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Recent ISDA Cases Overview

Recent market volatility has meant that users of the 1992/2002 ISDA Master Agreements ("ISDA MA") have gone to extraordinary lengths to try and curtail their losses. In such times, market participants naturally attempt to side-step contractual obligations on increasingly technical grounds. In this context, claimants are ever more imaginative with their arguments which has in turn led to some interesting results and legal decisions.

There have been a number of cases based on the ISDA MA over the past year both in the UK and in the US. These cases have affirmed traditional ISDA MA jurisprudence but have also provided a few surprises along the way.

In this Client Alert we provide an overview of the key legal principles which can be extracted from five recent noteworthy cases along with a tabular summary in the Appendix which outlines the facts and principles of each case for easy reference.

1. Modification of ISDA MA terms by Oral Agreement
   AS Klaveness Chartering v Pioneer Freight Futures Co. Ltd. [2009] EWHC 3386

   Under the terms of Section 9(b) of the ISDA MA, any amendment must be in writing. However the Court in this case held that an oral agreement between the parties constituted an oral collateral agreement, the effect of which was an amendment of the ISDA MA terms. The parties were negotiating a novation agreement whereby Klaveness would take over Pioneer's position in some trades under which Pioneer was significantly in the money. The parties did this because although Klaveness owed Pioneer an amount for the December 2008 payment, from January 2009 onwards, Pioneer was significantly out of the money under various Forward Freight Agreements which incorporated the ISDA MA. During the negotiation, it was agreed that the December 2008 payment owed by Klaveness would be "washed out".

   Even though the negotiations continued, Pioneer invoiced Klaveness for the December payment amount and issued cure notices when this was unpaid. Klaveness did not pay, on the understanding that the parties had agreed the December wash out under the near finalised novation agreement. The novation agreement was still not agreed by the January 2009 payment date and it was then Pioneer's turn to make payment, which Pioneer failed to do citing Klaveness' "default" in December. Klaveness then issued cure notices and ultimately set an early termination date.

   The Court held that the oral agreement between the parties (i.e. washing out the December amount) was binding even though it amended the terms of the ISDA MA.This is interesting as under the terms of the ISDA MA, any amendment must be in writing. Viewing this judgment in context, it is unlikely that *any* oral agreement between the parties will automatically be a valid ISDA MA amendment notwithstanding the requirement of writing. However, it seems that the Court is willing to enforce the terms of a *collateral oral agreement*. Furthermore the Court held that parties may agree set-off sums from different calendar months under a collateral oral agreement notwithstanding the Section 9(b) requirements.

   This decision seems unusual and may therefore be the product of an equitable solution to the issues of this particular case given the broader factual matrix. In any event, ISDA MA users should be careful in their oral communications with counterparties and ensure that they make it clear in any oral discussions that only a written agreement will vary the ISDA MA terms.

2. English Court Challenges Traditional View of Condition Precedent in the ISDA MA

Marine Trade SA v Pioneer Freight Futures Co. Ltd. [2009] 2656

Although not a key issue in this case, the judge provided a surprising challenge to the traditional view of the operation of the condition precedent contained in Section 2(a)(iii) of the ISDA MA. The Court held that this provision does not simply suspend a party's obligations whilst an event of default subsists, but goes as far as to permanently extinguish all obligations that fall due during an event of default situation.

The traditional view was that the words "*occurred and is continuing*" contained in Section 2(a)(iii) meant that a party was entitled to not perform only whilst the event of default persisted. Once the event of default was cured, then the obligation would resurrect.

The Court held that the ISDA MA terms did not expressly provide for such a resurrection and therefore such a presumption was unfounded. On reflection, however, it is possible that the Court was misguided as the 2002 ISDA MA does in fact provide indicative reference to the suspensive nature of Section 2(a)(iii) in the context of examining the interest accruing on deferred payments referring to interest being paid "after such [withheld] amount becomes payable". Additionally the Court's new interpretation is also at odds with the early termination provisions of the ISDA MA as both versions state that amounts that were not paid by the non-defaulting party pursuant to Section 2(a)(iii) ought to be accounted for as "unpaid amounts [to the defaulting party]" when it comes to calculate the early termination amount.

This new interpretation has some major implications:

Section 2(a)(iii) mainly comes into play when an ISDA MA that is capable of being terminated early is, in fact, not terminated (as is likely when a non-defaulting party is out of the money). It is arguably less justifiable for the non-defaulting party to be rewarded by its obligations owed to the counterparty being extinguished, even if the default were eventually to be cured. This reinforces the incentive to invoke Section 2(a)(iii) even when a party knows that the other party's financial difficulties are transitory or even when a failure to pay is only due to an administrative error in the payment procedures.

Another potentially harsh consequence of the Court's decision is that Section 2(a)(iii) is also triggered upon the occurrence of a "Potential Event of Default". This means that the mere possibility of an event of default in respect of a party would entitle the other party to treat its obligations as extinguished.

