DERIVATIVES LAWS AND REGULATIONS FOR ALTERNATIVE ASSET MANAGERS

PRECISION AND PROCESS IN CLOSE-OUT: NAVIGATING ENFORCEMENT AND CALCULATION UNDER THE ISDA MASTER AGREEMENT

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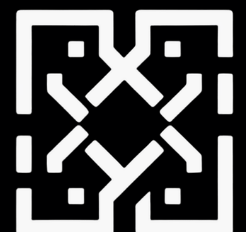

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Introduction

The ISDA Master Agreement lies at the heart of the over-the-counter (OTC) derivatives market and, accordingly, the contractual enforcement mechanism built in to the ISDA Master Agreement (referred to as closing out) lies at the heart of risk mitigation of the derivatives market. It serves as the primary legal mechanism by which a specified party can terminate outstanding transactions, calculate exposures, and crystallize obligations in response to an Event of Default or Termination Event under the ISDA Master Agreement. The party which has the right to terminate will depend on whether an Event of Default or Termination Event (and then, which type of Termination Event) has occurred and is discussed in further detail below. Whilst conceptually straightforward, the close-out process involves a series of critical procedural steps—each with significant legal, operational, and financial consequences if not executed in strict compliance with the terms of the agreement.

Over the past two decades, a growing body of case law—particularly in the wake of the global financial crisis (GFC) and more recently during the market disruptions triggered by the COVID-19 pandemic—has underscored the importance of precision in executing close-outs. Institutions that failed to follow the contractual provisions strictly have found their terminations challenged, their valuations disputed, and their rights to enforce close-out amounts impaired. These procedural missteps often stem not necessarily from a misunderstanding of the substantive rights under the ISDA framework, but from lapses in following the precise letter of the terms of the contract.Notwithstanding that a procedural mis-step may seem relatively minor to the innocent bystander, the economic ramifications of doing so can be significant. For example, you may have a portfolio of derivatives transactions with Counterparty A which is in-the-money to you at the time at which you attempt to close-out. Had you closed out correctly, that amount would have been payable to you because the exposure under the transactions crystalizes at the point of termination.But by virtue of failing to deliver a notice correctly (for example), the transactions continue to live on and by the time you find out your mistake, the market has moved in the opposite direction.Thus, when you actually crystalize exposure by correctly terminating, you owe Counterparty A money instead. If you had hedged your position with Counterparty B and closed out the hedge at the same time as the initial (unsuccessful) attempt to close out in the above example, you would have owed money to your hedge Counterparty B on closing out the hedge, and then continued unhedged in respect of exposure to Counterparty A, owing it money in addition when you are eventually successful in closing out against them.

This chapter aims to provide a clear and practical roadmap for navigating the close-out process under the ISDA Master Agreement. It focuses in particular on the legal and operational importance of correctly giving termination-related notices—a frequently underestimated aspect of close-out mechanics and a recurring source of institutional error - and also focuses on recent industry initiatives aimed at facilitating the process. By examining both the traditional steps involved in enforcing close-out rights and the emerging tools developed by ISDA to support this process, this chapter highlights the critical interplay between documentation, internal procedures, and enforceability. The objective is to equip practitioners with the knowledge needed to execute close-outs with confidence and legal certainty, while avoiding common and often costly pitfalls.

Capitalised terms not otherwise defined in this article have the meanings given to them in the 1992 or 2002 ISDA Master Agreement, as published by the International Swaps and Derivatives Association, Inc (ISDA®).

The Close-Out Process under the ISDA Master Agreement

The ISDA Master Agreement provides a standardized contractual framework for managing default scenarios in respect of derivatives transactions entered into under it. Central to this framework is the close-out process, which enables a specified party to terminate specified transactions, quantify exposure, and seek recovery of net obligations. This section outlines the key stages of the close-out process, beginning with the identification of a default or other event entitling a party to terminate and culminating in final settlement. It also highlights structural differences between the 1992 and 2002 ISDA Master Agreements, with particular focus on the valuation methodologies that govern the determination of losses.

A. Events of Default and Termination Events

The close-out process is triggered by the occurrence of either an Event of Default or a Termination Event, each defined in Section 5 of the ISDA Master Agreement (and potentially added to or amended pursuant to the Schedule to the ISDA Master Agreement by specific negotiation). Events of Default include insolvency, failure to pay or deliver, breach of agreement, and cross-default, among others and tend to be seen as fault based events. Termination Events include Illegality, Force Majeure, and Tax Events, as well as Additional Termination Events negotiated in the Schedule, and tend to be seen as less fault based.

Events of Default typically confer discretionary termination rights on the non-defaulting party and result in the termination of all outstanding Transactions. However, if so elected in the Schedule, certain Bankruptcy related events may lead to an automatic early termination of all outstanding Transactions, without the need for service of any notice. Parties would only typically be advised to elect to apply the automatic early termination provisions where recommended under the relevant insolvency jurisdiction of their counterparty (where otherwise elective termination post the relevant insolvency events might not be enforceable).The procedural advantages of not applying automatic early termination provisions (where such provisions are not required as described above) are that the non-defaulting party has more control over the timescales involved and is thus more able to meet the timing requirements set out in the terms of the agreement. Termination Events typically confer discretionary termination rights in respect of Affected Transactions, but may require certain procedural steps and/or mutual cooperation to resolve the event in question before those rights arise. In both cases, the exercise of close-out rights must comply with formal requirements—including the timely and proper delivery of relevant notices (save where automatic early termination applies).

