To: DC Secretary

Re: Issue Number: 2018101502 (Bankruptcy Credit Event in respect of Sears Roebuck Acceptance Corporation)

Date: November 13, 2018

Pursuant to Rule 3.3(d) of the 2018 ISDA Credit Derivatives Determinations Committee Rules (September 28, 2018 version) (the "DC Rules"), we hereby challenge the inclusion of all of the obligations on the Supplement List that did not appear on the Initial List, other than the two obligations that were the subject of the challenge filed on Friday November 9, 2018 (the obligations so challenged herein defined as the "Challenged Obligations"). Capitalized terms used but not defined herein shall have the meanings set forth in the 2014 Credit Derivatives Definitions (the "Definitions"), or otherwise in the DC Rules.

We believe that members of the Convened DC should Resolve not to include any of these Challenged Obligations on the Final List because the documentation available in respect of these Challenged Obligations fails to establish that any of them is, or will be at the point in time at which it would be Delivered to settle a CDS Transaction arising out of the relevant Auction, a "Deliverable Obligation." These flaws primarily arise from the fact that the Challenged Obligations are solely the result of inter-company arrangements without the discipline of negotiation with any arms-length creditors. Specifically:

1. The Challenged Obligations may not constitute "Borrowed Money," as they may have arisen from inter-company cash management activities or inter-affiliate capitalization transactions among the debtors and their affiliates.

2. The Challenged Obligations are not currently Transferable and it is unclear whether they will ever be and, if so, on what terms. Among other things, any obligation that would be Delivered by an entity that is in bankruptcy cannot be delivered until the Bankruptcy Court authorizes such delivery. The Bankruptcy Court has not done so.

3. It is not possible (at present) to determine the "Outstanding Principal Balance" of the Challenged Obligations because neither the Bankruptcy Court nor, to the extent applicable, the Bermuda insurance regulator, have articulated the terms on which they will permit them to be transferred out of the estate of the debtors (or, as applicable, the regulated insurer) and such terms might require the transferees to take the Challenged Obligations subject to rights of set-off, voting by the debtor or similar adjustments that may reduce the amount or standing of the claim.

4. The Challenged Obligations will be recharacterized as equity by the Bankruptcy Court and will therefore fail to be "Not Subordinated" as they do not appear to have been issued on an arms-length basis.

Given these problems in assessing key characteristics of the Challenged Obligations (each of which is discussed in more detail below), we believe it would not be appropriate for the Convened DC to include them on the Final List. To do otherwise would set a precedent that would undermine the certainty of the CDS contract.

The DC's responsibility to ensure an orderly Auction means that the burden of proof for convincing the DC to include an obligation on the Final List must fall on the party seeking to have such obligation included. The Auction is intended to provide a centralized mechanism for market participants which elect to physically settle their outstanding CDS contracts to do so in a standardized manner, which has the additional benefit of producing a Final Price that can be used to cash settle the CDS contracts of participants which do not elect physical settlement. Accordingly, in considering whether an obligation can be included on the Final List for an Auction, the Convened DC must put itself in the position of a credit protection seller accepting Delivery of an obligation. If the Convened DC concludes that the credit protection seller would be correct to claim that its counterparty has failed to establish that the obligations it seeks to Deliver meet the relevant Deliverable Obligation Characteristics, such obligations must not be included on the Final List. Therefore, the DC must require that any party seeking to include an obligation on the Final List must address all legitimate concerns as to whether each meets the relevant Deliverable Obligation Characteristics. No one has done so with respect to any of the Challenged Obligations.

In general, we believe the Determinations Committees worldwide must exercise special care before admitting inter-company obligations not disclosed until a Bankruptcy to the Final List in any Auction. In most cases, including the current one, doing so will introduce considerable ex-ante uncertainty for CDS market participants attempting to determine the universe of Deliverable Obligations for any Reference Entity without producing a corresponding benefit to CDS market participants. To make matters worse, these obligations are strong candidates to be considered the "cheapest-to-deliver" in any Auction, as they will be unsecured obligations, entered into on potentially off-market terms and likely subject to inter-company set-off and other adjustments effected by an insolvency process. The terms of inter-company obligations normally do not result from arms-length negotiations and can be created merely at the stroke of a pen, making them potentially useful tools (if allowed as Deliverable Obligations) for the creation of "narrowly-tailored" Credit Events of the sort that ISDA and its members generally hope to prevent. Allowing such obligations to be placed on the Final List would potentially provide Reference Entities with a powerful tool to manipulate CDS contracts.

