Closing out ISDA Contracts: a Practical Guide

By Kingsley Ong
Eversheds
Hong Kong
and
Jonty Lim
KPMG
Hong Kong

Introduction

Despite global efforts, the 2008 financial crisis seems far from over. Since the collapse of Lehman Brothers, the world of derivatives trading has attracted unprecedented attention. Although this financial crisis was primarily attributed to unsound lending practices, securitisation, collateralised debt obligations (CDOs) and derivatives (especially credit default swaps or CDS) have been widely blamed for spreading the losses much further than would otherwise have been the case.

It is estimated that the notional amount of over-the-counter (OTC) derivatives contracts currently stands at about US$648 trillion (i.e. 43 times the size of annual US GDP). Unsurprisingly, regulators around the world are concerned about the size of the OTC derivatives market and its adverse impact to the systemic stability of the global financial system. For example, a European credit event could easily trigger a domino default across the global financial system causing a catastrophic collapse. In many jurisdictions, legislative process is underway to enact regulatory reforms for OTC derivative trading, although this ex post facto effort cannot resolve the existing crisis.

The standard form ISDA Master Agreement (which comes in either the 1992 or 2002 versions) remains the pre-eminent market standard contract used to document OTC derivative transactions. It is becoming increasingly essential for insolvency professionals to be familiar with closing out ISDA contracts. This article provides a general overview of the process and common pitfalls in 10 basic steps.

1. Collect and review all relevant documentation

Before making any decision (e.g. whether to terminate an ISDA contract), it is important to understand your legal position. The first and most important step is to collect all the relevant documentation in order properly to ascertain your rights.

Documents include:

- The ISDA Master Agreement;
- The Schedule to the ISDA Master Agreement;
- All transaction confirmations;
- Any credit support documentation;
- Any other agreements that affect the terms of the ISDA Master Agreement; and
- Any amendments, supplements or restatements in respect of any of the above.

2. Events of Default and Termination Events

Next, determine if any Event of Default or Termination Event is applicable (s. 5 and 6 of the ISDA contract, as amended or supplemented). Look for any applicable conditions (e.g. grace periods) to close out as well. Insolvency is an Event of Default under s.5(a)(vii) of the ISDA Master Agreement.

(a) Automatic Early Termination ("AET")

Check if AET is applicable - if so, your contract may have already terminated (even without your knowledge). If you are unsure of the Early Termination Date or find that the date is unfavourable, speak to your counsel.

(b) Designation of Early Termination Date

Where an Event of Default has occurred and is continuing, and AET does not apply or has not been triggered, the Non-defaulting Party may give notice to designate an Early Termination Date with respect to all outstanding Transactions.

If you are the Non-defaulting Party, refrain from rushing to designate an Early Termination Date. Seek counsel’s advice about the most optimal termination date as well as rights to withhold payment in the meantime.

If you are the Defaulting Party (e.g. if acting for an insolvent estate), unless your counterparty is also in default, the ISDA Master Agreement does not give you any right to terminate the contract.

(c) Anti-Deprivation Rule

Note that s.2(a)(iii) of the ISDA Master Agreement allows the Non-defaulting Party to suspend its payment and delivery obligations under the ISDA contract if the Event of Default is ongoing. Non-defaulting Parties may indefinitely delay termination especially if they are out-of-the-money under the contract. In such event, creditors of an insolvent estate would be effectively deprived of the benefit of a valuable in-the-money ISDA contract. This controversial effect has been the subject of recent litigations around the world. The outcome is conflicting: the US court held that these contractual provisions violate US bankruptcy law; whereas the English court upheld these ISDA provisions. For more information, see: Kingsley Ong, “The ISDA Master Agreement: Insolvency Stalemate and Endgame Solutions for Hong Kong Liquidators” (INSOL World, 2011 Q1, p. 14).

(d) Notice Requirements

If you are entitled to terminate the ISDA contract and you wish to do so, and your chosen event requires a notice to be issued, ensure that any notice you give is in accordance with s.12 of the ISDA Master Agreement (as amended). This is usually considered a clerical process where quite often, amateurish errors are made. Mundane errors like whether the notice should be in writing, sent by courier, etc may render the notice invalid. The content of the Notice is also important and should contain sufficient and correct information. Notices rendered invalid due to ambiguous references and clumsy mistakes could be very costly.

3. Recovery - Enforcing security/guarantee

Under the ISDA credit support documents and any
guarantee, you may be entitled to enforce security over all posted collateral or call on the guarantee. Check if the conditions for enforcement are met.