B. Stages of the Close-Out Process

The close-out process typically unfolds in certain key stages:

1. Crystalizing a right to terminate

Depending on the specific termination event that a party is looking to invoke, certain steps might be required in order to crystalize that right. For example, if a party is looking to terminate as a result of its counterparty failing to pay an amount owing, it must first, pursuant to the terms of Section 5(a)(i) of the ISDA Master Agreement, deliver a notice to the counterparty (often referred to as a Potential Failure to Pay notice).The counterparty then has a one Local Business Day grace period in which to pay the amount owing. It is only if the counterparty has failed to remedy the failure within one Local Business Day of such notice that it will become an Event of Default under Section 5(a)(i). If a Potential Failure to Pay notice is not given in accordance with the terms of the ISDA Master Agreement, then no Failure to Pay Event of Default will have occurred and no right to terminate will have arisen (and any purported exercise of such a termination right would be void). A further example is a Tax Event, where a party is required as a condition to its right to terminate, to use all reasonable efforts to transfer its obligations such that the Tax Event ceases to exist. Waiting Periods also exist in respect of Illegality and Force Majeure Termination Events before they crystalize into a right to terminate.

It is critical therefore that a party looking to exercise a right to terminate looks carefully at the requirements of the ISDA Master Agreement and follows them to the letter in order to crystalize that right before purporting to designate an Early Termination Date.

2. Designation of the Early Termination Date (ETD)

Section 6(a) of the ISDA Master Agreement provides that where an Event of Default has occurred, the Non-defaulting party may, by not more than 20 days notice to the Defaulting Party, designate a day not earlier than the day such notice is effective as an Early Termination Date in respect of all outstanding Transactions, thereby terminating all Transactions governed by the Master Agreement. Section 6(b) of the ISDA Master Agreement sets out the party entitled to designate an Early Termination Date in respect of a Termination Event and the Transactions in respect of which it may make such designation. This will depend on the particular Termination Event you are seeking to rely upon. So where, for example, an Additional Termination Event has occurred and there is only one Affected Party, the party specified in the Schedule as the Non-affected Party may by not more than 20 days notice to the other party designate a day not earlier than the date such notice is effective as an Early Termination Date in respect of the Transactions specified in the Schedule as Affected Transactions.

By contrast, the 2002 ISDA Master Agreement introduced a unified and more flexible concept: the Close-Out Amount, which permits the determining party to use commercially reasonable procedures to arrive at a replacement cost or loss valuation, including observable market data and internal pricing models. Each of these methodologies is looked at in further detail below.

The party calculating the early termination amount will be the Non-defaulting party where the termination follows from an Event of Default or the Non-affected Party where the termination follows from a Termination Event and there is a single Affected Party (meaning the calculation is on its side of the market). Where there are two Affected Parties, each Affected Party will make calculations of value and an average will be taken. Where the Termination Event concerned is an Illegality or Force Majeure, a mid-market value (without regard to the credit worthiness of the determining party) will be taken. The early termination amount calculated under Section 6(e) will be a single sum representing the net of positive and negative termination values for each terminated transaction or group of terminated transactions plus or minus Unpaid Amounts.

3. Delivery of Termination and Valuation Notices

The next step involves the formal communication of termination and valuation outcomes. Under Section 6(d) of the ISDA Master Agreement, the party specified as making calculations under Section 6(e) will provide to the other party a statement showing those calculations in reasonable detail (including any quotations, market data or information from internal sources used in making the calculations), specifying the early termination amount payable and giving details of the relevant account to which any amount payable is to be paid.

As discussed in greater depth in subsequent sections, the correct service of these notices is essential to preserve enforceability, as is ensuring that they contain a sufficient level of detail. Procedural deficiencies in notice delivery and content have given rise to protracted disputes. Following the Court of Appeal judgment in Videocon Global Ltd & Anr v Goldman Sachs International [2016] EQCA Civ 130 it has been clarified that the requirements of Section 6(d) (namely to communicate the amount payable and to communicate in reasonable detail the calculations leading to that determination) can be met in multiple notices, however.

The effective selection of the Early Termination Date is critically important, as it is when exposure under the Terminated Transactions is crystalized. This is because, pursuant to Section 6(c) of the ISDA Master Agreement, upon effective designation of an Early Termination Date, no further payments are due under the Terminated Transactions themselves and instead a single amount calculated in accordance with the close-out procedure becomes payable. Thus, the Early Termination Date defines the valuation point for outstanding obligations and can materially affect the quantum of recovery or exposure.

The notice of Early Termination Date must be served in strict accordance with Section 12 (Notices) of the Master Agreement and any elections or modifications made in the Schedule. A failure to comply with notice provisions—such as sending to an incorrect address or using an unapproved method of communication—can render the termination invalid or open to dispute. It is also important to note that the Early Termination Date designated must be a day not earlier than the day the notice designating it is effective.So if, for example, you designated Friday 27 June as the Early Termination Date and sent the notice on 27 June, but as a result of the notice provisions the notice is not effective on that date (because for example it is not a Local Business Day or was delivered or received after close of business), then the notice will not be effective until Monday 30 June. As a result, you will not have met the requirement of designating an Early Termination Date “not earlier than the day the notice designating it is effective” and will therefore not have effectively designated an Early Termination Date nor terminated the relevant Transactions (the exposure under which will therefore continue to move in accordance with the market).

3. Calculation of Close-Out Amount

On or as soon as reasonably practicable following the occurrence of an Early Termination Date, the party specified in Section 6(e) of the ISDA Master Agreement must make the calculations required of it under that Section. This essentially means that it must determine the single net close-out amount payable, which will be based in part on the economic value of the Terminated Transactions and will also take into account amounts which had previously become due and payable but remain unpaid, together with interest that has accrued on those amounts under the terms of the ISDA (these amounts, including interest, being referred to as Unpaid Amounts). Under the 1992 ISDA, Transactions are valued using either the Market Quotation method (based on dealer quotations for an amount that would be paid or payable to enter into a replacement transaction) or the Loss method (an assessment of the gains or losses incurred as a result of the termination, including the cost of terminating or re-establishing hedge positions), depending on the elections in the Schedule.

