Clients&FriendsMemo

High Court Interprets Section 2(a)(iii) of the ISDA Master Agreement

22 December 2010

Introduction

Yesterday, the High Court gave its judgment in the case of *Lomas and others v JFB Firth Rixson, Inc and others*[1] upon application by 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 ISDA Master Agreement ("Master Agreement") pursuant to which LBIE was the floating rate payer. LBIE's entry into administration was an Event of Default under each Master Agreement. Section 2(a)(iii) of each 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.

Each of LBIE's counterparties ("Counterparties") relied on Section 2(a)(iii) of the Master Agreement as the basis for their refusal to make payments which would have otherwise fallen due to LBIE.

Summary

The Court: rejected the argument that the condition precedent in Section 2(a)(iii) should be interpreted as being subject to a limitation that it may only be relied upon for a "reasonable time";

- rejected the argument that a Non-defaulting Party had an obligation to designate an Early Termination Date;
- found that Section 2(a)(iii) is "suspensive" in effect, overturning the non-binding comments in the *Marine Trade* case[2] that Section 2(a)(iii) is a once-and-for-all test;
- found that there was no breach of the anti-deprivation principle under English insolvency law in the context of the Swaps.

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1 [2010] EWHC 3372 (Ch)

2 *Marine Trade S.A. v Pioneer Freight Futures Co Ltd and another* [2009] EWHC 2656 (Comm)

Joint Administrators' Application

The Joint Administrators' challenge to the Counterparties' interpretation of Section 2(a)(iii) can be grouped under four broad headings, namely that such interpretation: (1) is commercially absurd and must yield to implied terms to the contrary; (2) offends the anti-deprivation principle; (3) gives rise to a penalty, and (4) constitutes a forfeiture against which the Court should grant relief.

Implied Terms

As a preliminary issue, the Court addressed the question of whether Section 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 Section 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 Section 2(a)(iii) has a "suspensive" effect, the Court went on to consider the question of how long the suspended payment obligation remains in suspense. The Court noted 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 Court then rather surprisingly relied on Section 9(c) of the Master Agreement[3] to reach the conclusion that where any obligation is suspended by Section 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[4].

The Joint Administrators made three alternative submissions as to the construction of Section 2(a)(iii), namely that:

- Section 2(a)(iii) operates so as to suspend the Non-defaulting Party's payment obligations only for a "reasonable time".

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[3] 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".

[4] In this regard, we note the comments of the International Swaps and Derivatives Association, Inc. ("ISDA") in relation to this conclusion contained in its news release yesterday:

"The Court's finding that payments under certain types of transactions that have been suspended under Section 2(a)(iii) may be extinguished on the last date for payment under the transaction is surprising and is at odds with the market's expectations. Nothing in the ISDA Master Agreement suggests that those suspended obligations would be extinguished at the end of the transaction's term."

- In relation to this submission, the Court, having considered the principles for identification of implied terms of contracts[5], decided that it was unable to imply a term that Section 2(a)(iii) operates only for a "reasonable time";
- Section 2(a)(iii) operates so as to suspend the Non-defaulting Party's payment obligations until expiry of the natural term of the transaction, at which point the Non- Defaulting Party is obliged to designate an Early Termination Date.
- In relation to this submission, the Court decided that any such implied term would be at variance with the plain language of the Master Agreement and would be tantamount to an Automatic Early Termination – such election not having been made in the Swaps; 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.

In relation to this submission, the Court concluded that the decision of the Non-Defaulting Party that its interests are best served by not terminating could not be categorised as dishonest, in bad faith or exercised otherwise than for the purpose for which it was conferred.

Anti-deprivation Principle

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 Section 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, it being no answer that the condition precedent had existed from the moment when the asset was created.

The Court held that Section 2(a)(iii) does not infringe the anti-deprivation rule 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 Court however was quick to stress that the conclusion on this issue was based on the Swaps being considered. It also warned that but for the concession of the parties that the Swaps operated on a net rather than gross basis (i.e., that the Non-defaulting Party cannot

[5] 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.

enforce the Defaulting Party's payment obligation without having its own reverse payment taken into account), the Court may have found that Section 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.

Penalty and Forfeiture

The Court quickly dismissed the Joint Administrators' argument that Section 2(a)(iii) operates as a penalty - the common law doctrine of penalty is inapplicable where the triggering event is not breach of contract. The Court also quickly dismissed the Joint Administrators' argument that the loss of LBIE's right to contingent net payments was a forfeiture for which the Court can grant relief - the right to contingent net payments does not constitute property in respect of which the jurisdiction to grant relief from forfeiture exists.

Where to now?

In the course of its ruling, the 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. The objective of predictability is not however enhanced by the fact that the decision in *Metavante* in the U.S. reached an entirely different outcome[6]. 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 was "in any way speculative". The concession that the Swap payments operated on a net basis clearly helped the decision that the anti-deprivation principle is not violated.

It is expected that the Joint Administrators will appeal the decision. In the meantime, in its reaction to this decision, ISDA has stated that it has already started a process of preparing a form of amendment to Section 2(a)(iii) in response to concerns raised by supervisors, including the UK Treasury, as to the potential effect of Section 2(a)(iii) following the failure of a major financial institution.

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Please feel free to contact any of the following attorneys if you have any questions about this memorandum.
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[6] See http://www.cadwalader.com/assets/client_friend/092909Lehman_Bankruptcy_Court_Ruling.pdf