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The Lehman Brothers Bankruptcy F: Introduction to the ISDA Master Agreement

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Abstract

When Lehman Brothers Holdings, Inc. (LBHI) sought Chapter 11 protection, the more than 6,000 counterparties with which its subsidiaries had entered into over 900,000 over-the-counter (OTC) derivatives transactions faced the question of how best to respond to protect their interests. The existence of standardized documentation developed by the International Swaps and Derivatives Association (ISDA) for entering into such transactions meant that the counterparties likely thought that they were dealing with a well-defined and robust set of options in answering this question. Yet, in practice, the resolution of Lehman's OTC derivatives portfolio ended up being less orderly than the existence of standardized documentation might have suggested it would be. This case explores: (1) whether the default provisions contained in the Master Agreement played any meaningful role in Lehman Brothers' bankruptcy and its outcome, (2) whether changes should be made to the Master Agreement to reduce the systemic risk associated with derivatives transactions, and (3) how attempts to create global certainty through the use of standardized agreements can be thwarted by the operation of local laws.

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[1] This case study is one of eight Yale Program on Financial Stability (YPFS) cases modules considering the Lehman Brothers Bankruptcy:

- The Lehman Brothers Bankruptcy A: Overview
- The Lehman Brothers Bankruptcy B: Risk Limits and Stress Tests
- The Lehman Brothers Bankruptcy C: Managing the Balance Sheet Through the Use of Repo 105
- The Lehman Brothers Bankruptcy D: The Role of Ernst & Young
- The Lehman Brothers Bankruptcy E: The Effects on Lehman's U.S. Broker-Dealer
- The Lehman Brothers Bankruptcy F: Introduction to the ISDA Master Agreement
- The Lehman Brothers Bankruptcy G: The Special Case of Derivatives
- The Lehman Brothers Bankruptcy H: The Global Contagion

Cases are available from the Journal of Financial Crises.

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1. Introduction

When Lehman Brothers Holdings, Inc. (LBHI) sought Chapter 11 protection on September 15, 2008, in the largest bankruptcy proceeding in United States history, the more than 6,000 counterparties with which its subsidiaries had entered into over 900,000 over-the-counter (OTC) derivatives transactions faced the question of how best to respond to protect their interests. The existence of standardized documentation developed by the International Swaps and Derivatives Association (ISDA) for entering into such transactions meant that the counterparties likely thought that they were dealing with a well-defined and robust set of options in answering this question. Under both the 1992 and 2002 versions of the ISDA Master Agreement (referred to herein, together with the schedules, documents and other confirming evidence that accompany it, as the Master Agreement), Lehman's bankruptcy filing created an Event of Default that gave non-defaulting counterparties the right to terminate derivatives transactions and seek close-out payment of any amounts owed, while seizing any collateral previously provided in support of such obligations. Alternatively, counterparties could, according to the Master Agreement, elect not to terminate the transactions but refrain from making payments to Lehman while it remained in bankruptcy.

Yet, in practice, the resolution of Lehman's OTC derivatives portfolio ended up being less orderly than the existence of standardized documentation might have suggested it would be. The wave of terminations that followed the bankruptcy filing, coupled with shortcomings in the methodologies adopted by the Master Agreement for calculating amounts owed on early termination, resulted in what some believe was a significant loss of value to the Lehman bankruptcy estate. Furthermore, the operation of local bankruptcy law in jurisdictions such as the United States prevented certain provisions of the Master Agreement from being enforced, with the result that documentation intended to foster global certainty via standardization produced diametrically opposed outcomes in different parts of the world. Given that the Lehman bankruptcy appears to have been the first major test case for litigation surrounding the enforcement of these provisions, the diametrically opposed outcomes likely caught market participants unaware. In the wake of the Lehman bankruptcy and how its effects were felt in its derivatives portfolio, there have been calls to overhaul how the Master Agreement treats derivatives in bankruptcy, most significantly by placing limits on the ability of non-defaulting counterparties to terminate transactions.