4. Settlement and Payment Obligations

The amount payable by a party and set out in the settlement notice will take into account the net early termination amount calculated under Section 6(e) of the ISDA Master Agreement (which is actually defined as the Early Termination Amount under the 2002 ISDA Master Agreement, but is not defined as such in the 1992 ISDA Master Agreement), collateral balances (to the extent not included in that calculation), interest claimed on the early termination amount pursuant to Section 9, expenses claimed pursuant to Section 11 and net of any applicable set-off rights. It is important to note that where collateral is held under a title transfer arrangement (e.g. English law governed Credit Support Annex (CSA)), the CSA constitutes a Transaction in its own right under the ISDA Master Agreement. As such, its “value” (which will be equal to the amount of collateral transferred to a party, expressed as a negative figure) will form an integral part of the net amount payable under Section 6(e). Where collateral is held under a security arrangement (e.g. English law governed Credit Support Deed (CSD) the secured party may enforce against that security and apply the proceeds of such enforcement against the early termination amount (thus reducing the amount payable). The settlement notice should make clear the way in which collateral has been treated.

As clarified in the Videocon case referred to above, the early termination amount becomes due on the Early Termination Date, but is payable on the date the Section 6(d) notice is effective.

C. Key Differences Between the 1992 and 2002 ISDA Master Agreements

While the overarching structure of the close-out process is broadly consistent across ISDA versions, there are important differences in both terminology and methodology:

- Valuation Framework:
    - 1992 ISDA: Parties must elect between Market Quotation and Loss methodologies (although there is a fall back to the Loss methodology where Market Quotation cannot be determined or would not produce a commercially reasonable result). Market Quotation is based on dealer quotes; Loss is a more discretionary measure of actual or reasonably expected loss.

    - 2002 ISDA: Replaces both with the Close-Out Amount, which allows for a wider range of valuation inputs and recognizes commercial reasonableness as the standard. Note that it is possible to have a 1992 ISDA Master Agreement and still use the Close-Out Amount valuation contained in the 2002 ISDA Master Agreement where the parties have both adhered to ISDA’s Close Out Amount Protocol.

- Payment Methodology:
  - 1992 ISDA: Parties may elect either the First Method or Second Method in the event of termination. Under First Method, no payment is made if the defaulting party is owed money. This method has largely fallen out of use due, amongst other reasons, to the capital implications of including such a walkaway clause.
  - 2002 ISDA: The First Method is eliminated, with all net payable amounts due regardless of which party is in-the-money.

These changes reflect the industry's evolving preference for greater flexibility and commercial discretion in stress scenarios, while also simplifying documentation and dispute resolution.

The Central Role of Properly Served Notices

Among the many procedural elements involved in the close-out process, the proper service of notices is both deceptively simple and disproportionately consequential. Despite the availability of standard contractual provisions under the ISDA Master Agreement, institutions frequently fall short in executing this critical step—often with costly results. Notice-related failures have emerged as one of the most common sources of litigation and dispute in the aftermath of close-outs, particularly in periods of financial stress such as the 2008 global financial crisis and the COVID-19 market dislocations.

A. Institutional Error and the Legal Weight of Notices

The service of notices is not a mere formality—it is a contractual precondition to effective termination. Unless notice is delivered in strict compliance with the agreed method, timing, format, and recipient details set out in the ISDA Master Agreement and accompanying Schedule, the purported termination may be legally ineffective. This can undermine the validity of the designation of an Early Termination Date, delay the calculation of close-out amounts (thus meaning that exposure under Transactions is not crystalized and continues to be subject to market volatility), potentially lead to a party unintentionally breaching its own obligations under Transactions (which remain outstanding until correctly terminated), and render any demand for payment open to challenge.

Such errors often arise not from misunderstanding substantive rights under the agreement, but from lapses in administrative practice: using outdated addresses, using addresses that are not specified in the Schedule, delivering to the wrong individual, relying on email when courier service is required, or failing to retain verifiable proof of delivery. These mistakes are especially prevalent during periods of stress, when counterparties may be in insolvency, reorganizations, or otherwise operationally disrupted.

B. Case Law and Disputes Post-GFC and COVID-19

Disputes over notice have formed the basis of high-profile litigation, especially following the 2008 crisis. In many cases, counterparties challenged the enforceability of close-outs on the grounds that termination notices were either never received, delivered by unauthorized methods, or addressed to the wrong legal entity. The COVID-19 pandemic exposed similar weaknesses, with office closures, remote work, and outdated records impairing the ability of firms to comply with notice provisions exactly as drafted.

Courts have generally taken a strict contractual interpretation of Section 12 of the ISDA Master Agreement. Where parties have attempted delivery via email for example, such delivery —even if acknowledged—may not satisfy the formal requirements as Section 12 (unless amended in the Schedule) provides that notices under Section 5 and 6 of the ISDA Master Agreement (which includes a notice designating an Early Termination Date) may not be given by electronic messaging system or e-mail. This places the burden squarely on the terminating party to ensure procedural compliance.

C. Section 12 and the Role of the Schedule

Section 12 of the ISDA Master Agreement governs notices and communications, including requirements for method of delivery, deemed timing of receipt, and designation of contact details. However, the core terms of Section 12 may be heavily customized by each party in the Schedule.

Typical Schedule elections may specify:

- Permitted methods of delivery (e.g., personal delivery, courier, fax, or in some cases, email);
- Physical or electronic addresses for service of notice;
- Named contact persons or departments;
- Hours or days during which notice is deemed effective (e.g., business days, local time zones).

These elections override the default language and must be followed precisely. In amended or novated agreements, or in the context of ongoing counterparty onboarding, it is common for notice information to become outdated—posing further risk if internal systems are not updated to reflect the latest Schedule terms.

D. Common Pitfalls in Practice

Several recurring errors have been observed across institutions, often exacerbated during high-volume or high-pressure close-out scenarios:

- Failure to follow the agreed method of delivery: Substituting email or soft-copy transmission for required courier or fax delivery, without express authorization in the Schedule.
- Use of outdated or incorrect notice details: Relying on pre-novation or superseded versions of the Schedule, or failing to verify counterparty office relocations or contact changes.

