SEAT PG: Failure to Pay or Not, the Question Facing the DC

SEAT Pagine Gialle appears not to have paid the interest amount of approximately EUR 50 million originally due on or about 31 October 2011 on its borrowing from Lighthouse International Company S.A., a Luxembourg orphan vehicle. The Determinations Committee (DC), a series of geographically-based committees set up by the International Swaps and Derivatives Association, Inc. (ISDA) to decide whether or not credit events have occurred under credit derivative transactions, now has the task of determining whether that non-payment amounted to a “Failure to Pay” for the purposes of the credit events (Credit Events) standardly included (and defined in the Credit Derivatives Definitions referred to below) in credit derivative transactions naming SEAT PG as “Reference Entity”.

SEAT PG and Lighthouse

SEAT PG has indebtedness under senior notes and bank debt, but also has subordinated funding in the form of a loan from Lighthouse of the proceeds of certain high yield notes issued by Lighthouse. The loan is referred to below as the “proceeds loan”.

Lighthouse is a stand-alone company outside the SEAT PG group, which relies on the cash flows under the proceeds loan to service its obligations under its high yield senior secured notes.

The proceeds loan therefore, as would be expected, contains provisions to ensure that various events prescribed under the Lighthouse notes result in corresponding consequences under the proceeds loan. For example, if there is a withholding tax imposed on the Lighthouse notes which would require a gross up by Lighthouse, the interest payable under the proceeds loan is increased to cope with the increased cash flow requirement.

Under the terms of the Lighthouse notes, interest (i.e. the coupon) was due on or about 31 October 2011. It was not paid. There is a grace period of 30 days in the Lighthouse notes in respect of the payment of interest before that non-payment amounts to an “Event of Default” under the terms of the Lighthouse notes. Consequently, all other things being equal, the failure by Lighthouse to pay out that coupon will not constitute an Event of Default under the Lighthouse notes (thereby giving raise to certain rights for noteholders in relation to, for example, acceleration of the notes) until the end of November 2011.

If Lighthouse had received the payment of the corresponding interest amount under the proceeds loan on or before 31 October, it would have been obliged to pay out the coupon, there being no good reason for Lighthouse to delay that
payment if it were in funds. We have therefore assumed that Lighthouse did not pay that coupon because it was not in funds to do so. We believe that situation can only have occurred in the current circumstances where SEAT PG did not in fact pay to Lighthouse the corresponding interest payment under the proceeds loan.

The Question

And so we reach the question: If SEAT PG did not in fact pay the corresponding interest payment on the proceeds loan on or about 31 October 2011, did that constitute a “Failure to Pay” Credit Event in respect of SEAT PG for the purposes of credit derivative transactions for which SEAT PG is the Reference Entity? As we understand it, this is the question in front of the DC at the moment.

The DC Process

The process that the DC is obliged to go through to accept a question and then to determine it is clear enough: it is set out in the DC rules which form an annex to the amended 2003 ISDA Credit Derivatives Definitions (as amended by the 14 July 2009 supplement dealing with auctions and restructuring) published by ISDA (the Credit Derivatives Definitions). However, we do not know what arguments have been presented to the DC for or against the proposition or what papers have been put forward. The DC may have taken legal advice on the matter, but we will not know what that advice was. If the DC were to have determined the question, we would expect ISDA to publish merely a "Yes" or "No" decision, with the date of the Credit Event in the case of "Yes". On this occasion, more information may be forthcoming, as the DC have been unable to determine the question by the relevant majority and so, under the DC rules, the question is being put in the hands of external reviewers. Three external reviewers will review the matter referred to them and will, after a process similar to an arbitration, decide the matter. Because the DC voting was so evenly balanced (8 for, 7 against), the external reviewers will be able to resolve the point by a majority. A summary of the external reviewers' reasoning and analysis will be published so we should on this occasion find out exactly what is the rationale for the ultimate decision. Decisions on Credit Events are, in general terms, not subject to review or appeal: virtually the entire CDS market has signed up to the relevant protocol or is now trading in CDS on the basis that it will live with whatever decisions are forthcoming from the DC and external review process.

