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Alert

Eurozone Crisis: ISDA Publishes the Illegality/Force Majeure Protocol

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The International Swaps and Derivatives Association ("ISDA") published the ISDA Illegality/Force Majeure Protocol (the "Protocol") on 11 July 2012.[1] The Protocol amends the 1992 version of the ISDA Master Agreement ("'92 ISDA") to include the Illegality and Force Majeure provisions from the 2002 ISDA Master Agreement ("2002 ISDA").

The Protocol is part of ISDA's more general efforts to provide an industry contingency plan for the Eurozone crisis.[2]

Background

There have been concerns about the impact of an exit of one or more Eurozone countries from the Euro as a currency on financial OTC derivatives transactions ("Transactions").

There is currently no legal process agreed upon for a country to exit the Euro and a number of potential scenarios have been identified. This uncertainty has in turn caused difficulty in identifying one clear process to deal with the impact of such an exit on Transactions. Examples of possible exit scenarios include:

- An exit by one or more member states from the Euro in an agreed process;
- A unilateral exit by one or more member states from the Euro;
- Currency re-denomination (i.e., Euro ceasing to exist); and
- Currency "split" (i.e., the split of the Euro into two or more currencies linked to different exchange rate mechanisms).

The Protocol Amendments

The Protocol enables adhering counterparties to amend the terms of each '92 ISDA to include the Illegality and Force Majeure Termination Events of the 2002 ISDA. Unlike Events of Default, under a Termination Event, a party may elect to (i) terminate one or more specific Transactions affected by the triggering event which, for example, might be the inability of the counterparty to make a payment or delivery due a Eurozone country exiting the Euro, or (ii) terminate the ISDA Master Agreement and all Transactions covered by the agreement with its counterparty.

[1] http://www.isda.org/2012illegalityProt/illegalityProt.html.

[2] http://www2.isda.org/functional-areas/legal-and-documentation/eurozone-contingency-planning/.

Under the Illegality Termination Event ("Illegality"),[3] termination rights arise if, after a Transaction is entered into, it becomes unlawful under applicable law:

(i) For the office through which a party is acting to make and receive payments or deliveries with respect to such Transaction or to comply with any material provisions of the ISDA Master Agreement, or

(ii) For a party or its credit support provider to perform its obligations to make or receive a payment or delivery of collateral under a credit support document in relation to a Transaction.

An example of an event which might constitute Illegality might be a change of legislation which made it unlawful for a party to continue to be a counterparty to a Transaction.

Illegality is also a Termination Event under the '92 ISDA. However, the 2002 ISDA (and the Protocol) version of Illegality occurs where a party is prevented from making or receiving a payment or delivery through the office through which it is acting regardless of whether or not it is able to make or receive a payment or delivery through another office.

The Force Majeure Termination Event ("Force Majeure")[4] covers events which fall outside of the Illegality event but which would hinder or prevent performance under the ISDA Master Agreement, such as the making or receiving of a payment by a party under a Transaction or the posting or receipt of collateral. Force Majeure also extends to actions taken by sovereign states ("act of state") that might not fall within the scope of Illegality.

The Illegality and Force Majeure events may only be triggered after giving effect to any applicable provision, disruption fallback or other remedy specified in the Transaction-specific terms or in the Transaction-specific ISDA product definitions, such as the 2002 Equity Derivatives Definitions or 1998 FX and Currency Option Definitions, which are applicable irrespective of the version of the ISDA Master Agreement.

Illegality and Force Majeure also include a Waiting Period.[5] The rational behind the Waiting Period is that it is, in some cases, appropriate to wait and see whether or not the event giving rise to termination rights will/might be resolved rather than there being an immediate termination right in favour of the non-affected party. For example, in a Eurozone exit by a member state re-denominating its currency, an unscheduled public holiday or non-banking day could be announced by the exiting country or indeed a number of countries while the exiting country re-denominates its currency. In such circumstances, where payment obligations under a Transaction are denominated in Euro and the Euro currency continues to exist in its current form, albeit without the membership of the exiting country, it might be argued that the payment obligations of a counterparty being subject to an unscheduled public holiday should be postponed temporarily by the Waiting Period after which the payment obligation would resume rather than the termination of the Transaction. The Waiting Period in the case of Illegality is a period of three business days and in the case of Force Majeure, eight business days.

The Protocol Mechanism

A protocol mechanism has been used by ISDA previously as a response to a market requirement or a crisis. Counterparties to an ISDA Master Agreement adhere to a published protocol by delivering an adherence letter to ISDA and a list of adhering parties is then published by ISDA on their website.[6] The effect of adherence is to amend or incorporate certain terms in the agreement or in relation to Transactions between adhering parties without the need to individually amend a counterparty's entire agreement population with each of its counterparties. Where parties incorporate the Protocol by reference as a term in their '92 ISDA, they will not be required to adhere to the Protocol.

[3] Schedule 1, paragraph (d).

[4] Schedule 1, paragraph (h).

[5] Schedule 1, paragraph (u).

[6] www.isda.org.

The Protocol introduces a Limited Right to Revoke provision,[7] under which an adhering party may elect to revoke its adherence to the protocol annually during a specified annual period being between 1 October and 31 October in a calendar year.

The protocol also includes the Ability of an Agent to Adhere to the Illegality/Force Majeure Protocol on Behalf of a Client provision.[8] This might be of interest to fund managers managing a number of funds or master funds being counterparties to ISDA Master Agreements (typically with banks or investment firms). Such managers may execute and deliver an Adherence Letter on behalf of their managed funds or master funds thereby reducing the operational burden and enabling a quicker and more convenient response than each managed fund or master fund adhering separately as a counterparty to an ISDA Master Agreement.

Applicability

It is important to note that the Protocol is not intended to address all Eurozone exit scenarios but rather form part of a contingency plan put forward by ISDA. For example, two non-Eurozone counterparties (a Cayman-organised fund and an English- or New York-organised dealer) to a swap consisting of Euro denominated payment obligations, may not necessarily be directly affected by or indeed prevented from making a Euro denominated payment where one or more member states exit the Euro and re-denominate their own currency but the Euro remains unchanged. In such a scenario, parties who are disrupted from making a payment or delayed in making a delivery due to a more general market disruption, may wish to review their Transaction-specific terms and applicable ISDA product definitions as to whether or not any termination rights arise or fallbacks become applicable in relation to their affected Transactions.

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[7] Protocol, paragraph 2(d).

[8] Protocol, paragraph 4(f).