Linklaters

3 April 2012

Court of Appeal Rules on the ISDA Master Agreement

Contents

In a decision that will be welcomed by the derivatives market, the Court of Appeal has today handed down judgment in a series of conjoined appeals involving the interpretation of the 1992 ISDA Master Agreement. The judgment resolves the uncertainty created by a number of recent decisions which, in certain respects, conflicted with each other as well as with market expectations.

Section 2(a)(iii): suspension or one time only?

The first of the appeals, *Lomas v JFB Firth Rixson, Inc*, concerned the operation of Section 2(a)(iii) of the ISDA Master Agreement. This provides that a party's obligations under a transaction are "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 Court held that, where a party is subject to such an event, Section 2(a)(iii) has the effect of *suspending* the other party's obligations and that this will last for as long as the Event of Default is continuing. If the Event of Default is subsequently cured, the suspended obligations fall due, even if this happens after the transaction's normal maturity date.

This brings to an end a judicial debate that commenced with the *obiter* statement of Flaux J in *Marine Trade SA v Pioneer Freight Futures Co Ltd* [2010] Lloyd's Rep 631 that whether the condition precedent is fulfilled is to be tested only on the scheduled performance date and that, if the Event of Default or Potential Event of Default ceases to exist, performance does not then become due. Flaux J's analysis raised the spectre of a party that experiences a minor and short-lived default, perhaps through no fault of its own, permanently losing any payments or deliveries that were scheduled to be made to it in the period before the issue is resolved. Although, at first instance in *Lomas v JFB Firth Rixson, Inc* [2011] 2 BCLC 120, Briggs J declined to follow it, he held that the suspension lasted only until the maturity date of the relevant transaction, and that the condition precedent could no longer be cured after that date. This was problematic because an Event of Default might occur immediately before the final payment date, resulting in the loss of the payments or deliveries that were to have been made to the Defaulting Party on that date.

Rejecting both of these approaches, the Court of Appeal explained that there is a distinction between a debt obligation and the obligation to pay it (following an analysis adopted by Gloster J in *Pioneer Freight Futures Co Ltd v TMT Asia Ltd* [2011] 2 Lloyd's Rep 96). Section 2(a)(iii) makes *payment* conditional on the absence of an Event of Default or Potential Event of Default (if the debt has not fallen due by the time the event occurs) but the underlying debt continues in existence. Since the conditionality lasts only for as long as there is an Event of Default or a Potential Event of Default, the payment obligation arises as soon as this ceases to be the case. There is no basis for concluding that this lasts only until the maturity date as there is nothing in the Agreement to support such a construction and the fact that the Non-defaulting Party may be subject to an indefinite contingent liability is too slender a basis for implying a provision extinguishing the liability on that date.

The Court also rejected an argument advanced by the administrators of Lehman Brothers International (Europe) that Section 2(a)(iii) implicitly operates only for a reasonable period of time, or only until the scheduled maturity date, with payment from the Non-defaulting Party then becoming due if an Early Termination Date has not been designated. It was held that there is no basis for implying such a term as the contract works perfectly well without one. The practical implications of this for other counterparties are, however, likely to be short-lived, since HM Treasury has already expressed dissatisfaction at the prospect of an out-of-the-money counterparty declining to terminate so as to avoid having to make a close-out payment to an insolvent bank or investment firm. An ISDA consultation to address the point is therefore currently under way. The outcome is likely to be a limit on the period during which reliance may be placed on Section 2(a)(iii), at least for counterparties that adhere to ISDA's proposals.

Payment netting

The Court of Appeal's decision has also resolved the question of whether, if a party's obligations are suspended under Section 2(a)(iii), it can nevertheless enforce the Defaulting Party's obligations without giving credit for the suspended obligations. In the *Marine Trade* case and *Pioneer Freight Futures Co Ltd v Cosco Bulk Carrier Co Ltd* [2011] 2 All ER (Comm) 1079, Flaux J held that payment netting under Section 2(c) of the ISDA Master Agreement is not available in these circumstances because it applies only where the relevant sums "would otherwise be payable" and the effect of Section 2(a)(iii) is to prevent them from becoming payable.

