Clients&FriendsMemo

English Court of Appeal Interprets the ISDA Master Agreement

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Last week the Court of Appeal of England and Wales handed down its decision in four appeals which raise a number of questions of construction in relation to derivatives in the form of interest rate swaps and forward freight agreements documented under the International Swaps and Derivatives Association Inc. Master Agreement (the "**ISDA Master Agreement**").[1] In particular, the decision focuses on the interpretation of section 2(a)(iii) of the ISDA Master Agreement.

Key Points

- Under section 2(a)(iii), the underlying debt obligation between the parties to the ISDA Master Agreement is undisturbed by an Event of Default – the section deals with the payment obligation alone.
- Under section 2(a)(iii), a Non-defaulting Party's payment obligation is not extinguished because of an Event of Default – it is merely suspended. Nor is the payment obligation extinguished on the maturity of the transaction.
- The suspension of the payment obligation may be indefinite – the condition precedent under section 2(a)(iii) continues in force until the Event of Default is cured. There is no implied term that the payment obligation revives at any other time.
- The suspensory effect of section 2(a)(iii) cannot be said to engage the English law anti-deprivation principle. Nor does section 2(a)(iii) breach the English law *pari passu* rule of distribution.
- A Non-defaulting Party who wishes to enforce the payment obligation of the Defaulting Party must give credit for what is due by the Non-defaulting Party under its part of the swap.

[1] The appeals are *Lomas & Ors (together the joint administrators of Lehman Brothers International (Europe))* v *JFB Firth Rixon & Ors* (the "**First Appeal**"); *Lehman Brothers Special Financing Inc.* v *Carlton Communications Ltd* (the "**Second Appeal**"); *Pioneer Freight Futures Company Limited (in liquidation)* v *Cosco Bulk Carrier Company Ltd* (the "**Third Appeal**"); and *Britannia Bulk Plc (in liquidation)* v *Bulk Trading SA* (the "**Fourth Appeal**")

- Individual transactions whose natural term has expired prior to the occurrence of Automatic Early Termination are subject to close-out netting. This is consistent with the "single agreement" provision in section 1(c).
- In determining "Loss", the parties are required to assume that the conditions precedent specified in section 2(a)(iii) to any payment obligations have been satisfied.
- The Metavante decision by the United States Bankruptcy Court concluded that the United States Bankruptcy Code prohibited the enforcement of section 2(a)(iii). However, the Court of Appeal decision and Metavante can be reconciled.

Commentary

The decision of the Court of Appeal will be studied closely by all market participants.

- Non-defaulting Parties that are "out of the money" will note that their obligation to pay is not extinguished after the scheduled maturity date of the underlying transaction.
- Market participants who have been concerned that they may be forced to designate an Early Termination Date will welcome the decision that there is no implied terms in the ISDA Master Agreement which require termination after a reasonable period.
- The derivatives industry may have to consider whether the ISDA Master Agreement will need amending to address concerns that its provisions may be used to withhold payments from insolvent entities.
- In its 2009 consultation paper,[2] HM Treasury expressed the view that payments due to insolvent counterparties should not be withheld indefinitely as this creates undesirable uncertainty for administrators and the general creditors of insolvent counterparties. It remains to be seen whether HM Treasury will introduce a statutory solution to the effect of section 2(a)(iii) as confirmed by the decision of the Court of Appeal.

The First Appeal

The First Appeal is from the decision of Briggs J in the High Court[3] and relates to a series of interest rate swap transactions entered into between Lehman Brothers International (Europe) ("**LBIE**") and a number of counterparties including JFB Firth Rixon. The entry into of administration by LBIE on 15 September 2008 constituted an Event of Default under each of the transactions entitling each of the non-defaulting counterparties to designate an Early Termination Date. The non-defaulting counterparties never designated an Early Termination Date – the transactions were "in the money" to LBIE – and instead relied on section 2(a)(iii) of

[2] "Establishing resolution arrangements for investment banks" available at http://www.hm-treasury.gov.uk/d/consult_investmentbank161209.pdf

[3] [2010] EWHC 3372 (Ch). See our previous analysis here: http://www.cadwalader.com/assets/client_friend/122210HighCourtInterpretsSect2aiii.pdf

the ISDA Master Agreement to argue that no further amounts were due to LBIE as any payment obligation is subject to the condition precedent that "no Event of Default has occurred and is continuing".

The issue raised by the First Appeal is whether obligations to make payments pursuant to the ISDA Master Agreement subsist after the party to whom payment is due has committed an Event of Default and, if so, for how long.

Did the occurrence of an Event of Default have the effect that no amounts ever became due and payable from the Non-defaulting Party?