- Misinterpretation of deemed receipt rules: Assuming that notice is effective when sent, rather than when actually received or deemed received under Section 12 or forgetting that a notice not delivered or received (as applicable) on a Local Business Day or before close of business on a Local Business Day will not be deemed effective until the next following Local Business Day.
- Service on non-designated individuals: Sending notices to legal or trading personnel not authorized to receive formal notices under the agreement.

E. Consequences of Defective Notice

The consequences of a defective notice can be severe. At a minimum, a defective notice may:

- Invalidate the designation of the Early Termination Date, disrupting the close-out timeline;
- Delay or undermine recovery by preventing crystallization of obligations;
- Expose the institution to counterparty litigation, especially if close-out amounts are contested;
- Trigger reputational and regulatory risk, particularly where valuation timing is disputed.

In enforcement scenarios—especially those involving distressed counterparties or insolvency proceedings—the burden of proof rests squarely on the party alleging proper service. Absent verifiable evidence of timely and contractually valid delivery, the non-defaulting party may find its rights substantially impaired.Certain jurisdictions may have additional requirements for evidencing service of notice, so the advice of local counsel may be required.

New ISDA Tools and Operational Supports

In recognition of the persistent challenges associated with the service of close-out notices, ISDA has introduced a series of digital tools aimed at enhancing legal certainty, operational efficiency, and standardization across the market. Chief among these are the ISDA Notices Hub and the Close-Out Framework initiative, which form part of a strategic shift toward digitizing the infrastructure underpinning termination and enforcement mechanics in the derivatives space.

A. The ISDA Notices Hub and Close-Out Framework Initiatives

The ISDA Notices Hub is an online platform designed to centralize and standardize the delivery of formal notices under ISDA documentation. The platform allows firms to upload and maintain verified contact information for notice delivery—including legal addresses, designated recipients, and preferred delivery methods—as specified in their Schedules or master data repositories. Through this centralized hub, market participants can serve notices in a manner that complies with the delivery provisions of the ISDA Master Agreement, while retaining an auditable trail of timing, content, and delivery method. The hub is integrated with ISDA Create such that notices drafted on ISDA Create can be served directly through the ISDA Notices Hub.

Complementing the Notices Hub is the ISDA Close-Out Framework, a reference tool that was prepared following the Signature Bank and SVB close-outs with the aim of helping market participants to prepare for potential close-out scenarios and thus facilitate orderly terminations during periods of systemic market stress. The framework provides a step by step guide on how to exercise close-out rights under the ISDA Master Agreement from default through to collateral enforcement.

Together, these initiatives reflect ISDA's broader effort to streamline legal execution and reduce disputes arising from procedural missteps—particularly in volatile or high-volume termination events or where parties are trying to deliver to a hostile environment (such as when parties were attempting to deliver termination notices to Russian counterparties following the invasion of Ukraine).

B. Benefits of Digitization: Accuracy, Evidence, and Efficiency

The operational benefits of digitizing notice delivery are substantial:

- Verified Contact Details: The Hub ensures that notice information is current and contractually accurate, reducing the risk of misdirected or ineffective delivery.
- Audit Trail: Time-stamped logs provide irrefutable evidence of notice transmission and receipt, supporting enforceability and dispute resolution.

The initiative is particularly relevant for global institutions managing large counterparty books, where manual processes have historically struggled to keep pace with legal and operational complexity.

A Protocol has been published which allows parties to an ISDA Master Agreement to amend the terms of their ISDA Master Agreement to allow for delivery via the ISDA Notices Hub by adhering to the Protocol. The amendments will be deemed to take effect in respect of ISDA Master Agreements where both parties have adhered to the protocol. For new ISDA Master Agreements, a standard form bi-lateral amendment agreement has been published. The ISDA Notices Hub went live on 15 July (which was the Protocol Effective Date), with adherents onboarding from that date and larger dealer institutions expected to reach out to their client base. As with all protocols, its success will depend on the level of adherence. As at the date of writing, approximately 150 institutions had adhered to the Protocol. Where both parties do not adhere (or otherwise amend their ISDA Master Agreements to the same effect), institutions will need to continue to rely on legacy processes, including email, fax, or physical courier services. Adoption of the new provisions could be hindered or delayed for some institutions due to internal system constraints or uncertainty around the legal sufficiency of digital platforms under applicable law.

D. Integration with Internal Systems

To realize the full benefit of these innovations, institutions must ensure that ISDA’s tools are fully integrated with internal systems, particularly across:

- Legal and Documentation teams (to align contractual terms with operational delivery mechanisms);
- Operations and Treasury functions (to coordinate timing and execution of notices and payments);
- Technology and Risk functions (to manage workflows, escalation procedures, and recordkeeping).

Embedding the ISDA Notices Hub into automated workflows—linked to termination triggers, document repositories, and transaction data—can materially reduce execution risk. For large or systemically active firms, this integration may form part of broader contract lifecycle management (CLM) or derivatives workflow automation initiatives.

Mechanics of Close-Out: Steps, Documentation, and Delivery

Executing a close-out under the ISDA Master Agreement requires not only the correct invocation of termination rights but also the timely and properly documented completion of a series of procedural steps. These steps are underpinned by specific legal notices, internal workflows, and evidentiary standards that must be adhered to in order to ensure enforceability. This section outlines the core documentation required, the internal responsibilities for their execution, and best practices for evidencing valid delivery. A. Core Notices and Documentation

The following documents are typically required in the course of a close-out. Each must be delivered in accordance with Section 12 (Notices) of the ISDA Master Agreement, as amended by any bespoke provisions in the Schedule:

1. Notice to Crystalize Event of Default or Termination Event (Section 5 Notice)
    - Certain Events of Default or Termination Events require a notice to be given in order to crystalize the relevant event into an actionable Event of Default or Termination Event. For example, where a party has failed to pay an amount, it only becomes a Failure to Pay Event of Default under Section 5(a)(i) of the ISDA Master once the other party has been notified of the failure and has not remedied that failure within one Local Business Day of such notice. The notice should be clear as to the particular Event of Default or Termination Event, the provisions of the Agreement for which the notice is being served and the consequence of any failure to act.

