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

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Introduction

For all of the legal difficulties which market participants are facing in light of the insolvency of Lehman Brothers, the insolvency is providing the Courts with the opportunity to pass judgment on many of the tricky provisions of the 1992 and 2002 versions of the ISDA Master Agreement (together the "**Agreements**").

In our Alert last November , we made reference to the Administrators of Lehman Brothers International (Europe) ("**LBIE**") making an application to the Courts asking for a declaration as to how the Administrators can treat those OTC counterparties who did not close out their positions as soon as LBIE went into Administration. Section 2(a)(iii) of the ISDA Master Agreement was at the centre of the application. Since LBIE will always be in default, the Administrators were arguing that counterparties should not be allowed to use Section 2(a)(iii) to "ride the market" and choose when to terminate, as to do so has the effect of allowing an exception to English insolvency laws.

The decision has now been published (Lomas v JFB Firth Rixson[2]). We discuss the decision below and also provide a useful quick-look summary box at the end of this Alert.

Factual Summary

Upon the insolvency of Lehman Brothers International Europe ("**LBIE**") four of its out-of-the-money counterparties exercised their right under Section 6(a) of the Agreements not to terminate the 1992 ISDA Master Agreement ("**1992 Agreement**") in place with LBIE. They then relied on Section 2(a)(iii) to not make payments which they would have been required to make but for this provision.

The LBIE Administrators asked the Court to consider the true interpretation of this controversial ISDA provision in addition to assessing its compatibility with certain principles of English insolvency law.

Implied Terms

The Court first considered whether Section 2(a)(iii) operated subject to an implied term requiring a party wishing to rely on it (and therefore withhold payments by reason of the existence of an Event of Default or Potential Event of Default) to do so for a "reasonable period" during which it may decide to nominate an Early Termination Date, but after which the right to withhold payment is extinguished.

The Court held, however, that such an implied term "was contrary to the express terms of the [Agreement, as] Section 2(a)(iii) unambiguously provides that the condition precedent is to subsist for as long as an Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing." The Court held that the alternative argument is not what a reasonable person would think the Agreement meant.

The Court also considered whether Section 2(a)(iii), once triggered, extinguished once-and-for-all any obligation on the Non-defaulting Party to pay or whether it merely suspended that obligation whilst the relevant condition existed and if such obligation was only suspended, whether such a suspension continued indefinitely or only until the expiry of the transaction. Contradicting the apparent effect of the decision in the Marine Trade case, the Court found that Section 2(a)(iii) is suspensive in effect.

The Marine Trade judgment had raised the possibility of any settlement sums that might otherwise be due to the defaulting party, never becoming due, no matter what happened or whether the defaulting party subsequently became no longer in default. However the Court in this latest case was of the opinion that such an interpretation was overly draconian, especially in the event of a minor or momentary default.

Furthermore, the Court held that a Non-defaulting Party had no obligation to designate an Early Termination Date upon the occurrence of an Event of Default. Mr Justice Briggs said:

"the discretion in Section 6(a) of the [Agreement allowing the Non-defaulting Party to designate an Early Termination Date] was given by way of contractual right to the Non-defaulting Party,

and was plainly to be exercised in such a way as the Non-defaulting Party considered best served its own interests, by way of a choice between alternative remedies arising out of a counterpart's default [...] the proposition that an election to do anything other than seek Early Termination amounted to a misuse of the Non-defaulting Party's discretion strikes me as completely unarguable."

What was however surprising is that the Court held (relying on Section 9(c) of the Agreement) that payments due 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. ISDA has publicly commented on this element of the judgment and stated that this is at odds with market expectations and that there is nothing in the Agreement to support this interpretation.

Remaining Marine Trade Issues

In the Marine Trade case it was held that a Non-defaulting Party, which has relied on Section 2(a)(iii), may still enforce the Defaulting Party's obligations in full without having to take into account its own payments due to the Defaulting Party ("the gross position"). But the parties in this case seemed to be in agreement that a net position should be taken - i.e. a settlement sum is calculated for each party and is netted with the party owing the greater amount ending up owing the difference to the other party ("the net position"). The Court was not therefore asked to provide a ruling on this issue, so while it remains open for future argument, perhaps an inference can be drawn that the market place now regards the net position as the standard to be adopted.

Penalty and Forfeiture

The Court rejected the argument that Section 2(a)(iii) operated as a penalty as the triggering event (Lehman's administration) was, although an Event of Default, not a breach of contract. Additionally, the Court held that Section 2(a)(iii) was a condition precedent and not an event of forfeiture and that the swaps which were the subject of the case are classic examples of commercial transactions in relation to which the existence of a jurisdiction to relief from forfeiture would give rise to "unacceptable uncertainties and fetters upon contractual rights".

Anti-deprivation Principle

As a general point of English insolvency law, after the occurrence of a formal event of insolvency it is not permitted to allow a party to remove assets from the pool available to creditors. The

LBIE Administrators argued that the creditors had been deprived of certain contingent assets in contravention of this principle through the operation of Section 2(a)(iii) - i.e. the suspended payments due from the Non-defaulting Party. However the Court held that this principle was not breached by the operation of Section 2(a)(iii), as the rights of the Defaulting party were contingent on its ability to be an effective interest rate hedge, which ability was undermined by the insolvency based Event of Default.

Future Developments

The Court recognised that the Agreement is the most important standard market agreement used in the financial world and that it is important that it should, as far as possible, be interpreted in a way that serves the objectives of clarity, certainty and predictability. Unfortunately this commendable aim is undermined by last year's U.S. Court decision in the Metavante case[3], which came to an entirely different conclusion. The decision has been the subject of some criticism and it was thought that an appeal scheduled for March this year might bring the U.S. position closer to that in the UK. However, the case settled, so unless the same issue comes before a different court in the U.S., this contradiction remains. In the meantime, ISDA is preparing a form of amendment to Section 2(a)(iii) in response to this general uncertainty.

Quick Look Summary

- Section 2(a)(iii) of the Agreement operates to suspend a payment obligation of a Non-defaulting Party and there is no implied limitation that it may only be relied upon for a "reasonable" amount of time;
- At least in relation to swap transactions, the suspension lapses on the normal expiry date of the relevant swap transaction;
- A Non-defaulting Party has the freedom to choose if, and when to designate an Early Termination Date based on its own interests;
- When used in relation to an insolvency based Event of Default, Section 2(a)(iii) is not a penalty and nor does it necessarily offend the anti-deprivation principle of English law (though the case does outline when its operation may be contrary to this principle);

— This case is contrary to dicta from other jurisdictions, most notably the U.S., and in any event is likely to be appealed;

— ISDA is consulting market participants with a view to amending Section 2(a)(iii) in light of the legal uncertainty surrounding the provision.

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1. OTC Derivative Litigation Update [November 2010]
2. Lomas and others (Administrators of Lehman Brothers International (Europe) v JRB Firth Rixson, Inc and others and The International Swaps and Derivatives Association Inc. (as Intervenor) [2010] EWHC 3372 (Ch)
3. reedsmithupdate.com/ve/ZZ8780Tj8294tkt61Ep

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