Section 2(a)(iii) of the ISDA Master Agreement and Emerging Swaps Jurisprudence in the Shadow of Lehman Brothers

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Introduction

In the dark days of 2008, as the world's financial markets were still struggling to recover from unprecedented illiquidity and the fire-sale purchase of Bear Stearns by JP Morgan Chase, Lehman Brothers began to teeter under the weight of its leveraged commercial real estate portfolio, a series of bad decisions by its management and an emerging crisis of confidence that prompted the massive exodus of most of its clients, drastic losses in its stock and the devaluation of its assets by the rating agencies.

Matters came to a head in the middle of the night of September 14–15, 2008, when Lehman Brothers Holdings Inc (LBHI), filed a voluntary petition for bankruptcy protection in the United States Bankruptcy Court for the Southern District of New York. Its English trading subsidiary Lehman Brothers International Europe (LBIE) entered into administration in London shortly thereafter. In the following weeks, many other Lehman Brothers subsidiaries filed for bankruptcy protection, including Lehman Brothers Inc, the United States broker-dealer (LBI), and Lehman Brothers Special Financing Inc (LBSF), which carried out the bulk of Lehman Brothers derivative-counterparty activity.[1]

Prior to its bankruptcy, LBHI had been the fourth-biggest investment banking firm in the United States, ranking behind only Goldman Sachs, Morgan Stanley and Merrill Lynch. On September 16, 2008, Lehman Brothers was the largest financial entity to have become a bankrupt debtor. Lehman Brothers demise convulsed the world's financial markets as it became clear how interconnected Lehman Brothers was as a counterparty in markets throughout the world, and, as an example, its bankruptcy led directly to unprecedented strains on money market funds and hedge funds. Its bankruptcy also had significant implications for derivatives markets because Lehman Brothers had hundreds of billions of dollars in gross notional amount of derivative positions outstanding on the date of its filing.

Disputes that have arisen in both the jointly administered bankruptcy case of LBHI and LBSF in New York and the administration of LBIE in London have put what (until recently) have been considered relatively non-controversial provisions of the form swap contracts published by International Swaps and Derivatives Association (ISDA) and a number of the legal principles that affect the enforceability of those provisions in the context of a counterparty's insolvency to an unprecedented test. The fact that similar issues have arisen on both sides of the Atlantic is a testament both to the wide popularity of the ISDA master agreement and to the international nature of the swaps markets. An interesting feature of the litigation to date is how courts in the two jurisdictions have taken divergent paths. Some points of departure reflect differences between the bankruptcy-law regimes in the United States and England and some reflect differences in the approaches taken by the judges in the two countries. These differences are potentially significant, not only because New York and London are generally acknowledged to be the world's two leading financial centers, but also because New York law and English law are the two alternative governing laws contemplated by the ISDA master agreement.

This article will focus on how the courts in both jurisdictions have approached the practical ability of a non-defaulting, non-bankrupt counterparty of Lehman to suspend payment obligations under s.2(a)(iii) of the ISDA master agreement. After providing an overview of the relevant contractual provisions embodied in the ISDA agreements and of the relevant bankruptcy principles in both jurisdictions, we will turn to a discussion of the leading Lehman Brothers cases that have addressed the effect of bankruptcy or insolvency on the rights of a non-defaulting counterparty under s.2(a)(iii) of the ISDA master agreement. In the United States, the leading case to date is *Metavante*,[2] a case in which the Lehman estate sought to compel the performance by Metavante Corporation, an interest rate swap counterparty of certain payment obligations that Metavante Corporation had suspended under s.2(a)(iii) in reliance of the event of

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1 LBSF commenced its Ch.11 bankruptcy case on October 3, 2008. LBHI and its subsidiaries are generally referred to herein as "Lehman Brothers."
2 *In re Lehman Brothers Holdings Inc* Case No. 08–13555 (JMP) (Bankr. SDNY September 15, 2009) (transcript of record excerpts) at 99 et seq. (*Metavante*).

default arising from the Lehman bankruptcy. In England, several cases have considered the effect of s.2(a)(iii) in similar circumstances, of which the most significant are *Lomas v JFB Firth Rixson*[3] and *LBSF v Carlton*.[4]

Overview of relevant principles

ISDA master agreement provisions

For over 20 years, over-the-counter swaps and other derivative contracts have been documented using the provisions prescribed by the forms of standard terms documents and master agreements and the related transaction architecture, all of which have been designed by ISDA. There are two versions of the ISDA master agreement, one published in 1992 and the other, in 2002. The 1992 version was the first to be designed in a form applicable to derivatives other than swaps and to accommodate both financially and physically settled transactions. The 2002 version is largely based on the 1992 version, but with several significant differences to reflect changes in the markets and lessons learned during the intervening decade. The principal changes reflected in the 2002 version are essentially changes to events of default and termination events, changes to the mechanism for electing cross-transaction payment netting, changes to the mechanism for calculating termination payments following an early termination date and inclusion of a detailed set-off provision.

Additionally, s.9(h)(i)(3) of the 2002 version of the ISDA master agreement contains a change pertaining to interest on defaulted and deferred payments and compensation for defaulted deliveries before early termination and for interest on early termination amounts and unpaid amounts following early termination. Entitled "Interest on Deferred Payments", this provision states:

> "[i]f: (A) A party does not pay any amount that, but for Section 2(a)(iii), would have been payable, it will, to the extent permitted by applicable law and subject to Section 6(c) and clauses (B) and (C) below, pay interest (before as well as after judgment) on that amount to the other party on demand (after such amount becomes payable) in the same currency as that amount, for the period from (and including) the date the amount would, but for Section 2(a)(iii), have been payable to (but excluding) the date the amount actually becomes payable, at the Applicable Deferral Rate."

The mechanism for termination following an event of default (including bankruptcy) is essentially the same in both the 1992 and the 2002 versions of the ISDA master agreement, even though the method for calculating the termination amount payable in connection with termination is very different. Section 6 of both versions of the ISDA master agreement establishes that upon the occurrence of an "event of default" with respect to a party (including a bankruptcy filing by a party or its guarantor), the non-defaulting party has the right (but not the obligation) to terminate all transactions under the ISDA master agreement and determine an early termination amount.[5] The non-defaulting party may also foreclose on collateral held by it and exercise rights of set-off. If a non-defaulting party chooses not to terminate transactions despite the occurrence of an event of default, s.2(a)(iii) of the master agreement subjects its ongoing payment obligations to the condition precedent that no event of default with respect to the other party has occurred and is continuing.[6]

Relevant bankruptcy principles of US and English law

The safe harbours from the automatic stay under the United States Bankruptcy Code

Providing for a debtor's assets to be distributed in a fair and equitable way among the creditors of the debtor is a fundamental policy underpinning the United States Bankruptcy Code.[7] A key concept in the enforcement of this policy is that of the "automatic stay", under which creditors of a bankrupt entity are automatically stayed from enforcing contractual rights against the debtor without the Bankruptcy Court's authorisation or a specific statutory exception.