1. Notice to Designate Early Termination Date (ETD) (Section 6(a)/6(b) Notice)
    - This notice sets out the specific contractual basis for the close-out and formally invokes the non-defaulting party’s right to designate an ETD.
    - In the case of a Section 6(a) (Event of Default) notice, it must specify the particular Event of Default (and should give sufficient detail to establish that Event of Default), which must be continuing and designate the ETD. The ETD designated must be no earlier than the date such notice is effective and no more than 20 days thereafter.

- In the case of a Section 6(a) (Event of Default) notice, it must specify the particular Event of Default (and should give sufficient detail to establish that Event of Default), which must be continuing and designate the ETD. The ETD designated must be no earlier than the date such notice is effective and no more than 20 days thereafter.
- In the case of a close-out under Section 6(b) (Termination Event) the notices required will depend on the particular Termination Event. So where, for example, an Additional Termination Event has occurred and is continuing, the Affected Party may deliver a notice which designates the ETD (which must be no earlier than the date such notice is effective and no more than 20 days thereafter), giving reasonable detail and specifying the Affected Transactions to be terminated under Sections 6(b)(i) and (iv) of the ISDA Master Agreement. The process for an Additional Termination Event is therefore much the same as for an Event of Default. By contrast, where there is a Tax Event (and only one Affected Party), that party should give notice under Section 6(b)(i) specifying the nature of the Termination Event and each Affected Transaction and giving the other party such information as it may reasonably require (the Section 6(b)(i) Notice) and, within 20 days of such Section 6(b)(i) Notice, use all reasonable efforts to transfer all its rights and obligations to remedy the Tax Event. Where it is not able to, it must give a further notice within that 20 day period, whereupon the other party may itself effect a transfer within 30 days after the Section 6(b)(i) Notice. Where that other party is not able to effect a transfer within such 30 day period to cure the Tax Event, any Affected Party may deliver a notice under Section 6(b)(iv) of the ISDA Master Agreement specifying the Termination Event and that it is still continuing in respect of the Affected Transactions and designating an ETD (which must be no earlier than the date such notice is effective and no more than 20 days thereafter). Different processes apply for separate Termination Events and the correct process, as set out in Section 6(b) of the ISDA Master Agreement, should be followed to the letter in respect of the particular Termination Event a party is looking to rely upon. This may involve multiple notices over time.
- Each notice must be sent to the correct notice address and by the agreed method of delivery (with proof of delivery retained in case of dispute) to ensure validity.

3. Statement of Amount Payable and Calculation (Section 6(d) Notice)
    - A calculation statement detailing the valuation of terminated transactions and the net amount payable, calculated in accordance with Section 6(e) of the Agreement should be provided by the party making those calculations under Section 6(e).
    - For agreements governed by the 2002 ISDA, this will reflect the “Close-Out Amount”; under the 1992 ISDA, it may involve “Loss” or “Market Quotation” methodologies, depending on Schedule elections.

- oThe statement should also set out the overall amount payable (which will take into account interest to the date of the statement, collateral positions and allowable expenses) and the account to which the amount payable should be paid.
- oThe calculation statement should show, in reasonable detail, the calculations including any quotations, market data or information form internal sources used. This does not require a party to show all data used or collected, but should be sufficient for a counterparty to be able to make a determination as to whether to challenge the claim based on the requirements of the Agreement. So, for example, it has been held in case law that it is not sufficient to simply say that an amount has been determined under an internal methodology without giving further details as to the parameters of that methodology. Whilst not necessarily contractually required to be given, supplementary materials evidencing how the Close-Out Amount or Loss was determined may be critical in the event of a dispute and may be requested by counterparties or regulators.
- These documents should be carefully reviewed, approved internally, and executed in accordance with firm policy, ensuring consistency with the governing agreement and audit readiness.

B. Internal Roles and Responsibilities

The close-out process involves coordinated action across multiple departments. To ensure procedural integrity, institutions should establish clear internal protocols assigning responsibility for drafting, reviewing, sending, and retaining close-out documentation, such as those below:

- Legal Department:
- Confirms contractual rights to terminate and ensures that notices are drafted and reviewed in line with the governing agreement.
- Operations/Middle Office:
- Responsible for coordinating delivery, tracking responses, and maintaining records of all outgoing notices and communications.
- Front Office or Trading:
- May provide pricing inputs or contextual background on the counterparty relationship; typically not responsible for formal notices.
- Treasury/Finance:
- Assists with payment netting, collateral reconciliation, and downstream settlement.

A centralized playbook or close-out protocol can help institutionalize these roles and ensure alignment under time-sensitive conditions.

C. Best Practices for Evidencing Delivery

Proper execution of a close-out is incomplete without demonstrable proof of delivery. Legal and operational certainty depends on preserving a defensible audit trail showing that notices were sent and received in accordance with the contract.

Key best practices include:

- Retention of Proof of Delivery
    - Maintain courier receipts, fax confirmations, read receipts (if email is permitted), or platform logs (e.g., from the ISDA Notices Hub).
    - Archive original documents and delivery records in a secure, easily retrievable repository.
- Timestamping
    - Ensure all notices are dated, time-stamped, and—where relevant—logged in systems that reflect the time of dispatch and receipt in the applicable time zone.
    - For email or electronic service, retain metadata or use systems that generate delivery acknowledgments.
- Internal Logging and Escalation Procedures
    - Record all notices in a centralized tracking system or legal database.
    - Implement escalation protocols for notices that are rejected, returned, or remain unacknowledged after a defined period.
    - Document follow-ups, counterparty responses, and any remedial steps taken in real time.

