International Swaps and Derivatives Association (“ISDA”) Issues 2002 Master Agreement

By Eddie Law

The standard agreements and definitions for over-the-counter (“OTC”) derivatives transactions developed by the International Swaps and Derivatives Association (“ISDA”) are widely used globally. They provide standard terminology and set of assumptions reflecting prevailing market practices to facilitate the documentation of privately negotiated derivatives contracts.

In order to take into account recent developments in market practices and to better redress the problems posed by the 1998 market turmoil in Asia and Russia, ISDA published the 2002 ISDA Master Agreement (the “2002 Agreement”) in January 2003, which represents its third generation master agreement after the 1987 and 1992 versions. A copy of the 2002 Agreement can be purchased online from ISDA’s website at www.isda.org.

The distinctive modifications made in the 2002 Agreement, when compared with its 1992 version (the “1992 Agreement”), include:

(i) the new arrangement regarding the Termination Event of Illegality;
(ii) the introduction of Force Majeure Event;
(iii) the introduction of Waiting Period;
(iv) the reduction of Grace Period;
(v) the adoption of a single mechanism to calculate Early Termination Amount;
(vi) the inclusion of a Set-off Provision; and
(vii) the amendment concerning the jurisdiction provisions.

Summary of Key Modifications

1. Illegality

A transaction may be terminated before its scheduled maturity if there occurs any Event of Default or Termination Event as defined in the 2002 Agreement. Events of Default are fault based whilst Termination Events are generally considered not to involve any element of fault of either party.

The Termination Event of “Illegality” is revised in the 2002 Agreement. In particular, the 1992 Agreement provides that it will only occur if the relevant illegality is caused by a change in applicable law. However, under the 2002 Agreement, any event or circumstances making the transaction or the performance of the transaction unlawful will suffice.

In addition, the 2002 Agreement allows the parties to have the option to early terminate only those transactions affected by Illegality which they want to terminate. This is not the case according to the 1992 Agreement, under which the parties must early terminate all transactions affected by Illegality.

2. Force Majeure Event

Force Majeure is not a Termination Event under the 1992 Agreement. The 2002 Agreement now adopts a new Termination Event of Force Majeure to cover situations beyond the parties’ control that are not covered by Illegality, such as natural or man-made disasters, labor riots, acts of terrorism and other unanticipated events that prevent the performance of a party’s obligations under the contract.

3. Waiting Period

A new concept of Waiting Period is introduced. In a nutshell, upon the occurrence of an Illegality or a Force Majeure Event, each payment or delivery which would otherwise be required to be made under the relevant transaction will be deferred to, and will not be due until, (i) the first Local Business Day (or in case of a delivery, the first Local Delivery Day as defined in the 2002 Agreement) following the end of the relevant Waiting Period, or (ii) the date on which the event or circumstance constituting or giving rise to the Illegality or Force Majeure Event ceases to exist.

Further, the parties may not rely on Illegality or Force Majeure Event to early terminate the related transactions unless the applicable Waiting Period has expired.

Generally, the Waiting Period for an Illegality lasts for three Local Business Days and the Waiting Period for a Force Majeure Event lasts for eight Local Business Days.

4. Grace Period

The 1992 Agreement provides for a grace period of three Local Business Days in relation to a failure to pay or deliver (being one of the Events of
Many market players found that this was too long in the case of financial crisis, such as those experienced during the late 1990s. In the 2002 Agreement, the three Local Business Day grace period has been reduced to one Local Business Day. Similarly, the grace periods for other Events of Default (such as Default under Specified Transaction and Bankruptcy) are also reduced.

5. Calculation of Early Termination Amount

When transactions are early terminated, the parties will need to calculate the settlement amount payable to each other by aggregating the positive and negative values of all those transactions. The calculation methods are rather complicated according to the 1992 Agreement, which distinguishes between early termination caused by (i) an Event of Default and (ii) a Termination Event, and requires the parties to select a combination of optional calculation measures and methods, such as the so-called First Method, Second Method, Market Quotation and Loss.

Under the 2002 Agreement, the calculation standard of Market Quotation and Loss have been replaced by a single standard, i.e., the Close-out Amount. The Close-out Amount contains elements of both Market Quotation and Loss and requires the parties to apply it in good faith and in accordance with commercially reasonable procedures.

Further, the 1992 Agreement allows the parties to select the First Method, according to which only the defaulting party is required to make a settlement payment. However, the 2002 Agreement contemplates that each party may be liable to pay the settlement amount to the other, without considering which party is the Defaulting Party.

6. Set-off

The 1992 Agreement provides that the settlement amount payable by the parties upon an early termination will be subject to any Set-off, which is defined to include combination of accounts, right of retention or withholding or similar right or requirement (whether arising under the 1992 Agreement, another contract, applicable law or otherwise). Nevertheless, the 1992 Agreement does not include a set-off provision for this purpose. Therefore, parties using the 1992 Agreement will need to add their own set-off clause in the Schedule, or rely on other set-off rights under other agreements or applicable law (if any).

The 2002 Agreement now includes a set-off provision regarding termination payments. Such provisions can be quite important for the non-defaulting party. Not only can the payment arrangement be simplified, but the non-defaulting party may also rely on it to reduce settlement risk, which will be high when there is an Event of Default.

7. Jurisdiction

Since there were doubts as to whether it was permissible to agree to anything other than exclusive jurisdiction under Article 17 of the 1968 Brussels Convention and the 1988 Lugano Convention (collectively, “Article 17 of the Conventions”), the 1992 Agreement provides that the parties will submit to the jurisdiction of the English courts if the agreement is expressed to be governed by English Law. It further provides that nothing in the agreement precludes either party from bringing Proceedings in any other jurisdiction (subject to certain exceptions).

However, the Council of the European Union adopted a Regulation on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters on December 22, 2000, according to which non-exclusive jurisdiction clauses are now permitted, although the uncertainty has not been removed completely as the courts of so many countries are involved. This event prompted ISDA to adopt a new jurisdiction provision in the 2002 Agreement, according to which, if the agreement is expressed to be governed by English law, the parties will submit to:

(i) the non-exclusive jurisdiction of the English courts if the Proceedings do not involve a court which is bound to apply Article 17 of the Convention; and

(ii) the exclusive jurisdiction of the English courts if the Proceedings do involve a court which is bound to apply Article 17 of the Conventions.

Please note that this article only highlights the more important modifications made in the 2002 Agreement. For the sake of clarity, the above explanations are inevitably simplified, and it is necessary to refer back to the original provisions in order to get a complete picture.

If you require further advice or have any other queries, please contact Eddie Law in Paul Hastings’ Hong Kong office at (852) 2867 9550 or via email at eddielaw@paulhastings.com.