However, beginning in 1982, the Congress formulated a series of amendments to the Bankruptcy Code with the objective of creating certain "safe harbors" to protect rights of termination and set-off under "securities contracts", "commodities contracts", and "forward contracts." Those changes were subsequently refined and expanded to cover "swap agreements", "repurchase agreements", and "master netting agreements." The "safe harbors" from the automatic stay reflected the recognition of Congress that financial instruments such as swaps raise unique systemic issues and that the imposition of a stay on the right of non-defaulting counterparties to such instruments to terminate or otherwise enforce rights under

[3] *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 (Ch).

[4] *Lehman Brothers Special Financing Inc v Carlton Communications Ltd* [2011] EWHC 718 (Ch).

[5] Generally speaking, the early termination amount is intended to approximate the amount which would be payable by (or to) the non-defaulting party as the premium (or reverse premium) for the setting up of a replacement transaction, on precisely the same terms as the Terminated Transaction for the remainder of its natural term.

[6] Section 2(a)(iii) of the ISDA master agreement provides in relevant part as follows: "Each obligation of each party [to make payment or delivery under the master agreement] 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 condition precedent that no Early Termination Date in respect of the relevant transaction has occurred or been effectively designated and (3) each other applicable condition precedent specified in this Agreement." Therefore, according to the express terms of the master agreement, following the occurrence and during the continuance of an event of default, the non-defaulting party is not *required* to terminate the ISDA master agreement following an event of default, with concomitant termination amounts owing to the defaulting party if the non-defaulting party is out of the money, and it equally is not *required* to perform obligations under the ISDA master agreement.

[7] Section 362(a) of the United States Bankruptcy Code imposes the automatic stay on creditors of the debtor at the moment a bankruptcy petition is filed. The automatic stay generally prohibits the commencement, enforcement or appeal of actions and judgments, judicial or administrative, against a debtor for the collection of claims that arose prior to the filing of the bankruptcy petition and also prohibits collection actions and proceedings directed toward property of the bankruptcy estate itself.

such instruments could expose those participants to rapid changes in market conditions and interest rates that could be very costly, or even lead to a domino-effect of settlement failures. In either case, Congress concluded that the automatic stay could ultimately have material adverse effects on the stability of the overall financial system.[8]

The principal safe harbours from the automatic stay that benefit swaps are ss.362(b)(17, 560 and 561 of the Bankruptcy Code.

Section 362(b)(17) provides that the filing of a bankruptcy petition:

> "does not operate as a stay … of the setoff by a swap participant or financial participant of a mutual debt and claim under or in connection with one or more swap agreements that constitutes the setoff of a claim against the debtor for any payment or other transfer of property due from the debtor under or in connection with any swap agreement against any payment due to the debtor from the swap participant or financial participant under or in connection with any swap agreement or against cash, securities, or other property held by, pledged to, under the control of, or due from such swap participant or financial participant to margin, guarantee, secure, or settle any swap agreement."

Section 560 is a safe harbour from the automatic stay for swap agreements. It provides as follows:

> "[t]he exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in Section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title."[9]

These provisions protect the rights of non-defaulting counterparties to set–off of mutual claims against an entity that has filed a bankruptcy petition and to exercise contractual rights that otherwise would have been automatically stayed upon the filing of such a petition.

The anti-deprivation principle of English insolvency law

English law also has mandatory rules in relation to the distribution of a debtor's assets in a formal insolvency procedure, notably in relation to the pari passu treatment of unsecured creditors as regards distributions made in a liquidation or administration pursuant to the English Insolvency Act 1986.[10]

Put simply, the anti-deprivation rule is founded on the premise that the parties to an agreement cannot contract out of mandatory provisions of legislation governing the distribution of an insolvent debtor's assets. The rule was recently considered by the Court of Appeal in *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd (Perpetual)*.[11] *Perpetual* has been appealed to the Supreme Court of England and Wales and it is conceivable that Briggs J's conclusions in relation to the anti-deprivation principle will be affected by the outcome of that appeal.

As Briggs J. commented in *Lomas v JFB Firth Rixson Inc* (*Lomas v JFB Firth Rixson*), the rule is easy to state, but difficult to apply.[12] It is invoked where the provisions of a contract purport either to deprive a company of property it owns as at the date it becomes subject to an insolvency process or to provide for a distribution of the company's assets contrary to applicable insolvency legislation. Where the property in question is a contractual right, the anti-deprivation rule can apply to a provision of the contract, even if the provision has been part of the contract since its inception.[13]

The way in which a contractual clause is drafted can affect whether it survives the application of the anti-deprivation rule. In the seminal case of *British Eagle International Airlines Ltd v Cie Nationale Air France*,[14] a clause providing for multi-lateral netting between members of the International Air Transport Association was found to constitute a "mini-liquidation" outside the scope of formal insolvency proceedings and therefore to have offended the anti-deprivation rule. The International Air Transport Association (IATA) revised its rules in an attempt to deal with the issues raised by *British Eagle*. The revised rules were subsequently considered in the Australian case of *International Air Transport Assoc v Ansett Australia Holdings Ltd* (which although not technically binding upon the judge in *Lomas v JFB Firth*

[8] The experience of the financial crisis may indicate that the existence of safe harbours from the general treatment of creditors in bankruptcy may have exacerbated instability by disincentivising participants in derivatives and repurchase markets from taking steps to effectively monitor the credit quality of their counterparties prior to bankruptcy and that the effective subsidy for derivatives and repurchase activity via bankruptcy benefits not open to other creditors exacerbated risky behavior in the market. For a cogent discussion of how special treatment of derivative contracts may increase systemic risk, see Mark J. Roe, "The Derivatives Market's Payment Priorities as Financial Crisis Accelerator", ECGI—Law Working Paper No.153/2010 Harvard Public Law Working Paper No. 0–17 (January 7, 2011).

[9] 11 U.S.C. § 560. Section 561 of the Bankruptcy Code, enacted in 2005, expands the safe harbour to cover a wider range of agreements. Enacted in 2005, it provides that a party may "cause the termination, liquidation, or acceleration of or to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more (or the termination, liquidation, or acceleration of one or more) … (5) swap agreements; or (6) master netting agreements …" 11 U.S.C. § 561.

[10] Relevant provisions of the Insolvency Act 1986 are para.65 of Sch.B1 (in relation to administration), s.107 in relation to voluntary winding up and r.4.181(1) of the Insolvency Rules 1986 (SI 1986/1925) (in relation to compulsory winding up).

[11] *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160; [2010] 3 W.L.R. 87 [2010] Bus. L.R. 632.

[12] *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 (Ch).

[13] e.g. *Jeavons Ex p. Mackay, Re* (1872–73) L.R. 8 Ch. App. 643; 42 L.J. Bcy. 68, 21 W.R. 664 (holding ineffective a clause in a contract which purported to terminate a right to receive royalties upon the bankruptcy of the recipient).

[14] *British Eagle International Airlines Ltd v Cie Nationale Air France* [1975] 1 W.L.R. 758; [1975] 2 All E.R. 390.

