Calling Time on Section 2(a)(iii) of the ISDA Master Agreement: ISDA Publishes an Amendment

On 19 June 2014, the International Swaps and Derivatives Association (ISDA) published a long-awaited amendment to s 2(a)(iii) of the ISDA Master Agreement, which concerns the payment or delivery obligations of a Non-defaulting Party to a derivative contract. The amendment limits the length of time the Non-defaulting Party may rely on s 2(a)(iii) in order to withhold payments or deliveries due to the Defaulting Party. This article sets out the background to the amendment and explores the factors counterparties might consider when adopting the amendment.

On 19 June 2014, the International Swaps and Derivatives Association (ISDA) published a long-awaited amendment to s 2(a)(iii) of the ISDA Master Agreement (the Amendment). Section 2(a)(iii) contains a condition precedent which relieves the Non-defaulting Party of its obligation to make payment or delivery to the Defaulting Party if an Event of Default or Potential Event of Default has occurred and is continuing with respect to that Defaulting Party.

Section 2(a)(iii) came under the spotlight in the wake of the 2008 financial crisis. Non-defaulting Parties that found themselves “out of the money”, rather than terminate the ISDA Master Agreement, sought to rely on s 2(a)(iii) to avoid making payments to their insolvent counterparties. A wave of litigation ensued on both sides of the Atlantic as to the true meaning and effect of s 2(a)(iii), particularly with respect to the length of time a Non-defaulting Party could rely on s 2(a)(iii). This resulted in a number of controversial (and arguably inconsistent) judicial decisions.

For example, in September 2009 the US Bankruptcy Court in a case known as Metavante held that s 2(a)(iii) was unenforceable as an “ipso facto clause” that did not fall within the “safe harbor” provisions of the US Bankruptcy Code. Consequently, Metavante could not rely on s 2(a)(iii) to withhold performance of its payment obligations to Lehman Brothers Special Financing, Inc (LBSF) under an ISDA Master Agreement (as a result of LBSF’s bankruptcy Event of Default pursuant to s 5(a)(vii)). In addition, the Court held that Metavante’s inaction for the period of one year since LBSF’s bankruptcy meant that it had waived its right to terminate the ISDA Master Agreement. Accordingly, Metavante was compelled to make all past payments due to LBSF (Re Lehman Brothers Holdings, Inc., Case No. 08-13555 et seq. (JMP)(jointly administered)).

On this side of the Atlantic, the English Court of Appeal in April 2012 in the leading case of Lomas and others v JFB Firth Rixson Inc and others [2012] EWCA Civ 419 held that a Non-defaulting Party could rely on s 2(a)(iii) for as long as the Event of Default was continuing (ie indefinitely), but that the payment obligation would revive if the Event of Default was cured. ISDA intervened in that appeal and its submissions were largely followed by the Court of Appeal (in holding that s 2(a)(iii) operates to suspend the Non-defaulting Party’s payment or delivery obligations for as long as the Event of Default is continuing).

THE NEED FOR CHANGE

The potentially draconian effect of s 2(a)(iii) is perhaps best illustrated by the case of Lehman Brothers Special Financing, Inc v Carlton Communications Limited (Carlton [2012] EWCA Civ 419, which was one of four appeals heard together in the Lomas case.

LBSF and Carlton were parties to a 1992 ISDA Master Agreement. Two linked interest rate swap transactions were entered into under the ISDA Master Agreement which provided for twice-yearly payments to be made on a net basis (depending on which party was out of the money) with the final payment falling due on 2 March 2009 (being the maturity date of the transactions). On that date, Carlton owed LBSF a net sum of approximately £2.5m and no further amounts were payable under the transactions. However, Carlton invoked s 2(a)(iii) to withhold this sum relying on LBSF’s bankruptcy as an Event of Default pursuant to s 5(a)(vii).

LBSF argued, adopting the submissions of Lehman Brothers International (Europe), that terms should be implied into the Master Agreement such that s 2(a)(iii) should operate: (a) for a “reasonable time” only; (b) until the maturity of the transaction(s); or (c) so as to oblige the Non-defaulting Party to exercise its discretion to designate an Early Termination Date reasonably. LBSF also argued that s 2(a)(iii) offended the anti-deprivation and pari passu principles. The Court of Appeal rejected these arguments, and held that s 2(a)(iii) operates indefinitely until the relevant Event of Default is cured.

Whilst the Court of Appeal’s decision provided clarity as to the effect of s 2(a)(iii), it also received widespread criticism from market participants and various governmental and regulatory bodies who expressed concern over the uncertainty caused to the Defaulting Party. Indeed, as early as December 2009, the UK Treasury called upon ISDA to find a “market solution”
to limit the operation of § 2(a)(iii) to a “reasonable period” (HM Treasury Consultation Paper dated 16 December 2009 entitled Establishing resolution arrangements for investment banks). ISDA responded by issuing a consultation paper dated 8 April 2011 asking its members to comment on a proposed amendment to § 2(a)(iii). This first proposed amendment was not ultimately adopted.