In *Pioneer Freight Futures Co Ltd v TMT Asia Ltd* [2011] EWHC 1888, on the other hand, Gloster J took the opposite view, pointing out that Section 2(a)(i) requires each party to make the payments and deliveries specified in the Confirmations "subject to the other provisions of this Agreement". This, she reasoned, indicates that the payment netting provisions operate *before* the condition precedent in Section 2(a)(iii) takes effect and reflects the fact that their commercial purpose is to achieve an automatic netting of reciprocal payment obligations as they arise.

The Court of Appeal has now upheld Gloster J's approach, concluding that the phrase "would otherwise be payable" means that payment netting must be applied to any sums that would be payable in the ordinary course of events, i.e. without regard to Section 2(a)(iii). The Court pointed out that it would make no commercial sense for the Non-defaulting Party to be able to recover from the Defaulting Party on a gross basis as this would fundamentally change the financial structure of the relationship. This is undoubtedly correct and the decision is to be welcomed.

The Court also held that Section 2(c) applies only in relation to payments falling due on the same date. A Defaulting Party will not, therefore, be able to require the Non-defaulting Party to give credit for any payments that were scheduled to be made by the latter on any *prior* dates.

Anti-deprivation and pari passu

A separate question that arose was whether Section 2(a)(iii) contravenes the anti-deprivation rule or the pari passu rule. The first of these prevents a company from agreeing that an asset to which it would otherwise be entitled ceases to be available to it in the event of its winding-up or administration, unless the agreement is entered into for proper commercial purposes rather than to achieve a deprivation of assets on bankruptcy (*Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2012] AC 383). The pari passu rule, on the other hand, prevents a company from contracting out of the requirement that, in a winding-up or distributive administration, its assets must be distributed to its creditors on a pari passu basis.

In one of the appeals considered by the Court, Carlton Communications Ltd ("Carlton"), in reliance on Section 2(a)(iii), declined to make a final payment under a swap to Lehman Brothers Special Financing Inc ("LBSF"), on the basis that LBSF was subject to insolvency proceedings so that an Event of Default had occurred. LBSF argued that, even if Section 2(a)(iii) merely had a suspensory effect, as the period of suspension could be indefinite, there was a deprivation of an asset because it could not, in practice, secure payment. It also argued that there was a breach of the pari passu rule because this affected the distribution of its assets amongst its creditors.

As regards the anti-deprivation rule, the Court held that the suspension of Carlton's obligations for the duration of LBSF's insolvency was a proper commercial response to the insolvency as it merely prevented Carlton from having to make payments to a bankrupt counterparty. It was not designed to avoid the effect of any bankruptcy laws. Although in Carlton's case there was no on-going credit risk, as only the final payment was due, the commerciality of Section 2(a)(iii) had to be judged by considering its operation throughout the life of the contract. In any event, the anti-deprivation rule applies only where the trigger is the company's own bankruptcy and, in LBSF's case, the suspension would have been triggered by the bankruptcy of its holding company anyway (as it was a Credit Support Provider). The rule was not, therefore, engaged.

It does not, however, necessarily follow that the same conclusion will apply in all circumstances. The Court emphasised that the application of the anti-deprivation rule to executory contracts must be considered on a case-specific basis. This reflects the approach adopted by Briggs J at first instance in *Lomas v JFB Firth Rixson, Inc*. He drew a distinction between contracts under which the chose in action is the quid pro quo for something done, sold or delivered before bankruptcy and something intended to be the quid pro quo for services yet to be rendered. He said that, in the first type of case, the Court will be slow to permit the insertion of a flaw in the asset which is triggered by the insolvency process, whereas, in the second, such a flaw is less open to objection. The Court of Appeal agreed that these factors will be relevant as part of the means of distinguishing between a legitimate commercial rearrangement of rights to reflect the economic consequences of insolvency and an attempt to pre-empt the distribution of assets in a bankrupt estate.

