The ISDA Master Agreement – Part II: Negotiated Provisions

By GuyLaine Charles

GuyLaine Charles is a partner at Teigland-Hunt LLP. She represents institutional investors, hedge-funds, financial institutions and corporate clients located in the United States, Europe and Canada in the negotiation and documentation of their trading agreements including physical and financial over-the-counter derivative and commodities transactions through ISDA Master Agreements and other industry standard forms, prime brokerage, securities lending, repurchase, futures and options, and clearing agreements. GuyLaine also negotiates lending agreements and represents investors in private equity funds.

Introduction

Part I of this article, which was published in the *January-February 2012* issue of this publication,[1] described the origins of the ISDA Master Agreements and how these agreements have evolved into the industry standard with respect to the documentation of over-the-counter (OTC) derivative trades. Part I also discussed some of the considerations that risk and compliance professionals should take into account prior to entering into, and during the course of, an OTC trading relationship documented under an ISDA Master Agreement (referred to herein as the "ISDA" or the "Agreement"). This Part II will deepen our analysis of the ISDA Master Agreement.

A typical negotiation will be initiated by one party sending the other its standard form of ISDA Master Agreement, which will consist of a Schedule to a pre-printed 1992 ISDA or 2002 ISDA (the "Schedule"). If the parties intend to collateralize their obligations under the Credit Support Annex to the Schedule (the "CSA"), a "Paragraph 13" to the CSA[2] will also be provided. As discussed in greater detail in Part I, the Schedule to the ISDA Master Agreement contains modifications and additions to the pre-printed ISDA, and likewise, Paragraph 13 of the CSA contains modifications and additions to the pre-printed Credit Support Annex. This Part II will introduce the central differences between the 1992 and 2002 ISDA Master Agreements (referred to herein as the "1992 ISDA" and the "2002 ISDA", respectively) and then discuss the most commonly negotiated provisions of ISDA Master Agreements.

1992 ISDA Master Agreement or 2002 ISDA Master Agreement?

Even before the negotiations begin, the threshold issue to be agreed on by the parties will be the form of ISDA Master Agreement into which they will enter. There are several differences between the two pre-printed forms that may make one form more suitable than the other. The main differences can be categorized as follows:

- differences in the Payments Upon Early Termination,
- differences in the Events of Default and Termination Events, and
- addition of Set-off to the 2002 ISDA.

Payments Upon Early Termination

Perhaps the most significant amendment in the 2002 ISDA is the inclusion of "Close-out Amount", a provision that sets out a single measure of damages where trades are being terminated as a result of an "Event or Default" or a "Termination Event"[3]. In the 1992 ISDA, the parties may elect between two different measures of damages, "Market Quotation" or "Loss". "Close-out Amount" was developed to offer greater flexibility to the party determining the amount due upon termination of their trades under an ISDA and to address some of the perceived weaknesses of Market Quotation that were highlighted during periods of market stress in the late 1990s. Close-out Amount is often described as a hybrid of Market Quotation and Loss.

Market Quotation

Market Quotation is a payment measure determined on the basis of quotations obtained from leading dealers in the relevant market selected by the party terminating the trades (unless a Termination Event has occurred in which there are two affected parties, for example a Tax Event (as defined in the ISDA), in which case both parties make the relevant determinations). The dealer quotations will be for the replacement cost of the relevant terminated transactions. If three or more quotations are provided, the Market Quotation will be the arithmetic mean of those quotations, without reference to the highest and lowest quotations. If only three quotations are provided, the highest and lowest quotations will be disregarded and the remaining one will be the Market Quotation. If less than three quotations are provided (i.e., a Market Quotation cannot be determined), or if the party making the determination does not reasonably believe that Market Quotation would produce a commercially reasonable result, then Loss will apply. Typically entities that believe they are *more likely* to be the party subject to an Event of Default or a Termination Event will negotiate for the applicability of Market Quotation in a 1992 ISDA in order to gain transparency in the calculation of the settlement amount.

