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OTC Derivative Litigation Update

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Publication Date: November 11, 2010

Section 2(a)(iii) of the ISDA Master Agreement, Similar Clauses and Insolvency

There have been so many articles written and opinions expressed on the spate of cases on the effect of how netting provisions in over-the-counter ("OTC") derivative contracts work when a counterparty becomes in default, that you would be forgiven for being confused about the current position. Now that the dust has settled (for the time being at least), this article takes stock and seeks to make matters as straightforward as possible.

The starting point is to draw a contrast between what has been happening in the UK and how related or similar cases have been decided in the U.S. This contrast exists despite these jurisdictions sharing similar legal principles as to how the assets of an insolvent company should be distributed.

- In the UK, insolvency law requires that the assets of a bankrupt are distributed equally, depending on the proportion owed to each person. This is called the *pari passu* principle. The consequence of this principle is that a term in a contract that tries to get around this principle is unenforceable. However, *pari passu* only comes into play once formal bankruptcy proceedings have been commenced.
- U.S. legislation reaches a similar outcome by making clauses in contracts unenforceable if they try to alter the relationship between contracting parties because of the event of the bankruptcy of one of them. These kinds of clauses are called *ipso facto* clauses and are prohibited under bankruptcy law with very narrow exceptions.
- OTCs usually contain clauses that potentially challenge these principles. The most pertinent example of such clauses is Section 2(a)(iii) of the ISDA Master Agreement. In a normal fiscal environment, this potential challenge may go, for the most part, untested. But in the face of the scale of recession-induced OTC defaults, this has given rise to a number of important cases.

The U.S. Safe Harbors

In the United States, mainly as a result of the Enron collapse, an exception to the *ipso facto* rule was introduced so as to create what are known as "Safe Harbors" for derivatives. If the counterparty of the holder of a derivative becomes insolvent, these Safe Harbors permit him to act in several ways that the *ipso facto* law would normally prohibit:

- he can terminate the OTC without leave of court;
- he can net any liabilities or payments arising as a result of or due at the date of the termination; and
- he can foreclose on collateral that he is holding.

Consequently, until recently, most who work with Section 2(a)(iii) of the ISDA Master Agreement assumed that it was also a right protected within the Safe Harbors, rather than an unenforceable *ipso facto* clause.

The UK's Approach to Section 2(a)(iii) and its kind

No such exceptions exist in the UK, but Section 2(a)(iii) takes effect when there is an *Event of Default* - such an event includes pre-bankruptcy insolvency - i.e., an inability to pay debts as they fall due. It is in this area where doubts as to the effect of Section 2(a)(iii) have emerged in circumstances where there is an insolvency event of default but no automatic early termination, and the non-defaulting party has decided not to terminate.

MARINE TRADE

The story started with the *Marine Trade v Pioneer*[1] case decided in October 2009. It could be said that the outcome of the decision was a fair one, but it was the way that Mr Justice Flaux construed the effect of S.2(a)(iii) in the event of an insolvency-based Event of Default, that has caused concern. As there have been no decisions directly on point since, the case stands as a statement of the current law. The decision itself was straightforward:

- when an Event of Default occurs, the defaulting party remains liable to the non-defaulting for the settlement payments due on the settlement date;

- any settlement payments that would have fallen due to the defaulting party, were it not in default, are no longer due and therefore are not subject to the netting provisions;
- this is the case even if the non-defaulting party later becomes subject to an Event of Default.
- What is controversial is that the settlement sums due to the first defaulting party never become due, no matter what happens or whether the defaulting party subsequently becomes no longer in default. This aspect of the decision contradicted commentators[2] and the only existing case on the issue (albeit a New South Wales 2003 decision)[3].

If this decision stands (more on this below), it has the effect of allowing a non-defaulting party to "ride the market" and choose to terminate the contract when the settlement payments have increased dramatically, while seeing no consequential increase in liability to the defaulting party.

PERPETUAL TRUSTEES

This approach appears to have been affirmed in a Lehman-insolvency-related decision in which a clause (not Section 2(a)(iii)) "flipped" the ranking of parties to payments in the event of a termination caused by the insolvency (*The Perpetual Case* [4]) of a counterparty. But this was in a situation where formal bankruptcy proceedings of the counterparty had not been commenced when the waterfall flip took place- only the parent/guarantor had filed for bankruptcy protection. This case does not affect the Marine Trade construction of Section 2(a)(iii), and is on appeal.

LEHMAN'S ADMINISTRATORS' APPLICATION

However, there has been a recent important development. The Administrators of Lehman Brothers International (Europe) ("LBIE") have made an application to the Courts asking for a declaration as to how the Administrators can treat those OTC counterparties who did not close out their positions as soon as Lehman went into Administration. S2(a)(iii) is at the centre of the application. The Administrators argue that, since LBIE will always be in default, counterparties should not be allowed to use S2(a)(iii) to "ride the market" and choose when to terminate, as to do so has the effect of allowing an exception to the *pari passu* principle.

In view of the amounts of money involved, it seems likely that whatever first instance decision is made, this case will end up in the Supreme Court. Consequently, a definitive answer may be some time off.

