DECISION AND ANALYSIS OF THE
EXTERNAL REVIEW PANEL
OF THE
U.S. DETERMINATIONS COMMITTEE
DC ISSUE 2018101502 (Sears)

The External Review Panel of the U.S. Determinations Committee (the "DC Committee") considered the question (the "Reviewable Question") presented to it on Friday, November 30, 2018:

> "Do the following obligations satisfy the Consent Required Loan Deliverable Obligation Characteristic for purposes of the Auction to be held with respect to SRAC?
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>> FIGI BBG00DX35360 2LL: PIK Term Loan – The Term Loan as defined in the Fifth Amendment to the Second Lien Credit Agreement Dated as of July 5, 2018.
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>> FIGI BBG00DX35360 2LL: Line of Credit Loans ($525.0m) – The Line of Credit Loans, as defined in the Fifth Amendment to the Second Lien Credit Agreement dated as of July 5, 2018."

On December 19, 2018, in accordance with the timetable provided in the DC Rules as extended by a vote of the DC Committee, we first announced the unanimous decision of the External Review Panel that "Yes" is the better answer to the Reviewable Question. Our answer followed our review of publicly available information, including briefs and supplemental materials presented to the External Review Panel by the "Yes" and "No" advocates, as well as an *amicus* brief submitted on behalf of certain unnamed ISDA members.[1] Our decision was also informed by a hearing on December 19 that was held in accordance with the DC Rules, the arguments made to us by counsel for the "Yes" and "No" positions, the responses to the questions that we put to them, and our understanding of the applicable law and markets.

As we said we would at the time of that initial announcement, and insofar as it may be helpful, we now include in the text below the principal reasons for our decision and certain facts and assumptions upon which it was based.

<u>Facts and Assumptions</u>

The Reviewable Question asks whether the obligations of Sears Roebuck Acceptance Corp. ("SRAC" in the text of the Reviewable Question above and hereinafter "Sears"), with FIGI number BBG00DX35360 (consisting of certain second-lien term loans and line of credit loans) (together, the "Contested Deliverables"), satisfy the Consent Required Loan Deliverable Obligation Characteristic. Specifically, the Reviewable Question asks whether the Contested Deliverables are Consent Required Loans that are "capable of being assigned or novated with the consent of the Reference Entity or the guarantor, if any, of such Loan (or

[1] These materials are available on the DC Committee's website at https://www.cdsdeterminations committees.org/cds/sears-roebuck-acceptance-corp/.

the consent of the relevant borrower if the Reference Entity is guaranteeing such Loan) or any agent," consistent with Section 3.14(b)(ii) of the Definitions (as defined below).

Both the "Yes" and "No" advocates agree that the operative language relating to the Contested Deliverables appears in the Fifth Amendment to the Second Lien Credit Agreement, dated as of July 5, 2018 (the "Fifth Amendment"), among Sears Holdings Corporation, Sears, Kmart Corporation, certain other Guarantors listed therein, the Lenders, and JPP, LLC, as Administrative Agent and collateral administrator.

Section 9.07 of the Fifth Amendment states, in relevant part:

> (a) Each Lender may, upon notice to the Borrowers and the Agent and with the consent, not to be unreasonably withheld or delayed, of the Agent, and, unless an Event of Default has occurred and is continuing, the Borrowers . . . assign to one or more Persons all or a portion of its rights and obligations under this Agreement . . . ; provided, however, that . . . (v) each such assignment . . . shall be to an Eligible Assignee . . . .

Section 1.01 of the Fifth Amendment defines an "Eligible Assignee" to be:

> (a) a commercial bank or any other Person engaged in the business of making asset based or commercial loans, or any fund or other Person (other than a natural Person) that invests in loans, which bank, Person or fund, together with its Affiliates, has a combined capital and surplus in excess of $300,000,000 and which bank, Person or fund is approved by the Agent, and, unless an Event of Default has occurred and is continuing at the time any assignment is effected in accordance with Section 9.07, the Borrowers, in each case such approval not to be unreasonably withheld or delayed, (b) an existing Lender or an Affiliate of an existing Lender or an Approved Fund, or (c) any Permitted Holder; provided that neither the Borrowers nor an Affiliate of the Borrowers (other than a Permitted Holder) shall qualify as an Eligible Assignee.

Capitalized terms used in this decision, unless otherwise defined in it, shall have the respective meanings as set forth in the 2014 ISDA Credit Derivatives Definitions (the "Definitions") or the Contested Deliverables, as appropriate.

