

**UPDATE 16**  
**October 2006**

**Contents**

[U16.01] Flawed Asset Provisions

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This update contains two approaches for dealing with an issue concerning Section 2(a)(iii) of the ISDA Master Agreement (commonly referred to as the “flawed asset” provision).

Section 2(a)(iii) of the ISDA Master Agreement provides that the obligation of a party to make a payment or delivery is subject to the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing.

There could be circumstances where, following a party becoming a Defaulting Party, the other chooses to exercise their rights under Section 2(a)(iii) to avoid making payments to the Defaulting Party. This could be to the disadvantage of the Defaulting Party because a Defaulting Party does not have the right to terminate the ISDA Master Agreement.

Examples of circumstances where a Non-defaulting Party may decide to exercise its rights under Section 2(a)(iii) are if the Defaulting Party:

- would be entitled to receive the Section 6(e) amount if the ISDA Master Agreement were to be terminated; or
- is holding only bought options and has fully met its premium obligations.

If Section 2(a)(iii) is not adjusted to deal with these types of circumstances, it can mean that the Non-defaulting Party is never required to pay (unless the event of Default or Potential Event of Default is no longer continuing), even if it is out-of-the-money. Some parties may find the outcome of section 2(a)(iii) inequitable.

The Guide now sets out in [18.02] two potential approaches for dealing with this issue, one based on amending the Condition Precedent in Section 2(a)(iii)(1), the other based on a Additional Termination Event.

The Guide formerly recommended only the amended Condition Precedent wording.