Subsequently, in January 2014 ISDA asked an internal working group to comment on a second draft amendment to § 2(a)(iii). The Amendment is the outcome of that consultation.

THE AMENDMENT

The Amendment appears as a new sub-section (2) which contains five clauses. It may be used for either the 1992 or the 2002 ISDA Master Agreement. A new definition of “Condition End Date” is also inserted into § 14. In essence, the effect of the Amendment is to require the Non-defaulting Party at the end of a specified period (the Condition End Date) either to elect to make its scheduled payments or deliveries and continue the contract, or otherwise designate an Early Termination Date.

Clause (i) entitles the party that is subject to an Event of Default to serve a notice on the Non-defaulting Party invoking clause (iii), which brings § 2(a)(iii) to an end on the “Condition End Date”. On the first Local Business Day on or after the Condition End Date, the Non-defaulting Party must fulfill its payment and/or delivery obligations which were suspended by § 2(a)(iii), together with accrued interest and/or compensation for late delivery. Similarly, clause (ii) entitles the party that is subject to a Potential Event of Default to serve a notice on the Non-defaulting Party, which crystallizes the Potential Event of Default into an actual Event of Default and invokes clause (iii), thereby bringing the suspension under § 2(a)(iii) to an end on the Condition End Date.

Clause (iv) caters for a situation where the Defaulting Party, having already served a notice under clause (iii), experiences another Event of Default or Potential Event of Default. In this situation, the Condition End Date will not occur and the Defaulting Party may serve another clause (iii) notice in respect of that subsequent Event of Default or Potential Event of Default. However, should the new Event of Default or Potential Event of Default be cured while the prior Event of Default or Potential Event of Default is continuing, the Defaulting Party may serve a new notice under clause (i) in respect of that prior Event of Default.

Lastly, clause (v) makes it clear that if the relevant Event of Default with respect to which the Defaulting Party has served a notice under clause (i) is the bankruptcy Event of Default (§ 5(a)(vii)), then clause (iv) will not apply and the Condition End Date will occur.

The first draft amendment proposed in January 2014 contemplated a fixed, non-negotiable time limit of 90 days for the operation of § 2(a)(iii). Interestingly, the new definition of “Condition End Date” allows the parties to negotiate this time limit. ISDA has suggested a period of 90 days in the Amendment, and the Financial Conduct Authority (the FCA) has indicated that the time period should not be any longer than this.

Market participants adopting the Amendment will need to give special consideration to the time period chosen for the Condition End Date. In particular, the scheduled payment dates for each transaction should be taken into account. If these provide for quarterly payments, and the Condition End Date is for a period of less than 90 days, the Non-defaulting Party’s obligation to perform in respect of the first payment will revive prior to the Defaulting Party’s next Event of Default on the subsequent quarterly payment date.

Additional considerations arise where one of the counterparties is based in the US, in light of the Metavante case. In that case, Judge Peck held that the Non-defaulting Party could not rely on § 2(a)(iii) to withhold payments or deliveries where the Event of Default is triggered by the bankruptcy or the financial condition of the Defaulting Party, and must either terminate the transactions “promptly” following the Event of Default or otherwise perform its payment or delivery obligations. Judge Peck did not define precisely what “promptly” meant, but noted that the Non-defaulting Party must act “fairly contemporaneously” with the Event of Default. On the facts of that case, he held that Metavante’s inaction for the period of one year was “unacceptable”.

Accordingly, in the context of a bankruptcy Event of Default, two issues arise. First, it is questionable whether the US Bankruptcy Court will recognise a clause which purports to permit a Non-defaulting Party to rely on § 2(a)(iii), for any period of time, to withhold payments or deliveries. Secondly, even if the US Bankruptcy Court were to recognise the Amendment, it is unclear how “promptly” the Non-defaulting Party must exercise its right to terminate the transaction(s) before it is deemed to have waived its right to do so. For example, if the Condition End Date specifies a period of 90 days, must the Non-defaulting Party nevertheless terminate prior to the expiry of that period, or otherwise forfeit its right to do so altogether?

CONCLUSION

ISDA was tasked with finding a “market solution” that struck the balance between affording the Non-defaulting Party adequate flexibility to manage the risks presented by a Defaulting Party and providing certainty to the Defaulting Party. It remains to be seen whether market participants on both sides of the Atlantic will incorporate the Amendment into their existing agreements. However, given the current status of § 2(a)(iii) under English law (absent the Amendment), and that the FCA has largely led the charge in the UK for the Amendment for the past year, it is possible that counterparties to English law governed ISDA Master Agreements and/or based in the UK will have the greatest appetite for the Amendment.

It will also be interesting to see how the US Bankruptcy Court approaches the Amendment in light of the Metavante case. Metavante did not address the operation of § 2(a)(iii) outside of the bankruptcy context, so it may be that similar questions with respect to non-bankruptcy related Events of Default also come before the US Courts in due course.