

**A practical guide  
for negotiation**

# **MASTERING THE ISDA® MASTER AGREEMENTS (1992 and 2002)**

- **An updated and comprehensive guide to the ISDA Master Agreements**
- **Includes simplified glossaries of terms used in the Agreements**

**third edition**

# Mastering the ISDA® Master Agreements (1992 and 2002)

A practical guide for negotiation

third edition

PAUL C. HARDING

*With a chapter on legal issues by  
Simon J. Leifer and Christian A. Johnson*



---

Harlow, England • London • New York • Boston • San Francisco • Toronto • Sydney • Dubai • Singapore • Hong Kong  
Tokyo • Seoul • Taipei • New Delhi • Cape Town • São Paulo • Mexico City • Madrid • Amsterdam • Munich • Paris • Milan

### Section 5(b)(iii)

A Tax Event takes place when a Change in Tax Law occurs and results in a party becoming (or very likely to become) burdened by a withholding tax which leads to a payer being required to gross up or a payee receiving a lower payment net of withholding with no gross up. A termination right arises in these cases because neither party is regarded as sufficiently “at fault” for it to be burdened by an unexpected tax charge until the maturity of the Transaction. The party having to gross up or the party receiving less than it expected because the withholding tax is being charged is called the Affected Party and is entitled to call for close out of Affected Transactions.

A Tax Event does not occur if a withholding tax is charged on default interest on late payments in the normal course of business or on interest payments upon early termination under Section 9(h) as these are likely to be small in amount.

So, if any withholding tax arises because of a Change in Tax Law after the date the parties enter into a Transaction, the party impacted by the withholding tax has a right to terminate the Transaction(s) concerned under this Section 5(b)(iii) and under Section 6(b) of the Agreement. The Section 6(b) procedure involves trying to transfer the Affected Transactions to one of its Affiliates (i.e. other group companies) or to a different Office within 20–30 days of the notice to avoid the Tax Event. The termination for the Affected Transactions is made on the basis that there is one Affected Party. This means the non-Affected Party makes the termination calculations.

However, please note that an Affected Party cannot unilaterally terminate an Affected Transaction before the 30 days following notice have expired. Hence an Affected Party may be unable to do anything about payments due within this 30-day period i.e. it may have to gross up for them or receive its payment net.

If a payee is not entitled to receive a gross up payment because it has given a false Payee Tax Representation or failed to deliver requested tax documentation, it will not be entitled to call a Tax Event.

If a change of facts occurs at the start or during the life of the Transaction this will not give a right to trigger a Tax Event because the party concerned should have done its analysis properly in the first place and should not be able to close out as a result of its own actions if the change of facts happens later in the Transaction’s life.

Please note that any Tax Event which impacts payments made by a Credit Support Provider is not covered by this Termination Event because Credit Support Providers are not joined to this Termination Event.

### Principal changes from the 1992 Agreement

- The court or tax authority decision (which leads to a Tax Event being declared by the Affected Party) must now arise after the date a Transaction is entered into and *not* “on or after” that date.
- A new definition-Scheduled Settlement Date is used instead of Scheduled Payment Date.

(iv) ***Tax Event Upon Merger.*** The party (the “Burdened Party”) on the next succeeding Scheduled Settlement Date will either (1) be required to pay an additional amount in respect of an Indemnifiable Tax under Section 2(d)(i)(4) (except in respect of interest under Section 9(h)) or (2) receive a payment from which an amount has been deducted or withheld for or on account of any Tax in respect of which the other party is not required to pay an additional amount (other than by reason of Section 2(d)(i)(4)(A) or (B)), in either case as a result of a party consolidating or amalgamating with, or merging with or into, or transferring all or substantially all its assets (or any substantial part of the assets comprising the business conducted by it as of the date of this Master Agreement) to, or reorganising, reincorporating or reconstituting into or as, another entity (which will be the Affected Party) where such action does not constitute a Merger Without Assumption;

### Section 5(b)(iv)

Under Section 5(b)(iv), a Tax Event Upon Merger arises if a withholding tax is charged which results in a merging party having to increase its payment or a non-merging party receiving any payment due to it net of withholding tax with no gross up. Such a transaction could result in the charging of withholding tax, for example, if the buyer's tax jurisdiction is different from that of the business being acquired. Again, only Affected Transactions are terminated. Please note that the Affected Party here is the one who has initiated the merger. The one who suffers is called the Burdened Party.

If a Tax Event Upon Merger happens, only the Burdened Party (who is not initiating the merger) can terminate the Affected Transactions but both it and the Affected Party must try to find a way to transfer them to another Office or Affiliate so that this Termination Event disappears (please see the commentary on Section 6(b)(ii)). Where this is not possible, the Burdened Party has the right to terminate the Affected Transaction(s). Again any termination payment to be made for Affected Transactions is calculated on the basis of one Affected Party with the non-Affected Party (i.e. the Burdened Party) making the termination calculations.

