

Novo Banco External Review

Decision and Analysis of the External Review Panel of the ISDA EMEA Determinations Committee with respect to DC issue Number 2015123002 pursuant to Section 4 of the 2016 ISDA Credit Derivatives Determination Committees Rules

1. This is the determination of an External Review Panel, comprising Adrian Beltrami QC, Mark Hapgood QC and Sir Bernard Rix (chairman), constituted to consider the following Reviewable Question:

Has a Governmental Intervention Credit Event occurred with respect to Novo Banco SA on or about 29 December 2015?

2. The “Yes” position was advocated in written and oral submissions by Timothy Howe QC, instructed by Linklaters LLP; and the “No” position was advocated in written and oral submissions by Robert Miles QC and Andrew de Mestre, instructed by Mayer Brown International LLP. There was a Statement of Agreed Facts prepared by the two positions.
3. The oral argument was heard on 12 February 2016.
4. The External Review followed a DC Vote, which was in favour of the “No” position by 11 votes to 4.
5. The External Review Panel is grateful for the cogent submissions which they have received, and for the helpful DC secretarial services provided by Allen & Overy LLP.
6. On the terms of our mandate, we are required to answer the Reviewable Question on the basis of which Presented Position is the “better answer” (DC Rule 4.6(d)). We have been asked to do so in accordance with English law as being the governing law.
7. We have each and unanimously concluded that the better answer is that a Government Intervention Credit Event (“GICE”) did *not* occur and that the “No” position is the better answer.

8. What follows are our brief reasons for this conclusion.
9. The Reviewable Question arises from the re-transfer on 29 December 2015 of five senior bonds (the “Bonds”) by the Bank of Portugal (“BoP”), in its capacity as the Portuguese Resolution Authority, from Novo Banco SA (“NB”, ie the “good bank”) back to Banco Espírito Santo, SA (“BES”, ie the “bad bank”). These bonds had originally been transferred with other assets and liabilities of BES to NB pursuant to a resolution of BoP, in its capacity as the Portuguese Resolution Authority, dated 3 August 2014, in accordance with the Applicable Resolution Law of Portugal, which had been amended to transpose into Portuguese law the EU Bank Recovery and Resolution Directive 2014/59/EU of 15 May 2014 (the “Directive”). As a result of the BoP’s resolution and with effect from its date, BES was substituted as the issuer and obligor of the Bonds, and NB ceased to have any continuing obligations in respect thereof.
10. The Reviewable Question has to be answered in accordance with Section 4.8 of the 2014 ISDA Credit Derivatives Definitions (the “Definitions”), which provides as follows:

Section 4.8 Governmental Intervention

(a) “Governmental Intervention” means that, with respect to one or more Obligations and in relation to an aggregate of not less than the Default Requirement, any one or more of the following events occurs as a result of action taken or an announcement made by a Governmental Authority pursuant to, or by means of, a restructuring and resolution law or regulation (or any other similar law or regulation), in each case, applicable to the Reference Entity in a form which is binding, irrespective of whether such event is expressly provided for under the terms of such Obligation:

- (i) any event which would affect creditors’ rights so as to cause:*
- (A) a reduction in the rate or amount of interest payable or the amount of scheduled interest accruals (including by way of redenomination);*

- (B) *a reduction in the amount of principal or premium payable at redemption (including by way of redenomination);*
- (C) *a postponement or other deferral of a date or dates for either (I) the payment or accrual of interest, or (II) the payment of principal or premium; or*
- (D) *a change in the ranking in priority of payment of any Obligation, causing the Subordination of such Obligation to any other Obligation;*
- (ii) *an expropriation, transfer or other event which mandatorily changes the beneficial holder of the Obligation;*
- (iii) *a mandatory cancellation, conversion or exchange; or*
- (iv) *any event which has an analogous effect to any of the events specified in Sections 4.8(a)(i) to (iii).*

11. It is common ground that the anterior requirements of Section 4.8(a), ie those in the chapeau to Section 4.8, are satisfied. Thus it is common ground that the Bonds constitute Obligations, that their aggregate amount is in excess of the Default Requirement, that the BoP is a Governmental Authority, that the Reference Entity is NB, and that the re-transfer was pursuant to a restructuring and resolution law and is binding.

12. It is also common ground that the events stated within sub-paragraphs 4.8(a)(i) and (ii) are not engaged.

13. The argument has therefore centred on whether the re-transfer was an event within sub-paragraphs (a)(iii) and/or (iv), ie whether it was a mandatory cancellation, conversion or exchange or an event which has an analogous effect to a cancellation, conversion or exchange.