The remainder of the case is organized as follows. Section 2 provides an overview of the history of the Master Agreement. Section 3 outlines the main components and sections of the current iteration of the Master Agreement. Section 4 discusses the controversial role played by the Master Agreement's default provisions in the Lehman Brothers bankruptcy, and Section 5 concludes with a summary of the current status of efforts to overhaul the Master Agreement to address this controversy.

Questions

1. Did the default provisions contained in the Master Agreement play any meaningful role in the Lehman Brothers bankruptcy and its outcome?

2. Should changes be made to the Master Agreement to reduce the systemic risk associated with derivatives transactions?
3. Can anything be done to ensure that attempts to create global certainty through the use of standardized agreements are not thwarted by the operation of local laws?

2. History of the Master Agreement

In the era prior to the standardization of documentation for entering into OTC derivatives transactions, parties to such transactions would typically use separate 15- to 25-page agreements for each new transaction (Allen & Overy 2002). As the same parties began to conduct repeated transactions with each other over time, rather than enter into new agreements each time, parties would often establish a single base agreement that would be supplemented by a short addendum setting forth the economic terms of a given transaction. While this standardization saved the two parties from having to execute full-blown agreements every time they wished to enter into a derivatives transaction with each other, if one of the parties sought to conduct a transaction with a different counterparty, such counterparty might demand a very different base agreement. Thus, participants in the OTC derivatives market might still be in the position of having to negotiate and use multiple agreements for entering into the same types of transactions.

In 1984, a group of derivatives dealers sought to address this issue by coming together to develop standard terms for interest rate swaps, a common type of OTC derivative. A year later, this resulted in the establishment of what was then known as the International Swap Dealers Association to promulgate standardized documentation for use by OTC derivatives market participants. Having since changed its name to the International Swaps and Derivatives Association (ISDA), the organization has become one of the largest global financial trade associations, with over 800 membership institutions from more than 60 different countries, according to its website. While ISDA's work on behalf of the industry has expanded over time, at the heart of its mission is still the development of standardized documentation for entering into OTC derivatives transactions.

ISDA's first foray into standardization came shortly after it was founded, when in June 1985 it published the Code of Standard Wording, Assumptions and Provisions for Swaps (known as the SWAPS Code) setting forth "a uniform vocabulary" for US-dollar-denominated interest rate swaps. ISDA's stated motivation in developing the SWAPS Code was to address "concern about the varied interpretations that might result if each market participant were independently to arrive at its own meanings for the principal terms used in rate swaps" (ISDA 1985, iv). The SWAPS Code thus provided standardized meanings for terms commonly used in swaps transactions, defining everything from New York Banking Day to LIBOR to Early Termination Date.

ISDA soon followed a 1986 edition of the SWAPS Code with its first two standard form agreements: the 1987 Interest Rate and Currency Exchange Agreement for single currency and multiple currency interest rate and currency swaps, and the 1987 Interest Rate Swap Agreement for US-dollar-denominated interest rate swaps. These were full-blown agreements that parties could use to document transactions in the derivatives covered. Addenda published by ISDA between 1989 and 1991 expanded the types of derivatives covered by the agreements.

The documents that ultimately became what we think of today when we refer to ISDA standard documentation first appeared in 1992 with the release of the 1992 ISDA Master Agreement. Featuring updates to the original standard form agreements developed during the 1980s, the 1992 Master Agreement in fact consists of two separate contracts—a Multi-currency, Cross-Border Master Agreement for transactions between parties located in different jurisdictions and/or transactions involving different currencies and a Local Currency, Single Jurisdiction Master Agreement for transactions between parties located in the same jurisdiction and transactions involving one currency. With the exception of provisions tied to the differences in the currencies and jurisdictions involved, these two agreements are otherwise identical.

The late 1990s were a period of financial turmoil that exposed certain weaknesses in the 1992 Master Agreement, particularly around its default and early termination provisions. These weaknesses included delays in the ability to designate an event of default and difficulty in employing the methodology used for calculating payments upon early termination in periods of market stress. Following the Asian currency crisis in 1997 and the Russian debt default and issues surrounding Long-Term Capital Management in 1998, ISDA saw a need to adjust the 1992 Master Agreement "to reflect the lessons learned from those experiences and to incorporate some of the changes that occurred in market practice after 1992" (ISDA 2003, i). The result was the introduction of the 2002 Master Agreement, which also combined the two agreements of the 1992 Master Agreement into one. Except as discussed in more detail below with respect to the calculation of amounts owed on early termination, the 1992 Master Agreement and the 2002 Master Agreement are essentially one and the same from the standpoint of the issues raised by the Lehman bankruptcy and are thus referred to together as the Master Agreement for purposes of this case.

