KEY POINTS

- In *Lomas and others v JFB Firth Rixson, Inc and others*, the English High Court was unable to imply a term that s 2(a)(iii) operates only for a 'reasonable time' therefore permitting the non-defaulting party to withhold payment indefinitely.
- Judge Peck held in the *Metavante* decision that the safe harbour provisions of the US Bankruptcy Code only protect actions that are taken reasonably promptly after the filing date and found against the non-defaulting party that had withheld payment in reliance on s 2(a)(iii).
- The two decisions provided different outcomes for the non-defaulting parties, but may be reconciled if one recognises that the *Metavante* decision primarily interprets the effect of the US Bankruptcy Code upon the swap agreement, as opposed to focusing primarily on the interpretation of s 2(a)(iii).

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Same question, different outcome: s 2(a)(iii) of the ISDA Master Agreement under English and US insolvency law

This article compares the different outcomes of the English case *Lomas and others v JFB Firth Rixson, Inc and others* and the US *Metavante* case and discusses how they might be reconciled.

PREDICTABILITY OF THE ISDA MASTER AGREEMENT

Section 2(a)(iii) of the ISDA (International Swaps and Derivatives Association) Master Agreement ('Master Agreement') provides that a party's payment obligations are subject to, *inter alia*, the condition precedent that there is no continuing event of default with respect to the other party. The right of the non-defaulting party to suspend payments due to the defaulting party under a Master Agreement in reliance on s 2(a)(iii) has now been considered in a number of jurisdictions.[1] The most recent decision is that of the English High Court (the 'High Court') in *Lomas and others v JFB Firth Rixson, Inc and others*[2] (the 'English case'). In the course of its ruling, the High Court observed that the Master Agreement is probably the most important standard market agreement used in the financial world and should be interpreted in a way that serves the objectives of clarity, certainty and predictability. However, the objective of predictability is not enhanced by the fact that the United States Bankruptcy Court for the Southern District of New York (the 'Bankruptcy Court')[3] reached an entirely different outcome in respect of Metavante Corporation (the '*Metavante* case').[4] This article compares the different outcomes of the English case and the *Metavante* case and discusses how they might be reconciled.

THE FACTS IN EACH CASE

The English case was heard upon application by the Joint Administrators (the 'Joint Administrators') of Lehman Brothers International Europe ('LBIE') for directions as to the construction and effect of five interest rate swap agreements ('Swaps') to which LBIE is a party. Each Swap incorporated the terms of either the 1992 or 2002 version of the Master Agreement pursuant to which LBIE was the floating rate payer. LBIE's entry into administration on 15 September 2008 was an Event of Default under each Master Agreement. Each of LBIE's counterparties ('Counterparties') relied on s 2(a)(iii) of the Master Agreement as the basis for their refusal to make payments which would have otherwise fallen due to LBIE.

In the *Metavante* case, Metavante Corporation had also entered into an interest rate swap incorporating the terms of a 1992 Master Agreement with Lehman Brothers Special Financing, Inc ('LBSF'). Lehman Brothers Holding Inc ('LBHI') was a credit support provider under the Master Agreement. LBHI's bankruptcy filing on 15 September 2008 and LBSF's bankruptcy filing on 3 October 2008 each constituted an Event of Default under the Master Agreement that entitled the non-debtor counterparty to terminate the swap. Notwithstanding the Bankruptcy Code's general prohibitions against the termination of executory contracts[5] to which the debtor is a party, special 'safe harbour' provisions of the Bankruptcy Code allow a non-debtor counterparty to a swap agreement to terminate, close out, offset and net under the swap agreement due to an insolvency event of default.[6]

At the time of commencement of the debtors' bankruptcy cases, however, Metavante was out-of-the-money and did not choose to exercise its safe harboured termination rights. In 2008, Metavante entered into a replacement swap with another counterparty and ceased making net payments to LBSF in reliance on s 2(a)(iii) of the Master Agreement. Subsequently, in May 2009, LBSF, together with certain other Lehman affiliates (collectively, the 'US Debtors'), filed a motion seeking to compel Metavante to perform its obligations under the Master Agreement.[7]