In contrast to the anti-deprivation rule, the pari passu rule does not depend for its application on questions of commerciality and good faith. However, it is only engaged in respect of any assets of the estate that exist at the commencement of the insolvency proceedings. It is these which are to be distributed on a pari passu basis. The Court held that, as Section 2(a)(iii) prevents any debt from becoming payable during the currency of the proceedings, there is no property which is capable of being distributed. This confirms that the flawed asset analysis is alive and well as regards the pari passu rule. It is only for the purpose of the anti-deprivation rule that the Court will consider the commercial substance of the arrangements. The Court went on to hold that, even if this were not the case, as Carlton was not a creditor of LBSF, there was no question of any assets being distributed to it. There could not, therefore, be a contravention of the requirement to distribute LBSF’s assets on a pari passu basis.

Close-out calculation

The issues discussed above arise where the Non-defaulting Party declines to designate an Early Termination Date. Where there *is* an Early Termination Date, under the definition of “Market Quotation” the condition precedent in Section 2(a)(iii) is assumed to be satisfied for all transactions that remain in effect. The Defaulting Party therefore obtains the benefit of the suspended payments and deliveries in the close-out payment calculation. One of the problems with the approach taken in the *Marine Trade* case and the first instance decision in *Firth Rixson*, however, was that, if the obligations affected by Section 2(a)(iii) cannot survive the maturity date of a transaction, it is hard to see how the transaction could be said to be “in effect”. It was not surprising, therefore, that, in *Pioneer Freight Futures Co Ltd v Cosco Bulk Carrier Co Ltd*, Flaux J held that this phrase excludes any transactions in respect of which the maturity date has passed.

Linklaters

Given the Court of Appeal's decision that Section 2(a)(iii) merely has a suspensory effect and that the suspension can continue indefinitely, it was clear that the *Cosco* decision could no longer stand. The Court has therefore reversed that decision, holding that a transaction remains in effect even after the maturity date if any obligations suspended under Section 2(a)(iii) remain unsatisfied. Where an Early Termination Date occurs, therefore, the payments suspended by Section 2(a)(iii) must be treated as Unpaid Amounts.

That disposes of the question where Market Quotation applies. However, one further issue remained. In contrast to the Market Quotation methodology, the definition of "Loss" does not state that each applicable condition precedent must be assumed to be satisfied. In *Britannia Bulk plc v Pioneer Navigation Ltd* [2011] 2 Lloyd's Rep 84, it was, somewhat ambitiously, argued that, in view of this, no credit had to be given for any suspended obligations. Instead, the Non-defaulting Party merely had to assess the gain it had made as a result of the termination. Since, in the absence of a termination, Section 2(a)(iii) would have prevented it from having to perform, according to this argument, the Non-defaulting Party had made no gain at all.

If successful, such an argument would have meant that Market Quotation and Loss would have proceeded on two entirely different bases, notwithstanding the conclusion, reached in a number of earlier cases, that they aim to achieve broadly the same result. Happily, it was therefore rejected both by Flaux J at first instance and by the Court of Appeal. Where Loss applies, therefore, the Non-defaulting Party must consider the position it would have been in if no Event of Default had occurred and ascertain the gain it has made as a result of being relieved of the liabilities it would have been subject to as a result of the termination.

Simon Firth

Author: Simon Firth

Contacts

For further information please contact:

Simon Firth
Partner, Derivatives and Structured Products Group, London

(+44) 20 7456 3764

simon.firth@linklaters.com

One Silk Street

London EC2Y 8HQ

Telephone (+44) 20 7456 2000
Facsimile (+44) 20 7456 2222

Linklaters.com