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**Practice Groups:**

**Derivatives and  
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Management**

## O Spirit of Love! Settlement of Credit Derivatives Transactions after a Reference Entity Leaves the Eurozone

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*O spirit of love, how quick and fresh art thou,  
Yet notwithstanding thy capacity  
Thou receivest as the sea: nought enters thee,  
Of what validity and pitch soe'er,  
But that falls into abasement and low price  
even in a minute.*

W. Shakespeare, Twelfth Night, Act I Scene 1

Long dismissed out of hand, the notion that a country in Europe's southern tier of "cloudless climes and starry skies" could abandon the euro to return to its own currency became a focus of attention in October 2011 when the then-prime minister of Greece threatened to submit to a popular referendum the negotiated bailout of his beleaguered country by other members of the European Union ("EU") and the International Monetary Fund.

The agreement in December 2011 by 26 member states of the EU to create a new treaty framework using EU institutions in unaccustomed ways to enforce structural reforms and fiscal discipline among eurozone states created a frisson of optimism that the euro would not cease to be legal currency in any member state of the eurozone.<sup>1</sup> However, the refusal of Great Britain to sign the treaty and legal concerns that EU institutions are not competent to act under a treaty that has not been agreed to by all EU members dampened the sense of relief engendered by that agreement. In December 2011 the concern that one or more stressed nation-states could exit the euro resulted in the inclusion of a risk factor in a draft prospectus for the European Financial Stability Facility to the effect that the euro could break apart or even cease to be a "lawful currency" entirely.<sup>2</sup>

Defections from the eurozone would have consequences at once far-reaching and unpredictable across a broad spectrum of financial transactions. Not least, a eurozone break-up may or may not entail a general default by a member state of the eurozone on its obligations denominated in euro or other foreign currencies. Even absent such a default, the decision by a European government to exit the euro could have profound implications for investors in credit default swaps, credit linked notes and other credit derivatives (collectively "CDS") that reference entities in those countries. The possible consequences are magnified because CDS market participants have so completely discounted the

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<sup>1</sup> The eurozone, formally known as the euro area, is a monetary union comprised of 17 member states of the EU that have adopted the euro as a common sole legal tender. The states comprising the eurozone are Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, the Slovak Republic, Slovenia and Spain.

<sup>2</sup> See "EFSF considers euro warning clause," Financial Times, December 15, 2011.

possibility that a European reference entity could reinstate its own currency that credit protection may have been systematically mispriced by neglecting to factor in unanticipated currency risk.

This article will discuss the possible consequences for CDS transactions if one or more reference entities were to leave the eurozone. It will start by describing the possible steps involved in a country's leaving the euro and also will describe the key CDS concepts that likely would be impacted by such a series of events.<sup>3</sup> It will then address how an exit from the eurozone could – or might not – give rise to credit events under CDS transactions and how the euro exit could affect the settlement obligations following the event determination date.

## **Stand Not Upon the Order of Your Going: How a Country Might Abandon the Euro**

As certain European countries have struggled without success to accommodate the consequences of unsustainable public finances and low growth, market perceptions have evolved concerning the instability of the euro, the potential reintroduction of individual currencies within the eurozone or the potential dissolution of the euro entirely. Several commentators have recently discussed the practical and logistical aspects of a retreat from the eurozone.<sup>4</sup>

The Treaty of Rome does not provide a mechanism for a member state to leave the eurozone. In the absence of an amendment to the Treaty of Rome agreed to by all member states of the EU (including those which are not currently members of the eurozone), a unilateral exit from the euro by a member state may be a breach of the Treaty of Rome which, as a practical matter, might also require the exiting country to leave the EU altogether. Despite the uncertainties and the difficulties it would pose, such a step might be forced upon policy makers if the exiting country is unable to meet its foreign currency obligations or if political circumstances require it to regain full control over its monetary policy with a view to stimulating economic activity and employment levels.

Leaving aside the inter-European legal aspects of a country's exit from the eurozone, commentators have identified two principal ways in which a country may cease to use the euro. In one scenario the exit would occur after the sovereign was forced to default on its external debt. In the other, the exit would occur prior to a default either in the hope of averting a default or to avoid the policy constraints entailed by continued membership of the eurozone.