Loss

Loss is a payment measure based on the principles of general indemnification. The party terminating the ISDA will reasonably determine in good faith its total losses and gains in connection with the terminated transactions. The terminating party's Loss may, *but need not*, be based on quotations obtained from leading dealers in the relevant markets. Typically entities that believe they are *less likely* to be the party subject to an Event of Default or a Termination Event will negotiate for the applicability of Loss in a 1992 ISDA in order to gain flexibility in the calculation of the settlement amount.

A Hybrid Approach - Close-Out Amount

As mentioned earlier, the weaknesses of Market Quotation became apparent during the market crises in late 1998 and early 1999, when many parties trying to determine payment upon early termination of their trades due to their counterparty default encountered difficulty in obtaining the required quotations from dealers because of the increase in market volatility. Even in instances where four quotations could be obtained, in an illiquid market, those quotations could be widely divergent. Close-out Amount balances the need for increased flexibility (lacking in Market Quotation) while incorporating certain objectivity and transparency requirements (lacking in Loss).

In determining the Close-out Amount, the party terminating the transactions may consider, without limitation, one or more of the following three categories of information: (i) quotations, either firm or indicative, from third parties (which may include dealers, end-users, information vendors and other sources), (ii) relevant market data (e.g., yields, yield curves, volatilities, spreads and correlations), and (iii) information from internal sources of the type described in clauses (i) and (ii), provided the internal information is of the same type used by the determining party in the regular course of its business for the valuation of similar transactions. The definition of Close-out Amount clarifies that the determining party will consider quotations and market data provided by third parties unless it reasonably believes in good faith that such quotations or relevant market data are not readily available or would not produce a commercially reasonable result. When markets are functioning in a normal manner, the expectation is that third-party (as opposed to internal) sources should be considered in calculating the Close-out Amount.[4]

Events of Default and Termination Events

Section 5 of the ISDA addresses Events of Defaults and Termination Events and the 2002 ISDA introduced various changes into this section. The most noteworthy of these changes are (i) a reduction in the applicable grace or cure periods, (ii) an expansion of the definition of "Specified Transaction", and (iii) the addition of Force Majeure as a Termination Event.

Reduction of Cure Periods

In the 1992 ISDA more lenient cure periods are provided than in the 2002 ISDA. Under the 1992 ISDA, a failure to pay or make a delivery under a transaction only crystallizes into an Event of Default if such failure is not cured within three Local Business Days[5] after notice of such failure has been given by the non-defaulting party. Under the 2002 ISDA, the cure period is one Local Business Day (or one Local Delivery Day[6] in the case of delivery failures). Similarly, where a "Specified Transaction" (discussed below) is not subject to a cure period under the terms that govern it directly, a cure period is granted through the ISDA. That period is three Local Business Days under the 1992 ISDA and one Local Business Day under the 2002 ISDA. Additionally, involuntary insolvency filings and enforcement actions are subject to a 30-day cure period under the 1992 ISDA, but only fifteen days in the 2002 ISDA. The chart below compares the cure periods applicable in the 1992 ISDA and 2002 ISDA.

In drafting the 2002 ISDA, the ISDA working group reduced the cure period for payment failures because its members believed three Local Business Days was too long a period of inaction during times of market stress and uncertainty. The reduction of the cure periods for involuntary insolvency and enforcement actions was not the result of members believing that a bankruptcy filing could be dismissed or stayed in fifteen days, but rather that it was sufficient time for the parties to communicate with each other to determine whether the filing or proceeding was frivolous or whether there were serious credit problems.

Expansion of the Definition of "Specified Transaction"

Section 5(a)(v) of the ISDA, sometimes described as a limited cross-default provision, provides that an Event of Default will occur if a party to the ISDA defaults under a "Specified Transaction" with the other party (subject to any cure periods provided for under such Specified Transaction). Under the 1992 ISDA, "Specified Transaction" is defined as a derivative transaction entered into between the parties to the ISDA that is a rate swap, basis swap, forward rate, commodity swap/option, equity or equity index swap/option, bond option, interest rate option, foreign exchange transaction, cap transaction, floor transaction, collar transaction, currency swap transaction, cross-currency rate swap transaction, currency option or any other similar transaction or any combination of these transactions.[7]

