

## Feature

### KEY POINTS

- Corporates use derivatives as a risk management tool in the ordinary course of their business.
- Corporates undergoing solvent restructuring need to consider the terms of any outstanding derivative transactions to avoid triggering events of default and termination events.
- With the regulatory spotlight focussed on manipulation in the derivatives market, corporates should be mindful to avoid playing an active role in an arrangement which may amount to a 'manufactured credit event'.

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# Derivatives issues to consider at the outset of a restructuring

## BACKGROUND

More than 94 per cent of the world's largest corporates use derivatives<sup>1</sup> to hedge a range of financial risks to which they are exposed in the normal course of their business. Corporates are often required by their lenders to establish various derivative hedges linked to their borrowing arrangements. For instance, if the base rate of a borrower's loan facility is floating,<sup>2</sup> the lender may require the borrower to enter into an interest rate swap pursuant to which the borrower will make fixed-rate payments (which the borrower will know in advance and can plan for) and receive floating rate payments (which will go to pay interest on the loan). The notional amount of such a swap would typically be based on the principal amount of the loan. A borrower may also have a mismatch between the currency of its loan and the currency of its revenue. In such a case, the lender may require the borrower to enter into a currency swap pursuant to which the borrower will make payments in the currency of its revenue and receive payments in the currency of its loan, such payments determined by reference to a pre-agreed exchange rate. In addition to interest rate and currency risks, corporates may use derivatives to hedge a range of other financial risks including credit risk and commodity price risk.

## NAVIGATING THE ISDA EVENTS OF DEFAULT AND TERMINATION EVENTS

The relationship of the corporate with its swap counterparty in respect of its derivative transactions will be governed by an umbrella ISDA Master Agreement (1992 or 2002 version<sup>3</sup>), as published by the International Swaps and Derivatives Association, Inc ('ISDA'), with each underlying transaction being documented under a separate confirmation.

The advisers to a corporate undergoing a solvent restructuring need to consider the terms of any outstanding derivative transactions in order to avoid triggering the termination provisions which may result in the corporate being liable for significant mark-to-market termination payments, and may lead to cross-defaults under other financing arrangements. This article briefly analyses the events of default and termination events that could potentially be triggered by a solvent restructuring and suggests that, in the context of a credit-related restructuring, corporates should also be mindful to avoid the moral hazard of being involved in an arrangement which may amount to a 'manufactured credit event'.

In a solvent restructuring, the aim of a corporate would be to avoid triggering the events of default and termination events under its ISDA Master Agreement (either in respect of itself or, if applicable, in respect of an entity designated as a Credit Support Provider or a Specified Entity). Of particular relevance to a corporate undergoing a solvent restructuring are the 'Bankruptcy' and 'Merger Without Assumption' events of default and the 'Tax Event Upon Merger' and 'Credit Event Upon Merger' termination events.

The occurrence of a 'Bankruptcy' or 'Merger Without Assumption' event of default in respect of the corporate or, if applicable, its Credit Support Provider or Specified Entity or the occurrence of a 'Tax Event Upon Merger' or a 'Credit Event Upon Merger' where the corporate is the Affected Party would enable the swap counterparty to close out all its outstanding derivatives transactions (or, in the case of the occurrence of a termination event only, all Affected Transactions) with that corporate potentially resulting in cross-default under the corporate's credit facilities and significant mark-to-market termination payments due by the corporate.

## Bankruptcy

Even in the context of a solvent restructuring, advisers will need to consider certain of the limbs of the 'Bankruptcy' event of default under the ISDA Master Agreement. For

example, an event of default will occur under s 5(a)(vii)(3) of the ISDA Master Agreement where the corporate: '... makes a general assignment, arrangement or composition with or for the benefit of its creditors ...'

'Arrangement' could be construed widely so as to include any type of arrangement between the corporate and its creditors, although the established view seems to be that the general assignment, arrangement or composition must occur due to a deterioration in the creditworthiness of the corporate rather than as a result of ordinary commercial arrangements. In addition, any such general assignment, arrangement or composition must be 'with or for the benefit of [the company's] creditors', rather than simply a particular class of creditors. This is likely to lead to the conclusion that an arrangement with the company's lenders only will fall outside the scope of this provision.<sup>4</sup>

An event of default will also occur under s 5(a)(vii)(9) of the ISDA Master Agreement where the corporate: 'takes any action in furtherance of, or indicating its consent to, approval of, or acquiescence in, any of [the other bankruptcy-related events]'.