A country that has resolved to replace the euro with its own currency likely would take several steps that may be relevant to how the transition to its own currency could affect CDS transactions. It is reasonable to expect that bank deposits and domestic debt would be converted immediately to new units of local currency at an exchange rate that would sooner or later represent a significant devaluation. Secrecy and initial speed would be crucial to the implementation of an exit from the eurozone, with the process beginning on a Friday afternoon to minimize the number of days that banks

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<sup>3</sup> The focus of this article is on how a euro exit affecting a reference entity may affect the ability of a credit protection purchaser to give an effective credit event notice, not on how the rights under a CDS would be affected if one or both of the counterparties to the CDS were to leave the eurozone. Therefore it assumes a transaction denominated in US dollars between two counterparties that are outside the eurozone and referencing a Greek or an Italian reference entity. Because a default by a eurozone country likely would cause that country to leave the eurozone, this article assumes that the decision by a relevant government to leave the euro is implemented before the occurrence of another event that would give rise to a credit event under CDS transactions. Because it is focused on redenomination risk, we also do not address other credit-related issues that may affect reference entities, such as whether or not the proposed consensual arrangement for modifying the terms of Greek sovereign debt or the consequences of a failure to negotiate such an arrangement would constitute a "restructuring" credit event for CDS transactions.

<sup>4</sup> See, e.g. S. Skaperdas, "How to Leave the Euro," [New York Times](#), November 9, 2011; T. Judd, "How could Greece leave the euro?" [EuropeanVoice.com](#), November 10, 2011.

would have to be closed. The government would need to freeze deposit accounts. It may also seek to impose currency exchange controls to limit the outflow of capital, particularly necessary if the initial exchange rate is pegged at an unsustainably high level, although because exchange controls would violate the Treaty of Rome a member state would not take that step lightly if it intended to remain in the EU.

Leaving the eurozone would not provide relief to domestic debtors on euro-denominated external debt, and indeed would initially make it more difficult for those debtors to satisfy their payment obligations on such debt because the effective devaluation would make the debt service more expensive in terms of local currency and because a scarcity of foreign exchange may make it impossible for the debtor to obtain sufficient hard currency with which to satisfy its obligations. To alleviate such difficulties, the government might need to guarantee private euro-denominated external debt of banks and certain other businesses. Whether the government sought to avoid defaulting on its own external debt would be a matter of political will, the need for international credibility and projections of how a rebalanced currency will affect public revenues over the medium term.

The impact on external debt of a withdrawal from the eurozone also may be affected by whether the break-up of the euro is limited to the withdrawal of a small number of smaller countries or whether the number or importance of the withdrawing countries is so great as to precipitate a general collapse of the eurozone and lead to the definitive demise of the euro as a currency unit.<sup>5</sup> A comprehensive analysis of the circumstances under which a monetary obligation denominated in euro would be redenominated into the new currency of an exiting member state is beyond the scope of this article.<sup>6</sup> For present purposes, we have assumed that the external financial indebtedness of the exiting member state would remain denominated in euros whereas indebtedness governed by domestic law would be redenominated into that state's new domestic currency, although this might not necessarily be true in all instances.

## Credit Events and Settlement Conventions for Western European CDS

### *General*

A CDS may provide protection on a specific obligation identified as a "reference obligation" in the confirmation. It also may provide protection on obligations of the reference entity that fit within a designated "obligation category" and that are described by the "obligation characteristics" specified

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5 For an analysis of various scenarios in which a eurozone break-up might occur, see J. Nordvig, "Currency Risk in the Eurozone: Accounting for break-up and redenomination risk," Nomura Foreign Exchange and Strategy, January 2012.

6 A court considering whether a payment obligation denominated in euros is effectively redenominated into a new local currency after a member state of the eurozone leaves the euro likely would consider the following factors: (a) the governing law of the contract, (b) the jurisdiction in which the court considering the contract is located, (c) the actual or presumed intention of the parties to the contract with regard to redenomination, (d) the place of payment as specified in the contract, (e) the location of the obligor, (f) whether the exit of the relevant member state from the eurozone was unilateral or by agreement with the other member states of the EU and (g) whether the euro continues as the lawful currency of the remaining member states of the eurozone. For a detailed discussion of this topic, see C. Proctor, Mann on the Legal Aspect of Money at chapter 27. See also C. Ball, "Distress Investing in Europe: Currency Risk Looms," New York Law Journal, December 22, 2011. Courts in EU members states may assess the application of these factors to a euro-denominated contract differently than might a court in a non-EU jurisdiction such as New York for several reasons, including that EU treaty obligations of the court's jurisdiction may raise unique public policy issues and other legal considerations.