The 2002 ISDA expands the definition of Specified Transactions to include the following transactions: swap option, credit protection transaction, credit swap, credit default swap/option, total return swap, credit spread transaction, repurchase transaction, reverse repurchase transaction, buy/sell back transaction, securities lending transaction, weather index transaction or forward purchase or

Event of Default	1992 ISDA Master Agreement	2002 ISDA Master Agreement
Failure to pay [§5(a)(i)]	3 Local Business Days from date of notice	1 Local Business Day from date of notice
Failure to deliver [§5(a)(i)]	3 Local Business Days from date of notice	1 Local Delivery Day from date of notice
Breach of agreement (generally) [§5(a)(ii)]	30 days from date of notice	30 days from date of notice
Default under Specified Transaction [§5(a)(v)]	3 Local Business Days	1 Local Business Day
Involuntary insolvency filing [§5(a)(vii)(4)]	30 days	15 days
Enforcement action by a secured party [§5(a)(vii)(7)]	30 days	15 days

sale of a security, commodity or other financial instrument or interest. Moreover, the definition in the 2002 ISDA includes any transaction that is similar to the specifically enumerated transactions "that is currently, or in the future becomes, recurrently entered into in the financial markets and which is a forward, swap, future, option or other derivative on one or more rates, currencies, commodities, equity securities or other equity instruments, debt securities or other debt instruments, economic indices or measures of economic risk or value, or other benchmarks against which payments or deliveries are to be made".[8]

The expansion of the definition of Specified Transaction effectively brings within the scope of this limited cross-default provision the parties' repurchase (repos), securities lending, and securities forward transactions. In adding repos, securities lending and securities forward transactions as potential triggers for an Event of Default under the ISDA, the 2002 ISDA also addresses delivery failures which as a practical matter, may occur due to administrative errors, settlement system problems or scarcity of the underlying security. Section 5(a)(v) of the 2002 ISDA clarifies that where repos, securities lending and securities forward transactions are subject to a master agreement,[9] a failure to deliver a security under such agreement will only trigger an Event of Default under the ISDA if all transactions under the relevant master agreement are accelerated or terminated.

Force Majeure

The 2002 ISDA introduces the Force Majeure (or impossibility) Termination Event in Section 5(b)(ii), which may be triggered if by reason of a force majeure event or act of state that is beyond the control of a party (or its credit support provider) (i) the office through which a party (or its credit support provider) is acting is prevented from making or receiving payments or deliveries or complying with any other material obligation under the ISDA or a credit support document or it becomes impossible or impracticable for that office to make or receive payments or deliveries or comply with any other material obligation under the ISDA or a credit support document, (ii) such party (or credit support provider) could not overcome the force majeure event using reasonable efforts, and (iii) a waiting period of eight business days has elapsed (unless the force majeure event affects a payment or delivery or the ability to comply under a credit support document, in which case there is no waiting period).

The Force Majeure provision is rarely negotiated but there are a few points to note about the provision. There is no definition of "force majeure", other than that it is a force majeure or act of state that prevents or makes it impossible to make or receive payments or deliveries or comply with obligations under the ISDA or credit support document. Additionally, although a party (or its credit support provider) is required to attempt to overcome the force majeure event using reasonable efforts, such party need not incur a loss in doing so. Finally, only the party affected by the Force Majeure event is the "Affected Party," and therefore, it is the party that determines the Close-out Amount (based on mid-market values).

Set-off

The 2002 ISDA standardized set-off language that prior to 2002 was often incorporated by participants in the Schedule to the 1992 ISDA is based on language suggested in the User's Guide to the 1992 ISDA. Specifically, Section 6(f) permits the non-defaulting party, upon the termination of all transactions due to the occurrence of an Event of Default or a Termination Event where all outstanding transactions are terminated, to offset any amount owed under the ISDA against other amounts owed under other agreements between the parties (whether mature or contingent). Often market participants seek to expand the set-off right to include amounts owed under agreements with affiliates. However, a recent decision has ascertained that cross-affiliate set-off is not enforceable in insolvency proceedings for lack of mutuality.[10]

Frequently Negotiated Provisions

After agreeing on a 1992 ISDA or 2002 ISDA, the negotiation of the Schedule and Paragraph 13 will usually focus on credit, risk, and legal provisions, some of which we have touched on above and in Part I of this article. Other frequently negotiated provisions are summarized below.

