Linklaters

Memorandum

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Eurozone Contingency Planning: Capital Controls and their Impact under the 1992 and 2002 ISDA Master Agreements

1 Capital Controls

ISDA has arranged for a number of papers to be produced to assist members in their Eurozone contingency planning around possible steps which might be taken by an EU member state to address economic and fiscal instability.

This paper considers the impact of Capital Controls (defined further below) under 1992 and 2002 ISDA Master Agreements governed by English law, having regard to the scope of the Illegality Termination Event. Market participants will be aware that Capital Controls may form part of a package of measures imposed by an EU member state which go beyond Capital Controls, some of which may be addressed in the other papers referred to above.

Terms used but not otherwise defined in this paper will have the meanings given to such terms in the 1992 ISDA Master Agreement (the "**1992 Agreement**") or the 2002 ISDA Master Agreement (the "**2002 Agreement**") as appropriate. Section references are to sections in the 1992 Agreement or 2002 Agreement as appropriate.

For the purposes of this paper we make the following assumptions:

(a) the relevant 1992 Agreements and 2002 Agreements are governed by English law and their terms have not been modified by a Confirmation and/or additional definitions which affect the provisions referred to below;

(b) Capital Controls have been introduced by an EU member state (the "**Imposing State"**) to prevent or restrict outflows of capital across its borders;

(c) the imposition of such Capital Controls is legally binding and enforceable under the law of the Imposing State.

Parties should note that this paper sets out general guidance in relation to interpreting the particular provisions in the 1992 Agreement and 2002 Agreements discussed in parts 5 and 6 below. To the extent that, in a particular case, either agreement has been modified by additional provisions set out in a Confirmation or by incorporating product specific definitions which impact (directly or indirectly) on the areas discussed below, a different analysis may apply.

2 Executive Summary

- Capital Controls may be introduced by an Imposing State in the context of addressing economic and fiscal instability including in, but not limited to, circumstances of an actual or possible Eurozone exit. The result of any Capital Controls is that it will be illegal under the laws of the Imposing State for a party which is subject to the Capital Controls to make some or any payments or deliveries to its counterparty in respect of Transactions under a 1992 Agreement or 2002 Agreement.
- In such circumstances, failure to pay or deliver under a 1992 Agreement or 2002 Agreement will be classified as an Illegality Termination Event rather than an Event of Default or Force Majeure Event.
- The consequences of Illegality under the 1992 Agreement are less favourable to the party which is not the Affected Party than those under the 2002 Agreement, because that party continues to be obliged to make payment and delivery obligations for a period of up to 30 days before an Early Termination Date can be designated in respect of the Illegality.
- The ability of a Party to enforce, contrary to Capital Controls, payment of an Early Termination Amount determined in accordance with the Illegality provisions, will raise complex questions of law and procedure. Generally such payment will not be enforced by the courts of the Imposing State. Other jurisdictions will have their own rules; a brief description of the rules under English law is given below.
- Market participants using the 1992 Agreement may wish to make amendments to the 1992 Agreement either on a bilateral basis or using the ISDA Illegality/Force Majeure Protocol.

3 Capital Controls (background and issues)

3.1 What are capital controls?

Capital controls are measures taken by a government, central bank or other regulatory body of a country to regulate or limit the flow of foreign capital into or out of the domestic economy, or both (“**Capital Controls**”). These can, technically, be distinguished from measures which regulate ‘current’ transactions such as payments in connection with foreign trade and business, services including short-term banking facilities and the payments of interest or income generated from capital investments – current transactions tend to be subject to less stringent (if any) controls[1]. We note, however, that the term 'Capital Controls’ is often used

[1] Exchange controls are a sub-set of capital controls and comprise a range of possible measures which seek to control the relationship between domestic and international currency markets – that is, they control the purchase/sale of foreign currencies by residents and/or the purchase/sale of local currency by non-residents of the imposing-State.

loosely, so as to encompass measures which extend to current transactions, and the term is used in that sense in this paper, to the extent that they purport to prohibit or restrict performance of payment or delivery obligations by a counterparty to a 1992 Agreement or 2002 Agreement.

Generally, Capital Controls can be expected to apply to counterparties making payments from within the Imposing State or where they are otherwise subject to the jurisdiction of the Imposing State.

It is of course possible that Capital Controls could be introduced by an EU member state which restrict or prohibit flows of capital *into* its jurisdiction, which circumstances will also raise complex legal issues and could impact payments and deliveries under a 1992 Agreement or 2002 Agreement. The position described below will broadly apply but the details are outside the scope of this paper.

