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Sovereign CDS: Lessons from the Greek Debt Crisis

By Jennifer Grady and Richard J. Lee

Greece is proceeding with the largest sovereign debt restructuring in history after its bondholders accepted a significant debt reduction in the face of mounting evidence that a Greek default was inevitable without such relief. In a related market development garnering only slightly less attention than the debt restructuring itself, the International Swaps and Derivatives Association, Inc. ("ISDA") announced on March 9, 2012 that a “credit event” had triggered Greek credit default swaps (“CDS”) as a result of Greece’s imposition of the terms of the restructuring on non-consenting holders of bonds governed by Greek law.

Multiple events during the course of the extraordinary restructuring led to the determination that a credit event had occurred, and sovereign CDS market participants followed the developments closely. Although Greek CDS contracts will be settled in the weeks ahead, heightened attention on the debt burden of other European sovereign issuers, including Portugal, Spain and Italy, suggests that the saga of sovereign CDS in Europe may not end with Greece.

In this memorandum, we outline the general structure of Western European sovereign CDS and summarize the fundamental features of these transactions highlighted by the Greek experience.

BACKGROUND: WESTERN EUROPEAN SOVEREIGN CDS

Sovereign CDS enables market participants to purchase protection against the risk of default of a state, government or certain governmental authorities. ISDA has published standard sets of terms that apply to various categories of sovereign CDS contracts, and “Western European” describes the category that includes Greek sovereign CDS (referencing the Hellenic Republic as the “Reference Entity”), as well as CDS referencing other high-profile sovereign entities, including Portugal, Spain and Italy.

At the most basic level, CDS is a financial contract pursuant to which the buyer purchases protection from the seller against the risk of the occurrence of certain predefined defaults, or “credit events,” with respect to a specified reference entity. During the term of the CDS contract, the buyer makes periodic payments to the seller in exchange for the seller’s promise of protection, and if a credit event occurs, the parties settle the contract to enable the buyer to collect its protection payment. Typically, the parties “cash settle” pursuant to an auction process, where the seller makes a cash payment to the buyer based on an auction-generated market price of certain eligible debt obligations of the reference entity. In the absence of an auction, the buyer receives the benefit of its protection through “physical settlement,”
pursuant to which it delivers an eligible debt obligation of the reference entity in exchange for a cash payment equal to the par value of that obligation. The decision as to whether a credit event has occurred is typically made by a “Determinations Committee” (“DC”), which is comprised of ten voting dealers and five voting non-dealer market participants, based on an analysis of the relevant contractual language contained in the 2003 ISDA Credit Derivatives Definitions (the “Definitions”).

Three credit events can trigger a buyer’s protection under a Western European sovereign CDS transaction: Failure to Pay, Restructuring and Repudiation/Moratorium.

- A “Failure to Pay” credit event is the most straightforward and applies to all other types of standard CDS transactions, both sovereign and corporate. This credit event will be triggered by a payment default in an amount of at least USD 1 million by the reference entity on certain defined debt obligations (“Obligations”) after the expiration of any grace period.

- A “Restructuring” credit event can be triggered by the occurrence of one of five specified events with respect to the reference entity’s Obligations in relation to an amount of USD 10 million or more. These five events include: (i) a reduction in interest payable, (ii) a reduction in principal or premium payable, (iii) a postponement or deferral of certain payment or accrual dates, (iv) a change in ranking or priority resulting in “Subordination,” as defined in the Definitions, and (v) a change in the currency of a payment to any currency that does not qualify as a “Permitted Currency.” Various conditions must be met before a Restructuring credit event can occur, including that the relevant event must occur in a form that binds all holders of the relevant obligations, and that the event must result from a deterioration in the creditworthiness or financial condition of the reference entity.

- A “Repudiation/Moratorium” credit event applies only to sovereign CDS, not corporate CDS. In order for this credit event to be triggered, two conditions must be satisfied: (i) the sovereign entity must either repudiate or declare a moratorium on payments under its Obligations in relation to an amount of USD 10 million or more and (ii) within a specified period of time (generally, 60 days after the initial repudiation or moratorium declaration), a “Failure to Pay” or “Restructuring” must occur, without regard to the amount of the affected debt.

While these general descriptions of the relevant credit events provide a basic overview of Western European sovereign CDS contracts, understanding the terms of any CDS contract requires a close and careful review of the relevant contractual language contained in the Definitions, particularly with respect to credit events. While some market participants have recently bemoaned the ineffectiveness of CDS contracts in protecting against certain losses, a review of the contractual language makes many of the risks underlying these transactions knowable.

UNDERSTANDING THE RESTRUCTURING CREDIT EVENT AFTER GREECE

The intense focus on Greek CDS in the context of the Greek debt restructuring has highlighted the importance of understanding the nuances of the “Restructuring” credit event as applied to Western European sovereign CDS contracts.

