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Alert Memo

DECEMBER 23, 2010

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UK High Court holds that non-defaulting parties are entitled under an ISDA Master Agreement to withhold net payments under Section 2(a)(iii) and are not obliged to designate an Early Termination Date

On December 21, 2010 the judgment of Mr Justice Briggs was handed down in respect of the application by the Administrators of Lehman Brothers International (Europe) (in administration) ("**LBIE**") which had been brought to seek the court's direction as to whether, subsequent to the commencement of the administration of LBIE, its counterparties under derivatives transactions documented using ISDA Master Agreements were (a) entitled to withhold payments in reliance on Section 2(a)(iii) or (b) obliged to designate an Early Termination Date.

The respondents in the application were counterparties to LBIE which had, since the commencement of LBIE's administration, neither made payments under their interest rate swaps with LBIE nor designated an Early Termination Date. Due to the importance of the interpretation of these aspects of the ISDA Master Agreement, ISDA participated in the application as an intervenor.

The same questions have previously been considered by the courts in Australia (in Enron Australia v TXU Electricity) with a similar conclusion to the decision of Mr Justice Briggs and, with a very different conclusion, in the United States (in the Lehman Brothers Holdings Inc. Chapter 11 proceedings decision referred to as the "Metavante" decision, in which the Bankruptcy Court held that a party waived its right to designate an Early Termination Date through the passage of time, and that it could also not invoke Section 2(a)(iii) of the ISDA Master Agreement based on Lehman's bankruptcy).

I. BACKGROUND

The ISDA Master Agreements provide in Section 2(a)(iii) that the obligation of each party to make payments "is subject to the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred or is continuing". The ISDA Master Agreement also provides in Section 6 that, "if an Event of Default with respect to a party (the "Defaulting Party") has occurred and is then continuing, the other party (the "Non-defaulting Party") may…designate…an Early Termination Date in respect of all outstanding Transactions".

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The Administrators, with a view to ensuring that LBIE's counterparties who were "out of the money" paid to LBIE the "out of the money" amounts, argued that the counterparties should not be able to rely on Section 2(a)(iii) and should designate an Early Termination Date as to do otherwise would (a) be an absurd or unreasonable interpretation of the ISDA Master Agreement, (b) offend against the "anti-deprivation" principle, (c) constitute a "penalty" and/or (d) constitute a "forfeiture".

II. THE DECISION

A. Interpretation

Mr Justice Briggs held that the correct interpretation of Section 2(a)(iii) was that it operated to "suspend" the non-defaulting party's obligation to make payments (in a variation on the *obiter* comments in the 2009 decision of Mr Justice Flaux in Marine Trade S.A. v Pioneer Freight Futures). Contrary to the submission and expectations of ISDA, Mr Justice Briggs was also of the view that payment obligations that had been suspended by Section 2(a)(iii) did not survive the expiry of a Transaction at the end of its scheduled term if the condition precedent to the payment obligation continued to be unsatisfied.

The Administrators' arguments that the ISDA Master Agreement should be construed to imply a period within which the non-defaulting party should be required to designate an Early Termination Date under Section 6 were rejected.

B. Anti-deprivation

Although the judgment of Mr Justice Briggs was clear that the operation of Section 2(a)(iii) in the case of the five interest rate swaps he was considering did not offend against the anti-deprivation rule, the decision sets out two important caveats.

First, Section 2(a)(iii) could offend the anti-deprivation rule in other circumstances where the obligations that are suspended are not ongoing obligations as a quid pro quo for ongoing obligations of the other party. Secondly, Section 2(a)(iii) would have offended the anti-deprivation rule if the parties had asserted Section 2(a)(iii) relieved a party from making payments on a gross (rather than net) basis.

C. Penalty

As the common law doctrine of penalty only applies where there has been a breach of contract, the doctrine was held to be not applicable in this case.

D. Forfeiture

The Administrators' submission that Section 2(a)(iii) amounted to forfeiture were rejected by Mr Justice Briggs on the grounds that the discretion of the court to give relief from forfeiture did not apply in contractual disputes of this nature and, in any event, Section 2(a)(iii) was a condition precedent and not a forfeiture.

III. IMPLICATIONS

This decision is another example, after the Perpetual Trustees case, of how the answer to the same question in two broadly similar jurisdictions can be very different when insolvency rules apply. The result for the “out of the money” counterparties of LBIE may seem to be something of a windfall and likely to give rise to an appeal or, at least, further questions as to whether it can be right that payment obligations of an “out of the money” party can be not just suspended but also extinguished as a result of a continuing default relating to the other party.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under the “Derivatives” or “Bankruptcy and Restructuring” section of our website at http://www.clearygottlieb.com.

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