Institutions should periodically test and review these processes, particularly for high-risk counterparties or in anticipation of stress events. A well-documented close-out not only enhances enforceability but also strengthens regulatory defensibility and reduces post-termination litigation exposure.

Calculating the Close-Out Amount

Valuation is the linchpin of the close-out process. The party specified in Section 6(e) of the ISDA Master Agreement (the Determining Party, which will be the Non-defaulting Party where the Early Termination Date has been designated as a result of an Event of Default, for example) must, on or as soon as reasonably practicable following the occurrence of an Early Termination Date, make the calculations set out in Section 6(e). This means that it will determine the economic impact of terminating the affected transactions, involving quantifying replacement costs or losses and producing a defensible Close-Out Amount in accordance with the methodology prescribed by the relevant version of the ISDA Master Agreement and any elections made in the Schedule. The credibility, documentation, and timing of this calculation are central to enforceability, particularly in the event of dispute.

A. Key Calculation Approaches

The method by which close-out exposure is calculated differs significantly between the 1992 ISDA Master Agreement and the 2002 ISDA Master Agreement.

1. 2002 ISDA: The “Close-Out Amount” Framework

The 2002 ISDA Master Agreement replaced the bifurcated “Loss” and “Market Quotation” options with a single, more flexible concept: the Close-Out Amount. Defined in Section 14, this requires the Determining Party to act in good faith and use commercially reasonable procedures to calculate the losses or costs (expressed as a positive number) or gains (expressed as a negative number) in replacing or providing the economic equivalent of the material terms of the terminated transactions. The Determining Party may consider any relevant information in making its calculation, including, without limitation:

- Market quotations from dealers;
- Internal models and pricing systems;
- Published prices or market screens;
- Relevant market data.

The emphasis is on commercial reasonableness, which provides broader discretion than earlier formulations but also introduces a higher burden of procedural fairness and documentation. The 2002 framework also enables the Determining Party to take into account the cost of funding, liquidity conditions, and efforts to mitigate losses through hedging or offsetting trades.A Close-out Amount may be determined in respect of each

Terminated Transaction separately or in aggregate in respect of a group of Terminated Transactions. Note that Unpaid Amounts (being amounts due but not paid under Transactions prior to the designation of an ETD) do not form a part of the “Close-out Amount” but do form part of the “Early Termination Amount” due under Section 6(e), which is formed of the aggregate of Close-out Amounts (positive or negative) together with Unpaid Amounts owed to or owing by the Determining Party (with each amount converted into the Termination Currency). Interest and legal fees and out of pocket expenses allowed pursuant to Section 11 do not form part of the Early Termination Amount (save to the extent interest on unpaid amounts forms a part of the Unpaid Amount itself), but can be claimed under the Section 6(d) Notice.

2. 1992 ISDA: “Loss” and “Market Quotation” Methods

Under the 1992 ISDA, parties may elect in the Schedule to apply either:

- Market Quotation: An average of firm quotations obtained from leading dealers, reflecting the amount a party would pay or receive to replace the terminated transactions;
- Loss: An amount the Determining Party reasonably determines in good faith to be its total losses and costs (expressed as a positive number), or gains (expressed as a negative number) including any loss of bargain, cost of funding or losses incurred in terminating, liquidating, obtaining or re-establishing any hedge or related trading positions.

The Market Quotation method offers greater objectivity but may become unworkable during market disruption or illiquidity. Where Market Quotation cannot be determined (which is deemed to be the case if fewer than three quotations are provided) or would not produce a commercially reasonable result, the valuation methodology falls back to Loss. The Loss method allows greater flexibility, but has historically given rise to more valuation disputes, especially where the determining party fails to document the basis of its calculation or the steps taken to mitigate losses. As with the Close-out Amount methodology, Market Quotations or Loss may be determined in respect of each Terminated Transaction separately or in aggregate in respect of a group of (or all) Terminated Transactions.Note that Unpaid Amounts do not form a part of “Market Quotation” but do form part of “Loss”. The amount due under Section 6(e) is formed of the aggregate of Market Quotations (positive or negative) together with Unpaid Amounts owed to or owing by the Determining Party or Losses (which include Unpaid Amounts) (with each amount converted into the Termination Currency). Again, interest and legal fees and out of pocket expenses allowed pursuant to Section 11 do not form part of the amount payable under Section 6(e) (save to the extent interest on unpaid amounts forms a part of the Unpaid Amount itself), but can be claimed under the Section 6(d) Notice.

B. Valuation Timing and Data Sources

The relevant valuation date should be on or as soon as reasonably practicable following the occurrence of an Early Termination Date. What constitutes "as soon as reasonably practicable" will be a matter of judgement based upon the facts in question. So if, for example, there are one or two simple option Transactions under the ISDA Master Agreement, it would be reasonable to expect valuation to occur straight away, unless there was market disruption meaning it would not be commercially reasonable to use market data collected on such date. On the other hand, if your portfolio consists of hundreds of bespoke trades across a variety of asset classes and Transaction types, a longer timeframe will be needed in order to carry out valuation procedures. It is important to note the requirement for valuation to occur in a commercially reasonable timeframe, however, and preparations for valuation should be taken into account when considering the timing of notices designating an ETD.

Acceptable data sources include:

- Dealer quotes (solicited bids);
- Market screens (e.g., Bloomberg, Reuters);
- Internal pricing models, where external quotes are unavailable;
- Executed or indicative replacement transactions.

Institutions should exercise care in selecting and documenting these sources, especially if the calculation results in a significant payable or receivable amount. The use of stale, interpolated, or unverified data can undermine the validity of the Close-Out Amount in a contested enforcement scenario.

C. Documentation of Pricing Assumptions and Mitigation Efforts

Robust internal documentation is essential to defend the integrity of a Close-Out Amount.

