

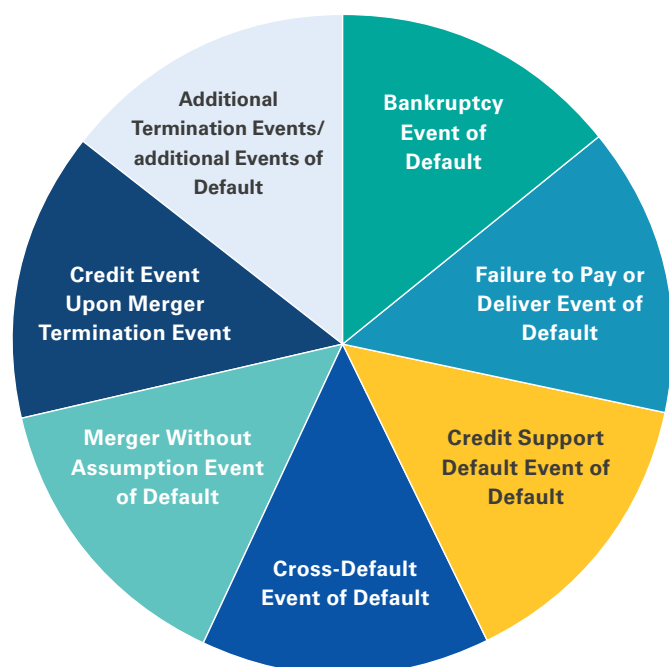
With all the market turmoil and headlines about insolvencies or potential insolvencies in the financial sector and the wider markets, and potential rescue of stressed/distressed entities, many clients are concerned, and should be thinking, about the potential impact of these developments on their derivatives (commonly documented under an ISDA master agreement (an ISDA)) and, in particular: (a) if the relevant event constitutes a default, potential event of default, event of default or termination event or, alternatively, will trigger automatic early termination, under their ISDAs with their counterparties; (b) if such an event constitutes a potential event of default, an event of default or a termination event under the ISDA, what are the potential consequences of the occurrence of such an event; and (c) what practical considerations should be taken into account.

It is important for clients to be closely reviewing the terms of their ISDAs, paying particular attention to any deviations from standard terms.

### Events of Default/Automatic Early Termination/Termination Events

We consider certain of the standard Events of Default and Termination Events under the English law 2002 ISDA Master Agreement<sup>1</sup> (2002 ISDA Agreement) (all defined terms used herein and not otherwise defined shall be as defined in the 2002 ISDA Agreement).

Broadly, we expect the following events could potentially come into play:



- **Bankruptcy Event of Default** – A Bankruptcy Event of Default could be triggered by events such as a party’s/ Credit Support Provider’s/Specified Entity’s admission that it is insolvent or admission in writing of an inability to pay its debts generally as they become due, the giving of consent to an entry of decree for voluntary insolvency, institution of involuntary insolvency proceedings, appointment of a receiver or similar official, making of assignments or other proposals for the benefit of creditors, or committing another “act of bankruptcy” under any applicable bankruptcy law (subject to grace periods in certain circumstances).

Depending on which jurisdictions the parties are incorporated in, they may or may not have elected Automatic Early Termination (AET) under their ISDAs. In most cases, we anticipate that parties will not have elected AET, as the preferred position tends to be that parties wish to retain control over when their Transactions are terminated and will only apply AET were recommended by the ISDA industry opinions with respect to the insolvency laws of a jurisdiction.

Broadly, however, if such election has been made, AET designates an Early Terminate Date on the occurrence of certain “Bankruptcy” events, thereby automatically terminating all Transactions without any notice from the Non-defaulting Party.

<sup>1</sup> Please note that many market participants continue to use the 1992 ISDA Master Agreement (Multicurrency – Cross Border). The position under those agreements will likely be different, although for some time, the market standard approach has been to make appropriate amendments to bring such agreements in line with the wider default and termination provisions in the 2002 ISDA Agreement.

It is important to determine whether AET applies and, if so, appropriately manage the market risk between the date of the Event of Default and the time that the Non-defaulting Party actually closes out its Transactions. To the extent that a Non-defaulting Party is exposed to market risk after Transactions have automatically terminated (but before actual close-out of Transactions), the standard position is that the Non-defaulting Party will only be entitled to payment on the basis of market rates at the time of the Event of Default (and will not be indemnified for losses incurred should the market move against it in the intervening period).

