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

PREDICTABILITY OF THE ISDA MASTER AGREEMENT

Section 2(a)(iii) of the ISDA 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. 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 (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’) reached an entirely different outcome in respect of Metavante Corporation (the ‘Metavante case’). 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 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 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.

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 harbour terminated 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.

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.
the statute's language is narrow enough to preclude parties to safe-harbour 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 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. 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. 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’.6

**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. 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 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’). 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.

An appeal of the High Court’s decision in the English case was lodged with the Court of Appeal on 17 January 2011. 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(4)(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 upon the swap agreement, as opposed to focusing primarily on s 2(4)(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.

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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 4526).
8 An ipso facto clause is a contractual provision pursuant to which the filing of a bankruptcy petition or the financial condition of the

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’s liability under the bond had expired and there was no liability for BACB to pass on to BOC under 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 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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