Key elements include:

- Pricing assumptions (e.g., volatility, interest rate curves, credit spreads);
- Model inputs and methodologies, if internal systems are used;
- Evidence of dealer outreach, including failed quote attempts;
- Hedging or mitigation strategies taken to reduce loss exposure;
- Approval processes and internal review records.

Well-maintained records enhance credibility in disputes, facilitate internal audit and regulatory review, and provide transparency in counterparty communications.

D. Handling Illiquid or Distressed Positions

Illiquidity—particularly in exotic derivatives, bespoke structured products, or stress markets—poses unique challenges. Where no reliable market data exists, institutions may need to rely on:

- Internal models validated by risk and valuation committees;
- Proxy instruments or curve extrapolations;
- Discounted cash flow analyses or scenario-based pricing.

These valuations must still conform to the principle of commercial reasonableness and be supported by contemporaneous documentation. Failure to reasonably explain the chosen approach or failure to attempt price discovery may expose the Close-Out Amount to challenge under both ISDA's terms and general principles of good faith and fair dealing.

E. Treatment of Collateral and Set-Off

The final net payable amount following close-out must reflect:

- Any posted or received collateral under the Credit Support Annex (CSA) which can be applied (to the extent such amount is not already included as an integral amount under the amount payable under Section 6(e) where the CSA has been valued as a Transaction (as will be the case in a title transfer CSA));
- Interest accrued on the early termination amount under the ISDA Master Agreement;
- Applicable set-off rights, whether contractual or equitable;
- Expenses which have been indemnified against under Section 11 of the ISDA Master Agreement.

Proper reconciliation of collateral at the time of close-out is critical, particularly in margin call disputes or where collateral includes illiquid assets (e.g., securities or crypto tokens). Institutions must also ensure that collateral is applied in accordance with the CSA's terms and consistent with local legal enforceability rules, especially in cross-border or insolvency contexts.

Disputes and Enforcement: Lessons from the GFC and COVID-19

The global financial crisis (GFC) of 2008 and the COVID-19 pandemic of 2020–2021 exposed significant fault lines in the close-out processes employed across the derivatives market. These periods of systemic stress highlighted not only the legal and operational complexity of enforcing close-outs but also the frequency with which procedural missteps can undermine enforceability. A review of the litigation and regulatory developments from these crises reveals a set of recurring issues—including defective notices, valuation disputes, and confusion over contractual relief clauses—which continue to inform best practices in close-out execution today.

A. Litigation over Close-Out Mechanics

Several prominent post-GFC and pandemic-era cases have arisen from close-outs, including disputes over:

- Defective or misdelivered notices: Parties have frequently contested the effectiveness of termination notices where the delivery method did not comply with the ISDA Master Agreement or where notices were sent to incorrect or outdated addresses. Courts have taken a strict approach to notice provisions, requiring exact compliance with Section 12 and Schedule elections.
- Improper valuation: Disputes have also centered on the methodology and timing of close-out calculations. For instance, in Lomas v. Firth Rixson and Lehman Brothers International (Europe) v. ExxonMobil, issues arose around the calculation of "Loss" and the timing of market quotes during periods of illiquidity. Challenges have arisen relating to what is considered to meet the standards of reasonableness or good faith, as in Barclays Bank Plc v Unicredit Bank AG. Similar challenges followed the market volatility of early 2020, when counterparties disagreed on whether the prevailing prices used in Close-Out Amount determinations were reflective of market reality or distorted by temporary dislocations. Disputes have also been raised based upon the level of disclosure of sources used to calculate an early termination amount, such as in Videocon Global Ltd & Anr v Goldman Sachs International (see prior).
- Disputed termination dates: In some cases, counterparties failed to clearly designate the Early Termination Date, or disputes emerged over whether a valid termination event had occurred in the first place. Without a properly documented and timely Early Termination Date, the close-out valuation—and the contractual right to demand payment—may be compromised.

These disputes underscore the importance of accurate, well-documented, and procedurally correct execution at every stage of the close-out lifecycle.

B. Evidentiary Expectations from Courts and Regulators

Both courts and regulators have reinforced the need for evidentiary rigor when close-outs are challenged. Key expectations include:

- Detailed documentation of pricing inputs, quote requests, and valuation methodologies;
- Demonstrable compliance with contractual notice provisions;
- Contemporaneous records of communications, decision-making, and approvals;
- Clear designation of the Early Termination Date and the calculation basis for any amounts demanded.

Failure to meet these standards may result in courts refusing to uphold a close-out amount, delaying enforcement, or awarding only nominal damages. Regulators, particularly in the aftermath of the GFC, have also scrutinized firms' internal procedures around termination and valuation, especially in cases involving systemic institutions or widespread margin disputes.

Firms that maintain robust internal playbooks, audit trails, and escalation protocols are significantly better positioned to defend their termination actions under regulatory or judicial review.

C. Force Majeure. Illegality and Market Disruption Clauses

Both the GFC and COVID-19, as well as more recent events such as the invasion of Ukraine by Russia and the subsequent sanctioning of Russian entities brought renewed attention to force majeure and illegality clauses and market disruption provisions, particularly in the context of close-out timing and valuation. While force majeure and illegality clauses are more commonly invoked in the context of performance obligations under commercial contracts, their role in derivatives documentation—particularly where a Termination Event is triggered—remains significant.

Under the 2002 ISDA Master Agreement, the Force Majeure Termination Event allows a party to delay performance for a limited period, after which termination may be triggered if the event is not resolved. During COVID-19, several counterparties considered invoking this provision due to government-imposed shutdowns, settlement failures, or other operational disruptions. The Illegality Termination Event came into focus because, whilst a party that was unable to make or receive payments from a Russian counterparty due to sanctions may

have been able to designate an ETD (after the Waiting Period in the case of the 2002 ISDA Master Agreement), it may (as sole Affected Party) not be the party entitled to calculate the Close-out Amount under Section 6(e).