- **Failure to Pay or Deliver Event of Default** – A payment or delivery is not made after the first Local Business Day/ Local Delivery Day a party receives a notice of such failure. For this to be triggered, a party must send a notice on non-payment/delivery – it does not happen automatically. The grace period may have been changed in the Schedule.
- **Credit Support Default Event of Default** – The failure of a party's Credit Support Provider to perform its obligations under a Credit Support Document or the termination thereof or a failure to be secured thereunder.
- **Cross-Default Event of Default** – A default of a party/ Credit Support Provider/Specified Entity under any obligation for borrowed money resulting in such obligation being capable of or becoming accelerated in an aggregate monetary amount equal to or greater than the Threshold Amount (as specified in the Schedule). The Cross-Default Event of Default will only apply if specified to apply in the Schedule (although market practice is that it would be unusual to exclude this). Parties should carefully check the applicable Threshold Amount, in particular, where a bank/market-maker (if it is likely to be the Defaulting Party) has set high thresholds for itself or, alternatively, used an unfixed reference point (e.g. % of shareholders' equity), which is not unusual for banks.
- **Merger Without Assumption Event of Default** – A party or its Credit Support Provider consolidates or amalgamates with, or merges with or into, or transfers all or substantially all its assets to, or reorganises, reincorporates or reconstitutes into or as, another entity and (1) that entity does not assume such party's/Credit Support Provider's obligations under the 2002 ISDA Agreement or Credit Support Document, as applicable or (2) the benefits of any Credit Support Document fail to extend (without the consent of the other party) to the performance by such resulting, surviving or transferee entity of its obligations under the 2002 ISDA Agreement.

- **Credit Event Upon Merger Termination Event** – The creditworthiness of a party, Credit Support Provider or a Specified Entity (each "X") or, if applicable, the successor, surviving or transferee entity X, after taking into account any applicable Credit Support Document, is materially weaker<sup>2</sup> immediately after the occurrence of one of the following events (and such event does not constitute a Merger Without Assumption) than that of X immediately prior to the occurrence of such event:

(1) X consolidates or amalgamates with, or merges with or into, or transfers all or substantially all its assets (or any substantial part of the assets comprising the business conducted by X as of the date of the 2002 ISDA Agreement) to, or reorganises, reincorporates or reconstitutes into or as, another entity.

(2) Any person, related group of persons or entity acquires directly or indirectly the beneficial ownership of (a) equity securities having the power to elect a majority of the board of directors (or its equivalent) of X or (b) any other ownership interest enabling it to exercise control of X.

(3) X effects any substantial change in its capital structure by means of the issuance, incurrence or guarantee of debt or the issuance of (a) preferred stock or other securities convertible into or exchangeable for debt or preferred stock or (b) in the case of entities other than corporations, any other form of ownership interest.

The Credit Event Upon Merger Termination Event will only apply if specified to apply in the Schedule.

- **Additional Termination Events/Additional Events of Default** – An ISDA also permits parties to specify Additional Termination Events and additional Events of Default in the schedule, which could include ratings downgrades, change of control or other credit-related defaults. A party should review the schedule carefully to see what other default or termination triggers exist, and who they apply to. It is worth bearing in mind that an ISDA may be a more "one-sided" document, with the bank/market-maker party benefitting from additional protections.



<sup>2</sup> Note that the "materially weaker" trigger may, in fact, have been replaced with a more definitive trigger by the parties.

## Potential Consequences

The principal remedies provided under the 2002 ISDA Agreement to the Non-defaulting Party and Non-affected Party, as applicable, are a right of termination of all outstanding Transactions (in the case of an Event of Default) or all Affected Transactions (in the case of a Termination Event) and the application of close-out netting and set-off.

### Early Terminations

In general, the Non-defaulting Party (in the case of an Event of Default) or the Non-affected Party (in the case of a Termination Event) will have a right to designate an Early Termination Date and where they decide to exercise this right, must send a notice designating a termination date of the Transactions and the reason therefor (an Early Termination Date), which cannot be earlier than the date of the notice or more than 20 days after such date; however, if Automatic Early Termination is designated in the Schedule, the Early Termination Date will occur immediately upon the occurrence of certain types of "Bankruptcy" with respect to a party.

The notice provisions of an ISDA must be followed. In general, any notice with respect to Section 5 or Section 6 must be hand delivered by mail or courier. Sending a notice by email or an electronic messaging system will not be effective delivery, although it may be sent as a courtesy. Even though sending by fax may be permitted, it may no longer work in practice.

