; Noble; Hema).
- It may also entail delaying the auction until after the closing of a restructuring to facilitate a smoother auction without deliverability constraints (Steinhoff).
- Where deliverable obligations survive a Credit Event but may be altered or impaired before the auction process and related settlements complete, the EMEA Determinations Committee may permit a package of replacement assets to be delivered in lieu of the original deliverable obligations (Steinhoff; Hema). This is very much an extraordinary tool and isn't equivalent in scope or nature to fulsome "asset package delivery".

Deliverability and Lock-Ups

- Deliverability is an important consideration, particularly for market participants who both hold an asset of the Reference Entity and hold CDS protection. The terms governing standard European corporate CDS require obligations to be "Transferable" in order to be deliverable into auction.
- A obligation of the Reference Entity is "Transferable" if it is "transferable to institutional investors without any contractual, statutory or regulatory restriction".
- This provision generally does not capture restrictions such as those imposed under Rule 144A or Regulations S, but it is often implicated by essential restructuring tools such as lock-ups.
- There are numerous examples of lock-ups impacting the deliverability of locked-up obligations into auctions (Isolux; Noble; New Look).
- Lock-ups typically cannot be forced on subsequent transferees. Further, they typically prohibit transfers of otherwise deliverable obligations to third parties who do not consent to the terms of the lock-up. This poses a challenge to smooth functioning of the physically-settled portion of the auction process (i.e., the entry into so-called "representative auction-settled transactions" or "RASTs").
- The fact that some (but not all) of an outstanding deliverable obligation issue is subject to a lock-up may not be fatal to the deliverability of the non-locked-up portion of the issue (Isolux; Noble; New Look).
- The EMEA Determinations Committee may be inclined to permit locked-up obligations that are not technically "transferable" to be delivered into auction with the caveat that auction participants need not accept delivery of such locked-up obligations (Isolux). This approach is all the more important where all or a significant majority of the deliverable obligations are subject to such a lock-up. Fundamentally, though, auction dynamics can still be materially impacted by lock-ups, even where the locked-up obligations are permitted into auction.
- This flexibility should not be taken for granted, however. Careful drafting of lock-up agreements can improve the chances of deliverability, particularly where the lock-up does not restrict transfers with the purpose of settling (Hema). This doesn't necessarily ensure an optimal result for all parties, however.

New UK "Restructuring Plan"

- The Corporate Insolvency and Governance Act 2020 was enacted on June 25, 2020. The Act improves the ability of companies to be efficiently restructured. For Kirkland's analysis of the reforms, see here.
- The centerpiece of the reforms is the introduction of a new, flexible, "restructuring plan" procedure, with cross-class cram-down.
- There are certain subtle differences between the new restructuring plan and the original scheme of arrangement (on which the new plan was modelled, and which remains available). These features — including the availability of cross-class cram-down — bring the new restructuring plan closer to a US-style Chapter 11 proceeding.
- The reforms also include the introduction of a stand-alone moratorium. However, the moratorium is generally unavailable to bond issuers (unless the bond is unsecured and unguaranteed, or <£10m); accordingly, it will likely have little impact on the CDS market.
- Like a scheme of arrangement, the new restructuring plan takes effect only following sanction by the court (and the various changes effected thereby become effective). Accordingly, from a Credit Event perspective, the new plan does not obviously lead to a new analysis — even though an element of financial difficulty is required as a condition to eligibility.
- The fact that — all things being equal — the *institution* of the new restructuring plan procedure does not impair creditors or impose an automatic stay suggests that merely filing with a court to begin the process will not be any more meaningful from a Credit Event perspective than filing with a court to begin a traditional scheme of arrangement. However, this remains to be tested once the structure is run through the EMEA Determinations Committee in a live example.
- Of course, once the restructuring plan becomes *effective*[1], one or more Credit Events are likely to be triggered.

1. Upon filing of the court's sanction order with Companies House, or, in the case of an overseas company that is not required to register particulars, published in the Gazette.

Narrowly Tailored Credit Events

In large part due to a series of actual and potential "Failure to Pay" Credit Events that captured international regulatory and commercial attention and were:

- not clearly linked to a decline in the creditworthiness of the Reference Entity; and/or
- arguably "engineered" to give the Reference Entity access to favorable refinancing,