THE OUTCOME OF EACH CASE

In the English case, the High Court held that s 2(a)(iii) is 'suspensive' in effect – permitting the non-defaulting party to withhold payment to LBIE. The High Court concluded that s 2(a)(iii) cannot be interpreted as being subject to the limitation that it can be relied upon for a 'reasonable time' only – the non-defaulting party being under no obligation to designate an early termination date under the agreement. The High Court found no breach of the anti-deprivation principle

under English insolvency law in the context of the Swaps.

In the *Metavante* case, due to the substantial period of time that had passed since the commencement of the US Debtors' bankruptcy cases, the Bankruptcy Court ruled that Metavante had waived its right to terminate the swap agreement under the applicable safe harbour provisions. The Bankruptcy Code's automatic stay on actions against the debtor and its prohibition against the enforcement of *ipso facto* clauses[8] prohibited Metavante from enforcing s 2(a)(iii) against the US Debtors. Metavante's reliance on New York State contract law for the proposition that failure of a condition precedent excuses a party's performance obligation was trumped by federal bankruptcy law.[9]

THE ISSUES

Implied terms

As a preliminary issue of the English case, the High Court addressed the question of whether s 2(a)(iii) has a 'once and for all' effect or a 'suspensive' effect – that is, if an Event of Default occurs and is continuing on a date for payment, does the payment obligation never arise (even if the Event of Default is subsequently cured) (the 'once and for all' effect) or is the effect of the Event of Default merely to suspend the payment obligation until the Event of Default is cured (the 'suspensive' effect)? The court concluded that a 'once and for all' construction would produce a pointlessly draconian outcome in the event of a minor or momentary default, noting that the s 2(a)(iii) condition to payment is also unsatisfied where there is merely a Potential Event of Default which may never mature into an Event of Default.

Having decided that s 2(a)(iii) has a 'suspensive' effect, the High Court went on to consider the question of how long the suspended payment obligation remains in suspense. The Joint Administrators submitted that s 2(a)(iii) operates so as to suspend the non-defaulting party's payment obligations only for a 'reasonable time'. However, the High Court, having considered the principles for identification of implied terms of contracts,[10] decided that it was unable to imply a term that s 2(a)(iii) operates only for a 'reasonable time'.

Noting that it would be wholly inconsistent with any reasonable understanding of the Master Agreement that payment obligations arising under a transaction could give rise to indefinite contingent liabilities because of the possibility that an Event of Default may be cured long after the expiry of a transaction, the High Court rather surprisingly relied on s 9(c) of the Master Agreement[11] as providing that where any obligation is suspended by s 2(a)(iii) because of the non-fulfilment of a condition precedent, that obligation does not survive the termination of a transaction at the end of its natural term, if by then the condition precedent is still unsatisfied.

"The High Court held that s 2(a)(iii) does not infringe the anti-deprivation principle ..."

In the *Metavante* case, the Bankruptcy Court noted that while the Bankruptcy Code does not specify that non-defaulting counterparties must act promptly after a filing in order to rely on the protections afforded by its safe harbour provisions, the legislative history of the Bankruptcy Code establishes that Congress intended only to shield parties to financial contracts from the systemic risk that would result from cascading losses due to a counterparty's bankruptcy filing.[12] Because the degree of systemic risk that could result from a single filing diminishes over time, both this decision and existing precedent[13] held that the safe harbour only protects actions that are taken reasonably promptly after the filing date. Moreover, although the statute is silent as to whether the non-debtor may withhold payment pending its decision whether to exercise safe harboured rights, the statute's language is narrow enough to preclude parties to safe harboured financial contracts from taking any actions other than those specified – such as termination, close out and netting – in reliance on these provisions. The Bankruptcy Court therefore held that Metavante had lost its right to terminate and rejected Metavante's argument that it needed to withhold payment in order to preserve potential setoff rights upon termination.

