It's not my (de)fault!

Options following counterparty default under the ISDA Master Agreement

Introduction

What are your options if your ISDA counterparty defaults?

Termination of any affected transactions is the obvious option. However, termination triggers a process which usually involves a reconciliation of all amounts owed by, and to, each party prior to termination, as well as all costs (or gains) in obtaining replacement transactions. As such, it can require a Non-defaulting Party to make payment to a (possibly insolvent but 'in the money') Defaulting Party. It is this issue which has resulted in some Non-defaulting Parties choosing not to terminate and instead opting to withhold further performance on the basis of Section 2(a)(iii) of both the 1992 and 2002 ISDA Master Agreements.

Background

Section 2(a)(iii) is a "flawed asset" provision which renders the obligations of each party to make payment or delivery conditional upon the non-occurrence of certain events, particularly an Event of Default. Its original purpose was to protect a Non-defaulting Party from having to (i) make payment to a Defaulting Party in circumstances where that Defaulting Party might default on its obligations, or (ii) prematurely close out all transactions. However, the increased reliance on Section 2(a)(iii) as a mechanism to permanently avoid making payment to defaulting or insolvent counterparties has unsurprisingly become the subject of litigation in the wake of Lehman's demise.

Is Section 2(a)(iii) enforceable?

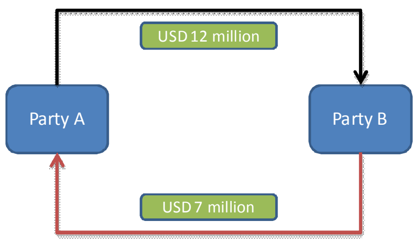
Yes, at least as a matter of English law. However, the US Bankruptcy Court in *Metavante Technologies* held that Section 2(a)(iii) is unenforceable in a US bankruptcy context. Moreover, it found that Section 2(a)(iii) does not benefit from the US Bankruptcy Code's "Safe Harbour" provisions which afford certain protections to derivative contract counterparties. As a result, a Non-defaulting party is not justified in withholding either payment or performance indefinitely against a Defaulting Party, even an insolvent one. In these circumstances, Non-defaulting Parties can only choose to:

- maintain the contract and continue to make scheduled payments; or
- terminate and pay amounts owed (if any) to the Defaulting Party.

Furthermore, termination must occur within a "reasonable" period of the default occurring or the Non-defaulting Party risks being regarded as having waived its "Safe Harbour" rights. Unfortunately, little guidance exists as to what is "reasonable", except that "riding the market" for a year without terminating (as *Metavante* did) is unlikely to qualify.

"Net" or "gross" basis payments?

Consider the scenario where Party A and Party B enter into a number of USD denominated transactions governed by an ISDA. A payment date arises on 1 March 2011 and on that date Party A owes Party B USD 12,000,000 and Party B owes Party A USD 7,000,000. Under normal circumstances, Section 2(c) of the ISDA would create a single obligation on Party A to pay USD 5,000,000 to Party B.



But what if Party B is subject to an Event of Default on 1 March 2011?

Specifically, can Party A rely on Section 2(a)(iii) to withhold payment to Party B whilst simultaneously enforcing Party B's payment obligation in full (the "gross" basis)? Or does Party A have to give Party B credit for amounts owed by Party A to Party B (the "net" basis)? In this case, it is the difference between paying USD 5,000,000 and receiving USD 7,000,000.

This question was considered in 2009 in *Marine Trade v Pioneer Freight*. The court held that the "gross" basis applied. Its rationale was that credit only has to be given for amounts that are *payable* and not for amounts that are *not payable* due to an unfulfilled condition precedent under Section 2(a)(iii).