within the confirmation, whether as primary obligor or as provider of a qualifying guarantee.<sup>7</sup> (We refer to reference obligations and such other obligations as “relevant obligations.”) If a specified credit event affects any relevant obligations during the scheduled term of the CDS transaction, the credit protection buyer will be entitled to commence the settlement process to realize its protection. The basic terms of credit default swaps and other credit derivatives are contained in the 2003 Credit Derivatives Definitions (the “2003 Definitions”) published by the International Swaps and Derivatives Association (“ISDA”).

The 2003 Definitions list six well-defined credit events: (i) bankruptcy of the reference entity, (ii) failure to pay principal of or interest on a relevant obligation, (iii) repudiation of or declaration of a moratorium with respect to a relevant obligation,<sup>8</sup> (iv) acceleration of relevant obligations in excess of an aggregate threshold amount, (v) the occurrence of an event of default under relevant obligations in excess of an aggregate threshold amount and (vi) restructuring. As discussed in greater detail below, the credit events specified in the ISDA physical settlement matrices that appear potentially relevant to reference entities located in member states of the eurozone are failure to pay, restructuring, bankruptcy and repudiation/moratorium.

Once a credit event has occurred and the conditions to settlement are satisfied, a CDS may be settled physically or by cash settlement. In physical settlement (subject to applicable cash settlement fall-back provisions and buy-in procedures set forth in Article 9 of the 2003 Definitions) the credit protection buyer receives cash in an amount equal to the notional amount of the CDS in exchange for physical delivery of “deliverable obligations” specified in the notice of physical settlement having a face amount equal to the notional amount of the CDS.

If cash settlement applies to a transaction, a valuation process occurs with respect to the reference obligation or other valuation obligations; on settlement, the credit protection buyer is entitled to receive cash in an amount equal to the difference between the notional amount of the swap and the market value of deliverable obligations having a par or face amount equal to such notional amount.

In either case, the credit protection buyer has significant discretion to select the cheapest obligation of the reference entity that falls within agreed “category” and “characteristic” parameters for purposes of delivery (in physical settlement) or valuation (in cash settlement).

In March 2009, ISDA published the so-called “big bang” credit derivatives protocol (the “BB Protocol”) and supplement (the “March 2009 Supplement”) to the 2003 Definitions. By adhering to the BB Protocol, adhering parties are deemed to incorporate the March 2009 Supplement into their existing CDS documentation. This has the effect of replacing existing settlement options with “auction” settlement and authorizing regional “Determinations Committees” established by ISDA to make binding determinations with respect to key matters, including whether a credit event has taken place and which deliverable obligations may be used to satisfy any physical delivery settlement

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7 The ISDA physical settlement matrices provide that “all guarantees” apply to both Western European corporate and European sovereign reference entities. Therefore if the government of a country that left the euro were to guarantee certain relevant obligations of its domiciliaries, the guarantee of those relevant obligations could become separately covered by CDS referencing the sovereign if the guaranteed relevant obligation were comprised within the “underlying obligations” guaranteed by the sovereign’s guarantee.

8 An act of repudiation or moratorium does not crystallize into a credit event unless (i) the repudiation or moratorium occurs during the scheduled term of the transaction and (ii) a failure to pay or restructuring occurs with respect to any amount of debt under relevant obligations on or prior to a date (the “repudiation/ moratorium evaluation date”) that occurs 60 days after the act of repudiation or moratorium or (in the case of relevant obligations that consist of bonds) the lesser of such period or the time to the first payment date under the relevant obligations that are bonds.

requirements; and establishing standardized “lookback” limits that limit the amount of time that may elapse from the occurrence of certain credit events until the time that they are asserted by a party.<sup>9</sup>

### *ISDA Physical Settlement Matrices for European Corporate and Western European Sovereign Reference Entities*

The physical settlement matrices published from time to time by ISDA standardize the credit events, obligation characteristics and deliverable obligation characteristics that are applicable to particular types of CDS depending on the jurisdiction of the reference entity and whether it is a sovereign or a corporate entity. In some cases, the physical settlement matrix amends the standard terms contained in the 2003 Definitions.

