Derivatives Week
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Learning Curves

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The Importance Of Being Specified--Designating Affiliates

Many institutional market participants enter into derivatives transactions through multiple affiliates. By designating these affiliates as "Specified Entities" for the purposes of Section 5 (a)(v)--"Default under Specified Transaction"--of the 1992 **International Swaps and Derivatives Association** master agreement, a party is able both to book trades in the most advantageous location and to have maximum flexibility in the event its counterparty defaults.

Despite this, derivatives counterparties often forego that flexibility in order to minimize the effects of their own potential default, sometimes without fully understanding the consequences and alternatives. This article addresses the impact on a party's rights of including or excluding affiliates as Specified Entities for the purposes of Section 5(a)(v) of the master agreement.

Consider The Following Example

An investment bank affiliate ("swapco") enters into a master agreement with a hedge fund to cover swapco's fixed income derivatives trading with the fund. One of swapco's affiliates ("equityco") enters into a separate master agreement with the fund to cover equity derivative transactions between equityco and the fund.

The hedge fund enters into an interest rate swap with swapco and sells a plain vanilla equity option to equityco. Equityco's option is in the money at the same time that swapco's required payment to the fund exceeds the fund's required payment to swapco. Equityco exercises its option, but the fund fails to make its required payment to equityco.

Unfortunately for swapco, the hedge fund's default on its payment obligation to swapco's affiliate, equityco, does not excuse swapco from its obligation to make the net swap payment. Unless swapco can establish a separate legal basis for withholding that payment, payment will be required even in the face of the fund's default.

Whether swapco has legal grounds to refrain from making that payment to the fund depends on whether equityco is listed as a Specified Entity in relation to swapco for the purposes of Section 5(a)(v) of the master agreement between swapco and the fund. If it is, then the equity option between the hedge fund and Equityco would constitute a "Specified Transaction," and the fund's failure to pay equityco would be an Event of Default under Section 5(a)(v) of swapco's master agreement.

Default Under Specified Transaction

Under Section 14 of the master agreement, "Specified Transaction" includes swaps, options, foreign exchange and other similar transactions. The current draft of the 2002 master agreement includes an even broader range of transaction types. A default in a derivatives transaction (a "Separate Transaction") not covered by the master agreement (the "Primary Master agreement") between the parties will constitute a default under Specified Transaction regardless of the size of the Separate Transaction, but only if the Defaulting Party's counterparty in the Separate Transaction (1) is the non-defaulting party (or its "Credit Support Provider," e.g., guarantor) in the Primary master agreement, or (2) is listed in the Primary master agreement as a "Specified

Entity" of that non-defaulting party for purposes of Section 5(a)(v).

In addition, in order for the default in the Separate Transaction to constitute a default under Specified Transaction, the default:

* must have caused the acceleration or early termination of the Separate Transaction; or

* must have been with respect to a final payment.

If swapco's master agreement with the fund includes equityco as a Specified Entity for the purposes of Section 5(a)(v), then the fund's failure to pay equityco would constitute a Potential Event of Default in the swapco master agreement with respect to which the hedge fund would be the potential defaulting party. Under Section 2(a)(iii)(1) of the master agreement (which states that a party's payment obligation is conditioned on the absence of an Event of Default or Potential Event of Default with respect to the other party), swapco would be entitled to withhold payments otherwise due to the fund under the swap even if the grace period under the equityco master agreement had not yet expired. If the master agreement between swapco and the fund includes a Credit Support Annex ("CSA"), swapco would be entitled to withhold any Delivery Amount or Return Amount due to the fund under Paragraph 4(a)(i) of the CSA. Finally, because the amount due upon exercise of an option is a final payment, swapco would be entitled under Section 6(a) of its master agreement to designate an Early Termination Date for the swap and any other Transactions between swapco and the fund covered by the master agreement.

If, on the other hand, swapco failed to include equityco as a Specified Entity, then in the absence of a separate Event of Default with respect to the fund, swapco would be required to make its payment.

Cross Default

Unlike "Default under Specified Transaction," the "Cross Default" Event of Default under Section 5(a)(vi) of the master agreement does not require any relationship between the Defaulting Party's master agreement counterparty and the third party as to which the Defaulting Party has defaulted. However, a "Cross Default" Event of Default must satisfy two tests:

* the default must be with respect to "Specified Indebtedness," defined in Section 14 as "any obligation . . . in respect of borrowed money;" and

* the amount in question must be no less than a minimum amount: the "Threshold Amount."

While certain types of swaps may be functionally equivalent to 'borrowed money,' a plain vanilla equity option is not. Therefore, the fund's default to equityco would not qualify as a Cross Default. Even if swapco could establish that the equity option constituted Specified Indebtedness, swapco would have to establish that the option's in-the-money amount was at least equal to the designated Threshold Amount.

A default by the fund on obligations to its lender at least equal to the Threshold Amount would constitute a "Cross Default" under Section 5(a)(vi) of the master agreement, entitling swapco to the rights described in our hypothetical example.

Inadvertent Payment Defaults & Good-Faith Disputes

The reluctance of market participants to expand "Specified Indebtedness" to include swaps and other derivatives often is attributable to fear of technical defaults arising from disputes over the determination of the payment amount. The concern is not that the Specified Entity will default because of a liquidity problem (many affiliate transactions are guaranteed by the same parent), but that a payment default due to administrative error or a good faith dispute with the counterparty could cause defaults by multiple affiliates. Counsel can address such concerns and still retain flexibility in counterparty default scenarios:

Disputes over failures to pay due to administrative error can be addressed by extending the applicable grace period on the condition that the failure was due to administrative error, the payer had sufficient liquidity to make the payment, and the payer makes the payment within the extended grace period.

Good faith disputes over the amount owed can be addressed by drafting dispute resolution procedures tailored to the particular transaction and limiting payment defaults to those situations in which the payer fails to follow the agreed upon procedures.

There are exceptions . . .

When a company (the "Primary Entity") lists affiliates as Specified Entities for purposes of Section 5(a)(v), it assumes the risk that one or more such designated affiliates may default in a Specified Transaction with the counterparty (or its Credit Support Provider or Specified Entity), thereby triggering an Event of Default with respect to the Primary Entity. Though the potential benefits to the Primary Entity may justify this risk, at times they do not.

For example, companies that traditionally are borrowers as well as derivatives counterparties may be subject to loan agreement default provisions that could be triggered by an ISDA master agreement Event of Default. Similar issues arise if the Primary Entity was created solely to enter into a particular structured transaction or derivative with highly rated entities and relies on a high credit rating to enable it to engage in such transactions. Because such credit ratings are based in part on the entity's minimizing default risk through its organizational or transaction structure, the rating agency may view the Section 5(a)(v) Specified Entity designation as introducing an unacceptable element of risk.

The Bottom Line

In the over-the-counter principal-to-principal derivatives market no stock exchange stands in the middle to guarantee counterparty performance. As a result, each party has an incentive to negotiate provisions that provide it with the flexibility to choose the nature and timing of its response in the event the creditworthiness of its counterparty begins to deteriorate. The bottom line is that a derivatives counterparty and its counsel should consider carefully all relevant factors when determining whether to include affiliates as Specified Entities for purposes of Section 5(a)(v).

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