In analysing section 2 of the ISDA Master Agreement, the court drew a distinction between payment obligations and underlying debt obligations and concluded that the underlying debt obligation is undisturbed by the Event of Default – it is merely the payment obligation which is barred if there is an Event of Default.

Did the occurrence of an Event of Default extinguish the payment obligation or merely suspend it?

The court upheld the decision of Briggs J in the High Court that a "suspensory construction" was to be preferred over the "once and for all" construction – that is, the occurrence of an Event of Default suspended the payment obligation – it did not have the effect of extinguishing the payment obligation once and for all. The reasons for so concluding included:

- To treat the payment obligation as extinguished is altogether too drastic a remedy because the possible Events of Default and Potential Events of Default are so many and various;
- The calculations of Loss on early termination require it to be assumed that any condition precedent has been satisfied and therefore it would be counter-intuitive to find that in other cases the existence of the relevant condition precedent means that the underlying obligation is extinguished rather than suspended.

Does the payment obligation revive at any other time while the contract continues to exist?

It was argued by the administrators of LBIE that even if the Event of Default was not cured but continuing, there must come a time when the obligation of the Non-defaulting Party to make payment must revive. The administrators sought to argue that, as a matter of construction, various terms could be implied into the ISDA Master Agreement:

- That section 2(a)(iii) suspends the Non-defaulting Party's payment obligation only for a reasonable time.

  The court concluded that such a proposed implied term is not only not a necessary implication to make the contract work but it is contrary to the express words of section 2(a)(iii) "… and is continuing". Indeed, the court held that the option to designate a date as

an Early Termination Date is a right which should not be subject to any implied limitation. In so holding, the court stated[4]:

> *"The Non-defaulting Party is, however, entitled to be the guardian of his own interest and make his own assessment whether early termination is likely to be to his benefit or not. It cannot have been the intention of the parties that he should be constrained to make a choice in favour of early termination at any particular time, not of his own choosing".*

- That section 2(a)(iii) suspends the Non-defaulting Party's payment obligation until such time as the transaction has run its course.

  Again, the court concluded that such a proposed implied term was not necessary to make the contract work and that implying such a term would constitute the re-writing of the contract between the parties which is not the business of the court.

- That the Non-defaulting Party is under an obligation to exercise its discretion whether or not to designate an Early Termination Date in a manner which is not arbitrary, capricious or unreasonable so that, once it is clear that the other party's default is permanent, or where the Non-defaulting Party decides to re-hedge, it must exercise its discretion in favour of early termination.

  This argument was rejected by the court as being "even more hopeless" than the others. The court likened the right of the Non-defaulting Party to terminate the ISDA Master Agreement upon the occurrence of an Event of Default to the right to accept repudiatory conduct as repudiation of a contract. In the case of the latter, no one would suggest that there could be any impediment to accepting repudiatory conduct as a termination of the contract based on the fact that the innocent party can elect between termination and leaving the contract on foot. Likewise, there should be no impediment to the exercise of the Non-defaulting Party's discretion to terminate upon the occurrence of an Event of Default.

Does the payment obligation extinguish on maturity?

Briggs J had held in the High Court that although the payment obligation of the Non-defaulting Party was suspended during the term of the underlying transaction, the suspension ended on maturity of the transaction and the payment obligation was then extinguished. In doing so, Briggs J relied on section 9(c) of the ISDA Master Agreement which 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".

However, the court concluded that it could not construe that section as providing that any suspended payment obligation should be extinguished on maturity. The court's view was that if

[4] See paragraph 42

that had been the intention of the drafters, they would have made that intention much more explicit. Accordingly, on the basis that the parties had made no express provision for what is to happen to suspended obligations when the transaction matures, the question then became whether the court should imply a term that such obligations are to be so extinguished. After reviewing the law on implied terms, the court concluded that no such term could be implied.

The court concluded that there is no terminus, either by way of extinction or revival, to the condition precedent – it continues in force until the Event of Default is cured.

The Second Appeal

The Second Appeal is from the decision of Briggs J in the High Court[5] and relates to interest rate swaps incorporating the terms of the ISDA Master Agreement entered into between Lehman Brothers Special Financing Inc. ("**LBSF**") and Carlton Communications Ltd ("**Carlton**") under which Lehman Brothers Holdings Inc ("**LBHI**") acted as LBSF's credit support provider. LBHI entered Chapter 11 bankruptcy on 15 September 2008 and LBSF entered Chapter 11 bankruptcy on 3 October 2008 – each such event constituting an Event of Default under the ISDA Master Agreement. Carlton relied on section 2(a)(iii) of the ISDA Master Agreement to argue that no further amounts were due to LBSF.

In addition to the issues raised in the First Appeal, the court was asked to consider whether the operation of section 2(a)(iii) engages either the anti-deprivation principle or the operation of the *pari passu* rule of distribution.