This provision widens the scope of the 'Bankruptcy' event of default to include action taken by the corporate prior to the occurrence of the 'Bankruptcy' event that would otherwise be an event of default. In this context, the action must be in furtherance of something

that will be an event of default under one of the other bankruptcy-related events. This means, for example, that preliminary discussions with creditors about alternative financial restructuring options would likely not fall within the scope of this event of default; although negotiating the terms of a restructuring that will involve a general assignment for the benefit of the corporate's creditors would likely fall within the scope of the event of default. Drawing the line between those actions that fall within the scope of the provision and those actions that do not may be difficult.

### Merger Without Assumption

In a restructuring involving an amalgamation of entities or a transfer of assets, a corporate would need to ensure that a 'Merger Without Assumption' event of default is not triggered under s 5(a)(viii) of its ISDA Master Agreement. Such an event would occur where the corporate or its Credit Support Provider:

'consolidates or amalgamates with, or merges with or into, or transfers all or substantially all of its assets to, or reorganises, reincorporates or reconstitutes into or as, another entity and ... [such entity] fails to assume all the obligations of such party ... under [the ISDA Master Agreement] or any Credit Support Document ... or the benefits of any Credit Support Document fail to extend ... to the performance by [such entity] of its obligations under [the ISDA Master Agreement]'.

Although many commentators view this as a narrow and unlikely event<sup>5</sup> since under the laws of most jurisdictions, and also under the terms of most security documents, the surviving entity is liable for the obligations of its constituent parts, advisers to corporates undertaking a solvent restructuring will need to conduct due diligence on such matters.

### Tax Event Upon Merger

The tax advisers of the corporate need to consider whether, as a result of the restructuring, a 'Tax Event Upon Merger' under s 5(b)(iv) of the ISDA Master

Agreement will occur. Such a trigger will occur where withholding tax is imposed as a result of:

'a party consolidating or amalgamating with, or merging with or into, or transferring all or substantially all its assets (or any substantial part of the assets comprising the business conducted by it as of the date of [the ISDA Master Agreement]) to, or reorganising, reincorporating or reconstituting into or as, another entity...'

### Credit Event Upon Merger

A 'Credit Event Upon Merger' will capture a wide range of 'change of control' events, including: mergers, asset transfers, reorganisations, direct or indirect changes in beneficial ownership of equity securities having the power to elect a majority of the board of directors or any other ownership interest enabling a person to exercise control, or any substantial change in a party's capital structure through the issuance, incurrence or guarantee of debt or the issuance of preferred stock or convertible securities.

A termination event will occur if the creditworthiness of the surviving entity is 'materially weaker' immediately after such a 'change in control' event. The subjective element to this termination event creates uncertainty from the point of view of a corporate undergoing solvent restructuring – does it, for example, capture liquidity problems, rating downgrades, increases in credit facilities or breaches of the swap counterparty's credit policies? Because of this element of subjectivity, the corporate contemplating a restructuring should start negotiations with its swap counterparty early.

### MANUFACTURED CREDIT EVENTS

A credit-related restructuring may have implications in respect of credit default swaps ('CDS') referencing the relevant corporate. In order to reduce its credit exposure to a corporate, a lender may have entered into a CDS to provide protection, akin to an insurance policy, against the credit risk of that corporate. The lender would pay a periodic fee to the seller of protection in

return for protection payments being made by such seller upon the occurrence of defined credit events – typically being 'Bankruptcy', 'Failure to pay' and 'Restructuring'.

Although the corporate undertaking the restructuring is unlikely to have a direct interest in whether a credit event has occurred where it is the Reference Entity,<sup>6</sup> the corporate would want to ensure that it avoids playing an active role in an arrangement which may amount to what has come to be known as a 'manufactured credit event' whereby, as part of a restructuring and in order to enable the lender to recover from a protection seller under a CDS referencing the borrower, a lender forces the occurrence of a credit event or persuades the corporate to take action that amounts to a credit event. This risk typically arises in restructuring negotiations where banks who have bought CDS protection on their borrower may have an incentive to see a credit event occurring.

Section 9.1(b)(iii) of the 2003 Credit Derivatives Definitions states that each party to a CDS may:

'engage in any kind of commercial or investment banking or other business with, a Reference Entity ... and may act with respect to such business *in the same manner as such of them would ... if [the CDS] did not exist*, regardless of whether such action might have an adverse effect on a Reference Entity ... or the position of the other party to [the CDS]...'

Some commentators<sup>7</sup> have interpreted the underlined language as preventing a protection buyer from colluding with the corporate that is a Reference Entity under the CDS to disadvantage the protection seller in a way that was not within the contemplation of the parties. Other commentators<sup>8</sup> have pointed out that in practice it may be difficult to prove whether a purported credit event was 'manufactured', and that such disputes are likely to end in litigation.

