

Force Majeure Clauses and Financially Settled Transactions Under the ISDA Master Agreement

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KEY POINTS

- The 2002 ISDA Master Agreement has a force majeure clause, but the 1992 ISDA Master does not.

- A force majeure defense is unavailable unless payment/delivery is actually prevented.

- Under a Force Majeure Event, payment/delivery under a Transaction can be delayed up to eight days.

- A Force Majeure Event is a Termination Event, not an Event of Default.

Introduction

In the wake of COVID-19's rapid spread throughout the country and around the world, many derivatives market participants, including project developers and their hedge providers have been analyzing force majeure provisions to determine whether performance under their existing contracts may be excused. Many of these contracts are financially settled and are documented pursuant to a New York law-governed International Swaps and Derivatives Association (ISDA) Master Agreement. This article highlights the key aspects of the standard force majeure provision found in the ISDA 2002 Master Agreement, and explains some of the factors that market participants should consider in assessing force majeure claims in the context of financially settled transactions. Force majeure claims under physically settled power transactions will be discussed under a series of subsequent articles.¹

1992 ISDA Master Agreement and Force Majeure Events

Although the standard-form 1992 ISDA Master Agreement (*Multicurrency—Cross Border*) (the “**1992 Master Agreement**”) does not include a force majeure provision, market participants may incorporate the force majeure provision from the ISDA 2002 Master Agreement by adhering to the ISDA Illegality/Force Majeure Protocol. In such circumstances, the analysis set forth under “ISDA 2002 Master Agreement,” below, applies. This article does not address cases where parties have incorporated custom force majeure clauses or have otherwise adopted the “Impossibility” provisions from the User’s Guide to the 1992 ISDA Master Agreement. This article also does not

¹ Capitalized terms used and not defined in this article will, unless the context otherwise requires, have the meanings given to such terms in the ISDA 2002 Master Agreement.

address the various specific pricing fallbacks and disruption events that can be found in many ISDA commodity definitions dealing with reference prices linked to the prices of assets traded on exchanges and similar platforms that are susceptible to trading interruptions and closures.

ISDA 2002 Master Agreement and Force Majeure Events

ISDA 2002 Master Agreement Force Majeure Provision

Section 5(b)(ii) of the standard-form ISDA 2002 Master Agreement (the “**2002 Master Agreement**”; each of the 1992 Master Agreement and 2002 Master Agreement may be referred to herein as a “Master Agreement”) includes the following force majeure clause as a Termination Event (the “**2002 Force Majeure Provision**”):

“(b) **Termination Events.** The occurrence at any time with respect to a party or, if applicable, any Credit Support Provider of such party or any Specified Entity of such party of any event specified below constitutes . . . a Force Majeure Event if the event is specified in clause (ii) below, . . .

(ii) **Force Majeure Event.** After giving effect to any applicable provision, disruption fallback or remedy specified in, or pursuant to, the relevant Confirmation or elsewhere in this Agreement, by reason of force majeure or act of state occurring after a Transaction is entered into, on any day:—

(1) the Office through which such party (which will be the Affected Party) makes and receives payments or deliveries with respect to such Transaction is prevented from performing any absolute or contingent obligation to make a payment or delivery in respect of such Transaction, from receiving a payment or delivery in respect of such Transaction or from complying with any other material provision of this Agreement relating to such Transaction (or would be so prevented if such payment, delivery or compliance were required on that day), or it becomes impossible or impracticable for such Office so to perform, receive or comply (or it would be impossible or impracticable for such Office so to perform, receive or comply if such payment, delivery or compliance were required on that day); or

(2) such party or any Credit Support Provider of such party (which will be the Affected Party) is prevented from performing 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, from receiving a payment or delivery under such Credit Support Document or from complying with any other material provision of such Credit Support Document (or would be so prevented if such payment, delivery or compliance were required on that day), or it becomes impossible or impracticable for such party or Credit Support Provider so to perform, receive or comply (or it would be impossible or impracticable for such party or Credit Support Provider so to perform, receive or comply if such payment, delivery or compliance were required on that day), so long as the force majeure or act of state is beyond the control of such Office, such party or such Credit Support Provider, as appropriate, and such Office, party or Credit Support Provider could not, after using all reasonable efforts (which will not require such party or Credit Support Provider to incur a loss, other than immaterial, incidental expenses), overcome such prevention, impossibility or impracticability; . . .”

Analysis of 2002 Force Majeure Provision

Has a Force Majeure Event occurred?

The 2002 Force Majeure Provision does not become applicable until after the parties have given effect to any applicable provision, disruption fallback or remedy in their documentation, including relevant ISDA definitions. Once it does apply, one must keep in mind that New York courts have generally held that force majeure provisions should be interpreted narrowly.

The key questions that must be answered to determine if there has been a Force Majeure Event are: (1) has an event constituting a “force majeure or act of state” for purposes of the 2002 Master Agreement occurred after the date upon which the relevant Transaction was entered into; (2) was performance precluded, impossible, or impracticable or would be so precluded, impossible or impracticable (if such obligation were required on the date of determination) as a result of such event or condition; (3) was such event or condition beyond the control of such party; and (4) did the relevant party use “all reasonable efforts” to overcome the effects of such event or condition.