Certain exceptions apply to this. For instance, a Tax Event Upon Merger cannot occur because of interest payments due under Section 9(h) nor will it apply if Transactions are impacted by the Merger Without Assumption Event of Default (Section 5(a)(viii)) because they can be terminated through an Event of Default which is more serious and will close out all Transactions under the Agreement.

If a payee is not entitled to receive a gross up payment because it has given a false Payee Tax Representation or failed to deliver requested tax documentation, it will not be entitled to call a Tax Event Upon Merger.

Please note that any Tax Event Upon Merger which impacts payments made by a Credit Support Provider is not covered by this Termination Event because Credit Support Providers are not joined to this Termination Event.

### Principal changes from the 1992 Agreement

- The new definition – Scheduled Settlement Date – is used instead of Scheduled Payment Date.
- A Tax Event Upon Merger can now arise where a party receives a net payment because of any Tax and not just an Indemnifiable Tax suffering a withholding.
- Extension of “merger” events to a substantial portion of a party's business assets as at the date of the Agreement and to reorganisation, reincorporation or reconstitution into or as another entity.

(v) **Credit Event Upon Merger.** If “Credit Event Upon Merger” is specified in the Schedule as applying to the party, a Designated Event (as defined below) occurs with respect to such party, any Credit Support Provider of such party or any applicable Specified Entity of such party (in each case, “X”) and such Designated Event does not constitute a Merger Without Assumption, and the creditworthiness of X or, if applicable, the successor, surviving or transferee entity of X, after taking into account any applicable Credit Support Document, is materially weaker immediately after the occurrence of such Designated Event than that of X immediately prior to the occurrence of such Designated Event (and, in any such event, such party or its successor, surviving or transferee entity, as appropriate, will be the Affected Party). A “Designated Event” with respect to X means that:—

- (1) X consolidates or amalgamates with, or merges with or into, or transfers all or substantially all its assets (or any substantial part of the assets comprising the business conducted by X as of the date of this Master Agreement) to, or reorganises, reincorporates or reconstitutes into or as, another entity;
- (2) any person, related group of persons or entity acquires directly or indirectly the beneficial ownership of (A) equity securities having the power to elect a majority of the board of directors (or its equivalent) of X or (B) any other ownership interest enabling it to exercise control of X; or
- (3) X effects any substantial change in its capital structure by means of the issuance, incurrence or guarantee of debt or the issuance of (A) preferred stock or other securities convertible into or exchangeable for debt or preferred stock or (B) in the case of entities other than corporations, any other form of ownership interest; or

### Section 5(b)(v)

The rationale for Credit Event Upon Merger is that a party may not have entered into an Agreement in the first place had it known that its counterparty would merge or be taken over and, as a result, become a much worse credit risk. However, parties do not usually trigger Credit Event Upon Merger as a knee jerk reaction but try to evaluate if the new counterparty will be able to perform its obligations under the Agreement or if, for example, collateral will need to be taken.

Section 5(b)(iv) of the Agreement only applies to a party if this is stated in Part 1(d) of the Schedule on page 30.

If a deal is done and an Agreement is not in place and the dealer does not say to its counterparty that Credit Event Upon Merger is to apply in his dealing conversation and a Confirmation does not state this either, then Credit Event Upon Merger will not apply. However, this is less serious than if Cross Default did not apply in the same circumstances. I have only known Credit Event Upon Merger to be a problem three times in the past 19 years and in each case the circumstances were the same, i.e. a private equity group conducting a leveraged buy-out of my counterparty and loading it with debt. What happened? The banks which were unhappy about the situation had their OTC derivatives transactions taken over by banks who were happy with the situation. Those banks had provided the debt. Therefore the situation was resolved amicably.

This is also the last chance to choose Specified Entities in Part 1(a) of the Schedule on page 29.

Credit Event Upon Merger covers the situation where your counterparty, its Credit Support Provider or any Specified Entity is taken over by or merges with another entity and this results in a big reduction in your counterparty's creditworthiness or that of its Credit Support Provider or its Specified Entity. A Termination Event will occur under this provision if the Transaction does not result in a Merger without Assumption Event of Default (Section 5(a)(viii)). So if Credit Event Upon Merger happens, the party who has entered into, or whose Credit Support Provider or Specified Entity has entered into, a financially adverse merger or takeover transaction is the Affected Party and the other party is entitled to terminate all Transactions under the Agreement. This is because the merger taints all Transactions and not just some of them.

Some market players amend this Termination Event to define "materially weaker" more objectively in the Schedule in terms of, for example, credit rating agency downgrades, a set minimum level of credit ratings or the loss by a merged party of its credit rating altogether.

The basic Credit Event Upon Merger provision in the 1992 Agreement described North American merger practice where the surviving entity is not the same as the original party to the Agreement. Over the years in many