However, the story does not end there. The matter was subsequently considered in 2010 in *Lomas v JFB Firth Rixson, Inc*. In this case, both parties asked the judge not to follow the "gross" basis precedent set in *Marine Trade*. It seems that this was to avoid the risk that Section 2(a)(iii) be deemed to offend the "anti-deprivation" rule - the proposition that one cannot contract out of the provisions of insolvency legislation which requires pari passu treatment of creditors. In part because of the agreed "net" basis approach, the court held that Section 2(a)(iii) amounted to a "flawed asset" provision with respect to things yet to be done and so did not offend the anti-deprivation rule. Nonetheless, the court made clear that, if the "gross/net" question had been contentious, it would have found it difficult not to follow the precedent set by *Marine Trade*.

Consequently, as a matter of English law, the "gross" basis continues to apply. However, given that the court in *Lomas* stated that had section 2(a)(iii) operated on a "gross" basis, it might well have offended the anti-deprivation rule, any party seeking to enforce this right against an insolvent party is warned that it faces an increased risk of Section 2(a)(iii) being found to be unenforceable.

“Suspension” or “Once and for All”?

A further question arises with respect to the 1992 ISDA as to whether the existence of an Event of Default on a payment date merely SUSPENDS payment obligations of the Non-defaulting Party until the Event of Default is cured, or whether this has the effect of destroying the Non-defaulting Party’s payment obligation ONCE AND FOR ALL with the effect that no obligation to pay arises even following a subsequent cure.

In *Marine Trade*, the court commented, obiter, that payment obligations are indeed extinguished “once and for all”. However, the court in *Marine Trade* was not referred to earlier contradictory comments in *Enron Australia v TXU Electricity* which suggested that payment obligations are suspended only. Based partly on this fact; party on the premise that the permanent destruction of payment obligations in relation to minor, momentary or potential defaults would be very draconian; and partly because the ISDA termination mechanism effectively resurrects past payment obligations and thus runs counterintuitive to the “once and for all” argument, the court in *Lomas* concluded “on a fairly narrow basis” that payment obligations are suspended only.

This question does not arise under the 2002 ISDA as section 9(h)(i)(3)(A) specifically contemplates that amounts may become payable following satisfaction of the condition precedents in Section 2(a)(iii), thus supporting the suspensory position.

For how long are payment obligations suspended?

All of the following have been suggested as answers to this question:

- payment obligations are suspended indefinitely but never die;
- payment obligations are suspended for a “reasonable” period, sufficient to enable Non-defaulting Parties to elect to terminate or to continue to perform;
- the condition precedent in Section 2(a)(iii) itself (i.e. not the payment obligation) only lasts until such time as the last transaction under the ISDA has ended at which point it falls away, triggering a netting process which takes account of all suspended payments;
- Non-defaulting Parties are under a CONSTANT duty to consider whether to terminate in a manner which is not arbitrary, capricious or unreasonable - once it is clear that the Defaulting Party’s default is permanent, or where the Non-defaulting Party rehedges, it must terminate.

In reality, none of the above apply. The court in *Lomas* held that payment obligations are suspended until the expiry of the relevant Transaction, at which point they die if the condition precedent remains unsatisfied. This decision was based on the belief that ISDA parties would be unlikely to contemplate, never mind expressly agree to, leaving contingent obligations outstanding indefinitely.

The future?

More recently, the market has witnessed an emerging trend whereby counterparties are attempting to address Section 2(a)(iii) risks by including an Additional Termination Event allowing a Defaulting

Party to terminate provided that it has satisfied all of its payment and delivery obligations and the Non-Defaulting Party refuses to make payment based upon the condition precedent in Section 2(a)(iii).

However, individual efforts to mitigate this risk seem likely to be relatively short-lived. In December 2009, an HM Treasury consultation paper highlighted the disadvantage that a Defaulting Party and its creditors can suffer if prevented from claiming monies owed under an ISDA. A market solution, which facilitates flexible termination and safeguards Non-defaulting Parties whilst providing certainty for Defaulting Parties that termination will occur within a reasonable period, was encouraged. The government did not rule out legislating in the absence of such a solution. In response, ISDA established a working party to re-examine the wording of Section 2(a)(iii), but the conclusion must be that its future is far from clear.

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