We set out our concerns in more detail below:

1. <u>The Challenged Obligations may not have been created in respect of "Borrowed Money</u>." Because these Challenged Obligations appear to have arisen in transactions between commonly-owned affiliates, it is possible that the Reference Entity did not receive cash or any other similar financial consideration in connection with the issuance of these Challenged Obligations.

    a. The "Borrowed Money" Obligation Category is set out in Section 3.13(a)(ii) of the Definitions as follows:

"Borrowed Money" means any obligation (excluding an obligation under a revolving credit arrangement for which there are no outstanding, unpaid drawings in respect of principal) for the payment or repayment of borrowed money (which term shall include, without limitation, deposits and reimbursement obligations arising from drawings pursuant to letters of credit).

Borrowed money is not the same as indebtedness or payment obligations. Indeed, as the Debtors' own filings make clear, inter-company obligations of the Debtors often arise for reasons other than the borrowing of money, such as services rendered.[1] Consequently, unless it is clear, in relation to each of the Challenged Obligations, that it was in fact issued for a borrowing in money terms, then that Challenged Obligation must not be included on the Final List. Unlike the case of a publicly marketed note or bond issuance, in which it may be reasonable for the DC to rely on the processes conducted by unaffiliated third parties to conclude that the obligation reflects an actual borrowing of money, such an assumption would not be warranted in the case of inter-company obligations created without the involvement of any outside parties. No evidence has been presented in the documentation made available to the DC in respect of the Challenged Obligations that any of them were issued in respect of borrowed money.

b. With respect to the Challenged Obligations held by Sears Reinsurance Inc. ("Sears Re"), a so-called "captive" reinsurance entity owned by the holding company of the Reference Entity and licensed and regulated as an insurance company in Bermuda, it is possible that these Challenged Obligations were also created in exchange for services rendered or were instead used as a mechanism to capitalize Sears Re's business without any transfer of funds. Regardless, no record has been made available to the DC to show that the Challenged Obligations held by Sears Re were issued in exchange for borrowed money, rather than to effect its capitalization or for some other purpose.

c. It may in fact be more appropriate to characterize the Challenged Obligations as equity infusions in the relevant debtors, as public information strongly suggests that, to the extent funds were advanced to the Reference Entity, the funds came only from entities holding the entirety of the equity of the debtors. We further note that the Challenged Obligations were issued to the Debtors and their affiliates at a time when

[1] Motion of Debtors for Authority to (I) Continue Using Existing Cash Management System, Bank Accounts, and Business Forms, (II) Implement Ordinary Course Changes to Cash Management System, (III) Continue Inter-company Transactions, and (IV) Provide Administrative Expense Priority For Postpetition Inter-company Claims and Related Relief, *In Re Sears Holding Corporation, et al.*, Case No. 18-23538-rdd, at ¶ 24 (Bankr. S.D.N.Y. Oct. 15, 2018).

Sears was unable to borrow money from unaffiliated creditors on an unsecured and unguaranteed basis, which strongly implies that these Challenged Obligations were not true debt obligations negotiated at arms-length. In fact, at the time these notes were originally issued, Sears (via SRAC) was only able to issue short-term commercial paper (average maturities of less than 35 days) to its affiliate and control party ESL and its affiliate Fairholme. Further, over $500 million of these Challenged Obligations were scheduled to mature starting in July 2017 and the company extended their terms by up to 2 years. It is notable than even ESL would not purchase unsecured commercial paper from SRAC during that period and instead chose to lend to SRAC only on short term second lien secured basis further bolstered by guarantees from virtually every subsidiary of Sears.[2] Accordingly, had the Challenged Obligations been issued on an arms-length basis to unrelated parties, they would have had to have been issued at a significant discount compared to their currently stated principal amount, further suggesting that the terms presented to the DC do not provide a complete description of the nature of the Challenged Obligations.

