

Maroan Maizar / Michael Jaquet / Till Spillmann*

Credit and counterparty risk: Why trade under an ISDA with a CSA?

Inhaltsübersicht

- I. Corporate Risk Management
- II. Legal Framework for Derivatives
 1. ISDA Master Agreement
 2. (Deal specific) Confirmations
 3. Credit Support Annex (CSA)
- III. Credit Risk Mitigation: Collateralization of derivatives
 1. Concept and mechanism
 2. Default example
 3. Benefits and practical issues around CSAs
- IV. Enforceability of the ISDA Master Agreement & Credit Support Annex
 1. Legal Opinions
 2. Enforceability of collateral provided under the CSA
 - 2.1 General
 - 2.2 Avoidance of transactions
 - a. Avoidability due to insolvency (*Überschuldungspauliana*)
 - b. Avoidability for intent (*Absichtspauliana*)
- V. Conclusion

I. Corporate Risk Management

On 15 September 2008, Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy protection. Swiss investors in structured products issued by Lehman Brothers Switzerland either suffered significant losses on their positions or were fortunate enough to be reimbursed by their Swiss bank intermediaries.

The implications of Lehman's collapse for Swiss corporate entities are less transparent and have not attracted as much press coverage as structured products that are targeted mainly to retail customers. It is reasonable to assume that a few Swiss corporate entities have also incurred losses, but more importantly the bankruptcy of a major financial intermediary has raised the awareness for credit risk in general and counterparty risk in bilateral or over-the-counter derivatives in particular.

As part of their day-to-day treasury risk management activities, corporates enter into hedging transac-

tions – as referred to herein «derivatives» for the sake of simplicity – with financial intermediaries such as Lehman Brothers. The following three risk categories are, amongst others, the main risks for a corporate:

- FX risk (appreciation of the Swiss Franc): a corporate reporting in Swiss Francs will seek to hedge its Euro cash inflow from sales in the Eurozone back into CHF to protect its margin;
- Interest rate risk (increase in interest rates): a corporate will transform a portion of its floating rate into fixed debt when mid to long term interest rates are low;
- Commodity risk (increase e.g. in oil price): a corporate will lock in the oil price when energy costs represent a significant portion of its gross margin.

Whenever such hedges are «in-the-money» i.e. have a positive market value in favor of the corporate, this entity is then exposed to *counterparty risk*: if the bank counterparty goes bankrupt, the corporate can lose a large portion of its positive market value hedge and might have to replace its hedge at current market conditions which are less favorable than the initial hedge, hence at a cost.

In the market environment of late 2008 and throughout 2009, a sharp increase in market volatility coincided with a deterioration of counterparties' credit quality. Not only has the likelihood of incurring a loss risen significantly (higher default probability), but also the likelihood of suffering a much larger loss is greater due to the increase in volatility (foreign exchange, interest rates, commodities etc.).

This article aims to offer a short overview of (i) the legal framework for derivatives, (ii) the possibility of credit risk mitigation by way of using credit support annexes, and (iii) the legal issues in connection with the enforceability of credit support annexes according to Swiss insolvency law.

II. Legal Framework for Derivatives

Hedging transactions such as FX, interest rate and commodity derivatives are usually covered by the combination of a standard master agreement and deal specific confirmations.

* Maroan Maizar, Managing Director and Branch Manager of Deutsche Bank Zurich, Deutsche Bank AG; Michael Jaquet, Director, Deutsche Bank AG and Dr. iur. Till Spillmann, Rechtsanwalt, Bär & Karrer AG.

1. ISDA Master Agreement

The *International Swaps and Derivatives Association* is a trade organization of participants in the market for over-the-counter (=OTC) derivatives. It is headquartered in New York and has developed a standardized contract (the «ISDA Master Agreement») to govern derivatives transactions.

The ISDA Master Agreement¹ is a bilateral framework agreement which contains general terms and conditions, such as provisions relating to payment netting, representations, basic covenants, events of default and termination, and provisions for close-out netting. However, it does not, by itself, include details of any specific derivative transaction the parties may enter into (see confirmations below).

The ISDA Master Agreement is a standardized format that will not be amended. The Agreement also includes a *Schedule* in which the parties elect certain options and may modify sections of the Master Agreement if desired.²

The two primary issues dealt with in the ISDA Master Agreement are:

- *Credit:*
Events of Default. The ISDA Master Agreement includes eight Events of Default, the most important of which are generally considered to be Failure to Pay or Deliver, Bankruptcy and Cross Default. Cross Default refers to a default of Specified Indebtedness, which is defined as any obligation in respect of borrowed money. It is called «Cross» because it relates to transactions entered into with third parties.
- *Termination Events.* The ISDA also includes Termination Events, which are distinguished from Events of Default since they are considered events that are

not the fault of the counterparty. In addition to the enumerated Termination Events, the ISDA Master Agreement allows parties to specify «Additional» Termination Events in the Schedule or in a Confirmation, which can be specially tailored. These are often linked to credit concerns, with parties utilizing the provision, for instance, to incorporate downgrades in credit ratings (either unilaterally or bilaterally), or to include a trigger upon material changes in the management structure of a party.

