DERIVATIVES WEEK
VOL. XIII, NO. 27 & 28, JULY 5 & 12, 2004

LEARNING CURVE

Do End-users Benefit from Entering into ISDA Master Agreements?

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END-USER CONCERNS

The ISDA Master Agreement is widely accepted as a comprehensive and legally enforceable master agreement, reflecting the collective experience of the derivatives industry. Its provisions address a range of legal issues relevant to derivatives, including bankruptcy laws, tax laws and judicial decisions, and it has become an industry standard.

Nonetheless, the question remains: does the ISDA Master Agreement benefit end-users in derivatives transactions with dealer counterparties?[1] Some end-users view the ISDA Master Agreement as a dealer-oriented document and prefer negotiating a non-standard master agreement or relying on individual trade confirmations. Others are wary of the ISDA Master Agreement because they believe its default provisions are more useful to non-defaulting parties, discount the possibility that their dealer counterparties will default (despite dramatic evidence to the contrary in recent years), and consequently believe the default provisions are more likely to hurt them than to benefit them. Finally, end-users that are unfamiliar with the ISDA Master Agreement form may believe that they will incur unnecessary expense with the negotiation.

THE BENEFITS OF AN ISDA MASTER AGREEMENT

Although the ISDA Master Agreement may not be appropriate for all end-users in all circumstances, it is usually the best choice for an end-user market participant. This article highlights some of the ways in which an ISDA Master Agreement benefits both parties and some of its specific advantages for end-users.

Certainty and Consistency

Because an ISDA Master Agreement governs the overall relationship between the parties, it provides two very important benefits to both dealer counterparties and end-users: certainty and consistency. Without a master agreement, the rights

and obligations of the parties in the event of a dispute would be governed by a combination of statute, common law and market practice. These could vary from transaction to transaction, depending on the determination in each instance of the appropriate venue and the applicable law. With an ISDA Master Agreement, the parties can select, in advance, the venue and the law for adjudicating all disputes under the agreement, eliminating at least one element of uncertainty in the dispute resolution process.

An ISDA Master Agreement also provides the parties with consistency: uniform termination triggers, grace periods, and remedies that apply to all transactions governed by the agreement. End-users avoid the cost of monitoring disparate rules for myriad transactions, savings that will help defray, if not exceed, the cost of negotiating the master agreement.

Market Practice

Because the ISDA Master Agreement represents accepted market practice, there is widespread familiarity with its terminology and provisions among market participants in every major financial market. Furthermore, ISDA has procured legal opinions from law firms in 39 countries regarding the enforceability of the Master Agreement's boilerplate provisions. The familiarity of market participants with the ISDA Master Agreement, buttressed by these legal opinions, can simplify the negotiation process and provide significant cost savings to both dealer counterparties and end-users.

The ISDA Schedule: a Roadmap for Negotiations

The standard schedule to the ISDA Master Agreement (the "Schedule"), which permits the parties to make various elections and otherwise customize the Agreement, addresses the major issues, such as the identification of Specified Entities (Part 1(a)), the determination of Threshold Amount (Part 1(c)), the definition of Specified Indebtedness (Part 1(c)), and the applicability of certain Events of Default (e.g., Part 1(c) or (d)), that are likely to arise in the course of a derivatives transaction. Consequently, it provides a useful checklist for less-experienced end-users and an efficient mechanism for getting these issues on the table in the course of the negotiation, giving the end-user a more complete picture of the risks entailed in the covered transactions. Once the end-user becomes familiar with the Schedule, and the manner in which it addresses the issues, future negotiations should proceed more smoothly.