3. Summary of the Current Master Agreement

A fully executed Master Agreement consists of not one document, but several. The Master Agreement itself sets forth the terms that will be applicable to all the transactions the parties enter into pursuant to it and allows only for the insertion of the parties' names and the date of execution. A separate Schedule to the Master Agreement (the Schedule) allows the parties to customize the Master Agreement by, among other things, further defining terms contained in the Master Agreement and selecting which optional terms will be applicable. For example, the Master Agreement allows the parties to designate Credit Support Providers that will act as guarantors of their respective obligations. The Schedule is the document the parties would use to make this designation. The parties would also use the Schedule to establish things like whether or not an optional term like Automatic Early Termination will apply, whether or not certain optional tax representations apply, and under which jurisdiction's laws the Master Agreement will be construed. Additionally, definitional booklets set forth defined terms applicable to specific types of derivatives transactions. The use of the Schedule to do things like designating Credit Support Providers can become critical in the context of the bankruptcy of an organization with a complex corporate structure, as discussed in more detail below. However, in many cases the optional terms that can be selected using the Schedule are not essential to the functioning of the Master Agreement but are rather a reflection of the parties' preferences for how their transactions will be governed.

The Master Agreement as customized by the Schedule and further defined by the definitional booklets lays out the terms that will govern the specific transactions entered into by the parties. These specific transactions, in turn, are documented using confirmations outlining the economic terms of a given transaction. The intended sequence is the execution of a Master Agreement, followed by one or more such confirmations, but as a practical matter, sometimes parties exchange confirmations documenting a specific transaction and then go back and execute a Master Agreement (ISDA 2003, 1).

Figure 1 provides a brief summary of the main sections of the Master Agreement. Master Agreement provisions that are especially noteworthy in the context of the Lehman bankruptcy and systemic risk will be discussed in greater detail elsewhere in this module.

Figure 1: Main Sections of the Master Agreement

Section	Key Provisions
Section 1 – Interpretation	• 1(a) – the Master Agreement and all Confirmations form a single agreement (important for netting)
Section 2 – Obligations	• 2(a)(iii) – a party's payment obligations are conditioned on the other party not being in default • 2(c) – payments are netted
Section 3 – Representations	• 3(b) – the parties must represent to each other that no Event of Default or Potential Event of Default has occurred and is continuing
Section 4 – Agreements	• 4(a) – the parties will provide each other with necessary documentation related to the transaction
Section 5 – Events of Default and Termination Events	• 5(a)(vii) – bankruptcy is an Event of Default giving the non-defaulting party the right to terminate
Section 6 – Early Termination; Close-Out Netting	• 6(a) – the non-defaulting party has the right to terminate following an Event of Default • 6(e) – amounts owed upon early termination will be calculated pursuant to approaches set forth in Section 6

Source: Project Editor Notes.

4. Master Agreement Default Positions and the Lehman Brothers Bankruptcy

Master Agreement Default Provisions

On September 15, 2008, Lehman Brothers Holdings, Inc. (LBHI) sought Chapter 11 protection, initiating the largest bankruptcy proceeding in United States history. Among the myriad of consequences flowing from this filing was the triggering of default provisions related to most (but, significantly, not all) of the 930,000 derivatives transactions Lehman then had outstanding pursuant to 6,120 separate Master Agreements in its US estate.[4] Under Section 5(a)(vii) of the Master Agreement, a bankruptcy filing by a party to the Master Agreement or a Credit Support Provider of that party constitutes an Event of Default with respect to such party. The occurrence of such an Event of Default gives the non-defaulting counterparty the right to, among other things, terminate the Master Agreement and seek close-out payment of any amounts owed, while seizing any collateral previously provided in support of such obligations. Importantly, unless the parties have selected the optional Automatic Early Termination provisions contained in the Schedule, this early termination right may or may not be exercised by the non-defaulting counterparty, in its sole discretion.

