Proposed Changes to ISDA Section 2(a)(iii) and the "Flawed Asset" Approach

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One of the cornerstones of the ISDA Master Agreement[1] is Section 2(a)(iii), which provides in relevant part that "Each obligation of each party under Section 2(a)(i) [*that is, each obligation of that party to make a payment or delivery*] is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing . . . ."[2]

The vast majority of market transactions under ISDA Master Agreements involve reciprocal payments or deliveries due from each party to the other from time to time during the transaction's term. Section 2(a)(iii) is intended to ensure that a party need not make payments or deliveries to the other party—at the times when they would otherwise fall due—if the other party is then subject to an Event of Default or a Potential Event of Default (and thus may be unlikely to perform its obligations to the first party).[3] Such protection against increasing exposure to a potentially non-creditworthy counterparty has long been a key expectation of participants in the swap market. In fact, provisions similar to Section 2(a)(iii) were included in the earliest forms of swap documents published by ISDA. Until recently, most practitioners were confident that they understood the implications of this contingency as it has been built into the ISDA architecture.

Financial crises, unfortunately, have a habit of stressing the intended meanings of legal provisions. The events of the Great Recession did not disappoint, and have so far resulted in a number of judicial decisions, both in the United States and England, which have come to inconsistent conclusions and have included several surprises for the derivatives market. In an attempt to restore certainty to the operation of the ISDA Master Agreement, and to address concerns identified by both courts and regulators, ISDA is in the process of developing several potential amendments to the ISDA Master Agreement. This article will review some of the relevant caselaw and a consultation paper by the UK Treasury seeking a market-based solution and then summarize ISDA's considered response.

The Cases

Key judicial decisions construing Section 2(a)(iii) to date include the following:

Enron Australia v TXU Electricity.[4] In this case involving the liquidation of an Australian affiliate of Enron Corp., the Supreme Court of New South Wales held that a counterparty to a swap agreement was entitled to withhold payment indefinitely on the basis of Section 2(a)(iii) so long as the other party suffers an Event of Default as a result of its bankruptcy. This appears to have been the first time any court specifically considered this provision, and it stood alone for a number of years until the onset of the financial crises later in the decade.

Metavante.[5] Metavante Corporation was a party to an ISDA Master Agreement with Lehman Brothers

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Special Financing, Inc., a subsidiary of Lehman Brothers Holdings Inc. (**LBHI**). Following the bankruptcy of LBHI and its subsidiaries, Metavante withheld further payments in reliance on Section 2(a)(iii). U.S. Bankruptcy Judge Peck, ruling from the bench, held – contrary to *Enron Australia v TXU* – that a non-defaulting party could not rely indefinitely on Section 2(a)(iii) to withhold payment, and instead is obligated at some point to either exercise its right to terminate the transactions early as a result of the Event of Default or accept the obligation to continue to perform. At the time of the ruling, which came approximately one year after LBHI's bankruptcy filing, the judge found that Metavante could no longer withhold payments, and by its inaction for nearly a year had waived its right to terminate the transactions as a result of the bankruptcy. The court's decision was based in part on the perception that it would be unfair to allow Metavante to time the market in deciding whether or when to terminate the transactions. The decision was initially appealed by Metavante, but the appeal was withdrawn when Metavante settled with the estate. To the author's knowledge, no higher court in the US has yet ruled on this issue.

Marine Trade SA v Pioneer Freight Futures Co Ltd BVI.[6] In an English High Court case interpreting English law, Mr Justice Flaux – in accord with *Enron Australia v TXU* and contrary to *Metavante* – upheld the ability of a party to rely indefinitely on Section 2(a)(iii) to withhold payments to a defaulting counterparty. However, two aspects of the court's judgment were notable. First, the court found not only that the defaulting party continues to bear its payment obligations, but also that such payment obligations are due ***in gross***, since the obligations against which they would be netted – the obligations of the non-defaulting party – are not due as a consequence of the failure of the condition precedent to be satisfied, and accordingly there is nothing to net them against. While a strict reading of Section 2(a)(iii) arguably supports this result, it was nonetheless not the result expected by many participants in the derivatives market. Second, the court concluded that when the conditions precedent to a payment are not satisfied on the scheduled date for payment, such payments are not merely suspended, but in fact will never become due.[7] Even more so than the first, this latter view was generally thought inconsistent with the intent (and, many believed, legal terms) of the ISDA Master Agreement.

