Client Alert

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Breaking the ISDA Section 2(a)(iii) Insolvency Stalemate

stale-mate

*[**steyl**-meyt]*
noun

1. *A drawing position in chess in which the king, although not in check, can move only into check and no other piece can move.*

2. *Any position or situation in which no action can be taken or progress made; deadlock.*

On 19 June 2014, the International Swaps and Derivatives Association ("ISDA") published an amendment to the ISDA Master Agreement for use in relation to section 2(a)(iii) of that agreement, for parties who wish to amend their ISDA Master Agreements to insert a time limit on the operation of that provision in circumstances where an event of default has occurred in relation to one of the parties.

The Background

For over 20 years now it has been market practice, for OTC derivatives trades governed by an ISDA Master Agreement, that following your counterparty's default, you do not have to perform any payment or delivery obligations until that default is cured. The essential rationale behind this concept is that the non-defaulting party, although it has the right under the ISDA Master Agreement to bring about an early termination of all transactions under the ISDA Master Agreement as a result of such default, may have legitimate reasons for not rushing into such a decision. It may instead wish to carefully monitor the situation, particularly if there is a prospect of a cure, before taking such a final decision. Nevertheless, the understanding has long been that, for so long as the counterparty remains in default, the non-defaulting party should not be required to deliver assets or pay money to the defaulting party, given that it has a limited expectation of the defaulting party ever complying with its obligations.

These so-called "suspension rights" are contained in section 2(a)(iii) of the ISDA Master Agreement (both the 1992 and the 2002 versions). The "suspension" is effected by providing that the payment and delivery obligations of a party are conditional upon, among other things, there being no Event of Default or Potential Event of Default with respect to the other party that has occurred and is continuing, and that no Early Termination Date has been designated in respect of the relevant transaction. Strictly speaking, therefore, if on the scheduled date for a payment or delivery, there is in existence an Event of Default with respect to the other party, the first party's obligation to make the scheduled payment or delivery has not in fact even arisen.

The Issue

So far, so good. However, these provisions have given rise to a good deal of uncertainty, and some contrasting case law, in the context of the bankruptcy or insolvency of one of the parties. The commencement of bankruptcy proceedings, say, in relation to Party A will generally constitute an Event of Default under the ISDA Master Agreement. As such, until an Early Termination Date is specified by Party B, Party B's scheduled payment and delivery obligations will not arise for so long as Party A remains in default.[1] Among the typical Events of Default under an ISDA Master Agreement, an Event of Default based on bankruptcy is arguably the least likely event to be cured, with the defaulting party most often either being reorganised or liquidated through the bankruptcy proceeding. The discontinuance of a bankruptcy proceeding with the defaulting party being restored to its precommencement status is a rare event. Thus, as a practical matter, once an Event of Default based on bankruptcy commences, the condition precedent in Section 2(a)(iii) will in fact never be satisfied.

Many market participants, as a matter of practice, will promptly terminate all transactions with a counterparty following the occurrence of a bankruptcy Event of Default with respect to that counterparty. By doing so, a market participant crystallises the amount of its claim based on then current pricing data. This provides the market participant with a claim against or amount owing to the bankrupt counterparty that will not fluctuate during the pendency of the bankruptcy proceeding and that is less likely to become subject to valuation disputes at a later date. In addition, many market participants are eager to implement, and to determine the costs of implementing, replacement transactions and to manage, adjust or terminate hedges or other related positions that they may hold in connection with the terminated transactions. Attending to all these matters promptly is an approach favoured by many large market participants. Even so, some non-defaulting parties (particularly those with out of the money positions) have determined that their preferred course of action, when faced with their counterparty's insolvency, is not to exercise their right to terminate and instead rely on section 2(a)(iii) to suspend their payment and delivery obligations to the defaulting party for all or some part of the period during which the bankruptcy Event of Default continues – not a bad situation to be in, some might say.

The extent to which the section 2(a)(iii) provisions could be used in such a way, for an indefinite period of time, became fully apparent in the aftermath of the Lehmans collapse, in relation to the many OTC derivatives where the insolvent Lehman entity was in the money, and resulted in a great deal of litigation on this point on both sides of the Atlantic. There had been differences in judicial views as to whether the suspension of performance under section 2(a)(iii) could continue until the condition was satisfied (i.e., indefinitely), or whether the suspension had to end after a "reasonable" period of time, or no later than the scheduled expiry date for the relevant transaction.