Significantly, the ability of Lehman counterparties to terminate derivatives transactions following the Chapter 11 filing was a function not only of the provisions of the Master Agreement, but also of the US Bankruptcy Code. Under the Code, in a typical bankruptcy case, the filing of a Chapter 11 petition would trigger an automatic stay that would, among other things, prevent the termination of agreements and the seizing of related collateral, notwithstanding the expressed provisions of those agreements. Additionally, the debtor generally would be entitled to select which agreements to assume going forward and which to reject.

However, in 2005 the US Congress adopted expansive “safe harbor” provisions that enable most derivatives transactions to avoid key provisions of the Code such as the automatic stay. The ostensible reason for adopting these safe harbor provisions was to reduce systemic risk. According to ISDA, “[i]f [the ability to terminate transactions and net them out] in insolvency is not enforceable in a jurisdiction, a liquidator might pursue payment on transactions with positive value while disclaiming those with negative value. The primary concern with such ‘cherry-picking’ is that [the] inability to terminate and net the transactions increases the risk of a chain of interrelated defaults, that is, systemic risk” (ISDA 2009). Seeking to avoid such risk, Congress largely exempted derivatives transactions from provisions of the Code that would prevent such close-out netting. As a result, unlike other parties to the Lehman bankruptcy, those in derivatives transactions were (for the most part) able to terminate contracts and seize collateral.

[4] “The exact total number of Lehman’s derivatives trades and contracts at the time of bankruptcy remains unclear. Reports by the Lehman estate variously put the number of trades at 906,000, 930,000, and 1,178,000 and the number of contracts at 6,120, 6,340, and 6,355 (Fleming and Sarkar 2014, 11, Fn 20).

The option of designating Credit Support Providers to be included in the Master Agreement default provision is extremely significant because, given the complex corporate structures of many financial institutions, agreements are often signed with subsidiaries, while the intent remains to contract with the corporate parent. The specific corporate entity with which a counterparty is transacting may not file for bankruptcy at the same time as the struggling corporate parent. If the parties have not agreed that the corporate parent is designated a Credit Support Provider, the counterparty would be unable to terminate the Master Agreement until such time as the specific corporate entity that is party to the agreement files for bankruptcy. For example, Lehman Brothers conducted the vast majority of its US derivatives business through a subsidiary known as Lehman Brothers Special Financing, Inc. (LBSF) which itself did not declare bankruptcy until several weeks after the LBHI filing. (Note: Lehman Brothers also conducted derivatives transactions outside of the United States through its Lehman Brothers International (Europe) subsidiary.) For transactions in which LBHI was a named Credit Support Provider for LBSF, this gap in time was not an issue—the bankruptcy filing of LBHI triggered the default provisions of Master Agreements entered into by LBSF.

However, as noted above, it is not uncommon for parties to engage in a derivatives transaction pursuant to a deemed generic Master Agreement, intending to put a specific Master Agreement into place after the fact. If this has not yet been accomplished at the time of a bankruptcy, no Credit Support Partners have been agreed to and therefore no Event of Default has occurred unless the transacting entity itself has filed for bankruptcy. In the case of Lehman Brothers, it has been reported that there were counterparties (although likely not that many) who found themselves in exactly this position, unable to terminate their transactions until LBSF's filing on October 3, 2008 (Parker and McGarry 2008).

Payment Provisions on Termination

Notwithstanding the existence of some counterparties who may have been initially unable to terminate their transactions, by November 13, 2008, approximately 733,000 of the 930,000 Lehman derivatives transactions outstanding had in fact been terminated according to a bankruptcy court filing by Lehman. For these terminated transactions, the question then became the amount of any payments owed upon termination. Here, the difference between the 1992 Master Agreement and the 2002 Master Agreement becomes significant.