Requirements for a Failure to Pay Credit Event

In the case of CDS transactions for which SEAT PG is the reference entity, there is a series of conditions that would need to be satisfied in order for the failure to pay to constitute a Credit Event in respect of any particular CDS transaction. But, we are assuming that all of these conditions are generally not in question, barring only the question of the status of the payment itself, as discussed below.

The requirement for a “Failure to Pay” Credit Event is that, after the expiration of any applicable Grace Period (after the satisfaction of any conditions precedent to the commencement of such Grace Period), there is a failure by SEAT PG to make, when and where due, any payments in an aggregate amount of not less than the Payment Requirement under one or more Obligations, in accordance with the terms of such Obligations at the time of such failure. We go through these items in turn. Capitalised terms used in this paragraph have the meanings set out in the Credit Derivatives Definitions.

Payment Requirement

The payment will exceed the standard Payment Requirement. The coupon on the Lighthouse notes is 8% per annum, payable semi-annually. The Lighthouse notes constitute EUR1.3 bn of principal. So, in round terms, the coupon would be in the region of EUR 50m, well above the USD 1m Payment Requirement.
Was the Payment Due?

So, was the payment due? It would appear so.

The proceeds loan provides that the loan “shall accrue interest on terms ... corresponding to those for interest payable from time to time in respect of the [Lighthouse notes]...” and that, subject to certain provisions which appear not to be relevant to this situation, “interest will be due and payable (i) with respect to interest calculated by reference to outstanding [Lighthouse notes], no later than the date one Business Day prior to the date on which interest in payable under the Indenture...”

Interest is payable under the Lighthouse notes on or about 31 October. The grace period under the Lighthouse notes is not a permission for Lighthouse to be late in paying. It is merely a contractual arrangement that if Lighthouse is over 30 days late in paying, certain extra rights (e.g. acceleration rights) arise in favour of noteholders. So, the date for payment of the interest amount under the proceeds loan was the date that the coupon was originally due on the Lighthouse notes, i.e. on or about 31 October.

Is the Proceeds Loan an Obligation?

Is the proceeds loan an “Obligation”? Under standard CDS terms (as to which the Physical Settlement Matrix published by ISDA is the guide), the relevant “Obligations Category” for the determination of Credit Events will be “Borrowed Money”, with no Obligation Characteristics being applicable. The proceeds loan constitutes borrowed money and the fact that it may or may not be subordinated is not relevant to the determination of the Credit Event. We have assumed that the terms of the proceeds loan have not been amended and that the signed proceeds loan of 22 April 2004 is still the governing document.

The Grace Period Debate

Finally then, the question of the Grace Period: there is no obvious grace period in the proceeds loan. We discuss below the risk of the importation of a grace period from the Indenture but, if the conclusion is that there is in fact no grace period in the proceeds loan then, under Section 1.12 of the Credit Derivatives Definitions, a Grace Period of three “Grace Period Business Days” is deemed to apply.

The proceeds loan contains provides in clause 1.2, that “…an Event of Default under and as defined in the Indenture [for the Lighthouse notes] shall constitute an Event of Default hereunder. Consequently, upon the occurrence of an Event of Default under the Indenture, an Event of Default shall have occurred hereunder.”

By its terms, this provides that certain events under the Lighthouse notes are to be treated in a certain way under the proceeds loan. It does not provide a set of provisions dealing with what would be Events of Default under the proceeds loan to be judged by reference to events under the proceeds loan. This language does not, for example, state that a failure to pay by SEAT PG on the proceeds loan has any particular status or effect. It states that if, for example, there is a Lighthouse insolvency event then that will constitute an Event of Default under the proceeds loan. It is not possible to read this provision as transcribing into the proceeds loan the text of the Lighthouse notes Events of Default, changed so as to refer to SEAT PG in place of Lighthouse, and so on.