Rixson was cited by him as an authority).[15] It was held that the revisions were effective to avoid the operation of the anti-deprivation rule, even though the substantive commercial effect was identical to that intended (but not achieved) by the original rules.

Comparative analysis of case law under s.2(a)(iii)

Metavante

Facts

In late 2007, Metavante Corp (Metavante) and LBSF entered into an interest rate swap transaction documented under a 1992 ISDA master agreement together with a trade confirmation. LBHI was the credit support provider for LBSF's payment obligations under the agreement.

As a result of a decline in interest rates after the parties had entered into the transaction, the value of LBSF's position under the agreement increased such that by May 2009 Metavante owed LBSF in excess of six million dollars, representing quarterly payments due in November 2008, February 2009 and May 2009, plus default interest in excess of $300,000. Metavante refused to make any payments to LBSF or to perform any of its other obligations under the Agreement as of November 3, 2008, arguing that LBSF and LBHI, by filing their respective petitions for relief under Ch.11 of the United States Bankruptcy Code, had each caused an event of default under the Agreement. Metavante argued that as a result of the occurrence and continuance of those events of default it had the right, but not the obligation, under the safe harbour provisions of the Bankruptcy Code, to terminate all outstanding derivative transactions under the Agreement. Metavante also maintained that, as a matter of New York State contract law, it was "not otherwise required to perform under the Agreement" because the occurrence and continuance of the events of default constituted a failure of a condition precedent specified in the swap agreement, namely s.2(a)(iii) of the master agreement.[16]

On September 15, 2009, the first anniversary of LBHI's bankruptcy filing, in a ruling read from the bench, the bankruptcy court judge ruled, in effect, that the provisions of s.2(a)(iii) of the ISDA master agreement (which condition a swap counterparty's obligation to perform its obligations under a swap agreement upon the absence of a continuing event of default with regard to its counterparty) are subject to the automatic stay provisions of the Bankruptcy Code.

Analysis

Metavante argued that the occurrence of an event of default under the Agreement entitled it, but did not require or obligate it, as the non-defaulting party, to terminate the transaction under the safe harbour from the automatic stay. In Metavante's view, it was well-established as a matter of New York State contract law that a failure of a condition precedent (in this case, the non-existence of an event of default) excuses a party's obligation to perform.[17] Metavante argued that under state law it could not be compelled to make payments under the swap contract because LBSF and LBHI were unable to provide the essential item of value for which Metavante had bargained, namely an effective counterparty. On the other hand, LBSF and LBHI argued that the Court should treat the agreement like a "garden variety executory contract" and that Metavante had effectively waived the benefits of the safe harbour from the automatic stay owing to its failure to act, notwithstanding the provisions of s.560 and 561 of the United States Bankruptcy Code.

The Bankruptcy Court held in favor of LBHI and LBSF. A crucial factor in the decision was a sense that Metavante was effectively "riding the market for the period of one year, while taking no action whatsoever" with respect to the swap and that doing so was "simply unacceptable and contrary to the spirit of [the safe harbor] provisions of the Bankruptcy Code."[18] The judge dismissed Metavante's reliance on s.2(a)(iii) under state contract law out of hand on the grounds that the Bankruptcy Code trumps any state law excuse of nonperformance. The court also found that the suspension of a non-defaulting swap counterparty's obligations that appears to be permitted under the express terms of s.2(a)(iii) (even when the event of default is bankruptcy) did not fall within the safe harbour from the automatic stay, because the safe harbour provisions ss.560 and 561 of the United States Bankruptcy Code protect a non-defaulting swap counterparty's contractual rights solely to liquidate, terminate or accelerate one or more swap agreements because of a condition of the kind specified in s.365(e)(1), or to:

> "offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation or acceleration of one or more swap agreements"

—none of which Metavante was seeking to do. In fact, far from invoking termination or liquidation rights, Metavante's reliance on s.2(a)(iii) was predicated on the absence of a decision (which it had the contractual right to make) to terminate the agreement with Lehman.

15 *International Air Transport Association v Ansett Australia Holdings Ltd* [2008] H.C.A. 3.
16 *Lehman Brothers Holdings Inc, Re* (No.08-13555) (JMP) (Bankr SDNY September 15, 2009) (transcript of record, excerpts) at 102–104 and 107–108.
17 The bankruptcy court judge relied in part on *Lucre Inc, Re* 339 B.R. 648 (W.D. Mich. 2006) for the proposition that a non-debtor counterparty is justified by an uncured pre-petition breach of an executory contract (such as a bankruptcy) in refusing to tender performance under the contract while conversely the commencement of bankruptcy proceedings and the imposition of the automatic stay without more does not empower the debtor to compel performance from a non-debtor party.
18 *In re Lehman Brothers Holdings Inc* Case No. 08–13555 (JMP) (Bankr. SDNY September 15, 2009) transcript at p.110.

Moreover, the court found that the legislative history of the safe harbour provisions evidenced Congress's intent to allow for the "prompt" closing out or liquidation of open accounts upon the commencement of a bankruptcy case. Consequently, the Bankruptcy Court held that, one year after the filing, Metavante's window to act promptly under the safe harbour provisions had passed, and that even though Metavante may not have been obligated to terminate immediately upon the filing of LBHI or LBSF, it should have acted "fairly contemporaneously with the bankruptcy filing" if it had wished to avail itself of the safe harbour. Because Metavante did not, according to the court, Metavante, had simply waived its right to do so.

Implications of the decision in Metavante

The Bankruptcy Court decision in *Metavante* leaves many issues unresolved. As seen above, the court gave short shrift to Metavante's contractual arguments based on New York law, essentially on the grounds that s.2(a)(iii) operated as an unenforceable "ipso facto" clause where the operative event of default was bankruptcy. However, the decision does not appear to have made any distinction between the bankruptcy of LBHI as credit support provider as the event of default that arguably triggered Metavante's right to enforce rights under s.2(a)(iii) at a time when LBSF had not filed a bankruptcy petition and was not substantively consolidated in the LBHI bankruptcy estate. To the extent that the suspension of payments modifying the contractual rights of LBSF occurred owing to the guarantor's bankruptcy default it would appear to fall altogether outside the prohibitions against ipso facto clauses and the safe harbour provisions of the US Bankruptcy Code.[19] Because the Bankruptcy Court dismissed the contractual issues it did not have occasion to address issues such as the extent of the s.2(a)(iii) suspension of payments. As will be seen below, these issues were important considerations in *Lomas v JFB Firth Rixson*.

The "use it or lose it" aspect of the decision regarding swap terminations is not altogether surprising, as swaps market participants have long been aware that a non-defaulting party that waits too long to give a notice of termination following the occurrence of an event of default runs some risk that the right to use the safe harbour could expire at some point following the period during which the automatic stay otherwise became effective.[20] The Bankruptcy Court's decision underscores the lack of certainty over many aspects of the relationship between the safe harbour provisions of s.560 or 561 of the Bankruptcy Code and the *failure* to terminate swap transactions. One can extrapolate from the Bankruptcy Court's decision that after a year of inactivity following the bankruptcy the non-defaulting counterparty would be considered to have waived the safe harbour, with the consequence that its open swap contracts are mere executory contracts, enforceable by the debtor against it, but not enforceable by it against a debtor that has not expressly assumed the obligations and cured all defaults as provided in s.365 of the United States Bankruptcy Code. This in turn raises the question of whether and to what extent the Bankruptcy Court's decision is limited to its facts and whether the holding would have been significantly different had there been different facts or circumstances than those considered before the Bankruptcy Court in the *Metavante* proceeding.