Credit

Some of the most significant negotiating points relate to a party's ability to declare an Event of

Default or Termination Event resulting in the right to terminate all transactions under the ISDA and potentially triggering defaults under other agreements that the defaulting party has in place. The party that is viewed as the more creditworthy counterparty, usually the sell-side participant (although post-Lehman that assumption can be challenged), will seek to broaden the Events of Default and to shorten the cure periods under the ISDA form to maximize its ability to terminate the trades under the Agreement promptly. Conversely, the party that is viewed as the less creditworthy counterparty will seek to limit the Events of Default and maintain the lengthier cure periods. These points arise most frequently in the negotiation of the Cross-Default provision, Default under Specified Transaction and Additional Termination Events.

Cross-Default

Section 5(a)(vi) of the ISDA provides that an Event of Default will occur if a party defaults on a third-party obligation and the default or the obligation is in excess of a specified threshold amount. The third-party obligation must be an obligation in respect of borrowed money (whether present or future, contingent or otherwise, as principal or surety or otherwise) and is referred to as "Specified Indebtedness". The negotiation of the Cross-Default provision typically revolves around the following three points:

- amendment of the provision to provide for cross-acceleration and the addition of an administrative error carve-out;
- expansion of the definition of Specified Indebtedness; and
- agreement on a threshold amount.

Cross Acceleration and Administrative Error Carve-Out

Corporate and buy-side participants often seek to delay or eliminate the application of the Cross-Default provision. With respect to the first prong of the Cross-Default provision (clause (1)), which addresses any type of default having occurred under the Specified Indebtedness, they seek to require that in order to trigger an Event of Default under the ISDA not only must the default have occurred under the Specified Indebtedness, but the creditor must have also chosen to demand payment of the obligation ("cross acceleration"). Under the second prong of the Cross-Default provision (clause (2)), which addresses payment defaults under the Specified Indebtedness, they seek to require that a payment default will not trigger an Event of Default if the failure to pay was due to an administrative or operational error, the party had the funds necessary to make the payment and the payment is cured within a certain period of time, usually between one and three Local Business Days ("administrative error carve-out").

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Expanding the Definition of Specified Indebtedness

Sell-side participants sometimes seek to expand the definition of Specified Indebtedness to include Specified Transactions (and to expand the definition of Specified Transactions to include transactions with third parties). Participants are most likely to request this change from counterparties that have little in the way of "borrowed money" (mainly loans). This way, if a counterparty defaults on an obligation under a derivative or securities transaction with a third-party in excess of the threshold amount (and where cross-acceleration applies such obligation is accelerated), the other party may declare an Event of Default.[11]

Threshold Amount

A party to an ISDA will attempt to negotiate a sizeable threshold amount for itself to prevent an Event of Default from being triggered by a default on a de minimis loan obligation or payment. On the other hand, parties will want to keep their counterparties' threshold amount as low as possible in order to allow for greater opportunities to declare an Event of Default. Parties often agree to asymmetrical threshold amounts which are fair to each party as they are set at either (i) a percentage of an entity's shareholders' equity or members' capital, for corporations or limited liability companies, or net asset value, for investment funds (three percent is not an atypical percentage), (ii) a fixed dollar amount which makes sense for each party based on their borrowed money, or (iii) the lesser of (i) and (ii).

Default Under Specified Transaction

As discussed above, certain parties will prefer the 2002 ISDA because of its expanded definition of "Specified Transaction," which affords more opportunities to declare an Event of Default. It is not uncommon for parties negotiating a 1992 ISDA to incorporate the 2002 ISDA definition of "Specified Transaction." Some parties will push for an even broader definition of Specified Transaction, to pull in the parties' obligations under their prime brokerage agreements. While such a request is appropriate where the prime brokerage client has agreed to portfolio margining (or netting collateral across prime brokerage and OTC trades), it is less appropriate where no such arrangement is in place.

Negotiation of the Schedule and Paragraph 13 will usually focus on credit, risk, and legal provisions….