Principal Reasons for the External Review Panel's Determination

1. In our view, a New York court, consistent with the plain meaning of the words in the definition of Consent Required Loan, and applying that definition to Sections 9.07 and 1.01 of the Fifth Amendment, would (i) view the Contested Deliverables as "capable of being assigned . . . with . . . consent," in accordance with Section 3.14(b)(ii) of the Definitions, and (ii) would not exclude the Contested Deliverables from the definition of Consent Required Loan due to the limitation on transfer to Eligible Assignees set forth in Section 9.07 of the Fifth Amendment and the other limitations reflected in the Standard Terms and Conditions for Assignment and Acceptance appearing in Exhibit B to the Fifth Amendment.

2. We reach our conclusion because, in our view, the Contested Deliverables are still "capable of being assigned . . . with . . . consent," even though the limitations noted above have the practical effect of narrowing (but not eliminating altogether) the universe

of possible assignees. In so concluding, we do not find, and we expressly reserve for future determination, whether other limitations might be so commercially unreasonable as to effectively block an instrument from being "capable of being assigned . . . with . . . consent."

3. We believe that the definition of Consent Required Loan is deliberately general, but we do not believe that makes the definition ambiguous. It is the nature of a relational contract, like the ISDA Master and the transactional confirmations and the terms incorporated by them, that it will include language that is general to accommodate the variety of fact patterns to which such language will apply. In order to ascertain the meaning of Consent Required Loan, therefore, the business purpose sought to be achieved by the drafters of the ISDA standard documentation is relevant. In our long experience, we believe the commercial objectives that animated the drafting of the Definitions to be in no small part to grow the CDS marketplace and not overly restrict the participants that would find it of use in their investing and hedging strategies. To achieve this goal, it was important to ensure sufficient *flexibility* among a range of users and to mitigate the risk of fact-specific disputes, and the attendant risk of protracted litigation, by providing parties with latitude in the exercise of contractual rights subject to commercial reasonableness and good faith. In that respect, in contemplation of the menu of Deliverable Obligation Characteristics, the commercial objective was to cast a wide net to ensure greater liquidity through greater deliverability in order to avoid situations where no deliverables were available and, therefore, a CDS protection buyer could not receive the benefit of its contract, and also to reflect a more complete view of the recovery rate of credit instruments issued by a particular borrower when settling the related CDS contracts.

4. We are of the view that, notwithstanding the Eligible Assignee requirement, the Contested Deliverables remain senior unsecured debt of the Borrowers, entitled to *pari passu* treatment with the Borrowers' other senior unsecured debt, capable of being assigned with consent to a pool of assignees that includes many (although not necessarily all) leading CDS dealers and protection sellers.

5. Consistent with the above, we conclude that (i) at the time the definition of Consent Required Loan was drafted, it was (and continues to be) common to include additional restrictions on transferability beyond required consent; (ii) such restrictions were (and continue to be) agreed by participants in the loan markets without particular reference to considerations of the CDS marketplace; (iii) this reality was known to the drafters of the Definitions, who could have (but did not) exclude instruments with such restrictions from the definition of Consent Required Loan; and (iv) the restrictions applicable to the Contested Deliverables do not appear to affect the holders' claims in bankruptcy.

6. There has been no suggestion here of bad faith or commercially unreasonable restrictions; this is not a situation such as might arise through a "manufactured" set of facts.

7. As noted above, we can imagine, at least theoretically, a situation arising where, because of commercially unreasonable restrictions, no one would be eligible to accept an assignment of a loan or, at least, no CDS market participant would be capable of offering a price with the ability to receive the loan and, if needs be, hold it to maturity, even if on its face the loan would appear to be "capable of being assigned . . . with . . . consent." However, that is not the case here. There are realistic circumstances where an

assignment of the Contested Deliverables, with consent, can occur. In that regard, we note that it is certainly the case that leading dealers in the CDS market would meet all the tests in the Fifth Amendment to be an Eligible Assignee of the Contested Deliverables.

8. It may also be the case that restrictions on transfer may so reduce the value of a loan that, on its face, is "capable of being assigned . . . with . . . consent" that they will reduce the price a CDS protection seller could receive on resale after receiving that loan as part of a physical settlement. However, we have been given no clear evidence of that with respect to the Contested Deliverables. Neither have we been convinced that, as a primary commercial objective, protecting or facilitating a protection seller's resales drove the inclusion of the Consent Required Loan definition as much as the broader purpose (described above) of growing the CDS marketplace and expanding the pool of deliverables available to it.

9. For the foregoing reasons, we are of the view that the better answer to the Reviewable Question is "Yes".

Analysis

Interpretation. Are the Contested Deliverables "capable of being assigned . . . with . . . consent"? Counsel for the "Yes" position say they are because the fact that the Contested Deliverables can be assigned to Eligible Assignees makes the possibility of assignment more than theoretical. Counsel for the "No" position say that the test should be whether the Contested Deliverables are capable of being assigned generally and without material restriction. Both counsel are happy to rest their argument on the plain meaning of the text.