3.2 When are Capital Controls likely to be introduced

In the context of the ongoing economic problems affecting the Eurozone area an Imposing State may impose Capital Controls in an attempt to maintain economic stability, the integrity of its domestic banking system and/or its domestic economy more generally. The imposition of such Capital Controls may or may not be associated with the exit by the Imposing State, or another EU member state, from the Eurozone.

3.3 Legality of, and legal issues associated with, Capital Controls

The imposition of Capital Controls raises a number of complicated, and interlocking, legal issues.

First, the legality, as a matter of international law, of introducing Capital Controls may be constrained in a number of ways - for an EU member state by its membership of the European Union[2] and for almost all countries by the Articles of Agreement of the IMF. In some circumstances, bilateral investment treaties may apply additional constraints. However, for the purposes of this paper, we assume that, as introduced, the Capital Controls are at least legally binding as a matter of the law of the Imposing State and therefore will bind a counterparty to a 1992 Agreement or 2002 Agreement subject to the jurisdiction of that Imposing State.

Secondly, where a contract is impacted by the introduction of Capital Controls, there will often be a potential tension between the contractual obligation on a party to perform and a criminal or civil prohibition under the Capital Controls on that performance. Where the jurisdiction of the governing law of the contract is not that of the Imposing State, the conflict of laws rules of that jurisdiction (which may in part look to the legality under international law of the Capital Controls) will apply, together with the substantive law of the contract in dispute, to resolve that tension.

For more details on all the general issues discussed in this part 3, please see the Linklaters Eurozone Bulletin of April 2013 entitled "*Capital and Exchange Controls*" - click here.

However, where a contract provides for what happens on the introduction of Capital Controls, and/or their effect, then to the extent of such provisions (assuming that they do not themselves conflict with the Capital Controls) these issues do not need to be examined, and instead the parties are simply bound by the relevant contractual terms. As discussed below, this should be

[2] In particular refer to the Treaty on the functioning of the European Union.

the case under both a 1992 Agreement and a 2002 Agreement, at least at the first stage of determining termination and close-out rights. See paragraph 7 below as to the subsequent enforceability of any obligation to pay an Early Termination Amount so determined.

4 Capital Controls: non payment, Illegality or Event of Default?

The first question to be addressed is how a failure to pay resulting from imposition of Capital Controls (which constitutes an Illegality) is to be classified in terms of the various Events of Default and Termination Events.

Broadly, both the 2002 Agreement and 1992 Agreement provide a hierarchy in Section 5(c) for determining how events are to be classified when they constitute Events of Default as well as certain Termination Events. The hierarchy in the 2002 Agreement is more sophisticated and draws more detailed distinctions between different types of event. However, both provide that the circumstances contemplated in this paper of a failure to make any payment or delivery[3] or to comply with a material provision of the relevant Agreement or any Credit Support Document[4] which is an Illegality will not also constitute an Event of Default or (in the case of a 2002 Agreement[5]) a Force Majeure Event.

The contractual provisions as to Illegality will preclude the right to claim discharge of the contractual arrangements under the English law doctrine of frustration, as such doctrine does not apply where a contract specifically regulates the parties' rights on the occurrence of the relevant event.

5 The 2002 Agreement: Illegality and its contractual consequences

5.1 What constitutes Illegality

Section 5(b)(i) sets out what constitutes an Illegality in respect of a party or, if applicable, any Credit Support Provider of such party:

(i) ***Illegality.*** *After giving effect to any applicable provision, disruption fallback or remedy specified in, or pursuant to, the relevant Confirmation or elsewhere in this Agreement, due to an event or circumstance (other than any action taken by a party or, if applicable, any Credit Support Provider of such party) occurring after a Transaction is entered into, it becomes unlawful under any applicable law (including without limitation the laws of any country in which payment, delivery or compliance is required by either party or any Credit Support Provider, as the case may be), on any day, or it would be unlawful if the relevant payment, delivery or compliance were required on that day (in each case, other than as a result of a breach by the party of Section 4(b)):—*

> *(1) for the Office through which such party (which will be the Affected Party) makes and receives payments or deliveries with respect to such Transaction to perform any absolute or contingent obligation to make a payment or delivery in*

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[3] Capital control measures imposed by a state will constrain payment and/or delivery obligations and, as such, will constitute an Illegality

[4] Section 5(c) goes on to provide that in any circumstances not described above (i.e. other than payment/delivery/material default, where an event or circumstance which would constitute or give rise to either (i) an Illegality or (ii) another Termination Event or an Event of Default, that event or circumstance will be treated as that other Termination Event or Event of Default (as applicable) and will *not* give rise to an Illegality. This paper is concerned with payment and delivery defaults, and so we do not consider these provisions further.