Under the 1992 Master Agreement, payments upon termination are based either on the "Market Quotation" or "Loss" approach. The Market Quotation approach requires the non-defaulting party to obtain at least three quotations from leading derivatives dealers on the amounts they would expect to pay or receive to enter into a replacement transaction with the non-defaulting party. If three quotations are not available, if the quotations result in a commercial unreasonable result (as determined in good faith by the non-defaulting party), or if the parties have already so chosen in the Master Agreement, the Loss approach will apply. This methodology requires the non-defaulting party to make a good faith determination of its total losses and costs (or gains) stemming from the termination.

Each of these approaches has significant drawbacks. While potentially providing a more objective outcome, the Market Quotation approach can break down in times of market stress when quotations from leading derivatives dealers are not available or result in commercially unreasonable results as was reported to have happened in the wake of the Lehman bankruptcy. The Loss result does not depend on the existence of dealer quotations, but is highly subjective and involves a greater risk of manipulation by the non-defaulting party.

In an attempt to address these drawbacks, the 2002 Master Agreement replaced the Market Quotation and Loss approaches with a Close-Out Amount approach. (See Figure 2.) This new approach was intended to provide greater flexibility and requires the non-defaulting party to act in good faith and use commercially reasonable procedures to reach a commercially reasonable determination of the losses or gains resulting from replacing the terminated transaction. This may include using one or more of firm or indicative quotations and/or

Figure 2: Methods for Determining Amounts Owed on Termination

1992 Master Agreement

Market Quotation approach – non-defaulting party obtains at least three quotations from leading derivatives dealer for the amount the dealers would expect to pay or receive to enter into a replacement transaction with the non-defaulting party

Loss approach – non-defaulting party makes a good faith determination of its total losses and costs (or gains) stemming from the termination

2002 Master Agreement:

Close-Out Amount approach – non-defaulting party acts in good faith and uses commercially reasonable procedures to reach a commercially reasonable determination of the losses or gains resulting from replacing the terminated transaction; this may include using one or more of firm or indicative quotations and/or relevant market data such as rates, prices, yields, yield curves, volatilities and correlations whether from third parties or internal sources

Source: ISDA Master Agreement.

relevant market data such as rates, prices, yields, yield curves, volatilities, and correlations, whether from third parties or internal sources. Thus, the Close-Out Amount is in many ways a hybrid of the Market Quotation and Loss approaches, requiring the non-defaulting party to use more objective sources of information than required under the Loss approach, but not necessarily dealer quotations when such quotations cannot be obtained due to market stress.

The specific approaches applicable to a given transaction depend on the version of the Master Agreement pursuant to which the transaction was entered into, and the introduction of the 2002 Master Agreement neither replaced the 1992 Master Agreement then in effect nor required parties to use the 2002 Master Agreement instead of the 1992 Master Agreement when entering into new Master Agreements going forward. Thus, although Lehman's bankruptcy occurred in 2008, many of the derivatives transactions terminated in the wake of the filing were governed by the 1992 Master Agreement, and counterparties terminating derivative transactions were put in the unrealistic position of attempting to obtain dealer quotations during a period of extreme market stress.

Particularly in light of the drawbacks associated with different approaches for how to calculate payments due on the termination of derivatives transactions, the rush to terminate following the Lehman bankruptcy may have resulted in a loss of value to the bankruptcy estate in the form of inflated close-out payment demands and the fire-sale liquidation of associated collateral, with systemic risk implications, in addition to the harm done to Lehman. (For more information on the effect of derivatives terminations on the Lehman Brothers bankruptcy estate, see Wiggins, et al 2014G.)

While the wave of counterparties terminating their derivatives transactions pursuant to the provisions of the Master Agreement may have created difficulties for Lehman, those counterparties who opted not to terminate also posed a problem. Under Section 2(a)(iii) of the Master Agreement, the obligation of a party to pay amounts owing as a result of a derivatives transaction is conditioned on there being no continuing Event of Default with respect to the other party. Thus, under a literal interpretation of the provisions of the Master Agreement, a counterparty to an out-of-the-money derivatives transaction with a bankrupt entity has the choice of either (a) exercising the right of early termination and paying the bankrupt entity what is owed as a close-out payment, or (b) opting not to terminate the transaction and refraining from making payment of any amounts owed for as long as the entity remains in bankruptcy. (See Figure 3.)