Another key credit aspect of the ISDA Master Agreement is the ability to link entities related to the parties to the ISDA Master Agreement to the agreement by naming them as Specified Entities in relation to certain Events of Default and Termination Events. If an entity is designated as a Specified Entity («SE») for Party X in relation to an event and such an event occurs with respect to the SE, then the event will be triggered against Party X under the ISDA Master Agreement and the counterparty will have the right to terminate the ISDA Master Agreement even if the event has not occurred in relation to Party X itself. Parties may wish to provide for this if other entities of a group are also trading counterparties or if they are simply important from a credit risk perspective.

- *Netting:*
Payment or Settlement Netting. This form of netting deals with the offsetting of payment or delivery obligations owed under one or more transactions due on the same business day and expressed in the same currency or having the same International Security Identification Number («ISIN»). It is used to mitigate settlement risk, also known as *Herstatt Risk*, after a failed German bank that highlighted the dangers of settlement risk.
Close-out Netting. This form of netting deals with offsetting of market values or replacement costs calculated in respect of two or more transactions existing on an early termination date. It is used to mitigate credit risk. Netting of exposures across a variety of transactions (cross-product) enables a potential reduction of credit risk and recognition thereof for risk capital purposes. When the two or more transactions are terminated, close-out netting will be performed, the transactions will terminate and be replaced by a market value or replacement cost position. Then, a single amount in the termination currency will be determined payable by one party to the other.

¹ The ISDA Master Agreement is the most important of the standard agreements used in the derivatives market and one of the most important in the financial markets generally. Originally published in 1987 for the purpose of documenting interest rates and currency swaps, it was reissued in 1992 in format designed for use in connection with any type of OTC derivative transaction. Two versions of the 1992 agreement were issued: a Multi-currency-Cross Border version and a Single Currency – Single Jurisdiction version. The Single Currency – Single Jurisdiction version is rarely used outside the U.S. An updated version of the 1992 ISDA Master Agreement was issued in 2002, the ISDA 2002 Master Agreement. Separate User's Guides accompany the 1992 and the 2002 Master Agreement (User's Guide to the ISDA 2002 Master Agreement and User's Guide to the 1992 ISDA Master Agreement, respectively).

² The purpose of the ISDA Master Agreement is to set out the provisions governing the parties' relationship which are not transaction-specific. It comprises a printed standard form, which contains the terms that are relatively uncontroversial and so require little negotiation, and a Schedule which is completed after negotiation between the parties. For a discussion of the provisions that are commonly negotiated, see PAUL HARDING, *Mastering the ISDA Master Agreements (1992 and 2002): a practical guide for negotiation*, 2nd edition, London 2003.

2. (Deal specific) Confirmations

The details of individual derivative transactions are included in confirmations entered into by the parties to the ISDA Master Agreement. Each confirmation relates to a specific transaction and sets out the agreed commercial terms of that trade. Confirmations are generally

short as they will usually incorporate one or more of the definitions booklets as published by ISDA.³

3. Credit Support Annex (CSA)

ISDA also offers a credit support annex: the ISDA Credit Support Annex («CSA»), an add-on document that can be easily appended to an existing ISDA Master Agreement, which further permits parties to mitigate their credit risk by requiring a party to which a derivative transaction is «out-of-the-money» (i.e. has a negative market value) to post collateral such as cash or government bonds.

The main clauses negotiated in the CSA are:

- *Threshold*: defines the level of mark-to-market exposure below which no collateral is required to be posted;
- *Eligible Collateral*: defines the type of instruments which can be posted as collateral;
- *Valuation Date*: defines the regularity of the counterparties estimating their respective mark-to-market exposure for the purpose of determining any required collateral;
- *Minimum Transfer Amount*: assuming there is no independent amount defined, this is the amount by which a party's exposure must exceed the sum of the posted collateral, before more collateral may be called;
- *Distributions and Interest Amount*: posted cash would earn interest, while the counterparty who had posted it, is unable to use it; this clause defines what rate of interest it would earn (e.g. EONIA, 3m LIBOR). If securities are posted, the counterparty posting continues to receive bond coupons;
- *Rating Triggers*: should a counterparty be downgraded by one or more rating agencies to a pre-defined level, for example from A to BBB, certain provisions might become more stringent or become applicable at that point. The most commonly agreed consequences are the Threshold going to zero or the frequency being increased to daily etc.