d. The Challenged Obligations, pursuant to their own terms, offer no remedy to the affiliate creditors seeking recovery. Section 6.8 of the Indenture provides that "[n]o Securities of any series which are known by the Trustee to be owned or held by, for the account of or for the benefit of, the Company or any other obligor under this Indenture or any Affiliate of the Company or of such other obligor (other than Securities of that series pledged in good faith which would be deemed outstanding under the provisions of Section 7.4) shall be deemed outstanding for the purpose of any payment or distribution provided for in this Article."[3] Taken at face value, this provision means that following a default the Reference Entity did not expect to have to pay its affiliates and that said affiliates had no expectation of repayment. Such an expectation that payment would not be owed cannot be consistent with the conclusion that the Challenged Obligations are borrowed money.

2. <u>They do not satisfy the "Transferable" Deliverable Obligation Characteristic</u>. To satisfy the "Transferable" Deliverable Obligation Characteristic, an obligation must be "…transferable without any contractual, statutory or regulatory restriction…" other than typical securities law restrictions (such as Rule 144A). At present, all of these Challenged Obligations are held either by (a) affiliates of the Reference Entity that are "debtors" in the Bankruptcy proceeding currently

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[2] SRAC did have $40 million in commercial paper outstanding at quarter-end October 29, 2017 – all of it was held by ESL Investments, Inc. and had average maturity of approximately 7 days.

[3] Indenture between Sears Roebuck Acceptance Corp. and BNY Midwest Trust Company, dated as of October 1, 2002 (the "<u>Indenture</u>").

underway in respect of the Reference Entity or by (b) Sears Re. To the extent these Challenged Obligations are held by a "debtor" involved in the Bankruptcy proceeding relating to the Reference Entity, they constitute property of the estate that cannot be sold without the approval of the Bankruptcy Court.[4] To the extent these Challenged Obligations are held by Sears Re, it is very likely that Sears Re will be unable to transfer them without receiving appropriate approvals from its regulator in Bermuda. We would further note that to the extent that the Bankruptcy Court requires the Challenged Obligations to be transferred subject to rights of set-off, without attached voting rights or subject to any other claims, the Challenged Obligations will not be able to be "Delivered" in accordance with Section 8.12 of the Definitions, which provides that any such transfer must be made ". . . free and clear of any and all liens, charges, claims or encumbrances (excluding any liens routinely imposed on all securities in a relevant clearance system, but including, without limitation, any counterclaim, defense (other than a counterclaim or defense based on the factors set forth in Section 4.1(a) to (d) (Credit Event)) or right of set-off by or of the Reference Entity or any applicable Underlying Obligor) . . ."

3. <u>The "Outstanding Principal Balance" of the Challenged Obligations cannot be clearly determined.</u> Because these Challenged Obligations arose out of inter-affiliate transactions, they are likely subject to set-off or other adjustment rights among the various debtors as is typically the case in a bankruptcy proceeding. If applied, such set-offs and adjustments would only serve to reduce the Outstanding Principal Balance of the claim, possibly to zero.

    a. In a bankruptcy proceeding, inter-company claims are only considered to be valid debt obligations if specifically allowed by the court or express provisions of the Bankruptcy Code.

    b. For the Challenged Obligations to be allowed by the court, SRAC must schedule the claims in a filing with the bankruptcy court, which it has not done.

    c. If the Challenged Obligations are scheduled, they are highly likely to be challenged by other creditors or interested parties, in which case the holder of the Challenged Obligation must show that the claim is valid.[5]

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[4] This is why counsel for the Reference Entity and its affiliates has filed a petition in the Bankruptcy Court to request permission to sell some of the Challenged Obligations. *See* Motion of Hearing on Emergency Motion of Debtors for Order Approving Sale of Medium Term Notes, *In Re Sears Holding Corporation, et al.*, Case No. 18-23538-rdd (Bankr. S.D.N.Y. Nov. 9, 2018).