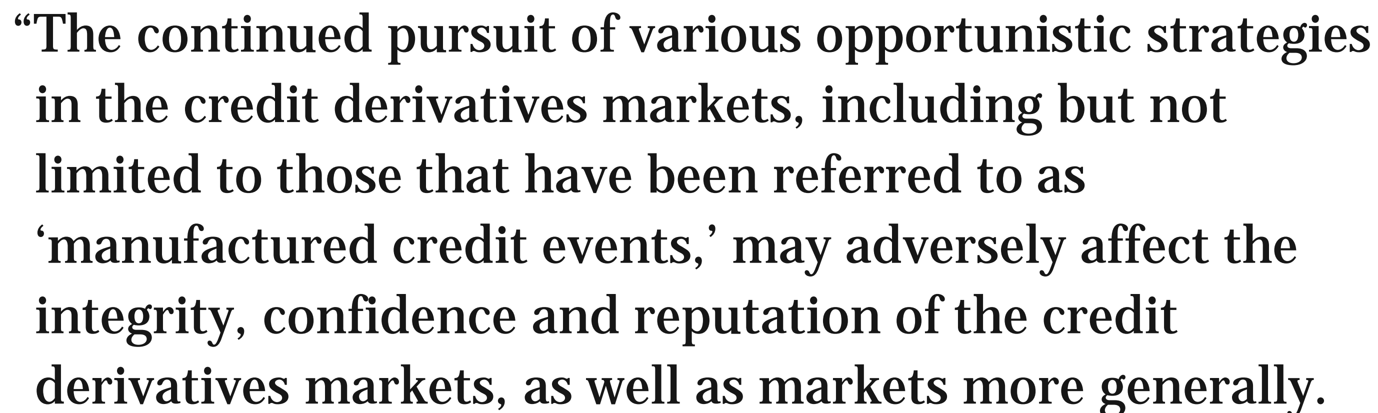
the 2014 Definitions were recently amended via the NTCE Supplement.

This new "credit deterioration requirement" is now hardwired into most standard corporate CDS contracts. At a minimum, it requires those contemplating and planning a restructuring to evaluate whether and to what extent deliberate payment failures (e.g., those used to ensure the trigger of CDS in a restructuring scenario) will pass muster as resulting from or resulting in a decline in the creditworthiness of the Reference Entity.

The importance of CDS to the restructuring process was not lost on the drafters of the NTCE Supplement.

- Accordingly, the NTCE Supplement acknowledges that CDS holders "who have hedged their exposure to a Reference Entity using Credit Derivative Transactions may be likely to reject any restructuring of the Reference Entity's debt obligations if the terms of such restructuring would impair the value of such Credit Derivatives Transactions."
- Additionally, the NTCE Supplement provides that "within the context of a bona fide debt restructuring, if the Reference Entity enters into an arrangement or understanding with such creditors that includes a failure to make a payment with the purpose of causing settlement of such Credit Derivative Transactions so as to increase the likelihood of success of such bona fide restructuring, and in circumstances where without such restructuring the Reference Entity would be likely to enter into bankruptcy or similar proceedings, such arrangement or understanding should generally be considered to have the essential purpose of facilitating such restructuring rather than creating a benefit under a Credit Derivative Transaction."
- The NTCE Supplement was most recently tested where the EMEA Determinations Committee found that a "Failure to Pay" Credit Event occurred as a result of HEMA Bondco I B.V.'s failure to make a payment as part of a negotiated Scheme of Arrangement and that a "Failure to Pay" Credit Event occurred as a result of PizzaExpress Financing 1 plc's failure to pay on its senior secured notes against the backdrop of a widely publicized restructuring transaction.

Nevertheless, the global regulators' focus on allegedly "manufactured" Credit Events suggests that any engineered payment failures will be the focus of scrutiny.



"The continued pursuit of various opportunistic strategies in the credit derivatives markets, including but not limited to those that have been referred to as 'manufactured credit events,' may adversely affect the integrity, confidence and reputation of the credit derivatives markets, as well as markets more generally.

These opportunistic strategies raise various issues under securities, derivatives, conduct and antifraud laws, as well as public policy concerns."

JOINT SEC, CFTC AND FCA STATEMENT

Beyond the NTCE Supplement

- The NTCE supplement doesn't fully "solve" the narrowly-tailored credit event problem, and it may be both overinclusive and underinclusive.
- As the global regulators note, beyond the scope of the NTCE Supplement, there are many "opportunistic strategies that do not involve narrowly tailored credit events."
- The prospect of net short activism poses additional complications that are not addressed by tweaks to the "Failure to Pay" Credit Event – in particular, because such activism does not necessarily rely on the "Failure to Pay" Credit Event.
- Net short activists target potential weaknesses (e.g., defaults) under debt instruments with an eye to profiting from CDS positions referencing the relevant issuer.
- Net short activists buy into such debt in order to trigger defaults and/or litigate those defaults in order to generate a Credit Event.
- The market has developed language to allow issuers to disenfranchise (or even prohibit investment by) "net short" investors. Various forms of this "anti net-short investor" clause exist, though these have to date been more actively adopted in the U.S. market than in the European market.
- It will be instructive to observe this type of behavior going forward, particularly as global regulators have expressed concern regarding this.