III. Credit Risk Mitigation: Collateralization of derivatives

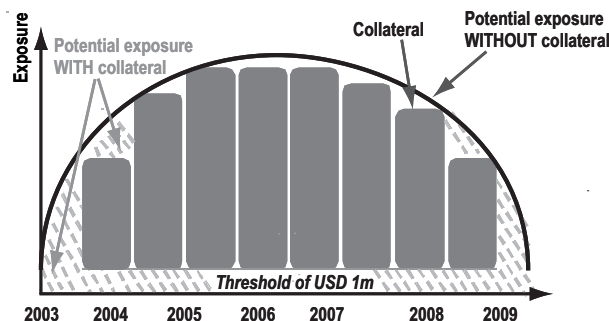
1. Concept and mechanism

In the OTC derivative practice, collateral represents assets owned by one party and transferred to the counterparty to support the first party's obligations. This concept is similar to the margining that is used on the futures and repo exchanges.

In the event that any required payments under the derivative contract are not made (e.g. due to insolvency), the counterparty is able to offset its losses by realizing the value of the assets posted as collateral. Collateralization has become the most widely used tool to mitigate the credit risk in OTC transactions.

To illustrate this with a concrete example, let's assume that in 2003 a Swiss corporate (the «Swiss Corporate») transformed its floating rate debt (USD 100m floating rate syndicated loan) into fixed rate debt via a fixed payer interest rate swap with Swiss bank B («Bank B»). As a result, the corporate pays a fixed rate of 3 % for 7 years. In 2005, the fixed rate for the same remaining duration rose to 5 %. In other words, the Swiss Corporate is paying 2 % less than the market price for another 5 years, which corresponds to a positive market value in favor of the Swiss Corporate representing 10 % of the loan notional USD 100m or USD 10m.

As per the bilateral CSA signed between the Swiss Corporate and Bank B, market values below USD 1m do not need to be collateralized (Threshold Amount). Bank B will therefore transfer USD 9m of cash collateral to the Swiss Corporate to offset the counterparty risk on this specific interest rate hedging transaction.



There is typically no collateral at the beginning of the transaction since there is no exposure as the market value of the swap is close to zero (swap is «at market» or «at-the-money», i.e. neither party is owed any money). Throughout the term of the swap, if rates rise, the swap will start gaining value in favor of the Swiss Corporate, which creates a credit exposure towards Bank B. The Swiss Corporate then has the right to periodically call collateral in the amount equal to the created exposure. If a default occurs, the Swiss Corporate will be able to offset the potential loss by realizing the value of the underlying collateral (USD 9m cash in our example).

2. Default example

In 2005, the hedging transaction with Bank B has a positive market value of USD 10m in favor of the Swiss Corporate. Bank B defaults and the assumed recovery is 40 % (this means that out of USD 100 of exposure, the Swiss Corporate will recover 40 and therefore lose 60).

³ See, in particular, the 2000 and 2006 ISDA Definitions.

- *Scenario 1: The Swiss Corporate and Bank B have an ISDA Master Agreement with a CSA in place:*

The Swiss Corporate is in possession of collateral valued at USD 9m (i.e. positive market value of USD 10m minus USD 1m threshold, below which no collateral is due). On a netted basis, Bank B «owes» the Swiss Corporate USD 1m. The Swiss Corporate then receives USD 0.4m after default and therefore the net credit loss of the Swiss Corporate is USD 0.6m.

- *Scenario 2: The Swiss Corporate and Bank B have an ISDA Master Agreement without a CSA in place:*

The Swiss Corporate has no collateral which could be offset against the obligation of Bank B. Therefore, Bank B «owes» the Swiss Corporate USD 10m. The Swiss Corporate receives USD 4m after default and its net credit loss is therefore USD 6m.

Result: In our example the CSA has made the impact of default ten times smaller for the Swiss Corporate.

3. Benefits and practical issues around CSAs

As illustrated above, the main benefit of the CSA is the *mutual risk reduction/mitigation*. Corporates that have signed a CSA with their bank counterparties will also benefit from a better pricing on their hedging transactions as credit and funding charges will be virtually eliminated. Major market makers have started to price lending of any type – and especially lending embedded in derivatives such as forwards, options and swaps – as this ties up its precious equity capital. In the past, a forward rate reflected the interest rate differential. Now that rates at which banks lend and deposit vary substantially, this will also impact their pricings. For credit/trading line intensive hedging instruments such as long term cross currency swaps, signing a CSA is not only essential for obtaining attractive prices, it becomes more and more a *conditio sine qua non* for getting access to the market and finding counterparties willing to take on the risk.

A CSA will also allow for more *flexible trading relationships* given that the capacity to trade with one or few core banks will be substantially increased, as opposed to having to broaden trading relationships at the detriment of the pricing or service quality just for avoiding concentration risk. By releasing hedging limits capacity, a CSA can also contribute to saving time during the internal approval process for an extension of trading lines or for a new bilateral loan.

The most frequently mentioned reasons for corporates not to enter into CSAs are that dealing with CSAs can be time consuming and relatively *resource intensive* (both in terms of management attention as well as costs) CSAs make it more difficult for corporate treasurers to *plan their liquidity needs* as they might have to post additional cash under the CSA. Provided corporates have several

hedging transactions in place with their bank counterparty across various products, it is reasonable to assume that not all transactions will move against the corporate at the same time, therefore reducing the amount of additional cash to be posted in the short term. It might also happen that the corporate will receive cash from its CSA with bank Y and pass on the cash as per its CSA with bank Z, so that the net impact is close to neutral.

