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## 2002 ISDA Master Agreement

The International Swaps and Derivatives Association, Inc. (*ISDA*) has recently published the first revision in 10 years of the standard form contract for documenting over-the-counter (*OTC*) derivatives. Given that the notional amount of outstanding OTC derivatives in 2001 was estimated at US\$100 trillion, this is no small change. Senior Associate Tom Highnam queries the need for some of the changes proposed.

Although the 2002 ISDA Master Agreement (the **2002 Agreement**) makes wholesale changes to the form of 1992 ISDA Master Agreement (the **1992 Agreement**), ISDA has highlighted four principal amendments. They are:

- (a) introduction of Close-out Amount;
- (b) introduction of force majeure termination event;
- (c) reduction of grace periods; and
- (d) introduction of set-off clause.

ISDA has explained two principal reasons for producing a revised draft of the ISDA Master Agreement. First, market events in the late 1990s, such as the Russian bank moratorium and the Asian currency crisis, focussed attention on the drafting of the agreement. Secondly, ISDA members felt that certain provisions of the ISDA Master Agreement, principally sections 5 and 6, should reflect market practice at 2002 rather than 1992.

### A: Introduction of Close-out Amount

Parties negotiating the Schedule to the 1992 Agreement had a choice of early termination payment measures. They could choose either Market Quotation or Loss. Essentially, if Market Quotation had been chosen, on an event of default or termination event applying to a party or transactions between the parties, the Non-defaulting Party or

the party who was not the Affected Party (in the 2002 Agreement, referred to as the **Determining Party**) could value the termination amount payable as a result of the event of default or termination event by asking market makers in the transactions in question what price they would pay (or would be willing to accept) to assume the rights and obligations of the defaulting party under the transactions in question. It provided a straightforward, non-subjective method for determining a termination payment in periods of commercial stress for both parties. For that reason, the choice of Market Quotation was popular.

If the parties chose Loss, the Determining Party would simply calculate its total losses and costs in connection with the ISDA Master Agreement as at the relevant date. Certain guidelines were provided for this calculation but it was essentially a subjective test.

A number of cases highlighted the fact that Market Quotation could, in certain circumstances, produce unreasonable results. See, for example, *Peregrine Fixed Income Limited v Robinson Department Store plc* and *Enron Australia Finance Pty Limited (in Liquidation) v Integral Energy Australia*. For this reason, ISDA has replaced the choice of Market Quotation and Loss in the 2002 Agreement with a single payment measure on early termination, being the **Close-out Amount**. Close-out Amount attempts to combine the favourable elements of both Market Quotation and Loss. It also attempts to cover certain issues that arose in litigation on the meaning of those terms.

Accordingly, in calculating its Close-out Amount, the non-defaulting party is *required* to calculate the amount of its losses and costs that are, or would be, incurred (similar to the 1992 Loss measure) in replacing or providing the economic equivalent of the payments and deliveries under the terminated transactions that would have been required but for the early termination (similar to the 1992 Market Quotation measure).

The definition of Close-out Amount goes on to provide a number of factors that the Determining Party *may* consider in assessing its losses and costs. Again, these provide a balance between the methods used in assessing Market Quotation and Loss in the 1992 Agreement. For example:

- (a) quotations from third parties, such quotations being permitted to take into account the creditworthiness of the Determining Party;
- (b) relevant market data provided by third parties; and

- (c) information of the type referred to in (a) and (b) from internal sources.

However, there is an important over-riding determination in assessing the Close-out Amount. The determining party must always use commercially reasonable procedures to produce a commercially reasonable result.

A number of market participants have recently preferred specifying Loss in the 1992 Agreement. This is probably for a combination of two factors – recent litigation questioning the applicability of Market Quotation in particular circumstances and the ability to apply a more subjective test in assessing damages payable under the 1992 Agreement. Loss has enjoyed a settled meaning, particularly following the decision of *Australia and New Zealand Banking Group v Societe Generale*. Arguably, the overarching principal of ‘commercially reasonable procedures to produce a commercially reasonable result’ in the new definition of Close-out Amount makes it less attractive than the current formulation of Loss. It adds uncertainty to, or at least a check on, the calculation made by the determining party on an event of default or termination event. The new definition of Close-out Amount may also require adjustment to the measures that market participants use to calculate mark-to-market exposure on a periodic basis during the course of normal trading.

## B: Introduction of force majeure termination event

The 1992 Agreement did not include a force majeure (or impossibility) termination event due to lack of market consensus on the need for such a provision. The events of the past two years have consolidated market opinion on the need for the force majeure termination event. It is introduced at section 5(b)(ii) of the 2002 Agreement.

A force majeure termination event will occur if, by reason of force majeure or act of state, the office through which a party (or its credit support provider) is acting is prevented from making or receiving payments or deliveries or it becomes impossible or impracticable for that office to make or receive payments or deliveries.

In order to trigger the termination event, three events must occur:

- (a) an event of force majeure occurs (as described above);
- (b) the force majeure event is beyond the control of

the party (or its credit support provider) and that party (or its credit support provider) could not overcome the event of force majeure by using all reasonable efforts; and

- (c) a waiting period of eight business days has expired (unless the event of force majeure affects a payment or delivery under a credit support document, in which case no waiting period applies).