Although not mandatory, the standard terms of ISDA’s physical settlement matrices are the starting point for understanding how the rights and obligations of parties to a CDS may be affected if a reference entity or its country of domicile leaves the eurozone. This article is based on the ISDA physical settlement matrices as published on March 16, 2011.<sup>10</sup>

For Western European corporate and sovereign reference entities the relevant obligations that are taken into consideration in determining whether a credit event has occurred are the broad category of “borrowed money,” which includes qualifying guarantees. The physical settlement matrices do not impose any characteristics or categories on the relevant obligations of such reference entities.<sup>11</sup> The practical significance of this is that the universe of relevant obligations does not exclude any categories of bonds or loans. This is in contrast to the situation that would apply to emerging European corporate entities, for which, by way of example, the physical settlement matrices exclude domestic currency obligations from the definition of “obligation.”<sup>12</sup>

The ISDA physical settlement matrices specify three credit events for European corporate entities. These are bankruptcy, failure to pay and restructuring.<sup>13</sup> Analogously, the credit events for Western European sovereigns are failure to pay, repudiation/moratorium and restructuring. In both cases, failure to pay is not subject to “grace period extension” as specified in the 2003 Definitions. However, restructuring for corporate entities is subject to the “modified restructuring maturity limitation and conditionally transferable obligation” requirement as specified in the 2003 Definitions – the so-called “modified modified” restructuring limitation. This restriction, which does not apply to sovereign reference entities, may affect the selection of deliverable obligations in transactions to which physical settlement applies.

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9 For a discussion of the BB Protocol, see G. Peery, R. Wittie and A. Nolan, “[A New Era for Credit Default Swaps](#),” March 13, 2009. The BB Protocol was subsequently amended to apply the auction process to restructuring.

10 Available [here](#).

11 The ISDA physical settlement matrices provide separate specialist treatment of certain types of European sovereign and Western European corporate reference entities, such as obligations of sovereign reference entities known as “sukuk” that comply with Islamic religious precepts and subordinated European insurance corporate reference entities. This article does not address those specialized types of reference entities.

12 It is interesting to consider whether a reference entity in a country that has exited the eurozone would subsequently be considered to be in the emerging Europe category for purposes of the ISDA physical settlement matrices. Such a characterization could conceivably address currency issues for subsequent CDS transactions that are put on after the country has left the euro, but it would be irrelevant to a consideration of rights and obligations under an existing transaction.

13 It is important to note that parties may conceivably specify credit events that do not conform to those in the ISDA physical settlement matrices. Thus, for example, the repudiation/moratorium credit event can apply to a corporate reference entity under the 2003 Definitions if parties elect, but such an election would derogate from the standard for European corporate reference entities set forth in the ISDA physical settlement matrices.

## Credit Events Potentially Occasioned by Abandonment of the Euro

The decision by a European country to leave the eurozone and issue its own currency may or may not affect CDS by causing a credit event to occur with respect to one or more reference entities for such CDS. Whether a credit event occurs and its exact contours and consequences would depend on several factors unique to the transaction. These would include the jurisdiction of the reference entity, whether it is a sovereign or a corporate name, the details of its particular situation and financing terms such as the relative volume of its debt that is governed by foreign law. They could also include whether the withdrawal from the eurozone is discrete or whether it is associated with a general cataclysm in which the euro ceases to exist as a currency. Below we analyze how the relevant credit events under a CDS may be implicated if a reference entity for that CDS were to leave the eurozone.<sup>14</sup>

### *Failure to Pay*

The “failure to pay” credit event occurs if, after the expiration of any applicable grace period (and after satisfaction of any conditions precedent to the commencement of such grace period) the reference entity fails to make, when and where due, any payments in an aggregate threshold amount specified in the CDS confirmation, under one or more relevant obligations in accordance with the terms of such relevant obligations at the time of such failure.<sup>15</sup>

In the case of relevant obligations consisting of external debt, the devaluation and imposition of any associated currency controls would not automatically give rise to a failure to pay, even if it appears likely that a reference entity would not be able to satisfy its payment obligations. Rather, it would be necessary to wait until the following payment date and expiration of any grace periods specified in the contracts governing the relevant obligation. Because the physical settlement matrices do not make grace period extension applicable to European corporate relevant obligations, the crystallization of a credit event for failure to pay would depend on the relation between the timing of the payment default, applicable grace periods and the scheduled termination date of the CDS transaction.