Corporates can also be uncomfortable with the *negative carry* associated with the CSA, for example when a corporate is paying LIBOR plus 1 % on its syndicated loan and receives LIBOR minus 0.25 % on its cash posted via the CSA, this would lead to a net interest rate cost of 1.25 % per annum. Banks have taken these concerns into consideration and have now come up with customized corporate CSAs. In specific cases where the corporate owes the bank a large amount, the bank might agree to reduce the impact of the negative carry by paying a spread above LIBOR on cash posted which can be as high as the syndicated loan spread.

IV. Enforceability of the ISDA Master Agreement & Credit Support Annex

Given the outlined attractiveness of CSAs, it goes without saying that the enforceability of the ISDA Master Agreement and the CSA⁴ in the event of insolvency is of great importance. In the following, we briefly touch on the available legal opinions and discuss in a second section important *caveats* in relation to the opinion in connection with the Swiss Debt Enforcement and Bankruptcy Act («DEBA»).

1. Legal Opinions

ISDA's members can rely on legal opinions obtained by ISDA throughout a large number of jurisdictions, including Switzerland. ISDA distinguishes netting opinions and collateral opinions. While netting opinions address, inter alia, close-out netting provisions and their enforceability in the relevant jurisdictions, collateral opinions deal with questions in connection with the enforceability of the provisions contained in ISDA's credit support documents. These opinions are updated annually. Due to their availability separate legal opinions are not routinely provided in connection with each and every relationship with a counterparty unless the transaction is very large or complicated or is part of a wider transaction (such as a syndicated loan or a bond issue) in relation to which opinions are being sought.

The Swiss netting opinion addresses, inter alia, questions as to the recognition and enforceability of the

⁴ For the sake of simplicity this refers to the Credit Support Annex governed by English law.

close-out netting and set-off mechanism as set out in the ISDA Master Agreement absent and in the context of insolvency. Furthermore, it refers to close-out netting for multibranch parties and addresses further specific questions.

The Swiss collateral opinion provides opinions as to the validity of security interests created under the security documents and the enforceability of rights under the different security documents by the secured party in the absence and after the start of insolvency proceedings.

As indicated above, the validity and enforceability of the collateral arrangements (i.e. of the CSA) in the event of Bankruptcy⁵ (as such term is defined in the ISDA Master Agreement) is an important prerequisite for a party entering into a CSA.

2. Enforceability of collateral provided under the CSA

2.1 General

For the purpose of this article we assume that the Swiss Corporate mentioned above entered into an ISDA Master Agreement and a CSA with (Swiss) Bank B, each governed by English law.

The concept of the CSA is basically the following: The net mark-to-market value of the transactions documented under the ISDA Master Agreement to which the CSA relates is determined periodically at so-called valuation dates agreed upon by the parties based on the amount that one party would be required to pay to the other if all outstanding transactions between them were terminated as of the relevant valuation date and a termination payment were calculated in accordance with the close-out and netting provisions of the ISDA Master Agreement.

The party having a net exposure is entitled to receive and hold credit support with a value equal to its exposure, plus an additional amount to cover future fluctuations of the exposure, as the case may be, less the agreed Threshold Amount as described above.

Technically, under the CSA the transferor must transfer outright full ownership in securities collateral to the transferee. The transfer is, however, subject to a conditional obligation to return equivalent fungible securities upon various circumstances such as in a Termination Event or an Event of Default⁶. Furthermore, the parties agree that all right, title and interest in and to the transferred credit support shall vest in the recipient free and

clear of any liens, claims, charges or encumbrances or any other interest of the transferring party and that the CSA does not intend to create in favor of any party a security interest in any cash or other property transferred.⁷ Therefore, the CSA is not a fiduciary transfer by way of security but rather an outright transfer of ownership under English law.

As indicated above, there is typically no collateral at the beginning of a transaction since there is no exposure as the market value of the derivative is close to zero (derivative is at market or «at-the-money» and neither party owes any money). Collateral will be called periodically throughout the lifetime of the derivative in the amount equal to the created exposure. If an Event of Default (as defined in the ISDA Master Agreement) occurs, the party will be able to offset the potential loss by realizing the value of the underlying collateral. According to Scenario 1 above, Bank B defaults and the Swiss Corporate is basically able to offset the potential loss by realizing the value of the credit support provided under the CSA.

As indicated above, the CSA provides, in principle, for an outright transfer of title (as opposed to a transfer of a limited right *in rem* of a regular or irregular pledge in the sense of Swiss law). There is a certain risk, however, that a Swiss court would recharacterize such outright transfer of title into an irregular pledge.⁸ However, no negative consequences would derive from such recharacterization.

Basically, irrespective of an insolvency of the transferor the rights of the transferee are enforceable in Switzerland in accordance with the terms of the ISDA Master Agreement and the CSA.⁹ However, the enforceability is subject to potential Swiss rules on avoidance actions (*paulianische Anfechtungsklagen*) which are explored in further detail below.