Additional Termination Events

Section 5(b)(v) of the ISDA provides for either or both parties to specify any "Additional Termination Events" or "ATEs" applicable to a party (the "Affected Party"), which will entitle the other party (also referred to as the non-affected party) to terminate the transactions under the ISDA. ATEs are intended to be leading indicators of the deteriorating credit condition of the Affected Party. They provide the non-affected party an opportunity to get out of its trades before the counterparty's problems lead it to default under the ISDA or worse, become insolvent. ATEs are specifically tailored to the type of entities involved. Discussed below are ATEs applicable to each of (i) an investment fund, (ii) a private corporation, and (iii) a rated entity.

Net Asset Value Triggers – Investment Funds

In order to track a trading counterparty's overall financial health, each party will ask for financial information in the form of annual or quarterly financial statements. It is common for a party facing an investment fund to also request monthly financial statements that set forth the fund's Net Asset Value (or "NAV"), which is calculated as total assets minus total liabilities. This statement of Net Asset Value, or "NAV Statement," provides a snapshot of the fund's performance for the month, and typically documents the redemptions or subscriptions made in the relevant month.

A sell-side participant facing an investment fund will seek to include Additional Termination Events based on the fund's NAV Statements. These events, commonly known as "NAV triggers", will be triggered by a decline in the fund's NAV in any given month, 3-month and/or 12-month period. For instance, it may be an ATE if a fund's NAV declines by 20% or more in a given month, 30% or more in any three-month period, or 40% or more in any twelve-month period. Often investment funds will request that the monthly and quarterly triggers be solely performance based and therefore exclude redemptions and subscriptions. However, sell-side counterparties tend to consider redemptions that cause a decline in excess of the agreed percentage indicators of an impending problem and therefore want to be entitled to act in light of such a decline. Another common NAV trigger is the "NAV floor," which would entitle the non-affected party to terminate the trades under the Agreement if the fund's NAV falls below a baseline amount. When negotiating these ATEs, investment funds should ensure that the agreed declines are not easily triggered and sell-side participants should ensure that they are adequately protected when there has been a considerable loss of assets.

Maintenance of Ownership – Private Corporation

When entering into an ISDA with a subsidiary of a customer (e.g., a bank entering into a swap with a subsidiary of its debtor) a sell-side participant will want to ensure that the subsidiary's ownership, if its credit relationship is really with the parent, does not change. For instance it may provide that an ATE occurs if the parent entity fails to own either directly or indirectly more than 51% of the voting securities of its counterparty.

Credit-Rating Downgrade – Rated Entity

A credit rating downgrade ATE is often requested from a counterparty that is a rated entity or that is guaranteed by a rated entity. The ATE can be drafted in numerous different ways but the upshot is that should such rated entity, or its guarantor suffer a downgrade in its credit-rating (e.g., below investment grade or higher), the other party will be entitled to terminate all the outstanding transactions under the ISDA. The utility of a credit-rating downgrade ATE hinges on the accuracy of the ratings published by the rating agencies. The fall of Lehman Brothers Holdings Inc. exposed the weakness of this lagging indicator. However, the Securities and Exchange Commission, mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act,[12] has proposed tougher regulations for credit rating firms that are intended to strengthen the integrity and improve the transparency of credit ratings,[13] which will hopefully lend greater effectiveness to the credit rating downgrade ATE.

Cure Periods

Under the 1992 ISDA, the most commonly negotiated cure period is failure to pay or deliver. If the parties agree to reduce the cure period for this Event of Default from three Local Business Days to one, they will also likely amend the corollary Event of Default in the Credit Support Annex (failure to deliver margin[14]) and reduce the cure period specified there from two Local Business Days down to one Local Business Day. As discussed above, the standard 2002 ISDA provides for cure periods of one day for failure to pay or deliver.

