

Switzerland

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Early termination of transactions under the 2002 ISDA Master Agreement

In January 2003 the International Swaps and Derivatives Association (ISDA) launched the new version of its standard contract for documenting over-the-counter (OTC) derivatives transactions – the 2002 ISDA Master Agreement. This new version is based on, and amends, its predecessor – the 1992 ISDA Master Agreement.

The core provisions of the 2002 ISDA Master Agreement concern, among others, the early termination close-out netting of all transactions under the agreement in the event of default of a party. These provisions particularly include the right of the solvent party to terminate all outstanding transactions upon notice of termination in the event of bankruptcy of its counterparty (optional early termination). Alternatively, the parties can agree to an automatic early termination in the event of bankruptcy, in which case all outstanding transactions under the agreement are considered to be automatically terminated immediately before a petition in bankruptcy is filed. All obligations of the parties are valued and converted into payment obligations in the same currency and set off against each other. As a result, a single net amount will be paid by one party to the other.

The question arises whether close-out netting provisions are enforceable in the event of bankruptcy to limit or prevent potential losses of the solvent party. Furthermore, under applicable banking regulations in most jurisdictions, the enforceability of such provisions determine whether a bank's gross open positions or its net open position under OTC derivative transactions are subject to regulatory capital adequacy requirements.

Automatic early termination

The successful enforcement of close-out netting provisions depends on the insolvency rules that apply in the jurisdictions where bankruptcy proceedings have been initiated. Under Swiss law, the automatic early termination and liquidation provisions of the 2002 ISDA Master Agreement are enforceable in the event of a party's bankruptcy. Even in the absence of such contractual arrangements,

derivative transactions (that is, fixed-date transactions, financial forward transactions, swaps and options) are automatically terminated and liquidated upon adjudication of bankruptcy as a matter of Swiss statutory insolvency law, subject to the condition that the value of the respective obligations is determinable based on market or stock exchange prices at the time of adjudication of bankruptcy. In both cases the bankruptcy trustee is deprived of its general power to continue profitable transactions for the benefit of the bankruptcy estate and to terminate all other transactions to the detriment of the solvent party (cherry picking). In the latter case, the solvent party's claim for damages against the bankruptcy estate would be reduced to a monetary claim and subject to partial satisfaction (if any), along with the claims of all other creditors.

Optional early termination

Under Swiss insolvency law, the exercise of the solvent party's option to close out all transactions upon the bankruptcy of its counterparty is considered enforceable, provided that the termination date is specified to occur no later than the date of adjudication of bankruptcy. However, any optional early termination that becomes effective after adjudication of bankruptcy is likely to be challenged by the bankruptcy trustee. The argument could be made that the solvent party has, for speculative reasons, unduly delayed the exercise of its close-out option to the detriment of the bankruptcy estate and the other creditors. In this case, the delayed exercise of the close-out option by the solvent party would most probably be voided by the above-mentioned statutory framework providing for automatic early termination and liquidation upon adjudication of bankruptcy.

The new 2002 ISDA Master Agreement, like its predecessor, has the benefit of standard legal opinions regarding the enforceability of its early termination close-out netting provisions for a large number of jurisdictions, including Switzerland. In November 2003 the Swiss Institute of Certified Accountants, in connection with Swiss regulatory capital requirements of banks recommended the recognition of early termination close-out netting under the 2002 ISDA Master Agreement regarding transactions with counterparties from a large number of jurisdictions. Such benefits will further consolidate the use of the ISDA Master Agreement in documenting international OTC derivative transactions.

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