Whether a withdrawal from the eurozone triggered a credit event for failure to pay on a relevant obligation would depend to a large extent on whether the relevant obligation was redenominated into a new currency before the payment date. This in turn could depend to a large extent on the governing law of the relevant obligation.

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<sup>14</sup> Because this discussion focuses on the consequences for CDS of a redenomination of a relevant obligation it does not address the circumstances in which a relevant obligation would be redenominated. In particular, in order to facilitate an analysis how a redenomination may affect the occurrence of a credit event for failure to pay in respect of a relevant obligation referenced in a CDS we assume that relevant obligations governed by the local law of the country leaving the eurozone would be redenominated into the new local currency immediately by decree and that relevant obligations governed by law of another country would remain payable in euros. Because of the time that such a judicial process would entail we assume that external obligations will not be redenominated before a payment date under the relevant obligation. That simplifying assumption may not be true in specific cases.

<sup>15</sup> If the parties to a transaction have elected to make “grace period extension” applicable to a CDS transaction and an act that would be a failure to pay after expiration of any applicable grace period under the terms of a relevant obligation occurs prior to the scheduled termination date of the transaction, the credit protection shall remain outstanding until the expiry of the applicable grace period. If grace period extension is not applicable to a potential failure to pay or an extension notice is not given for a potential repudiation/moratorium, the credit protection would terminate on the scheduled termination date even if that date came before the credit event had been able to crystallize. The ISDA physical settlement matrices do not elect “grace period extension” for Western European corporate reference entities or European sovereign reference entities, in opposition to the position for reference entities from emerging European reference entities.

## External Obligations

The decision by the government of a reference entity's domiciliary jurisdiction to leave the eurozone would not invalidate euro-denominated obligations governed by the law of a different jurisdiction. As mentioned previously, the question of whether the external debt of a member state that leaves the euro (and the external debt of companies incorporated in such member state) would be redenominated as a consequence of its exit from the eurozone is beyond the scope of this alert. However, assuming for the moment that such debt is not redenominated, it would be only a matter of time before a reference entity would incur a payment default under external borrowings unless it could obtain access to euro in an amount sufficient to permit it to pay its obligations.

Because the failure to pay credit event applicable to eurozone reference entities under the ISDA physical settlement matrices does not specify "grace period extension," a payment default under external debt will not give rise to a credit event under a CDS referencing a eurozone corporate or sovereign entity if it does not evolve into an event of default after application of applicable grace periods prior to the scheduled termination date of the CDS. If a reference entity defaults on a payment date that occurs after the scheduled termination date for a CDS transaction, the credit protection on that reference entity would expire without value to the credit protection purchaser. However, it may not be sufficient for the payment default to occur prior to the scheduled termination date if the associated grace period does not expire before the scheduled termination date. If the relevant obligation provides for a grace period for payment defaults, the payment default would become a credit event only if it is not cured before the expiry of the grace period. Unfortunately for the credit protection purchasers, the credit protection is lost with respect to a reference entity and a relevant obligation if the scheduled termination date of a CDS occurs before the grace period runs out on that relevant obligation.<sup>16</sup>

## Obligations Governed by Local Law of the Reference Entity's Jurisdiction

It is likely that a country's exit from the euro would be accompanied by legislation to effectuate the redenomination into the new local currency of obligations under contracts governed by that country's domestic law. There is no reason why a redenomination of a local currency obligation would itself cause a payment default provided that the obligor had sufficient access to local currency or credit support to enable it to pay its obligations at the official rate of exchange.

By the same token, under the 2003 Definitions and the ISDA physical settlement matrices, the failure to pay the amounts in the originally agreed currency would not give rise to a credit event for "failure to pay" under CDS for which the borrower was the reference obligor. This is because the failure to pay is tied to the failure to pay in currency in which the relevant obligation is denominated "in accordance with the terms of such [relevant obligation] at the time of such failure."