The Bankruptcy Court decision in the Metavante proceeding adopted a different tack than that taken in the most recent case that had previously considered the effect of bankruptcy on a non-defaulting party's ability to exercise rights under s.2(a)(iii) of the ISDA master agreement. In that case, *Enron Australia v TXU Electricity*, a court in New South Wales, Australia permitted a non-debtor counterparty to withhold performance pursuant to s.2(a)(iii) of the ISDA master agreement based on an event of default triggered by a debtor-counterparty's insolvency filing.[21] As will be seen below, it has not been followed by the English court in *Lomas v JFB Firth Rixson*. Therefore, there may be an open question as to how widely the case will be followed in the United States or internationally. There will likely be additional opportunities for the principle to be tested in the Bankruptcy Court and on appeal, as the same issue is present as LBHI and LBSF have made numerous demands to compel payment or performance on unterminated swap contracts based on the decision in Metavante. Several proceedings over similarly withheld payments are pending before the Bankruptcy Court in the Lehman Brothers case, including matters involving municipal entities such as the Chicago Board of Education, commodities companies such as Norton Gold Fields and financial entities that had entered into credit default swaps with LBSF.

Lomas v JFB Firth Rixson Inc. and Lehman Brothers Special Financing Inc v Carlton Communications Ltd

Two cases in the English courts have dealt with very similar facts as those described above, and were decided by the same judge. These are *Lomas v JFB Firth Rixson*

[19] In this regard, the decision appears to foreshadow an expansive view of the scope of the prohibition of "ipso facto" clauses in bankruptcies involving intertwined affiliates that was later articulated by the bankruptcy court judge in *Lehman Brothers Special Financing Inc v BNY Corporate Trustee Services Ltd (Lehman Brothers Holdings Inc, Re)* 422 B.R. 407 (Bankr. S.D.N.Y. 2010). In that case the court found that the automatic stay applied to a counterparty of LBSF not from the date of its bankruptcy filing but from the earlier date on which LBHI filed for bankruptcy protecton, triggering an event of default in a swap transaction with LBSF owing to credit support default under s.5(a)(iii) of the ISDS master agreement rather than bankruptcy under s.5(a)(vii).

[20] See e.g. *Amcor Funding Corp fka Lincoln Am Fin Inv Co, Re* No.CIV89-1231 PHX-RMB (D. Ariz. 1990) (Exercise of liquidation and set-off rights by the broker of a bankrupt customer not protected by the exception to the automatic stay provided by s.362(b) or s.555 of the Bankruptcy Code the when the broker waited for one year from the customer's bankruptcy before taking action).

[21] *Enron Australia v TXU Electricity* [2003] NSWSC 1169.

and *Lehman Brothers Special Financing Inc v Carlton Communications Ltd) (LBSF v Carlton)*.[22] In *LBSF v Carlton*, the judge described *Lomas v JFB Firth Rixson* as "essential pre-reading" and it is convenient to deal with *Lomas v JFB Firth Rixson* first before turning to the additional issues raised in *LBSF v Carlton*.

Facts of *Lomas v JFB Firth Rixson*

Lomas v JFB Firth Rixson concerned five interest rate transactions to which LBIE was party when it went into administration in the United Kingdom. In each case, LBIE was the floating rate payer and its counterparty was a commercial manufacturing and/or trading company which had entered into a transaction for hedging purposes. Each of the transactions was documented under either the 1992 or the 2002 version of the ISDA master agreement and was governed by English law.

LBIE's administration constituted an event of default under s.5(a)(vii) of each of the ISDA master agreements (as did LBHI's bankruptcy under Ch.11 which occurred about an hour earlier on the morning of September 15, 2008). Thereafter, each of LBIE's counterparties suspended further payments in reliance upon s.2(a)(iii) of the master agreement. As in the *Metavante* case, each of LBIE's counterparties was "out of the money" and none of them exercised its right under s.6 to designate an early termination date. None of the master agreements contained an automatic early termination election and therefore each of the transactions was continuing, although neither party was making further payments.

The Joint Administrators of LBIE argued that, as a matter of contractual interpretation, s.2(a)(iii) does not allow the counterparties to suspend payments indefinitely: either it operates only for a "reasonable time" or it operates only until the expiry date of the relevant transaction (i.e. the last date for the performance of payments under the relevant transaction or its termination by effluxion of time). Alternatively, they argued that, if the counterparties' interpretation of s.2(a)(iii) was correct, the operation of s.2(a)(iii) offended the anti-deprivation rule. For good measure, the Joint Administrators asserted that the counterparties' interpretation of s.2(a)(iii) gave rise to a penalty or a forfeiture against which the court should grant relief.

Against this, the various counterparties put forward two alternative interpretations of s.2(a)(iii). The first, based on the express terms of s.2(a)(iii), was that no payment obligation arises if an event of default or potential event of default exists on a scheduled payment date (either at that time or at any time thereafter). The second interpretation was that no payment obligation arises if an event of default or potential event of default exists on the scheduled payment date and continues until the expiry date of the relevant transaction (or alternatively until the expiry date of all transactions governed by the relevant ISDA master agreement). A third interpretation was advanced by ISDA, which intervened as an interested party with permission of the court. ISDA argued that no payment obligation arises if an event of default or potential event of default exists on the scheduled payment date, but that if and when the event of default or potential event of default ceases, the payment obligation will then arise (even if this occurs after the expiry date of the relevant transaction).

Contractual interpretation

The judge's decision in *Lomas v JFB Firth Rixson* can be distinguished from the bankruptcy court judges ruling in *Metavante* in that it contains a detailed analysis of the contractual construction of s.2(a)(iii) of the ISDA master agreement (as well as a consideration of the effectiveness of its terms in the context of insolvency). Before dealing with each of the various alternative interpretations of s.2(a)(iii) advanced by the Joint Administrators and by the respondents, the judge referred to two general considerations in interpreting s.2(a)(iii).

The first was the need, given the widespread use of the ISDA master agreement, for "clarity, certainty and predictability in its interpretation." The second concerned the limited circumstances in which an English court will find that a term is implied into a contract. Here the judge cited the Privy Council's judgment in *Att Gen of Belize v Belize Telecom Ltd* and in particular the passage which begins:

> "[i]t follows that in every case in which it is said that some provision ought to be implied in an instrument, the question for the court is whether such a provision would spell out in express words what the instrument, read against the relevant background, would reasonably be expected to mean."[23]

In other words, there is no scope for the court to find that a term is implied simply because it makes commercial sense or even because reasonable parties to the contract would have adopted the term had it been suggested to them. Rather, in order to imply a term, the court must find that it merely clarifies the parties' presumed intention. Further, as Lord Hoffmann remarked in *Belize Telecom*, the process of deciding whether the construction of a contract requires the implication of a term:

> "arises when the instrument does not expressly provide for what is to happen when some event occurs. The most usual inference in such a case is that nothing is to happen."