Does a Non-defaulting Party who wishes to enforce the payment obligation of the Defaulting Party have to give credit for what is due by the Non-defaulting Party?

As a preliminary matter, the court considered whether a Non-defaulting Party who wishes to enforce the payment obligation of the Defaulting Party must give credit for what is due under its part of the swap – that is, whether the Non-defaulting Party is obliged to give credit against the gross liability of the Defaulting Party. In *Marine Trade SA* v *Pioneer Freight Futures Co Ltd BVI & Ors*[6], Flaux J held that netting under section 2(c) was not available to the Defaulting Party as the conditions precedent contained in section 2(a)(iii) were not satisfied as of the date of payment – netting under section 2(c) applies only where the amount due from the Non-defaulting Party "would otherwise be payable". However, the court rejected the decision of Flaux J in *Marine Trade SA* and, endorsing the contrary view expressed by Gloster J in *Pioneer Freight Futures Company Ltd* v *TMT Asia Ltd*,[7] concluded that the words "would otherwise be payable" in section 2(c) take account of the payment requirements specified in each Confirmation regardless of whether the conditions precedent have been satisfied as at the

[5] [2011] EWHC 718 (Ch)

[6] [2009] EWHC 2656 (Comm)

[7] [2011] EWHC 1888

relevant date for payment. Accordingly, a Non-defaulting Party who wishes to enforce the payment obligation of the Defaulting Party must give credit for what is due under its part of the swap.

The anti-deprivation principle under English law

It was argued that the deprivation occurred when, but for the operation of section 2(a)(iii), LBSF would have been entitled to a payment from Carlton – the only bar to recovery being LBSF's bankruptcy.

Recognising that the decision in *Belmont Park Investments Pty Limited* v *BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc*[8] now represents an authoritative statement of the English law anti-deprivation principle, the court's view was that it is necessary to consider each transaction on its merits to see whether the shift in interests complained of could be justified as a genuine and justifiable commercial response to the consequences of insolvency. In applying that principle to section 2(a)(iii), the court was of the view that the purpose of the section is to protect the Non-defaulting Party from the additional credit risk involved in performing its own obligations whilst the defaulting counterparty remains unable to meet its own.

On that basis, the court was of the view that there could be no suggestion that section 2(a)(iii) is formulated in order to avoid the effect of any insolvency law or to give the Non-defaulting Party a greater or disproportionate return as a creditor of the bankrupt estate and concluded that it cannot be said that the suspensory effect of section 2(a)(iii) engages the anti-deprivation principle.[9]

The pari passu *rule of distribution*

It was also argued that section 2(a)(iii) had the effect of breaching the English law *pari passu* rule of distribution. Pointing out that the *pari passu* rule governs the distribution of assets within the estate following an event of bankruptcy,[10] the court concluded that section 2(a)(iii) does not infringe the rule because the section could operate at most to prevent the relevant debt ever becoming payable – the section does not deal with the distribution of assets of the estate and, accordingly, the section could not breach the *pari passu* rule of distribution.

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[8] [2011] UKSC 38. See our previous analysis here: http://www.cadwalader.com/assets/client_friend/081409StrucFinProvUpheldByHighCourt.pdf

[9] In addition, the court was of the view that the anti-deprivation principle could not succeed because the deprivation of which LBSF complains is as much attributable to the bankruptcy of LBHI (as credit support provider) (which took place before that of LBSF) as it is to that of LBSF

[10] To be contrasted with the anti-deprivation principle which is concerned with contractual arrangements which have the effect of depriving the bankrupt estate of property which would otherwise have formed part of it

The Third Appeal

The Third Appeal is from the decision of Flaux J in the High Court[11] and relates to a series of forward freight agreements entered into between Pioneer Freight Futures Company Ltd ("**Pioneer**") and Cosco Bulk Carrier Company Ltd ("**Cosco**") incorporating the terms of the ISDA Master Agreement under which the parties had elected for Automatic Early Termination to apply. Pioneer passed a resolution for its winding-up which constituted an Event of Default under the ISDA Master Agreement thereby triggering the Automatic Early Termination provisions. In respect of certain of the transactions which were "out of the money" to Cosco, Cosco contended that they were not subject to Automatic Early Termination because the last date for performance had passed prior to the Early Termination Date. Flaux J in the High Court had agreed with Cosco concluding that transactions which have already terminated at their natural expiry date are excluded from the close-out netting calculation under section 6(e).

The issue raised by the Third Appeal is whether obligations which have arisen, or but for section 2(a)(iii) have arisen, under individual transactions whose natural term has expired prior to the occurrence of Automatic Early Termination are subject to close-out netting.

Are obligations under individual transactions whose natural term has expired prior to the occurrence of Automatic Early Termination subject to close-out netting?