Creditors would doubtless strive mightily to challenge the essential legality of such a forced redenomination on the basis of organic national law or EU treaties and legislation. Such a challenge likely would result in protracted litigation over many years. Even if such a challenge were ultimately

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<sup>16</sup> In this respect, the ISDA physical settlement matrices are more favorable to credit protection purchasers under CDS on "emerging European" reference entities because they provide that the "failure to pay" credit event for those reference entities is subject to grace period extension, with the effect that the scheduled termination date is extended following a payment default on a relevant obligation so that it coincides with the grace period provided in the relevant obligation. Ironically, the current treatment of Western European corporate and European sovereign reference entities that may leave the eurozone is analogous to a barn door that is closed after the proverbial horse bolts its stall, as the event that may be considered to cause a country to move from "western European" to "emerging European" status does not provide credit protection purchasers with the same protection that they would have had if the country's credit risk had been recognized as belonging to the "emerging European" category when the CDS transactions were put on.

successful in validating the rights of creditors to accelerate the indebtedness owing to the failure to pay in the contractually specified currency, that victory likely would come too late to benefit credit protection purchasers under CDS transactions because it would come long after the scheduled termination date.

### *Restructuring*

The credit event for restructuring avoids many of the infirmities discussed above in relation to the failure to pay credit event. A restructuring occurs if one or more of certain enumerated events occur with respect to one or more relevant obligations in a form that binds all holders of the relevant obligation by agreement of a requisite majority or by unilateral action announced or otherwise decreed by the reference entity or a governmental authority in a form that binds all holders of the relevant obligation.

One of the enumerated events that give rise to a restructuring credit event is “any change in the currency or composition of any payment of interest or principal to any currency which is not a ‘Permitted Currency’.” Conversely, the redenomination of a relevant obligation into a Permitted Currency will categorically not give rise to a restructuring credit event.

The definition of Permitted Currency has two prongs. Under the first prong the legal tender of a member country of the Group of 7 (“G-7”) or successor is a Permitted Currency.<sup>17</sup> Significantly, France, Germany and Italy are the only eurozone members that are also members of the G-7 as expanded to comprise the G-8 and G-20. Under the second prong, the legal tender of a member country of the OECD is a Permitted Currency as long as that country has a local currency debt rating of AAA by one or more of Standard & Poor’s, Moody’s or Fitch.<sup>18</sup>

Consequently, if as a consequence of Italy’s leaving the eurozone relevant obligations were redenominated from euro into new lire or other domestic currency of the Italian Republic, a credit event for restructuring would not occur on CDS transactions providing credit protection on Italian reference entities because Italy’s membership in the G-7 and G-20 makes that currency a Permitted Currency. On the other hand, if Greece (or Ireland, Portugal or Spain) were to leave the euro, a similar redenomination would trigger a restructuring credit event unless that country obtained a local currency debt rating of AAA from at least one of the major credit rating agencies. It may be realistic to expect a country with full control of its monetary policy to obtain such a rating, particularly if the devaluation attendant to leaving the eurozone strengthens its economic fundamentals, but it may be a tall order to expect a country leaving the eurozone to obtain such a rating at the very moment that it introduces its local currency. This could be particularly true to the extent that the government maintains a high degree of secrecy in planning to introduce its own currency. Therefore, whether the abandonment of the euro by a country other than France, Germany or Italy would trigger a restructuring credit event may depend not only on whether that country can obtain a high local currency debt rating but also on how quickly it can do so.<sup>19</sup>

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17 Spain and the Netherlands have participated in summit meetings of the G-20 since 2008 but are not formal members of the G-20.

18 All members of the eurozone are also members of the OECD.

19 A similar analysis would apply in cases where a court may require that payment obligations in euro be redenominated into another currency external to that of the withdrawing country. The focus would be on whether the new currency satisfied the criteria to be considered a “Permitted Currency.” This could be difficult in cases where assets and obligations are redenominated into a newly created currency unit that is not contemplated by the 2003 Definitions.