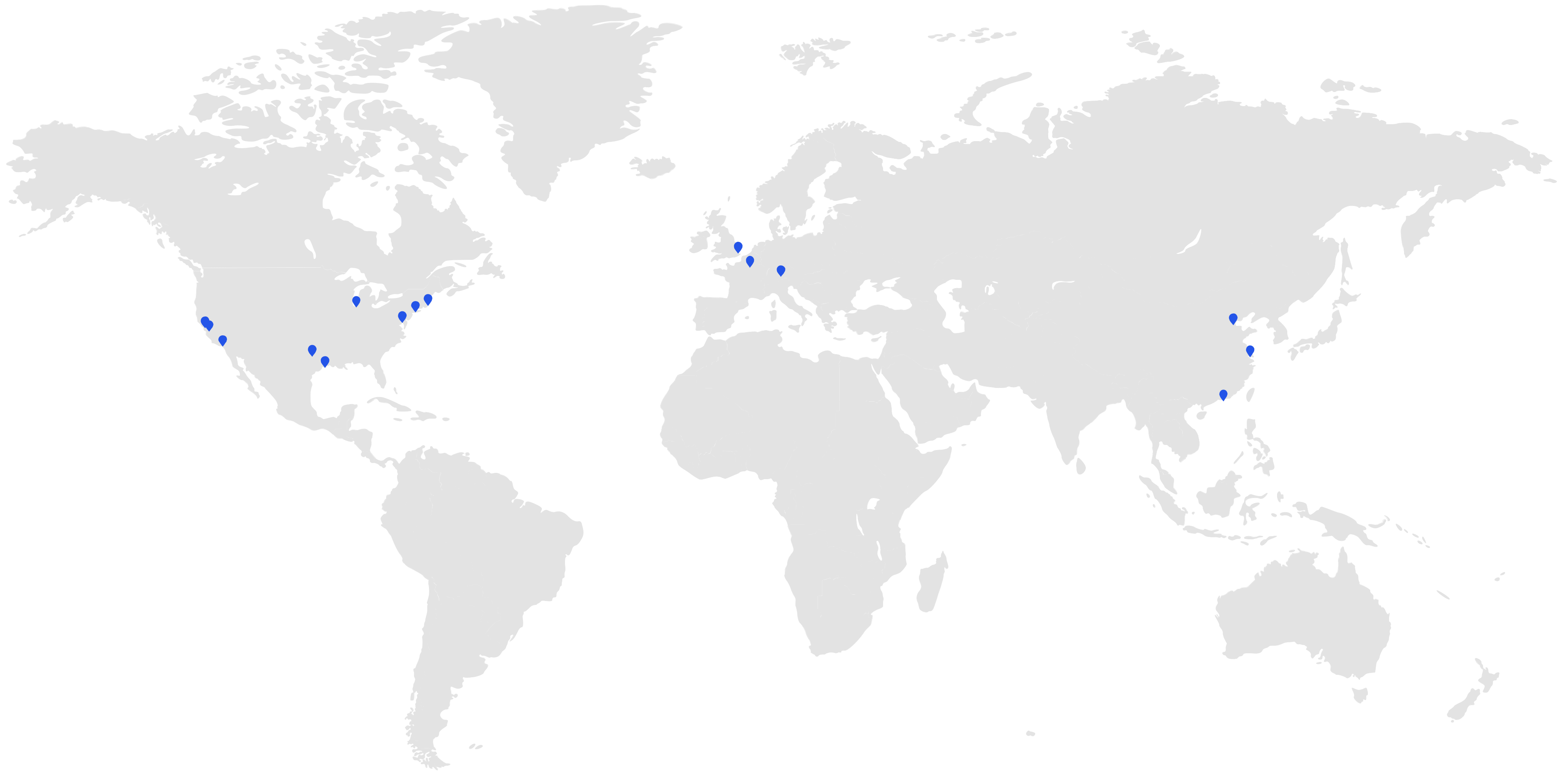
Beyond CDS...

Although the majority of the rules and regulations promulgated under the Dodd-Frank Act, EMIR and other similar legislative architectures have been finalized, the OTC derivatives landscape continues to evolve – particularly in the credit derivative space.

We expect to see a confluence of challenges and opportunities as we approach 2021, with numerous issues coming to the fore, including:

- Requirement for certain market participants to post and collect initial margin on uncleared OTC derivatives
- LIBOR cessation, publication of new ISDA interest rate definitions and related protocol
- Go-live date for SEC margin, capital and segregation rule requiring variation margin and initial margin on many security-based swaps (e.g., single-loan total return swaps, single-name credit default swaps)
- Transition period and potential compliance date for new SEC '40-Act derivatives use rule

International Reach



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