

## Banking, Business and Public Finance Client Service Group

From Bryan Cave, London

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### Section 2(a)(iii) of the ISDA Master Agreement - the latest case before the English courts still conflicts with the position of the US Bankruptcy Court

#### Introduction

*Lomas and others (together the Joint Administrators of Lehman Brothers International (Europe) (in administration)) v JFB Firth Rixson, Inc. and others and ISDA as intervenor* (2010) required the English High Court to look again at the consequences of section 2(a)(iii) of the ISDA Master Agreement (1992 and 2002 versions) on the obligations of the parties when an event of default occurs. Section 2(a)(iii) makes each party's obligation to make a payment conditional on there being no continuing event of default (actual or potential) on the part of the other party ("X"). X, if there is an on-going event of default in relation to it, is therefore prevented from claiming payment from the other, non-defaulting, party ("Y"). Clearly, where the event of default is the insolvency of X, this becomes a matter of immediate concern for X's creditors.

#### Non-defaulting party's payment obligation is merely suspended

In *Lomas*, the English High Court was clear that Y could rely on section 2(a)(iii) not to make payment under its swap with X whilst the relevant event of default was continuing. However, Y's payment obligation was merely suspended until the relevant event of default had come to an end - Y's payment obligation did not cease completely unless the event of default was still continuing at the termination date of the swap. Although in theory Y's payment obligation might at some future point in time revive, for so long as it is suspended it will be ignored for the purposes of calculating the liability of one party to the other following netting under section 2(c) of the ISDA Master Agreement (settlement netting). X's liability to make payment to Y is therefore greater than it would otherwise be. Close-out netting under section 6 of the ISDA Master Agreement is different since there is no such condition precedent to one party's payment obligation to the other.

## **Calls for ISDA to amend section 2(a)(iii)**

Section 2(a)(iii) protects Y from being placed in a disadvantageous position. However, in practice creditors of insolvent parties in the position of X have suffered as a result of the inability of X to claim payment otherwise due to X.

This has resulted in calls for ISDA to amend section 2(a)(iii) so as to produce a fairer outcome.

The problems with section 2(a)(iii) were highlighted in the earlier English High Court case of *Marine Trade SA v Pioneer Freight Futures Co. Ltd. BVI* (2009) where the court went further than the Lomas case and expressed the view that X's payment obligation simply ceased at the relevant settlement date - it could never revive according to the court even if the event of default was subsequently cured.

Whilst not central to the decision in *Marine Trade*, the inconsistency in the statements of the court is not helpful.

## **The US courts**

The US Bankruptcy Court for the Southern District of New York in 2009 in the *Lehman Brothers* bankruptcy case (prior to the English *Marine Trade* case) took the opposite position to the English courts - Y should continue to make its payments under the relevant swap or else terminate the swap and pay whatever was due from Y to X. Also, Y must make its decision whether to terminate within a reasonable time.

## **The commercial issue in Lomas**

Lehman Brothers International (Europe) ("LBIE") was in the position of X. The matter concerned a number of interest rate swaps which were in the money for LBIE since its floating rate payment liability under these swaps was significantly less than the fixed rate liability of the counterparties to LBIE. Therefore, LBIE's administrators would benefit if the counterparties terminated the relevant swaps and settled in accordance with section 6 of the ISDA Master Agreement. The counterparties would benefit if the swaps continued and they were able to rely on section 2(a)(iii) to have payments otherwise due from them ignored.

The court in *Lomas* disagreed with the arguments put forward by LBIE's administrators, in each case because of the court's construction of the terms of the ISDA Master Agreement.

## **Suspension or cessation**

Whilst the court disagreed with the views on this of the court in *Marine Trade*, ISDA's submission to the court in *Lomas* went further than the court in *Lomas* was prepared to go. In ISDA's view, the payment obligations of Y could revive at any time the default was cured even after the last date for payment (potentially resulting in a permanent contingent liability in the accounts of Y). Based on its construction of the ISDA Master Agreement, the court in *Lomas* disagreed with ISDA.

## **The anti-deprivation principle**

The anti-deprivation principle was the LBIE administrators' alternative argument in *Lomas*. This principle, under English common law, provides the court with the ability to override a contractual

provision which takes away from an insolvent company some asset which would otherwise benefit its creditors. However, since the payment obligations of the counterparties were not assets of LBIE because of the conditionality of section 2(a)(iii), the anti-deprivation principle was not offended according to the court in *Lomas*. (The court emphasised that its decision might be otherwise on different facts.)

## The future

Faced with pressure from supervisors and the UK Treasury, it is likely that ISDA will amend section 2(a)(iii). This is currently being considered within ISDA. ISDA has expressed surprise with the view of the English High Court in *Lomas* so it is unlikely simply to come up with an amendment which follows that court's construction of the current language of section 2(a)(iii), that Y's payment obligations are extinguished on the termination date of the relevant swap if the relevant event of default of X has not been cured by then. There will no doubt be discussion for some time between ISDA and market participants. What is clear is that, however resolved, resolution is likely to be by way of revising the drafting of section 2(a)(iii) since the view of the English courts is that the meaning and effect of section 2(a)(iii) is one of construction of its terms in accordance with the courts' usual rules of interpretation of contracts.

The UK Government wants the market to find a solution which gives Y some flexibility whilst giving certainty to creditors of an insolvent X that the derivative transactions will be terminated under section 6 within a reasonable period. The UK Government has not ruled out intervening itself by way of legislation if a solution is not found by the market. The issue is very much one of the recent financial crisis - the UK Government notes that until then it was normally assumed that the non-defaulting counterparty would eventually terminate and close-out the outstanding positions.

For further information on this topic, please direct your queries to your Bryan Cave contact or:

**Ed Marlow**  
London  
+44 (0)20 3207 1286  
[ed.marlow@bryancave.com](mailto:ed.marlow@bryancave.com)

**Martha Collins Rolle**  
London  
+44 (0)20 3207 1286  
[marty.rolle@bryancave.com](mailto:marty.rolle@bryancave.com)

**Denis McCusker**  
St Louis  
+1 (314) 259 2455  
[dpmccusker@bryancave.com](mailto:dpmccusker@bryancave.com)

**Bart Wall**  
St Louis  
+1 (314) 259 2765  
[bdwall@bryancave.com](mailto:bdwall@bryancave.com)

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