Termination and Netting Rights—Avoiding Cherry Picking

The automatic stay provisions of Section 362(a) of the United States Bankruptcy Code (the "Code") generally prevent post-petition termination of a pre-petition executory contract by the non-debtor party. Under Section 6 of the ISDA Master Agreement, in the event of a default under any derivatives transaction governed by the Agreement, the non-defaulting party has the contractual right to terminate all transactions under the Agreement. All the amounts owed in connection with those transactions are then "netted" to yield one net amount payable by one party to the other.[2]

Were it not for the safe harbor provisions of Sections 556 and 560 of the Code, Section 6 of the ISDA Master Agreement would conflict with the automatic stay provisions of Section 362(a) of the Code. Sections 556 and 560 of the Code preserve for a non-debtor swap participant its contractual termination and netting rights under a "swap agreement." An ISDA Master Agreement falls within the definition of "swap agreement" for

purposes of Sections 556 and 560. Under Section 362(b) of the Code, the "non-debtor" counterparty to a forward contract or swap agreement can terminate existing derivatives transactions and exercise set-off rights with respect to such transactions without first having to obtain permission of the court. Issues that exist as to cross-product netting are not discussed in this article.

Therefore, non-defaulting ISDA Master Agreement end-users retain their rights under Section 6 of the ISDA Master Agreement with respect to all transactions other than spot trades, notwithstanding the automatic stay provisions of Section 362(a). Without the Section 6 termination rights, the "debtor counterparty" could attempt to "cherry pick" the transactions it wished to preserve and reject the rest. Because Section 6 prevents such cherry picking, a swap participant generally can assess its counterparty risk on an overall relationship basis. Though the safe harbor provisions obviously benefit the non-debtor, non-defaulting party, Enron and other recent corporate scandals should serve as an object lesson to end-users who discount the possibility that their counterparty might default.

PROVISIONS THAT CAN BENEFIT EITHER PARTY

Without a crystal ball, and given the breadth of transactions that can be entered into between parties to an ISDA Master Agreement, it is almost impossible to predict whether a particular provision will benefit one party or the other. This is particularly true in the case of the tax provisions (see Section 1(d) of the ISDA Master Agreement and Part 2 of the Schedule), the Force Majeure Event/Illegality provisions (Section 5(b)(i) and (ii) of the 2002 form), and the Close-out Amount valuation method (defined in Section 14 of the 2002 form), as discussed below.

Tax Provisions

The ISDA Master Agreement contains a number of extremely important provisions regarding withholding taxes. In general terms, these provisions serve three functions: (1) they enable the parties to establish the necessary legal and factual basis for concluding whether the payments under the transaction are subject to any withholding tax; (2) if, contrary to the expectations of the parties, payments under the swap are held to be subject to withholding, they allocate the financial burden of the withholding tax to either the payor or payee of the payment; and (3) in certain circumstances, they allow the party that bears the financial burden of any such withholding tax to terminate the transaction. These provisions are important to U.S. end-user taxpayers, particularly when entering into derivatives transactions with non-U.S. counterparties or U.S. counterparties that are not corporations, because an unforeseen withholding obligation can have a serious impact on the economics of a transaction.

Though special rules for swaps that qualify as "notional principal contracts" exempt most swap payments from U.S. foreign withholding tax obligations, the exemption from "backup" withholding with respect to certain types of payments generally applies only if the non-U.S. counterparty represents in the transaction confirmation or a master agreement that it is a "foreign person" (unless, presumably, the payor knows or has reason to know that the representation is false).[3] This tax representation and certain other tax-related representations generally are included in Part 2 of the Schedule to the ISDA Master Agreement. The form of Schedule also includes as an optional provision a representation to be made by the payee that the payments qualify under the relevant tax treaty between the countries

in which the parties are located. If it turns out that the payee's representation is false, the withheld amount can be deducted from the payment otherwise due to the payee.

The parties also need to consider the possibility that a change in law can affect the tax status of their transactions. The ISDA Master Agreement benefits both parties because its tax provisions clearly allocate the financial burden of the withholding if a withholding tax is imposed, whether or not due to a change in law.

