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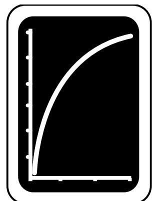

LEARNING CURVE®

Negotiating Section 2(a)(iii) In The ISDA Master

The bankruptcies of several large institutions have highlighted a potential ambiguity within the **International Swaps and Derivatives Association**'s Master Agreement relating to Section 2(a)(iii). Specifically, several courts have addressed the issue of whether a party can exercise its rights under Section 2(a)(iii) to withhold payment indefinitely following the bankruptcy of its counterparty without declaring an Early Termination Date. This article compares the recent rulings and offers some negotiating options for counterparties to consider.

Suspending Payment Under Section 2(a)(iii)

Section 2(a)(iii) provides that the obligations of each party to make payment as specified in the relevant confirmation is subject to, amongst other things, the condition precedent that no event of default or potential event of default with respect to the other party has occurred and is continuing. Several recent cases have reached different conclusions as to whether a party, following a counterparty default due to bankruptcy, can suspend payments indefinitely under Section 2(a)(iii) and, once those payments have been suspended, whether such amounts become due upon the natural expiration of the Transaction. The market expectation has been that these suspended payments would be due upon expiration of the Transactions under the Agreement.

The Cases

Lomas v. LBIE

Lomas v JFB Firth Rixson, Inc. (2010) was decided Dec. 21, 2010 in the U.K. When **Lehman Brothers International Europe** went into administration in Sept. 2008, LBIE's counterparties on five interest rate swaps relied on Section 2(a)(iii) to stop making payments under the swaps. At the time, LBIE would have been owed USD57.3 million. The administrators challenged the counterparties' interpretation of Section 2(a)(iii) that they could withhold payment indefinitely, arguing, among other approaches, that the interpretation contravened the anti-deprivation principle, in which a party cannot contract out of the provisions of the insolvency legislation that govern the way assets are dealt with in liquidation.

The court disagreed, stating that the swaps constituted an "ongoing relationship between the parties" in which "their rights to receive contingent net payments accrue from time to time as the *quid pro quo* for the provision of a continuing service…." The condition precedent that there should be no event of default was a provision designed to ensure that LBIE "would only receive its *quid pro quo* for providing an interest rate hedge for as long as it was in a financial condition to be able to do so." The court also rejected the administrator's argument that parties had an obligation to terminate the Agreement.

The court further held that (a) where a party exercises its right not to make payments under Section 2(a)(iii), the suspension of payments can be temporary in nature and did not have a once-and-for-all effect, and (b) payments that are suspended under Section 2(a)(iii) do not survive termination of the Agreement and would be extinguished on the last date for payment under the transaction.

ISDA has indicated that it found the court's holding mentioned in (b) at odds with the market's expectations, stating its belief that nothing in the Agreement suggests those suspended obligations would be extinguished at the end of the underlying Transaction's term.

Metavante v. Lehman

This much discussed case was decided in New York in Sept. 2009 as part of the Lehman bankruptcy proceedings. As a result of the Lehman bankruptcy and in reliance on Section 2(a)(iii), **Metavante Corporation** stopped making payments but did not terminate its out-of-the-money contracts with Lehman. Approximately nine months after the bankruptcy filing, Lehman moved to compel Metavante to make quarterly payments under the Agreement.

The court acknowledged that specific "safe harbor" provisions in the Bankruptcy Code protect a non-debtor swap party's right to liquidate, terminate or accelerate their positions upon the bankruptcy of its counterparty. However, the court narrowly construed the safe harbor and determined that the safe harbor and the terms of the Agreement did not permit a counterparty to simply withhold performance such as the making of quarterly payments. The court ruled that while a party's right to terminate did not need to be exercised immediately following the bankruptcy of its counterparty, a party would lose its right to terminate if it failed to "act promptly…" In failing to terminate the Transactions

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more than 11 months after Lehman's bankruptcy filing, the court found that Metavante had waived its right to terminate.

The court ruled that Metavante had to continue making payments and its attempts to control Lehman's right to receive payment under the Agreement constituted an attempt to control property of the estate in violation of the automatic stay. Though Metavante appealed the ruling, the parties ultimately settled out of court.

