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Section 2(a)(iii): the Suspense Continues

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Anyone with a passing knowledge of derivatives law will be aware of the controversy created by section 2(a)(iii) of the ISDA Master Agreement.[1] Differing interpretations of 2(a)(iii) have emerged in litigation in London and the United States since the collapse of Lehman Brothers. The recent judgement of the Court of Appeal in London in Lomas v. JFB Firth Rixson Inc[2] brings significant clarity from the English perspective. The decision upholds the interpretation of section 2(a)(iii) favoured by the derivatives market. This Client Alert puts the case in an international context, considers the impact on other agreements, and looks at how changes to the regulatory framework and proposed changes to section 2(a)(iii) may also affect the decision's long-term significance.

Section 2(a)(iii) – the issues

Section 2(a)(iii) of the ISDA Master Agreement is a condition precedent to payment and delivery obligations arising out of transactions governed by the ISDA Master Agreement. If an Event of Default or Potential Event of Default has occurred and is continuing in respect of a party (the "Defaulter"), the effect of section 2(a)(iii) is that the other party (the "Non-defaulter") does not have to make payments or deliveries to the Defaulter. Except where automatic early termination applies, where the Defaulter is subject to an Event of Default, the ISDA Master Agreement also leaves the Non-defaulter free to choose whether or not to call an Early Termination Date resulting in the close-out of all transactions under the ISDA Master Agreement. These two features have caused some Non-defaulters that would be net payers on a resulting close-out to seek to rely on section 2(a)(iii) to avoid calling an Early Termination Date, with the ultimate objective of escaping forever the obligation to make a net payment.

So what did the court decide section 2(a)(iii) means?

In several High Court cases preceding the Court of Appeal's judgment in Lomas, conflicting interpretations of section 2(a)(iii) were adopted. Lomas appears to have bought some clarity to this area.

If section 2(a)(iii) is triggered, does a debt continue to be owed?

Yes. Section 2(a)(iii) relates only to the obligation to make payments, it does not apply to the debt position between the parties. If section 2(a)(iii) has been triggered, a Non-defaulter that would otherwise be due to make a payment, continues to owe a debt to the Defaulter.

Does section 2(a)(iii) extinguish or suspend payment obligations?

The answer to this question flows logically from the court's answer to the first question. It was held that the effect of section 2(a)(iii) was to suspend payment obligations following the occurrence and during the continuance of an Event of Default, but it did not extinguish those obligations.

If payment obligations are suspended, are they ever revived?

Yes. The curing of the relevant Event of Default (or Potential Event of Default) will result in accrued payment obligations being revived.

The court was also asked to consider a number of implied terms that would have the effect of reviving the suspended payment obligations without the Defaulter's Event of Default having been cured (e.g. an implied term that disapplied the condition precedent spelt out by section 2(a)(iii) after a "reasonable time" following the occurrence of an Event of Default).

Each proposal was rejected. The court noted that the test for the implication of terms into a contract required that the implication was either necessary, or that it would be obvious to any disinterested third party that the contract must have the meaning which the implied terms would give it. None of the proposed terms met this test.

Are payment obligations ever extinguished?

This is the only point where the court departs from the High Court decision in Lomas. The High Court had decided that payment obligations were extinguished on the maturity of the relevant transaction if the conditions precedent in section 2(a)(iii) were still unsatisfied. The Court of Appeal rejected this conclusion, which it did not consider was supported by the express terms of

the ISDA Master Agreement. It also rejected implying a term to this effect into the ISDA Master Agreement on the basis of the supposed inconvenience of contingent obligations that could remain contingent indefinitely. This was said to form “a slender basis for implying a provision for extinction which the parties have not expressly agreed”.

Are claims net or gross?

Where a Non-defaulter relying on section 2(a)(iii) seeks to enforce the payment obligations of the Defaulter, does it have to give the Defaulter credit for its own suspended payment obligations in determining the payment obligations of the Defaulter (the “net basis of claim”)? Or can the Non-defaulter claim for the full amount of the Defaulter's payment obligation without giving such credit (“gross basis of claim”)? This was a live issue in the appeal from Pioneer Freight v Cosco. It was also relevant to the appeal from Lehman Brothers Special Financing Inc. v Carlton Communications. Both appeals were heard with the Lomas appeal and are dealt with in the same judgement.