Figure 3: Portion of Master Agreement

Section 2(a)(i) – Each party will make each payment or delivery specified in each Confirmation to be made by it, subject to the other provisions of this Agreement.

Section 2(a)(iii) – Each obligation of each party under Section 2(a)(i) is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing

Source: ISDA Master Agreement.

A number of Lehman counterparties did in fact exercise this latter option, resulting in several legal battles in which Lehman argued that, despite the plain language of Section 2(a)(iii), the Master Agreement should not be interpreted as allowing counterparties to indefinitely refrain from making payment of amounts owed pursuant to non-terminated derivatives transactions with Lehman. In London, a series of similar cases resulted in a determination by a court that Section 2(a)(iii) is effective to suspend (but not terminate) payment obligations of a non-defaulting party until such time as the default is cured, potentially resulting in an indefinite suspension of such obligations (*Lomas v. JFB Firth Rixson Inc.,* 2012).

A similar fact pattern resulted in the opposite outcome in a US bankruptcy court in New York. In December 2007, Lehman entered into an interest rate swap with Metavante Corporation, pursuant to which the former agreed to pay the latter three-month LIBOR in exchange for 3.865% fixed on a notional amount of $600 million. When interest rates dropped, the LIBOR payment owed by Lehman became less than the fixed payment owed by Metavante. Metavante ended up with a net payment obligation of approximately $6 million as of May 2009, representing quarterly net interest payments that Metavante should have made in November 2008 and February and May 2009. In refusing to make these payments, Metavante relied on the language of Section 2(a)(iii), arguing that, because Lehman was in bankruptcy, Metavante's obligation to make payments under the Master Agreement was suspended.

The court found that suspension of payments, although specifically provided for in the Master Agreement, constitutes "an attempt to control property of the estate," in violation of the automatic stay provisions of the US Bankruptcy Code and that the safe harbors enacted by Congress for derivatives transactions do not apply to suspending payment obligations (In re: Lehman Bros. Holdings Inc. 2009). Thus, in this instance, the provisions of local law trumped the explicit language of the Master Agreement, and a document intended to create global certainty via standardization produced diametrically opposed outcomes in two of the leading financial capitals of the world. In both London and New York, the Lehman Brothers bankruptcy appears to have provided the impetus for the first major litigation over the enforceability of Section 2(a)(iii), with the result that the diametrically opposed outcomes likely caught market participants unaware. Figure 4 summarizes the various outcomes that would result from a counterparty's decision to terminate or not terminate a derivatives transaction with Lehman following its bankruptcy filing.

Figure 4: Derivatives Termination Decision Matrix for Lehman Brothers' Counterparty

Status of Transaction	Counterparty (CP) Decision	Outcome
Lehman Owes Money (CP is in-the-money)	Terminate	Lehman bankruptcy estate required to pay early termination amount determined by counterparty per ISDA methodology now, subject to availability of funds and provisions of bankruptcy laws
	Don't Terminate	Lehman bankruptcy estate required to pay obligations as they become due, subject to availability of funds and provisions of bankruptcy law
Lehman is Owed Money (CP is out-of-the-money)	Terminate	Counterparty required to pay early termination amount determined by counterparty per ISDA methodology now
	Don't Terminate	Counterparty may or may not be required to pay obligations as they become due, depending on jurisdiction's treatment of Section 2(a)(iii)

Source: Author's Notes.

5. Master Agreement Reform

Both the rush to terminate derivatives transactions with Lehman following its bankruptcy filing and the uncertainty regarding whether out-of-the-money counterparties could refrain from making payments pursuant to Section 2(a)(iii) have resulted in calls for an overhaul of how the Master Agreement treats Events of Default and early terminations. In February 2009, ISDA published the ISDA Close-out Amount Protocol, which allows parties to amend the terms of existing 1992 Master Agreements to adopt the Close-out Amount approach instead of the Market Quotation and Loss approaches. By making this option available to parties to 1992 Master Agreements, ISDA hopes to encourage migration to the Close-out Amount approach to avoid the difficulties that were caused by seeking to determine termination payments based on dealer quotations in periods of extreme market stress.