### *Repudiation/moratorium*

The credit event for repudiation/moratorium applies uniquely to sovereign entities per the physical settlement matrices. Two things must come to pass for the credit event to occur. First, the reference entity or a governmental authority of the relevant country must either repudiate or declare a payment moratorium on relevant obligations having a minimum aggregate principal amount specified for the CDS transaction. Second, a failure to pay or a restructuring credit event occurs with respect to any amount owing under relevant obligations on or prior to a date (the “repudiation/moratorium evaluation date”) that occurs 60 days after the act of repudiation or moratorium or (in the case of relevant obligations that consist of bonds) the lesser of such period or the time to the first payment date under the relevant obligations that are bonds. The act of repudiation or moratorium must occur before the scheduled termination date of a CDS to trigger potential credit protection, but the credit protection will remain outstanding until the repudiation/moratorium evaluation date, even if that date occurs after the scheduled termination date if one party to the transaction has delivered an extension notice to the other prior to the scheduled termination date of the CDS transaction.

Whether a country leaving the eurozone actually repudiated or declared a moratorium on its relevant obligations would depend on the actions it took in connection with replacing the euro with its unique legal tender. If the departure from the euro were associated with a repudiation of or declaration of a moratorium on indebtedness, the practical effect could be to provide additional time for a credit protection purchaser to deliver a credit event notice, particularly if the currency change occurred near the scheduled termination date of the CDS because the protection would remain outstanding until the repudiation/moratorium evaluation date regardless of whether that date is later than the scheduled termination date of the CDS transaction. If a failure to pay or a restructuring occurred on or before the repudiation/moratorium date (without regard to the amount of the default) a credit event would crystallize and the credit protection purchaser would be entitled to deliver a credit event notice. However, whether a failure to pay or a restructuring actually occurred would be subject to the considerations described above.

### *Bankruptcy*

The credit event for bankruptcy applies uniquely to European corporate entities per the physical settlement matrices. Generally speaking, a bankruptcy credit event occurs if a reference entity is dissolved, becomes insolvent or unable to pay its debts in full, or seeks to become bankrupt or to become subject to a receivership or institutes or has instituted against it a proceeding seeking a judgment of bankruptcy or insolvency or other relief under bankruptcy or insolvency law. In the case of a bankruptcy case or proceeding instituted against the reference entity, the credit event does not crystallize until it has not been dismissed, discharged, stayed or restrained within 30 days of such institution.

Whether a reference entity would become bankrupt following its country of domicile abandoning the euro would depend in part on how much of its indebtedness remained denominated in euro and how much was redenominated in local currency. Indeed, the decision of a country to abandon the euro could significantly reduce the likelihood that companies domiciled in that jurisdiction would become bankrupt. On the other hand, bankruptcy may become more likely for corporations with significant amounts of foreign debt because the effective devaluation as well as any attendant exchange controls could result in the assets of the corporation being insufficient to pay its foreign currency obligations as they become due. The resolution of this question would involve a far broader range of considerations with respect to the reference entity than those that would be involved in determining whether a credit event occurred on any particular relevant obligation.

## Settlement Following Occurrence of a Credit Event

### *General; Deliverable Obligation Categories and Characteristics*

Following the occurrence of a credit event and satisfaction of the conditions to settlement specified in the 2003 Definitions, a CDS transaction would, in accordance with the ISDA physical settlement matrices, be cash settled through an auction as specified in the BB Protocol and the March 2009 Supplement, with a physical settlement backup if auction settlement is not available. The settlement of a CDS with a European corporate or Western European sovereign reference entity is based on a “deliverable obligation,” which is a bond or loan of the reference entity that satisfies specified characteristics on the date as of which it is tendered for delivery or valuation.

For both European corporate and Western European sovereign reference entities deliverable obligations consist of bonds or loans of the reference entity that satisfy seven characteristics specified in the ISDA physical settlement matrices: “specified currency,” “not contingent,” “assignable loan,” “consent required loan,” “transferable,” “not bearer” and “maximum maturity” of 30 years from issuance. In the case of a European corporate reference entity, the deliverable obligation also must satisfy the characteristic of “not subordinated.”<sup>20</sup>

If “restructuring” is the only credit event on a CDS referencing a European corporate, entity, the deliverable obligation also must meet the additional requirements specified for “modified restructuring maturity limitation and conditionally transferable obligation.” Under the first prong of this requirement the deliverable obligation must have a final maturity date not later than the later of (a) the scheduled termination date for the CDS transaction and (b) either (i) 60 months following the date of the restructuring if the deliverable obligation is the restructured bond or loan in respect of which the credit event occurred or (ii) 30 months in the case of all other deliverable obligations.

