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Client Alert

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ISDA Payment Suspension Provisions Upheld

The High Court in London has upheld the terms of the ISDA Master Agreement (1992 and 2002 versions) which makes it a condition precedent to any payment obligation that no Event of Default has occurred in relation to the other party. Event of Default is widely defined to include failure to pay (or to deliver), breach of the agreement, a default by a party providing credit support, misrepresentation, and, most importantly, an insolvency having occurred – the relevant event in this case. The case was brought by the administrators of Lehman Brothers International Europe (LBIE) and is reported as *Lomas and others (Administrators of Lehman Brothers International (Europe)) v JRB Firth Rixson, Inc* [2010] EWHC 3372 (Ch). Market participants have eagerly awaited the outcome of the case. This briefing explains its significance.

Facts

LBIE had a large portfolio of swap contracts on its books. It had entered into the five swaps being considered in the case incorporating the ISDA Master Agreement (three contracts using the 1992 version and the two others the 2002 version governed by English law). LBIE went into administration on 15th September 2008.

The ISDA Master Agreement (1992) contains the following Section:

"2 "(a) General Conditions

(i) Each party will make each payment or delivery specified in each Confirmation to be made by it, subject to the other provisions of this Agreement.

(ii) Payments under this Agreement will be made on the due date for value on that date in the place of the account specified in the relevant Confirmation or otherwise pursuant to this Agreement, ...

(iii) Each obligation of each party under Section 2(a)(i) is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each other applicable condition precedent specified in this Agreement."

A similar provision appears in the ISDA Master Agreement (2002).

Section 5(a)(vii)(6) states that a Bankruptcy Event of Default exists when a party:

"Seeks or becomes subject to the appointment of an administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official for it or for all or substantially all its assets;"

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As a result of movements in the interest rate market LBIE was in the money on the five swaps. That meant that if the swaps had been closed out under Section 6 of the ISDA Master Agreement – something the counterparties but not LBIE could trigger – then sums would be due for payment to LBIE. In this case rather than electing to close out the counterparties chose to withhold performance of their obligations relying on the provisions of Section 2(a)(iii).

Suspension of Payment

The administrators of LBIE asked the court for directions on how the ISDA Master Agreement should be construed and what rights it gave to each of the parties.

The first issue considered by the court was whether Section 2(a)(iii) had the effect in practice of negating rather than suspending any payment obligation in favour of LBIE where it was in the money. If it prevented any payment obligation from arising, rather than suspending it, the administrators thought they would be better placed to argue the provision was not enforceable against them. The judge decided that in both versions of the ISDA Master Agreement the correct construction of the contract was that the payment obligation did arise but was suspended.

In relation to the 2002 version of the ISDA Master Agreement Section 9 expressly provided for interest to accrue on any payment obligation during the period of suspension. The court thought that this would not have made sense if Section 2 had been intended to have the effect of preventing a payment obligation ever arising. Although the 1992 version of the ISDA Master Agreement did not contain this same provision for interest to accrue on suspension the judge reached a similar conclusion in relation to Section 2 in that version of the agreement. The judge thought construing the document as a whole that the "once and for all" construction – meaning no payment obligation would arise at all - would produce *"a pointlessly draconian outcome, in the event of a minor and momentary default"*. That is in cases where the Event of Default was cured it could not have been intended that no payment obligation had ever arisen because of the now cured default.

The second issue was the duration of the suspension imposed by Section 2. The administrators argued that a term should be implied into the ISDA Master Agreement that the suspension was not to be indefinite but for a reasonable period. The administrators considered the duration of this reasonable period would be the period necessary either (i) to allow the counterparty to decide whether to exercise the right to close out under Section 6 or (ii) for the transaction to run its normal course and expire through effluxion of time. The court decided that there was no basis upon which such a term could be implied into the swaps. The agreement meant what it said on this point. The suspension of payment was not limited in duration as the administrators had argued; rather the judge stated that where any obligation is suspended by virtue of Section 2(a)(iii), because of a non fulfilment of a condition precedent, then that obligation does not survive the transactions stated maturity.

The Anti-Deprivation Principle - Again

The anti-deprivation rule is the long established principle of English law which, as the judge explained, *"is essentially based on the proposition that one cannot contract out of the provisions of the insolvency legislation which govern the way in which assets are dealt with in a liquidation."* In recent times (mainly as a result of Lehman related litigation) it has become easy to state, but difficult to apply. In particular, courts have indicated an unwillingness to allow the principle to be used to rewrite bargains between sophisticated parties particularly between financial and commercial entities who are well advised and able to look after their interests at the inception of a deal.

Once again as in the recent case *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160 (discussed in our earlier alert *Getting Your Priorities Right*) the spectre of an insolvency officer of a counterparty being able to get around a default provision in a swap was raised.

The administrators argued first that the discretion afforded to the counterparties to close out the transaction under Section 6 had to be exercised in a rational manner. They also argued that if the suspension of the payment obligation effected by Section 2 was indefinite that it deprived LBIE's estate (and thus LBIE's other creditors) of an asset for all time because LBIE could never cure the relevant Event of Default under the ISDA Master Agreement to lift the suspension.

