

COVID-19 Derivatives Checklist – Part 1: Key ISDA Master Agreement and Collateral Agreement Issues and Considerations

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The novel coronavirus (**COVID-19**) pandemic is presenting the global markets with unprecedented challenges. Governments, corporations and the financial markets have been struggling to evaluate and adapt to the social and economic impact of COVID-19. We have created this three-part Client Alert to highlight some issues and considerations which, though general in nature and not intended to be exhaustive, we hope will be helpful as part of your preparations for the unique challenges ahead.

In this Part 1, we discuss the key legal and practical issues that market participants should consider under the ISDA Master Agreement and related ISDA collateral agreements. In Part 2, we discuss the issues as applied to certain over-the-counter (**OTC**) derivatives products. In Part 3, we discuss recent derivatives regulatory issues.

Background

While not a credit-driven event like that which occurred in 2008, the current evolving crisis has led to a dramatic 'pause' of people, capital and goods across the globe. It is difficult to assess the effects this unprecedented dislocation in cross-border capital flows will have and whether it will be followed by a significant recession in the global economy. However, we already see that COVID-19 is presenting derivative market participants with previously unknown paradigms. In Part 1 of this Client Alert, we summarise the key legal and practical issues that market participants should consider under the 1992 (Multicurrency – Cross Border) and 2002 ISDA Master Agreements (**1992 ISDA MA** and **2002 ISDA MA**, together the **ISDA MAs**) as the same may arise in relation to COVID-19.

ISDA Master Agreement

1. Termination Events: Illegality, Force Majeure Event and Additional Termination Events

Illegality

Section 5(b)(i) of both ISDA MAs contains a termination right that applies in certain circumstances where an event results in it becoming unlawful to make or receive a payment or delivery or comply with any material provision in respect of either a Transaction or a Credit Support Document. In recent days, national governments across the world have passed emergency legislation ranging from mandatory confinement of persons to bans on short selling. Parties will need to assess if the recently adopted legal measures by a number of governments have changed any relevant legal or regulatory provisions or simply make performance unlawful under the ISDA MA. The exact scope of each measure should be evaluated as applicable to the jurisdiction of relevant counterparties.

Force Majeure Event

- Section 5(b)(ii) of the 2002 ISDA MA contains a force majeure provision that applies in circumstances where it becomes impossible or impracticable to make or receive a payment or delivery, or comply with any material provision in respect of either a Transaction or a Credit Support Document. Terms used in this provision such as “impossibility”, “impracticability” and “act of state” are not otherwise defined. Depending on the fact pattern, it could apply where mandatory restrictions on movement prevent employees of a counterparty from being able to attend its office to send instructions, a fact pattern many market participants are encountering, and obligations cannot otherwise be fulfilled. Parties should therefore assess the risk of a party relying on such termination right (and/or its own ability to do so).
- It should be noted that, while the 1992 ISDA MA does not contain such a provision, many parties have historically included an “Impossibility” Additional Termination Event. While more limited in scope (in that it does not cover an impracticable situation), such provision may give rise to an equivalent termination right in certain circumstances.
- Parties can mitigate the effects of these Termination Events by effecting performance remotely.

Illegality and Force Majeure Event – Fallbacks, Waiting Periods and Close-out

- The Illegality and Force Majeure Event Termination Events only apply in the absence of any specific disruption or fallback provisions. These specific provisions should be checked first and will differ depending on the product type, the relevant ISDA definitions booklet and the elections made by the parties in their documentation, as applicable.
- Where an Illegality or Force Majeure Event is triggered, it creates a waiting period of three Local Business Days (in the case of an Illegality) or eight Local Business Days (in the case of a Force Majeure Event). Please see below as to how these may differ in respect of payments or deliveries under a collateral agreement.
- Note that unlike a close-out following an Event of Default, in the case of both an Illegality or Force Majeure Event, the Transactions are valued upon termination at mid-market. This could be advantageous to parties who are out of the money as it may reduce the amounts they otherwise would pay upon another termination.

Additional Termination Events

- Given the nature of Additional Termination Events (**ATEs**) as bespoke termination rights that can include those linked to net asset value, ratings and mark to market triggers, market participants should carefully evaluate whether ATEs may be capable of being triggered, resulting in a termination or an obligation to post collateral or novate to another counterparty.