This case is now on appeal, the results of which will be very interesting to all ISDA MA users.

Reed Smith published a client alert on this case available which is here.

3. ISDA Incorporated though a Confirmation
Calyon v Wytwornia Sprzetu Komunikacynego PZL Swidnik SA [2009] EWHC 1914

In this case, the jurisdiction of the English Court was questioned where an unamended ISDA MA governed a number of transactions by way of reference in a long-form confirmation. This confirmation contained a deemed acceptance provision which was initiated two business days after receipt.

The Court held that it had jurisdiction to hear the dispute. In reaching this conclusion the Court examined the jurisdiction requirements of Article 23(1)(b) of the Brussels Regulation (the "Regulation"). Calyon satisfied the Regulation requirements because it was able to demonstrate a course of dealings with Wytwornia and Wytwornia's signature of confirmations for previous structured derivative contracts which clearly stated that the contracts were subject to English law and governed by an ISDA MA (which itself contained an English law and jurisdiction clause).

Where a party is relying on the deemed execution of an ISDA MA to confer jurisdiction on English Courts, it should be clearly spelt out to the counterparty that the ISDA MA applies and that the transaction is governed by English law. The case also emphasises the importance of obtaining acknowledgment of confirmations (which proved very), even where the confirmation stipulates that if it is not acknowledged or corrected by the counterparty within a certain time frame the content of the confirmation will be considered correct.

4. ISDA MA Early Termination Provisions are not an Unenforceable Penalty
BNP Parbias v Wockhardt EU Operations (Swiss) AG [2009] EWHC 3116

In this case, the early termination procedures of the ISDA MA were challenged as being an unenforceable penalty

because they: (1) are not true liquidated damages as the requirement to reference a market price (which will invariably fluctuate significantly) makes it impossible to accurately agree the value in advance; and (2) apply uniformly to all events of default under the ISDA MA which arguably are not all of the same gravity i.e. a technical misrepresentation vs. an insolvency event.

The Court robustly rebutted the first argument as the effect of the clause was such that both parties received the benefit (or indeed the burden) of the unperformed transactions crystallising at a time of the non-defaulting party's choice. Therefore under the clause, the defaulting party may be *in the money* and it is therefore not right that this same party can on the one hand use the clause for its own benefit, and on the other argue that it was a penalty.

In addressing the second issue, the Court side-stepped a full analysis of this argument vis-à-vis all of the ISDA MA events of default and instead focused on the default in the case in hand i.e. failure to pay. In doing so, the Court determined that failing to pay was a contractual condition, a breach of which should trigger termination. This was reasonable and therefore not penal in nature. The Court has, however, left room for a future examination of the other ISDA MA events of default in this context.

Had the Court held that the relevant provisions of the ISDA MA constituted a penalty, then this would have had serious implications for the entire industry given the wide use of the ISDA MA. Such a ruling would inevitably have reached the Supreme Court for final determination.

5. US Bankruptcy Court Limits ISDA Counterparty Rights Upon a Bankruptcy Event of Default
In re Lehman Brothers Holdings, Inc., Case No. 08-13555 et seq. (JMP)(jointly administered)

In this US decision, the Bankruptcy Court held that the "*safe harbour*" protections of the US Bankruptcy Code only protect a non-defaulting party's right to liquidate, terminate or accelerate a swap, to offset and to net termination values and payment amounts and to foreclose on collateral, but do not permit the withholding of performance under a swap if the swap is not terminated.

In doing so, the Court forced the non-defaulting party, Metavante Corporation ("Metavante") to make all past payments due under certain interest rate swaps governed by the ISDA MA, together with default interest, as well as future scheduled payments as they came due, despite Metavante's contractual right under Section 2(a)(iii) of the ISDA MA to withhold such payments based upon the ongoing bankruptcy events of it's default of counterparty and the counterparty's credit support provider. Additionally the Court held that 11 months after the bankruptcy filing was too late for Metavante to invoke early termination and instead imposed a sunset on a non-defaulting counterparty's right to early termination upon a bankruptcy event of default despite no such sunset provision in either the derivatives ISDA MA or the US Bankruptcy Code itself.

The implications of this ruling are that: (1) the US *safe harbours* are specific and limited in scope and relate to terminated transactions and settlement payments; (2) the rights to withhold periodic scheduled payments due to the debtors under Section 2(a)(iii) of the ISDA MA are improper under US bankruptcy law when triggered by a bankruptcy event of default; and (3) the right to terminate early must be exercised promptly or be lost.

Metavante's appeal of the Court's decision is pending, but the debtors have proceeded to file numerous similar actions against other counterparties to compel withheld payments, in each case citing to the Metavante decision.

Reed Smith published a client alert on this case available which is here.

All of these cases all raise interesting issues, particularly those which are now on appeal. We will provide an update on the appeal cases once judgment has been passed.

Alert 10-150 Appendix

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