In November 2013, the Bank of England, the German Federal Financial Supervisory Authority, the US Federal Deposit Insurance Corporation and the Swiss Financial Market Supervisory Authority wrote a joint letter to ISDA requesting several changes to the Master Agreement to address "the risk of disorderly termination of derivatives contracts, particularly in the cross-border resolution context, arising out of the exercise of termination rights following the commencement of an insolvency or resolution action." Calling this risk a "key challenge" in the development of resolution strategies to "resolve global systemically important financial institutions in a manner that reduces the risk of global financial instability while minimizing moral hazard," the regulators proposed amending the Master Agreement to provide for a short-term suspension of termination rights and certain other remedies such as transfer or the appointment of a restructuring agent in the event of an insolvency. The purpose of such amendments would be to "allow, **where the operative law**

permits, the exercise of all applicable types of resolution powers, especially the transfer of the derivatives contracts and/or associated guarantee obligations to a third party, including a bridge entity, on an expedited basis, the bail-in of a failing institution through the write-down of liabilities, or the conversion of liabilities into equity." (Emphasis added.) Significantly, the regulators acknowledged that any amendments to the Master Agreement to address the issue of disorderly termination would only be effective to the extent such amendments are not precluded by local law, as the court's decision in Metavante illustrates. Thus, a real solution to the problem might require not only updates to the standardized documentation used to enter into transactions, but also changes to the laws of individual countries.

One area where there have been calls for changes to local law is the treatment of derivatives under bankruptcy codes. As noted above, the only reason the early termination provisions of the Master Agreement are even enforceable in a jurisdiction such as the United States is because the U.S. Bankruptcy Code contains safe harbors specifically exempting most derivatives transactions from key Code provisions that would otherwise act to bar terminations and the seizing of collateral. Some commentators have argued that these safe harbors enabled a run on troubled banks such as Lehman in the form of mass terminations of derivatives transactions and have called for their repeal. (See, for example, Lubben 2010.)

Adding to the calls for an overhaul of the Master Agreement are the provisions of the Dodd-Frank Act and the European Market Infrastructure Regulation (EMIR) that change how derivatives are regulated in the United States and Europe, respectively. With Dodd-Frank and EMIR mandating, among other things, the clearing of certain derivatives, risk mitigation techniques for uncleared derivatives, and business conduct and documentation standards, ISDA has been in the process of adopting protocols that enable market participants to conform existing Master Agreements to the new requirements (Servidio et al. 2014). How the Master Agreement functions in this new era of clearinghouses and risk mitigation will be a subject of considerable interest going forward.

In response to calls for reform, on November 4, 2014, ISDA published its 2014 Resolution Stay Protocol. Among the features of this reform are provisions requiring parties who adopt the Protocol to adhere to the "special resolution regimes" (such as Title II of Dodd-Frank), adopted to give regulators the ability to resolve failing banks in an orderly fashion. These regimes typically include a short stay of up to two business days on terminations following a bankruptcy in order to give regulators time to take action such as transferring failing banks' rights and assets to another entity. Particularly with cross-border transactions, it was not entirely clear whether the special resolution regime requirements of a given jurisdiction would bind parties not within the jurisdiction. The Protocol thus seeks to have parties agree contractually to be bound. A further provision of the Protocol deals specifically with the US Bankruptcy Code, restricting the counterparties of non-bankrupt affiliates of insolvent US financial holding companies from exercising cross-default provisions (ISDA 2014).

In connection with the introduction of the Protocol, eighteen major global banks agreed to adopt it effective January 1, 2015.[5] Further compliance is expected to occur as a result of regulators barring financial institutions within their jurisdictions from entering into derivatives transactions with counterparties who have not adopted the Protocol.

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[5] These banks are: Bank of America Merrill Lynch, Bank of Tokyo-Mitsubishi UFJ, Barclays, BNP Paribas, Citigroup, Crédit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Mizuho Financial Group, Morgan Stanley, Nomura, Royal Bank of Scotland, Société Générale, Sumitomo Mitsui Financial Group, and UBS.

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