Suspension

The fundamental question underlying the various alternative constructions of s.2(a)(iii) was whether it merely suspends payment obligations or whether it effectively extinguishes them "once and for all."

[22] *Lehman Brothers Special Financing Inc v Carlton Communications Ltd)* [2011] EWHC 718 (Ch).
[23] *Att Gen of Belize v Belize Telecom Ltd* [2009] UKPC 11; [2009] 1 W.L.R. 1988; [2009] Bus. L.R. 1316.

In this respect textual differences between the 1992 version of the ISDA master agreement and the 2002 version were crucial to the analysis. As noted above, s.9(h)(i)(3) of the 2002 version provides for interest to accrue on amounts which would have fallen due but for the operation of s.2(a)(iii). In the light of s.9(h)(i)(3), none of the parties in *Lomas v JFB Firth Rixson* argued that s.2(a)(iii) of the 2002 version operated to extinguish, once and for all, a payment obligation on its scheduled payment date if an event of default or potential event of default subsisted at that time. However, some of the counterparties sought to maintain that s.2(a)(iii) did have that effect in the 1992 version of ISDA master agreement.

The judge found some arguments that supported the counterparties' position. The "once and for all" interpretation was consistent with a literal interpretation of s.2(a)(iii) and had the merit of simplicity and certainty. It was also in keeping with Lord Hoffmann's remark in *Belize Telecom* to the effect that where no express provision is made for an event, the starting assumption is that no provision was intended. The event in this case relevant to the maxim of construction was the cessation of the event of default or potential event of default.

Despite those arguments, the judge decided that s.2(a)(iii) did not have the "once and for all" effect that the counterparties had suggested. His main reason was that this interpretation could lead to a very uncommercial result if the default were minor and short lived. He cited the hypothetical example of a vexatious litigant serving a winding up petition upon a company. The winding up petition would constitute an event of default under the company's ISDA master agreements for which it would be the defaulting party. On the counterparties' interpretation of s.2(a)(iii), all scheduled payments to which the company would be otherwise entitled under its ISDA master agreements during the period in which the winding up petition was in effect would be irrevocably waived. The judge considered that this interpretation would be pointlessly draconian and therefore could not have been intended by the parties.

Two further reasons were advanced in support of the decision: one was that s.2(a)(iii) is engaged not only by an event of default but also by a potential event of default, which might never become an event of default and could thus result in a potentially draconian result under the counterparties' interpretation that s.2(a)(iii) has a once and for all effect. The other reason was that, if s.2(a)(iii) resulted in the once and for all extinguishment of payment obligations, there is no obvious reason why those payment obligations should be taken into account in calculating a settlement amount on early termination, as provided by s.6 of the ISDA master agreement.

However, the judge decided that the suspension of payment obligations would last only until the expiry date of the relevant transaction. He rejected ISDA's assertion that the contingent payment obligation arising on a scheduled payment date that occurs during the continuation of an event of default or potential event of default could continue indefinitely. He considered that such a result would be wholly inconsistent with a reasonable understanding of the ISDA master agreement. He also found it to be at odds with the wording of s.9(c), which provides for the parties' obligations under the ISDA master agreement to survive the termination of any transaction "without prejudice to" rights under s.2(a). The judge considered that the implication of the words "without prejudice" is that the normal rule under s.9(c) that obligations under an ISDA master agreement survive the termination of any transaction did not apply to payment obligations suspended by operation of s.2(a)(iii).

That being the case, on the expiry date of the relevant transaction, do any payment obligations that are still suspended by s.2(a)(iii) become due and payable (as the Joint Administrators argued) or do they become extinguished for good? The judge found the Joint Administrators' position to be inconsistent with s.9(c) and could see no basis for implying into the ISDA master agreement the additional provisions that would have been necessary to deal with settlement (and for which the Joint Administrators advanced a number of alternatives). Accordingly, any suspended payment obligations still outstanding on the expiry date of the relevant transaction were extinguished.

The decision to terminate

The Joint Administrators argued for two limits on the discretion of the non-defaulting party in relation to the termination of an ISDA master agreement following an event of default.

First, they asserted that s.2(a)(iii) operates only for a reasonable time after which the non-defaulting party must elect either to terminate or to continue to perform its payment obligations in full. This essentially was a significant factor underlying the ruling in *Metavante*, albeit that the rationale advanced by the Joint Administrators in *Lomas v JFB Firth Rixson* on this particular point was based on contractual interpretation rather than general provisions of insolvency law. The court rejected the Joint Administrators' position. A payment default under an interest rate transaction deprives the non-defaulting party of the hedge it bargained for. The judge considered that the termination was simply one way in which the ISDA master agreement enables a non-defaulting party to manage risk arising from its counterparty's default. Termination would not necessarily protect the non-defaulting party. Although the broad effect of the ISDA master agreement's termination provisions is to entitle the non-defaulting party to the replacement cost of the hedge, the defaulting party would not necessarily be in a position to pay. Therefore, withholding payment in reliance upon s.2(a)(iii) should be viewed as an alternative way for the non-defaulting party to manage its risk, rather than being simply a precursor to termination.

The judge made a further (and perhaps more obvious) point in relation to the Joint Administrators' assertion that the suspension of payments under s.2(a)(iii) should last only for a reasonable period. The express language of s.2(a)(iii) states that the condition precedent to payment is to subsist for so long as the event of default or potential event of default "has occurred and is continuing." The suggestion that the suspension lasts only for a reasonable period was, according to the judge, contrary to that express provision as to the duration of the payment suspension.

The second putative limit on the non-defaulting party's discretion suggested by the Joint Administrators was that the non-defaulting party should not be permitted to exercise its discretion to designate an early termination date in a manner that is "arbitrary, capricious or unreasonable" and that, as a consequence, when it becomes clear that a default is permanent, or where it itself decides to re-hedge, it must exercise its right to terminate. Again, there are echoes of the *Metavante* decision here. In the bankruptcy court judge's words the conduct of Metavante in:

> "riding the market for a period of one year, while taking no action whatsoever, is simply unacceptable and contrary to the provisions of the Bankruptcy Code."

In *Lomas v JFB Firth Rixson*, the Joint Administrators invited the judge to find an implied term in the ISDA master agreement that would prevent the counterparties from "riding the market" in a way that might be thought to be contrary to the spirit of the ISDA master agreement itself.

The judge emphatically rejected the Joint Administrators' position on this point, reasoning that s.6 gives the non-defaulting party the discretion to terminate the ISDA master agreement upon the occurrence of an event of default in order to protect its own interests. It has a choice of alternative remedies (i.e. to terminate or to withhold payment under s.2(a)(iii) and is free to choose between them as it chooses). There was nothing in the counterparties' conduct that could be categorised as dishonest, in bad faith or exercised other than for the purpose for which it was conferred.