But it is unclear what the provision is intended to do, as there is no further language setting out any consequences of there being an Event of Default under the proceeds loan. The proceeds loan already contains language which provides for its early payment in circumstances where the Lighthouse notes have become payable early or have been accelerated (that is found in clause 3.2).
If clause 1.2 is taken to give rise to a grace period under the proceeds loan equal to the grace period under the Lighthouse notes, this would give SEAT PG until the end of November before the Failure to Pay Credit Event occurred, if it occurred at all (as the question of the occurrence of a Failure to Pay Credit Event must be answered by reference to the terms of the relevant Obligation at the time of the event, so there might be an opportunity to put in place a standstill agreement, as an example, to avoid such a Credit Event). What can be said is that, if was the intention of the language in clause 1.2 to include a grace period for SEAT PG’s payment obligations to Lighthouse, it has not been set out clearly, given the absence of any language setting out the consequences of an Event of Default under the proceeds loan and the fact that the inclusion in the proceeds loan of a non-payment under the Lighthouse notes as a proceeds loan Event of Default does not per se incorporate any grace period for SEAT PG on its proceeds loan payments. If that was the intention, the language in clause 1.2 appears deficient.

Rewriting the Proceeds Loan

If the language of a commercial contract is deemed to be deficient, it would be open to a judge to cure the problem by supplying provisions to make up for that deficiency. A court will only generally do so where the answer is obvious and the missing or erroneous drafting is easily supplied or cured. A court (at least an English court) will not draft the agreement that the parties ought (in its view) to have agreed. So, if it is not possible for the court to determine clearly what should have been included, then it will not supply the cure.

In this case, while it would no doubt be nice for SEAT PG to have a grace period of 30 days to make payment under the proceeds loan, it does not seem to us either that inclusion of such a grace period is required to make commercial sense of that part of the proceeds loan or that, even if there is a lacuna in the proceeds loan, it is sufficiently clear what language should to be incorporated to fill the gap.

In particular, sense can be made of the proceeds loan having no grace period while the Lighthouse notes have a 30-day grace period. There could be circumstances in which, for example, a payment might be made under the proceeds loan which did not reach the Lighthouse noteholders: the security over the proceeds loan might be enforced and while this would give rise to a separate Event of Default under the Lighthouse notes, it would not constitute a non-payment Event of Default under the Lighthouse notes for 30 days; or Lighthouse might be under some injunction or legal requirement not to make a payment out to noteholders in the middle of proposing restructuring terms and might be obliged to hold back payment pending resolution of those terms. Under the proceeds loan, there would not have been any failure to pay at all, so a separate Event of Default under the proceeds loan by reference to the Lighthouse notes Event of Default has been included in order to give rise to certain rights under the proceeds loan. The only language that is obviously missing is a statement that, on the occurrence of an Event of Default under the proceeds loan, the lender may accelerate, although, as noted above, this omission is not itself critical as the proceeds loan is already by its terms payable when the Lighthouse notes are payable. Inclusion of such language would permit the proceeds loan to be accelerated where there was an Event of Default under the Lighthouse notes but they had not been accelerated.

We therefore consider it very unlikely that a court would be persuaded, with sufficient certainty, that there should be a 30-day grace period on payments under the proceeds loan, so that it would incorporate such a provision.

As a result, the failure to pay interest on the proceeds loan on or about the date that the coupon was first due on the Lighthouse notes seems to us to satisfy the requirements for a Failure to Pay Credit Event, at least by the expiration of three Grace Period Business Days after the payment was first due.

We await the conclusions of the DC and external review process with interest.
This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Azam H. Aziz  
New York  
+1.212.848.8154  
aaziz@shearman.com

Patrick Clancy  
London  
+44.20.7655.5878  
patrick.clancy@shearman.com

Geoffrey B. Goldman  
New York  
+1.212.848.4867  
geoffrey.goldman@shearman.com

Donna M. Parisi  
New York  
+1.212.848.7367  
dparisi@shearman.com

Ian Harvey-Samuel  
London  
+44.20.7655.5000  
ian.harvey-samuel@shearman.com