Disagreeing with Flaux J in the High Court, the court concluded that all transactions under the ISDA Master Agreement were subject to Automatic Early Termination – there being no basis for excluding transactions in respect of which the last date for performance had passed prior to Automatic Early Termination taking effect. The court noted that the approach of the High Court is inconsistent with the "single agreement" provision in section 1(c) of the ISDA Master Agreement the effect of which is that the obligations contained in all transactions are not to be treated as separate and distinct, but are made subject to the contractual framework constituted by the ISDA Master Agreement including when an Early Termination Date occurs.

The Fourth Appeal

The Fourth Appeal is from the decision of Flaux J in the High Court[12] and relates to a series of forward freight agreements entered into between Bulk Trading SA ("**Bulk**") and Britannia Bulk plc ("**Britannia**") incorporating the terms of the ISDA Master Agreement under which the parties had elected for Automatic Early Termination to apply. Administrators were appointed to Britannia constituting an Event of Default and thereby triggering the Automatic Early Termination provisions. For the purposes of payments on early termination, the parties had selected Loss as the payment measure. Bulk as the Non-defaulting Party argued that in calculating its Loss it did not need to take into account sums which would have become due to

[11] [2011] EWHC 1692 (Comm)

[12] [2011] EWHC 692 (Comm)

Britannia had Britannia not remained subject to an Event of Default – Bulk's position was based on the argument that such sums were not payable to Britannia by virtue of section 2(a)(iii) and the definition of Loss does not say that the calculation must be made "assuming satisfaction of all conditions precedent" (unlike the definition of "Market Quotation").

The issue raised by the Fourth Appeal is whether the ISDA Master Agreement requires it to be assumed for the purpose of carrying out the relevant close-out calculations that each applicable condition precedent has been satisfied.

Does the ISDA Master Agreement require it to be assumed for the purpose of carrying out close-out calculations that each applicable condition precedent has been satisfied?

Relying on the decision of Briggs J in *Anthracite Rated Investments (Jersey) Limited* v *Lehman Brothers Finance SA (in liquidation)*,[13] the court concluded that, in determining Bulk's Loss, the loss of bargain must be valued on an assumption that, but for termination, the transaction would have proceeded to a conclusion and that all conditions to its full performance by both sides would have been satisfied however improbable that assumption may be in the real world. The court agreed with the conclusion of Flaux J in the High Court that although it is right that the first sentence of the Loss definition does not say "assuming satisfaction of all conditions precedent", it does not need to because that is the only basis upon which the assessment can proceed.

Comparison to Metavante

The United States Bankruptcy Court presiding over the Lehman Brothers Holdings Inc. chapter 11 case addressed section 2(a)(iii) of the ISDA Master Agreement in the case *In re Lehman Brothers Holdings Inc.*[14] ("**Metavante**"). In Metavante, the court ruled that efforts by the non-debtor party to a swap to enforce section 2(a)(iii) against a Lehman debtor violated the automatic stay of section 362(a) of the United States Bankruptcy Code.

While the Metavante decision would result in different outcomes for a counterparty to a US entity and a similarly situated counterparty to an English entity, the opinions are not technically in conflict. The Court of Appeal decision relates to the interpretation of the language of the ISDA Master Agreement, and with respect to the anti-deprivation principle and the *pari passu* rule of distribution, English law. The United States Bankruptcy Court in Metavante did not reach a different conclusion as to the meaning of the ISDA Master Agreement itself. It found that enforcement of section 2(a)(iii) was barred by a specific provision of United States law, a provision that was manifestly not applicable to and not considered in the English decision. Similarly, the United States Bankruptcy Court in Metavante did not consider the anti-deprivation

[13] [2011] 2 Lloyd's Law Rep 538

[14] No. 08-13555 (JMP), 2009 WL 6057286 (Bankr. S.D.N.Y. Sept. 17, 2009)

principle or the *pari passu* rule, because neither applied in the US proceeding. Thus, while the cases had different outcomes, the legal underpinnings of the opinions clearly can be reconciled.

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Please feel free to contact any of the following Cadwalader lawyers if you have any questions about this memorandum.

Nick Shiren	+44 (0) 20 7170 8778	nick.shiren@cwt.com
Mark Ellenberg	+1 202 862 2238	mark.ellenberg@cwt.com
Peter Friedman	+1 202 862 2347	peter.friedman@cwt.com
Ivan Loncar	+1 212 504 6339	ivan.loncar@cwt.com
Lary Stromfeld	+1 212 504 6291	lary.stromfeld@cwt.com
Assia Damianova	+44 (0) 20 7170 8564	assia.damianova@cwt.com
Douglas Mintz	+1 202 862 2475	douglas.mintz@cwt.com