Netting

The list of issues agreed in advance of the hearing included the question of whether, if the counterparty were to prove in the administration of LBIE, it could prove for the gross amount owed to it by LBIE under the ISDA master agreement. To put it another way, would the counterparty have to bring into account amounts with respect to which the payment obligation was suspended by the operation of s.2(a)(iii)? This issue invited a re-examination of the court's finding in *Marine Trade SA v Pioneer Freight Futures Co Ltd BVI* that s.2(c) of the ISDA master agreement (which deals with pre-termination netting) does not apply to amounts that are suspended by operation of s.2(a)(iii), so that the non-defaulting party is entitled to require the defaulting party to pay gross.[24]

In the event, the judge was not required to consider this question. By the time of the hearing, the Joint Administrators and the counterparties agreed that the fixed/floating rate swaps that were the subject of *Lomas v JFB Firth Rixson* could be distinguished from the forward freight agreements considered in *Marine Trade* on the supposed grounds that they contained simultaneous and inter-dependent payment obligations. The judge noted that, had the parties not been in agreement, his determination might have been different. While the parties to *Lomas v JFB Firth Rixson* are bound by their agreement, the case does not set a precedent in relation to this particular question.

Application of the anti-deprivation rule

The Joint Administrators' case in relation to the anti deprivation rule was essentially as follows: LBIE was the owner of an asset when it went into administration, namely its contingent right to receive payments under the various outstanding interest rate transactions (the right being contingent upon LBIE being "in the money" on each relevant payment date and there being no subsisting event of default or potential event of default). Because there was no real prospect of LBIE emerging from administration, s.2(a)(iii) purported to deprive LBIE of this right upon its administration (as the entry of LBIE into administration constituted an event of default under s.5(a)(vii)) of each of the ISDA master agreements.

Therefore, the judge ruled that the anti-deprivation rule could potentially apply. As has been noted above in respect of *Jeavons Ex p. Mackay, Re*, the mere fact that s.2(a)(iii) was present in the ISDA master agreements from the outset did not necessarily exclude the operation of the anti-deprivation rule. The judge drew a distinction between cases in which the contractual right is a quid pro quo for something already done, sold or delivered before the onset of insolvency (where the "court will be slow to permit the insertion, even ab initio, of a flaw in the asset triggered by the insolvency process" and cases where the contractual right is the quid pro quo for services yet to be rendered (where "the court will readily permit the insertion, ab initio, of such a flaw").

The judge considered that the interest rate swap transactions between LBIE and its counterparties fell into the latter category. The right of LBIE to receive ongoing payments under the ISDA master agreements was the quid pro quo for the ongoing provision by LBIE of interest rate hedges. Section 2(a)(iii) was properly understood as a provision designed to ensure that LBIE would only receive that quid pro quo for as long as it was in a financial condition to meet its own obligations (rather than as an attempt to deprive LBIE of payment for services already rendered).

[24] *Marine Trade SA v Pioneer Freight Futures Co Ltd BVI* [2009] EWHC 2656 (Comm); [2010] 1 Lloyd's Rep. 631; [2009] 2 C.L.C. 657.

The judge caveated his conclusion in two ways. He made it clear that his decision was based on the economic terms of the interest rate transactions before him, all of which constituted an "ongoing relationship" between the parties under which it was contemplated that each of them would continue to make periodic payments. The same conclusion would not necessarily apply to all transactions governed by an ISDA master agreement. The judge also said that he might have decided differently but for the stipulation by the parties that the disputed payment related to the net amount that would have been owed by one to the other (but for s.2(a)(iii)s.2(a)(iii) of the ISDA master agreement) rather than the gross amount of the payments each would have been required to make but for s.2(a)(iii). Had the parties disputed payment obligations been a gross amount, the financial burden upon LBIE would have been greater than it would have been had it not gone into administration, and the judge indicated that in that circumstance the anti-deprivation rule might well have been contravened.

The judge also addressed one further issue: the question of how LBHI's entry into Ch.11 (which itself constituted an event of default) would have affected the operation of the anti-deprivation rule, had it otherwise applied. He concluded that, had LBHI's insolvency occurred first, the anti-deprivation rule could not have applied: at the moment of LBIE's entry into administration, it would have had no asset of which it could be deprived (as LBHI's insolvency would have already effectively deprived it of the asset). The same logic would apply if the Bankruptcy Events of Default in relation to LBIE and LBHI had occurred at the same time.

Penalty and forfeiture

The Joint Administrators' case that s.2(a)(iii) either constituted a penalty or resulted in the forfeiture of property for which the court should grant relief were dealt with briefly and rejected. At trial, counsel for the Joint Administrators conceded that the section could not constitute a penalty clause, because the triggering event (i.e. the occurrence of a bankruptcy event of default) was not a breach of contract. However, the issue was fully argued in *LBSF v Carlton* as set out below. In relation to forfeiture, the judge decided that the contingent right of LBIE to receive ongoing payments under each ISDA Master Agreement did not fall into one of the categories of property for which the court would grant relief from forfeiture and that, even if it had done, s.2(a)(iii) gave rise to a condition precedent to payment rather than a forfeiture.

LBSF v Carlton: additional issues

The facts of *LBSF v Carlton* were very similar to those in *Lomas v JFB Firth Rixson*. Carlton is an English media and broadcasting company. It had entered into an interest rate transaction for hedging purposes with LBSF, a subsidiary of LBHI and the principal company within the Lehman group engaged in fixed-income OTC derivatives. LBSF was placed in Ch.11 bankruptcy on October 3, 2008. As mentioned above, LBHI had itself been placed in Ch.11 on September 15. Both Ch.11 proceedings constituted events of default under the ISDA master agreement between LBSF and Carlton.

There was one difference between the interest rate transactions considered in *LBSF v Carlton* and those considered in *Lomas v JFB Firth Rixson* that was material in the context of the anti-deprivation rule. In *LBSF v Carlton* there was only one further scheduled payment date after the date on which the first event of default occurred. Counsel for LBSF therefore sought to distinguish the two cases on the grounds that the ongoing relationship involving continuing scheduled periodic payments that characterised *Lomas v JFB Firth Rixson* was not present in *LBSF v Carlton*. At the point in time at which Carlton's payment obligation was suspended by s.2(a)(iii), there were no further payments scheduled and therefore there was no ongoing relationship. The transaction therefore fell into the first of the two categories described in *Lomas v JFB Firth Rixson* (in relation to which the judge had stated that the court should be slow to permit the insertion of a flaw or contingency into the payment obligation).