Under the second prong of this requirement, if the deliverable obligation is a loan it must be capable of being assigned or novated to any bank, financial institution or other entity that is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets without the consent of the relevant reference entity, its guarantor or any other person, or as long as there is a contractual requirement in the deliverable obligation that such consent shall not be unreasonably withheld.

### *“Local Law” and “Local Currency” Deliverable Obligation Characteristics*

The deliverable obligation characteristics applicable to European corporate and Western European sovereigns contain features that may have unexpected implications for the value of deliverable obligations. One important feature is that the deliverable obligation characteristics do not preclude the credit protection purchaser from settling a CDS transaction on the basis of a deliverable obligation that is governed by the local law of the reference entity. Thus, if a credit event is triggered, the credit protection purchaser would be permitted to deliver (or use for valuation) an obligation that is governed by local law.<sup>21</sup>

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20 Of course, the actual deliverable obligations are subject to the specific terms agreed in relation to a particular CDS. Those terms may deviate from the standard provisions set forth in the relevant ISDA physical settlement matrices, although such a deviation would be unlikely in most cases.

21 In this respect, the ISDA physical settlement matrices provide greater protection to credit protection purchasers of CDS referencing emerging European reference entities, as the deliverable obligation characteristics for those reference entities require that the deliverable obligation satisfy the characteristic of “not local law.”

The ISDA physical settlement matrices provide that the deliverable obligation for a CDS that references a Western European corporate or a European sovereign reference entity must satisfy the deliverable obligation “specified currency.” The 2003 Definitions set forth specific parameters for the term “specified currency” if the CDS confirmation does not specify a particular currency. The term is defined to mean any obligation that is payable in the lawful currency of Canada, Japan, Switzerland, the United Kingdom and the United States of America, as well as the euro. The clear import of the “specified currency” definition appears to be to ensure that, in the absence of a contrary agreement by the parties to a transaction, a deliverable obligation will be denominated in a major currency that is not subject to exchange controls that could adversely affect the value in a way that could result in a windfall for the buyer of credit protection.

However, the definition of “specified currency” also includes any “successor currency” to the currencies enumerated. This therefore raises the question whether the new local currency of a country that has left the eurozone may be considered the “successor” of the euro for purposes of the definition of “specified currency.” If the newly issued drachmae, lire, pesos or punt of such a country were to be a “specified currency” on the basis that it was the successor currency of the euro within that country’s borders, this protection would not be available to the seller of credit protection on a reference entity of that country. Coupled with the failure of the ISDA physical settlement matrices to prohibit the selection of deliverable obligations that are governed by local law, this could expose the seller of credit protection on a CDS covering a former eurozone reference entity to significant currency-related risks that could have a materially adverse effect on the value of deliverable obligations, and consequently on the extent to which a credit event would expose that party to losses.

Whether a new local currency was the “successor” of the euro would be a question of great import for CDS participants. Credit protection sellers would likely argue that the term “successor” as applied to the euro refers only to a successor common currency that represents legal tender of all members of the eurozone under Article 50 of the Lisbon Treaty. Buyers of credit protection, on the other hand, likely would argue that any local currency that a country introduces in replacement of the euro as the legal tender within that country’s borders must be considered to be in fact and in law the euro’s “successor” within that country.

## Conclusion

It has long been a truism to say it is unthinkable for a country to leave the eurozone. By the same token, the credit default swap markets have long operated on the premise that the eurozone is like the Hotel California of the eponymous song by the Eagles: “you can check in any time you like / but you can never leave.” The apparent stability of the eurozone and the benefits of a strong currency affected credit derivatives transactions referencing many eurozone countries that traded as if they were more like Germany and France than like the emerging European economies. These characteristics are reflected in the ISDA physical settlement matrices. Now that the forbidden theme has begun to preoccupy economic policy makers and financiers, it is necessary for participants in CDS transactions to consider how the gap between emerging monetary and political realities in Europe and the standard documentation for CDS referencing entities from weaker eurozone countries may give rise to unanticipated consequences for the effectiveness of credit protection and the economics of transactions.

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