Anti-deprivation principle; *Ipso facto*

A long established principle of English law is that one cannot contract out of the provisions of the insolvency legislation which govern the way in which assets are dealt with in insolvency. The Joint Administrators contended that s 2(a)(iii) offends the anti-deprivation principle on the basis that upon LBIE going into administration, it was deprived of an asset consisting of a contingent liability owed by each of its Counterparties.

The High Court held that s 2(a)(iii) does not infringe the anti-deprivation principle in the circumstances being considered. The court made a distinction between, on the one hand, the case where the asset of the insolvent company is a debt representing consideration for services yet to be rendered or something still to be supplied by the insolvent company in an ongoing relationship, where a court will permit one party to adjust or terminate what would otherwise be an ongoing relationship with the insolvent company at the point when it goes into the insolvency process; and, on the other hand, the case where the asset of the insolvent company is a debt representing consideration for something already done, sold or delivered before the onset of insolvency. The High Court stressed that the conclusion on this issue was based on the Swaps under consideration. It also warned that but for the concession of the parties that the Swaps operated on a net rather than gross basis (that is, that the non-defaulting party cannot enforce the defaulting party's payment obligation without having its own reverse payment taken into account), the court may have found that s 2(a)(iii) offends the anti-

deprivation principle if it increased LBIE's obligation on any future payment date from a net amount to a gross amount.

In the *Metavante* case, the US Debtors argued that Metavante's failure to make required payments under the swap transaction implicated an unenforceable '*ipso facto*' clause that altered the parties' obligations due to the US Debtors' bankruptcy filing. LBHI also argued that under the Bankruptcy Code, in order to preserve the assets of the estate during the period in which a debtor has the right to elect whether to assume or reject an executory contract, the non-debtor counterparty must continue to perform its obligations under the contract. As a result, Metavante's failure to make net payments to LBSF under the swap represented control by Metavante over property of the bankruptcy estate in direct violation of the automatic stay.

Judge Peck concluded that Metavante's withholding payment was not permitted under the parties' agreement or under the financial contract safe harbour provisions.[14] He noted that as it had not been terminated, the swap agreement constituted a 'garden variety' executory contract under which performance was due, to some degree, from both parties. Under the Bankruptcy Code and applicable case law, a non-debtor is required to perform its obligations under an executory contract pending its disposition within the bankruptcy case, notwithstanding that performance of an unassumed executory contract could not be compelled from the debtor.[15] The creditor risks violating the automatic stay if it fails to perform. Although the court acknowledged that LBHI's and LBSF's bankruptcy filing constituted an event of default that entitled the non-debtor to exercise its safe harboured rights to terminate, close out and net, the court stated that Metavante's 'conduct of riding the market for the period of one year, while taking no action whatsoever, is simply unacceptable and contrary to the spirit of these provisions of the Bankruptcy Code'.[16]

SOME OBSERVATIONS

On one view, it would seem that the conclusions of the High Court in the English case result in a quasi-'walk away' provision for the non-defaulting party which may owe money to the in-the-money defaulting counterparty – introducing the old-style 'First Method' into every Master Agreement – which may have certain regulatory implications.[17] In particular, the enforceability of close-out netting provisions (that is, the ability to value each terminated transaction, to net those amounts and to calculate a single amount which is then payable by one party to the other) is vital to market participants as it permits the allocation of capital on a 'net' rather than 'gross' basis. The Financial Services Authority (the 'FSA') in the UK sets out various conditions before a firm is able to treat contractual netting as risk-reducing[18] and provides that 'a firm must not recognise as risk-reducing any contract containing a provision which permits a non-defaulting party to make limited payments only, or no payments at all, to the estate of the defaulter, even if the defaulter is a net creditor (a 'walkaway clause')'.[19] Therefore, if a regulated firm has entered into a derivative transaction to transfer risk (say it bought protection under a credit default swap), it remains to be seen if the outcome of the English case may prompt the regulator to view Master Agreements as contracts with 'walkaway clauses' with consequential adverse regulatory treatment.[20]

An appeal of the High Court's decision in the English case was lodged with the Court of Appeal on 17 January 2011.[21] If the decision of the High Court is upheld, future cases may still be distinguished on their facts as the court was careful to limit the application of its decision to the particular facts of the case; emphasising that interest rate swaps were the only agreements with which it was concerned, noting that none of the Swaps were 'in any way speculative'.