Similarly, market disruption events, commonly found in equity, FX, and commodity derivatives, may delay valuation or settlement under individual confirmations. During the peak of the pandemic, such provisions were tested in instruments referencing suspended markets or assets with no observable price. These disruptions complicated the timing and methodology of close-out calculations and prompted firms to reassess their fallback language and operational readiness.

In both contexts, the key legal lesson is that close-out rights must be exercised in good faith, with awareness of how contractual relief mechanisms may affect timing, valuation, and enforcement options.

Practical Recommendations and Internal Controls

Effective execution of a close-out under the ISDA Master Agreement demands not only legal precision but also robust internal controls and institutional readiness. The lessons drawn from past disputes, evolving best practices, and technological innovations highlight the need for a proactive, cross-functional approach to managing termination scenarios. This section offers practical recommendations for enhancing institutional preparedness and reducing the legal and operational risk associated with close-outs.

A. Cross-Functional Coordination

Close-outs require the seamless coordination of multiple internal teams. Legal, operations, risk, and front office personnel must work in alignment to ensure that the relevant rights are exercised correctly and that documentation, valuation, and communications are completed within the required timelines.

- The Legal function is generally responsible for assessing the contractual basis for termination, reviewing and drafting notices, and advising on risk exposure.
- The Operations function generally manages the logistical aspects of notice delivery, recordkeeping, and post-termination settlement.
- The Risk function ensures pricing and model inputs reflect market conditions and monitors potential counterparty exposure.
- Front Office provides insight into transaction context and supports valuation with market data and counterpart engagement.

Institutions should establish dedicated close-out working groups or escalation committees to coordinate actions during high-risk termination events.

B. Use of Pre-Approved Templates and Playbooks

To streamline the termination process and mitigate the risk of drafting or procedural errors, firms should develop and maintain pre-approved templates for the various notices potentially required throughout the close-out process (for each of the 1992 and 2002 ISDA Master Agreements to the extent both forms are still in use by that firm).

These templates should reflect firmwide policy and be reviewed regularly by Legal and Compliance teams. Additionally, institutions should maintain a close-out playbook—a standardized guide detailing step-by-step procedures, contact roles, approval thresholds, and escalation pathways. This enables consistent execution, even under time pressure or during volatile market conditions.

C. Ongoing Review and Verification of Counterparty Notice Details

A significant number of notice-related failures stem from outdated or inaccurate counterparty contact information. Institutions must implement routine verification procedures to:

- Validate the current notice address and permitted delivery methods per the latest ISDA Schedule or amendment;
- Confirm the designated contact person or department authorized to receive formal communications;
- Update internal records promptly following novations, amendments, mergers, or changes in counterparty operations.

Integration with platforms such as the ISDA Notices Hub can assist in maintaining current and verified notice data across the institution's counterparty portfolio.

D. ISDA Schedule Drafting Tips to Support Enforceability

Many disputes over close-outs could be avoided through careful and forward-looking Schedule drafting. Key drafting recommendations include:

- Electing permitted delivery methods that reflect current operational practices (e.g., allowing for electronic delivery) or allowing for delivery via the ISDA Notices Hub;
- Designating specific notice recipients and fallback addresses;
- Clarifying the methodology for Close-Out Amount determination, including permitted data sources and valuation timeframes;
- Avoiding ambiguous or boilerplate language that may be insufficient in a contested enforcement context.

Where counterparties agree to incorporate digital tools (e.g., the ISDA Notices Hub or automated workflow systems), this should be reflected in the Schedule to ensure legal recognition or there should be a clear process to check whether parties have adhered to the relevant protocol.

E. Training and Awareness for Frontline and Middle-Office Teams

Operational execution failures frequently occur due to a lack of awareness or training among teams directly involved in the day-to-day management of counterparty relationships. Institutions should provide:

- Targeted training to middle office, operations, and legal support staff on notice obligations and ISDA requirements;
- Periodic simulations or tabletop exercises to rehearse close-out scenarios and test readiness;
- Cross-training between functions, enabling backup coverage and improved situational awareness during high-pressure events.

A culture of procedural discipline and legal awareness—supported by tools, training, and internal governance—can materially reduce the risk of enforceability issues in the close-out process.

Conclusion

The close-out process under the ISDA Master Agreement is a critical mechanism for managing counterparty risk in the derivatives market. While the legal framework is well established and tested in the courts, effective execution requires more than knowledge of the contract—it demands operational precision, procedural discipline, and institutional coordination.

This chapter has attempted to highlight some core best practices for ensuring close-outs are conducted with legal and operational certainty: strict compliance with notice provisions; timely designation of Early Termination Dates; transparent and commercially reasonable valuation methodologies; and thorough documentation of all steps and assumptions. Perhaps most importantly, it has emphasized that notice precision is not a formality—it is a strategic risk control. A close-out is only as enforceable as the process by which it is carried out.

The increasing complexity of derivative portfolios, coupled with evolving market conditions and remote operational structures, has introduced new vulnerabilities into the close-out process. However, these challenges are being met with meaningful technological innovation. Tools such as the ISDA Notices Hub, automated workflow systems, and integrated contract lifecycle management platforms now offer institutions the ability to reduce manual errors, verify delivery, and create real-time audit trails. As the industry continues to embrace these technologies, the potential for procedural failures should decline—but only if accompanied by the right governance and contractual alignment.

The call to action is clear: institutions must treat the close-out process as a core component of their risk management architecture. This includes regular internal testing, ensuring systems are properly configured to meet contractual obligations, and conducting periodic legal health checks to validate that documentation, templates, and counterparty records remain fit for purpose.

In a market where timing, accuracy, and evidence can determine the difference between enforceable recovery and protracted dispute, the firms best positioned to manage stress events will be those that invest in the people, processes, and platforms needed to get close-outs right.

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