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The ISDA Master Agreement: from here to eternity

The ISDA Master Agreement should be interpreted strictly in accordance with its written terms, without implying additional rights or obligations that are not expressly spelt out, according to the Court of Appeal. In particular, a payment obligation is suspended if the potential recipient is subject to an Event of Default (eg insolvency), but the obligation is never extinguished. The Master Agreement does not provide for extinction, and there is no basis to imply a term to that effect since the parties have not provided for it expressly. As a result, a payment obligation could revive if the Event of Default is cured at any stage, however far in the future the cure takes place.

Introduction

The ISDA Master Agreement is one of the most used forms - if not the most used form - of financial contract in the world. Any guidance from the courts as to what the Agreement means is therefore potentially important for the financial markets as a whole. The Court of Appeal has given a major judgment in four appeals raising issues on the ISDA Master Agreement, two appeals arising from Lehman's collapse and two from the turmoil in the freight futures market. The first instance judgments showed a division of opinion within the judiciary on some important issues, which these appeals (*Lomas v JFB Firth Rixson*, *LBSF v Carlton Communications*, *Pioneer Freight Futures v Cosco Bulk Carrier Company* and *Britannia Bulk v Bulk Trading* [2012] EWCA Civ 419) have now resolved.

The ISDA Master Agreement is used to govern derivative transactions (eg interest rate swaps). Derivatives often involve a stream of payments over a period of time from one party or the other, with both the direction and the quantum of the payments depending on movements in interest rates or other underlying market values or indices. Payments due on the same date, on the same transaction and in the same currency are netted, producing a single sum due (section 2(c)). It is a condition precedent to payment by a party that no Event of Default or Potential Event of Default has occurred with regard to the payee.

If an Event of Default has occurred with regard to the payee, the non-defaulting party can terminate all the transactions subject to the Master Agreement, crystallising the sum due to or from the defaulting party. The non-defaulting party does not have to exercise its right of termination but can, instead, sit on its hands, relying on section 2(a)(iii) to avoid further payments. Lehman complained that some of its counterparties had done just that, depriving Lehman of the sums otherwise due or the sums that Lehman said would become due to Lehman on early termination. Lehman therefore looked for ways to

Key issues

- The failure of the condition precedent to payment in section 2(a)(iii) of the ISDA Master Agreement suspends the payment obligation but does not extinguish the debt
- The suspension has no end date, and lasts as long as the Event of Default continues
- The payment obligation revives when the Event of Default is no longer continuing
- Section 2(a)(iii) does not offend the anti-deprivation or pari passu principles applicable in insolvency law.

avoid this outcome - though Lehman, of course, has not paid sums it owes on the transactions.

Suspension or extinction?

The first issue was whether the effect of section 2(a)(iii) of the Master Agreement was to extinguish a payment obligation or only to suspend it. Does section 2(a)(iii) provide a once and for all condition precedent that must be met on the payment date, failing which the payment will never become due, or can the condition precedent be fulfilled at a later date?

The Court of Appeal distinguished between the underlying debt obligation and the timing of its payment. The Court considered that the underlying indebtedness arises from the provisions specific to a transaction (interest movements and such like); section 2 of the Master Agreement determines when that debt must be paid. In those circumstances, section 2 has a suspensory effect on a payment of the debt, but does not extinguish the debt. The parties could not, in the Court of Appeal's view, have intended a consequence as drastic as the extinction of a debt to be caused by what could be a minor and temporary Event of Default or Potential Event of Default.

How long is the suspension?

The next question was how long any suspension lasted. If Lehman's counterparties were able to rely on section 2(a)(iii) for ever, and Lehman could not cure the Event of Default, Lehman would recover nothing even though it was in the money on the transactions. Lehman therefore argued that a term should be implied that limited the ability of its counterparties to rely on section 2(a)(iii), eg the payment obligation revived after a reasonable time or at the maturity of the transactions in their normal course.

The Court of Appeal would have none of it. There was nothing in the Master Agreement that placed any limit on a party's ability to rely on section 2(a)(iii), and the Court of Appeal could see no reason to imply a term that did so. As a result, Lehman could only obtain payment if, at the least, it came out of the insolvency procedures to which it is subject.

One of the first instance judgments had concluded that any obligation to pay Lehman would finally disappear at the maturity of the relevant transactions. The Court of Appeal disagreed. In keeping with its refusal to imply the terms suggested by Lehman, the Court of Appeal refused to imply any limit on the period of the suspension. The suspension is indefinite, and can therefore be revived at any time in the future if the Event of Default is no longer continuing.

The first instance judge had also relied on section 9(c) of the Master Agreement to reach his conclusion, though recognising that its language was "inelegant for the purpose of encapsulating the concept that the payment obligation suspended by section 2(a)(iii) does not survive termination." Section 9(c) provides that, "without prejudice to section 2(a)(iii)" the obligations of the parties survive termination.

The Court of Appeal considered that the only conclusion to be drawn from the inelegance of hiding such a concept in a clause headed "Miscellaneous" and using obscure language was that the drafters of the Master Agreement did not intend section 9(c) to bear the weight attributed to it by the judge.