Risk

In order to mitigate counterparty credit risk, parties will enter into a CSA. The CSA provides a contractual framework for the posting of collateral to secure a party's "Exposure." For any given day, Exposure is the net amount that one party would pay to the other based on the mid-market replacement value of all transactions between the parties, as if they were to be terminated on that day. The form CSA provides that:

- on every valuation day (defined in Paragraph 13 – usually every business day) the party that is in-the-money (the "Secured Party") may make a demand for collateral (a "collateral call") to the other party (the "Pledgor"), who will have to transfer collateral ("variation margin") within the amount of time specified in the agreement;
- if the market moves in favor of the Pledgor and the Secured Party is over-collateralized, the Pledgor may make a collateral call and the Secured Party will return collateral to the Pledgor[15]; and
- either party can be the Pledgor or the Secured Party depending on which party is in-the-money.

Segregation of Independent Amounts

If parties choose to collateralize their obligations under the CSA, one party may be required to post an "Independent Amount." The Independent Amount,[16] or initial margin, has historically been an amount required by sell-side participants to guard against credit exposure that may arise between the demand for and the delivery of variation margin including movements in value occurring between the time a party defaults and the time the non-defaulting party designates a termination date. The Independent Amount is posted in addition to the daily variation margin requirements in the CSA.

A dealer may hold a significant amount of assets as Independent Amounts for a single trading counterparty depending on the size of its OTC trading portfolio. When the dealer becomes a credit-risk and enters insolvency proceedings, as was the case with Lehman, the counterparty's claim for a return of its Independent Amounts becomes a general unsecured claim. Since Lehman's insolvency an increasing number of buy-side participants have requested that their Independent Amounts be held with a third-party custodian in order to ensure that the collateral posted to cover their Independent Amount is held with a bankruptcy-remote entity from which it is more readily recoverable.[17] Segregation of Independent Amounts can be a costly proposition, both in terms of the upfront legal and other fees required to set-up the relationship as well as the ongoing fees to the custodian.

Eligible Collateral

In Paragraph 13 of the CSA, the parties will specify the forms of "Eligible Collateral" that may be delivered as collateral. The most common forms of Eligible Collateral are U.S. dollars and U.S. treasuries (or U.S. dollars and letters of credit with respect to commodity counterparties). In some instances a party will have access to a specific class of assets, such as municipal or foreign governmental bonds, that it would like to be able to post as collateral. The parties will then agree on the class and maturities of the assets that would be considered Eligible Collateral, as well as the discount that would apply to the valuation of the assets in determining how much collateral has been posted. The parties may also have to negotiate terms that address enforcement issues that may arise in connection with foreign domiciled assets.

Transfer Timing

The term "transfer timing" refers to the period within which collateral called for under the CSA must be transferred. A failure to transfer within that period will give rise to a Potential Event of Default.[18] The standard CSA provides that if a collateral call is made before the notification time (a time agreed by the parties), then the collateral must be transferred by close of business on the next Local Business Day. If the collateral call is made after the notification time, then the collateral must be transferred by close of business on the second Local Business Day.

Current market practice calls for collateral demands to be satisfied within one business day. Therefore, parties will often seek to reduce the transfer timing such that if a call is made before the notification time, then the collateral must be transferred by close of business on the same day, otherwise the transfer must be made by close of business on the next Local Business Day. Whether this timeframe is operationally feasible for a trading entity often depends on the notification time. An early notification time (e.g., 10:00 a.m.) will give a pledgor most of the day to satisfy the call. A later notification time (e.g., 1:00 p.m.) may make same-day transfers operationally challenging. This is pretty straightforward when the parties are in the same geographical location. Parties that are located in different time zones will have to agree to a time that works for each party with respect to both making a collateral call and receiving one. Parties should also take into account the agreed grace period for margin failures in negotiating transfer-timing terms.

Miscellaneous

Other frequently negotiated terms deal with a party's rights upon the occurrence and continuance of an Event of Default, and any limitation on, or waiver of, such rights.

Limitation on Reliance on Section 2(a)(iii)

Section 2(a)(iii)(1) of the ISDA provides that each obligation of a party to make each payment or delivery specified in a confirmation 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. Accordingly, if an Event of Default or Potential Event of Default has occurred with respect to a party (the defaulting party), the other party (the non-defaulting party) at its option may either (i) designate an Early Termination Date under the agreement, or (ii) cease making any payment or delivery obligations to the non-defaulting party in reliance on Section 2(a)(iii)(1). Paragraph 4(a)(i) of the CSA provides the non-defaulting party a corresponding right to cease transferring collateral upon the occurrence and continuance of an Event of Default, Potential Event of Default or Specified Condition.[19] The non-defaulting party may choose not to terminate its trades under the ISDA, perhaps because it is net out-of-the-money on all trades, and yet may cease performing in reliance on these provisions. In the meantime, the defaulting party is still required to make timely payments, deliveries and margin transfers to the non-defaulting party.