14. It will be immediately apparent that the most obvious way of describing the re-transfer of the Bonds is by use of the word “transfer”, which was in fact the word used repeatedly by both sides throughout their submissions to describe the event in question. And it may also be observed that the event of “transfer”, although found in the immediately preceding sub-paragraph (ii) dealing with the position of holders, is not found in sub-paragraph (iii)

which deals with the status of the Obligation itself. The draftsman cannot have overlooked the possibility of referring to a transfer of an Obligation in sub-paragraph (iii), because he had just used the word “transfer” in sub-paragraph (ii).

15. Moreover the concept of “transfer” is elsewhere familiar to the draftsman. It is to be found in Section 3.11, wherein “Permitted Contingency” is defined as any reduction to a Reference Entity’s payment obligations as a result of inter alia “(a)(i) any provisions allowing a transfer, pursuant to which another party may assume all of the payment obligations of the Reference Entity”. The Directive also refers extensively to a “transfer” of assets, rights and liabilities (see eg Article 40). Whilst the Directive was issued a number of months after the Definitions, the Definitions were drawn up in a period when the Directive was in preparation, and both sides referred to it as providing a background and general context to the interpretation of the Definitions.

16. In these circumstances, it would seem therefore that the draftsman has deliberately decided not to include the expression of “transfer” as an event within the definition of a GICE within sub-paragraph (iii).

17. This is the background against which we come to the “Yes” position’s first submission, which was that the transfer was within sub-paragraph (iii) as “a mandatory cancellation, conversion or exchange”. Priority was in fact given to the words “conversion or exchange” and an alternative and secondary submission was made that it was a cancellation.

18. In our view, the re-transfer was none of these events. It was not a cancellation, because the Bonds continued in existence. The fact that NB’s liabilities in respect of the Bonds had ceased following their transfer to BES does not mean that the Bonds themselves had been cancelled.

19. Nor was the re-transfer a conversion. The natural meaning of such a conversion is the alteration of the Bonds into some other category of obligation (see for instance Section 3.13 which details Obligation Categories). The paradigm example of such a conversion is the conversion of debt into equity. In the context of governmental restructuring and

resolution it is of some relevance that the Directive speaks of conversion in the sense indicated (see articles 43.2, 46.1(b) and 59). Although following the transfer and re-transfer of the Bonds the obligor of the Bonds changed from BES to NB and then back to BES again, nothing in the nature of the Bonds was converted.

20. Nor was the re-transfer an exchange. An exchange refers to a process by which one bond is surrendered for another for cancellation in exchange for the issue of a new bond on (presumably) different terms. In the present case, the Bonds remained the same instruments or obligations, with no alteration in their existence or status, other than that the obligor altered first from BES to NB and then back to BES again. Their ISIN remained the same. We agree with the submission of the “No” position that it is not apt to describe a case as an exchange where there is one continuing instrument whose terms remain unchanged but with the obligor changing or being substituted by operation of law.

21. The question next arises whether nevertheless the re-transfer was, pursuant to sub-paragraph (iv), “any event which has an analogous effect to any of the events specified” in sub-paragraphs (i) to (iii).

22. This it seems to us is the critical question. There is an obvious tension in a definitional section between three carefully drafted sub-paragraphs, in one of which the event of “transfer” is included and in another of which (and the crucial sub-paragraph) it is not included, on the one hand, and a fourth, so-called “catch-all” sub-paragraph drafted in apparently wide terms. In speaking of sub-paragraph (iv) as being drafted in apparently wide terms, we refer to its language such as “any” in the expression “any event”, a word often used to express an all-inclusive meaning); “analogous” (a somewhat slippery word, and not the equal of “same” or “identical”); and the word “effect” (which appears to concentrate on functional and pragmatic outcomes rather than on definitional categories). The ultimate question is how that tension is to be resolved.

23. The “Yes” position submits that by reason of sub-paragraph (iv) (and for other reasons such as the broad scope of the Directive and the different categories of Obligations), the Section 4.8 definition should be given a

broad scope, irrespective of attendant uncertainty. The “No” position submits, on the other hand, that Section 4.8 gives every impression of having been tightly drawn; and that uncertainty in the application of such a definitional section should be avoided as much as possible, citing Briggs J in *Lomas v. JFB Firth Rixson* [2010] EWHC 3372 (Ch) at para [53], where speaking of the ISDA Master Agreement he said:

It is axiomatic that it should, as far as possible, be interpreted in a way that serves the objectives of clarity, certainty and predictability, so that the very large number of parties using it should know where they stand: see Scandinavian Trading Tanker Co. v Flota Petrolera Ecuatoriana [1983] QB 529, [1983] 1 All ER 301, [1983] 2 WLR 248 (“The Scaptrade”) per Robert Goff LJ at 540.