2.2 Avoidance of transactions

According to art. 285 DEBA the receiver in a bankruptcy and certain creditors may challenge certain acts that the debtor made during a certain prescribed period prior to the opening of bankruptcy proceedings or the grant of a debt moratorium (*Nachlassstundung*) in connection with composition proceedings (*Nachlassverfahren*). Three voidability actions can be distinguished: (i) the action to avoid a gift (*Schenkungs pauliana*); (ii) avoidability due to insolvency (*Überschuldungspauliana*); and (iii) avoidability for intent (*Absichtspauliana*).

⁵ The ISDA Master Agreement contains a series of insolvency-related events the occurrence of any of which in relation to a party to the ISDA Master Agreement (or any Credit Support Provider or Specified Entity of it) constitutes and Event of Default (see Section 5(a)(vii) ISDA Master Agreement).

⁶ See Sections 5(a) and 5(b) of the ISDA Master Agreement.

⁷ See Paragraph 5(a) and (b) of the CSA (Credit Support Annex governed by English law). If parties wished to create a security interest or charge they should consider using the ISDA Credit Support Deed (English law) or the ISDA Credit Support Annex (New York law).

⁸ See also Swiss Collateral Opinion, Part 2 Question 22.

⁹ Swiss Collateral Opinion, 26.

In the present context avoidability actions due to insolvency and for intent have to be further explored:

**a. Avoidability due to insolvency
(Überschuldungspauliana)**

Pursuant to art. 287 DEBA (i) the granting of collateral for existing obligations which the debtor was until that point in time not obliged to secure; (ii) the settlement of a debt of money by another manner than in cash or by other unusual means of payment; and (iii) the payment of an unmatured debt are voidable actions if the debtor had taken them during the year prior to the opening of bankruptcy proceedings and was at that time already insolvent. The transaction may not be voidable if the recipient proves that it was unaware, and need not have been aware, of the debtor's insolvency.

For illustration purposes two scenarios should be outlined below:

Scenario A: Bank B and the Swiss Corporate entered into the ISDA Master Agreement (including a CSA) and one or more confirmations outside the prescribed period. However, later on during the prescribed period of one year collateral was provided by Bank B to the Swiss Corporate under the CSA due to an increased exposure of the Swiss Corporate.

In our view, the provision of collateral during the prescribed period of one year is not subject to an avoidability action due to insolvency because the collateral was provided due to an obligation that already existed at that point in time¹⁰.

This view is supported by the fact that in connection with the coming into force of the Swiss Book-Entry Securities Act as of 1 January 2010 (*Bucheffektengesetz*), an additional paragraph was added to art. 287 DEBA (article 287 para 3 DEBA). According to this new paragraph collateral provided in the form of securities or book-entry securities or other securities traded on a representative market is not subject to voidability due to insolvency if the obligation to provide collateral was entered into before and the obligation requires a party to provide additional collateral in order to reflect market fluctuations of either the security provided or the underlying secured obligation (the same applies to the replacement of one security with another). In other words, if, in our example, Bank B provided additional collateral in the form of securities, book-entry securities or other securities traded on a representative market and the obligation to provide such securities already existed at that point in time (pursuant to a CSA), the provision of collateral by Bank B is, according to art. 287 para 3 not subject to an avoidability action due to insolvency.

As indicated above, art. 287 para 3 DEBA was newly inserted in connection with the new Swiss Book-Entry

Securities Act. The rule was in substance copied from art. 8 para 3 of the EU Directive on Financial Collateral Arrangements (Directive 2002/47/EC) which provides for the obligation of member states to ensure, inter alia, that the provision of financial collateral or substitute or replacement of financial collateral in connection with an obligation to provide financial collateral in order to take account of changes in the value of the financial collateral or in the amount of the relevant financial obligations shall not be treated as invalid or declared void on the sole basis that, for instance, such provision was made in a prescribed period prior to an insolvency.

In addition, as the report of the Swiss Federal Council on the Federal Act on Book-Entry Securities states, the new paragraph is only supposed to reflect applicable law and jurisdiction and was added to article 287 DEBA only to avoid all possibility of doubt as regards the interpretation of art. 287 DEBA and, therefore, for the mere sake of legal certainty.¹¹ In our view, this means that there was no intention to limit the scope of the existing provision. As a consequence, not only the provision of collateral in the form of the securities mentioned above may not be subject to avoidability due to insolvency but also the provision of collateral in other forms such as cash.

Scenario B: Bank B and the Swiss Corporate entered into the ISDA Master Agreement (including a CSA) and one or more confirmations and collateral was provided by Bank B to the Swiss Corporate during the prescribed period of one year prior to the start of insolvency proceedings under the CSA.