Section 2(a)(iii)(1) allows the non-defaulting party to game the market by refusing to terminate its transactions under the Agreement until it is beneficial for it to do so, or when the market swings in its favor. It is unclear how long a party can rely on 2(a)(iii)(1) when facing an entity that is subject to U.S. insolvency proceedings.[20]

The negative consequences to the defaulting party can be significant. Excess collateral and settlement payments owed to the defaulting party may be withheld by the non-defaulting party, thereby creating or further deepening the defaulting party's credit problems. This lack of liquidity may cause the defaulting party to default on its obligations with other trading counterparties, triggering a wave of defaults that leads to the defaulting party's demise.

In order to prevent this result, parties will often negotiate a limitation on the right to rely on Section 2(a)(iii)(1) in not making any payment or delivery obligations, by providing that the non-defaulting party may only cease to perform for a certain number of days after the occurrence of the Event of Default that gave rise to such right. Typically the parties agree to anywhere between 30 and 90 days, the rationale being that such number of days is sufficient time for the non-defaulting party to decide if it will continue performing to the defaulting party (thereby preserving the trading relationship), or terminate the trades under the ISDA. Entities that are less likely to be a defaulting party will resist the limitation or seek to extend the time period as much as possible. Currently, an ISDA working group (dubbed the "Section 2(a)(iii) Working Group") is considering potential amendments to Section 2(a)(iii) to address, amongst others, the issues highlighted above.

"Fish or Cut Bait"

A related but different legal limitation is commonly referred to as the "fish or cut bait" or "use it or lose it" provision. This term provides that upon the occurrence and continuance of an Event of Default or Termination Event, the non-defaulting party or non-affected party will have to terminate its trades under the ISDA within a certain number of days or forever waive its right to terminate the trades based on such event. The "fish or cut bait" is negotiated principally to address the occurrence of misrepresentations, which do not have a cure period, as well as ATEs that either cannot be cured or may take some time to cure.

The concern is that a non-defaulting or non-affected party will use the existence of an Event of Default or Termination Event as an excuse to terminate the trades under the ISDA, long after the fact and after the parties have continued to perform. In order to avoid this result, a party may request a "fish or cut bait" provision pursuant to which the non-defaulting or non-affected party waives its right to terminate its transactions under the ISDA based on an Event of Default or Termination Event within a certain number of days following the occurrence of the event.

Conclusion

In entering into an ISDA relationship parties must first agree on the ISDA form they will use and then negotiate certain provisions of the Agreement to ensure that their economic and legal rights are preserved. In addition, parties should be aware of the changes to the ISDA documentation that the International Swaps and Derivatives Association is working on that reflect the current state of the law and of the industry. While a number of these modifications are meant to be adopted on an industry-wide basis (e.g., the suggested documentation of the Section 2(a)(iii) Working Group), they can sometimes take a long time to be finalized by the ISDA working groups. Counterparties may want to be proactive and bilaterally amend their agreements to reflect these changes either in the law or in industry practice.

ENDNOTES

1 *The ISDA Master Agreement – Part I: Architecture, Risks and Compliance*, Practical Compliance & Risk Management for the Securities Industry, January-February 2012.

2 If the parties' ISDA Master Agreement is subject to New York law, they will enter into a mark-to-market security arrangement under a 1994 ISDA Credit Support Annex (CSA). If the parties' ISDA Master Agreement is subject to English Law, they may enter into either (1) a 1995 ISDA Credit Support Annex (Transfer – English Law), which provides for transfer of title of collateral (rather than creating a security interest), or (2) a 1995 ISDA Credit Support Deed (Security Interest – English Law), which provides for the creation of a formal security interest in the collateral. Parties that intend to use assets located in Japan as credit support would also likely enter into or incorporate into their CSA the terms of the 2008 ISDA Credit Support Annex (Loan/Japanese Pledge) in order to minimize exposure to counterparties through collateral arrangements in respect of cash, deposit accounts, Japanese government bonds or other marketable securities located in Japan.

