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English Court Challenges Traditional View of Condition Precedent in ISDA Master Agreement

Introduction

Users of the International Swaps and Derivatives Association ("ISDA") Master Agreement should be aware of the recent decision of the English High Court in *Marine Trade -v- Pioneer Freight Futures* on the effect of the "flawed-asset" conditional payment provision of Section 2(a)(iii) of the ISDA Master Agreement.

Section 2(a)(iii) of the ISDA Master Agreement (both in the 1992 and 2002 version) makes a party's obligation to pay or deliver subject to the condition precedent that "no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing."

The English Court has recently disagreed with traditional views on one important effect of Section 2 (a) (iii). In this alert we consider the implications of this view.

Facts

Marine Trade S.A. ("MT") and Pioneer Freight Futures Co Ltd ("PFF") entered into 14 forward freight agreements ("FFAs"), governed by the 1992 ISDA Master Agreement.

Under the January 2009 contract month, the aggregate settlement sums in favour of MT and PFF were approximately $7 million and $12 million respectively.

By the end of January 2009 MT believed, from market information, that PFF was affected by a bankruptcy event of default under Section 5(a)(vii)(2) of the ISDA Master Agreement. Thus MT considered PFF was not entitled to set off the $7 million it owed to MT against the $12 owed by MT but which MT was able to withhold by virtue of Section 2(a)(iii). Accordingly, MT invoiced PFF for the gross amount of $7 million on 30 January 2009. On 1 February, PFF invoiced MT for the net balance of $5 million.

Neither party paid on the due date and PFF served a notice of failure to pay on MT under Section 5(a)(i) of the ISDA Master Agreement. The difficulty MT faced was that if PFF was not, in fact, subject to an event of default, MT's failure to settle the $5 million invoice would have resulted in an event of default on MT's part. This could, in turn, have led PFF to terminate all FFAs early which would have resulted in MT having to pay a large termination amount to PFF.

Thus, on 13 February 2009, after failing to obtain an interim injunction from the Commercial Court to effectively preserve the status quo, MT paid a net balance of $5 million under protest. Subsequently, on 17 February 2009, MT served a notice of failure on PFF to pay the $7 million.

MT then became insolvent between April and May 2009.

The Proceedings

MT brought proceedings for the restitution of the $5 million payment on the basis that MT had paid this sum in reliance on a mistake as to PFF's state of solvency. MT therefore argued that such payment constituted an unjust enrichment of PFF.

PFF initially claimed it was solvent at the time the settlement sum was due from MT but ultimately accepted that it was technically insolvent. Instead PFF argued that it owed nothing to MT because MT had become insolvent between April and May 2009, and PFF could therefore also rely on the condition precedent in Section 2(a)(iii) (even though the insolvency occurred well after the settlement sum had become due).

The Judgement

The Court determined the issues as follows:

1. PFF was affected by an insolvency event of default for the January 2009 contract month. As a result MT could rely on Section 2(a)(iii) and was not obliged to pay PFF the January settlement amount but PFF could not set off against such amount (pursuant to Section 2(c)) the money it owed MT in respect of the same settlement period. MT had, therefore been correct to invoice PFF on a gross basis for $7 million.

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2. MT was not entitled to claim for the restitution of $5 million it paid to PFF under protest because there was no mistake on MT's part.
3. PFF's claim that it owed nothing to MT (based on a retrospective application of Section 2(a)(iii)), was dismissed.
4. Section 2(a)(iii) does not merely suspend a party's obligations whilst an event of default subsists but goes as far as to permanently extinguish all obligations that happen to fall due whilst an event of default affects the other party.

Issue 1

In deciding the first issue, the court accepted that, as from the fourth quarter of 2008, the event of default set out in Section 5(a)(vii)(2) had occurred in respect of PFF. The court explained that such event of default consists of: (i) a party being **unable** to pay debts when they fall due, and (ii) a party **failing** generally to pay debts. The Court decided that these are two separate and not cumulative elements. i.e. the occurrence of one or another alone will amount to an event of default.

The **inability** element is forward looking and captures situations where an actual payment default has not yet happened (though an actual and unjustified payment default can, itself, be evidence of defaults in the near future) but is imminent. As to the **failure** to pay debts, the court concluded that the adverb "generally" refers to the word "debts" rather than "fail."

