Allen&Overy Client briefing:

English High Court rules on the construction and effect of Section 2(a)(iii) of the 1992 and 2002 ISDA Master Agreements

On 21 December 2010, in *Lomas v JFB Firth Rixson, Inc*, the English High Court ruled on an application for directions by the Joint Administrators of Lehman Brothers International (Europe) (**LBIE**) as to the true construction and effect of Section 2(a)(iii) of the 1992 and 2002 ISDA Master Agreements. Section 2(a)(iii) provides, amongst other things, that the obligation of each party to make the payments specified in each confirmation is subject to the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing.
The key rulings of Mr Justice Briggs are that: (i) Section 2(a)(iii) has merely a "suspensory" effect until the default is cured; (ii) the suspended contingent obligations of the Non-defaulting Party end on the expiry of the term of the applicable transaction; (iii) the Non-defaulting Party is entitled to exercise its discretion whether or not to designate an Early Termination Date in such a way as it considers best serves its own interests; (iv) in the context of the swap transactions in question, Section 2(a)(iii) does not offend against the "anti-deprivation principle" under English insolvency law; and (v) the loss of LBIE's right to contingent net payments occasioned by its Bankruptcy Event of Default is not a forfeiture for which the court could grant relief.

Background

At the time that LBIE went into administration on 15 September 2008, it was a party to a number of interest rate swap agreements (the **Swaps**) with four manufacturing and/or trading companies who had entered into the Swaps to hedge their interest rate risk. A number of the Swaps had been entered into under the 1992 ISDA Master Agreement; others had been entered into under the 2002 ISDA Master Agreement. The governing law in respect of each was English law.
LBIE's entry into administration constituted an Event of Default under each of the applicable ISDA Master Agreements. LBIE's counterparties subsequently relied upon Section 2(a)(iii) of the ISDA Master Agreements as the basis for a refusal to make further payments to LBIE under the Swaps. Challenging their interpretation of the ISDA Master Agreements, LBIE applied to the High Court for directions as to the true construction and effect under English law of Section 2(a)(iii). Given the potentially wide-ranging implications for the derivatives markets generally, ISDA (represented by Allen & Overy LLP, Antony Zacaroli Q.C. and Jeremy Goldring) was permitted to participate in the proceedings as an intervener.

The High Court decision

Referring to the ISDA Master Agreement as "probably the most important standard market agreement used in the financial world", Mr Justice Briggs ruled, amongst other things, on the following key issues:

1. *Whether certain implied terms should be read into Section 2(a)(iii).*
It was submitted on behalf of LBIE that, either as a matter of construction or of implication of terms, Section 2(a)(iii) only suspends the Non-defaulting Party's payment obligations for a reasonable time or, alternatively, until such time as the transaction(s) have run their course (such that, at the expiry of the natural term of the last transaction, the Non-defaulting Party must either

submit to a netting process which calls for payment of all suspended payment obligations or submit to the consequences of an early termination as at that date). LBIE further submitted that the Non-defaulting Party is, under Section 6(a) of the ISDA Master Agreements, under a constant 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.
Mr Justice Briggs rejected each of these submissions, considering them contrary to the express terms of the ISDA Master Agreements.

2. *Whether Section 2(a)(iii) is a "once and for all" provision or whether its effect is merely "suspensory".*
Three of the respondents submitted that Section 2(a)(iii) meant that, if an Event of Default or Potential Event of Default had occurred and was continuing on a date for payment by the Non-defaulting Party, then that payment obligation never arose and would not thereafter arise in the event that the default was cured. The alternative submission, made on behalf of ISDA (and as held by Austin J in the New South Wales Supreme Court in *Enron Australia v TXU Electricity [2003] NSW SC 1169)*, was that the effect of Section 2(a)(iii) was that the Event of Default or Potential Event of Default only suspended the coming into effect of the payment obligation until the default was cured (described by Mr Justice Briggs as a "suspensory" construction).
Noting that Section 9(h)(i)(3)(A) (*Interest on Deferred Payments*) of the 2002 ISDA Master Agreement expressly contemplates that the effect is suspensory, Mr Justice Briggs ruled in favour of the suspensory construction in relation to the 1992 ISDA Master Agreement, placing emphasis on the draconian results that could otherwise follow. In so doing, Mr Justice Briggs declined to follow the view to the contrary expressed *obiter* by Flaux J in *Marine Trade SA v Pioneer Freight Futures Co Ltd BVI [2009] EWHC 2656 (Comm)*.
Mr Justice Briggs further ruled that the contingent obligations suspended by Section 2(a)(iii) would expire upon the expiry of the term of the applicable transaction.