2. Events of Default: Failure to Pay or Deliver, Breach of Agreement; Repudiation of Agreement, Misrepresentation, Credit Support Default, Cross Default & Bankruptcy

Failure to Pay or Deliver

- Section 5(a)(i), the 'Failure to Pay or Deliver' Event of Default contains a payment grace period of three Local Business Days (under the 1992 ISDA MA) and one Local Business Day (under the 2002 ISDA MA), in each case following notice of the relevant default being provided. We are already assisting many clients with failures to pay or deliver by their counterparties, primarily in the context of margin calls. Parties should consider in such circumstances that (1) such provisions (especially in the context of finance linked hedges) may be subject to provisos for administrative errors, 'disruption events' or additional notification requirements and (2) may give rise to an argument from counterparties that the relevant event actually constitutes an Illegality or Force Majeure Event (noting the hierarchy of events in Section 5(c) of the ISDA MAs and the obligation to give notice of Termination Events in Section 6(b)(i) of the ISDA MAs).

Breach of Agreement; Repudiation of Agreement

- Section 5(a)(ii) of the ISDA MAs provide for a right to terminate where a party fails to comply with any agreement or obligation by the end of the standard grace period of 30 days after notice of such failure is given to the party. The 2002 ISDA MA also includes a right to terminate where the agreement is subject to repudiation. Previously, such grace period would have seemed ample time to remedy any such failure; this may well not be the case in the COVID-19 crisis and such obligations should be reviewed in light of each party's likely failure to comply (e.g., delivery of financial statements may be delayed past the scheduled date).

Misrepresentation

- In a situation which is being completely reshaped by economic, financial, regulatory and political decisions, it is vital to double-check the representations that you have given under the ISDA MA, those that were made to you and the times at which such representations are made. Any breach may constitute a Misrepresentation Event of Default under Section 5(a)(iv) of the ISDA MA.

Credit Support Default, Cross-Default and Bankruptcy

These key credit related termination rights should be considered for the following reasons:

- **Credit Support Default – Section 5(a)(iii)** of the ISDA MAs will apply where a Credit Support Document and/or Credit Support Provider has been specified in the Schedule. Such agreements should be subject to enhanced monitoring given the potential that a trigger could occur in respect of such entity or document that does not necessarily lead to a trigger in respect of the counterparty itself pursuant to the terms of the ISDA MAs.
- **Cross-Default – Section 5(a)(vi)** of the ISDA MAs deals with cross-defaults in respect of other 'Specified Indebtedness' howsoever defined. Careful consideration should be given to the occurrence of cross-defaults under third-party financings both in terms of the ability to rely on such Event of Default and the consequences of notifying counterparties that such Event of Default (or Potential Event of Default) has occurred (e.g. delivery of a 'soft' notice of non-payment in respect of a failure to pay could unintentionally trigger cross-default provisions in third-party financings). It is worth noting under Section 5(c)(ii) of the ISDA MAs that an event which would otherwise constitute an Illegality or Force Majeure Event will be treated first as a Cross-Default should it also constitute such an event.
- **Bankruptcy – Section 5(a)(vii)** of the ISDA MAs covers a number of insolvency related scenarios. An economic downturn will increase the risk of failure of a large number of corporates in many countries (particularly in certain severely affected industries). Therefore, it is likely that counterparties will – or may have already become – insolvent from a technical perspective. Less apparent triggers (such as the admission in writing that a party is unable to pay its debts) should be monitored for individual counterparties in order that market participants may exercise close-out rights at the appropriate time.

3. Issues surrounding Close-out

Notices – requirements, practical issues

The 2008 financial crisis saw challenges to the validity of the notice served under Section 6 of the ISDA MAs designating an Early Termination Date for a variety of reasons. In the current environment, notice delivery may be complicated by additional factors, such as no ‘responsible employee’ actually on the premises to receive a facsimile transmission or no functioning courier service to make delivery. The service of notices is strictly regulated by the relevant agreement, which is often subject to amendment both by way of agreement and also notification. Potential challenges as to the validity of such notice may arise in certain circumstances, including without limitation, due to:

- the method of service not complying with the terms of the relevant agreement (e.g., Section 6 notices may not be given by electronic messaging systems or email under the 2002 ISDA MA);
- delivery of the notice occurring outside of the designated business hours in the agreement;
- delivery of the notice to an inappropriate person (e.g., a building rather than the party’s reception); and
- provision of the required calculation statement not being delivered ‘as soon as reasonably practicable’ or containing the required level of detail as to how such calculations have been determined.