The court rejected both arguments. It held that (i) 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 a purpose for which it was conferred and (ii) the counterparties could decide to exercise (or not to exercise) its rights under Section 6 in whichever manner it considered best served its own interests by way of a choice between alternative remedies arising out of LBIE's default. The judge indicated that it would be *"a very rare case in which the apparently regular exercise of a purely contractual discretion can be successfully challenged"*. Good news for freedom of contract and certainty in commercial dealings.

As far as the anti-deprivation principle was concerned the judge thought that the principle was not engaged in the case of these five swaps because the nature of LBIE's rights did not change on 15th September 2008 when it went into administration. Its rights to a payment were contingent before that date. They remained contingent after that date. Essentially, he came to the same conclusion the English court reached in the earlier *Perpetual* litigation when it considered a default provision in another swap contract.

Penalties and Forfeiture

The court rejected the administrator's suggestion that Section 2(a)(iii) operates as a common law penalty and is consequently unenforceable. It stated that the common law doctrine of penalty is not engaged where the trigger for the relevant provision to operate is not a breach of contract.

The court also rejected the administrators argument that LBIE's loss of the right to a payment (albeit a right that was contingent) as a result of the occurrence of a Bankruptcy Event of Default was a forfeiture in relation to which the court could grant discretionary relief. It held that the contingent payment right is not one of the types of property falling within the scope of the court's equitable jurisdiction to afford relief from forfeiture.

Commentary

ISDA had intervened in the case given its importance to the derivatives market worldwide. It wanted to assist the counterparties in arguing that no term should be implied into the contract and that the discretion afforded by Section 6 was one that was not subject to any qualification that it should not be exercised "capriciously or irrationally" as the administrators had argued. The judge agreed and would not accept any such terms should be implied. He believed the market wanted stability and that this was best served by having certainty of contract. That could best be achieved by refusing to imply terms into a contract concluded between sophisticated parties. That is good news for market participants[1].

An important factor for the judge in arriving at the conclusion that the ISDA Master Agreement did not offend the anti deprivation principle was the fact that all parties agreed for the purposes of this application that payment netting would still apply without regard to the suspending effect of Section 2(a)(iii). The judge was consequently able to ignore the earlier decision in *Marine Trade SA v. Pioneer Freight Futures Co Ltd BVI* [2009] EWHC 2656 (Comm) where the court had decided that if a payment was suspended under Section 2 it did not have to be taken into account for the purposes of the ISDA Master Agreement payment netting provisions. In essence the counterparties could have argued that LBIE had to make gross payments based on this earlier decision but chose not to do so. That earlier decision was technically binding on the judge in this case. However, because of the agreement of the parties that net rather than gross payments would be made, that issue was not a matter the court had to consider. If there had been any question of the parties claiming payments gross or if one party's payment obligations had ceased completely at the time the matter fell to be decided the judge left the door open for the application of the anti deprivation principle if a court considered the facts warranted it.

This judgment adds further weight to the view held by many that the circumstances in which a court will allow an insolvency officer to circumvent a default provision based upon the anti-deprivation principle of English insolvency law should now be considered very narrow - at least where the financial markets are concerned. It remains to be seen whether counterparties in a similar position would fair equally as well in other jurisdictions.

The decision confirming the effectiveness of Section 2(a)(iii) is welcome news for the derivatives industry. However, the situation is still fluid.[2] The administrators may yet appeal the decision. Moreover the UK Treasury in its December 2009 consultation paper[3] stated that it wants ISDA to find a market solution to enable a greater degree of certainty with respect to the timing of derivatives transaction termination. Indeed ISDA is already in the process of drafting an amendment to Section 2(a)(iii) on which it plans to consult with members in the new year.

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1 Whilst ISDA was happy about this aspect of the judge's decision ISDA was clearly unhappy with the judge's conclusion that any suspended payment obligations do not survive the relevant transactions stated maturity. In its press release dated 21st December 2010 ISDA stated: "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."

2 Please note that the enforceability of Section 2(a)(iii) has been considered in both Australia and the US. See: *Simms (in his capacity as liquidator of Enron Australia Finance Pty Ltd (in liq)) v TXU Electricity Ltd* (2003) 204 A.L.R. 658 affirmed (2005) A.C.S.R 295, and the Metavante ruling by the US Bankruptcy Court for the Southern District of New York in the Lehman Brothers U.S. chapter 11 cases. In Australia, the court upheld the right of TXU to indefinitely suspend its obligations (which decision may have been influenced by the existence of certain rights of Enron to bring the agreement to an end after the last date of performance under all open trades on satisfaction of certain conditions), whereas the US Bankruptcy Court ruled that Metavante Corporation was not permitted to withhold payments owing to Lehman Brothers Special Financing Inc. under Section 2(a)(iii). For further advice on this and related topics clients should consult their Baker & McKenzie derivatives contact.

3 HM Treasury "Establishing resolution arrangements for investment banks". December 2009 paragraphs 7.5 to 7.14.