The U.S. Cases

METAVANTE

Shortly before the *Marine Trade* decision was handed down, a similar Lehman-related decision was decided in the U.S. It is known as the "Metavante" decision[5]. The important distinction between the two is that in Metavante, the defaulting party had commenced formal bankruptcy proceedings under the U.S. Bankruptcy Code. Metavante did not terminate its derivatives upon the Lehman counterparty bankruptcy and instead had been riding the market for a year on an out-of-the-money contract without making the periodic payments otherwise due the Lehman debtor.

Judge Peck found that, in the circumstances, Section 2(a)(iii) was an *ipso facto* clause since it did not fit within the limited rights to terminate, net payments and foreclose on collateral that are permitted under the Safe Harbors. His decision may be read to suggest that, if Metavante had terminated at a time *less than a year after the default*, it might have been able to use Section 2(a)(iii) as a Safe Harbor right. But the decision has come to stand for the unenforceability of Section 2(a)(iii) under US Bankruptcy law and for the temporal limitation on the Safe Harbor right to terminate the derivative contract upon a bankruptcy event of default. This left the glaringly unsatisfactory question of how long Metavante could have left it before it lost its Safe Harbor protections. While the Metavante decision was appealed, the parties settled their dispute before an appellate decision was entered, leaving Judge Peck's determination the only on-point ruling in the U.S. thus far.

LEHMAN v BNY

Then in January 2010, Judge Peck made a ruling in the parallel US proceedings on the *Perpetual* waterfall flip clause case[6]. The English court had already ruled that the flip clause was effective in the situation present in the UK (where there were no formal bankruptcy proceedings by the counterparty), but was able to avoid making a contradictory judgement on the basis that his task was to apply US bankruptcy law to the issues. He found that, even though formal bankruptcy proceedings had not been started in respect of the Lehman entity that was a party to the transaction, the flip clause was an *ipso facto* clause because the automatic stay that prohibited such clauses taking effect was activated by the earlier bankruptcy filing of that party's US parent company. Further, the right to flip the waterfall of distributions under a derivative and related investment structure was not a provision specifically enumerated within the Safe Harbor provisions, thus handing Lehman a second win. Their third was soon to follow. This case is going to appeal.

SWEDBANK

In May 2010 in a case known as the *Swedbank* case[7], Judge Peck again had to decide on the netting effect and set-off rights in OTCs between a Lehman entity and Swedbank, the Swedish bank. The sums claimed by Lehman were not counterparty settlement payments, but sums deposited at Swedbank after bankruptcy proceedings had been started, whereas Swedbank's claims were settlement payments owed to it by Lehman as of the commencement of the bankruptcy proceedings. Lehman argued that there was no mutuality of debt[8] (which Swedbank admitted) and that therefore no netting and set-off was permitted under US bankruptcy law (which Swedbank contested, citing broad language in the Safe Harbors about rights of the non-defaulting party). Judge Peck again found in Lehman's favour, rejecting any expansive reading of the Safe Harbors. With the public support of ISDA, this decision is also going to appeal on the scope of set-off rights against an insolvent counterparty.

Summary and Conclusion

1. In the UK, if a counterparty is in default, it never has any entitlement to settlement payments that subsequently become due, whereas, it remains liable for any settlement payments that become due to counterparties not in default, even if they ride the market.

2. In the U.S, the position is the same before insolvency proceedings are commenced. But once proceedings are commenced, Section 2(a)(iii) will not be enforced against the debtor, and Safe Harbor rights to terminate will be lost if not acted upon relatively contemporaneously with the commencement of bankruptcy proceedings. There is only speculation as to how long that period may be.

3. However, the position in one or each jurisdiction is likely to change next year as the respective court actions come to be decided and as new actions work their way through the respective legal systems. Whether these actions result in an unequivocal and final statement of the effect of Section 2(a)(iii) is doubtful as appeals from these decisions seem likely to leave the situation open.

4. Perhaps the broadest and safest conclusion to draw from these recent developments is that, whatever the correct construction of Section 2(a)(iii) may be, the effect of that construction has to be set against local bankruptcy law.

5. As regards the question of whether ISDA needs to change the clause, commentators have said that all the current perceived problems with the clause can be addressed by making it a requirement to serve an

Early Termination Notice within a few months of the event of default. ISDA is looking at all of the issues but has yet to decide how to proceed. It currently acts as an interested party to the on-going litigation in both jurisdictions and expresses its views on the issues being considered by the various courts.

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1. *Marine Trade SA v Pioneer Freight Futures Co Ltd BVI* [2009] EWHC (Comm) [See also Client Alert 10-150, dated 25 June 2010].
2. *Firth, Derivatives: Law and Practice*, paras 11-012 to 11-013 and *Henderson on Derivatives*, para 18.3.
3. *Enron Australia v TXU Electricity* [2003] NSWSC 1169 and [2005] NSWCA.
4. *Perpetual Trustee & Belmont Park Investments v BNY Corporate Trustee Services [2009] EWCA Civ 1160.*
5. In *re Lehman Brothers Holdings Inc*., No 08-13555(JMP) (Bankr. SDNY Sept. 15, 2009) [See also Client Alert 10-150, dated 25 June 2010].
6. *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd,* No. 09-01242 (Bankr. S.D.N.Y.) (JMP).
7. *In re Lehman Brothers Holdings Inc.,* No 08-13555(JMP) (Bankr. SDNY May, 5, 2010).
8. The debt has to (a) exist before bankruptcy, (b) arise out of the same contract/s and (c) exist between the two parties-i.e., a third party with an interest in the payments does not have mutuality.

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