The key issue is whether section 2(c) of the ISDA Master Agreement, commonly known as the payment netting provision, applies. In Cosco, the High Court had held that netting under section 2(c) was not available to the Defaulter, where the conditions precedent in section 2(a)(iii) were not satisfied as of the date of payment. The Court of Appeal rejected this view. Section 2(c) is applicable in circumstances where the Non-defaulter relies on section 2(a)(iii).

Netting under section 2(c) is limited in scope so that the net basis of claim may not always apply. The court held that section 2(c) only nets payment obligations originally expressed to be payable on the same date. Parties may elect whether it applies across transactions. Without specific amendment, section 2(c) does not apply to payment obligations expressed in different currencies or to delivery obligations.

Does section 2(a)(iii) offend the anti-deprivation rule?

Anti-deprivation is a principle of English insolvency law. The essential idea is that the estate should not upon insolvency be deprived of assets that would otherwise be available to meet the claims of the estate’s creditors. Where the Defaulter is subject to an English insolvency procedure, will section 2(a)(iii) offend against the anti-deprivation principle? This was a live issue in the Carlton appeal.

The court rejected the challenge to the effectiveness of section 2(a)(iii) based on the anti-deprivation principle. In the recent decision in Belmont[3], the Supreme Court stated the anti-deprivation principle was directed towards the intentional or inevitable evasion of the principle that a debtor's property is part of the insolvent estate, and also stated the principle should be applied in a commercially sensitive manner. Applying this narrow approach, section 2(a)(iii) did not offend the principle. Indeed, as a standard form provision that is not negotiated between the parties to the contract, its inclusion can hardly be seen as evidence of intent to avoid insolvency rules.

Further thoughts

Invoking section 2(a)(iii) has risks

The Court of Appeal decision makes it clear that the Non-defaulter seeking to rely on section 2(a)(iii) takes the risk that it might be called upon to perform the suspended obligations if the Defaulter emerges from the Event of Default/Potential Event of Default. In the case of delivery obligations especially, this might take place at a time when the Non-defaulter is wholly unprepared to make the required performance, thus risking liability for damages or the Non-defaulter being subject to an Event of Default itself, thereby giving the Defaulter the right to call an Early Termination Date.

While a Non-defaulter may never have to make a net payment to the Defaulter, whether this will happen remains uncertain after when section 2(a)(iii) is first invoked. Thus, section 2(a)(iii) can be distinguished from classic “walk-away” clauses, which allow Non-defaulters simply to escape straight away from a net payment to the Defaulter. When added to the accounting issues that could arise for the Non-defaulter in accounting for its contingent liability to the Defaulter, it is clear that invoking section 2(a)(iii) is not straightforward and has risks.

Remember the impact of foreign laws

If the Defaulter is subject to an insolvency procedure outside of England, then that insolvency procedure may affect the application of section 2(a)(iii), notwithstanding that the ISDA Master Agreement is governed by English law.

A well-known example of insolvency law prohibiting the use of section 2(a)(iii) is the September 2009 decision of the U.S. Bankruptcy Court in the Southern District of New York in Chapter 11 proceedings in relation to Lehman Brothers Special Financing Inc ("LBSF"). Approximately one year after LBSF's filing under Chapter 11, Judge Peck ruled that the U.S. Bankruptcy Code prevented Metavante Corporation from relying on section 2(a)(iii) on the grounds that it conflicted with certain provisions of the Bankruptcy Code relating to safe harbours for swap counterparties and executory contracts. Parties looking to rely on section 2(a)(iii) against insolvent counterparties should take advice on the impact of local insolvency laws.

Where the ISDA Master Agreement is governed by New York law, or where the equivalent provisions are contained in an agreement with a different governing law, remember that the governing law may take a different approach to that taken by the court in Lomas. For example, in some civilian systems of law, courts may be more ready to imply principles limiting the time period during which a party may rely on section 2(a)(iii).