Lomas v JFB Firth Rixson.[8] This case, another before the English High Court, also arose from the bankruptcy of LBHI, specifically the administration of its subsidiary Lehman Brothers International (Europe) (**LBIE**). Similar to the result in the *Marine Trade* case (and again contrary to the holding in *Metavante*), Mr Justice Briggs found that Section 2(a)(iii) provides for an indefinite suspension of a party's payment obligations so long as the other party is subject to a default. Contrary to *Marine Trade*, however, Mr Justice Briggs held that Section 2(a)(iii) merely suspends the payment obligation, and that if the condition precedent is thereafter satisfied (that is, the default ceases to exist), the payment obligation is restored. However, the court also held that if the condition precedent is not satisfied by the scheduled date for the termination of the transaction, the suspended payment obligation expires and the payments then never need be made at all. While the first two parts of the decision were consistent with the general expectations of the market, the last part was not.

Frustrated Market Expectations

The language of Section 2(a)(iii) appears, on a simple reading, to be unambiguous. Unfortunately, when pressed by the circumstances of parties in financial distress, courts have been inconsistent in their interpretations of the provision. This has led to uncertainty in the market as to both the extent to which a party may rely on Section 2(a)(iii), as well as how this provision would in fact be applied in any given circumstances.

Under the court's ruling in *Metavante*, a party cannot rely on Section 2(a)(iii) to withhold payments indefinitely, although the length of the period which would be permissible is unclear. Whatever that time period may be (and the court's decision would suggest something less than one year), before it expires the non-defaulting party

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needs to either terminate the transactions as a result of the related Event of Default (as permitted under exceptions to the automatic stay included in the U.S. Bankruptcy Code) or re-commence performance. Although the author is not aware of any subsequent decisions in the U.S. on this issue, many practitioners expect that Judge Peck's ruling will be influential on courts in other bankruptcy cases as well as in proceedings involving financial institutions whose insolvency is handled under non-Bankruptcy Code law.

The Australian and English courts, on the other hand, appear comfortable with an indefinite suspension under Section 2(a)(iii) so long as the failure of a condition precedent continues. However, the effect of the suspension under English law is not certain. Under the ruling in *Marine Trade*, a defaulting party may not have the benefit of netting its obligations against the obligations of the non-defaulting party, as the suspension of the non-defaulting party's obligations is taken into account ***before*** giving effect to the netting. The decisions in *Marine Trade* and *Lomas* differ over whether Section 2(a)(iii) merely suspends payments until the triggering event is cured, or whether a failure to satisfy the condition at the time the obligation otherwise falls due eliminates the obligation forever. And even under *Lomas*, the obligation to make the suspended payments ceases to exist if the condition precedent is not satisfied before the scheduled termination of the relevant transactions.

As noted above, several of the conclusions set forth in these decisions are viewed by many members of the derivatives market as being inconsistent with the legal terms of the ISDA Master Agreement or, even if not inconsistent with the actual language, with the reasonable expectations of the market's participants. Certainly the market did not expect that the mechanisms by which Section 2(a)(iii) operates would themselves be subject to such disparate interpretations. Liquidity in the swaps market requires that the consequences of events be understood and determinable. Uncertainty is anathema to the smooth and regular workings desired by its participants.

The UK Treasury Consultation

While English and Australian courts may be comfortable with an unlimited suspension of payments under Section 2(a)(iii), regulators may find such a result troubling. In December 2009, the UK Treasury issued a **consultation paper** relating to resolution arrangements for investment firms. In it, the UK Treasury recognized that Section 2(a)(iii) provides necessary flexibility to a solvent party to terminate its transactions with an insolvent counterparty in an orderly and commercially reasonable manner. However, permitting suspension for an unlimited time period would deprive the administrators of an insolvent investment firm of the certainty that its derivatives positions would be brought to an early termination within a reasonable period. The UK Treasury thus called upon ISDA to find a market-based solution to this uncertainty, while reserving the right to take further action were an adequate solution not developed.