A statement showing, in reasonable detail, the Early Termination Amount payable, and the payment date must also be provided. In practice, this is usually included with the Early Termination Date notice. It should be noted that the methods of determining the Early Termination Amount are different under the 1992 ISDA (Multicurrency – Cross Border) and the 2002 ISDA Agreement.

### Withholding Payments/Deliveries

It should also be noted that where a Potential Event of Default or Event of Default has occurred, the Non-defaulting Party will have the right to withhold payment and deliveries in reliance of Section 2(a)(iii) of the ISDA for as long as the Potential Event of Default or Event of Default persists. Note, under current New York law, pursuant to the Bankruptcy Court's ruling under *In re Lehman Brothers Holdings, Inc.* (commonly referred to as "Metavante"), which was a Non-defaulting Party that withheld payments to Lehman under Section 2(a)(iii) of the ISDA, the Non-defaulting Party cannot withhold performance indefinitely and must close out Transactions "promptly" after a Bankruptcy Event of Default.

"Promptly" is interpreted as fairly contemporaneously. The longer a party waits the less likely it will be seen as fairly contemporaneously.

Some market participants have included "sunset" restrictions in their ISDAs (including ISDAs governed by English law (but we would be of the view this is not the market practice in the UK)), which effectively provide that a Non-defaulting Party can no longer sit on its payment/delivery obligations indefinitely, but for an agreed period of time only.

### Close-out Netting

Close-out netting is the termination and closing out of all outstanding Transactions or Affected Transactions, as the case may be, and determining one lump sum to be paid or received by a party, which sum and who receives such sum depends on the market value of the Transactions.

### Set-Off

The 2002 ISDA Agreement provides for a contractual right of set-off (whereas the 1992 ISDA Master Agreement (Multicurrency – Cross Border) does not unless expressly amended under the terms of the schedule). Set-off is essentially the right to offset amounts that a party may owe to its counterparty under the 2002 ISDA Agreement against amounts the counterparty owes such party under other agreements between the parties.



## Practical Considerations

Set out below is a list of items that may be helpful to think about, whether with respect to a potential trigger against a counterparty or yourself.

- Are there any counterparties that give rise to credit concerns that need to be monitored?
- Could counterparties be viewing you as a stressed/distressed party?
- From a practical perspective, a party needs to take a holistic view of its entire credit relationship with its counterparties. This may not necessarily be limited to derivatives only, and could extend to other arrangements (e.g. facility agreements or prime brokerage arrangements).

For example:

- Are the swap transactions related to a loan agreement? If so, does the loan agreement have any provisions that could affect rights under the ISDA? For example, are there any restrictions on the designation of an Early Termination Date? Is set-off available?
- Is the ISDA part of prime brokerage arrangements? If so, what other agreements are in place as part of the prime brokerage arrangements? Do the close-out rights extend to all other group trading relationships or only certain trading relationships?
- Has any credit support been given?
- Is a party posting any collateral to its counterparty, either on a two-way or one-way basis? Is the collateral a title-transfer transaction or merely giving the counterparty security rights only? What happens operationally when a counterparty goes into default? How can money posted as collateral be retrieved?
- Will the relevant events that have occurred trigger further collateral calls and can the relevant collateral provider meet such calls? Is the ability to satisfy any margining requirements giving rise to any concerns?
- What other credit support is there (e.g. guarantees)? Can such credit support be enforced/claimed under?
- What Events of Default and Termination Events apply under the ISDA and could be triggered? What are the grace periods? Are there any restrictions on the designation of an Early Termination Date? Will you exercise the right to close-out?
- What are the notice provisions? Are you in a position to be ready to serve any notices?
- Are there any rights to close-out or terminate early prior to the occurrence of an Event of Default or Termination Event? Even if not expressly provided for, the parties could mutually agree to close-out or terminate early. Could it make sense to close-out or terminate early? Are the derivative contracts an asset for you?

- If you will be the Determining Party, are you able to make the calculations as a Determining Party or would you need a third party to perform the calculations for you?
- Are there any hedging-related transactions that would need to be closed out at the same time? Can such transactions be terminated?
- Where a party is out-of-the-money, how can the termination payment obligations be satisfied?

More than ever, it is important to enlist experienced legal counsel to help you navigate your existing derivatives documentation and help you understand derivative risk profiles. Our Derivatives and Structured Finance Practice Group and Restructuring and Insolvency Practice Group have been assisting a wide range of financial institutions and corporate clients with derivative-related matters and would be happy to assist in any assessment of a party's derivative risk profile.

## Key Contacts

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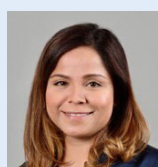
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