[5] The 1992 Agreement does not include the concept of Force Majeure Event.

respect of such Transaction, to receive a payment or delivery in respect of such Transaction or to comply with any other material provision of this Agreement relating to such Transaction; or

(2) for such party or any Credit Support Provider of such party (which will be the Affected Party) to perform any absolute or contingent obligation to make a payment or delivery which such party or Credit Support Provider has under any Credit Support Document relating to such Transaction, to receive a payment or delivery under such Credit Support Document or to comply with any other material provision of such Credit Support Document;

As explained above, we assume that Capital Controls binding on one Party prohibit it from making a payment or delivery in a manner falling within Section 5(b)(i).

5.2 Consequences of an Illegality – payment suspension

Section 5(d) provides that once an Illegality has occurred and is continuing[6] with respect to a Transaction, each payment or delivery which would otherwise be required to be made (by either party) will be deferred until the earlier of:

(a) the first Local Business Day / Local Delivery Day (as applicable) – or the first of such relevant days that would have occurred but for the Illegality – following the end of the three Local Business Day 'Waiting Period'; and

(b) the date on which the Illegality ceases to exist (or, if that date is not a Local Business Day / Local Delivery Day (as applicable), the first such day to occur after the Illegality ceases to exist).

There is an exception to the application of this Waiting Period where both (i) the Illegality relates to Section 5(b)(i)(2) (i.e. where the Illegality relates to a payment or delivery or the ability to comply with any other material obligation under a Credit Support Document) and (ii) the payment or delivery or compliance with another obligation is required on the date of the Illegality, in which case that obligation is not deferred during any Waiting Period.

Under Section 9(h)(i)(3) interest accrues on such deferred payments at the Applicable Deferral Rate (which applies at different rates during and following the Waiting Period).

5.3 Consequences of an Illegality – Notice

Illegality constitutes a Termination Event. Section 6(b)(i) provides that, promptly upon becoming aware of the Illegality, the Affected Party (i.e. the party for whom it becomes illegal to, or to have its Credit Support Provider, perform its obligations) must notify the other party, specifying the nature of the Illegality and each Affected Transaction, and giving the other party such other information about the Illegality as the other party may reasonably require.

5.4 Consequences of an Illegality – Early Termination

Section 6(b)(iv)(2)(A) provides that if an Illegality has occurred and is then continuing, following the three Local Business Day 'Waiting Period' (to the extent applicable) either party (subject to the provisions described in the next paragraph as regards Credit Support Documents) may by not more than 20 days' notice to the other party designate a day not earlier than the day on which such notice becomes effective as an Early Termination Date in respect of all Affected

6 There is no construction provision setting out what it means for an Illegality to be 'continuing'.

Transactions or, if only some but not all Affected Transactions are being terminated, designate a day not earlier than the date two Local Business Days following the day on which such notice becomes effective. Where an Early Termination Date has been designated in respect of less than all Affected Transactions, the recipient party may, by notice to the designating party, designate that same day as an Early Termination Date in respect of any or all other Affected Transactions.

Where the Illegality relates to performance by the Affected Party, or its Credit Support Provider, under a Credit Support Document, the Affected Party may not designate an Early Termination Date as a result of that Illegality without the other party to the Agreement first designating an Early Termination Date in respect of some, but not all, of the Affected Transactions.

Provided that the Illegality is continuing at the time of the notice designating an Early Termination Date, it does not matter whether the Illegality is continuing on the Early Termination Date itself (see Section 6(c)(i)).

Upon the occurrence or effective designation of an Early Termination Date, among other things, no further payments or deliveries are required to be made under Section 2(a)(i) or Section 9(h)(i), but all relevant amounts shall instead be calculated and payable under Sections 6(d) and (e) respectively.

5.5 Consequences of an Illegality – Adjustment for Illegality or Force Majeure Event

The amount calculated and payable under Sections 6(d) and (e) represents the Early Termination Amount. Section 6(e)(iv) provides that to the extent this is not paid for reasons which would constitute an Illegality or Force Majeure under a Transaction then it shall accrue interest and, in some circumstances, may be treated as an Unpaid Amount.