24. The “No” position therefore submits that the analogy in question is with something which is essentially similar to the carefully defined events within the previous sub-paragraphs of the definition.
25. The “Yes” position nevertheless submits that sub-paragraph (iv) should be given a broad interpretation, pointing out that the substitution of BES for NB as the obligor of the Bonds could have been achieved by an exchange involving the surrender of the original Bonds and their replacement by new bonds. If the re-transfer could have been achieved in this way, and since it achieved the same result or “effect” as such an exchange, then it can and should be concluded that the re-transfer is an event which has “an analogous effect” to a sub-paragraph (iii) event.
26. We resolve this tension in favour of a narrower interpretation of sub-paragraph (iv) and the “No” position, for essentially the following reasons:
- (a) Although it is inevitable that the inclusion of the language of sub-paragraph (iv) leads to a degree of uncertainty, nevertheless in principle it would be preferable to approach its interpretation on the basis that it is intended to be of limited rather than expansive application.
 - (b) Otherwise, sub-paragraph (iv) would dominate the whole of the definition, which is inconsistent with its careful and detailed drafting. If sub-paragraph (iv) were to be given the broad interpretation favoured by the “Yes” position, then the whole of Section 4.8 would have been drafted more simply, briefly, and broadly. The scheme of identifying a

series of specific events and then including a more general provision at the end is more consistent with a tight approach to interpretation.

- (c) Particularly persuasive, for the purpose of the decision which we have to make in this case, is the absence of the word “transfer” from sub-paragraph (iii), which we have already inferred was a deliberate choice on the part of the draftsman.
- (d) We reject the submission that if an event could have been achieved by one of the means expressly identified in sub-paragraph (iii), then it falls within sub-paragraph (iv). That would give to sub-paragraph (iv) too broad and over-riding an effect.
- (e) We therefore infer that what sub-paragraph (iv) was intended to catch is the risk of a relatively small and potentially unknowable species of events that are functionally equivalent to the specified events but which, perhaps for some technicality arising out of the particular nature of the Obligation in question or under some local rule of law, do not quite qualify within the applicable defined term. Moreover, we can visualise that one of the events defined in sub-paragraph (i) might be achieved functionally in a number of different ways, or that “expropriation” (within sub-paragraph (ii)) can be a term which could be debated and which is therefore supported by sub-paragraph (iv).

27. We also considered that it was a defect of the “Yes” position that it concluded that it had to postulate that even the original transfer from BES to NB was “any event” within sub-paragraph (iv), a position which has not so far been adopted. This suggestion also runs counter to the prevailing mood of Section 4.8, which is that the events in question are all impairments of the obligees’ rights against the Relevant Entity. That mood is also reflected in Section 3.11(a)(v) (“*provisions which permit the Reference Entity’s obligations to be altered, discharged, released or suspended in circumstances which would constitute a Governmental Intervention...*”). We therefore asked ourselves whether the words “conversion” and “exchange” in sub-paragraph (iii) ought to be understood as requiring impairments of the obligees’ rights, so as to limit those categories and in doing so also limit the expansive nature of sub-paragraph (iv). However, we concluded that it was dangerous to imply such language

and equally dangerous to introduce an uncertain test of impairment which is not expressly stated.

28. In sum, once it is concluded that all transfers have been consciously excluded from sub-paragraph (iii), it must follow that it would be inappropriate to use the general provision in sub-paragraph (iv) to bring back in either all transfers or some unclear sub-set of transfers. Because it is a different species of event, consciously excluded from sub-paragraph (iii), it is not within the scheme of Section 4.8 as an event which has an analogous effect to cancellation, conversion or exchange. A transfer is not essentially similar to a cancellation, conversion or exchange. If it were, the draftsman would have included “transfer” within sub-paragraph (iii).

29. It is unnecessary to draw any conclusions concerning the interesting and difficult arguments which were addressed to us on both sides as to the interrelationship between Section 4.8 and the successor provisions of Section 2.2. It might also be dangerous to do so in circumstances where, as we understand the matter, Section 2.2 raises a further question currently before the Determinations Committee.

30. We have therefore concluded that the “No” position is the better answer. The re-transfer of the Bonds from NB to BES was not a GICE within Section 4.8.

Adrian Beltrami QC

Mark Hapgood QC

Sir Bernard Rix (chairman)

15 February 2016