The court rejected the proposed distinction between the two cases. The principle reason given was that the question of whether s.2(a)(iii) offends the anti-deprivation rule should be viewed generally rather than by reference to the date on which the insolvency event actually occurs. This appears to imply that the effectiveness of s.2(a)(iii) (or any other condition precedent to payment) should be assessed with reference to circumstances as at the time the ISDA master agreement (or perhaps the particular transaction) is entered into. The court also found force in the argument that the suspension took effect at the time at which the first event of default occurred (at which point there was one further scheduled exchange of payments and therefore the relationship between the parties could be viewed as ongoing in any event). Finally, on the particular facts of the case, the event which had deprived LBSF of its right to payment was the insolvency of LBHI rather than its own insolvency (and so the anti-deprivation rule did not apply).

Counsel for LBSF also argued that if, on its true construction, s.2(a)(iii) operates to terminate any remaining suspended payment obligations on the expiry date of the relevant transaction, it would amount to a "walk away" clause which, counsel submitted, would lead to regulated entities subject to capital adequacy requirements being unable to report their credit exposures under ISDA master agreements on a net basis. Counsel for LBSF argued that, as regulated entities are regular users of ISDA master agreements, this result could not have been intended by the parties. Perhaps unsurprisingly, this point was also rejected, mainly on the grounds that any expectation that a regulated entity might have in relation to the capital treatment of an ISDA master agreement was not part of the general commercial knowledge that parties to an ISDA master agreement could reasonably be assumed to have.

Counsel for LBSF also raised to the issue of whether or not s.2(a)(iii) is void as a penalty because it provides for damages for breach of contract in excess of a reasonable pre-estimate of loss. (The Joint Administrators had chosen not to pursue this issue at trial in *Lomas v JFB Firth Rixson*). However, the judge rejected this argument too on the ground that, as the doctrine of penalties is a derogation from the general presumption in favor of freedom of contract; as such, the court declined to extend it to apply to events of default, particularly in the context of sophisticated financial contracts.

Postscript to Lomas v JFB Firth Rixson: the Nil Loss cases

In the short time since its publication, *Lomas v JFB Firth Rixson* has been considered in two English cases concerning the termination of transactions under s.6 of the ISDA master agreement: *Pioneer Freight Futures Company Ltd (in liquidation) v TMT Asia Ltd*[25] and *Britannia Bulk plc (in liquidation) v Pioneer Navigation Ltd*.[26] Both cases concerned forward freight agreements (FFAs) entered into by Pioneer Freight Futures Co Ltd (Pioneer). FFAs are derivative transactions under which one party pays to the other the difference between a fixed price and the actual freight price published by the Baltic Exchange in relation to a designated shipping route and a specified period. The FFAs were governed by the FFABA terms which incorporated by reference the terms of the 1992 ISDA master agreement and specified that automatic early termination and the Loss method of calculating early termination amounts were applicable.

At the height of the financial crisis in 2008, a number of companies active in the freight derivatives market were in financial difficulties. In both cases, a party to an FFA contract suspended making payments in reliance upon s.2(a)(iii). Subsequently, an early termination was triggered under the automatic early termination provisions applicable to the FFAs.

The issue in both cases was whether payments which would otherwise have become due under the FFAs in the absence of s.2(a)(iii) should be taken into account in calculating the early termination amounts. The non-defaulting counterparties sought to argue that s.2(a)(iii) had a "one off" effect rather than suspending the right to payment. Therefore, the non-defaulting counterparties argued, no amounts which were scheduled to be paid to defaulting party at any time after it became subject to an event of default should be taken into account. As the defaulting party would not have been entitled to any further payments, it suffered no loss on the termination of the FFAs. The non-defaulting counterparties maintained this position both in relation to scheduled payment dates falling due after the event of default but before termination (termed in *Pioneer v TMT* the retrospective nil loss argument) and also in relation to scheduled payment dates after the termination of the FFAs (the prospective nil loss argument).

In both cases, the non-defaulting counterparties' arguments were rejected and the defaulting counterparty was entitled to bring into account payments which would otherwise have been due to it both before and after the termination of the FFAs. In both cases, that conclusion was based in part upon an analysis of the words "assuming satisfaction of each condition precedent" in the definition of "Loss" which were held to mean that, in calculating Loss, the parties should make the hypothetical assumption that the requirements of s.2(a)(iii) and any other conditions precedent to payment were met (rather than meaning that the definition was only concerned with those payment obligations in relation to which all conditions precedent had in fact been satisfied). The judgments in both cases also emphasise the commercial intention behind the selection of the Second Method in ISDA master agreements that a party should not be deprived of the economic benefit of its hedging transaction simply because it is in default (an intention which would have been largely circumvented had the non-defaulting counterparties' arguments been accepted). Both judges also pointed out that the non-defaulting counterparties' interpretation of the reference to conditions precedent in the definition of "Loss" would have resulted in the economic effect of an early termination calculation based on the Loss definition being very different to one based on Market Quotation—a conclusion which they considered would not have been intended by the parties to an ISDA master agreement.

Both *Pioneer v TMT* and *Britannia Bulk* support the conclusion in *Lomas v JFB Firth Rixson* that s.2(a)(iii) is intended to suspend the right to payment rather than terminate it for once and for all. Given that finding and the fact that all of the transactions considered in *Pioneer v TMT* and *Britannia Bulk* had terminated, the anti-deprivation rule was not relevant to the analysis.

Implications of Lomas v Rixson and LBSF v Carlton

The central conclusion of the contractual analysis set out in *Lomas v JFB Firth Rixson* and followed in *LBSF v Carlton* was that, under English law, s.2(a)(iii) operates to suspend the obligation to pay rather than effectively extinguishing it "for once and for all." This conclusion will surely be welcomed by most market participants. The overwhelming use of the "second method" under the 1992 version of the ISDA master agreement as the method for calculating termination payments shows that the market does not consider that a defaulting party should be permanently deprived of the economic terms of a swap transaction simply because it is in default. Moreover, in coming to that result, the analysis in *Lomas v JFB Rixson*

[25] *Pioneer Freight Futures Company Ltd (in liquidation) v TMT Asia Ltd* [2011] EWHC 778 (Comm).
[26] *Britannia Bulk plc (in liquidation) v Pioneer Navigation Ltd* [2011] EWHC 692 (Comm).

Firth is consistent with existing English precedent in relation to the interpretation of contracts and gives due emphasis to the express terms contained in the ISDA master agreement itself. This, too, is to be welcomed in promoting certainty as an objective in the interpretation of financial contracts and preserving the ability of the market, should it so choose, to amend the standard ISDA master agreement terms to arrive at a different result.

The judge's conclusion that the expiry date of a transaction brings to an end any subsisting right to payment which has been suspended under s.2(a)(iii) will be perhaps less readily understood. Depending on the circumstances, there may or may not be a period of time for the defaulting party to remedy the event of default and therefore bring the suspension of its right to receive payment to an end. However, the termination of suspended payment obligations upon the expiry of the relevant transaction permanently deprives the defaulting party of a payment which it has bargained for, just as much as a "once and for all" interpretation of s.2(a)(iii) would have done. The judge's assumption that the parties to an ISDA master agreement would not countenance contingent obligations remaining outstanding for an indefinite period is weakened by the fact that this was the position advocated by ISDA (which should have a better understanding of what market participants would expect, or what the master agreements are intended to provide, than anyone).