The Court's finding in relation to Section 5(a)(vii)(2) is significant in that it clarifies that evidence of the failure to pay a single debt of a substantial amount is sufficient to meet the test set out by such provision. The alternative interpretation of the clause, namely that it would only apply in a case of a payment default towards a multitude of counterparties, had favoured the practice of selective payment defaults.

This practice meant that companies experiencing sudden cash flow problems would keep performing their obligations towards counterparties to which they owed relatively small settlement amounts and would cease performing their obligations towards creditors to whom they owed larger amounts. The intention was to avert the triggering of Section 5(a)(vii)(2) and thereby keep the business going so that creditors to whom larger sums were owed would consider restructuring the debt at a discount. However in light of the Court's decision this practice should not be relied upon as a means of avoiding an event of default under Section 5(a) (vii) (2).

Issue 2

The decision on this issue falls outside the scope of this alert.

Issue 3

The Court's third conclusion, establishing the non retrospective effect of Section 2(a)(iii), is in line with the common interpretation of 2(a)(iii). The same cannot be said of the Court's fourth conclusion below.

Issue 4

Although this conclusion was not on a key issue in the case, it has caused the most surprise. In considering the third issue mentioned above the Court concluded that Section 2(a)(iii) is a "one time" provision which the Court decided cannot apply retrospectively. In relation to issue 4 Flaux J took the reasoning one step further and decided that Section 2(a)(iii) has an irretractable effect.

Prior to this decision the words "occurred and is continuing" under Section 2(a)(iii) were believed to mean that a party was entitled to not perform whilst the event of default persisted (see *Henderson on Derivatives*, 18.3). Where the event of default ceased to affect the other party the obligation would then spring back up. In other words, Section 2(a)(iii) had merely a suspensive effect on the obligation.

However, the Court held that the words "is continuing" relate to whether an event of default arises at the time the obligation to pay has accrued. The judge stated that there *"is nothing in the wording of the provisions of the contract to suggest that if the condition precedent is fulfilled at a later date, some obligation to pay then springs up."* This means that an event of default need only occur once, and only at the time the settlement sums are due, for section 2(a)(iii) to become effective. All obligations that become due whilst 2(a)(iii) is effective are, as a result, **permanently extinguished**.

The Implications

Prior to this case commentators generally considered the effect of Section 2(a)(iii) to be merely suspensive. This conclusion had also been reached in *Enron Australia -v- TXU Electricity* by the Supreme Court of New South Wales (albeit this decision is not binding on an English Court).

The new interpretation of Section 2(a)(iii) as having an extinctive effect has some major implications.

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First, Section 2(a)(iii) mainly comes into play when an ISDA Master Agreement that is capable of being terminated early is, in fact, not terminated. This is likely to be the case when a Non-defaulting Party is out of the money. As a result, should the Non-defaulting Party choose to terminate the agreement it would end up owing the termination amount to the Defaulting Party. Thus by not terminating the Non-defaulting party avoids payment but obviously takes the risk/benefit of continued exposure to market movements.

In such a scenario, whilst by not terminating and suspending the performance of its obligations the Non-defaulting Party is provided with the means to encourage the counterparty to remedy the default and thereby resolve the stalemate, it is arguably less justifiable for the Non-defaulting Party to be rewarded by its obligations owed to the counterparty being extinguished, even if the default were eventually to be cured.

This in our view reinforces the incentive to invoke Section 2(a)(iii) even when a party knows that the other party's financial difficulties are transitory or even when a failure to pay is only due to an administrative error in the payment procedures.

Another potentially harsh consequence of the Court's decision is that Section 2(a)(iii) is also triggered upon the occurrence of a "Potential Event of Default". This means that the mere possibility of an event of default in respect of a party would entitle the other party to treat its obligations as extinguished.

A further argument in favour of the traditional interpretation of Section 2(a)(iii) is provided by the newer version of the ISDA Master Agreement. Section 9(h)(i)(3)(A) of the 2002 ISDA Master Agreement, which deals with interest accruing on deferred payments, refers to interest being paid "after such [withheld] amount becomes payable". By contemplating that an amount withheld pursuant to Section 2(a)(iii) can again become payable the 2002 ISDA implicitly confirms that the effect of Section 2(a)(iii) is merely to suspend.