In our view, the execution of an ISDA Master Agreement with or without the provision of collateral is not voidable according to art. 287 DEBA since the entering into agreements is not an act listed in art. 287 para 1(1)-(3) DEBA which may be voidable. In relation to collateral provided after the execution of the ISDA Master Agreement under a CSA, basically the same applies as described under Scenario A above.

b. Avoidability for intent (Absichtspauliana)

Pursuant to art. 288 DEBA, all transactions carried out by the debtor during the prescribed period of five years prior to the opening of bankruptcy proceedings with the intention, apparent to the other party, of disadvantaging its creditors or allowing certain creditors preference to the disadvantage of others, are voidable.

In order to be voidable according to art. 288 DEBA a transaction of the debtor must have the following elements:

- (i) The transaction must privilege or damage creditors (i.e. at least one creditor must suffer a damage or

¹⁰ See art. 287 para 1(1) DEBA *e contrario*.

¹¹ See Botschaft zum Bucheffektengesetz sowie zum Haager Wertpapierübereinkommen, BBl 2006, 9315 et seq., 9395.

must be favored).¹² For instance, the payment of a payable debt is to the detriment of other creditors since the debtor's assets are reduced and the creditor that was paid is favored because 100 % of its claim was compensated while other creditors will eventually have to share a loss on their claims (as a result of insolvency proceedings). On the other hand, the execution of an agreement as part of which the debtor provides assets and concurrently receives consideration in an equal amount does not result in a damage to the other creditors and is, thus, not voidable. For instance, the entering into a loan agreement against the provision of security is not voidable because collateral is provided in return for a loan amount in an economically corresponding value. However, the repayment of such loan during the prescribed period may be subject to avoidability.¹³

- (ii) As a subjective element, the debtor must have the intention to prefer or disadvantage creditors. According to jurisprudence, it suffices if the debtor could or should have recognized that as a consequence of the challenged act creditors could be preferred or disadvantaged.¹⁴ The mere acceptance of a possible disadvantaging or preference of creditors suffices.¹⁵ In reality, based on this jurisprudence it could be argued that this leads to a rebuttable presumption for the debtor's intent to prefer and/or disadvantage creditors.
- (iii) As a second subjective element, the preferred creditor must have recognized the debtor's intention described above. The Swiss Federal Supreme Court holds that this prerequisite is met if a creditor, acting diligently, could have or should have recognized such intent.¹⁶

For illustration purposes, again two scenarios should be distinguished:

Scenario X: Bank B and the Swiss Corporate entered into the ISDA Master Agreement (including a CSA) and one or more confirmations at a time outside the prescribed period of 5 years before Bank B was declared bankrupt but additional collateral was provided on various occasions by Bank B to the Swiss Corporate (and vice versa) within such prescribed period under the CSA.

As indicated above, as far as the objective element of a damage or preference of creditors is concerned, jurisprudence holds that any act or transaction that diminishes the substance available to cover creditors' claims in bankruptcy falls under art. 288 DEBA. Therefore, the grant of security for pre-existing debt¹⁷ or the repayment of unsecured debt is generally voidable in a subsequent bankruptcy or composition proceedings. To our knowledge, the Federal Supreme Court has, however, never considered this doctrine in the context of collateral provided under a collateral arrangement in the form of a CSA.

On the other hand, the provision of new collateral for new debt is, according to jurisprudence, not challengeable as the debtor in return for the granting of collateral receives money in an amount at least corresponding to the value of the collateral given. Thus, whenever a debtor receives *prior to or at least at the same time* for its provision of collateral a corresponding value in return (such as for instance cash under a loan), such act or transaction is not voidable.¹⁸

However, recently the Swiss Federal Supreme Court seems to have amended its practice to some extent. In a decision in connection with the composition proceedings of SAir Group it held that payments by SAir Group during the term of a share swap agreement entered into between SAir Group and a bank are not voidable under Swiss insolvency law.¹⁹ In short, the Federal Supreme Court argued that in the specific case the share swap transaction was basically a share purchase with periodic purchase price adjustments based on the fluctuations of the market value of the shares. Furthermore, the share swap was qualified as a reciprocal agreement (*Synallagma*). Interestingly, the Swiss Federal Supreme Court held that the purchase price adjustment payments by SAir Group are not voidable even though they were paid at a later stage due to a pre-existing obligation.²⁰

In the present context, it could, therefore, be argued that the later provision of collateral due to a pre-existing obligation under the CSA does not necessarily result in a damage to creditors, because the transaction also represents an exchange of benefits of an equal value and, similar to the share swap transaction, the respective timing of the exchange of values is not relevant either (i.e. had the Bank B and the Swiss Corporate entered into the derivative transaction with the same parameters at the time of the provision of additional collateral, the same amount of collateral would have been provided). It remains to be seen whether the Swiss Federal Supreme

¹² See Decision of the Federal Supreme Court 4C.262/2002; E.4.1; BGE 101 III 94; 99 III 26 et seq.

¹³ See for instance BGE 134 III 452 et seq. in relation to the repayment of a loan by SAir Group to Zürcher Kantonalbank.