Proposed Changes to the ISDA Master Agreement

One of the principal missions of ISDA, as a leading trade organization for major participants in the swap market, is to develop and publicize form agreements which can be widely used to document swap transactions. Given the uncertainty now surrounding a key feature of the ISDA Master Agreement, as well as the impetus provided by the UK Treasury, ISDA has sought out feedback from its members and has issued proposed changes to the ISDA Master Agreement to resolve the uncertainty. As proposed in a consultation paper issued by ISDA on April 8, 2011, the ISDA Master Agreement would be amended as follows:

- A party will be entitled to suspend payments and deliveries for only a specified period of time under Section 2(a)(iii) as a result of a Potential Event of Default or Event of Default with respect to its counterparty. This period would begin on the day on which the non-defaulting party first withholds a payment or delivery as a result of the

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failure to satisfy such condition precedent, and would end either 90 or 180 days later (being the "Condition End Date").

- Section 2(a)(iii) is expressly made applicable only after the netting provision of Section 2(c) is given effect. As a result, a defaulting party's prospective obligations are calculated on a net basis, not gross.
- Section 2(a)(iii) is clarified so that its effect is only to suspend the obligation to make payments or deliveries, not to eliminate the obligation permanently, if the conditions precedent are not satisfied. The non-defaulting party is expressly obligated to make the suspended payments and deliveries once the conditions precedent are satisfied or if the Condition End Date is reached.
- The ISDA Master Agreement is further amended to make it clear that payment and delivery obligations suspended as a result of Section 2(a)(iii) become due once the conditions precedent are satisfied or the Condition End Date is reached, even if the last scheduled date for payment or performance has already passed.
- Finally, a conforming change is made to the 1992 ISDA Master Agreement so that interest or compensation accrues on payments and deliveries suspended as a result of Section 2(a)(iii) (thus bringing the older form into line with the existing terms of the 2002 ISDA Master Agreement).

As of this writing, ISDA has not yet issued a revised proposal or scheduled additional consultation with members. Once final language has been settled upon, it can be expected that ISDA will publish a form of amendment to the ISDA Master Agreement reflecting the proposed changes. In addition, ISDA may consider publication of a protocol which would permit market participants who so elect to provide for amendment of their swaps through accession via ISDA's website rather than undergoing the time-consuming execution of individual, bilateral amendment documents.

This article represents the views of the author alone, and does not represent the views of Sidley Austin LLP or any of its clients.

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1 References to the "ISDA Master Agreement" in this article refer to either the 1992 ISDA® Master Agreement or the 2002 ISDA® Master Agreement (each as published by the International Swaps and Derivatives Association, Inc. (ISDA)), unless otherwise specified. Except as the context requires, capitalized terms are used in this article as defined in the ISDA Master Agreement.

2 Since Section 2(a)(iii) sets forth a condition precedent to payment or delivery, if the condition is unsatisfied the obligation to pay or perform simply does not arise. In its consultation paper referred to below, ISDA takes pains to note that, as a result, Section 2(a)(iii) does not effect a "suspension" of payment or delivery or give a party a right to "withhold" a payment or delivery. Rather, there simply is no obligation to pay or deliver until the condition is satisfied. This distinction is important when considering whether

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Section 2(a)(iii) might constitute a "deprivation clause" under English law. Nevertheless, for the purposes of fluidity of language, this article will refer to the effects of Section 2(a)(iii) by the use of terms such as "suspension" and permitting a party to "withhold" payment or delivery.

3 This contingency inherent in a party's right to receive payment or delivery – that is, the requirement to satisfy conditions precedent, such as the absence of a default or potential default – is sometimes referred to by describing that right as a "flawed asset".

4 [2003] NSWSC 1169.

5 *In re Lehman Brothers Holdings Inc.*, Case No. **08-BK-13555** (JMP) (Bankr. S.D.N.Y. September 15, 2009). *See* Order Pursuant to **Sections 105(a)**, **362** and **365** of the Bankruptcy Code to Compel Performance of Contract and to Enforce the Automatic Stay, *In re Lehman Brothers Holdings Inc.,* No. 08-BK-13555 (JMP) (Bankr. S.D.N.Y. Sept. 17, 2009) (Docket no. **5209**).

6 [2009] EWHC 2656 (Comm), [2009] 2 CLC 657.

7 It should be noted that this second conclusion was not necessary to reach the decision in the case, and accordingly is *obiter dicta*, which does not constitute a binding part of the decision or a precedent applicable to subsequent cases.

8 [2010] EWHC 3372 (Ch), 21 December 2010. A judgment consistent with *Lomas* was subsequently issued by Mr Justice Briggs in *Lehman Brothers Special Financing Inc. v Carlton Communications*, **[2011] EWHC 718 (Ch)**, 28 March 2011.

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