Our remit is to decide this issue as a matter of New York law. New York law, in the first instance, does not ask: "What did the parties intend to say?" but rather: "What did the parties say?" A contract will be enforced by a New York court applying New York law as written and without reference to extrinsic or parol evidence *unless* a party seeking to go beyond the four corners of the written agreement establishes that its material terms are ambiguous.

Although they offered extrinsic evidence of market practice, both counsel confirmed at the hearing that they thought the words chosen by the ISDA drafters of the Consent Required Loan definition were clear and not ambiguous when given their plain meaning. We agree.

Both parties referenced in their submissions the definitions of "Assignable Loan"[2] and "Transferable"[3] set forth in the Definitions. Both pointed to language in one or the other

[2] "'Assignable Loan' means a Loan that is capable of being assigned or novated to, at a minimum, commercial banks or financial institutions (irrespective of their jurisdiction of organization) that are not then a lender or a member of the relevant lending syndicate, without the consent of the Reference Entity or the guarantor, if any, of such Loan (or the consent of the applicable borrower if the Reference Entity is guaranteeing such Loan) or any agent[.]" Definitions at Section 3.14(b)(i).

[3] "'Transferable' means an obligation that is transferable to institutional investors without any contractual, statutory or regulatory restriction, provided that none of the following shall be considered contractual, statutory or regulatory restrictions: [listing certain restrictions required to comply with the U.S. federal securities laws, restrictions on permitted investments, and restrictions on blocked periods on or around payment dates or voting periods]." Definitions at Section 3.14(b)(iv).

definition that, having been used in the Definitions, could have made the decision we face today clearer. We also agree. But for the reasons we give below, and especially in light of the range and variety of market practice, we can understand a reluctance on the part of the ISDA drafters in this instance to set an "at a minimum" requirement (as they did for an Assignable Loan), but we do think the absence of the "without any contractual, statutory or regulatory restriction" language (as is used in the definition of Transferable) is telling. The ISDA drafters did not include that limitation in the definition of Consent Required Loan although they demonstrated they knew how to do so by including that language in the Transferable definition.

Is the language "capable of being assigned . . . with . . . consent" ambiguous? We believe it is more accurately characterized as general. As we wrote in an earlier External Review Panel decision,[4] this should not be surprising. It is the nature of a relational contract, like the ISDA Master and the transactional confirmations and the terms incorporated by them, that it will include language that is general to accommodate the variety of fact patterns to which it will apply. Overly long and detailed provisions are death knells for standard form agreements.

The brief of the "Yes" advocates cites the dictionary. It asks, "How would the words be ordinarily understood?" We believe the better view, in light of the nature of the ISDA Master, is to ask, "How would a person or market participant cognizant of industry practices, usages, and customs understand the term to mean?" In response, we believe that such a person or market participant would be aware of the wide variety of contractual restrictions that appear in the global loan markets and, in our view, would expect "capable of being assigned . . . with . . . consent" to be flexible enough to accommodate that variation.

We appreciate, too, that when assessing the plain meaning of the words chosen by the drafters, "the meaning of particular language should be examined in light of the business purpose sought to be achieved".[5] We were not given much guidance in the briefs on the commercial objectives thought to have animated ISDA's drafting of the Consent Required Loan definition. However, we collectively bring relevant experience to the table and, in our view, the CDS market was expressly designed to be a holistic view of a Reference Entity's creditworthiness given that debt obligations often span a wide range of issue sizes, currencies, jurisdictions, and instrument types. For that reason, the original intent of the Definitions was more likely to have been to include as many deliverable obligations as possible based on the premise that the holders of all senior unsecured obligations of the defaulting Reference Entity would have the same claim in bankruptcy.

We also believe that the briefs may have understated ISDA's ambition when it crafted the Definitions (and at each reiteration of earlier versions) to grow the CDS business, provide credit protection for an ever-expanding universe of obligations and investments, and reduce the problems arising in the earlier days of the markets when a more limited pool of deliverables raised their prices as counterparties which were not originally holding them sought to acquire them to settle. In terms of the commercial objectives that animated the

[4] *See* https://www.cdsdeterminationscommittees.org/documents/2015/02/20150210-isda-caesars-erp-dafinal-feb10-2015.pdf.

[5] *Lehman Bros. Special Fin. Inc. v. Bank of Am. Nat'l Ass'n*, Ch. 11 Case No. 08-13555, Adv. No. 10-03547, 553 B.R. 476 (Bankr. S.D.N.Y. 2016).

drafting of the Consent Required Loan definition, we expect the drafters would have been sensitive to the fact that the narrower the category of deliverable obligations, the less likely a protection buyer would be able to obtain the specifically required deliverable obligation on a timely basis and the more likely it would be unable to perform its delivery obligations and thereby lose its protection. This then is not so much a matter of price but of the credibility and viability of the credit protection on offer.