¹⁴ See BSK SchKG III-STAEHELIN, art. 288 note 14 et seq.; HANS-UELI VOGT, Krisenmanagement unter dem Damoklesschwert der paulianischen Anfechtung, GesKR 2/2009, 163 et seq., 179 et seq., with further references.

¹⁵ See Decision of the Federal Supreme Court 4C.262/2002, E. 5.1.; 5A.29/2007.

¹⁶ See Decision of the Federal Supreme Court 5C.3/2007, E.3.4; 5A.29/2007, E.8.4.

¹⁷ See BGE 101 III 92, 94; BGE 99 III 89 ff.

¹⁸ See BSK SchKG III-STAEHELIN, art. 288 note 11; HANS-UELI VOGT/THOMAS KÄSER, Paulianische Anfechtung der Rückzahlung eines Kredits und von Zahlungen im Rahmen einer *share swap transaction*, GesKR 4/2009, 583 ff., 588.

¹⁹ Decision of the Federal Supreme Court 5A_420/2008.

²⁰ See VOGT/KÄSER (footnote 18), 588.

Court really intended to change its practice (which we doubt) and whether it would also be applicable in a case where there is no purchase contract but rather an outright transfer of cash or securities in order to (economically) provide collateral.²¹

In addition, the Swiss Federal Supreme Court held in two recent decisions that the payment of interest under a loan in the ordinary course of business does not result in a damage to creditors and is, therefore, not subject to an avoidance action for intent.²² In particular, the court held that there is an equivalent countervalue of the payment of interest (i.e. the upholding of the relevant loan agreement by the respective lender) and, therefore, no damage. In the present context we are of the view that the same should apply. In short, the equivalent countervalue of the provision of collateral in the ordinary course of business under a CSA is the upholding of the hedge.

In relation to the two subjective elements (i.e. the intent to disadvantage or prefer creditors and the recognizability of such intent by the creditor) jurisprudence holds, as indicated above, that the debtor does not necessarily have to act with the direct intention to disadvantage or favor creditors. It suffices if the debtor, while not directly aiming at such preference or disadvantage, merely accepted such preference or disadvantage as a possible consequence of its act. As legal scholars correctly point out, this jurisprudence results in the fact that the subjective element of intent is in practice almost always met which cannot be the rationale of the law as to the avoidability action for intent.²³

In our view, the provision of collateral on a mark-to-market basis is not intended to disadvantage or favor creditors in the sense of art. 288 DEBA for the following reasons:

Firstly, the obligation to provide collateral was already in existence and the original entering into such an obligation was clearly not intended to disadvantage or favor creditors. It was rather an act which intended to enable the Swiss Corporate and Bank B to operate more efficiently: on Bank B's part, commercially advantageous on the Swiss Corporate's part, to hedge against market risks. What is more, the act took place at a time which is not within the scope of Swiss insolvency law. The additional provision of collateral itself indeed occurred within the prescribed period but was not intended to damage or favor creditors either. The only intention was to hedge credit and counterparty risk which, from a policy point of view, is desirable because it increases market efficiency. This argument may be further sup-

ported if Bank B and the Swiss Corporate used ratings-related trigger levels (as mentioned above) – as opposed to trigger levels tied explicitly to insolvency proceedings. In other words, we believe the interpretation of the debtor's intent should be limited again to what it is really supposed to be (i.e. the protection of creditors from a debtor whose direct intention is to damage and/or favor certain creditors). The subjective element of intent becomes irrelevant, if it was factually deemed to be established whenever there is a damage or preference of creditors.

Secondly, the same collateral arrangement obliging a debtor to provide additional collateral obliges the creditor likewise to promptly return any collateral surplus should the risk exposure be reduced or even entirely shifted to the debtor (in which case the debtor benefits from collateral provided by the creditor).

Thirdly, the legal certainty as to the enforceability of collateral arrangements in connection with derivative transactions is vital for the efficiency and operability of the international financial markets. The Directive on Financial Collateral Arrangements correctly states that the sound market practice favored by regulators whereby participants in the financial market use top-up financial collateral arrangements (i.e. in the present context a CSA) to manage and limit their credit risk to each other by mark-to-market calculations of the current market value of the credit exposure and the value of the financial collateral and, accordingly, carry out margin calls for top-up financial collateral or return the surplus of financial collateral should be protected against certain automatic avoidance rules.²⁴

For the avoidance of doubt, the Directive does not aim to prejudice the possibility of questioning under national law a financial collateral arrangement and the provision of financial collateral as part of the initial provision, top-up or substitution of financial collateral, for example where this has been intentionally done to the detriment of the other creditors. The Directive's aim is not to «legalize» the intentional damaging or preferring of creditors but rather to increase legal certainty with respect to the entering into and the compliance with standard financial collateral arrangements. Against this background, in our view, the jurisprudence and doctrine in Switzerland seems to interpret the term «intent» according to art. 288 DEBA too broadly. As indicated above, no direct intent (*dolus directus*) is required, *dolus eventualis* or, according to certain legal scholars, even gross negligence may suffice.²⁵ This is not in line with the Directive because it ultimately results in a situation where each provision of collateral based on a financial collateral arrangement is voidable which is clearly not

²¹ As mentioned above, the provision of collateral under the English law CSA is not intended to be legally qualified as the granting of charge or other security interest.