5.6 Summary of key consequences

Where the Illegality relates to payment or delivery obligations under, or the compliance with a material provision of, the 2002 Agreement itself (which is the main concern addressed in this paper) rather than any Credit Support Document, and provided the Illegality continues to exist the parties will be subject to a three Local Business Days ‘Waiting Period’ during which payments are suspended. Following that Waiting Period, either party may give notice to the other party designating an Early Termination Date in respect of some or all of the Affected Transactions, upon which further payments or deliveries then cease to be payable – with the relevant amounts instead being calculated and payable under Sections 6(d) and (e).

This structure avoids the party not subject to the Illegality from having to make payments or deliveries to the Affected Party in a situation where his counterparty is unlikely to comply with his own obligations to do the same.

6 The 1992 Agreement: Illegality and its contractual consequences

The position under the 1992 Agreement is different to that under the 2002 Agreement, producing what may be an unexpected, or at least unattractive, result for the party which is not the Affected Party.

6.1 What constitutes Illegality?

Section 5(b)(i) sets out what constitutes an Illegality in respect of a party or, if applicable, any Credit Support Provider of such party:

(i) ***Illegality.*** *Due to the adoption of, or any change in, any applicable law after the date on which a Transaction is entered into, or due to the promulgation of, or any change in, the interpretation by any court, tribunal or regulatory authority with competent jurisdiction of any applicable law after such date, it becomes unlawful (other than as a result of a breach by the party of Section 4(b)*[7]*) for such party (which will be the Affected Party):*

(1) to perform any absolute or contingent obligation to make a payment or delivery or to receive a payment or delivery in respect of such Transaction or to comply with any other material provision of this Agreement relating to such Transaction; or

(2) to perform, or for any Credit Support Provider of such party to perform, any contingent or other obligation which the party (or such Credit Support Provider) has under any Credit Support Document relating to such Transaction.

As for the 2002 Agreement, we assume that Capital Controls binding on one party prohibit it from making a payment or delivery in a manner falling within Section 5(b)(i).

6.2 Consequences of an Illegality – payment suspension

There is no provision under the 1992 Agreement equivalent to the 2002 Agreement's Section 5(d) deferral of payments during a Waiting Period. As such, until an Early Termination Date is designated under the 1992 Agreement (which, as discussed below, may in certain circumstances be at least 30 days after the occurrence of the Illegality) all payments remain due and payable in accordance with the other terms of the 1992 Agreement.

6.3 Consequences of an Illegality – Notice

As regards notice, the 1992 Agreement is no different to the 2002 Agreement. Illegality constitutes a Termination Event. Section 6(b)(i) provides that, promptly upon becoming aware of the Illegality, the Affected Party must notify the other party, specifying the nature of the Illegality and each Affected Transaction, and giving the other party such other information about the Illegality as the other party may reasonably require.

6.4 Consequences of an Illegality – Transfer

Under Section 6(b)(ii), where the Illegality arises under Section 5(b)(i)(1) (i.e. it relates to payment or delivery by the Affected Party, or compliance by it with any material provision of the 1992 Agreement itself (as opposed to a Credit Support Document)) and there is only one Affected Party, the Affected Party must, as a condition to its right to designate an Early Termination Date (as discussed below), use all reasonable efforts (which does not require the incurrence of a loss, excluding immaterial, incidental expenses) to transfer, within 20 days of giving notice under Section 6(b)(i), all its rights and obligations under the 1992 Agreement in respect of the Affected Transactions to another of its Offices or Affiliates so that the Illegality ceases to exist.

If the Affected Party is unable to make the necessary transfer it must notify the other party within the above-mentioned 20 day period. The other party may (but is not obliged to) then transfer its rights and obligations under the 1992 Agreement in respect of the Affected Transactions to another of its Offices

[7] Section 4(b) provides for an undertaking by each party to use all reasonable efforts to maintain in full force and effect all consents of any governmental or other authority that are required to be obtained by it with respect to the ISDA Master Agreement or any Credit Support Document to which it is a party and an undertaking to use all reasonable efforts to obtain any such consent that may become necessary in future.

or Affiliates so that the Illegality ceases to exist. Any such transfer must occur within 30 days of the Section 6(b)(i) notice becoming effective.

However, any transfer – whether effected by the Affected Party or the other party – is subject to obtaining its counterparty's written consent.

There is no transfer obligation where the Illegality arises under Section 5(b)(i)(2), i.e. it relates to obligations under a Credit Support Document.