> " An indefinite contingent liability might be inconvenient to the non-defaulting party, but that was not a reason to imply a provision for extinction of the debt that the parties had not expressly agreed."

The Court of Appeal therefore concluded that the payment obligation was suspended indefinitely. An indefinite contingent liability might, the Court of Appeal conceded, be inconvenient to the non-defaulting party, but that was not a reason to imply a provision for extinction of the debt that the parties had not expressly agreed.

Lehman may have literally an eternity in which to try to come up with a scheme that will allow it to come out of insolvency, thereby curing the Event of Default that deprives it of the right to payment. That could, however, prove difficult for Lehman, and, even if Lehman can do something, its counterparties will still have a range of other arguments to keep payment at bay.

Unilateral or bilateral suspension?

Derivatives subject to the ISDA Master Agreement often provide for payments in opposite directions in the same currency on the same day, which are netted leaving a single sum

due one way or the other (section 2(c)). In one judgment not the subject of this appeal (*Marine Trade v Pioneer Freight Futures* [2010] Lloyd's Rep 631), Flaux J had concluded that if one party was subject to an Event of Default, that party's payments remained due but the non-defaulting party had no payment obligation to the defaulting party by virtue of section 2(a)(iii). As a result, the non-defaulting party could claim the gross amount due to it, without giving any credit for the sum that would otherwise have been due to the defaulting party.

The Court of Appeal rejected this interpretation of the Master Agreement, preferring the view expressed by Gloster J in *Pioneer Freight Futures v TNT Asia* [2011] EWHC 1888 (Comm) in another case not under appeal. Section 2(c) of the Master Agreement requires the two sums to be netted before the payment obligation arises. As a result, it is only payment of the net sum that is suspended by section 2(a)(iii).

The anti-deprivation and pari passu principles

Lehman's insolvency has reinvigorated interest in the anti-deprivation principle, although the courts have been reluctant to use it to override parties' bargains. The anti-deprivation principle is concerned with contractual arrangements that have the effect of depriving a bankrupt of property that would otherwise have formed part of its bankruptcy estate. According to the Supreme Court in *Belmont Park Investments v BNY Corporate Trustee Securities* [2011] UKSC 38, the principle is only engaged if the parties make an illegitimate attempt to evade bankruptcy law rather than making a genuine and justifiable commercial response to the consequences of insolvency (see our briefing *Perpetual litigation comes to an end* of July 2011).

The Court of Appeal was clear that section 2(a)(iii) is a justifiable commercial response to the consequences of insolvency (the Supreme Court had already hinted strongly that this was the case). The suspension of the payment obligation prevented a party having to make payments to an insolvent counterparty for which it might receive nothing in return. The Court of Appeal considered that there was no suggestion that section 2(a)(iii) was formulated to avoid the effect of insolvency law or to give the non-defaulting party a greater or disproportionate return from an insolvent estate.

The pari passu principle is related to the anti-deprivation principle but governs the distribution of assets that fall within the bankrupt estate, rather than whether an asset forms part of the estate, invalidating any attempt by a creditor to obtain from the estate more than its proper share. The Court of Appeal considered that the pari passu principle was not engaged at all by section 2(a)(iii) because section 2(a)(iii) prevented the debt becoming payable to the defaulting, insolvent, party. The insolvent estate therefore never had any asset capable of distribution to creditors.

Automatic early termination and the sums due

Freight futures agreements frequently provide for the automatic early termination of all transactions subject to the ISDA Master Agreement on the occurrence of an Event of Default (here, insolvency). Early termination requires the calculation of the sum due, which could be payable to either party. The Court of Appeal decided, again disagreeing with Flaux J, that the calculation was required to include the debts owed to the defaulting party even if payment of those debts had been suspended by section 2(a)(iii). Since the Event of Default suspended, rather than extinguished, the obligation to pay the defaulting party, the wording of the Master Agreement still required the debts to be taken into account on termination at any stage.

Further, the Court of Appeal concluded that the calculation of the sums due on termination required the parties to assume that each would have performed its obligations in full, reiterating again that the Loss basis under the 1992 Master Agreement is intended to reach a broadly similar outcome to the Market Quotation basis.

Conclusion

The Court of Appeal has given valuable guidance on the interpretation of the ISDA Master Agreement and, in doing so, has followed, largely, views generally held in the market. Subject to any appeal to the Supreme Court, the aspect of the judgment that is likely to give rise to the most debate is the decision that section 2(a)(iii) suspends indefinitely the non-defaulting party's payment obligation but that the obligation revives if the Event of Default in question is cured at any time in the future. Should any of the Lehman entities come out of insolvency - even if only for a single day - that may revive its counterparties' payment obligations unless, of course, other Events of Default mean that payment does not in fact become due or there are other grounds to achieve that

same result. The endgame may be some way off.

Clifford Chance LLP acted for BEIG Midco Ltd, one of the successful parties in the *Firth Rixson* case.

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