From the perspective of the corporate and its lender, it should also be noted that CDS can be susceptible to the FSA's powers under the market abuse regime. CDS are not traded on prescribed markets, which is one

## Feature

### Biog box

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of the usual prerequisites for susceptibility to committing one of the market abuse offences. However, the legislation also covers behaviours affecting 'related instruments' or investments 'whose price or value depends on the price or value of the qualifying investment',<sup>9</sup> which definition may in turn capture CDS. Although it is difficult to see how the manufacturing of a credit event could amount to abusive behaviour under the current market abuse regime, it remains to be seen whether regulatory developments may come to affect the issue of manufactured credit events in the derivatives market. In particular, in a recent report<sup>10</sup> of the House of Lords EU Committee, Treasury and FSA officials stated that they supported increased regulation that would curb manipulation in derivatives markets.

### CONCLUSION

The advisers to a corporate undergoing a solvent restructuring should carefully

consider the terms of any outstanding derivative transactions to avoid the corporate having to find replacement swap counterparties, to avoid cross-defaults under other financing arrangements and to avoid triggering requirements to make significant mark-to-market termination payments.

Where there are areas of doubt, early negotiations with the corporate's swap counterparties are recommended. In the context of credit-related restructurings, corporates should also be mindful to avoid playing an active role in an arrangement which may amount to a 'manufactured credit event'.

<sup>1</sup> According to an ISDA survey published on 23 April 2009. See [www.isda.org/press/press042309der.pdf](http://www.isda.org/press/press042309der.pdf).

<sup>2</sup> For example, based on LIBOR.

<sup>3</sup> For the purposes of this article, we have

assumed that the corporate and its swap counterparty have used the 2002 version of the ISDA Master Agreement.

<sup>4</sup> Firth, *Derivatives Law and Practice*, Sweet & Maxwell 2009 at 11-076.

<sup>5</sup> Henderson, *Henderson on Derivatives*, LexisNexis UK, Butterworths, 2003 at 18.21.

<sup>6</sup> Unless they have entered into a self-referencing type of arrangement, the enforceability of which is doubtful.

<sup>7</sup> Firth, *Derivatives Law and Practice*, Sweet & Maxwell 2009 at 16-106 and 16-107.

<sup>8</sup> Glass, 'ACA Restructuring Triggers First Monoline CDS Credit Event', 26 August 2008.

<sup>9</sup> Section 130A(3) Financial Services and Markets Act 2000.

<sup>10</sup> 'The Future Regulation of Derivatives Markets – Is the EU on the right track?' 31 March 2010, [www.publications.parliament.uk/pa/ld200910/ldselect/ldcom/93/93.pdf](http://www.publications.parliament.uk/pa/ld200910/ldselect/ldcom/93/93.pdf).

## KNOWING RECEIPT AND PIERCING THE CORPORATE VEIL

### LAW SOCIETY OF ENGLAND AND WALES V HABITABLE CONCEPTS LTD AND ANOTHER [2010] ALL ER (D) 156 (CHANCERY DIVISION) (NORRIS J)

#### FACTS

A law firm (the 'Firm') committed a large-scale mortgage fraud by collecting in mortgage advances totalling almost £5,800,000 from lenders. Since the Firm had paid monies out of its client account in breach of trust, the Law Society of England and Wales ('LS') intervened under the Solicitors Act 1974.

LS ascertained that a sum of approximately £450,000 had been paid out of the Firm's client account to Habitable Concepts Ltd ('Habitable'), a company whose shareholder and director was an individual named Mr Onykechi Oniuri ('Oniuri'). LS made claims for knowing receipt against both Habitable and Oniuri.

Both Habitable and Oniuri admitted receiving the monies, but contended that the payment had been made on behalf of a client of the Firm, and as such, had been received in good faith, without dishonesty and for good consideration.

#### CONCLUSION

Habitable knowingly received money from the Firm in breach of trust and was liable to account as constructive trustee for the money received. Further, LS was entitled to trace the proceeds of the payment.

LS submitted that it could pierce the corporate veil of Habitable,

but the judge disagreed. In order to do so, LS needed to prove that receipt by Habitable was a mere 'façade or device' to facilitate or conceal receipt by Oniuri. The judge commented that whilst the arrangements seemed deeply suspect, suspicion was not a substitute for proof – particularly when there was an alternative cause of action in Oniuri dishonestly assisting in a breach of trust.

Oniuri's knowledge about the payment to Habitable had to be such so as to render his participation contrary to normal and acceptable objective standards of honest conduct. In respect of the claim for dishonestly assisting in a breach of trust, the court noted a number of facts that inferred Oniuri's assistance in the breach of trust.

The judge was satisfied that there was a breach of trust and that Oniuri had assisted in it. The court's inference was that Oniuri was assisting the Firm, in an unauthorised manner, in order to dispose of money which did not belong to it. The court held that Oniuri had been dishonest and that both Habitable and Oniuri were liable to account as constructive trustees for the sum transferred by the Firm to Habitable.

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