In the UK, the key judicial decision is contained in the case of *Lomas v. JFB Firth Rixson Inc.* [2012] EWCA Civ 419. In that case, the Court of Appeal essentially decided that a non-defaulting party can, by virtue of section 2(a)(iii), refuse to make payments to a defaulting party while the Event of Default is continuing, and that the payment obligation remains suspended (potentially indefinitely) while the condition precedent remains unfulfilled. However, once the default is cured, and the condition is fulfilled, the "suspended" payment obligation revives. The court rejected the argument that there should be an implied term of the contract that the non-defaulting party must terminate the transaction after a certain time, as well as the argument that the suspension of obligations had any time-limit or long-stop date.

In the U.S., however, a different result was reached in the landmark decision in *In re Lehman Brothers Holdings, Inc. et al* (Case No. 08-13555(JMP), Bankr SDNY, 15 September 2009), commonly known as the Metavante case,

[1] For certain jurisdictions, such as Japan, it is common to provide for Automatic Early Termination ("AET") of the transactions under the ISDA Master Agreement upon the occurrence of certain insolvency-related events. In the case of such an event, section 2(a)(iii) would become irrelevant, since all payments and deliveries would then automatically cease, but be brought into account in determining the early termination payment. However, in the case of Events of Default that do not give rise to AET, and for those jurisdictions where AET is not applied, section 2(a)(iii) remains relevant.

due to the operation of the U.S. Bankruptcy Code. In that case, Judge James M. Peck[2] considered that on the facts of the case, the non-defaulting counterparty, Metavante Corporation, was not entitled to rely on the section 2(a)(iii) condition as part of the "safe harbor" provision of the U.S. Bankruptcy Code, where no attempt had been made to terminate the agreement or apply any close-out netting. Judge Peck held that Metavante's "conduct of riding the market for the period of one year, while taking no action whatsoever, is simply unacceptable and contrary to the spirit of [the safe harbor] provisions of the Bankruptcy Code."

The ISDA Proposed Solution

As a result of the various contrasting decisions that were emerging in relation to section 2(a)(iii), ISDA has for several years been considering whether additional changes to the ISDA Master Agreement were necessary or desirable to address this issue. In addition, the UK Treasury, the Bank of England and the UK Financial Services Authority (the forerunner to the Financial Conduct Authority) undertook a lengthy dialogue with ISDA on this issue, driven by their particular interest in ensuring that insolvent financial counterparties should not, in effect, be precluded from realising on the inherent value of their OTC derivative contracts.

All this has culminated in the issuance in June 2014 by ISDA of an optional bilateral agreement to amend the ISDA Master Agreement in respect of section 2(a)(iii).

The effect of this amendment, if both parties to the ISDA Master agree to such amendment, is that the defaulting party will be given the ability to specify by notice a long-stop date after which the cure of the relevant Event of Default will cease to be a condition precedent to the obligations of the non-defaulting party. This will therefore mean that, by no later than the first local business day after the long-stop date, the non-defaulting party must either make its scheduled payments or deliveries, together with any applicable contractual interest or compensation, to the defaulting party, or alternatively must have declared an Early Termination Date in respect of the transaction. In the latter case, this would have the effect of constituting the suspended obligations as Unpaid Amounts, to be brought into account in determining the final termination amount payable by one party to the other in respect of the terminated transactions.

The amendment goes on to provide that, in respect of Events of Default other than those falling within section 5(a)(vii) (bankruptcy and insolvency defaults), if a subsequent Event of Default occurs in relation to the defaulting party prior to the long-stop date, then the previous designation of the long-stop date is considered null and void, and the defaulting party would have to set a new, later long-stop date by a new notice to the non-defaulting party. This would not apply where the original default was a section 5(a)(vii) default, in respect of which the long-stop date is a "hard" stop.

The parties are free to agree regarding the specified number of days following the relevant notice, on which the long-stop date will occur. ISDA has suggested a period of 90 days following the notice, and the FCA in the UK has expressed the opinion that a period of more than 90 days is too long.

Conclusion

Parties to ISDA Master Agreements should now give thought to whether or not to adopt the ISDA Amendment, and in so doing should consider whether or not a similar solution is required also to address a similar issue arising in relation to any New York law credit support annex or English law credit support deed. These documents contain a similar condition precedent to the obligation of a party to transfer collateral under those documents. However, due to its structure, separate thought does not need to be given to this issue in the English law credit

[2] Who has now retired as a judge and is a key member of Morrison & Foerster's Business Restructuring and Insolvency Group, based in New York.

support annex, since obligations under this credit support annex are classed as Transactions under the ISDA Master Agreement and therefore are automatically subject to what the parties agree in respect of section 2(a)(iii).

It is to be expected though that, in the UK at least, authorities will be strongly encouraging authorised financial institutions to adopt this ISDA Amendment, in order to obviate difficulties caused by the existing section 2(a)(iii) in a financial sector insolvency situation.

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