European Market Infrastructure Regulation (EMIR)

Since the financial crisis, the international regulatory community pressed ahead with major infrastructural changes to the OTC derivatives markets. In the EU, EMIR will require much greater use of central clearing and collateralization of OTC derivative contracts. The U.S. Dodd-Frank legislation does the same. The effect of the Court of Appeal decision will probably be more subtle as a result.

Clearing

Central clearing applies standard structures to relationships between counterparties which take away the freedom of clients of clearing members to make choices such as to rely on conditions precedent to avoid making a net payment. Some clearing services for OTC derivatives do not use the ISDA Master Agreement and Credit Support Annex (CSA) structure as a basis for client clearing. Where they do, the central counterparty's rules will change the position in key ways, e.g. to enable the central counterparty to force close-outs of clearing members. This is likely to reduce a client's ability to rely on section 2(a)(iii).

Collateralised trading

Where central clearing is not used, EMIR will require financial counterparties and non-financial counterparties that exceed the clearing threshold to meet collateralisation requirements including full variation margining. This will reduce occurrences where the Non-defaulter would be required following an Early Termination Date to make a significant net payment to the Defaulter. Thus, there are likely to be far less situations where it is seen as worthwhile to invoke section 2(a)(iii).

It is important to remember that under the ISDA Credit Support Documents, the obligation to deliver collateral is subject to section 2(a)(iii) (in the case of the English law CSA), or to similarly worded conditions precedent (in the case of the New York law CSA and the English Deed). Hence, a party relying on the other party's Event of Default not to make payments and deliveries under normal transactions can do the same with respect to demands for collateral to cover the Defaulter's exposure.

ISDA may introduce a time limit on the application of section 2(a)(iii)

ISDA has been consulting for some time on amending section 2(a)(iii) of the ISDA Master Agreement and related provisions. Some amendments were intended to clarify legal uncertainties removed by the Court of Appeal decision, and it is unclear whether these will be taken forward.

ISDA also proposed introducing a time limit on the application of the conditions precedent in section 2(a)(iii). This followed statements[4] by the UK Treasury expressing concern at the uncertainty caused to administrators of failed investment banks not knowing whether, and if so when, the estate will receive a net-in-the-money payment from a Non-defaulter relying on section 2(a)(iii). Lomas does not remove this issue.

In response, ISDA has proposed that section 2(a)(iii) is subject to a 90- or 180-day time limit. ISDA's consultation also explores amending conditions precedent in the New York law CSA and English Deed.

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Other Master Agreements - financial

Conditions similar to section 2(a)(iii) are to be found in other industry standard forms. For example, the 2011 version of the Global Master Repurchase Agreement contains a similar provision, and an English court would be likely to apply the same reasoning as the Court of Appeal in considering it. In contrast, the Global Master Securities Lending Agreement – July 2009 only permits a party to withhold performance following an event of default until such time as the other party has made “arrangements which are sufficient to assure full delivery”.

Other Master Agreements – commodities and energy

Commodity and energy standard forms tend not to include provisions equivalent to section 2(a)(iii). But many commodities and energy trading documents (e.g. EFET, GTMA and SCoTA 8) include rights for the Non-defaulter to suspend the performance of some or all of its obligations while the default event subsists. This differs from section 2(a)(iii), which rather than giving a party the right to suspend or withhold performance, simply states that the obligations do not arise as long as the condition precedent is not fulfilled.

But the Court of Appeal decision is relevant to English law agreements of this type in that it suggests that rights to suspend performance will also be indefinite so long as the agreement does not specifically state otherwise.

Conclusion

The decision in Lomas will be of vital importance in a number of current disputes and will be playing a part in future financial markets failures. But the world has moved on and the circumstances that made section 2(a)(iii) so crucial in the fall-out from the financial crisis may not materialise again. The regulatory response to the crisis, including new regimes regulating OTC derivatives, will see to that.

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