The conclusion that the interest rate transactions considered in *Lomas v JFB Firth Rixson* and *LBSF v Carlton* do not offend the anti-deprivation rule is also to be welcomed. However, it is regrettable that that conclusion rests, at least in part, upon the concession by the counterparties that the interest rate swaps contained simultaneous and inter-dependent payment obligations, and that therefore the counterparties were not entitled to prove for the gross amount of their claims without giving credit for the contingent obligations due to them. Unless the interest rate confirmations were drafted in a very unusual manner, there appears to be no obvious basis for distinguishing them from the swaps considered in *Marine Trade*. There is a clear inference in *Lomas v JFB Firth Rixson* that the outcome of the case could have been different had this concession (which was essentially a concession about a matter of law) not been made. The same would also be true in *LBSF v Carlton*.

The cases also leave a great deal of uncertainty about the ambit of the anti-deprivation rule. It is, as the judge put it in *Lomas v JFB Firth Rixson* a "difficult dividing line." Not only may it be difficult to put a particular transaction on one side of the line or the other, but the cases also raise the prospect that transactions documented on similar terms will end up on different sides of the line: s.2(a)(iii) may well offend the anti-deprivation rule in the context of other swap transactions. This does not promote the goal of certainty.

Moreover, it is not possible to state the rule with any degree of precision. Where a contractual right is a quid pro quo for something already done, sold or delivered before the onset of insolvency, it appears that the court will be reluctant to allow the asset to be flawed or made contingent upon the non-occurrence of an insolvency event. However, the exact circumstances in which such a flaw or contingency will contravene the rule are unclear. It is not even possible to say that the outcome will depend in each case upon the judge's determination of the substantive issue of fairness, because the application of the anti-deprivation rule can be affected by other factors such as the form in which the underlying contract is drafted (as in *Ansett Australia Holdings*) or matters which do not appear to have any bearing on the substantive issue of fairness (such as the order in which LBIE and LBIH entered insolvency proceedings during the space of an hour on the morning of September 15, 2008).

Given that the Supreme Court's decision in *Perpetual* is expected shortly, it is hoped that current uncertainties in relation to the anti-deprivation rule are resolved and that we are left with an anti-deprivation rule which is precise in scope and recognizes the effectiveness of flawed asset arrangements to complement the clear contractual analysis of the ISDA master agreement contained in *Lomas v JFB Firth Rixson* and followed in *LBSF v Carlton*.

Conclusion

The effectiveness of s.2(a)(iii) is a matter of great concern to both regulators and market participants.[27]

In *Metavante* and *Lomas v JFB Firth Rixson* the United States and English courts, respectively, reached different conclusions as to the effect of s.2(a)(iii). To an extent, the different conclusions reflected differences in the insolvency laws of the two jurisdictions. The judge found that ss.560 and 561 of the United States Bankruptcy Code did not exempt the operation of s.2(a)(iii) from the "automatic stay" on enforcement of contractual rights by counterparties of a debtor in a bankruptcy case. In contrast, the moratorium on enforcement against a company in administration which is provided for by para.42 of Sch.B1 of the English Insolvency Act 1986 does not apply to contractual "self-help" remedies such as set-off or the withholding of payments. Therefore, the central issue in Metavante (i.e. whether s.2(a)(iii) is caught by mandatory automatic stay/moratorium provisions under applicable insolvency law) did not arise in *Lomas v JFB Firth Rixson*.

[27] In the UK, HM Treasury's consultation paper "Establishing Resolution Arrangements for Investment Banks" published in December 2009 called upon the market to develop proposals to enable a greater degree of certainty with respect to derivatives transaction termination and, in particular, to require transactions to be terminated after a period of time following an event of default. As this article has gone to press, ISDA has proposed potential amendments to s.2(a)(iii) to address concerns raised in that paper and relating to some of the decisions discussed above. A link to the ISDA press release discussing the proposed potential amendments and the establishment of a Working Group of ISDA members to consider it follows—*http://isda.informz.net/isda/archives/archive_1122732.html* [Accessed May 23, 2011].

Notwithstanding this difference, the English court in *Lomas v JFB Firth Rixson* was equally concerned with insolvency law, albeit in relation to the application of the anti-deprivation rule rather than automatic stay/moratorium provisions. Although on the facts the anti-deprivation rule was not offended, the judge in *Lomas v JFB Firth* considered that there might be other circumstances in which the operation of s.2(a)(iii) is affected by the operation of the anti-deprivation rule. On the basis of current English precedent, there appears to be no basis for challenging that determination. Some commentators (including, it seems, HM Treasury) have concluded that *Lomas v JFB Firth* is authority for the proposition that the English Courts will respect the operation of s.2(a)(iii). The case certainly provides a strong working assumption that this will be the case, but at least until the Supreme Court's decision in *Perpetual* is published, there remains at least a theoretical possibility that the anti-deprivation rule may have an impact on s.2(a)(iii) in other circumstances.

From the standpoint of the derivatives market, there are strong policy arguments for treating the effectiveness of s.2(a)(iii) and other flawed asset arrangements as being a matter of contract law (so that, assuming the payer is not itself insolvent, the only question of insolvency law would be whether the contract itself could be challenged under applicable rules governing the adjustment of preferential transactions). This would bring greater certainty to the interpretation of the ISDA master agreement. It would also accord with the expectations of market participants, who might be forgiven for assuming that their own liability to pay amounts under an ISDA master agreement would be determined in accordance with the governing law of the contract rather than the law governing their counterparty's insolvency.

In other respects, the cases are very different. *JFB Firth Rixson* contains a far more detailed discussion of the pertinent terms of the ISDA master agreement. In part this is a function of the basis on which the New York and English cases were decided. However, it may also reflect the English court's express recognition of the importance of the issue in point, not only for the parties involved in it, but also for the wider derivatives market. This concern is also borne out by the elevation of *Perpetual* to the English Supreme Court.

That is not to say that the position arrived at by the court in *JFB Firth Rixson* is preferable, from the perspective of the derivatives market, to that arrived at by the bankruptcy court judge in *Metavante*. While the effectiveness of s.2(a)(iii) was upheld in *Lomas v JFB Firth Rixson*, the grounds on which the case was decided leave some uncertainly as to whether the section would be effective in relation to other ISDA transactions. In contrast, the court came to a clear conclusion in *Metavante, Re* which enables all of LBHI's other swap counterparties to understand their position under both New York contract law and US federal bankruptcy safe harbours as regards s.2(a)(iii).

In addition to the appeal to the English Supreme Court in Perpetual we understand that the first instance decisions in *Lomas v JFB Firth Rixson*, *LBSF v Carlton* and *Britannia Bulk v Pioneer* are also due to be appealed. It remains to be seen whether the courts or indeed the legislatures in either the United States or the United Kingdom will provide a basis for recognizing the effectiveness of s.2(a)(iii) and other flawed asset arrangements in accordance with their express terms, without reference to the Bankruptcy Code or the anti-deprivation rule, respectively. To do so would surely promote the use of their own law as a governing law for international finance transactions.