Time will tell how market participants react to the inclusion of a force majeure termination event. The new termination event can be criticised. First, there is no definition of force majeure – only that an event of force majeure prevents or makes it impossible or impracticable to make or receive payments or deliveries. It would be disappointing if the market were to permit parties to force the close-out of transactions due to unfavourable economic conditions based on the force majeure termination event. Secondly, although a party is obliged to attempt to overcome the event of force majeure using all reasonable efforts, the 2002 Agreement specifically states that the party need not incur a loss in doing so, effectively rendering the obligation toothless. Thirdly, only the party affected by the event of force majeure is deemed to be the Affected Party. As such, it is the party that determines the Close-out Amount.

The criticisms are tempered by the fact that an event of force majeure can only apply after all disruption fallbacks and other remedies agreed in the relevant confirmation or the 2002 Agreement have been given effect to. The relevant set of ISDA definitions, commonly incorporated by reference in confirmations between parties, often include fairly exhaustive disruption fallbacks to deal with commonly anticipated events that would otherwise fall within the definition of an event of force majeure. Further, although the party affected by the event of force majeure determines the Close-out Amount, either party is entitled to terminate because of the event of force majeure. Indeed, where the event of force majeure affects payment obligations under a credit support document, only the non-affected party is entitled to terminate.

## C: Reduction of grace periods

A number of the grace periods in the 1992 Agreement have been shortened in the 2002 Agreement. The changes are largely as a result of market participants' experiences during the Russian bank moratorium and the Asian currency crises. It was agreed that the grace

periods in the 1992 Agreement were too long, given the rate at which market movements occur during times of local economic turmoil.

The grace period for a payment default section 5(a)(i) of the 2002 Agreement has been reduced from three local business days to one local business day. A similar change has been made to a default under a specified transaction (effectively a derivative between the parties or agreed affiliates not governed by the 2002 Agreement between the parties).

The grace periods for the bankruptcy event of default (section 5(a)(vii)) have been amended even further. Where the relevant bankruptcy event has been initiated by a third party, the grace period has been reduced from 30 to 15 days. Where the relevant bankruptcy event has been initiated by the counterparty itself or its principal regulator, the grace period has been removed altogether.

Finally, a new definition of 'Local Delivery Day' has been introduced for delivery failures. It is defined by reference to days on which settlement systems necessary to accomplish the relevant delivery are generally open for business.

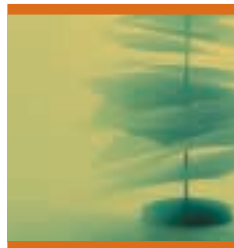
The amendments to the grace periods in the 2002 Agreement appear to be practical and reflect current market practice.

## D: Inclusion of set-off clause

Section 6(f) of the 2002 Agreement incorporates a set-off clause. Although there was no set-off clause in the 1992 Agreement, a suggested ISDA set-off clause was included in the User's Guide to the 1992 Agreement and a set-off clause was invariably added to Part 5 of the schedule when parties negotiated the 1992 Agreement.

Section 6(f) follows very closely the ISDA suggested set-off clause in the User's Guide to the 1992 Agreement. It applies if there has been an event of default or a termination event under section 5(b)(v) of the 2002 Agreement. It applies at the option of the non-defaulting party and sets off any early termination amount payable to a party against any other amounts owing by that party to the other party.

In circumstances where insolvency of a party has triggered an event of default, the enforceability of section 6(f) will depend on the insolvency set-off rules in the jurisdiction of the defaulting party.



Market participants have frequently incorporated their own set-off clauses, rather than relying on ISDA's suggested version in the 1992 Agreement. The enforceability of certain of these clauses was questionable. For example, a reference to set off against affiliates of the defaulting and non-defaulting parties was often included.

On the insolvency of a party, attempting to set off amounts owing to or from affiliates of either party against amounts owing to or from the insolvent party would be void for lack of mutuality.

Parties would also try to apply the set-off as early possible, often on the date of the relevant event of default or termination event. Such application would affect the netting of payments under section 6(e) of the 1992 Agreement.

The inclusion of section 6(f) in the 2002 Agreement is welcome, insofar as it standardises the approach taken to set-off by market participants.

## E: What was not included

Apparently, there was much debate in the negotiation of the 2002 Agreement on section 2(a)(iii) of the 1992 Agreement. Section 2(a)(iii) operates a flawed asset approach to payment and delivery obligations applying under transactions governed by the ISDA Master Agreement. It states that each obligation to make a payment or delivery under a transaction is subject to the condition precedent that no event of default or potential event of default with respect to the other party has occurred and is continuing.

Market participants frequently amend this clause with respect to transactions where one party has performed all of its obligations and the event of default or potential event of default then applies with respect to it. It is seen as inequitable that the other party should be able to defer its obligations in those circumstances, particularly in circumstances where that party may be out-of-the-money if an early termination event were declared. Arguably, failing to amend this clause in such circumstances gives residual effect to limited two-way payments (the 'First Method' under the 1992 Agreement). This option has been removed by the 2002 Agreement.

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