Each step of this analysis requires a careful assessment of the relevant facts and circumstances, as certain provisions (e.g., Additional Termination Events that simply refer to the occurrence or non-occurrence of a given event or condition) may fall outside the scope of protection offered by the 2002 Force Majeure Provision. For those objecting to a Force Majeure Event claim, the claimant’s failure to carefully assess the 2002 Force Majeure provision may offer a variety of persuasive defenses.

One particular point for consideration is that, unlike the force majeure provisions used in many contracts, the 2002 Force Majeure Provision does not include a long, detailed list of events that may qualify as a force majeure. Instead, after referring to a “force majeure or act of state,” the 2002 Force Majeure Provision moves straight into the consequences of the relevant event or condition. Furthermore, the terms “force majeure” and “act of state” are not defined in Section 14 of the 2002 Master Agreement. Therefore, whether an event or condition constitutes an act of state or force majeure is a matter of judicial interpretation and is a fact-specific analysis.

What does a Force Majeure Event trump?

Under Section 5(c) of the 2002 Master Agreement, only certain defaults would be excused by a Force Majeure Event, as follows:

“Hierarchy of Events.

(i) An event or circumstance that constitutes or gives rise to an Illegality or a Force Majeure Event will not, for so long as that is the case, also constitute or give rise to an Event of Default under Section 5(a)(i), 5(a)(ii)(1) or 5(a)(iii)(1) insofar as such event or circumstance relates to the failure to make any payment or delivery or a failure to comply with any other material provision of this Agreement or a Credit Support Document, as the case may be.

(ii) Except in circumstances contemplated by clause (i) above, if an event or circumstance which would otherwise constitute or give rise to an Illegality or a Force Majeure Event also constitutes an Event of Default or any other Termination Event, it will be treated as an Event of Default or such other Termination Event, as the case may be, and will not constitute or give rise to an Illegality or a Force Majeure Event.

(iii) If an event or circumstance which would otherwise constitute or give rise to a Force Majeure Event also constitutes an Illegality, it will be treated as an Illegality, except as described in clause (ii) above, and not a Force Majeure Event.”

Accordingly, Section 5(c) provides that if an event or conditions constitutes both a Force Majeure Event, on the one hand, and an Event of Default under either Section 5(a)(i) (*Failure to Pay or Deliver*), Section 5(a)(ii)(1) (*Breach of Agreement*) or Section 5(a)(iii)(1) (*Credit Support Default*), on the other hand, it will be treated as a Force Majeure Event and not an Event of Default. However, this does not apply with respect to other Events of Default (such as Bankruptcy or Cross Default) or any Termination Event (including any Additional Termination Event).

For how long can payments and deliveries be deferred?

Section 5(d) of the 2002 Master Agreement provides in general that any payment, delivery or compliance affected by a Force Majeure Event can be deferred for a Waiting Period of up to eight Local Business Days if the event is

continuing. For payment, delivery or compliance obligations due under a Credit Support Document, however, no deferral is permitted where the relevant payment, delivery or compliance is actually required on the relevant day. Once the relevant Waiting Period is over, the obligation to pay, deliver or comply is no longer excused, and all requirements under the Agreement apply.

What is required to terminate following a Force Majeure Event?

Following the applicable Waiting Period (and assuming performance has not occurred), either party may terminate any or all of the Transactions affected by the Force Majeure Event pursuant to Section 6(b)(iv)(2) of the 2002 Master Agreement. The termination notice must be given at least two days, and no more than 20 days, before the proposed termination date. If a party has proposed terminating less than all Affected Transactions, the other party may by notice terminate the rest of the Affected Transactions on the same date. However, a party does not have any right to initiate termination of Transactions if the Force Majeure Event relates to performance by such party or any Credit Support Provider of such party of an obligation to make any payment or delivery under, or to compliance with any other material provision of, a Credit Support Document, but such party can terminate remaining Affected Transactions if the other party has only terminated some of them.

Does a party have to give notice of a Force Majeure Event?

It should be noted that Section 6(b)(i) of the 2002 ISDA Master Agreement provides that “If a Force Majeure Event occurs, each party will, promptly upon becoming aware of it, use all reasonable efforts to notify the other party, specifying the nature of that Force Majeure Event, and will also give the other party such other information about that Force Majeure Event as the other party may reasonably require.” However, while there is an obligation to notify the counterparty, not surprisingly, the Waiting Period runs from the time such force majeure arises, not the date of notification.

Conclusion

Due to the rapid spread of COVID-19, market participants will likely be required to assess the validity of force majeure claims under their financially settled contracts. To the degree that these transactions are documented under a Master Agreement and include the 2002 Force Majeure Provision, a careful assessment of the Force Majeure Event provisions will be required to avoid forfeiting rights and remedies that may be available. Please contact us if you would like to schedule a consultation to determine whether a force majeure would be applicable to your outstanding transactions.

CONTACTS

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