²² See Decisions of the Swiss Federal Supreme Court 5A_750/2008 and 5A_758/2008.

²³ See also VOGT (footnote 14), 179.

²⁴ See Whereas Clause 16 Directive 2002/47/EC.

²⁵ See BSK SchKG III-STAHELIN, art. 288 note 16.

the intention of EU regulation. The EU Directive rather obliges EU member states to implement into their national laws that, in principle, the provision of collateral based on a pre-existing financial collateral arrangement should not be voidable in order to facilitate an efficient and secure financial market where creditors, subject to certain conditions²⁶, are able to validly and in an enforceable manner secure their credit risk exposures on a mark-to-market basis.

The concept and the rationale of the Directive is also acknowledged and accepted in Switzerland. After all, the Swiss legislator would not have, as mentioned above, only recently included parts of the provisions of the Directive into art. 287 DEBA. Although the elements of an avoidability action for intent are different from the ones of the avoidability action due to insolvency, it would be contradicting to revise the law as to one provision in order to increase legal certainty in relation to certain transactions (i.e. the provision of collateral based on financial collateral arrangements) while at the same time the same transaction would be voidable under a different title (i.e. due to an avoidability action for intent).

Concluding the above, in our opinion the provision of collateral by a debtor within the prescribed period of five years due to a standard collateral arrangement in the form of a CSA attached to an ISDA Master Agreement should not be subject to avoidability action for intent.

Scenario Y: Bank B and the Swiss Corporate entered into the ISDA Master Agreement (including a CSA) and one or more confirmations at a time within the prescribed period of 5 years before Bank B was declared bankrupt and collateral was provided on various occasions by Bank B to the Swiss Corporate (and vice versa) within such prescribed period under the CSA.

In our example, the Swiss corporate transformed its floating rate debt into a fixed rate debt via a fixed payer interest rate swap with Bank B. At the time the swap was agreed no collateral was provided (as indicated, usually at the beginning of its lifetime the derivative is priced at market). The execution of the swap does not damage or favor a creditor. The transaction merely aims to change the profile of cash flows of the corporate (upsides are, inter alia, increased ability to foresee cash flows and, therefore, simplified financial planning) and Bank B (typically Bank B would hedge its exposure with another back-to-back transaction).

In relation to collateral provided after the execution of the ISDA Master Agreement under a CSA, basically the same applies as described under Scenario X above.

V. Conclusion

Post Lehman's filing for Chapter 11, the world has become less secure and corporate treasurers are faced with a much bigger challenge in their day-to-day hedging activities. The probability to incur a loss and the possible loss severity have both increased substantially.

The ISDA Master Agreement, the authoritative contract widely used by industry participants has established international contractual standards governing privately negotiated derivatives transactions that reduce legal uncertainty and allow for a reduction of credit risk through netting of contractual obligations. As the business has developed and grown, ISDA expanded and updated the Master Agreement and its supporting documents, a process that continues today. The efforts within the European Union in connection with increasing legal certainty of standard collateral arrangements such as CSAs (i.e. increasing the likelihood of validity and enforceability of such arrangements throughout the European Economic Area) may serve both as an indication of the importance of legal certainty of such arrangements as well as an effective step towards such legal certainty. As shown above, Swiss insolvency law is in line with such European efforts although legislative steps towards a clarification as to the enforceability of collateral provided within the prescribed period based on an ISDA Master Agreement, in particular under art. 288 (avoidability for intent), would be highly welcomed by the financial industry and bolster trust in the financial market which is scarce nowadays.

It cannot be the corporates' responsibility to «guess» the next Lehman (and avoid every credit event in the company's credit risk portfolio), but corporates can significantly reduce the loss severity by implementing a solid framework around their hedging transactions, and especially a Credit Support Annex (CSA) in complement with the ISDA Master Agreement and the specific deal confirmations.

The collateralization of derivatives will prevent corporates from being «stuck» with deep «in-the-money» hedges. Rather than having to constantly monitor the evolution of the market value and the credit spread of the counterparty, the CSA will automatically adjust the collateral to fluctuations in the market value. This explains why the CSA has become the most widely used risk mitigation tool in the OTC interbank market.

Not to hedge is rarely an alternative and, as «The Economist» pointed out in an article on corporate hedging: «The only thing more dangerous than having too many derivatives floating around the financial system, it seems, may be having too few of them.»²⁷

²⁶ For instance, the Directive sets forth that collateral provider and collateral taker must fall in certain categories. In particular, if a party to a collateral arrangement is a legal person, the other party must be financial institution (see art. 1 para 2(e) Directive 2002/47/EC).

²⁷ The Economist, «The perils of prudence», June 20th, 2009.