THE LEHMAN BANKRUPTCY AND SWAP LESSONS LEARNED
NEGOTIATING AN ISDA MASTER AGREEMENT IN TODAY'S MARKET

Recent market events have caused many entities to examine their agreements regarding a variety of relationships they have with brokers and other trading counterparties. Many over-the-counter derivative trades are documented using the form of Master Agreement of the International Swaps and Derivatives Association Inc. ("ISDA"), and therefore many entities have been paying particular attention to these ISDA Master Agreements and their related schedules and confirmations.

ISDA has two forms of the Master Agreement: the 1992 form and the 2002 form. In both forms, the Master Agreement contains generic provisions covering important issues such as representations, events of default and mechanics for terminating an agreement, which parties can negotiate in a schedule that then supplements and amends the Master Agreement.

This memorandum highlights certain provisions of the ISDA Master Agreement that have generated significant interest for counterparties as market conditions have changed.

Additional Termination Events. The inclusion of counterparty-specific Additional Termination Events in agreements is a useful way of ensuring that parties will be able to terminate trades prior to a counterparty's creditworthiness deteriorating to the point of bankruptcy. Declaring an early termination of an agreement due to an Additional Termination Event is at the election of the nonaffected party, and those parties should consider whether their trades are in or out of the money prior to termination.

End-users as well should examine Additional Termination Events that are specific to them, especially events tied to declines in net value or changes in management, and events of default such as Credit Event Upon Merger. Given current operations, do parties anticipate a change of ownership or change in personnel? Have parties assessed the impact that recent redemptions or a drop in the market value of assets under management have had on their net asset value? The answers to these questions may require parties to consider requesting a waiver or other modification to the Additional Termination Events or Events of Default in their ISDA Master Agreement.

Conditions precedent to payment obligations. Parties should consider placing a time limit on how long a nondefaulting party can withhold its payment obligations following a default but prior to declaring an early termination date under the agreement.

Right of set-off. Parties may also want to confirm that their agreements in fact have a set-off clause and whether the right of set-off should be extended to affiliates of the nondefaulting party. Older agreements may not include a right of set-off and if they do, the right may not extend to affiliates.

Credit Support Annex. The collateral requirements under a Credit Support Annex to the Master Agreement have become critical as parties evaluate the creditworthiness of their counterparties and the merit of any long-term debt ratings of such counterparties.

In the past, many Credit Support Annexes were unilateral, but parties should review their trades and determine whether the Credit Support Annex should be amended to be bilateral. A bilateral Credit Support Annex offers greater protection against negative movements in transactions covered by the ISDA Master Agreement and requires both parties, subject to certain thresholds, to meet collateral requirements when an exposure under a transaction arises.

A standard Credit Support Annex also contains an election that would permit the secured party to sell, pledge or rehypothecate posted collateral. Parties may want to consider not permitting this election.

In order to provide for clear segregation of posted collateral, the use of a tri-party custody agreement might be explored. Such an option might add costs to the transaction, but could afford better protection in the event collateral is required to be returned.

Finally, although the subject of this memorandum was ISDA Master Agreements, the points for consideration raised in this memorandum may be applied to repurchase agreements and any other trading agreements parties may have in place.

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If you have any questions regarding this memorandum or would like to discuss current negotiations with swap counterparties or existing agreements that you have, please contact Thomas H. French (212-728-8124, tfrench@willkie.com), Jack I. Habert (212-728-8952, jhabert@willkie.com), or the attorney with whom you regularly work.

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