Enron v. TXU

In ***Enron Australia Fin. Pty Ltd*** *(in. liq) v.* ***TXU Elec. Ltd****. (2003)*, TXU and Enron were parties to electricity contracts governed by the Agreement pursuant to which an Event of Default occurred as a result of Enron's bankruptcy. At the time, TXU was out-of-the-money and would have had to make a payment to Enron if it had designated an early termination date. Consequently, TXU stopped making payments pursuant to Section 2(a)(iii).

Enron's liquidator sought leave of the court to liquidate the transactions, invoking a provision of the Australian insolvency law that permits liquidators to disclaim contracts on terms and conditions the Court determines to be just and equitable. In the alternative, the liquidator sought an order that the early termination payment be declared as if TXU had designated an early termination date, thus causing TXU to owe Enron a settlement amount.

The Australian court upheld the provisions in the Agreement, permitting TXU not to terminate and to withhold further payments. The court provided that the statute giving it the right to disclaim contracts "does not permit the Court to bestow on the company in liquidation substantive rights that it did not have under the contract which is to disclaimed… It does not, as a matter of construction, permit the Court to deprive the counterparty of its contractual rights, such as the right not to designate an Early Termination Date under Section 6(a) after an Event of Default occurs and the right under Section 2(a)(iii) not to make a payment under Section 2(a)(i) while an Event of Default continues." The court here, as in *Lomas*, suggested that the suspended payments would not survive termination of the Agreement providing that the suspension under 2(a)(iii) is, in substance, a term of the Agreement and that for so long as an event of default continues, there will be no liability on the non-defaulting party to make any payment.

Going Forward

While the *Lomas* and *Enron* courts each reached the same conclusion, the *Metavante* precedent remains the outlier, raising the question: is there some undefined window of time in which a party must declare an early termination date following the withholding of payments pursuant to Section 2(a)(iii) or risk losing such right to terminate? While the 11-month period in *Metavante* was viewed as too long, there has been no clear guidance as to what would be a "reasonable" period. Additionally, the *Lomas* and *Enron* courts both viewed the suspended payments as not surviving the termination of the Agreement, which is contrary to market expectations that all such payments would be due at the natural conclusion of the Agreement. In the face of such uncertainty, are there alternative options to counterparties going forward? ISDA has also announced that it is convening a working group to examine the issues surrounding Section 2(a)(iii).

Automatic Early Termination

One option is for the parties to elect that automatic early termination applies to both parties. If automatic early termination has been elected, an early termination date will be deemed to have occurred as of the time immediately preceding the bankruptcy proceeding. It should be noted that automatic early termination can also disadvantage the non-defaulting party since the termination is deemed to occur immediately before the bankruptcy event occurs, and the parties will have to calculate the close-out amount using prices that may not represent the current market.

Additionally, the automatic nature of the provision does not give a party the ability to make a decision based on the value of its position at the time the bankruptcy occurs. As highlighted in the cases discussed herein, if the non-defaulting party's position is out-of-the-money at the time the bankruptcy occurs and transactions are automatically terminated, the non-defaulting party will have to make a payment before it would normally be due. Since parties at the outset of entering into an Agreement cannot predict whether they will be the defaulting party, they must weigh the risks of making such an election.

Setting a Reasonable Time Limit

If parties want to retain the right to determine when to terminate transactions, another option to consider is to include a provision in the Schedule that limits the right to withhold payments or performance under Section 2(a)(iii). For example, the parties to the swap would agree that following an event of default, the condition precedent under Section 2(a)(iii) will be deemed to expire within some reasonable number of calendar days (e.g., 30 or 90 days) after the first date of any suspension of payment. However, as is the case with electing automatic early termination, this option has disadvantages for the non-defaulting party that is out-of-the-money at the time the event of default occurs. Such a party must either designate an early termination date, in which case it will likely have to make a payment to the defaulting party or, following the expiration of the negotiated period of time, resume its payment and delivery obligations to a now bankrupt counterparty.

Conclusion

In light of the inconsistent decisions reached by courts relating to the application of Section 2(a)(iii), parties to an Agreement may wish to consider taking additional precautions to protect their interests. Parties to an ISDA Master Agreement should consider that they may be the defaulting party one day and with this is mind, negotiate an ISDA Master Agreement to reach an equitable result should one of the parties experience a bankruptcy event of default.

This week's Learning Curve was written by ***Matthew Magidson, Joanna Miller-Suna*** *and* ***Melissa Sulivan*** *of* ***Lowenstein Sandler****.*

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