4. Determine Termination Payments
If you have a 1992 ISDA contract, check which prescribed methodologies should be used: Market Quotation or Loss, and First Method or Second Method. The 2002 ISDA contract only provides for the Close-out Amount methodology.

(a) Market Quotation
If you are the Determining Party, seek exactly four quotations from four Reference Market-makers. If a Reference Market-maker does not provide a quotation, do not seek further quotations - otherwise your counterparty may accuse you of picking the four best quotations out of many.

The Market Quotation for each Terminated Transaction or group of Terminated Transactions is determined according to the number of quotations obtained (as set out in below table).

<table>
<thead>
<tr>
<th>Number of Quotations Obtained</th>
<th>Determination of Market Quotation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Four</td>
<td>Average of remaining two quotations after highest and lowest quotations are discarded</td>
</tr>
<tr>
<td>Three</td>
<td>The remaining quotation after highest and lowest quotations are discarded</td>
</tr>
<tr>
<td>Two or that Fewer</td>
<td>Fallback to Loss because it will be deemed Market Quotation cannot be obtained</td>
</tr>
</tbody>
</table>

If you believe that Market Quotation would not produce a "commercially reasonable result", then you may elect to use the Loss methodology instead. This is a call that should be exercised judiciously (especially during periods of market stress).

(b) Loss
Loss is the amount required to put the Determining Party in the position that it would have been in had the contract been performed.

(c) Close-out Amount
The Close-out Amount is the sole methodology provided in the 2002 ISDA contract. The Close-Out Amount is intended to reflect the losses or costs/gains to the Determining Party in replacing or providing the economic equivalent of material terms of the Terminated Transactions and the options rights of the parties in respect of the Terminated Transactions under the prevailing circumstances.

If unsure, seek counsel for advice on what may and may not be included in the determination of Loss and Close-out Amount.

5. Determine interest on Unpaid Amounts
Unpaid Amounts accrue interest on every day elapsed from the date when the relevant amount should have been paid. The applicable rate for such interest depends on your particular situation and your version of the ISDA contract. Seek counsel to ensure that the correct rate of interest is applied.

6. Conversion to Termination Currency
If any amount of Loss, Market Quotations, Unpaid Amounts and Close-out Amounts are not denominated in the Termination Currency (specified in the Schedule), such amounts should be converted into the Termination Currency.

7. Adjustment for Bankruptcy
Where AET applies, s.6(6)(ii) of the ISDA Master Agreement permits adjustments to the amount due in respect of the close-out for payments or deliveries made during the period between such Early Termination Date and the date on which the close-out amount is due.

8. Set-off
Set-off can be used to reduce the amount owed by either party. The 1992 ISDA contract does not expressly allow a party to set-off payments due on close-out against any sum that is due under another agreement (but check if any set-off provision is provided in the Schedule).

The 2002 ISDA contract expressly provides for set-off of the close-out amount to take place at the option of the Non-defaulting or Non-affected Party. If the exact amount of your obligation is unascertained, you may make a good faith estimate for applying set-off provided you account to the other party once that exact amount is ascertained.

The laws applicable to set-off are complex as there are many factors that could affect the ability to effect a valid set-off, including conflict of laws issues. Before attempting to exercise any right to set-off, seek counsel’s advice.

9. Calculation statement
Each party must prepare a calculation statement of the close-out amounts payable in reasonable detail, and provide this to its counterpart. This should be done "on or as soon as reasonably practicable following the occurrence of an Early Termination Date".

If you are the Non-defaulting Party, remember to include all reasonable out-of-pocket expenses (including legal fees, execution fees and stamp duty) incurred in enforcing and protecting your rights under the ISDA contract. Seek counsel to ensure your calculation statement is in your best interest.

10. Payment date
The amount calculated in respect of a close-out is payable:

(a) in the case of an Event of Default, on the date on which the calculation statement is effective and;

(b) in the case of Termination Event, two Local Business Days following the date on which the calculation statement is effective.

Interest will accrue on this amount from the due date until such payment is made. Reasonable expenses incurred by a Non-defaulting Party after the due date may also be recoverable.

Conclusion
Given market volatility in the current economic climate, mistakes and delays can be costly. By its nature, derivatives are complex financial instruments and dealing in derivatives contracts generally require specialist knowledge. The information contained in this article is intended for general guidance purposes only and should not be regarded as a substitute for taking professional advice. The views expressed in it are personal to the authors and do not necessarily represent the views of the institutions that they are associated with.