It should be noted that while the *Metavante* decision appears to be at odds with the decision in the English case with respect to the interpretation of s 2(a)(iii), *Metavante* reflects the effect of the US Bankruptcy Code upon the ISDA Master Agreement. The difference in outcome is due to the substantial difference between applicable English insolvency law and the protections afforded to debtors under the US Bankruptcy Code, notwithstanding the safe-harbour provisions that afford some relief to financial contract counterparties. The two decisions may be reconciled if one recognises that the *Metavante* decision primarily interprets the effect of the US Bankruptcy Code[22] upon the swap agreement, as opposed to focusing primarily on s 2(a)(iii). However, the outcomes of the two cases do invite market participants to observe how, in an interconnected financial world where parties use the same master agreement to govern their trades, the choice of counterparty may result in entirely different financial consequences for the non-defaulting party based purely on the jurisdiction where the defaulting party commences insolvency proceedings. ■

1 *Enron Australia v TXU Electricity Ltd* [2003] NSWSC 1169; *Marine Trade SA v Pioneer Freight Futures Co Ltd BVI* [2009] EWHC 2656 (Comm).

2 [2010] EWHC 3372 (Ch).

3 On 15 September 2009.

4 See Order Pursuant to ss 105(a), 362 and 365 of the Bankruptcy Code to Compel Performance of Contract and to Enforce the Automatic Stay, *In re Lehman Brothers Holdings Inc*, Case no 08-013555 (JMP) (Bankr. 17 SDNY Sept 2009).

5 Generally, a contract under which material performance remains due from both parties.

6 See 11 USC §§ 101 (53B), 362(b)(17) and 560.

7 See Debtors' Motion Pursuant to ss 105(a), 362 and 365 of the Bankruptcy Code to Compel Performance of Metavante Corporation's Obligations under an Executory Contract and to Enforce the Automatic Stay, *In re Lehman Brothers Holdings Inc*, N 08-013555 (JMP) (Bankr. SDNY 29 May 2009 (Docket no 3691). The Motion was supported by a Statement of Official Committee of Unsecured Creditors of Lehman Brothers, dated 15 June 2009 (Docket no 3958) and a Statement of Ad Hoc Group of Lehman Brothers Creditors, dated 10 July 2009 (Docket no 4326).

8 An *ipso facto* clause is a contractual provision pursuant to which the filing of a bankruptcy petition or the financial condition of the

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debtor triggers a right to terminate the contract.

9 See Transcript of Hearing *In re Lehman Brothers Holdings Inc*, Case No. 08-013555 (JMP) (Bankr. SDNY 15 Sept 2009) ('Transcript') at 108–111.

10 The court does not make contracts for the parties, but simply interprets the contract which the parties have made for themselves; any implied term must 'go without saying'. See *Attorney General of Belize v Belize Telecom Ltd* [2009] UKPC 11; *Throllope&Colss v Northwest Metropolitan Regional Hospital Board* [1973] 1 WLR 601.

11 Section 9(c) of the Master Agreement provides 'Without prejudice to Sections 2(a)(iii) and 6(c)(ii), the obligations of the parties under this Agreement will survive the termination of any Transaction'.

12 See Transcript at 111 citing H.R. Rep. 97-420, at 1 (1982) and Sen. R. No 101-285, at 1 (1990).

13 See Transcript at 111 '[n]oting that a counterparty's action under the safe harbour provisions must be made fairly contemporaneously with the bankruptcy filing, less the contract be rendered just another ordinary executory contract' citing *In re Enron Corp.*, Case No 01-16034 (AJG), 2005 WL 3874285, at *4.