3 Events of Default are set forth in Section 5(a) of the ISDA and entitle the party that is not the defaulting party to terminate all transactions between the parties. The Events of Default under 5(a) are: (i) Failure to Pay or Deliver, (ii) Breach of Agreement, (iii) Credit Support Default, (iv) Misrepresentation, (v) Default under Specified Transaction, (iv) Cross-Default, (vii) Bankruptcy and (viii) Merger without Assumption. Termination Events are set forth in Section 5(b) of the ISDA and entitle the party that is not affected by the Termination Event to terminate any transactions between the parties that are affected by such event (or typically all the transactions in the case of an Additional Termination Event). The Termination Events under 5(b) are (i) Illegality, (ii) Tax Event, (iii) Tax Event Upon Merger, (iv) Credit Event Upon Merger, (v) Additional Termination Event, and (vi) Force Majeure (under the 2002 ISDA only).

4 *See* Int'l Swaps and Derivatives Ass'n, *User's Guide to the ISDA 2002 Master Agreement,* 26 (2003 ed.).

5 Generally, a day on which commercial banks are open for business in the city of the defaulting party. *See* Int'l Swaps and Derivatives Ass'n, ISDA Master Agreement, §14 (1992) (the "1992 ISDA").

6 Generally, a day on which settlement systems necessary to accomplish the relevant delivery are generally open for business. *See* Int'l Swaps and Derivatives Ass'n, 2002 ISDA Master Agreement §14 (2002) (the "2002 ISDA").

7 1992 ISDA §14.

8 2002 ISDA §14.

9 For example, a Master Repurchase Agreement, Master Securities Lending Agreement, and a Master Securities Forward Transaction Agreement, or their global counterparts (for non-trading in non-U.S. securities), as applicable.

10 *In re Lehman Bros. Inc.,* 458 B.R. 134 (Bankr. S.D.N.Y. 2011) (holding that there is no exception to the mutuality requirement of Section 553 of the U.S. Bankruptcy Code that would permit cross-affiliate set-off even if the right to set-off debts across affiliates was clearly contemplated by a valid, prepetition contract).

11 It is unclear how a party may come to know of a cross-default or cross-acceleration Event of Default. If the default or acceleration is worthy of media attention, the defaulting party has likely already defaulted under one of the other enumerated Events of Default (e.g. failure to pay).

12 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

13 Nationally Recognized Statistical Rating Organizations from the Securities and Exchange Commission, Release No. 34-64514, *Proposed Rules for Nationally Recognized Statistical Rating Organizations,* available at http://www.sec.gov/rules/proposed/2011/34-64514.pdf.

14 CSA, at Par. 7(i).

15 Transfers will be subject to Minimum Transfer Amounts and Rounding, *See* CSA, Paragraph 3.

16 Independent Amounts are specified in Paragraph 13(b)(iv)(A) of the CSA.

17 For an in-depth discussion on segregation of Independent Amounts, see the Independent Amounts White Paper, published by ISDA, MFA and SIFMA, dated March 1, 2010, *available at* http://www.isda.org/c_and_a/pdf/Independent-Amount-WhitePaper-Final.pdf

18 A Potential Event of Default means any event which, with the giving of notice or the lapse of time or both, would constitute an Event of Default. *See* the1992 ISDA, §14.

19 The parties agree in Paragraph 13 which of the Termination Events specified in the ISDA Master Agreement will be "Specified Conditions" for the purposes of the CSA.

20 *See In re Lehman Brothers© Holdings Inc.,* Case No. 08-19555 (JPM) (Bankr. SDNY Sept. 15, 2009) (transcript of record) (ruling from the bench that the U.S. Bankruptcy Code did not permit a debtor (creditor in bankruptcy) to rely on Section 2(a)(iii) in accordance with its terms, approximately one year after the creditor's (debtor in bankruptcy) insolvency filing).