3. *Whether Section 2(a)(iii) offends against the anti-deprivation principle.*
As a matter of English law, an agreement that provides that assets are to belong to a company until the commencement of insolvency proceedings, but are then to be taken away from the insolvent estate, is invalid as a matter of public policy. This is often referred to as the "anti-deprivation principle". This principle is based on the fact that it is not possible to contract out of the provisions of the insolvency legislation which govern the way in which assets are dealt with in an insolvency process (primarily those which provide for distributions in an insolvency process to be made to creditors of the same class on a *pari passu* basis).
Mr Justice Briggs ruled that Section 2(a)(iii) of the Master Agreements did not contravene the anti-deprivation principle in the context of the Swaps. The contingent rights to future payments which LBIE enjoyed under each of the Swaps, were the *quid pro quo* not merely for services previously rendered by LBIE, but for the ongoing provision of the interest rate hedges. The contingency that there should be no bankruptcy Event of Default was a provision designed to ensure that LBIE would only receive its *quid pro quo* for providing the interest rate hedge for as long as it was in the financial condition to be able to do so. This placed the contingent rights of which LBIE had been deprived by virtue of its administration clearly on the side of the difficult dividing line which permitted the parties to include an insolvency based "flaw" when the rights were created without infringing the anti-deprivation principle.

4. *Whether the loss of LBIE's right to contingent net payments occasioned by its Bankruptcy Event of Default was a forfeiture for which the court could grant relief.*
Mr Justice Briggs ruled that the condition precedent in Section 2(a)(iii) is not a forfeiture, but a condition precedent and that, in any event, a contingent right to net payments of money under a contract was not a type of property in respect of which the jurisdiction to grant relief from forfeiture

exists (as it would give rise to unacceptable uncertainties and fetters upon contractual rights).

Comment

To many, the ruling of Mr Justice Briggs is likely, in large part, to represent a welcome confirmation of the orthodox industry understanding of Section 2(a)(iii) of the ISDA Master Agreements as it is intended to operate under English law. The High Court accepted the majority of submissions made on behalf of ISDA and adopted an interpretation quite different from that adopted by Judge Peck in the U.S. Bankruptcy Court in proceedings brought by a US Lehman Brothers debtor against the Metavante Corporation (which suggested that, under US bankruptcy law, a Non-defaulting Party is unable to rely on Section 2(a)(iii) where it does not also terminate the contract)[1]. For a number of reasons however Section 2(a)(iii) of the ISDA Master Agreements is likely to remain the subject of substantial discussion:

a. *How long should the "suspensory" effect of Section 2(a)(iii) last?* The ruling of Mr Justice Briggs that the contingent obligations suspended by Section 2(a)(iii) would expire upon the expiry of the term of the applicable transaction, was contrary to the submissions made on behalf of ISDA that such suspension should in theory be potentially indefinite. There is a concern that such an interpretation could have the unfortunate effect of encouraging out-of-the-money parties to withhold payments and may be contrary to market expectations.

b. *Gross v Net.* Another important issue is whether, where a Non-defaulting Party proves in the administration of the Defaulting party, the Non-Defaulting Party is entitled to prove in respect of the entirety of the Defaulting Party's payment obligations where the Non-Defaulting Party has not met those obligations which would have fallen due under the Transaction but for Section 2(a)(iii), without giving credit for obligations which would have arisen but for Section 2(a)(iii) (i.e. on a gross basis, rather than a net basis). Mr Justice Briggs considered it unnecessary to rule on this issue on the basis that all the parties had agreed that the net basis was the correct approach in the present case. Mr Justice Briggs therefore expressed no view one way or the other upon the ruling of Flaux J to the contrary in *Marine Trade*.

c. *Anti-Deprivation Principle.* It is important to note that Mr Justice Briggs did not decide that Section 2(a)(iii) could never infringe the anti-deprivation principle. Mr Justice Briggs was clear that the decision applied only to the Swaps and that a different analysis might be appropriate where a Master Agreement was incorporated in other types of transaction. Moreover he indicated that the concession that Section 2(a)(iii) operates under the Swaps on a net rather than a gross basis was important. If he had concluded (without that concession) that Section 2(a)(iii) operates so as to increase LBIE's obligation on any future payment date from a net amount to a gross amount, that might have offended the anti-deprivation principle. The judgment contains some useful clarifications regarding the scope of the anti-deprivation principle which is a topical issue at the moment. The UK Supreme Court is currently due, in March 2011, to consider the anti-deprivation principle in relation to a clause which provided for the subordination of a swap counterparty's rights to collateral on the counterparty's insolvency[2]. It is hoped further clarity on the principle's operation will be provided by the Supreme Court's judgment.

d. *Appeal.* Mr Justice Briggs granted LBIE permission to appeal in relation to the anti-deprivation, construction and penalty issues.

e. *Future of Section 2(a)(iii)*. Even before this case was brought, ISDA had indicated that it was in the process of updating Section 2(a)(iii) in response to regulatory concerns including those of HM Treasury in its consultation regarding failed investment firms. ISDA intends to consult with its members regarding any changes that may be necessary to Section 2(a)(iii) in light of these concerns.

[1] It should be noted that the US *ipso facto* provisions on which the *Metavante* decision was based are very different from the English anti-deprivation principle.

[2] Although the case brought by one of the parties, Perpetual, has now settled, it is hoped that the Supreme Court will still hear the appeal in relation to a second party, Belmont.