14 See Transcript at 109.

15 See Transcript at 109–110 citing NLRB v. Bildisco & Bildisco, 465 US 513, 531 (1984); *McLean Industries, Inc v Medical Laboratory Automation, Inc*, 96 BR 440, 449 (Bankr. SDNY 1989).

16 Id.

17 Only the 'Second Method' is Basel II compliant and assumes that insolvent institutions will be able to recover any positive net value from its swap positions (that is, what is owed to it from the out-of-the money non-defaulting counterparty).

18 BIPRU, 13.7, Contractual netting.

19 BIPRU, 13.7.9.

20 It is also worth noting that, in its reaction to the English decision, ISDA has stated that it has already started a process of preparing a form of amendment to s 2(a)(iii) in response to concerns raised by supervisors, including the UK Treasury, as to the potential effect of s 2(a)(iii) following the failure of a major financial institution. In its recent consultation paper, the UK Treasury considered the weakness of s 2(a)(iii) and stated that it favours certainty to the time frame within which early termination may occur and encouraged the market to develop a solution; warning that failure of a suitable market solution may lead to government intervention, for example, legislation requiring automatic termination of all derivative transactions upon administration, or termination of contracts by counterparties within a certain period.

21 Metavante's appeal of Judge Peck's decision has been withdrawn as the parties have entered into a court-approved settlement agreement with respect to the dispute; see Order Granting Debtors' Motion for Approval of a Settlement Agreement with Metavante Corporation, In *re Lehman Brothers Holdings Inc.*, Case No 08-013555 (JMP) (Bankr. SDN. Apr. 15, 2010).

22 Title 11, United States Code, 11 USC §§ 101 et seq.

Counter-guarantees

BRITISH ARAB COMMERCIAL BANK PLC V BANK OF COMMUNICATIONS AND ANOTHER [2011] EWHC 281 (COMM) (QUEEN'S BENCH DIVISION, COMMERCIAL COURT) (BLAIR J) (17 FEBRUARY 2011)

Sichuan Machinery, a Chinese company, submitted to a Syrian government entity a performance bond governed by Syrian law issued by the Commercial Bank of Syria ('CBS') in connection with a Syrian dam project. British Arab Commercial Bank ('BACB') gave a counter-guarantee to CBS (the 'BACB Counter-Guarantee'). Bank of Communications ('BOC') in turn gave a counter-guarantee governed by English law to BACB (the 'BOC Counter-Guarantee'). The BACB Counter-Guarantee did not have a specified governing law.

The court applied Syrian law to the BACB Counter-Guarantee. CBS had not demonstrated with reasonable certainty a choice of Syrian law. Neither could BACB demonstrate a choice of English law. Although there were some connecting factors with England, in the circumstances the connecting factors to Syria were stronger. The case law emphasised the importance of the connection of the counter-guarantee to the governing law of the underlying guarantee. There were factors that BACB advanced as connecting the BACB Counter-Guarantee with England. BACB is geographically located in London where the key element of performance of honouring its payment as counter-guarantor would take place. However, there was no term in the instrument which gave this place of payment contractual effect. Whilst the BOC Counter-Guarantee was governed by English law, the case law has emphasised the importance of the connection with the guarantee rather than the counter-guaranteeing bank's own security arrangements. The court would also need to look to Syrian law in relation to the meaning of 'claim' as used in both the performance bond and the BACB Counter-Guarantee.

The court held that BACB was not liable to CBS under the BACB Counter-Guarantee, so that neither BACB nor BOC were liable on their respective counter-guarantees. The court considered the Syrian law of guarantees in reaching this conclusion. CBS was not liable to extend the performance bond by reason of the Syrian government entity's request for an extension. CBS's liability under the bond had expired and there was no liability for CBS to pass to BACB, and there were thereafter no liabilities which BACB was bound to stand behind. Therefore there was no liability for BACB to pass on to BOC under the BACB Counter-Guarantee.

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