[5] We note that, if in fact these claims are valid, the interests of the various debtors within the case would diverge, raising the question as to whether each of them requires separate legal representation for purposes of addressing the subject Challenged Obligations.

d. Even if the Challenged Obligations are scheduled and not challenged by other creditors, any claims that can be asserted on account of these obligations by affiliate holders are automatically voided by the provisions of section 6.8 of the Indenture. Because in a bankruptcy proceeding the claims of all creditors are crystallized at the time of the bankruptcy filing, the effect of section 6.8 of the Indenture is to render all of the Challenged Obligations worthless, and the transfer of a claim does not and cannot change its character or value.

e. Depending upon the Bankruptcy Court's decision about the terms on which the Challenged Obligations may be transferred, the entire Outstanding Principal Balance of the Challenged Obligations may have to be excluded from the "Non-Contingent Amount" calculated under Section 3.8(b) of the Definitions.

i. Unless the court orders otherwise, any purchaser of the obligations would take them subject to the rights of set-off (among other rights) of the transferor.

ii. The right of set-off constitutes a "Prohibited Action" under section 3.10 of the Definitions and therefore reduces the Outstanding Principal Balance by an amount equal to the set-off amount.

iii. This set-off right could reduce the Outstanding Principal Balance to zero if the amount of set-off claims are determined to be greater than the principal of the Challenged Obligations.

iv. Although it is impossible to determine the amount of the "Prohibited Action" reduction, we do know that the entire amount of the Outstanding Principal Balance is subject to the Prohibited Action, and thus the entire Outstanding Principal Balance would have to be reduced to zero pursuant to section 3.8(a)(ii) of the Definitions.

4. <u>The Challenged Obligations might be "Subordinated".</u> Some or all of the Challenged Obligations may be subject to legitimate claims of equitable subordination. In fact, section 6.8 of the Indenture governing these obligations already provides that these claims are automatically voided following a default. Based on what is known about the terms and origins of the Challenged Obligations, it appears that the Challenged Obligations should be considered Subordinated under the Definitions.

We note that the holders of the Challenged Obligations which are debtors in the Bankruptcy proceeding have asked the Bankruptcy court for permission to sell the Challenged Obligations and for such sale to occur with the protections of Section 363 of the Bankruptcy Code, which, in summary terms, would allow for the purchasers of the Challenged Obligations to receive them free and clear of all claims that might arise as a result of the Bankruptcy proceeding.

Superficially, it may appear that if such permission were granted on those terms, the second and third objections above would be addressed.[6] We note, however, that it is certain that creditors will dispute the ability of the Debtors to transfer the Challenged Obligations free and clear of set-off and other rights. It is therefore unlikely that this question will be resolved by the Bankruptcy Court quickly because, aside from the fact that a 363 sale process typically takes months to develop and consummate, the sale of the Challenged Obligations will give rise to questions about the allocation of losses and benefits among various different creditors. In this regard, it is worth noting that debtors' counsel has effectively acknowledged in its recent filing that the sale of the Challenged Obligations by a debtor may cause a shift in value between different creditors of the estate and this will require some form of "true up."[7] As a matter of logic, such a process will be either (1) time consuming to design because the actual value of the Challenged Obligations after set-off, etc. first needs to be established, (therefore preventing the Challenged Obligations from becoming "Transferable" in time for the Auction) or (2) simple because the Challenged Obligations actually have no proper value at all (therefore proving, consistent with section 6.8 of the Indenture, that they have no Outstanding Principal Balance), which prevents their Challenged Obligations from being a Deliverable Obligation.

[6] Of course, even if the court were to approve the sale of the Challenged Obligations without any claims or rights of set-off, such an approval would not address the foundational issue of whether the Challenged Obligations were created in exchange for borrowed money.

[7] Motion of Hearing on Emergency Motion of Debtors for Order Approving Sale of Medium Term Notes, Exhibit A, at ¶ 3.