At the time the Definitions were first reported out, it was acknowledged that investors who had sold protection with the physical settlement option could be required, with the advent of a credit event, to receive obligations during the physical settlement of CDS which they were unauthorized or unable to accept (such as loans for a bond investor, a domestic security for a foreign investor, and a security in default for an investment grade investor). An option was provided to allow cash settlement via an auction process to alleviate this issue. This auction allowed for dealers (for their own account and on behalf of clients) to establish a settlement price for defaulted CDS and, at the same time, net settle their physical delivery obligations. The gross value of CDS transactions often exceeds the notional amount of the corresponding deliverable obligations. The CDS market, therefore, relies for the most part on cash settling their transactions based on the auction process, which is determined by a very limited set of dealers as a conduit for the market. It is also our sense of common market practice for non-dealer CDS market participants to assign/novate or terminate their CDS contracts to dealers. This is especially true for participants not wanting to participate in the auction process.

Permissibility of conditions. Both counsel accept that *some* restrictions are contemplated by the Obligation Characteristic before us. Counsel for the "Yes" position said that a restriction that was so commercially unreasonable as to be impossible to meet would fail the test of being a Consent Required Loan. However, they offered evidence (some of it disputed) that the Contested Deliverables permitted a significant and relevant pool of Eligible Assignees to which these obligations could be assigned.

Counsel for the "No" side took the position that the Consent Required Loan provision requires a Deliverable Obligation to be capable of being assigned *generally* and, except for the consent requirement, without material restriction. Admitting the possibility of acceptable *de minimis* exceptions, they cited a restriction on assignments to natural persons as an example of a permissible restriction. However, they were unable to confirm to our satisfaction what the treatment or relevance of a number of other transfer restrictions used in the loan markets should be, including restrictions on assignments that increase a borrower's costs (through, for example, a tax gross up or increased cost clause); a restriction to ensure compliance with sanctions, currency controls, or other regulatory requirements; a restriction that gives comfort to a borrower on "know thy lender" grounds or by excluding or disqualifying particular competitors or other identified institutions; minimum amount transfer restrictions; a requirement of transfer fees; or a requirement of corporate capacity and authorisations to assume the assignment.

Indeed, given the wide and varied usage of transfer restrictions when assignments have been contemplated in the global loan markets, we think it unlikely that the addition of Consent Required Loan to the Obligation Characteristics list was ever intended to exclude deliverables with any or several of these restrictions without more express guidance. Neither would we have assumed an intention that each and every time one or more of these restrictions applied to a potential deliverable, guidance should be sought from the DC Committee.

Potential consequence of decision. We recognize that a "Yes" decision may result in the prevention of some CDS contract holders from participating in the auction as a contingent buyer of the Contested Deliverables. We further understand that removing some natural buyers of an instrument may depress the price of that instrument if the natural selling interest is unchanged. In the case of an auction to determine the settlement price for a CDS contract for the market in its entirety, this could result in the "cheapest to deliver" changing.

However, the fact remains that there are also a limited set of eligible buyers who could acquire the Contested Deliverables on assignment prior to the auction in order to sell them into the settlement, and it is likely that few natural existing holders would own them outright and be using the auction as a method of disposal. In any case, since the Contested Deliverables remain *pari passu* to all other senior unsecured obligations of Sears, there is a natural limit to any price discrepancy. It is our view that the transfer restrictions applicable to the Contested Deliverables, while probably affecting their liquidity, do not affect their fundamental value. Indeed, their inclusion as a deliverable obligation in the auction process, in our view, would likely result in a more, not less, representative price of the senior unsecured claims of the Reference Entity.

In addition, we note that it remains an option for all non-eligible CDS protection sellers to unwind their positions prior to the auction, which will consolidate the settlement process to a limited set of eligible purchasers of the deliverables.

We further note that the trading of loan risk by other methods, such as participations, has been commonplace and has required no consent of the borrower or its agent, and has not been limited to Eligible Assignees, which, in our view, effectively mitigates the loan disposal concerns raised by counsel on behalf of the "No" position.

The External Review Panel is cognizant of the possible effect its decision may have with respect to any future questions presented to the DC Committee, and by expanding in this way on our initial decision we mean to give a better understanding of the scope of our review but do not mean necessarily to set any precedent. We also wish to emphasize that, while we make reference to wider market practice in our analysis, our decision should be limited to DC Issue **2018101502 (Sears)**.

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