6.5 Consequences of an Illegality – Agreement

If the Illegality arises under Section 5(b)(i)(1) and both parties are Affected Parties, they are required under Section 6(b)(iii) to use all reasonable efforts to reach agreement, within 30 days of the Section 6(b)(i) notice becoming effective, on action to avoid the Illegality. There is no such obligation where the Illegality arises under Section 5(b)(i)(2), i.e. it relates to obligations under a Credit Support Document.

6.6 Consequences of an Illegality – Early Termination

Section 6(b)(iv) provides that if an Illegality has occurred and is continuing:

(a) under Section 6(b)(i)(1) and neither a transfer under Section 6(b)(ii) nor an agreement under Section 6(b)(iii) has been effected within 30 days of the Section 6(b)(i) notice becoming effective; or

(b) under Section 6(b)(i)(2) – i.e. the Illegality relates to performance by the Affected Party or its Credit Support Provider under a Credit Support Document,

either party may by no more than 20 days' notice to the other party designate an Early Termination Date in respect of all Affected Transactions, and with such date not being earlier that the day such notice becomes effective.[8]

Upon the occurrence or effective designation of an Early Termination Date, among other things, no further payments or deliveries are required to be made under Section 2(a)(i), but all relevant amounts shall instead be calculated and payable under Sections 6(d) and (e) respectively.

6.7 Summary of key consequences

Payments and deliveries remain due (by each party) in accordance with their terms, despite the occurrence of the relevant Illegality, until a party has designated an Early Termination Date in respect of all Affected Transactions. Before a party may so designate an Early Termination Date following an Illegality relating to payment or delivery obligations, certain transfer obligations arise for a period of 30 days.

This clearly involves potential risk on the party other than the Affected Party, as it may have to continue performing for a 30 day period in which it is aware that performance in the other direction by the Affected Party is unlikely to occur.

7 Payment of Early Termination Amount

We have set out above the contractual provisions as to close-out when an Illegality occurs, which we described in paragraph 3.3 above as the "first stage" of the issues to be addressed by Parties. There

[8] As with the 2002 Agreement, the Early Termination Date will occur on the designated date, whether or not the Illegality ceases to be continuing on that date (Section 6(c)(i)).

remains, of course, the question of whether a Party will be able to enforce payment of any Early Termination Amount under either the 2002 Agreement or 1992 Agreement.

This is a complex question. Obviously the courts of the Imposing State itself will be bound to impose the Capital Controls and so will not enforce a contract in breach of them. Other jurisdictions will have their own conflict of law rules which will determine whether or not to excuse performance on the grounds of the Capital Controls. The details of the English law rules are beyond the scope of this note, but the broad position under English law is that English courts will give effect to Capital Controls, by determining a contract to be unenforceable, in three main scenarios:

(a) where the governing law of the contract is that of the Imposing State (with a possible exception where the imposition of the Capital Controls did not comply with any relevant international law (such at the Treaty on the functioning of the European Union) or the Articles of the IMF));

(b) where the place for performance of the contract is stipulated to be the Imposing State; and

(c) where a contract is determined to be an "exchange contract" which falls within Article VIII(2)(b) of the IMF Articles – under English law (and other jurisdictions take a wider view) this only covers contracts whose subject matter is the conversion of one currency into another, such as certain currency or FX derivatives.

For a fuller consideration of these issues see the Linklaters Eurozone Bulletin of April 2013 entitled "*Capital and Exchange Controls*" mentioned in paragraph 3.3 above.

8 Mechanisms to address concerns with the 1992 Agreement

Market participants uncomfortable with the position described above under the 1992 Agreement may wish to amend the relevant provisions to bring them into line with the 2002 Agreement.

There are a number of possible ways of achieving this. It is always possible for counterparties to an ISDA to agree amendments bilaterally, though this can be a time consuming and labour intensive process where an institution has a large number of counterparties and has some documentation/legal risk where counterparties require differently worded amendments.

Helpfully, ISDA has already considered this problem and implemented the ISDA Illegality/Force Majeure Protocol with effect from 11 July 2012. Effectively this Protocol amends (for those who adhere to it) the Illegality definition and introduces associated provisions and amendments to replicate the approach taken in the 2002 Agreement with the aim of ensuring that once an Illegality occurs there is a payment freeze and an earlier right to terminate Affected Transactions.

A list of adhering parties is available on the ISDA website. The detailed implications of, and process for, adhering to this Protocol are set in more detail on the ISDA website, click here to access the ISDA Illegality/Force Majeure Protocol.