Force Majeure Event/Illegality Provisions

The new Force Majeure Event/Illegality provisions of the ISDA Master Agreement reflect the experiences of the entire derivatives industry following the September 11th terrorist attack, when payment and delivery systems were inoperative. The provisions entitle the parties to terminate "Affected Transactions" following a specified "Waiting Period" and defer the parties' obligations until such time as payment/delivery is practicable. Because it is impossible to predict what particular events could cause such disruption, the term "Force Majeure Event" is defined only with respect to its effect (i.e., an event that prevents a party from making or receiving a payment or delivery) and therefore has broad applicability.

Close-out Amount

During the Asian currency crisis of 1997 and the Russian financial crisis in 1998, the derivatives industry learned that the Market Quotation valuation method (preferred by most end-users, with most dealers preferring the more flexible "Loss" method) was not workable because the turbulence of markets made quotations unreasonable or illiquid markets rendered quotations unavailable. More recently, many end-users facing Enron as defaulting party have had their own difficulties with Market Quotation.

These lessons are reflected in the new termination payment valuation method (called "Close-out Amount") in the 2002 form of the ISDA Master Agreement. "Close-out Amount" was intended to be a compromise between the perceived objectivity of Market Quotation and the perceived subjectivity of Loss. While, in most cases, the non-defaulting party is not permitted to rely on internal data, the range of permissible third-party information has expanded beyond actual quotes for replacement trades to include a broad range of "relevant market data."

Benefits to the Defaulting Party -- Two-way Termination Payments

It is well settled that a party that materially defaults on its contractual obligations without a prior default by another party to the contract will be entitled to damages only if, prior to its default, it conferred a tangible benefit on the non-defaulting party. Otherwise, a default by one party frees the non-defaulting party from its obligations under the contract and the defaulting party is not entitled to receive any compensation for loss of its bargain or other damages.[4] If this rule were applied to derivatives transactions, a defaulting party would not receive the benefit of its bargain from any of its outstanding transactions with its counterparty, even if all of them were "in the money" at the time of the breach.[5]

Under the 1992 form of ISDA Master Agreement, counterparties can elect to have "two-way termination payments" govern their transactions following an event of default by choosing "Second Method" in the Schedule to the 1992 form. The 2002 form of ISDA Master Agreement eliminates this choice and provides instead that the Close-out Amount (or its absolute value) of all terminated transactions will be paid to whichever party is net "in the money." Thus, upon a default, if the non-defaulting party decides to

terminate the outstanding trades, those trades will be valued at market prices, allowing the "in the money" counterparty to receive the benefit of its bargain, even if that party is the defaulting party.

CONCLUSION

In most circumstances it is to the advantage of most dealers and most end-users to enter into a master agreement governing all their transactions. The ISDA Master Agreement is usually the best choice, particularly in its 2002 form, because it is the product of broad-based market experience covering the entire history of the derivatives markets, for the most part represents standard market practice, and is the most widely-used multiple product master agreement form available today.

1. In this article, except where otherwise specified, the term "ISDA Master Agreement" will apply to both the 1992 and 2002 forms.
2. This is obviously a significant benefit to the non-defaulting party, which probably would not want to continue to be exposed to the risk that its counterparty will default on other outstanding trades.
3. When dealing with non-U.S. counterparties, and despite the special rule for swaps that qualify as notional principal contracts, U.S. withholding tax would apply to interest on margin collateral (or embedded interest on off-market swaps), although in many cases the payor's withholding tax obligation can be eliminated by its obtaining the appropriate tax form from the counterparty payee (generally, a Form W-8). If the payee is a U.S. person, backup withholding can be eliminated if the payee provides the payor with a Form W-9 or if it has certain indicia of being a U.S. corporation, bank or other exempt entity type.
4. 26 Williston on Contracts 68:29. The principle that a defaulting party is barred from all recovery, except to prevent unjust enrichment, is described in Amtorg Trading Corp. v. Miehle Printing Press & Mfg. Co., 206 F.2d 103, at 105 (2d Cir. 1953) (interpreting New York law).
5. An event of default with respect to an option buyer would not result in a forfeiture of the value of its option because the option premium paid to the option seller would constitute a tangible benefit conferred upon the non-defaulting party.

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