

**INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.**

**1999 ISDA CREDIT DERIVATIVES DEFINITIONS**

**OPINION**

1. I am asked to advise the International Swaps and Derivatives Association, Inc. in relation to its 1999 definition of the expression "Not Contingent". This is defined as meaning:-

"any obligation (A) the payment or repayment of principal in respect of which is not an amount determined by reference to any formula or index, or which is not subject to any contingency and (B) which bears interest at either a fixed or floating rate that is paid on a periodic basis and computed on a benchmark interest rate plus or minus a spread, if any."

The question arises in the context of bonds of Railtrack Plc which are exchangeable into shares of Railtrack Group Plc at the election of the bondholder (and at the option of a trustee for bondholders under a typical "widows and orphans" clause). The question is whether such bonds are eligible for delivery under physically-settled credit default swap transactions which specify that the obligation must be "Not Contingent".

2. For present purposes the relevant wording is "any obligation the payment or repayment of principal in respect of which ... is not subject to any contingency". In the current context the contingency which is relevant is a contingency as to the obligation to pay or repay the principal.
3. The first issue is whether a simple option for a bondholder to exchange his bonds for shares renders the bonds "contingent" on the basis that the obligation to pay principal is contingent on the bondholder not exercising his right to convert. I do not think this can possibly be right. The definition is concerned with whether the obligation to pay principal is contingent. In this case,

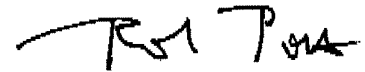
the decision on whether to convert is that of the bondholder himself and is entirely within his own control. I do not think that the expression “any contingency” can extend to a right exercisable exclusively by the bondholder himself. I think a requirement for the trustee or a clearing system to give the notice of conversion at the direction and on behalf of individual bondholders attracts the identical conclusion. I also agree that mere mechanical requirements which must be satisfied in order to obtain payment, such as the presentation of a bond to the issuer, do not render the bonds “contingent”. Where the requirement is not merely mechanical then the position might be different.

4. The next issue relates to the inclusion of a “widows and orphans” clause. The bondholder, in such a case, only has a right to payment if the trustee does not exercise the trustee’s option to exchange the bonds for shares. I think the words “any contingency” are wide enough to cover the right of the trustee to elect to exchange. The obligation of the issuer is contingent on the trustee not exercising this right, being a right which the trustee can exercise without reference to the bondholders as long as certain conditions are satisfied. As a matter of literal construction the existence of such a provision could be said to operate to render the obligation to pay subject to a (ie “any”) contingency. Nonetheless, the Courts may adopt a more purposive construction to avoid producing a result which is in its view clearly perverse (see Investors’ Compensation Scheme v West Bromwich Building Society [1988] 1 WLR 896 and IRC v Trustees of Sir John Aird’s Settlement [1984] Ch 382). I think the prospects of the Court adopting this approach are correspondingly greater the more unlikely it is that the supposed contingency would occur. The high water mark is where the supposed contingency is so unlikely that there is no real possibility that it will occur. That would be a matter to be determined at the relevant time - in this case the date of physical delivery - and in the light of all relevant circumstances, including the time at which a trustee would be entitled to exchange. This approach involves the Court asking “could the parties, in the real world, sensibly have

intended to preclude the delivery of bonds at that time containing a widows and orphans clause”, having regard to the facts as they actually stood at the time of delivery?

5. In relation to the issue as to “widows and orphans” clause, I can only say that the position is unclear. However, on balance my view is that if there were no real possibility of the trustee actually exchanging the bonds for shares and absent any agreement between the parties to the contrary it is likely that the Court would hold that the bonds are “Not Contingent” for the purposes of the Definitions.
6. I summarise my conclusions as follows:-
  - (1) I do not think that the inclusion of a right of exchange or conversion in favour of, and exercisable only by, bondholders results in the bonds being otherwise than “Not Contingent”. The same is true where the exchange or conversion right is exercised by a trustee or clearance system on behalf of bondholders but only following the direction of individual bondholders.
  - (2) The additional inclusion of a “widows and orphans” clause exercisable by a trustee for bondholders at its own discretion does give rise to a possibility, as discussed above, that the bonds could be held to be otherwise than “Not Contingent”.
  - (3) For the reasons given above a Court could hold that bonds were “Not Contingent” even where they contained a “widows and orphans” clause if it concluded that at the date of delivery neither party could sensibly have regarded the bonds as being otherwise than “Not Contingent” having regard to the fact that there was no real possibility of the clause being operated by the trustee.

- (4) If it can be concluded that there will not at the date of delivery of any Railtrack bonds be a real possibility that the trustee might operate thereafter the “widows and orphans” clause then, on balance, I think the Court is likely to conclude that such bonds are “Not Contingent”.



Erskine Chambers  
Lincoln's Inn  
18 October 2001