Voluntary Restructurings are Unlikely to Trigger

As described above, a “Restructuring” credit event must occur in a form that “binds all holders” of the relevant obligation. Because of this contractual condition, unless all of the relevant holders consent to a restructuring, it is highly unlikely that an entirely voluntary debt restructuring would trigger a credit event.

Impact of Collective Action Clauses

A collective action clause, or CAC, is a set of provisions in bond documentation that enables a specified supermajority of bondholders to bind minority holders to certain restructurings and other modifications to the terms of the bonds. CACs can facilitate an orderly restructuring by enabling the sovereign issuer to avoid costly and lengthy negotiations with hold-out creditors.
who may have differing objectives. CACs are frequently found in sovereign bond documentation, particularly where governed by English law and, increasingly in recent years, New York law. However, Greek bond documents governed by Greek law did not include CACs at the time those bonds were issued.

Second, the use of a CAC will, in most cases, make the occurrence of a Restructuring credit event more likely. Assuming all other conditions to the occurrence of a Restructuring credit event are satisfied, the use of a CAC may be one of a limited number of ways that a sovereign issuer can achieve a restructuring that “binds all holders” of its debt obligations.

**The Economic Pain of Effective Subordination is Insufficient to Trigger**

Events in Greece have also illustrated the importance of a close review of the definition of “Subordination” in CDS contracts. Under the Definitions, a Restructuring credit event can be triggered by a change in the ranking or priority of an Obligation which causes the “Subordination” of that Obligation to another. “Subordination” must involve a “contractual, trust or similar arrangement” providing that either the claims of holders of the senior obligation will be satisfied prior to those of the subordinated obligation in the case of a liquidation, or that the holders of the subordinated obligation will not be entitled to receive any payments if the reference entity is in default on the senior obligations.¹

On February 23, 2012, Greece retroactively imposed a CAC on its Greek law governed bonds by enacting Law No. 4050/2012, known as the Greek Bondholder Act, which would allow Greece to force all holders of those bonds to participate in the proposed debt exchange so long as it received the approval of holders of at least two-thirds (2/3) by face amount of a quorum (constituting one-half (1/2) by face amount) of such bonds. By modifying the terms of these bonds through legislation, Greece heightened investors’ fears that sovereign issuers have wide latitude to change their laws in order to impair the rights of the holders of bonds governed by domestic law.

Greece’s enactment of the Greek Bondholder Act not only has widespread implications for sovereign debt restructurings in general, but also serves to highlight the impact of CACs on sovereign CDS transactions.

First, as the DC unanimously determined on March 1, 2012, the mere passage of the Greek Bondholder Act by the Greek legislature did not constitute a credit event. Although this outcome surprised some market participants, this result is not controversial under the CDS definition of “Restructuring.” While the inclusion of a CAC, or the passage of a law such as the Greek Bondholder Act, may indicate that a debt restructuring proposal could be forced on minority holders, a CDS credit event is unlikely to occur until the necessary supermajority of bondholders has actually agreed to enable the sovereign issuer to use the CAC to effect a restructuring. In this case, it appears that on March 1, the DC was asked to call a credit event prematurely.

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On February 24, 2012, a CDS market participant asked the DC to determine whether a Restructuring credit event under Greek CDS was triggered when Greece allowed the European Central Bank (the “ECB”) to exchange its Greek debt obligations for new bonds prior to the enactment of the Greek Bondholder Act and excluded such new bonds from the obligations affected by the CAC, thus shielding the ECB from being forced to accept the debt restructuring. Despite arguments that this pre-CAC exchange effectively subordinated other bondholders to the ECB by granting the ECB with more favorable terms, the DC unanimously decided that the ECB exchange did not constitute a credit event.² The contractual language contained in the Definitions does not allow for the argument that “effective” subordination that may exist between the ECB and other

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¹ The definition also provides that, only in the case of a sovereign reference entity, priorities arising by operation of law will be considered when analyzing whether “Subordination” has occurred.

² A similar determination was made by the DC, again unanimously, in March of 2011 when a market participant requested that the DC consider whether the International Monetary Fund’s loan to the Republic of Ireland caused other holders of Irish debt to be “Subordinated” to the IMF.
holders of Greek bonds should trigger CDS. The fact that one creditor or group of creditors is treated more favorably than another, without further evidence of contractual or otherwise legally mandatory payment subordination, will generally not be sufficient to satisfy the contractually defined threshold for “Subordination” in CDS.

CONCLUSION
The Greek experience has subjected the CDS market to heightened scrutiny over the past few months, and the events leading up to the trigger of Greek CDS have provided market participants with greater insight into the nuanced technical, economic and political factors that will determine whether and when Western European sovereign CDS will provide protection payments to buyers of protection. As market participants attempt to gauge the impact of other potential sovereign defaults in the eurozone, the lessons of the Greek bond restructuring should remind sovereign CDS market participants to review the relevant “credit event” definitions carefully and take a broad view of a sovereign’s ability to modify existing contractual terms in a time of crisis. Both lessons are essential to a comprehensive understanding of the risks and benefits inherent in sovereign CDS transactions.
QUESTIONS
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