Whilst the two versions of the ISDA Master Agreements are contracts in their own right and as such cannot be used to interpret each other (although the 2002 version is intended to improve on the 1992 one), it is curious that the two versions should differ from one another so significantly in this respect.

In addition the Court does not appear to have considered that the new interpretation of Section 2(a)(iii) is in apparent contradiction with the early termination provisions of both the 1992 and the 2002 ISDA Master Agreement. Both contracts expressly state that amounts that were not paid by the Non-defaulting Party pursuant to Section 2(a)(iii) ought to be accounted for as "unpaid amounts [to the Defaulting Party]" when it comes to calculate the early termination amount.

By combining the new interpretation of Section 2(a)(iii) with the above mentioned early termination provisions it appears that, upon the early termination of the agreement, obligations that were otherwise extinguished come back to life or, more precisely, they "reincarnate" into a strange type of obligation that only counts for the purpose of calculating the early termination amount.

Practical Consequences

It is possible that a party that is affected by an event of default subsequently manages to cure it. However it seems that after the Court's decision in the Marine Trade case, such a party could only recover the amounts "withheld" by the other party pursuant to section 2(a)(iii) if the contract was subsequently terminated early.

This would be the case if: (i) a new event of default affected the original Defaulting Party and the Non-defaulting Party had an interest in terminating this time around; (ii) an event of default affected the Non-defaulting Party; (iii) an Automatic Early Termination occurred or (iv) a Termination Event occurred resulting in an early termination.

The only other possible alternative for the Defaulting Party to recover the withheld amount is to put itself into liquidation in the hope that the insolvency law of the relevant jurisdiction might enable recovery of the amounts due to it.

In this regard the reader is reminded of how the suspensive effect of Section 2(a)(iii) vis-à-vis liquidators was dealt a powerful blow in the Metavante ruling that was recently given in the New York bankruptcy court in relation to the Lehman Brothers insolvency (see our Client Alert of 3 December 2009). There it was concluded that the Non-defaulting Party cannot rely indefinitely on the condition precedent and has to act promptly in terminating after a bankruptcy event of default has occurred or risk being found to have waived its right to terminate.

This approach is reflected in the conclusions reached by the UK Treasury in its consultation paper Establishing Resolution Arrangements for Investment Banks which canvasses ways to avert the potentially devastating effect of Section 2(a)(iii) in the context of the recent financial turmoil that brought a number of financial institutions close to the brink of collapse.

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Conclusion

The *Marine Trade* case is the first reported English law case on the effect Section 2(a)(iii) of the ISDA Master Agreement and we have highlighted above some of the implications of the English Court's novel approach.

As to the potential impact the decision will have on the market, we believe that it is likely to encourage reliance by Non-defaulting Parties on Section 2(a)(iii) which, in the case of insolvency events of default, could encourage Defaulting Parties to instigate voluntary insolvency proceedings in an effort to overcome the effect of Section 2 (a) (iii).

We understand, however, that the decision in the *Marine Trade* case is being appealed to the Court of Appeal. We will consider the impact of any decision by the Court of Appeal in another Client Alert.

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News from Reed Smith

We are delighted to announce that **Siân Fellows** has rejoined our Energy, Trade & Commodities Group, which she left in 2007 to take up a senior position in-house at Shell. Siân has twenty years' experience in the sector and brings with her expertise in the field of carbon emissions trading and origination. She has wide experience in drafting and negotiating trading agreements (including derivatives) and of dispute resolution in the energy, trading and shipping sectors.

We are also pleased to announce that the firm has recently promoted **Vassia Payiataki** of the Energy, Trade & Commodities Group to Of Counsel. Vassia joined Reed Smith in 1998 and over the last 12 years she has played an important role in ensuring that the Energy, Trade and Commodities Group has maintained its position as the marker leader.

Finally, we would like to welcome **Michael Fosh** to our Beijing office. Michael is a capital markets lawyer with a particular strength and expertise in listing Chinese companies in the energy and natural resources sector on the Hong Kong Stock Exchange. Michael is fluent in both written and spoken Mandarin.

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About Reed Smith

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