Parties should carefully check both the standard terms of the ISDA MAs and the relevant amendments prior to service of any notices and consider alternative methods carefully when all permitted methods have been unsuccessful. Post-Lehman litigation affirming the efficacy of the provisions in Section 2(a)(iii) allowing parties to suspend their obligations (without being obliged to designate an Early Termination Date) should also be considered to the extent the ability to rely on such right is available and has not been fettered by amendment.

Close-out mechanics

The 1992 ISDA MA and 2002 ISDA MA contain significantly different valuation mechanics upon close-out. The ‘Market Quotation’ close-out mechanic of the 1992 ISDA MA is, as in the market crises of 2008, likely to once again demonstrate its limitations requiring careful consideration of its application. Although the market has – aside from certain structured, rated trades – moved to adopt the 2002 ISDA MA as standard, market participants should be particularly aware of the level of discretion afforded to the determining party in calculating the relevant termination amount pursuant to this methodology and the standard to which the determining party is held.

4. Unscheduled Holidays

- Payments and deliveries under the ISDA MAs and their associated collateral agreements may only be due on business days in the relevant jurisdiction(s). If a public holiday is declared in an area that is affected by COVID-19, this may impact whether the payment or delivery is actually due. This, in turn, may affect calculation periods.
- The ability to serve notices may also be affected, either because of an unscheduled holiday (such that the notice cannot become effective until the next business day), or because in practice, it is impossible to deliver notices in a manner that is permitted by the documents. For example, parties will often either need to – or prefer to – serve default notices and early termination notices by hand or by courier. In an area that is affected by quarantine, this may not be possible.
- Whilst, at the time of writing, such event has not occurred in a major derivatives market such as the UK, USA or EU, market participants should note the significant disruption to trade valuation and settlement occurring as a result of the extended Lunar New Year holiday in Mainland China in February and the market closure in the Philippines in March in order to consider the potential impact should such an event occur in a major market. See Part 2 of the Client Alert.

ISDA Collateral Agreements

1. Valuation Dates & Settlement Dates

- The market volatility resulting from COVID-19 has already led to a significant rise in large collateral demands under ISDA standard collateral agreements such as the 1995 / 2016 Credit Support Annexes (English law) and the 1994/2016 Credit Support Annexes (New York law).
- COVID-19 will require an enhanced consideration of what constitutes a 'Valuation Date', 'Regular Settlement Day', 'Settlement Day' and 'Local Business Day' given the increasing frequency of – for example – the closure of commercial banks on unscheduled days in a number of jurisdictions.

2. Waiting Periods – Illegality & Force Majeure Event

Market participants should note the difference in treatment that may arise under Section 5(d) of the 2002 ISDA MA regarding payments and deliveries under a "Credit Support Annex" (such as the 1995 / 2016 ISDA Credit Support Annexes) and a "Credit Support Document" (such as the 1994 ISDA Credit Support Annex). To take the example of a Force Majeure Event, Section 5(d) provides that "*if a Force Majeure Event has occurred and is continuing with respect to a Transaction, each payment or delivery which would otherwise be required to be made under that Transaction will be deferred to...the first Local Business Day... following the end of the applicable Waiting Period*". A plain reading of this provision would suggest that a payment or delivery due under, e.g., a Credit Support Annex (which is a 'Transaction' rather than a 'Credit Support Document') would always be subject to the Waiting Period, whereas a payment or delivery due under a Credit Support Document would not be subject to the Waiting Period where the caveat above applies.

Market participants should also keep in mind mandatory regulatory margin requirements such as strict delivery and settlement timings, which typically do not allow for waiting periods in the circumstances of an Illegality or Force Majeure Event.

3. Failure to Pay or Deliver

- A failure to meet a collateral demand can lead to the close-out (i.e. termination) of all outstanding derivatives transactions. Such demands can occur at unexpected speeds and levels where extreme market volatility occurs such as is the case with COVID-19.
- Typically, following a formal demand, the counterparty has only one or two Local Business Days to post the collateral, depending on when the demand is delivered and whether it is delivered on a valid 'Local Business Day' and prior to the relevant time specified in the collateral agreement. If the collateral demand is not met, the non-defaulting party will (subject to the application of any grace period) have the right to terminate all outstanding transactions under Section 5(a)(i) (or Section 5(a)(iii), as the case may be) of the ISDA MAs. Whether a party will choose to terminate or not and whether it will instead seek to rely on any other protections (e.g., the right to suspend performance) may depend upon a number of factors, including whether it would be receiving or making a payment on termination.

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